S. HRG. 112–523

TAX REFORM AND THE TAX TREATMENT OF FINANCIAL PRODUCTS

JOINT HEARING

BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

AND THE

COMMITTEE ON WAYS AND MEANS
HOUSE OF REPRESENTATIVES

ONE HUNDRED TWELFTH CONGRESS

FIRST SESSION

DECEMBER 6, 2011

SERIAL 112–14



Printed for the use of the Committee on Finance

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TAX REFORM AND THE TAX TREATMENT OF FINANCIAL PRODUCTS

TUESDAY, DECEMBER 6, 2011

U.S. SENATE,
COMMITTEE ON FINANCE,
U.S. HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
Washington, DC.

The hearing was convened, pursuant to notice, at 10:05 a.m., in room HVC–210, Capitol Visitor Center, Senator Max Baucus (chairman of the Senate Finance Committee), presiding.

OPENING STATEMENT OF HON. MAX BAUCUS, A U.S. SENATOR FROM MONTANA, CHAIRMAN, COMMITTEE ON FINANCE

Chairman BAUCUS. The hearing will come to order.

Warren Buffett once wrote to his shareholders, "No financial instrument is evil per se. It is just that some variations have far more potential for mischief than others."

This potential for mischief is one of the reasons we are holding this joint hearing. Many financial instruments do serve essential business purposes. They allow individuals and companies to hedge against risks and minimize exposure to losses, especially in these turbulent economic times. For example, Darin Arganbright, a small grain farmer in my home State of Montana, uses futures contracts to reduce the impact of the market's ups and downs. These contracts help him lock in prices for his crops in advance. But too many resources are spent developing new and complex financial instruments simply to avoid taxes. Over the past decade, the use of one type of financial product, derivatives, has grown considerably.

The notional or theoretical value of derivatives held by U.S. commercial banks has grown by more than 6 times in the past decade and now totals about $230 trillion. Globally, the notional value of over-the-counter derivatives is estimated to total more than $700 trillion. It equals more than 3 times the value of all global financial assets.

This growth can make it harder to determine the value of a business holding these financial instruments. Some believe this lack of transparency is one of the problems that gave rise to the financial crisis. Financial advisors have created a complex web of new products that mix debt, equity, and derivatives. The only purpose of some of these is to avoid taxes, or at least defer taxes, and, of course, a deferral of taxes is tantamount to an interest-free loan that some wealthier people can take advantage of, but most other folks cannot.

Those who benefit from these new financial products are often large companies and high net worth individuals who can afford to hire expensive lawyers and advisors to structure their investments and lower their tax liabilities. These complicated transactions to avoid taxes result in wasted investment, and they are not fair to taxpayers who cannot afford those high-priced lawyers and accountants.

So let us clarify and simplify the tax treatment of these products. Let us ensure that they are taxed rationally and fairly and work to make the tax code reflect the goals of transparency, consistency, and protection of the American taxpayer. And, as Mr. Buffet alluded to, let us limit the potential for mischief.

I want to thank Chairman Camp for our continued work together as we tackle the broader issues of tax reform. This is one of a couple of joint hearings we have held, the Finance and Ways and Means Committees, and I expect there will be others. I think it is an opportunity for us to work together, hearing the same information from the same witnesses, and hearing each others' questions, which tends to help us work better together.

[The prepared statement of Chairman Baucus appears in the appendix.]

Chairman BAUCUS. I would like to recognize the chairman of the House Ways and Means Committee, my compadre here, Chairman David Camp.

OPENING STATEMENT OF HON. DAVE CAMP, A U.S. REPRESENTATIVE FROM MICHIGAN, CHAIRMAN, COMMITTEE ON WAYS AND MEANS

Representative CAMP. Thank you, Chairman Baucus, and thanks to all of you for joining us this morning at this hearing of the House Ways and Means Committee and the Senate Finance Committee. As Senator Baucus said, having served on Ways and Means for a number of years, I will say that having one, let alone two joint hearings, on the subject of tax reform has not been the norm, but this does reflect the deep interest that Chairman Baucus and I have on the subject of tax reform.

So we are here today to explore the taxation of financial products and the report on that topic that was prepared by the staff of the Joint Committee on Taxation which was requested by Chairman Baucus and myself earlier this year.

The JCT report provides two critically needed tools. First, the report is helpful in demystifying much of the murkiness that surrounds financial products. Today's marketplace features a wide array of products that can result in different tax or financial accounting treatment of economically similar products, including debt, equity—and mixtures of the two—and financial derivatives, such as options, futures, and forward contracts and swaps.

Second, the report also highlights the complexity of tax rules in this area. In part, this reflects the inherent variety of products, but the complexity has been further exacerbated by the tendency of Congress to enact tax legislation affecting a particular financial product without evaluating whether or not the approaches would provide more uniformity or simplicity to the existing taxation of future financial products.

A greater understanding of how the tax treatment of these products' influences or use affects the complexity of the tax code is badly needed, and I look forward to the insight that our witnesses will offer on this issue.

Over the years, there have been few proposals to reform the taxation of financial products on a comprehensive basis. In addition to the Joint Committee report, I am encouraged by some of the information recently shared by the tax section of the American Bar Association in this area. The ABA report is one perspective, and I hope others will add their voices to the discussion. Gaining a better understanding of these products is imperative if we are to enact tax reform that combines the needed flexibility in financial markets with certainty and predictability in the tax code.

I look forward to Mr. Barthold's testimony on the JCT report and to the testimony of our other witnesses who are adding their expertise to today's discussions. I want to thank you all for being here, and I want to thank also Chairman Baucus, my good friend, for holding this hearing, and I look forward to the testimony. Thank you.

Chairman BAUCUS. Thank you, Chairman Camp.

I would now like to recognize the ranking member of the Senate Finance Committee from Utah, Orrin Hatch.

OPENING STATEMENT OF HON. ORRIN G. HATCH, A U.S. SENATOR FROM UTAH

Senator HATCH. Thank you to both chairmen. I want to thank both Senator Baucus and Congressman Camp for this hearing, and thank you, Mr. Barthold and the staff of the Joint Committee on Taxation, for producing this important report on the tax treatment of financial products.

Twenty-five years ago, the Tax Reform Act of 1986 was signed into law by President Ronald Reagan. At the time of the 1986 Act, which was the last major tax reform we have had in the United States, the tax treatment of financial instruments and derivatives was relatively new and highly undeveloped as an area of our Nation's tax law. In fact, derivatives were unknown to most of the American public, although early evidence of these types of instruments can be traced all the way back to ancient Greece.

As I have said before, when Congress undertakes comprehensive tax reform, and it must, that reform should be based on the same three principles that led to the enactment of the Tax Reform Act of 1986: fairness, simplicity, and economic growth. I am very much looking forward to what our witnesses have to say today, particularly as these three principles relate to the tax treatment of financial instruments and derivatives.

Allow me to share a few of my initial thoughts. Financial instruments generally refer to stocks, bonds, hybrid instruments, and derivatives. Derivatives include options, forward contracts, future contracts, and swaps. They are called derivatives because their value is derived from some other asset, some other liability, or some other measure.

The use of derivatives has skyrocketed in the last 20 to 25 years. According to the Bank for International Settlements, in June 2011 the total notional amount of outstanding over-the-counter deriva-

tives was $707 trillion. Of this amount, $554 trillion was due to interest rate contracts and $65 trillion to foreign exchange contracts. These figures are, to me, mind-boggling. To give some perspective, the size of the U.S. economy is about $15 trillion.

In the last several years, there has been a lot of discussion of credit default swaps, which are a type of derivative. These swaps became front page news during the recent financial crisis involving Lehman Brothers and American International Group, AIG. According to the Bank for International Settlements, the volume of credit default swaps peaked at $58 trillion in 2007 and declined to about $30 trillion at the end of 2010.

Surprisingly, given the size and number of credit default swaps for a number of years, it was not clear how these swaps were treated for tax purposes. It was just 3 months ago that the U.S. Treasury Department issued proposed regulations addressing the tax treatment of credit default swaps.

Generally, the tax treatment of financial products involves three major issues: timing, character, and source. The timing issue relates to when an item of income or expense is taken into account for tax purposes; the character issue relates to whether the income is ordinary income or capital gain; and the source issue relates to whether the income is U.S. source or foreign source. Although these three issues involve principles that are fundamental to the U.S. itself, or to the U.S. income tax system in general, they are particularly applicable to the taxation of financial products.

Again, I would like to thank our witnesses for attending this hearing, and I look forward to their comments on this timely and complex issue.

Again, Chairman Baucus and Chairman Camp, thank you for holding this important hearing on tax reform.

Chairman BAUCUS. Thank you, Senator, very much.

[The prepared statement of Senator Hatch appears in the appendix.]

Chairman BAUCUS. I would now like to recognize the ranking member of the House Ways and Means Committee, a member from Michigan. He has been a very valuable member of the committee and Congress, and has spent a lot of time making things happen: Congressman Levin.

OPENING STATEMENT OF HON. SANDER M. LEVIN, A U.S. REPRESENTATIVE FROM MICHIGAN

Representative LEVIN. Thank you, Mr. Chairman and Mr. Chairman, Senator Hatch, and to all of you. I think we all join in thanking Tom and his staff for all of their usual hard and effective work, and in thanking our three witnesses.

Clearly there has been an explosion in terms of financial instruments. This explosion has been part of the downturn in the economy. I do not think we understood fully what was happening. We essentially had an increasing number of instruments that had similar economic features but were taxed in very different ways, and sometimes were not taxed at all. Also, very importantly, there was very little transparency. So it is clear that today's economic landscape is vastly different than it was in 1986, and I think we very much need to delve into this as we undertake tax reform.

But I would like to bring a sense of urgency and reality today while we are considering this report. I do not think anybody, except those who wrote it, has had a chance to fully master it. It is 90-some pages, and sometimes people say this is the kind of work that is good for bedtime reading. It is important work, but we have not had a chance to master it.

But what we clearly have to master is action in the next couple of weeks, because we have unresolved issues that are in the domain of our two committees: the Finance Committee and the Ways and Means Committee. As we sit here today, these issues are unresolved. The payroll tax cut remains very much uncertain; 150 million-plus taxpayers have their taxes at stake. We have over 6 million people in this country who may be out of their unemployment insurance next year if we do not act. That would be, except for the Great Depression, historic in this country.

We have SGR also within our jurisdiction that remains to be resolved, and here it is just a few weeks before Christmas. And while it is important for us to hold this hearing today, I think it is clear that we cannot leave Washington for the holidays until these issues are resolved.

So, I want to thank Tom and your staff and our three witnesses for coming, but to also strike a note of absolute urgency on the issues that are within the domain of our two committees, that are within the domain of Congress, and that are, I think, today, in the domain of the people of our country. I hope in these next weeks we will see some effective action in response to these needs.

Thank you very much.

Chairman BAUCUS. Thank you, Congressman Levin.

If there are any other members who wish to insert statements in the record, they are certainly welcome. Also, if there is no objection, I would like to include the recent GAO study recently referred to on the taxation of financial products, and the recently released ABA report on the taxation of financial products, as part of the official record.

[The documents appear in the appendix on p. 150.]

Chairman BAUCUS. I would like to introduce our witnesses. The first is Thomas Barthold, Chief of Staff for the Joint Committee on Taxation. Welcome again, Tom. Second, Mr. Alex Raskolnikov, tax law professor and co-chair of the Charles E. Gerber Transactional Studies Program at Columbia Law School. Welcome, Professor. Next, Ms. Andrea Kramer, partner at the law firm of McDermott, Will, and Emery. And finally, Mr. David Miller, partner at the law firm of Cadwalader, Wickersham, and Taft.

Thanks for coming. Your prepared statements will be automatically included in the record. I would urge you to summarize in about 5 minutes. As I said to you privately, just say what is on your mind. Let her rip.

Tom, you are first.

STATEMENT OF THOMAS BARTHOLD, CHIEF OF STAFF, JOINT COMMITTEE ON TAXATION, WASHINGTON, DC

Mr. BARTHOLD. Thank you, Chairman Baucus, Chairman Camp, Mr. Levin, Senator Hatch, and members of the committees. It is our pleasure to have worked on this report, JCX–56–11, on the tax-

ation of financial products and instruments, which was requested by the chairmen earlier in the year. The staff's efforts in this report were to describe what the law is and what incentives the law might create, and I want to highlight just a few points in the few minutes allotted.

First of all, it is important to remember that financial instruments are the means of financial intermediation by which the resources of savers are transferred to investors who may need those funds to acquire capital assets or working capital for their business enterprise. This intermediation involves the transfer not only of the capital from one party to the other, but also of rights of ownership, risks, and potential returns.

Now, our report discusses in detail the tax law applicable to the basic financial instruments of stocks, bonds, options, forwards and futures, and swaps, known under the Treasury regulations as notional principle contracts. It is important to recognize that these instruments represent specific ways of allocating the rights of ownership, the risks, and the potential returns. And in fact, as we demonstrate, there can be an infinite number of ways to allocate these attributes by designing different financial instruments, and there can also be multiple different ways to combine financial instruments and arrangements to attain the same allocation of rights, risks, and returns. But the bottom line result is that, while the underlying economics of two different financial situations may be identical, the tax treatment under present law may not be equal.

Let me just present very briefly a simplified, very stylized example. Assume with me that market interest rates are 6 percent. My colleague seated behind me here, Patrick, takes $100 and purchases a zero coupon bond that, with 6-percent interest rates, will pay him $112 2 years from now. My other colleague over here, David, he takes $100—we do not get paid that much—and purchases a share of stock in XYZ corporation. But, at the same time, David sells a call option on XYZ with a strike price of $112 and settlement date 2 years from now. With a premium received, he purchases a put option on XYZ, also with a strike price of $112 and settlement date 2 years from now.

Now, because of the offsetting put and call, as you can see, working through David's financial structure, David receives, just as did Patrick, 2 years from now, he will have assured himself of the receipt of $112.

The tax rules provide, though, a different tax result for David and Patrick. Patrick's $12 of income is characterized as ordinary income, taxable at ordinary income tax rates up to a maximum of 35 percent under present law, and the income must be reported and taxed annually under the original issue discount rules of the Internal Revenue Code.

David, on the other hand, will have held his share of XYZ stock for 2 years, and his $12 of income will generally be characterized as long-term capital gain, taxable at a maximum rate of 15 percent under present law. David also will have deferred the time at which he pays any tax for a full 2 years.

As our report details, the taxation of any financial instrument can be determined, as was noted by Senator Hatch, by understanding the character of the income: is it deemed ordinary or cap-

ital; the timing of receipt of the income: is it received in the current year, upon realization at some future date, or in limited cases, is it marked to market at each year's end; and then the source of the income: is it income from a U.S. source or is it income from a foreign source?

My example of Patrick and David shows how constructing financial instruments can reach the same economic result, but in that particular example, changes the timing and character and, consequently, the taxation of what is fundamentally an identical economic outcome.

The report also provides a number of other examples of similar issues and uncertainties arising under the present law rules related to character, timing, and source of the income, uncertainties and issues that lay before the committees in their consideration of possible reform in this area.

I thank you for your time. We thank you for the opportunity to present this material to the committees, and, as always, we are available to answer any questions that you may have.

Chairman BAUCUS. Thank you very much.

[The prepared statement of Mr. Barthold appears in the appendix.]

Chairman BAUCUS. Next, Mr. Raskolnikov.

STATEMENT OF ALEX RASKOLNIKOV, CHARLES EVANS GERBER PROFESSOR OF LAW AND CO-CHAIR, CHARLES E. GERBER TRANSACTIONAL STUDIES PROGRAM, COLUMBIA LAW SCHOOL, NEW YORK, NY

Mr. RASKOLNIKOV. Thank you. Chairman Camp, Chairman Baucus, Ranking Members Levin and Hatch, distinguished members of the committees, thank you for inviting me to testify at this historic joint hearing.

Let me begin by emphasizing that there is a lot to like about financial products also known as derivatives. They help businesses to manage risk, they facilitate financial intermediation, and they offer investors a breathtaking menu of products. But it is also true that derivatives have been used to game every aspect of our tax system. There are derivatives that defer income, generate inappropriate deductions, convert high-tax into low-tax income, and change the source of income, allowing it to escape the U.S. tax altogether. There is a lot of money at stake. The incentives facing taxpayers and financial engineers are extremely powerful. And the results are in: the taxation of financial instruments is in dire need of reform.

So what can be done? It will not surprise you to hear that there is good news and bad news. The bad news is that fixing the taxation of derivatives with incremental reforms is like patching up small leaks on a ship hit by a torpedo. The leaks may be stopped, but the ship will keep on sinking. In slightly more technical terms, no benchmark of an effective and efficient tax regime can be achieved without a substantial revision of the existing rules. This means that symmetry, a system in which both sides of every transaction are taxed under the same timing rule and rate; consistency, a system in which economically similar transactions are taxed the same way, regardless of the labels attached to them by taxpayers; and balance, a system in which gains and losses from each deriva-

tive are treated alike, are all unattainable without a fundamental reform of financial product taxation.

But there is good news as well. If we take a deep breath and look closely at the reform alternatives, we will realize that there are three, just three possible conceptual approaches. Each is well-known, each can be adjusted in a variety of ways, and each is already reflected in the existing law, even if to a limited extent.

So the first alternative is mark to market. This regime already applies to securities and commodities dealers and certain other taxpayers and financial products. The second alternative is anticipatory taxation. I understand that it sounds obscure, but it is already reflected in taxation of contingent debt and certain swaps. And the third alternative is retroactive taxation. That regime is already used to tax holdings in offshore investment funds' and hedge funds' derivatives.

So the options are known. They certainly can be implemented. Each obviously has its own advantages and drawbacks. What is needed is a will to act, a choice based on balancing relevant cost and benefits, and some work on details.

Needless to say, financial products is only one area of a fundamental reform your committees have considered, are considering, or may consider in the near future. It is important to realize that these other reforms will have differing implications for the urgency of fixing the taxation of derivatives.

Any reform that eliminates the distinction between different types of income, eliminates taxpayers' ability to choose one tax treatment or another, or eliminates capital income from the tax base altogether, would reduce the pressure to reform the taxation of derivatives. Any reform that increases that disparity in taxation of different types of income would have the opposite effect.

So, reforms that take the pressure off include eliminating the difference between taxation of ordinary income and capital gains, eliminating the difference between taxation of debt and equity, switching to mark to market for publicly traded assets, and switching to some form of a consumption tax. On the other hand, a substantial reduction of corporate tax rates and a switch to a territorial tax system are likely to increase the urgency of reforming the taxation of financial products.

Yet, whatever other reforms take place today or tomorrow, an effort to rethink taxation of derivatives cannot come too soon. The problems with financial products' taxation are very serious, and they will not go away on their own. In fact, these problems are certain to persist and worsen if Congress fails to act.

Thank you, and I look forward to your questions.

Chairman BAUCUS. Thank you, Professor, very much.

[The prepared statement of Mr. Raskolnikov appears in the appendix.]

Chairman BAUCUS. Ms. Kramer, you are next.

STATEMENT OF ANDREA S. KRAMER, PARTNER, McDERMOTT, WILL, AND EMERY, LLP, CHICAGO, IL

Ms. KRAMER. Chairman Camp, Chairman Baucus, Ranking Members Levin and Hatch, and distinguished members of the committee, thank you for the opportunity to appear this morning. I am

here at the request of the committees on my own behalf, and the views I express are entirely my own.

In the time I have, what I would like to do is flag what I believe is the real issue with respect to the taxation of derivatives, and that is that the basic hedging rules are too restrictive in that they inhibit legitimate commercial and financial activities.

Each of the code sections that we have that addresses derivatives concerns anti-abuse provisions. Once you have an entire system that has a framework that is based on anti-abuse, you need exceptions to assure that appropriate transactions can continue. So, in the derivatives tax area, what we basically have is, we have sets of matched pairs of rules. We have the "thou shalt not do this" rules, and then the "in these specific circumstances, you can do the following" rules. And it is these specific circumstances rules that I want to focus on this morning—and those are the exceptions to the anti-abuse rules, and the exceptions that I want to discuss concern hedging.

The substance of the exceptions is found in the definitions of hedging, and, in all cases, the definition is too limited. It needs to be expanded to give our businesses the flexibility to manage their risks without running afoul of disruptive and punitive anti-abuse rules. And the way that this can be accomplished is by expanding the definitions of hedging, and that would actually make the taxation of derivatives simpler and fairer, and it would do so without opening any loopholes. And, as I can explain, I believe that this expansion can actually eliminate a variety of abuses.

Now, in making this claim, I do not mean to minimize the technical difficulties in expanding the hedging definitions, and careful attention needs to be paid to the types of taxpayers, the types of products, and the differential tax rates, and I acknowledge that those are very important issues that we have to deal with. But I believe that these are really technical difficulties that should not stop us from moving forward with the need to expand the hedging definitions.

Let me give you a simple example. A taxpayer has a receivable denominated in a foreign currency. The taxpayer has the risk that the value of the U.S. dollar goes down relative to that currency before receiving payments. To protect itself, the taxpayer can buy a futures contract, could buy an option or enter into a swap, and all of these derivative transactions are hedging or risk-management transactions.

Now, in the context of derivative taxation, hedging functions in an important way, and two of the basic anti-abuse rules that apply to derivatives are straddle rules and section 1256 treatment, both from 1981. And together, the straddle rules and section 1256 treatment are principally designed to prevent taxpayers from creating artificial losses in one year, pushing the gains into the next.

Now, if a taxpayer entered into derivatives that qualified as hedges, those transactions would be exempt from the straddle and the 1256 rules, but they would be subject to a separate set of matching rules, which is entirely sensible. And, if the taxpayer actually used derivatives to manage a business or investment risk, it would make no sense for those transactions to be taxed on any-

thing other than a clear reflection of income standard. Tax accounting requires clear reflection of income for hedges.

The problem is, how do we define hedging? And, in the 40 seconds I have left, what I can say is that the Treasury regulations that were adopted to follow the statutory provision do not carry out the purposes of the hedging rules, and that the regulations need to be expanded. At the same time, I would also say that the code needs to be expanded to include other types of transactions than just ordinary income, ordinary assets, ordinary obligations, and borrowings. I also mention in my written statement a couple of other hedging sections that I obviously cannot mention today.

But what I would like to end with is to say that I am not objecting to the basic approach taken in the code and the Treasury regulations in creating exemptions and then anti-abuse rules for hedging. What I am objecting to is the fact that we could fix the problem and also fix abuses by expanding the definitions of hedging.

So my suggestion is really very simple. We identify the types of risks that we want to have managed and call them risk-management transactions, classify them as hedges, and we could be done with it. The transactions would be subject to clear reflection of income for hedges generally and integration for qualified foreign currency hedges and debt security hedges, which I have not had a chance to mention.

With that, I would like to thank everybody, and I am happy to answer questions.

Chairman BAUCUS. Thank you very much, Ms. Kramer. We appreciate that.

[The prepared statement of Ms. Kramer appears in the appendix.

Chairman BAUCUS. Mr. Miller, you are our final witness.

STATEMENT OF DAVID S. MILLER, PARTNER, CADWALADER, WICKERSHAM, AND TAFT LLP, NEW YORK, NY

Mr. MILLER. Chairman Camp, Chairman Baucus, Ranking Members Levin and Hatch, and members of the committee, thank you for giving me the opportunity to speak to you today. I am here to talk about the Federal income tax treatment of financial instruments, but I am going to start with Claudius Ptolemy.

Claudius Ptolemy was the 2nd-century astronomer who created a model of the heavens that predicted the positions of the sun, the moon, and planets that was used for over 1,400 years. There was just one problem with his universe—the Earth was in the middle. To explain and predict heliocentric planetary patterns in his Earth-based model, Ptolemy had the planets travel in a series of ellipses or epicycles around the Earth. His model was extraordinarily complex and, in the end, did not work very well.

Our Federal system for taxing financial instruments is truly Ptolemaic. As Ptolemy's system was geocentric, our Federal tax system is based on the equally archaic system of realization, the concept that income is not earned and therefore not taxed until the taxpayer actually sells property for cash or exchanges it for materially different property. Our modern capital markets understand that true economic income is measured by the increase in the value of assets regardless of when they are sold, and so taxpayers can

borrow against and spend the unrealized appreciation in their publicly traded property without tax.

Like Ptolemy and his ellipses, Congress and the IRS have tried to correct for our fundamentally flawed system of taxation. The wash sale rules, the straddle rules, the original issue discount rules, the conversion transaction rules, and the constructive ownership and sale rules are the ellipses of our tax system. So we are left with a system as complicated as Ptolemy's; over a dozen cubbyholes for various financial instruments, each with their own set of rules, many of them inconsistent.

Because our system of taxation has no basis in the reality of economics, sophisticated taxpayers are free to choose a tax treatment that minimizes their taxes. And choose they do. I offer three examples.

First, some taxpayers take the position that their credit default swaps are options for tax purposes so that the premiums can be deferred. Others take the position that the very same credit default swaps are notional principal contracts, so that they can claim current, ordinary losses.

Second, wealthy individuals with appreciated stock can enter into variable prepaid forward contracts that hedge their risk on the stock and provide them with current cash without tax.

And finally, over $200 billion in structured notes have been issued in the past 10 years in public transactions registered with the SEC. Many of these notes are structured as prepaid forward contracts which offer their investors deferral and long-term capital gains rates. The ability of taxpayers to choose their tax treatment arises because there is no single guiding principle governing the taxation of financial instruments.

But there is an alternative that matches economic income precisely. It is simple to apply and all but foolproof. It is called mark to market. Under a mark-to-market system, the taxpayer simply compares the value of the instrument at the end of the year with its tax basis and pays tax on the difference regardless of the type of financial instrument and regardless of whether the instrument is sold.

I have proposed a system that would require large companies and the one-tenth of 1 percent of the wealthiest and highest-earning individual taxpayers to mark to market all of their publicly traded property and their derivatives of publicly traded property that are not used to hedge business assets and liabilities. This system would at once abandon our Ptolemaic tax system and finally match tax with economics. But it is radical because it would apply to stocks and securities as well as to derivatives.

But incremental change is also possible. Mark-to-market treatment could be applied selectively to derivatives. In an appendix to my testimony, I have outlined how a mark-to-market system of taxation for derivatives might work.

It took 1,300 years for Nicolaus Copernicus to challenge Ptolemy's Earth-centered model with a competing but infinitely simpler view that happened to correspond to reality. It is the Earth, the moon, and the planets that revolve around the sun.

Our own tax system was conceived at the beginning of the last century when economic income could only be measured by cash,

and the effect of a tax deferred was little understood. Our markets are now liquid, our taxpayers sophisticated. To bring our system for taxing financial instruments into the 21st century, tax must match the reality of economic income. Only a mark-to-market system of taxation does that.

Thank you. I welcome your questions.

Chairman BAUCUS. Thank you, Mr. Miller.

[The prepared statement of Mr. Miller appears in the appendix.]

Chairman BAUCUS. For this hearing, we will alternate back and forth.

You talk about Ptolemy. I thought for a minute you might be referring—there are a couple of articles in today's paper about the discovery of this huge black hole. I thought it was going to suck up all the rational thinking on this subject. It was fascinating. The size of the black hole—our solar system is one-tenth the size of this black hole that was discovered.

Sandy Levin will get to ask the first question. Is that correct? No. Dave, you ask the first question.

Representative CAMP. Thank you very much, Mr. Chairman.

Mr. Barthold, your report notes that the notional amount of outstanding derivatives traded in the U.S. has grown dramatically since 1998 and at a rate of over 16 percent. Credit derivatives in particular have grown since that time at an annual rate of 42 percent. What do you think are the reasons for this growth and the implications obviously for tax policy associated with that?

Mr. BARTHOLD. I think the reasons are, people are seeking different ways to divide risks across different potential investors, to hedge risks. It makes the cost of capital cheaper. I would say that is the primary means of growth. There are more financial transactions that go across borders so that we see more flows in and out of the country seeking returns.

As far as the taxation, we outlined in the report a number of issues. Since it is possible to replicate similar economic outcomes with different characteristics of timing, character, and source of income, we do not always provide equal taxation. So the challenge is to try and have a neutral tax system layered on top of financial innovation.

Representative CAMP. Mr. Raskolnikov, in your written testimony, you state that a narrowly based tax reform that just lowered corporate rates but did not lower rates for individuals—and some have advocated going that route—would have the result of increased base erosion because of the use of tax planning and other financial instruments. Can you explain your reasoning behind that?

Mr. RASKOLNIKOV. Sure. Thank you, Mr. Chairman.

So the reasoning is that, if we drop the corporate tax rate substantially below the top individual rate, there is going to be a greater payoff for devising financial instruments, among other things, that will shift income to the low-taxed corporations while shifting related deductions to high-taxed individuals. If the rates are similar, there is just less of an incentive to do this.

So that is not an argument against reduction of the corporate tax rate. It is a point that, if we were to do this, there is going to be more pressure to fix derivatives, because there is going to be much

greater incentive to invent products that will accomplish this, and therefore there will be a revenue drain.

Representative CAMP. Do any of the other witnesses disagree with that comment?

Mr. MILLER. I agree with that comment.

Representative CAMP. Ms. Kramer?

Ms. KRAMER. I agree as well.

Representative CAMP. Thank you. I think one of the witnesses mentioned that, in the past, Congress has taken a real piecemeal approach to changing tax rules related to financial products, and usually looking at a specific financial product with a specific change in the rules. What are some of the problems with that approach, and what are some of the ways we can deal with that? I guess I would just quickly ask Mr. Miller.

Mr. MILLER. Sure. Let's take one quick example. So, quite a number of years ago, taxpayers were able to enter into short against-the-box transactions and avoid the tax on their appreciated securities, hedge all of the risk of loss and opportunity for gain, and achieve cash. The way that Congress addressed that particular transaction was to enact the constructive sale rules which effectively say that, if a taxpayer eliminates substantially all of their risk for loss and substantially all of the benefits of the particular appreciated position, then and only then is the taxpayer treated as if they had sold the underlying security. But because Congress limited the definition of a constructive sale to only those derivatives that eliminate substantially all of the risk, it left an opportunity for taxpayers to eliminate something less than substantially all of their risk, but still a great percentage receive cash and avoid tax. So that is how the piecemeal method of our tax system applies in a real-life example.

Representative CAMP. Thank you very much.

Thank you, Mr. Chairman.

Chairman BAUCUS. Thank you, Chairman Camp.

A sort of a theme a couple of the witnesses had was mark to market, and, Ms. Kramer, I do not know how much you would agree with that, so I am going to ask you. I have several questions around marking to market. One, it is a major step, as you mentioned, Mr. Miller. It depends on what securities you apply it to. A second question I have is the ease in determining what the market rate is—and some of these products are pretty complicated, so what is the market value? Third is frequency; it is how often to mark to market. End of the year? More frequently?

And then beyond that is, Ms. Kramer, whether you agree or disagree with those two other witnesses who tend to think that that is a good reform here, that it gets at, in a sweeping way, some of the potential abuses.

So let me, all of you, first Professor Raskolnikov, if you could answer the first three questions, I will go right down the line there and have each of you address marking to market.

Mr. RASKOLNIKOV. Thank you, Mr. Chairman. Yes, I think mark to market is a very plausible alternative. The ease of determining fair market value is to an extent in the eye of the beholder, but it is important to remember that, you know, there is very little hard data, but sort of anecdotally from my experience—and other

panelists can comment—with the vast majority of derivatives, one of the counterparties is either an exchange, so they are already publicly traded and subject to a mark-to-market regime, many of them, or a financial institution that either marks—that probably marks to market that very derivative for its own tax purposes. Of course, with Dodd-Frank regulations coming through, there are going to be more exchange-cleared or -traded financial instruments, so that will make marking to market easier.

There are some concerns on the other side. They will need to be addressed. But in general, I think it is plausible. Frequency is annually. That is how our tax system was built. You need to calculate your income and losses on an annual basis, and that is how the existing mark-to-market regime works.

And just to comment on sort of—it is also important to remember that mark to market excepts hedging transactions. Hedging transactions should be subject to a separate regime, and they can be discussed, but there are separate rules, good or bad, sufficiently or insufficiently broad today, and there will need to be hedging rules as well in the mark to market.

Chairman BAUCUS. So you are referring more to speculative trades?

Mr. RASKOLNIKOV. Yes. Anything other than hedging or managing risk. There will be a challenge in defining what does it mean to manage risk, but yes.

Chairman BAUCUS. We restrict ourselves to 3 minutes here, so we have run out of time. I will ask my next question of you, Ms. Kramer, next round.

I turn now to you.

Representative CAMP. Mr. Levin is recognized.

Representative LEVIN. Thank you. You know, I think the problem is there may be no Copernicus when it comes to taxation. Whether we like it or not, we are all somewhat Ptolemaic.

Chairman BAUCUS. The sun is the center of the solar system.

Representative LEVIN. I know, but what is the center of our tax system? We have trouble agreeing on that even with 2 weeks left and the inability to move on a few concrete tax and tax-related issues. I think, in a sense, this hearing is very topical, because I would think for the average person listening, they might conclude that this explosion in these financial instruments is very much related to the recession that we have and the depths of it.

Do you think that is true? We have talked about how different it is from 1986, the huge increase in the use of these instruments and the failure to understand them. Do you think this was an important cause of where we are today? Do any of you want to venture an answer to that?

Tom, I guess I should not ask you that. Do you want to answer it anyway?

Mr. BARTHOLD. Mr. Levin, a number of observers have made the point that you have, that a failure of the housing market may have contributed to increased risk that some people did not realize that they were undertaking at the time. So I think it can reasonably be said that some financial market problems certainly contributed to our current economic slow growth and recession of 2 years ago.

Representative LEVIN. Do any of you disagree with that? Do any of you feel strongly about that? Mr. Miller, you talked about the need to move from Ptolemy to Copernicus. That would seem to indicate something was very wrong, no?

Mr. MILLER. I was referring specifically to our tax system and the fact that our tax system does not measure economic income, which I think should be the center of our tax universe. I do not disagree with Tom's statement, but it is a little out of my area of expertise.

Representative LEVIN. The same for you?

Mr. RASKOLNIKOV. Yes.

Representative LEVIN. Mr. Raskolnikov, if we plug some of the loopholes that you referred to, would we obtain sufficient added revenue perhaps to cover the issues that we now face? Do you think so?

Mr. RASKOLNIKOV. I think that by plugging some of the loopholes, you will obtain some revenue temporarily, but financial engineers are extremely adept at focusing on the remaining loopholes or finding new ones. That is why incremental reform is good as far as it gets, but eventually it is not going to succeed. It has not succeeded. You have been plugging loopholes, but some of those plugs did not work. But even those that did work, people found new loopholes.

Representative LEVIN. I yield back. Thank you.

Chairman BAUCUS. Thank you, Congressman.

I would like now to recognize Senator Hatch.

Senator HATCH. Thank you, Mr. Chairman. I want to commend each of you for being able to understand these areas. They are very difficult for people in Congress and elsewhere.

This is a question first for Mr. Raskolnikov, and then for the entire panel. Professor, you make the point that basic financial instruments are unquestionably linked, at least, I think you make that point. For example, a share of stock plus two options may be used to produce an economic return that is the equivalent of interest on a bond. Yet we tax these instruments differently based on what cubbyhole they fit into, and not on their economic effect.

Can you elaborate for us on how this can distort investment and lead to tax avoidance?

Mr. RASKOLNIKOV. Well, it can distort investment and lead to tax avoidance because taxpayers have choices of making investments in different forms, and needless to say, they are likely to choose the form that results in the lowest tax liability. But in the real world, alternatives are similar to each other, but not exactly the same. And when there are two alternatives—let's say there are only two. There are usually more than two, but when there are two alternatives and, as a business, I would prefer alternative one, putting taxes aside, but alternative two, that I actually do not like quite as much, has a great tax result, overall I am going to end up taking alternative two. That is the distortion, and also it is a lot of wasteful tax planning going on in creating alternative two to offer to businesses and taxpayers.

Senator HATCH. My time is running out, so I would just like to ask one more question that is different. I am sorry I did not have time to ask each of you. And this is a question for the entire panel.

The United States has a worldwide tax system with deferral of earnings earned by foreign subsidiaries and a foreign tax credit for income taxes paid to foreign countries. Now, if the United States were to adopt a territorial tax system in the form of a dividend exemption, how would that impact the use of financial products? Maybe we could start with you, Mr. Raskolnikov, and go to others.

Mr. RASKOLNIKOV. I will be very quick. It is the same problem in a way or a similar problem as dropping the corporate tax rate. It does not mean that it is not worth considering very seriously. But instead of deferral, success in moving income offshore is now permanent forgiveness, if you will. So there is a great incentive to do this. Some of the problems that already exist today remain and possibly some new appear. So just the stakes are higher, so the pressure is greater.

Mr. MILLER. I agree with that statement absolutely. That is, if the active income earned offshore is not taxable at all, then there is a tremendous pressure to move income offshore, whether economically, or, if it is possible to use derivatives to do that, then to do it that way.

Senator HATCH. Ms. Kramer?

Ms. KRAMER. I think that one of the key issues is that all of the pieces kind of fit together and move maybe. And so what we have is, if we can advantage one type of income or one type of investment, then, as my panelists have said, the consequences are that it is going to then force decisions to be made to do business in a way that is going to be most advantageous.

Senator HATCH. Mr. Barthold?

Mr. BARTHOLD. Thank you, Senator Hatch. I think it is important to remember that a number of the issues that are raised do not involve cross-border transactions. While a number of them can, a number do not. My simple, super-stylized example was an all-domestic transaction. A number of responses that the Congress has made over time have really been in response to financial innovations that can be exploited solely in the domestic market. For example, 30 years ago, the OID rules for original issue discount bonds, whether we had a territorial system as our corporate system or not, that would not really have mattered to that financial innovation.

Senator HATCH. Thank you all. I appreciate it very much.

Representative CAMP. Mr. Herger is recognized.

Representative HERGER. Thank you, Mr. Chairman. The JCT report describes how derivatives allow investors to magnify their position with leverage, because derivatives generally do not require an up-front commitment of capital. Is this a distinction that should matter for tax purposes? Mr. Raskolnikov first.

Mr. RASKOLNIKOV. So it is a question of leverage, and leverage magnifies risk. Leverage can be certainly achieved with derivatives; it can also be achieved without derivatives. So now you are thinking about the regulation of risk-taking, and that is a somewhat separate question than taxation of different types of income. So, if you are particularly concerned about risk-taking and you think there is too much in the economy, you would be concerned about derivatives, but also about some non-derivatives as well.

Representative HERGER. Ms. Kramer?

Ms. KRAMER. The concept of leverage is not unique to derivative products, and there are some products that are going to have more of an opportunity for leverage than others. In the context of the new financial services regulations and Dodd-Frank, we are going to be seeing less leverage based on at least the proposed rules that I have been seeing that have been proposed so far.

Representative HERGER. Thank you. Mr. Miller?

Mr. MILLER. Yes. I can borrow $100 and buy IBM stock, and I am completely leveraged. I could also enter into an equity swap on 100 shares of IBM stock, and economically those are the same transactions. My risk profile is exactly the same. One might make the argument that those two transactions should be taxed the same way for tax purposes, even though they are both completely leveraged.

Representative HERGER. Thank you. I yield back.

Chairman BAUCUS. Senator Wyden.

Senator WYDEN. Thank you, Mr. Chairman. I want to come back to the question of these transactions, Mr. Barthold, in the context of tax reform. As you know, there is great interest in the Congress in looking at a territorial tax system, in effect, where you would have a company only paying taxes in the country where they earned the income. And Mr. Raskolnikov raised concerns about this, talking about how this could make the problems associated with derivatives worse. And there was a very good article written by your predecessor, Ed Kleinbard, "The Lessons of Stateless Income." Are you familiar with that, or have you heard about that article?

Mr. BARTHOLD. Yes, I have had a chance to look at it some.

Senator WYDEN. Here is what concerns me—I think it is a very important issue for the purposes of tax reform. What Professor Kleinbard essentially says is, if you go to a territorial system and you try to prevent abuses, the question of generating income in one place and booking it somewhere else and the gaming associated with expenses, you create so many additional problems for yourself that it makes it more attractive to go the alternative route—which is essentially what I have advocated—where you essentially drive the rates down for our businesses. That way you do not have the incentive to do all this gaming, and you do not have the incentive to take businesses offshore the way you would have with a territorial system. So the key, of course, is, competitive rates solve so many of the problems.

Now you touched on with Senator Hatch the question of dealing with derivatives and hedging and the like on the domestic front, but I see so much of the economy—and certainly, if the Congress goes the territorial route—going global. So, if you could, touch on the challenges—I do not want to turn you into a legislator here—but touch on the challenges that Congress would have to deal with with derivatives and hedging and the instruments we are looking at today if you go with the territorial system.

Mr. BARTHOLD. Well, thank you, Senator Wyden. Obviously, you raise a really complicated and broad question. A number of the points that Ed Kleinbard identified are really about the location of income in any system, whether it is worldwide or territorial. So a number of the challenges that you see before you today in terms

of thinking through the taxation of derivatives can be somewhat independent of the underlying system of business taxation. So I think the broad point that is laid out in our report and that the chairmen's opening statements have made is, can we fashion a system that has complete neutrality, or at least more neutral treatment across more instruments, or will the Congress always be in the situation of chasing after the most recent or 5-year-old financial innovation because we did not like the outcome?

I think that is the challenge for the members in the context of broad tax reform, whichever way you intend to go in terms of the business taxation system that you may create.

Senator WYDEN. Thank you, Mr. Chairman.

Chairman BAUCUS. Thank you, Senator.

Representative CAMP. Mr. Johnson is recognized.

Representative JOHNSON. Thank you. Ms. Kramer, in your testimony, you believe there is not really a tax loophole problem with respect to derivatives, but rather that the basic rules are far too restrictive and, as a result, are inhibiting legitimate commercial and financial activities. Let me ask at the outset, do you believe these rules are having a negative impact on job creation?

Ms. KRAMER. Yes, I do. I would clarify that there are derivatives that are used for abusive transactions, but that many of the types of abuses that we are talking about could actually be addressed in the context of a broader hedging and risk-management exception. And I do know from personal experience that there are inhibitions put on activities that businesses do because they are concerned about the tax treatment of their transactions. And those are nonabusive risk-management and hedging transactions.

Representative JOHNSON. Well, from my understanding, you recommend creating an IRS list of acceptable hedges. Would we not however be better off with a hedging definition that could withstand the test of time; in other words, a definition that could more or less keep up with the innovations in hedging? Would you comment?

Ms. KRAMER. I would agree with you that having a list of acceptable hedges is not really the appropriate way to go. We would need to be defining the types of transactions that we would want to qualify as hedges or risk-management transactions. And it turns out that many of those transactions could actually—if we expanded the definitions of hedging beyond ordinary assets, ordinary obligations, and borrowings—what we could do is, we could actually sweep in a lot of the structured product transactions that currently require new and creative rules to stop them, because they could be swept into the hedging rules and would be subject to the clear reflection of income or the integration rules that apply to hedging transactions.

And so, it could actually do two things: it could both encourage business and investment activities, but it could also stop some of the abuses where one derivative is taxed in a particular way, and it is paired up with another product taxed in a different way.

Representative JOHNSON. Thank you, ma'am. I yield back.

Chairman BAUCUS. Thank you. Next, Senator Cardin.

Senator CARDIN. Thank you, Mr. Chairman, and let me thank our witnesses for their testimony here.

Let me ask a fundamental question, and that is, can we really do anything about this within the existing tax code? Sure, we can make some short-term corrections. We could do mark to market for a certain segment and catch those who are currently abusing the intent of the code. But, as we have seen over the last 5 years, with the new products that are on the market, and with the type of tax planning that goes forward, it is hard to predict what type of financial instruments are going to be out there 5 years from now. And whether we put exceptions in, as some of you have suggested, in dealing with legitimate hedge investments, where the definition of that becomes subject to abuse, or we use income limits, which can be subject to abuse, or we do other things with exemptions, as Congress tends to do as it develops the political realities of what we do around this place, the question is whether we can, over any period of time, handle the abuses that are currently in the financial products that you are talking about within our current tax code, which I think brings about the fundamental question of, how soon we can get to fundamental tax reform in this country.

I have been proposing that we use less income taxes and use more consumption taxes, and do it in a way that is more progressive than our current tax code, which has been suggested. My question to you is, is there a way to permanently fix this, or do you believe that, even if we look at some of the suggestions that you are making on a current basis, we should really be looking at fundamental change in our tax code? Because what is happening with the taxation of financial products is, I think, symptomatic of the fundamental problem of our current income tax code that we tried to simplify in 1986. It lasted maybe 1 year before we started changing it. Any comments?

Mr. MILLER. I can comment. As you know, I think mark to market is the only system that accurately measures economic income. I think the broader the number and types of financial instruments that are subject to mark to market, the more accurate our tax system is. I have somewhat arbitrarily limited my broad comprehensive proposal to the one-tenth of 1 percent of wealthiest individuals and corporations, and that is somewhat arbitrary, but I think that those are really the only class of individuals who enter into these type of derivatives that we are talking about. And I think that the bang for the buck is highest at those levels.

Senator CARDIN. Let me interrupt for a moment. I agree with what you are saying. The problem is, in 1986 we thought we were doing fundamental tax reform, and it did not last very long. If we go mark to market for a limited group, how long do you think it will remain in Congress before we start changing it?

Ms. KRAMER. Can I jump in on that one? One of the things is that, if it were a year last time, maybe you might get 18 months, so I think that is really what the issue is. Because, wherever there is an opportunity, then there is going to be planning. And so my concern with scrapping the existing system, where at least we know how it works and where the pieces are—that is, if we were to go to something like a mark-to-market system, it would need to be, what is in, what is out? I mean, that is the first question. What would be covered? How would it be valued? Who would do the valuation? I know that Mr. Miller has a lot of opinions about that, and

we could talk about the differences there. But the reality is that, whatever changes are made, there will be new opportunities, and those opportunities will be filled. If not, 18 months would be the outer limits in my judgment.

Senator CARDIN. Thank you. I thank the witnesses.

Representative CAMP. Mr. Rangel is recognized.

Representative RANGEL. Thank you. This is an exciting exchange, and I just hope that it is not just academic. It seems to me that the creation of these exotic instruments basically is an incentive for people who want to avoid taxes; is that right?

Mr. RASKOLNIKOV. To a certain extent. To an extent for businesses to manage risk and——

Representative RANGEL. While it is great talking to professors, when I was chairman and as long as I have been on this committee, the policymakers fiscally in the corporate structure, you can talk with them, and they say generally, I do not mind a fair system as long as it is fair to my particular industry. But when the lobbyists come down, they do not care what is fair or not. They are paid to make changes that the people who pay them want. And so the whole idea of good government—I think outside of the tax-writing committees that want so badly to believe this is on the level, to a large extent it is, where is the leadership in the country to determine what risk members of Congress are prepared to take? So somebody would be hurt when you bring in reform. And I do not know whether, because you teach it, you get such a great satisfaction out of, "Gee, if I had my way," but you do not have your way. And we cannot agree as Democrats and Republicans to give tax fairness to middle America. People are making commitments to, "I do not care what happens, I am not going to change anything; if it is a loophole and it creates revenue, count me out."

Where do all of the studies you have and all of the students whom you are sending out—what could you suggest before we start making the difficult decisions? What do we have to do as a Congress to even contemplate making the dramatic reforms that are so necessary for economic growth to our great Nation?

Mr. RASKOLNIKOV. So, in connection with financial products, I would say the broader the reform, the fewer possibilities there are to create loopholes. So that is the guiding principle: fewer opportunities are there for lobbyists who come and have separate exceptions for this, that, or the other thing. If the incremental line drawing continues, that is just an invitation to continue as has been done so far.

Representative RANGEL. But the decision has to be made by how the voters respect us in doing the thing that is in the Nation's best interest. And I know this is outside of your portfolio, but, if people do not like each other and do not talk with each other, and there is going to be risk involved, political risk, and one of your students was to ask you, how do we get started in this—you are sending them out in the real world; do you tell them that this is just an academic thing? Yes, ma'am.

Ms. KRAMER. Well, I actually teach as well, at Northwestern Law School, the taxation of derivatives.

Representative RANGEL. The fact that most of you teach was the basis of my assumption.

Ms. KRAMER. But in response to that though, what I would have to say is that perhaps the reason that my reform proposal seems so modest compared to my panelists is because I am a realist, and I think that the likelihood that we could actually get the types of dramatic changes made in a way that would work across the board are impossible. And so, looking at the system that we have and trying to figure out how we can avoid abuse and encourage the economic development that we need, it seems to me that by putting more transactions into the hedging and risk-management bucket, I view that as being a major improvement in the system. But as to totally scrapping it and starting over, I cannot imagine that that is a likely possibility.

Representative RANGEL. Thank you, Mr. Chairman. I hope, Professor Kramer, that you might send to me the answer you would give to a student who asked my question. Thank you.

Ms. KRAMER. Afterwards.

Chairman BAUCUS. Thank you very much. Senator Nelson, you are next.

Senator NELSON. The complexity and the appearance of special interest treatment in the tax code is what has the American people understandably upset. I want to zero in on one particular provision where the Dodd-Frank Act amended section 1256. It was that the holder of a derivative must pay capital gains tax on any appreciation on their derivatives on that contract at the end of the year, regardless of whether the holder had sold it off. And to defer to Mr. Miller, that is the mark-to-market tax treatment. But there was a section 1256 in both the House and Senate versions of Dodd-Frank that had no change. In the conference committee, at the last moment, a change was added that exempted traders from section 1256, and Dodd-Frank thus ensured that these traders can continue to defer taxes on their derivative holdings.

Now, Mr. Barthold, I wanted to ask you, does this Dodd-Frank provision, does it continue to defer taxes on the income generated, as it apparently does, by the derivative holdings? Who are the likely beneficiaries of that provision? And would it be more appropriate for credit default swaps and other exchange-traded derivatives to be subject to the annual taxation on their gain?

Mr. BARTHOLD. Senator Nelson, thank you for the question. Maybe just to clarify for all the members, under section 1256, regulated futures contracts, which are basically the scope of section 1256, are marked to market annually at the close of the year. So that identifies their timing in terms of one of the aspects of thinking of financial instruments. They are also given a special character in that they are accorded 60-percent long-term capital gain treatment and 40-percent short-term capital gain treatment.

You asked about the change; in particular you are focusing on the change in the conference agreement on the Dodd-Frank bill. What you had going into that conference—and I assume that this is what the conferees had discussed—is the scope of regulated futures contracts subject to 1256 under present law is somewhat unclear. There is some argument about the breadth of what would be regulated futures contracts. So the question in the Dodd-Frank bill was, was 1256 going to continue to apply only to what you might call traditional futures contracts or was it going to be any contract,

including swaps? The Internal Revenue Service has always taken what my colleagues and I think of as a rather narrow view of 1256 contracts. So one interpretation absent the changes in conference is that you could have had an expansion of 1256.

Now, since a lot of these contracts are reconciled within a 12-month period, in the normal course, a number of contracts would be short-term gain to individuals. So any change changing the breadth of what is covered under 1256 potentially benefits some people; it could also harm some people. You could benefit if you are automatically given the 60/40 treatment on your contract, which you would not have gotten otherwise under present law. So what the conference agreement did is, it was really intended to clarify the scope of 1256 to say that it did not include swap contracts.

Now, the second part of your question is, should it include swap contracts, and that is not really a question for me. We could talk further.

Senator NELSON. Well, what you are saying is, there are winners and losers. Who are the winners?

Mr. BARTHOLD. Well, I will tell you—as we reported for the purpose of the CBO analysis of the Dodd-Frank legislation—that we estimated, in fact, that there would be a modest increase in revenues from the change that was made in conference. That is a consequence of adding clarity that individuals could not take the position that this was, in fact, a 1256 contract on which they could take 60-percent long-term capital gains, the preferential rate under present law. So, for the purpose of scoring that legislation, we said that the result of this change made in conference was to increase by a little over $100 million across the budget period, the revenues incoming as a result of the legislation.

I cannot—I will have to look further and follow up with you on potential types of taxpayers who would have benefitted or lost in terms of individuals, different types of business entities, and I will follow up—my staff and I will follow up with you on that.

Senator NELSON. Mr. Chairman, could that follow-up be inserted as part of the record?

Chairman BAUCUS. Absolutely.

Senator NELSON. Thank you.

Chairman BAUCUS. You bet.

Representative CAMP. Thank you. Mr. Davis is recognized.

Representative DAVIS. Thank you, Mr. Chairman, and for both chairs for holding this hearing. I would disagree with the gentleman who spoke earlier and made the comment that someone has to get hurt when there are reforms. I think that base is a false premise and actually asks the wrong question.

From my experience in business operation process reforms, I would probably go in a little different direction. The premise I learned to operate under in metrics and measurements was that, if you want to maximize effectiveness, transparency, accountability, in effect, measure the right things, you have to strive to minimize complexity, hopefully not with the fate that Copernicus suffered for sharing the truth.

In a more immediate context, what I see in much of this discussion over financial regulatory aspects and taxation is, if we have broken processes at the core and we paper them over by adding

more rules leading to more overhead cost for compliance, less agility for the institutions, and difficulty in performing to standard, that in fact can lead to an increase in subjectivity in enforcement or even contradictory rules depending on what side of the process we are dealing with.

With that said, Ms. Kramer remarked that Sarbanes-Oxley was 66 pages long and mandated 16 rulemakings and 6 studies. In contrast, Dodd-Frank, which I do not believe has been helpful to solving the root cause of the problem, is 849 pages long, or over 2,000 pages counting the pages from the committee print, and mandates more than 240 rulemakings and nearly 70 studies. Many of the deadlines are tight and many have been exceeded already and missed. Here is a question for any of the witnesses: do you think the enormity of the regulatory projects in Dodd-Frank, keeping in mind the premise I had laid out that, to maximize effectiveness, you minimize complexity, do you think that these very quick deadlines could result in mistakes that would have implications for the tax treatment of these instruments? I throw that open to any of the witnesses.

Ms. KRAMER. Well, it is my view that it is better to go slowly and get it right than to come up with rules that do not work. And so although the——

Representative DAVIS. That would be a novel concept in Washington.

Ms. KRAMER. But that is really what my view is, which is that the Congress really gave the regulators an impossible task of trying to accomplish in 360 days what the equity markets took 70 years to figure out. And so I think that it is better that the rules are done carefully and slowly than to just get them out and they are wrong.

Mr. RASKOLNIKOV. I just want to mention, as related to financial products taxation, your view would suggest that we are much better off with broader reform because we can explain three basic approaches here in 10 minutes or 20 minutes. If you ask us to explain current rules, you know, it would take, I don't know, months. And so, any kind of fundamental reform that treats derivatives as a group, even if it is much more transparent, much clearer, still a few underlying issues will remain: derivative versus non-derivative, and derivative versus derivative used as a hedge. But there is a few compared to, you know, 500.

Representative DAVIS. Thank you. Mr. Barthold?

Mr. BARTHOLD. Mr. Davis, my colleagues and I always prefer a more deliberate approach to try to get all the technical details right so that the members have an opportunity to think through the ramifications, the policy changes. I believe that is what Chairman Camp and Chairman Baucus have been trying to do throughout these years: take a very deliberative look at the Internal Revenue Code.

Mr. MILLER. I will decline to speak on Dodd-Frank.

Representative DAVIS. Probably a wise choice. Thank you very much, Mr. Chairman. I yield back.

Chairman BAUCUS. I thank everybody. I do not see any more Senators, so I will ask another question.

I told you, Ms. Kramer, I would give you an opportunity to talk about mark to market. Is there anything else you want to say about mark to market? Do you agree with the concept, or do you just think it is too complicated and, therefore, cannot be implemented?

Ms. KRAMER. There are situations where we do have the mark-to-market rules in place now. And what my concerns are with going to a broad mark to market—and I already mentioned some of them. What is in? What is out? How do you value it? How do we address the issues with respect to the pieces that are in mark to market versus the pieces that are not? Because to throw everything into a mark-to-market system then would raise questions about illiquid assets and how do we value these. And I think that the problem that we have is that, from an administrative and policy standpoint, I personally believe that it would be very, very difficult to impose a mark-to-market system that would actually accomplish the reforms that we are talking about.

Chairman BAUCUS. Professor, how do you deal with that?

Mr. RASKOLNIKOV. The problem is that, while everything Ms. Kramer said is correct, she is identifying a line-drawing problem: what is in, what is out, what is subject to mark to market, and what is not. It is a problem; it always exists whenever there is a line. The difference is that today we have like 50 of those lines. We need to decide what is the difference between a forward and a swap and an option and a swaption, and we can keep going on and on. No, seriously, there is such a thing as a swaption. So, caps and floors; it is endless.

Chairman BAUCUS. There is a swaption?

Mr. RASKOLNIKOV. Swaption—it is an option and a swap.

Ms. KRAMER. You do not really want to know.

Mr. RASKOLNIKOV. You do not really want to know. So mark to market, there will be a line-drawing problem, two actually big line-drawing problems: what is subject to mark to market and what is not, and what is a derivative that is a hedge that is totally separate and what is not. But now we have 22 or 222.

Chairman BAUCUS. How would you deal with variable prepaid forward contracts?

Mr. RASKOLNIKOV. Well, in the mark-to-market regime, it is very simple: you look at the fair market values. Again, with the vast majority of counterparties, at least one counterparty on a variable prepaid forward contract is a financial institution that is already on mark to market for its tax purposes and has to determine those fair market values. They just need to tell the investor or the company, whoever is on the other side, what they are including.

Chairman BAUCUS. Ms. Kramer, do you think it is too difficult to implement, or do you also disagree with the principle?

Ms. KRAMER. I also disagree with the principle.

Chairman BAUCUS. Why is that? Why is that not right? Just cut to the chase: what is the market value?

Ms. KRAMER. Well, if we are only talking about publicly traded instruments, then it is easier to find market value; you know what it is. But in the context of expanding mark to market to other types of products or instruments, then I have to say that there will be broad differences as to value and differences of opinion, even some-

thing that has a long date to it, a long maturity date. That has really been a very, very big issue in trying to figure out valuation. So I really see it as a critical problem with the whole thing.

Chairman BAUCUS. My time has expired. Chairman Camp?

Representative CAMP. Mr. Reichert is recognized.

Representative REICHERT. Thank you, Mr. Chairman, and thank the witnesses for their testimony.

Professor Raskolnikov, you testified that the IRS has authority to share information with analysts about the use of financial instruments, but it does not do so. Why do you think they do not share that information?

Mr. RASKOLNIKOV. It is hard to say. Actually it is hard to say, because the standard answer is taxpayer privacy and taxpayer protection, and, of course, this is a paramount concern. It is in the law and absolutely essential to preserve that protection, but IRS now has enormous amounts of data in electronic form. And stripping taxpayer identifying information is not that hard. So this is the greatest opportunity to urge you to give them a little nudge, because it will be incredibly useful, and they are talented, dedicated economists who will be delighted, at no cost to the public, to do this research and give us a much better idea about what is going on.

Representative REICHERT. Is there just a small group of the population of taxpayers that is affected by this concern regarding privacy?

Mr. RASKOLNIKOV. No, I think it is not a small group. But the privacy can be preserved, that is the more important——

Representative REICHERT. Some transactions, I understand, are so unique that some taxpayers might be identified just by looking at what kind of transaction it might be.

Mr. RASKOLNIKOV. Maybe. And so the IRS will need to look more carefully. A lot of transactions, variable prepaid forwards, are done by hundreds if not probably thousands of taxpayers. And so what do we know about the magnitude of revenue losses? What do we know about what these people would have done if they could not do this variable prepaid forward——

Representative REICHERT. I am an old retired cop; that is my background. I want to know everything. I think the more information we have, the better off we are making decisions about tax reform. You just touched on a couple of things there. What do you think Congress could gain from acquiring the information that the IRS has regarding the use of these tools?

Mr. RASKOLNIKOV. The most simple answer is, you will have a much better idea of revenue estimates.

Representative REICHERT. Okay. Thank you. To move on to another question—I have 40 seconds here. We normally think of complex financial products as being the domain of the sophisticated and wealthy, but there seems to be a trend toward developing a tax-advantaged financial product for smaller, more retail investors. Are you seeing that? I understand the so-called exchange-traded notes are an example of such a product. Does anyone wish to comment on that? Mr. Miller?

Mr. MILLER. I think the trend has been toward expanding the investor base for those products. There are, as I mentioned, $200 bil-

lion in publicly registered SEC exchange-traded notes or structured notes. So that has been the trend.

Representative REICHERT. Anyone else?

Mr. RASKOLNIKOV. I agree.

Representative REICHERT. Mr. Chairman, I yield back.

Representative CAMP. Mr. Lewis is recognized.

Representative LEWIS. Thank you, Mr. Chairman. Mr. Chairman, the last time both of our committees were together in this room, we were approaching the debt ceiling and did not talk about it. This time we find our committees together, and again we are not talking about the most pressing issues of the day. There is a growing gap between the haves and the have-nots. All across the globe, economic inequality is increasing. And right here at home in the United States, over the past 30 years, we have seen a tremendous increase in wealth for the richest among us, those who have the most.

Make no mistake, there is nothing wrong with making money, but something is wrong when the middle class and the working poor are left out and left behind, they are forgotten. The last 30 years have not been kind to them: stagnating wages, loss of their jobs, their homes, and their retirement savings. Unemployment insurance is a critical lifeline for too many of the people, not just in my district or my State, but throughout our country.

Many who call my office are unemployed for the first time in their careers. Some have 10, 20, 30 years of work experience. They are educated and never thought this would happen to them. Others are just entering the workforce and are the first to be cut when times are tough and difficult. These are our fathers, our mothers, our daughters, our sons, our brothers, our sisters, aunts and uncles and cousins, who lost their jobs through no fault of their own.

Congress needs to be compassionate; we must listen to the people. This is the worst economic crisis since the Great Depression, and it calls for extraordinary action, here and now. I strongly believe that we must pass a clean extension of unemployment benefits, and we must pass it now. It is the right thing to do; it is the moral thing to do, Mr. Chairman. I wonder whether any member of the panel has any response to my statement? Professor, you are a teacher, you are an educator. You educate a lot of young people, train a lot of students.

Mr. RASKOLNIKOV. When I teach them, we certainly talk about the growth of income inequality in this country, but as far as financial products are concerned, there is nothing I can tell about any direct connection between one or another.

Representative LEWIS. Any other members of the panel?

Ms. KRAMER. Well, what I would like to add to that is, given the situation that you have painted, the reality, my concern is that trying to turn the existing system upside down could cause some problems, and that working with a broader—I feel like I am saying the same thing again, but working with broader hedging and risk-management exemptions for businesses, I think, could only benefit the employees as well.

Representative LEWIS. But some people suggest maybe we have to turn things upside down to turn it right side up. Mr. Miller?

Mr. MILLER. I harken back to Congressman Rangel. I agree with him that cooperation and conversation are good things, and I am an optimist. I would not be here unless I did not think you can improve things.

Representative LEWIS. Mr. Barthold? I am hopeful and optimistic——

Mr. BARTHOLD. It is not appropriate for me to comment. These are member decisions, as you pointed out.

Representative LEWIS. Thank you very much, Mr. Chairman, and Mr. Chairman.

Representative CAMP. Thank you. Mr. Paulsen is recognized.

Representative PAULSEN. Thank you, Mr. Chairman. Let me ask this question of all the witnesses. Because the financial instruments that are used have parties on both sides of the equation, oftentimes the treatment of the issue of an instrument must be mirrored by the holder as well. And so, in theory, that symmetry that is going to be there is going to tend to minimize the consequences even to the IRS because, even if the issuer receives a tax advantage to the holder, supposedly in practice, on the other side there may be an advantage or disadvantage if it goes both ways. Advantage versus disadvantage—any comments on that in terms of if, in practice, that actually exists with those financial products and how that——

Mr. MILLER. In practice it does not exist. Let me give you a few examples. First we talked before about prepaid forwards that allow investors to defer their income and gain. On the other side of every one of those transactions is a financial institution that is on mark to market. Those financial institutions are completely indifferent. So there is no symmetry; they are simply paying tax on their profits, whereas the taxpayer is able to defer.

Mr. RASKOLNIKOV. Just to give you one more example of how this works. So there are financial instruments called convertible bonds, and you can add a little bit of an uncertainty to this convertible bond, and it will become a contingent convertible bond. So convertible bonds give low-interest deductions to issuers, and therefore low-interest inclusions to holders. Contingent convertible bonds that are really similar economically—not identical, but very similar—give high-interest deductions to the issuers and high-interest inclusions to the holders. So you would say, isn't that fixed; there is a friction? Well, the answer is no, because there are clientele effects, and corporations and markets direct convertible bonds and contingent convertible bonds to the right investors.

So, where issuers take high deductions, the holders are all tax-exempt—pension funds, for example, or foreigners—so they are not including income. When the issuer does not need high deductions, then there are taxable holders of those bonds. So financial markets are extremely good at doing this kind of thing so there is no friction, and therefore there are revenue losses.

Representative PAULSEN. Thank you. I yield back, Mr. Chairman.

Representative CAMP. Mr. Marchant is recognized.

Representative MARCHANT. Thank you, Mr. Chairman. When we think about complex financial instruments, we usually think that these are instruments that are primarily used by the rich or the sophisticated or those who can afford the advice. But in the last 2

years, one of the most explosive new products on the market has been the exchange-traded funds, which have pretty much put at the fingertips of very small investors and very unsophisticated investors, some very sophisticated tax planning, tax vehicles. Could the panel comment today on how we might take those new instruments into consideration when we look at the reform of the tax code?

Mr. RASKOLNIKOV. Well, exchange-traded funds are less of a derivative. I think what you might be referring to are exchange-traded notes, that have proliferated dramatically in the past few years. They are derivatives, and they are fairly complicated. They allow one both to defer income and convert some of the short-term capital gain and ordinary income into long-term capital gain. In fact, you know, there is definitely a derivatives-to-the-masses movement, and you should be concerned about this because, in terms of revenue, once middle-class investors are allowed this opportunity to convert and defer income on an instrument that, at least before the financial crisis, looked very similar to an investment in a mutual fund, they will start investing into the lower-tax alternative, and the revenue will be lost.

And going back to the prior discussion, then it turns out that these exchange-traded notes are not exactly like mutual funds. When you invest in mutual funds, you actually have assets, but exchange-traded notes are unsecured claims, and when the exchange-traded notes are issued by Lehman Brothers, you know, the holders of those notes are not feeling so good right now.

So that is how tax systems sort of move people to do things they would not have done otherwise. So, in addition to revenue losses, there are other social costs—because Lehman ETN investors would have been better off if they had held Vanguard shares, so all of this is serious.

Representative MARCHANT. Mr. Miller?

Mr. MILLER. I agree with what the professor said. I tend to think, although these products are issued to lower-income investors as well—and I am referring to the ETNs—I tend to think, and yet I do not have the data, but I tend to think they are overwhelmingly purchased by the wealthy. I think generally the comments made are accurate that, for a low-income investor, in most cases, they would be better advised to invest in a more traditional mutual fund.

Representative MARCHANT. Ms. Kramer?

Ms. KRAMER. I really do not have anything to add on the exchange-traded notes other than what has been said.

Representative MARCHANT. Okay. I yield back, Mr. Chairman.

Representative CAMP. Mr. Crowley is recognized.

Representative CROWLEY. I thank the chairmen, both Camp and Baucus, for this hearing today. And I find it interesting. Overall, the potential taxation of these instruments is complicated, to say the least. And, while the topic at hand is one that has the Princeton economics department atwitter, I think we need to really focus back on what is really important to the average American citizen today.

Mr. Barthold, in 3 weeks, on December 31st, the payroll tax holiday created by Congress last year will expire; is that correct?

Mr. BARTHOLD. Yes, sir.

Representative CROWLEY. The payroll tax holiday was passed into law by the former Democratic majority in the House and Senate and was meant to provide an immediate cut in the payroll tax, which is paid by all workers and employers at a rate of 6.2 percent each on the first $106,800 of wages earned in the given year. This payroll tax cut meant tax savings of $1,100 this year in a worker's paycheck for a family earning $55,000, probably an average income in the area that I represent. But on January 1st, 2012, if the Republican-led House continues its path of doing nothing for the middle class, nothing for job creation, people with an annual income of $55,000 will see their income taxes raised by $1,100. Talk about an unhappy New Year.

It has been 3 months since President Obama not only proposed extending this payroll tax relief, but expanding it to make it more generous for workers, as well as to provide payroll tax relief for employers, those actually trying to create jobs in this economy. Yet despite the leadership of the President and calls for action from the American people, this Congress continues to operate at a standstill. This Congress has provided no vision, no plan for how to move the Nation forward and get our economy back on track.

Now, with only 25 days until the end of the year, we are on a collision course to let income taxes increase on Americans by over $1,100 due to the continued refusal of the House to even consider legislation to extend the payroll tax cut.

My colleagues, the American people need more than knee-jerk legislation; they need more than last-minute squabbling about whether or not middle-class families and small businesses deserve tax relief. Let us give relief to small businesses and working people today, and let us start spending time on creating a bigger vision for how to ensure America's best days are still ahead. With that, Mr. Chairman, I yield back the balance of my time.

Representative CAMP. Thank you. Mr. Berg is recognized.

Representative BERG. Thank you, Mr. Chairman. This question is really for the whole panel, and one of the areas I am most interested in is derivatives. My question is, is there an example of some other country that has really figured out the best way to tax derivatives? Is there an example that is out there that is being tested that we can look to and say, hey, there is a model we can follow?

Mr. BARTHOLD. Mr. Berg, I am not aware of another western country that has gone completely to mark to market or, as was suggested, retroactive taxation or anticipatory taxation with a broad treatment across every possible financial instrument.

Mr. RASKOLNIKOV. I am not aware either, but I want to emphasize that, with a few exceptions of major financial centers—London, Hong Kong, Tokyo, and a few others—there are really not that many countries that face the pressure as much as we do and where the volume of financial innovation is anywhere comparable to that volume in the United States.

Chairman BAUCUS. Why is that?

Mr. RASKOLNIKOV. That is because the U.S., New York, is a major financial center of the world, and there is an incredible number of highly trained and very talented people focused on this, as

is true of London and a few others. So there is just capacity to develop this.

Chairman BAUCUS. Thank you. I apologize, Mr. Berg.

Representative BERG. No, no, not at all; any time, Mr. Chairman. I yield.

Chairman BAUCUS. It was a question in my mind too. I was going to ask—there is a movement among many countries to move to a LIFO system of accounting. Is there any movement overseas on how to tax these new exotics? You have already answered the question: apart from the other major financial centers, this is really not as much of an issue as it is in this country. I apologize. Go ahead.

Representative BERG. Just a quick—I suppose I get another minute now, though.

Chairman BAUCUS. Take a couple.

Representative BERG. No, no, no. One quick follow-up. The follow-up is, if we go to mark to market on derivatives, are there unintended consequences that might happen? I am just wondering if people, because they are really not getting cash, if they pay a tax on that, would that force them to liquidate things to generate cash? Does anyone see that as an unintended consequence?

Mr. MILLER. I will take that. One thing that is the natural consequence of imposing mark to market on some products rather than others is that you tend to move people into those other products, and, once again, people start looking for ways out of the mark-to-market system. So, for example, if you mark to market derivatives and you do not mark to market physicals, people could use physicals to create partnerships that create synthetic derivatives. So you have to think about the behavioral responses to a partial mark-to-market system. So one is, you have to police around those margins.

Second, your point is well-taken that if you are imposing mark-to-market taxation, that is, taxing people before they have the cash, you have to ask, are they sufficiently liquid? If you are only doing publicly traded derivatives, then you have a mark, and usually sophisticated taxpayers can negotiate for the requisite liquidity. The idea is, if you establish the clear rule and it applies prospectively, then taxpayers who are worried about the liquidity will not enter into the derivatives.

Representative BERG. Thank you. I yield back.

Representative CAMP. Mr. Reed is recognized.

Representative REED. Thank you, Mr. Chairman. I was just interested—there has been some discussion, some debate about a little, unrelated issue, it may be related, on imposing taxes on the actual transaction—the financial transaction tax. I have taken a position on it—I do not want to share that position with you—but I am interested in having the conversation. If the panel could offer some insight as to the pros and cons of imposing a financial transaction tax, I would be appreciative of that. Anyone, other than Mr. Barthold? Go with the professor; he is always on the spot.

Mr. RASKOLNIKOV. We are almost all professors. But I think—I do not have a strong view. I, you know, did not prepare for this hearing to answer this question, but I think it certainly should be considered. I know that you have discussed it at the previous joint

hearing. It is sort of like throwing sand in the wheels; you sort of hope to slow down things that you cannot quite control. If you really are buying time, maybe—but it would be great also to figure out the ways to control things that you are trying to control. But this is not a particularly educated view, so maybe I should not have said as much as I have said.

Representative REED. No, I appreciate that. The other two please, just your comments. We are going to put you on the spot. Ladies first.

Ms. KRAMER. The sand in the gears is really the concern with the transaction tax, because what happens is, it discourages the transactions. And so the question is, is that really the objective or the way that we want to solve whatever issue it is that we are dealing with? And, in the context of the derivatives that we have been talking about, the concept of a transaction tax probably does not make sense unless we are only looking at exchange-traded products, where we would be able to capture that tax readily.

Mr. MILLER. I have been focused on a tax system that matches economic income so that it does not affect taxpayers' behavior. Obviously, a transaction tax is a very different type of tax, in part, because it is designed to affect taxpayers' behavior. I think that is a sort of different inquiry. I think you have to worry a lot about exactly how it is constructed. The EU has proposed a financial transaction tax that has the consequence of imposing multiple taxes on single transactions, so you have to worry about exactly how it is implemented, and you have to tread very carefully.

Representative REED. With that, I will yield back. Thank you.

Representative CAMP. Mr. Neal is recognized.

Representative NEAL. Thank you, Mr. Chairman. Professor, I thought you did a good job in explaining the difference between exchange-traded notes and mutual funds: the difficulty is the issue of risk. For the bank that offers that opportunity, the problem is, as you cited with Lehman Brothers, where would individual investors go to collect? I guess the question I would have for you is, how do you explain in the market that element of risk when there is no congressional backup to fill the tax gap? I offered legislation on this in 2006.

Mr. RASKOLNIKOV. Of course, I supported that legislation.

Representative NEAL. That might have been singular. But the question I raised at the time is still prevalent in the sense it has been discovered here.

Mr. RASKOLNIKOV. So the reason it is still prevalent is because of Too Big to Fail. So, on the one hand, the financial crisis, and Lehman in particular, revealed very starkly that exchange-traded notes are different from mutual fund shares, and investors should think very hard before they decide that an unsecured claim on a bank or a financial institution is as good as actual assets in a mutual fund.

On the other hand, today a lot of the exchange-traded notes are issued by huge financial institutions. My impression is that, you know, even before the bailouts, but especially after the bailouts, nobody believes that any major financial institution will be allowed to fail. And not only that, during the bailout, if the memory serves right, not only the major financial institutions in the United States

were bailed out, basically nobody lost money; no creditors lost money. And so, if that is true, then there is really nothing to worry about for ETN holders, and so then the problems that you were trying to address 3 years ago very much exist today.

Representative NEAL. So it is heads they win and tails they win?

Mr. RASKOLNIKOV. In the case of a bailout? Yes, meaning that ETN investors defer taxes, they convert high-tax income into low-tax income, and then, when the financial institution is in trouble, taxpayers come and bail them out.

Representative NEAL. Mr. Chairman, I think we have done a good job in the committee this year holding hearings. They have been very helpful in terms of a variety of opinions as we talk about this. But I also think that the country would be well-served if we were to insist that the presidential candidates next year took up this issue earnestly and moved away from some of the issues that frequently cloud the debate.

And I call that to your attention because I think we could be very helpful on that basis, and the truth is, unless those two candidates crystallize these issues, the American people will continue to feel very sour about the tax code. Much of the debate is frequently driven by the front page of major publications, including the Estée Lauder story in *The New York Times*. The witnesses are very helpful to this discussion, but what they do is they provide us with a lot of ammunition and a lot of information.

The difficulty is, I suspect, until the Presidential candidates say we are going to aggressively hear what everybody has to say on this and we are going to offer some far-reaching proposals—because the issue that I have just talked about here with exchange-traded notes, they are moving again. They are moving again. And they came to sort of a calamitous halt after Lehman Brothers, but they are becoming attractive again. And as the professor suggested, of course, they are going to be attractive if the investor comes to believe that the government is going to step in afterwards and make everybody whole. Thank you.

Chairman BAUCUS. Thank you. That is a very constructive idea, and I appreciate that.

Representative CAMP. Thank you. I might have just one more question.

First of all, I agree. I appreciate the testimony today. But different participants in this market are treated differently, whether you are an investor, a trader, or a dealer, as you all have pointed out. Does that help lead to the differential treatment, tax treatment of financial products, and is it worth looking at how to treat these different participants in a more uniform way?

If you would like to comment, anyone who would like to comment on that.

Mr. MILLER. I think one point, and this was alluded to before, is we have dealers who are subject to mark to market, we have investors who are not. Therefore, dealers can permit investors to defer with no adverse tax consequences to the dealer. If we expanded that treatment of mark to market across the spectrum to investors, then we would not have the situation where one party is deferring their tax and the other is indifferent.

Representative CAMP. And should those who are hedging be treated differently than those who are speculating?

Mr. MILLER. I think they should be. So, in each of my proposals, I have carved out or excepted taxpayers that hedge their ordinary income and liabilities, like the farmers and the business owners. So I think that it is appropriate to carve out taxpayers who hedge in the ordinary course of their business their ordinary income and assets.

Representative CAMP. Thank you.

Mr. Schock is recognized.

Representative SCHOCK. Thank you, Mr. Chairman.

As an Illinois member and home to the CME and the Board of Trade, we have a lot of traders in our State. Ms. Kramer, being from Illinois yourself, I am interested in your perspective on some rulemaking that has just been posted.

On September 16th of this year, the Treasury Department issued proposed regulations entitled "Swap Exclusions for Section 1256 Contracts." I am sure you are aware that many of the traders in Illinois are large corporations, but also there is an entrepreneur element, pass-through entities. And knowing that those small businesses—I have visited them—in our State that employ these traders that benefit from CME and the Board of Trade being in Illinois, their tax treatment is different. Specifically the 60–40, they benefit more from that than a C corp.

The rulemaking that the Treasury Department proposed seeks to do away with that. I am interested, as a tax attorney from Illinois, whether you are aware of that and, if so, if you have an opinion on it, and whether those regulations concerning 1256 which expand further the definition of a swap and narrow the definition of a section 1256 contract, are consistent with what was intended by the Dodd-Frank Act, or do you believe that they go further than what was intended in that legislation?

Ms. KRAMER. A great question. As a starting point, the provision to remove certain swap products from 1256 treatment has been discussed previously, and the concept behind that was that the concern was to get—that there would be more products that would be moving into 1256 treatment, and the exclusion that was put in Dodd-Frank is to make it clear that certain products cannot migrate into the 1256 regime. So, based on my view that that is what the statute was intended to do, then the regulations that have been proposed are beyond what was contemplated by Congress, and the regulations go too far.

Representative SCHOCK. Well, I would agree. You know, the stated intent of the Dodd-Frank legislation was to promote transparency and safety in the financial markets, and, in particular, the goal was to move derivatives on to exchanges which offer the most transparent and safest form for trading.

Based on what you just said, do you think the treatment of futures and other exchange-traded contracts under section 1256 is consistent with these objectives or outside the stated objectives for Dodd-Frank?

Ms. KRAMER. Well, I think that the fact that they are exchange-traded already and they do have the clearing mechanism, means that the objectives that Dodd-Frank is looking for for the over-the-

counter products are met with respect to the current treatment of futures and exchange-traded options.

Representative SCHOCK. Thank you.

Mr. Chairman, I know my time has expired, but I do not see anyone else waiting around to ask questions, so, if you would indulge me for 30 seconds.

I know you talked about—I am curious—moving to mark to market not only for these financial products but also expanding them to stocks and other assets. I am wondering if—I realize this is focused on financial products, but it is also investments, obviously, if you talk about including stocks. What about real estate?

Mr. MILLER. No, I would not expand mark to market to real estate, for several reasons. One, valuation is incredibly difficult for real estate. Real estate is not liquid. It would be a real hardship for people to have to pay tax on the appreciation of their real estate without the cash to be able to pay that tax.

Representative SCHOCK. Does that favor then one investment vehicle over another?

Mr. MILLER. Yes. If my comprehensive mark-to-market proposal were adopted and only publicly traded securities were subject to mark to market, at the margins, if somebody is considering an investment in real estate as opposed to an investment in publicly traded property, they might elect real estate and achieve the deferral to avoid the mark-to-market treatment. However, there are real economic differences between an investment in real estate and an investment in a publicly traded security. They would lose the liquidity that an investment in publicly traded securities would give.

Representative SCHOCK. Thank you, Mr. Chairman. I appreciate it.

Chairman BAUCUS. I have a question. With all the problems in Europe today, if you are a very creative tax lawyer, what would you be counseling your very lucrative client to be looking at? I can always think about the Euro falling, maybe selling short. I am just trying to put myself in the mind of some pretty big wealthy investors and thinking about new opportunities. Everything is an opportunity. Even bad news is an opportunity. Do any come to mind, or is that just too idle to be worth contemplating?

Mr. MILLER. Well, if you could tell me where the market will go, I can derive the financial instrument that will minimize your taxes.

Chairman BAUCUS. Of course, that is the key question. Even back in the financial debacle days, different people had different views whether these Collateralized Debt Obligations were worth anything or not.

Mr. MILLER. And if you truly do not know, then only a mark-to-market system will assure that you are not subject to adverse tax consequences when the market goes against you, because you can take your loss.

Chairman BAUCUS. Let's hope that Europe does not tank.

I thank the witnesses very, very much. The hearing is adjourned.

[Whereupon, at 12:06 p.m., the hearing was concluded.]

APPENDIX

ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

PRESENT LAW AND ISSUES RELATED TO THE TAXATION OF FINANCIAL INSTRUMENTS AND PRODUCTS

A REPORT TO THE JOINT COMMITTEE ON TAXATION

Prepared by the Staff
of the
JOINT COMMITTEE ON TAXATION



December 2, 2011
JCX-56-11

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INTRODUCTION AND SUMMARY

Introduction

This document[1] has been prepared by the staff of the Joint Committee on Taxation, in response to the request of the Chairman and Vice Chairman of the Joint Committee on Taxation for a report of Federal tax rules relating to the taxation of financial instruments.[2]

Starting in 2008, there have been a series of financial shocks, an ensuing worldwide recession, and persistent instability in global financial markets. The volume of financial instruments traded in the United States and abroad increased dramatically in the two decades preceding these developments. Policymakers have sought to understand the role of financial instruments in the economy.

At the same time, policymakers have been interested in the tax treatment of financial instruments, in part out of concern about inconsistent treatment of instruments with similar economic characteristics.

Financial instruments include basic investments such as stocks and bonds (or, more broadly, equity and debt), assets that combine features of both equity and debt, and contracts referred to as derivatives. Derivatives are instruments the value of which derives from the value of other property, liabilities, or other measures. Common derivatives are options, forward and futures contracts, and swaps. The tax term for a swap is a notional principal contract.

Options, forwards and futures, and swaps have the following definitions:

- An option is a contract between two parties that gives the holder of the option the right but not the obligation to buy from (in the case of a call option) or sell to (in the case of a put option) the issuer of the option a specified amount of property (such as 100 shares of Microsoft stock) at a fixed price and specified time.
- In a forward contract one party to the contract obligates itself to purchase from the other party a fixed quantity of property (such as 1,000 shares of General Electric stock) at a fixed price on a fixed future date.
- A futures contract is a standardized forward contract that is traded on an exchange such as the Chicago Mercantile Exchange. Futures contracts historically have been for the purchase and sale of commodities.

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[1] This document may be cited as follows: Joint Committee on Taxation, *Present Law and Issues Related to the Taxation of Financial Instruments and Products* (JCX-56-11), December 2, 2011. This document can be found on our website at www.jct.gov.

[2] The request was made at the 112th Congress Organizational Meeting of the Joint Committee on Taxation on March 15, 2011.

- A swap or notional principal contract is an agreement between two parties to exchange over a specified period of time payments that are calculated by reference to an identified instrument (such as stock or a basket of stocks), index (such as the S&P 500 stock index), other amounts (such as fixed or variable interest rates), or the outcome of a specified event (such as a corporation's default on its indebtedness).

Equity, debt, and derivatives are traded in public markets on exchanges and by private means, also referred to as over-the-counter ("OTC") trading.

In absolute and historical terms, the volume of financial instruments traded in the United States is large. As Table 1 illustrates, at the end of 2010, U.S. persons held or issued $9.4 trillion of Treasury securities, $11.5 trillion of corporate and foreign bonds, $13.8 trillion of mortgages, $23.2 trillion of corporate equities, and $7.9 trillion of mutual fund shares.

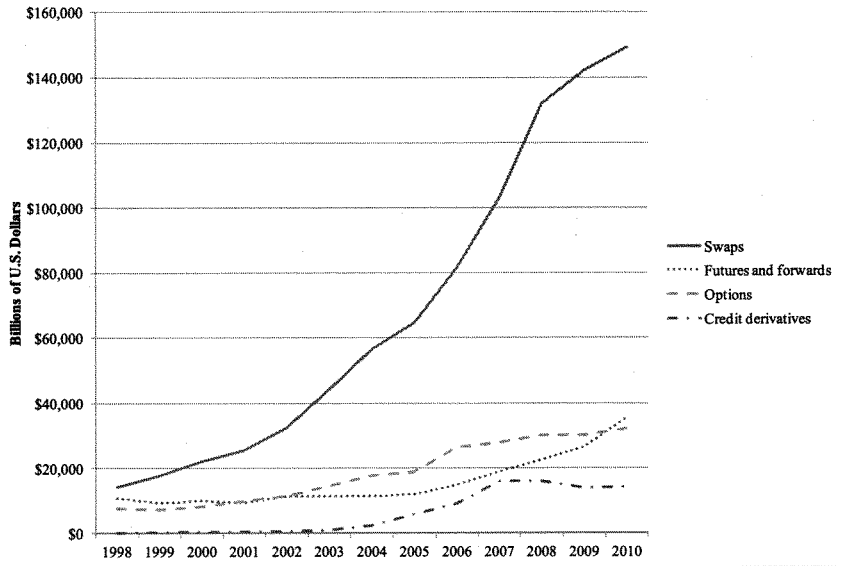
Table 1.–Selected Financial Instruments Issued or Held by U.S. Persons
As of December 31, 2010
(Billions of U.S. Dollars)

	2010
Money market fund shares	2,755
Credit market instruments	52,494
Open market paper	1,058
Treasury securities	9,362
Agency- and GSE-backed securities	7,598
Municipal securities	2,928
Corporate and foreign bonds	11,473
Bank loans not elsewhere classified	1,874
Other loans and advances	1,951
Mortgages	13,817
Consumer credit	2,435
Corporate equities	23,247
Mutual fund shares	7,935
Security credit	1,215

Source: Federal Reserve Board, Flow of Funds.

Figure 1 shows the rapid growth since 1998 in the notional amount outstanding of swaps (not including credit derivatives) held by banks required to report to the U.S. Office of the Comptroller of the Currency, from $14.3 trillion at the end of 1998 to $149.2 trillion at the end of 2010. Futures, forward, and option contract volumes have grown less quickly. The notional amount outstanding of credit derivatives (credit default swaps) has grown from $144 billion at the end of 1998 to $14.1 trillion at the end of 2010, after peaking in 2008 at $15.9 trillion.

Figure 1.–Notional Amount Outstanding of OTC and Exchange-Traded Derivatives, As Reported to the U.S. Office of the Comptroller of the Currency, by Product



Source: Office of the Comptroller of the Currency.

This report proceeds in the following manner. Section I describes economic, financial accounting, and regulatory considerations related to holding, issuing, and structuring financial instruments. Section II describes in broad terms the basic U.S. income tax principles of timing, character, and source that underlie the taxation of financial instruments. Section III provides an overview of the timing, character, and source rules for five financial instruments – equity, debt, options, forward contracts, and notional principal contracts. That section also describes economic relationships among various financial instruments (so-called put-call parity) and the financial accounting treatment of financial instruments. Section IV is a discussion of selected timing, character, source, and categorization issues in the taxation of financial instruments. This section includes background on problems that have arisen related to taxpayer trading in financial instruments and how those problems have been addressed (or have not been addressed) by legislation and regulation. An appendix presents data about holdings and issuances of financial instruments.

Summary

Individuals and businesses have various economic motives for trading in financial instruments. For example, businesses issue financial instruments to raise money to finance projects, and individuals hold financial instruments to achieve returns on savings. Businesses also use financial instruments to hedge against risks such as price fluctuations in raw materials, exchange rate movements, and changes in the cost of capital. These financial instruments include equity and debt, instruments that combine features of equity and debt, and derivative instruments. The decision to hold or issue one instrument rather than another is based on a number of economic considerations including the riskiness of a particular instrument, the timing of cash flows produced by the instrument, and the rights or obligations, such as voting control, of the parties to an instrument.

Businesses also take into account financial accounting and regulatory considerations in holding, issuing, and structuring financial instruments. Financial reporting is intended to provide information to investors and the public about the economic condition of the reporting firm. A particular firm considering equity or debt financing may prefer the financial accounting results of issuing one form of capital rather than the other. Financial accounting issues may arise because some instruments have characteristics of both equity and debt. There are also questions about whether a particular instrument or transaction must be reflected on a firm's consolidated balance sheet or instead is considered "off balance sheet" because, for example, it is held or undertaken by a special purpose entity. Regulated financial institutions may issue or hold one financial instrument rather than another economically similar instrument because the chosen instrument yields favorable results under capital adequacy requirements.

Tax considerations affect decisions related to holding, issuing, and structuring financial instruments. The taxation of financial instruments generally depends on a categorization based on the type of instrument rather than on the economic characteristics of the instrument, though those economic characteristics affect the categorization. Because instruments with similar or identical economic characteristics may be categorized differently from one another, a taxpayer with a particular economic goal may choose one instrument rather than another because of tax considerations.

Timing, character, and source are principles fundamental to the U.S. income tax generally and, more particularly, affect the taxation of financial instruments. The timing principle relates to when an item of income or expense is required or allowed to be taken into account for tax purposes. Some financial instruments (such as debt) produce income that is required to be taken into account annually, while other instruments (such as stock on which no dividends are paid, options, and forward contracts) produce income that is taken into account only when there is a realization event such as the sale of the instrument or the underlying asset. The character principle concerns whether an asset or a liability, or an income or expense item, is capital or ordinary in the hands of a particular taxpayer. Many factors, including the status of a taxpayer in the marketplace and whether property is held as inventory or an investment, affect character. Consequences of the characterization of income as capital or ordinary include the rate of tax applicable to the income and whether loss limitation rules apply. The source of income as foreign or domestic is determined on a category-of-income basis by factors including the residence of the recipient of the income, the residence of the payor of the income, the location or

place of use of the property producing the income, and the location of the activities producing the income. Whether an item of income is foreign or domestic affects U.S. and foreign taxpayers differently. Both U.S. and foreign taxpayers with cross-border activities generally prefer to have foreign-source income, foreign taxpayers because in general they are taxed by the United States only on U.S.-source income and U.S. taxpayers because the foreign tax credit is allowed to reduce only U.S. tax on foreign-source income.

The timing, character, and source rules apply differently to (and are sometimes uncertain for) equity, debt, options, forward contracts, and notional principal contracts. These five basic instruments can be combined in various ways to replicate the economic returns of any underlying asset. Individuals and firms also regularly create new instruments intended to produce particular economic outcomes. This ability to combine basic instruments and to create new instruments represents financial innovation that might lower the cost of capital for business expansion or might mitigate the risk of new projects. The flexibility of financial instruments also creates great difficulties in the taxation of financial instruments. This report provides examples of taxpayers' uses of financial instruments to achieve desired timing, character, and source outcomes and describes how the tax laws have or have not addressed this tax planning.

I. CONSIDERATIONS IN HOLDING, ISSUING, AND STRUCTURING FINANCIAL INSTRUMENTS

Individuals and businesses hold, issue, and structure financial instruments to achieve a variety of economic objectives such as raising capital, producing fixed or variable income streams, or hedging risks such as price and interest rate fluctuations.

The taxation of financial instruments principally depends on a categorization based on the type of instrument rather than on the economic characteristics of a particular instrument. In some circumstances those economic characteristics affect the instrument's categorization. Because instruments with the same or similar economic characteristics may be categorized differently from one another for tax purposes, a taxpayer who has a particular economic objective may choose one financial instrument rather than another because of tax considerations.

By holding one instrument rather than another, a taxpayer may achieve a desired timing of income or expense recognition, a desired characterization of income or loss as capital or ordinary, or a desired source of income or expense as foreign or domestic. Tax rules governing timing, character, and source determine the treatment of the various categories of instruments.

Although tax considerations may affect the type of financial instrument that an individual or business chooses to hold or issue, nontax considerations also guide decisions about trading in financial instruments. This section describes economic, financial accounting, and bank regulatory considerations related to trading in financial instruments.

A. Economic Considerations

Financial instruments generally

Financial instruments facilitate transfers of cash or property with specific timing and risk characteristics at a particular price or expected return. Businesses issue financial instruments primarily to raise money to finance investment projects. Individuals typically hold financial instruments because they have savings upon which they would like to earn a rate of return.

These financial instruments may be common stocks or other forms of equity, bonds or other forms of debt, hybrid instruments that combine features of equity and debt, or derivatives. The economic choice to issue or to hold a particular financial instrument depends on a variety of factors including the rights and obligations the parties may have (*e.g.*, voting control, or rights in bankruptcy), the risk of paying or receiving any return (*e.g.*, entirely subject to the fortunes of the venture, or an unqualified promise to pay a sum certain on a specified date), and the timing of cash flows.

Derivatives

A derivative is a financial instrument the value of which is dependent upon–derived from–the value of an underlying asset or index, or the occurrence of an event with an ascertainable outcome.[3] Two parties enter into a contract that specifies the timing and amount of any payments (in cash or in kind) to be made between them where the amount is determined with reference to the value of the underlying asset. Common types of derivatives include: (1) options, which provide one party the right but not the obligation to purchase a quantity of the underlying asset at a set price, (2) forwards and futures, which obligate one party to purchase or sell a quantity of the underlying asset at a set price, and (3) swaps, which involve the exchange of returns on underlying assets. The most common type of swap is an interest rate swap in which parties exchange fixed interest rate payments for floating interest rate payments on a loan. Many other types of derivatives have been created. New derivatives can be created to customize the rights and obligations, risk, returns, and timing that issuers and investors desire.

Derivative financial instruments allow participants to alter the risk and the distribution of returns of their portfolios relative to holding the underlying investments. For example, instruments that eliminate the risk of some position in a portfolio, or an entire set of positions, serve the function of hedging. Alternatively, derivatives can increase risk in a portfolio as the cost of seeking higher returns.

Businesses regularly use commodity derivatives to hedge against price fluctuations in raw materials. Similarly, businesses commonly use currency derivatives to hedge against exchange rate fluctuations and interest rate derivatives to hedge against changes in the cost of capital. An investor or a portfolio manager that owns an underlying financial instrument may

[3] There are derivative financial instruments the value of which is dependent upon the value of stocks, stock indices, commodities, interest rates, weather-related events, and credit default events, among others. For ease of exposition, this report generally uses the term underlying asset to include any of these potential items.

use a derivative to hedge against a decrease in its value. Other investors may use derivatives to establish leveraged risky positions consistent with the investors' specific views of future market movements.

Derivatives are fundamental tools to manage risk. For example, the flexibility of the OTC derivative market enables taxpayers to create customized contracts to accomplish their trading and portfolio strategies. The trading of derivatives (and the quotation of their prices) makes markets more efficient by facilitating price discovery,[4] both with respect to related derivatives and with respect to the underlying assets.

Derivative contracts typically afford a party much higher leverage than would be possible (or permitted by relevant margin regulations) if the party were to establish a position in the underlying asset.[5] That is, an investor may use derivatives to take on more risk, in the expectation of greater return, with respect to the price of the underlying asset with smaller cash outlays than would otherwise be possible. For example, an investor with $1,000 could purchase 10 shares of $100 stock. Suppose that an option to purchase a share of the same stock for $100 costs $5. The same investor could purchase options on 200 shares of stock with $1,000. The options magnify potential profits in the same manner as leverage, by exposing the investor to more shares.

Alternatively, options on 10 shares could be purchased at a significantly lower cost than purchasing the 10 shares outright. At $5 each, the investor could purchase options on 10 shares for $50 rather than purchasing 10 shares outright for $1,000. The options allow a slightly smaller potential for gain because any movement in the stock price is reduced by the $50 option premium paid. However, they limit the amount of any loss to the $50 option premium paid (as opposed to $1,000 had the investor purchased the shares outright).

An investor could also enter into a total return swap on 10 shares of stock in which the investor receives payments from a counterparty for any dividends and appreciation in the stock price and makes payments to the counterparty of interest and for any depreciation in the stock price.[6] With this arrangement, the investor realizes the return on 10 shares of stock with no upfront investment of his own capital. It is as if the investor makes a 100-percent leveraged purchase of the stock. By contrast with the example in which the investor buys options to acquire the 10 shares of stock (and the potential loss is limited to the $50 option premium paid), the potential loss under the swap contract is the entire value of the shares ($1,000).

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[4] Price discovery is the process by which information about market conditions are incorporated into the price of goods or assets Interactions between buyers and sellers in a free marketplace determine the market price or value based on supply and demand. For a study of price discovery and derivatives markets, see Torben G. Anderson, et al., "Real-time Price Discovery in Global Stock, Bond, and Foreign Exchange Markets," *Journal of International Economics*, vol. 73, 2007, pp. 251-277.

[5] See the discussion of the relevant margin regulations on page 41 of this document.

[6] Payments under a total return swap are typically netted so that only one party makes a payment at any one time.

B. Financial Accounting Considerations

In general

The Financial Accounting Standards Board ("FASB") has promulgated standards known as Generally Accepted Accounting Principles ("GAAP") and created a conceptual framework for financial reporting that it uses in setting the relevant standards. This framework specifies that financial reporting is intended to provide information that is useful for making reasoned choices among alternative uses of scarce resources in the conduct of business and economic activities.[7]

The objective of financial reporting is to provide information that reflects the underlying economics of a transaction. In some instances, however, an economic arrangement can be structured in alternative ways to achieve different financial statement treatment. Firms may prefer one alternative financial statement treatment to another, depending on the firm's particular circumstances. At other times, the use of financial instruments and transaction structures are primarily motivated by accounting and reporting concerns, rather than by the economics of the arrangement. Structuring transactions to achieve accounting and reporting goals that do not conform to the economic substance of an arrangement may reduce transparency in financial reporting.

Debt versus equity financing

A firm interested in raising additional capital can do so by issuing traditional debt or equity instruments. Each option has its drawbacks in terms of control of the firm, earnings, and various financial ratios. Additional stock offerings dilute the ownership of the firm (and earnings per share) and may dilute control of the firm. Additional issued debt generally has no impact on ownership or voting control, but increases interest expense (decreasing earnings) and increases the risk of financial distress. In addition, lenders typically require borrowers to agree to various covenants and limitations.[8] Because of the covenants and limitations associated with debt financing, a firm with a certain amount of indebtedness may have difficulty issuing additional debt. Depending on a firm's individual circumstances, one firm may prefer the financial accounting impact associated with raising capital through issuing equity, while another may prefer the financial accounting impact associated with debt financing.

Financial innovation provides companies with alternative sources of financing, but also increases the complexity and risk for the users of financial information. Today many financial instruments have characteristics of both debt and equity. As financial instruments have become

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[7] FASB, *Concepts Statement No 1 Objectives of Financial Reporting by Business Enterprises ("Con No 1")*, November 1978, par. 9. Although the FASB Concepts Statements do not establish generally accepted accounting standards, they are intended to serve the public interest by setting the objectives, qualitative characteristics, and other concepts for financial reporting. Furthermore, Concepts Statements guide the FASB in developing sound accounting principles and provide the FASB and its constituents with an understanding of the appropriate content and inherent limitations of financial reporting.

[8] See section III.C below for a more detailed discussion of debt and equity financing, and the financial accounting for instruments with characteristics of both debt and equity.

more complex, the form and substance of some financial instruments have diverged. The FASB has acknowledged that accounting standards do not adequately address the features in financial instruments that exist today.[9]

The FASB and the International Accounting Standards Board ("IASB") are undertaking a joint project to develop a comprehensive standard on financial instruments with characteristics of equity, liabilities, or both.[10]

Off-balance-sheet accounting

If a firm's investment in another legal entity is "consolidated," the gross assets and liabilities of the legal entity are reflected on the firm's consolidated balance sheet, regardless of whether the firm or the separate legal entity holds legal ownership of the assets and liabilities. However, if a firm's investment in another legal entity is not consolidated, the assets and liabilities owned by the separate legal entity would not be included in the firm's financial statements. Such an investment is referred to as off-balance-sheet.[11]

Special purpose entities (entities created to fulfill narrow, specific, or temporary objectives) are typically used to isolate a firm from financial risk.[12] They commonly hold derivative instruments (such as swaps) and perform other financial transactions for a sponsor firm. They have also been used to hide debt, hide ownership, and obscure relationships between different legal entities which are in fact related to each other. For example, prior to a change in

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[9] For example, in its *Preliminary Views Financial Instruments with Characteristics of Equity* (No. 1550-11), November 2007, the FASB notes that in some cases, an issuer can effectively choose how to report an instrument or instruments by altering their form without changing the substance very much, if at all. For example, under current accounting requirements, a written call option settled with cash is classified as a liability. However, a written call option is classified as equity if the issuer can choose to settle in cash or shares. The issuer may insert a share-settlement provision to obtain equity classification even if the intent is to settle in cash.

[10] At their joint meetings in April and October 2005, the FASB and the IASB discussed the future of reporting for financial instruments. The Boards worked jointly on a research project to reduce the complexity of the accounting for financial instruments. This joint effort resulted in the IASB's issuance of the March 2008 discussion paper, *Reducing Complexity in Reporting Financial Instruments*, which the FASB also published for comment by its constituents.

[11] See discussion of financial accounting rules for equity investments at III.C below. While the term off-balance-sheet may suggest something less than transparent, many legitimate transactions generate questions of whether items should or should not be included on the balance sheet. However, firms might be motivated by a desire to move poorly performing assets off the balance sheet or a desire to reduce the debt outstanding on the balance sheet to improve the appearance of the firm's financial position and liquidity.

[12] Special purpose entities are commonly used to securitize loans or other receivables. For example, if a bank wishes to issue a mortgage-backed security whose payments come from a pool of loans, the loans must be legally separated from other obligations of the bank to ensure that the holders of the mortgage-backed securities have the first priority right to receive payments on the loans. This legal separation is achieved by creating a special purpose entity and transferring the loans from the bank to the special purpose entity. Although the bank may have some residual obligation with respect to the securities transferred, the bank would not have legal ownership of the special purpose entity.

the GAAP standard for consolidation, if an independent third party holding a "substantive" investment (defined as at least three percent of the value of the special purpose entity's assets) was granted voting control of the entity by the sponsor firm, the special purpose entity was not required to be consolidated with the financial statements of the sponsor firm despite the fact that the sponsor firm bore the majority of the risks and rewards of the special purpose entity.[13]

The Sarbanes-Oxley Act[14] modified rules for corporate governance and financial reporting practices. As part of this legislation, the Securities and Exchange Commission ("SEC") was required to conduct a study of off-balance-sheet arrangements. The SEC found that the significant use of accounting-motivated transactions had contributed to a reduction in the transparency and credibility of financial statements and made various recommendations for improving financial accounting guidance in this area.[15] In response to perceived abuses, the FASB introduced new consolidation rules based on risks and rewards rather than ownership and voting rights.[16] The FASB has continued to adjust the financial accounting rules in response to innovations in financial instruments.[17]

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[13] For an example of abusive transactions involving the use of special purpose entities, see William C. Powers, Jr., "Report of Investigation of the Special Investigative Committee of the Board of Directors of Enron Corp." (Feb 1, 2002), http://i.cnn.net/cnn/2002/LAW/02/02/enron.report/powers report.pdf.

[14] Pub. L. No. 107-204 (2002).

[15] Office of the Chief Accountant, Securities and Exchange Commission: *Report and Recommendations pursuant to Section 401(c) of the Sarbanes-Oxley Act of 2002 On Arrangements with Off-Balance-Sheet Implications, Special Purpose Entities, and Transparency of Filings by Issuers* (2005). For a description of the financial accounting motivated transactions with off-balance-sheet implications related to the Enron case, see Joint Committee on Taxation, *Report of Investigation of Enron Corporation and Related Entities Regarding Federal Tax and Compensation Issues and Policy Recommendations* (JCS-3-03), February 2003, pp 313-331.

[16] FASB Interpretation No. 46(R). Consolidation of Variable Interest Entities (revised December 2003). This guidance is now incorporated into Accounting Standards Codification ("ASC") 810 - Consolidations. Prior to the issuance of this new standard, entities were required to be consolidated only if the sponsor held the majority ownership/voting rights in the special purpose entity. Under the risks and rewards approach, the requirement to consolidate is based on whether the firm absorbs the majority of the losses or gains of the special purpose entity (renamed variable interest entity).

[17] FASB Interpretation No. 45: Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others (now ASC 460), issued in 2002, required expanded recognition and disclosure of liabilities related to guarantees by the guarantor. FASB Interpretation No. 46(R): Consolidation of Variable Interest Entities (now ASC 810), issued in 2003, made it harder to exclude debt from the balance sheet via special purpose entities. Those guidelines were further tightened in 2009 with the issuance of SFAS No. 167: Amendments to FASB Interpretation No. 46(R) (now ASC 810) and the issuance of SFAS No. 166: Accounting for Transfers of Financial Assets (now ASC 860) which changed the way financial institutions account for securitizations and special purpose entities. In addition, in October 2008, the FASB and IASB formed the Financial Crisis Advisory Group to advise the Boards about the accounting standard setting implications of the financial crisis and potential changes in the global regulatory environment.

C. Regulatory Considerations

In addition to economic and financial accounting considerations, financial institutions subject to capital adequacy requirements may issue, or hold, financial instruments designed to produce favorable results under those rules.

Under U.S. regulatory capital requirements, financial regulators generally require the institutions they supervise to maintain minimum levels of capital.[18] The capital requirements measure a financial institution's equity capital relative to the institution's risk profile, with riskier assets requiring more equity capital to be held by the institution to absorb potential losses. These requirements, intended to reduce institution failures and minimize losses to creditors, customers, and taxpayers in the event of a failure, are generally based on accords promulgated by the Basel Committee on Banking Supervision of the Bank of International Settlements (the "Basel Accords"). There have been three Basel Accords commonly referred to as Basel I[19] (adopted in 1988), Basel II[20] (announced in 2004) and Basel III[21] (final rules published in December 2010).[22]

Financial institutions may have an incentive both to issue financial instruments that qualify as regulatory capital (to help satisfy minimum requirements) and to hold financial instruments that require less capital to be held against them. As regulatory rules and standards change over time, one can expect financial institutions to develop new financial instruments and products favorable under those new rules and standards.

Trust preferred securities are an example of a financial instrument developed, and adapted over time, to achieve beneficial treatment under the regulatory capital requirements.[23] Prior to the enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act

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[18] There are multiple financial institution regulators in the United States, including the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Federal Reserve Board, and the National Credit Union Administration.

[19] Basel Committee *International Convergence of Capital Measurement and Capital Standards*, available (with updates) at http://www.bis.org/list/bcbs/tac_1/tid_21/index.htm.

[20] *Basel II International Convergence of Capital Measurement and Capital Standards a Revised Framework*, available (with updates) at http://www.bis.org/publ/bcbs107.htm.

[21] *Basel III A global regulatory framework for more resilient banks and banking systems* and *Basel III International framework for liquidity risk measurement, standards and monitoring*, available at http://www.bis.org/list/basel3/index.htm.

[22] For a description of the Basel Accords and their implementation in the United States, see Walter W. Eubanks, Congressional Research Service, *The Basel Accords The Implementation of II and the Modification of I*, Report RL33278 (June 16, 2006); Walter W Eubanks, Congressional Research Service, *The Status of the Basel III Capital Adequacy Accord*, Report RL41467 (October 28, 2010); Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2012 Budget Proposal* (JCS-3-11), June 2011, pp. 141-145.

[23] For a more detailed discussion of trust preferred securities, see Joint Committee on Taxation, *Present Law and Background Relating to Tax Treatment of Business Debt* (JCX-41-11), July 11, 2011, pp. 82-84.

("Dodd-Frank"),[24] trust preferred securities meeting certain requirements and issued by bank holding companies regulated by the Federal Reserve Board (but not financial institutions supervised by other regulators) counted as the highest quality regulatory capital, defined as Tier 1 capital.[25] However, trust preferred securities issued by these institutions were designed to qualify as debt (not equity capital) for Federal tax purposes, thus giving the corporate issuer an income tax deduction for payments made with respect to the instruments. For banks other than bank holding companies, trust preferred securities did not count as Tier 1 capital.

However, Section 171(b) of Dodd-Frank generally phases out the treatment of trust preferred securities as Tier 1 capital for most large bank and thrift holding companies. Specifically, the section prohibits bank holding companies with assets in excess of $15 billion on December 31, 2009, to count trust preferred securities issued after May 19, 2010, as Tier 1 capital and phases previously issued trust preferred securities out of Tier 1 capital by January 2016. Bank holding companies with $15 billion or less in assets are not allowed to include trust preferred securities issued on or after May 19, 2010, in Tier 1 capital, but are not required to phase out trust preferred securities outstanding before that date. Federal home loan banks and certain small bank holding companies (*i.e.*, bank holding companies with less than $500 million in assets) are exempted from the limitation provision (*i.e.*, these entities may continue to count trust preferred securities as Tier 1 capital), as are trust preferred securities issued to the United States or any agency or instrumentality thereof pursuant to the Emergency Economic Stabilization Act of 2008.[26]

In addition, Dodd-Frank directs the Federal banking agencies to develop capital requirements applicable to insured depository institutions, depository institution holding companies, and nonbank financial companies supervised by the Federal Reserve Board that address the risks that the activities of such institutions impose on the market, including rules that address activities in derivative instruments, securitized products, securities borrowing and lending, and repurchase and reverse repurchase agreements.[27] Depending upon how such rules develop, financial institutions may have additional incentives or disincentives for using derivative financial instruments.

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[24] Pub. L. No. 111-203.

[25] Generally, Tier 1 capital includes common stock plus noncumulative preferred stock plus minority interests in consolidated subsidiaries, less goodwill and other intangible assets

[26] Pub. L. No. 110-343.

[27] Pub. L. No. 111-203, sec. 171(b)(7)(A) and (B).

II. U.S. INCOME TAX PRINCIPLES

Fundamental to the Federal income tax system is the determination of income subject to tax. This section outlines the basic principles of timing, character, and source. These three principles are central to the application of the income tax. A variety of factors affect their application.

A threshold issue for application of the income tax is determining to whom the tax should apply. Although it is generally the owner of the income who is subject to the tax, the Code does not provide a definition of ownership. In the absence of specific rules, courts have detailed factors relevant to determining the owner of income for Federal tax purposes. In the context of financial instruments these factors include who (1) bears the risk of loss and has the opportunity for gain; (2) has the right to receive current income or distributions; (3) may exercise any rights attending the instrument such as voting or enforcement rights; and (4) has the right to dispose of the property. Considerations of ownership may be complicated by the ability of taxpayers to structure financial arrangements that deliver some (or all) of the economics of ownership but none (or some) of the other attributes of ownership.

The manner of a taxpayer's participation in the market also may affect the timing, character, and source of income. For example, the Code taxes investors, traders, and dealers in securities and commodities and related financial instruments differently. A taxpayer's status in this regard is generally determined by both the nature and the extent of his activities. Generally, an investor is a taxpayer who seeks to profit solely from changes in the price of, and income earned on, financial products he holds, and is not engaged in a trade or business.[28] In contrast, a trader is someone in a trade or business of buying and selling assets in an effort to catch swings in the daily market and profit thereby on a short-term basis.[29] A person is a dealer in securities, for example, if such person regularly purchases securities from or sells securities to customers in the ordinary course of a trade or business, or regularly offers to enter into, assume, offset, assign, or otherwise terminate positions in securities with customers in the ordinary course of a trade or business.[30] A taxpayer may qualify for more than one status at any given time with respect to different instruments.

Some parties to a transaction may be indifferent to the timing, character, and source of income because they are either exempt from tax or are required to mark positions to market as ordinary income in any event (*e.g.*, section 475 securities dealers) or for other reasons. In such cases taxable parties may enter into transactions with the tax indifferent party to achieve a desired tax result.

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[28] *Whipple v. Commissioner*, 373 U.S. 193 (1963).

[29] See, *e.g.*, *Liang v. Commissioner*, 23 T.C. 1040, 1043 (1995).

[30] See sec. 475(c)(1) (defining a securities dealer for purposes of section 475); *Bielfeldt v. Commissioner*, 231 F.3d 1035 (7th Cir. 2000) (describing the difference between a trader and a dealer and noting that "the dealer's income is based on the service he provides in the chain of distribution of the goods he buys and resells, rather than on fluctuations in the market value of those goods, while the trader's income is based not on any service he provides but rather on, precisely fluctuations in the market value of the securities or other assets that he transacts in.").

In addition to considerations of the taxpayer's status, other activities of the taxpayer may come into play. For example, specialized rules for tax hedges, transactions entered into in the normal course of a taxpayer's trade or business primarily to manage certain risks with respect to ordinary property or obligations, can change the timing, character, and source of income.[31] As another example, financial products issued by life insurance companies, such as life insurance contracts and annuity contracts, are subject to different rules that are not described in this document.

Following is a description of some of the most relevant rules for determining timing, character, and source of income in the context of financial instruments.

[31] Sec. 1221(b)(2).

A. Timing of Income Rules

A fundamental principle of income tax is the determination of when an item of income (or expense) is required to be taken into account for income tax purposes.[32] Because of the time value of money, whereby the present value of a future tax liability is less than the value of the same tax liability in the current year and holding other factors such as tax rates constant, most taxpayers prefer to delay taking income into account. The tax rules do not, however, permit a taxpayer to choose the timing of income simply to minimize that taxpayer's tax burden. Instead, as a general matter, a taxpayer must compute taxable income under a method of accounting that "clearly reflect[s] income."[33] Within this broad requirement that a taxpayer's accounting method produce a clear reflection of the taxpayer's income, the timing rules vary based on the taxpayer's method of accounting as well as the particular item of income.

In general, for a cash basis taxpayer (*e.g.*, an individual), an amount is included in income when received.[34] For an accrual basis taxpayer (*e.g.*, a corporation), an amount generally is recognized (and included in income) the earlier of when such amount is earned by, due to, or received by the taxpayer, unless an exception permits deferral or exclusion.[35]

Regardless of a taxpayer's method of accounting (cash or accrual), some forms of income are taxed as they accrue, while the taxation of other forms of income are delayed until a later date. For example, an employee generally is taxed on wages and other compensation for services when the employee receives the wages or other compensation.[36] In contrast, an employee generally is not taxed on amounts under certain employee benefit plans until the employee withdraws the amounts.[37] However, when dealing in financial instruments, it is not always clear when the amounts exchanged, pledged, or promised upon execution of a contract should be included in the taxpayer's income (*e.g.*, upon physical receipt of the payment, when another step of the transaction occurs, or upon completion of the entire contract). One way of understanding the general approach to the timing of taxation of financial instruments is that

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[32] For purposes of brevity, this discussion addresses only the timing of income inclusion (including gains and losses from the sale, exchange or disposition of a financial instrument), not the timing of an expense allowance. Expenses, though, present similar issues of timing. See Joint Committee on Taxation, *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984* (JCS-41-84), December 31, 1984, pp. 258-269, for a detailed discussion of when an expense may be taken into account.

[33] Sec. 446(b).

[34] Sec. 451(a).

[35] Sec. 451. For examples of deferral opportunities, see sections 453 or 455, Treas. Reg. section 1.451-5, or Rev. Proc. 2004-34, 2004-1 C.B. 991.

[36] See also section 83 which provides special rules for property, including stock and options, transferred in connection with the performance of services.

[37] For example, amounts withdrawn from pension accounts during retirement (and included in income when withdrawn) often relate to services that the employee performed at an earlier time. See, *e.g.*, sections 401, 402, 403.

income from instruments with fixed returns (such as bonds) is taxed annually, while income from instruments with contingent returns (such as stock) is taxed on a wait-and-see (open transaction) basis.[38]

Income is recognized for most financial instruments on a wait-and-see basis whereby the execution of the contract has no immediate income tax consequences. Instead, the taxpayer includes amounts in income when they are "realized." For example, although a taxpayer has income in an economic sense when the price of a share of stock that the taxpayer owns increases, the taxpayer does not have taxable income from that price appreciation until there is a realization event in respect of the stock – that is, until the taxpayer sells the stock.[39] As is described in more detail in section III.A. below, income from an option or a forward or futures contract is also generally taxed on a realization basis. As with stock, the returns on these derivative financial instruments are contingent. However, if the option or forward or futures contract is subject to section 1256 (discussed in section IV.E.1. below), the income may be included at an earlier time.

As with most areas of the Federal tax code, there are exceptions to the general realization rules. One such exception relates to interest from a bond. For example, just as an individual is taxed on interest income that the individual receives from holding a bond (an instrument that provides fixed returns), taxpayers are taxed under the original issue discount ("OID") rules on interest that is deemed to accrue each year on a bond that pays no interest (a zero-coupon bond) until the maturity date.[40]

Another such exception requires gains or losses from financial instruments to be recognized in advance of when the contract would otherwise dictate (*i.e.*, when the amounts are realized). Mark-to-market is the most common tax accounting method requiring early recognition.[41] This departure from the normal realization-based tax accounting principles requires certain types of taxpayers (*e.g.*, dealers) with certain types of contracts (*e.g.*, regulated futures contracts or foreign currency contracts) to recognize the gain or loss with respect to those unsettled financial contracts as if the transactions were completed on the last day of the tax year, if not more frequently.

Similarly, in certain instances, amounts are required to be included in income upon execution of the contract. For example, shares of stock traded in an OTC market or on an exchange are considered purchased or sold on the date that the taxpayer enters into a binding contract to buy or sell the stock ("trade date") even if the stock is transferred on another date

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[38] See, Alvin C. Warren, Jr., "Financial Contract Innovation and Income Tax Policy," *Harvard Law Review*, vol. 107, p. 465. Warren argues that the different taxation of fixed returns and contingent returns is unworkable when financial instruments offer both kinds of returns. For a discussion of this difficulty, see section III.B. below

[39] For the rule codifying the realization principle, see section 1001.

[40] Discussed in more detail in section IV.B.1 below. See also sections 1271-1275.

[41] See secs. 475 and 1256. These mark-to-market rules supersede the fixed-versus-contingent return distinction.

("settlement date"). Accordingly, revenue is recognized and amounts are included in the taxpayer's income on the trade date.[42] Conversely, there are other instances where gains or losses from financial instruments are allowed to be deferred even though the underlying contract is complete.[43] More detailed discussions of the effect of timing on financial instruments are included in sections III and IV below.

[42] For both cash and accrual taxpayers, section 453(k) provides that the recognition of gain or loss on an exchange takes place on the trade date. See also Rev. Rul. 93-84, 1993-2 C.B. 225.

[43] See, *e g*, secs. 1043 (conflict of interest) and 1044 (qualified small businesses).

B. Character of Income Rules

In general

The characterization of income, gain, or loss as ordinary or capital is another significant income tax principle in calculating income tax liability. While a dollar of income is just that, a dollar, whether it is from, for example, the performance of services (*e.g.*, wages), the trading of a financial instrument (*e.g.*, stock), or the sale of an asset (*e.g.*, depreciable property) affects the rate at which the income is taxed and the amount of losses that may be taken as a current deduction. The tax rules distinguish between ordinary and capital income. Thus, the characterization of the gains or losses derived from the sale, exchange, or disposition of a financial instrument can affect the amount of a taxpayer's tax liability.[44]

In general, gains considered ordinary in nature are taxed at the taxpayer's marginal tax rate for the year such amounts are included in income. Conversely, the amount of ordinary losses in excess of ordinary gains that can be taken into account by a taxpayer in any given year may be limited due to a taxpayer's filing status (*e.g.*, individual or corporation).[45] Capital gains, on the other hand, may be taxed at a lower rate for certain taxpayers.[46] Similar to ordinary losses, the deduction for capital losses in excess of capital gains may be limited in any given year.[47] While a dollar of income is a dollar of income regardless of the origin, there is a distinction between capital and ordinary income for tax purposes.[48]

Capital gain treatment

Capital gains and losses result when a capital asset is sold, exchanged, or disposed. In general, a capital asset is defined as property held by a taxpayer other than: (1) inventory; (2) property subject to the allowance for depreciation, including real property;[49] (3) a copyright, a

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[44] The computation of taxpayer's gain or loss from the sale of a financial instrument is not discussed in detail. As with most other sales of property, section 1001 provides that gain or loss from the sale of most financial instruments is measured by the difference between the seller's basis and the amount of money plus the fair market value of property (if any) received. The seller's basis usually consists of the amount paid for the stock (adjusted to take into account any distributions of capital, stock dividends, etc.) plus capitalized costs of acquisition (primarily brokers' commissions).

[45] See, for example, section 469 regarding passive activity loss limitations for an individual But, also see section 165 for treatment losses of a corporation.

[46] See section 1(h) for capital gains tax rates for individuals

[47] See section 1211 for capital loss limitations.

[48] This distinction between capital and ordinary income might be justified in promoting certain nontax policy goals, such as saving or investment.

[49] However, section 1231 provides that to the extent gains from the sale, exchange, or involuntary conversion of property used in the taxpayer's trade or business exceeds losses from similar property, such gains and losses shall be treated as long-term capital gains and long-term capital losses. Section 1231 specifically excludes inventory and property held primarily for sale in the ordinary course from the definition of property used in the taxpayer's trade or business for purposes of this section.

literary, musical, or artistic composition, a letter or memorandum, or similar property held by the taxpayer;[50] (4) accounts or notes receivables acquired in the ordinary course of business (*e.g.*, for providing services or selling property); (5) a publication of the U.S. government other than that which is held for sale by the U.S. government; (6) any commodities derivative financial instrument held by a commodities dealer unless clearly identified as a capital asset; (7) any hedging transaction clearly identified as such; or (8) supplies of a type regularly consumed in the taxpayer's ordinary course of business.[51] Further, gains or losses attributable to the cancellation, lapse, expiration, or other termination of a right or obligation with respect to a capital asset would be characterized as capital in nature.[52]

Short-term versus long-term

Once it is determined that gain or loss from the sale of property is capital gain or loss, it is necessary to determine whether such gain or loss is short- or long-term determined in reference to the holding period.[53] In general, short-term capital gains and losses are those related to the sale, exchange, or disposition of a capital asset held by the taxpayer for not more than one year.[54] Conversely, long-term capital gains and losses are those derived from the sale, exchange, or disposition of a capital asset held by the taxpayer for more than one year.[55] However, there are exceptions to the general rules regarding classification of capital gains and losses as short or long-term.[56]

The classification of gains and losses as short- or long-term may result in more favorable tax treatment since short and long-term gains must be netted with their respective short- or long-term losses for any given tax year.[57] Further, the tax rates for capital gains may be lower than the tax rates on ordinary income. For example, the tax rate for long-term capital gains derived

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[50] This includes a letter, memorandum, or similar property held by a taxpayer for whom such property was prepared or produced.

[51] Sec. 1221(a).

[52] Sec. 1234A. Specifically excluded from the above definition of right or obligation are securities futures contracts defined in 1234B. Further, section 1256 contracts are excluded from the capital treatment afforded in section 1234A.

[53] Sec. 1223(a) and Treas. Reg. sec. 1.1223-1(a). See also section 1234A.

[54] Sec. 1222(1) and (2).

[55] Sec. 1222(3) and (4).

[56] See sections 475 (mark-to-market), 1233 (discussed in section C of part IV below) and 1256 (discussed in section E of part IV below).

[57] See section 1(h).

from the sale by an individual of a financial instrument could be 10 to 20 percentage points less than a taxpayer's individual tax rate on ordinary income.[58]

Capital loss limitation

To the extent capital losses exceed capital gains in any given tax year, a taxpayer's entity choice may result in limiting the amount of losses that can be claimed by the taxpayer. In general, corporations may only claim capital losses to the extent of such gains.[59] All other taxpayers may claim capital losses up to $3,000 in excess of capital gains for such taxable year.[60]

Ordinary income

Amounts not otherwise determined to be capital in nature are generally included as ordinary income and taxed at the applicable rates. This includes amounts earned by dealers, interest, dividends, as well as amounts earned from property held by a taxpayer that is specifically excluded from the definition of a capital asset. While dividends are considered ordinary income, qualifying dividends are taxed at capital gains rates for the 2003-2012 tax years.[61] Further, as with the rules regarding capital treatment, there are exceptions to the general rules that dictate ordinary income treatment.[62]

[58] See section 1(h)(1) for graduated capital gains rate information.

[59] Sec. 1211(a). A corporation with net capital losses for any taxable year may be eligible to carry such losses back three years and forward 10 years. See section 1212(a).

[60] Sec. 1211(b). Taxpayers other than a corporation may carryover their net capital losses to future years until the loss is used. The character of the loss (as either short or long-term) also is retained. See section 1212(b).

[61] See section 1(h)(11).

[62] See, *e g* , section 1221 (hedging transactions).

C. Source of Income Rules

When a resident of one country derives income connected with activities or investment in another country, the income could be subject to tax in both countries. U.S. law and other countries' tax laws include provisions intended to relieve this double taxation. These provisions include rules for determining whether an item of income has a domestic or a foreign source. In the United States these source-of-income rules affect U.S. and foreign taxpayers differently. The U.S. source rules matter for foreign taxpayers because the United States generally imposes tax only on the U.S.-source income of foreign taxpayers. The U.S. source rules matter for U.S. taxpayers because, although U.S. taxpayers are subject to U.S. tax on both U.S.-source and foreign-source income, the foreign tax credit, which mitigates double taxation of a U.S. taxpayer's cross-border income by giving a credit against U.S. tax for foreign tax imposed on that income, is allowed to reduce only U.S. tax on foreign-source income. Consequently, both U.S. and foreign taxpayers generally prefer that income is treated as foreign source rather than as U.S. source.

The U.S. tax rules use different factors for determining the source of different categories of income, including the residence of the payor of the income, the residence of the recipient of the income, the location or place of use of the property that produces the income, and the location of the activities that produce the income. For example, interest and dividend income generally is sourced based on the residence of the taxpayer that pays the interest or dividend; rental income is sourced based on the location of the property producing the income; royalties for the use of patents and other intellectual property are sourced based on the place of use of the property; and compensation for personal services is sourced based on where the services are performed.[63] Subject to a number of exceptions, income from the sale of personal property is sourced based on the residence of the seller of the property.[64] There are a number of special source rules, including, for example, for transportation income, space and ocean activities income, and international communications income.[65]

The Code does not provide source rules for all types of income. In the absence of a source rule for a particular kind of income, courts have determined the source of that income by applying the rule for the type of income to which the disputed income is most closely analogous.[66]

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[63] Secs. 861(a)(1)-(4), 862(a)(1)-(4).

[64] Sec. 865(a). For exceptions from the general residence-based rule, see, for example, sections 861(a)(6), 862(a)(6), 863(b)(2), and 865(b) through (e), (for inventory property income, depreciable personal property income, contingent income from intangibles, and sales through offices or fixed places of business).

[65] Sec. 863(c)(2) (50-50 U.S.-foreign source rule for income from transportation beginning or ending in the United States); sec. 863(d)(1) (space or ocean activity income sourced based on residence of the recipient of the income); sec. 863(e)(1) (50-50 rule for international communications income of U.S. persons and general foreign-source rule for the same income of foreign persons).

[66] *Hunt v. Commissioner*, 90 T.C. 1289 (1988)

Disputes about the source of particular items of income arise regularly. Financial instruments may contribute to source disputes because their flexibility permits taxpayers to produce favorable source results by holding one instrument rather than another instrument with the same economic characteristics. Section IV.D below describes examples of source questions and their resolution (or lack of resolution).

III. INCOME TAX AND ACCOUNTING RULES AND ECONOMIC ANALYSIS RELATED TO FIVE FUNDAMENTAL FINANCIAL INSTRUMENTS

A. Income Tax Rules

1. Equity

In general

Stock is an instrument representing an equity or ownership interest in a corporation. In its purest form, stock is risk capital entirely subject to the fortunes of the corporate venture. Stock represents the capital of the corporation that is subject to the greatest risk (compared to debt capital). The holder of stock may receive a share of the corporation's profits in the form of dividends. Appreciation or depreciation in value of the corporation's business is reflected in the price of the stock. Stock may be acquired directly upon issuance by the corporation of the stock or in the market from another holder of the stock. Federal securities laws impose registration and other requirements on publicly traded stock. Applicable Federal and State laws permit multiple classes of corporate stock with differing rights.

A partnership interest represents the partner's equity or ownership interest in capital and profits of the partnership. Unlike a corporation, a partnership is not treated as separate taxable entity, but rather, is treated as a passthrough entity for Federal tax purposes.[67] A publicly traded partnership generally is treated as a corporation for Federal tax purposes, however.[68]

Because a partnership is a passthrough entity, it is not subject to entity-level tax. Rather, income earned by a partnership, whether distributed or not, is taxed to the partners, and distributions generally are tax-free to partners. Partnership interests may be acquired directly upon issuance by the partnership or from another partner. State laws provide for general partnerships, in which partners do not have limited liability for obligations of the partnership, and limited partnerships, in which limited partners have only limited liability for obligations of the partnership. State laws also provide for limited liability companies ("LLCs"), whose members typically have limited liability. LLCs generally are treated as partnerships for Federal tax purposes.[69]

Timing

Realization and recognition

The realization requirement generally applies throughout the Federal income tax law. The realization requirement provides that changes in the value of property are generally ignored

[67] Sec. 701

[68] Sec. 7704.

[69] An LLC is generally treated as a partnership for Federal tax purposes unless it elects to be treated as a corporation, and a single-member LLC may be disregarded as a separate entity. Treas. Reg sec. 301.7701-3.

for Federal income tax purposes until the occurrence of a taxable event such as sale or exchange of the property. Upon the occurrence of the taxable event, gain or loss with respect to the property is considered to have been realized. A sibling concept is that of recognition. Gain or loss generally is considered to be recognized, and is taken into account for Federal income tax purposes, when it is realized, unless a specific nonrecognition rule applies that defers or permanently excludes or disallows the gain or loss.[70]

Timing of gain and loss from stock

If an instrument is treated as stock for Federal income tax purposes, gain or loss with respect to the stock is recognized at the time of a taxable sale or exchange in accordance with the holder's method of accounting. Whether an exchange is a taxable event depends in part on the type of entity or person disposing of the stock, and the nature of the transaction.[71]

In otherwise taxable transactions, the wash sale rule defers the recognition of losses in situations involving sales and reacquisitions of stock.[72] More specifically, the wash sale rule disallows losses from the disposition of stock or securities if substantially identical stock or securities (or an option or contract to acquire such property) are acquired by the taxpayer during the period beginning 30 days before the date of sale and ending 30 days after the date of sale. Commodity futures are not treated as stock or securities for purposes of this rule. The basis of the substantially identical stock or securities is adjusted to take account of the disallowed loss. Similar rules apply to disallow any loss realized on the closing of a short sale of stock or securities if substantially identical stock or securities are sold (or a short sale, option or contract to sell is entered into) during the applicable period before and after the closing of the short sale.

Mark-to-market timing rules apply to dealers, and electively to traders, in securities. In the case of a dealer in securities, including stock, any security that is not inventory and that is held at year end is treated as if it were sold at year end at its fair market value.[73] An election for traders in securities provides that electing taxpayers recognize gain or loss on securities held in that connection as if the securities were sold at year end for fair market value.[74]

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[70] For a detailed analysis of the concepts of realization and recognition, see, for example, Daniel N. Shaviro, "An Efficiency Analysis of Realization and Recognition Rules Under the Federal Income Tax," *Tax Law Review*, vol. 48, p.1, 1992.

[71] For example, if the person disposing of the stock is a tax-exempt organization, gain or loss on the sale or exchange of stock is not recognized so long as the unrelated business income tax rules do not apply in the situation (secs. 501, 511-515). As another example, nonrecognition rules may apply when stock is exchanged in a transaction constituting a tax-free corporate reorganization (sec. 368) or in another type of corporate transaction to which nonrecognition is accorded such as in a contribution of property by persons in control or in a spinoff (secs. 351, 355)

[72] Sec. 1091.

[73] Sec 475

[74] Sec. 475(f)

Timing of dividends from stock

A dividend is generally includable in income when received, without regard to the method of accounting of the recipient.[75] No distinction is made between cash method and accrual method taxpayers for this purpose.[76]

Timing of gain or loss from sale or exchange of partnership interests

A partner that sells or exchanges its partnership interest recognizes gain or loss at the time determined under the partner's method of tax accounting. Thus, a partner who is an individual using the cash method of accounting generally takes account of gain or loss on receipt of the consideration. An accrual method partner (such as a corporate partner) takes account of gain or loss from sale or exchange of a partnership interest when received or accrued.

Timing of income or loss from partnership interests

A partner takes into account on its tax return its distributive share of separately stated partnership items and of the partnership's nonseparately stated taxable income or loss. In computing the taxable income of a partner, the inclusions are based on the income, gain, loss, deduction or credit of the partnership for the taxable year of the partnership ending within or with the taxable year of the partner.[77]

Character

Character of gain and loss from stock

Gain or loss recognized on the sale or exchange of stock held as a capital asset (*e.g.*, for investment) is generally capital gain or loss.[78]

Net capital gain of an individual is generally taxed at rates lower than those applicable to ordinary income. Net capital gain is the excess of the net long-term capital gain for the taxable year over the net short-term capital loss for the year. An individual holder of stock treats gain or loss as long-term, rather than short-term, if the stock is held for more than one year. Individual taxpayers may deduct capital losses against up to $3,000 of ordinary income in each year. Any remaining unused capital losses may be carried forward indefinitely to another taxable year.[79]

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[75] Treas. Reg. Sec. 1.301-(1)(b). In the case of amounts treated as corporate distributions under section 305, however, specific timing rules apply. Sec. 305(c).

[76] Dividends on stock (unlike interest on debt) are not deductible by the corporation paying the dividend, so the issue of matching the timing of the deduction of the payor and the income inclusion of the recipient generally does not arise for dividends

[77] Sec. 706.

[78] Sec. 1221.

[79] Secs. 1, 1211 and 1222.

A dealer in securities, including stock, however, must compute its income using the mark-to-market method of accounting.[80] Gain or loss taken into account under these provisions is generally treated as ordinary gain or loss.

Under the mark-to-market rules for dealers in securities, any security that is inventory must be included in inventory at its fair market value, and for any security that is not inventory and that is held at year end, gain or loss is recognized as if it were sold for its fair market value. There is an exception to mark-to-market treatment for any security identified as held for investment or not held for sale to customers (or a hedge of such a security). For this purpose, a dealer in securities is a person who (1) regularly purchases securities from or sells securities to customers in the ordinary course of a trade or business, or (2) regularly offers to enter into, assume, offset, assign or otherwise terminate positions in securities with customers in the ordinary course of a trade or business. For this purpose, a security is any stock in a corporation, any partnership or beneficial ownership interest in a widely held or publicly traded partnership or trust, any note, bond, debenture, or other evidence of indebtedness, an interest rate, currency, or equity notional principal contract, any evidence of an interest in, or a derivative financial instrument of any security described above, and certain positions identified as hedges of any of the above.[81]

Character of dividends from stock

Dividends are treated as ordinary income.[82]

Qualified dividends received by individuals are taxed at the same rates that apply to net capital gain, however, for taxable years beginning before 2013. Thus, for taxable years beginning before 2013, an individual's qualified dividend income is taxed at rates of zero and 15 percent. The zero-percent rate applies to qualified dividend income that otherwise would be taxed at a 10- or 15-percent rate (under the ordinary income rates applicable to individuals) if the special rates did not apply. Qualified dividend income generally includes dividends received from a domestic corporation.[83]

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[80] Sec. 475.

[81] Sec. 475(c).

[82] Under the rules of subchapter C of the Code, a dividend is a distribution from the earnings and profits of a corporation. Corporate distributions that exceed corporate earnings and profits are treated first as return of capital to the extent of the shareholder's basis, and then as capital gain to the extent the distribution exceeds basis. Secs. 301(c) and 316.

[83] Qualified dividend income also includes dividends received by an individual from a qualified foreign corporation, which includes a foreign corporation that is eligible for the benefits of a comprehensive income tax treaty with the United States that the Treasury Department determines to be satisfactory and that includes an exchange of information program. In addition, a foreign corporation is treated as a qualified foreign corporation for any dividend it pays with respect to stock that is readily tradable on an established securities market in the United States.

A corporate taxpayer may partially or fully deduct dividends received from a domestic corporation,[84] effectively reducing the rate of tax on the dividend income. The percentage of the allowable dividends received deduction depends on the percentage of the stock of the distributing corporation that the recipient corporation owns. Generally, the percentage is 100 percent for dividends received from a member of the same affiliated group (which generally requires ownership of at least 80 percent of the total voting power and total value of the stock of the corporation); the deduction percentage is 70 percent if the ownership percentage is less than 20 percent and the deduction percentage is 80 percent otherwise.[85]

Character of gain or loss from sale or exchange of partnership interests

Gain or loss from the sale or exchange of a partnership interest is generally capital gain or loss.[86] However, the amount of money and the fair market value of property received in the exchange that represent the partner's share of certain ordinary income-producing assets of the partnership give rise to ordinary income rather than capital gain.[87]

Character of income or loss from partnership interests

The character of partnership items passes through to the partners, as if the items of income, gain, or loss were realized directly by the partners.[88] Thus, for example, long-term capital gain of the partnership is treated as long-term capital gain in the hands of the partners.

A partner holding a partnership interest includes in income its distributive share (whether or not actually distributed) of partnership items of income and gain, including capital gain eligible for capital gain tax rates. A partner's basis in the partnership interest is increased by any amount of gain thus included and is decreased by losses. These basis adjustments prevent double taxation of partnership income to the partner, preserving the partnership's tax status as a passthrough entity. Money distributed to the partner by the partnership is taxed to the extent the amount exceeds the partner's basis in the partnership interest.

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[84] Sec. 243 *et seq.* Conceptually, dividends received by a corporation are retained in corporate solution; these amounts are taxed when distributed to noncorporate shareholders so the corporate-level tax is not paid repeatedly on the same income item.

[85] Secs. 243-246A provide rules and impose limitations with respect to the dividends received deduction. Additional limitations on the dividends received deduction apply under other provisions; for example, see the insurance company proration rules of secs. 805(a)(4) and 832(b)(5)(B)-(E).

[86] Sec. 741

[87] Sec. 751(a). These ordinary income-producing assets are unrealized receivables of the partnership or inventory items of the partnership.

[88] Sec. 702.

Source

Source of gain and loss from stock

Capital gain or loss from the sale or exchange of stock is generally sourced based on the residence of the taxpayer.[89] Thus, U.S. persons typically recognize U.S.-source gain or loss, and non-U.S. persons typically have foreign-source gain or loss. Exceptions to this residence-based source rule apply in the case of sales of stock of foreign affiliates and other foreign corporations; gain from such sales is sourced outside the United States.[90]

Source of dividends from stock

In general, dividend income is sourced based on the residence of the taxpayer that pays the dividend. Dividends from domestic corporations are generally U.S. source.[91] A pro rata portion of dividends from a foreign corporation are U.S. source, unless less than 25 percent of its gross income for the preceding three years is (or is treated as) effectively connected with the conduct of a trade or business within the United States and thus subject to U.S. income tax.[92]

Source of gain or loss from sale or exchange of partnership interests

In determining the source of gain or loss from the sale or exchange of a partnership interest, IRS administrative guidance has taken the approach of looking through the partnership interest to the partnership fixed place of business or assets. The IRS has concluded that a foreign partner's income from the sale of an interest in a partnership engaged in a U.S. business through a fixed place of business is U.S. source and that a U.S. resident partner's gain from the sale of an interest in a foreign partnership the sole activity of which is building and leasing an asset abroad is foreign source.[93]

Source of income or loss from a partnership interest

There is no single source rule for income paid or received by a partnership or by a partner of the partnership. Consequently, the source of partnership-related income depends on the nature of the income.

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[89] See sec. 865(a).

[90] Sec. 865(f) and (h).

[91] Sec. 861(a)(2)(A). For this purpose, a corporation electing under section 936 is not treated as a domestic corporation.

[92] Sec. 861(a)(2)(B). Additional special source rules apply to dividends paid by foreign corporations. See, for example, section 861(a)(1)(C) and (D).

[93] Priv. Ltr. Rul. 9142032 (July 23, 1991); Rev. Rul. 91-32, 1991-1 C.B. 107 See secs. 865(e) and (i) and sec. 875(1).

For example, there are specific source rules for a partnership's income from the sale of personal property, for interest paid by a foreign partnership, and for income from services performed by a partnership. Although the residence of the partnership (as opposed to the residence of the partners) may determine the source of partnership income that is of a type sourced by reference to the residence of the recipient of the income, the source of income from a partnership's sale of personal property is generally determined by applying the applicable section 865 source rule at the partner level.[94] Interest paid by a foreign partnership is U.S.-source income only if the interest is paid by a U.S. trade or business conducted by the partnership or is allocable to income that is effectively connected with the conduct of a U.S. trade or business.[95] A partnership's compensation for services is U.S. source to the extent the compensation is attributable to labor or personal services performed in the United States, as determined on the basis that most correctly reflects the proper source of the income under the facts and circumstances, typically apportionment on a time basis.[96]

2. Debt

In general

In its purest form, debt is an unqualified promise to pay a sum certain on a specified date with fixed interest. The holder of debt is a lender and is normally entitled to repayment of the amount loaned. The debt holder receives compensation for the use of money in the form of interest. Appreciation or depreciation in the value of the debt arises from changes in prevailing interest rates and in the creditworthiness of the borrower.

A bond is an instrument representing a debt obligation. Corporate bonds represent the debt of a corporation. Bonds may be acquired directly from the issuing corporation upon issuance of the bond or in the market from another holder of the bond. Federal securities laws impose registration and other requirements on publicly traded bonds. Applicable Federal and State laws permit multiple classes of corporate debt with differing rights.

Timing

Gain and loss from bonds

If an instrument is treated as corporate debt for Federal income tax purposes, such as a bond, gain or loss with respect to the bond is recognized at the time of a taxable sale or exchange in accordance with the taxpayer's method of tax accounting. Issuance and repayment of the debt are generally not treated as taxable events. As is the case with corporate stock,[97] whether an

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[94] Sec. 865(i).

[95] Sec 861(a)(1)(B).

[96] Treas. Reg. sec. 1.861-4(b)(1)(i). This rule also applies to services performed by other entities such as corporations.

[97] The person disposing of the bond may be a tax-exempt organization or a foreign person not subject to U.S. tax on the transaction. Under nonrecognition rules permitting the tax-free exchange of securities for securities

exchange is a taxable event depends in part on the type of entity or person disposing of the bond, and the nature of the transaction.

Interest on bonds

Interest income is generally includable when received (in the case of taxpayers using the cash method of accounting, which includes almost all individuals) or when accrued (in the case of accrual method taxpayers). Interest on tax-exempt bonds, however, is not includable in income.[98]

The holder of a debt instrument with OID generally accrues OID over the life of the obligation.[99] This OID timing rule applies even though the includable amount of interest may not be received until the subsequent maturity of the instrument. The amount of OID with respect to a debt instrument is the excess of the stated redemption price at maturity over the issue price of the debt instrument. The amount of OID with respect to a debt instrument is allocated over the life of the instrument through a series of adjustments to the issue price for each accrual period.

Statutory limitations on the deductibility of interest expense apply in some cases in which an immediate deduction would produce a mismatching of income and expense. If the full interest deduction is not permitted on a current basis, the deduction may be disallowed, deferred until a later time, or required to be capitalized into the basis of related property. For example, section 263A generally denies a current deduction for costs incurred in manufacturing or constructing tangible property, requiring that such costs be capitalized. Section 263(g) requires taxpayers to capitalize certain otherwise deductible expenditures, including interest expense, that are allocable to personal property that is part of a straddle.[100]

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in a corporate reorganization (sec. 368), a bond with a maturity of at least five years is generally considered a security for this purpose.

[98] Sec. 103. The outstanding market value of municipal securities as of the end of 2010 is $2.9 trillion, as shown in Table A-1 in the appendix to this document.

[99] Sec. 1272.

[100] These limitations are discussed in more detail in Joint Committee on Taxation, *Present Law and Background Relating to Tax Treatment of Business Debt* (JCX-41-11), July 11, 2011

Character

Character of gain and loss from bonds

Gain or loss recognized on the sale or exchange of a bond held as a capital asset (*e.g.*, for investment) is generally capital gain or loss.[101]

Character of interest on bonds

Interest is treated as ordinary income.

Source

Source of gain and loss on bonds

Gain or loss from the sale or exchange of a debt instrument is generally sourced based on the residence of the taxpayer.[102] Thus, U.S. persons typically recognize U.S.-source gain or loss, and non-U.S. persons typically have foreign-source gain or loss, on the sale or exchange of a debt instrument.

Source of interest on bonds

In general, interest income is sourced based on the residence of the person that pays the interest. Interest on interest-bearing obligations (such as bonds) of domestic corporations is sourced in the United States.[103] Interest on deposits with a foreign commercial banking branch of domestic corporation, however, is treated as foreign-sourced.[104]

3. Options

In general

An option is a contract between two parties that gives the holder of the option the right, but not the obligation, to buy from, or sell to, the counterparty a specified amount of property at a fixed price (the "strike price") at a specified time. The party with the choice to buy (or sell) the underlying property is commonly referred to as the "holder" or "buyer" of the option. The party with the matching obligation to sell (or buy) the underlying property is commonly referred to as the "writer," "seller," or "issuer" of the option. A contract giving the holder the option to buy something is referred to as a call option (or a "call").[105] A contract giving the holder the option

[101] Sec. 1221.

[102] See sec. 865(a).

[103] Sec. 861(a)(1). This rule was amended in 2010 to strike the 80-percent foreign business test. See Pub. L. No. 111-226, sec. 217.

[104] Sec. 861(a)(1)(A).

[105] A "warrant" is a call option that is written by a corporation on its own stock.

to sell something is referred to as a put option (or a "put"). An option can specify a particular date for performance (a "European-style option") or can allow for performance at any time during a specified period of time (an "American-style option").

The option buyer pays the writer a premium for the option. Traditionally, most options are structured with prepaid premiums. That is, the holder pays the option premium at the inception of the contract.

The amount of the premium varies with the strike price, the term of the option, the volatility of trading prices for the underlying asset, cash flow generated by the underlying asset (if any), and interest rates. Very generally, in the case of a call option to buy stock, the premium increases as the strike price decreases, the term of the option is set longer, or the trading price of the underlying stock becomes more volatile. Options may be physically settled, meaning the underlying asset is delivered at settlement, or net cash settled, meaning that one party pays cash at settlement equal to the difference between the strike price of the option and the value of the underlying asset.

A call option can represent the purchaser's expectation that the value of the underlying asset will increase (and the writer's expectation that the price of the underlying asset will fall or, alternatively, that it will not rise to the level of the strike price).

Example 1.–European-style, net cash-settled call option. Party A purchases a European-style, net cash-settled call option on a single share of XYZ stock from Party B (the issuer) on December 1, 2011, when XYZ is trading at $100 per share. To purchase the option, Party A pays a nonrefundable premium to Party B. The option requires Party B to pay Party A the amount (if any) by which the market price of XYZ on the settlement date exceeds $110. Suppose the value of XYZ stock on the settlement date is $150. Party B pays Party A $40. Conversely, if the value of XYZ is $105 on the settlement date, the option expires unexercised.

A put option can represent the purchaser's expectation that the price of the underlying asset will fall (and the writer's expectation that the price of the underlying asset will increase or, alternatively, that it will not fall to the level of the strike price).

Example 2.–European-style, physically-settled put option. Party A purchases a physically settled, European-style put option on a single share of XYZ stock from Party B (the issuer) on December 1, 2011, when XYZ stock is trading at $100 per share. The option gives Party A the right (but not the obligation) to sell one share of XYZ stock to Party B on December 31, 2012, for $100.[106] If the price of a share of XYZ is below $100 on the settlement date, Party A exercises the option and requires Party B to buy the XYZ share for $100. However, if the price of XYZ stock increases, Party A will not exercise the option because he could obtain a better price selling the stock in the market. The option therefore expires and Party B profits to the extent of the premium Party A paid. For example, assume that on the settlement date the price of one share of XYZ is $90. Party A exercises his option and requires Party B to purchase

[106] This option is referred to as an "at-the-money" put option; that is, one where the strike price equals the market price for XYZ stock at inception.

a share for $100. Since Party A can acquire a share in the market for $90 and immediately sell it to Party B for $100, Party A profits by $10 (less the amount of option premium that Party A paid to Party B).[107]

Timing

In general, gain or loss from options on stock is recognized on an open transaction basis. The option holder capitalizes the cost of the option premium, and the option writer does not immediately include it in income.[108] Instead, the amount of gain or loss is determined at the time of a subsequent recognition event, that is, when the option is exercised or sold or when it expires unexercised.[109]

For instance, the purchaser of a cash-settled call option determines gain or loss at the time the option is exercised by subtracting the option premium from the amount (if any) received from the writer of the option. In contrast, if the same option were physically settled, recognition of gain or loss for the holder is deferred until the acquired underlying asset is itself sold or exchanged. The premium paid to acquire the option is added to the basis of the acquired underlying asset (along with the strike price) at the time of exercise.[110] For the writer of a call option, the premium is taken into income at the time the option is exercised or expires.

Special rules apply to options that qualify as section 1256 contracts.[111] These include options on broad-based equity indices (such as an option on the S&P 500 index). In general,

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[107] Party A could take a similar position by "shorting" XYZ stock. Party A would establish a short sale by borrowing one share from a broker and selling it into the market. To close his short position, Party A delivers a share of the stock to the broker (which may be worth more or less than the amount Party A received when Party A sold the share short). If the price of the stock falls, Party A can close the short sale by purchasing stock in the market for less than the price at which it previously sold the borrowed shares. If the stock price rises, Party A spends more to close the short position than it obtained by selling the stock short. In a "naked" short sale, the investor sells shares short without first having borrowed them. In that case, the short seller must go into the market and acquire shares to deliver at settlement (generally three days following the trade date). Failure to obtain replacement shares can result in a "failure to deliver." SEC Rule 204 of Regulation SHO under the Securities and Exchange Act of 1934 requires broker-dealers to promptly borrow or purchase securities to deliver on a short sale. The down side risk of a put option is limited to the premium paid. In contrast, a short position has a potentially unlimited down side risk because there is no limit to how much the price of shorted stock might increase. For this reason, a put option may be a more attractive financial instrument for some investors.

[108] See Rev. Rul 78-182, 1978-1 C.B. 265.

[109] *Ibid.*

[110] *Ibid.*

[111] A "section 1256 contract" is any (1) regulated futures contract, (2) foreign currency contract, (3) nonequity option, (4) dealer equity option, and (5) dealer securities futures contract. Sec. 1256(b)(1). The term does not include (1) any securities futures contract or option on such a contract unless such contract or option is a dealer securities futures contract, or (2) any interest rate swap, currency swap, basis swap, interest rate cap, interest rate floor, commodity swap, equity swap, equity index swap, credit default swap, or similar agreement Sec. 1256(b)(2) The special rules for section 1256 contracts are discussed in greater detail in section IV.E.1. below.

section 1256 requires taxpayers to treat each section 1256 contract as if it were sold (and repurchased) for its fair market value on the last day of the year (*i.e.*, "marked to market"). Any gain or loss with respect to a section 1256 contract that is subject to the mark-to-market rule is treated as short-term capital gain or loss to the extent of 40 percent of the gain or loss, and long-term capital gain or loss to the extent of the remaining 60 percent of the gain or loss (the "60/40 rule").

Character

Gain or loss attributable to the sale or exchange of an option, or loss attributable to failure to exercise an option by the purchaser of an option, is considered to have the same character as the property to which the option relates in the hands of the option purchaser (or would have if acquired by the purchaser).[112] Thus, in the case of a purchaser of an option on publicly traded stock as an investment, gain or loss is capital. Different results are obtained if the purchaser is a dealer in securities, a taxpayer uses the option as a hedging contract, or a corporation purchases an option on its own stock. In the case of an option writer, gain or loss from delivery is typically capital (unless the option is granted in the ordinary course of the taxpayer's business). That gain or loss may be affected by the straddle rules of section 1092.[113]

For the writer of an option, gain or loss from the termination of the option (other than through delivery of the underlying asset), and any gain on a lapse of the option typically is treated as short-term capital gain or loss, regardless of the term of the contract.[114]

Source

The Code does not provide rules for the source of income from trading in options (including, for example, income from the lapse of an option or gain or loss from the sale of an option). Instead, as part of a broad revision to the source rules in 1986, Congress directed the Secretary of the Treasury to prescribe necessary or appropriate regulations applying the source rules for personal property sales to income derived from trading in futures contracts, forward contracts, options contracts, and other instruments.[115] Treasury has not yet issued such regulations. In the absence of rules addressing the source of income from trading in options, the source of this income is generally determined by analogy to existing source rules for income from sales of personal property. Under section 865, income from the sale of personal property is generally sourced based on the residence of the taxpayer, but there are many exceptions to that general rule, including for sales of inventory property and for sales attributable to a U.S. or foreign office or other fixed place of business.

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[112] Sec. 1234.

[113] The rules of section 1092 are discussed below.

[114] Sec. 1234(b)(1).

[115] Sec. 865(j).

4. Forward contracts

In general

A forward contract is a bilateral executory contract pursuant to which the forward buyer agrees to purchase from the forward seller a fixed quantity of property at a fixed price (the "forward price") on a fixed future date (the "delivery date"). In a traditional, postpaid forward contract, neither party to the contract makes a payment at the time the contract is executed; payment and delivery occur on the fixed future date.[116] A prepaid forward contract requires the forward buyer to pay the forward seller the forward price (discounted to present value on the date of the payment) at the time the parties enter into the contract.[117]

A forward contract can represent the forward buyer's expectation that the price of the underlying property will increase and the forward seller's expectation that the price will fall. Like options, forward contracts can be physically settled (settlement by delivery of the underlying asset) or net cash settled (settlement by a payment in cash equal to the difference between the contract price and the then-current price at the time the contract expires) or either, at the option of one of the parties.

A futures contract is a forward contract that is standardized and traded on an organized futures exchange, such as the Chicago Mercantile Exchange. The exchange acts as the counterparty to every transaction. As a result, every trade on the futures exchange effectively results in two contracts: one between the forward buyer and the exchange, and the other between the forward seller and the exchange. The parties to a futures contract post variation margin, an amount adjusted daily to reflect the extent to which the position of a futures contract buyer or seller is "in the money" (*i.e.*, has an unrealized profit) or "out of the money" (*i.e.*, has an unrealized loss).

Example 3.–Net cash-settled, forward contract. On December 1, 2011, when XYZ stock is trading at $100 per share, Party A, the forward seller, enters into a net cash-settled forward contract with Party B, the forward buyer, for the forward sale of one share of XYZ stock at a forward price of $106 on December 31, 2012. If the price of XYZ stock on the settlement date is above the forward price, the contract requires Party A to pay Party B the excess of the market price over $106. If the price is below $106 on December 31, 2012, Party B is required to pay Party A the amount by which $106 exceeds the market price.

Current prices of forward and futures contracts and current prices of underlying assets provide similar information about expectations of future prices. Under standard arbitrage theory,

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[116] Although payment of the forward purchase price is not made, the parties may make arrangements for the posting of collateral.

[117] Prepaid forward contracts were relatively uncommon in the markets until the development of publicly traded forward (not futures) contracts some 20 years ago. See, *e.g.*, Douglas H. Walter and Stephanie E. Balcerzak, "Innovative Transactions: Salomon Phibro Crude Oil Trust," vol. 69 *Taxes* (July 1991), p. 416 (describing the offering of a five-year, oil-based prepaid forward contract by Salomon Brothers and its subsidiary, Phibro Energy, Inc.).

the price under a traditional forward or futures contract for a nonperishable, storable commodity (gold, for example) or a traded financial instrument is determined by the item's current spot price at the time the contract is executed, plus the cost to carry the item for the term of the contract (a time value of money return on the cash that would be invested in acquiring the item at execution of the contract and holding it until the final delivery date, together with any warehousing or similar expenses), minus the expected cash yield on the item (for example, expected dividends if the item is corporate stock) over the term of the contract.[118] For example, if one share of stock in Company XYZ costs $100 today, the one-year interest rate is six percent, and XYZ is expected to pay $4 per share in dividends over the coming year, the one-year forward price of one share of XYZ stock would be $102 ($100 plus six percent interest minus $4 yield). If XYZ stock paid no dividend (or instead XYZ stock was a precious metal or foreign currency), the forward price would be $106, reflecting the time value of money.[119]

In each case, the forward price reflects the current spot price, plus the cost to carry, minus projected cash returns over the contract term. If forward prices were higher than that predicted by this model, then arbitrageurs could earn riskless profits by buying the property today with borrowed funds and selling it forward for more than the net cost of the financing and storage. If forward prices were lower, arbitrageurs would sell the property short today, invest the cash proceeds at current interest rates, and buy the property forward to later close the short sale.

Example 4.–Prepaid forward contract. Assume the forward price under a traditional (postpaid) forward contract for one share of XYZ stock on December 31, 2012, is $106. Assume XYZ today does not pay dividends and XYZ stock today trades at $100 per share. On December 1, 2011, Party A and Party B enter into a net cash-settled, prepaid forward contract. Party B, the forward buyer, pays Party A $100 (which is both the current trading price of XYZ stock and the present value on December 1, 2011, of a $106 payment on December 31, 2012). On the settlement date, Party A pays Party B the value of XYZ stock on that date.

Both a traditional postpaid forward contract and a prepaid forward contract afford the buyer the economic return on the asset underlying the contract. If the underlying asset has a current cash yield, then the seller in a prepaid forward contract passes that expected yield to the buyer in the forward price. If the underlying asset does not have a current cash yield (like the share of XYZ stock that does not pay dividends), then the forward price reflects only the spot price of the asset plus any warehousing or similar expenses, and the transaction is similar to a current cash sale.

The forward buyer in a prepaid forward contract pays for the item at the outset. In contrast with a traditional postpaid forward contract, the seller of a prepaid forward contract has use of the buyer's money during the term of the prepaid forward contract. The amount paid to the buyer at settlement thus includes compensation to the buyer for the time value of money. In Example 4, if the price of XYZ stock on December 31, 2012, is $110, Party A pays Party B

[118] Storage of physical assets such as gold (in a vault) or wheat (in a silo) involves actual storage cost; the storage cost for financial assets like stock or Treasury bills is generally expected to be *de minimis*.

[119] These examples ignore storage costs and minor timing differences in the cash flows.

$110, $6 of which compensates Party B for the use of $100 during the term of the contract. If Party B had invested the $100 at prevailing interest rates on December 1, 2011, he would have had $106 on December 31, 2012. The additional $4 that Party A pays Party B represents the additional return on XYZ stock relative to prevailing interest rates.

Timing

The execution of a forward contract generally has no immediate income tax consequences. Like an option, a standard forward contract is an executory contract and is treated as an open transaction until the contract is settled. If a forward contract is settled by delivery of the property underlying the contract, the taxpayer delivering the property recognizes gain or loss based on the difference between the price received and the taxpayer's basis in the property.[120] The forward purchaser, by contrast, reflects the contract price as the basis for the property so acquired; gain or loss (if any) is deferred until the time of a subsequent sale or exchange of the property. The fact that a prepaid forward contract calls for payment by one party to the other party at the time the contract is executed has not been treated as changing the tax treatment of the contract.[121]

Futures contracts traded on futures exchanges are generally treated as "section 1256 contracts" and are subject to a mark-to-market regime and special character rules. As applied to equity futures contracts held by investors, the rules of section 1256 apply primarily to futures contracts on broad-based indices; single-stock futures contracts are governed by a different set of rules in section 1234B.[122] Different rules can apply to section 1256 contracts held as part of a hedging transaction or a mixed straddle.

Character

The character of the gain or loss with respect to a forward contract generally is the same as the character of the property delivered. If the underlying asset is delivered, the forward buyer does not immediately recognize gain or loss, but is treated as having purchased the property with a basis equal to the purchase price. The forward seller recognizes gain or loss equal to the difference between his basis and the forward price. The character of the forward seller's gain

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[120] Sec. 1001.

[121] *Cf* Rev. Rul. 2003-7, 2003-1 C.B. 363 (Feb. 3, 2003) (holding that a shareholder of a publicly traded corporation who entered a variable prepaid forward contract on such stock with an investment bank and pledged the maximum number of shares that might be required to be delivered was not considered to have sold or constructively sold the stock where the amount of stock to be delivered in the future varied significantly depending on the value of the shares on the delivery date, the taxpayer retained an unrestricted legal right to substitute cash or other shares for the pledged shares, and the taxpayer was not economically compelled to deliver the pledged shares).

[122] Section 1234B provides that gain or loss attributable to the sale, exchange, or termination of a securities futures contract shall be considered gain or loss from the sale or exchange of property which has the same character as the property to which the contract relates has (or would have) in the taxpayer's hands. Section 1234B also provides that gain or loss on a securities futures contract, if capital, is treated as short-term capital gain or loss

generally depends upon the character of the property delivered.[123] If a forward contract is settled by a cash payment, or is cancelled or otherwise terminated, the gain or loss is capital if the underlying asset is capital in nature.[124] If a forward contract is sold, the character of the gain or loss is generally capital if the forward contract is a capital asset in the hands of the selling taxpayer.

As mentioned above, certain traded futures contracts qualifying as section 1256 contracts are subject to a mark-to-market regime and special character rules. Capital gain or loss with respect to a section 1256 contract is treated as long-term capital gain or loss to the extent of 60 percent of the gain or loss and short-term capital gain or loss to the extent of 40 percent of the gain or loss, regardless of the investor's holding period. Different rules can apply to section 1256 contracts held as part of a hedging transaction or a mixed straddle.

Source

The Code does not provide rules for the source of income from trading in forward contracts (including for example, gain or loss from the sale of a forward contract). Instead, Congress directed the Treasury Secretary to prescribe necessary or appropriate regulations applying the source rules for personal property sales to income derived from trading in futures contracts, forward contracts, options contracts, and other instruments.[125] Treasury has not yet issued regulations. In the absence of rules addressing the source of income from trading in forward contracts, the source of this income is generally determined by analogy to existing source rules for income from sales of personal property. Under section 865, income from the sale of personal property is generally sourced based on the residence of the taxpayer, but there are many exceptions to that general rule, including for sales of inventory property and for sales attributable to a U.S. or foreign office or other fixed place of business.

5. Notional principal contracts

Treasury regulations define a NPC as a financial instrument that provides for the payment of amounts by one party to another party at specified intervals calculated by reference to a specified index upon a notional principal amount in exchange for specified consideration or a promise to pay similar amounts.[126] A specified index is defined as a fixed rate, price or amount that must be based on objective financial information not in control of either party. A notional principal amount is defined as a specified amount of money or property that, when multiplied by a specified index, measures a party's rights and obligations under the contract but is not borrowed or loaned between the parties. The regulations exclude certain instruments from the

[123] The character of gain or loss recognized by a forward seller may be affected by the tax straddle and short sale rules of sections 1092 and 1233, respectively.

[124] Sec. 1234A and Prop. Treas. Reg. sec. 1.1234A-1(c)(1).

[125] Sec 865(j)

[126] Treas. Reg. sec. 1.446-3(c)(1)(i). The definition of an NPC covers instruments commonly referred to as swaps, but that term is not defined in the Code.

definition of NPC including: (1) section 1256 contracts, (2) futures contracts, (3) forward contracts, (4) options, and (5) instruments or contracts that constitute indebtedness for Federal tax purposes.[127]

A traditional interest rate swap is an example of an NPC. Pursuant to such a swap, one party typically agrees to make payments to the other based on a fixed interest rate (*e.g.*, five percent) applied to a notional amount (*e.g.*, $1 million) at regular intervals (*e.g.*, quarterly for two years). In return, the other party agrees to make interest payments based on a variable, or floating, interest rate (*e.g.*, the London Interbank Offered Rate ("LIBOR")) applied to the same notional amount at the same intervals. The $1 million notional amount is used only to calculate the payments required by each party, and does not itself change hands. Amounts owed by the parties are typically netted, so that only a single payment is made on any given payment date.

A traditional interest rate swap can reflect one party's expectation that the payments of a floating interest rate will exceed a specified fixed interest rate (or vice versa) over the term of the contract. These contracts can be understood as the economic equivalent of back-to-back loans of the notional amount. Interest rate swaps can also be understood as a series of cash-settled forward contracts that have been leveled. For example, to replicate the swap, the two parties could enter a series of cash-settled forward contracts on short-term deposits, one paying the fixed rate of interest and the other paying the floating rate of interest. The parties would enter two cash-settled forward contracts for each quarter end.

Other swaps, like a total return swap, can be understood as the economic equivalent of making a 100-percent leveraged investment in the underlying asset. For example, an equity swap is a total return swap on a specified equity security.

Example 5.–Equity Swap. Party A agrees to make 10 payments to Party B on December 31 of each of the next 10 years, in an amount equal to the sum of: (1) the appreciation, if any, in value of 100 shares of XYZ stock during the year, and (2) dividends paid on 100 shares of XYZ stock during the year. Likewise, Party B agrees to make 10 identically timed payments to Party A, in an amount equal to the sum of: (1) the depreciation, if any, in value of 100 shares of XYZ during the year, and (2) a fixed (or floating) rate of interest multiplied by the value of 100 shares of XYZ stock at the beginning of the year. Since the payments are all due on the same day, the parties agree that all payments are netted, and only one party makes a net payment to the other.

Economically, this equity swap puts Party B in the same economic position as it would have been in if it bought XYZ stock at the inception of the swap contract from Party A with money borrowed from Party A, with an agreement to sell the stock back to Party A and repay the borrowing at the end of the 10-year period. Party B incurs the same costs (expressed as the interest on a notional principal amount), receives the same current returns (dividend-equivalent amounts), and is subject to the same market opportunities and risks (appreciation or depreciation

[127] On September 16, 2011, the Treasury Department promulgated proposed amendments to the income tax regulations under sections 1256 and 446 of the Code (Notice of Proposed Rule Making, Fed. Reg. Vol. 76, No. 180, p. 57684). The proposed amendments affect the scope of the term "section 1256 contract" and revise the scope of the notional principal contract regulations under section 446.

in the value of the stock). An equity swap and a leveraged purchase are not, however, identical in every respect. For example, the parties to an equity swap are exposed to the credit worthiness of their counterparties. The holder of an equity swap does not have any of the legal rights that attach to actual stock ownership such as the right to vote on corporate matters or the rights to corporate property upon liquidation. In addition, current securities laws limit leveraged margin purchases to 50 percent of the value of the underlying security.[128] The leverage implicit in an equity swap, however, is not subject to securities margin rules.

Both the interest rate swap and the equity swap described above are common derivative contracts, and both qualify as NPCs under Treasury regulations. Swaps are not, however, limited to interest rates or equities. The variety of possible swaps is limited only by the imagination and investment objectives of parties willing to enter such contracts.

Timing

Regulations promulgated under section 446 require that the parties to an NPC classify each payment pursuant to the contract as either: (i) a periodic payment; (ii) a nonperiodic payment; or (iii) a termination payment.[129] Each type of payment is treated differently. Taxpayers generally must recognize (as income or deduction, whichever is relevant) the ratable daily portions of all periodic and nonperiodic payments for the taxable year to which that payment relates, and must recognize a termination payment in the year the NPC is extinguished, assigned, or terminated (*i.e.*, in the year the payment is made).[130] A swap with a significant nonperiodic payment is treated as two separate transactions consisting of an on-market level payment swap and a loan. The loan must be accounted for independently of the swap. Under proposed regulations, contingent nonperiodic payments (such as a single payment tied to the increase or decrease in the value of the underlying asset) are accrued over the term of the swap based on an estimate of the amount of the payment.[131] The amount of a taxpayer's accrual is periodically redetermined as more information about the expected amount of the noncontingent payment becomes available.[132]

Character

Unlike the character of the income recognized from options and forwards, which typically is determined with reference to the character of gains and losses that result from a

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[128] See 12 C.F.R. 220 (Regulation T, establishing securities margin rules for securities brokers and dealers), 12 C.F.R. 221 (Regulation U, establishing securities margin rules for commercial banks that are not securities brokers or dealers), and 12 C.F.R 224 (Regulation X, establishing securities margin rules for loans not covered by Regulations T or U).

[129] Treas. Reg. sec. 1.446-3(e), (f) and (h).

[130] *Ibid.*

[131] See Prop. Treas. Reg sec. 1.446-3

[132] *Ibid.*

taxpayer's transactions with respect to the underlying asset, the character of NPC payments is generally not determined by the character of the underlying asset. Final Treasury regulations do not directly address the tax character of each type of payment made under an NPC. However, proposed Treasury regulations issued in 2004 under section 1234A provide that any payment on an NPC other than a termination payment (*i.e.*, a periodic or nonperiodic payment) generally constitutes ordinary income or expense.[133] The preamble to the proposed regulations explains that ordinary income is warranted because neither periodic nor nonperiodic payments involve the sale or exchange of a capital asset. In contrast, the proposed regulations provide that, by application of section 1234A, gain or loss attributable to the termination of a swap contract would be capital if the contract is a capital asset in the hands of the taxpayer.[134] The proposed regulations state that final settlement payments with respect to an NPC are not termination payments under section 1234A.[135]

Source

To the extent a payment is not otherwise treated as a dividend equivalent payment under section 871(m), income from an NPC is generally sourced by reference to the residence of the recipient, unless the income is effectively connected with a U.S. trade or business.[136] Consequently, a foreign person's income related to an NPC referencing stock of a U.S. corporation, including amounts attributable to dividends paid on the stock, is generally foreign source income and exempt from U.S. withholding tax.

Under special rules described in section IV.D. below, some payments to foreign persons on some NPCs are treated as U.S.-source dividend equivalent payments subject to U.S. withholding tax.

Summary Table

The following table summarizes the general rules with respect to timing, character, and source of income and gain or loss with respect to each of the foregoing types of instruments. Exceptions to the general rules apply in many instances, though these exceptions are not noted in the interest of brevity.

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[133] Prop. Treas. Reg. sec. 1.1234A-1.

[134] The proposed regulations would treat any payment on a "bullet swap" or forward contract, including payments made pursuant to the terms of the contract, as termination payments for purposes of Section 1234A. Both of these types of contracts provide for all payments to be made at or close to the maturity of the contract. Prop. Treas Reg. sec 1.1234A-1(c). More recent proposed amendments to the income tax regulations under sections 1256 and 446 call into question this analysis. Among other things, the proposed amendments treat the fixing of an amount as a "payment" for purposes of the definition of a notional principal contract, even if the actual payment reflecting that amount is to be made at a later date

[135] Prop Treas. Reg. sec. 1.1234A-1(b).

[136] Treas. Reg. sec. 1.863-7 The regulations provide exceptions for income earned through a U.S. branch and certain section 988 transactions.

Table 2.–Overview of Tax Rules for Certain Financial Instruments[1]

Instrument	Timing	Character	Source
Stock	Gain or loss deferred until taxable disposition Dividend income taken into account when received or accrued	Gain or loss long-term or short-term capital depending on holding period Dividend income ordinary (subject to long-term capital gains tax rate through 2012)[2]	Gain or loss on disposition generally taxpayer residence Dividend income generally residence of payor
Partnership interest	Gain or loss deferred until taxable disposition Partnership income taken into account in the partner's taxable year within or with which the partnership taxable year ends, regardless of whether or not distributed	Gain or loss on disposition capital except to the extent attributable to certain partnership ordinary income assets Character of partnership income determined at partnership level and passed through to partner	Gain or loss on disposition generally taxpayer residence (see discussion) Partnership income depends on nature of the income item
Debt	Gain or loss recognized at time of taxable sale or exchange Interest taken into account when received or accrued, OID accrues over life of instrument	Gain or loss on disposition capital Interest income ordinary	Gain or loss on disposition generally taxpayer residence Interest income generally residence of payor
Option	Deferred until settlement date or expiration	Capital based on sections 1234 and 1234A	See discussion
Forward Contract	Deferred until settlement date	Based on nature of underlying asset (usually capital)	See discussion
Exchange-traded futures and options	Marked to market at end of taxpayer's tax year	60 percent long-term capital and 40 percent short-term capital (unless otherwise ordinary) under section 1256, regardless of holding period	See discussion
NPC	Accrual of periodic and non-periodic payments. Gain or loss deferred until taxable disposition or early termination	Periodic and non-periodic payments generally ordinary income Termination payment capital based on section 1234A	Generally taxpayer residence on NPC income

[1] Table adapted from Stevie D. Conlon and Vincent P. Aquilino, *Principles of Financial Derivatives, U.S. and International Taxation*, Exhibit B1.1, p. B1-5 (2010). The table assumes the relevant asset is (or would be) held as a capital asset

[2] Corporate recipients of dividends may be eligible for a dividends received deduction.

B. Relationships Among Financial Instruments

The preceding discussion has described five basic financial instruments separately. However, there are relationships among the various financial instruments. Fundamentally, financial instruments facilitate transfers of cash or property with specific timing and risk characteristics at a particular price or expected return. Equity affords voting rights and risky returns subject to the fortunes of the venture. Debt is senior to equity in bankruptcy proceedings and typically involves the payment of a sum certain on a specified date (or dates) in the future. Basic options permit an investor to assume the risk of price movements in underlying assets in one direction or another. Forward contracts create an obligation to purchase property at a fixed price on a fixed future date. Swaps are flexible instruments that can be used to take on many different economic risk positions.

These basic financial instruments can be combined to replicate the economic returns of virtually any underlying asset or to create an economic profile that is unique. A total return swap, for example, achieves this directly through the specified terms of the contract. Similar results can be achieved, however, through combinations of other financial instruments. Forward contracts, option contracts, and swaps on a common underlying asset are all directly related to each other, and to the underlying asset that they reference. In practice, this close connection means that financial specialists can engineer one such contract from the others, or separate one component of an underlying asset's returns from the others, and sell those separate components to different taxpayers. Innovative financial instruments often represent new ways of combining characteristics of existing financial instruments, such as timing or risk, to achieve a different combination of the characteristics of existing products.

Financial equivalency

Forwards and options

A postpaid forward contract is economically equivalent to selling a European-style put option and purchasing a European-style call option where the strike prices are equal in both cases to the forward price. (This is the basis of "put-call parity," described below.) For example, if the forward price of a share of XYZ stock on December 31, 2012, is $106, a party selling a put with a $106 strike price and buying a call at the same strike price assumes the same risk as the forward buyer (Party B) in Example 3 (on page 36). In the case of the forward, if the price of XYZ stock on the settlement date is above the forward price, the contract requires Party A to pay Party B the excess of the market price over $106. If the price of the stock is below $106 on December 31, 2012, Party B is required to pay Party A the amount by which $106 exceeds the market price. Similarly, in the case of the options, if the price of XYZ stock is above $106 on December 31, 2012, the call option gives Party B a right to the upside in XYZ's stock price, and if the price is below $106, the put option will require Party B to pay the downside.

Similarly, a prepaid forward contract is economically equivalent to the sale of a put and the purchase of call at the forward price plus the acquisition of a zero-coupon bond (maturing on the delivery date) with a principal amount equal to the forward price. For example, the forward buyer (Party B) in Example 4 (on page 37) could purchase a zero-coupon bond from the prepaid forward seller (Party A) that pays an amount equal to the forward price ($106) on the delivery

date (rather than paying the same sum to the counterparty under the forward contract). Then, as discussed above, Party B could enter into offsetting puts and calls with Party A with a strike price equal to the forward price. The effect of purchasing the zero-coupon bond is the same as prepaying the forward price. Party B will not have to produce additional funds to pay Party A to exercise its call option (if the underlying asset increases in price) or satisfy its obligation on the put (if the underlying asset decreases in price).

Put-call parity

Consider the relationship between the price of a stock, a zero-coupon bond, a put option, and a call option. The relationship between European-style put and call options with the same strike prices and expiration dates is known as "put-call parity." This relationship is expressed algebraically in Equation 1 below.

$$S + P(K) = Z(K) + C(K) \qquad \text{(Equation 1)}$$

Where:

S is the value of a share of stock, which pays no dividends, on the expiration date of European-style put and call options (P and C);

P(K) is the value of an option to sell (put) S at a strike price of K on the expiration date;

Z(K) is a zero-coupon bond worth K on the expiration date of the options (P and C); and

C(K) is the value of an option to buy (call) S at a strike price of K on the expiration date.

One commentator has explained the relationship expressed by Equation 1 as follows:

> Intuitively, this relationship [among the values of the stock, the bond, and the options] makes sense, because an investor who holds both a share of stock and a put at a strike price of K . . . will at the date of exercise have assets worth S but no less than K, because he will exercise the put if S is less than K. Similarly, an investor who holds a zero[-coupon bond] that will pay K on the exercise date and a call at a strike price of K is guaranteed the value of K on that date; if S is then greater than K, she will exercise the call to receive stock with the value of S. If the stock plus a put must equal the zero[-coupon bond] plus a call on the exercise date, the two positions must also be equal in value before that date if there are competitive markets for each contract. Otherwise, arbitrageurs would sell the more expensive position and acquire the cheaper position to obtain a riskless windfall to the extent of the difference in value.[137]

[137] Alvin C. Warren, Jr.,"Financial Contract Innovation and Income Tax Policy," *Harvard Law Review*, vol. 107, 1993, pp. 460, 466

Using simple algebra, Equation 1 can be solved for S, showing the combination of instruments that capture the value of the stock. This is expressed algebraically as Equation 2 below.

$$S = Z(K) + C(K) - P(K) \qquad \text{(Equation 2)}$$

The value of the stock, S, on the expiration date of the options can be replicated by: (1) purchasing a zero-coupon bond that pays K (the strike price of the options) on the expiration date of the options, C and P; (2) purchasing a call option, C, on S at price K; and (3) writing a put option on S at price K (with the same expiration date as the options). If the value of S on the expiration date of the options is greater than K, the call option is exercised, increasing the return to the holder of the option/bond combination to the amount that would have been provided by ownership of S. If the value of S on the expiration date of the options is less than K, the put option is exercised by the counterparty, reducing the return to the holder of the option/bond combination to the amount that would have been provided by ownership of S.

Different treatment of economically equivalent portfolios

As noted above, derivatives can be used to replicate the cash returns of virtually any underlying asset. An investor may construct a portfolio of underlying securities and derivatives to achieve the desired combination of risk and return attributes related to the rights and obligations under the contracts and timing of cash flows. However, economically equivalent ownership of assets and derivatives may be treated differently for tax purposes. Differences in tax treatment of economically equivalent portfolios may allow taxpayers to some extent to elect the timing, character, and/or source of income for tax purposes that is most advantageous.[138]

For example, consider the tax treatment of the following economically equivalent portfolios. Portfolio A involves: (1) purchasing stock S; (2) writing a call option C on S at a strike price of K; (3) purchasing a put option P on S at a strike price of K. Portfolio B involves the purchase of a zero-coupon bond that pays K on the expiration date of the options in portfolio A. Assume that on the expiration date the price of S has risen. The investor sells S, satisfies the call option that is exercised against him by the counterparty, and allows the put option to expire. The values of these two portfolios on the expiration date of the options are equal. However, the tax treatment of the two portfolios differs.

Portfolio A affords the taxpayer deferral on any gain or loss on the sale of stock and on any change in the value of the options. The character of any income is capital.

Portfolio B requires the taxpayer to include in income annually OID on the zero-coupon bond. There is no deferral. Furthermore, the character of the income is ordinary.

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[138] David M. Schizer, "Sticks and Snakes: Derivatives and Curtailing Aggressive Tax Planning," *Southern California Law Review*, vol. 73, pp. 1339-1406, available at http://www-bcf.usc edu/~usclrev/pdf/073603 pdf.

Efficiency consequences

If two portfolios are economically equivalent in terms of risk, pretax return, rights, obligations and timing, an investor should be indifferent between the two. However, if different tax treatment of the two portfolios results in different after-tax returns, investors may alter the form of their portfolios to exploit this different treatment. Investors may expend additional resources on tax planning to achieve this result, representing an inefficient allocation of resources as they result in no additional pretax return.

Different tax treatment of otherwise economically equivalent transactions also creates opportunities for adverse selection by taxpayers against the fisc. That is, if taxpayers to some extent can choose their tax treatment, they are likely to choose arrangements that result in a lower combined tax bill for all parties involved in a transaction. As alternative investment portfolios become more readily accessible to retail investors and provide more opportunities for them to replicate various positions at lower costs, investors may gravitate towards tax-advantaged forms of investment, thus reducing overall tax revenues. To raise a given amount of revenue, the government may need to increase tax rates elsewhere. This could lead to efficiency losses in the economy if these taxes distort the decisions of taxpayers to work or invest.

Equity consequences

Different tax treatment also raises issues of horizontal and vertical equity. In the context of an income tax, horizontal equity means that taxpayers with similar incomes pay similar amounts of tax, while vertical equity means that taxpayers with higher incomes pay more in tax. Taxpayers with similar incomes from two portfolios that are treated differently for tax purposes may pay different amounts of tax. The taxpayer who holds portfolio A defers any gain and pays tax at preferential capital gains rates on that income. The taxpayer who holds portfolio B pays taxes currently at ordinary income tax rates. Deferral lowers the effective tax liability of the taxpayer with portfolio A relative to the taxpayer with portfolio B, even in the absence of any preferential capital gains tax rate.

To the extent that higher income taxpayers may have a greater ability to restructure portfolios in a tax advantageous manner, disparate treatment of economically similar portfolios may raise concerns about vertical equity as well. That is, taxpayers with higher economic income, who can more readily restructure their portfolios, may pay the same amount of tax as taxpayers with lower economic income, violating the principle that differently situated taxpayers should be treated differently.

C. Financial Accounting Treatment of Financial Instruments

1. In general

The main purpose of financial accounting is to prepare financial reports that provide information about a firm's financial position to external parties such as investors and creditors. Such information is intended to be useful in making economic decisions by providing information that reflects the underlying economics of a firm's transactions.

Holding or issuing debt or equity, or entering into derivative contracts, affect firms' financial reports under GAAP. The financial reporting rules for financial instruments determine whether a particular type of instrument should be recorded at historical cost or at fair value. Historical cost is a measure of value based on the nominal or original cost at the time of acquisition. Fair value is a measure of value based on current market prices at the financial statement date and is comparable to mark-to-market in the Code.[139] GAAP has adopted a set of rules for valuing financial instruments (including equity, debt, and derivatives) that contains elements of both the fair value and historical cost approaches, often referred to as the "mixed attribute" model. GAAP further distinguishes between gains and losses that are reported in earnings versus those that are recorded in shareholder's equity as other comprehensive income ("OCI").[140]

A firm's relationship to a financial instrument largely determines the valuation of that instrument for financial reporting purposes. Financial accounting treatment varies if a firm is a holder as opposed to an issuer of an instrument. Debt instruments that a firm holds receive different treatment depending on the firm's intention with respect to the holding period of the instrument. Equity instruments receive different treatment depending on whether the investment allows the firm to exert influence or control over the other entity. Derivative instruments are valued at fair value, but special treatment is provided for instruments designated as a hedge. Additional special rules apply to instruments with embedded derivatives and instruments containing characteristics of both debt and equity (hybrid instruments).

This section outlines the financial accounting consequences of holding and issuing debt and equity instruments and the consequences of entering into derivatives contracts. This discussion is followed by a description of special rules for hedging, derivatives embedded in other instruments, and hybrid instruments. This section concludes with a discussion of the major differences between the financial accounting and tax rules for financial instruments and the consequences of those differences on a firm's financial reports.

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[139] Under fair value accounting, financial instruments are valued at the estimated prices at which they could change hands in orderly transactions based on current information and conditions.

[140] OCI is recorded directly to the equity section of an entity's balance sheet and does not impact a firm's reported earnings or earnings per share.

2. Consequences of holding and issuing debt and equity

A firm's debt and equity instrument holdings are included in the asset section of the firm's balance sheet. The determination of whether debt or equity instruments are recorded at fair value or historical cost is made according to the type of instrument (debt or equity), the firm's proportional ownership share of any equity investment, and the firm's intent with respect to the holding period of the security. In addition, GAAP permits a firm to elect fair value measurement for a wide range of financial assets and liabilities where such treatment is not otherwise required.[141] Thus, fair value accounting is permitted for most financial instruments held by a firm.

When a firm issues debt or equity, the instrument is recorded in either the liabilities or the shareholders' equity portion of the balance sheet. The classification as either debt or equity affects earnings as well as various ratios that are important to creditors, regulators, and investors. The issuer of debt and equity instruments generally records the instrument at historical cost rather than fair value. The fair value election is generally available for debt instruments issued, but does not apply to equity instruments issued. In addition, the issuer must disclose the fair value of outstanding debt instruments in the footnotes to the financial statements.

Holding debt

A firm's intention regarding the holding period of a debt instrument determines its financial accounting treatment. GAAP provides different accounting treatment for three separate categories of debt instruments: held-to-maturity securities, trading securities, and available-for-sale securities.[142]

Debt instruments that a firm has the positive intent and the ability to hold to maturity (held-to-maturity securities) are valued at historical amortized cost, reduced by any other-than-temporary losses.[143] Other-than-temporary losses must be charged to earnings in the period in which the loss occurs. Thus, temporary unrealized gains and losses are not reported in the firm's earnings. By valuing debt instruments held for long-term investment at historical cost, firms

[141] ASC 825 - Financial Instruments. Eligible instruments include all recognized financial assets or liabilities except for investments in consolidated subsidiaries, interests in consolidated variable interest entities, assets or obligations relating to employee benefits, financial assets or liabilities relating to leases, demand deposit liabilities and financial instruments where all or part are classified as a component of equity by the issuer.

[142] ASC 320 - Investments (debt and equity). Examples of debt securities include bonds, convertible debt, collateralized mortgage obligations, preferred stock that must be redeemed, real estate mortgage investment conduits, and interest-only and principal-only strips. Examples of equity securities include common stock, preferred stock, warrants, and rights.

[143] The term "other-than-temporary" is designed to distinguish certain declines in value from those that are temporary. An impairment in value need not be considered permanent to be classified as other-than-temporary. ASC 320 provides many factors that must be considered in making a determination of whether a decline is temporary or not.

avoid earnings volatility related to temporary changes in the market value of debt instruments they intend to redeem for the full face amount at maturity.[144]

Debt instruments bought and held primarily for sale in the near term (trading securities)[145] are valued at fair value, and all unrealized holding gains and losses (both temporary and other-than-temporary) are included in earnings. Debt instruments that do not meet the criteria to be classified as either held-to-maturity or trading (available-for-sale securities) are valued at fair value, but unrealized gains and losses are reported in OCI as opposed to earnings.[146]

Issuing debt

Debt instruments issued by a firm are recorded in the liabilities section of the balance sheet at historical amortized cost.[147] In general, any instrument treated as debt for financial reporting purposes has an actual or imputed interest expense component. This interest expense must be taken into account in deriving net income and, thus reducing the issuer's earnings per share. Furthermore, creditors (lenders) often require issuers to meet interest coverage ratios[148] pursuant to covenants agreed to in loan documents.[149] The more interest expense an issuer has, the more earnings are required to maintain the interest coverage ratio to avoid violation of debt covenants.

Issuing additional debt instruments increases a firm's leverage ratio.[150] This ratio is often used by lenders to determine whether a firm can obtain additional future financing, how expensive that financing will be (for example, an increase in an firm's leverage ratio can reduce

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[144] However, as noted above, a fair value election is allowed for held-to-maturity securities

[145] For example, trading securities include instruments that organizations hold in lieu of cash to earn a higher rate of return than a bank account.

[146] A fair value election is allowed for available-for-sale securities If the election is made, unrealized gains and losses are reported in earnings.

[147] However, a fair value election is generally allowed for debt instruments treated as liabilities for financial accounting purposes

[148] The interest coverage ratio is a measure of the number of times a firm could make the interest payments on its debt with its earnings before interest and taxes ("EBIT"). In general, the lower the interest coverage ratio, the higher the debt burden and the greater the possibility of bankruptcy or default. The formula for the interest coverage ratio is: EBIT / interest expense.

[149] Debt covenants are generally agreements between a firm and its creditors requiring or forbidding certain actions of the firm. For example, a firm may be required under a covenant to limit other borrowing or to maintain no more than a certain level of leverage.

[150] In general, the leverage ratio is a measure of the amount of equity in comparison to debt or the amount of earnings in comparison to debt. Although there are variations on the formula used, one leverage ratio, the debt-to-equity ratio, is as follows: (short term debt + long term debt) / shareholder's equity. Shareholder's equity includes the paid-in capital amounts plus retained earnings

its credit rating or increase the rate of interest), and whether the firm is in compliance with debt covenants under its existing obligations.[151]

Holding equity

The financial accounting for equity instruments is based on the extent to which the firm's total investment in another entity allows it to influence or control the other entity. Equity investments are separated into three categories: investments that do not give rise to influence, investments giving rise to influence, and investments giving rise to control. For financial reporting purposes, no distinction is made between equity instruments held in legal entities organized as corporations versus those organized as partnerships.

Investments that do not give rise to influence

An investment of less than 20 percent in an entity is presumed not to enable the firm to exert a significant influence, unless such ability can be demonstrated. If a firm holds equity instruments for the short term they are classified as trading securities and marked to fair value with gains and losses recorded in earnings. If an equity instrument does not meet the criteria to be classified as a trading security, it is treated as an available-for-sale security and valued at fair value with gains and losses recorded in OCI.[152]

Investments giving rise to influence

An investment giving rise to influence is a 50-percent or less interest that gives the firm the ability to exercise significant influence over operating and financial policies of an entity. The equity method is generally used to account for this type of equity investment.[153] This category of equity investment is commonly used to report investments in corporate joint ventures where a firm holds less than a controlling interest.

Under the equity method, the equity investment is recorded on the firm's balance sheet at its historical cost. Thus, the proportional share of the net assets (equal to assets minus liabilities) is included as an asset (or liability) in the firm's financial statements. Over time, the value of the investment is increased by the firm's proportional share of the equity investment's earnings and is reduced by any dividends received. The proportional share of the equity investment's earnings is included in the firm's earnings for the current period.

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[151] The specific loan requirements vary on a case-by-case basis. Another common ratio used in loan covenants is the debt service coverage ratio, computed as: cash available for debt servicing / (interest + principal + lease payments). It is used to measure a firm's ability to produce enough cash to cover its debt payments.

[152] A fair value election is allowed for available-for-sale securities. If the election is made, unrealized gains and losses are reported in earnings.

[153] ASC 323 - Investments. A fair value election is generally allowed for equity investments giving rise to influence.

Investments giving rise to control

An investment giving rise to control is a more than 50-percent interest in another entity. For this category of equity investment, the assets and liabilities of the entity must be consolidated with those of the firm.[154] If entities are consolidated, the gross values of the assets, liabilities, revenues, and expenses of the investment (subsidiary) are included in the firm's financial report, even though the firm (the parent) may own less than a 100-percent interest. The firm's income statement and balance sheet contains a single line item subtracting proportional net income and net assets attributable to any minority ownership interests in the entity.

Issuing equity

When a firm issues equity, the proceeds are recorded in the shareholders' equity section of the balance sheet (historical cost). A payment on equity is treated as a dividend which reduces the issuer's shareholders' equity on the balance sheet, but does not reduce net income (earnings).

A firm that issues equity instead of debt reports higher net income as a result of the forgone interest expense. Nonetheless, the issuance of additional equity generally dilutes earnings per share (since the denominator, number of shares issued and outstanding, increases, while the numerator, net income, is not impacted by the additional equity issuance). In addition, although the issuance of equity has no impact on the interest coverage ratio, it decreases the leverage ratio (since the denominator, equity, increases). Improvements in the leverage ratio resulting from an equity issuance may afford a firm greater ability to borrow in the future.

3. Consequences of entering into a derivative contract

While the tax rules prescribe different treatment for different types of derivatives, for financial reporting purposes, all derivative instruments are required to be measured at fair value.[155]

Generally, all unrealized gains and losses must be reported in current period earnings. Derivative instruments are required to be recorded on an entity's balance sheet.[156] If an entity expects to receive payment, the derivative instrument is classified as an asset. If an entity expects to make a payment, it is classified as a liability. Changes in the value of the underlying item and corresponding changes in the expected receipts or payments under the derivative contract can cause the classification as an asset or liability and the recorded amount to vary over time. Separate rules apply to instruments that are designated as a hedge (described below).

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[154] ASC 810 - Consolidation. The fair value election is not allowed for equity investments that are required to be consolidated.

[155] ASC 815 - Derivatives and Hedging.

[156] Prior to the issuance of guidance on derivatives and hedging, effective for the year ended December 31, 2001 for calendar year end financial statement issuers, entities were not required to report derivative instruments on the balance sheet. SFAS No. 133 (now ASC 815) was the first comprehensive framework for accounting and reporting standards for derivative instruments and for hedging activities.

The amount of the asset or liability recorded on the balance sheet reflects a snapshot of the value of the instrument at that point in time. GAAP requires additional disclosures to be made in the footnotes to the financial statements to provide supplemental information regarding the risks associated with derivative instruments and the potential consequences if underlying conditions change.

4. Special rules

Hedging

Much of the complexity surrounding the financial accounting for derivatives is related to hedge accounting. Similar to the tax rules for hedging ordinary exposures, the objective of hedge treatment for financial reporting purposes is a proper matching of the timing of gain or loss recognition on a derivative instrument used for hedging purposes with the income or expense recognition related to the item being hedged.[157] Although the objective of the financial accounting and tax rules are the same, the rules involved, including the definition of a "hedge," are different. For example, for tax purposes, neither the hedging instrument nor the underlying asset is marked to market.[158] In contrast, for financial reporting purposes, the hedging instrument and the underlying asset are both marked to market.

GAAP defines three separate categories for risks that can be hedged: fair value hedge, cash flow hedge, and net investment hedge. The specific treatment of a hedge depends on the type of risk being hedged. Identification of the hedge at the onset of a contract and substantial documentation are required to qualify an instrument for hedge treatment.

Fair value hedge

For a derivative designated to hedge the exposure to changes in the fair value of an asset, liability, or a firm commitment, a timing difference arises if the derivative instrument is valued at fair value while the underlying asset is required to be valued at historical cost (such as a held-to-maturity debt security) or the lower of cost or market value (such as inventory). GAAP addresses this inconsistency by creating an exception that allows the hedged item to be marked to market.[159] Thus, the gain or loss recognized on the derivative is offset by the gain or loss on

[157] For tax rules related to hedging, see generally sec. 1221(b)(2) and the accompanying regulations.

[158] See, *e g* , sec. 475(b) (exempting securities held for certain hedging purposes from the section 475 mark-to-market rules)

[159] ASC 815-20-25 - Derivatives and Hedging: Hedging: Recognition. Common examples of a fair value hedge include the use of an interest rate swap to economically change fixed rate debt into variable rate debt, use of futures contracts to hedge the fair value of inventory (such as commodities), the use of a forward contract to hedge a firm commitment to buy or sell inventory, and the use of purchased options to hedge available-for-sale securities.

the hedged item, resulting in a net effect in earnings only to the extent to which the hedge is not perfectly effective in offsetting changes in the fair value of the hedged item.[160]

Cash flow hedge

For a derivative designated to hedge the exposure to variable cash flows of an upcoming, forecasted event, a different type of timing mismatch can occur for which the firm may wish to enter into a cash flow hedge.[161] For example, if a firm expects to purchase steel in the future, the firm is exposed to variability in the future price of steel. The firm may enter into a forward contract to purchase steel at a price of $700/ton to hedge this exposure. A subsequent decrease in the price of steel to $650/ton has no economic impact on the firm because the contract offsets the benefit of the price decrease. The forward contract constitutes a liability, as it requires the firm to purchase steel at a price ($700/ton) above the current market price. However, the firm's balance sheet does not recognize an obligation related to the expected price of future purchases. Current recognition of the unrealized gains and losses on the forward contract creates a timing mismatch because the future cash flow that is being offset does not affect earnings until a later period. GAAP addresses this inconsistency by allowing the portion of the gain or loss that is determined to be effective as a hedge to be initially reported as OCI.

The gains and losses are subsequently reclassified into earnings at the time the underlying cash flow affects earnings. Like the fair value hedge, the ineffective portion of the gain or loss is reported in earnings immediately.

Net investment hedge

For a derivative designated as hedging the foreign currency exposure of an investment in a foreign operation, a timing mismatch can occur because translation gains and losses are included in OCI rather than earnings. GAAP addresses this inconsistency by allowing the portion of the gain or loss that is determined to be effective to be reported in OCI rather than earnings. Like the fair value hedge and cash flow hedge, the ineffective portion of the gain or loss is reported in earnings immediately. Hedges of foreign currency risk that do not relate to an investment in a foreign operation, such as a foreign currency hedge on an available-for-sale security, are treated as a fair value hedge or a cash flow hedge, as appropriate.

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[160] GAAP deems a hedge effective to the extent that the changes in fair value or cash flow of the hedged item and the hedging derivative offset each other. Any remaining gain or loss that does not offset with the change in the value of the hedged item considered to be ineffective. By electing the fair value option for an asset or a liability that is otherwise valued at historical cost, a firm may be able to replicate hedge accounting treatment for a fair value hedge by electing to mark the hedged item to market, as would be permitted for a hedge, while avoiding the identification and documentation requirements of hedge accounting.

[161] ASC 815-20-25-3 - Derivatives and Hedging. Common examples of a cash flow hedge include a hedge of a forecasted sale or purchase of a commodity with forward futures or option contracts, hedge of variable interest payments or receipts on a debt instrument or investment through the use of an interest rate swap that economically converts the variable payments or receipts into fixed payments or receipts, hedge of a forecasted foreign-currency-denominated sale or purchase through the use of foreign currency forward contracts.

Embedded derivatives

In some instances, a derivative feature may be embedded within a contract that does not meet the definition of a derivative in its entirety. When this occurs, a determination must be made as to whether the derivative is to be bifurcated and the component pieces accounted for separately under GAAP.[162] This treatment prevents a firm from avoiding the GAAP required reporting for derivatives merely by embedding a derivative instrument in a nonderivative financial instrument or other contract.

Hybrid instruments

In practice, the traditional distinction between equity and debt is blurred through the use of instruments with characteristics of both. [163] For example, convertible bonds are a type of debt that the holder can convert into equity of the issuing firm at an agreed-upon price under certain stipulated terms.[164] Additionally, preferred stock commonly has characteristics similar to debt, such as maturity amounts and dates at which the preferred shares must be redeemed.[165]

These hybrid instruments raise the question of whether they should be recorded as a liability or equity for the issuing firm. The GAAP treatment of convertible debt depends on the specific terms involved. Traditional convertible debt is classified entirely as a liability and upon conversion the carrying amount of the liability is reclassified as equity.[166] However, in circumstances in which debt contains a conversion option that is in the money at the date of issue, or if the debt can be settled wholly or partly in cash, GAAP generally requires the issuer of the instrument to split the instrument into its separate debt and equity components.[167] The issuer does so by first valuing the debt component and then subtracting this value from the total proceeds received to derive the equity component. As discussed above, if a debt or equity instrument contains a derivative component, that component must be separated and treated according to the rules for derivatives.

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[162] ASC 815-15-25-1- Derivatives and Hedging

[163] For a more detailed discussion of the financial accounting consequences of debt and equity financing, see Joint Committee on Taxation, *Present Law and Background Relating to Tax Treatment of Business Debt* (JCX-41-11), July 11, 2011, pp 90-94.

[164] Although it typically has a low interest rate, the convertible bond provides additional value to the holder through the option to convert the bond into stock. The reduced cash interest payment benefits the issuer. If the bonds are converted to stock, the issuer's debt disappears, but the equity in the issuer is diluted.

[165] FASB *Concepts Statement No 6 ("Con No 6") Elements of Financial Statements*, December 1985, par 55.

[166] ASC 470-20-05 - Liabilities.

[167] FASB Emerging Issues Task Force, *Income Tax Consequences of Issuing Convertible Debt with a Beneficial Conversion Feature* (Issue No. 05-08), August 29, 2005, and FASB Staff Position APB 14-1, *Accounting for Convertible Debt Instruments That May Be Settled in Cash upon Conversion (Including Partial Cash Settlement)*, May 9, 2008.

In other cases, GAAP requires financial instruments labeled as equity that have characteristics of both debt and equity to be classified as a liability on the balance sheet. For example, preferred stock is classified as equity when settlement requires delivery of an ownership interest. However, some instruments labeled as preferred stock are instead classified as liabilities. For example, mandatorily redeemable preferred stock is classified as a liability.[168] These instruments are structured such that they embody an unconditional obligation requiring the issuer of the instrument to redeem it by transferring assets at a specified or determinable date (or dates) or upon an event that is certain to occur.

5. Issues in financial accounting for financial instruments

As discussed above, the objective of financial accounting is to provide information that can be used in economic decision making. However, financial reports have a limited ability to impart information to investors about additional leverage and increased risks (or potential rewards) associated with financial instruments because financial statements are historical in nature. In addition, questions have been raised about the appropriateness of valuing financial instruments at historical cost versus fair value. This section includes a discussion of these issues in financial accounting.

Historical nature of financial reports

The information provided by financial reporting largely reflects the financial effects of transactions and events that have already happened. Management may communicate information about its plans or projections, but financial statements and most other financial reporting are historical.[169] For example, the current market price of a readily marketable equity instrument and the purchase price of a bond that is held to maturity are historical facts. Similarly, the fair value of a derivative instrument on the balance sheet reflects a snapshot of the value of the instrument at that point in time. The value of a derivative instrument reported on the balance sheet does not provide insight into the effects of macroeconomic developments or the risks and consequences if conditions underlying the value of derivative instruments should change.[170]

Because of the leverage derivatives allow, an identical value on a balance sheet at one point in time can have different consequences for the future. For example, an investor with $1,000 could purchase 10 shares of $100 stock or could purchase 100 options to purchase a share of stock for $100 per share on some date in the future for $10 per option. Each investment is recorded as an asset with a fair market value of $1,000. If the stock decreases in value to $90 on the next financial statement date, the investment in 10 shares of stock is recorded at a fair market value of $900, but the 100 options may be worth almost zero (because of the market's perceived

[168] ASC 480-10-25-4- Distinguishing Liabilities from Equity provides that a mandatorily redeemable financial instrument is classified as a liability unless the redemption is required to occur only upon the liquidation or termination of the reporting entity.

[169] *Con No 1*, paragraph 21.

[170] Financial Crisis Advisory Group, *Report of the Financial Crisis Advisory Group*, July 28, 2009. This report is available at www.fasb.org.

likelihood that the share price will exceed the strike price is zero). The identical $1,000 value recorded for both investments at the earlier financial statement date does not impart any information to the investor on the different risk profile of each investment.

Another question in financial reporting is whether an instrument should be recorded at fair value or at historical cost. The principle of fair value reporting is comparable to mark-to-market principles in the Code.[171] While historical cost reporting remains important in financial reporting, fair value reporting is more common in financial reporting than in measuring taxable income.[172] The application of this principle of fair value reporting is one factor creating differences between reported financial income and taxable income, so-called "book-tax" differences (discussed below).

Fair value versus historical cost

Fair value and historical cost accounting each have certain advantages and disadvantages to achieving the objective of providing an accurate and precise statement of a firm's financial position. While historical cost information may become out-of-date, the acquisition cost at some point in time is a precise measure. In contrast, fair value records are timely and more comparable across firms because they are based on current values rather than on values at varying historical points in time. However, when objective published market values for a financial instrument or its underlying asset are not available, fair values may be difficult to estimate and unreliable.[173]

The use of one approach versus the other can affect reported earnings when market prices fluctuate. Financial accounting standards are intended to avoid selective omissions of losses (or gains) from an income statement.[174] Under the historical cost approach, a firm has the ability to manage the timing of profits or losses by selecting to realize cumulative unrealized gains and losses on certain positions through the timing of a transaction. In contrast, under the fair value

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[171] Under fair value accounting, financial instruments are valued at the estimated prices at which they could change hands in orderly transactions based on current information and conditions.

[172] In recent years the prevalence of fair value accounting under GAAP has increased. See ASC 815 - Derivatives and Hedging (released in 1998), ASC 820 - Fair Value Measurements (released in 2006), and ASC 825 - Financial Instruments (released in 2007).

[173] While many assets have observable market prices (*e g* , a stock traded on the New York Stock Exchange) or inputs that are based on them (*e g* , interest rate swap where its components are observable data points like the yield on a 10-year Treasury bond), many assets include one or more inputs that do not have observable prices. Fair value of these assets is reliant on management estimates and various models may be used to estimate the fair value. When companies "mark to model" they are not forced to write down prices because of current market turmoil, but footnote disclosures that are required to be included in the financial statements provide information for investors and regulators to assess the adequacy of the write-downs. In addition, if models are used, a firm's management must take current market pricing and conditions into account as if the position were being sold or terminated.

[174] FASB Statement of Financial Accounting Concepts No. 5: Recognition and Measurement in Financial Statements of Business Enterprises (December, 1984), par. 35.

approach, a firm cannot selectively realize gains and losses because all financial instruments are marked to market (*i.e.*, unrealized economic gains and losses are reported in the period in which they occur).

When market prices for a financial instrument fluctuate temporarily, a financial report based on historical cost avoids volatility in net income related to temporary changes in the fair value of instruments (which are arguably irrelevant to the firm's financial position if the temporary change reverses itself while the firm continues to hold the financial instrument). However, if the market prices for a financial instrument change permanently, a financial report based on historical cost principle delays reporting gains or losses associated with the change in price until realization and may mislead creditors and investors regarding a firm's financial position. Furthermore, some have argued that fair value accounting exacerbates the cyclical nature of financial markets.[175]

6. Major differences between tax and financial accounting for financial instruments

Differences between book and tax reporting primarily arise in the areas of exclusions of interest or dividends from taxable income,[176] timing of income inclusion, and treatment of hybrid instruments. Questions of character and source that are important aspects of the taxation of financial instruments are not relevant in the financial accounting context, except to the extent that the character or source affects the reporting for income taxes associated with a financial instrument.

Because tax laws provide special rules as to whether certain items related to financial instruments are included in or excluded from income, some items either enter into pretax financial income but never into taxable income, or enter into taxable income but never into pretax financial income. Because the book/tax difference created by these items does not reverse over time, these items create "permanent differences".

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[175] In its "Report of the Financial Crisis Advisory Group" (July 28, 2009), p. 3, the Financial Crisis Advisory Group notes that in the earlier part of the 2008 financial crisis, the principal criticism of financial reporting focused on the impact of fair value accounting. Some argued that prior to the 2008 financial crisis, fair value accounting led to overstatement of profits. However, during the crisis, falling asset prices led to accounting write-downs. As capital adequacy standards are closely tied to accounting figures, the write-downs caused firms to convert some assets into Tier 1 capital assets (such as cash) to meet the standards. The increased selling of assets exacerbated the fall in the prices for those assets. However, the staff of the SEC observed that fair value accounting did not appear to play a meaningful role in bank failures occurring during 2008. Rather, bank failures in the United States appeared to be the result of growing probable credit losses, concerns about asset quality, and, in certain cases, eroding lender and investor confidence. For the failed banks that did report sizable fair value losses, it does not appear that the reporting of these losses was the reason the banks failed. See SEC, Office of the Chief Accountant, Division of Corporation Finance, *Report and Recommendations Pursuant to Section 133 of the Emergency Economic Stabilization Act of 2008: Study on Mark-to-Market Accounting* (Release No. 33-8975), December 30, 2008.

[176] For example, see section 103 for exclusion of interest on state and local bonds, and sections 243-246A for deductions for dividends received by corporations.

When a firm receives interest on state and local bonds that generate tax-exempt interest, the interest income is included in financial statement income, but it does not enter into the computation of taxable income, resulting in a permanent difference. When a firm subtracts allowable dividends-received deductions from taxable income, but not from pretax financial statement income, it results in permanent differences related to stock holdings for firms organized as corporations.[177]

Because tax laws and financial accounting standards differ as to when some items are recognized and how they are measured, items may be reported sooner or later or in different amounts on the tax return than in the financial statements. These items generally create "temporary differences," or differences between the tax basis and book basis of an asset or liability. Differences in the timing of gain or loss recognition produces temporary book-tax differences as, over the life of the instrument, the cumulative (nominal value of the) income or expense is the same for book income reporting and taxable income computation purposes.

Temporary differences generally do not affect the total nominal amount of tax liability reported by a corporation for the year. However, temporary differences do affect the amount of cash taxes paid by the corporation for a given year. To keep the total tax expense constant, firms accrue tax expense (or benefit) to reflect the portion of the year's tax expense which will be paid (or refunded) in a future year. This accrual is known as deferred tax expense (or benefit) and results in an asset (or liability) on the firm's balance sheet. These balance sheet items are referred to as deferred tax assets and deferred tax liabilities.

As discussed above, all derivatives and many types of debt and equity holdings are recorded at fair value for financial reporting purposes, with unrealized gains and losses reported in current earnings. In contrast, present tax law largely requires gains and losses to be recognized at the time of realization and provides for mark-to-market treatment in limited circumstances.[178] These differences in the timing of income recognition create temporary differences on the financial statements.

Hybrid instruments are more often required to be bifurcated into separate debt and equity components for book purposes than for tax purposes. However, the Federal income tax rules generally treat an instrument as all debt or all equity.[179] Differences in the classification of instruments give rise to both temporary and permanent differences.[180]

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[177] For examples of these permanent differences, see Christopher H. Hanna, Mark R. Martin, Michael J. Donohue, E. Daniel Leightman, and Cym Lowell, *Corporate Income Tax Accounting* (2011 Edition), Thomson Reuters/WG&L, 2010, pp. 4-7 to16.

[178] See, *e g* , secs. 475, 1256, and 1296.

[179] Although in 1989, Congress gave Treasury regulatory authority under section 385 to treat an interest in a corporation as part debt and part equity, no regulations have been promulgated.

[180] Prior to the issuance of SFAS No. 150, *Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity* (now ASC 480-10) in 2003 (which required certain financial instruments with characteristics of debt and equity to be treated as liabilities), a number of firms issued instruments

Example 6: purchase of equity.–Assume a firm purchased 10 shares of XYZ for $100 per share, for a total investment of $1,000. Assume the investment does not enable the firm to exert significant influence over XYX. At the end of year one, the share price is $110 per share. During year two, the firm sells its shares for $110 per share.

For financial accounting purposes, in year one, the firm reports $100 of income ($10 increase in share price, multiplied by 10 shares). However, for tax purposes, gain or loss is not recognized until the time of sale of the shares. Consequently, no cash taxes are paid in year one. In year one, the firm accrues a deferred tax expense of $35 ($100 gain multiplied by the 35-percent statutory tax rate). In year two, the firm recognizes the $100 gain ($10 increase in share price, multiplied by 10 shares) for tax purposes when the shares are sold. The firm records a current tax expense of $35 ($100 gain multiplied by the 35-percent statutory tax rate), but also records a deferred tax benefit of $35 to reverse the deferred tax expense accrued for this item in year one. Thus, in year two, the $35 current income tax expense is offset against the $35 deferred tax benefit, resulting in income tax expense of zero for financial reporting purposes in year two.

Although the gain is not recognized for tax purposes until year two, the income tax expense associated with the gain is reported for financial reporting purposes in year one, the same time that the gain is reported for financial reporting purposes. In addition, the nominal amount of the tax liability associated with the gain, $35, is the same for tax purposes and financial reporting purposes over the two year period that the instrument is held.

Example 7: purchase of a hybrid instrument.–Assume a firm receives proceeds of $100 for issuing convertible debt with a conversion feature with a stated principal amount of $100. The debt is convertible into four shares of the firm's stock. On the date of issuance, the firm's stock has a fair market value of $30 per share. The conversion feature is in-the-money on the date of issuance because the fair market value of the stock into which the security is convertible is worth $120 ($30 per share multiplied by four shares), while only $100 in proceeds were received. Thus, the value of the conversion feature is $20, equal to the difference between the $120 fair market value of the firm's stock into which the debt is convertible and the $100 proceeds the firm received for issuing the convertible debt.

For financial reporting purposes, the convertible debt is required to be bifurcated between its debt and equity components because the conversion feature is in-the-money on the date the convertible debt is issued. The value of the conversion feature of $20 is recorded as equity (paid-in capital). The firm records the remaining proceeds received of $80 ($100 proceeds less $20 allocated to equity) as a liability on the balance sheet. Because the convertible debt has a par value of $100, but is allocated basis of only $80, a $20 discount is recorded for the difference between the $100 par value and the $80 liability. As the $20 discount is amortized, additional interest expense is reported and earnings are reduced for financial reporting purposes.

(*e g* Trust Preferred Securities) in which the firm treated the payments on the instruments as interest for tax purposes but distributions on equity for financial accounting purposes. The firm deducted the interest for tax purposes, but did not report interest expense for financial reporting purposes. Such treatment created a permanent difference between taxable income and pretax financial income that was favorable to the firm.

For tax purposes, the convertible debt is treated entirely as a liability. The tax basis in the convertible debt is $100, resulting in a basis difference in the instrument between book and tax of $20 ($80 book basis compared to $100 tax basis).[181] This basis difference is treated as a temporary income tax difference for financial reporting purposes. The firm records a deferred tax liability of $7, equal to the basis difference of $20 multiplied by the 35-percent statutory tax rate. The GAAP rules further provide that this initial deferred tax liability of $7 is charged directly to the equity section of the balance sheet, and thus does not reduce earnings. However, after the initial deferred tax liability is recorded, the firm is required to record deferred tax expense (benefit) for changes in the difference in the book and tax basis, multiplied by the applicable tax rate, which may decrease (increase) earnings reported.

[181] There is also a book/tax basis difference in the equity instrument of $20. However, the accounting standards only consider basis differences for assets and liabilities. Differences in equity do not give rise to a temporary difference.

IV. DISCUSSION OF SELECTED TAX ISSUES

The following is a discussion of selected Federal income tax rules and issues related to the basic principles outlined above, including the characterization of financial instruments and the timing, character, and source of income related thereto. Several of the selected legislative rules were enacted in response to perceived issues presented by the application of the existing rules to a particular transaction or instrument. For existing tax rules, the discussion presents an example of the issue that prompted enactment of the rule. For specific financial instruments, the discussion highlights some of the Federal income tax issues they present.

A. Issues Related to the Categorization of an Instrument

Hybrid instruments with features of both debt and equity

There is no bright-line definition that distinguishes debt from equity for Federal tax purposes.[182] Instead, the characterization of a particular instrument depends on a consideration of the terms of the instrument and all the surrounding facts and circumstances, analyzed in terms of economic and practical realities. A substantial body of common law has developed numerous factors to consider in such an analysis.

Between the extremes of an instrument that is clearly debt for tax purposes (generally considered an unqualified promise to pay a sum certain on a specified date with fixed interest) or clearly equity (generally considered an investment representing risk capital entirely subject to the fortunes of the venture), taxpayers have the ability to create a practically unlimited variety of instruments incorporating both debt- and equity-like features. Instruments that blend features of debt and equity are commonly referred to as hybrid instruments. The variety of these hybrid instruments is limited only by the ingenuity of taxpayers (and their advisors) and the contexts in which a hybrid instrument may be useful.

Hybrid instruments give rise to tax issues beyond the fundamental issue of whether the instrument is best treated as debt or as equity. Once the instrument is determined to be either debt or equity for tax purposes, the instrument's hybrid features can affect the results under applicable tax rules. The tax treatment of a hybrid instrument can depend on relatively slight differences in the terms of the instrument. For example, an instrument that is treated as debt rather than equity for tax purposes, but which has some equity-like features, can be treated quite differently under tax rules requiring interest accrual than is a fairly similar debt instrument with slightly different equity-like features.

The magnitude of the difference in tax treatment may not match the magnitude of the difference in the economics of somewhat similar hybrid instruments. This is illustrated in the following examples of several debt instruments with differing equity-like features under the OID rules. Different forms of contingent convertible debt have been used to give equity-like returns to holders while allowing debt-like interest deductions for the issuer. A further illustration is the

[182] For additional analysis, see Joint Committee on Taxation, *Present Law and Background Relating to Tax Treatment of Business Debt* (JCX-41-11), July 11, 2011.

tax treatment of feline PRIDES.[183] Feline PRIDES are an example of an instrument that combines a debt instrument with an agreement to buy the issuer's stock in the future. Such instruments are intended to allow issuers to currently monetize the value of their common stock while providing the issuer interest deductions. Also described below are convertible preferred equity certificates, or CPECs, which illustrate the differences in tax treatment of the same instrument under the laws of different countries in a cross-border context. CPECs, as used by taxpayers in foreign tax planning, are designed to be treated as debt for Luxembourg tax purposes but equity for U.S. tax purposes.

Debt with equity conversion features

Certain contingent convertible debt compared to other instruments

Debt instruments can be issued with rights to obtain stock of the debt issuer (known as convertible debt). If stated interest on the instrument is treated as insufficient under the tax rules, the tax rules impute interest over the life of the instrument (original issue discount, or OID), generally measured by the difference between the issue price of the instrument and the stated redemption price at maturity.[184]

Certain debt instruments issued with economically similar rights to obtain stock of the issuer are treated differently from each other under the OID rules depending on how the rights are structured. These differences affect the amount and timing of the issuer's current interest deduction, as well as the holder's inclusions. A comparison of these instruments provides an example of the different tax treatments that can be achieved depending upon the form chosen for an instrument.[185]

For example, an issuer might issue an investment unit consisting of a debt instrument plus a warrant to acquire the issuer's stock. The unit might be issued for a price equal to the amount payable at the maturity of the debt instrument. In this case, the warrant is treated as a separate property right under the OID rules and the issue price is allocated between the debt instrument and the warrant, based upon the relative fair market values at the time of issuance. Accordingly, a portion of the issue price is allocated to the warrant and treated as the amount the investor paid to purchase the warrant. Because in this example the issue price allocated to the debt instrument is reduced by the amount allocated to the warrant, the issue price is below the

[183] Feline PRIDES is the name of an instrument designed by Merrill Lynch as a modification of another Merrill Lynch product, PRIDES. "PRIDES" is an acronym for preferred redeemable increased dividend equity securities. "Feline" is an acronym for flexible equity-linked exchangeable security. Like other hybrid instruments, different investment bank creators have different names for similar instruments. For example, Morgan Stanley created PEPS, and Citigroup created "upper DECS."

[184] The OID rules are described in section II.A.2., relating to debt, and IV.B.

[185] See generally David C. Garlock, *Federal Income Taxation of Debt Instruments*, CCH, 2010, Paragraphs 901-908 and 1001. For simplicity, the examples in the text above assume that the referenced debt instrument and equity of the issuer are publicly traded.

amount payable at maturity. Consequently, the debt instrument has OID that is created by reason of the warrant.[186]

As another example, a single debt instrument can be issued that is itself convertible into, or exchangeable for, stock of the issuer. Again, this convertible instrument may be issued for a price that is the amount payable at maturity of the instrument. Under the regulations, none of the purchase price of the instrument is allocated to the value of the conversion feature. In this case, since the instrument was issued for a price that is the amount payable at maturity, no OID is created by reason of the convertibility feature.[187]

As a third example, an instrument can be issued that is convertible into stock of the issuer in the event of a contingency (*e.g.*, if the instrument's market price exceeds a certain dollar amount)[188] and the contingency is not remote or incidental. In this case, the IRS has ruled that the comparable yield of the instrument is determined based on the yield of a comparable instrument that is not convertible, in other words, based on the yield of an instrument that does not offer the holder a conversion right and without adjustment for the existence of the conversion feature.[189] As in the prior two cases, the conversion right has value for which an investor would pay. An investor would require a lower yield (apart from the value represented by the equity conversion right) on an instrument with such an equity feature than on an instrument without such a feature. Allowing the market yield on a nonconvertible instrument to determine the yield of the issued instrument results in a greater yield to maturity. Hence, there is more OID on this instrument than on the instruments in either of the prior examples.

Depending on the terms of the warrant in the first example, the point at which a fixed conversion price on a convertible debt is set in the second example, or the conditions of the contingency in the third example, the instruments could be economically very similar.[190]

The IRS has issued a notice requesting comment on whether the treatment of the various types of instruments should be more closely conformed in whole or in part.[191] Commentators have debated the issue.[192]

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[186] Sec. 1273(c)(2)(B); see also *Custom Chrome v Commissioner*, 76 T.C.M. 386, *aff'd in part and rev'd in part*, 217 F. 3d 1117 (9th Cir 2000).

[187] Treas Reg. sec. 1.1273-2(j)

[188] The market price of the instrument would reflect the value of the combined debt and equity features of the instrument.

[189] Rev. Rul. 2002-31, 2002-1 C. B. 1023.

[190] In addition, an issuer could issue debt and warrants separately, in which case each instrument could be analyzed with results comparable to the investment unit example. See David C. Garlock, *op cit.* at Par 1001 07.

[191] Notice 2002-36, 2002-1 C.B. 1029.

[192] See, *e g* , David P. Hariton, "Conventional and Contingent Convertibles: Double or Nothing," *Tax Notes* vol. 96 no. 1, July 1, 2002, p. 123, Jeffrey Strnad, "Taxing Convertible Debt," 56 *Southern Methodist*

Feline PRIDES

Feline PRIDES are a complex instrument sold by an issuer to raise capital. For Federal tax purposes, the issuer seeks to effectively issue stock (without doing so currently) while generating current interest deductions.[193] The following simplified description of feline PRIDES is based on the facts of Revenue Ruling 2003-97 in which the IRS ruled that interest accruing on a feline PRIDES-like instrument was deductible for tax purposes.[194]

Feline PRIDES are two instruments packaged together into a single investment unit. The instrument consists of a three-year forward contract to purchase the issuer's common stock and a five-year note paying interest. The forward contract obligates the holder to purchase, and the issuer to sell, an amount of the issuer's common stock in three years. The amount of common stock to be purchased is determined by reference to the market price of the stock on the settlement date three years in the future. The note obligates the issuer to pay a sum certain in five years. The five-year note serves as collateral for the holder's obligation under the forward contract. The issuer of the single purchase-contract/note unit allocates the aggregate amount paid between the forward and the note as if the instruments were in fact separately issued. The amount allocated to the note is the stated principal amount of the note.

While issued to holders as a single instrument, a critical feature of the instrument for its Federal tax classification is that the two parts are separable. Although the holder pledges the five-year note as collateral for its obligation under the three-year forward contract, the holder may legally separate the note and the forward by posting new collateral for the purchase contract (*e.g.*, Treasury securities). The holder could then dispose of either the note or the forward contract, or both. Another critical feature of the instrument is that the issuer agrees to remarket the notes periodically, meaning that the issuer will attempt to resell the notes in the market. If a remarketing is successful, the proceeds of the remarketing are used by the holder to satisfy the forward purchase obligation, rather than the note itself (as collateral).

Treatment of the combined purchase-contract/note unit is not entirely clear for Federal tax purposes because the two contracts are linked. Revenue Ruling 2003-97 notes a number of possible characterizations. For purposes of illustrating a critical debt/equity issue, assume the combined unit were treated for Federal tax purposes as a single instrument properly classified as debt.

University Law Review, 2003, p. 399; Jeffrey Strnad, "Laboring in the Pin Factory: More on Taxing Convertible Debt," 56 *Southern Methodist University Law Review*, 2003, p 471; Dana L. Trier and Lucy V. Farr, "Rev. Rul. 2002-31 and the Taxation of Contingent Convertibles, Parts 1 and 2," *Tax Notes* vol. 95 no. 13, June 24, 2002, p. 1963 and *Tax Notes* vol. 96 no.1, July 1, 2002, p. 105; Edward D. Kleinbard, Erika W. Nijenhuis and William L. McRae, "Contingent Interest Convertible Bonds and the Economic Accrual Regime," *Tax Notes* vol. 95 no. 13, June 24, 2002, p.1949, Edward D. Kleinbard, "Taxing Convertible Debt: A Layman's Perspective," 56 *Southern Methodist University Law Review*, 2003, p 453

[193] As described in greater detail below, the holders of feline PRIDES are not current shareholders for corporate law purposes, but do have an obligation to perform on a contract to purchase stock in the future.

[194] Rev. Rul. 2003-97, 2003-2 C.B. 380 (July 24, 2003)

Section 163(l) generally disallows a deduction for interest on a debt instrument issued by a corporation that is payable in equity of the issuer. The section was enacted by the Taxpayer Relief Act of 1997[195] in response to Congressional concern that corporate taxpayers could issue instruments denominated as debt, but that more closely resembled equity for which an interest deduction is not appropriate. Debt is treated as payable in equity under section 163(l) if a substantial amount of the principal or interest is mandatorily convertible or convertible at the issuer's option into such equity. A debt instrument also is treated as payable in equity if it is part of an arrangement that is reasonably expected to result in payment on the debt instrument with or by reference to such equity, such as in the case of certain issuances of a forward contract in connection with the issuance of debt.[196]

One might think that the purchase-contract/note unit would be subject to section 163(l) because at maturity, the holder will effectively have paid the principal amount in exchange for stock of the issuer. However, feline PRIDES have features that are designed to prevent application of section 163(l). For example, a feline PRIDES issuer agrees to remarket the notes, and to use the proceeds of a successful remarketing to satisfy the forward contract while the note remains outstanding. If the forward contract is satisfied in year three and the notes remain outstanding in the hands of another holder until year five (at which time the issuer is obligated to pay off the notes in cash), it is more difficult to conclude that the note is payable in equity.

Cross-border hybrids: CPECs

It is possible for taxpayers to design instruments that are treated differently for foreign and U.S. tax purposes. These instruments are often used within a multinational group to accomplish foreign or U.S. tax base erosion or to engage in foreign tax credit planning.[197] Such instruments may also be used by investors (*e.g.*, investment funds) making cross-border investments. One such example is a CPEC, a hybrid financing instrument designed to be regarded as debt of a Luxembourg issuer from a Luxembourg tax perspective,[198] but equity from a U.S. tax perspective.[199] Typical features of a CPEC include a 49-year term; a fixed annual interest rate computed based on the "arm's-length" principle, taking into consideration their conversion feature; convertibility into shares of the issuer at a fixed ratio established upon the issuance of the CPEC; an ability to be redeemed at fair market value under certain conditions;

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[195] Pub L No 105-34

[196] Sec. 163(l)(3)(C).

[197] The ability to use hybrid instruments to engage in foreign tax credit planning was significantly curtailed with the enactment of Code section 909. Pub. L No. 111-226, sec. 211. Prior to enactment of section 909, hybrid instruments treated as debt for foreign tax purposes and as equity for U.S. tax purposes were used to help facilitate certain "foreign tax credit splitter" transactions where creditable foreign taxes were separated from the underlying foreign earnings and profits.

[198] Although the IRS will typically not issue a private letter ruling, it is not uncommon for issuers of CPECs to obtain a ruling from Luxembourg tax authorities confirming the treatment of CPECs as debt.

[199] Profit participating loans are another example of a hybrid instrument that may be treated as debt in Luxembourg and certain other foreign jurisdictions while being treated as equity from a U.S. tax perspective.

transferability by the holder only with the simultaneous transfer of an equivalent portion of the holder's shares of the issuer; subordination to other debt; and no voting power.

Because CPECs are treated as debt for Luxembourg tax purposes, interest expense may be imputed on CPECs resulting in Luxembourg tax deductions. Interest paid to the holder of the CPECs is generally exempt from Luxembourg gross withholding tax. From a U.S. perspective, assuming the holder is treated as owning equity, any interest imputed on a CPEC for Luxembourg tax purposes does not result in corresponding imputed interest income in the United States. Equity holders typically owe U.S. tax on dividend income only when declared and paid. In addition, CPECs are convertible into common shares and under certain circumstances are redeemable. Because conversion or redemption is typically carried out at the fair market value of the shares at the time of the conversion or redemption, holders are able to extract appreciation in the issuer in a tax efficient manner. If the Luxembourg company has appreciated in value, the CPEC holder exchanges CPECs for appreciated stock. From a Luxembourg perspective, a conversion is not a dividend subject to withholding, and from a U.S. holder's perspective, the exchange may qualify for a preferential rate of tax as qualified dividend income or the sale or exchange of a capital asset.[200]

[200] Since CPECs also are treated as equity in certain foreign jurisdictions, CPECs may also be used to facilitate cross-border arbitrage between Luxembourg and other foreign jurisdictions.

B. Issues Related to Timing

When an amount is included in income (or expense) can affect a taxpayer's tax liability. While the type of entity and financial instrument selection can often be used to achieve more favorable tax results, legislative changes have addressed some perceived abuses with respect to timing. The following discussion outlines a few of these instances and the corresponding rules.

1. Deferral of income

Original issue discount

Background

Original issue discount is a term generally used to describe the measurement and timing of interest income and expense related to debt instruments (*e.g.*, loans). For example, it is generally accepted that "[t]he $6 earned on a one-year note for $106 issued for $100 is precisely like the $6 earned on a one-year loan at 6 percent stated interest."[201] Similarly, a $100 note issued for $94.34 is the same as a one-year loan with a 6 percent interest discount. While the basic principle was widely recognized, the lack of detailed rules led to perceived abuses.

Under prior law, the issuance of debt instruments at a discount resulted in timing differences. For instance, assume a loan is issued at a discount whereby the holder (borrower) is given less money up front than is due the issuer (lender) at maturity. The borrower is an accrual basis taxpayer (*e.g.*, corporation) and the lender is a cash basis taxpayer (*e.g.*, individual). The borrower accrues interest expense over the period of the loan. Conversely, the lender does not recognize interest income until the debt instrument is sold or exchanged. This resulted in a mismatch of when the income and expense were included in the taxpayers' computations of tax liability.

To prevent future mismatches of income and expense, Congress enacted rules requiring the issuer and holder (including successors) to measure the amount of the discount using identical rules and to recognize such amounts currently, regardless of the taxpayer's overall method of accounting.[202]

Present law

For debt instruments issued with a discount at origination, section 1272 requires the borrower to include amounts in income for each day of the tax year that corresponds to the daily discount received.[203] Rather than include the full amount of the OID income at the time the

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[201] *U.S. v. Midland-Ross Corporation*, 381 U.S. 54, 58 (1965).

[202] Prior to the enactment of section 1272 in 1984, the rules for OID were found in section 1232.

[203] Section 1272 does not apply to tax exempt obligations, U.S. savings bonds, short-term obligations, obligations issued prior to date of enactment (March 2, 1984), or loans between natural persons. See sec. 1272(a)(2).

contract is entered into, the taxpayer recognizes such amounts ratably over the term of the debt. The lender expenses a corresponding daily amount as interest expense.[204]

Similarly, convertible bonds are treated like basic debt instruments (*e.g.*, loans) until conversion. The holder of the bond includes stated interest in income in accordance with its overall method of accounting (*i.e.*, cash or accrual) and any amounts associated with the OID as it accrues. The issuer of the bond generally deducts accrued interest and OID until the date of conversion, even if such amounts are never paid. The conversion of the convertible bond into the issuer's stock ("converted stock") is a nontaxable event.[205] Upon ultimate sale of the converted stock, income is recognized consistent with the treatment for stock transactions generally.

Constructive sales

Background

The recognition of gain or loss may be postponed for open transactions. For example, in the case of a short sale (*i.e.*, when a taxpayer sells borrowed property such as stock and closes the sale by returning identical property to the lender), no gain or loss on the transaction is recognized until the closing of the borrowing.

Under prior law, transactions designed to reduce or eliminate risk of loss on financial assets often did not constitute realization events. For example, a taxpayer could lock in gain on securities by entering into a "short sale against the box" transaction, that is, when the taxpayer owns securities that are the same as, or substantially identical to, the securities that are borrowed and sold short. Thus, the Code provided rules to prevent taxpayers from using short sales against the box to convert short-term capital gain into long-term capital gain or long-term capital loss into short-term capital loss. However, prior law did not prevent taxpayers from deferring the recognition of gain on an appreciated financial position while locking in the built-in gain. This result was attained because the creation of the short position results in any future increase or decrease in the market price of the underlying asset (up to whatever the taxpayer shorted) being perfectly offset within the taxpayer's portfolio. When both positions were ultimately unwound in the taxpayer would recognize the accrued gain that existed on the date on which the short position was opened.[206]

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[204] Section 163(e).

[205] Treas. Reg. section 1 1001-3(c)(2)(ii) and Rev. Rul. 72-265, 1972-1 C.B. 222.

[206] One widely reported example of such a transaction involved the 1995 initial public offering of the Estee Lauder Companies Estee Lauder and her son, Ronald Lauder, were significant shareholders in the Estee Lauder Companies prior to the company's initial public offering ("IPO"). Had the two simply sold their shares to the public in the IPO, they would have had to pay tax on the difference between the offering price ($26 per share) and their adjusted basis in the stock for the year of the sale Rather than sell their own shares, Estee and Ronald Lauder went short against the box in an effort to defer, and potentially eliminate, any tax on the disposition of their shares. In connection with the IPO, the Lauders borrowed Estee Lauder Companies stock from family members and sold these borrowed shares to the public. Because gain or loss on the short sale of stock is deferred until the short sale is

In 1997, section 1259 was enacted, requiring the recognition of gain related to certain appreciated financial positions.[207]

Present law

For a holder or issuer of appreciated financial positions, the rules relating to constructive sales under section 1259 can require gain to be recognized as if the financial positions were sold. A taxpayer is considered to have made a constructive sale with respect to a financial position if the taxpayer or related person enters into: (1) a short sale of the same or substantially identical property; (2) an offsetting notional principal contract with respect to the same or substantially identical property; (3) a futures or forward contract to deliver the same or substantially identical property; or (4) one or more transactions (or acquires one or more positions) that have substantially the same effect as a transaction previously described and included in Treasury regulations.[208]

2. Acceleration of losses

Wash sales

Background

A wash sale occurs when a taxpayer sells a security (*e.g.*, stock, bond, option) at a loss and replaces the security by purchasing the same or a substantially identical security shortly before or after the sale transaction. Without the wash sale rules under section 1091, a taxpayer could recognize a tax loss without realizing an economic loss. This is because the taxpayer would own the same or a substantially identical security after the sale as before the sale. To prevent taxpayers from recognizing losses associated with the sale of investments that are immediately replaced such that the underlying economics are not altered, the wash sale rules under section 1091 were enacted.

Present law

Section 1091 defers the recognition of losses associated with the sale of shares of stock or securities if the taxpayer acquires, or enters into an option contract to acquire shares of

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closed, the Lauders could defer the tax due on the IPO until they delivered their own shares to close the short position. Moreover, if the Lauders died before closure of the short sales, it was possible for the short positions to be closed with stock the basis of which would be equal to its fair market value, thus eliminating any gain on the short sale. See, *e.g.*, Allan Sloan, "Lauder Family's Stock Maneuvers Could Make a Tax Accountant Blush," *The Washington Post* (Nov. 28, 1995); Laura Jereski and Laura Bird, "Beauty Secrets: Ronald Lauder's Debts and Estee's Old Age Force a Firm Makeover." *Wall Street Journal* (Nov., 8, 1995), p. A1; Lee A. Sheppard, "News Analysis: Fixes to Ensure that Tax is Paid on Capital Gains," *Tax Notes*, vol. 69 (Dec. 4, 1995), pp. 1165 - 1168.

[207] Taxpayer Relief Act of 1997, Pub. L. No. 105-34, sec. 1001(a).

[208] Sec. 1259.

substantially similar stock or securities within 30 days before or after the date of the loss transaction.

C. Issues Related to Character

Taxpayers may have incentives to convert what would otherwise be an ordinary gain into a capital gain or a capital loss into an ordinary loss depending on their tax profile. For example, because the capital gains of individuals may be taxed at lower tax rates than their ordinary income, an individual benefits from the conversion of an ordinary income item into a capital gain. Conversely, the capital losses of an individual may generally be used only to the extent of capital gains. Up to $3,000 of any excess capital loss may be used to offset ordinary income, but the balance must be carried forward to future tax years. Accordingly, a taxpayer with no capital gain facing a large capital loss would benefit from converting the capital loss to an ordinary loss that could be used to offset ordinary income (*e.g.*, wage income). Taxpayers have devised a variety of ways to convert the character of gain and loss items. The following discussion outlines a few of the special rules designed to limit these conversion opportunities.

1. Conversion of short-term gain into long-term gain

An exception to the general rules for classifying gain or loss applies under section 1233 for short sales. In addition to providing general guidance for the holding periods of short sale transactions, these rules were enacted to prevent taxpayers from converting short-term gains into long-term gains and long-term losses into short-term losses.

In a short sale of stock, for example, a person sells more shares of stock than he owns at the time of sale. It is as if the seller has borrowed stock in order to sell. In order to complete the sale, the seller must acquire additional shares to deliver.

Under section 1233, if between the time the short sale is entered into and closes, the stock borrower owns, or acquires stock that is substantially identical to the stock that is sold short, and has owned such stock for a not more than one year, any gain (but not loss) is recognized upon the closing of the short sale is short-term.[209] Additionally, the holding period for substantially identical stock, acquired between the time the short sale is entered into and closes, begins on the earlier of the date the short sale is closed or the date the substantially identical stock is sold.[210] Conversely, if the stock borrower owns stock that is substantially identical to the stock that it sold short, and has owned that stock for more than a year, any loss (but not gain) recognized upon the closing of the short sale is long-term.[211]

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[209] Sec. 1233(b)(1) and Treas. Reg. sec. 1.1233-1(c)(2).

[210] Sec. 1233(b)(1) and (2) and Treas. Reg. sec. 1.1233-1(c)(2) and (5)

[211] Sec. 1233(d) and Treas. Reg. sec. 1.1233-1(c)(4).

2. Conversion of capital to ordinary and vice versa

Background

The definition of a capital gain or loss in section 1222 requires that there be a sale or exchange of a capital asset. Courts have interpreted this requirement to mean that when a disposition is not a sale or an exchange, but rather, for example, a lapse or cancellation, the disposition produced ordinary income or an ordinary loss. This interpretation has applied even to dispositions that are economically equivalent to a sale or exchange of a capital asset.

Some taxpayers and tax shelter promoters attempted to exploit this ability to convert a capital item to an ordinary item. For example, a taxpayer might enter into a forward contract on a security, where the forward contract would constitute a capital asset in the taxpayer's hands. If the value of the forward contract increased (because the value of the underlying security increased), the taxpayer could sell the forward contract and report a capital gain. On the other hand, if the forward contract declined in value, the taxpayer would pay a fee to the counterparty to cancel the contract. Under case law prior to the enactment of section 1234A, a cancellation or extinguishment of the contract was not viewed as a sale or disposition and the taxpayer would report the loss as a fully deductible ordinary loss. Congress enacted Section 1234A to override, in some instances, the extinguishment doctrine which allowed some taxpayers effectively to choose the recognition of a capital gain or an ordinary loss with respect to a capital asset.[212]

Present law

Section 1234A generally provides that gain or loss attributable to the cancellation, lapse, expiration, or other termination of a right or obligation with respect to property which is (or on acquisition would be) a capital asset in the hands of the taxpayer is treated as gain or loss from the sale of a capital asset.[213] Thus, in the above example, the taxpayer would have a capital gain or loss regardless of whether the contract was sold or cancelled.

Unlike the character of the income recognized from options and forwards discussed above, which typically is determined with reference to the character of gains and losses that result from a taxpayer's transactions with respect to the underlying asset, the character of swap payments is not determined by the character of the underlying asset. Proposed regulations issued in 2004 under section 1234A clarify that any swap payment other than a termination payment

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[212] Report of the Committee on Finance, United States Senate, on H.J. Res. 266, Economic Recovery Tax Act of 1981, S. Rep. No. 97-144, July 6, 1981, p. 170, in which the Finance Committee stated, "The Committee believes that the change in the sale or exchange rule is necessary to prevent tax-avoidance transactions designed to create fully-deductible ordinary losses on certain dispositions of capital assets, which if sold at a gain, would produce capital gains. The transactions already cause significant losses to the Treasury." See also Joint Committee on Taxation, *General Explanation of the Economic Recovery Tax Act of 1981* (JCS-71-81), December 29, 1981, pp. 313-314.

[213] This section also applies to section 1256 contracts. However, section 1234A does not apply to the gain or loss attributable to securities futures contracts, as defined in 1234B, or the retirement of any debt instrument.

generally constitutes ordinary income or expense.[214] This is consistent with the view that ongoing payments with respect to a swap or similar notional principal contract should be treated as ordinary income because these payments are not made with respect to a sale or exchange of a capital asset. Conversely, by application of section 1234A, gain or loss attributable to the termination of a swap contract should be capital if the contract is a capital asset in the hands of the taxpayer, and the proposed regulations clarify this point as well.[215]

[214] Prop. Treas. Reg. section 1 1234A-1.

[215] The proposed regulations treat any payment on a "bullet swap" or forward contract, including payments made pursuant to the terms of the contract, as termination payments for purposes of section 1234A. Prop. Treas. Reg. sec. 1.1234A-1(c). More recent proposed amendments to the income tax regulations under sections 1256 and 446 call into question this analysis See the discussion in section III A.5., above.

D. Issues Related to Source

The source of income related to a financial instrument may not always be clear. The source-of-income rules apply on a category by category basis, and income may have a different source for tax purposes if it is in one category rather than another. The source rules do not address the source of every type of income. The source of a taxpayer's income also may vary based on that taxpayer's status in the market. This section describes examples of sourcing challenges that arise from the category by category nature of source rules, the lack of a comprehensive definition of source, and the effect on sourcing of a taxpayer's role in the marketplace. As the first example illustrates, the flexibility of financial instruments produces sourcing challenges because economically equivalent instruments can be used to achieve different source outcomes.

1. Category of income conversion

A foreign investor seeking returns from the U.S. equity markets could purchase stock in U.S. companies. Dividends paid on this stock generally would be considered U.S. source and therefore would be subject to withholding tax at a 30-percent (or reduced treaty) rate.[216] Substitute dividend payments on stock of a domestic corporation, which a foreign investor could receive under a securities lending or sale-repurchase agreement, are U.S. source as well and are generally subject to U.S. withholding tax.[217]

Instead of actually owning the stock, a foreign investor can create synthetic ownership by holding an equity derivative contract. For example, a foreign investor might become a party to a total return swap under which returns to each party are based on the returns generated by a notional investment in a specified dollar amount of stock. The foreign party to this swap agrees for a specified period to pay to the counterparty (a) interest calculated at a market rate (such as LIBOR) on the notional amount of stock and (b) any depreciation in the value of the stock, and the counterparty agrees for the specified period to pay the investor (c) any dividends paid on the stock and (d) any appreciation in the value of the stock.[218] This swap is economically equivalent to a transaction in which the foreign investor actually purchases the stock from the counterparty, using funds borrowed from the counterparty, and at the end of the period sells the stock back to the counterparty and repaid the borrowing.

This equity swap has nearly identical economic characteristics to a leveraged purchase of stock except that the equity swap party has credit exposure to its swap counterparty. The tax

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[216] Secs. 861(a)(2)(A), 871(a)(1)(A), and 881(a)(1).

[217] Sec. 871(m)(2)(A), enacted in the Hiring Incentives to Restore Employment ("HIRE") Act, Pub. L. No 111-147, sec 541, as one category of a U.S.-source dividend equivalent. For purposes of the imposition of the 30-percent withholding tax, substitute dividend payments (and substitute interest payments) received by a foreign person under a securities lending or sale-repurchase transaction have the same character as dividend (and interest) income received in respect of the transferred security. Treas. Reg. secs. 1 871-7(b)(2), 1.881-2(b)(2)

[218] Amounts owed by each party under a total return swap typically are netted so that only one party makes an actual payment.

treatment of the foreign investor is different, however. Because the source of income from an equity swap (one type of a notional principal contract) is determined by reference to the residence of the recipient of the income, amounts representing dividends in this example are foreign source and therefore are not subject to U.S. withholding tax.[219] In the leveraged purchase transaction (a purchase of stock of a U.S. corporation using borrowed funds), by contrast, the foreign investor would receive actual dividends, and those dividends would be U.S. source and, therefore, generally would be subject to U.S. withholding tax.

To restrict foreign investors' use of notional principal contracts to avoid U.S. withholding tax that would be imposed on dividends received by those investors in respect of stock of U.S. companies, Congress legislated rules in 2010 that treat certain payments made under specified notional principal contracts as U.S.-source "dividend equivalent payments" subject to U.S. withholding tax.[220] A dividend equivalent includes any payment made under a specified notional principal contract that (directly or indirectly) is contingent upon, or determined by reference to, the payment of a dividend from sources within the United States. A dividend equivalent also includes any other substantially similar payment as determined by the Secretary.[221] For this purpose, a specified notional principal contract is any notional principal contract that has any one of the following five characteristics: (1) in connection with entering the contract, any long party to the contract transfers the underlying security to any short party to the contract; (2) in connection with the termination of the contract, any short party to the contract transfers the underlying security to the long party to the contract; (3) the underlying security is not readily tradable on an established securities market; (4) in connection with entering the contract, any short party to the contract posts the underlying security as collateral with any long party to the contract; or (5) the Secretary identifies the contract as a specified notional principal contract. For payments made more than two years after the date of enactment of the 2010 rules, all notional principal contracts are specified notional principal contracts unless the Secretary determines the contract is of a type that does not have the potential for tax avoidance. The Secretary has not yet made a determination.

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[219] Treas Reg. sec. 1 863-7(b). For a presentation of hypothetical equity and interest rate swaps and stock lending transactions and a discussion of whether and when imposition of withholding tax might be appropriate, see David P. Hariton, "Equity Derivatives, Inbound Capital, and Outbound Withholding Tax," *Tax Lawyer* 60 (Winter 2007), 313. See also Jasper L. Cummings, Jr., "Equity Derivatives: If 1 + 1 Sometimes Does Not Equal 2, Can It Ever Equal 2?" *Corporate Tax Insights*, vol. 5, no. 19 (Oct 9, 2007). Whether particular arrangements should be considered as ownership of stock of U.S. corporations rather than as contractual rights and obligations under notional principal contracts attracted attention when the Permanent Subcommittee on Investigations of the U.S. Senate Committee on Homeland Security & Governmental Affairs held a hearing related to cross-border notional principal contract, securities lending, and sale-repurchase transactions entered into or facilitated by certain investment funds and investment banks. See *Dividend Tax Abuse How Offshore Entities Dodge Taxes on U S Stock Dividends*, S. Hrg. No. 110-778, 110th Cong , 2d Sess. (Sept. 11, 2008).

[220] HIRE Act, Pub. L. No. 111-147, sec. 541.

[221] As described in footnote 217, a dividend equivalent also includes any substitute dividend made under 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 U.S. sources.

2. Gaps in source rules

Source rules do not cover every kind of income. Disputes between the IRS and taxpayers arise when taxpayers treat income for which no source rule exists as having a certain source (foreign, for example) and the IRS asserts that the income has the opposite source (U.S.). In disputes over the appropriate source of particular items of income, courts have determined the source of the income by applying the source rule for the category of income to which the disputed income is most closely analogous, based on all facts and circumstances. For example, letters of credit commissions have been sourced by analogy to interest.[222] This section describes three other examples of sourcing by analogy.

Guarantee fees

Business entities often guarantee the obligations of related or unrelated entities under loans made to those other entities. The entities providing the guarantees typically receive fees for the guarantee. The Code has no rule for the source of income from guarantee fees.

In a 2010 case, the U.S. Tax Court rejected IRS arguments that fees paid by a domestic corporation to its foreign parent for guarantees issued by the parent for the debts of the domestic corporation were analogous to interest.[223] The Tax Court concluded that the payments were more closely analogous to compensation for services and determined that the source of the fees should be the place where guarantees were produced, which was the country of residence of the foreign parent-guarantor. As a result, the income was treated as income from foreign sources.

As a legislative override of the opinion in *Container Corp.*, Congress recently amended the source rules of section 861 and 862 to address income from guarantees issued after the date of enactment. Under new section 861(a)(9), income from sources within the United States includes amounts received, whether directly or indirectly, from a noncorporate resident or a domestic corporation for the provision of a guarantee of that U.S. resident's indebtedness.[224] The scope of the provision includes payments that are made indirectly for the provision of a guarantee. For example, the provision treats as income from U.S. sources a guarantee fee paid by a foreign bank to a foreign corporation for the foreign corporation's guarantee of indebtedness owed to the bank by the foreign corporation's U.S. subsidiary, where the cost of the guarantee fee is passed on to the domestic subsidiary through, for example, additional interest charged on the indebtedness.

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[222] *Bank of America v United States*, 230 Ct. Cl. 679, 680 F.2d 142 (1982), *aff'g in part, rev'g in part*, 47 AFTR 2d 81-652 (Ct. Cl. 1981).

[223] *Container Corp v Commissioner*, 134 T.C. No. 5 (February 17, 2010), *gov't notice of appeal filed* (5th Cir. June 1, 2010).

[224] Small Business Jobs Act of 2010, Pub. L. No. 11-240, sec. 2122.

Life insurance proceeds

The Code has no rule for the source of income from a payment of proceeds on a life insurance contract. In 2009 the IRS considered the source of a foreign corporation's income from the proceeds of a life insurance contract covering the life of a U.S. resident.[225] In one of the fact patterns that the IRS addressed, B, a foreign corporation not engaged in a U.S. trade or business, purchased from A, a U.S. citizen and resident, a life insurance contract on the life of A for $20,000 with the intent of making a profit. The contract was originally issued by IC, a domestic corporation, to A in 2001. B made regular premium payments after buying the contract. A died in 2009, and IC paid $100,000 to B under the life insurance contract. B had paid monthly premiums totaling $9,000 to keep the contract in force. The IRS concluded that B must recognize $71,000 of income ($100,000 of proceeds less the $20,000 purchase price and $9,000 in premium payments) and that this amount was fixed or determinable annual or periodical income subject to U.S. withholding tax because it was U.S. source.

In concluding that the proceeds of the life insurance contract were U.S. source, the IRS considered the sourcing rules for interest (generally residence of the payor, with IC in the example a domestic corporation), for premiums received for the issuance of a life insurance contract (generally residence of the insured, with A in the example a U.S. resident), and for income from the sale of property (generally residence of the seller, with B in the example a foreign person). The IRS did not state which analogy it was adopting in determining that the income in question was U.S. source.

Futures contracts

The Code does not provide rules for the source of income from trading in futures contracts, forward contracts, option contracts, and other instruments. Instead, Congress has directed the Treasury Secretary to prescribe necessary or appropriate regulations applying the source rules for personal property sales to income derived from trading in these derivative instruments.[226] Treasury has not issued regulations.

In the absence of rules addressing the source of income from trading in futures contracts, forward contracts, and options contracts, the source of this income may be determined by analogy to existing source rules for income from sales of personal property. In some circumstances the source results under the personal property sales source rules depend on the manner in which a taxpayer participates in the market – as, for instance, a trader or a dealer.

For example, assume a U.S. taxpayer enters into a cash-settled oil futures contract on the New York Mercantile Exchange to purchase 1,000 barrels of oil three months in the future. Assume the price of oil appreciates and the taxpayer has gain when the contract settles for cash. By analogy, the source of income from the futures contract might be the same as the source of income from an actual sale of 1,000 barrels of oil. If the taxpayer is acting as a trader in oil

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[225] Rev. Rul. 2009-14, 2009-21 I.R.B. 1031 (2009)

[226] Sec. 865(j)(2)

futures and the barrels of oil would be personal property of the taxpayer, the source of the income from cash settlement under this analogy would be U.S. since the taxpayer is a U.S. resident. Does the answer differ if the U.S. taxpayer is an oil company trying to hedge its risk? In that case, the oil futures contract may be more analogous to inventory such that the source of income from cash settlement should be determined under the inventory property sales source rule, which is where the title to inventory property is passed. In this example of a cash-settled futures contract, though, there is no actual delivery of oil. The source outcome therefore might be different from the source result for income related to a futures contract that calls for delivery of the underlying property.[227]

[227] See *Zander & Cia Ltd v Commissioner*, 42 U.S. Board of Tax Appeals 50 (June 13, 1940) (declining to apply the title passage rule in determining the source of a Brazilian corporation's income from trading in cash-settled futures contracts on the New York Coffee and Sugar Exchange).

E. When Issues of Timing, Character, and Source Intersect

1. Timing and character rules for section 1256 contracts and tax straddles

Background

In the early 1980s, Congress recognized rapid growth in the use of tax straddles to affect both the timing and character of income.[228] A straddle is generally defined as offsetting long and short positions with respect to personal property. Thus, for example, holding a futures contract to buy gold in one month and holding a futures contract to sell gold in a different month is a straddle because the two contracts offset each other: if the price of gold increases, the futures contract to buy gold increases in value while the contract to sell decreases in value. In the absence of special rules, it was possible for taxpayers to defer gains, accelerate losses, and convert the character of income. Use of straddles for tax sheltering was so widespread that it was blamed for distortions recognized in the commodities markets.[229]

A typical commodity futures straddle worked as follows. A taxpayer established a position with two commodity futures contracts, one to buy and one to sell a commodity (*e.g.*, for wheat), with equal prices (*e.g.*, $100,000). The two contracts were identical in every respect, except for the delivery months. Because a futures contract buyer does not pay the purchase price up front, the cost for entering these offsetting positions was instead only the initial margin required by the futures exchange. For offsetting contracts the initial margin requirement was quite low, as little as one percent of the contract prices, or $2,000 in this example.

With the position established, the taxpayer waited for the price of wheat to change. Regardless of whether the price of wheat increased or decreased, one contract would increase in value and the other would decrease by a like amount. At any time, the taxpayer could liquidate the loss by entering into the opposite futures contract for the same month. In order not to become exposed to subsequent changes in the price of wheat, the taxpayer simultaneously replaced the liquidated contract with another wheat contract for a third month. The taxpayer claimed the realized loss from the liquidated contract as a short-term capital loss for tax purposes. This loss could be used to offset a short-term capital gain in the year of the liquidation. However, the taxpayer could continue to hold the gain contract into the subsequent tax year, deferring the built-in gain for at least one tax year. If that contract remained in a gain position and the taxpayer held the contract for more than one year, he could then recognize the gain as long-term capital gain. Moreover, the taxpayer did not have to make any payment on the liquidated contract because his margin account, reflecting the offsetting positions, showed no net

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[228] Report of the Committee on Finance, United States Senate, on H.J. Res. 266, Economic Recovery Tax Act of 1981, S. Rep No. 97-144, July 6, 1981, p 146, and see Joint Committee on Taxation, *General Explanation of the Economic Recovery Tax Act of 1981* (JCS-71-81), December 29, 1981, p. 294.

[229] Report of the Committee on Finance, United States Senate, on H.J. Res. 266, Economic Recovery Tax Act of 1981, S. Rep No. 97-144, July 6, 1981, p. 147; and see Joint Committee on Taxation, *General Explanation of the Economic Recovery Tax Act of 1981* (JCS-71-81), December 29, 1981, p. 283.

loss. In addition, because the taxpayer maintained a balanced position, he ordinarily was not required to post additional margin.

Thus, for the cost of posting a modest amount of collateral, taxpayers used basic financial instruments to defer gains, accelerate losses, and convert short-term capital gain to preferentially taxed long-term capital gain, and in some instances, to convert ordinary income into long-term capital gain.[230]

Prior to the Economic Recovery Tax Act of 1981,[231] the Code did not contain any special rules dealing with straddles in commodities or in futures contracts for commodities. In the case of a typical straddle in commodity futures contracts, neither the wash sale rules applicable to stocks or securities (section 1091, discussed above), nor the special short sales rules, preventing conversion of short-term gain to long-term gain or long-term losses to short-term losses, applied.

Present law

Section 1256 provides special timing and character rules for a contract identified as a section 1256 contract. Any gain or loss with respect to a section 1256 contract is subject to a mark-to-market timing rule. The character of gain or loss (if not otherwise ordinary) is determined under the 60/40 rule. That is, it is treated as long-term capital gain or loss, to the extent of 60 percent of the gain or loss, and short-term capital gain or loss, to the extent of the remaining 40 percent of the gain or loss regardless of the taxpayer's holding period.[232] Gain or loss is recognized upon the termination (or transfer) of a section 1256 contract, by offsetting, taking or making delivery, by exercise or by being exercised, by assignment or being assigned, by lapse, or otherwise, and is also generally treated as 60 percent long-term capital and 40 percent short-term gain or loss.[233] A taxpayer other than a corporation may elect to carry back its net section 1256 contract losses for three taxable years.[234]

A section 1256 contract is defined as any (1) regulated futures contract; (2) foreign currency contract; (3) nonequity option, (4) dealer equity option, and (5) dealer securities futures contract.[235] The term section 1256 contract does not, however, include (1) any securities futures contract or option on such a contract unless such contract or option is a dealer securities futures contract, or (2) any interest rate swap, currency swap, basis swap, interest rate cap, interest rate

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[230] Because of special rules for the taxation of Treasury bills, it was possible to use Treasury bill straddles to convert ordinary income (*e g*, salary and interest) into long-term capital gain. See Joint Committee on Taxation, *General Explanation of the Economic Recovery Tax Act of 1981* (JCS-71-81), December 29, 1981, pp. 308-310.

[231] Pub. L. No. 97-34.

[232] Sec. 1256(a)(3). This general rule does not apply to 1256 contracts that are part of certain hedging transactions or section 1256 contracts that but for the rule in section 1256(a)(3) would be ordinary income property.

[233] Sec. 1256(c)(1)

[234] Sec. 1212(c).

[235] Sec. 1256(b).

floor, commodity swap, equity swap, equity index swap, credit default swap, or similar agreement.[236]

Section 1256 resolves the timing and character issues presented by futures straddles by requiring the recognition of gain or loss on an annual basis and providing the 60/40 rule for character.

To address straddles involving actively traded personal property other than futures, the Economic Recovery Tax Act of 1981 also added section 1092. Section 1092 addresses straddle timing issues by allowing any loss realized on one or more positions in a straddle only to the extent that the amount of the loss exceeds the unrecognized gain (if any) with respect to one or more offsetting positions.[237] Any disallowed loss is carried over and treated as a loss sustained in the succeeding taxable year. Section 1092, and the regulations promulgated thereunder, address straddle character issues by preventing the conversion of short-term capital into long-term capital gain with special holding period rules[238] and character rules.[239]

Issues relating to tax treatment under section 1256

The existence of special timing and character rules for section 1256 contracts creates both incentives and disincentives for taxpayers to trade in section 1256 contracts and to characterize financial instruments as section 1256 contracts.

Individual taxpayers, for example, may find trading in section 1256 contracts favorable because of the 60/40 rule, notwithstanding the mark-to-market requirement. For instance, if a taxpayer's investment strategy does not generally involve holding assets for more than one year, trading in section 1256 contracts (rather than the underlying asset(s) directly) converts 60 percent of any gains into preferentially taxed long-term capital gain.

The 60/40 rule may be less attractive to a corporate taxpayer. Corporate taxpayers are not eligible for a reduced rate of tax on long-term capital gains and may use capital losses only to offset capital gains (not ordinary income). In addition, a corporate taxpayer's unused capital losses may only be carried back three years and forward five. Corporations are not so limited in their use of ordinary losses, and may generally carry ordinary losses back two and forward 20 years.

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[236] Sec. 1256(b)(2)

[237] Sec. 1092(a)(1) The special rules of section 1092 do not apply to hedging transactions (sec. 1092(e)), straddles composed entirely of section 1256 contracts (sec. 1256(a)(4)) or qualified covered calls (sec. 1092(c)(4)) Special rules apply for mixed straddles (generally, straddles composed of both section 1256 contracts and non-section 1256 contracts) and identified straddles (sec. 1092(a)(2))

[238] Sec. 1092(b) and Treas. Reg. sec. 1.1092(b)-2T(a).

[239] Sec. 1092(b) and Treas Reg. sec. 1 1092(b)-2T(b)(1).

Another factor affecting taxpayers' use of section 1256 contracts relates to provisions of legislation enacted in 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Act,[240] related to swaps. That Act requires that certain swaps be cleared through a regulated clearing party and executed on a regulated exchange or swap execution facility. During Congressional consideration of the legislation, some commentators questioned whether those requirements might have the effect of causing such swaps to meet the definition of regulated futures contracts under section 1256(g) and therefore to be section 1256 contracts subject to mark-to-market treatment and the 60/40 rule.[241] A provision added to Dodd-Frank excludes certain swaps, caps, floors and similar agreements from the definition of a section 1256 contract.[242] The exclusion is intended to clarify the scope of section 1256 in response to the recharacterization of income as a result of increased exchange-trading of derivative contracts.[243]

Notwithstanding the addition of this exclusion from the definition of a section 1256 contract, some uncertainty regarding the scope of section 1256 persists.[244] In addition to potential issues raised by the enactment of Dodd-Frank, developments in the futures markets are testing the boundaries of the term "regulated futures contract" under section 1256. For example, futures contracts have been created with economic terms identical to bilateral interest rate swaps.[245] This uncertainty may create traps for the unwary, or alternatively, encourage aggressive tax planning by those taxpayers who find the tax results of section 1256 contracts attractive, as well as for those interested in avoiding the timing and character rules of section 1256. On September 15, 2011, however, the Treasury Department and the IRS issued a Notice of Proposed Rulemaking that would eliminate any overlap between NPCs and section 1256 contracts by treating any contract that is an NPC as not being a section 1256 contract.[246]

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[240] Pub. L No 111-203.

[241] See, *e g*, Erika W. Nijenhuis, "New Tax Issues Arising from Derivatives Reform," 127 *Tax Notes* 1235 (June 14, 2010) (published before the enactment of Dodd-Frank) and "New Tax Issues Arising From the Dodd-Frank Act and Related Changes to Market Practice for Derivatives," *Columbia Journal of Tax Law*, vol. 2, no 1 (January 6, 2011) (a later version of the same article published after the enactment of Dodd-Frank).

[242] Sec. 1601 of Pub L. No. 111-203, adding section 1256(b)(2)(B) to the Code.

[243] H.R. Conf Rep. No. 517, 111th Cong., 2d Sess., p. 879 (2010).

[244] See, *e g*, Erika W. Nijenhuis, "New Tax Issues Arising From the Dodd-Frank Act and Related Changes to Market Practice for Derivatives," *Columbia Journal of Tax Law*, vol. 2, No. 1 (January 6, 2011) (discussing issues arising from Dodd-Frank and market developments).

[245] See, *e g*, Erika W. Nijenhuis, "New Tax Issues Arising From the Dodd-Frank Act and Related Changes to Market Practice for Derivatives," *Columbia Journal of Tax Law*, vol. 2, No. 1 (January 6, 2011), pp. 31-33 (discussing cleared interest rate swaps and interest rate swap for futures exchange transactions) and International Derivatives Clearinghouse website, http://idcg.com/idch/index.html (offering "market participants the ability to replace existing bilateral interest rate swap contracts with economically equivalent listed" swap futures contracts).

[246] Notice of Proposed Rule Making, Fed. Reg. vol. 76, no. 180, p. 57684 (proposed amendments affecting the scope of the term "section 1256 contract" and addressing the definitions in the notional principal contract regulations under section 446)

2. Constructive ownership transactions under section 1260

Background

An entity taxable as a partnership is generally treated for Federal income tax purposes as a passthrough entity and is not such to Federal income tax at the entity level. Rather, each partner includes its share of partnership income, gain, loss, deduction, or credit in determining the partners' taxable income. Generally, the character of items of income, gain, and loss is determined at the partnership level. The Code also provides for other types of entities that allow for passthrough of character and that are either not subject to tax at the entity level,[247] or that may reduce or eliminate the entity level tax,[248] if applicable requirements are met.

Under the law in effect prior to the enactment of section 1260 in 1999, and recognizing that derivative contracts can be used to generate the same or similar economic benefits as owning property directly but with potentially different tax consequences, taxpayers used derivative contracts with respect to partnerships and other passthrough entities both to defer and to convert the character of income and gains.

One example of a transaction involving derivatives and passthroughs that purported to convert the character of income is as follows. Assume that a taxpayer enters into an arrangement with a securities dealer whereby the dealer agrees to pay the taxpayer any appreciation with respect to a notional investment in a hedge fund taxable as a partnership in three years time. In return, the taxpayer agrees to pay the securities dealer any depreciation in the value of the notional investment at such time. Under the arrangement, the taxpayer is in substantially the same economic position as if he owned the interest in the hedge fund directly. However, the taxpayer is not required to include items of partnership income or gain in income as earned by the hedge fund partnership, thus deferring the payment of tax on those amounts. In addition, if the taxpayer holds the contract until settlement, and if the partnership interest would be a capital asset in the hands of the taxpayer, then regardless of the character of income and gain allocated to actual partners over the three year period, the taxpayer with a derivative on the partnership could treat any appreciation resulting from the contractual arrangement as long-term capital gain.[249]

Present law

Under section 1260, gain from a constructive ownership transaction with respect to any financial asset that would otherwise be treated as long-term capital gain is recharacterized as ordinary income to the extent that the gain exceeds the aggregate net capital gain the taxpayer

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[247] See, *e g* , subchapter S corporations.

[248] See, *e g* , real estate investment trusts and regulated investment companies

[249] Section 1234A and Prop. Treas. Reg. sec. 1.1234A-1(b). Prop. Treas. Reg. sec 1 1234A-1(c). Proposed amendments to the income tax regulations under sections 1256 and 446 call into question this analysis. See discussion in section III.A.5. above.

would have had if the financial asset had been acquired, taking into account only gains and losses from such deemed ownership. The amount of capital gain thus treated as ordinary income is then subject to an interest charge reflecting the deferral of the gain recognition. A constructive ownership transaction is defined to include any circumstance in which a taxpayer (1) holds a long position under a notional principal contract with respect to a financial asset; (2) enters into a futures or forward contract to acquire a financial asset; (3) is the holder of a call option and the grantor of a put option with substantially equal strike prices and substantially contemporaneous maturity dates with respect to a financial asset, or (4) enters into any other transaction described in Treasury regulations that has substantially the same effect as any of the foregoing transactions.[250] A financial asset means any equity interest in a "pass-thru entity" defined to include a regulated investment company, real estate investment trust, S corporation, partnership, trust, common trust fund, passive foreign investment company, or real estate mortgage investment conduit.[251]

In effect, section 1260 treats the taxpayer as if he were obligated to include the current return on his investment in income on a current basis over the life of the transaction but failed to do so.[252] In other words, the taxpayer is placed in roughly the same position as if he had actually owned the underlying financial asset but had failed to pay tax on his investment return on a timely basis.

Issues relating to constructive ownership transactions

Section 1260 applies to reduce the benefit of deferral and character conversion in a relatively narrow set of conditions. Section 1260 only applies with respect to a specified list of "pass-thru" entities and only with respect to a specified list of "constructive ownership transactions." Therefore, a constructive ownership transaction with respect to an asset that is not a pass-thru entity is not affected by section 1260. For example, a taxpayer who enters a total return swap on the stock of a dividend paying corporation has not engaged in a constructive ownership transaction. The discussion of exchange traded notes, below, illustrates tax planning to defer income and convert its character using derivative products with respect to assets other than pass-thru entity interests.

Conversely, a taxpayer entering a derivative transaction with respect to a pass-thru entity that is not a constructive ownership transaction is not subject to section 1260. Although the section authorizes the Secretary of the Treasury to expand the list of identified transactions that have substantially the same effect, no regulations have been issued. An option with respect to an interest in a pass-thru entity is not an identified "constructive ownership transaction." However,

[250] Sec. 1260(d)(1).

[251] Sec. 1260(c)(1) and (2).

[252] This approach is analogous to the treatment of a U.S. shareholder upon a disposition of stock in a passive foreign investment company under section 1291.

options structured to replicate characteristics of ownership risk recharacterization as ownership.[253]

3. Exchange traded notes

Background

Exchange traded notes ("ETNs") are a derivative financial instrument sold to retail investors and traded on major securities exchanges that give investors economic exposure to a wide range of asset classes and investment strategies. Although ETNs are a relatively new financial instrument (the first ETN was issued in 2006), the ETN market has grown rapidly. In the first two years following their introduction, the market for ETNs exceeded $6 billion. Notwithstanding the recent financial crisis and the bankruptcy of Lehman Brothers (a sponsor of several ETNs), the ETN market has continued to expand. As of October 31, 2011, total assets invested in U.S. listed ETNs totaled over $15 billion.[254]

An ETN is a bilateral, executory contract with a relatively long maturity date (*e.g.*, 30 years) pursuant to which an investor makes an initial payment in exchange for a promise by the issuer to pay an amount at maturity. ETNs are structured so that the future payment amount is linked to the return on a notional investment in a specified market index or strategy, less fees owed the issuer. ETNs may, but often do not, pay a current coupon. ETNs are available that track, among other things, changes in the values of physical commodities, currency exchange rate movements, the performance of equities or groups of equities, and a variety of trading strategies.[255] Because ETNs are actively traded during normal trading hours on major exchanges, they afford investors an opportunity to liquidate their investment through sales in an active market.

It is not uncommon for ETNs to track investments that generate a current yield (*e.g.*, dividends, call premiums). ETN terms generally provide that current dividends or other yields on the underlying assets are notionally reinvested, so that the relevant index constitutes a total return index. It may also be the case that the notional investment involves the sale or purchase of the underlying assets. For example, for an ETN tracking a securities index, the specific securities constituting the index may be periodically adjusted in accordance with the predetermined rules of the investment strategy.

The economic position of the investor in an ETN is similar (but not identical) to that of an investor who pursues the underlying investment strategy by, for example, buying and selling the securities that comprise the index directly, purchasing stock in a mutual fund pursuing the same strategy, or holding a partnership interest in a partnership pursuing the same investment

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[253] See, *e g* , Chief Counsel Attorney Memorandum 2010-005, October 15, 2010 (treating the holder of a call option on a basket of securities as the owner of the securities for tax purposes where the option holder was economically compelled to exercise the option and essentially managed the basket of securities).

[254] See http : www nsx com/content/etf-assets-list (last accessed on November 8, 2011).

[255] The discussion herein is limited, however, to ETNs that reference equity securities

strategy directly. In addition to timing differences, trading and brokerage fees paid by a direct investor may differ from the management and other fees charged by the ETN issuer. The ETN investor is also exposed to the creditworthiness of the ETN issuer, to whom it will look for payment at maturity, typically as long as 30 years in the future.[256]

Issuers of ETNs are typically financial institutions. These financial institutions typically hedge their exposure under the ETNs by purchasing the underlying assets referenced in the contract or by acquiring an offsetting contract. Financial institutions that are securities dealers for purposes of section 475 are generally required to mark their positions to market with any gain or loss being characterized as ordinary. As a result, net income from the institution's two offsetting transactions would, in effect, constitute fees for serving as intermediary.

Present law

The proper tax classification of ETNs is not entirely clear.[257] ETNs generally are treated as debt for financial accounting purposes, and holders of these securities are subject to the credit risk of the issuer. Nonetheless, the prevailing view among issuers of ETNs and their counsel is that ETNs are not indebtedness for Federal income tax purposes, but should be treated for tax purposes as prepaid forward contracts.[258] This conclusion is based, in part, on analogy to the treatment of other prepaid forward contracts that have been issued in the capital markets in recent years.[259] Thus, ETN market participants take the position that an ETN investor is not required to include in income any amounts of interest, dividends, or gains during the time the ETN investor holds the security, and that any gain or loss recognized upon maturity or other disposition of the security would generally be treated as capital gain or loss.

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[256] Although the failure of a major financial institution is comparatively rare, the bankruptcy of Lehman Brothers during the recent financial crisis demonstrated to ETN holders that counterparty credit risk can be a significant issue. Holders of ETNs issued by Lehman Brothers became general unsecured creditors in the Lehman Brothers bankruptcy.

[257] In Notice 2008-2, 2008-2 I.R.B. 252, the IRS requested public comment on the proper tax treatment of ETNs and other transactions referred to as prepaid forward contracts. A number of interested parties responded with differing proposals including the Vanguard Group, the Investment Company Institute, the New York State Bar Association Tax Section and the Securities Industry and Financial Markets Association. The current IRS Priority Guidance Plan includes regulations on prepaid forward contracts. See Department of the Treasury, 2011-2012 Priority Guidance Plan, First Quarter Update (October 31, 2011), p. 12.

[258] Taxpayers take this position with respect to ETNs that are not currency-linked ETNs described in Rev. Rul. 2008-1, 2008-2 I.R.B. 248. In that Revenue Ruling, the IRS finds that a currency-linked ETN is in fact properly classified as debt for Federal income tax purposes. In Notice 2008-2, 2008-2 I.R.B. 252, the IRS solicited comments from the public on how OID accruals should be computed on currency-linked ETNs treated as debt and also solicited comments on the proper tax treatment of non-currency-linked ETNs.

[259] Rev. Rul. 2003-7, 2003-1 C.B. 363.

Issues relating to tax treatment of ETNs

The classification of ETNs as prepaid forward contracts results in significant differences between the timing and character of income from an ETN investment and other economically similar investments. The following discussion seeks to illustrate these differences, and the general principles set out in earlier sections of this report, by examining a hypothetical ETN over a 10-year period.

Dogs of the Dow ETN

Assume that an individual investor wants to invest $1,000 in the stock market, following the Dogs of the Dow investment strategy over a 10-year period. Under this strategy, an investor selects annually for investment the 10 stocks in the Dow Jones Industrial Average with the highest dividend yields (in other words, whose dividend is the highest fraction of their price). The investor invests equal dollar amounts in each of the 10 stocks, and the portfolio is adjusted annually based on the closing price of each stock in the DJIA on the last trading day of the year.

Instead of investing in the stocks directly, assume the investor purchases from the issuer $1,000 worth of an ETN designed to track the Dogs of the Dow strategy.[260] Under the terms of the ETN, the investor receives no payment from the issuer until maturity of the security in 10 years. On maturity, the investor receives an amount equal to the amount he or she would have received from an actual $1,000 investment in a basket of stocks managed in accordance with the Dogs of the Dow strategy over the 10-year life of the security. Current dividends paid on the underlying stocks are notionally reinvested in the basket, and the constituent securities in the basket are annually adjusted in accordance with the predetermined rules of the Dogs of the Dow strategy.

Tax treatment of a direct investment in Dogs of the Dow stocks

The investor investing directly in the Dogs of the Dow portfolio includes in income currently any dividends paid on the stocks in the portfolio. In addition, to the extent that the strategy requires annual sales of stock to adjust the portfolio, the direct investor recognizes capital gain or loss at the time of the sale. Such gain or loss is short-term or long-term, depending upon the holding period for the particular stock sold. The investor also recognizes long-term or short-term capital gain when the portfolio is sold after 10 years, depending upon his holding period for the individual stocks sold.

Similarly, if an investor purchases for $1,000 shares in a mutual fund[261] that tracks the Dogs of the Dow strategy and holds those mutual fund shares for 10 years, the investor includes

[260] The discussion assumes that the investor is not subject to any special rules by virtue of his or her status (for example, that the investor is not a dealer in ETNs) and thus is subject to the general rules governing timing, character, and source of investment income

[261] Diversification requirements under the Code and securities laws to which mutual funds are subject may preclude a mutual fund from following the Dogs of the Dow strategy precisely, but we have used this example for ease of illustration. The analysis set out herein applies equally to an investment strategy involving a larger and more diverse portfolio of actively managed stocks.

currently each year amounts distributed by the fund reflecting dividend distributions on the underlying stocks and any net gain recognized by the fund in connection with portfolio adjustments.[262] The investor recognizes long-term capital gain or loss upon disposition of the mutual fund shares after 10 years.

Tax treatment of Dogs of the Dow ETN

Treatment of the Dogs of the Dow ETN as a prepaid forward contract produces different tax results for the investor than following the strategy through direct stock investments. The execution of a forward contract generally has no immediate income tax consequence under current law, but is treated as an open transaction until the contract is settled.[263] In addition, if a forward contract is settled by delivery of the property underlying the contract, the taxpayer acquiring the property pursuant to the terms of the forward recognizes no gain or loss and takes a basis in the property equal to the purchase price. If a forward contract is cash-settled, gain and loss are recognized when the contract is settled. This gain or loss is capital if the underlying property is capital in nature.[264] If a forward contract is sold, gain or loss is recognized, and the character of the gain or loss is capital if the forward contract is a capital asset in the hands of the selling taxpayer.

Direct investment in Dogs of the Dow securities results in current annual inclusions of both ordinary dividend income (perhaps eligible for a preferential rate through 2012) and capital gain or loss on dispositions made to adjust the portfolio, some of which may be short-term gain taxable at ordinary income rates. In contrast, investment in the portfolio through the Dogs of the Dow ETN defers all income recognition until maturity (or sale) and allows for the conversion of ordinary dividend income and potential short-term capital gain on portfolio adjustments into long-term capital gain.

The availability of the Dogs of the Dow ETN as an alternative to direct ownership of a Dogs of the Dow portfolio presents a tax planning opportunity for investors. On the one hand, this may suggest that the tax treatment of the ETN, and prepaid contracts more generally, should be changed to conform more closely to the treatment of the returns from actual ownership of the underlying assets. On the other hand, the existing treatment of a prepaid forward contract as an open transaction reflects the principle that income generally is not taxed until realization occurs

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[262] Sec. 852. A regulated investment company is effectively required to distribute substantially all of its taxable income to shareholders to avoid taxation of that income at the level of the regulated investment company. An investor may elect to reinvest the distribution in shares of the fund, but the investor is still taxed on the distribution in that circumstance

[263] The fact that a forward contract calls for prepayment has not been treated as changing the tax treatment of the contract, but compare Rev. Rul. 2003-7, 2003-1 C.B. 363. The normal tax treatment of forward contracts may be affected by special rules applicable to section 1256 contracts, constructive sale transactions, short sales, straddles, hedging transactions, and conversion transactions. Special rules also apply under section 988 to forward contracts that relate to a foreign currency In the case of forward contracts entered into by a dealer, mark-to-market rules apply under section 475.

[264] Sec. 1234A

(*e.g.*, upon a sale, exchange, or payment), when the amount of the income is known and the taxpayer has cash to pay the tax.

Exceptions to the realization principle exist under current law pursuant to which taxpayers are required to include imputed income prior to realization. In general, these exceptions apply only in contexts where the taxpayer is assured of receiving at least a repayment of his investment, for example, the rules governing debt instruments with original issue discount. In the case of a contingent debt instrument that yields a return contingent on the performance of an index, an investor is required to include income currently at an imputed fixed rate notwithstanding that he may receive more or less than that amount (including no return at all, if the index performs poorly) when actual payments are made on the debt instrument. (Adjustments are made to reflect differences between the imputed income included currently and actual payments when they are eventually made.) In that case, however, the investor will generally receive at least a repayment of his principal amount under the terms of the debt instrument. The tax treatment of a contingent payment debt instrument can be analogized to the treatment of a fixed rate debt instrument coupled with a swap of the fixed return for a contingent return.

By contrast, the investor in an ETN is not assured of receiving any return at all, including repayment of his original investment. For that reason, the ETN is not subject to the income imputation regime that applies to contingent debt instruments. Rather, to date, ETNs have been classified as forward contracts for which income imputation is not required.

APPENDIX: DATA ON FINANCIAL INSTRUMENTS

Value of financial instruments held or issued by U.S. persons

Table A.1 provides information on the market value of certain basic financial instruments outstanding and held or issued by U.S. persons. In 2010, total credit market instruments outstanding represented $52.5 trillion, the largest component of which was mortgages at $13.8 trillion, followed by corporate bonds at $11.4 trillion, Treasury securities at $9.4 trillion, and government agency and government sponsored enterprise ("GSE") securities at $7.6 trillion.[265] Nearly $3 trillion of municipal bonds were outstanding at the end of 2010. The market value of corporate equities was $23.2 trillion. This is in addition to the value of mutual fund shares ($7.9 trillion) and money market fund shares ($2.8 trillion).[266]

Table A.1.–Market Value of Selected Financial Instruments Outstanding (Billions of U.S. Dollars)

	2005	2006	2007	2008	2009	2010
Money Market Fund Shares	2,007	2,312	3,033	3,757	3,258	2,755
Credit Market Instruments	41,281	45,355	50,045	52,434	52,347	52,494
Open market paper	1,644	1,958	1,789	1,599	1,137	1,058
Treasury securities	4,678	4,862	5,099	6,338	7,782	9,362
Agency- and GSE-backed securities	6,165	6,492	7,397	8,167	8,107	7,598
Municipal securities	2,226	2,403	2,619	2,680	2,810	2,928
Corporate and foreign bonds	8,694	9,982	11,435	11,013	11,508	11,473
Bank loans not elsewhere classified	1,578	1,705	2,027	2,721	1,922	1,874
Other loans and advances	1,901	2,072	2,605	2,712	2,276	1,951
Mortgages	12,075	13,465	14,517	14,610	14,327	13,817
Consumer credit	2,321	2,416	2,555	2,594	2,479	2,435
Corporate Equities	20,636	24,339	25,581	15,641	20,123	23,247
Mutual Fund Shares	6,049	7,068	7,829	5,435	6,962	7,935
Security Credit	1,038	1,250	1,526	1,129	1,091	1,215

Source: Federal Reserve Board, Flow of Funds

[265] Agency- and GSE-backed securities include debt securities issued by budget agencies (such as the Tennessee Valley Authority and the Federal Housing Administration), GSEs (such as Fannie Mae), and GSE-backed mortgage pools. Until 2010, agency- and GSE-backed securities represented a larger share of credit market instruments outstanding than Treasury securities.

[266] All categories shown in Table A.1 are mutually exclusive. For example, in 2005, the $6 trillion in mutual fund shares does not include the $2 trillion in market value of money market fund shares. As a further example, security credit is not considered a credit market instrument because it is an indirect form of credit. Security credit consists of certain loans to security brokers and dealers from the commercial banking sector for purchasing and carrying securities for which securities are used as collateral, as well as customer balances with brokers and dealers. For additional data descriptions, see table descriptions in the Board of Governors of the Federal Reserve System, *Flow of Funds Guide*, September 16, 2011, available at http://www.federalreserve.gov/apps/fof/FOFTables.aspx.

The financial crisis of 2008 is evident in the data in various ways. Holdings of money market fund shares increased 23.9 percent between 2007 and 2008, perhaps representing a shift in investor portfolios towards lower risk assets. This reallocation along with stock market price declines reduced the value of corporate equities and mutual fund shares by 38.9 percent and 30.6 percent, respectively. Credit market instruments, however, grew throughout the period as increases in Treasury and municipal borrowing and stability among corporate bonds outstanding offset declines in the commercial paper market and bank lending.

New U.S. debt and equity issuances

Table A.2 contains historical information on the volume of new issuances of financial instruments. Data are reported separately for corporate debt, corporate equity, and government debt. Corporate debt consists of straight corporate debt (without conversion features and not backed by specific assets), convertible bonds, asset-backed debt, and mortgage-backed securities issued by corporations other than the GSEs. Corporate equity issuances in the United States are reported separately for common and preferred stock. In addition, Table A.2 includes information on municipal bonds, Treasury debt, GSE debt, and GSE mortgage-backed securities.

New issuances of corporate debt peaked in 2006 at $2.8 trillion, but were less than half that level in 2010. Equity issuances, by contrast, have remained relatively strong, dominated by common stock offerings. Treasury debt issuance has tripled since 2007 to $2.3 trillion.

Table A.2.–Market Value of New Issuance of Debt and Equity Financial Instruments
(Billions of U.S. Dollars)

Year	Corporate Debt					Corporate Equity			Government Debt				
	Straight Corporate Debt	Convertible Debt	Asset-Backed Debt	Non-Agency MBS[1]	Total Corporate Debt	Common Stock	Preferred Stock	Total Corporate Equity	Municipal Bonds	Treasury Debt	Agency Debt	Agency MBS[1]	Total Other Debt
1990	77	6	44	43	169	19	5	24	128	398	55	235	816
1991	160	9	52	59	281	56	20	76	173	466	81	268	987
1992	240	8	56	83	386	73	29	102	235	506	110	455	1,305
1993	340	15	63	118	535	102	28	131	293	507	147	568	1,514
1994	222	12	82	74	390	61	16	77	165	477	158	359	1,158
1995	280	12	113	37	441	82	15	97	162	511	228	269	1,169
1996	343	21	168	52	584	116	37	152	185	612	278	371	1,446
1997	466	26	223	69	785	120	33	153	221	540	323	368	1,452
1998	611	18	287	192	1,107	115	38	153	287	438	596	727	2,049
1999	629	27	287	141	1,084	164	28	192	228	365	548	685	1,825
2000	588	50	282	102	1,020	189	15	205	201	312	447	482	1,442
2001	776	78	326	219	1,399	128	41	170	288	381	941	1,093	2,702
2002	637	31	374	289	1,330	116	38	154	358	572	1,042	1,444	3,415
2003	776	73	462	441	1,751	119	38	156	383	745	1,268	2,130	4,525
2004	781	33	652	533	1,997	170	33	203	360	853	882	1,017	3,112
2005	753	30	754	901	2,438	161	30	190	408	746	669	966	2,790
2006	1,059	63	754	917	2,793	157	33	191	387	789	747	915	2,837
2007	1,128	76	510	774	2,488	188	60	248	429	752	942	1,149	3,272
2008	707	42	140	45	934	165	78	243	392	1,037	984	1,148	3,561
2009	902	33	151	32	1,118	255	10	264	410	2,075	1,086	1,653	5,223
2010	1,063	29	107	19	1,218	239	22	262	433	2,304	1,179	1,403	5,319

[1] Mortgage-backed securities.
Source: Securities Industry and Financial Markets Association.

U.S. equities transaction activity

The SEC reports data on the volume of trading activity on all regulated U.S. exchanges. Table A.3 reports data on the total market value of all sales of equities and options listed on an exchange. It also reports the value of such options that were exercised and the value of single-stock futures that were delivered under futures contracts. Information on options and futures on indices is specifically excluded.

In 2009, there were nearly $60 trillion of equities and options trades on U.S. exchanges along with option exercises and futures deliveries. This was down more than 25 percent from a peak of over $82 trillion in 2008. However, transaction volume in 2009 was still nearly ten times the level in 1995.

Equity trading constitutes over 95 percent of the market value of sales, though options activity has increased as a share of volume since 2002.

The SEC began reporting security futures trading data in November 2002. The final column of Table A.3 reports the number of round-trip (one sale and one purchase) contracts in single-stock futures traded on an exchange. Activity more than tripled from 2003 through 2007, but returned to 2003 levels by 2009.

Table A.3.–U.S. Transaction Activity in Equities, Options, and Security Futures Market Value of Sales (Millions of U.S. Dollars)

Year	Total	Equity Trading	Option Trading	Option Exercises and Futures Deliveries	Security Futures Trading (Contracts)
1991	2,666,702	2,590,422	27,104	49,177	NA
1992	3,148,024	3,077,507	26,586	43,931	NA
1993	4,261,937	4,179,743	33,779	48,415	NA
1994	4,591,283	4,501,577	35,883	53,823	NA
1995	6,321,475	6,207,746	50,803	62,926	NA
1996	8,266,339	8,123,748	67,862	74,729	NA
1997	11,692,830	11,487,872	104,535	100,422	NA
1998	15,164,183	14,903,153	140,261	120,769	NA
1999	23,218,783	22,813,331	260,294	145,159	NA
2000	36,275,278	35,557,087	485,106	233,085	NA
2001	26,138,050	25,636,203	277,549	224,298	NA
2002	23,028,157	22,657,944	161,278	208,935	307,169
2003	22,737,469	22,291,534	164,085	281,851	2,501,247
2004	27,875,851	27,158,223	222,962	494,666	2,175,093
2005	34,567,580	33,222,684	350,365	994,531	5,493,850
2006	43,940,594	41,797,793	531,302	1,611,498	7,793,480
2007	66,135,906	63,064,287	860,659	2,210,959	7,858,431
2008	82,012,446	78,653,007	1,095,766	2,263,674	3,733,682
2009	59,849,805	57,565,681	709,842	1,574,282	2,728,266

NA= Not available.
Source: Securities and Exchange Commission.

U.S. exchange traded and OTC derivatives markets

Notional amounts outstanding

The Office of the Comptroller of the Currency ("OCC") reports quarterly on bank derivative activities and trading revenues based on regulatory Call Report information provided by all insured U.S. commercial banks and trust companies, reports filed by U.S. financial holding companies, and other published data.[267] More than 1,000 insured commercial U.S. banks report derivatives activity as of the end of the second quarter of 2011; however, that activity is heavily concentrated in the largest financial institutions. The top five institutions account for 95.9

[267] See, for example, Office of the Comptroller of the Currency, *Quarterly Report on Bank Trading and Derivatives Activities*, Second Quarter 2011, available at http://www.occ.gov/topics/capital-markets/financial-markets/trading/derivatives/dq211.pdf.

percent of the notional principal amount outstanding of total derivatives, while the top 25 institutions account for 99.9 percent of amounts reported by the OCC.

Table A.4 contains historical data on the notional values outstanding of derivative activity of U.S. commercial banks. While "changes in notional volumes are generally reasonable reflections of business activities," the OCC notes that it "does not provide a useful measure of either market or credit risks."[268] Data are presented by type of contract and by type of derivative instrument.

By type of contract

As of the end of 2010, there were over $231 trillion in notional amount of derivatives contracts outstanding. Interest rate contracts represent about 84 percent of the total at $193.5 trillion, followed by foreign exchange contracts (9.1 percent, $21.0 trillion) and credit derivatives (6.1 percent, $14.2 trillion). Equity-linked contracts and commodity contracts account for less than 1 percent of the notional amount outstanding each.

The notional amount of derivatives outstanding has grown at an average annual rate of 16.2 percent since 1998, when there was just under $33 trillion notional amount outstanding. The growth in credit derivatives has led the expansion of the overall market, increasing at an average annual rate of 42.3 percent, while foreign exchange derivatives and equity-linked derivatives have grown more slowly. The notional value of foreign exchange contracts represented 22.4 percent of all notional amounts outstanding in 1998 compared with only 9.1 percent in 2010.

By type of instrument

Swaps represent nearly two-thirds of the total notional principal outstanding of derivatives reported to the OCC at $149.2 trillion, followed by futures and forwards (15.4 percent, $35.7 trillion), options (13.9 percent, $32.1 trillion), and credit derivatives (6.1 percent, $14.2 trillion).

Swaps have grown as a share of all derivative instruments to 64.6 percent in 2010 from 43.5 percent in 1998. The notional principal outstanding of swaps has increased at an average annual rate of 19.7 percent during that period. As noted above, credit derivatives have also increased dramatically since 1998. Futures and forwards have declined as a share of all derivative instruments from 33.1 percent in 1998 to 15.4 percent in 2010. While the notional principal outstanding of options has increased fourfold since 1998, they have decreased as a share from 23 percent in 1998 to 13.9 percent in 2010.

[268] *Ibid.* p. 8.

Table A.4.–Notional Amounts Outstanding of U.S. OTC and Exchange-Traded Derivatives
(Billions of U.S. Dollars)

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
By Type of Contract													
Interest rate contracts	24,785	27,772	32,938	38,305	48,347	61,856	75,518	84,520	107,415	129,574	164,404	179,555	193,482
Foreign exchange contracts	7,386	5,915	6,099	5,736	6,076	7,182	8,607	9,282	11,900	16,614	16,824	16,553	20,990
Equity-linked contracts	501	672	858	770	783	829	1,120	1,255	2,271	2,522	2,207	1,685	1,364
Commodity contracts	183	171	222	179	233	214	289	598	893	1,073	1,050	979	1,195
Credit derivatives	144	287	426	395	635	1,001	2,347	5,822	9,019	15,861	15,897	14,036	14,150
Total	32,999	34,816	40,543	45,385	56,075	71,082	87,880	101,477	131,499	165,645	200,382	212,808	231,181
By Type of Instrument													
Swaps	14,345	17,779	21,949	25,645	32,613	44,083	56,411	64,738	81,328	103,090	131,706	142,011	149,247
Futures and forwards	10,918	9,390	9,877	9,313	11,374	11,393	11,373	12,049	14,877	18,967	22,512	26,493	35,709
Options	7,592	7,361	8,292	10,032	11,452	14,605	17,750	18,869	26,275	27,728	30,267	30,267	32,075
Credit derivatives	144	287	426	395	635	1,001	2,347	5,822	9,019	15,861	15,897	14,036	14,150
Total	32,999	34,817	40,543	45,386	56,074	71,082	87,880	101,478	131,499	165,645	200,382	212,808	231,181

Note: Details may not sum to totals due to rounding.
Source: Office of the Comptroller of the Currency.

Revenue

U.S. commercial banks reported $22.5 billion of trading revenue attributable to derivatives for 2010. This was approximately $75 million less than the record of $22.6 billion of trading revenue in 2009. Increases in credit, foreign exchange, and equity derivatives trading revenues offset declines in interest rate and commodity contracts. Table A.5 reports annual trading revenue data for commercial banks and holding companies (since 2008).[269]

OCC reports generally focus on the activity of insured commercial banks. However, investment banks historically have been responsible for a significant amount of derivatives trading revenues. Since the financial crisis, many investment banks have converted to bank holding companies. The former investment banks participated in a significant amount of trading activity that is now included in holding company trading revenue but not in commercial bank trading revenue. Therefore, the OCC began reporting trading revenue for bank holding companies in 2010 to provide a more complete picture of trading revenues in the banking sector.

For 2010, holding company trading revenue was nearly $61 billion, down 10.9 percent from 2009. Increases in credit and foreign exchange revenue were more than offset by declines in interest rate, equity, and commodity trading revenue. For 2008, holding companies lost $53.5 billion as a result of their derivatives trading activity.

Table A.5.–Derivatives Trading Revenue
(Millions of U.S. Dollars)

	2005	2006	2007	2008	2009	2010
Commercial Banks						
Interest rate contracts	4,466	4,618	7,902	866	14,470	6,162
Foreign exchange contracts	6,219	7,953	6,974	11,363	5,595	9,081
Equity-linked contracts	3,108	4,952	2,991	-2,017	1,061	2,051
Commodity contracts	593	1,265	295	1,543	1,460	618
Credit derivatives			-12,673	-12,590	6	4,605
Bank total trading revenue	14,385	18,787	5,489	-836	22,592	22,518
Bank Holding Companies						
Interest rate contracts				-33,673	23,998	4,962
Foreign exchange contracts				12,611	11,457	14,554
Equity-linked contracts				-3,609	17,389	14,542
Commodity contracts				2,331	11,000	5,486
Credit derivatives				-31,159	4,578	21,415
Holding company total trading revenue				-53,499	68,422	60,959

Source: Office of the Comptroller of the Currency.

[269] Office of the Comptroller of the Currency , *Quarterly Report on Bank Trading and Derivatives Activities*, Fourth Quarter 2010, available at http://www.occ.gov/topics/capital-markets/financial-markets/trading/derivatives/dq410.pdf.

Global derivatives markets

Over-the-counter derivatives market

Tables A.6 and A.7 show data presented by the Bank for International Settlements ("BIS").[270] These tables report the notional principal amounts, gross market values, and gross credit exposure outstanding of the worldwide consolidated OTC derivatives positions of major banks and dealers in the G10 countries.[271]

The gross market values of OTC derivates in Table A.7 measure the positive market value of all derivative contracts of entities that report to BIS. It also includes the absolute value of the negative market value of reporting entities' contracts with nonreporting counterparties. A contract has a positive market value for one party to the contract on a particular date if the counterparty would be required to make a payment to that party to terminate the contract on that date (*i.e.*, the contract is in the money). A contract has a negative market value for one party on a particular date if the party is required to make a payment to the counterparty to terminate the contract on that date (*i.e.*, the contract is out of the money).

Gross credit exposure is a measure of the risk that a party to a derivative contract faces if the counterparty defaults on its obligations under the contract. For example, if under a total return equity swap, Party B (the short party under the swap) would be required to pay Party A (the long party under the swap) $100 to terminate the swap on December 31, 2011, because the stock underlying the swap increased in value by $100, the swap contract would have a positive market value to Party A of $100 on December 31, 2011. If Party B is unable to make the payment of $100, Party A loses $100. Party A is therefore said to face credit risk of $100 with respect to Party B.

Suppose that under another derivative contract between Party A and Party B, Party A owes Party B $30. This contract has a negative market value for party A of $30. Party A poses a credit risk of $30 with respect to Party B. If Party A and Party B have a legally enforceable bilateral netting agreement that covers all of the derivative contracts between the two parties, contracts with negative values offset contracts with positive values. Gross credit exposure[272] is the measure of credit risk after netting the positive and negative values. In this case, Party A has gross credit exposure of $70 with respect to Party B.

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[270] Bank for International Settlements, *BIS Quarterly Review*, September 2011, p. A140.

[271] The Group of Ten or G10 refers to the group of countries that agreed in 1962 to participate in the General Arrangements to Borrow to make resources available to the International Monetary Fund: Belgium, Canada, France, Germany, Italy, Japan, the Netherlands, Sweden, the United Kingdom, and the United States. Although Switzerland joined the agreement in 1964 as the eleventh member, the group's name remains the same.

[272] Net credit exposure is the credit exposure under derivatives contracts after considering both the benefits of legally enforceable bilateral netting agreements and any collateral posted by the counterparty. In the example above, if Party B had posted collateral with Party A equal to $10, then the net credit exposure would be $60.

In 2010, there were over $600 trillion in notional value of OTC derivatives contracts outstanding worldwide (including the United States), with a gross market value of $21.1 trillion and gross credit exposure of $3.3 trillion. These amounts have more than doubled since 2005 and have increased approximately sevenfold since 1998. The most common OTC derivative contracts are interest rate contracts, accounting for over three-quarters of the notional principal amounts outstanding as of the end of 2010. Foreign exchange contracts account for about 10 percent of derivative contract volume, credit default swaps five percent, and equity-linked contracts and commodity contracts less than one percent each. Fewer than seven percent of contracts are attributable to positions of counterparties that do not regularly report detailed information.

Table A.6.–Notional Amounts Outstanding of OTC Derivatives
(Billions of U.S. Dollars)

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Total contracts	80,309	88,202	95,199	111,178	141,665	197,167	258,628	299,261	418,131	585,932	598,147	603,900	601,046
Foreign exchange contracts	18,011	14,344	15,666	16,748	18,448	24,475	29,289	31,360	40,271	56,238	50,042	49,181	57,796
Forwards and foreign exchange	12,063	9,593	10,134	10,336	10,719	12,387	14,951	15,873	19,882	29,144	24,494	23,129	28,433
Currency swaps	2,253	2,444	3,194	3,942	4,503	6,371	8,223	8,504	10,792	14,347	14,941	16,509	19,271
Options	3,695	2,307	2,338	2,470	3,226	5,717	6,115	6,984	9,597	12,748	10,608	9,543	10,092
Interest rate contracts	50,015	60,091	64,668	77,568	101,658	141,991	190,502	211,970	291,581	393,138	432,657	449,875	465,260
Forward rate agreements	5,756	6,775	6,423	7,737	8,792	10,769	12,789	14,269	18,668	26,599	41,561	51,779	51,587
Interest rate swaps	36,262	43,936	48,768	58,897	79,120	111,209	150,631	169,106	229,693	309,588	341,128	349,288	364,377
Options	7,997	9,380	9,476	10,933	13,746	20,012	27,082	28,596	43,221	56,951	49,968	48,808	49,295
Equity-linked contracts	1,488	1,809	1,891	1,881	2,309	3,787	4,385	5,793	7,488	8,469	6,471	5,937	5,635
Forwards and swaps	146	283	335	320	364	601	756	1,177	1,767	2,233	1,627	1,652	1,828
Options	1,342	1,527	1,555	1,561	1,944	3,186	3,629	4,617	5,720	6,236	4,844	4,285	3,807
Commodity contracts	408	548	662	598	923	1,406	1,443	5,434	7,115	8,455	4,427	2,944	2,922
Gold	175	243	218	231	315	344	369	334	640	595	395	423	397
Other commodities	233	305	445	367	608	1,062	1,074	5,100	6,475	7,861	4,032	2,521	2,525
Forwards and swaps	137	163	248	217	402	420	558	1,909	2,813	5,085	2,471	1,675	1,781
Options	97	143	196	150	206	642	516	3,191	3,663	2,776	1,561	846	744
Credit default swaps	NA	NA	NA	NA	NA	NA	6,396	13,908	28,650	58,244	41,883	32,693	29,898
Single-name instruments	NA	NA	NA	NA	NA	NA	5,117	10,432	17,879	32,486	25,740	21,917	18,145
Multi-name instruments	NA	NA	NA	NA	NA	NA	1,279	3,476	10,771	25,757	16,143	10,776	11,753
Index products	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	7,476
Unallocated	10,387	11,408	12,313	14,384	18,328	25,508	26,613	30,794	43,026	61,387	62,667	63,270	39,536

NA= Not available.
Source: Bank for International Settlements.

Table A.7.–Gross Market Values of OTC Derivatives
(Billions of U.S. Dollars)

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Total contracts	3,232	2,813	3,183	3,788	6,360	6,987	9,405	9,800	9,791	15,802	35,281	21,542	21,296
Foreign exchange contracts	786	662	849	779	881	1,301	1,546	997	1,266	1,807	4,084	2,070	2,482
Forwards and foreign exchange	491	352	469	374	468	607	643	406	469	675	1,830	683	886
Currency swaps	200	250	313	335	337	557	745	453	601	817	1,633	1,043	1,235
Options	96	60	67	70	76	136	158	138	196	315	621	344	362
Interest rate contracts	1,675	1,304	1,426	2,210	4,266	4,328	5,417	5,397	4,826	7,177	20,087	14,020	14,746
Forward rate agreements	15	12	12	19	22	19	22	22	32	41	165	80	206
Interest rate swaps	1,509	1,150	1,260	1,969	3,864	3,918	4,903	4,778	4,163	6,183	18,158	12,576	13,139
Options	152	141	154	222	381	391	492	597	631	953	1,764	1,364	1,401
Equity-linked contracts	236	359	289	205	255	274	498	582	853	1,142	1,112	708	648
Forwards and swaps	44	71	61	58	61	57	76	112	166	239	335	176	167
Options	192	288	229	147	194	217	422	470	686	903	777	532	480
Commodity contracts	43	60	133	75	86	128	169	871	667	1,898	955	545	526
Gold	13	23	17	20	28	39	32	51	56	70	65	48	47
Other commodities	30	37	116	56	58	88	137	820	611	1,829	890	497	479
Credit default swaps	NA	NA	NA	NA	NA	NA	133	243	470	2,020	5,116	1,801	1,351
Single-name instruments	NA	NA	NA	NA	NA	NA	112	171	278	1,158	3,263	1,243	884
Multi-name instruments	NA	NA	NA	NA	NA	NA	22	71	192	862	1,854	558	466
Unallocated	492	428	485	519	871	957	1,642	1,710	1,709	1,759	3,927	2,398	1,543
Gross Credit Exposure	1,329	1,023	1,080	1,171	1,511	1,969	2,075	1,900	2,036	3,256	5,005	3,521	3,480

NA= Not available.
Source: Bank for International Settlements.

Exchange-traded derivatives market

Table A.8 reports the notional principal amounts of exchange-traded derivatives worldwide, including the United States, in billions of U.S. dollars. Amounts are reported separately for futures and options and by the type of instrument: interest rate, currency, or equity index derivative. As of the end of 2010, there were $22.3 trillion of notional principal outstanding for exchange-traded futures derivatives and $45.6 trillion of exchange-traded options. The volume of futures contracts outstanding has increased tenfold since 1991, while the volume of options contracts outstanding has experienced that rate of increase since 1997. During the entire period from 1986 to 2010, the notional principal amount outstanding of futures contracts increased at an average annual rate of 18.3 percent (led by equity index futures, which grew at 20.2 percent), while the notional principal amount outstanding of futures contracts increased at an average annual rate of 24.8 percent (led by interest rate options, which grew at 26.5 percent).

Turnover in the exchange-traded derivatives market has increased dramatically since 1986. The notional principal amount traded in futures and options on exchanges worldwide was $31.9 trillion and $8.6 trillion, respectively, in 1986. By 2010, these amounts had grown to $343.6 trillion and $135.2 trillion, respectively. On average, futures volume grew at an annual rate of 10.4 percent during this period, while options volume grew at an annual rate of 12.2 percent. Turnover of interest rate contracts led the growth in overall volume at 10.6 percent for interest rate futures and 14.4 percent for interest rate options.

Interest rate futures and options are by far the largest category of exchange-traded derivatives. For 2010, interest rate contracts represent $21 trillion of the notional principal of futures contracts outstanding and $40.9 trillion of the notional principal of options contracts outstanding. They have represented over 95 percent of futures contracts and nearly 88 percent of options contracts since 1986. Equity index contracts are the next largest category of exchange-traded derivates. They constitute on average about 3.7 percent of all exchange-traded futures contracts and 11.5 percent of all exchange-traded options contracts over that period. While currency contracts represented a significant share of exchange-traded options in the late 1980s, since the late 1990s they have accounted for less than one percent of exchange-traded derivates.

Interest rate futures and options account for the largest share of turnover in exchange-traded derivatives as well. They have represented over 91 percent of futures contract turnover and 76 percent of options contract turnover since 1986. Equity index options turn over more frequently than other options contracts; they account for a larger share of trading volume (22.6 percent on average since 1986) than they do for notional principal amounts outstanding (11.5 percent).

Since 1999, turnover has increased faster than notional principal amounts (16.8 percent vs. 9.4 percent). This suggests that contracts are trading more frequently. This is particularly true of futures contracts (16.8 percent vs. 9.3 percent) rather than options contracts (22.9 percent vs. 21.6 percent). As a result the ratio of turnover to notional principal amount outstanding has increased during this period from approximately 7.5:1 to more than 15:1.

Table A.8.–Derivative Financial Instruments Traded on Organized Exchanges
(Billions of U.S. Dollars)

	Notional Principal Amount Outstanding								Turnover							
Data as of December	Total Futures	Interest Rate Futures	Currency Futures	Equity Index Futures	Total Options	Interest Rate Options	Currency Options	Equity Index Options	Total Futures	Interest Rate Futures	Currency Futures	Equity Index Futures	Total Options	Interest Rate Options	Currency Options	Equity Index Options
1986	394	370	10	14	224	146	39	38	31,869	27,488	1,450	2,931	8,626	3,802	585	4,239
1987	520	488	15	18	210	123	60	28	55,836	50,709	1,835	3,292	10,355	5,251	996	4,108
1988	935	895	12	27	370	279	48	43	61,789	56,595	1,983	3,212	9,328	5,740	1,070	2,518
1989	1,258	1,201	16	41	508	388	50	70	93,985	86,904	2,210	4,870	17,063	9,948	1,151	5,963
1990	1,541	1,455	17	69	750	600	56	94	102,020	93,595	2,745	5,681	22,432	15,316	1,253	5,864
1991	2,252	2,157	18	76	1,272	1,073	63	137	107,829	97,657	2,549	7,624	24,671	16,990	1,429	6,252
1992	3,019	2,913	26	80	1,620	1,385	72	163	151,380	142,927	2,400	6,053	33,075	25,881	1,420	5,773
1993	5,105	4,960	35	110	2,670	2,362	76	232	48,688	46,062	715	1,911	10,207	8,233	336	1,638
1994	5,976	5,808	40	128	2,922	2,624	56	243	68,680	65,415	812	2,453	14,259	11,788	281	2,189
1995	6,082	5,876	34	172	3,200	2,742	120	338	56,037	52,681	680	2,676	12,128	9,497	367	2,265
1996	6,212	5,979	38	196	3,806	3,278	133	395	60,934	56,922	655	3,357	12,983	10,233	234	2,516
1997	7,840	7,587	42	211	4,567	3,640	119	809	76,796	72,195	642	3,960	16,160	12,497	226	3,436
1998	8,355	8,031	32	291	5,620	4,623	49	948	75,592	69,990	612	4,991	18,373	14,659	93	3,621
1999	8,304	7,925	39	340	5,286	3,756	22	1,509	62,027	55,734	673	5,620	13,978	9,366	67	4,546
2000	8,353	7,908	78	367	5,897	4,734	21	1,141	72,607	66,652	692	5,263	17,063	12,302	51	4,710
2001	9,675	9,270	73	332	14,081	12,493	27	1,561	117,533	111,140	932	5,461	46,088	38,722	97	7,269
2002	10,357	9,956	52	349	13,475	11,759	27	1,688	119,963	112,492	735	6,736	50,065	39,942	91	10,032
2003	13,708	13,124	88	497	22,992	20,794	38	2,160	152,676	142,978	1,234	8,464	54,583	41,519	132	12,932
2004	18,902	18,165	114	624	27,619	24,604	61	2,954	208,163	195,445	2,346	10,371	70,542	56,574	191	13,778
2005	21,599	20,709	121	769	35,660	31,588	66	4,005	243,570	225,315	3,298	14,958	99,069	76,831	234	22,003
2006	25,676	24,476	179	1,021	43,723	38,116	79	5,528	310,007	285,310	4,664	20,033	120,562	95,791	318	24,453
2007	28,051	26,770	180	1,101	51,037	44,282	133	6,622	375,357	334,405	5,819	35,132	162,903	123,919	655	38,329
2008	19,508	18,732	125	651	38,236	33,979	129	4,128	246,001	214,700	5,122	26,179	133,360	107,515	445	25,401
2009	21,738	20,628	144	966	51,380	46,429	147	4,804	307,224	276,222	7,571	23,431	137,151	106,520	582	30,049
2010	22,312	21,013	170	1,128	45,635	40,930	144	4,560	343,640	307,252	9,182	27,205	135,206	95,986	696	38,523

Source: Bank for International Settlements.

112TH CONGRESS 1ST SESSION

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DEC 23 2011

Honorable Bill Nelson
United States Senate
716 Senate Hart Office Building
Washington, D.C. 20510

Dear Senator Nelson:

This letter is a follow up response to your question regarding section 1601 of the Dodd-Frank Wall Street Reform and Consumer Protection Act[1] ("Dodd-Frank") which amended section 1256 of the Internal Revenue Code (the "Code") to exclude certain swaps, caps, floors, and similar agreements from the definition of a section 1256 contract. During the December 6, 2011, Joint Hearing on Tax Reform and the Tax Treatment of Financial Products, you asked for more information regarding the taxpayers who might benefit from this exclusion from section 1256.

Section 1256 contracts

As outlined in greater detail in our report, *Present Law and Issues Related to the Taxation of Financial Instruments and Products* (JCX-56-11), section 1256 provides special timing and character rules for a contract identified as a section 1256 contract. Each section 1256 contract held by a taxpayer at the close of the taxable year is treated as sold for its fair market value on the last business day of such taxable year, and any gain or loss is taken into account in that year (the "mark-to-market rule"). Section 1256 also provides that any gain or loss with respect to a section 1256 contract (if not otherwise ordinary) is treated as 60 percent long-term capital gain or loss and 40 percent short-term capital gain or loss, regardless of the taxpayer's actual holding period (the "60/40 rule"). Gain or loss is recognized upon the termination (or transfer) of a section 1256 contract by offset, taking or making delivery, by exercise or being exercised, by assignment or being assigned, by lapse, or otherwise, and is also generally subject to the 60/40 rule.

A section 1256 contract is defined as any (1) regulated futures contract, (2) foreign currency contract, (3) nonequity option, (4) dealer equity option, and (5) dealer securities futures contract.[2] The term section 1256 contract does not, however, include (1) any securities futures contract or option on such a contract unless such contract or option is a dealer securities futures

[1] Pub. L. No. 111-203.

[2] Sec. 1256(b).

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contract, or (as amended by section 1601 of Dodd-Frank) (2) any interest rate swap, currency swap, basis swap, interest rate cap, interest rate floor, commodity swap, equity swap, equity index swap, credit default swap, or similar agreement.[3]

Benefits and detriments of section 1256 rules

Section 1256 tax treatment is not an unmitigated benefit or detriment to taxpayers generally, and the impact of the special timing and character rules depends upon the status of the taxpayer. For example, the mark-to-market rule accelerates a taxpayer's gains and losses, but an individual taxpayer may find the 60/40 rule a significant benefit, particularly if the individual's investment strategy does not generally involve holding assets for more than one year. In contrast, the 60/40 rule may be relatively less attractive to corporate taxpayers because corporations are not eligible for a reduced rate of tax on long-term capital gains, and corporate capital losses can only be used to offset capital gains and are generally subject to less favorable carryover rules.[4]

A taxpayer's status as an individual or corporation is not the only factor determining whether section 1256 treatment is beneficial. Other taxpayer characteristics may also matter. For example, pursuant to section 475, a dealer in securities must generally mark its positions in section 475 securities to market and treat its gains and losses as ordinary.[5] Dealers in commodities and traders in securities and commodities may elect similar treatment.[6] For these taxpayers, the acceleration of section 1256 contract gains and losses is not a detriment, because they mark their positions to market under section 475. However, the 60/40 rule can present issues because a "security" under section 475 does not generally include any contract to which

[3] Sec. 1256(b)(2).

[4] A corporation may generally carry ordinary net operating losses back two years and forward 20 years (sec. 172(b)(1)(A)). In contrast, a capital loss may generally be carried back three years and forward only five years (sec. 1212(a)(1)).

[5] Sec. 475(a).

[6] Sec. 475(e) (election of mark to market for dealers in commodities) and Sec. 475(f) (election of mark to market for traders in securities or commodities).

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section 1256 applies.[7] Thus, a taxpayer subject to section 475 holding section 475 securities and section 1256 contracts marks both categories of instruments to market, but may recognize ordinary income on its section 475 securities and capital gain (or loss) on its section 1256 contracts. In such a case, the 60/40 rule is of no benefit, but rather creates the possibility of limited capital losses in an otherwise ordinary portfolio.

For a corporation that is not subject to section 475 (for example, an operating business, an insurance company, or a financial institution) both the timing and character rules of section 1256 can be unfavorable, particularly if such taxpayer uses a section 1256 contract to hedge or offset a non-section 1256 contract.[8] In such risk management cases, the taxpayer generally prefers that the timing and character of the two positions match. For example, an interest rate swap taxable as a notional principal contract generally gives rise to current, ordinary income inclusions or expense. If the contract is used to manage risk of interest rate changes with respect to borrowings made by the taxpayer, the timing and character of income and expense generally match. The timing and character of income and expense do not match, however, if the interest rate swap is marked to market (accelerating gain or loss on the swap position but not the borrowing) and any resulting gain or loss on the swap is treated as 60 percent long-term capital gain or loss and 40 percent short-term capital gain or loss.[9]

The Code includes rules designed to avoid character and timing mismatches if a section 1256 contract is part of a hedging transaction[10] or a straddle.[11] For example, for a section 475

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[7] Sec. 475(c)(2) flush language. Note that section 475(c)(2)(D) specifically defines "security" to include interest rate, currency, and equity notional principal contracts. Thus, section 475 controls the tax treatment of these contracts for section 475 dealers and electing traders (see sec 475(d)(1)), but section 1256 would control the tax treatment of any other derivative instrument that qualifies as a section 1256 contract.

[8] See, *e.g.*, "Prudential Financial Alerts Treasury to Unintended Consequences of Financial Reform," *Tax Notes Today*, April 23, 2010, Doc. 2010-9908

[9] Where a taxpayer enters offsetting positions, like a hedge, the tax straddle rules of section 1092 may also apply. These rules can defer the use of mark-to-market losses until gain is recognized on the other position(s) in the straddle.

[10] See sec. 1256(e) (providing that section 1256(a) does not apply to hedging transactions).

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dealer or trader, a section 1256 contract that qualifies as a tax hedge and is clearly identified by the taxpayer as a tax hedge on the day it is acquired or entered qualifies under section 475(c)(2)(F) as a section 475 security. Thus, such a section 1256 contract is marked to market under section 475 and the resulting gain or loss is ordinary (not capital). For other taxpayers, section 1256 includes special rules to prevent character and timing mismatches if a section 1256 contract is part of a mixed straddle[12] or identified hedging transactions.[13] In certain circumstances, however, these exceptions may be difficult to apply,[14] or potentially unavailable.[15]

Section 1256 and Dodd-Frank

Prior to the consideration of Dodd-Frank, taxpayers with different tax characteristics had some flexibility to choose or to avoid section 1256 treatment. Taxpayers seeking 60/40 character treatment could choose to trade in section 1256 contracts. Taxpayers for whom section 1256 treatment was undesirable could pursue strategies or use financial instruments that were not subject to section 1256.

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[11] See sec. 1256(d)(1) (providing an election to have section 1256 not apply to section 1256 contracts that are part of a mixed straddle).

[12] Sec. 1256(d).

[13] Sec. 1256(3).

[14] See, *e.g.*, Erika W. Nijenhuis, "New Tax Issues Arising From the Dodd-Frank Act and Related Changes to Market Practice for Derivatives," *Columbia Journal of Tax Law*, vol. 2, No. 1 (January 6, 2011), pp 51-58 (discussing the effect of section 1256 treatment for over-the-counter derivatives)

[15] The definition of a hedging transaction for Federal tax purposes does not encompass every transaction a taxpayer might enter into to manage risks. Generally, for tax purposes, a hedging transaction is a transaction entered in the normal course of a taxpayer's business primarily to manage risk of price changes or currency fluctuations with respect to ordinary property held (or to be held) by the taxpayer, to manage risk of interest rate or price changes, or currency fluctuations with respect to borrowings made or to be made, or ordinary obligations incurred or to be incurred (sec. 1221(b)(2)). Thus, for example, a transaction that "hedges" the risk of a change in the price of a capital asset cannot qualify as a tax hedge. In addition, for a hedging transaction to qualify as a tax hedge, it must be contemporaneously identified by the taxpayer as such (see, *e.g.*, sec. 1221(a)(7) and 1256(e)(2)).

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The requirement in Dodd-Frank (and in prior versions of the legislation considered by Congress) that certain swaps be cleared through a regulated clearing party and executed on a regulated exchange or swap execution facility raised a question about whether cleared and traded swaps might satisfy the definition of a regulated futures contract and thus become subject to section 1256. Although the Internal Revenue Service generally adopts a narrow reading of "regulated futures contract," on its face the definition is broad. As a result, in estimating the revenue impacts of the Senate-passed version of Dodd-Frank (which did not clarify the scope of section 1256), the Joint Committee staff assumed that some taxpayers would take the position that cleared and traded derivative contracts were section 1256 contracts. Joint Committee staff also assumed that the Secretary of the Treasury would issue guidance narrowly interpreting the scope and application of section 1256 to such contracts. Thus, it was expected that requiring certain widely used swaps to be cleared and traded would create considerable uncertainty about the application of section 1256 to such contracts.[16] And while pre-Dodd-Frank taxpayers could generally choose whether to avail themselves of section 1256 treatment or not, this uncertainty would have been difficult for taxpayers to avoid.[17]

Accordingly, by clarifying the scope of section 1256, section 1601 of Dodd-Frank is a detriment to some taxpayers and a benefit to others. Section 1601 is a detriment to those taxpayers (*e.g.*, individuals) who would have benefitted from the application of the 60/40 rule to cleared and traded swap contracts, and the section is a benefit to those taxpayers (*e.g.*, certain corporations) for whom application of the timing and/or character rules of section 1256 to such contracts would be less favorable. However, in context, the benefit for these taxpayers is arguably the resolution of an uncertainty, and relief from character and timing issues that would arise to the extent those taxpayers could not avoid the use of section 1256 contracts in their business or could not avail themselves of the exceptions to section 1256 contract status discussed above.

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[16] See, *e.g* , Congressional Budget Office Cost Estimate of the Amendment in the Nature of a Substitute for S. 3217, Restoring American Financial Stability Act of 2010 (May 3, 2010), available at http://www.cbo.gov/ftpdocs/114xx/doc11476/s3217amendmt.pdf.

[17] Dodd-Frank did not itself create this uncertainty, but highlighted it. See, *e g.*, *Sesco Enterprises, LLC v U.S.*, 108 AFTR 2d 2011-7051 (3d Cir. 2011) (litigation in progress regarding, *inter alia*, the treatment of electricity futures contracts as section 1256 contracts).

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This effect is reflected in a comparison of the estimated revenue impacts of the Senate-passed version of Dodd-Frank which did not include the section 1256 contract clarification (estimating a $1.3 billion revenue loss over the period 2010-2020) and Dodd-Frank as enacted (estimating $120 million of revenue raised over the period 2010-2020).[18] The estimated loss reflects the assumption that individual taxpayers would take advantage of the section 1256 character rules to convert otherwise ordinary or short-term capital gains into 60 percent preferentially taxed long-term capital gains. This loss estimate assumes that taxpayers for whom section 1256 for cleared and traded swaps would be disadvantageous would respond, to the extent possible, by using the hedging exceptions and/or restructuring their investments. The positive estimate reflects the fact that (1) 60/40 treatment would not be available for cleared and traded swaps, (2) other taxpayers would not be subject to the character and timing issues outlined above, and (3) the amendment would preclude the position that some taxpayers were already taking that certain traded swaps qualified as section 1256 contracts.

I hope this information has been helpful to you. If we can otherwise be of further assistance in this matter, please let me know.

Sincerely,

Thomas A. Barthold

Thomas A. Barthold

cc: Committee on Finance Members
Committee on Ways and Means Members

[18] Congressional Budget Office Cost Estimate of H.R. 4173, Dodd-Frank Wall Street Reform and Consumer Protection Act (June 28, 2010), p. 10, available at http://www.cbo.gov/ftpdocs/115xx/doc11596/hr4173.pdf.

COMMITTEE ON FINANCE
NEWS RELEASE
Max Baucus (D-Mont.)
http://finance.senate.gov

Hearing Statement of Senator Max Baucus (D-Mont.)
Regarding the Tax Treatment of Financial Products
As prepared for delivery

Warren Buffet once wrote to his shareholders, "No financial instrument is evil per se; it's just that some variations have far more potential for mischief than others."

This potential for mischief is one of the reasons we are holding this joint hearing today.

Many financial instruments serve essential business purposes. They allow individuals and companies to hedge against risks and minimize exposure to losses, especially in this turbulent economic time.

For example, Darin Arganbright, a small grain farmer in my home state of Montana, uses futures contracts to reduce the impact of the market's ups and downs. These contracts help him lock in prices for his crops in advance. But too many resources are spent developing new and complex financial instruments simply to avoid taxes.

Over the past decade, the use of one type of financial product, derivatives, has grown considerably. The notional – or theoretical – value of derivatives held by U.S. commercial banks has grown more than six times in the past decade. It now totals $230 trillion. Globally, the notional value of over-the-counter derivatives is estimated to total more than $700 trillion. That equals more than three times the value of all global financial assets.

This growth can make it harder to determine the value of a business holding these financial instruments. Some believe this lack of transparency is one of the problems that gave rise to the financial crisis.

Financial advisors have created a complex web of new products that mix debt, equity and derivatives. The only purpose of some of these new products is to avoid taxes.

Those who benefit from these new financial products are often large companies and high net-worth individuals who can afford to hire expensive lawyers and advisors to structure their investments and lower their tax liabilities.

These complicated transactions to avoid taxes result in wasted investment, and they aren't fair to taxpayers who can't afford those high-priced lawyers and accountants.

So let us clarify and simplify the tax treatment of these financial products, let us ensure they are taxed rationally and fairly, let us work to make the tax code reflect the goals of transparency, consistency, and the protection of the American taxpayer, and as Mr. Buffet alluded to, let us limit the potential for mischief.

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United States Government Accountability Office

GAO

Report to Congressional Requesters

September 2011

FINANCIAL DERIVATIVES

Disparate Tax Treatment and Information Gaps Create Uncertainty and Potential Abuse



GAO-11-750

September 2011

GAO
Accountability * Integrity * Reliability
Highlights

Highlights of GAO-11-750, a report to congressional requesters

FINANCIAL DERIVATIVES

Disparate Tax Treatment and Information Gaps Create Uncertainty and Potential Abuse

Why GAO Did This Study

Recently, concerns have arisen about the use of certain financial derivatives to avoid or evade tax obligations. As requested, this report (1) identifies and evaluates how financial derivatives can be used to avoid or evade tax liability or achieve differing tax results in economically similar situations, (2) evaluates Internal Revenue Service (IRS) actions to address the tax effects of investments in financial derivatives through guidance, and (3) evaluates IRS actions to identify financial derivative products and trends through information from other agencies. GAO reviewed research and IRS documents and interviewed IRS and, Department of the Treasury (Treasury) officials and other experts. GAO analyzed the completion of financial derivative projects on the agencies' Priority Guidance Plans (PGP) from 1996 to 2010.

What GAO Recommends

GAO recommends that (1) Treasury determine whether alternatives to the current approach to taxing financial derivatives would promote consistent treatment of economically similar positions and be beneficial, that (2) Treasury and IRS provide more public information on the status of PGP projects, including those related to financial derivatives, and that (3) IRS strengthen information-sharing partnerships with relevant agencies. IRS agreed with the third recommendation and disagreed with the second; Treasury disagreed with the first two recommendations GAO continues to believe its recommendations would be beneficial.

View GAO-11-750 For more information, contact Michael Brostek at (202) 512-9110 or brostekm@gao.gov.

What GAO Found

Taxpayers have used financial derivatives to lower their tax liability in ways that the courts have found improper or that Congress has disallowed. Taxpayers do this by using the ease with which derivatives can be redesigned to take advantage of the current patchwork of relevant tax rules. As new products are developed, IRS and taxpayers attempt to fit them into existing "cubbyholes" of relevant tax rules. This sometimes leads to inconsistent tax treatment for economically similar positions, which violates a basic tax policy criterion. While the tax rules for each cubbyhole represent Congress's and Treasury's explicit policy decisions, some of these decisions were made long before today's complex financial derivative products were created. Some experts have suggested alternate methods to the current approach for taxing financial derivatives. IRS and Treasury, because of their unique position to define policy and administer the tax code, are best positioned to study and recommend a new approach.

When application of tax law is complex or uncertain, as is often the case for financial derivatives, guidance to taxpayers is an important tool for IRS to address tax effects and potential abuse. However, between 1996 and 2010, Treasury and IRS did not complete 14 out of 53 guidance projects related to financial derivatives that they designated as a priority on their annual PGP. While completing guidance is important in providing certainty to taxpayers and IRS and reducing the potential for abuse, challenges like the risk of adverse economic impacts of guidance changes and the transactional complexity of financial derivatives may delay the completion of guidance. Since challenges may prevent IRS from finalizing guidance within a 12-month PGP period, taxpayers need to be aware of ongoing guidance projects' status, some of which may span a number of years.

IRS sometimes identifies new financial derivative products or new uses of them long after they have been introduced and gained considerable use. This slows its ability to address potential abuses. IRS's 2009-2013 Strategic Plan lists strengthening partnerships across government agencies to gather and share information as key to identifying and addressing new products and emerging tax schemes more quickly. Through their oversight roles for financial derivative markets, the Securities and Exchange Commission (SEC) and the Commodity Futures Trading Commission (CFTC) may have information on financial derivatives that is relevant to IRS. Similarly, bank regulators may gain relevant knowledge of derivatives' use. IRS officials said such routine communications in the early 1990s did provide relevant information. Although IRS communicates with SEC and CFTC on derivatives, it does not do so systematically or regularly. Strengthening partnerships would increase opportunities for IRS to gain information on new financial derivative products and uses. Studies of interagency coordination suggest that agencies should look for opportunities to enhance collaboration in order to achieve results that would not be available if they were to work separately, and a number of best practices exist to help agencies meet this goal.

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United States Government Accountability Office
Washington, DC 20548

September 20, 2011

The Honorable Max Baucus
Chairman
The Honorable Orrin G. Hatch
Ranking Member
Committee on Finance
United States Senate

The Honorable Charles E. Grassley
Ranking Member
Committee on the Judiciary
United States Senate

Over the past few years some attention has been focused on certain financial derivatives that have been used to avoid or evade tax obligations. Financial derivatives are financial instruments whose value is based on one or more underlying reference items.[1] Recent legislation has directly addressed one of the most prominent tax avoidance transactions enabled by financial derivatives, and another was addressed through litigation.[2] While a majority of the world's largest companies use financial derivatives to manage and hedge risks, some taxpayers have used financial derivatives to reduce their tax liabilities in ways that have been aggressive and later disallowed, and such use is likely to continue.

In response to your request, this report (1) identifies and evaluates how financial derivatives can be used to avoid or evade tax liability or achieve differing tax results in economically similar situations, (2) evaluates Internal Revenue Service (IRS) actions to address the tax effects of investments in financial derivatives through its taxpayer guidance, and (3) evaluates IRS actions to identify new financial derivatives products

[1]A glossary of terms is provided at the end of the report.

[2]Cross-border total return equity swaps were used to avoid paying withholding tax on dividend payments to foreign entities, and were addressed by the Hiring Incentives to Restore Employment (HIRE) Act. Pub. L. No. 111-147 § 541, 124 Stat. 71, 115–117 (2010). Variable prepaid forward contracts coupled with a share-lending agreement were used to defer income recognition, and were addressed in *Anschutz Co. v. Commissioner.* 135 T.C. No 5 (July 22, 2010).

and trends through information sharing with its partners in other federal financial regulatory agencies.

To identify and evaluate how financial derivatives can be used to avoid or evade tax liability, we reviewed academic studies and IRS documents. We also interviewed officials and staff at IRS and the Department of the Treasury (Treasury), and tax experts from the private sector. For this part of the report, we focused on two case studies of financial derivative transactions—variable prepaid forward contracts and cross-border total return equity swaps—as illustrations of the use of financial derivatives to achieve improper or disallowed tax results. We analyzed the taxation of financial derivatives against consistency, a criterion meaning that transactions with equivalent economic outcomes are taxed the same. We identified this criterion through testimonial evidence from tax experts and Treasury officials, and a review of research on the taxation of financial derivatives. It was one of the most frequently cited criteria by these sources, and also the most applicable to our objectives. The criterion of consistency is related to simplicity, administrability, and economic efficiency, several of the criteria for a good tax system that are discussed in our 2005 report on tax reform.[3] A lack of consistency can make the tax system more difficult for taxpayers to comply with, more difficult for IRS to administer, and reduce economic efficiency by influencing the investments taxpayers make by taxing different investments under different tax rules. While consistency may not be the only criteria to consider, we believe it is an important guideline to evaluate whether financial derivatives can be used by taxpayers for abusive purposes.

To evaluate IRS actions to address the tax effects of investments in financial derivatives through its guidance, we reviewed IRS documents and interviewed IRS and Treasury staff and officials about the guidance process, with a specific focus on IRS's and Treasury's processes for developing their Priority Guidance Plan (PGP), which identifies and prioritizes the tax issues that IRS believes are most important to taxpayers and tax administration and should be addressed through guidance. We analyzed financial derivative-related guidance projects included in the PGP from the years 1996 to 2010, determined how long it took for Treasury and IRS to release guidance on those projects, and

[3]GAO, *Understanding the Tax Reform Debate: Background, Criteria, and Questions*, GAO-05-1009SP (Washington, D.C.: Sept. 1, 2005).

compared the time required with the criteria established by IRS and Treasury for the PGP. In addition, we completed case studies of four financial derivative issues that were included in the PGP and were highlighted as significant in interviews with Treasury, IRS, and private sector experts. The four case studies cover credit default swaps, contingent swap payments, variable prepaid forward contracts, and cross-border total return equity swaps.

To evaluate IRS actions to identify new financial derivatives products and trends through information sharing with its partners in other financial regulatory agencies, we examined IRS's information sharing with other federal financial market regulators. To examine information sharing with other agencies, we interviewed relevant officials and staff at IRS and at two financial market regulatory agencies, the Securities and Exchange Commission (SEC) and the Commodity Futures Trading Commission (CFTC). As our criterion, we used IRS's 2009-2013 Strategic Plan, which lists strengthening partnerships across government agencies to gather and share additional information as key to enforcing tax law in a timely manner to ensure taxpayers meet their obligations to pay taxes. In prior work, we have also reported on the importance and value of cross-agency information sharing and coordination, and have established criteria on federal agency coordination and information sharing.[4] We also identified the legislative authorities that govern IRS's disclosure of taxpayer information.

For the purposes of this review, we determined that data on financial derivatives from the Office of the Comptroller of the Currency (OCC) and the subset of IRS PGP data used in our analysis were reliable. See appendix 1 for additional details on our scope and methodology. We conducted this performance audit from May 2010 through September 2011 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

[4]See GAO, *Results-Oriented Government: Practices That Can Help Enhance and Sustain Collaboration among Federal Agencies*, GAO-06-15 (Washington, D.C.: Oct. 21, 2005).

Background

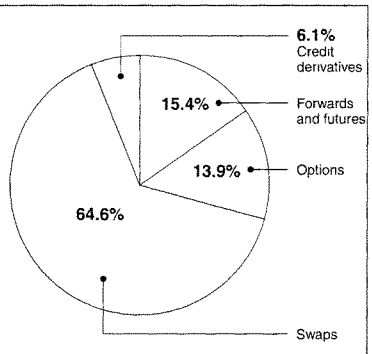
Financial derivatives are globally used financial products that unbundle exposure to an underlying asset and transfer risks—the exposure to financial loss caused by adverse changes in the values of assets or liabilities—from entities less able or willing to manage them to those more willing or able to do so. The values of financial derivatives are based on an underlying reference item or items, such as equities, debt, exchange rates, and interest rates. Since 2001, interest rate contracts have made up the vast majority of all financial derivative contracts, on average 80 percent of all derivatives in terms of notional amount outstanding, and are used to hedge against changes in the cost of capital.[5]

Parties involved in financial derivative transactions do not need to own or invest in the underlying reference items, and often do not. The most common purpose of financial derivatives is to manage the holder's risk, and this is often accomplished by constructing financial derivative contracts that produce more favorable rather than unfavorable tax results. Financial derivatives are sold and traded either on regulated exchanges or in private, over-the-counter markets that allow highly customized transactions specific to the needs of the parties. Financial derivatives are bilateral agreements that shift risk from one party to another but can be used to structure more complicated arrangements involving multiple transactions and parties. Simple financial derivatives act as building blocks for more complex products, and can be broken down into three general categories of products, described in figure 1. Credit derivatives, depending on their structure, fall into one of these three categories, but are often measured as a separate category by government agencies.

[5]Total notional amount represents the value of the reference items underlying financial derivative transactions, and is the amount upon which payments are computed between parties of derivatives contracts. Notional amount does not represent money exchanged, nor does it represent the risk exposure. For example, one party in an interest rate swap pays a 3 percent fixed rate on a notional amount of $100,000, making payments of $3,000 per period. The other party in the interest rate swap would pay a variable rate on the same notional amount in exchange for the fixed-rate payment of $3,000. These two payments are netted and the positive balance is received by one party. The fair market value of all open derivatives contracts reports the value of all trades should they be closed at the time of valuation, and is often used to gauge counterparty credit risk exposure.

Figure 1: Basic Financial Derivative Contracts and Their Market Share by Product Type as of the Fourth Quarter of 2010

Product	Description
Forwards and Futures	Contract between two parties in which the forward buyer agrees to purchase from the forward seller a fixed quantity of the underlying reference item at a fixed price on a fixed date. A futures contract is a forward contract that is standardized and traded on a organized futures exchange, while a forward contract is privately negotiated among the buyer and seller
Options	Contract that gives the holder of the option the right, but not the obligation, to buy (call option) or sell (put option) a specified amount of the underlying reference item at a predetermined price (strike price) at or before the end of the contract
Notional Principal Contracts (NPC), or Swaps	According to section 1 446-3(c)(1)(i) of title 26, Code of Federal Regulations, a notional principal contract (NPC) is defined as a financial instrument that provides for the payment of amounts by one party to another at specified intervals calculated by reference to a specified index on a notional amount in exchange for specified consideration or a promise to pay similar amounts An NPC is a swap under which the parties agree to exchange payments calculated by reference to a notional amount, however not all swaps are considered NPCs.
Credit derivatives	Contract that is designed to explicitly shift credit risk from one party to another. Payments are contingent on the occurrence of a credit event and the value of the contract is derived from the credit performance of one of more corporations, sovereign entities, or debt obligations. Credit derivatives can be structured as forwards, options, or swaps.



Source GAO analysis of Office of the Comptroller of the Currency (OCC) data

Note Office of the Comptroller of the Currency (OCC) reports credit derivatives separate from the other three categories above

Dealers participate in the financial derivatives market by quoting prices to, buying derivatives from, and selling derivatives to end users and other dealers. They also develop customized derivative products for their clients. Commercial banks, which most often act as dealers, are typically one of the two parties involved in financial derivative transactions. In 2010 the holdings of five large commercial banks represented over 95 percent of the banking industry's notional amounts outstanding.

End users, including commercial banks, securities firms, hedge funds, insurance companies, governments, mutual funds, pension funds, individuals, commercial entities, and other dealers, often use derivatives

to protect against adverse change in the values of assets or liabilities, called hedging. Hedgers try to protect themselves from risk by entering into derivatives transactions whose values are expected to change in the opposite direction from the values of their assets or liabilities. According to a 2009 survey conducted by the International Swaps and Derivatives Association, over 94 percent of the largest companies' worldwide use financial derivatives to manage and hedge risks. End users can also use derivatives for speculation by taking on risk in an attempt to profit from changes in the values of derivatives or their reference items. Derivatives are attractive to speculators because they can be more cost-effective than transactions in the underlying reference item, due to reduced transaction costs and the leverage that derivatives provide. Financial derivatives transactions are generally leveraged since parties to these transactions most often initiate the transaction with little money down relative to the expected outcome of the transaction. In any financial transaction, the degree of permissible leverage is determined by the collateral required to secure the transaction. While a high degree of leverage has the potential for large gains, it also carries risks of large losses. As we and others have reported, the risk exposures resulting from derivatives were one of many factors that contributed to the systemic risk that led to the recent financial crisis.[6]

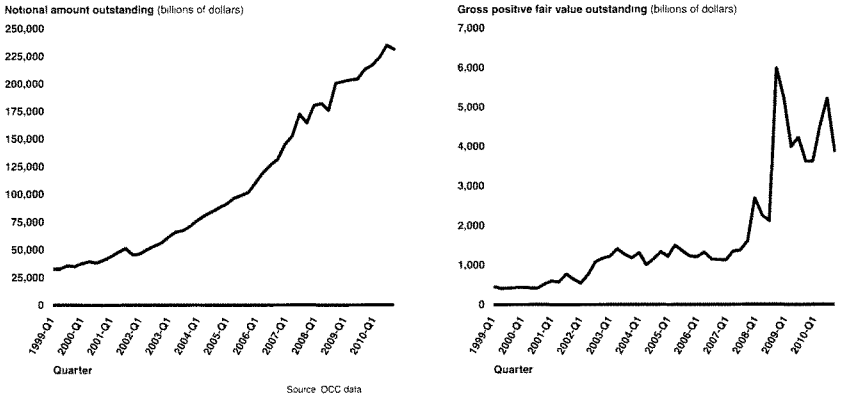
The market for financial derivatives has grown considerably in size over the past two decades. Two common ways to measure the size of financial derivative markets overall are total notional amount and fair market value. Total notional amount represents the value of the reference items underlying financial derivative transactions, and is the amount upon which payments are computed between parties of derivatives contracts. Notional amount does not represent money exchanged, nor does it represent the risk exposure. The second measure, fair market value, can be either the gross positive fair value or the gross negative fair value. The gross positive fair value represents the sum of the fair values of the financial derivative contracts where the commercial bank is owed money by the other party in the contract and represents the maximum losses the

[6]See GAO, *Financial Regulation. A Framework for Crafting and Assessing Proposals to Modernize the Outdated U S. Financial Regulatory System*, GAO-09-216 (Washington D.C.: Jan. 8, 2009) and Financial Crisis Inquiry Commission, *The Financial Crisis Inquiry Report: The Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States* (Washington, D.C.: January 2011).

bank could incur if all other parties in the contracts default.[7] According to the OCC, between the first quarter of 1999 and the fourth quarter of 2010, the total notional amount outstanding used to calculate payments for derivatives contracts held by insured U.S. commercial banks and trust companies grew over six times, from $32.7 trillion to $231.2 trillion. For those same institutions, gross positive market value grew nearly seven-and-a-half times, from $0.46 trillion to $3.87 trillion (see fig. 2). The difference in these numbers is due to the fact that the notional amount is used to calculate payments from the contracts, which are typically a small percentage of the notional amount. The net present value of these payments determine, in part, gross positive market value. Because commercial banks are one of the parties involved in over 95 percent of financial derivative contracts, these measures are good indicators of the entire U.S. market. The volatility seen in figure 2 during the latter part of 2007 and 2008 is attributed in part to turmoil in financial markets and banking consolidation. In part because different types of financial derivatives are reported differently to IRS by taxpayers and third parties, and in most cases are not clearly identified as financial derivatives, IRS told us that data are not available to estimate overall gains and losses of income earned from financial derivatives.

[7]The losses assume no netting of the contracts and that the bank holds no collateral from the other parties in the contract.

Figure 2: Growth in U.S. Derivative Markets: Quarterly Notional Amount Outstanding and Gross Positive Fair Value (1999–2010)



Source: OCC data

The range and complexity of financial derivative products have grown along with the market. Whereas the first financial derivatives were simple forwards and options contracts on commodities, today financial derivatives can be based on more complex reference items, such as bundles of mortgage-backed securities. These transactions may also combine different simple derivatives with traditional assets like debt or equity, and involve various contractual contingencies, such as credit default or the occurrence of catastrophic events. For example, credit derivatives, which are derivative contracts designed to shift credit risk between parties in the contract, have developed from simple contracts based on a single credit event to more complicated structured products that combine different contracts into a single security.

In its role in administering the tax code, IRS must implement the laws enacted by Congress, through detailed regulations and guidance. The IRS Office of Chief Counsel produces several forms of guidance to accomplish this. The seven most common forms include regulations, revenue rulings, revenue procedures, private letter rulings, notices,

announcements, and technical advice memorandums.[8] Regulations, which provide taxpayers with directions on complying with new legislation or existing sections of the tax code, hold more legal weight than IRS's other forms of guidance. Generally, regulations are first published in draft form in a Notice of Proposed Rulemaking, and final regulations are issued after public input is fully considered through written comments and potentially a public hearing. Where new or amended regulations may not be published in the immediate future, notices are often used to provide substantive interpretations of the tax code and other provisions of the law. In addition, IRS issues revenue rulings to provide official interpretations of the tax code, related statutes, tax treaties, and regulations. These interpretations are specific to how the law is applied to a particular set of facts. Revenue procedures provide return filing or other instructions concerning an IRS position. Private letter rulings are written statements issued to a single taxpayer that interpret and apply tax laws to that taxpayer's specific set of facts. They are not officially published and may not be relied on as precedent by other taxpayers or IRS.[9] Announcements, which generally have only immediate or short-term relevance, summarize laws and regulations without making any substantive interpretation; state what regulations will say in the future; or notify taxpayers of the existence of an approaching deadline. Finally, technical advice memorandums are developed in response to technical or procedural questions that develop during an examination or a processing in Appeals.

[8]In this report we use IRS's definition of guidance, which includes regulations, although regulations and guidance are typically considered separate and distinct categories.

[9] Internal Revenue Code (IRC) section 6110 requires public access to rulings, determination letters, technical advice memoranda, and Chief Counsel advice with any taxpayer identification information redacted.

Financial Derivatives Do Not Fit Neatly into the Tax System, Allowing Taxpayers to Use Them in Potentially Abusive or Improper Ways

Unique characteristics of financial derivatives make them particularly difficult for the tax code and IRS to address. The tax code's current approach to the taxation of financial derivatives is characterized by many experts as the "cubbyhole" approach. Under this approach, the tax code establishes broad categories for financial instruments, such as debt, equity, forwards, and options, each with its own rules governing how and when gains and losses are taxed. As new instruments are developed, IRS and taxpayers attempt to fit them into existing tax categories by comparing the new instrument to the most closely analogous instruments for which tax rules exist. However, a new financial instrument could be similar to multiple tax categories, and therefore IRS and taxpayers must choose between alternatives. This could result in inconsistent tax consequences for a transaction that produces the same economic results.

Derivative contracts, particularly those traded over-the-counter, are highly flexible, allowing taxpayers to structure transactions to take advantage of the different tax rules for each tax category. Derivatives can also be coupled with each other and with other types of financial instruments, like more traditional debt or equity instruments, to create hybrid securities. Because hybrid securities often do not clearly fall within a single tax category, it can be challenging for IRS and taxpayers to determine which tax rules are appropriate, and whether the hybrid should be treated as a single instrument or broken up into multiple instruments. While the tax rules for each tax category represent Congress's and Treasury's explicit policy decisions, some of these decisions were made long before today's complex financial derivative products were created. The cumulative effect of these decisions combined with the fact that many financial derivatives do not fit neatly in any one tax category can result in mistakes or opportunities for abuse by taxpayers.

A Patchwork of Rules from Different Parts of the Tax Code Govern the Taxation of Financial Derivatives

Tax rules governing financial derivatives can be broken down into rules governing the timing, character, and source of gains and losses, as described in table 1. These rules vary depending on a number of factors, including the type of financial derivative product, the underlying reference item, the transaction's cash flows, the type of taxpayer, the taxpayer's purpose for using the transaction, and applicable anti-abuse rules. Over time, as financial derivative products have been developed that do not fit neatly into existing tax categories, numerous tax rules have been created to address new financial products, sometimes without anticipating the relationship between those transactions and others. Therefore, tax rules for financial derivatives can vary widely from one transaction to another.

Table 1: Timing, Character, and Source Applied to Financial Derivatives

Timing	When is the gain or loss taxed? Examples include deferral of income recognition until settlement date or expiration of the contract, marking-to-market at the end of the taxpayer's year, or amortizing over the life of the contract. When gains and losses are recognized can affect the tax rate, as well as the present value of the gains and losses actually taxed.
Character	What is the type of gain or loss? Income or losses can be either ordinary income or loss or short- or long-term capital gains or losses, which affects the tax rate and the ability to defer gains and deduct losses.
Source	Where is the source of the gain or loss located? Source, either foreign or domestic, affects whether the income is taxed by the U. S., whether foreign tax credits are available, or whether withholding taxes apply.

Source: GAO analysis of IRS publications and tax research

While the source of gains and losses resulting from financial derivatives is generally that of the residence of the recipient, the tax rules for timing and character are more complicated. As stated above, some of these tax rules depend on the type of financial derivative product. For example, nonequity options not held to hedge a transaction are taxed under section 1256 of the Internal Revenue Code (IRC), which requires that the timing of gains and losses are marked-to-market at the end of the tax year, and that the character of gains and losses is treated as 60 percent long-term capital and 40 percent short-term capital.[10] Equity options held by dealers are also taxed under section 1256. However, for equity options not held by dealers, the timing rules are that gains and losses are not realized until the contract matures. Depending on the option's term, the character is either 100 percent short-term capital gain or loss or 100 percent long-term capital gain or loss.

Some tax rules for character also depend on the underlying reference item, regardless of the transaction type. An example of this is a foreign currency contract (known as a section 988 transaction), which may be ordinary or capital depending on a variety of factors outlined in IRC section 988. The gains or losses on a section 988 transaction are

[10]In other circumstances, if a taxpayer holds an investment for more than 1 year, any capital gain or loss is a long-term capital gain or loss. If a taxpayer holds the investment 1 year or less, any capital gain or loss is a short-term capital gain or loss. Tax rates on long-term capital gains are generally lower than short-term capital gain rates and vary depending on the taxpayer's income.

ordinary to the extent they are due to changes in exchange rates. However, the taxpayer may elect capital treatment in certain instances if the contract is a capital asset in the hands of the taxpayer and not part of an offsetting position, also known as a straddle.

Other timing and character rules are based on the purpose of the transaction, such as transactions used for hedging, which are generally treated as ordinary and timed according to the hedged item.[11] Regardless of the type of transaction or reference item, if the transaction qualifies as a hedge, these rules apply.

There are also timing and character rules that are based on the type of taxpayer. For example, the rules under IRC section 475 apply to dealers in securities and, if they elect, commodities dealers and traders in securities or commodities, who must generally mark-to-market securities or commodities under IRS section 475 and recognize gains and losses annually.[12] The character of these gains and losses is ordinary. Since a securities dealer is typically one of the two parties involved in a financial derivative transaction, this often results in different tax treatment for both sides of the transaction. The dealer would generally mark-to-market annually the gains and losses from a financial derivative contract and treat the income or losses as ordinary, while the other party to the transaction would be taxed depending on the factors described in this section.

Finally, the rules for the timing and character of financial derivatives can also vary for different types of payments within a single financial derivative transaction. For example, periodic payments in a NPC are treated differently than nonperiodic payments. Periodic payments are taxed as ordinary income and recognized annually on an accrual basis like interest payments. Nonperiodic payments must be amortized and

[11]26 U.S.C. § 1221(a)(7), (b)(2), 26 C.F.R. §§ 1 446-4, 1.1221-2.

[12]Under a mark-to-market approach, a dealer or electing trader would be treated as though it had sold its securities at the end of each taxable year for fair market value and then repurchased the securities as of the beginning of the following taxable year at the same price. The dealer or electing trader would thus be taxed annually on unrealized appreciation in the securities, and its basis in the securities would be increased to avoid double taxation of that appreciation upon maturity or an actual disposition. If the value of the securities declined, the dealer or electing trader generally would be entitled to claim the unrealized loss.

recognized as ordinary income over the life of the contract. However, early termination payments in a NPC are recognized for timing purposes when they occur, and they give rise to capital gain or loss if the underlying item is capital. In contrast, nonperiodic, contingent payments do not have defined treatment; the tax rules only require taxpayers to account for the payments in a manner consistent with other tax positions. Proposed regulations issued in 2004 stated that taxpayers could use a noncontingent swap method to determine the timing and character of these payments or elect mark-to-market treatment.[13]

There are a number of anti-abuse rules that can supersede the tax rules described above, which further complicate the tax treatment of a transaction. Many sections of the tax code exist for the sole purpose of applying additional rules for certain transactions, including IRC sections 1091 (wash sales), 1092 (straddles), 1233 (short sales), 1258 (conversion transactions), 1259 (constructive sales), and 1260 (constructive ownership transactions). For example, under IRC section 1092, for two or more transactions that are offsetting positions, known as a straddle, a realized loss on one position is currently deductible only to the extent that the loss exceeds unrecognized gains in any remaining offsetting positions. A second example involves constructive sales, or transactions that are treated as sales for tax purposes even though ownership in the property may not have legally transferred. Constructive sales include when a taxpayer enters into a short sale of the same or substantially identical property, an offsetting notional principal contract with respect to the same or substantially identical property, or a futures or forward contract to deliver the same or substantially identical property. Under IRC section 1259, taxpayers are considered as having sold a position at fair market value on the date of the constructive sale.

The tax rules for character, timing, and source described above can be challenging for both taxpayers and IRS to apply. Where these rules overlap or contradict one another, they can create gray areas that allow the same economic outcome to be taxed differently. Even anti-abuse rules, some of which IRS and tax experts believe are largely effective,

[13]Under proposed regulations, the noncontingent swap method requires taxpayers to project the expected amount of contingent payments, to take into account annually the appropriate portions of the projected contingent amounts, to reproject the contingent amounts annually, and to reflect the differences between projected amounts and reprojected amounts through adjustments. 69 Fed. Reg. 8886 (Feb. 26, 2004).

can contribute to the uncertainty because determining when to apply them can be difficult.

Financial Derivative Transactions with Economically Similar Positions Can Have Inconsistent Tax Treatments

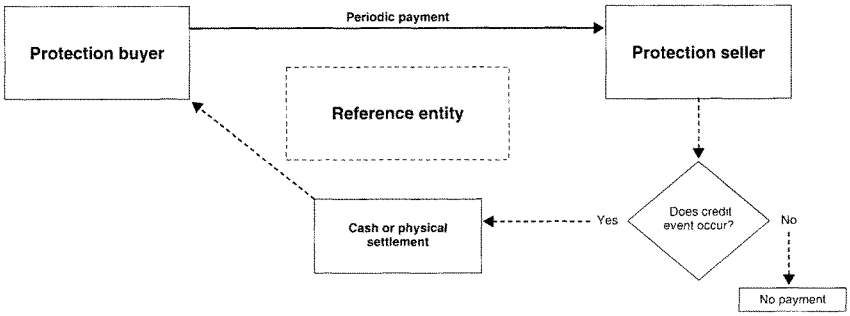
One basic principle of taxation commonly used to evaluate the tax treatment of financial derivatives is consistency, meaning that transactions with equivalent economic outcomes are taxed the same. The tax rules for financial derivatives with equivalent economic outcomes are not always consistent, in part because of their piecemeal development over time as well as the difficulty of developing tax rules for products that are constantly changing. For some types of financial derivatives, similar transactions can fall under different tax rules, particularly if the transactions do not fit well into the tax categories of the existing tax code.

While the pretax economic outcome of a taxpayer using a financial derivative and actually holding the financial asset underlying the derivative may be the same, due to the inconsistent tax treatment of derivatives, the after-tax outcome can be starkly different. The flexibility in financial derivative contracts allows them to be used to mimic different economic positions. By combining the basic building blocks of financial derivatives highlighted in table 1, together with traditional instruments like debt and equity, taxpayers can virtually create any synthetic position that allows the same economic returns as the reference item without actually owning the reference item. Financial derivatives therefore allow users, in many circumstances, to structure transactions to alter the timing, character, and source of gains and losses to produce more tax-favorable results. For example, through financial derivatives taxpayers can defer gains or accelerate losses, change ordinary income into capital gains or vice versa for losses, or alter the source of the gains to avoid paying withholding taxes.[14] While permitting taxpayers to elect a more favorable tax treatment is not uncommon, when they have done so using financial derivatives, the result has at times been disallowed by Congress. In other cases, IRS and Treasury have successfully challenged during audit or in litigation taxpayers' treatment of financial derivatives.

[14]Besides the lower tax rate applied to long-term capital gains, there is an additional economic benefit of deferring taxes paid associated with the time value of money. Each year a taxpayer defers paying tax on income, that income can be invested in a risk-free asset and increase in value. Assuming tax rates do not change, the tax owed on the original income does not increase. The taxpayer in effect pays less tax in real dollars each year he or she is allowed to defer income recognition. IRC requires accrual of this increase in value for debt instruments, but not equity

In certain instances, financial derivative transactions can be used to produce equivalent economic outcomes that have different tax results because one financial derivative can fall under numerous tax rules. One prominent example of this is the credit default swap (CDS), which first appeared on the market in the early 1990s. As is shown in figure 3, in a CDS, the buyer pays a periodic fee to the seller in return for compensation if a specified credit event occurs to a reference item. The reference item may be bonds or loans from a corporate entity, sovereign debt, an asset, or an index of these. The credit event may be default, bankruptcy, debt restructuring, or any number of events related to the significant loss in value of the underlying reference item.

Figure 3: Credit Default Swap



Sources: GAO and IRS publications

Although CDSs became prominent in the market in the 1990s, their tax treatment has remained uncertain. In the absence of guidance, taxpayers do not take a uniform treatment of CDSs, instead selecting the tax position that is most favorable. Taxpayers commonly elect NPC treatment for CDS transactions. As discussed previously, different payments from a NPC have different character treatments, and CDS users can take advantage of these differences to lower their tax liability when one party in the transaction is neutral to the tax results. For example, in a situation when a taxpayer holds a CDS that has appreciated in value and the other party is a dealer, rather than hold the contract until maturity and pay

ordinary rates on the income, the taxpayer can terminate the contract early. By doing so the taxpayer receives a termination payment of the same economic value but pays lower long-term capital gains rates. Experts that we interviewed stated that the inconsistent treatment of CDSs increases compliance risk for taxpayers. In the final guidance, Treasury and IRS may determine that the tax treatment of CDSs does not align with how a taxpayer elected to treat a CDS now, and there is a risk that a different treatment could be imposed on transactions entered into prior to the new guidance.

Financial derivatives also allow taxpayers to take advantage of the inconsistencies between asset classes, such as differences in deductions between payments on debt and equity. Taxpayers have done this with one type of financial derivative, by coupling a forward contract with the issuance of debt, which is one type of a mandatory convertible security. Mandatory convertibles are a broad class of securities linked to equity that automatically convert to common stock on a specific date, and allow the issuer to raise capital that is treated as debt in financial statements. However, interest payments on the issuance can be deducted, which would not be possible with dividend payments on a more traditional equity security. In the transaction, a corporation issues units of the security that consist of two components: a forward contract to purchase the corporation's equity, and debt in the form of the corporation's note. The purchaser of the unit pledges the note back to the corporation as collateral to pay the settlement price of the forward contract. If the note and the forward are treated as a single hybrid instrument for tax purposes, the single instrument resembles an equity position, and payments on such a position would not be deductible. Currently the note and the forward can be separated for tax purposes under certain circumstances, in which case the corporation can deduct all payments on the note as interest payments on debt, despite the presence of the forward contract.[15]

Financial derivatives also have allowed taxpayers to mimic the ownership of assets such as equities, while achieving a lower tax liability than direct ownership of those assets. One example of this was the disparate treatment of dividend payments on U.S. equity and dividend-equivalent

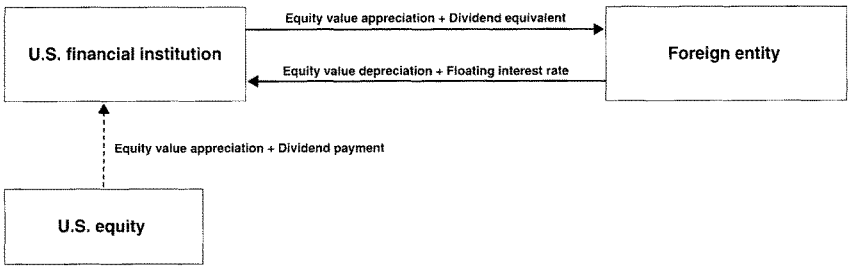
[15]See IRS Revenue Ruling 2003-97. For these tax results to hold, the transaction must have specific legal characteristics, as described in the ruling.

payments from a total return equity swap (equity TRS), held by foreign entities. Foreign entities must pay 30 percent withholding taxes on any dividends received from U.S. sources because the dividend is considered U.S.-source income.[16] However, until recently payments from a swap based on that U.S. asset would not be subject to withholding taxes, as swaps are sourced to the residency of the recipient of swap payments, the foreign entity in the case of the equity TRSs that attempt to avoid withholding taxes. In order to avoid withholding taxes on dividends, a foreign entity would enter an equity TRS, replacing the dividends with dividend-equivalent payments that arise from the swap. In this transaction, a U.S. financial institution pays the foreign entity a cash-flow equivalent to the dividends of a given stock plus any appreciation in the stock price, while the foreign entity pays a floating interest rate used to enter into the agreement plus any stock depreciation. The contract results in the foreign entity mimicking stock ownership without paying withholding tax by taking advantage of differences in source rules for dividend payments and dividend-equivalent payments. The use of equity TRS by foreign entities to avoid withholding had become standard practice since the 1990s, until the Hiring Incentives to Restore Employment (HIRE) Act statutorily required withholding on dividend-equivalent payments (see fig. 4).[17] For tax years before the enactment of the HIRE Act, IRS is challenging equity TRS transactions through the examination process, arguing that they were used to improperly avoid withholding taxes. In addition, IRS issued an Industry Director Directive on January 14, 2010, to assist IRS agents to identify and develop cases with questionable equity TRS transactions.

[16]26 U.S.C. §§ 871(a)(1)(A), 881(a)(1). The 30 percent withholding tax, which is typically withheld at the source, is not imposed in all circumstances, such as when the income is from certain portfolio debt investments or when a tax treaty sets a different rate.

[17]Pub. L. No. 111-147, § 541, 124 Stat. 71, 115–117 (2010), *codified at* 26 U.S.C. § 871(m).

Figure 4: Cross-Border Total Return Equity Swap



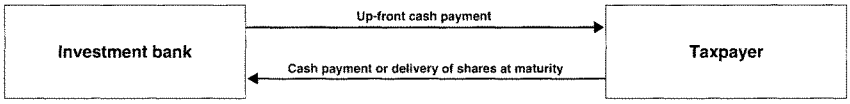
Source: GAO analysis of IRS publications

Another example where taxpayers have used the inconsistent tax treatment between financial derivatives and direct ownership of the underlying asset was the case of a variable prepaid forward contract (VPFC) held in combination with a share-lending agreement. Taxpayers attempted to use this transaction to defer income by mimicking a sale of equity without recognizing the gains for tax purposes. When taxpayers sell an appreciated security, they must pay short-term or long-term capital gains taxes upon sale. However, over the past decade, taxpayers have used VPFCs to monetize gains in a security's value without paying taxes at the time of the sale. In situations where VPFCs have been used for this purpose, taxpayers agree to sell a variable number of shares to the other party in the transaction, usually an investment bank, at an agreed-upon date, typically 3 to 5 years in the future. VPFCs are customized to the investor and an option to cash-settle is usually included in the contract. The number of shares delivered (or the cash value thereof) is based on a formula involving the stock price on the contract's expiration date.[18] The

[18]The variable nature of the contract mitigates the downside risk at the expense of a cap on gains for both parties. As a simplified example: if a share is originally worth $100, and the VPFC relates to 10,000 shares of stock, the seller of the VPFC may agree to deliver 10,000 shares if the share price is less than $100, the number of shares worth $1,000,000, if the share prices is between $100 and $125, or 10,000 shares, less the number of shares worth $250,000, if the price rises above $125.

dealer typically pays the taxpayer between 75 percent and 85 percent of the market value of the shares up front that is not required to be repaid. By manipulating differences in timing rules, the VPFC thus closely mimics the sale of stock, but the income is not recognized for tax purposes until the contract matures. Because of the variability in the number of deliverable shares, the transaction avoids anti-abuse rules that do not permit deferred recognition of prepaid sales (see fig. 5).[19]

Figure 5: Variable Prepaid Forward Contract

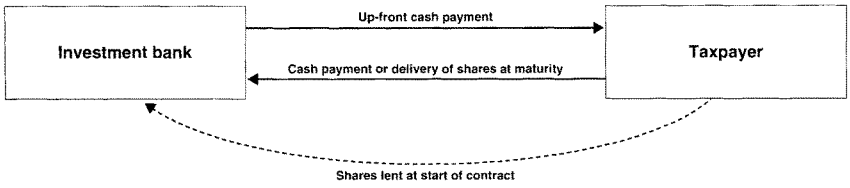


Source: GAO analysis of IRS publications

While holding a VPFC, taxpayers still retain control of the underlying asset. To earn a greater return on the VPFC as discussed above, taxpayers sometimes couple the VPFC with a share-lending agreement. This type of agreement stipulates that taxpayers lend shares to the investment bank to sell, invest, or use in other ways the shares in its course of business. In this manner, the taxpayers have transferred substantially all of the attributes of owning the shares, but have argued that the shares have not been sold for tax purposes (see fig. 6).

[19]See IRC section 1259 rules on constructive sales.

Figure 6: Variable Prepaid Forward Contract and Share-Lending Agreement



Source: GAO analysis of IRS publications

The current tax treatment is not the only possible method of taxing financial derivatives, and experts have suggested a number of alternatives that they believe would adopt a more consistent view of financial derivatives and potentially reduce abuse. For example, one common idea is to require mark-to-market treatment on all financial derivatives for all taxpayers, meaning that all gains and losses from financial derivatives would be recognized at the end of each tax year, and to treat all such income as ordinary income. While this approach would result in higher tax burdens for some, proponents cite benefits, which include reduced compliance costs and potential for abuse. This report does not evaluate this approach or any other alternative approaches, which would require significant changes to the tax code. We have previously developed criteria for establishing a good tax system, which include equity; economic efficiency; and simplicity, transparency, and administrability.[20] Consistency, the criterion used in this report, is related to simplicity, administrability, and economic efficiency. While the examples above describe issues that arise from inconsistent tax rules, any alternative approach would involve tradeoffs among these criteria. In considering the effects of alternative tax rules on economic efficiency, IRS and several experts told us that one potential effect of any alternative with less favorable tax outcomes could be that certain financial sector activity might leave the United States. Because of their unique position to define policy and administer the tax code, Treasury and IRS are in the best

[20]See GAO-05-1009SP.

position to recommend an alternative approach to the taxation of financial derivatives.

Challenges Slow the Development of Guidance on Financial Derivatives Increasing Uncertainty and Potential for Abuse

In their role of implementing tax laws enacted by Congress, Treasury and IRS play the crucial role of translating tax laws into detailed regulations, rules, and procedures. When application of the law is complex or uncertain, as is often the case for financial derivatives, guidance is an important tool for addressing tax compliance and emerging abusive tax schemes. Particularly when financial derivative products are new, how financial derivative products should be taxed under the current tax regime can be unclear. However, Treasury and IRS face a number of challenges in developing guidance for financial derivatives that may delay completion of guidance. Although taxpayers are accustomed to exercising judgment when taking a tax position for their transactions, the lack of clarity for many derivatives can lead to heightened compliance risk and abuse.

Taxpayers we interviewed said that Treasury and IRS have not issued guidance on a number of financial derivative tax issues that have a significant impact on their decision making. For example, before the passage of the HIRE Act in 2010, the last guidance IRS issued on transactions that avoid withholding taxes on dividends similar to cross-border equity TRSs were final regulations in 1997.[21] During the past two decades, the use of equity TRSs to avoid withholding taxes grew as many taxpayers interpreted the lack of tax guidance as IRS's approval of the tax treatment of the transaction.

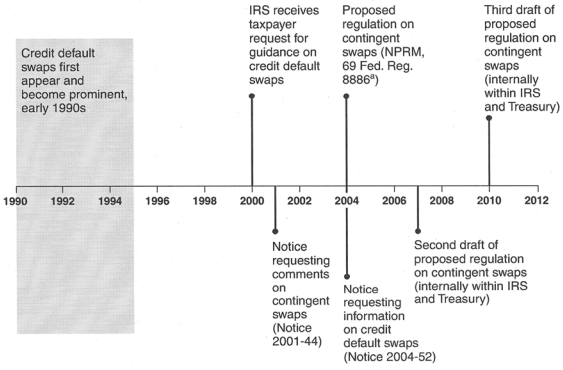
Similarly, IRS has not issued final regulations on contingent swaps since the proposed regulations in 2004, and finalized guidance on the appropriate tax treatment of CDSs has not been issued since a notice requesting comment on their tax treatment in 2004 (see fig. 7 for a timeline). This leaves taxpayers with little clarity on how to treat gains or losses from a swap payment dependent on a contingency. Contingent swaps are swaps that contain contingent nonperiodic payments determined by the occurrence of a specified event, such as the price

[21] 62 Fed. Reg.53, 498 (Oct. 14, 1997).

movement of an underlying asset.[22] CDSs are a special type of a contingent swap, where the triggering event is a credit event, such as the default of debt issued by a third party. According to IRS, the only requirement for taxpayers is that they clearly reflect income in their method of accounting for these transactions. IRS first issued a notice soliciting comments on the tax treatment of contingent swap payments in 2001, which eventually led to a first round of proposed regulations in 2004. These proposed regulations offer two accounting methods: (1) mark-to-market treatment, or (2) annually projecting the expected value of the contingent payment and paying the appropriate tax as if it were a nonperiodic, noncontingent payment, known as the noncontingent swap method. After issuing the proposed regulations in 2004, IRS has gone through several internal iterations of draft regulations without issuing final regulations on contingent swaps.

[22]According to proposed regulations, a contingent nonperiodic payment is "any nonperiodic payment other than a noncontingent nonperiodic payment," which in turn is "a nonperiodic payment that either is fixed on or before the end of the taxable year in which a contract commences or is equal to the sum amounts that would be periodic payments if they are paid when they become fixed." 69 Fed. Reg 8886, 8893 (Feb. 26, 2004).

Figure 7: IRS Actions on Contingent Swaps and CDS



Source: IRS.

[a]Notice of Proposed Rulemaking (NPRM).

Note: In 1996, Treasury and IRS issued their first finalized regulations on contingent payments for any financial instrument, which addressed contingent payment debt instruments. 61 Fed. Reg. 30,133 (June 14, 1996). Although the regulations helped frame IRS and Treasury's thinking on contingent swaps, these regulations are not included in the timeline because they did not specifically address contingent swaps. For additional details see appendix II.

IRS first learned of CDSs in a request for a private letter ruling from a taxpayer in 2000. However, IRS did not issue any guidance on CDSs until 2004, when it requested information from taxpayers on four alternative treatments. In the absence of finalized guidance, the 2004 notice allows taxpayers to place CDSs in one of four distinct tax categories for financial instruments.[23] Experts and practitioners told us that the tax treatment for

[23]Notice 2004-52 describes CDS as similar to a NPC, an option, an insurance contract, and a financial guarantee.

CDSs is unclear, the alternatives do not necessarily arrive at the same tax liability, and taxpayers do not uniformly use one of the alternatives. The lack of guidance has resulted in taxpayers choosing different tax treatments, and according to some taxpayers we interviewed, deferring income recognition even when they are reasonably certain of gains. Taxpayers and experts that we interviewed also stated that the inconsistent treatment of CDSs increases the tax compliance risk they face because Treasury and IRS may determine that the final tax treatment of CDSs will not align with how some taxpayers are treating CDSs now and that determination may be applied to transactions entered into in prior years.

The absence of guidance on contingent swaps and CDSs affects IRS's ability to assess tax liability and address potential abuse. When exam teams in IRS identify a potentially abusive financial derivative used by a taxpayer, they have a number of resources to understand the tax effects and determine the appropriate tax liability. IRS has specialists in financial instruments that regularly assist revenue agents, as well as IRS attorneys who provide specialized legal advice. When an IRS exam division determines that a potential abuse has a large enough scale to warrant the necessary resources to address broadly, there are multiple avenues to raise the issue beyond the particular exam. One of these avenues is the issuance of guidelines by an IRS exam division to field examiners, such as an Industry Directive, as was the case with cross-border equity TRSs.[24] Another mechanism is a request for nonprecedential guidance from IRS's Chief Counsel in the form of a legal memorandum to IRS staff. Issues can also be developed into a series of cases for litigation. For issues that are broad enough, Chief Counsel can eventually issue published guidance, which differs from the previous options in that it typically has a broader legal application. The other alternatives are not generally legally binding on IRS or taxpayers, except with regard to the taxpayer involved. As another example, for VPFCs with share-lending

[24]See LMSB-4-1209-044 *Industry Directive on Total Return Swaps Used to Avoid Dividend Withholding Tax*, issued January 14, 2010.

agreements, IRS has issued guidance from exam divisions and Chief Counsel, and has also developed a number of cases for litigation.[25]

IRS and Treasury issue guidance in the form of regulations, revenue rulings, revenue procedures, notices, and announcements as well as other types of guidance. IRS Chief Counsel and Treasury's Office of Tax Policy have established a prioritization schedule for developing and issuing guidance, known as the Priority Guidance Plan (PGP).[26] The PGP is issued each year and identifies the guidance projects that are the current IRS and Treasury guidance priorities to be completed over a 12-month period that runs from July 1st to June 30th of that PGP year. The PGP is available to the public on IRS's website, and is updated periodically to include additional guidance project priorities and identifies which guidance projects have been completed up to that point. However, periodic updates to the PGP do not identify guidance projects that have been removed from the plan without having any guidance issued. Not all guidance projects being worked on are on the PGP, and a number of pieces of guidance affecting derivatives were not PGP projects. For example, Notice 2002-35, which addressed tax shelters using NPCs, was not on the PGP before it was published. The PGP serves as both a public statement of the guidance taxpayers can expect to receive over a 12-month period and an internal prioritization of resources within IRS and Treasury. Given the pace at which derivative markets evolve, timely guidance that addresses tax issues is important to reduce uncertainty and opportunities for abusive tax strategies. However, Treasury and IRS face a number of challenges that are discussed below that may delay the completion of guidance.

[25]In 2006, the Pre-Filing and Technical Guidance office within the Large and Mid-Size Business (LMSB) division issued an Emerging Issue Paper. In 2008, LMSB issued Coordinated Issue Paper LMSB-04-1207-077. Starting in 2004, IRS has entered into litigation against at least three separate taxpayers, in relation to these issues.

[26]The PGP is also known as the Guidance Priority List or the Business Plan.

Between 1996 and 2010 IRS and Treasury Did Not Complete One-Fourth of the Priority Guidance Projects That Involved Financial Derivatives

We analyzed 53 projects that involve financial derivatives that IRS and Treasury have placed on the PGP since 1996, and found that one-fourth of the projects were not completed (see table 2).[27] Almost all of the guidance projects that were completed were published within 2 years of first appearing on the PGP.[28]

Table 2: Completion Rate of Financial Derivative Guidance Projects, 1996-2010

	Count	Percentage
Complete	39	74
Incomplete	14	26
Total	**53**	**100**

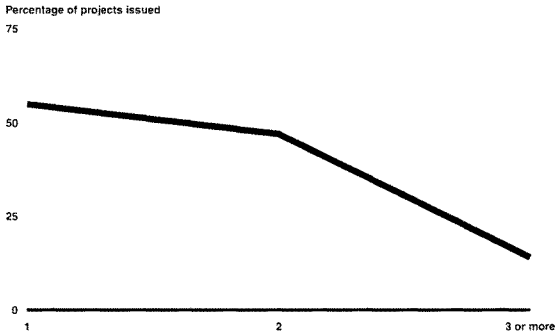
Source: GAO analysis of IRS data

Of the 53 projects on the PGP, IRS and Treasury completed just over half (29) within their first year on the plan, and removed 5 that were not completed. Of the 19 projects that remained on the plan for 2 years or longer, just under half of those (9) were completed and 3 were not completed and removed. Only 1 of the 7 projects that were on the PGP for 3 or more years was completed as of the end of the 2010 PGP year (June 30, 2010). Some of the PGP projects that were removed or not completed from 1996-2010 dealt with tax issues related to the case studies described above on contingent swaps and equity TRSs. Figure 8 presents the completion rates for projects related to financial derivatives on the plan for 1 or more years.

[27]IRS Chief Counsel's database which tracks guidance projects, Counsel Automated Systems Environment-Management Information System (CASE-MIS), only has data available going back to 1996.

[28]See appendix II for list of the 53 priority guidance projects.

Figure 8: Completion Rates of Financial Derivative Guidance Projects, 1996-2010



Source: GAO analysis of IRS data

We found, that on the basis of our analysis, projects not issued within 3 years were more likely to be regulations, and related to more complex issues. Four projects that were on the plan for 4 years or longer without being completed were regulations addressing particularly controversial and complicated issues, including (1) capitalization of interest and charges in straddles under IRC section 263(g), (2) constructive sales rules under IRC section 1259, (3) contingent payments in notional principal contracts, and (4) elective mark-to-market accounting for certain qualifying taxpayers under IRC section 475. While it is important for IRS and Treasury to finalize guidance on these projects to provide clarity to IRS and taxpayers, there are a number of challenges involved, including the patchwork structure of the relevant tax rules and other issues discussed below. These challenges can make it difficult to issue guidance on the tax treatment of financial derivatives within the 12-month time frame established in the PGP.

Challenges Specific to Financial Derivatives Slow the Guidance Process

While some reasons for the delay in the issuance of guidance on financial derivatives are common to all guidance projects, financial derivatives have characteristics that present challenges to IRS and Treasury.

Overcoming these challenges requires time and resources, which can cause significant delays in issuing guidance that addresses the concerns facing taxpayers and IRS.

The transactional complexity of many derivative products and the complex tax rules governing them make it difficult to determine appropriate tax treatment

The growing sophistication of financial derivatives and the complex tax rules governing them have made it difficult for Treasury and IRS to resolve issues not addressed in legislation or existing guidance. On the one hand, financial derivative products can involve multiple transactions and entities, or terms can be altered to reach different tax results. These factors impede IRS's ability to identify a product's economic outcome, business purpose, and the applicable tax rules. The complexity of VPFCs is one example where IRS concluded and the courts agreed that some claimed tax results of the transactions were improper, depending on the entities involved and what other contracts the VPFCs were coupled with. On the other hand, multiple tax rules can apply to the same financial derivative product depending on certain factors such as the type of taxpayer, the underlying asset, and the context in which the product is being used. Treasury and IRS often spend years working through these complexities, and at times have been unable to reach a consensus.

The tax treatment of gains and losses that are contingent on a particular event is an example of an issue that Treasury, IRS, and private sector experts have identified as particularly difficult to resolve. Treasury and IRS legal counsel have devoted considerable resources—as of April 2011 IRS alone had logged nearly 7,800 staff hours over a 9-year period—to determine the appropriate treatment of contingent swap payments, but have been unable to reach a consensus. Despite being on the PGP every year since 2004, when proposed regulations were issued, Treasury and IRS have been unable to establish the appropriate treatment of contingent nonperiodic payments in final regulations in large part due to the complexity of the timing and character issues, as well as other issues discussed earlier. CDSs have also been the subject of considerable analysis by Treasury, IRS, and experts on the appropriate tax treatment. Since issuing a notice in 2004, IRS has not issued any guidance on how CDSs should be treated for tax purposes. During this time, the structure of CDS products has diversified from products that were referenced to a single entity to products based on a pool of obligations, such as an index and others that are rolled into more complex products. IRS and Treasury have not established the appropriate treatment of a basic CDS product, a necessary first step in determining the tax treatment of more complex CDS products.

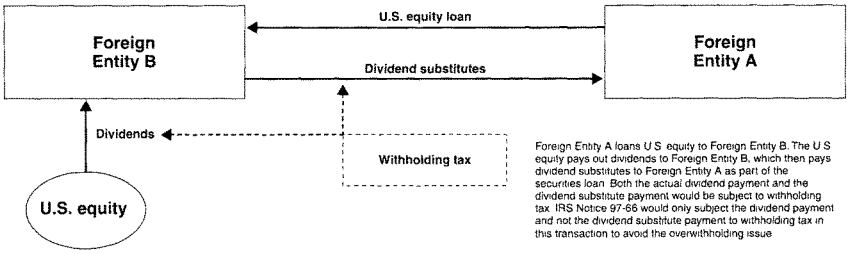
Some financial derivatives have been developed to take advantage of new guidance in ways unintended by IRS

The timeliness of Treasury and IRS guidance is also affected by concerns that issuing new guidance could provide new opportunities for tax abuse. This is especially true for financial derivatives, as they can easily be altered to achieve a desired tax effect. IRS told us that whether it issues further guidance depends on a careful consideration of the possible unintended effects that guidance might have, and that Treasury and IRS must carefully evaluate potential guidance changes to help ensure that while addressing problems in one area they do not raise issues in another. One example of guidance that Treasury and IRS issued that had unintended consequences was IRS Notice 97-66, which dealt with withholding taxes on dividend-substitute payments. Certain payments made by a domestic entity to a foreign entity may be subject to a 30 percent withholding tax, depending on source rules for that type of payment. Dividend payments made from owning equity and dividend substitute payments made from a securities loan are subject to withholding tax. Prior to the passage of legislation in 2010, some taxpayers and representatives took the position that dividend-equivalent payments made from an equity TRS were not subject to withholding tax.[29] IRS had begun challenging the equity TRS transaction based on judicial doctrines before the 2010 legislation was enacted.

When Treasury finalized the regulations for dividend-substitute payments in 1997, tax practitioners were concerned that the regulations could result in the cascading of withholding taxes in cases where the same shares of equity were lent between two foreign parties. As seen in figure 9, in this transaction, the actual dividend and the dividend-substitute payment would be subject to withholding tax, resulting in withholding tax exceeding the 30 percent withholding rate.

[29]Dividend substitute payments on U S equity made when a foreign owner loans the equity securities to a U.S. entity are sourced similar to a transferred security according to 1997 regulations, meaning they are also subject to the 30 percent withholding tax when payments are made to foreign entities. (Treas. Reg. 1.861-3(a) (6), adopted by T.D. 8735, 11-6-97) However, according to 1991 regulations, the source of dividend-equivalent payments made from a total return equity swap is determined by the residence of the taxpayer, so a U.S entity making payments to a foreign entity does not need to withhold taxes. (Treas Reg. 1.863-7(b), adopted by T.D. 8330, 1-11-91).

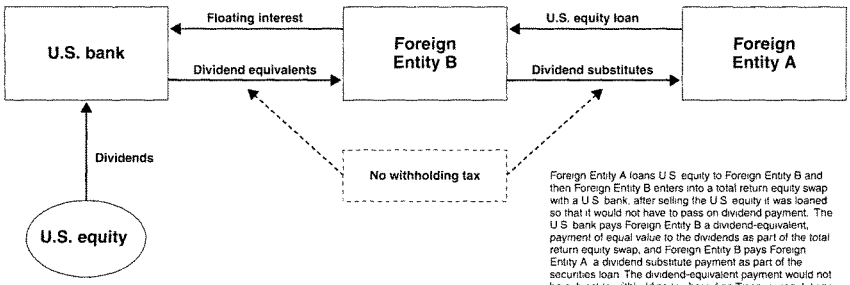
Figure 9: Cascading Withholding Taxes through Equity Securities Loan



Source: GAO analysis

In response, IRS issued Notice 97-66, intended to avoid cascading withholding on instances described in the example above. However, some financial institutions took the position that a literal reading of the IRS notice meant that a dividend-substitute payment made between two foreign parties located in jurisdictions subject to the same withholding rate was not subject to any withholding tax. As seen in figure 10, in this transaction, the dividend-equivalent payment would not be subject to withholding tax because of 1991 Treasury regulations and the dividend-substitute payment would not be subject to withholding tax based on the taxpayer's interpretation of IRS Notice 97-66. As stated above, Congress eventually disallowed the avoidance of dividend withholding through this transaction with the passage of the HIRE Act.

Figure 10: Combining a Total Return Equity Swap and an Equity Securities Loan



Source: GAO analysis

This example and others have made Treasury and IRS aware of the importance of weighing the need for guidance with the potential that new guidance may also provide new opportunities for taxpayers to aggressively reduce their tax liability by altering the structure of a transaction. The ability of financial market participants to react quickly to guidance means that Treasury and IRS have to consider the unintended effects that may occur when issuing guidance. As indicated in the example above regarding Notice 97-66, the time it takes Treasury and IRS to identify and mitigate any tax avoidance strategies that arise from issuing guidance can take a number of years.[30] While timeliness is an important factor for issuing guidance, taking steps to ensure the effectiveness and the desired results of the guidance are also important factors for IRS and Treasury to consider.

[30]After the passage of HIRE Act, enacted March 18, 2010, IRS replaced Notice 97-66 with Notice 2010-46.

The rapid growth of the financial derivatives market increased the potential economic impact of guidance

The considerable growth in financial derivatives markets has increased the potential economic effects of guidance issued by Treasury and IRS. IRS officials have said that in preparing guidance they do not consider the number of taxpayers taking a certain tax position on a financial derivative product, but rather they base their decisions on tax rules established in the IRC, Treasury regulations, and judicial doctrine. However, in light of the size of a product's market, officials told us that it is important to consider the economic effects of their guidance decisions. Economic consequences of concern identified by officials and experts include losing financial business overseas to countries with more business-friendly tax regimes.

An example of one of the economic risks facing IRS and Treasury surfaced during the process of issuing guidance on how withholding taxes should apply to cross-border derivative payments. When Treasury and IRS considered requiring withholding on cross-border equity TRSs in 1998, Congress, IRS, and Treasury faced numerous concerns from taxpayers that this would limit foreign investment in the U.S.[31] Withholding has also been a concern for cross-border CDSs. In terms of notional amount outstanding, the U.S. share of the global CDS market has, on average, been about one-third of the total market since the end of 2004. IRS staff and private sector experts have said that subjecting CDSs to withholding tax presents a risk that investors will move their business overseas. IRS officials said that this has been a major impediment in the resolution of whether withholding tax should apply to CDSs, particularly in light of the rapid growth of the credit derivatives market.

Staff turnover, legal authority, and enforcement responsibilities have delayed the progress of financial derivative guidance projects

As Treasury and IRS work through the many complexities of issuing guidance for financial derivatives, they also must deal with institutional factors such as staff turnover, legal authority, and the different roles of Treasury and IRS that can delay the issuance of guidance. Staff turnover at IRS and Treasury can bring current market knowledge from the private sector; however, this turnover can also sometimes affect the timeliness of guidance. New staff typically have to familiarize themselves with the issues raised in ongoing guidance projects, may have a different perspective on the issues raised in the projects, or may believe the project should have a different priority.

[31]See the proposed rules regarding trading safe harbors. 63 Fed. Reg. 32,164 (June 12, 1998).

Determining whether Treasury and IRS have the necessary authority to take certain positions can also delay the development of guidance projects. Treasury and IRS have at times been reluctant to explore and ultimately issue guidance to resolve tax issues when there is concern about whether IRS has the legal authority to require a certain tax treatment for financial products. For example, although many experts consider mark-to-market treatment the most appropriate resolution for contingent swap payments, IRS had concerns about whether it could require taxpayers to follow mark-to-market treatment for contingent swap payments.

IRS's enforcement responsibilities can also affect the time it takes to complete guidance projects. Treasury and IRS may want to issue guidance on a certain issue, but if IRS is currently conducting litigation or auditing on that issue it may be difficult to consider alternative guidance positions when IRS has already taken a position in an audit or in court. For example, one of the reasons that Treasury and IRS did not attempt to address gaps in existing guidance on VPFCs with new guidance was because IRS was litigating the issue and did not want to publish guidance that might affect IRS's case.

Delayed Guidance Increases Compliance Risk and Costs, among Other Negative Consequences

Delays in the issuance of guidance on financial derivatives have substantial negative consequences for both taxpayers and IRS, which are summarized in table 3. However, IRS and Treasury may also benefit by not issuing timely guidance. The ambiguity that results from a lack of clear guidance could make taxpayers less willing to take risky tax positions because of the concern that IRS may determine the position is abusive in the future.

Table 3: Negative Consequences of Delayed Guidance on Financial Derivatives

Consequences for taxpayers	Consequences for IRS
• Uncertainty • Imperfect market competition • Reduced confidence in tax system	• Increased time and resources in audits and litigation • Opportunities for tax abuse • Negative reputation

Source: GAO analysis of interviews with Treasury, IRS, and tax experts.

Exchange-Traded Notes

The case of exchange-traded notes (ETN) is an example of the increased compliance risk associated with uncertainty. ETNs are contractual obligations, traded on an exchange, which generally provide investors the right to receive a return that is based on changes in the value of an index. ETNs are sold, or issued, by financial institutions to investors in the form of debt instruments. The investor makes a prepayment to the issuer of the ETNs for a payment at maturity based on the performance of the index. In this sense, an ETN is a prepaid forward contract traded on an exchange. Economically, an ETN produces a similar investment and risk profile as an exchange-traded fund (ETF) that all may track the same index, with the exception that the ETN investor is exposed to the risk of the issuer. For tax purposes, however, ETFs differ from ETNs. In order to track an index, ETFs must yearly rebalance the shares they hold and investors must generally pay capital gains taxes on shares sold. In addition, the shares held by ETFs may pay dividends, for which the holder must pay taxes even if the dividends are reinvested into the underlying shares. Investors in an ETN, on the other hand, generally treat all gains and losses generated by the ETN as a prepaid forward contract. This means ETNs are treated as open transactions and any gains or losses would not be recognized until the ETN is traded or redeemed. In 2007, IRS issued guidance requiring ETNs on foreign currency to accrue interest income that is taxed at ordinary rates, but the general tax treatment of returns on ETNs has not been established by IRS and Treasury.[33] The market has grown considerably since 2006, when ETNs first appeared. Developing guidance on ETNs has been listed as a priority by IRS and Treasury since 2009. As of August 2011, 170 ETNs had assets of almost $16 billion. One of the major attractions to ETNs is their beneficial tax treatment, and the delay in issuance of guidance could put an increasingly large number of taxpayers at risk of noncompliance.

For taxpayers, one of the main tax-related consequences is the increased compliance risk associated with uncertainty. (For an example see the sidebar on Exchange-Traded Notes.) For example, if no clear guidance exists on how to treat a transaction for tax purposes, taxpayers must come up with their own position, which may be different than IRS's approach and present increased compliance risk. Tax positions may also differ among taxpayers, which causes a consistency problem for both taxpayers and IRS. In developing tax positions where no clear guidance exists, taxpayers often look to other sources of information provided by IRS and Treasury that lack the legal status of finalized guidance. Tax experts said that they prefer written guidance to informal statements made by agency officials at conferences, which do not necessarily represent IRS's official position on a transaction. In addition, taxpayers rely on nonprecedential advice that IRS issues to either individual taxpayers or to IRS exam teams.[32] If IRS disagrees with a taxpayer's position, the taxpayer is at risk of either penalties or litigation costs if the taxpayer decides to challenge the agency. If guidance is later issued that affects positions taken by taxpayers retroactively, this could put taxpayers' current positions at risk of being noncompliant, although officials said it may be unlikely that Treasury and IRS would do this, as long as the taxpayer's method was reasonable and consistently applied.

Another consequence that the absence of guidance results in is imperfect market competition. According to market participants, because most derivatives are not tax driven, contracts may be executed even if the tax results are unclear. Taxpayers may look for other parties in a transaction who are willing to take on the additional tax risk, resulting in what one expert called a "race to the bottom" as parties vie for business by taking on riskier tax positions. In addition, all of these issues can reduce taxpayers' confidence in the fairness of the tax system.

[32]Nonprecedential advice includes Private Letter Rulings (PLR), Technical Advice Memorandums (TAM), and Chief Counsel Advice (CCA). PLRs and TAMs are issued to taxpayers and exam teams and are only binding on the IRS and the taxpayer in the specific circumstances addressed. CCA is issued to exam teams and is not legally binding.

[33]See IRS Revenue Ruling 2008-1 and IRS Notice 2008-2.

Variable Prepaid Forward Contracts

The case of variable prepaid forward contracts (VPFC) is an example of the negative consequences to both taxpayers and IRS of delayed guidance. In 2003, IRS issued Revenue Ruling 2003-7, which addressed what IRS thought was the most prevalent form of VPFCs. The ruling allowed taxpayers to use VPFCs to defer income for tax purposes, avoiding capital gains rules under IRC section 1001 and constructive sale rules under IRC section 1259. However, it was not until after the issuance of the revenue ruling that the agency became aware of the coupling of VPFCs with a share-lending agreement, described in the text above and which taxpayers had been using since at least 2000 to monetize their assets while claiming that there was no sale for tax purposes. IRS did not publish further guidance to address the newly identified transaction. Further, exam teams had to wait approximately 2 years before a technical advice memorandum (TAM) was issued, which gave them the legal support to challenge this practice. Although TAMs are public, taxpayers can not rely on them as legal precedent. Because of the shortcomings of IRS's initial guidance and IRS's inability to quickly issue new guidance, taxpayers were led to believe their transactions would not be challenged. For the same reasons, IRS exam teams were limited in their ability to take action against what they considered and IRS ultimately judged to be an improper tax result.

For IRS, one negative consequence of delays in guidance on financial derivatives is increases in time and resources spent on examinations and litigation. Without clarity on a tax issue, audit teams must often spend more resources examining the tax results of derivative transactions, which may include requesting advice from IRS Chief Counsel, often a time-consuming process. IRS staff told us that having clear, timely guidance can significantly reduce the amount of time and uncertainty revenue agents and IRS counsel encounter resolving tax issues during an exam. If taxpayers and revenue agents have divergent views on tax positions, a technical advice memorandum or other legal memorandum may be requested, which can increase the amount of time in exam. If IRS is unable to issue guidance on a transaction, they may pursue a litigation strategy, which itself can take years and require a great deal of resources from both IRS and the taxpayer.

Another negative consequence for IRS is that in the absence of guidance taxpayers may attempt to take positions that may be abusive. (For an example see the sidebar on Variable Prepaid Forward Contracts.) For both cross-border equity TRSs and VPFCs, delays in guidance from IRS led to the transactions becoming more widespread throughout the market. The burden may be increased on exam teams to address a greater number of completed transactions. Delays in issuing guidance can also put IRS's reputation at risk. Tax experts and practitioners that we spoke with expressed frustration at the delay in the issuance of guidance on financial derivatives and in the lack of information on the status of guidance projects, which negatively affected their perspectives of IRS.

Taxpayers are Unaware of the Status of Guidance Projects for Financial Derivatives

IRS and Treasury guidance priorities may change due to a number of factors, including changes in legislation, policy, market circumstances, and management agendas. Taxpayers need to know about these changes when they affect their tax planning and business decisions. As discussed earlier, one-fourth of derivative guidance projects were not completed between 1996 and 2010, and tax experts and practitioners that we spoke with were not aware of the status and prioritization of many of these guidance projects. Tax experts and practitioners stated that information about the status of projects was not publicly available, and they often only knew about a project's status through informal statements made by IRS and Treasury officials at conferences and other meetings. IRS will purposely keep some guidance projects off the public list when the issue is legally sensitive and could negatively affect IRS's efforts in an audit or litigation if the guidance projects were publicly announced.

The current system for communicating the PGP does not allow IRS to effectively communicate the status of guidance projects to taxpayers. For most years since 1996, IRS has issued periodic updates on its website to the PGPs after initial plans were released, listing projects that were added or completed during the year. All PGPs, whether initial or updated, are potentially subject to change. However, because projects can be added to the PGP at any time without an accompanying change in the publicly available plans, changes in guidance prioritization are not always clearly communicated to taxpayers. In addition, PGPs do not include target completion dates, something IRS uses internally, which would give taxpayers a clearer timeframe for expecting guidance. Therefore, taxpayers lack clarity as to when they can expect guidance on issues that IRS and Treasury have publicly stated are priorities. While there may be challenges and risks in communicating more detailed information and updated status, particularly when there may be unanticipated setbacks in the development of guidance, other federal agencies routinely do so.

Providing status information for PGP projects would require IRS to maintain reliable internal monitoring data on guidance projects. IRS Chief Counsel uses a data management system, Counsel Automated Systems Environment – Management Information System (CASE-MIS), to track progress of guidance projects and monitor interim milestones in project lifecycles. CASE-MIS has been available since 1996, and was modified in 2008. The effectiveness of this system has been critiqued multiple times over the past 10 years by the Treasury Inspector General for Tax Administration, and in response IRS has made improvements to the monitoring of projects in the database.[34] In our own review of data used by IRS to monitor guidance projects, we found a number of data reliability issues that may impede the agency's ability to effectively monitor guidance projects in order to report status to taxpayers. Most notable, the current status and target date of projects are not consistently recorded correctly for all projects. In addition, discerning when a project moved onto the PGP, its date of publication, and when or why it was removed without publication is difficult. This information is essential for IRS and

[34]See Treasury Inspector General for Tax Administration (*TIGTA) 2010-10-106: Chief Counsel Can Take Actions to Improve the Timeliness of Private Letter Rulings and Potentially Reduce the Number Issued*; *TIGTA 2008-10-075: The Published Guidance Program Needs Additional Controls to Minimize Risks and Increase Public Awareness*; and *TIGTA 2003-10-081: Improvements to the Office of Chief Counsel's Published Guidance Process Would Enhance Guidance Provided to Taxpayers and the Internal Revenue Service.*

Treasury to effectively manage the guidance process and to communicate project status to taxpayers. Although status information can be collected manually, the electronic management system is intended to improve efficiency and reporting capability by avoiding time-consuming manual data collection and processing. Since 2008, IRS has been taking steps to improve the effectiveness and reliability of CASE-MIS, including the issuance of staff memorandums and closer attention to reliable data entry, with the purpose of increasing efficiency, productivity, and decision making.[35]

Opportunities Exist for IRS to Leverage Information from SEC and CFTC on Financial Derivatives

IRS Does Not Systematically or Regularly Communicate with SEC or CFTC on Financial Derivatives

Currently, IRS does not systematically or regularly communicate with SEC or CFTC on financial derivatives. IRS's 2009-2013 Strategic Plan lists strengthening partnerships across government agencies to gather and share additional information as key to enforcing the law in a timely manner to ensure taxpayers meet their obligations to pay taxes. SEC's and CFTC's oversight role for financial derivative markets make them key agencies for IRS to partner with on financial derivatives. Both regulatory agencies told us that opportunities may exist to share additional information on financial derivatives with IRS. However, IRS's ability to share taxpayer information with other federal agencies is limited under IRC section 6103, which governs the confidentiality of taxpayer data. IRS officials say that the lack of reciprocal information sharing is an impediment to effective collaboration with SEC and CFTC.

IRS has occasionally received information from SEC on financial derivatives that were suspected of being used for abusive tax purposes. Such information, however, is received only on an ad hoc basis, either

[35]See, for example, Chief Counsel Notices *CC-2011-009: File Maintenance and Management Information System Requirements*, issued on March 11, 2011.

through requests initiated by IRS or referrals from SEC. SEC officials told us that when potential tax abuses have been identified and shared with IRS, the SEC examiner involved in the case typically had some tax expertise or had worked with IRS in the past. For example, in 2008, SEC examiners discovered a strategy employed by hedge funds to structure short-term capital gains into long-term capital gains through the use of options. This information was referred to IRS because SEC staff believed that IRS may conclude that the structuring of transactions in this manner may result in an incorrect treatment of capital gains. IRS said that this information was essential to the eventual development and issuance of related guidance.[36] However, agency officials told us that SEC and CFTC examiners often do not have tax expertise. As a result, potential tax abuses may not be identified and shared with IRS.

Information from SEC and CFTC Could Help IRS Identify New Products, Emerging Trends, and Relevant Issues

The proliferation of financial derivatives present a challenge for IRS in identifying potential abuses and ensuring timely guidance addresses the full range of financial derivative products. In recent years, new uses of financial derivative products have been introduced, and abusive uses have spread faster as technology developments have made it easier to create new products.

In the past, IRS met regularly with a group of federal agency officials, including those from SEC and CFTC, academics, and other market experts, to discuss financial products, including financial derivatives, and market trends. The group was established by an academic institution and met for about 10 years beginning in 1990, and participants joined the group by invitation. IRS and others who were part of the group told us that academic sponsorship encouraged both federal agency and private sector experts to join the group and candidly share information on new financial derivative products and uses. According to Treasury officials, regularly participating in these meetings with officials from SEC and CFTC and the private sector helped them to (1) identify new financial derivatives, (2) improve their understanding of these new products, (3) become aware of regulatory schemes that may have tax implications, and (4) make contacts with other knowledgeable agency officials and experts in financial derivative products. IRS told us that understanding all sides of a financial derivative transaction, both tax and regulatory, helps

[36]IRS Chief Couns. Mem. AM2010-005 (Oct. 15, 2010).

to clarify the purpose of the transaction and reveal potential tax abuse. Since the group disbanded after the academic sponsorship dissolved, there has been no regular, coordinated communication process for sharing information on financial derivatives between IRS and SEC and CFTC. According to IRS officials, such a process could help IRS ensure they are fully using all available information to identify and address compliance issues and abuses related to financial derivatives.

In addressing problems in financial markets that emerge quickly, we have found that collaboration between federal agencies is especially important for federal agencies to maximize performance and identify and resolve problems faster.[37] IRS officials told us that they typically uncover new financial derivative abuses during an audit, meaning by the time IRS identifies the financial derivative product, and issues guidance, the market for a financial derivative product can be relatively large and developed. SEC may identify new products and emerging trends in financial derivatives trading before IRS because new products on exchanges must be approved by SEC before they can be traded, and others may be disclosed in financial statements. According to IRS officials, improved collaboration could help IRS more quickly identify and analyze emerging financial trends and new products in the financial derivatives market before taxpayers even file their tax returns.

According to IRS officials, having a more regular way to obtain information about certain sales reported to SEC in disclosures of insider trading could have sped IRS's identification of the use of VPFCs with share-lending agreements. When taxpayers deferred income recognition by not considering a VPFC and share-lending agreement as constituting a sale on their tax return, some taxpayers reported the transaction as a sale for SEC purposes. IRS officials obtained this information, but had they been regularly and systematically communicating with other agency officials on financial derivatives, problems with these transactions may have been identified earlier. IRS officials believe that because certain information on financial derivatives may be reported for both regulatory and tax purposes, reviewing certain types of transactions collaboratively with SEC and CFTC could help IRS better identify abuse. For example, IRS told us that certain information on financial derivatives from SEC

[37]See GAO-06-15.

Form 4s, which relate to insider trading, and 10Ks have been useful for identifying new financial derivative products and potential tax issues.

Federal banking regulators, such as OCC, also have information on financial derivatives. Although the federal banking regulators do not oversee derivatives markets, their oversight of banking institutions includes evaluations of risks to bank safety and soundness from derivatives activities. For example, as we reported in 2009, their oversight captures most CDS activity because banks act as dealers in the majority of transactions and because they generally oversee CDS dealer banks as part of their ongoing examination programs.[38] Furthermore, as OCC-regulated banks may only engage in activities deemed permissible for a national bank, the agency periodically receives requests from banks to approve new financial activities, including derivatives transactions. Information collected during these reviews may provide IRS with information on financial derivatives.

As we were completing our audit work, IRS officials told us that they had recently begun developing plans to have regular meetings with SEC to discuss new products and emerging issues related to financial derivatives. In previous work, we have established best practices on interagency coordination to help maximize results and sustain collaboration.[39] These best practices suggest that agencies should look for opportunities to enhance collaboration in order to achieve results that would not be available if they were to work separately. Federal agencies can enhance and sustain collaborative partnerships and produce more value for taxpayers by applying the following eight best practices:

1. Define and articulate a common outcome.
2. Establish mutually reinforcing or joint strategies.
3. Identify and address needs by leveraging resources.
4. Agree on roles and responsibilities.
5. Establish compatible policies, procedures, and other means to operate across agency boundaries.
6. Develop mechanisms to monitor, evaluate, and report on results.
7. Reinforce agency accountability for collaborative efforts through agency plans and reports.

[38]See GAO-09-397T.

[39]See GAO-06-15.

8. Reinforce individual accountability for collaborative efforts through performance management systems.

These best practices would support a collaborative working relationship between the IRS and SEC and CFTC. While we generally believe that the application of as many of these practices as possible increases the likelihood of effective collaboration, we also recognize that there is a wide range of situations and circumstances in which agencies work together. Following even a few of these practices may be sufficient for effective collaboration.

Conclusions

Although financial derivatives enable companies and others to manage risks, some taxpayers have used financial derivatives to take advantage of the current tax system, sometimes in ways that courts have later deemed improper or Congress has disallowed. The tax code establishes broad categories for financial instruments, such as debt, equity, forwards, and options, each with its own tax rules governing how and when gains and losses are taxed. However, as new financial derivative products and uses are developed, they could be similar to multiple tax categories, and therefore IRS and taxpayers must choose different tax treatments. In certain instances, this has allowed economically equivalent outcomes to be taxed inconsistently. Without changes to the approach to how financial derivatives are taxed, the potential for abuse continues. Experts have suggested alternative approaches that they believe would provide more comprehensive and consistent treatment. However, each alternative would present tradeoffs to IRS and taxpayers, including tradeoffs to simplicity, administrability, and economic efficiency. This report does not address or evaluate alternatives for taxing financial derivatives. Because of their unique role in defining policy and administering the tax code, Treasury and IRS are best positioned to study and recommend an alternative approach to the taxation of financial derivatives.

Outside of any comprehensive changes to the current approach to the taxation of financial derivatives, one way that Treasury and IRS address potential abuses and provide clarity to tax issues is through its taxpayer guidance. The lack of finalized guidance has negative consequences for both IRS and taxpayers, including uncertainty that inhibits IRS staff during audits and litigation and leaves taxpayers uncertain about whether they have appropriately determined their tax liabilities. However, challenges that IRS and Treasury face in developing guidance for financial derivatives, including the risk of adverse economic effects of guidance changes and the complexity of financial derivative products, have resulted

in some PGP projects taking longer than the 12-month period established in the plan. As such, uncertainty is heightened because taxpayers may not be aware when projects are going to take longer than the 12-month period and IRS does not provide public updates to the PGP as changes occur to project status, priorities, and target dates.

The growth in the complexity and use of financial derivatives presents another challenge for IRS. IRS sometimes identifies new financial derivative products or new uses of existing products long after they have been introduced into the market. Consequently, IRS is not always able to quickly identify and prevent potential abuse. One way to identify new products or new uses of products in a timelier manner could be through increased information sharing with SEC and CFTC given their oversight role of financial derivative markets and products. Our prior work suggests that there may also be opportunities for bank regulators to share any knowledge of derivatives that they gain. This would be consistent with IRS's goal of strengthening partnerships across government to ensure taxpayers meet their obligations to pay taxes.

Recommendations for Executive Action

To better ensure that economically similar outcomes are taxed similarly and minimize opportunities for abuse, the Secretary of the Treasury should undertake a study that compares the current approach to alternative approaches for the taxation of financial derivatives. To determine if changes would be beneficial, such a study should weigh the tradeoffs to IRS and taxpayers that each alternative presents, including simplicity, administrability, and economic efficiency.

To provide more useful and timely information to taxpayers on the status of financial derivative guidance projects, the Secretary of the Treasury and the Commissioner of Internal Revenue should consider additional, more frequently updated reporting to the public on ongoing projects listed in the PGP, including project status, changes in priorities, and target completion dates both within and beyond the 12-month PGP period.

To more quickly identify new financial derivative products and emerging tax issues, IRS should work to improve information-sharing partnerships with SEC and CFTC to better ensure that IRS is fully using all available information to identify and address compliance issues and abuses related to the latest financial derivative product innovations. IRS should also consider exploring whether such partnerships with bank regulatory agencies would be beneficial.

Agency Comments and Our Evaluation

We provided a draft of this report to the Secretary of the Treasury and the Commissioner of Internal Revenue for review and comment. Treasury disagreed with our first recommendation to undertake a study that compares the current approach to alternative approaches for the taxation of financial derivatives. Treasury cited a body of literature written by academics, practitioners, and others that considers the subject. Treasury also mentioned that Congress has resources available, such as the Joint Committee on Taxation, which could advise them about alternative approaches to the taxation of financial derivatives. Treasury said that its resources would be better spent drafting and issuing guidance on these subjects. Treasury also noted that it is available to assist the Ways and Means Committee and the Finance Committee in any undertaking concerning alternative approaches to the taxation of financial derivatives.

In our report, we describe how the current approach to the taxation of financial derivatives results in inconsistent tax consequences for transactions that produce similar economic outcomes. We cite the existing body of literature and alternatives to the current approach of taxing financial derivatives proposed by some tax experts and practitioners that they believe would adopt a more consistent and comprehensive view of financial derivatives and potentially reduce abuse. However, no consensus has emerged on these issues from existing literature or from the resources available to Congress. As the tax policy setting body for the executive branch, the Treasury Department, in consultation with IRS, is uniquely suited to weigh the alternative approaches and, along with Congress, make judgments as to which is best for the economy, tax administration, and the proper application of sound tax principles. While Treasury states it would rather focus on guidance development to address tax compliance and emerging abusive tax schemes, the current piecemeal development of guidance as well as the difficulty of developing tax rules for new products has presented challenges and opportunities for abuse. We believe that as the locus of tax policy expertise in the executive branch, Treasury has a responsibility to make proposals to overcome the deficiencies to the current approach to taxing financial derivatives. Towards that end, we recommended Treasury should undertake a study that compares the current approach to alternative approaches to the taxation of financial derivatives. Regardless of whether Treasury decides it needs a study to make such proposals, achieving a more comprehensive approach is the desired end.

IRS and Treasury disagreed with our second recommendation to provide more timely and useful information to taxpayers on the status of financial derivative guidance projects. IRS said that while it firmly supports

transparency in the regulatory process, officials do not believe that the additional reporting recommended would be worth the additional resources such reporting would require. They believe that the annual updates provide an appropriate measure of the status of projects. Treasury also said that it would be difficult to provide precise predictions of when guidance would be issued and that attempting to pinpoint the timing of when guidance might be released would not necessarily be that helpful.

We agree that it is important for IRS and Treasury to balance the usefulness of additional reporting on the status of priority guidance projects with any additional administrative burden. However, Treasury and IRS also need to ensure that taxpayers have sufficient information to make intelligent decisions. In this report, we describe that one-fourth of financial derivative guidance projects on Treasury and IRS's PGP were not completed between 1996 and 2010. A number of the guidance projects that were not completed were on the PGP for 3 or more years, and tax experts and practitioners that we spoke with said they were not aware of the status and prioritization of many of these guidance projects. In recommending more frequent updates to the public on priority guidance projects, we recognize the difficulty in estimating how long the development of a particular piece of guidance may take. Our recommendation did not envision pinpointing the timing of when guidance may be released, but rather being timelier in officially revising estimates when the agencies know that announced time frames are no longer realistic. When it becomes likely that a project on the PGP will not be completed in the plan year because of delays or a change in priorities, the public should be alerted. Tax experts and practitioners we interviewed said that information about the status of projects was not publicly available, and that they often only knew about a project's status through informal statements made by IRS and Treasury officials at conferences and other meetings. Such information on the status of guidance projects should be provided to all interested taxpayers as part of formal periodic updates to the PGP. Some of this information is already available in IRS's internal guidance tracking database and providing it would, therefore, likely add little additional administrative burden for the agencies.

IRS agreed with our third recommendation to improve information-sharing partnerships with the SEC and CFTC. IRS said that they recognize the benefits of systematically gathering and sharing information that would identify new financial products and the potential for abusive tax avoidance transactions.

IRS's and Treasury's letters commenting on our report are presented in appendix III and IV. IRS also provided technical comments, which we incorporated as appropriate.

As we agreed with your office, unless you publicly announce the contents of this report earlier, we plan no further distribution of it until 30 days from the date of this report. At that time, we will send copies of this report to the Chairmen and Ranking Members of other Senate and House committees and subcommittees that have appropriation, authorization, and oversight responsibilities for IRS. We are also sending copies to the Commissioner of Internal Revenue, the Secretary of the Treasury, the Chairman of the IRS Oversight Board, and the Director of the Office of Management and Budget. Copies are also available at no charge on the GAO website at http://www.gao.gov.

If you or your staffs have any questions or wish to discuss the material in this report further, please contact me at (202) 512-9110 or brostekm@gao.gov. Contact points for our offices of Congressional Relations and Public Affairs may be found on the last page of this report. GAO staff members who made major contributions to this report are listed in appendix V.



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Strategic Issues

Appendix I: Additional Methodology Details

Criteria to Evaluate How Well the Tax System Addresses Financial Derivatives

To evaluate the tax rules for financial derivatives, our criterion was consistency, meaning that economically similar transactions are taxed similarly. We identified this criterion through interviews with tax experts and a review of research articles on the taxation of financial derivatives. This was the most commonly mentioned criterion by these sources, and also the most applicable to our objectives. We evaluated the tax effects of financial derivatives based on testimonial evidence, academic studies, and our analysis of four financial derivative case studies. These case studies included cross-border total return equity swaps, variable prepaid forward contracts, credit default swaps, and contingent swaps. Through interviews with Department of the Treasury (Treasury) and Internal Revenue Service (IRS) staff, former Treasury staff, and other tax experts, we identified how the transactions were structured, when IRS first recognized these transactions, and all guidance issued by Treasury and IRS on these issues. We also identified the challenges of issuing timely guidance and the consequences for IRS and taxpayers due to delayed or absent guidance. Based on these case studies, we applied the criterion of consistency to highlight how the structure of these transactions was not in line with the criterion.

Criteria and Methodology to Evaluate the Issuance of Published Guidance Related to Financial Derivatives

To evaluate IRS's and Treasury's ability to publish timely guidance on emerging financial derivative tax issues, we analyzed guidance projects from Treasury and IRS's Priority Guidance Plan (PGP). We also performed an in-depth study of four case studies of specific financial derivative transactions that have had delayed guidance. According to Treasury and IRS, the PGP is used each year to identify and prioritize the tax issues that should be addressed through regulations, revenue rulings, revenue procedures, notices, and other published administrative guidance. The PGP focuses resources on guidance items that are most important to taxpayers and tax administration. To measure the timeliness of guidance on financial derivative tax issues, we used the criterion established by Treasury and IRS that guidance projects on the PGP are intended to be published within the 12-month period of the PGP year.

We reviewed the projects included on the PGP from 1996 to 2010, the years for which IRS had electronic records available. We submitted a data request to IRS Chief Counsel from their Counsel Automated Systems Environment-Management Information System (CASE-MIS), which the agency uses to track the development of guidance projects. We searched the database for projects, focusing primarily on the units within Chief Counsel that work closest with financial derivatives. We selected projects whose description mentioned either a type of derivative in

particular (future, forward, swap/notional principal contract, or option), a section of the Internal Revenue Code that directly affects financial derivatives, or a use or abuse of financial instruments that typically involves derivatives (such as hedging or straddles). In reviewing the data from CASE-MIS, we encountered some data issues, such as the same guidance project showing up more than once on the same PGP year or guidance projects with start dates after their publication date, among other issues, which led us to conclude that the CASE-MIS data were unreliable for an analysis of all guidance projects, which did not allow a comparison of derivative projects to nonderivative projects. However, we did determine that the use of CASE-MIS data was sufficiently reliable to analyze the subset of projects dealing with financial derivatives alone. This is because the small number of derivative projects allowed us to address and resolve individually each of the data issues we encountered, something not feasible for the much larger dataset of all PGP guidance projects. After identifying the financial derivative guidance projects based on the criteria above we submitted the list to IRS Chief Counsel for their verification. They identified additional projects we had not found in our prior searches, some of which did not meet our criteria for selecting projects or our scope and were not included. In total, we identified 53 guidance projects in the PGP related to financial derivatives.

To analyze the timeliness of the identified projects, we calculated completion rates for projects that were completed within the 1-year criterion, and rates for projects that were completed at any point. These calculations only included projects that were on the plan before the current PGP year. To take account of the fact that guidance projects can be censored (i.e., have not yet been completed within the time frame of the study or were dropped from the PGP before they had a chance to be completed), we estimated completion rates over time using hazard rates. Hazard rates calculate the rate at which projects are complete in a period, given that they were open at the start of that period, and therefore allow us to adequately account for censored projects. In the report, we refer to hazard rates as completion rates. The small sample size does not allow us to draw conclusions on the process for issuing guidance in IRS and Treasury more generally beyond financial derivatives or the time period under study.

To further examine the IRS and Treasury guidance process and evaluate the challenges that IRS and Treasury face when issuing guidance on financial derivatives, we selected four financial derivative case studies that have been on the PGP and have been highlighted in interviews with Treasury, IRS, and tax practitioners as financial derivative transactions

that presented tax abuse or tax compliance concerns. The case studies that met this criterion included contingent payment swaps, credit default swaps, variable prepaid forward contracts, and cross-border total return equity swaps. For each of the four case studies, we interviewed IRS and Treasury officials and other tax experts, and analyzed research on the taxation of derivatives, to discuss the identification and progression of these transactions as guidance projects, the challenges IRS and Treasury face issuing guidance on these transactions, and the consequences IRS and taxpayers face from a lack of guidance.

Appendix II: Financial Derivative Priority Guidance Projects

	Description of guidance projects	Guidance published	Years on PGP	First year on PGP	Completed
1	Information reporting requirements for securities futures contracts	Notice 2003-8	1	2002	Yes
2	Tax shelter using options to shift tax basis	Notice 2001-45	1	2001	Yes
3	Tax shelter using foreign currency straddle	Notice 2002-50	1	2002	Yes
4	Tax shelter using foreign currency straddle	Notice 2002-65	1	2002	Yes
5	Tax shelter using foreign currency options	Notice 2003-81	1	2003	Yes
6	Tax shelter using S corporations and warrants	Notice 2004-30	1	2003	Yes
7	Tax shelter using options to toggle grantor trust status	Notice 2007-73	1	2007	Yes
8	Exchange traded notes (prepaid forward contracts)	Notice 2008-2	1	2007	Yes
9	Overwithholding and U.S. tax avoidance from dividend-substitutes payments	Notice 2010-46	1	2009	Yes
10	Clarification of notional principal contract abuses	Notice 2006-16	1	2005	Yes
11	Contingent payments in notional principal contracts	Notice 2001-44	1	2001	Yes
12	Valuation under §475	Announcement 2003-35	1	2002	Yes
13	Exchange-traded equity options without standard terms	Final regulations, 65 Fed. Reg. 3812	1	1999	Yes
14	Character of hedging transactions	NPRM, 66 Fed. Reg. 4738	1	2000	Yes
15	Character of hedging transactions	Final regulations, 67 Fed. Reg. 12863	1	2001	Yes
16	Exchange-traded equity options without standard terms	NPRM, 66 Fed. Reg. 4751	1	2000	Yes
17	Exchange-traded equity options without standard terms	Final regulations, 67 Fed. Reg. 20896	1	2001	Yes
18	Dealer to dealer assignment of notional principal contracts	Final regulations, 63 Fed. Reg. 4394	1	1997	Yes
19	Securities futures contracts under §1256(g)	Revenue Procedure 2002-11	1	2001	Yes
20	Safe harbor in valuing securities and commodities for broker-dealers under section 475	Revenue Procedure 2007-41	1	2006	Yes
21	Classifying exchange as Qualified Board of Exchange for §1256	Revenue Ruling 2007-26	1	2006	Yes
22	The effect of collars on qualified covered calls status.	Revenue Ruling 2002-66	1	2002	Yes
23	Classifying exchange as Qualified Board of Exchange for §1256	Revenue Ruling 2010-3	1	2009	Yes
24	Classifying exchange as Qualified Board of Exchange for §1256	Revenue Ruling 2009-24	1	2009	Yes
25	Exchange traded notes (prepaid forward contracts)	Revenue Ruling 2008-1	1	2007	Yes
26	Contracts that provide total-return exposure on a commodity index	Revenue Ruling 2006-1	1	2005	Yes
27	Notional principal contracts that hedge debt instruments	Revenue Ruling 2002-71	1	2002	Yes
28	Variable prepaid forward contracts	Revenue Ruling 2003-07	1	2002	Yes

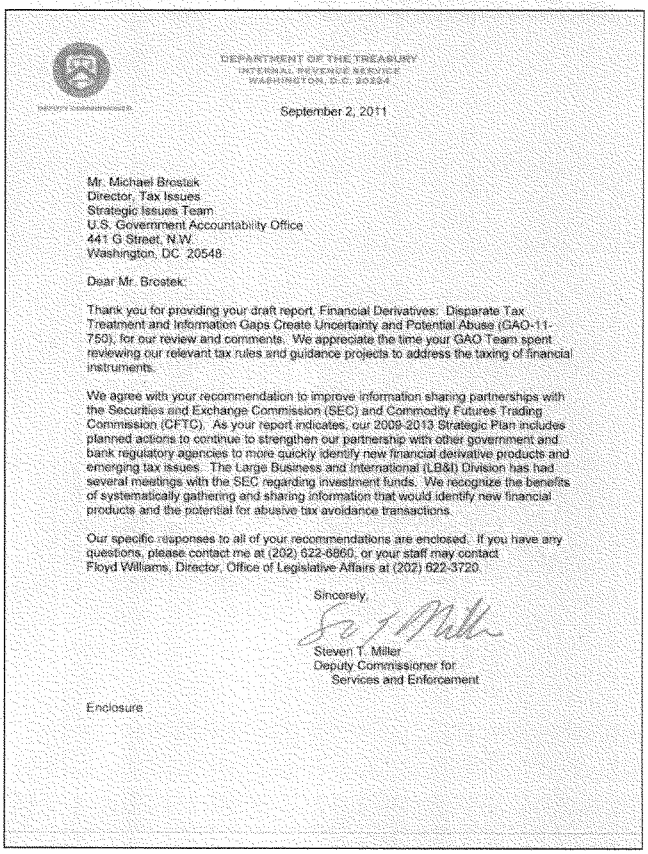
	Description of guidance projects	Guidance published	Years on PGP	First year on PGP	Completed
29	Definition of dealer in securities futures contracts	Revenue Ruling 2004-94 and Revenue Ruling 2004-95	1	2004	Yes
30	Credit default swaps	Notice 2004-52	2	2003	Yes
31	Valuation under §475	NPRM, 70 Fed. Reg. 29663	2	2003	Yes
32	Valuation under §475	Final regulations, 72 Fed. Reg. 32172	2	2005	Yes
33	Exchange-traded equity options without standard terms	NPRM, 63 Fed. Reg. 57636	2	1997	Yes
34	Mark-to-market accounting for commodities dealers and electing traders in securities and commodities under §475	NPRM, 64 Fed. Reg. 4374	2	1998	Yes
35	Capitalization of interest and carrying charges in straddles	NPRM, 66 Fed. Reg. 4746	2	2000	Yes
36	Treatment of interest rate swaps in arbitrage restrictions on tax-exempt bonds	NPRM, 72 Fed. Reg. 54606	2	2006	Yes
37	Accounting for unidentified hedging transactions	Revenue Ruling 2003-127	2	2002	Yes
38	Classifying exchange as Qualified Board of Exchange for §1256	Revenue Ruling 2009-4	2	2007	Yes
39	Contingent payments in notional principal contracts	NPRM, 69 Fed. Reg. 8886	4	1999	Yes
40	Definition of foreign currency contracts under §1256(g)(2)[a]	Notice 2007-71	2	2004	No
41	Prepaid forward contracts under §446	No guidance issued	1	2001	No
42	Application of §1256 to certain derivative contracts[b]	No guidance issued	1	2010	No
43	Dividend-equivalent payments under section 871(M) (following HIRE Act)[b]	No guidance issued	1	2010	No
44	Effect of credit risk on swap valuations under §475	No guidance issued	1	2000	No
45	Straddles with uneven positions	No guidance issued	1	2001	No
46	Treatment of interest rate swaps in arbitrage restrictions on tax-exempt bonds	No guidance issued	2	2004	No
47	Equity derivatives	No guidance issued	2	2000	No
48	Exchange traded notes (prepaid forward contracts)[b]	No guidance issued	3	2008	No
49	Securities lending and other withholding tax	No guidance issued	3	2002	No
50	Constructive sale rules under §1259	No guidance issued	4	1998	No
51	Capitalization of interest and carrying charges in straddles	No guidance issued	5	2002	No
52	Mark-to-market accounting for commodities dealers and electing traders in securities and commodities under §475	No guidance issued	5	2002	No
53	Contingent payments in notional principal contracts[b]	No guidance issued	7	2004	No

Source: GAO analysis of IRS data.

[a]This project was completed in 2007, when it was no longer on the Priority Guidance Plan (PGP). To be designated as completed for our analysis, a project must be completed while on the PGP.

[b]Guidance has not been issued for these projects, although they were still on the PGP as of the end of June 30, 2010.

Appendix III: Comments from the Internal Revenue Service



DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

DEPUTY COMMISSIONER

September 2, 2011

Mr. Michael Brostek
Director, Tax Issues
Strategic Issues Team
U.S. Government Accountability Office
441 G Street, N.W.
Washington, DC 20548

Dear Mr. Brostek:

Thank you for providing your draft report, Financial Derivatives: Disparate Tax Treatment and Information Gaps Create Uncertainty and Potential Abuse (GAO-11-750), for our review and comments. We appreciate the time your GAO Team spent reviewing our relevant tax rules and guidance projects to address the taxing of financial instruments.

We agree with your recommendation to improve information sharing partnerships with the Securities and Exchange Commission (SEC) and Commodity Futures Trading Commission (CFTC). As your report indicates, our 2008-2013 Strategic Plan includes planned actions to continue to strengthen our partnership with other government and bank regulatory agencies to more quickly identify new financial derivative products and emerging tax issues. The Large Business and International (LB&I) Division has had several meetings with the SEC regarding investment funds. We recognize the benefits of systematically gathering and sharing information that would identify new financial products and the potential for abusive tax avoidance transactions.

Our specific responses to all of your recommendations are enclosed. If you have any questions, please contact me at (202) 622-6860, or your staff may contact Floyd Williams, Director, Office of Legislative Affairs at (202) 622-3720.

Sincerely,

Steven T. Miller
Deputy Commissioner for
Services and Enforcement

Enclosure

Enclosure

RECOMMENDATION 1:

To better ensure that economically similar outcomes are taxed similarly and minimize opportunities for abuse, the Secretary of the Treasury should undertake a study that compares the current approach to alternative approaches for the taxation of financial derivatives. To determine if changes would be beneficial, such a study should weigh the tradeoffs to IRS and taxpayers that each alternative presents, including simplicity, administrability, and economic efficiency.

MANAGEMENT RESPONSE:

The Secretary of the Treasury will address this recommendation in a separate response to the GAO draft report.

RECOMMENDATION 2:

To provide more useful and timely information to taxpayers on the status of financial derivative guidance projects, the Secretary of the Treasury and the Commissioner of the IRS should consider additional, more frequently updated reporting to the public on ongoing projects listed in the Priority Guidance Plans (PGP), including project status, change in priorities, and both target completion dates within and beyond the 12-month PGP period.

MANAGEMENT RESPONSE:

The IRS firmly supports transparency in the regulatory process, and through the priority guidance plan (PGP) and its regular updates provides notice to the public of the projects on which Treasury and the IRS are focusing their resources. In addition, Treasury and IRS officials routinely speak at meetings and public conferences about guidance projects, and those appearances are widely reported in the tax press. This activity provides the public with continual insight into the guidance plan progress.

The IRS does not believe that the additional reporting recommended would be constructive or necessary. We believe that the annual updates provide an appropriate measure of the status of projects. The additional reporting recommended will not provide taxpayers with information that, on balance, justifies the additional administrative burden on the government, particularly given that the existing process provides a substantial amount of transparency.

RECOMMENDATION 3:

To more quickly identify new financial derivative products and emerging tax issues, the IRS should work to improve information sharing partnerships with SEC and CFTC to better ensure that the IRS is fully using all available information to identify and address

compliance issues and abuses related to the latest financial derivative product innovations. The IRS should also consider exploring whether such partnerships with bank regulatory agencies would be beneficial.

MANAGEMENT RESPONSE:

We agree with this recommendation. The IRS will consider ways to improve information sharing partnerships with SEC and CFTC regarding financial derivatives, particularly in the area of new products. The IRS will also consider whether partnerships with banking regulatory agencies would be beneficial.

Appendix IV: Comments from the Department of the Treasury

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

September 2, 2011

Mr. Michael Brostek
Director, Tax Issues
Strategic Issues Team
U.S. Government Accountability Office
441 G Street, NW
Washington, DC 20548

Dear Mr. Brostek:

We appreciate the effort that went into GAO's draft report titled "Financial Derivatives: Disparate Tax Treatment and Information Gaps Create Uncertainty and Potential Abuse" and the understanding of complex issues that it conveys. We are pleased to respond to the recommendations contained in the draft report.

The "Recommendations for Executive Action" section of the report sets forth two recommendations for the Secretary of the Treasury. The first recommendation is that "the Secretary of Treasury should undertake a study that compares the current approach to alternative approaches for the taxation of financial derivatives." There is already a substantial body of literature written by academics, practitioners, and others that considers this subject. For example, reports prepared by the American Bar Association, the New York State Bar Association, and industry trade groups routinely discuss the issue of alternative ways to address the taxation of derivatives. Moreover, Congress has also conducted hearings and engaged in other activity related to financial derivative taxation, and has available to it its own resources, including the Joint Committee on Taxation, that could advise about alternative legislative approaches. Rather than generate yet another study that considers how derivatives should be taxed, Treasury believes that its resources would be better spent drafting and issuing guidance on these subjects. The Treasury Department is, of course, always available to assist the Ways and Means Committee and the Finance Committee in any undertaking concerning alternative approaches to the taxation of financial derivatives.

The second recommendation is that "the Secretary of the Treasury and the Commissioner of the IRS should consider additional, more frequently updated reporting to the public on ongoing projects listed in the [priority guidance plan], including project status, changes in priorities, and both target completion dates within and beyond the 12-month period." The Treasury Department firmly believes in and supports transparency in the regulatory process, and through the priority guidance plan (PGP) and its regular updates provides notice to the public of the projects on which Treasury and the IRS are focusing their resources. In addition, Treasury and IRS officials

routinely participate in and speak at Bar Association meetings and public conferences about guidance projects, and those appearances are widely reported in the tax press. This activity provides the public and practitioners with continual insight into the guidance plan progress. However, the Treasury Department does not believe that the additional reporting recommended in the report would be constructive or necessarily be worth the additional administrative resources such reporting would require. In light of the fluid nature of the development of guidance it would be very difficult to provide precise predictions of when guidance would be issued. In addition, it is not clear whether attempting to pinpoint the timing when guidance might be released would necessarily be that helpful. It is our experience that legitimate tax planning is not materially affected by the current approach of communicating guidance activity through the PGP, and that the existing process provides a substantial amount of transparency to the public.

We appreciate the opportunity to comment on the draft report, and look forward to working with you in the future.

Sincerely,

Mark J. Mazur
Deputy Assistant Secretary (Tax Analysis)

-2-

Appendix V: GAO Contact and Staff Acknowledgments

GAO Contact	Michael Brostek, (202) 512-9110 or brostekm@gao.gov
Staff Acknowledgments	In addition to the contact named above, the following staff made significant contributions to this report, Jay McTigue, Assistant Director; Kevin Averyt; Timothy Bober; Tara Carter; William Cordrey; Robin Ghertner; Colin Gray; George Guttman; Alex Katz; Natalie Maddox; Matthew McDonald; Edward Nannenhorn; Jose Oyola; Andrew Stephens; Jason Vassilicos; and James White.

Glossary

Bifurcation	The process of dividing a financial instrument into its component parts.
Constructive Ownership Transaction	Under Internal Revenue Code (IRC) section 1260, gains from constructive ownership transactions are taxed as ordinary income and not capital gains to the extent that such gains exceed the net underlying long-term capital gains and impose accompanying interest charges. Section 1260 applies to derivatives that stimulate the return of certain assets, such as a hedge fund or another pass-though entity by offering the holder substantially all of the risk of loss and opportunity for gain from the underlying asset.
Constructive Sale	A transaction where a taxpayer attempts to obtain economic gains from the sale of an appreciated position without legally transferring ownership and triggering taxable income. IRC section 1259 contains rules that affect the treatment of gains from constructive sales.
Contingent Swap	A swap contract in which a payment is contingent or otherwise conditional on some event occurring during the period of the contract.
Conversion transaction	A transaction that generally consists or two or more positions taken with regard to the same or similar investments, where substantially all of the taxpayer's return is attributable to the time-value of the taxpayer's net investment in the transaction. IRC section 1258 contains rules for the treatment of conversion transactions.
Credit Default Swap (CDS)	Bilateral contract that is sold over-the-counter and transfers credit risk from one party to another. The seller, who is offering credit protection, agrees, in return for a periodic fee, to compensate the buyer, who is buying credit protection, if a specified credit event, such as default, occurs.
Fair Value	See gross positive fair value.
Forward	A privately negotiated contract between two parties in which the forward buyer agrees to purchase from the forward seller a fixed quantity of the underlying reference item at a fixed price on a fixed date.

Future	A forward contract that is standardized and traded on an organized futures exchange.
Gross Positive Fair Value	The sum total of the fair values of contracts owed to commercial banks. Represents the maximum losses banks could incur if all other parties in the transactions default and the banks hold no collateral from the other party in the transaction and there is no netting of the contracts.
Hedging	The process whereby an entity will attempt to balance or manage its risk of doing business or investing.
Mark-to-Market	For tax purposes, under mark-to-market rules, any contract held at the end of the tax year will generally be treated as sold at its fair market value on the last day of the tax year, and the taxpayer must recognize any gain or loss that results.
Mandatory Convertible	Security linked to equity that automatically converts to common stock on a prespecified date.
Notional Principal Contract (NPC)	According to section 1.446-3 (c)(1)(i) of title 26, Code of Federal Regulations, a financial instrument that provides for the payment of amounts by one party to another at specified intervals calculated by reference to a specified index upon a notional principal amount, in exchange for specified consideration or a promise to pay similar amounts.
Notional Amount	Total notional amount represents the amount of the reference items underlying financial derivative transactions, and is the amount upon which payments are computed between parties of financial derivatives contracts. Notional amount generally does not represent money exchanged, nor does it represent the risk exposure.
Option	Contracts that gives the holder of the options the right, but not the obligation, to buy (call option) or sell (put option) a specified amount of the underlying reference item at a predetermined price (strike price) at or before the end of the contract.

Over-the-Counter Derivatives	Privately negotiated financial derivative contracts whose market value is determined by the value of the underlying asset, reference rate, or index.
Short Sale	This type of transaction occurs when a taxpayer borrows property (often a stock) and then sells the borrowed property to a third party. If the short seller can buy that property later at a lower price to satisfy his or her obligation under the borrowing, a profit results; if the price rises, however, a loss results. IRC Section 1233 contains rules that can affect the treatment of gains and losses realized on short sales.
Straddle	The value of offsetting positions moves in opposite directions so a loss on one position is cancelled out by the gain on an offsetting position. IRC Section 1092 contains rules that can affect the treatment of straddles.
Total Return Equity Swap	A contract that provides one party in the transaction with the total economic performance from a specified reference equity or group of equities and the other party in the transaction receives a specified fixed or floating cash flow that is not related to the reference equity. A cross-border total return equity swap is a contract that occurs between a domestic and foreign party.
Variable Prepaid Forward Contract (VPFC)	Agreement between two parties to deliver a variable number of shares at maturity (typically 3 to 5 years) in exchange for an up-front cash payment, which generally represents 75 to 85 percent of the current fair market value of the stock. The VPFC usually has a cash settlement option in lieu of shares at maturity.
Wash Sale	A wash sale is when a taxpayer acquires a stock or security within 30 days of selling a substantially similar stock or security; under IRC section 1091, the taxpayer is not generally permitted to claim a loss on such a sale.

AMERICAN BAR ASSOCIATION
SECTION OF TAXATION

OPTIONS FOR TAX REFORM IN THE FINANCIAL TRANSACTIONS TAX PROVISIONS OF THE INTERNAL REVENUE CODE

These options for tax reform ("*Options*") are submitted on behalf of the American Bar Association Section of Taxation and have not been approved by the House of Delegates or the Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

These Options are submitted as part of a series of tax reform options from the American Bar Association Section of Taxation, the objectives of which are to improve the tax laws and to make them simpler to understand and to administer.

These Options were prepared by individual members of the Financial Transactions Committee of the American Bar Association Section of Taxation. Principal responsibility for preparing these Options was exercised by Jason Chlipala, Dale Collinson, David Garlock, Jeffrey Maddrey, Eileen Marshall, Erika Nijenhuis, and Matthew Stevens of the Financial Transactions Committee (the "*Committee*"). These Options were coordinated and reviewed by Lucy Farr, Chair of the Committee. They were further reviewed by Steve Rosenthal, Council Director for the Committee, and by Peter Blessing, on behalf of the Committee on Government Submissions.

Although many of the members of the Section of Taxation who participated in preparing these Options have clients who may be affected by the federal tax principles addressed in these Options or who have advised clients on the application of such principles, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Options.

Contact Person:

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Date: December 2, 2011

Options for Tax Reform
Financial Transactions

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I. Executive Summary

Our goal for this report was to identify areas of the tax law related to financial transactions that we believe should be reformed. We did not attempt a complete overhaul of the tax rules applicable to financial transactions; rather, we attempted to address discrete issues that we believe arise regularly under the current statutory framework. Although in places we identified areas where regulations could be helpful or necessary, we strove to discuss problems that can, and should, be addressed legislatively.

The report is broken up into four sections. The first section deals with debt instruments. It contains several interrelated options that would modify the treatment of debt of distressed companies, with a view to aligning debt investors' taxable income with actual economic returns from the debt. In particular, we identify options that would limit the rate at which interest and market discount accrue on all debt instruments, and eliminate their current accrual altogether in the case of severely distressed debt. To prevent character mismatches, we identify as an option that losses on debt instruments be treated as ordinary to the extent of prior ordinary income inclusions. We also identify as options certain changes to the rules governing debt-for-debt exchanges, with a purpose of avoiding the recognition by a debt issuer of cancellation-of-debt income in connection with a restructuring where the principal amount of the debt does not change. Finally, we identify as an option repealing Section 279 of the Code because most of Congress' original concerns at enactment of the provision no longer apply, and are better addressed by other Code provisions in any event.

The second section of the report relates to the character of gain and loss on derivatives. We identify options for simplifying and unifying the rules in Sections 1234, 1234A and 1234B that relate to dispositions of derivatives, which under current law can apply differently depending on the type of disposition and the type of derivative. The option attempts to provide a consistent set of rules, while retaining the link between dispositions of a derivative and dispositions of the underlying property, a key feature of current law. Very generally, the option would provide that the character of any gain or loss on the disposition of a derivative match the character of a sale of the underlying property (and if the derivative is not with respect to property, that the character match the character of any gain on the sale of the derivative). We also identify as an option repealing Section 1236 and significant portions of Section 1233 given that they are largely redundant under current law. Finally, we identify as an option eliminating the requirements under Section 1221 and 1256 to identify hedging transactions in certain instances that we believe are both likely to be valid hedges and unlikely to present opportunities for abuse.

The third section of the report relates to mark-to-market treatment for financial transactions. We identify options for updating Section 1256 based on the dramatic changes to the financial transactions markets, and to the types of financial instruments, that have taken place since that section was enacted in 1981. In particular, we identify the option of unifying the treatment of dealers in Section 1256 contracts with the treatment of dealers in securities, and of modifying Section 1256 to include certain newer financial instruments whose economics make them appropriate for mark-to-market treatment. Furthermore, we identify as an option that all taxpayers be able to make the Section 475(f) election to mark all their securities to market, as long as the election is made in advance and with respect to all securities (with a view to eliminating any danger of cherry-picking).

The final section contains three options that do not fit into any of the previous sections. We identify options for modernizing the Section 1091 wash sale rules and Section 1032 to better deal with the numerous new financial products that have been developed since those provisions were enacted and that are not presently addressed in a clear fashion. Finally, we identify the option of treating swap expenses as above-the-line deductions because we do not believe the limitations on miscellaneous itemized deductions were intended to, or should, apply to losses on derivatives.

II. Options for Tax Reform: Financial Transactions.

A. Debt Instruments

1. Revise the treatment of market discount and OID on distressed debt

Present law

The rules governing the taxation of debt instruments are a mix of statutory rules, regulations and common law. Separate but interrelated rules apply to qualified stated interest, original issue discount ("OID") and market discount.

Qualified stated interest is defined in regulations as interest payable unconditionally at least annually in cash at a single fixed or floating rate. Holders of debt instruments account for qualified stated interest under their regular method of accounting for tax purposes, generally the cash or accrual method.

Holders must account for OID on a debt instrument as it accrues, based on a constant yield to maturity, regardless of their regular method of tax accounting. OID is defined in regulations as the excess of (i) the sum of all payments on the debt instrument other than qualified stated interest over (ii) the issue price of the debt instrument. Under this definition, interest that is payable in kind ("PIK interest") is treated as OID for tax purposes.

Market discount is generally defined as the excess of a debt instrument's revised issue price over the holder's basis in the debt immediately after acquisition. The revised issue price of a debt instrument is its issue price plus the aggregate accruals of OID, if any, prior to the acquisition date and minus all prior payments other than payments of qualified stated interest. Unless a taxpayer so elects, market discount need not be included in income as it accrues, even by an accrual method taxpayer. Rather, (i) any gain on the sale or other disposition of a market discount bond, and (ii) any payment on the bond (other than a payment of qualified stated interest) is treated as ordinary income to the extent of the accrued market discount at the time of the disposition or payment. Market discount accrues (i) on a constant yield basis (using OID principles) if the taxpayer so elects or, if not, (ii) for a bond calling for only qualified stated interest payments prior to the maturity date, on a straight line basis, or (iii) in any other case, in a manner to be prescribed by regulations. No such regulations have ever been issued.

A retirement of a debt instrument is deemed to be an exchange transaction, so that gain or loss on the retirement of a debt instrument held as a capital asset is treated as capital gain or loss. Originally applicable only to corporate and government obligations, this rule was extended to all debt instruments in 1997.

Regulations provide that any payment on a debt instrument is treated first as a payment of interest to the extent accrued at the time of the payment and as a payment of principal to any remaining extent. No exception to this rule is made for the final settlement of a debt instrument at a discount.

With very limited exceptions, the statutes and regulations governing debt instruments have no exceptions or special rules for distressed debt instruments. A distressed debt instrument might be defined as any debt instrument for which there is a substantial risk that the obligor will not be able to make all of the required payments on the debt as they come due. Common law, however, contains several principles applicable to distressed debt. The first is that a holder of a

debt instrument using the accrual method of accounting need not include interest in taxable income as it accrues if, at the time of the accrual, there is no reasonable expectation that the interest will be paid (the "doubtful collectability" rule).[1] The Internal Revenue Service (the "Service") has taken the position that this common law rule does not apply to OID.[2]

The second common law rule is that if a debt investment is "speculative," any payments on the debt instrument other than stated interest payments can be applied to reduce the holder's basis in the debt without the recognition of gain unless and until the holder's basis has been reduced to zero.[3] The cases that form the basis of this common law rule antedate the enactment of the market discount rules, and it is not clear to what extent the common law rule survives.

Reasons for change

The general absence of exceptions or modifications to the rules governing the taxation of debt for distress situations can produce inappropriate timing results for holders in many cases, and in some of these cases inappropriate character mismatches also arise (ordinary income followed by a capital loss). Among the most common situations in which these results can arise are: (i) a holder is required to include OID in income when there is no reasonable expectation of collection, (ii) the ordering rule treats as interest payments that reflect the economic return of the holder's basis (*i.e.*, because it is clear that a debt instrument will not be paid in full) and (iii) the market discount rules are applied without modification for distressed debt.

For example, consider a case where the taxpayer holds a distressed bond bearing PIK interest. Although there may be a high likelihood that the issuer will fail to pay the PIK interest and principal in full at maturity, the Service takes the position that the holder is required to keep accruing the PIK interest into income as OID, with the likely result that the holder will earn significant ordinary income followed by a capital loss.[4] Alternatively, a holder may acquire a severely distressed debt instrument that is nonetheless paying stated interest currently even though there is little to no chance that much if any principal will be repaid. This situation can arise in the context of asset-backed securities, where (absent default) the payment "waterfall" pursuant to a security's indenture typically requires the payment of stated interest prior to the payment of principal. Under the payment ordering rules contained in the regulations, the stated interest received will generally be required to be included in full by the holder as ordinary income. If a holder acquires such a security bearing an 8% coupon at the discounted price of 40% of par, for example, the interest income required to be included by the holder in full would effectively represent a rate of 20% when applied to the holder's purchase price, a result significantly in excess of the holder's true expected economic return.

The market discount rules were enacted at a time of high interest rates, which caused most outstanding debt instruments to trade at a discount. Congress correctly understood that, in

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[1] *Corn Exchange Bank v. United States,* 37 F.2d 34 (2d Cir. 1930); *Atlantic Coast Line Railroad Co. v. Comm'r,* 31 B.T.A. 730 (1934), *acq.*, XIV-2 C.B. 2; *American Central Utilities Co. v. Comm'r,* 36 B.T.A. 688 (1937); *H. Liebes & Co. v. Comm'r,* 90 F.2d 932 (9th Cir. 1937); *Great Northern Ry. Co. v. Comm'r,* 8 B.T.A. 225 (1927), *petition dismissed,* 40 F.2d 372 (8th Cir. 1930), *cert. denied,* 282 U.S. 855 (1930). *See also* Rev. Rul. 80-361, 1980-2 C.B. 164.

[2] T.A.M. 9538007 (June 13, 1995).

[3] *Liftin v. Comm'r,* 36 T.C. 909 (1961), *aff'd,* 317 F.2d 234 (4th Cir. 1963); *Underhill v. Comm'r,* 45 T.C. 489 (1966).

[4] *See* T.A.M. 9538007, *supra* note 2.

such a high-interest environment, market discount is like OID, *i.e.*, an economic equivalent of interest. In that context, it is appropriate to treat market discount like OID because both are "fixed and predictable."[5] Congress failed to recognize, however, that market discount can arise from a source having nothing to do with high prevailing interest rates: doubt as to the borrower's ability to pay the debt according to its terms. At a high enough level, that form of market discount is entirely distinguishable from OID: it is no longer predictable that it will be paid, and newly-issued "debt" bearing an equivalent amount of OID would, in the event an issuance of such debt even occurs as a practical matter, most likely be treated as equity rather than debt for tax purposes. In that context, taxing market discount as an OID-equivalent is not rational.

To address systematically the inappropriate timing and character consequences arising from the application of the interest, OID and market discount rules to distressed debt, we offer two main options to change the tax treatment of distressed debt instruments. These options could be enacted separately or together. The first option generally limits the rate of accrual on any debt instrument to a rate chosen to represent the upper limit of yields on newly issued debt instruments. The second is limited to severely distressed debt instruments and provides for no accrual whatsoever on instruments in this category. Both options have character rules designed to correct the character mismatches noted above.

A third option would essentially codify the principles of the doubtful collectability authorities, *i.e.*, that yield should not be accrued if there is no reasonable expectation that the holder will collect it.[6] This would provide certainty to taxpayers that the concepts underlying these cases apply equally to OID as to interest. A final option would require accrual-method taxpayers to include all accruals of interest and discount (including market discount) in income on a current basis, subject to the limitations in the other proposals. A separate but related option described in section II.A.2 of this submission would also address the character mismatches arising from distressed debt by treating certain losses on debt as ordinary.

Note that these options would affect the taxation only of holders of debt instruments, not issuers, and so under these options the interest deductions for issuers of debt would not necessarily match the inclusions of interest income by holders of that debt. Nonetheless, except in the case of severely distressed debt instruments (proposal 2) and debt instruments of doubtful collectability (proposal 3), an initial holder of debt would generally[7] have treatment symmetric to that of the issuer under the proposals.[8] Asymmetric treatment as to the issuer is entirely appropriate for a

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[5] *See* Revenue Proposals Contained in the Administration's Fiscal 1985 Budget, General Explanations (Feb. 23, 1984) ("Market discount is in all respects the equivalent of interest income to the holder of a bond; it exists in lieu of coupon interest, and is reflected in the fixed and predictable growth in value of the bond according to a compound interest formula.")

[6] *See supra* note 1.

[7] However, note that a holder that takes a partial worthlessness deduction would in a sense be treated as a "new" holder of the relevant debt; this is appropriate because the partial worthlessness rule functions as a form of "reset" of the holder's position.

[8] Although option 1 is not designed to have an effect on initial holders of debt, such a holder might sell and reacquire the debt or cause a deemed termination of the debt under Section 1001 in order to try to get the benefit of the proposal. However, in many such cases the wash sale rules would apply, with the result that the holder's basis for the newly reacquired or modified debt would equal the holder's basis in the original debt, thereby preventing the holder from benefiting from the proposal.

secondary purchaser of debt, whose economic position ordinarily differs from both the issuer of the debt and earlier holders because that position depends significantly on the price at which the holder acquired the debt.[9] Indeed, certain rules applicable to the taxation of a holder of debt – specifically, the acquisition premium and amortizable bond premium rules – generally recognize this principle by permitting a secondary holder's income inclusions to deviate from the issuer's to reflect the particular holder's yield from holding the debt.

Options 2 and 3, which are intended to apply to debt instruments whose issuers are in considerable distress, apply to all holders including initial holders, and thus have the potential for the issuer/initial holder asymmetry mentioned above. While those options could easily be made applicable to issuers as well as to holders, given that an issuer in that condition is likely to have substantial net operating losses it seemed to us that the practical import of applying the options to issuers would be limited.

Assuming that sensible rules can be enacted to limit the accrual of interest and discount on a debt instrument to a rate that truly represents interest or an interest equivalent, there is no good reason why an accrual-method taxpayer should not be required to include accrued interest income and discount in income as it accrues, regardless of whether the return is in the form of stated interest, OID or market discount. Unlike the situation that existed in 1984 when the market discount rules were originally enacted, all taxpayers holding discount bonds should now have access to information and computing power that will allow the computation of accrued discount on a yield to maturity basis. Further, once rules have been enacted to limit the accrual of yield on a debt instrument to a rate that truly represents an economic accretion of value, the general principles of the accrual method of accounting should require current inclusion in income of the accrued interest.

Options for Consideration

Limitation on yield required to be accrued (Option 1)

Option 1 provides that, for the holder of any debt instrument:

- The rate at which the total yield on the debt accrues (i.e., interest, OID and market discount) shall not exceed the greater of (i) the applicable Federal rate ("AFR") plus 10 percent[10] and (ii) the debt instrument's yield to maturity plus 5

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[9] Another way of making this point is that when a debt instrument is sold at a loss in the secondary market, the taxation of the issuer cannot sensibly match the treatment of the original and subsequent holder of the debt. To achieve matching, the issuer would have to recognize income at the time of the sale equal to the loss recognized by the seller of the debt. But certainly this would not represent sensible tax policy, for in no sense does the issuer of debt have an item that could be called taxable income merely because its debt has been sold from one creditor to another at a loss.

[10] The choice of the AFR plus 10 percent is based on the premise that yields on newly issued debt instruments with even the lowest credit ratings do not exceed this rate. Historically, the understanding of the Committee is that this has generally been true, except for a very brief period during the recent financial crisis. Treasury could be given the authority to provide a higher threshold should market conditions change and AFR plus 10 percent no longer represent a reasonable proxy for the highest yields on newly issued debt instruments.

percent,[11] in each case as applied to the fair market value of the debt instrument at the time acquired by the holder.

- For this purpose, the AFR is the rate at the time of purchase for a fixed-rate debt instrument based on the term of the debt, and the Federal short-term rate at the time of the accrual in the case of a variable rate debt instrument.

- For purposes of this rule, the fair market value of a debt instrument shall be the purchase price paid by the holder if the debt was acquired for cash or publicly traded property, or the trading price of the debt instrument if the debt was publicly traded at the time of purchase and the preceding clause does not apply. In any other case, the fair market value of the debt instrument is generally deemed equal to its face amount, except that the Treasury Department shall be given authority to issue regulations permitting the taxpayer to use the true fair market value of a nonpublicly traded debt instrument in certain circumstances.[12]

- Total yield accrued in any accrual period shall be treated first as qualified stated interest to the extent thereof, then as OID to the extent thereof, and last as market discount. Cash payments are allocated under the same ordering rule. Thus, as under current law, accrued market discount is required to be included in income only to the extent of cash payments treated as principal, unless the taxpayer elects current inclusion or the fourth proposal described below is enacted.

- If a taxpayer validly claims a deduction for partial worthlessness of a debt instrument, the rules of this option shall be applied at the time the debt is partially charged off for financial statement purposes as if the debt had been purchased on that date for a price equal to the taxpayer's basis in the debt instrument immediately after the partial worthlessness deduction.[13]

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[11] This prong of the option ensures that a debt instrument's yield, as measured based on its fair market value, must rise at least 5% from its initial yield before the option would have any effect on that debt. Another consequence of this prong is that the option would not generally affect initial holders of debt, even if the debt's yield at issuance exceeds AFR plus 10%.

[12] For example, if the holder has a qualified financial statement, it could elect to follow its financial statement accounting for determining the accrual of total yield on the debt instrument. A qualified financial statement is a financial statement that is required to be filed with the SEC under Section 13(a) or Section 15(d) of the Securities Exchange Act of 1934 and/or under Rule 17a-5 or Rule 17a-12 promulgated thereunder.

[13] To be consistent with the rules applicable to market discount and short-term debt, interest on any indebtedness incurred or continued to purchase or carry a debt instrument would be deductible only to the extent income on the latter is includible in taxable income. Any excess would be carried forward to potentially offset future inclusions and, to the extent not so used, would be added to the basis of the debt for purposes of computing gain or loss on the sale or exchange (including a retirement) of the debt instrument. Additionally, in a case in which the issuer of the debt instrument is related to the holder within the meaning of Section 267(b) or (...continued)

Severely distressed debt instruments (Option 2)

This option provides that, for a holder of a severely distressed debt instrument (as defined below):

- The holder shall not accrue interest or OID.
- The market discount rules shall not apply.
- Any payment on the debt instrument, regardless of how designated, shall be treated as a return of the holder's basis to the extent thereof, with any remaining portion being treated as a payment in retirement of the debt instrument.[14]
- Definition of severely distressed debt instrument:
  - Any debt instrument acquired for a price not greater than the lesser of
    - 50 percent of the debt's adjusted issue price, or
    - the present value of all remaining payments on the debt instrument, using a discount rate equal to the AFR at the time of purchase plus 15 percent;[15]
  - Any publicly traded debt instrument whose trading price is less than the price described in the prior bullet point; and
  - Any other debt instrument for which the taxpayer has claimed a valid complete worthlessness deduction.

Codification of doubtful collectability doctrine (Option 3)

This option provides that no amount of yield be accrued if, at the time of the accrual, there is no reasonable possibility that the amount the holder will thereafter collect on the debt instrument will exceed the holder's basis in the debt instrument.

(continued...)

Section 707(b)(1), rules similar to those in Section 267(a)(2) would apply, so that the issuer's deductions for interest and OID would be limited to the amount the related holder includes in income.

[14] Interest on any indebtedness incurred or continued to purchase or carry the severely distressed debt instrument would not be deductible and instead would be added to the basis of the severely distressed debt instrument. As in the case of the first option, in a case in which the issuer of the debt instrument is related to the holder within the meaning of Section 267(b) or Section 707(b)(1), rules similar to those in Section 267(a)(2) shall apply, so that the issuer's deductions for interest and OID would be limited to the amount the related holder includes in income.

[15] A higher threshold, and hence a narrower definition of severely distressed debt instrument, might be appropriate if both options are enacted, while a lower threshold (and hence a broader definition) would seem appropriate if the second option stands on its own as the only change to the tax treatment of distressed debt.

Accrual of market discount (Option 4)

This option provides that, if (and only if) one of the first two options is enacted, accrual-method holders of debt instruments would be required to include interest and discount in income as it accrues, regardless of whether the accrual is attributable to stated interest, OID or market discount. This option would remove distinctions between economically equivalent forms of interest and other amounts compensating for "the use or forbearance of money."[16] In so doing, it would make the market for debt instruments more efficient and would simplify the administration of the tax system. Because this change would be effective only in conjunction with one or both of the first two proposals, taxpayers should not be required to include in income any amount that does not represent a true economic accrual of income.

2. Change the character of losses on debt

Present law

Under current law, the character of loss on a debt instrument, including a deduction under the rules applicable to "bad" or "worthless" debt, depends on a number of factors, including (i) whether the debt is held as a capital asset, (ii) whether the debt is foreign-currency denominated or is a contingent payment debt instrument, and (iii) whether the bad debt expense rules apply.

In cases where debt is not held as a capital asset, any loss (including a bad debt expense deduction) is ordinary. Debt in this category includes (i) debt that is marked to market under Section 475 by a securities dealer or trader,[17] (ii) debt held by certain financial institutions described in Section 582,[18] (iii) trade or business receivables described in Section 1221(a)(4), and (iv) debt in the hands of certain loan originators and/or liquidity providers.[19]

In cases where debt is held as a capital asset, realized loss generally is capital. If the loss arises from a sale or exchange, the loss is capital under Section 1222. If the loss arises from a retirement of all or part of the debt, the loss is deemed to arise from a sale or exchange under Section 1271 and is therefore capital.

In certain cases, special rules can apply to characterize realized loss as ordinary. If the debt instrument is foreign-currency denominated, realized loss is ordinary to the extent the loss is attributable to an unfavorable exchange-rate movement during the period the holder held the debt. If the debt instrument is a contingent payment debt instrument subject to the noncontingent bond method of Treasury Regulations Section 1.1275-4(b), realized loss is ordinary to the extent of net prior interest income from the debt instrument.

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[16] *Deputy v. du Pont*, 308 U.S. 488, 498 (1940).

[17] Section 475(d)(3).

[18] Section 582(c)(1).

[19] *See* Federal National Mortgage Association, 100 T.C. 541 (1993) (holding that mortgage loans acquired by the taxpayer on the secondary market were ordinary assets because the acquisition "enhance[d] the efficiency of the secondary market in mortgages" and therefore rendered a service in the taxpayer's ordinary course of business); *Burbank Liquidating Corporation*, 39 T.C. 999 (1963), *acq.* 1965-2 C.B. 6, *aff'd*, 335 F.2d 125 (9th Cir. 1964) (holding mortgage loans made by a savings and loan association were "notes receivable acquired . . . for services rendered" and therefore ordinary assets).

Finally, in certain situations where debt is held as a capital asset, it is possible for a holder to take a Section 166 bad debt expense deduction in advance (or instead) of a realized capital loss. Under Section 166(a)(1), the holder of a debt instrument, even one held as a capital asset, can take a bad debt expense deduction (in an amount equal to its basis in the debt) if (i) the debt becomes wholly worthless during the year, (ii) the holder is a corporation (or if the holder is not a corporation, the debt is held "in connection with" the holder's trade or business) and (iii) the worthless debt was either issued by an entity other than a government or a corporation or was not issued in registered form. Under Section 166(a)(2), a holder is entitled to a partial bad debt expense deduction with respect to unrealized loss in a debt instrument if (i) the three requirements above are met (substituting "partially" for "wholly") and (ii) the same amount is "charged off" for financial accounting purposes.

Reasons for change

The present taxation of an investment in debt is inherently asymmetric from the holder's perspective, in that most of the economic income from the debt instrument – whether interest, OID or market discount – is treated as ordinary income, while economic losses are generally capital. This imbalance can create a character whipsaw within a single debt instrument; for example, as discussed above in section II.A.1 of this submission, a holder may be required to accrue ordinary OID income over many periods and then suffer a corresponding capital loss if the debt instrument becomes impaired. For an investor that owns a pool of debt instruments but few other investment assets, the capital losses generated by the distressed debt instruments within the pool can often be completely unusable, resulting in distortive taxation of the holder's income.

In practice, the bad debt expense rules often generate arbitrary results. The bad debt rules draw a critical distinction between widely available non-corporate debt, such as debt of a REMIC or of a limited partnership (generally eligible for the bad debt expense deduction), and economically similar debt of a corporation (generally not eligible). The distinction appears to be little more than an artifact of history—when the provision was originally drafted, Congress clearly meant to preclude bad debt expense treatment for "securities," which Congress assumed were limited to registered-form corporate and governmental debt. Over the intervening decades, non-corporate issues have become more prevalent, due to the evolution of the asset-backed securities market, and therefore the bad debt expense deduction has become available for some instruments that are largely indistinguishable from "securities" of the type Congress intended to exclude from the bad debt rules.

There has also been an evolution in the "registered form" concept critical to the bad debt regulations. When originally enacted, the registered form requirement was likely designed to distinguish between true investment securities (typically in registered form and intended to be outside the scope of the bad debt provisions) and non-traded debt instruments (such as receivables or intercompany accounts) that were not typically in registered form. Through evolutions in the tax law definition of registered form and in market practice, registered form is no longer a reliable indicator of an investment security. Nowadays, many trade receivables and intercompany obligations appear to meet the "registered form" standard and, therefore, when issued by a corporation, are ineligible for the bad debt expense deduction.

An additional ambiguity regarding the scope of the bad debt expense provisions arises when an eligible debt is settled though a negotiated settlement (or a foreclosure where there is no deficiency claim by the creditor). In this case, the resultant loss can be viewed as either a realized loss from the retirement of the debt or a wholly worthless loss on the deficiency. At the time the bad debt rules were originally enacted, the rule (now in Section 1271) that deems a retirement to be a sale or exchange was limited to corporate and governmental obligations—the very obligations unlikely to be covered by the Section 166 bad debt rules. Since 1997, the deemed sale or exchange rule of Section 1271 applies to all debt, including debt that would otherwise be eligible for a bad debt expense deduction. The expansion of Section 1271 has created an issue as to whether a loss crystallized in a negotiated settlement ought to be characterized as a realized loss

and therefore capital or as a wholly worthless deficiency and therefore a bad debt expense under Section 166. There are technical arguments and authorities supporting either result.

The rules governing the character of loss on debt instruments held as capital assets need to be rationalized and simplified. One idea is to expand the scope of the "recapture" character rule applicable to losses on contingent payment debt instruments. Under those regulations, realized losses on any particular contingent payment debt instrument are treated as ordinary to the extent of net prior interest inclusions from the instrument. This rule prevents an inappropriate character whipsaw (interest income, capital loss) on a single debt investment. This rule could be expanded to cover all debt instruments.

Finally, if the recapture character rule applies to all debt instruments held as capital assets, the bad debt expense rules could be modified to be consistent with the rules for other debt dispositions.

Options for Consideration

The option would amend Section 1271 to treat realized loss on a debt instrument held as a capital asset as ordinary loss to the extent of net prior ordinary income inclusions with respect to the debt. To address potential cherry-picking concerns, consideration could be given to limiting the taxpayer's ordinary deductions with respect to debt losses for the taxable year to the taxpayer's ordinary interest income and gains from debt for that year.

A further option would amend Section 166 to treat bad debt expense deductions as ordinary only to the extent that realized losses from a disposition of the debt instrument would be ordinary.

3. Modify "issue price" in debt-for-debt exchanges

Present law

Debt Modifications

Under current law, if the terms of a debt instrument are modified, the debt instrument in many cases will be treated for U.S. federal income tax purposes as if it were retired in exchange for a new debt instrument with the modified terms. An exchange is deemed to occur if, based on all the facts and circumstances, the legal rights or obligations that are altered by the modification, and the degree to which they are altered, are economically significant.[20] Changes in the yield of a debt instrument or in the timing of payments, for example, may be considered economically significant, even though the principal amount of the debt remains the same.[21] The conceptual underpinning of the relevant Treasury regulations on debt-for-debt exchanges, commonly known as the *Cottage Savings* regulations after the case that prompted their issuance,[22] is that a realization event occurs when one asset is exchanged for another that is materially different.[23]

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[20] Treas. Reg. § 1.1001-3(e)(1).

[21] Treas. Reg. § 1.1001-3(e)(2) & (3).

[22] *Cottage Savings Association v. Commissioner,* 499 U.S. 554 (1991).

[23] *See* Treas. Reg. § 1.1001-1(a).

From the issuer's perspective, the U.S. federal income tax consequences of a debt-for-debt exchange under the *Cottage Savings* regulations depend primarily upon the issue price of the modified debt instrument. Specifically, Section 108(e)(10) of the Code provides that, for purposes of determining the issuer's income from cancellation of debt ("COD income"), if a debt instrument is issued in satisfaction of another debt instrument, the issuer will be treated as having satisfied the existing debt for an amount of money equal to the issue price of the modified debt. Thus, the issuer will recognize COD income to the extent that the issue price of the modified debt instrument, determined as set forth below, is less than the adjusted issue price of the existing debt instrument, even if the principal amount of the debt is not reduced. Further, the issue price of the modified debt relative to its stated redemption price at maturity will determine whether it is treated as having been issued with OID,[24] as well as whether the rules applicable to certain high yield debt instruments (the "AHYDO rules") may defer or disallow the interest expense deductions attributable to the OID.[25] Thus under current law, a debt workout commonly results in adverse timing consequences to the issuer in the form of current COD income on the existing debt, with OID deductions over the term of the modified debt, and in some cases a permanent difference where the AHYDO rules apply to disallow the OID deductions.

The issue price of the modified debt also generally determines the amount realized in a debt-for-debt exchange by the holder of the existing debt, and whether the holder will be required to recognize additional interest income as a result of OID. Regardless of the tax consequences of the exchange to the issuer (*e.g.*, COD income), any gain or loss realized by the holders may be deferred if both the existing debt and the modified debt are "securities" and the deemed exchange constitutes a recapitalization under the tax-free reorganization rules of Section 368(a).[26] In that case, if the holder bought the debt for less than its principal amount in the secondary market, the deemed exchange generally will turn the market discount on the debt, which would have been recognized only upon disposition or repayment,[27] into OID required to be recognized as it accrues. On the other hand, if the holder has a high basis in the existing debt instrument, the holder's realized loss is not recognized in a reorganization. Although the modified debt will be treated as issued with OID, the holder's high basis in the debt generally will offset the OID as it accrues.[28] If the deemed exchange does not qualify as a reorganization, the holder's gain or loss is fully recognized,[29] including potentially the recognition of phantom gain to the extent that the issue price of the modified debt exceeds the holder's basis in the existing debt. The gain generally is

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[24] Section 1273; Treas. Reg. § 1.1273-1.

[25] Section 163(e)(5) & (i).

[26] Reorganization treatment is available only if the issuer is a corporation and both the existing debt and the modified debt constitute securities for U.S. federal income tax purposes. Section 354(a). The determination of whether a debt instrument is a security for this purpose depends on all the facts and circumstances, but the term of the instrument is considered an important factor. Very short-term instruments tend to be less likely to be treated as securities because they do not represent an interest in the fortunes of the issuer.

[27] Section 1276(a). One option described above would provide that market discount is required to be currently accrued by accrual method taxpayers if, and only if, one of our main proposals with respect to distressed debt is adopted.

[28] Sections 171 & 1272(a)(7).

[29] Any loss may be subject to deferral under the wash sale rules. *See* section 1091(a).

reportable under the installment method, but may be subject to an onerous deferred interest charge under Section 453A.

Determination of issue price and amount of COD income

Under current law, the issue price of a debt instrument issued (or deemed to be issued) in exchange for another debt instrument depends upon whether the existing debt or the modified debt is publicly traded. If the modified debt is publicly traded, the issue price of the debt is its fair market value on the issue date.[30] If the modified debt is not publicly traded, but the existing debt is publicly traded, the issue price of the modified debt is the fair market value of the existing debt on the issue date of the modified debt.[31] If neither the existing debt nor the modified debt is publicly traded, then the issue price of the modified debt is its stated redemption price at maturity if the debt bears adequate stated interest, generally based on the AFR.[32] If the modified debt does not bear adequate stated interest, then its issue price is an imputed principal amount, using the AFR as the discount rate.[33]

The practical result of the rules for determining issue price is that the issuer will recognize COD income on modifications of publicly traded debt in any case where the issuer's creditworthiness has declined or market interest rates have risen, because the existing debt will be treated as satisfied for an amount of cash equal to the lower fair market value of the modified debt. Under current law, this result ensues even if the principal amount of the debt has not changed, so that the issuer remains legally liable for the full face amount of the debt. In contrast, if the modified debt is not publicly traded, its issue price generally will be equal to the face amount of the debt and the issuer will not recognize any COD income, as long as the debt bears adequate stated interest.

Definition of publicly traded

Under current law, a debt instrument is treated as publicly traded if, at any time during the 60-day period ending 30 days after the issue date, the debt instrument is, among other things, listed on a U.S. national securities exchange or certain foreign exchanges, or:

> it appears on a system of general circulation (including a computer listing disseminated to subscribing brokers, dealers, or traders) that provides a reasonable basis to determine fair market value by disseminating either recent price quotations (including rates, yields, or other pricing information) of one or more identified brokers, dealers, or traders or actual prices (including rates, yields, or other pricing information) of recent sales transactions (a quotation medium).[34]

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[30] Section 1273(b)(3)(A); Treas. Reg. § 1.1273-2(b).

[31] Section 1273(b)(3)(B); Treas. Reg. § 1.1273-2(c).

[32] Sections 1273(b)(4) & 1274(a)(1); Treas. Reg. §§ 1.1273-2(d)(1) & 1.1274-2(b)(1).

[33] Section 1274(a)(2); Treas. Reg. §§ 1.1273-2(d)(1) & 1.1274-2(b)(2).

[34] Treas. Reg. § 1.1273-2(f)(4). A debt instrument also would be considered publicly traded if it was listed on an interdealer quotation system sponsored by a national securities association registered under section 15A of the Securities Exchange Act of 1934, was property of a kind that is traded either on a board of trade designated as a contract market by the Commodities Futures Trading Commission or on an interbank market or if price quotations were readily available from dealers, brokers, or traders, subject to certain safe harbors.

Issuers and their advisors have found it very difficult to conclude that particular debt instruments are not publicly traded under this definition, especially given the myriad technological advances that have expanded the availability of pricing information. A consensus view has developed among practitioners that debt issuances appearing on the "Trade Reporting and Compliance Engine" ("TRACE") website of the Financial Industry Regulatory Authority are publicly traded under this definition, since actual trading prices as well as limited trade history are presented. TRACE covers only debt that is registered with the Securities and Exchange Commission, but pricing information for many unregistered issuances, including some bank loans, is available from other electronic sources.

In recently issued proposed regulations,[35] Treasury and the Service have taken a broad view of the meaning of publicly traded for purposes of determining the issue price of debt instruments, on the grounds that the improved depth and transparency of the debt markets have diminished concerns that the trading prices of debt instruments may not reflect their fair market value. Thus, the preamble states, "to the extent accurate pricing information exists, whether it derives from executed sales, reliable price quotations, or valuation estimates that are based on some combination of sales and quotes, the Treasury Department and the Service believe that that information should be the basis for the issue price determined under section 1273(b)(3)."[36] Under the proposed regulations, property would be considered publicly traded if, during the 31-day period ending 15 days after the issue date of the debt instrument (i) the property is listed on an exchange, (ii) a sales price for the property is reasonably available, (iii) there are one or more firm quotes for the property, or (iv) there are one or more indicative quotes for the property.[37]

Directionally, the proposed regulations mean that even more debt instruments will be considered publicly traded, and therefore even more issuers will face the risk of recognizing significant amounts of COD income if their debt is modified.

Reasons for change

COD income

The substitution of one debt obligation of an issuer for another obligation with modified terms but the same principal amount generally is not an appropriate occasion for the recognition of COD income by the issuer or the imposition of tax. The *Cottage Savings* rationale for treating a significant debt modification as a taxable event is that one asset has been exchanged for a materially different asset. This rationale may make perfect sense where the new asset is cash or widgets or even stock of the issuer, because afterward the issuer is no longer liable to repay the indebtedness for which the new asset was exchanged. The issuer and the holder are in very different positions after the exchange, and there is no particular reason not to give the exchange tax effect.

Contrast this with a debt-for-debt exchange where the principal amount is not reduced: The holder's investment in the issuer continues in the modified form, and it is clear as a matter of common sense that the issuer still owes the same amount of money to the holder. The fact that the debt may be worth less than its principal amount at the time of the modification does not change

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[35] REG-131947-10; 2011-8 I.R.B. 521.

[36] *Id.*

[37] The proposed regulations provide exceptions to the expanded definition of publicly traded for certain *de minimis* trading and small issuances.

the issuer's legal obligation to repay the principal amount. Consistent with that legal obligation, the holder's claim against the issuer in bankruptcy generally would be the principal amount of the debt.[38] Further, absent the application of the AHYDO rules discussed below, the current recognition of COD income generally should be reversed by future deductions of OID in the same amount, which begs the question of whether it is worth requiring the COD income to be recognized in the first place.

The issue price rules for publicly traded debt instruments adopt the fiction that the issuer has raised cash proceeds from the issuance of the modified debt for its fair market value, which it uses to fully retire the existing debt. This fiction ignores the continuity of the holder's investment in the issuer (*i.e.*, that the debt has not actually been retired). It also ignores the economic reality that debt modifications typically are undertaken when the debtor is having financial difficulties and likely would be hindered from raising new money in the capital markets. Further, unless the debtor can exclude the COD income because of bankruptcy or insolvency (which the debtor may have been trying to avoid by restructuring its debt), or has available net operating losses to fully offset the COD income, the result under current law for modifications of publicly traded debt will only exacerbate the troubled debtor's situation.

In adopting Section 108(i) as part of the American Recovery and Reinvestment Act of 2009,[39] Congress sought to mitigate the problem of COD income in debt workouts by adopting a temporary deferral election for COD income realized in 2009 or 2010 upon the reacquisition, exchange or modification of any debt instrument issued by a C corporation, or any other person in connection with the conduct of a trade or business. The deferral period is five tax years for transactions in 2009 and four tax years for transactions in 2010, after which the COD income must be recognized ratably over a period of five tax years. If the transaction included the issuance (or deemed issuance) of a new or modified debt instrument in exchange for the outstanding debt, deductions with respect to any OID on the new debt are deferred for the same four- or five-year period,[40] and are then taken into account ratably over the five-year recognition period for the COD income. Section 108(i) was only a temporary solution, which is inapplicable to debt exchanges and modifications after 2010.

Prior to its 1990 repeal, Section 1275(a)(4) had established a floor for the issue price of a debt instrument issued in a debt-for-debt exchange pursuant to a plan of reorganization under Section 368(a): The issue price of the modified debt could not be less than the adjusted issue price of the existing debt for which it was (or was deemed to be) exchanged. Further, common law principles, to which the courts, the Service and most practitioners adhered, indicated that the reference point for determining the amount of COD income on a debt-for-debt exchange was the principal amount of the existing and modified debt, rather than its fair market value.[41] There was

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[38] *In re Chateaugay Corp.*, 961 F. 2d 378 (2d Cir. 1992) (overturning holding of lower court that allowable bankruptcy claim is limited to fair market value of new debt on exchange date).

[39] American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, Section 1232(a) & (c).

[40] OID deductions exceeding the amount of the deferred COD income are not deferred.

[41] *See, e.g., United States v. Kirby Lumber Co.*, 284 U.S. 1 (1931); *Commissioner v. Coastwise Transportation Corp.*, 71 F.2d 104 (1st Cir. 1934), *cert. denied*, 293 U.S. 595 (1934); Rev. Rul. 77-437, 1977-2 C.B. 28; P.L.R. 7752002 (Sept. 2, 1977); G.C.M. 36602 (Mar. 1, 1976). *See also* Richard M. Lipton, *Section 1274 and COD Income Due to Modification of the Interest Rate in a Debt Instrument*, 68 Taxes 504, 506-08 (1990); Benjamin Cohen & Richard Reinhold, (...continued)

a concern, however, that a literal reading of Section 1275(a)(4) permitted COD income to be avoided where the principal amount of the modified debt was reduced. The purported result under this literal application of the statute was the creation of bond premium on the modified debt instead of COD income. This issue, as well as other forms of selective taxpayer avoidance of Section 1275(a)(4) in order to trigger COD income and OID,[42] apparently precipitated the abrupt repeal of Section 1275(a)(4) less than three weeks after a proposal to do so was publicly released.

It is not clear that the issues articulated with respect to Section 1275(a)(4) warranted its outright repeal.[43] For example, the concern about the avoidance of COD income where the principal amount of the modified debt is reduced could be readily addressed by including language in the statute preventing this result, such as the language proposed below. Further, the particular forms of selectivity under Section 1275(a)(4) have merely been replaced by different strategies selectively employed by issuers under current law. These new forms of selectivity will be prevented if our issue price proposal is adopted. For example, under current law, an issuer with publicly traded debt trading at a discount may be able to refresh its NOLs by modifying its debt in a manner sufficient to trigger a deemed exchange under the *Cottage Savings* regulations, recognizing COD income against its existing NOLs and being treated as issuing the modified debt with deductible OID (again assuming no limitations on deductibility). Conversely, an issuer with publicly traded debt trading at a premium may trigger an exchange in order to deduct that premium.[44] The point is that selectivity is not necessarily a reason for or against treating a debt modification as a taxable event.

Further, if the option identified below is adopted and a debt modification generally is not a taxable event, the most obvious strategies to avoid that result are susceptible to challenge under general step transaction principles. For example, if an issuer were to agree with its current debt holders to issue modified debt for cash and immediately use the proceeds to satisfy the old debt at a discount in order to refresh its NOLs, the separate steps might not be respected under general step transaction principles. Anti-abuse rules could be promulgated as necessary to combat this and

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(continued...)

No Cancellation of Debt Income in Section 1275(a)(4) Cases, 47 Tax Notes 1247 (June 4, 1990); Glen Arlen Kohl, *The Fundamentals of Debt Swaps*, 48 Tax Notes 1037 (Aug. 20, 1990). *But cf.* Prop. Treas. Reg. § 1.1273-2(f)(5), Example (6), 1986-1 C.B. 820, 861; Letter from Stuart S. Lipton, Howard, Rice, Nemerovski, Canady, Robertson & Falk, to Robert Scarborough, Department of the Treasury, and Tom Wessel, Office of the Chief Counsel of the IRS (Sept. 25, 1990), *available at* 90 TNT 210-63.

[42] For example, because Section 1275(a)(4) applied only to a reorganization within the meaning of Section 368(a), an issuer could avoid the statute by issuing a debt instrument that was not a security for such purposes, or by having an affiliate make the exchange, and trigger COD income to refresh its net operating losses by using currently those that might expire and creating new NOLs from the resulting OID deductions (assuming none of the provisions that would limit those deductions, such as the AHYDO rules, applied).

[43] Both the New York State Bar Association and the American Bar Association Tax Section previously have recommended reinstatement of Section 1275(a)(4) in some form. *See New York State Bar Association Tax Section Report of Ad Hoc Committee of Provisions of the Revenue Reconciliation Act of 1990 Affecting Debt-for-Debt Exchanges*, 91 TNT 69-37 (Mar. 25, 1991); *The Case for Reinstatement and Expansion of Section 1275(a)(4)*, 94 TNT 9-60 (Jan. 10, 1994).

[44] Treas. Reg. § 1.163-7(c).

similar strategies. It may be appropriate, for instance, to apply the proposed non-recognition rule even where the principal amount of the debt is reduced if this reduction is coupled with an increase in interest rate intended to replicate the overall return to the holders (albeit shifting principal to interest).

AHYDO

As noted above, under current law, a workout of publicly traded debt commonly results in adverse timing consequences to the issuer in the form of current recognition of COD income on the existing debt, with OID deductions over the term of the modified debt. In many cases, however, it is not even possible for an issuer to deduct the OID resulting from the deemed exchange, because of the application of the AHYDO rules. Thus, the tax consequences of a modification of publicly traded debt are not merely timing issues of current recognition of COD income by the issuer coupled with OID deductions of the same gross amount over the term of the debt. Instead, under current law, it frequently is the case that the interest expense deductions for the associated OID are disallowed entirely under the AHYDO rules.

The AHYDO rules apply to any debt instrument issued by a corporation that has a term of more than five years, a yield to maturity of at least the AFR in effect at issuance plus five percent, and "significant OID."[45] Very generally, a debt instrument has significant OID if more than one year's worth of yield on the debt instrument (including interest and OID) remains unpaid at the end of any accrual period ending after the date five years from the issue date.[46] The AHYDO rules are extremely complex in their application, but suffice it to say that many debt modifications implicate the rules because the modified debt is treated as newly issued and its issue price is based on the public trading price, which in almost all debt restructurings will be at a discount to the stated redemption price at maturity.

If the yield on the modified debt instrument does not exceed the relevant AFR by more than six percent, the AHYDO rules merely defer the deductions attributable to the OID until payment is made (other than payment-in-kind in the form of other debt or stock of the issuer or a related party). If the yield does exceed the AFR plus six percent, however, a portion of the total yield on the debt is not deductible at all.[47] During the economic downturn of 2008, Congress recognized the difficulty of this result for financially troubled debtors and provided temporary relief from the AHYDO rules for many debt modifications, but this relief expired at the end of 2010.[48] Thus, debtors who modify their publicly traded debt run the risk not only of recognizing

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[45] Section 163(i)(1). The AHYDO rules also apply to debt issued by a partnership to the extent attributable to corporate partners. Treas. Reg. § 1.701-2(f), Ex. 1.

[46] Section 163(i)(2).

[47] Section 163(e)(5)(A)(i). The disqualified portion of the OID is treated as a distribution eligible for the dividends-received deduction for corporate holders as it accrues. Section 163(e)(5)(A)(ii).

[48] American Recovery and Reinvestment Act of 2009, Section 1231(a). During the downturn, corporate bond spreads rose to extremely high levels, resulting in large numbers of bonds, including investment grade, with yields in excess of the AFR by 6 percent or more. *See, e.g.*, Serena Ng, *In Bad Year for All, Bonds Suffer Most*, Wall. St. J., November 22, 2008 at B3 ("Investment-grade corporate bonds on average now yield roughly 9%–about six percentage points more than Treasurys. . . . Junk-bond spreads, meanwhile, have surged to 19.5 percentage points . . . .").

COD income but also the disallowance of the associated OID deductions, resulting in a permanent mismatch.

Divergent holder consequences depending on reorganization status

Under current law, the tax consequences of a debt modification to the holder depend heavily on whether the deemed exchange resulting from the modification qualifies as a reorganization within the meaning of Section 368(a) of the Code. Status as a reorganization depends in turn on whether the debtor is a corporation, and whether the debt instruments constitute "securities" for purposes of the reorganization rules.[49] If the exchange constitutes a reorganization, then regardless of the tax consequences of the exchange to the issuer (such as COD income), the holder does not recognize gain or loss, and takes a carryover basis in the modified debt. If the exchange does not constitute a reorganization, either because the debtor is not a corporation or the debt instruments are not securities, gain or loss is recognized fully by the holder. In cases where the issue price of the modified debt instrument is determined based on its principal or imputed principal amount rather than on public trading,[50] a holder that purchased the debt at a discount may be required to recognize a large amount of phantom gain.

As noted above, we do not view the substitution of one debt obligation of an issuer for another obligation of that issuer with modified terms, where the principal amount stays the same, as an appropriate occasion for the recognition of gain or loss or the imposition of tax. There is no clear policy rationale for limiting holder non-recognition treatment to obligations of corporate debtors, or to debt instruments that constitute securities for purposes of the reorganization rules. Many large business enterprises are organized in non-corporate form, and in most respects are indistinguishable from corporations in terms of size, complexity and creditworthiness. In addition, the term "security" is not defined in the Code or in Treasury regulations, nor has it been clearly defined by judicial decisions. In general, a debt instrument is a "security" for these purposes if, based on all the facts and circumstances, the debt instrument constitutes a continuing investment in the issuer.[51] One of the most important factors that may affect the determination of whether a debt instrument is a "security" is the original term of the instrument. Many practitioners consider a term exceeding five years to be particularly relevant to this determination.[52] Under the substitution of obligation theory, however, the relevance of the original term of the existing debt instrument is quite attenuated, particularly where the debt is publicly traded and the holder may have acquired it only a short time before the deemed exchange. The remaining term of the existing debt and the term of the modified debt are of much greater significance economically to both the issuer and the holder. The distinctions between corporate and non-corporate debtors and between securities and non-securities are arbitrary, and give rise to divergent tax consequences for no apparent policy reason. Extending non-recognition treatment to all debt modifications would rationalize the tax consequences of similar transactions.[53]

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[49] *See supra* footnote 26.

[50] *See supra* footnote 28-31.

[51] *Camp Wolters Enterprises, Inc. v. Comm'r*, 230 F.2d 555 (5th Cir. 1956), *cert. denied*, 352 U.S. 826 (1956)..

[52] The IRS stated in Rev, Rul. 2004-78, 2004-31 I.R.B. 108 (8/2/2004), that "[u]nder case law, an instrument with a term of less than five years generally is not a security."

[53] The option focuses on situations in which principal is reduced or stays the same, as would ordinarily be the case in a debt restructuring. As under current law in the context of a (...continued)

In addition, nonrecognition treatment will tend toward symmetry between the issuer and holder in any particular exchange because, unless the principal amount is reduced, neither the issuer nor the holders will recognize gain or loss. Under current law, there frequently is divergence between the current tax consequences of a debt workout to the issuer and the holder: If the issue price of the modified debt is less than the adjusted issue price of the existing debt, such as where the debt is publicly traded, the issuer generally will recognize COD income, but if the exchange constitutes a reorganization under Section 368(a) of the Code, any gain or loss realized by the holder will be deferred. Conversely, if the issue price of the modified debt equals or exceeds the issue price of the existing debt, such as where the debt is not publicly traded, the issuer will not recognize COD income, but if the exchange does not constitute a reorganization, the holder generally will recognize phantom gain to the extent that the issue price of the modified debt exceeds the holder's basis in the existing debt. As noted in the options on distressed debt in section I.A above, matching or symmetry between the issuer and holders does not always make sense, such as triggering income or loss to the issuer based on secondary market trading between holders. Where the issuer and the holders are counterparties to the same transaction, however, consistent treatment of the transaction as a non-recognition event for both parties generally would be sensible. We note, however, that symmetry breaks down in cases where the principal amount is reduced. Whereas the issuer clearly should recognize COD income, since its legal obligation to repay the principal has been reduced, the holder may or may not have realized a loss from the reduced principal amount, depending on such factors as the holder's basis in the debt and its value at the time of the reduction in principal. We therefore have not presented the option of permitting the recognition of the holder's loss in cases where the issuer recognizes COD income because of a reduction in principal amount.

Option for Consideration

The statute could provide that, in a debt-for-debt exchange in which the issuer of the debt does not change, including a deemed exchange under Treasury Regulations Section 1.1001-3 resulting from a modification, the issue price of the modified debt is equal to the lesser of (x) the adjusted issue price of the existing debt, or (y) the issue price of the modified debt determined under Section 1274, regardless of whether the debt would be considered publicly traded. Thus, under (y) the issue price would be the stated principal amount if the modified debt bears adequate stated interest, or the imputed principal amount if it does not.[54] This formulation generally would avoid the recognition of COD income by the issuer if the principal amount of the modified debt is not reduced and the debt has adequate stated interest, but would address certain of the issues that led to the repeal of Section 1275(a)(4), including requiring recognition of COD income where the principal amount is reduced.

Further, from the holder's perspective, the exchange should be a non-recognition transaction with carryover basis, regardless of whether it otherwise would constitute a reorganization within the meaning of Section 368(a) of the Code (*i.e.*, regardless of whether the issuer is a corporation and the debt is a security). Therefore, a holder with basis in the existing debt that is less than the issue price of the modified debt would not be required to recognize phantom gain as a result of the deemed exchange, and a holder with basis in the existing debt that

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(continued...)

recapitalization, it would seem appropriate to tax a holder upon an exchange in which the holder receives securities with a greater principal amount than those transferred. *See* Section 356(d)(2)(B).

[54] Sections 1273(b)(4) & 1274(a)(1); Treas. Reg. §§ 1.1273-2(d) & 1.1274-2(b)(1); Section 1274(a)(2); Treas. Reg. §§ 1.1273-2(d) & 1.1274-2(b)(2).

exceeds the issue price of the modified debt would not be permitted to recognize loss, and there would be no arbitrary distinctions between workouts undertaken by corporate versus non-corporate debtors or between debt instruments that are securities versus debt instruments that are not.

4. Repeal of Section 279

Present law

Section 279 disallows interest deductions on "corporate acquisition indebtedness" ("CAD"). In general, CAD is indebtedness of an issuer corporation: (i) issued to provide direct or indirect consideration to acquire stock, or two-thirds or more of the business assets, of another corporation, (ii) that is subordinated to certain other indebtedness of the issuer, and (iii) that is convertible directly or indirectly into stock of the issuer (or that is part of an investment unit or other arrangement that includes an option to acquire directly or indirectly stock in the issuer), if, on specified dates, the issuer has either (x) a ratio of debt to equity that is higher than 2:1 or (y) a ratio of "projected earnings" to annual interest that is 3:1 or lower.[55] An issuer's annual interest deductions on CAD are limited to: (i) $5 million minus (ii) the amount of interest paid or accrued during the year on non-CAD obligations that were issued to finance acquisitions of another corporation's stock or two-thirds or more of its business assets.

An obligation is treated as providing direct consideration for an acquisition if it is issued to the shareholders of the target corporation in exchange for their equity interests in the target. An obligation is treated as providing indirect consideration for an acquisition of stock or assets if: (i) at issuance, the issuer "anticipated the acquisition of such stock or assets and the obligation would not have been issued" if the issuer had not anticipated the acquisition or (ii) at the time of the acquisition, the issuer "foresaw or reasonably should have foreseen that it would be required to issue obligations to meet its future economic needs."[56]

To fall within the "subordination" prong in the definition of CAD, the acquisition indebtedness must be either: (i) subordinated to the claims of the issuer's trade creditors generally or (ii) expressly subordinated to the payment of any substantial amount of unsecured indebtedness.[57] In general, Section 279 is applied by treating all members of an affiliated group in the aggregate as the issuer of the obligation; however, the target corporation is not treated as a member of the issuer's affiliated group for this purpose.[58]

There are detailed rules for calculating the debt/equity and projected earnings/annual interest ratios. These ratios are tested as of the last day of the issuer's taxable year when it has issued debt to finance acquisitions of stock, or two-thirds or more of the business assets, of another corporation.[59] Under certain circumstances, these ratios must be re-tested in subsequent

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[55] Section 279(b).

[56] Treas. Reg. § 1.279-3(b)(2).

[57] Section 279(b)(2); Treas. Reg. § 1.279-3(c).

[58] Section 279(g).

[59] Section 279(c)(1).

years.[60] The debt/equity ratio is a relatively straightforward calculation: the ratio of the total indebtedness of the issuer over the sum of its money and the adjusted basis of its other assets. However, determining the projected earnings/annual interest ratio requires more complex calculations. In addition, there are special rules for applying these tests to issuers that are financial institutions.[61]

If an issuer extends, renews or refinances CAD, the refinanced obligation will be CAD, even if the refinanced obligation does not satisfy the four prongs in the definition of CAD (*e.g.*, if the refinanced obligation is not convertible into stock of the issuer).[62] However, a different result may obtain if an issuer issues obligations that are not CAD (*e.g.*, bank debt) to acquire stock of another corporation and then later repays those obligations with newly-issued subordinated, convertible debt. In that case, the Service under certain facts has privately ruled that the newly-issued obligations are not CAD.[63]

There are a number of exceptions to Section 279. For example, obligations that are issued in tax-free stock acquisitions or in acquisitions of the stock or assets of a foreign corporation are generally not subject to interest disallowance under Section 279.[64] In addition, Section 279 does not apply to obligations that are issued by a corporation to acquire its own stock.[65]

Reasons for change

Congress enacted Section 279 in 1969, at a time when many corporate acquisitions were financed by the issuance of convertible bonds. Congress was concerned that certain corporate bonds more closely resembled equity, rather than indebtedness, for U.S. federal income tax purposes.[66] Congress believed that bonds issued in connection with an acquisition of a target corporation were particularly suspect, as the selling shareholders were substituting bonds of the

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[60] For example, if a corporation has issued an obligation that is treated as CAD, but the obligation would not be treated as CAD if tested as of the end of three subsequent consecutive years, the obligation will no longer be subject to the interest disallowance rule of Section 279. *See* Section 279(d)(4).

[61] Section 279(c)(5).

[62] *See* Section 279(h)(1).

[63] G.C.M. 39618 (Mar. 30, 1987) ("[S]ection 279(h)(1) provides that a refinancing of an existing debt shall not be deemed to be the issuance of a new obligation. Thus, section 279(h)(1) deems a refinancing obligation a continuation of the old obligation whose issuance dates back to the issuance of the old obligation. . . . In short, if the old obligation evidencing the debt being refinanced is not corporate acquisition indebtedness, then the obligation issued to refinance it is not corporate acquisition indebtedness either.").

[64] *See* Section 279(e) & (f).

[65] *See* Section 279(b)(1) (the Section 279 rules may apply to an obligation that "is issued to provide consideration for the acquisition of...stock in *another* corporation") (emphasis added).

[66] H.R. Rep. No. 413, 91st Cong., 1st Sess., 104 (Aug. 2, 1969) ("[The] committee does not believe that many corporate bonds and debentures which presently are being treated as debt are, in fact, debt rather than equity.").

acquirer for their equity holdings in the target.[67] Such substitution, Congress believed, was easier to bring about at the time of a merger because the selling shareholders were more willing to hold debt of the acquiring corporation than would be a more sophisticated creditor.[68]

The concerns that gave rise to the enactment of Section 279 are not very relevant to many convertible debt instruments issued in today's capital markets, particularly convertible debt issued for cash. The rules for determining whether an obligation is CAD are complex and often difficult to apply, and therefore consume time and resources even when, as is very typically the case in convertible debt issued into the capital markets, an exception to the application of Section 279 ultimately applies. Finally, the Code contains other provisions capable of dealing with concerns about equity-like debt, including the applicable high yield discount obligation ("AHYDO") rules and Section 385. In particular, Section 163(l), enacted in 1997, addresses certain significant concerns about present-day debt with equity-like features in a manner that is more effective than that of Section 279.

In modern capital markets, convertible debt is used by corporations to obtain relatively inexpensive financing.[69] Although these offerings can be SEC-registered, convertible debt is frequently issued to qualified institutional buyers under Rule 144A of the Securities Act of 1933.[70] Corporations use the cash proceeds of these offerings for many purposes, including to fund acquisitions of other corporations.

In this context, Congress' original concerns about the use of convertible debt to make acquisitions do not seem warranted. While Congress was concerned about unsophisticated selling shareholders being influenced by the possibility of an acquisition to accept equity-like debt, modern convertible debt investors are generally sophisticated, independent investors not otherwise involved in the potential corporate acquisition, and are paying cash for their bonds.[71]

In addition to no longer addressing Congress's original concerns, the Section 279 rules are flawed in various respects. Depending on the relevant facts, Section 279 can require a subjective determination regarding the issuer's intent; it can apply in an inappropriately broad fashion; the resources required to make a determination under Section 279 can be significant; and, because certain determinations under Section 279 are made post-issuance, the provision can impede rational planning.

The application of the Section 279 rules to a potential convertible debt offering is often subjective. For example, an investigation into the issuer's intent is required when testing whether an obligation is issued indirectly "to provide consideration" for the acquisition of stock of another

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[67] Staff of the Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1969*, 123 (Dec. 3, 1970).

[68] *Id.*

[69] *See, e.g.*, David Bogoslaw, *Convertible Bonds: Opportunity Knocks,* Bloomberg Businessweek (Mar. 31, 2009), *available at* http://www.businessweek.com/investor/content/mar2009/pi20090331_341971.htm.

[70] Rongbing Huang & Gabriel Ramirez, *The Rise of the Rule 144A Market for Convertible Debt Offerings*, *available at* http://69.175.2.130/~finman/Orlando/Papers/ConvertibleGrossSpreadFMA.pdf.

[71] In our experience, hedge funds and other institutional investors such as mutual funds are the typical investors in a convertible bond offering.

corporation. Pursuant to regulations, the relevant test is whether the issuer "anticipated the acquisition" and the obligation "would not have been issued" if the issuer had not anticipated the acquisition.[72] Similarly, where an obligation is issued after the acquisition of the stock of another corporation, the relevant test is whether the issuer "foresaw or reasonably should have foreseen that it would be required to issue" the obligation.[73] Intent-based rules can be difficult to apply in practice.

The Section 279 rules can also be a trap for the unwary. If a corporation issues a non-convertible debt obligation and warrants on its stock in a single transaction, the debt obligation may be CAD even though it is not convertible.[74] As a result, corporations that issue relatively low-value warrants on their equity—sometimes referred to as "equity kickers"—to lenders in financing transactions must be mindful of the Section 279 rules.

The "subordination" prong of Section 279 has an unduly broad reach in the holding company context. For reasons unrelated to taxation, public corporate groups frequently issue debt at the parent corporation level while carrying on their business activities at the level of one or more operating subsidiaries. Because Section 279 requires an analysis based on the entire consolidated group, all debt of the parent corporation in a pure holding company structure will be treated as subordinated, because it is structurally subordinated to trade creditors of the operating subsidiaries. While the Service has acknowledged that such a result was not intended and has issued private letter rulings mitigating this potentially harsh result, those rulings were not public and were limited to specific facts.[75]

Furthermore, because the debt/equity and projected earnings tests must be carried out on a date after the issuance of the convertible debt, planning can be difficult. In effect, an issuer must make decisions based on an estimate, up to a year in advance, about its earnings and debt/equity ratio, and risks losing its interest deductions if a market downturn causes those estimates to be wrong.

As a practical matter, in our experience, Section 279 almost never ends up applying to a convertible debt instrument issued in the capital markets because one of the many exceptions applies.[76] Nonetheless, determining whether Section 279 applies can consume substantial time

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[72] Treas. Reg. § 1.279-3(b)(2).

[73] Treas. Reg. § 1.279-3(b)(2).

[74] *See* Section 279(b)(3)(B) (including as CAD any bond that is "part of an investment unit or other arrangement which includes…an option to acquire, directly or indirectly, stock in the issuing corporation"). However, the Service has ruled that Section 279 would not apply if the issuer issued common stock (rather than a warrant) to the lender in connection with the financing transaction. *See* P.L.R. 8810001 (Oct. 1, 1987).

[75] *See* P.L.R. 8640073 (July 10, 1986); P.L.R. 8337018 (June 9, 1983); P.L.R. 8336009 (June 9, 1983).

[76] In the rare case where Section 279 will apply to a proposed convertible bond offering, in our experience the issuer would choose an alternative transaction (e.g., high yield debt) that is not subject to Section 279 rather than proceed with the proposed convertible bond offering.

and resources. For example, to calculate the debt/equity ratio for a corporate group, the group must determine the basis for each of its assets, information that is not always readily available.[77]

Finally, other provisions of the Code are better suited for dealing with the types of equity-linked debt instruments that are issued in today's markets. Section 163(l), which was enacted in 1997, denies interest deductions under certain circumstances on indebtedness if a substantial amount of the principal or interest of the indebtedness is payable in, or determined by reference to, equity of the issuer or a related party.[78] The stated purpose for enacting Section 163(l) was similar to the purpose for enacting Section 279: Congress believed that corporate taxpayers were issuing obligations denominated as debt but that "closely resemble[d] equity."[79] The operative rules for determining when indebtedness is subject to Section 163(l) are not as technically complex as the rules under Section 279, and do not require numerical calculations. In addition, Section 163(l) contains an important carve out for convertible debt instruments that are commonplace in the current marketplace—debt instruments that are convertible only at the holder's option and that have, at issuance, a strike price that is significantly higher than the issuer's stock price at issuance. Under Section 163(l), a debt instrument that is convertible only at the option of the holder (*i.e.*, a debt instrument where the issuer cannot require the holder to accept stock as payment of a substantial amount of the principal or interest) would not be subject to Section 163(l) unless the conversion into stock is "substantially certain."[80] Accordingly, as long as there is not a "substantial certainty the option will be exercised," Section 163(l) generally would not apply to a plain-vanilla convertible debt instrument. Section 163(l) and Section 279 share a common purpose — preventing issuers from taking interest deductions on obligations that Congress believed too closely resembled equity — but Section 163(l) is better tailored to the current convertible debt market. It excludes from its application ordinary convertible debt but applies to instruments where receipt of equity is certain or very likely; we believe that this distinction is an appropriate one.

The AHYDO rules and Section 385 further deal with debt instruments that have an equity flavor. In 1989, Congress added the AHYDO rules of Section 163(e)(5) and Section 163(i), which defer (and in some cases permanently disallow) a portion of the interest deductions attributable to certain high-yield instruments with original issue discount.[81] In the same legislation, Congress

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[77] If the issuer has issued CAD, it may expend substantial time and effort to comply with the rules applicable to CAD. For example, the CAD rules may apply to such an issuer with respect to future indebtedness issued by the issuer in a refinancing (even if that indebtedness would not otherwise satisfy the four prongs of the definition of CAD). If an issuer repays its CAD with cash and then later issues new, non-convertible debt, it is possible that the non-convertible debt might be treated as CAD under the refinancing rules. David Garlock, *Federal Income Taxation of Debt Instruments* ¶ 606.09[C] (6th ed. 2010) ("[O]ne issue not fully explored is how separated new debt must be to avoid being classified as a refinancing of other debt subject to section 279.").

[78] Taxpayer Relief Act of 1997, Pub. L. No. 105-34, Section 1005.

[79] Staff of the Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in 1997, 193* (Dec. 17, 1997).

[80] In addition, the legislative history to Section 163(l) indicates that a plain-vanilla optionally-convertible debt instrument should not be subject to Section 163(l) if the conversion price of the instrument is "significantly higher than the market price of the stock on the issue date of the debt." H.R. Rep. No. 148, 105th Cong., 1st Sess., 458 (1997).

[81] Omnibus Budget Reconciliation Act of 1989, Pub. L. No. 101-239, Section 7202.

also amended Section 385(a) to give Treasury the authority to treat interests in a corporation as partially debt and partially equity.[82] Viewed as a whole, these provisions, Section 163(l) and the extensive body of case law on the debt-equity distinction[83] are fully capable of addressing concerns about equity-like convertible debt, rendering Section 279 unnecessary.

Option for Consideration

Under the option, Section 279 would be repealed.

B. Character of Gain and Loss on Derivatives

1. Update and clarify Sections 1234 and 1234A

Present Law

Section 1234(a)

Under section 1234(a), gain or loss attributable to the sale or exchange of, or loss attributable to failure to exercise, an option to buy or sell property is considered gain or loss from the sale or exchange of property that has the same character as the property to which the option relates has in the hands of the taxpayer (or would have in the hands of the taxpayer if acquired by him). This rule does not apply to (A) an option that meets the inventory or stock in trade characterization of Section 1221(a)(1); (B) in the case of gain attributable to the sale or exchange of an option, any income derived in connection with such option that, without regard to that subsection, is treated as other than gain from the sale or exchange of a capital asset; and (C) a loss attributable to failure to exercise an option described in Section 1233(c). For purposes of applying the rule in Section 1234(a), if a loss is attributable to failure to exercise an option, the option shall be deemed to have been sold or exchanged on the day it expired. Additionally, under Section 1234(b), in the case of the grantor of the option with respect to "property," gain or loss from any closing transaction[84] with respect to, and gain on lapse of, an option in property is treated as a gain or loss from the sale or exchange of a capital asset held not more than one year. For purposes of Section 1234(b), the term "property" means stocks and securities (including stocks and securities dealt with on a "when issued" basis), commodities, and commodity futures. However, Section 1234(b) does not apply to any option granted in the ordinary course of the taxpayer's trade or business of granting options. Finally, Section 1234(c) provides that gain or loss shall be recognized on the exercise of an option on a Section 1256 contract (within the meaning of Section 1256(b)). Section 1234(c) also provides that, for purposes of subsections (a) and (b), a cash settlement option shall be treated as an option to buy or sell property.[85]

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[82] *Id.* at Section 7208(a).

[83] *See* William T. Plumb, Jr., *The Federal Income Tax Significance of Corporate Debt: A Critical Analysis and a Proposal*, 26 Tax L. Rev. 369 (1971).

[84] The term "closing transaction" means any termination of the taxpayer's obligation under an option in property other than through the exercise or lapse of the option. Section 1234(b)(2)(A).

[85] For this purposes, the term "cash settlement option" means any option which on exercise settles in (or could be settled in) cash or property other than the underlying property.

Section 1234A

Under Section 1234A, gain or loss attributable to the cancellation, lapse, expiration, or other termination of (A) a right or obligation (other than a securities futures contract, as defined in Section 1234B) with respect to property which is (or on acquisition would be) a capital asset in the hands of the taxpayer, shall be treated as gain or loss from the sale of a capital asset.[86] Similarly, gain or loss attributable to the cancellation, lapse, expiration, or other termination of a Section 1256 contract (as defined in Section 1256) that is not described in the previous sentence but that is a capital asset in the hands of the taxpayer shall be treated as gain or loss from the sale of a capital asset.[87] This rule does not apply to the retirement of any debt instrument (whether or not through a trust or other participation agreement).

Under proposed regulations, none of the following payments would terminate or cancel a right or obligation for purposes of Section 1234A: a periodic payment described in Treas. Reg. § 1.446-3(e), a nonperiodic payment described in Treas. Reg. § 1.446-3(f), a contingent nonperiodic payment described in Prop. Reg. § 1.446-3(g)(6) to which Prop. Reg. § 1.446-3(g)(6)(ii) applies, or mark-to-market income inclusions and deductions described in Prop. Reg. § 1.446-3(i)(1). Accordingly, under the proposed regulations, Section 1234A would not apply to any of these items, including any final scheduled payment. However, under those proposed regulations, any gain or loss arising from the settlement of obligations under a bullet swap (as defined in such proposed regulations) or forward contract (including a payment pursuant to the terms of the obligations) is treated as gain or loss from a termination of the bullet swap or forward contract, and therefore would be subject to Section 1234A.

Section 1234B

Under Section 1234B(a), gain or loss attributable to the sale, exchange, or termination of a securities futures contract is considered gain or loss from the sale or exchange of property which has the same character as the property to which the contract relates has in the hands of the taxpayer (or would have in the hands of the taxpayer if acquired by the taxpayer). Section 1234B(a), however, does not apply to (1) a contract which constitutes property described in paragraph (1) or (7) of Section 1221(a), and any income derived in connection with a contract which, without regard to that section, is treated as other than gain from the sale or exchange of a capital asset. Moreover, except as provided in the regulations under Section 1092(b) or Section 1234B, or in Section 1233, if gain or loss on the sale, exchange, or termination of a securities futures contract to sell property is considered as gain or loss from the sale or exchange of a capital asset, such gain or loss shall be treated as short-term capital gain or loss. For purposes of Section 1234B, the term "securities futures contract" generally means any security future (as defined in section 3(a)(55)(A) of the Securities Exchange Act of 1934, as in effect on December 21, 2000). For purposes of the Code, a securities futures contract is not treated as a commodity futures contract.

Reasons for Change

Problems with current Sections 1234, 1234A and 1234B

Under the common law extinguishment doctrine, the termination of a contract by agreement of the parties was generally not treated as a sale or exchange of the contract, because

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[86] Section 1234A(1).

[87] Section 1234A(2).

the contract ceased to exist following the termination. Accordingly, any economic gain or loss from such termination could not be considered gain or loss from the sale or exchange of a capital asset and was therefore ordinary in character.[88] This gave the taxpayer electivity of character with respect to such contracts (assuming they were capital assets). That is, if the taxpayer had an unrealized economic gain on the contract, he could sell it and the gain would be capital, while if the taxpayer had an unrealized economic loss, he could pay the counterparty to release him from his obligations under the contract, and the resultant loss would be ordinary. Section 1234A is intended generally to reduce this electivity by treating a negotiated termination of certain derivatives as a sale or exchange of that derivative (the "deemed sale" rule). Section 1234(a), in the case of an option, and Section 1234B, in the case of a securities futures contract, are also intended to reduce the electivity with respect to the derivative contracts to which they apply. Current law, however, is defective in several respects. See generally Michael S. Farber, "Capital Ideas: The Taxation of Derivative Gains and Losses," Tax Notes, Mar. 22, 2010, p. 1493.

First, under current law, the deemed sale rule applies only where the right or obligation that is terminated relates to property. There are many derivatives where a right or obligation either clearly does not relate to property (e.g., a weather derivative) or arguably does not relate to property (e.g., a fixed-for-floating interest rate swap[89]), and Section 1234A therefore does not appear to apply to such derivatives (unless the derivative could be viewed as a right or obligation with respect to itself, which requires a convoluted reading of the statute[90]). Under current law, however, gain on the sale or exchange of such a derivative generally would be characterized as capital gain. Moreover, under the conventional tax definition of an "option," Section 1234 would not apply either in this situation.[91] Thus, if a right or obligation does not relate to property, a taxpayer could cause gain to be capital by selling the derivative and could cause loss to be ordinary by terminating the derivative by negotiation with the counterparty. Such electivity is inconsistent with the overarching purpose of Section 1234A.

Second, under current law, the deemed sale rule under Section 1234A generally does not apply to a closing transaction in which the asset underlying the derivative would produce ordinary gain or loss if sold or exchanged.[92] Therefore, in the case of a derivative that is a capital asset, but that relates to property that would be ordinary property in the hands of the taxpayer (e.g., a "store on the board" transaction), a taxpayer with a gain on the derivative can sell the derivative and recognize capital gain, while a taxpayer with a loss on the derivative can terminate it and receive

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[88] *See, e.g., Fairbanks v. United States*, 306 U.S. 436, 437 (1939).

[89] For example, if an interest rate swap reflects LIBOR, which is an average of interest rates charged in the interbank market, it could be argued that the swap relates to the interbank loans from which LIBOR derives.

[90] But cf. Treas. Reg. Sec. 1.1092(d)-1(c)(2) (treating, for straddle purposes, the rights and obligations of a party to a notional principal contract as rights and obligations with respect to personal property (presumably including in the case of an interest rate swap).

[91] *Old Harbor Native Corp. v. Commissioner*, 104 TC 191 (1995) (option requires unconditional offer to do or not do a certain act, plus an agreement to leave the offer often for a defined period of time). An option on a weather derivative index, which must of necessity be cash-settled, arguably does not represent an offer to do or not do anything (*e.g.*, to delivery or purchase property) other than to pay money.

[92] On the other hand, Section 1234(a) and Section 1234B apply by their terms where the underlying property is ordinary.

ordinary loss treatment.[93] Alternatively, a taxpayer with a loss on the derivative can take delivery of the underlying property, which could be sold at an ordinary loss.

Third, Section 1234A is unclear as to whether a final payment made under a derivative pursuant to its terms constitutes a transaction described in Section 1234A. This creates electivity on the part of taxpayers, because a taxpayer who anticipates a gain upon the receipt of such payment could negotiate an early termination of the derivative and receive capital gain on such termination, while a taxpayer who anticipates a loss upon the making of such payment could simply make the payment according to the terms of the instrument and take the position that the resulting loss was ordinary. Proposed regulations reflect this ambiguity, indicating that a final nonperiodic contingent payment on a notional principal contract over an equity index is outside the scope of Section 1234A, but the final (and only) payment on a cash-settled forward contract over that same index is within the scope of Section 1234A.

Fourth, Section 1234A has the potential to create inconsistencies in the context of positions that represent liabilities in the taxpayer's hands. For example, a taxpayer may have entered into a "long" equity swap where the underlying stock has fallen in value since the swap's inception and thus the swap has a negative value to the taxpayer. Assuming the underlying stock would be a capital asset in the hands of the taxpayer, Section 1234A would cause a termination of that swap to be capital, while assignment of the swap to a third party (which presumably would require a payment by the taxpayer to the third party as incentive to assume the swap) would not clearly give rise to capital treatment under Section 1221 because it is not literally a sale or exchange of property.

Fifth, there is overlap and inconsistency among the three Code sections. An option could be described in both Section 1234(a) and Section 1234A. While the three Code sections are very similar in their operation, they differ in important ways. Sections 1234(a) and 1234B apply to derivatives on ordinary or capital property, while Section 1234A only applies to derivatives on property that is (or would be) capital in the taxpayer's hands. Section 1234(b) has a flat rule treating gain or loss on a written option as capital, albeit only for options on stocks, securities, commodities and commodity futures and not for dealers in such options. Section 1234A(2), addressing Section 1256 contracts, differs from Section 1234A(1), Section 1234(a) and Section 1234B in that it causes capital treatment to apply if the contract itself is (or would be) a capital asset without regard to the character of the underlying in the taxpayer's hands. Finally, the three sections differ in the types of termination transactions to which they apply; for example, Section 1234A does not apply to a termination by sale, exchange or assignment, while Section 1234(a) applies to "closing transactions," defined broadly. Consolidating the rules into a single Code section would result in significant simplification and consistency, and could also avoid unintended results in particular cases.

Possible approaches to modifying Sections 1234, 1234A and 1234B

In preparing this option, we considered the issues described above and various possible approaches to modifying these Code sections. In so doing, we believed that the threshold purpose of these sections is to prevent inconsistent results from arising when the taxpayer disposes of the same derivative contract in different ways.

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[93] Similarly, the termination of a derivative with respect to a Section 1231 asset (such as the termination of a lease on real property by either the lessor or the lessee) generally will not be subject to the deemed sale rule. In this situation, too, a taxpayer is allowed electivity in a manner that is inconsistent with the overarching purpose of Section 1234A.

On this basis, one option we considered, but ultimately rejected, was a simple rule that would center on the character of the derivative, rather than the underlying property, in the hands of the taxpayer. Like Section 1234A(2), such a rule could state simply that gain or loss with respect to any disposition of a derivative (including a termination by the terms of the contract, and including by assignment of the contract) that is (or would be) a capital asset in the hands of the taxpayer would be capital gain or loss. In addition to ensuring that gain or loss from all types of dispositions would be treated similarly, and thereby reducing electivity, this approach has the merit of applying equally to derivatives that do not clearly relate to any underlying property.

However, we viewed this approach as not entirely satisfactory, in that it would provide electivity to a taxpayer for whom the derivative and the underlying property are of different character, such as a taxpayer that is a dealer in the underlying property but not derivatives on that property. Such a taxpayer with an economic gain could sell the derivative to trigger capital gain, while a taxpayer with an economic loss could accept physical delivery of the underlying property pursuant to the derivative and then sell it to generate ordinary loss. While this electivity could be eliminated by treating the making or taking of delivery under a derivative contract as a mark-to-market event in at least some circumstances, doing so would have raised administrative issues, increased complexity, and represented a substantial change from current law.

Moreover, while ensuring consistency across settlement modes is a fundamental purpose of these sections, they appear, at least in the case of Sections 1234(a) and 1234B,[94] to have a broader purpose in that by referencing the character of the underlying property they promote a general consistency of character between property and derivatives to which that property relates (a "look-through" or "transparency" rule).

On reflection, we favor retaining the "look-through" approach that is found in Sections 1234(a) and 1234B and applying it equally to those derivatives that are presently addressed only by Section 1234A. While not always true under current law, it seems to us that consistency of character between derivatives and their underlying property is desirable as a general matter. It seems logical to us, for example, that a dealer in a particular type of property should generally have ordinary treatment with respect to contracts in that property entered into in connection with its dealing business even if it is not in fact a dealer in those contracts. Put another way, if the underlying property bears such a relation to the business of the taxpayer as to generate ordinary gain or loss upon a disposition of such property, it is reasonable to treat gain or loss from the a disposition of a derivative with respect to such property as ordinary as well.

We are aware that this approach would change the existing treatment of gains and losses from the disposition of certain derivatives. For derivatives other than options and securities futures contracts addressed by Section 1234(a) and 1234B, respectively, a taxpayer that is a dealer in property[95] but not in derivatives on that property can at present only get ordinary treatment with

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[94] Section 1234A(1) only performs this function for derivatives with respect to property that is capital in the taxpayer's hands, while the other listed sections also apply to ordinary property.

[95] One issue raised by both current law and the expanded "look-through" approach presented by the option we present is that a particular category of underlying property may potentially have ordinary or capital character in the taxpayer's hands depending on the circumstances involved. For example, a dealer in securities can, by identification, treat certain securities as capital assets not held in connection with the taxpayer's business as a securities dealer. See Section 475(b). This potential ambiguity could be addressed in regulations, perhaps through default rules or a contemporaneous taxpayer identification requirement similar to that in the hedging transaction rules.

respect to derivatives treated as hedges. Under the option we present, derivatives on that property would generally be ordinary whether or not they meet the threshold necessary to be a hedging transaction.[96]

We also considered the proper treatment of the disposition of positions that are obligations to the taxpayer, which can arise both when the contract is bilateral (as in the case of a swap) or unilateral (as in the case of an option written by the taxpayer). We believe that dispositions of these derivatives (including by assignment) should be treated in a manner that is consistent with that applying to dispositions of derivatives that are assets to the taxpayer at the time of their disposition. That way, a taxpayer entering into both long and short positions on similar derivatives will have gain and loss of a similar character.

Option for Consideration

Under the option, Section 1234A would be amended to provide that the character of any gain or loss attributable to the disposition or termination (by lapse, cancellation or in any other manner) of a right or obligation with respect to property shall be the same as the character of any gain that would have resulted from a sale of the underlying property. For example, if a taxpayer's sale of property underlying a right or obligation would produce capital gain, then gain or loss attributable to the disposition or termination of that right or obligation would be capital gain or loss. Similarly, if a taxpayer's sale of property underlying a right or obligation would produce gain described in Section 1231, then gain or loss attributable to the disposition or termination of such right or obligation would be Section 1231 gain or loss.[97]

Section 1234A would also be amended to provide that the character of any gain or loss attributable to the disposition or termination of a right or obligation other than with respect to property (e.g., a heating degree-day swap) shall be the same as the character of any gain that would have resulted from a sale of the right or obligation.

The rules in new Section 1234A would be intended as default rules; they would not be intended to override more specific rules that apply to particular items based on the status of the taxpayer (e.g., Section 475) or on particular characteristics of a given product (e.g., Sections 988 or Section 1256). Moreover, they are not intended to override existing common law doctrines, such as the assignment of income doctrine (which, in general, relates to a transfer of the taxpayer's right to income rather than a transfer of property), that can affect the character of income or loss

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[96] We also considered the opposite situation, i.e., where the underlying property is (or would be) a capital asset in the taxpayer's hands even though a contract on that property would (but for the recommended rule) be ordinary because, for example, the taxpayer is a dealer in such contracts. In fact, current law Sections 1234 and 1234B contain exceptions for certain contracts that are ordinary in the taxpayer's hands, and a similar provision could be added to our proposed Section 1234A. Our belief is that this situation is likely to be infrequent, because a dealer in contracts on a type of property will often deal in the underlying property; moreover, Section 475 will require ordinary treatment in the case of securities dealers and electing commodities dealers in any event.

[97] The Service may wish to consider whether an instrument should be deemed to be disposed of in the case where there the taxpayer has remaining rights or obligations with respect to the instrument but those rights or obligations are not substantial. We are not aware that this has been a significant issue under current Section 1234A.

recognized on the disposition of an interest in a financial instrument.[98] While those doctrines are worthy of study in their own right, we believed that they were beyond the scope of this proposal.

2. Repeal redundant portions of Section 1233

Present law

Section 1233 provides rules addressing the character (and in one case the timing) of gain or loss realized from short sale transactions and put options. Section 1233(a) provides that gain or loss from the closing of a short sale is capital in character if the underlying asset is a capital asset. Section 1233(h) provides that gain is realized with respect to a short position when the underlying property becomes substantially worthless.

Short-against-the-box holding period coordination

Sections 1233(b) and (d) provide holding period coordination rules for short against the box situations (*i.e.*, situations where a single taxpayer is simultaneously long and short the same stock). Under Section 1233(b)(1), gain from closing a short sale is short term to the extent the taxpayer held substantially identical property with a short term holding period at any time while the short sale was outstanding. Under Section 1233(d), loss from closing a short sale is long-term to the extent the taxpayer held substantially identical long-term property at the time the short sale position was entered into. Finally, under Section 1233(b)(2), if a long position has not attained a long-term holding period at the time a corresponding short sale is entered into, the holding period of the long position is eliminated and begins to accrue again only when the short sale is closed. Where there are multiple long positions with short-term holding periods, this rule is applied on a first-in, first-out basis.

Significantly, the short-against-the-box holding period coordination rules[99] apply by their terms only to short-against-the-box positions not governed by the straddle rules of Section 1092.[100] Until 2004, short-against-the-box positions were excluded from the straddle rules and therefore most short-against-the-box situations were addressed by Sections 1233(b) and (d). In 2004, Congress broadened the scope of the straddle rules to include short-against-the-box positions where the stock was actively traded.[101] Under current law, short-against-the-box positions in actively traded stock established on or after October 22, 2004, are governed by the

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[98] Similarly, this proposal is not intended to override existing doctrines that may affect the treatment of life insurance contracts. Under Rev. Rul. 2009-13, 2009-21 I.R.B. 1029, the Service ruled that the surrender of a life insurance contract by the insured gave rise to ordinary income. Without explanation, the Service stated that the conclusion was not changed by Section 1234A. The Service also ruled that the sale of the contract by the insured gave rise to ordinary income in part under the "substitute for ordinary income" doctrine.

[99] Section 1233(b) and (d).

[100] *See* Section 1233(e)(2)(A).

[101] American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 888(c)(1) (amending Section 1092(d)(3) to treat as a straddle a transaction in which a taxpayer holds actively traded stock and an offsetting position). *See also* Erika Nijenhuis, "Have Straddles Swallowed Short Sales?," in *Examining the Straddle Rules After 25 Years*, 125 Tax Notes 1301, 1308-09 (2009); Dale S. Collinson & Michael E. Bauer, *Modern Taxation of Short Against the Box Transactions*, 113 J. Taxation 268, 269 (2010).

holding period rules of Treasury Regulations Section 1.1092(b)-2T and not by Sections 1233(b) and (d). Sections 1233(b) and (d) only apply to (i) short-against-the-box positions established prior to October 22, 2004 and (ii) short-against-the-box positions in stock that is not actively traded (if any).

The short-against-the-box holding period coordination rules of Sections 1233(b) and (d) and the straddle holding period coordination rules of Treasury Regulations Section 1.1092(b)-2T work similarly in situations where a taxpayer's entire long position is offset by a short position. In situations where there are multiple-cost lots and less than the entire long position is covered by the open short position, the two sets of rules operate differently. The short-against-the-box holding period coordination rules of Sections 1233(b) and (d) operate to ensure that the open short sale is "stacked" against the long positions in the manner that is least favorable from a holding period perspective. If a taxpayer holds lots with both long-term and short-term holding periods, loss generated from closing the open short sale position is long-term (to the extent of the long-term lots), even where the loss is generated by delivering the short-term lot to close the short sale. Similarly, gain generated from closing the short sale is short-term (to the extent of the short-term lots), even where the gain is generated by delivering the long-term lot to close the short sale. Under the straddle rules, by contrast, a taxpayer holding more long positions than open short sale positions can identify the short position with a subset of the long positions, thereby ensuring that it receives the same long-term or short-term character as the position it is identified with even if there are other long positions with a different holding period profile. The Sections 1233(b) and (d) rules provide for the least favorable answer; the straddle rules provide for the identified answer.

Put options under section 1233 and the "married put" rule

Under the flush language of Section 1233(b), a purchased put option is considered a short sale (i) for purposes of classifying gain realized from the settlement of the put and (ii) for purposes of determining the holding period of the underlying long position. Thus, gain from the settlement of the put is short-term, and if the long position does not have a long-term holding period at the time the put was acquired its holding period is eliminated and does not begin to accrue while the put is held. The so-called "married put" rule of Section 1233(c) excepts from Section 1233(b) situations where the long position and the put option are acquired on the same day, provided the two positions are identified with each other and, if the put is exercised, it is exercised by delivery of the identified long position.

Significantly, Section 1233(b) has not applied to put options with respect to actively traded stock since the straddle rules were amended in 1984 to include within their scope most stock-put option positions where the stock is actively traded.[102]

Hedging transactions in commodities futures

Section 1233(g) excludes from the scope of Section 1233 hedging transactions in commodities futures. Given the hedging transaction rules of Section 1221(a)(7), this provision is basically redundant.

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[102] Treas. Reg. Section 1.1092(b)-2T(d) provides a narrow exception for purposes of a now-repealed special provision previously applicable to regulated investment companies. The exception provides support for the general non-applicability of Section 1233(b) to these transactions.

Reasons for change

Section 1233 has largely been supplanted by the straddle rules as a result of their 2004 expansion. Section 1233(b) through (g) are essentially dead letter provisions, and their repeal would simplify and improve the Code.

Option for Consideration

Under this option, Section 1233(b) through (g) would be repealed.[103]

3. Treat financial hedges as deemed to be identified as tax hedges

Present law

Special hedging rules have applied to certain business hedges since 1981,[104] when Section 1256 was enacted. Under Section 1256, described in more detail in section II.C.1 of this submission, Section 1256 contracts that are hedging transactions are not subject to the mark-to-market and 60/40 capital gain and loss rules that would otherwise apply to them.[105]

Under case law in a number of Federal courts prior to 1988, business hedges generally were treated as giving rise to ordinary, rather than capital, gain or loss. In 1988, the U.S. Supreme Court rejected this interpretation in *Arkansas Best v. Commissioner*.[106] In response to that decision, Treasury regulations were issued in 1994 to provide for ordinary character for business hedges and to provide timing rules requiring that gains or losses on hedging transactions be taken into account in a manner that matches the income or loss from the hedged item or items. The Tax Relief Extension Act of 1999[107] amended Section 1221 to exclude a hedging transaction from the definition of a capital asset and to provide a definition of a hedging transaction.

In language that is based on the definition of a hedging transaction that was in Section 1256(e)(2), as enacted in 1981, Section 1221(b)(2)(A) defines "hedging transaction" as "any transaction entered into by the taxpayer in the normal course of the taxpayer's trade or business primarily (i) to manage risk of price changes or currency fluctuations with respect to ordinary property which is held or to be held by the taxpayer, (ii) to manage risk of interest rate or price changes or currency fluctuations with respect to borrowings made or to be made, or ordinary obligations incurred or to be incurred, by the taxpayer, or (iii) to manage such other risks as the Secretary may prescribe in regulations."

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[103] Certain definitional or operational provisions in Section 1233(e) would be preserved to the extent needed for application of the remaining provisions of Section 1233.

[104] Other tax provisions recognize the special nature of hedging transactions in a variety of contexts. For example, issuers of tax-exempt bonds may take into account the results of qualified hedging transactions in determining the yield on their bonds under the arbitrage bond regulations (Treas. Reg. § 1.148-4(h)), investors and issuers may integrate certain hedges with qualified debt instruments (Treas. Reg. § 1.1275-6), and investors and issuers may integrate a non-functional currency debt instrument and one or more qualified hedging transactions (Treas. Reg. § 1.988-5(a)).

[105] Section 1256(e).

[106] 485 U.S. 212 (1988).

[107] Pub. L. No. 106-170.

Identification requirement and consequences of failure to identify

As originally enacted in 1981, the definition of a hedging transaction in Section 1256(c) required that "before the close of the day on which such transaction was entered into . . . the taxpayer clearly identifies such transaction as being a hedging transaction."[108] The legislative history for this provision indicated in general that "regulations should allow taxpayers to minimize bookkeeping identification requirements in as many cases as practical," particularly where opportunities for manipulation are minimal.[109]

The regulations issued under Section 1221 also contain a requirement that a hedging transaction be identified as such by the close of the day on which the taxpayer enters into the transaction, reflecting similar language in Section 1221(a)(7). An early preamble describes the objectives of the identification requirement as aiding the Service in administering the law and preventing manipulation, "such as recharacterization of transactions in view of later developments."[110] Under the Section 1221 regulations, "[t]he identification of a hedging transaction for financial accounting or regulatory purposes does not satisfy this requirement unless the taxpayer's books and records indicate that the identification is also being made for tax purposes."[111]

Under the Section 1221 regulations, if a taxpayer fails to properly identify a transaction for which it has no reasonable basis to treat as other than a hedging transaction, the Service can treat gain from the transaction as ordinary. Conversely, loss from a transaction that is a hedging transaction but is not so identified is treated as capital unless the failure to identify was due to "inadvertent error" and certain other conditions are met.[112]

Hedge timing

Regulations under Section 446 (the "hedge timing rule") govern the timing of gain or loss resulting from a hedging transaction.[113] Under this rule, the timing of recognition of gain or loss on a hedging transaction must generally match the timing of gain or loss on the hedged item.[114] The hedge timing rule applies to any transaction that is a hedging transaction whether or not it has been identified as such for purposes of Section 1221.[115] Although these hedge timing regulations

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[108] Section 1256(e)(2)(C).

[109] Staff of the Joint Committee on Taxation, *General Explanation of the Economic Recovery Act of 1981*, 300 (1981).

[110] T.D. 8493, 1993-2 C.B. 255. This concern was particularly evident in the context of stock investments, where uncertainty as to treatment led to taxpayers' treating losses as ordinary and gains as capital. Under the Section 1221 regulations, stock holdings may not be hedging transactions, so their treatment is now clear. Treas. Reg. § 1.221-2(d)(5)(i).

[111] Treas. Reg. § 1.1221-2(f)(4)(ii).

[112] Treas. Reg. § 1.1221-2(g)(2).

[113] Treas. Reg. § 1.446-4.

[114] Treas. Reg. § 1.446-4(d).

[115] Treas. Reg. § 1.446-4(a); Rev. Rul. 2003-127, 2003-2 C.B. 1245.

also contain additional recordkeeping and identification requirements, compliance with them does not appear to be a prerequisite for application of the hedge timing rule.[116]

Special considerations for Section 1256 contracts

In connection with the 1999 amendments to Section 1221 to codify the separate treatment of business hedges, the separate definition of a hedging transaction in Section 1256(e)(2) was replaced by a cross-reference to the definition in Section 1221(b)(2)(A). However, 1256(e)(2) retains its own same-day identification requirement, without any provision for an inadvertent error exception.[117] In a situation where the inadvertent error exception applies for purposes of the application of Section 1221, the character of gain or loss on the Section 1256 contract will be ordinary, but it is not clear whether the hedge timing regulation applies to override the mark-to-market timing rule of Section 1256. The hedge timing rule provides that it overrides any inconsistent timing rule in another regulation,[118] but the Section 1256 mark-to-market timing rule is statutory. The result of a failure to override the statutory rule would be mark-to-market timing and ordinary character.

Financial accounting for hedging transactions

In parallel with the tax rules applicable to hedging transactions, similar financial accounting rules for hedges have developed over time. In June 1998, the Financial Accounting Standards Board (FASB) issued Statement No. 133 (Accounting for Derivative Instruments and Hedging Activities), which has since been amended on several occasions. For financial accounting purposes, "derivatives" (which can include certain elements embedded in a "host" contract[119]) are assets or liabilities for financial accounting purposes and, if not designated as a hedging instrument or not meeting the requirements for hedge accounting, are generally required to be held at fair value.[120]

The standards for treating a hedge as such for financial accounting purposes are generally higher than those for hedging transaction treatment under the tax rules: a financial accounting hedge must be "highly effective" in offsetting the hedged item, as demonstrated by prospective and ongoing quantitative analyses.[121] In contrast, a hedging transaction for tax purposes must merely "manage" risk.[122]

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[116] A willful failure to keep required records may result in penalties under Section 7203.

[117] Treas. Reg. § 1.1256(e)-1(c) provides that an identification made for purposes of Section 1221 will also serve as an identification for purposes of Section 1256. If a taxpayer shows that it inadvertently identified a transaction as a hedging transaction as permitted by the Section 1221 regulations, the transaction will also be treated as not having been identified for purposes of Section 1256. Finally, a Section 1221 identification that does not satisfy all of the detailed identification requirements of the Section 1221 regulations will nevertheless be treated as an identification under Section 1256.

[118] Treas. Reg. § 1.446-4(a).

[119] FASB ASC No. 815-15-15-01.

[120] FASB ASC No. 815-10-10-1(b).

[121] *See, e.g.,* Finnerty, John D., and Dwight Grant, "Testing Hedge Effectiveness Under SFAS 133," The CPA Journal, Apr. 2003, available at http://www.nysscpa.org/cpajournal/2003/0403/features/f044003.htm.
(...continued)

For financial accounting purposes, two primary types of hedging transactions are recognized: cash flow and fair value hedges. Cash flow hedges are transactions structured to reduce the variability of cash flows due to changes in rates or prices (*e.g.*, a floating-to-fixed interest rate swap), and the portion of the changes in their fair value that is effective as a hedge is allocated to other comprehensive income ("OCI") and then reclassified into earnings during the period in which the variability of the hedged item impacts earnings. Fair value hedges are transactions structured to reduce exposure to changes in the fair value of an asset or a liability (or a portion thereof) that is attributable to a particular risk (*e.g.*, a fixed-to-floating interest rate swap), and fluctuations in their fair value are recognized currently into earnings along with similar fluctuations in the hedged item. Like the tax rules applicable to hedging transactions, the hedge accounting rules have the effect of aligning the income recognition of a derivative used as a hedging transaction with that of the hedged item.

While the financial accounting rules applicable to each type of hedge vary, both require companies to formally document the hedging transaction at its inception. This documentation must include, inter-alia, formal documentation of the hedging relationship and the entity's risk management objective and strategy for undertaking the hedge, as well as identification of the hedging instrument, the hedged item, the nature of the risk being hedged, and how the hedging instrument's effectiveness will be assessed.[123] These documentation requirements parallel the detailed identification requirements in the Section 1221 regulations and, like those requirements, are intended to prevent companies from using hindsight in establishing treatment of a transaction.[124]

Reasons for change

The rules for financial accounting hedges and tax hedges both serve to match the treatment of the hedge with the hedged item whose risk it manages, and both require contemporaneous identification in order to avoid determinations made in hindsight. Because of the more stringent requirements for financial accounting hedges, most financial accounting hedges of a risk enumerated in Section 1221(b)(2)(A) will also meet the risk management standard for a tax "hedging transaction." As a result, transactions identified by a taxpayer as financial accounting hedges that are eligible for hedging transaction treatment should also in most instances be treated as tax hedges: their timing should match the hedged item and their character should be ordinary.

The rule that hedging transactions must be separately identified for tax purposes and that an identification for financial accounting purposes is insufficient has created tax uncertainty in numerous cases in which the facts clearly establish that the primary purpose of a transaction is to hedge one of the risks enumerated in Section 1221(b)(2)(A). Responsibility for hedging transactions is often lodged with accounting personnel who do not immediately advise their tax department colleagues that a hedging transaction has occurred. That a separate identification may be required for tax purposes is not intuitive.

(continued...)

[122] Section 1221(b)(2)(A).

[123] FASB ASC No. 815-20-25-3.

[124] ASC 815 recognizes that without concurrent designation, "an entity could retroactively identify a hedged item, a hedged transaction, or a method of measuring effectiveness to achieve a desired accounting result." *Id.*

Relatively little formal guidance exists with respect to the inadvertent error exception. While in practice the facts will often support the availability of the inadvertent error exception, it should be unnecessary to undertake the required analysis in a case in which the taxpayer's hedging purpose for entering into the transaction is clearly established by its accounting treatment.

During the period of initial development of the tax hedging rules, the financial accounting standards for hedging transactions were also in a developmental stage. Currently, those standards are relatively stable, and the financial accounting identification requirements for hedging transaction are clear and detailed, leaving little uncertainty about whether a transaction has been identified as a hedge for financial accounting purposes. As a result, these identifications would serve the same purposes the tax identification requirement is intended to serve: aiding the Service in administering Section 1221, and preventing manipulation by the taxpayer.

Because Section 1256 contains no inadvertent error exception, there is significant uncertainty about the proper timing treatment of Section 1256 contracts, such as foreign currency contracts, that serve as hedging transactions for tax purposes but were not identified as tax hedges. If these contracts are required to be marked to market because the hedge timing rule does not override the timing rules of Section 1256, the timing of recognition of gain and loss on these contracts will not match the timing of the hedged item, resulting in a distortion of income.

Option for Consideration

A transaction would be treated as meeting the hedge identification requirement under Section 1221[125] if the transaction qualifies as a hedging transaction for tax purposes, is identified as a hedging transaction for financial accounting purposes, including the requirement that the hedge be identified at inception. Under the option, the taxpayer's treatment as a hedge for financial accounting purposes would also satisfy the separate identification and recordkeeping requirements under the hedge timing regulations.

The option addresses only the separate identification requirement. A transaction identified as a hedging transaction for financial accounting purposes would be treated as a hedging transaction for tax purposes only if it was a hedging transaction as defined in Section 1221(b)(2)(A).

For identified financial accounting hedges, a taxpayer would be permitted to make a specific identification out of hedging treatment for tax purposes by the end of the day of the transaction, in which case the transaction would not be treated as a hedge for tax purposes unless the taxpayer has no reasonable basis for treating the transaction as other than a hedging transaction for tax purposes. A failure to identify out of tax hedge treatment in this manner would not preclude the taxpayer from taking the position that the transaction is not a hedging transaction for purposes of Section 1221(b)(2)(A) if it can support such a position, but the taxpayer would no longer have the benefit of the presumption that the transaction should not be treated as a tax hedge under Section 1221.[126]

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[125] Because of a statutory cross-reference, adoption of the proposal could affect the application of a special hedging rule applicable to REITs. *See* Section 856(c)(5)(G)(i). Consideration should be given to whether the modification of the identification requirements should also apply for purposes of that rule and other special hedging rules.

[126] The purpose of the proposal is to relieve taxpayers from the burden of showing that the failure to make a separate hedging tax identification was due to inadvertent error in cases in which the transaction is identified as a hedge for accounting purposes and the transaction clearly (...continued)

A taxpayer would not be precluded from making a separate tax identification, whether or not the transaction is identified as a hedging transaction for financial accounting purposes.

The separate Section 1256 identification requirement would be eliminated so that a transaction that qualifies as a hedging transaction under Section 1221(b)(2)(A) would also qualify as a hedging transaction under Section 1256(e)(2).

4. Repeal of Section 1236

Present law

Section 1236 provides rules addressing the character of items of gain and loss with respect to securities in the hands of a securities dealer. Under Section 1236(a), capital gain treatment is limited to securities that (i) at the time of their acquisition, are "clearly identified in the dealer's records" as held for investment and (ii) at no time were held for sale to customers (*i.e.*, included in securities inventory). Under Section 1236(b), ordinary loss treatment is limited to (i) securities afforded ordinary treatment under Section 582(c) (generally debt securities held by banks and other financial institutions), and (ii) securities that have never been identified as held for investment. Regulations define a "securities dealer" for purposes of Section 1236 as a "merchant of securities" "regularly engaged in the purchase of securities and their resale to customers."[127]

Reasons for change

In 1993, Congress enacted Section 475 to provide comprehensive timing and character rules for securities in the hands of securities dealers. The Section 475 definitions of "securities" and "securities dealers" are broader than those of Section 1236. All Section 1236 securities are Section 475 securities, but not vice versa, and all Section 1236 dealers are Section 475 dealers, but not vice versa.

Section 475 prevents character manipulation by dealers (the same policy concern of Section 1236) by a similar mechanic. If a security is held for sale to customers (*i.e*, a security described in Section 475(a)(1)), gains and losses from it are ordinary under 1221(a)(1). If a security is held by a dealer but is not technically inventory (*i.e.*, a security described in Section 475(a)(2)), the dealer must identify the security in or out of its mark-to-market book under Section 475(b)(1). If the security is included in the mark-to-market book, gain or loss in respect of it generally would have ordinary character under Section 475(d)(3). If the security is excluded from the mark-to-market book, gain or loss with respect to it would have character determined without regard to Section 475—usually capital.

Section 475's rules are adequate to prevent character whipsaws. There is no need to apply the largely overlapping rules of Section 1236 in situations where both technically apply. Under current law, a failure to synchronize Section 475 and Section 1236 identification statements can result in inappropriate character whipsaws. Accordingly, Section 1236 represents a trap for

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(continued...)

falls within the definition of a hedging transaction for tax purposes. If there is concern that taxpayers may seek to game the system by claiming a transaction is not a hedging transaction when it results in gain rather than loss, which should be possible only when the qualification of the transaction as a tax hedging transaction under Section 1221(b)(2)(A) is not clear, taxpayers could be required to meet a higher standard in such cases

[127] *See* Treas. Reg. § 1.1236-1(c)(2) (cross-referencing Treas. Reg. § 1.471-5).

the unwary and a compliance burden for taxpayers without a corresponding tax policy benefit. Repealing it would simplify and improve the Code.

Options for Consideration

Under the option, Section 1236 would be repealed.

C. Mark-to-Market of Financial Transactions

1. Rationalize Section 1256

Present law

Gains and losses from the taxable sale, exchange, disposition or deemed disposition of property generally are capital, except for a dealer in the property, in which case they are ordinary.[128] Capital gain or loss generally is long-term if the property was held for more than one year, subject to various limitations, and otherwise is short-term.[129] Capital losses generally can be carried back three years and carried forward for five years in the case of a corporation, while other taxpayers may not carry back capital losses but may carry them forward indefinitely.[130]

Special rules apply to gains and losses with respect to "Section 1256 contracts." Any gain or loss with respect to a Section 1256 contract, including gain or loss on the termination or transfer of a Section 1256 contract, is subject to a mark-to-market rule and generally is treated as long-term capital gain or loss, to the extent of 60 percent of the gain or loss, and short-term capital gain or loss, to the extent of the remaining 40 percent of the gain or loss (the "60/40 rule"), regardless of the taxpayer's actual holding period for the contract. A taxpayer other than a corporation may elect to carry back its net Section 1256 contracts loss for three taxable years to offset Section 1256 gains in those years.[131] In the case of an options dealer or commodities dealer, net capital gain from dealing in or trading Section 1256 contracts is treated as included in net earnings from self-employment subject to tax under Section 1401.[132]

When Section 1256 was enacted in Section 1981, its mark-to-market rule was based on constructive receipt principles, because taxpayers that entered into the only contracts to which Section 1256 applied (futures contracts traded on U.S. commodities exchanges) are subject to rules under which daily "variation margin" is paid or received by each party to the contract, in cash, in an amount equal to the change in value of the contract from the prior business day. Because any cash received generally may be withdrawn and used by the taxpayer, the concerns about valuation and liquidity of daily gains and losses that often are cited as reasons for the use of a realization method of accounting were not considered a bar to imposing mark-to-market

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[128] *See* Section 1221(a)(1) (excluding stock in trade, inventory and other property held primarily for sale to customers in the ordinary course of business from the definition of "capital asset").

[129] Section 1222.

[130] Section 1212(a)(1) (corporations) & (b)(1) (other taxpayers).

[131] Section 1212(c).

[132] Section 1402(i).

accounting on these contracts. However, Section 1256 was soon expanded to apply to other contracts that are not subject to daily variation margin requirements for both parties to the contract.

The 60/40 rule appears to have been intended to provide relief to taxpayers previously not subject to mark-to-market tax accounting rules for futures contracts.[133] The net loss carryback rules and self-employment tax rules create a special regime for Section 1256 traders that bears some resemblance to the rules that ordinarily apply to taxpayers engaged in an operating business.

Section 1256 generally applies to any (i) regulated futures contract, (ii) foreign currency contract, or (iii) nonequity option, as those terms are defined by Section 1256. Regulated futures contracts and nonequity options are traded on commodities exchanges while foreign currency contracts are traded in the over-the-counter market. In addition, in the case of dealers therein, these rules also apply to any (4) dealer equity option and (5) dealer securities futures contract.[134] Taxpayers may elect to have Section 1256 not apply to a Section 1256 contract that is part of a "mixed straddle" or a "hedging transaction."[135] In addition, Section 1256 does not apply to any interest rate swap, credit default swap or certain other specified swaps and similar agreements.[136]

Special rules also apply under Section 475 to dealers in securities, dealers in commodities, and traders in securities or commodities. Dealers in securities, including derivative financial instruments on equities, debt instruments or currencies, are required to mark their securities positions to market and to treat any gain or loss thereon as ordinary, unless the position is held for investment or, with respect to the character of gain or loss, the position is not held in connection with the taxpayer's activities as a dealer in securities.[137] For this purpose, a Section 1256 contract is not treated as a "security" unless it hedges a security.[138] Dealers in commodities and traders in securities or commodities may elect similar mark-to-market and ordinary treatment.[139] Section 1256 contracts are included in the term "commodities" for this purpose.[140] Consequently, under Section 475 dealers and traders in commodities that elect mark-to-market treatment for their commodities positions treat Section 1256 contracts on commodities in the same way as other commodities derivatives, i.e., as giving rise to ordinary gain or loss, while dealers and electing traders in securities treat Section 1256 contracts on securities as giving rise to ordinary gain or loss only if the contract hedges a security.

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[133] We note, however, that relief for the traders that had been using straddles to zero out their income was provided by an out-of-Code installment payment mechanism in Section 509.

[134] Section 1256(b)(1). For this purpose, an options dealer is defined as a market maker or specialist in listed options. Section 1256(g)(8). In the case of securities futures contracts, members of an exchange that regularly provide two-way (bid and ask) quotations for securities futures contracts qualify as dealers. *See* Section 1256(g)(9)(B); Rev. Rul. 2004-95, 2004-2 C.B. 493.

[135] Section 1256(d) (mixed straddles) & (e) (hedging transactions).

[136] Section 1256(b)(2).

[137] Section 475(c)(2).

[138] Section 1256(c)(2)(F) & flush language.

[139] Sections 475(e) (dealers in commodities), (f)(1) (traders in securities) & (f)(2) (traders in commodities).

[140] Section 475(e)(2)(C).

Reasons for change

In the case of dealers and market makers in Section 1256 contracts, the treatment of gain or loss as capital gain or loss and the application of the 60/40 rules are inconsistent with the Code's general rules. Gain or loss from property held in connection with a dealer's business ordinarily is treated as ordinary, in accordance with the long-standing rule of the Code that ordinary rather than capital treatment is appropriate for taxpayers engaged in the normal course of their business activities. While some may argue that the activities of dealers and market makers in futures and other Section 1256 contracts are closer to those of traders than dealers in stocks, bonds and over-the-counter derivatives, it has long been the law that a taxpayer may be a dealer even if it buys and sells solely on an exchange with other professional market participants.[141] Moreover, the commodities exchanges impose requirements on market makers that do not apply to other traders on those exchanges, and accord them special privileges like lower fees in recognition of their market-maker status.[142] Accordingly, we believe for example that market makers in exchange-traded equity options should be not be treated differently from dealers in over-the-counter equity options.[143]

In the case of other taxpayers, capital gain or loss treatment generally is appropriate. We believe, however, that consideration should be given to the scope of mark-to-market treatment for contracts that are traded on exchanges and, pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"),[144] on swap execution facilities, or that are cleared through clearinghouses, in order to develop a more coherent framework for determining when a contract should be marked to market for tax purposes. In addition, we believe that 60/40 treatment should be repealed, as the transition considerations that apparently animated its adoption should have dissipated since it is now 30 years after Section 1256 was enacted.

Under current law, there are many discontinuities in the scope of mandatory mark-to-market rules for non-dealers that enter into a derivative financial instrument. For example, broad-based equity index options traded on an exchange are subject to Section 1256, but single stock or narrow-based equity options traded on an exchange are not. Contracts traded on a regulated securities or commodities exchange are automatically treated as Section 1256 contracts if they otherwise fall within the Section 1256 contract definition, while similar contracts traded on other exchanges are treated as Section 1256 contracts only at the Service's discretion.

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[141] *See Helvering v. Fried*, 299 U.S. 175 (1936) (specialist on New York Stock Exchange, all of whose customers were other members of the exchange, was a dealer in stock and entitled therefore to use the inventory method of accounting for its stock positions); Rev. Rul. 60-321, 1960-2 C.B. 166 (specialist on stock exchange is a dealer and may use LIFO inventory method to value his securities).

[142] *See, e.g.*, http://www.cmegroup.com/trading/interest-rates/files/NewIRMarketMakerProgramAnnouncement.pdf (announcement of market maker programs for certain exchange-traded options, and related rebates of exchange fees).

[143] Similarly, there is no policy reason why dealers in exchange-traded equity options are subject to 60/40 capital gain or loss treatment, while traders in equity options must elect ordinary treatment under Section 475(f) to benefit from marking those positions to market, for example in order to eliminate the need to defer losses under the straddle rules of Section 1092.

[144] Pub. L. No. 111-203 (2010).

These discontinuities arise in part because of the split regulatory framework for securities and commodities. More generally, however, they are the result of the development of many new types of exchange-traded contracts and new types of markets on which financial instruments are traded since 1981. For example, the commodities exchanges have continued to develop new contracts for trading on their exchanges, some of which are now largely indistinguishable from contracts not traded on exchanges.[145] Another example is that there are now markets for trading derivative financial instruments, including regulated markets, that do not fall within the definition of a "qualified board or exchange" for Section 1256 purposes.[146] The changes to derivatives markets now under way as a result of Dodd-Frank will create further discontinuities in tax treatment between similar instruments, as a result of the requirement to clear certain categories of swaps. It is difficult to draw rational lines between over-the-counter interest rate swaps, cleared interest rate swaps, futures with interest rate swap payment terms, and futures contracts whose settlement payment is based on the terms of an interest rate swap, all of which exist today in the market.

The lack of coherence in the tax rules for Section 1256 contracts also is the result of changes in the law. As noted above, the enactment of Section 1256's mark-to-market rules was based on constructive receipt principles, but Section 1256 now applies to financial instruments that are not subject to two-way variation margin requirements (*e.g.*, certain equity options), and to financial instruments that are not subject to any mandatory margin requirement (*e.g.*, foreign currency contracts). Conversely, Section 1256 does not apply to interest rate and credit default swaps that are subject to two-way variation margin requirements, although those requirements differ in some important respects from variation margin payable on futures contracts.[147] While each of these rules has a rationale, as a whole the rules are not coherent and should be rethought.

The 60/40 rule results in a blended rate for gains and losses on Section 1256 contracts that is significantly lower than the rate for short-term capital gains and losses. We are aware of no policy reason to provide preferential treatment for these gains and losses. Lower capital gains rates are intended to encourage long-term investments in capital assets such as stock. Whatever the merits of extending preferential rates to derivative financial instruments generally, we do not believe that there is a policy basis for providing those preferential rates to taxpayers who have not made such long-term investments. Furthermore, the fact that traders choose to make elections to mark their securities and commodities to market under Section 475, at the cost of ordinary income taxation, suggests that no special rate inducements need be provided for traders on commodities exchanges.

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[145] For example, the OMX exchange offers a futures contract on interest rate swaps that provides for periodic fixed-versus-floating payments identical to those of over-the-counter interest rate swaps.

[146] *See Sesco Enterprises, LLC*, 2010-2 USTC ¶ 50,733 (concluding that the Service has complete discretion to decide whether markets for trading electricity futures contracts regulated by the Federal Energy Regulatory Commission are "qualified boards or exchanges" for Section 1256 purposes and that taxpayer cannot sue to force the Service to make such a determination).

[147] Under current clearinghouse rules, the variation margin system for cleared swaps is not identical to the variation margin system for other contracts. Notably, interest is paid on variation margin for cleared swaps, so that it functions more like a loan than a payment to the margin recipient.

Options for Consideration

Dealers and market makers

In order to conform the treatment of dealers and market makers in Section 1256 contracts to the treatment of dealers in other similar derivative financial instruments, an option for consideration is to amend Section 1256 so that it does not apply to dealers and market makers. A correlative change would be to amend Section 475 to require mark-to-market and ordinary treatment for dealers and market makers in such contracts, similar to the rules that apply to dealers in securities.[148] In the case of Section 1256 contracts with respect to equities, debt instruments and currencies, the rules for dealers in securities can be modified to treat such contracts as securities. In the case of Section 1256 contracts on commodities and other risk positions, additional modifications to Section 475 would need to be made in order to mandate mark-to-market and ordinary treatment for such contracts. If these options are adopted, the special rules treating net capital gains of options market makers and commodities dealers as subject to self-employment income should be repealed or revised so that such dealers' income is subject to self-employment tax in the same way as other self-employed taxpayers. Similarly, the special loss carryback rules for Section 1256 losses would no longer apply to these taxpayers, but the normal net operating loss rules of the Code would be applicable. Because these taxpayers are actively engaged in the day-to-day activities of their businesses, the new 3.8 percent tax imposed by Section 1411 should not apply to their income from dealing in futures and other contracts subject to mark-to-market treatment, as long as the income is derived from their activities as dealers.

Non-dealers

A threshold question is whether contracts like futures contracts traded on a commodities exchange should be subject to mark-to-market treatment. We agree with Congress's determination in 1981 that mandatory mark-to-market for futures contracts was appropriate, in light of (i) the daily receipt or payment of cash margin that economically functions like a payment on the contract, and (ii) the ability to obtain a reliable valuation of the contract on a daily basis. Other attributes of futures contracts that support mark-to-market treatment are (iii) the fact that futures contracts provide for a single bullet payment,[149] generally at a near-term maturity,[150]

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[148] Section 475 provides for ordinary income treatment if securities are held in connection with the business of dealing in securities. Similar rules presumably would apply to these contracts.

The special rules of Section 1221(a)(6) and (b)(1)(B)(i) that provide that commodity derivative financial instruments, other than Section 1256 contracts, generally do not constitute capital assets if held by a commodities derivatives dealer, also should be amended to remove the reference to Section 1256 contracts.

[149] The lack of periodic payments on a futures contract, as compared for example to an interest rate swap contract, means that mark-to-market gain or loss reflects a single payment that will be fixed only at maturity, rather than a payment that accrues over time, and thus avoids potentially difficult questions about how to take accrued time value of money amounts into account. For example, if the payor on the fixed leg of an interest rate swap were to recognize a capital loss at the end of year 1 because fixed rates exceed floating rates and the swap therefore was out-of-the-money to that taxpayer, and subsequently floating rates dropped with the result that in year 2 the taxpayer received rather than made a periodic payment on the swap, the same economic term of the swap – the obligation to pay fixed and the right to receive floating rates – would have given rise to a capital loss and ordinary income.

and (iv) the fact that taxpayers may close out a futures contract at any time and thus fix their gain or loss.[151] Accordingly, we propose no change to Section 1256(a)(1) (mark to market) or Section 1256(a)(2) (corresponding adjustments) as they apply to futures contracts.

An option for consideration would be to cause contracts with similar terms to be subject to mandatory mark-to-market treatment. (For ease of discussion, we refer to any such contracts as "MTM contracts.") The identification of contracts that are sufficiently similar to contracts that satisfy all of the requirements described above depends on which of those criteria are considered the most critical. For example, it may be desirable for different rules to apply to long-term contracts that provide for periodic payments, like interest rate swaps, than to short-term bullet payment contracts like futures contracts. However, a distinction of this kind raises issues similar to those considered by Congress in 1984 when it expanded the scope of Section 1256 to include options to enter into futures contracts in order to eliminate potential whipsaw or arbitrage between such options and the underlying futures contracts, because an exchange-traded option or future to enter into or make a settlement payment determined by reference to such a swap presumably would be a MTM contract. Accordingly, an alternative approach might be to treat any contract that satisfies criteria (i), (ii) and (iv), or any contract to enter into such a contract, as an MTM contract. A further question would be whether to treat only exchange-traded or cleared contracts as MTM contracts, or to apply similar rules to contracts in the over-the-counter market with similar characteristics.

Mandatory mark-to-market rules for financial instruments that are capital assets raise a number of ancillary issues, including, if the 60/40 rules are repealed, how to determine the holding period of gains and losses once the contract has been in existence for more than one year. There is no precedent for addressing this issue. Another issue to be considered is whether to continue the special loss carryback rule for net capital losses from Section 1256 contracts to alleviate the capital loss limitation rules for active traders in Section 1256 contracts. A third question is whether to modify the treatment of taxpayers that enter into Section 1256 contracts for hedging purposes.

In the case of holding period, we do not believe that it is desirable to develop a system under which the holding period of gain or loss on a MTM contract changes once the contract has been held for more than one year. First, treating only post-one-year gains or losses as long-term gains or losses does not reflect our current approach to long-term capital gain/loss treatment, which treats all gain or loss recognized after the one-year mark as eligible for favorable rates in the hands of individual taxpayers. Second, because mark-to-market treatment in part reflects the

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[150] When a contract has a short term, the lag between the date on which the taxpayer recognizes gain (or loss) under a mark-to-market regime and the date on which the taxpayer's right to that gain (or obligation to pay the loss) is permanently fixed is short. Consequently, concerns about the impermanence of mark-to-market gains and losses are mitigated. The amount of difference between the mark-to-market gain/loss and the final gain/loss is also less likely to be significant when the contract is short-term rather than long-term.

[151] If a taxpayer cannot terminate a contract prior to its maturity without the consent of another party, requiring the taxpayer to pay tax on mark-to-market gain, or permitting the taxpayer to deduct mark-to-market losses, may be less appropriate. How significant the existence of a right to terminate at any time should be as a basis for subjecting a contract to mark-to-market treatment is open to debate, however, as taxpayers can sell a stock or bond position at any time, and the constructive receipt doctrine does not apply if a taxpayer must surrender a material economic benefit, like the potential for future gain, in order to obtain cash.

fact that the taxpayer could readily close out the contract and enter into a new one, applying different holding period rules to MTM contracts that are actually closed out and reentered into and MTM contracts that a taxpayer continues to hold does not seem to have a compelling policy logic, and would invite arbitrage. Third, treating pre-one-year and post-one-year gains and losses differently could give rise to short-term capital loss/long-term capital gain, or short-term capital gain/long-term capital loss, from the same contract, which could give rise to either a tax advantage or tax disadvantage to any particular taxpayer on a random basis. Any attempt to adjust for those results is likely to be complex. Finally, under current law most contracts that would be MTM contracts are short-term in any event, so developing a novel system for addressing post-one-year gain or loss would have limited effect. Accordingly, an option would be to treat all capital gain or loss from a MTM contract as short-term capital gain or loss.

If the options discussed above to repeal 60/40 treatment and treat all MTM contract capital gains and losses as short-term capital gains or losses are adopted, then the timing rules for taxpayers that speculate through the use of MTM contracts will be disfavored compared to taxpayers that use other types of financial instruments in several ways. First, because MTM contracts are marked to market, taxpayers cannot delay the recognition of their capital gains. Moreover, they may recognize capital gains in one year and capital losses in the next year from the same contract, with the potential result that they must pay tax in the first year without being able to deduct the loss in the second year. The option discussed above of retaining the special loss carryback rule for losses from Section 1256 contracts would address the second of these and consequently alleviate the effect of the first.

On the other hand, most contracts to which Section 1256 applies today are short-term contracts. A contract that is entered into and closed out in the same taxable year is properly taxed on a current basis on the resulting gains and losses. Retaining the special loss carryback rule for Section 1256 losses thus provides more relief than may be necessary to alleviate the potential whipsaw that can arise if a taxpayer holds a MTM contract over year-end. Moreover, taxpayers that are concerned about their ability to deduct losses from MTM contracts can make a Section 475 election.

On balance, we believe that the option of retaining the special loss carryback rule has merit in view of the unusually harsh results that can arise from mandatorily marking contracts that may give rise to capital losses to market. However, the option of limiting the carryback period to one year should be considered in view of the generally short-term nature of most current Section 1256 contracts.

In the case of taxpayers that use Section 1256 contracts as a hedge of another position, like a bond portfolio, existing law provides some relief, but imperfectly. Under current law, a taxpayer may elect for Section 1256 not to apply to a Section 1256 contract if the contract is part of a "mixed straddle" (Section 1256(d)) or a "hedging transaction" (Section 1256(e)). We believe that the hedging transaction rules work well, subject to the discussion of Section 1256(e) in section II.B.3 of this submission. They allow taxpayers that use MTM contracts to which those rules apply to avoid the acceleration of MTM gains, the capital loss limitation rules, and deferral of MTM losses under the straddle rules under circumstances where MTM creates a mismatch between the hedged item and the hedge. However, those rules apply only to hedges of ordinary assets or liabilities. Taxpayers that hedge capital assets, for example by hedging a bond portfolio held for investment, may suffer from similar concerns but lack a comparable matching rule to alleviate them. An option to better deal with this issue would be to replace the mixed straddle rule, which is difficult to apply because of uncertainty about when it is available and the restrictive nature of its identification rules, with a rule that allows taxpayers to elect to treat MTM contracts as not subject to Section 1256 if the contracts and the assets they hedge would be within the scope of the hedging transaction election if the assets were ordinary assets. In particular, this rule would incorporate upfront identification requirements similar to those currently required for hedging transactions, in order to prevent taxpayers from making determinations with the benefits of hindsight.

2. Broaden the scope of Section 475(f)

Present law

Under Section 475(f), a taxpayer that is a "trader" in securities (or commodities) can elect to recognize income and loss on its securities or commodities activities on a mark-to-market basis. To be eligible for the election the taxpayer must be engaged in a trade or business as a "trader" (a "trader business") in the year the election is made.[152]

The election applies to all securities (or commodities) that have some "connection" with the trader business. A taxpayer may exclude from its mark-to-market election (by a date-of-acquisition identification statement) only those securities (or commodities) "having no connection" to the activities of the taxpayer as a trader.[153]

If the election is properly made and the securities (or commodities) included in the election are properly identified, the securities are accounted for on a mark-to-market basis for tax purposes.[154] The character of all gain or loss is ordinary.[155]

Reasons for change[156]

Section 475(f) was enacted because Congress believed that, with respect to market-traded property, a mark-to-market tax accounting method represented a clear reflection of income and was not easily manipulated.[157] From the perspective of an electing trader, the mark-to-market method was viewed as desirable, notwithstanding that all income is taxed at ordinary rates and in some instances accelerated, because the trader has relative simplicity and certainty of treatment, avoids having unusable capital losses, and generally avoids the sometimes harsh consequences of the straddle and wash sale rules.[158]

Although Section 475 does not define "trader," the term has been defined in cases addressing whether a non-corporate taxpayer may take above-the-line deductions under Section 162 for expenses, such as brokerage fees, that relate to the taxpayer's transactions in securities.

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[152] Section 475(f)(1)(A) & (f)(2).

[153] Section 475(f)(1)(B).

[154] Section 475(f)(1)(A).

[155] Section 475(f)(1)(D).

[156] For ease of reading and because much of the relevant authority applies to securities transactions, this discussion will refer generally to securities and not to commodities. However, as noted below, this proposal is intended to apply equally to commodities as defined by Section 475.

[157] *See, e.g.*, House Ways and Means Committee Report, Description of Revenue Reconciliation Bill, reprinted at 97 T.N.T. 118-23 (June 13, 1997) ("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.").

[158] *See, e.g.*, Lee A. Sheppard, *News Analysis: Making Traders Mark to Market*, 97 TNT 154-5 (Aug. 11, 1997) ("Ordinary treatment recommends itself to traders who would rather not be subject to capital loss limitations, as well as the loss deferral rules of sections 1091 and 1092.").

Perhaps motivated by concerns about permitting individual taxpayers who dabble in securities trading to deduct things like home offices and newspaper subscriptions, courts addressing the issue have adopted stringent requirements – in particular, a very high volume of annual trades – for "trader" classification.[159] As a result, many investment funds and other taxpayers whose annual securities trading volume is quite substantial, including corporate entities not concerned about the Section 162 deduction issue that fueled the "trader" cases, may nonetheless fall below the standard required for trader status.

Moreover, because of the fact-specific nature of the analysis, the determinations as to (i) whether and when a taxpayer's activities as a whole rise to the level of a trader business and (ii) whether and when a particular security position bears a sufficient connection with a trader business are often difficult to make with certainty and can vary from year to year. For a taxpayer that may be but is not clearly a trader under the relevant case law – or that holds securities that are not clearly connected to its trading business – the stakes of judgments can be high because the mark-to-market method and the realization method can provide such different results.[160]

Although they engage in a lower annual volume of securities transactions, these "near traders" often have the preference for certainty and simplicity in tax treatment, and the same concerns about the straddle and wash sale rules and capital losses, as do taxpayers that are undoubtedly Section 475 traders.

From the government's perspective, permitting these taxpayers to mark their securities holdings to market, where those securities are publicly traded or otherwise subject to a robust method of establishing valuation, should provide a clear reflection of income in the same way the method does for traders, assuming the election must be made in advance (as is currently true for traders) and that any concerns about selectivity among securities positions can be addressed. Under these circumstances, the government should not be disadvantaged because it cannot generally be known in advance whether mark-to-market treatment will result in more or less tax than the realization method.[161] In fact, many commentators have argued that mark-to-market accounting is, as a policy matter, the most appropriate treatment for securities and derivatives whose values are easily measureable.[162]

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[159] *See, e.g., van der Lee v. Comm'r,* T.C. Memo. 2011-234, Sept. 29, 2011 (taxpayer not a trader despite 159 trades during the year); *Moller v. United States*, 721 F.2d 810 (Fed. Cir. 1983) (holding that taxpayers who engaged in 100-125 trades a year and devoted 40-42 hours per week to trading did not have a trade or business).

[160] In proposed regulations, the Service has asserted that it can, upon examination, move securities out of an electing trader's mark-to-market book if it determines the securities have "no connection with" the trading activities. *See* Prop. Treas. Reg. § 1.475(f)-2(a)(5). In theory, the Service could use this authority to flip the character of losing investments to capital (and timing to realization) even though, had the taxpayer made a profit on the investment, the taxpayer would have been required to account for it as ordinary income (with mark-to-market timing).

[161] As under current Section 475(f), there may be circumstances, for example in connection with a wasting asset, in which it would be appropriate for Treasury to provide an exception to mark-to-market treatment to prevent abuse. *Cf.* Section 475(c)(4), exempting certain trade receivables from mark-to-market treatment.

[162] *See, e.g.*, David S. Miller, *A Progressive System of Mark-to-Market Taxation*, 109 Tax Notes 1047 (2005) (arguing that mandatory mark-to-market accounting of derivatives for large companies and wealthy individuals would improve economic efficiency, fairness and tax abuse (...continued)

Assuming it is appropriate to expand the category of taxpayers eligible for Section 475(f), a question arises as to whether any minimum securities trading volume should be necessary for eligibility. While it would be possible to come up with a test that has a lower threshold than is presently applicable, the Committee believes that there is no clear reason why the election should not be available to holders of securities in general as long as their securities valuations are reliable and they are not permitted to mark to market certain securities and not others.

Options for Consideration

An option for consideration would be to repeal the trader business requirement for a Section 475(f) election. To eliminate the need for identifications and the risk of cherry-picking, the election would apply to all eligible securities (or commodities) held by the electing taxpayer, regardless of when acquired.[163] Losses incurred as a result of marking these securities (or commodities) to market would give rise to above-the-line deductions under Section 162.

Under this option, Section 475(f) would continue to reference the definition of securities in Section 475(c)(2) and the definition of commodities for electing commodities dealers in Section 475(e)(2).[164] Consideration could be given to limiting the scope of the Section 475(f) mark-to-market election to a specified subset of securities (or commodities) that are eligible for mark-to-market treatment in the hands of dealers. In particular, the Section 475(f) election could be limited to securities (or commodities) that are publicly traded or whose end-of-year mark-to-market value is reported in an audited financial statement for the year in which the security (or commodity) is acquired.

Transitioning into Section 475(f) mark-to-market treatment

Under the option discussed above, an electing taxpayer (including a trader) would be required to mark to market all of its securities (or commodities) for changes in value occurring after the date of election. It is necessary to have transition rules to address the built-in gain or loss that exists as of the date of election. There are three basic approaches. First, the built-in gain or loss as of the date of the election could be treated as a Section 481(a) adjustment.[165] Second, the

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prevention); Hearing on Derivatives Before the Subcommittee on Select Revenue Measures of the House Committee on Ways and Means, 110th Cong. 17-26 (March 5, 2008) (statement of Alex Raskolnikov, Professor, Columbia Law School) (recommending that all derivatives be subject to mark-to-market tax accounting).

[163] Consideration should be given by Treasury to the proper treatment of securities held by related taxpayers and whether in some instances they should also be required to be marked to market to prevent abuse, which is also an issue under current law.

[164] Because the proposal does away with the trader nexus, it may be appropriate to revisit whether certain assets that heretofore were unlikely to be held in direct connections with a trader business and therefore were unlikely to be marked by an electing trader are appropriately treated as Section 475(c)(2) securities. For example, interests in partnerships that hold only securities and/or variable annuity contracts could be considered securities under the "derivative" prong of the current definition. *See* Section 475(c)(2)(E). It may be appropriate to exclude these types of securities from the election.

[165] *Cf.* Rev. Proc. 99-17, 1999-1 C.B. 503 (under current Section 475(f), electing traders take into account built-in gain or loss as a Section 481(a) adjustment).

net built-in gain or loss could be taken into account immediately under a deemed sale-and-repurchase model.[166] Third, the net built-in gain or loss could be taken into account under a so-called mark-and-freeze methodology where the built-in gain or loss is computed on an asset-by-asset basis and taken into account when those assets are eventually disposed of.[167] A fourth model might be to require net gain to be taken into account currently and net loss to be spread over some period of years.

Character of transition gain or loss must also be considered. Regardless of when the built-in gain or loss is taken into account, the character of the individual items comprising the built-in gain or loss ought to be determined by reference to a hypothetical sale or exchange of the securities (or commodities) as of the effective date of the election.[168] It may be desirable to have an exception to this general rule for gain or loss attributable to debt instruments that are not distressed. With debt of this type, gain or loss realized upon the transition arguably should be ordinary (even if a sale as of the date of election would have produced a capital item) in order to match the character of future accruals and/or mark-to-market adjustments to the character of the built-in gain or loss. For example, consider an electing taxpayer with a portfolio of debt instruments held as capital assets and purchased and carried at par but trading at a premium. If a Section 475(f) election is made, a built-in gain will be computed and taken into account. Going forward the securities would produce a loss (or bond premium deductions) equal to the built-in gain. To match the character of the built-in item to the inevitable reversal, the built-in item arguably ought to have ordinary character.

D. Other Options

1. Modernize Section 1091

Present law

The wash sale rules prevent a taxpayer from generating deductible losses with respect to stock, securities and certain related transactions if the loss arises in a transaction in which the taxpayer, broadly speaking, has not meaningfully changed its economic position within a specified period before and after the realization of the loss.

The principal operative provision applies when stock or securities are sold at a loss, and the taxpayer within a 30-day period before or after the sale date (the "window period") acquires substantially identical stock or securities, or enters into a contract or option to acquire such stock or securities. In such a case, the loss generally is not allowed, the basis of the sold property carries over to the replacement property, with adjustments reflecting any differences between the sale price and purchase price, and the holding period of the sold property also tacks to the holding

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[166] *See, e.g.*, Treas. Reg. §§ 1.1092(b)-3T(b)(6) & -4T(c)(5) (requiring built-in gain or loss on positions placed in identified mixed straddles and identified mixed straddle accounts to be recognized currently).

[167] *See, e.g.*, Section 475(b)(3).

[168] This is a change from current law. Under Rev. Proc. 99-17, 1999-1 C.B. 503 (Feb. 9, 1999), an electing trader treats the built-in gain or loss as a section 481(a) adjustment that has ordinary character, regardless of whether a sale of the assets immediately before the election would have produced capital gain or loss.

period of the replacement property.[169] Special rules apply if the amount of replacement property acquired is more than, or less than, the amount of loss property sold, under which generally a "first in time" rule applies.[170] The term "stock or securities" includes contracts or options to acquire or sell securities. The wash sale rules were amended in 2000 in order to apply the rules to securities futures contracts and other cash-settled contracts.[171]

The wash sale rules also apply to a loss realized on the closing of a short sale if within the window period substantially identical stock or securities are sold, or another short sale of stock or securities was entered into.[172] These rules apply to dispositions and acquisitions of short positions in securities futures contracts.

Reasons for change

The wash sale rules date from the 1920's. While they have been amended from time to time in recent decades, they do not capture the full spectrum of transactions that raise wash sale issues. There are also a number of technical issues with the wording of the wash sale rules that should be resolved.[173]

In their current form, the wash sale rules operate as a relatively narrow, bright line set of rules. They are narrow because they apply primarily when property acquired by the taxpayer is identical, or substantially identical, to property sold by the taxpayer.[174] The bright line nature of the rules makes them arbitrary, on the one hand, but administrable, on the other hand. Modernization of the wash sale rules could be accomplished by adopting a different, broader approach, that would disallow losses even when taxpayers make a more meaningful change to their economic position. Alternatively, it could be accomplished within the current narrow framework by making only targeted "fixes" to current gaps and uncertainties in the rules. Because the wash sale rules generally are viewed as having achieved their intended effect, in an administrable way, for those transactions to which they apply, the proposals below are based on the second approach.

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[169] Section 1091(a) (loss disallowance); Section 1091(d) (basis carryover); Section 1223(3) (holding period).

[170] Section 1091(b) & (c); Treas. Reg. § 1.1091-1(c) & (d). Under these rules, if a taxpayer sells 100 shares of stock at a loss, and within the window period carries out more than one transaction in which it acquires or enters into a contract or option to acquire that stock, generally the acquisition transactions are matched with the sold shares in the order in which they were entered into.

[171] Section 1091(f).

[172] Section 1091(e).

[173] The concerns described in this paragraph have been discussed in a number of articles, including Lucy W. Farr & Michael S. Farber, *Dirty Linen: Airing Out the Wash Sale Rules*, Tax'n Fin'l Prods 41 (Summer 2002); Erika W. Nijenhuis, *Wash Sales Then and Now*, Tax'n Fin'l Prods 43 (Fall 2003); David Schizer, *Scrubbing the Wash Sale Rules*, 82 Taxes 67 (2004).

[174] By comparison, a number of other rules of the Code come into effect if a taxpayer takes a position that is "substantially similar or related property" to stock held by the taxpayer. *See* Section 246(c)(4)(C); Section 901(k); Section 1(h)(11).

Stock or securities

The wash sale rules apply to losses realized on the sale or other disposition of "stock or securities," including contracts or options to acquire or sell stock or securities. The terms "securities" and "contracts or options to acquire or sell" are not defined for this purpose, and no consistent definition has emerged from case law or the Service's ruling practice. Thus, there is uncertainty as to the scope of the rules, for example with respect to equity swaps. Moreover, wash sale issues may be raised by transactions in financial instruments that are not treated as "stock or securities," such as transactions in commodity derivatives or in exchange-traded equity of a publicly traded partnership like a master limited partnership.

In addition, the wash sale rules by their terms apply only if the taxpayer "acquires," or enters into "a contract or option so to acquire," replacement property, thus limiting the types of replacement transactions that trigger the wash sale rules. For example, a call option written by a taxpayer is not an option acquired by the taxpayer and is not an option to acquire property.[175]

Contract or option as replacement property

The treatment of contracts or options to acquire stock or securities as transactions that trigger the operation of the wash sale rules is potentially too broad. The wash sale rules properly apply if a taxpayer sells stock and within the window period enters into a contract or option to acquire the same stock that is likely to be exercised, because the taxpayer will be in the same economic position before and after the sequence of transactions if it acquires the stock by exercise of the option. If the option is unlikely to be exercised, however, the taxpayer has materially changed its economic position and is unlikely to reacquire the stock, raising questions about whether it is appropriate for the wash sale rules to apply. Moreover, if the taxpayer first purchases an out-of-the-money option and then within the window period repurchases the stock (not pursuant to the option), the taxpayer may be able to deduct the original loss when the option expires if the form of the transaction is respected and the taxpayer's basis in the sold property carries over to the option.

In addition, it is not certain how the wash sale rules should apply if a taxpayer sells a stock or security at a loss and then enters into a contract or option to acquire a basket of stocks or securities that include the loss property sold. For example, a taxpayer may take the position that if it sells XYZ stock at a loss, and within the window period enters into an equity swap on a basket of stocks including XYZ, the transaction is not subject to the wash sale rules if the basket as a whole differs substantially from XYZ stock.[176]

Short positions

The wash sale rules apply if a taxpayer closes a short sale or terminates a short securities futures contract position and replaces it with another short sale or short securities futures contract

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[175] *See* T.A.M. 7730002 (Apr. 14, 1977) (entry into written call option is not a wash sale).

[176] *Cf.* Treas. Reg. § 1.246-5(c)(1) (for purposes of rules limiting the availability of the dividends-received deduction, a position that reflects the performance of a basket of 20 or more stocks generally is not "substantially similar or related property" to any one stock held by the taxpayer as long as the basket does not substantially overlap with the stock).

position. The rules do not specifically refer to other types of short positions, such as the purchase of a put option or entering into a forward contract to sell securities.[177]

Substantially identical standard

The meaning of the "substantially identical" standard is articulated in regulations and in case law.[178] Under the leading case in the area, two assets are substantially identical where there is an "economic correspondence [between them] exclusive of differentiations so slight as to be unreflected in the acquisitive and proprietary habits of holders of stocks and securities."[179] This standard, which is based on whether as a real-world matter taxpayers ordinarily consider the two assets to be functionally identical, generally has provided sufficient guidance, particularly when considered with a number of authorities that have applied the standard to specific facts.[180] Accordingly, the wash sale rules apply to prevent taxpayers from harvesting losses when they have made no meaningful change to their economic position.

There are circumstances, however, where it is not clear how the standard should be applied. One such case is where the taxpayer disposes of, or acquires, an interest in multiple stocks or securities at the same time. For example, if a taxpayer sells an S&P 500 index mutual fund and within the window period buys an S&P 500 index mutual fund from another fund group, under current law the transaction may or may not be a wash sale. Another case is when the assets disposed of or acquired constitute derivative financial instruments. For example, if a taxpayer disposes of an option on stock at a loss, and purchases another option on the same stock, perhaps with a different strike price or expiration date, no guidelines exist to determine whether the two options are "substantially identical."[181]

Options for Consideration

Stock or securities

An option would be to expand the term "stock or securities" to include derivative financial instruments, including derivative instruments relating to underlying risks other than stock

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[177] *Cf.* Section 1233(b), flush language (acquisition of an option to sell property at a fixed price treated as a short sale for section 1233 purposes), section 1233(c) (limiting the scope of section 1233(b)). Section 1233(b) generally is thought to have been superseded by the straddle rules of section 1092. See section II.B.2 of this submission.

[178] *See* Treas. Reg. § 1.1233-1(d)(1); *Hanlin v. Commissioner*, 108 F.2d 429 (3d Cir. 1939).

[179] *Hanlin*, 108 F.2d at 430.

[180] As applied by those authorities, it is relatively rare for two assets to be treated as substantially identical. *Compare* Rev. Rul. 77-201, 1977-1 C.B. 250 (convertible preferred stock is substantially identical to underlying common stock where preferred stock trades as common stock equivalent) and *Margaret E. Kidder*, 30 B.T.A. 59 (1934) (non-voting trust certificates were substantially identical with the underlying stock) *with Seymour H. Knox*, 33 B.T.A. 972 (1936) (stock of an operating company was not substantially identical to the stock of a holding company whose sole asset was the stock of the operating company).

[181] G.C.M. 38285 (Feb. 22, 1980) recommended issuing a ruling that options identical in all respects other than strike price should be treated as "substantially identical." This rule, however, was never included in any published guidance.

or debt. For example, the wash sale provision could be expanded to cover transactions in commodity derivatives and other liquid financial instruments. One possible approach would be to redefine the scope of the wash sale rules so that they apply to any "security" within the meaning of Section 475(c)(2) (without regard to Section 475(c)(2)(F)) or any "commodity" within the meaning of Section 475(e)(2) (without regard to Section 475(e)(D)), other than any security or commodity that is marked to market for tax purposes, whether mandatorily or by taxpayer election. Treasury should have authority to expand the scope to other derivative financial instruments and evidences of interest therein.[182] It should not matter for this purpose whether the instrument is one that is "acquired" or otherwise entered into.

If this option is adopted, corresponding changes will need to be made to the basis and holding period rules to ensure that the wash sale rules continue to apply effectively as deferral, rather than disallowance, provisions.[183]

Contract or option as replacement property

While the conceptual basis behind the contract or option rule is not entirely consistent with the premise that the wash sale rules should apply only when a taxpayer has not materially changed its economic position, in practice the rule generally is well understood and easy to apply. Moreover, it serves to discourage taxpayers from entering into wash sales by eliminating their ability to retain the potential for increases in value in the sold stock or security during the window period. Accordingly, we believe that only limited changes to this rule are necessary. As an initial option for consideration, the term "contract or option to acquire" might be replaced or modified to make clear that entering into a notional principal contract or other derivative financial instrument that does not provide for a taxpayer to "acquire" the underlying asset but that provides "long" exposure to a sold asset will trigger the wash sale rules if entered into within the window period. An additional option would be to grant Treasury explicit authority to disregard an out-of-the-money option if it is entered into primarily for the purpose of allowing a loss from the sale of stock or securities to be deducted that would otherwise be subject to the wash sale rules.

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[182] This proposal is made to address the fact that the statutory definitions of "security" and "commodity" may not clearly capture every type of risk on which derivative financial instruments are written. For example, a weather swap is not a "security" and may not be a "commodity."

[183] Under current law, it is not certain whether the basis of sold property carries over to a contract or option to acquire that property, as a result of the way that Section 1091(d) is phrased (basis of sold stock or securities carries over to *substantially identical stock or securities* acquired). The Service has also taken the position that basis does not carry over to a taxpayer's investment in an IRA when a taxpayer sells stock at a loss and repurchases it in its IRA. Rev. Rul. 2008-5, 2008-3 I.R.B. 271. We believe that basis always should carry over to replacement property. Accordingly, Section 1091(d) should be revised to make that result clear. A similar change should be made to the holding period rule of Section 1223(3).

Rev. Rul. 2008-5 also raises a larger issue, which is whether Section 1091 should apply to transactions between related parties. That function is principally carried out today by Section 267, and, in the case of sales between partners and partnerships, Section 707. However, Sections 267 and 707 can operate to disallow a loss permanently, while the wash sale rules merely defer the loss. We suggest that consideration be given to expanding the scope of Section 1091 to sales of loss property to a related party, and correspondingly narrowing the scope of Sections 267 and 707.

In the case of a contract or option on a basket of stocks or securities, another option would be to give Treasury the authority to determine when the wash sale rules should apply. In general, we think that the rules for applying the "substantially identical" standard of the wash sale rules should be no broader than the "substantially similar or related property" test applicable for purposes of Section 246, since "substantially identical" is a more difficult standard to meet than "substantially similar or related property."

Short positions

As an additional option for consideration, the wash sale rules should apply to losses derived from any short position, including short derivative financial instruments in commodities, in parallel with the scope of the proposed expansion of the wash sale rules to losses from long positions.[184] Accordingly, a loss from the termination of a short position of any kind would be disallowed if a taxpayer acquires or enters into a substantially identical short position.[185] The wash sale basis and holding period rules should be revised to make clear how they apply in the case of losses from short positions.

Because section 1091(e) currently does not apply when a taxpayer closes out a short position and enters into a new short position other than a substantially identical new short sale or short securities futures contract, and because the wash sale rules are intended to apply to transactions in which taxpayers do not materially change their economic position, we do not propose to add the equivalent of a "contract or option to acquire" provision to the wash sale rules for short positions. We are not aware of any abusive transactions involving the closing of a short sale and entering into a non-substantially identical replacement position. However, Treasury should have authority to provide rules to address any abuses that may materialize.

Substantially identical standard

As described above, while the *Hanlin* standard as supplemented by later cases and rulings generally provides sufficient guidance, there are a number of circumstances for which the application of the standard should be clarified.

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[184] In addition, Section 1091(e)(1) should be repealed as surplusage. The legislative history of that provision is sparse, but a description of its purpose is provided in James W. Wetzler, *The Tax Treatment of Securities Transactions Under the Tax Reform Act of 1984*, 25 Tax Notes 453, 469-70, 472-73 (1984). According to the Wetzler article, Section 1091(e)(1) was enacted to address certain short-against-the-box transactions that were closed out in a manner that straddled the end of the taxable year, which under prior law allowed a taxpayer to recognize a loss in one year and an offsetting gain in the following year under certain circumstances. Section 1091(e)(1) is no longer necessary to defer the loss as a result of subsequent changes to the law. If the taxpayer closes out both positions in the same year, Section 453(k)(2) now generally provides that both gain and loss on such transactions must be taken into account in the first year. If instead a taxpayer were to close out only the loss position in the current year and hold the gain position until the following year, the straddle rules would defer the loss. Thus, in either case the gain and loss would be taken into account in the same year.

[185] If Section 1091(e) is expanded in this manner, it would be possible for both Section 1091(a) and Section 1091(e) to apply to some transactions, for example the disposition of a purchased put option at a loss followed by the purchase of a substantially identical put option, since a purchased put option on stock is a "security" and would presumably also be treated as a short position. We recommend that only one subsection of Section 1091 apply to such transactions.

Stock of one company ordinarily is not treated as substantially identical to stock of another company, unless one is convertible into the other and the relative values, price changes and other circumstances are such that they trade as essentially the same stock.[186] Moreover, generally there is no "look-through" to the assets of a corporation.[187] Under these rules, stock of one mutual fund generally is not treated as substantially identical to the stock of another mutual fund. In the case of actively managed mutual funds, where performance and fees may vary substantially even for funds in the same sector, that result is consistent with the general "substantially identical" standard. In the case of passive index funds, however, a different rule may be appropriate as it is less likely that investors perceive significant differences between them.

In the case of derivative financial instruments, there is very little law on how to determine when financial instruments other than debt or stock are considered substantially identical to each other – for example, when a change to the terms of a swap, forward or option is sufficiently immaterial that the modified instrument should be treated as not differing materially in kind or extent from the unmodified instrument. It is also difficult to analogize from the standards that apply to debt or stock because the ways in which financial instruments differ from each other do not necessarily correspond to the variances between different debt instruments or shares—for example, there is no analogy to the strike price on an option – and even when there are similar legal differences they may not have the same economic significance.

Accordingly, as an additional option for consideration, the expansion of the wash sale rules with respect to derivative financial instruments might be coupled with a grant of authority to Treasury to determine when such an instrument is substantially identical to another such instrument or to the underlying asset. In addition, if this option is adopted, we urge that legislative history provide guidance to Treasury in formulating its rules, which could describe factors that Congress expects would or would not be taken into account and provide some examples in order to illustrate Congressional intent. Legislative history of this kind would also be important in order to enable taxpayers to comply with the law prior to the issuance of regulations. The legislative history of Section 1259 would be a useful model for legislative history in this area.

In our view, the overall standard for determining whether two derivative financial instruments are substantially identical to each other should be the same – that is, whether investors ordinarily view the instruments as essentially identical – as it is under current law. We believe that the value of the instrument and important terms such as the underlying asset, the maturity of the instrument and, in the case of options, the strike price of the option and whether the option is in- or out-of-the money, are factors that typically would be taken into account in determining whether two financial instruments are substantially identical as an economic matter.[188]

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[186] Treas. Reg. § 1.1233-1(d)(1); Rev. Rul. 77-201, 1977-1 C.B. 250.

[187] *Seymour H. Knox*, 33 B.T.A. 972 (1936).

[188] Other factors such as liquidity and embedded leverage do not seem relevant to the policies of the wash sale rules.

Whether to take into account the identity of the counterparty is a more difficult issue, as credit risk is a material risk for derivative financial instruments. However, unlike the case of a debt instrument, the primary drivers of a derivative's value will be its underlying reference property and its contractual terms (e.g., strike price), at least outside the case where the counterparty is distressed. Accordingly, for non-debt financial instruments credit risk should not be relevant unless there is a "change in payment expectations" as provided in Treas. Reg. § 1.1001-3(e)(4) for debt instruments. Under an approach of this kind, if a taxpayer terminates an (...continued)

Because the bright line nature of the wash sale rules is important to their administrability, it is important to provide examples or safe harbors even if they do not cover every case. For example, if a taxpayer enters into a rolling series of one-month forward contracts on a commodity, each contract relates to a distinct period of time. When contract #1 is about to expire, one would not expect an investor to view that contract as similar to contract #2 maturing a month later.[189] A loss on contract #1 therefore should not be disallowed under the wash sale rules. On the other hand, if a taxpayer has a position in a long-dated swap, and replaces it today with another long-dated swap with a different maturity, the distant nature of the maturity date makes the change in maturity less significant.[190]

Options are more complex instruments than instruments like forwards, futures or swaps that provide complete "upside" and "downside" exposure to the underlying asset. Options have more variables affecting their value, so that devising a precise test for options is challenging. Very generally, the value of a conventional option is determined by reference to (a) whether the strike price for the option (generally, the price at which a holder of the option may buy or sell the underlying property) is greater or less than the current fair market value of the underlying property,[191] and (b) the remaining term of the option,[192] because both of those factors affect the likelihood that the option will be exercised. Thus, the relative strike prices and maturities of options are generally significant in determining whether investors consider them to be

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interest in an option written by Dealer X at a loss, and replaces it with an identical option written by Dealer Y, and both Dealer X and Dealer Y are creditworthy financial institutions, the wash sale rules would apply. *Cf.* Temporary Treas. Reg. § 1.1001-4T (assignment of derivative financial instrument from one dealer to another does not give rise to deemed exchange, subject to certain conditions that do not include an evaluation of credit risk). *But cf.* Corn Products Refining Co., 16 T.C. 395 (1951) (holding that corn futures contracts were not substantially identical in part because "it would be purely accidental if the new contract was with the same party as the one who had agreed to sell the commodity in the earlier contract"). If however Dealer X were Lehman and the termination was the result of Lehman's bankruptcy, the wash sale rules would not apply to the loss from terminating the option.

[189] *See* Section 1233(e)(2) (futures maturing in one month not treated as substantially identical to futures maturing in a different month).

[190] *Cf. Hanlin*, 108 F.2d 429 (3d Cir. 1939) (differences in bond call dates or maturities that are many years distant are unlikely to be considered economically significant).

[191] The difference between an option's strike price and the value of the underlying asset is its "intrinsic value." For example, if a taxpayer holds a call option to buy XYZ stock for $100, and the stock is currently trading at $110, the option has $10 of intrinsic value.

[192] The remaining time to maturity of an option affects its "time value." The time value of an option is the difference between the value of the option if purchased or sold today and its intrinsic value. Time value takes into account the possibility that the option will be exercised even if it is not currently in the money. For example, if the option described in note 192 were exercisable tomorrow its time value would be very different from its time value if it were not exercisable for a year, because the closer the option is to the exercise date the less uncertain it is whether the option will be exercised. Time value thus is determined by reference to both remaining time to maturity and how deeply in or out of the money the option is, and is greatest when an option is "at the money" (meaning that its strike price equals the current fair market value of the underlying asset).

substantially identical. Another way to compare options is to ask whether changes in the value of the options as a result of a change in value of the underlying property could be expected to be substantially identical over a wide range of potential changes in value.[193] This change-in-value test may be particularly useful for put options that have strike prices that are substantially higher than, and call options with strike prices substantially lower than, the current fair market value of the underlying property, because options of that kind are more likely to be comparable as an economic matter to an outright long or short position in the underlying property and relatively insensitive to changes in strike prices and maturities.[194] For options that are closer to at-the-money, the change-of-value test ordinarily would not be met unless the strike prices and maturities of the options being compared were very close, which may well be an appropriate result.[195] Whatever the test, it will be important to include either safe harbors or examples in the legislative history so that taxpayers can properly apply the test prior to the issuance of detailed regulatory guidance.[196]

Once a "substantially identical" standard for derivative financial instruments has been formulated, we think that the same standard should be used to determine whether a derivative financial instrument is substantially identical to the underlying stock or security for purposes of the situation where a derivative has been disposed of an the underlying stock or security acquired.[197]

Contract or option concept when sold property is a derivative financial instrument

We have considered at length whether and how the concept that a "contract or option to acquire" sold property triggers the wash sale rule should apply when the sold property is a derivative financial instrument. Under current law, while such a rule applies, it has essentially no effect as a practical matter. For example, a taxpayer that wishes to terminate its interest in an option on ABC stock in order to recognize a loss in the option while retaining exposure to ABC

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[193] More technically, this approach asks whether the delta of the options is similar over a wide range in values. Delta refers to the degree of correspondence between an $X change in the value of the underlying asset and the change in value of the option. It is sometimes used as an approximate surrogate for the probability that an option will be exercised, because an option with a delta close to 1 is virtually certain to be exercised while an option with a delta close to zero is virtually certain not to be exercised.

[194] Any two options on the same underlying property will change in value proportionately to changes in the value of the underlying property (although not necessarily the same proportion), hence proportionately to one another. Thus, measuring whether the change in value remains proportional over a wide range of changes in value is a very useful way to identify options that truly are substantially identical.

[195] Such a test would also have the virtue of being applicable to many types of complex derivatives, not just to simple options.

[196] A possible approach would be to provide that, if the old position and the new position have the same or substantially identical underlying stock or security and have (a) strike prices within X percent of each other and (ii) maturities within Y period of each other, the positions are presumed to be substantially identical.

[197] *Cf.* Rev. Rul. 77-201, 1977-1 C.B. 250 (convertible preferred stock is substantially identical to the underlying common stock if, among other matters, it sells at prices that do not vary significantly from the number of shares of common stock into which it can be converted).

stock may enter into a similar replacement option on ABC stock. If the two options are substantially identical, then the "contract or option to acquire" language is not necessary or relevant to disallow the loss. That is, the transaction is subject to the wash sale rules in the same way that selling ABC stock and then buying ABC stock would be. If the two options are not substantially identical, then under current law the taxpayer is entitled to take the loss, subject to any common law doctrines, because the taxpayer has actually acquired the new option, rather than entering into a "contract or option to acquire" the new option. That is, the "contract or option to acquire" language is not relevant because the taxpayer has not entered into a contract today to acquire the new option in the future; instead, its second transaction is the completed purchase of the new option.[198]

Expanding the wash sale rules to apply when a taxpayer terminates its interest in a derivative financial instrument and enters into the economic equivalent of a "contract or option to acquire" that instrument would be consistent with the rules that apply when sold property is an equity or debt instrument. However, we believe that such a rule in practice would result in disallowing a loss from a derivative financial instrument whenever the taxpayer enters into another derivative financial instrument on the same underlying asset within the window period, even if the new instrument unquestionably gives rise to a materially different risk exposure. This would be a very significant expansion of the wash sale rules, because it would have the effect of writing the "substantially identical" standard out of the statute if the sold property were a derivative financial instrument. On balance, because we are not aware of abuses involving transactions of the kind described in the paragraph above, we do not recommend any option to expand these rules. That is, we believe that the "contract or option to acquire [or other long derivative on the same underlying asset]" standard should apply when the sold property is stock, a security or a commodity, but not when it is a derivative financial instrument. When the sold property is a derivative, we believe that the "substantially identical" standard should apply to test the relationship between the sold property and the acquired property. However, we believe an appropriate option would be to give Treasury authority to expand the rule if necessary to prevent abuse.

2. Modernize and expand Section 1032

Present law

Pursuant to Section 1032, a corporation does not recognize gain or loss on the issuance of its stock.[199] As originally enacted, Section 1032 provided that a corporation would not recognize gain or loss on the "receipt of money or other property in exchange for stock (including treasury stock) of such corporation." The statutory scope of Section 1032 has been expanded over time to cover additional situations, including a corporation's repurchase of options on its stock and transactions involving certain securities futures contracts.[200] In addition, Section 1032 has been interpreted by Treasury and the Service to cover certain additional situations, including the

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[198] Similarly, if a taxpayer today were to close out an equity swap on XYZ stock and then purchase a call option on XYZ stock, we do not believe that the wash sale rules currently would disallow a loss on the swap.

[199] Section 1032(a).

[200] *See* House Report 98-432 (part 2), 98th Congress, 2d Session (1984) (in 1984, Congress added what is now the second sentence of Section 1032(a), without the reference to securities futures contracts); *General Explanation of Tax Legislation Enacted in the 106th Congress* (Apr. 19, 2001) (in 2000, Congress added the reference to securities futures contracts in the second sentence of Section 1032(a)).

issuance of stock in exchange for services,[201] the issuance by a corporation of stock in exchange for shares of its own stock,[202] and the cash settlement by a corporation of a written put option on its stock.[203]

Reasons for change

Commentators have noted that there are a number of uncertainties and inconsistencies in the existing framework under Section 1032.[204] For example, it is not clear whether Section 1032 applies to: (i) the cash settlement by a corporation of a forward contract (whether pursuant to its terms or by negotiated settlement) written on the corporation's stock, (ii) the cash settlement of an option acquired by a corporation with respect to its own stock, or (iii) payments to or by a corporation on a swap or other contract that are determined by reference to the value of the corporation's stock. While the literal statutory language does not appear to address these transactions, common law authorities predating Section 1032's enactment held that transactions by a corporation relating to the corporation's own stock—including certain transactions where no stock was actually issued—were "capital" in nature and did not give rise to income or loss.[205] A number of private rulings have addressed certain of the circumstances discussed above where it is not clear whether Section 1032 applies to the transaction, generally holding that no gain or loss was recognized.[206]

In light of the current uncertainty about whether Section 1032 applies to a specified transaction, a corporation that is in a "loss" position with respect to the transaction might take the position that Section 1032 does not apply, while a corporation that is in a "gain" position with respect to the transaction might take the opposite approach. When amending the scope of Section 1032 in 1984, Congress specifically stated that it intended to limit this type of "whipsaw" against the government.[207]

While a legislative response to this uncertainty could aim to narrow the scope of Section 1032, so that it applied only to actual stock issuances but not to the cash settlement of any derivatives linked to the corporation's stock, such a choice would cause transactions that are economically equivalent to result in very different tax consequences. For example, a corporation that entered into an option to sell its stock, where the settlement mode was at the corporation's

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[201] Treas. Reg. § 1.1032-1(a).

[202] Treas. Reg. § 1.1032-1(b).

[203] Rev. Rul. 88-31, 1988-1 C.B. 302.

[204] *See generally* New York State Bar Association Tax Section, *Report on Section 1032* (June 15, 1999); Michael L. Schler, *Exploring the Boundaries of Section 1032*, 49 Tax Lawyer 543 (1996).

[205] *See, e.g.*, *Illinois Rural Credit Association*, 3 B.T.A. 1178 (1926) (holding that receipt by a corporation of partial payment in subscription for its stock was not taxable income because the payment was to provide capital for the corporation).

[206] *See, e.g.*, P.L.R. 201105030 (Oct. 29, 2010) (holding that a corporation did not recognize gain or loss on the cash settlement of certain outstanding forward contracts on its stock); P.L.R. 200450016 (Aug. 17, 2004) (same); C.C.A. 200832022 (Apr. 23, 2008) (same).

[207] *See* Staff of the Joint Committee on Taxation, *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984*, 161 (Dec. 31, 1984).

election, could physically settle the contract if it appreciated (thereby recognizing no gain under Section 1032) or cash settle the contract if it depreciated (recognizing loss). Alternatively, it would be possible to create a rule that treated the physical settlement of any derivative on a corporation's own stock as a deemed cash settlement coupled with an on-market sale (or purchase) of stock for cash. However, this approach would not only depart from the existing statute and the early case law on the topic, but it would also differ from the treatment of physically settled derivatives on other types of property.

In one of the rulings addressing Section 1032's scope, the Service described "[its] view that Congress did not intend § 1032 to be elective or to be avoided by economically equivalent transactions, and that it should be applied broadly . . . . [T]he overriding principle that is present in the Service's rulings and the history of § 1032 . . . is that when taxpayers engage in transactions that result in a gain or loss that is based on the value of their own stock, § 1032 requires nonrecognition of such gain or loss."[208] We agree with the Service's decision in those private rulings to apply Section 1032 broadly. To promote consistency and the promulgation of clear rules of general application, an option would be to broaden Section 1032 legislatively.

Option for Consideration

In order to limit whipsaw against the government and to promote consistency in the tax treatment of economically equivalent transactions, Section 1032 could be broadened to include income, gain, loss and deduction where such items arise out of (i) an option, forward or futures contract, to the extent such option or contract relates to the corporation's stock, or (ii) any contract or other position to the extent that such items reflect (or are determined by reference to) changes in the value of the corporation's stock.

We note that under current law and even under this possible expansion of Section 1032 significant technical and policy questions would remain regarding the precise scope of Section 1032. For example, consideration should be given to the treatment of derivatives that relate in part to a corporation's stock and in part to some other asset, to the consequences that arise when as the result of a merger or other event a derivative contract no longer relates to the stock of the taxpayer and to the proper timing and character of non-stock linked payments on a complex derivative such as a notional principal contract on a corporation's own stock. We think, however, that these issues are best addressed by Treasury in regulations, and the need for their resolution does not undermine the rationale for expansion of Section 1032 in the manner proposed.

3. Treatment of swap expenses as above-the-line deductions

Present law

A notional principal contract ("NPC" or "swap") is a bilateral contract where one party makes periodic payments determined by applying a rate or formula to a notional amount in exchange for specified consideration.[209] One common example is an "interest rate swap" where one party agrees to make periodic payments determined by applying a fixed rate to the notional principal amount in exchange for periodic payments equal to the product of a floating rate and the same notional amount. Such a swap is commonly referred to as a "fixed-for-floating" interest rate swap.

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[208] C.C.A. 200832022 (Apr. 23, 2008).

[209] *See* Treas. Reg. § 1.446-3(c)(1)(i).

Swaps are often used to manage economic exposures created by assets or liabilities. For example, an entity that invests in floating-rate bonds may borrow at a fixed rate to fund its investments. To better match the interest-rate risk with respect to the borrowing with that of the assets, the entity may chose to enter into a floating-for-fixed swap.

In other cases, swaps are used to gain economic exposure to particular assets. For example, an investor seeking exposure to the S&P 500 stock index can enter into a "total return" swap where the investor makes periodic payments equal to a floating rate applied to a notional amount and receives periodic payments equal to the change in value of an investment in the S&P 500 having an initial value equal to the notional amount.

Regulations under Section 446 provide detailed tax accounting rules for swaps. The net periodic payment in each period is taken into account for tax purposes in the taxable year to which it relates. Non-periodic payments are allocated to the taxable years under detailed rules and, once allocated, adjust the net income or expense for the relevant year. Each swap produces a single item of net income or expense for the year.[210]

If a swap is entered into by an individual or a partnership other than in connection with a trade or business, any net expense item would be a Section 212 expense (expense for the production of income outside of a trade or business). Because swap expenses are not enumerated in Section 62(a), they are below-the-line expenses allowable as itemized deductions. Because swap expenses are not enumerated in Section 67(b), they are miscellaneous itemized deductions subject to the 2% floor on miscellaneous itemized deductions.

Reasons for change

The 2% floor on miscellaneous itemized deductions was enacted as a simplification measure, to relieve taxpayers of recordkeeping obligations and to relieve the Service of enforcement and administrative burdens in respect of items that are typically small and as to which taxpayers are prone to error regarding their deductibility.[211] Examples of investment expenses at which the provision is aimed are investment advisory fees, subscriptions to investment advisory publications, certain attorneys' fees, and the cost of safe deposit boxes.[212]

As bilateral, often multi-year contracts, swaps are very different from the types of expenses for which the provision was intended. First, subjecting losses on swaps to the 2% floor will not meaningfully reduce recordkeeping or auditing burdens, since the Service, in the event of an audit, and the taxpayer will likely need to track items on the swap to determine if there is net income or loss in the first place, and to account for any nonperiodic payments that could affect subsequent years.

More significantly, under current law a taxpayer may recognize income on a swap in some years but suffer non-deductible losses on that same swap in other years, with the result that the taxpayer's overall net income inclusion on the swap does not accurately reflect its economic income—a distortive result at odds with any rational policy. This problem will become more significant if the Service makes final proposed regulations in respect of contingent nonperiodic payments on swaps, because those regulations can, depending upon the particular facts involved,

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[210] *See* Treas. Reg. § 1.446-3(d)-(f).

[211] *See, e.g.*, Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1986.

[212] Treas. Reg. § 1.67-1T(a)(1)(ii).

require "phantom" ordinary inclusions or deductions that can be reversed in subsequent years.[213] In fact, the Service has recognized in the context of contingent payment debt instrument that ordinary losses on a financial instrument should not be treated as miscellaneous itemized deductions by exempting "negative adjustments" on these instruments from the miscellaneous itemized deduction rules.[214]

Outside of the trade or business context (where swap expenses would give rise to an above-the-line Section 162 deduction), swaps are typically entered into in order to (i) manage funding costs and/or (ii) increase or decrease investment exposure to specified assets. The interest expense managed by an interest rate swap is not subject to the 2% floor (see Section 67(b)(1)). Investment losses are also typically capital and therefore above-the-line (see Section 62(a)(3)). Swap expenses are more akin to these expenses than to other common Section 212 expenses described above.

For these reasons, and because there is no affirmative policy rationale for treating them as miscellaneous itemized deductions, an option would be to treat swap expenses as above-the-line deductions.

Option for Consideration

Section 62(a) could be amended to treat swap expenses as above-the-line deductions.

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[213] Prop. Treas. Reg. § 1.446-3(g)(6).

[214] Treas. Reg. § 1.1275-4(b)(6)(iii)(D).

STATEMENT OF HON. ORRIN G. HATCH, RANKING MEMBER U.S. SENATE COMMITTEE ON FINANCE HEARING OF DECEMBER 6, 2011 TAX REFORM AND THE TAX TREATMENT OF FINANCIAL PRODUCTS

WASHINGTON – U.S. Senator Orrin Hatch (R-Utah), Ranking Member of the Senate Finance Committee, today delivered the following remarks during a Joint Senate Finance-House Ways and Means Committee hearing on tax reform and the tax treatment of financial products:

Thank you, Chairmen Baucus and Camp for this hearing. And thank you Mr. Barthold and the staff of the Joint Committee on Taxation for producing this important report on the tax treatment of financial products.

Twenty-five years ago, the Tax Reform Act of 1986 was signed into law by President Ronald Reagan. At the time of the 1986 Act, which was the last major tax reform we have had in the United States, the tax treatment of financial instruments and derivatives was a relatively new and highly undeveloped area of our nation's tax law. In fact, derivatives were unknown to most of the American public, although early evidence of these types of instruments can be traced back to ancient Greece.

As I have said before, when Congress undertakes comprehensive tax reform —and it must — that reform should be based on the same three principles that led to the enactment of the Tax Reform Act of 1986: fairness, simplicity and economic growth. I am very much looking forward to hearing what our witnesses have to say today, particularly as these three principles relate to the tax treatment of financial instruments and derivatives.

Allow me to share a few of my initial thoughts. Financial instruments generally refer to stocks, bonds, hybrid instruments, and derivatives. Derivatives include options, forward contracts, future contracts, and swaps. They are called derivatives because their value is derived from some other asset, liability, or other measure. The use of derivatives has skyrocketed in the last 20 to 25 years. According to the Bank for International Settlements, in June 2011, the total notional amount of outstanding over-the-counter derivatives was $707 trillion. Of this amount, $554 trillion was due to interest rate contracts and $65 trillion to foreign exchange contracts. These figures are mind boggling — to give some perspective, the size of the U.S. economy is about $15 trillion.

In the last several years, there has been a lot of discussion of credit default swaps, which is a type of derivative. These swaps became front page news during the recent financial crisis involving Lehman Brothers and American International Group (AIG). According to the Bank for International Settlements, the volume of credit default swaps peaked at $58 trillion in 2007, and declined to about $30 trillion at the end of 2010. Surprisingly, given the size and number of credit default swaps, for a number of years, it was not clear how these swaps were treated for tax purposes. It was just three months ago that the U.S. Treasury Department issued proposed regulations addressing the tax treatment of credit default swaps.

Generally, the tax treatment of financial products involves three major issues: timing, character and source. The timing issue relates to when an item of income or expense is taken into account for tax purposes. The character issue relates to whether the income is ordinary income or capital gain. And the source issue relates to whether the income is U.S. source or foreign source. Although these three issues involve principles that are fundamental to the U.S. income tax system in general, they are particularly applicable to the taxation of financial products.

Again, I would like to thank our witnesses for attending this hearing and look forward to their comments on this timely and complex issue.

And again, Chairmen Baucus and Camp, thank you for holding this important hearing on tax reform.

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Statement of Andrea S. Kramer
to the
U.S. Senate Committee On Finance
and the
U.S. House Committee On Ways & Means

Tax Reform and the Tax Treatment of Financial Products

December 6, 2011

Chairman Baucus, Chairman Camp, Ranking Members Hatch and Levin, and distinguished members of the Committees, thank you for the opportunity to appear this morning as your Committees consider Tax Reform and the Tax Treatment of Financial Products. I am here today at the request of the Committees.

I am a partner in the law firm of McDermott Will & Emery LLP, where I am head of its Financial Products, Trading & Derivatives Group. My legal practice focuses on the use, regulation, and taxation of derivatives. I principally represent derivatives users who engage in risk management transactions, as opposed to the dealers that sell such products to them. I am also an Adjunct Professor of Law at Northwestern University School of Law, where I teach "Taxation of Financial Derivatives" in the graduate tax program. I am here on my own behalf and the views I express are entirely my own.[1]

BASIC STRUCTURE OF DERIVATIVES TAXATION

Often in discussing the tax treatment of derivative transactions, the focus is on their inappropriate or illegitimate uses to game the tax system. The reality is that derivatives are an economically valuable financial products and are principally used for legitimate risk management and hedging purposes. As was reported in the

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[1]I am the author of *Financial Products: Taxation, Regulation & Design*, which is now in its third edition. I regularly speak at tax seminars across the country. I have developed and have presented 14 training courses and full day workshops for the IRS, typically for Financial Product Specialists as part of their annual training programs. I was a founding member of FISC/WISC (Financial Innovation Study Committee/Weird Instrument Study Committee), a group of attorneys, accountants, regulators, and economists that met in the 1990s in Washington, D.C., to study, on an interdisciplinary basis, financial products and derivatives. A list of my professional activities and publications is available at http://www.mwe.com/info/bios/andreakramer.pdf.

recent GAO report *Financial Derivatives: Disparate Tax Treatment and Information Gaps Create Uncertainty and Potential Abuse*,[2] "over 94 percent of the largest companies worldwide use financial derivatives to manage and hedge risks."[3] In addition, the GAO Report notes that "[t]he market for financial derivatives has grown considerably in size over the past two decades..."[4]

Yet despite the enormous size of the derivatives market and American businesses' use of it primarily for entirely appropriate and economically beneficial purposes, there continues to be a lot of talk about abusive derivative transactions and the need to close "tax loopholes." A variety of proposals have been put forward to do this, including proposals to move to a mark-to-market system for all derivatives. I believe that these proposals are the result of a misguided perspective on the derivatives market, and I believe more specifically that a move to a more pervasive system of marking-to-market would be a fundamental mistake. Quite simply, we should not go there.

The problem, as I see it, is *not* that there are serious loopholes in the taxation of derivatives — at least, not with respect to taxpayers who use derivatives to manage their risks. The real tax problem with respect to derivatives is that the basic rules are far too restrictive and as a result are inhibiting legitimate commercial and financial activities. Let me explain.

Each provision of the Code that addresses derivative products was specifically enacted to prevent a perceived tax abuse. These abuses include unjustified deferral of income, inappropriate transformation of the tax character of income, and the elimination of taxation all together. But whatever the perceived abuse, every one of our derivative tax rules is an anti-abuse provision. Of course, once you have an entire system of taxation designed to prevent abuse, you need exceptions to assure that appropriate transactions can continue. And so, what we now have in the derivatives tax area are matched pairs of tax rules: anti-abuse rules and rules that provide exceptions to them. It is as though in the derivatives area there are "thou shalt not do that rules," matched with "in these specific circumstances you can do that" rules.

This is hardly an ideal tax structure but it is the one we have. And I believe it can be substantially improved through relatively modest changes to the "exceptions" portion of our derivatives tax structure. All of my suggestions have

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[2] U.S. GAO, Report to Congressional Requesters, GAO-11-750, Sept. 2011.
[3] *Id.*, at 6, *citing* to a 2009 report by the International Swaps and Derivatives Association.
[4] *Id.*

to do with changes in the various definitions of "hedging" in the Code and the Treasury regulations, and, I believe that in principle, at least, they are non-controversial, even if their details may pose technical difficulties. What I hope to show is that the definitions of hedging are too limited and that the substance of these hedging definitions needs to be expanded. I am convinced that these changes would make our system of taxing derivatives both simpler and fairer - - without opening up any "loopholes."

HEDGING AND RISK MANAGEMENT

Let me begin by offering a few comments about the meaning of hedging, why taxpayers do it, and how taxpayers use derivative transactions to accomplish it. Hedging is quite simply the process of changing or reducing an economic risk associated with commercial or investment activities. Hedging and risk management are sometimes characterized as different: hedging being the reduction or elimination of risk, and risk management being the alteration of the scope or nature of risk. In my view, this is a false distinction and I will treat the two terms as synonymous.

The risks that taxpayers seek to manage or hedge through the use of derivative transactions are various: price risk, interest rate risk, supply risk, liquidity risk, credit risk, revenue risk, weather risk, counterparty risk, foreign currency risk, and on and on. And the types of derivative products that taxpayers use to manage or hedge such risks are also various: futures contracts, options, forwards, swaps, and combinations of these products with one another or with traditional types of securities. Let me give you a very simple hedging example. A taxpayer has a foreign currency receivable. It has the risk that the value of the dollar will go down before it receives the foreign currency. To protect itself against this risk, the taxpayer could (1) buy a futures contract on that foreign currency (which would go up in value if the value of the dollar went down); (2) buy an option on the foreign currency (which would also go up in value if the foreign currency appreciated relative to the dollar); or (3) enter into a swap in which it received payment if the dollar went down and make payments if the dollar went up.

With that as background let me give some slightly more elaborate examples of real world risk management or hedging activities.

- A textile manufacturer agrees to sell cotton goods in the future, which contract requires more cotton than the amount of cotton on hand or that can be immediately purchased at a favorable price. To protect itself against a

rising cotton market (during the period between the cotton goods order and the agreed delivery date), the manufacturer enters into long futures contracts for cotton. As the manufacturer buys spot cotton from time to time to manufacture the goods specified in its orders, it closes out the long futures contract. This is a buying hedge.

- A manufacturer buys quantities of spot cotton that will be on hand for some months before being manufactured into goods and sold. To protect itself from losses if the cotton market declines during this period, the manufacturer sells futures contracts for the delivery of equivalent amounts of cotton a few months in the future. From time to time, as the cotton is used to manufacture cotton goods, the short futures contracts are concurrently disposed of by closing transactions. This is a selling hedge.

- A construction company needs to borrow a fixed amount of money in the future and wants to lock in an interest rate for the loan it must obtain. To eliminate the risk of rising interest rates, the company can either sell futures contracts or purchase a put option position. This is a selling hedge.

THE HEDGING EXEMPTION FROM THE STRADDLE RULES AND SECTION 1256 TREATMENT

Two of the basic anti-abuse rules applicable to derivative products are the "Straddle Rules"[5] and "Section 1256 Treatment."[6] Both of these provisions are designed to prevent taxpayers from creating artificial losses in one year and "pushing" gains into a future tax year. There is a fundamental assumption, however, that if a taxpayer's derivative transactions are true "hedges," then those transactions should be taxed in the normal manner without regard to either of these anti-abuse rules. This is an entirely sensible approach. If a taxpayer is actually using derivative transactions to manage its business or investment risks, it does not

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[5] The Straddle Rules include the loss deferral rule at I.R.C. §1092(a)(1), which requires a taxpayer who holds "offsetting positions" in "actively traded" "personal property," where the value of one position moves inversely to the other, to defer losses taken on one position to the extent of unrecognized gain on offsetting positions. This is a one-way whipsaw against taxpayers. The Straddle Rules also require at I.R.C. §263(g) that interest and carrying charges with respect to personal property that is part of straddle cannot be deducted and instead must be added to the basis of the position to which the interest and carrying charges relate.

[6] Section 1256 Treatment provides two rules for "section 1256 contracts," as defined at I.R.C. §1256(g). For contracts that qualify as Section 1256 Contracts, the following anti-abuse provisions at I.R.C. §1256 apply. First, each contract that is open at the close of the tax year is treated as if sold for its fair market value on the last business day of the taxable year, that is, section 1256 contracts are marked to market. I.R.C. §1256(a)(1). Second, for those section 1256 contracts that are capital assets in the taxpayer's hands, any gain or loss is treated as 60 percent long-term and 40 percent short-term capital gain or loss. I.R.C. §1256(a)(3).

make sense to force those transactions to be marked-to-market or for the losses and gains on the transactions to be taxed other than in a manner that clearly reflects the taxpayer's overall income.

Excepting derivatives hedging transactions from the Straddle Rules and Section 1256 Treatment results in modern, sensible tax results with the tax character and tax timing matched. I think that everyone familiar with the taxation of derivatives, the IRS included, should agree with this as good tax policy. The problem, of course, is how to define "hedging." The current definition of hedging, in my view, is seriously deficient because it does not encompass many entirely appropriate risk management transactions. This problem arises in the Treasury regulations adopted to implement I.R.C. §1221(a)(7).

RISK MANAGEMENT TRANSACTIONS UNDER I.R.C. §1221

Risk management transactions that fall within I.R.C. §1221(a)(7) are exempt from the Straddle Rules and Section 1256 Treatment. This exemption was added to the Code in 1999. In this Code section, "hedging transaction" is defined as "any transaction" entered into by a taxpayer in the normal course of its trade or business "primarily to *manage* risks. . . ."[7]

In enacting I.R.C. §1221(a)(7), Congress made clear it intended to "broaden" the existing standard for transactions qualifying as hedges from a requirement that the transactions "reduce risk" to one that they "manage risk." According to the Report of the Senate Finance Committee, Congress believed that the risk management standard "better describes modern business hedging practices that should be accorded ordinary character treatment." In the Congress' view, to continue to require "risk reduction" to qualify for a hedging transaction would adversely affect "modern business hedging practices that should be accorded [exemptions from the anti-abuse rules]."[8]

In 2002, the Treasury issued regulations purportedly to "carry out the purposes of" I.R.C. §1221(a)(7), but it did so by basically ignoring the "management of risk" language and reverting to the older "reduction of risk" approach. The Final 2002 Regulations state that, except as determined in public guidance or by a private letter ruling, a transaction is not a hedging transaction unless it is specifically described in the regulations. And, to simplify somewhat — but only somewhat — the only transactions that the Treasury has been willing to

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[7] I.R.C. §1221(b)(2)(A).
[8] S. Rep. No. 106-201 (1999) (LEXIS-NEXIS 17).

explicitly describe as hedging transactions are those that (1) are "risk reducing"; (2) transform an interest rate from a fixed to a floating rate or from a floating to a fixed rate; or (3) cancel a pre-existing hedging transaction. To say that the Treasury approach to hedging has "chilled" legitimate hedging activities would be an understatement.

Let me give you just a few examples of common risk management transactions that do not qualify as tax hedges but clearly should.

- A company uses derivative transactions to convert the price of its inventory from fixed to floating. This is clearly a risk management transaction but it does not qualify as a hedging transaction.

- A company purchases a debt security with interest payments denominated in a foreign currency. The company enters into a derivative to manage its currency risk for a portion of the security's term. This is not a tax hedge.

- An electric utility earns a significant portion of its yearly revenue in the summer months. It enters into a "cooling degree day" weather derivative to protect itself against the risk that summer temperatures will be lower than expected. This is not a tax hedge.[9]

- A company enters into a derivative contract to hedge the value of the capital equipment it uses in its trade or business. This is not a tax hedge.[10]

I could provide many more examples but I believe you get the point. The current definition of a hedging transaction exempt from the Straddle Rules and Section 1256 Treatment is simply far too narrow. And it is so because the Treasury refused to follow Congress' clear direction in I.R.C. §1221. In making this point, I don't want to minimize the complications that would be involved in bringing the Treasury's hedging standard into line with modern, non-abusive business practices.

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[9] There are many such "volume" or "revenue hedges," none of which qualify as tax hedges. They include, among other things, the use of various types of weather derivatives, including heating degree days; maximum and minimum temperature events; cumulative average temperature indexes; perceived temperature or chill indexes; precipitation and rainfall; humidity indexes; wind speeds; frost; water flow; drought; and sunshine indexes. *See* Andrea S. Kramer and William R. Pomierski, *Energy and Environmental Hedging and Risk Management: The Risks and How They are Managed and Taxed in the United States*, Chapter 18 *in* ENERGY AND ENVIRONMENTAL PROJECT FINANCE LAW AND TAXATION: NEW INVESTMENT TECHNIQUES (Andrea S. Kramer and Peter C. Fusaro eds., Oxford University Press 2010).

[10] The definition of a hedging transaction should not be limited to transactions generating ordinary income and loss. When the hedge timing rule of clear reflection of income is applied to a risk management transaction, it should not matter whether the item or risk being hedged generates capital gain or loss.

But it would be well worth the effort. Until changes are made with respect to both tax character and tax timing in the definition of hedging transactions, we as a country will continue to inhibit the legitimate economic activities of our most dynamic and entrepreneurial businesses.

The first step to be taken in this reform effort would be for the Treasury to acknowledge that when taxpayers enter into derivative transactions that change their exposure to economic risks of any type, those transactions should be regarded as legitimate tax hedges exempt from the Straddle Rules and Section 1256 Treatment. I have written extensively on this subject and would be prepared to submit a detailed memorandum with suggested statutory or regulatory language. But until the Treasury acknowledges the need to move forward in this area, or Congress expresses a willingness to legislate in a manner that forces the Treasury to do so, I am afraid that such a detailed memorandum would fall on deaf ears.

INTEGRATED TAX TREATMENT FOR FOREIGN CURRENCY HEDGES

Let me turn from hedging transactions under I.R.C. §1221 to foreign currency hedging. The Code's treatment of nonfunctional currency derivative transactions is very convoluted. In simplified terms, however, if a derivative is a "Section 988 transaction," which is a derivative transaction the value of which relates to the value of a foreign currency, then the taxpayer's gain or loss on the derivative is calculated separately from any gain or loss on the underlying transaction. If, however, the derivatives transaction is a so-called Section 988(d) hedge, then the gain or loss on the transaction is integrated with the underlying transaction.[11] Tax integration not only eliminates a separate calculation of the derivative's gains and losses, but takes the transaction out of the Straddle Rules and Section 1256 Treatment. Gain or loss on the hedge is rolled into (that is, integrated with) the underlying transaction. As a result, when a foreign currency derivative is treated as a hedge, it and the underlying items are treated as a single transaction, eliminating mismatch possibilities.

The problem is that under Treasury regulations, the foreign currency derivatives must qualify as part of a Section 988(d) hedge. I.R.C. §988(d)(2) broadly defines a Section 988(d) transaction to mean "any transaction" that is entered into by the taxpayer "primarily to *manage* the risk of currency fluctuations" with respect to property, borrowings, or obligations. The Treasury

[11] I.R.C. §988(d)(1).

regulations, however, have unnecessarily limited the transactions that are eligible for Section 988(d) integrated hedge treatment to three types: (1) executory contracts; (2) debt securities; and (3) hedges of currency risk between the trade date and settlement date for certain stocks sales. Within each of these types, Section 988(d) hedge treatment is inappropriately restricted. Let me give just three examples in the executory contract area to illustrate just how unnecessarily restrictive the Treasury's Section 988(d) definition of hedging is.

- Company A has an executory contract -- it has agreed to pay or receive foreign currency in the future in exchange for the purchase or sale of equipment used in its business. If it wants to hedge that contract, it must maintain the hedge from the date the hedge is identified to the end of the executory contract. This means that a taxpayer with such an executory contract that requires progress payments in the foreign currency cannot hedge its purchase price risk.

- If corporate policy requires members of a consolidated group to enter into all of their risk management derivative transactions with another group member (such as a Treasury Center or Hedge Center), and that Center, in turn, will execute hedges with third party dealers (a very common corporate policy), none of those transactions would qualify for Section 988(d) integrated hedge treatment. This is because the Treasury regulations require that none of the parties to a Section 988(d) hedge be related parties.

- Corporation A has an executory contract to buy equipment denominated in a foreign currency in the future. Corporation B, a member of the same consolidated tax group, enters into a derivative transaction to reduce the risk for the consolidated group of A's executory contract. B's risk reducing transaction does not qualify as a Section 988(d) hedge because the Treasury regulations require both the executory contract and the hedge to be entered into by the same corporation.

INTEGRATED TAX TREATMENT FOR DEBT HEDGES

The last tax hedging provision I will mention is the integrated hedge rules for certain debt securities under Treas. Reg. §1.1275-6. This regulatory provision basically builds off of the tax timing and character integration concepts for foreign currency in I.R.C. §988(d). It provides that if a derivative meets the definition of a Section 1.1275-6 hedge, the taxpayer treats the gain or loss on the hedge and the underlying debt security as a single integrated transaction and neither the Straddle Rules nor Section 1256 Treatment applies. Once again, a taxpayer's derivative

transactions must meet unnecessary and far too narrow requirements to qualify for integration. I suspect that I do not need to provide examples to make my point because the pattern is similar to that for Section 988(d) hedges.

CONCLUSION

In conclusion, I am not at all objecting to the basic approach taken by the Code and Treasury regulations of creating exceptions from the derivatives anti-abuse rules for hedging transactions. What I am objecting to is the restrictive nature of the exemptions for definitions of hedging transactions. The substance of the hedging exemption needs to be expanded. My suggestion is simple, let's identify all of the risk management transactions for which the application of the Straddle Rules and Section 1256 Treatment makes no sense. I have given several examples but there are many more. Once we have done that, let's classify them as hedges -- subject to the clear reflection of income requirement (at Treas. Reg. §1.446-4) for I.R.C. §1221(a)(7) hedges and tax integration for Section 988(d) and Section 1.1275-6 hedges -- and be done with it.

I would be happy to supply the Committees with whatever additional information they request.

Answers to Questions Posed to Ms. Andrea S. Kramer

after

Senate Finance Committee and House Ways & Means Committee Hearing

"Tax Reform and the Tax Treatment of Financial Products"

on

December 6, 2011

Questions from Chairman Max Baucus

1. **There has been much discussion about regulatory reform and the desire of increased transparency, oversight, and market stability. What is less frequently discussed is whether the tax treatment of financial products contributes in a positive or negative way to these goals.**

   a. **Several witnesses at the hearing discussed how tax planners can create almost any tax consequence they desire by tinkering with and combining different financial products. For example, they can alter the timing, character, or source of income. Do the resulting financial products contribute in a positive or negative way to the goals of transparency, oversight and market stability?**

Tax planning is an important accompaniment to our tax system. Our tax laws are very complicated and taxpayers do and should pay careful attention to the tax consequences of how they structure their economic activities. Simple examples of this process include the choice of the entity within which to conduct a trade or business (C corporation, S corporation, partnership, individual, or foreign); the selection of the type of transactions to use to accomplish a merger, reorganization or recapitalization; and the determination of the vehicle to hold assets for estate planning purposes. Taxpayers, whether corporate or individual, would be foolish if they did not consider taxes in structuring their economic activities. In this context, it is hardly surprising that taxpayers use tax planning when they engage in derivative transactions. Therefore, I believe that the issue is not whether tax planning in connection with derivatives is good or bad, but whether it is possible at present to utilize tax planning to achieve tax results from derivative transactions that are "legal" but could be perceived as abusive. By abusive, I am referring to derivative transactions with little or no economic consequences that produce a distortion of reportable income or deferral or avoidance of taxation for reasons unrelated to the legitimate operation of the taxpayer's trade or business or its legitimate investment activities.

Let me then slightly modify your original question, do I think that through "tax planning" derivative transactions can be used to achieve abusive tax results? To that question, my answer is "no." Quite simply, tax planners cannot legitimately use derivatives or any other financial instruments, in your words, to "create almost any tax consequence they desire." They cannot do this because the entire framework of the Tax Code and the judicial doctrines interpreting it are specifically addressed to preventing such tax abuses.

Let me remind you of just some of the Code provisions that are designed to prevent the inappropriate transformation of taxable income:

- Code §475: Mandatory tax mark to market for securities dealers
- Code §988: Ordinary tax character for foreign currency transactions
- Code §1092: Tax straddles
- Code §1256: Section 1256 contracts
- Code §1260: Constructive ownership transactions
- Code §1221(a)(6): Ordinary tax character for commodity derivatives dealers
- Code §1221(a)(7): Ordinary tax character for qualifying tax hedges

Code provisions and Treasury regulations that prevent an inappropriate recognition of gains and losses on derivatives include the following:

- Code §475: Imposing a mark to market method of tax accounting on securities dealers
- Treas. Reg. §1.446-3: Requiring accrual accounting principles for notional principal contracts
- Treas. Reg. §1.446-4: Requiring clear reflection of income for tax hedge transactions
- Code §988(d) and Treas. Reg. §1.988-5: Providing tax integration for qualifying currency hedges
- Code §1091: Disallowing losses for wash sales on stock and securities
- Code §1092: Deferring losses on tax straddles
- Code §1256: Requiring tax mark to market for section 1256 contracts
- Code §1259: Gain acceleration on constructive sale transactions

- Code §1260: Toll charge on income deferral on constructive ownership transactions
- Treas. Reg. §1.1275-6: Providing tax integration for qualified debt instruments

Because of these and other Code provisions, as well as the various judicial doctrines interpreting them, the opportunities to use derivatives in a tax abusive manner have largely been eliminated. They have not been entirely eliminated, grant you, but the reason they have not been is weak enforcement, rather than inadequate rules. The IRS has neither the resources nor the expertise to challenge and prevent abusive derivative transactions that if challenged would likely be prohibited by the courts. With respect to resources, it is impossible to challenge abusive transactions with inadequate IRS funding.[1] With respect to expertise, budget cuts prompt offers of early retirement and employee buyouts. Given how technically complex the taxation of derivatives is, it is unrealistic to expect that enforcement can be done without senior employees with attractive pay packages and job security.[2]

Accordingly, I believe that if the Congress' concern is tax abuse through the use of derivative transactions, then the clear answer is to strengthen the IRS' enforcement capability. But I think it would be a mistake to focus exclusively on abuses, for the legitimate uses and potential for further legitimate uses of derivatives are of far greater policy and economic importance. As I tried to make clear in my Testimony, I believe that our Tax Code and regulations need to be appropriately amended to encourage the use of derivatives in legitimate risk management (hedging) transactions. As I hope I made clear, our economy would benefit enormously from expanded definitions of tax hedging that would open up new but entirely appropriate business and investment opportunities that are now discouraged or made uncertain by our tax rules. Indeed, let me emphasize more strongly than I may have in my Testimony that while such an expansion of the definitions of "hedging transactions" would open up meaningful new business

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[1] *See* Chuck O'Toole, Senate Passes Fiscal 2012 Spending Bill, Cutting IRS Funding, Tax Analysts, Document Service, Document 2011-26687; David van den Berg. Inadequate Funding Harms IRS, Taxpayer Advocate Says, TNT 2012 TNT 8-1 (1-12-12); David Kocieniewski, Budget Cuts Hamper IRS in Efforts to Collect Billions in Taxes, Report Says, *The New York Times,* Thursday, Jan. 12, 2012, B2.

[2] *See* fn 1. *See also* Bigger Budget Will Help IRS Improve Service and Enforcement, Shulman Says, 2010 TNT 37-1 (2-24-10).

opportunities, it would also make the IRS' enforcement job easier by forcing more taxpayers to treat the character and timing of their derivatives gains and losses on a "clear reflection of income" test or a tax integration method. To put that point most simply, if we were to expand the hedge matching requirement, we would encourage economic development while also making it significantly easier for the IRS to prevent taxpayers from using offsetting derivative transactions to "game" our tax system.

Let me give you an example of what I mean. More than 10 years ago, a transaction surfaced involving offsetting debt instruments. It was commonly referred to as a "bull-bear bond transaction." The taxpayer acquired two debt instruments, where the value of one instrument would increase, based on the occurrence of a contingency, while the other instrument would decrease (by a like amount) on the occurrence of the same contingency. Taxpayers sought to recognize tax losses on the sale of the instrument that decreased in value, while deferring the equivalent amount of gain by retaining (and locking in the value of) the other instrument. Bull-bear bond transactions were addressed by the IRS in Revenue Ruling 2000-12.

To prevent this perceived abusive transaction, the IRS relied on the integrated tax hedging rules for qualified debt instruments at Treas. Reg. §1.1275-6 that I refer to above. The IRS characterized the offsetting bonds as hedges of each other and used its authority under these regulations to integrate the offsetting debt instruments. By this tax integration, the two offsetting debt instruments were treated as a single debt instrument for tax purposes, thus denying recognition of the loss on the sale of the loss bond.

Revenue Ruling 2000-12 shows that where offsetting transactions are entered into in a perceived abusive setting, requiring integrated tax hedge treatment or the matching of the timing and character of gains and losses on a nonintegrated basis can be used to effectively prevent taxpayer abuses. This ruling points out the limitations of the use of these hedging rules under current law, however. In the bull-bear bond transaction, integration was available to the IRS because the bonds were so perfectly offsetting that Treas. Reg. §1.1275-6 applied.

To summarize, I think our focus needs to be on getting the tax treatment right for the vast majority of legitimate users of derivative products and not on the

far fewer number of tax abusers.[3] If we do that and make the taxation of derivatives fairer and more appropriate for our country's businesses and investors that use derivatives to advance their legitimate economic ends, we will, in the words of your question, assure that derivative products contribute in a "positive . . . way to the goals of transparency, oversight, and market stability."

b. Do the tax rules for financial products encourage riskier behavior among taxpayers?

If by "riskier" you mean economically riskier, then, my answer is "no." Taxpayer's motivations to engage in derivative transactions that have significant economic risk is to gain significant economic profits – not tax advantages. Absent an offsetting position, it would be safe to assume that a taxpayer would not purposefully enter into a risky derivative with the goal of losing money in order to generate a tax loss.

If , however, by "riskier" you mean riskier tax behavior, then my answer is "yes." But the reason my answer is "yes" is not because of the tax rules themselves but the lack of timely guidance from, and enforcement by, the Treasury and the IRS. Lack of guidance often forces taxpayers into one of two categorizations. Either they become immobilized and refuse to enter into appropriate risk management transactions or they become unwilling to wait for tax guidance and proceed forward with transactions that avoid economic risks but that pose tax risks. In both cases, the real concern is Treasury and IRS inaction, not taxpayer behavior.

[3] I provide an example, in my response to the follow up question posed to me by Congressman Rangel at the Hearing, of an appropriate and desirable risk management transaction entered into by an insurance company with fixed-rate obligations to its policyholders. The insurance company funds its obligations with a portfolio of floating-rate securities that it "hedges." This risk management transaction might not qualify as a tax hedge under current law. *See* my answer to Congressman Rangel that will also be made a part of the Hearing Record.

c. Does applying mark to market only to certain publicly-traded derivatives and derivatives with respect to publicly-traded property for which there is a reasonable basis to determine fair market value increase the incentive to trade over-the-counter or in less easily-valued property and, therefore, cause individuals to enter into less transparent transactions.

Mark to market tax treatment was a radical step when it was introduced into the Tax Code in 1981. At present, such treatment applies only to Section 1256 contracts and to those taxpayers that are in Code § 475, either on a mandatory basis (securities dealers) or on an elective basis (securities traders, commodities dealers, and commodity traders). Therefore, it is important to recognize that if Congress were to extend mark to market tax treatment to all derivatives that were somehow viewed as publicly-traded or related to publicly-traded property, it would take an enormous and even more radical step than it did in 1981. I am not in any way criticizing the original mark to market initiative: quite the contrary, for I was actively involved in the process. But I am cautioning that a further expansion of this unique type of treatment should only be undertaken with careful attention to both its "need" and its consequences. And as I stated in my Testimony, I believe that as proposed it would be an undesirable step for both practical and policy reasons.

But before I explain why I believe that the expansion of the mark to market regime is a bad idea, let me answer the question as it is posed. Individuals who would face mark to market tax treatment on publicly-traded derivatives and derivatives with respect to publicly-traded property would have the theoretical opportunity to trade in the over-the-counter (OTC) market and in less easily-valued property. That opportunity, however, would be of limited practical significance. Taxpayers trade derivatives either to hedge a current or anticipated risk, or to earn a profit. I am aware of very few circumstances in which hedging or economic gain from publicly-traded derivatives or derivatives with respect to publicly traded property could be replicated in the market using less easily-valued property.

Now let me return to my opening comment. Even if taxpayers were unable to find any attractive OTC opportunities for avoiding a mark to market regime in the "publicly traded" world, why would we want to go there in the first place? The claim is that a mark to market regime would solve problems of derivatives tax abuse. As I stated at the Hearing, I do not agree. A mark to market regime is simply not workable for derivatives or underlyings that are difficult to value, regardless of whether they are "publicly-traded." I have seen far too many drawn

out and costly valuation disputes in tax audits involving positions that are subject to mark to market that lead me to seriously doubt that an extension of that system would "solve" more problems than it created. Let me offer just a few of the arguments against extending the mark to market regime:

- How would we mark to market illiquid positions underlying "publicly-traded" derivatives?
- An expansion of mandatory mark to market seems a very disruptive shift in tax policy in times of severe economic stress.
- Realization is the general tax accounting rule for most transactions so why single out derivatives for unique tax treatment? What about other types of actively-traded property?
- Taxpayers would be required to mark gains to market and pay tax on gains that they might never actually realize. Is it really fair to tax taxpayers today and force them to wait 18 months or more to receive the benefit of a tax refund?
- Mark to market would allow taxpayers to receive the benefit of losses they might never realize. These losses might then be given back in a later year if the losses are never in fact realized.

I do not want to beat a dead horse but I feel so strongly that an extension of the mark to market regime is a bad idea that I think that before giving further consideration to this idea, the following questions need to be answered:

- What's in? What's out? Derivatives? Physical Securities? Physical Commodities? Underlying transactions?
- If derivatives are in, but underlying transactions are not, how are tax distortions between the two to be avoided?
- If underlying transactions are put into a tax mark to market regime, how can they be valued? What about existing inventory methods? What if mark to market specifically conflicts with other explicit Code provisions or other subchapters of the Code?
- How can taxpayers pay tax on gains on illiquid positions?

- Unless all of a taxpayer's underlying transactions are also marked to market, imposing a mark to market regime on derivatives without curtailing the existing Straddle Rules would totally freeze legitimate hedges and risk management transactions. Gains would be marked to market but losses would be deferred. Thus, we would need to turn off the Straddle Rules (we cannot allow tax on mark to market gains while deferring mark to market losses).

I find the fundamental rationale for moving to a mark to market regime a puzzle. The only rationale I have heard is that because derivatives are now taxed in different ways – some mark to market, others "when realized," and still others on "accrual" – – that taxpayers are free to pick and choose among these products based on timing or character preference. But if this is the rationale, then I think it is not an argument for an extension of mark to market to derivatives and beyond, but for the adoption of my original proposal. If the definition of hedging were expanded, more derivatives and their underlying transactions would be put on clear reflection of income or integration tax accounting and much of this unnecessary and counterproductive tax "engineering" could be avoided.

2. **Many financial products serve long-standing, essential business purposes. It is important that farmers and producers are able to manage their risks.**

   At the same time, in the past few weeks there have been several news reports that suggest that high-wealth individuals are able to defer taxation for many years on appreciated stock in ways that seem like abuses of the tax code. We also are aware of other creative financial products that take advantage of character and source rules and thereby benefit from favorable tax treatment.

   There is the perception that this isn't fair. I'm trying to get a sense of the revenue loss we are talking about.

   What portion of these contracts are entered into for speculative purposes rather than managing business risk?

Apart from my representation of professional securities and commodities traders, my clients are businesses and individuals who use derivatives to manage their economic risks. In this regard, I believe I see a representative cross section of the derivatives market, for as the recent GAO Report on Financial Derivatives states, "over 94 percent of the largest companies worldwide use financial

derivatives to manage and hedge risks." Based on my experience, extensive reading, and anecdotal evidence, I am convinced that the vast majority of derivative transactions occur, to use your own phrase, for "essential business purposes." Nevertheless, I share your concern that derivative products are now often recognized as being used in ways that are not "fair" because of press reports of high profile wealthy taxpayers using derivatives to shelter appreciated stock positions. I want to make two separate and unrelated comments about this perception.

First, we have a rule based system of taxation in this country – not just for derivatives but for every other area of economic activity as well. If taxpayers comply with the rules, which include a variety of judicial doctrines designed to assume that the objective of the formal tax provisions are adhered to, they are entitled to calculate their taxes as the Tax Code prescribes. The press reports to which I believe you are referring, concern taxpayers who utilized so-called variable pre-paid forward contracts to sell an estimated amount of appreciated stock for delivery in a future tax year. Without commenting on the appropriateness of the particular transactions reported on in the press, I think it should be recognized that under our tax system, if transactions of this sort comply with the rules – and I mean all of the rules including the determination of whether or not a taxable sale has occurred and the judicial doctrine of substance over form -- then they are entirely appropriate transactions.

My second point is that if transactions such as these are, despite their current "legality," subsequently deemed to be abusive, we must be careful how we fix the abuse. The changes we make to avoid abuse should not discourage the economic development we need for our legitimate business and investment activities. And, we should put more transactions into the hedging and risk management buckets, which would require clear reflection of income or integration and that would also catch many tax abuses.

3. The 'cubbyhole' approach of taxing financial products and the lack of timely guidance by the IRS have led to similar products being taxed inconsistently. Even if transactions have the same pre-tax economic outcome, their after-tax economic outcome can be starkly different.

a. Let's assume Congress continues along with the system of incrementally fixing perceived problems in the taxation of financial derivatives (rather than legislating a more global approach). What can be done to more quickly address the development of new financial products so that the IRS is not always playing catch up?

The fastest way to "address the development of new financial products so that the IRS is not always playing catch up" would be to expand the definition of hedging to include more business and investment transactions. Expanded hedging definitions would eliminate many tax character and tax timing mismatches resulting from offsetting economic positions (the principal sources of derivatives tax "abuses") by requiring taxpayers to either clearly reflect their income or to integrate their hedges with their underlying hedged items or risks.

Both the clear reflection of income test and tax "integration" basically treat gains or losses on a hedge as part of the underlying transaction. Both doctrines match source, timing, and character of hedging gains and losses with those of the hedged items or risks. Thus, while the expansion of the hedging definitions would mean that certain new types of transactions would be outside the Straddle Rules and Section 1256 Treatment, these transactions would be subject to not only clear reflection of income or tax integration but they would also be subject to the existing constructive sale or constructive ownership rules. As a result, such transactions could be safely regarded as non-abusive without any need for the IRS to play catch up.

b. Could a simpler system with guidelines based on the substance of a transaction rather than its form benefit both taxpayers and tax administrators? Would this require a legislative change?

Much of our tax system is based on taxing the form of transactions rather than their substance (think forward contract versus futures contract: different form, same substance, different tax treatment.). To achieve a tax system based on the substance of transactions, rather than their form, would require a rewrite of large portions of the Tax Code. In addition, economic substance is not something that reasonable people – or even economists -- always agree about. This would not be an easy change either practically or theoretically.

c. Is part of the uncertainty on how derivatives are taxed due to inconsistent definitions used by the tax code versus those used in US securities and commodities law? Could this uncertainty be mitigated by seeking to reconcile the terminology?

In one word, "No." There are different objectives in defining derivatives for purposes of regulation by the IRS, SEC, CFTC, and the Financial Accounting Standards Board, to name but a few of the key regulatory bodies. Given these different objectives, it would be a terrible mistake to try to reconcile the definitions in the Tax Code with these other disparate terminologies.

4. To what extent do corporations create or invest in financial products that provide them favorable equity treatment for accounting and regulatory purposes but which allow them debt treatment for tax purposes?

I have no personal experience in this area.

Do you consider this a problem that should be addressed as part of tax reform? If so, how would you suggest we address it?

I have no personal experience in this area.

Questions from Senator Bill Nelson

Section 1256 of the Internal Revenue Code imposes "marked to market" treatment on certain financial instruments. Under the provision, section 1256 contracts are subject to tax annually based on their fair market value on the last business day of the taxable year. A portion of the income or loss on a section 1256 contract is taxed as short-term capital gain or loss, and a portion is taxed as long-term capital gain or loss. The conference report for the Dodd-Frank Wall Street Reform and Consumer Protection Act included a provision -- not included in the original House-passed or Senate-passed version -- which amended section 1256. The provision created a new statutory rule that excludes credit default swaps, interest rate swaps, equity swaps, commodity swaps, and other agreements from the definition of a section 1256 contract.

a. In your view, what would have been the likely consequences of the Dodd-Frank Act on the tax treatment of derivatives transactions if this provision had not been included in the final bill?

In the absence of Code § 1256(b)(2)(B), some OTC swap contracts may have become Section 1256 contracts. I say "may" because that tax result would have been by no means clear. Code § 1256 treatment turns, in my view, on whether the counterparties to an OTC swap that is cleared by a registered clearing organization receives back a Section 1256 contract. (*See* Andrea S. Kramer, *Financial Products: Taxation Regulation and Design,* Part Thirteen, Taxation of Section 1256 Contracts (3d ed. 2012 Supplement).) Many OTC swaps currently cleared through CME Clearport receive back a Section 1256 contract; those cleared through ICE Clearing receive back a "swap," not a Section 1256 contract. But it is by no means certain that this pattern would continue once the CFTC finalizes its post-Dodd-Frank clearing regulations.

Also, by its terms, Section 1256 contract status is limited to contracts that trade on certain designed exchanges (currently (1) a CFTC "designated contract market," (2) a national securities exchange registered with the SEC, or (3) an exchange or market designated by the Treasury as a "qualified board or exchange"). Because the exchanges on which various swap contracts might ultimately be traded post-Dodd-Frank would not necessarily be exchanges designated as CFTC contract markets or registered with the SEC, it would be in the power of the Treasury to designate an additional qualified board or exchange upon the request of the particular exchange or market seeking designation, it would appear that even without the adoption of Code §1256(b)(2)(B), the migration of cleared swaps into Code §1256 would have been limited by Treasury discretion.

So quite frankly, I simply do not know what would have been the tax consequences if Code § 1256(b)(2)(B) had not been included in Dodd-Frank.

b. Are some taxpayers likely to pay less in income taxes on their derivatives transactions as a result of the provision?

I have no information on the basis of which to answer this question.

c. Which industries, sectors, or classes of taxpayers are most likely to benefit?

I have no information on the basis of which to answer this question.

d. Does the provision create new opportunities for tax avoidance?

No.

Questions from Ranking Member Orrin Hatch

1. **A number of commentators made the point that financial instruments are unquestionably linked. For example, a share of stock plus two options may be used to produce an economic return that is the equivalent of interest on a bond. Yet, we tax these instruments differently – based on what "cubbyhole" they fit into – not their economic effect. Can you elaborate for us on how this can distort investment and lead to tax avoidance?**

Much of our tax system is based on taxing the form of transactions rather than their substance, that is, their economic effect. Please see my answer to Chairman Baucus' question 3.b., above.

2. **In 2004, the IRS stated that it was studying the tax treatment of credit default swaps and welcomed comments from market participants. Seven years later, Treasury issued proposed regulations addressing the tax treatment of credit default swaps. What is it about credit default swaps that makes a determination of the proper tax treatment so difficult?**

I have no information as to why it took the Treasury so long to issue proposed regulations on credit default swaps or why it believes that a determination of their proper tax treatment is so difficult.

3. **The United States has a classical system for taxing the earnings of a corporation. In other words, dividends paid to shareholders are not deductible to the corporation. This creates two levels of taxation of corporate earnings – once at the corporate level and a second time at the shareholder level. In 2003, Congress provided some tax relief to individual shareholders on receipt of dividends. If the United States were to integrate the corporate and individual tax systems so that corporate earnings would only be taxed once, to what extent would that impact the creation and use of financial products?**

I have no information that would suggest that the integration of the corporate and individual tax systems would have either a positive or a negative effect on the use of financial products.

4. **The United States has a worldwide tax system with deferral of earnings earned by foreign subsidiaries, and a foreign tax credit for income taxes paid to foreign countries. If the Unties States were to adopt a territorial tax system in the form of a dividend exemption, how would that impact the creation and use of financial products?**

I have no information as to how or whether a territorial tax system would affect the creation or use of financial products.

Statement of Senator Carl Levin (D-Mich)
on
Tax Reform and the Tax Treatment of Financial Products
Before the
Joint Hearing of the
Senate Finance Committee and House Ways & Means Committee

December 6, 2011

The Senate Finance Committee and House Ways & Means Committee are to be commended for holding today's hearing on how profits from complex financial products are or should be taxed. To put it simply, when it comes to taxing derivatives and other complex financial products, the tax code contains too many loopholes and is in many ways a mess. Tax code definitions are confusing, impractical, and often out of alignment with federal securities and commodities laws. In some cases, two different taxpayers, who earn income from trading identical financial products, are treated differently. In other instances, two economically equivalent financial products receive different tax treatment. Under a flawed regulation, derivative payments coming from the United States are treated as non-U.S. income.

At a minimum, the provisions create confusion, impose unnecessary compliance costs on taxpayers, and favor some Wall Street firms over other taxpayers. At worst, they provide perverse incentives that, in addition to costing the Treasury substantial revenues, skew the financial markets. As Congress considers ways to simplify the tax code and balance the budget, cleaning up the taxation of complex financial products should be a priority.

Inconsistent Definitions

One reason for the current problems and disparities in the tax treatment of complex financial products involves issues related to nomenclature. The recent GAO study on the taxation of derivatives, as well as many tax experts, found that financial innovations often lead to tax treatment uncertainties, particularly when market participants and federal financial regulators use different terminology than the tax code. Tax uncertainties and compliance costs could be dramatically reduced by working to harmonize tax terminology, to the extent possible, with the terminology used in the financial marketplace.

For example, one particular concern I have relates to swaps, which are a common type of derivative, which take multiple forms, and involve trillions of dollars in financial products. Prior to the enactment of the Dodd-Frank Act in 2010, the tax code relied on a concept called "notional principal contract" to determine the tax treatment of swaps. This term is defined by the IRS in 26 CFR 1.446-3. Yet, it is unclear where the regulatory definition came from, the basis for its provisions, and whether it covers all types of swaps, including swaps that involve a single payment. The Dodd-Frank Act initiated a cleanup of the terminology problem when its Section 1601 imposed a new tax rule for swaps and actually used the term "swap" instead of "notional principal contract" in the law. The IRS is now working to reconcile the Dodd-Frank provision with its existing regulation, including determining how to treat the term "swap" as used in the Dodd-Frank Act compared to the existing regulatory definition of "notional principal contract." The resulting confusion over the competing definitions is leading to increased costs,

inefficiencies, and damage to the tax code. Enabling financial institutions to use the same definition of "swap" when complying with federal financial laws and the federal tax code would likely simplify compliance in both areas, reduce compliance costs for taxpayers, and facilitate effective tax administration.

In that vein, some sections of the tax code already rely on federal securities laws to define financial instruments. For example, Section 1234B defines a "securities futures contract" using a definition from the Securities Exchange Act of 1934. But other tax code provisions use definitions that seem out of alignment and even at odds with the federal securities laws. For example, Section 475(c)(2) of the tax code defines "security" to include a range of financial instruments that federal securities and commodities laws would not treat as securities. For example, it defines the term "security" as including not just shares of stock, but also "interest rate, currency or equity notional principal contracts," which are common types of swaps. We could say the definition of "dog" includes a "cat" and a "horse," but why would anyone want to? It is confusing and disruptive for the tax code to say that "swaps" are "securities" when U.S. securities and commodities laws treat them as different types of financial instruments, subject to different legal requirements and different regulators.

Blended Rate

A second cause of the current problems and dispartities in the taxation of complex financial products involves the fact that some taxpayers have been able to carve out for themselves certain special tax preferences. Perhaps the most visible example is the tax code provisions that currently favor speculation in commodity futures over investments in company stock.

Since 1981, Section 1256 of the tax code has allowed taxpayers to apply a so-called blended tax rate, which is 60% capital gains and 40% ordinary income, to gains from certain financial instruments such as commodity futures contracts. This blended rate essentially allows a taxpayer to take advantage of a lower tax rate no matter how briefly the taxpayer holds the covered financial instrument. In fact, gains from futures contracts are typically short term, often measured in months, days, or even seconds. The legislative history suggests that there was, at the time, no articulated reason for bestowing this special treatment on commodity futures or the other financial instruments selected for the lower tax rate. It seems that this benefit was intended simply to ease the burden on taxpayers who were about to become subject to mark-to-market tax treatment, which was then a newer development in the tax code. Today, mark-to-market tax treatment for financial services firms is much more commonplace and provides little or no justification for a special lower tax rate.

The disparity in tax treatment between Section 1256 financial products, such as commodity futures, and other financial products such as shares of stock, creates an incentive for increased trading and speculation in the favored products. Further, it siphons investors' capital away from the types of capital investments the tax code has traditionally favored, such as long term equity investments. This Wall Street giveaway distorts the financial markets and reduces tax revenues to the benefit of the fortunate few. Congress should end the blended tax rate.

Derivatives Source Rule

A third issue with derivatives taxation relates to determining for tax purposes the source of U.S. income for these transactions. I have been examining offshore tax issues for years through the Permanent Subcommittee on Investigations, which I chair. That Subcommittee has held hearings and issued a number of reports on how U.S. firms have used offshore tax havens to legally—and illegally—lower their own or their customers' taxes. We found that, while some taxpayers hid assets in secret bank accounts, which is illegal on its face, others were able to legally avoid tax on their income using various types of derivative transactions.

One tactic was to take advantage of the "source rule," a regulation which the Treasury Department and IRS issued in 1991. This rule, which can be found at 26 CFR 1.863-7, outlines when a payment related to a notional principal contract like a swap has to be treated as income coming from the United States. If a U.S. person makes a payment on a notional principal contract such as a swap and sends that payment to a person who is a resident in another country, the current source rule requires that payment to be treated as non-U.S. source income—even though the payment came from the United States. That's because the rule says that the "source" of the income is determined by the "residence of the taxpayer."

In other words, the current regulation deems the "source" of these payment to be determined by its recipient—the exact opposite of the normal definition of the word "source." Suppose a U.S. bank sent a payment in connection with a credit default swap to a Cayman Island hedge fund with an office and employees in the Caymans. That hedge fund would likely be able to treat that payment as non-U.S. source income, even though the payment came from the United States. It gets worse. Suppose the Cayman hedge fund didn't actually have an office or any employees in the Cayman Islands—they were all right here in the United States. Suppose that the hedge fund opened a bank account at a U.S. bank. The credit default swap payment would then go from one U.S. bank to another U.S. bank, never leave the United States, yet might be treated as non-U.S. source income. That doesn't make sense, and it may be responsible for billions of dollars in lost tax revenues. This loophole, along with many other offshore-related tax loopholes, should be closed.

These are just a few examples of the many problems plaguing the taxation of complex financial products. Creating consistent financial instrument definitions, eliminating the blended rate, and reforming the derivative source rule are three critical changes in the tax code that could lower compliance costs, increase tax fairness, and eliminate offshore tax loopholes.

Thank you for this opportunity to share my concerns. I look forward to working with you on tax reform that will increase tax fairness and restore the revenues we need to make our country strong.

Testimony to the Senate Finance Committee and the House Ways and Means Committee on the Taxation of Financial Products

David S. Miller

December 6, 2011

Chairman Baucus, Ranking Member Hatch, Chairman Camp, Ranking Member Levin, and members of the committees: Thank you for giving me the opportunity to speak to you today.

I am here to talk about the federal income tax treatment of financial instruments. But I am going to start with Claudius Ptolemy.

Our Ptolemaic System of Realization Taxation: Its Fundamental Flaw and its Corrective Ellipses.

Claudius Ptolemy was the second century astronomer who created a model of the heavens that predicted the positions of the sun, moon and planets, and was used for over 1,400 years.

There was just one problem with his universe: The earth was in the middle.

How could a model that was just plain wrong provide sufficient accuracy to be used by Western civilization for over 14 centuries?

With a great deal of complexity.

To explain and predict heliocentric planetary patterns in a geocentric model, Ptolemy's planets traveled in a series of ellipses or epicycles around the earth. But this alone

was insufficient. To correct further, Ptolemy had the planets move closer and then further away from the earth, and even slow down and reverse in their orbits.

Our federal system for taxing financial instruments is truly Ptolemaic. As Ptolemy's system was geocentric, our federal tax system is based on the equally archaic system of realization – the concept that income is not earned, and therefore not taxed, until a taxpayer actually sells property for cash or exchanges it for materially different property.

In the 1920s-1930s, two American economists, Robert Haig and Henry Simons, recognized that true economic income is measured by the increase in the value of assets, regardless of when they are sold.[1] Our modern capital markets understand this, and taxpayers are free to borrow against and spend the unrealized appreciation in their publicly-traded property. And yet our tax system remains grounded in the antiquated system of realization.

Like Ptolemy with his ellipses, Congress and the IRS have tried to correct for our fundamentally-flawed system of taxation. The wash sale rules, the straddle rules, the capital loss limitation rules, the original issue discount rules, the contingent payment debt instrument rules, the conversion transaction rules, the constructive ownership and sale rules, and the contingent swap rules are the ellipses of our tax system. And yet we retain our realization tax system as stubbornly as Europe through the middle ages retained Ptolemy's geocentric system.

And so we are left with a system as complicated as Ptolemy's. We have over a dozen cubbyholes for various financial instruments, each with their own set of rules, many of them inconsistent. Because our system of taxation has no basis in the reality of economics,

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[1] *See* Robert M. Haig, *The Concept of Income–Economic and Legal Aspects*, *in* THE FEDERAL INCOME TAX (Robert M. Haig ed., 1921); Henry C. Simons, PERSONAL INCOME TAXATION: THE DEFINITION OF INCOME AS A PROBLEM OF FISCAL POLICY 206 (1938).

sophisticated taxpayers are free to choose a tax treatment that minimizes their taxes. And choose they do. I offer three examples.

The Taxation of Credit Default Swaps

First, credit default swaps can be structured as options for tax purposes or they can be structured as "notional principal contracts". If they are structured as options, the taxpayer can defer tax on the premiums. If they are structured as notional principal contracts, the taxpayer can rely on the "contingent swap" regulations proposed by the IRS to claim immediate ordinary losses when the risk of default increases. Some taxpayers initially took the position that credit default swaps are options and deferred the premiums, and then, after the market turned downward, changed their minds and treated the very same credit default swaps as notional principal contracts to claim immediate ordinary losses.

The Use of "Variable Prepaid Forward Contracts" To Monetize Appreciated Stock

Second, as was recently reported in a *New York Times* article by David Kocieniewski and a *Bloomberg* story by Jesse Drucker,[2] wealthy individuals with appreciated stock are able to enter into variable prepaid forwards that hedge their downside risk, and provide them with cash, all tax-free. Hundreds of millions of dollars of cash. Although the IRS has challenged one variant of this transaction, it has issued a Revenue Ruling declaring the basic technique completely legal.[3] In fact, in June, Ronald Lauder entered into a variable prepaid forward contract on his Estée Lauder shares and received over $72 million in cash tax-free.

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[2] *See* David Kocieniewski, *A Family's Billions, Artfully Sheltered*, N.Y. TIMES, Nov. 26, 2011, at A1; Jesse Drucker, *Buffett-Ducking Billionaires Avoid Reporting Cash Gains to IRS*, BLOOMBERG, Nov. 21, 2011.

[3] Revenue Ruling 93-7, 2003-1 C.B. 363.

These are not transactions available to working-class Americans, but our realization-based tax system permits them.

Structured Notes and the "Open Transaction" Doctrine

And finally, in the past 10 years, over $200 billion in structured notes have been issued in public transactions registered with the SEC. Among these structured notes is a type that promises its holders a relatively secure principal amount at maturity plus contingent interest tied to the return of an equity index like the S&P 500. Notes like these resemble contingent payment debt instruments that would subject an investor to annual original issue discount accruals and ordinary income at maturity. But these notes are structured as prepaid forwards. Under the "open transaction" doctrine of our realization-based tax system, holders pay no tax until maturity and then, at maturity, are eligible for long-term capital gains rates.

These notes are not tax shelters in any nefarious sense. They are registered with the SEC in public documents, and their beneficial tax treatment is simply the natural consequence of our realization tax system.

The deferral that these three different products permit is an artifact of our realization system. The ability of taxpayers to choose their tax treatment arises because there is no single guiding principle governing the taxation of financial instruments. And our system is numbingly complex because Congress and the IRS must again and again correct for a system that has no basis in reality.

An Alternative: Mark-to-Market Taxation

But there is an alternative that matches economic income precisely. It is simple to apply and all but foolproof. It is called mark-to-market.

For instruments subject to a mark-to-market system of taxation, the taxpayer would simply compare the value of the instrument at the end of year with its tax basis and pay tax on the difference, regardless of whether the instrument is sold.

I have proposed a system that would require all public companies, all private companies with $50 million or more of net assets, and the 1/10th of 1% of the wealthiest and highest-earning individual taxpayers to mark-to-market all of their publicly-traded property, derivatives of publicly-traded property (other than business hedges), and some publicly-traded debt and liabilities. (A copy of my proposal is attached.)

Mark-to-market gains of individuals would be taxable at long-term capital gains rates and losses would be deductible (and the tax refundable) to the extent of prior mark-to-market gains.

This system would at once abandon our geocentric tax system and finally match tax and economics. It would help level the playing field between middle-class wage earners who pay tax on all of their economic income and the billionaires who pay no tax on their appreciated stock, and it would eliminate the need for the tax ellipses, permitting tremendous simplification. But it is radical because it would apply to stock and securities as well as derivatives.

But incremental change is also possible: Mark-to-market treatment could be applied selectively to derivatives. This selective treatment would require more line drawing, but

still would be an improvement over our current system. In an appendix to my testimony, I have outlined how a mark-to-market system of taxation for derivatives might work.

* * *

Thirteen hundred years after Ptolemy proposed his earth-centered model of the skies, Nicolaus Copernicus challenged it with a competing and radical but infinitely simpler view that happened to correspond to reality: it is the earth, the moon and the planets that revolve around the sun.

Our own tax system was conceived at the beginning of the last century when economic income could be measured only by cash, and the effect of a tax deferred was little understood. Our markets are now liquid, our taxpayers sophisticated. To bring our system for taxing financial instruments into the twenty-first century, tax must match the reality of economic income. Only a mark-to-market system of taxation does that.

Thank you. I welcome your questions.

A Mark-to-Market System of Taxation for Publicly-Traded Derivatives and Derivatives With Respect to Publicly-Traded Property

1. All publicly-traded derivatives, and derivatives with respect to publicly-traded property for which there is a reasonable basis to determine fair market value, would be subject to mark-to-market treatment, and all taxpayers would report mark-to-market gains as ordinary income or loss.[1]

2. Other derivatives would remain subject to the current rules, except that an interest charge would apply to prepaid derivatives. Thus, nontraded derivatives could give rise to capital gains and losses and no tax would be paid by a taxpayer that receives nontraded property upon the exercise of an option or upon the maturity of a forward contract until the underlying property is sold or exchanged (although interest would accrue on prepayments). For example, taxpayers that purchase options on real estate and private businesses would not be subject to mark-to-market treatment. It is not practical to apply mark-to-market treatment to illiquid and hard-to-value derivatives.

3. Broker-dealers would be required to conduct the mark-to-market valuations. The IRS would establish or approve industry-wide valuation guidelines and would audit broker-dealer valuation methodologies, but would not challenge individual valuations that are made in good faith. Taxpayers that do not enter into mark-to-market derivatives with broker-dealers would have to designate an approved broker-dealer to value their derivatives or face a penalty in the nature of an interest charge.

4. An exception to mark-to-market taxation would exist for taxpayers that use derivatives to hedge their ordinary assets and liabilities under existing regulations sections 1.1221-2 and 1.446-4, and for taxpayers that integrate their interest-rate and currency swaps into debt instruments under existing regulations section 1.1275-6. So mark-to-market taxation would not apply to a farmer that uses derivatives to hedge her risk on the next crop, or to an energy company that hedges fuel costs.

5. Partnerships, trusts, and tracking stock can be used to create derivatives, and mark-to-market derivatives can be embedded in nontraded derivatives. An anti-abuse rule would allow the IRS to treat any portion of a nontraded derivative, nonderivative security, or any other arrangement (including stock, and interests in partnerships and trusts) as a derivative potentially subject to mark-to-market treatment if a principal purpose of the arrangement is to avoid mark-to-market treatment. So, for example, assume that a taxpayer contributes $10 to a partnership and an investment bank contributes $90; the partnership uses the $100 to buy

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[1] If retention of long-term capital gains rules is desirable, mark-to-market treatment would not begin until the second December 31 after acquisition, and long-term capital gains rates would apply to gains on actual dispositions occurring after a year, and for mark-to-market gains thereafter. For prepaid derivatives, an ordinary-income interest charge could be applied to the prepayment; long-term capital gains rates would apply to gains in excess of the interest charge.

publicly-traded XYZ stock and allocates all dividends, loss and the first $10 of gain to the investment bank, and all gain in excess of $10 to the taxpayer. Under the anti-abuse rule, the IRS could treat the taxpayer's partnership interest as a derivative (i.e., an option on XYZ stock) that is subject to mark-to-market treatment. Variable-rate debt instruments, contingent payment debt instruments, and conventional convertible and exchangeable debt and stock would not ordinarily be deconstructed.

6. The 60% long-term/40% short-term capital gain treatment for section 1256 contracts would be repealed. There is no policy justification for reduced rates of tax for short-term section 1256 contracts.

7. Mandatory mark-to-market treatment under section 475 would apply to commodities dealers. There is no policy reason why commodities dealers enjoy more favorable tax treatment than securities dealers.

8. Investors (and not only dealers and traders) would have the ability to elect mark-to-market treatment under section 475 for all of their securities.

taxanalysts special report

A PROGRESSIVE SYSTEM OF MARK-TO-MARKET TAXATION

By David S. Miller

David S. Miller is a partner with Cadwalader, Wickersham & Taft LLP, New York.

On November 1, the President's Advisory Panel on Federal Tax Reform released its recommendations. As expected, the panel recommended a repeal of the alternative minimum tax. However, to offset the lost revenue, the panel proposed to eliminate the deduction for state and local taxes, and limit the deductions for home mortgage interest and charitable contributions.

Already, Democrats and Republicans alike have declared the panel's proposed offsets unenactable. Rep. Charles Rangel, D-N.Y., has promised to "fight to the death" the panel's proposal to deny the deduction for state and local taxes, House Minority Leader Nancy Pelosi, D-Calif., declared the home mortgage interest deduction "untouchable," and even Senate Finance Committee Chair Chuck Grassley, R-Iowa, said that the panel's proposal "just doesn't meet the common sense test."

This article offers an alternative that would repeal the AMT, better achieve the president's objectives, and preserve the deductions for state and local taxes, home mortgage interest, and charitable contributions. It proposes "progressive" mark-to-market taxation as a component of fundamental tax reform.

Under the proposal, all public companies, all private companies with $50 million or more of net assets, and all individuals and married couples with $1.6 million of adjusted gross income or $5 million of publicly traded property — representing the top 0.1 percent of highest-earning and wealthiest individuals — would be required to mark to market their publicly traded property and derivatives.

Mark-to-market gains of corporations would be subject to tax at the current marginal rate of 35 percent. Mark-to-market losses of corporations would be fully deductible against ordinary income or capital gain.

Mark-to-market gains (and qualified dividends) of individuals would be subject to tax at the long-term capital gains rate of 15 percent, and their interest and other ordinary income would remain subject to tax at the ordinary income rate of 35 percent.

Individuals' mark-to-market losses would be fully deductible to the extent of prior mark-to-market gains, could then be used to offset capital gains, and then mark-to-market losses could offset 43 percent (15 percent/35 percent) of ordinary income or could be carried forward indefinitely.

By a conservative (but back-of-the-envelope) estimate, Miller concludes that the proposal would generate between $490 billion and $750 billion of new revenue over a 10-year horizon. The revenue generated by the proposal would be applied to repeal the AMT.

A progressive system of mark-to-market taxation, he says, would achieve all of the president's objectives for fundamental tax reform. It would help repeal the AMT but would adversely affect fewer than 400,000 households.

It would not increase rates, deny deductions, or impose new taxes. Therefore, Miller says, it would not violate the president's "no new taxes" pledge.

Also, he explains, it would help achieve the president's goal of progressivity, it would allow significant simplification, and it would prevent nearly all tax shelters for mark-to-market property.

The author wishes to thank Linda Z. Swartz for her particularly helpful comments. This article was first presented to the Tax Forum on October 5, 2005.

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I. Introduction

In his first press conference after winning the 2004 presidential election, President Bush established tax reform as a priority for his second term.[1] In January 2005 the president appointed an advisory panel on tax reform to make recommendations,[2] and on November 1 it issued its report. This coming January, in his State of the Union Address, Bush is expected to introduce his own proposals for fundamental tax reform.

Bush's call for tax reform is not unexpected. Ever since the last major tax reform in 1986, government officials and politicians have periodically called for a fundamental revision of the Internal Revenue Code[3] and several recent developments have again elevated the issue:

- the dramatic increase in taxpayers that will be subject to the alternative minimum tax beginning in 2010 (from 1.3 million in 2000 to 3 million in 2005 to 30 million in 2010, representing 94 percent of all married filers with children that make between $75,000 and $100,000);[4]
- the exposure of a number of prominent corporate and individual tax shelters;[5]

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[1]Gregg Hitt, "Bush Sets Plans To Revamp Taxes, Social Security," *The Wall Street Journal*, Nov. 5, 2004, at 1; David Wessel, "Questions for the President on Tax Reform," *The Wall Street Journal*, Nov. 11, 2004, at A2.

[2]*See* "Executive Order Establishing Advisory Panel on Tax Reform" (Jan. 7, 2005), *available at* http://www.whitehouse.gov/news/releases/2005/01/20050107-1.html.

[3]*See, e.g.*, Pamela F. Olson, "Memorandum to Secretary of Treasury Paul O'Neill: Tax Reform Materials" (dated Nov. 7, 2002), *Doc 2004-18280, 2004 TNT 180-15* (Sept. 16, 2004) ("Fundamental tax reform is necessary to achieve the simplicity, efficiency, fairness, and predictability that is possible in a world class tax system"); "Members of Congress Urge Fundamental Tax Reform as Bush Administration Priority," *Doc 2002-24899, 2002 TNT 216-18* (Nov. 7, 2002); Tax Termination Act of 1998, H.R. 2097 (1998); "Lott Calls for 'Fundamental Tax Reform'," *Doc 98-7771, 98 TNT 42-32* (Mar. 4, 1998); "Five Senators Call For Tax Reform," *Doc 97-10719, 97 TNT 80-43* (Apr. 15, 1997).

[4]Editorial, "Mr. Bush's Stealthy Tax Increase," *The New York Times*, Mar. 13, 2005, section 4, at 10; David Leonhardt, "Case of Vanishing Deductions: Alternative Tax Called Culprit," *The New York Times*, Feb. 21, 2005, at A1.

[5]*See, e.g.*, U.S. Government Accountability Office, "Tax Shelters: Services Provided by External Auditors" (Feb. 24, 2005), (report detailing tax shelter activity from 1998-2003), *Doc 2005-3771, 2005 TNT 37-12*; Joint Committee on Taxation, "Report of Investigation of Enron Corporation and Related Entities Regarding Federal Tax and Compensation Issues, and Policy Recommendations," JCS-3-03 (Feb. 13, 2003), *Doc 2003-4185, 2003 TNT 31-11*, *Doc 2003-4299, 2003 TNT 31-12*, and *Doc 2003-4300, 2003 TNT 31-13* (report on tax shelters entered into by Enron).

Some commentators attribute the significant decline in the proportion of federal taxes paid by corporations (from approximately 27.5 percent between 1950 and 1959 to 15 percent in 1970-79 to a projected figure of 9.6 percent in 2000-09) to corporate tax shelters. Mihir Desai, "The Corporate Base, Tax Sheltering Activity, and the Changing Nature of Employee Compensation," NBER Working Paper 8866 (April 2002). Those conclusions are controversial. George K. Yin, "The Problem of

(Footnote continued on next page.)

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- the dawning realization that existing tax rules are incapable of accurately taxing the increasing number of complex financial products;[6]
- the federal budget deficit, and the increasing urgency to reduce it;[7]
- the rising page count and complexity in the code;[8] and
- the increase in after-tax income and concentrated wealth among the highest percentiles of earners.[9]

Those developments have surfaced in public opinion polls. A majority of voters now support simplification of the tax code,[10] and most believe that the rich do not pay their fair share of taxes.[11]

During the campaign, President Bush established his goals for the federal tax system. Any reform, he said, should make the tax code "simpler" and "fairer." A simpler tax code would reduce taxpayers' cost and administrative burdens to comply with the law.[12] A fairer tax code would close loopholes to "ensure that everyone pays his or her fair share." But fairness also means that the tax system is progressive, which President Bush called "an attribute that is fundamental to fairness in taxation."[13] And tax reform should be "revenue neutral,"[14] promote long-term economic growth and job creation, better encourage work effort, savings, and investment, and make American workers and firms more

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Corporate Tax Shelters: Uncertain Dimensions, Unwise Approaches," 55 *Tax L. Rev.* 405 (2002) ("The measures of a book tax disparity used . . . may both be too crude to capture the book-tax effects of certain corporate tax shelters. Thus, even if shelters are proliferating and causing ever greater discrepancies between financial and tax reporting, existing methods of analysis may not permit us to perceive the existence of such trends.").

[6]*See* David H. Hasen, "A Realization-Based Approach to the Taxation of Financial Instruments," 398 *Tax L. Rev.* 397, 398 (2004) ("In recent years, a consensus has emerged among practitioners, policymakers, and tax scholars that financial contract innovation poses significant challenges to the federal tax system.") (citations omitted); Dale S. Collinson (IRS special counsel to the associate chief counsel (financial institutions and products)), "Grumpy Observations on Reality in Financial Instruments," *Tax Notes*, June 20, 2005, p. 1587 at 1588 ("I believe that current efforts to achieve effective taxation of a great many financial transactions result in an application of scarce IRS resources that is excessive in relation to the results received and that this adverse input/output ratio is destined to worsen rather than to improve. Consequently, a radical change in approach may be required."); *see generally* David M. Schizer, "Balance in the Taxation of Derivative Securities: An Agenda for Reform," 104 *Colum. L. Rev.* 1886, 1888 (2004) (hereinafter Balance) ("It is well understood that aggressive tax planning among high-income individuals and corporations represents a threat to the U.S. tax system, and that derivatives are staples of this planning. . . . Even when the use of derivatives is not tax-motivated, moreover, the relevant tax rules are complicated but sill fail to provide answers to basic questions — obviously, a frustrating combination.") (citations omitted).

For example, in February 2004 the IRS proposed exceedingly complicated rules for taxing "contingent swaps" and requested comments on their application. *See* 64 *Federal Register* 8886 (Feb. 26, 2004) In Ann. 2004-75, 2004-40 IRB 580, *Doc 2004-19463, 2004 TNT 192-16*, the IRS requested help in constructing a tax regime for REMIC IO interests and, in Notice 2004-52, 2004-32 IRB 168, *Doc 2004-14751, 2004 TNT 139-8*, the IRS opened up a project to characterize and determine the tax treatment of credit derivatives.

[7]Joint Statement of John W. Snow, Secretary of the Treasury, and Joshua B. Bolten, Director of the Office of Management and Budget, on Budget Results for Fiscal Year 2005 (Oct. 14, 2005), *available at* http://www.ustrea.gov/press/releases/js2973htm (deficit of $319 billion for fiscal year ending Sept. 30, 2005); Edmund L. Andrews, "Greenspan Says Federal Budget Deficits Are 'Unsustainable'," *The New York Times*, Mar. 3, 2005, at A1.

[8]The Internal Revenue Code contains 45,622 pages. Nicholas Confessore, "Breaking the Code," *The New York Times magazine*, Jan. 16, 2005, at 39 [hereinafter Breaking the Code]. Other page counts are higher. *See* http://www.cch.com/wbot2004 (60,044 pages). The Joint Committee on Taxation estimated that in 2000 the Internal Revenue Code and regulations contained 9.4 million words. *See* JCT staff, Pub. No. JCS-3-01, *Study of the Overall State of the Federal Tax System and Recommendations for Simplification, Pursuant to Section 8022(3)(B) of the Internal Revenue Code of 1986*, app. D at 4 (2001). Americans spend 1.6 billion hours each year filling out tax returns. Confessore, *supra*, at 35.

[9]*See* David Cay Johnston, "Richest Are Leaving Even the Rich Far Behind," *The New York Times*, June 5, 2005, at A1 (average income for the top 0.1 percent grew 250 percent, from $1.2 million in 1980 to $3 million in 2002, after adjustment for inflation); Martin J. MacMahon Jr., "The Matthew Effect and Federal Taxation," *Tax Notes*, Dec. 6, 2004, p. 1383 (in the Forbes 400 index, "[t]he average wealth of the top 10 individuals grew by 611 percent to nearly $27.1 billion," from 1989 to 1999).

[10]David D. Kirkpatrick, "Talk of Taxes, Social Security and Blogs at G.O.P. Retreat," *The New York Times*, Jan. 30, 2005, section 1 at 5 (hereinafter Talk of Taxes) ("House Republicans heard a report on Saturday from the National Republican Congressional Committee on the potential politics of changing the tax system, saying that there was broad support for 'simplification', but not for a flat tax, a national sales tax or abolishing the Internal Revenue Service, people familiar with the report said.").

[11]Scott Hodge, "Polls Show We're Ready for Tax Reform" (Apr. 14, 2005), *available at* http://www.taxfoundation.org/news/show/346.html (81 percent are concerned with complexity; the public believes that the rich with help from their lawyers and accountants get away with not paying their fair share of taxes); Adam Nagourney and Janet Elder, "Americans Are Concerned About Bush Agenda, Poll Shows," *The New York Times*, Nov. 22, 2004, at A1 ("In the poll, more than 6 in 10 of the respondents said people with higher incomes should pay a greater proportion of their income in taxes."); "Federal Budget and Taxes," *available at* http://www.pollingreport.com/budget.htm (out of 1,010 people surveyed, 84 percent felt the rich did not pay their fair share) (last visited June 6, 2005); "Americans' View on Taxes" (April 2003), *available at* http://www.npr.org/news/specials/polls/taxes2003/ (46 percent concerned that the wealthy do not pay their fair share; and 31 percent concerned with complexity).

[12]Office of the Press Secretary, "President Bush Provides Leadership on Tax Reform" (Sept. 2, 2004), *available at* http://www.whitehouse.gov/news/releases/2004/09/20040902-7.html (description of Bush's tax agenda).

[13]*Id.*

[14]*See* "Executive Order Establishing Advisory Panel on Tax Reform," *available at* http://www.whitehouse.gov/news/releases/2005/01/20050107-1.html; http://www.whitehouse.gov/news/releases/2005/01/20050107-1.html (detailing the goals of the advisory panel on federal tax reform).

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competitive.[15] Those goals were repeated in the executive order establishing the tax reform panel.[16]

Those are lofty but potentially achievable objectives. However, the administration has added three additional conditions for fundamental tax reform that together significantly dim its prospects.

First, tax reform must "fix" the AMT (at an estimated cost of $1.2 trillion);[17] second, tax reform must retain deductions for home mortgage interest and charitable contributions (or at least recognize "the importance of homeownership and charity in American society");[18] and, finally, because President Bush and congressional Republicans have signed a "no new taxes" pledge, although tax reform should be revenue neutral, it must not raise rates or, as the pledge is widely understood, impose any new taxes.[19]

In short, the president has demanded that tax reform forgo $1.2 trillion of tax revenue generated by the AMT but remain revenue neutral without raising rates or new taxes, and without sacrificing home mortgage interest or charitable contribution deductions.

And even if the administration's goal of revenue neutrality is abandoned, any proposal must significantly broaden the tax base or otherwise tap a new source of revenue because the president has pledged to reduce the $319 billion federal deficit to $260 billion,[20] and the federal government faces significant additional costs: Nearly $1.8 trillion over the next 10 years to make Bush's tax cuts permanent;[21] $105 billion in 2005 alone and as much as $458 billion over the next 10 years for the wars in Iraq and Afghanistan;[22] $500 billion for the new Medicare prescription program;[23] more than $100 billion and as much as $200 billion for the recovery costs for hurricanes Katrina and Rita;[24] and a long-term Social Security shortfall of $10.4 trillion.[25]

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[15]Office of the Press Secretary, "President Bush Provides Leadership on Tax Reform" (Sept. 2, 2004), *available at* http://www.whitehouse.gov/news/releases/2004/09/20040902-7.html.

[16]*See* "Executive Order Establishing Advisory Panel on Tax Reform," *available at* http://www.whitehouse.gov/news/releases/2005/01/20050107-1.html ("The purpose of the Advisory Panel shall be to submit to the Secretary of the Treasury in accordance with this order a report with revenue neutral policy options for reforming the Federal Internal Revenue Code. These options should: (a) simplify federal tax laws to reduce the cost and administrative burdens of compliance with such laws; (b) share the burdens and benefits of the federal tax structure in an appropriately progressive manner while recognizing the importance of homeownership and charity in American society; and (c) promote long-run economic growth and job creation, and better encourage work effort, saving, and investment, so as to strengthen the competitiveness of the United States in the global marketplace").

[17]Brett Ferguson, "White House Asks Tax Reform Panel to Delay Report Until End of October," *BNA Daily Tax Report* (Sept. 14, 2005) (Treasury Secretary John Snow "expects 'fixing' the laws relating to the alternative minimum tax to be a priority in the [tax reform panel's] report."); Kurt Ritterpusch, "Reform Panel to Recommend AMT Repeal; Revenue Offset, High-Income Issues Open," 139 *BNA Daily Tax Report* G-9 (July 21, 2005) (repeal of AMT would result in "$1.2 trillion in lost revenues over 10 years").

[18]*See* "Executive Order Establishing Advisory Panel on Tax Reform," *available at* http://www.whitehouse.gov/news/releases/2005/01/20050107-1.html; http://www.whitehouse.gov/news/releases/2005/01/20050107-1.html (detailing the goals of the advisory panel on federal tax reform).

[19]Confessore, "Breaking the Code," *supra* note 8, at 35 (222 members of the House, 46 senators, and President Bush himself have pledged never to raise tax rates); Wesley Elmore, "Tax Reform Will Take Back Seat to Deficit Reduction, Analysts Predict," *Highlights and Documents*, Nov. 30, 2004, p. 2145 (Brookings Senior Fellow William G. Gale "agreed that a VAT would be a viable solution to the country's revenue needs, but warned that Bush and most congressional Republicans have signed a 'no new taxes pledge' so it is 'extraordinarily unlikely' that they will raise taxes. Republicans have 'systematically ruled out most of the solutions to deficit problems because of that stance.'").

[20]*See* Heidi Glenn, "Former Treasury Officials Slam National Retail Sales Tax, Praise VAT," *Doc 2004-22807, 2004 TNT 231-3* (Dec. 1, 2004) ("We'll need a significant new revenue source," citing Bruce Bartlett, former deputy Treasury assistant secretary for economic policy). The administration measures its progress against the $521 billion deficit it predicted last February and will claim that the president has satisfied his pledge if he reduces it to $260 billion. Edmund L. Andrews, "In Plan To Reduce Deficit By Half, Bush Administration Turns To Old Projections," *The New York Times*, Jan. 16, 2005, at A16.

[21]Edmund L. Andrews, "Trim Deficit? Only if Bush Uses Magic," *The New York Times*, Feb. 6, 2005, at 1 ("Mr. Bush wants to permanently extend his tax cuts rather than allow them to expire in 2011. That would cost about $1.8 trillion over the next decade, and most would occur after 2009"). In testimony before the Senate Finance Committee, Robert J. Carroll, the deputy assistant Treasury secretary for tax analysis, stressed the importance of making these cuts permanent: "Permanent extension of these tax cuts is a key component of the President's economic agenda to ensure that taxes do not increase for millions of Americans." Testimony of Robert J. Carroll Before the Senate Finance Committee (Mar. 15, 2005), *available at* http://www.finance.senate.gov/hearings/testimony/2005test/rctest031605.pdf.

[22]Adam Entous, "Bush Sending $82 Billion War Spending Plan to Congress" (Feb. 14, 2005), *available at* http://www.globalsecurity.org/org/news/2005/050214-war-supplemental.htm (wars will cost $105 billion in 2005 alone). *See also* "Bush Criticized for Continuing Dishonest War Budgeting" *available at* http://www.ombwatch.org/article/articleview/2817/1/339 (May 2, 2005) (estimating that the cost for war over the next 10 years could reach $458 billion).

[23]Edmund L. Andrews, "In Plan to Reduce Deficit by Half, White House Turns to Old Projections," *The New York Times*, Jan. 2, 2005, at A1.

[24]David E. Sanger and Edmund L. Andrews, "Bush Rules Out A Tax Increase For Gulf Relief," *The New York Times*, Sept. 17, 2005, at A1 ("others have said that the federal government will quickly run through the $62.3 billion already approved in relief aid by Congress, and could wind up spending as much as $200 billion."); Edmund L. Andrews and Carl Hulse, "Cost of Recovery Surges, as Do Bids to Join in Effort," *The New York Times*, Sept. 9, 2005, at A1 ("White House officials and Congressional budget experts now are sure that federal costs for the hurricane will shoot past $100 billion, which itself is more than twice the entire annual federal budget for domestic security.").

[25]David E. Rosenbaum and Robin Toner, "Introducing Private Investments to the Safety Net," *The New York Times*, Feb. 3,

(Footnote continued on next page.)

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Fundamental tax reform faces other hurdles. First, any proposal must appeal to public opinion.[26] According to polls, there is broad support for "simplification" but not for more radical changes.[27]

Second, as former Treasury Secretary James Baker urged the advisory panel when he testified in March, any fundamental tax reform proposal must be politically acceptable and likely will need some bipartisan support.[28]

Initially, President Bush's advisers offered two competing models for tax reform. One, championed by Vice President Dick Cheney, would scrap the entire income tax and replace it with a national sales tax or single-rate flat tax on wages. The second, supported by Chief of Staff Andrew Card and Treasury Secretary John Snow, would retain the income tax but substantially simplify and improve it by broadening the base and lowering rates, along the lines of the Tax Reform Act of 1986.[29]

Preliminary feedback suggested that a national sales tax or VAT would fail to clear two of the three conditions for enactment. Broad support exists to "simplify" the federal tax system but not for a flat tax or national sales tax.[30] And because Bush and most congressional Republicans have signed a "no new taxes" pledge, they are unlikely to agree to a VAT or national sales tax "supplement" to the income tax.[31]

Republican leaders then retreated from the VAT and national sales tax proposals. Instead, administration officials suggested a piecemeal evolution, widely referred to as the "five easy pieces," toward a consumption tax: (i) marginal income tax rates would be reduced, (ii) the estate tax would be repealed, (iii) the tax rates on stock dividends and capital gains would be reduced, (iv) tax-free health and "lifetime" savings accounts would be expanded, and (v) the cost of new buildings and equipment would be immediately written off.[32] Those tax costs would be offset by a denial of deductions for state and local taxes and corporate interest expense.[33]

Over a two-day period in May, the tax reform panel heard testimony on a number of comprehensive reforms to the federal tax system, including a retail sales tax, Prof. Graetz's hybrid income tax/VAT system, David Bradford's X-Tax, and the flat tax.[34] Later that month, four former assistant Treasury secretaries for tax policy strongly urged the panel to recommend piecemeal improvements to the tax code rather than wholesale change.[35]

On November 1, the tax reform panel issued its report, which offers two alternative plans.[36] The Simplified Income Tax Plan would repeal the AMT, reduce the maximum individual tax rate from 35 percent to 33 percent, condense the number of tax brackets from six to four (15 percent, 25 percent, 30 percent, and 33 percent), eliminate all taxes on dividends paid by U.S. corporations, and reduce the maximum long-term capital gains tax rate on the sale of stock of a U.S. corporation from 15 percent to 8.25 percent (but apply ordinary marginal rates to all other capital gains). Section 401(k) plans and other saving incentives would be simplified into three accounts; the "marriage penalty" would be reduced; the standard deduction, personal exclusion, child care credit, and head of household filing status would be streamlined into a new family tax credit; and the earned income

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2005, at A1; Edmund L. Andrews, "Bush Says He Won't Raise Taxes for Social Security Overhaul," *The New York Times*, Dec. 10, 2004, at A30.

[26]David D. Kirkpatrick, "Talk of Taxes," *supra* note 10

[27]*Id.*

[28]Edmund L. Andrews, "Fed's Chief Gives Consumption Tax Cautions Backing," *The New York Times*, Mar. 4, 2005 at A1 ("James Baker cautioned that "[a] basic recognition of political reality will help you shape recommendations that can survive the legislative process."); *Testimony of the Honorable James A. Baker, III before the President's Advisory Panel on Federal Tax Reform, available at* http://www.taxreformpanel.gov/meetings/pdf/baker_03032005.pdf (Mar. 3, 2005) ("The broadest level of bipartisan support is still desirable, if only to avoid plunging the debate over reform into partisan acrimony.").

[29]*See* Martin A. Sullivan, "The Rise and Fall of the National Sales Tax," *Tax Notes*, Nov. 15, 2004, p. 916 at 918; Daniel Altman, "Taxes and Consequences: The Second Term Begins," *The New York Times*, Nov. 7, 2004, section 3 at 4 ("Simplification could take several forms, from closing loopholes and streamlining rates (as in the 1986 restructuring), to a complete overhaul resulting in a flat tax. So which is it?").

Some commentators have suggested other paths. *See* Michael J. Graetz, "To the Point of No Returns," *The New York Times*, Nov. 15, 2004, at A21 (14 percent national sales tax, tax exemption for families that earn less than $100,000, and a 25 percent reduced rate of income tax for all other individuals); *see also* Gene Sperling, "No Pain, No Savings," *The New York Times*, Jan. 5, 2005, at A23 ("universal 401(k)s" supplemented by governmental contributions and funded by a 3 percent surcharge on all incomes exceeding $200,000).

[30]Adam Nagourney and Janet Elder, "Americans Show Clear Concerns on Bush Agenda," *The New York Times*, Nov. 23, 2004, at A1 (34 percent of polled voters opposed the flat tax system compared with 26 percent in favor; 37 percent responded "Don't know enough"); *see also* David D. Kirkpatrick, Talk of Taxes, *supra* note 10.

[31]Nicholas Confessore, Breaking the Code, *supra* note 8, at 35 (222 members of the House, 46 Senators and President Bush himself have pledged never to raise tax rates); Wesley Elmore, "Tax Reform Will Take Back Seat to Deficit Reduction, Analysts Predict," *Highlights and Documents*, Nov. 30, 2004, p. 2145, *supra* note 19.

[32]*See* William G. Gale, "Tax Reform Options in the Real World," in *Toward Fundamental Tax Reform* 38 (Alan J. Auerbach and Kevin A. Hassett) (2005).

[33]Edmund L. Andrews and David D. Kirkpatrick, "G.O.P. Constituencies Split on Tax Change," *The New York Times*, Nov. 22, 2004, at C1. ("Many proponents of tax overhaul . . . have suggested eliminating major deductions, like state and local taxes and corporate interest payments.").

[34]Heidi Glenn, "Tax Reform Panel Picks Apart Fair Tax Proposal," *Doc 2005-10332, 2005 TNT 91-1* (May 12, 2005).

[35]Heidi Glenn, "Tax Reform Hearing Focuses on Piecemeal Changes as Panel Heads Behind Closed Doors," *Doc 2005-10888, 2005 TNT 95-2* (May 17, 2005).

[36]The President's Advisory Panel on Federal Tax Reform, "Simple, Fair & Pro-Growth: Proposals To Fix America's Tax System" (November 2005), *Doc 2005-22112, 2005 TNT 211-14.*

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tax credit and refundable child care credit would be replaced with a new work credit.

Corporate rates would be reduced from 35 percent to 31.5 percent. Small businesses would be permitted to use a simplified tax accounting system, and would be permitted to immediately deduct any investment in land and buildings. Depreciation deductions for large corporations would also be simplified. And the U.S. international tax system would be converted into a territorial system that exempts active foreign income from U.S. federal income tax and eliminates the U.S. foreign tax credit system. To offset the tremendous revenue loss from those proposals without raising tax rates or adding new taxes, the panel would deny a series of deductions.

First, the panel would repeal the federal income tax deduction for state and local taxes. Second, the panel would convert the home interest mortgage deduction into a 15 percent credit, and then cut the maximum amount of an eligible mortgage from $1 million to the average regional price of housing (ranging from about $227,000 to $412,000). Third, the panel would allow charitable donation deductions only to the extent they exceed 1 percent of the taxpayer's income (rather than the full amount, as under current law). And the panel would tax employees on any employer-paid health insurance premiums in excess of $5,000 a year for an individual and $11,500 a year for a family.

A second alternative — the Growth and Investment Tax Plan — is a more radical shift to a hybrid income/consumption tax system. Taxation of individuals would be similar to the Simplified Income Tax Plan, except that the number of tax brackets would be reduced to three (15 percent, 25 percent, and 30 percent), and all dividends, interest, and capital gains would be taxed at 15 percent. The corporate tax rate would be reduced to 30 percent, and corporations would be taxed on their sales minus capital investment, wages, and other compensation (that is, all investment would be expensed), but interest deductions would be denied for all businesses other than financial institutions. Finally, cross-border transactions would be taxed on a destination basis (that is, exports would be excluded from the tax base but imports would be included).

Those proposals meet many of President Bush's objectives and criteria for fundamental tax reform. The proposals repeal the AMT, offer some simplification, and are intended to be revenue neutral. And denying deductions rather than imposing new taxes or increasing tax rates technically complies with President Bush's no new taxes pledge (although some disagree).[37]

However, the limitations on home mortgage interest and charitable donation deductions are inconsistent with the spirit (if not the letter) of Bush's directive to "recognize the importance of homeownership and charity in American society." The panel also failed to enhance progressivity, as President Bush instructed. The denial of deductions for state and local taxes, the reduction in home mortgage interest and charitable contribution deductions, and the imposition of a tax on employer-provided health insurance will hit the middle and lower classes, but the reductions in individual and corporate tax rates, the exemption of tax on dividend income received from U.S. corporations, and the reduction in the capital gains rate for sales of U.S. corporate stock under the Simplified Income Tax Plan will primarily benefit high-income individuals.[38]

The tax reform panel also ignored the sage advice of former Treasury Secretary James Baker to offer suggestions that can gain broad bipartisan support and survive the legislative process.[39] Already, Democrats and Republicans alike have declared the tax panel's proposed offsets unenactable. House and Ways Committee ranking minority member Charles Rangel, D-N.Y., has promised to "fight to the death" against any proposed denial of the deduction for state and local taxes,[40] House Minority Leader Nancy Pelosi, D-Calif., declared that the home mortgage interest deduction is "untouchable,"[41] and even Senate Finance Committee Chair Chuck Grassley, R-Iowa, said that the panel's proposal "just doesn't meet the common sense test."[42]

This article offers an alternative to the tax reform panel's recommendations that would better achieve the president's objectives; preserve deductions for state and local taxes, home mortgage interest, and charitable contributions; and maintain the current exemption for

[37]Letter from Robert R. Davis, executive vice president and managing director, government relations, America's Community Bankers, to Connie Mack, Chairman of the President's Advisory Panel on Federal Tax Reform (Oct. 14, 2005) ("Changes to the interest deduction would be a disguised tax increase").

[38]*See generally* David Cay Johnston, "Higher Tax Rates for Most, Breaks for Some," *The New York Times*, Nov. 2, 2005.

[39]Edmund L. Andrews, "Fed's Chief Gives Consumption Tax Cautious Backing," *The New York Times*, Mar. 4, 2005, at A1, *supra* note 28.

[40]*See* Ian Urbina, "Bush Plan Could Imperil Tax Write-Off for New York," *The New York Times*, Dec. 27, 2004, at B1 ("'We'll fight this to the death,'" said Representative Charles B. Rangel of New York, the senior Democrat on the Ways and Means Committee," referring to a proposal to deny the deduction for state and local income taxes); Charles B. Rangel, "Letter to President's Advisory Panel on Tax Reform," (May 12, 2005), at 93. ("I do not believe that a plan [that can become law] can include repeal of the deduction for State and local taxes"); *see also* Gerald B. Silverman, Drew Douglas and Laura Mahoney, "States Assess Impact of Presidential Panel's Tax Reform Ideas," *BNA Daily Tax Report* (Oct. 25, 2005) (quoting New York Sen. Charles Schumer as pledging to "do everything in our power to defeat this pernicious proposal.").

[41]Kurt Ritterpusch, "Rep. Rangel Asks President Bush to Take Stance on Reform Panel's Ideas," *BNA Daily Tax Report* (Oct. 21, 2005).

[42]Kurt Ritterpusch, "Mortgage Interest Cap May Cause Recession, Community Bankers' Group Warns In Letter," *BNA Daily Tax Report* (Oct. 17, 2005); *see also* Tom DeLay, "A Swing and Miss on Tax Reform," *The Washington Post*, Nov. 4, 2005, at A23 ("The panel's recommendations reveal . . . a minefield of serious political trouble").

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employer-provided health insurance and long-term capital gains rates for all property. It proposes mark-to-market taxation as a component of fundamental tax reform.

Mark-to-market taxation is not a new idea. For more than 30 years, academics have suggested two forms of mark-to-market taxation. The first — a comprehensive system — would impose mark-to-market on all taxpayers and all assets.[43] Critics of that approach agree that a mark-to-market (or accrual) system of taxation best measures Haig-Simons accretion to wealth and therefore is the optimal method to tax income,[44] but identify three "insurmountable" obstacles to the implementation of a comprehensive regime.[45] First, annual valuation is administratively unfeasible (the "valuation" concern); second, without realization, taxpayers will not have the cash to pay their tax (the "liquidity" concern); and third, taxing "paper gains" is psychologically unacceptable (the "psychological" concern) and therefore politically unsaleable.[46]

Those valuation and liquidity concerns were addressed in a second generation of proposals that restricted mark-to-market taxation to publicly traded securities only and suggested other measures of taxation for nontraded assets.[47] Critics, in turn, charged that this "partial" system of mark-to-market taxation would create new inefficiencies by providing an artificial incentive for taxpayers to purchase non-mark-to-market assets; it would not adequately solve the valuation issues; and it would not at all address the most difficult issue of all: the psychological concern of taxing paper gains.[48] As a result,

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[43]*See, e.g.*, Carl S. Shoup, "The White Paper: Accrual Accounting for Capital Gains and Losses," 18 *Can.-U.S. Tax. J.* 96 (1970); *See also* Fred B. Brown, "Complete Accrual Taxation," 33 *San Diego L. Rev.* 1559 (1996); David Shakow, "Taxation Without Realization: A Proposal for Accrual Taxation," 134 *U. PA. L. Rev.* 1111 (1986); Comm'n To Revise The Tax Structure, *Reforming The Federal Tax Structure* 37 (Fund for Public Policy Research 1973); Comm'n. On Taxation, *Facing The Tax Problem* 476-484 (1937).

[44]*See* Deborah H. Schenk "A Positive Account of the Realization Rule," 57 *Tax L. Rev.* 355, 355 (2004) [hereinafter, A Positive Account] (referring to mark-to-market taxation as the "optimal method to tax income.").

[45]*See id.* at 382 ("In summary, at least in the near term, a complete mark-to-market tax system is neither feasible nor politically viable.").

[46]*See id.* at 359-360; Thomas L. Evans, "The Realization Doctrine After Cottage Savings," 70 *Taxes* 897, 898 (1992) ("an attempt to repeal the realization doctrine on a wholesale basis for individual taxpayers would create such a firestorm of political opposition that few politicians would seriously consider such a proposal."); Edward A. Zelinsky, "For Realization: Income Taxation, Sectorial Accretionism, and the Virtue of Attainable Virtues," 19 *Cardozo L. Rev.* 861, 893-900 (1997) [hereinafter For Realization] (discussing resistance to taxation of paper gains); David M. Schizer, "Realization as Subsidy," 73 *N.Y.U. L. Rev.* 1549, 1595, 1607 (1998) [hereinafter Realization]; Clarissa Potter, "Mark-to-Market as the Way to Save the Income Tax — A Former Administrator's View," 33 *Val. U.L. Rev.* 873, 881 (1999) [hereinafter Mark to Market] ("a partial mark-to-market system would be unsaleable").

In *Eisner v. Macomber*, 252 U.S. 189 (1920), the Supreme Court held that stock dividends are not "income" within the meaning of the Sixteenth Amendment because they had not been realized and therefore may not be taxed by Congress without apportionment to the states. One commentator has argued on the basis of *Macomber* that mark-to-market taxation would be unconstitutional. *See* Henry Ordomer, "Revisiting Realization: Accretion Taxation, the Constitution, Macomber *and Mark-to-Market*," 13 *VA. Tax Rev.* 1 (1993). However, the Supreme Court subsequently discredited the reasoning of *Macomber*, *see, e.g., Helvering v. Horst*, 311 U.S. 112 (1940) (realization requirement is "founded on administrative convenience"), several courts have permitted taxation without realization, and, other commentators have unequivocally concluded that the realization requirement is merely an administrative — and not a constitutional — rule. *See generally* Schizer, Realization, *supra* at 1576 and nn. 108-110, *citing Murphy v. United States*, 992 F.2d 929, 931-32, *Doc 93-4599*, *93 TNT 103-17* (9th Cir. 1993) (upholding constitutionality of mark-to-market taxation under section 1250 for commodity futures contracts under section 1256 under a narrow "constructive receipt theory" because taxpayers had immediate access to the cash value of the appreciation without deciding "the broader issue of whether Congress could tax the gains inherent in capital assets prior to realization or constructive receipt"); *Garlock Inc. v. Commissioner*, 489 F.2d 197, 200-201 (2d Cir. 1973) (upholding tax on shareholder's share of current but undistributed earnings of controlled foreign corporation; "the argument that Section 951 . . . is unconstitutional we think borders on the frivolous in light of this court's decision in *Eder v. Commissioner*. . . . " (citation omitted)); *Eder v. Commissioner*, 138 F.2d 27, 28-29 (2d Cir. 1943) (upholding tax on undistributed earnings of foreign personal holding companies); Marvin A. Chirelstein, *Federal Income Taxation* 71 (7th ed. 1994) ("[R]ealization is strictly an administrative rule and not a constitutional, much less an economic, requirement of 'income.'"); Joseph T. Sneed, *The Configurations of Gross Income* 65-72 (1967) (discussing "the Court's erosion of the constitutional requirement of realization"); Boris I. Bittker, "Charitable Gifts of Income and the Internal Revenue Code: Another View," 65 *Harv. L. Rev.* 1375, 1380 (1952) (expressing "no doubt" that realization is not constitutionally required); Richard B. Stone, "Back to Fundamentals: Another Version of the Stock Dividend Saga," 79 *Colum. L. Rev.* 898, 916-18 (1979) (realization is issue of policy, not constitutional law); Stanley S. Surrey, "The Supreme Court and the Federal Income Tax: Some Implications of the Recent Decisions," 35 *Ill. L. Rev.* 779, 791 (1941) (most commentators agree that realization is not constitutionally mandated); *see also* Noel B. Cunningham and Deborah H. Schenk, "Taxation Without Realization: A 'Revolutionary' Approach to Ownership," 47 *Tax L. Rev.* 725, 741 and n.69 (1992) (citing both judicial and academic authority for the proposition that realization requirement is not constitutionally mandated).

[47]*See* David A. Weisbach, "A Partial Mark-to-Market Tax System," 53 *Tax L. Rev.* 95 (1999); Schizer, Realization, *supra* note 46, at 1595 and n.201 (it is relatively "simple" to valuate publicly held securities). Although I refer to this group as the "second generation," it was first suggested by David Slawson almost 40 years ago. *See* David Slawson, "Taxing as Ordinary Income the Appreciation of Publicly Held Stock," 76 *Yale L. J.* 623, 623 (1967) [hereinafter Taxing as Ordinary Income].

[48]*See generally* Schenk, A Positive Account, *supra* note 44, at 355; Potter, Mark to Market, *supra* note 46, at 879; Schizer, Realization, *supra* note 46, at 1549.

(Footnote continued in next column.)

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those commentators unanimously concluded that even a partial mark-to-market system of taxation is not saleable.[49]

This article makes a third attempt. It proposes a "progressive" system of mark-to-market taxation.

Under the proposal, all public companies, all private companies with $50 million or more of net assets, and all individuals and married couples with $1.6 million of adjusted gross income or $5 million of publicly traded property would be required to mark to market their publicly traded property, derivatives with respect to publicly traded property, and certain publicly traded debt and other liabilities (described below).

Married individuals with annual taxable income of $58,100 (unmarried individuals with annual taxable income of $29,050) and investment assets of $50,000 or less (excluding assets held in tax-exempt retirement accounts) would be exempt from tax on all capital gains, dividends, and interest.[50] (Alternatively, rather than exempt investment income for low-income taxpayers, tax-free retirement accounts could be expanded more generally.)

All other taxpayers would remain on the realization system. Realization taxpayers would be permitted to elect mark-to-market treatment for any publicly traded property they hold.

Mark-to-market gains of corporations would be subject to tax at the current marginal rate of 35 percent. Mark-to-market losses of corporations would be fully deductible against ordinary income or capital gain.

Mark-to-market gains (and qualified dividends) of individuals would be subject to tax at the long-term capital gains rate of 15 percent, and the interest and other ordinary income of individuals would remain subject to tax at the ordinary income rate of 35 percent. Individuals who are securities dealers, or who receive allocations of gains for performing investment services, would not benefit from the reduced rates of tax.

Individuals' mark-to-market losses would be fully deductible to the extent of prior mark-to-market gains, could then be used to offset capital gains, and then mark-to-market losses could offset 43 percent (15 percent/35 percent) of ordinary income or could be carried forward indefinitely.

The proposal would generally bifurcate financial instruments into a debt component and a nondebt mark-to-market component and, for corporations, isolate any section 1032 component. The proposal would also generally accelerate the recognition of deferred compensation that is measured by reference to publicly traded property.

How much revenue could be generated by the proposal? If it had been in place in 2004, the proposal would have generated more than $2.2 billion from the two founders of Google alone.[51] Although no direct data exists on the long-term revenue potential of the proposal,[52] an indirect back-of-the-envelope conservative estimate suggests that it could raise between $490 billion and $750 billion over a 10-year horizon.[53]

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[49]*See, e.g.*, Schenk, A Positive Account, *supra* note 44, at 355, Potter, Mark to Market, *supra* note 46, at 879.

[50]The $59,400 and $29,700 figures correspond to the incomes of taxpayers currently entitled to the 5 percent rate on long term capital gains. *See* section 1(h)(1)(B) (2005). Those numbers roughly correspond to the lowest 30 percent of workers. *See* Robert C. Pozen, *A Social Security Plan for All* (Brookings Institution; Jan. 4, 2005), *available at* http://www.brookings.edu/comm/events/20050113_pozen.pdf [hereinafter Social Security Plan]. The $50,000 figure corresponds to the estimated value of the investment assets for the middle quintile of American households. *See* U.S. Census Bureau, *Asset Ownership of Households: 2000*, *available at* http://www.census.gov/hhes/www/wealth/1998_2000/wlth00-1.html (third quintile of households (representing middle 20 percent) had investment assets, including interest earning assets at financial institutions, other interest-earning assets, regular checking accounts, stocks and mutual fund shares, and U.S. savings bonds, with an average value of $41,140).

[51]On Dec. 31, 2004, the founders of Google, Larry E. Page and Sergey Brin, had between them more than $14.5 billion of unsold Google stock. *Global Securities Information Inc., Google Inc. Insider Trading* 18, 101 (Feb. 18, 2005) (on file with author). Assuming that they had purchased their stock for $20 million (which is probably a very high estimate), even at reduced long-term capital gains rates, a mark-to-market tax system would have generated $2.2 billion of tax in 2004 from those two individuals alone.

[52]There is, apparently, no accurate measure of the deferral enjoyed by high net worth individuals. *Cf.* Alan J. Auerbach et al., "Capital Gains Taxation and Tax Avoidance; New Evidence from Panel Data," in *Does Atlas Shrug? The Economic Consequences of Taxing the Rich* 358-362 (Joel Slemrod ed., 2000) (attempting to measure deferral of high net worth individuals without any data on unrealized gains). *Cf.* David M. Schizer, Balance, *supra* note 6, at 1927-28 (pointing out the shortcomings of the Auerbach study).

[53]Over the 10-year period from 1995 through 2005, the wealth of the Forbes 400 grew from just over $500 billion to $1.13 trillion, an increase of 226 percent. *See* United For a Fair Economy, Born on Third Base: The Sources of Wealth of the 1996 Forbes 400, *available at* http://www.faireconomy.org/press/archive/Pre-1999/Forbes 400_study.html (the net worth of the Forbes 400 was just over $500 billion in 1995); Forbes.com, *The 400 Richest Americans*, *available at* http://www.forbes.com/home/lists/2005/09/19/400-richest-americans-2005-list_05rich400_land.html. If the assets of the Forbes 400 increase at this rate over the next 10 years, they will be worth $2.55 trillion in 2015, representing an increase of $1.76 trillion.

Economists estimate that the Forbes 400 hold 3.5 percent of all the individual wealth in the country, and the 0.1 percent wealthiest individuals hold 9 percent. Wojciech Kopczuk and Emmanuel Saez, "Top Wealth Shares in the United States, 1916-2000: Evidence from Estate Tax Returns," 47 *National Tax Journal* 445-487 (June 2004) [hereinafter Top Wealth Shares] (9 percent of wealth concentrated in wealthiest 0.1 percent). Those numbers suggest that the wealth of the top 0.1 percent wealthiest individuals is $2.91 trillion and, if their wealth increases at the same rate as the wealth of the Forbes 400 has increased over the past 10 years, the value of their assets will increase by $5.44 trillion.

However, 13.6 percent of the wealth of *Forbes*'s top 25 individuals is represented by two privately held companies — Mars and Fidelity Investments — and real estate investments, which would not be affected by the proposal. If one assumes that 13.6 percent also represents the percentage of private equity and real estate held by the 0.1 percent highest-income and wealthiest taxpayers, and the prior numbers are reduced by

(Footnote continued on next page.)

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The revenue generated by the proposal would be applied to repeal or modify the AMT and either eliminate tax on the investment earnings of low-income taxpayers or expand tax-free retirement accounts more generally.[54]

How much revenue could be generated by the proposal? If it had been in place in 2004, the proposal would have generated more than $2.2 billion from the two founders of Google alone.

The proposal is designed to attain the president's objectives for fundamental tax reform in a politically achievable manner. First, by repealing or substantially modifying the AMT, the proposal would offer significant simplification for the 30 million taxpayers that would otherwise be subject to it in 2010 and, by eliminating the ability of high-income and high-net-worth taxpayers to time their gains and losses, the proposal would eliminate the need for the straddle rules, the wash sale rules, the constructive ownership and constructive sale provisions, and the capital loss limitations for mark-to-market property. More importantly, mark-to-market taxation would prevent nearly all abuse and eliminate virtually all loopholes for mark-to-market positions, and would help to create a "fair" tax system under the president's definition.

By imposing mark-to-market taxation on high-income and high-net-worth taxpayers only, exempting low-income taxpayers from tax on investment income or expanding tax-free retirement plans, and retaining the realization system for all other taxpayers, the proposal would use the incidence of tax on investment assets to achieve progressivity: no tax for low-income taxpayers, mark-to-market for high-net-worth and high-income individuals, and realization for everyone else. In short, the proposal would expressly use realization as a subsidy for those who need it and deny it to those who do not.[55]

By eliminating tax on the investment income of low-income taxpayers or expanding tax-free retirement plans, the proposal also would encourage savings for the most important segment of the population, and would complement the administration's "progressive indexing" proposal for Social Security.[56] By eliminating deferral, lock-in/lock-out, and strategic trading for mark-to-market taxpayers, the proposal would enhance the efficiency of the tax system and the capital markets.

And, by conforming the tax and GAAP treatment of most publicly traded securities and derivatives, the United States would join the United Kingdom in what is likely to become a global trend toward increased book tax conformity.[57]

Finally, the proposal paves the way toward a fair consumption tax. One of the most serious issues in transitioning to a consumption tax is the potential exemption of untaxed appreciation in the investment assets of wealthy taxpayers. By taxing the appreciation in

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equal percentages, the current estimated wealth affected by the proposal would be $2.51 trillion and 10-year future appreciation would be $4.70 trillion.

Multiplying that number by a tax rate of 15 percent suggests a maximum tax of $705 billion from the appreciation in the assets of individuals and another potential $377 billion from existing wealth (for a total of $1.082 trillion). Even if that potential revenue is discounted by 30 percent (an entirely arbitrary percentage) to account for basis, and gain that would otherwise be recognized over the 10-year period (and any underestimation of privately held wealth), the proposal would produce between $493 billion and $757 billion of additional revenue over 10 years.

[54]The revenue generated by the proposal may not be sufficient to eliminate the alternative minimum tax and eliminate taxable income for low-income taxpayers or expand tax-free retirement plans. Recent estimates place the cost of repeal of the alternative minimum tax at between $600 million and $1.2 trillion over the next decade, or $385 billion to continue the temporary fixes for the next 10 years. Andrews, "Repeal of Alternative Tax Gains a Top G.O.P. Backer," *The New York Times*, May 24, 2005, at C3; Edmund L. Andrews, "Trim Deficit? Only if Bush Uses Magic," *The New York Times*, Feb. 6, 2005, at 1 ("Mr. Bush wants to permanently extend his tax cuts rather than allow them to expire in 2011. That would cost about $1.8 trillion over the next decade, and most would occur after 2009.").

[55]In this respect, the proposal borrows from David Schizer's observation that realization is a subsidy. *See generally* Schizer, Realization, *supra* note 46, at 1549.

Clarrisa Potter was the first commentator to suggest a mark-to-market system that would apply only to corporations and wealthy or high-income individuals. *See* Potter, Mark to Market, *supra* note 46, at 879.

[56]President Bush endorses Robert C. Pozen's "progressive indexing" proposal for social security under which workers averaging $25,000 a year or less (in today's dollars) — representing the lowest 30 percent of workers — and retiring after 2012, would receive their full benefits determined under the current formula, but workers with incomes averaging $113,000 or more (in today's dollars) would receive benefits that increase only enough to compensate for the rising cost of living rather than, under the current formula, increases in wages. *See generally* Pozen, Social Security Plan, *supra* note 50.

Rep. Bill Thomas, R-Calif., chair of the House Ways and Means Committee, has encouraged President Bush to blend his plans for Social Security with his goals of overhauling the tax code. *See* Edmund L. Andrews, "Lawmaker Links Overhauls on Social Security and Taxes," *The New York Times*, Jan. 19, 2005, at A14.

[57]Beginning in section 42 of the Finance Act 1998, the United Kingdom has generally followed book profits in computing taxable income, with specific adjustments. Under U.K. GAAP Financial Reporting Standard 26 and International Accounting Standard 39, all assets and liabilities held for trading (and certain other assets and liabilities), all derivative financial instruments, and any part of a hedged asset or liability in which the hedging instrument is marked-to-market must be marked-to-market for book purposes. Although those mark-to-market gains and losses are booked to "reserves" rather than earnings, under U.K. legislation enacted in 2004, the marked-to-market gains and losses are generally required to be recognized for tax purposes, subject to specific exceptions. *See* Finance Act 2004 Schedule 10 (paragraphs 3 and 49); 84A Finance Act 1996; Schedule 26 Finance Act 2002 (paragraph 16).

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publicly traded property held by high-net-worth individuals, the proposal would halt future untaxed appreciation and ease transition toward a fair consumption tax. Moreover, once high-income and wealthy shareholders are taxable on the untaxed appreciation in their public equities securities, the cost of integrating the corporate and individual tax systems may be manageable.

In short, the proposal would expressly use realization as a subsidy for those who need it and deny it to those who do not.

Significantly, the proposal does not increase rates, deny deductions, or impose new taxes, and therefore (in contrast to the tax reform panel's recommendations) does not violate the president's "no new taxes" pledge.[58] It would reduce or eliminate taxes for tens of millions of taxpayers, adversely affect fewer than 400,000 households, and therefore would be expected to win strong public support. (However, the proposal would directly affect the ultrawealthy taxpayers that form a core political constituency of the Republican party and so it would remain to be seen whether their opposition is stronger than the opposition facing other proposals.[59])

The proposal also attempts to address the most serious concerns of other mark-to-market proposals. By subjecting only high-net-worth and high-income individuals and large corporations to mark-to-market taxation, the proposal undercuts the primary psychological hurdle faced by other partial mark-to-market proposals.[60] Those taxpayers are fully capable of accessing their paper gains; for them, paper gains are actual cash. And only those taxpayers have access to financial products that defer or eliminate tax. Similar concerns were raised and cleared in the last major incursion on realization — section 1259 — when it was convincingly demonstrated that the proposal would affect only the wealthy.[61]

Liquidity concerns also should be manageable for superrich individuals and large corporations subject to mark-to-market tax on gains on their publicly traded securities and derivatives. Those positions are (or may be structured to be) entirely liquid. And the proposal offers the backstop of government-sponsored collateralized loans to pay the taxes of those taxpayers that hold restricted and other illiquid publicly traded property.

Two other charges cannot be as easily dismissed, but are addressed. First, some derivatives and debt are inherently difficult to value; critics will charge that requiring taxpayers to value them will lead to endless litigation. However, the force of this argument is diminished now that securities and derivatives valuation is required under GAAP. Under the proposal, taxpayers that maintain "reliable financials" could generally elect to use their financial reporting values for tax purposes.

And for other taxpayers, the proposal addresses the concern directly by adopting a "process-based" approach. As discussed in greater detail in Part II.K., below, the proposal assigns valuation responsibility in the first instance to financial institutions and other designated "mark providers." If a taxpayer relies on a mark provider's valuation in good faith, underreported gain in prior years would be subject only to an interest charge at market rates of interest. Penalties would be imposed on mark providers only if their valuations are unreasonable or conducted in bad faith. Some taxpayers would be permitted to value their own positions; those taxpayers would not benefit from the safe harbor.

Second, by subjecting only some assets to mark-to-market treatment, the proposal is open to the legitimate concern that mark-to-market taxpayers would shift their investments into real estate, private companies, and other "nontraded assets." That consequence is inevitable at the margins, but should not be overstated. The strategy would carry a significant cost: illiquidity. Our current tax system, by imposing a corporate-level tax only on publicly traded active businesses, already imposes a significant cost on liquidity, which has not deterred public offerings, even of highly profitable partnerships. In most cases, the benefits of liquidity would outweigh the loss of deferral.

Part II of this article describes the proposal in greater detail and discusses the choices and issues it raises. Part III addresses the anticipated criticisms of the proposal. Finally, Part IV catalogues its benefits and argues, ultimately, that it offers a model that is at least as politically plausible as the tax reform panel's recommendations and other reform proposals. The article concludes with Part V.

II. 'Progressive' Mark-to-Market Taxation

A. Mandatory Mark-To-Market Taxpayers

Under the proposal, only public companies, private companies with $50 million or more of reported shareholder equity or $75 million or more of net assets, and individuals and married couples with $1.6 million of adjusted gross income (including tax-exempt income) or $5 million of publicly traded property would be subject to mandatory mark-to-market taxation. Those limitations are designed to enhance progressivity, address the liquidity and psychological concerns of other mark-to-market proposals, and increase the likelihood of the proposal's political acceptance.

1. Public corporations. Under the proposal, publicly traded corporations would be subject to mark-to-market

[58]The administration interprets the pledge merely to prohibit an increase in rates or a new tax; thus, the pledge would not be violated by denying deductions for state and local taxes or interest, but it would be violated by the tax reform panel's proposal to increase the long-term capital gains rate for property other than U.S. corporate stock. Under the administration's standard, mark-to-market taxation also would not violate the "no new taxes" pledge.

[59]*See* Jackie Brown and Danielle DiPenti, "Bush Wins — Among Rich Listers," Forbes.com (Oct. 11, 2004), *available at* http://www.forbes.com/business/forbes/2004/1011/068a.html (of the 240 members of the Forbes 400 who contributed money to either campaign directly, "a whopping 72 percent gave to Bush. Only 28 percent support Democratic nominee John Kerry.").

[60]*See* Potter, Mark to Market, *supra* note 46, at 879.

[61]*See* Schizer, Realization, *supra* note 46, at 1606.

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taxation on their publicly traded securities and derivatives. Publicly traded companies are required under GAAP to annually mark to market their marketable equity securities, debt securities that are not intended to be held until maturity, and some of their derivatives, and use those valuations to report their earnings or other comprehensive income.[62] The ability of those companies to annually value their marketable securities and derivatives for financial accounting purposes undercuts the valuation concern.[63] (U.K. companies that report under U.K. GAAP or international accounting standards are already required to report certain assets and derivatives on a mark-to-market basis.[64]) Also, publicly traded companies have access to the capital markets, which undercuts the liquidity concern that they would not have sufficient cash to pay their tax under a mark-to-market system. And, finally, the psychological resistance to taxing mere "paper gains" is significantly less forceful if a public company is reporting its paper gains as earnings to its shareholders. Restating the point in a political sound bite, if "paper" earnings are real enough to be reported to shareholders, they should be real enough to be taxed.

2. Large private C corporations. Mark-to-market taxpayers would also include "large" private subchapter C corporations that report shareholder equity of $50 million or more on audited financials, or have net assets (that is, assets less liabilities) with a fair market value of $75 million or more.

Those thresholds correspond roughly to the requirements for listing on the NASDAQ and Amex stock exchanges.[65] The $50 million shareholder equity test is simple to apply, and a shareholder equity test is justified by the incentive of companies to maximize their asset value and minimize their liabilities for financial reporting purposes. However, it is possible that a company will eschew audited financials to avoid the lower $50 million threshold. That "avoidance" of mark-to-market taxation would not be considered abusive. However, it is more likely that the benefits of audited financials — such as access to the Rule 144A debt market — will outweigh the loss of deferral.

Although private companies do not have the same access to the capital markets as public companies, those valuation thresholds are set high enough so that "small" private companies would not be affected, and any private company of that size would normally have sufficient liquidity to pay annual appreciation on its appreciated securities, thereby mitigating the liquidity and psychological concerns. And any company maintaining audited financials would be required to value its publicly traded securities for GAAP purposes, thereby mooting the valuation concern.

Valuation issues would exist for companies that do not report $50 million of shareholder equity on audited financials. However, for those companies the threshold is set 50 percent higher (at $75 million) and, to prevent a windfall lawsuit settlement or other extraordinary events from triggering mark-to-market treatment, the test would require that the threshold be met during 30 days of the tax year.[66] Antiabuse rules would prevent corporations from avoiding the asset threshold through tax-motivated transfers or related-party borrowings.[67]

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[62]*See* Financial Accounting Standards Board, Statement of Financial Accounting Standards (FAS) 115, paragraph 7 (investments in debt securities for which the investor has a positive intent and the ability to hold until maturity are accounted for as held-to-maturity securities and are not marked-to-market); FAS 115, paragraphs 12.a and 13 (marketable equity securities and all debt securities that are bought and held principally for the purpose of selling them in the near-term (thus held for only a short period of time) [trading securities] are carried at fair value and changes in fair value are recognized in earnings on the income statement); FAS 115, paragraphs 12.b and 13 (marketable equity securities and all debt securities that are not held-to-maturity or trading securities are classified as available for sale securities; in this case the mark-to-market gains and losses are reflected in "other comprehensive income," which is reflected as equity on the balance sheet; FAS 133 (requiring derivatives to be marked to market); FAS 149 (modifying FAS 133); FAS 150 (establishing standards for classifying and measuring instruments that may be both liabilities and equity). *See generally* Alvin D. Knott and Jacob D. Rosenfeld, "Book and Tax (Part One): A Selective Exploration of Two Parallel Universes," *Tax Notes*, May 12, 2003, p. 865; Yoram Keinan, "Book Tax Conformity for Financial Instruments," 6 *Florida T. Rev.* 676 (2004) [hereinafter Book Tax Conformity].

[63]The Emerging Issues Task Force of the Financial Accounting Standards Board issued guidance in 2003 for valuing energy derivatives. This guidance is commonly used to value all derivatives. It provides, in general, that gain can be reported as earnings only if objective evidence of the gain exists. *See* EITF, Issue No. 02-3 ("issues involved in Accounting for Derivative Contracts Held for Trading Purposes and Contracts Involved In Energy Trading and Risk Management Activities."). *See generally* Alan B. Munro and Yoram Keinan, "The Case for Book-Tax Conformity for Mark-to-Market Valuations," 16 *J. of Taxation of Financial Institutions* 5, 9 n.13 (July/August 2003).

[64]*See* Finance Act 2004 Schedule 10 (paras. 3 and 49); 84A Finance Act 1996; Schedule 26 Finance Act 2002 (para. 16).

[65]*See* NASDAQ Rule 4450(b) ($50 million market value of listed securities or $50 million of total assets and total revenue for continued listing; $75 million for initial listing); Amex Standard 3 ($50 million total market capitalization and certain other requirements) and Standard 4 ($75 million total market capitalization and certain other requirements).

[66]Thus, if a C corporation were to win a significant lawsuit that increased its net asset value to greater than $75 million, but the C corporation distributed the proceeds to its shareholders within 30 days, the lawsuit alone would not cause the corporation to be subject to mark-to-market treatment.

[67]Thus, if a corporation were to sell or otherwise transfer assets with a primary purpose to avoid the asset threshold, the transfer would be disregarded and the corporation would be treated as a mark-to-market taxpayer.

For purposes of the $75 million threshold, all liabilities owed to shareholders and related parties (taking into account the attribution rules of section 318) and members of the controlled group of corporations that include the corporation (as defined in section 1563, but based on a 50 percent test and including insurance companies) would be treated as capital contributions rather than liabilities. Thus, if a shareholder contributed $10 million and loaned $75 million to a corporation, the corporation would be treated as satisfying the $75 million threshold.

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Insurance companies are likely to be hit hardest by the proposal because they typically maintain their reserves in publicly traded securities, and the insurance lobby may imperil the proposal. Nevertheless, subjecting insurance companies to mark-to-market treatment on their publicly held property is appropriate. If insurance companies were exempt from mark-to-market treatment, they would become tax shelters for wealthy taxpayers seeking deferral.[68]

3. Mark-to-market thresholds for individual taxpayers and trusts. The proposal would impose mandatory mark-to-market treatment on any individual, married couple, or trust with annual adjusted gross income (including tax-exempt income)[69] in excess of $1.6 million, and on any individual, married couple, or trust with $5 million or more of publicly traded property, cash, or cash-equivalent investment assets.

The $1.6 million threshold roughly corresponds to the highest 0.1 percent income-earning individual taxpayers and married couples (roughly 290,000 households), and would be adjusted annually in sizable increments (for example, $500,000) to track the taxable income of the 0.1 percent highest-income individual and married couples.[70]

Wealth is highly concentrated in that group. By some estimates, as much as 9 percent of all wealth is held by the 0.1 percent wealthiest individuals.[71] Thus, the $1.6 million threshold subjects a relatively high amount of wealth, but a relatively small number of taxpayers, to mandatory mark-to-market taxation.[72]

Moreover, because the wealth of that group is heavily weighted in corporate stocks and bonds, it disproportionately benefits from the deferral that is possible in a realization system.[73]

An income test alone is insufficient to identify the taxpayers that should appropriately be subject to mark-to-market treatment for their publicly traded property. If the threshold for mark-to-market treatment were based on income alone, an extremely wealthy individual with equity securities could avoid $1.6 million of adjusted gross income simply by avoiding dividend-paying stock, hedging his risk with derivatives, and either borrowing against the appreciated securities or entering into prepaid forward contracts or other derivatives that produce cash but no immediate taxable income. For that reason, an asset test is necessary.

Therefore, mandatory mark-to-market treatment would also be imposed for any tax year that an individual, married couple, or trust holds $5 million or more of publicly traded positions, cash, or cash equivalents that are investment assets.

The $5 million threshold roughly corresponds to the wealthiest 0.1 percent of taxpayers and also mirrors the

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[68]This phenomenon exists today with respect to the "active insurance company" exception to a PFIC. Some taxpayers have organized offshore companies to qualify as active insurance companies and invest in hedge funds in an attempt to escape the PFIC rules. *See* Hal Lux, "The Great Hedge Fund Reinsurance Tax Game," *Institutional Investor* 52 (April 2001).

[69]When the JCT measures income, it starts with adjusted gross income and adds (i) tax-exempt interest, (ii) employer contributions for health plans and life insurance, (iii) employer share of FICA tax, (iv) worker's compensation, (v) nontaxable Social Security benefits, (vi) insurance value of Medicare benefits, (vii) AMT preference items, and (viii) excluded income of U.S. citizens living abroad. *See Distributional Effects of the Taxpayer Refund Act of 1999*, *available at* http://www.house.gov/jct/x-50-99.pdf. For the sake of simplicity (and because all categories other than the first are likely de minimis in the aggregate for this class of taxpayer), the proposal would add back in only tax-exempt interest income.

[70]In 2001 the threshold was approximately $1.5 million (approximately 107,000 taxpayers, out of 104.16 million total returns filed), *available at* http://www.irs.gov/pub/irs-soi/01in35mt.xls.

[71]Kopczuk and Saez, Top Wealth Shares, *supra* note 53 (9 percent of wealth concentrated in wealthiest 0.1 percent). Kopczuk and Saez concede that their data may underestimate the concentration of wealth. In 2000 the wealthiest 0.01 percent of individuals controlled around 4 percent of wealth, the Forbes 400 (representing the 0.0002 percent of richest individuals) controlled 3.5 percent of all wealth in 2000 and the top four individuals (Bill Gates, Warren Buffett, Lawrence Ellison, and Paul Allen) had wealth totaling $166.33 billion, representing 0.52 percent of total net worth. *See also* James Poterba, "Stock Market Wealth and Consumption," 14 *Journal of Economic Perspectives* 99-118 (2000) (top 1 percent holds as much as 53 percent of household stock holdings).

[72]For example, if the threshold were expanded to the top 0.5 percent of taxpayers, double the number of taxpayers would be affected (534,356), but the annual income of the entire group would be only one-third greater ($327 billion in 2000). In contrast, the 0.01 percent wealthiest (average income of $5,349,795 in 2000) numbered only 13,354 in 2000, but their aggregate annual income was only $174 billion.

[73]Kopczuk and Saez, Top Wealth Shares, *supra* note 53 (corporate stock, bonds, and cash and deposits represent approximately two-thirds of the total wealth for the top one-third of the 0.5 percent wealthiest individuals).

Capital gains for the top 1 percent of income earners represent 57 percent of their total income. *See* Gregg A. Esenwein and Jane G. Gravelle, "An Analysis of the Tax Treatments of Capital Losses," at 8 (Congressional Research Service) (Oct. 9, 2002) (between 1979 and 1988, 57 percent of the income of the top 1 percent consisted of capital gains). The percentage is even higher for the elite taxpayers. *See* Leonard E. Burman and Deborah I. Kobes, "Composition of Income Reported on Tax Returns," *Tax Notes*, Nov. 10, 2003, p. 783 (in 2000, 71 percent of the income of the 400 highest-income taxpayers consisted of capital gains). In 2003 journalist Martin Sullivan compared the aggregate tax bill for the 400 highest-earning households between 1992 and 2000 ($76 billion) to the aggregate net worth increase of the Forbes 400 during that period ($380 billion to $1.235 trillion, representing an increase in net wealth of $855 billion). Although the long-term capital gains tax rate during that period was significantly higher than today (28 percent until 1997, when it was reduced to 20 percent), if the Forbes 400 paid the same amount of tax as the group of the 400 highest-earning taxpayers, the effective tax rate on their wealth would be something less than 9 percent (76/855). However, it is likely that this estimate grossly understates the tax savings, because it is highly unlikely that many of the Forbes 400 were in the group of 400 highest earning households. The effective tax rate on the appreciation of wealth of the Forbes 400 is likely a fraction of 9 percent.

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$5 million threshold that establishes a "qualified purchaser" under the Investment Company Act of 1940.[74] Under the proposal, the threshold would be presumed to be satisfied for any taxpayer in any tax year if the taxpayer represents (or is the beneficiary of a trust or the 10-percent-or-greater equity holder of any vehicle that represents) that it is a "qualified purchaser" for purposes of the Investment Company Act of 1940 in connection with the purchase of a security and the security is not directly used in, and reasonably necessary for, an active trade or business.

The asset test is designed to be set sufficiently high so that it applies only to those taxpayers who are sufficiently wealthy and sophisticated that they have access to adequate liquidity to borrow to pay tax on their mark-to-market gains. Those investors have a greater number of investments and financial products available to them that avoid current taxable income.

However, the asset test does not precisely correspond to the '40 Act test, which is designed to measure sophistication rather than liquidity.[75] Therefore, the $5 million threshold is based only on a taxpayer's publicly traded positions, cash, and cash equivalents that serve as investment assets. Thus, nontraded assets and assets that are directly used in and reasonably necessary for an active trade or business would be excluded.[76]

Also, for purposes of determining whether an individual satisfies the $5 million gross asset test, assets in qualified retirement plans (for example, 401(k)s, HR10s, and IRAs) and assets generated by up to $1 million of premiums paid for insurance policies or annuities would be excluded from the asset test. However, if an individual had paid more than $1 million in insurance or annuity premiums, a proportionate amount of the assets corresponding to the excess would be included for purposes of the asset threshold.[77]

The exclusion from the $5 million threshold for the assets generated by up to $1 million of life insurance premiums will encourage individuals at the $5 million threshold to maximize their investment in insurance to benefit from the exclusion. However, that inefficiency is relatively insignificant.

The asset test is based on gross assets rather than net assets. If the test were based on net assets, a taxpayer with $5 million of publicly traded securities could escape mandatory mark-to-market treatment by borrowing against the assets (and thereby reducing his or her net assets below the $5 million threshold) and using the proceeds to purchase non-mark-to-market assets (such as a bigger home). Tracing liabilities to assets would be an impossible task.

However, a gross asset test may cause some individual taxpayers with relatively low net wealth to be subject to mandatory mark-to-market treatment, and conceivably could invoke liquidity and psychological concerns. For example, if a taxpayer has $5 million of publicly traded assets, but is subject to $5 million in debt, the taxpayer would be subject to mandatory mark-to-market treatment even though the taxpayer has no net assets. However, the ability of taxpayers to borrow to pay their tax liability moots some of the liquidity concerns and it is unlikely that taxpayers with $5 million of investment assets will invoke much sympathy.

For purposes of determining whether a taxpayer satisfies the gross asset test, a taxpayer would be treated as owning her distributive share of the publicly traded assets held through a subchapter S corporation or any non-publicly-traded partnership, trust, registered investment company, real estate investment trust, and any non-mark-to-market domestic C corporation that satisfies the asset or income test for a passive foreign investment company or is organized (or marketed) with a principal purpose to avoid mark-to-market treatment. Those vehicles would be required to provide each mark-to-market partner, shareholder, and beneficiary with her share of the gross value of its publicly traded property. (Those vehicles are referred to as reporting vehicles.) Those reporting requirements are described in Part II.J.

Those attribution and reporting rules are not perfect, and add complexity, but are preferable to a series of antiabuse rules designed to prevent mark-to-market taxpayers from holding their publicly traded property in non-mark-to-market domestic C corporations.

The asset test would exclude nontraded assets, such as homes, real property, and collectibles. That exclusion would encourage taxpayers at the margins to invest marginal assets in nontraded property, or give them away. However, the cost of that strategy would be illiquidity. This topic is discussed in greater detail in Part III.B.

Also, the $5 million gross asset test produces a "cliff effect": A taxpayer with less than $5 million worth of publicly traded investment property (and less than $1.6 million of income) would remain a realization taxpayer for all of his property, but a taxpayer with $5 million of publicly traded investment property would be subject to mark-to-market on all of his publicly traded property. An alternative approach would have exempted the first $5

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[74]*See* Kopczuk and Saez, Top Wealth Shares, *supra* note 53 (each of the wealthiest 0.1 percent of taxpayers in 2000 had a minimum of $5,687,000 of wealth).

Section 3(c)(7) of the Investment Company Act of 1940 provides an exemption from registration for any funds that limits its investors to "qualified purchasers." An individual is a "qualified purchaser" under the Investment Company Act of 1940 if he owns $5 million in investments. 15 U.S.C. section 80a-2(a)(51).

[75]S. Rep. 293, 104th Cong., 2d. Sess. 10 (1996) ("Generally, these investors can evaluate on their own behalf matters such as the level of a fund's management fees, governance provisions, transactions with affiliates, investment risk, leverage, and redemption rights.").

[76]Thus, if a widget manufacturer operating as a sole proprietorship through a limited liability company were to enter into an interest rate swap to hedge the borrowings of his company, the interest rate swap would not in and of itself cause the widget manufacturer to be a mandatory mark-to-market taxpayer.

[77]For example, assume that an individual had paid $3 million in life insurance premiums and the cash value of the insurance policy was $6 million. In that case, $4 million (($3 million premiums — $1 million exclusion amount)/$3 million premiums x $6 million value) would be included in determining whether the individual passed the $5 million asset threshold.

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million of publicly traded investment property.[78] Although that approach would avoid the cliff effect, it would reduce revenue and create complexity (that is, the need to maintain both realization and mark-to-market accounts and rules to decide which securities are subject to each). For those reasons, the alternative approach was rejected.

B. Exempt Taxpayers

Unmarried individuals with annual taxable income of $29,050 or less, and married individuals with annual taxable income of $58,100, and investment assets of $50,000 or less (excluding assets in tax-exempt retirement accounts and assets generated by up to $50,000 of premiums paid for insurance polices or annuities), would be exempt from all tax on investment income as long as they are not otherwise mandatory mark-to-market taxpayers.[79] This exemption is designed to satisfy the president's objective of encouraging savings and investment.[80]

C. Realization Taxpayers

All taxpayers that are not mandatory mark-to-market taxpayers or exempt from tax on investment income would remain realization taxpayers. Realization taxpayers would be permitted to irrevocably elect mark-to-market treatment for any of their publicly traded property on acquisition.

D. Treatment of Mark-to-Market Corporations

Under the proposal, all mark-to-market corporations would be required to mark to market (that is, treat as sold and repurchased) their mark-to-market positions (and the positions attributed to them through reporting entities), report the resulting gains or losses, and adjust their basis accordingly.[81]

Corporations would treat their mark-to-market gains as ordinary income.[82] The decision to retain the 35 percent rate for mark-to-market gains of corporations assumes that the desire for revenue and simplicity will overcome arguments for a reduced rate of tax. However, it is true that requiring corporations to mark to market their corporate equity securities would exacerbate the double taxation inefficiencies of our classical tax system.

Because a mark-to-market system eliminates the ability of taxpayers to "cherry-pick" losses, the proposal would treat any mark-to-market losses as ordinary losses.[83] Accordingly, mark-to-market losses would be fully available to offset both capital gains and ordinary income of corporations.[84]

E. Special Rules for Individuals

1. Overview. Mark-to-market gains of individuals would be subject to tax at the long-term capital rate of 15 percent. Qualified dividends received by individuals would also be taxed at 15 percent, but the holding period requirement would be eliminated for stock that is mark-to-market property. Interest and other ordinary income of individuals would remain subject to tax at ordinary rates.

Mark-to-market losses of individuals could offset mark-to-market and other capital gains, and then 43 percent (15 percent/35 percent) of any remaining mark-to-market losses would be available to offset ordinary income, or could be carried over indefinitely.[85] The straddle rules and section 263(g), the wash sale rules, the constructive ownership and constructive sale provisions, the foreign currency rules, and the PFIC rules would not apply to mark-to-market property whose gain is fully recognized.

The proposal would bifurcate prepaid forwards, convertible bonds, and contingent payment debt instruments (CPDIs) into a nonconvertible/noncontingent debt component that would accrue original issue discount (taxable at the ordinary income rate of 35 percent), and a mark-to-market component (taxable at the long-term

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[78]The author is grateful to Prof. Daniel Shaviro for suggesting that alternative.

[79]Alternatively, tax-free retirement accounts could be expanded more generally.

[80]Office of the Press Secretary, "President Bush Provides Leadership on Tax Reform" (Sept. 2, 2004), *available at* http://www.whitehouse.gov/news/releases/2004/09/20040902-7.html (outline of Bush's tax agenda).

[81]As described below in Part II.P., under some forms of the proposal, preenactment built-in gain would not be required to be recognized immediately. In that event, mark-to-market losses would be limited to actual realized losses. Thus, assume that mark-to-market taxpayers are required to mark their securities to market but not recognize the preenactment built-in gain. If a taxpayer has mark-to-market property with a basis of $100 and a fair market value of $1,000 on the date of enactment, and at the end of the first year following enactment, the value of the property is $900, no loss would be recognized; if the value were $60, the taxpayer would recognize a $40 mark-to-market loss.

[82]To the extent that it is necessary to preserve the character of interest (and similar items of income and expense), either (i) the current law rules could be retained (*see* prop. Treas. reg. section 1.475(a)-1), (ii) the special rules in 2(f), for determining interest income for individuals, could be applied to corporations, or (iii) corporations would treat an amount equal to their net investment in all mark-to-market property (other than stock and debt, which would remain subject to the current rules) times an AFR-based rate, and would increase their tax basis in those securities by an equal amount to determine their mark-to-market gains or losses.

(Footnote continued in next column.)

[83]*See* Robert H. Scarborough, "Different Rules for Different Players and Products: The Patchwork Taxation of Derivatives," 72 *Taxes* 1031, 1044-1047 (1994) (mark-to-market treatment prevents cherry-picking).

[84]If preenactment built-in gains are grandfathered (and not required to be recognized on a mark-to-market basis), then mark-to-market losses on built-in gain property would be required to be realized to be recognized. Thus, if a mark-to-market taxpayer owns publicly traded stock with a basis of zero and value of $100 on the effective date of the proposal, and the "weak form" of the proposal (described in Part II.N.) is adopted so that the $100 of built-in gain is not required to be recognized before sale, then, if the value of the stock declines to $90 at the end of year two, the taxpayer would not be permitted to recognize the unrealized loss of $10.

[85]As discussed above, if preenactment built-in gain were not subject to mark-to-market taxation, any mark-to-market losses on built-in-gain property could be recognized only to the extent realized.

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capital gains rate of 15 percent).[86] The bifurcation rules are described in Part II.G.3., below.

2. Tax rates. The tax rates for mark-to-market gains and losses, and ordinary income, reflect a balance between the generation of revenue, political acceptability, and simplification.

The proposal taxes mark-to-market gains of individuals at the long-term capital gains rate of 15 percent because it is highly unlikely that a mark-to-market proposal could gain political acceptance if the rate for individuals is set higher than the current long-term capital gains rate. That rate has the effect of reducing the marginal rate for short-term capital gains and section 1256 contracts.[87] The decision to tax all mark-to-market gains at a single rate increases efficiency and simplicity.

The proposal would permit any realization individuals to voluntarily (but irrevocably) elect to mark to market a particular capital asset. Those individuals would report any first-year gain as short-term capital gain (taxable at 35 percent). Otherwise, realization taxpayers would mark to market all of their short-term assets and remain subject to realization for their long-term investments. However, a realization individual who irrevocably elects mark-to-market treatment for all of her mark-to-market property would be treated identically to a mandatory mark-to-market taxpayer, and all mark-to-market gains would be subject to tax at the long-term capital gains rate of 15 percent.

Under the proposal, individuals who are dealers in securities, and managers of investment partnerships that receive a carry for their investment advisory services, would not benefit from the reduced rates of tax for mark-to-market gains from their dealer activity or mark-to-market gains allocated to them for the investment services they provide because, for those taxpayers, those incomes and gains are wage equivalents, and permitting those taxpayers to receive a reduced rate of tax for those incomes and gains would not ensure that "everyone pays her fair share."

In his article on a partial system of mark-to-market taxation for publicly traded securities, Prof. David Weisbach recommended that the tax rate for mark-to-market gains be set at the effective rate for realization gains (which he approximated as the "average" rate on realization gains); otherwise, if the rate of tax on mark-to-market property is set higher than the rate for realization assets, Weisbach argued, the tax law would create an artificial incentive for taxpayers to purchase real estate and other nontraded assets.[88] The proposal, by failing to adopt that recommendation, would produce some marginal inefficiency. That inefficiency is discussed in Part III.B.

3. Qualified dividends. The proposal taxes qualified dividends received by mark-to-market individual taxpayers on mark-to-market equity securities at the 15 percent rate. Once gains on all mark-to-market stock are subject to a 15 percent maximum rate, a higher rate for dividends is difficult to justify and would simply encourage mark-to-market taxpayers who have not held their stock for the requisite dividend holding period to sell their shares immediately before a dividend record date, repurchase them immediately thereafter, and claim the 15 percent rate on the gain.

4. Interest income and other ordinary income. Although the mark-to-market gains and dividends of individuals are taxed at the reduced long-term capital gains rate of 15 percent, the proposal taxes all interest and other ordinary income at the ordinary income rates of 35 percent, and requires market discount to be accrued currently by mark-to-market taxpayers. That rate differential introduces complexity into the proposal, but there are four reasons why it is necessary.

First, the proposal would be too generous if interest and other ordinary income earned by mark-to-market taxpayers were reduced from 35 percent to 15 percent, and the proposal would generate significantly less revenue.

Second, the preferential rate for dividends helps to mitigate the double taxation of corporate earnings under our classical system. No similar reason exists to reduce the rate of tax on interest and other ordinary income.

Third, as David Weisbach pointed out, stock investments benefit from a lower effective rate of tax than debt because, under current law, noteholders are subject to tax currently on their return on investment (either as interest, if paid currently, or original issue discount, if not), but shareholders of non- or low-dividend-paying stock may defer their return indefinitely until a sale, taxable exchange, or other disposition.[89] That lower effective rate for stock helps balance the strong tax incentive for corporate taxpayers to issue debt (which permits the corporate taxpayer to claim deductions) rather than equity (which does not). If the deferral for corporate equities is eliminated for mark-to-market taxpayers, the incentive for debt financing would increase. Retention of the 35 percent rate for interest is designed to avoid exacerbating the tax law's incentive to debt finance.

And finally, if the effective tax rate for interest is reduced, the cost of funds for states and municipalities

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[86]This aspect of the proposal borrows from Noël B. Cunningham and Deborah H. Schenk, "Taxation Without Realization: A 'Revolutionary' Approach to Ownership," 47 *Tax L. Rev.* 725 (1992). It would reverse the treatment of complex and compound derivatives under current law. *See* Dickson G. Brown, "Separation Anxiety," *Tax Forum* No. 582 (2005) (compound financial instruments whose components may not be separated are generally treated as a single indivisible instrument for federal income tax purposes).

[87]Under current law, dealers in commodities are entitled to a reduced rate of tax of 23 percent (60 percent x 15 percent + 40 percent x 35 percent) on the gains and losses from section 1256 contracts. The proposal would repeal section 1256 and would eliminate the preference.

[88]*See* Weisbach, "A Partial Mark-to-Market Tax System," *supra* note 47, at 101 ("[T]axpayers faced with a choice of investing in an asset in the realization based and an asset in the mark-to-market base will face tax rates that are as similar as possible and, therefore, taxes will have the least influence on behavior.").

[89]*Id.*

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from tax-exempt bonds would increase, and the market value of outstanding tax-exempt bonds would drop precipitously.

However, if taxpayers are denied deductions for interest expense,[90] the first three reasons for imposing the higher rate on interest and other ordinary income earned on mark-to-market debt instruments would become less important; if all income and gain on mark-to-market property were taxable at a single rate, individuals would be subject to the same simple rules as corporations and the special rules for individuals that are discussed in this section would be unnecessary.

5. Section 1258. Section 1258 provides that if a taxpayer enters into a straddle (or certain other transactions) and "substantially all" of the taxpayer's expected return from the transaction is attributable to the time value of the taxpayer's net investment in the transaction, the transaction is treated as a "conversion transaction," and any capital gain is treated as ordinary income to the extent of the interest that would have accrued on the taxpayer's net investment in the conversion transaction for the term of the taxpayer's investment at a rate equal to 120 percent of the applicable federal rate. Section 1258 would be retained for individuals and applied to treat a portion of the mark-to-market gains of an individual mark-to-market taxpayer that enters into a conversion transaction as ordinary income.[91]

6. Market discount and acquisition premium. Under the proposal, individual mark-to-market taxpayers would be required to accrue market discount on a mark-to-market debt instrument at the 35 percent ordinary income rate (and would be permitted to deduct amortizable bond premium, as under current law). However, the proposal would modify current law to provide that market discount need not be accrued on any bond (i) that is in default, (ii) to the extent the market discount yield is greater than AFR plus 5 percent, or (iii) with a credit rating that is less than "junk."[92] Moreover, any loss following a default would be treated as an ordinary loss to the extent of prior accruals of ordinary income.

7. Convertible bonds, contingent payment debt instruments, and prepaid forwards and swaps. The proposal would change the treatment of individual mark-to-market holders of convertible bonds, CPDIs, and prepaid forward contracts, swaps, and other derivatives. Under the proposal, a mark-to-market individual that holds a mark-to-market convertible bond or CPDI that is itself publicly traded or references mark-to-market property would deconstruct the convertible bond or CPDI into a nonconvertible/noncontingent debt instrument with a yield equal to the issuer's comparable yield and a non-debt option or other derivative contract (that is, the convertible bond or CPDI would be treated as the equivalent unit).

Also, the taxpayer would deconstruct a prepaid forward, deep-in-the-money option, or prepaid swap into a debt instrument (or deposit) with an issue price equal to the prepayment or premium and a yield equal to the counterparty's comparable yield, and a mark-to-market derivative. The taxpayer would accrue OID (taxable at 35 percent) on the debt instrument component, add any accrual to its basis, and treat the difference between the fair market value of the instrument and its adjusted basis as mark-to-market gain or loss taxable at the 15 percent rate.[93] The issuer of a debt instrument or the financial institution counterparty on a derivative would be responsible for the bifurcation, and a designated position mark provider would be responsible for the valuation of each component. (Mark providers are described below in Part II.K.)

Those aspects of the proposal are optional (and complicated), but without them, individual mark-to-market taxpayers would still have an incentive to structure their investments as forwards, convertible bonds, prepaid forwards, and deep-in-the-money options and convert their time-value-of-money returns into mark-to-market gains, taxable at the 15 percent long-term capital gain rate.[94]

8. The use of mark-to-market losses to offset ordinary income. Under the proposal, mark-to-market gains of individuals are subject to a reduced 15 percent rate of tax. If mark-to-market losses of individuals were permitted to

[90]In 1992, during the administration of George H.W. Bush, the Treasury Department proposed a "comprehensive business income tax" that would allow an immediate deduction for capital expenditures but would deny deductions for interest expense. That proposal was raised again in 2002, and has recently been suggested as a possible element of fundamental tax reform. *See* Martin A. Sullivan, "The Tax Reform Plan That Won't Sell," *Tax Notes*, Feb. 28, 2005, p. 1014; Chris Edwards, "Options for Tax Reform" (Cato Institute) (Feb. 25, 2005) (corporate interest expense nondeductible); Edward D. Kleinbard, "The Business Enterprise Income Tax: A Prospectus," *Tax Notes*, Jan. 3, 2005, p. 97.

[91]Thus, although the proposal generally repeals the straddle rules for mark-to-market taxpayers, the straddle rules would continue to be used to determine whether a mark-to-market taxpayer had entered into a conversion transaction.

Under an alternative approach, mark-to-market individual taxpayers would report ordinary income (taxable at the 35 percent rate) equal to their net investment in all mark-to-market property (other than stock) times an AFR-based rate, and would increase their tax basis in the portfolio by an equal amount to determine their mark-to-market gains or losses. Stock would be excluded to permit taxpayers to retain the 15 percent rate for gain on actual stock purchases.

[92]*Cf.* American Bar Association Section of Taxation, "Comments Regarding Application of Market Discount Rules to Speculative Bonds" (Apr. 24, 1991). It is possible that an individual would accrue interest on a bond and pay tax at the 35 percent rate and then sell or mark the bond at a loss attributable to a decline in the issuer's credit rating (or an actual default in accrued interest). The proposal does not permit an ordinary deduction in this situation on grounds of complexity, although some ordinary deduction could be economically justified.

[93]The proposal would, therefore, permit appreciation on a CPDI (or gain on sale) to be taxable at the reduced 15 percent rate. Appreciation or depreciation attributable to changes in the issuer's credit would be taxable as mark-to-market gains or losses.

[94]*See generally* Schizer, Balance, *supra* note 6, at 1912 ("It is well understood that taxpayers prefer a low effective tax rate on time-value returns, and might engage in planning to attain it.").

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offset ordinary income on a dollar-for-dollar basis, the government would effectively subsidize taxpayers' losses and encourage them to take riskier bets. Therefore, under the proposal, mark-to-market losses would be fully deductible to the extent of individuals' mark-to-market gains, then could be used to offset other capital gains, and then 43 percent of any remaining mark-to-market losses would be available to offset ordinary income[95] or could be carried over indefinitely.[96]

9. Assets held in retirement accounts and through insurance and annuity policies. Under the proposal, assets held in qualified retirement plans and the assets generated by up to $1 million of premiums paid on insurance policies and annuities would be excluded from the definition of mark-to-market property.[97] The tax reform panel would tax currently all inside build up in insurance policies and annuities. However, if a mark-to-market individual had paid more than $1 million in insurance or annuity premiums, a proportionate amount of the assets corresponding to the excess would be treated as mark-to-market property and subject to current tax.[98] Because there are no limitations on the amount of income that may be sheltered through an insurance policy (other than the amount of insurance an insurance company is willing to write), in the absence of this rule, mark-to-market individuals could shelter unlimited amounts of assets from mark-to-market treatment with insurance.

F. Inflation Indexing

The proposal does not provide for inflation indexing. On one hand, the failure to index for inflation imposes an "inflation penalty" on mark-to-market taxpayers that arguably violates fairness.[99] On the other hand, proper inflation indexing would significantly increase the complexity of the proposal and decrease the revenue generated (and thereby affect the progressivity benefits).[100] In a relatively low-inflation environment,[101] simplicity and progressivity win.

G. The Scope of Mark-to-Market

1. Publicly traded property. Mark-to-market property would be defined broadly to include any property for which price quotations are readily available, so long as there exists a reasonable basis for determining fair market value.[102] Mark-to-market property would include stocks, securities, publicly traded partnership interests, commodities, foreign currency, and potentially any other publicly traded property.

More specifically, mark-to-market property would include all actively traded personal property as defined under Treas. reg. section 1.1273-2(f)(4)[103] and all property for which price quotations are "readily quotable" within the meaning of Treas. reg. section 1.1273-2(f)(5) (but determined without regard to the exclusions in Treas. reg. section 1.1273-2(f)(5)(ii)).[104] Also, property would be treated as mark-to-market property if quotations are available from the issuer (that is, a RIC or hedge fund that redeems interests periodically) or persons other than dealers, brokers, or traders.

Property would qualify as mark-to-market property if price quotations are available at least quarterly; less frequent valuations would be determined on a case-by-case basis, governed by the inclusive "reasonable basis for determining fair market value" standard. Also, any

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[95]15 percent/35 percent = 43 percent.

[96]It is possible that an individual would accrue interest on a bond and pay tax at the 35 percent rate and then sell or mark the bond at a loss attributable to a decline in the issuer's credit rating (or an actual default in accrued interest). The proposal does not permit an ordinary deduction in that situation because the system to permit an ordinary deduction would be quite complicated. However, some ordinary deduction is economically justifiable.

[97]The tax reform panel would tax currently all inside build-up in insurance policies and annuities.

[98]For example, assume that an individual had contributed $2 million to a life insurance policy and the cash value of the policy is $6 million. In this case, one-half of the assets ([$2 million contributions — $1 million exclusion amount]/$2 million contributions) that would otherwise be mark-to-market property held through the policy would be treated as mark-to-market assets.

[99]*See generally* Schizer, Realization, *supra* note 46, at 1562-63 (describing the inflation penalty and pointing out that it is more severe under a mark-to-market system than under realization).

[100]Accurate inflation indexing would have to take into account the period during which the taxpayer held the asset that generated the gain. Thus, assume that taxpayer A earns a wage of $100 on January 1, invests those funds in publicly traded

(Footnote continued in next column.)

property on that date, and they appreciate to $200. That taxpayer should receive a full-year inflation adjustment. However, if taxpayer B, who receives a wage of $100 on December 30, immediately invests those funds in publicly traded property and they appreciate to $200, she should receive only one day of inflation adjustment. The United Kingdom provides corporations with an inflation adjustment for capital gains calculated on a monthly basis.

[101]Conrad de Aenlle, "Keeping a Tight Lid on Inflation," *The New York Times*, Aug. 9, 2005, at C1 ("Inflation is dormant, and there are sound reasons to expect it to stay that way.").

[102]That standard would correspond to the standard under FAS 115 (security is marketable if it has a "readily determinable fair value"). *The Equity Method of Accounting for Investments in Common Stock*, APB Opinion No. 18, section 6a (March 1971).

[103]Under Treas. reg. section 1.1273-2(f)(4), property is treated as actively traded personal property if it appears on a system of general circulation that provides a reasonable basis to determine fair market value by disseminating either recent price quotations of one or more identified brokers, dealers, or traders or actual prices of recent sales transactions.

[104]In general, under Treas. reg. section 1.1273-2(f)(5), a debt instrument is readily quotable if price quotations are readily available from dealers, brokers, or traders. However, under Treas. reg. section 1.1273-2(f)(5)(ii), a debt instrument is not treated as regularly quotable if (A) no other outstanding debt instrument of the issuer is (i) listed on an exchange, (ii) traded on a board of trade or an interbank market, or (iii) appears on a quotation medium, (B) the original stated principal does not exceed $25 million, (C) the conditions and covenants relating to the issuer's performance regarding the debt instrument are materially less restrictive than the conditions in covenants included in all of the issuer's other traded debt, or (D) the maturity date of the debt instrument is more than three years after the latest maturity date of the issuer's other traded debt.

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nontraded property that is convertible into publicly traded property and any nontraded property that is substantially similar to publicly traded property would qualify as mark-to-market property.[105] The IRS would have the power to treat any non-publicly-traded property as publicly traded if restrictions are imposed to avoid characterization of the property as publicly traded.[106]

It is anticipated that, under those rules, stocks that appear on the NASDAQ bulletin boards would be treated as publicly traded, and stock traded only on the "pink sheets" would not generally be treated as publicly traded. However, if trading on the pink sheets is sufficiently robust to permit a reasonable basis to determine fair market value, then even pink-sheet-traded stock could be treated as mark-to-market property.

Finally, if a mark-to-market taxpayer reports earnings under GAAP, any property required to be marked-to-market under GAAP would be presumed to be mark-to-market property.

It may be necessary to define mark-to-market property to include (i) any property that would have been mark-to-market property on the date the proposal is introduced (or some period before introduction), (ii) any nontraded stock or security issued by a public company and held by any shareholder who has the legal or practical ability to cause the company to convert the nontraded stock into publicly traded stock, or even (iii) all stock and securities issued by a publicly traded company. In the absence of the first rule, a controlling mark-to-market shareholder of a publicly traded company could convert all of his publicly traded common stock into nontraded preferred stock, and thereby "lock-in" his built-in gain and avoid mark-to-market treatment.[107] In the absence of the second or third rule, a mark-to-market shareholder who had control of a public company could purchase nontraded preferred shares of the company and at some later time cause the company to convert the nontraded shares into publicly traded common stock, and thereby achieve deferral.

2. Treatment of debt and other liabilities of a mark-to-market taxpayer. Under the proposal, a mark-to-market taxpayer would not be required to mark to market the "plain vanilla" fixed-rate debt instruments and variable-rate debt instruments (VRDIs) that it issues (including plain vanilla — non-CPDI — convertible debt), even if the debt is actively traded, unless the taxpayer so elects. The current tax treatment of issuers of those instruments reasonably reflects their economic cost, and GAAP does not require an issuer to mark those liabilities to market.[108] Also, taxing a taxpayer that had issued a fixed-rate debt instrument in a rising interest rate environment might not accurately reflect the taxpayer's overall economic health if the taxpayer's non-market-to-market business is experiencing a simultaneous decline.[109] And finally, there is a strong nontax policy to defer the tax that would be due by a troubled debtor as its credit deteriorates.

Nevertheless, the issuer of those instruments would be permitted to mark them to market. A convertible debt instrument that is marked to market by its issuer would be bifurcated into a nonconvertible debt instrument issued at a discount and an option on the issuer's equity (that is, a convertible debt instrument would be treated as the equivalent unit). The issuer would be permitted to deduct the OID attributable to the discount debt instrument (as adjusted for the market value of the deemed instrument), but would not recognize gain or loss on the section 1032 component. However, if an issuer did elect to mark to market a convertible debt instrument, all holders (and not only mark-to-market holders) would be required to treat the instrument as if it were the equivalent unit.[110] (That treatment would maximize the issuer's interest deductions and holders' inclusions; however, that treatment is already effectively elective under current law.)

All other debt instruments and other liabilities of a mark-to-market taxpayer (other than fixed-rate debt instruments and VRDIs that the taxpayer has not elected to mark to market) for which price quotations are "readily available" would be treated as mark-to-market positions, and would be required to be marked to market. Moreover, if a mark-to-market taxpayer has actively traded debt outstanding for which price quotations are readily available, all nontraded debt of the taxpayer (other than fixed-rate debt instruments and VRDIs that the taxpayer has not elected to mark to market) would be treated as a mark-to-market position so long as there exists a reasonable basis to determine the fair market value of the nontraded debt (or a portion of the debt) by reference to the traded debt. Finally, all privately traded CPDIs that reference actively traded property (including the issuer's stock or dividend rate) issued by a mark-to-market taxpayer would be subject to mark-to-market treatment.

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[105]Thus, a class of nontraded supervoting "control shares" that bears all of the economics and supervoting power of a class of publicly traded stock would be treated as mark-to-market property.

[106]*Cf.* Treas. reg. section 1.1273-2(e) ("For purposes of determining the issue price and issue date of a debt instrument under this section, sales to bond houses, brokers, or similar persons or organizations acting in the capacity of underwriters, placement agents, or wholesalers are ignored.").

[107]The author is grateful to Richard Reinhold and Steven Todrys for suggesting that strategy and the rules that would help defeat it.

[108]*See* FASB, *Statement of Financial Accounting Concepts No. 5: Recognition and Measurement in Financial Statements of Business Enterprises*, paragraph 139 (1984), *available at* http://www.fasb.org/pdf/con5.pdf (SFAC 5); APB Opinion No. 14 (no bifurcation of convertible debts) (last visited June 9, 2005). The failure to bifurcate convertible debt into a nonconvertible debt instrument and an option acts to reduce the issuer's interest expense.

[109]*See generally* Edward D. Kleinbard, "Beyond Good and Evil Debt (and Debt Hedges): A Cost of Capital Allowance System," 42 *Taxes* 943 (December 1989) (positing a corporate taxpayer that has issued fixed-rate debt in a rising interest rate environment liability and wooing the company's mark-to-market tax bill "at precisely the same time that its operating business feels the business cycle slowdown of a credit crunch").

[110]Analogous rules would apply to partnerships unless the equity interests in the partnership are marked to market.

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All mark-to-market debt instruments issued by a taxpayer that reference the equity of the taxpayer or a related party or are payable or convertible into the equity of the issuer or related party would be deconstructed into a debt instrument that does not reference the taxpayer's (or the related person's) equity and one or more section 1032 derivatives (and possibly one or more non-section-1032 derivatives). The taxpayer would be entitled to interest deductions only with respect to the debt instrument, section 1032 would apply to the section 1032 derivatives, and section 163(l) could be repealed for mark-to-market taxpayers.

A mark-to-market CPDI issued by a mark-to-market taxpayer directly or through a reporting vehicle would be deconstructed into a plain vanilla fixed- or variable-rate debt instrument and one or more other mark-to-market property interests.[111] The plain vanilla debt component would accrue interest or OID (and would not be marked to market absent a specific election by the taxpayer), and the mark-to-market components would be marked to market (that is, the treatment will be identical to the treatment of the issuer under current law that issues a unit consisting of a discount obligation and one or more derivatives). That bifurcation rule would create complexity but appears necessary to achieve parity between an issuer of a plain vanilla debt instrument and an independent CPDI, on one hand, and an issuer of a single CPDI that is the economic equivalent of the two instruments, on the other.

If a mark-to-market taxpayer is subject to mark-to-market treatment with respect to debt or the debt component of a CPDI, the mark-to-market taxpayer would accrue interest or OID on the debt (or debt component) as under current law, and would adjust the adjusted issue price of the debt instrument accordingly. Differences between the fair market value of the debt instrument and its adjusted issue price at the end of the year would be reported as ordinary income or loss to the extent attributable to increases or decreases in the credit quality of the issuer and as mark-to-market gain or loss to the extent attributable to external market factors (such as interest rate changes or the value of property referenced in the debt instrument). The adjusted issue price of the debt instrument would be adjusted accordingly.

Mark-to-market gains on debt or other liabilities of a mark-to-market issuer that are attributable to a decrease in the creditworthiness of the issuer would be treated as ordinary income and would benefit from cancellation of indebtedness (COD) relief under section 108 only if the taxpayer is insolvent or bankrupt at the time of the mark. Mark-to-market losses that are attributable to an increase in the creditworthiness of the mark-to-market issuer would give rise to ordinary deductions to the extent of prior "credit" inclusions.[112]

Issuers of mark-to-market indebtedness would be responsible for deconstructing it into its components, but primary responsibility for the valuations of the components would lie with the financial institution that is designated as the mark provider for the particular instrument, as described below in Part II.K.

3. Treatment of derivatives and compound instruments held by a mark-to-market taxpayer. Any derivative or compound instrument that directly or indirectly references mark-to-market property would be treated as mark-to-market property to the extent its value changes based on changes in the mark-to-market property. Thus, an on-market equity swap referencing publicly traded stock would be treated entirely as mark-to-market property. For that purpose, an interest rate swap would be treated as mark-to-market property unless it is identified as a hedge with respect to non-mark-to-market property. A swap that provides for a significant upfront payment to the taxpayer would be bifurcated into a fixed-rate debt instrument or a VRDI issued by the taxpayer, and an on-market swap. The mark-to-market taxpayer would not be required to mark to market the fixed-rate debt instrument or VRDI component, but could elect to do so.

If a compound derivative or debt instrument references both mark-to-market and non-market-to-market property, the derivative would be bifurcated into a derivative that references solely mark-to-market property and a derivative that references solely non-mark-to-market property, based on relative fair market values.[113] Thus, a nontraded CPDI held by a mark-to-market taxpayer with a redemption price equal to the greater of par and a portion of the appreciation in a publicly traded index would be treated as a zero coupon bond plus a mark-to-market property interest in the index. Because positions in publicly traded foreign currency are treated as mark-to-market property, the proposal would require a taxpayer that purchases a nontraded debt instrument denominated in a foreign currency to bifurcate the instrument into a mark-to-market foreign currency swap and a non-mark-to-market dollar-denominated debt instrument. (However, as described below in Part II.H.3, if the foreign currency swap or the debt instrument functions as a hedge, the taxpayer could exclude it from mark-to-market treatment.)

All derivatives that reference the issuer's stock or dividend rate would also be bifurcated into a section 1032 derivative and a non-section-1032 derivative and the

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[111]The deconstruction would generally be relevant to a corporate taxpayer only for purposes of determining the portion of gains and losses that are treated as interest expense rather than mark-to-market gains and losses.

[112]Two other alternatives exist. First, changes in value attributable to changes in the creditworthiness of an issuer could be

(Footnote continued in next column.)

excluded from mark-to-market gains and losses and otherwise ignored, or those changes in value could simply be treated as mark-to-market gains and losses.

[113]Thus, assume that a mandatory mark-to-market taxpayer enters into a contract under which the taxpayer makes an upfront payment and, at maturity, receives the increase, if any, in the S&P 500 multiplied by a notional amount unless, at the maturity of the contract, the incidence of diabetes in the United States has declined by 5 percent, in which case the taxpayer would receive no maturity payment. Assume further that contracts referencing the incidence of diabetes are not publicly traded. In that case, the taxpayer would be required to mark to market a hypothetical contract that was identical to the contract except that it excluded the diabetes exception.

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taxpayer would recognize gain or loss only on the mark-to-market value of the hypothetical derivative that does not reference the issuer's stock or dividend rate. (In that respect, section 1032 would be expanded along the lines recommended by the Tax Section of the New York State Bar Association.[114]) Also, members of the issuer's consolidated group would recognize gain but not loss on any section 1032 gains relating to the issuer's stock.[115]

The requirement that taxpayers bifurcate "compound" derivatives (that is, a derivative that references mark-to-market property and either non-mark-to-market or section 1032 property) will increase the difficulty of valuing derivatives. However, that complexity is necessary to prevent arbitrage.[116]

Issuers of debt instruments would be responsible for deconstructing the instrument into its components and reporting the components to holders; however, as described below in Part II.K., the "position mark provider" would be responsible for valuing the components. Financial institution parties to derivatives would be responsible for deconstructing the components and, as the position mark provider, would report their respective values.

4. Deferred compensation and compensatory options. Under the proposal, if a mark-to-market taxpayer is entitled to deferred compensation and the deferred compensation directly or indirectly references mark-to-market property, the mark-to-market taxpayer would be subject to tax on the fair market value of the deferred compensation if (and when) it is no longer subject to substantial risk of forfeiture. Also, if a mark-to-market taxpayer receives a compensatory option with respect to the stock of a publicly traded employer (or a compensatory option with respect to any other entity if 25 percent or more of the entity's gross assets consist of mark-to-market property), the mark-to-market taxpayer would be subject to tax on the fair market value of the option to the extent it is in the money and not subject to a substantial risk of forfeiture. If such an option is issued by a nonpublic employer, it would be bifurcated into an option on the mark-to-market property of the employer and an option on the non-mark-to-market property, and the deemed mark-to-market option would be subject to mark-to-market treatment based on its fair market value when it is not subject to a substantial risk of forfeiture.[117]

The initial tax would be imposed on the employee at the 35 percent rate, and the employer would be entitled to an ordinary deduction when the mark-to-market employee reports the income. Thereafter, the mark-to-market employee would be subject to mark-to-market taxation on the deferred compensation or option (that is, the option would be valued) at mark-to-market rates (that is, 15 percent for mark-to-market individuals) and the employer would not report any gain or loss.

That aspect of the proposal is particularly controversial because it would accelerate recognition for stock options and other deferred compensation for some executives of publicly traded companies and managers of hedge funds.[118] However, it would permit those executives to qualify for a 15 percent rate of tax on appreciation after the initial inclusion. Moreover, permitting mark-to-market taxpayers to defer their nonqualified deferred compensation or stock options on publicly traded property would permit an unjustified exception from mark-to-market treatment on publicly traded property.[119] And the proposal would tend to conform the tax and accounting treatment of publicly traded employers: Under FAS 123R, companies must take a charge against earnings when granting share-based payment awards, including stock options, stock appreciation rights, restricted stock, bonuses, and other deferred compensation.

The proposal does permit deferral of compensation for as long as the mark-to-market employee's compensation is subject to a significant risk of forfeiture; it also permits holders of compensatory options on public stock to defer their tax until the option is in the money, and the proposal does permit mark-to-market employees to defer compensation so long as the deferral does not reference publicly traded property.[120] Those concessions anticipate

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[114]*See generally* New York State Bar Association (Tax Section), *Report on Section 1032* (June 15, 1999) (detailing proposal to expand the scope of 1032).

[115]*Cf.* Treas. reg. section 1.1502-13(f)(6)(i) (loss of member of a consolidated group in respect of stock of parent company is permanently disallowed).

[116]For example, a taxpayer might embed a section 1032 position in a derivative. If the position is out of the money as to the taxpayer, the taxpayer might settle the derivative with cash and claim the entire loss. Conversely, if the position is in the money as to the taxpayer, the taxpayer may accept cash for a modification of the derivative that eliminates the section 1032 component and claim that the gain is excluded. Current law does not provide for a bifurcation of derivatives containing section 1032 elements and therefore invites those transactions.

[117]Bifurcated options would be taxable before the date they are in the money; otherwise, it would be too difficult to determine whether the option is in the money.

[118]Under current law, employers are not permitted deductions for deferred compensation until the employee reports the compensation into income. The proposal would accelerate the taxable event and also the employer's deduction. However, thereafter the mark-to-market employee's stock options or other deferred compensation would be taxable on a mark-to-market basis. Unless the employer is also on a mark-to-market basis on all of its assets, the proposal would tend to generate additional revenue as the employer's stock price increases.

However, the tax reform panel would require taxpayers to include in income all amounts deferred under a nonqualified deferred compensation plan when the amounts are no longer subject to a substantial risk of forfeiture.

[119]That aspect of the proposal would generate revenue if the stock of the employer appreciates unless the employer marks to market all of its assets.

[120]Thus, the proposal does not go as far as the rule suggested by the JCT staff, which would include all deferred compensation in income when there is no substantial risk of forfeiture. Staff of the Joint Comm. on Taxation, *108th Cong., Report of Investigation of Enron Corporation and Related Entities Regarding Federal Tax and Compensation Issues, and Policy Recommendation*, at 635 and n.1922 (2003).

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the sympathetic psychological "paper gains" arguments that would be made by an employee who can be fired and lose his deferred compensation, an employee who cannot yet exercise his option and receive cash, and an employee whose deferred compensation remains subject to the company's creditors.

H. Foreign Tax Credit Issues

The proposal could give rise to, or increase, the excess foreign tax credits of mark-to-market taxpayers because it will tend to increase disparities between the timing of gain and loss under U.S. tax law and under foreign law.[121] Rules could be developed to ease those timing issues (which exist to some extent under current law, but would be exacerbated under a mark-to-market system). For example, a mark-to-market taxpayer might not be required to carry back her foreign tax credits and instead might be permitted an indefinite carryover of the foreign tax credits generated by mark-to-market property.

I. Exceptions From Mark-to-Market Property

1. Greater-than-50-percent-owned publicly traded subsidiaries of publicly traded corporations. The proposal excludes greater-than-50-percent owned subsidiaries of mark-to-market corporations from mark-to-market treatment for two principal reasons. First, subjecting parent corporations to tax on the appreciation in their substantial subsidiaries exacerbates the double level of tax; majority ownership establishes a convenient threshold between an investment that is appropriately subject to mark-to-market taxation and an integrated — albeit publicly traded — division. Second, 50 percent is the threshold used for purposes of section 475 and the proposal would create an awkward anomaly if it departed from that threshold. Alternative natural thresholds would be 20 percent, which is the threshold under GAAP,[122] and 80 percent, which is the threshold for a consolidated return.

2. REMIC residuals. Although REMIC residuals are rarely, if ever, publicly traded property, the proposal would exclude them from mark-to-market treatment as the regulations under section 475 currently do.[123]

3. Inventory of an active trade or business (other than a dealer in securities). Under the proposal, all publicly traded property of a mandatory mark-to-market taxpayer would potentially be subject to mark-to-market taxation. That broad scope could conceivably cause the produce of a farmer, the livestock of a rancher, the gasoline of a (particularly well-to-do) gas station owner, and the jet fuel of an airline to be subject to mark-to-market taxation. An exclusion for those taxpayers is appropriate because, if the commodity constitutes inventory (or is regularly used or consumed), the commodity would be expected to turn over rapidly and therefore does not present significant deferral or character-conversion issues; although the commodities held by those taxpayers are publicly traded, the nature of the commodities held by them may differ materially in value from the publicly traded version. Finally, because that property is not a capital asset in the hands of those taxpayers, permitting them a reduced rate of tax on the appreciation in that publicly traded property would be inappropriate.

Therefore, mark-to-market property would exclude commodities that are (i) stock in trade (or other property of a kind that would properly be included in inventory) of an active producer, processor, merchant, or handler of commodities, (ii) used in the trade or business of a taxpayer and are subject to the allowance for depreciation under section 167, or (iii) supplies of a type regularly used or consumed by the taxpayer in the ordinary course of a trade or business.[124]

However, that reasoning should not apply to the "inventory" of dealers in financial instruments (whether securities, commodities, or other property), which are subject to mark-to-market treatment under section 475; therefore, the publicly traded inventory of those taxpayers would not be excluded. Also, antiabuse rules may be necessary to prevent publicly traded inventory from being held for excessively long periods of time.

4. Hedging transactions. Under the proposal, a taxpayer could elect to exclude any mark-to-market position (including mark-to-market components) that is used in a hedging transaction (as defined in Treas. reg. section 1.1221-2) with respect to non-publicly-traded property from mark-to-market treatment.[125] Thus, if a farmer were to purchase futures contracts to hedge price movements for his crops, the farmer would not be required to mark to market the futures contract. Similarly, a taxpayer that enters into an interest rate swap to hedge non-mark-to-market debt could treat the interest rate swap as a hedge and would not be required to mark to market either the

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[121]For example, assume that a taxpayer holds publicly traded foreign securities. In one year, the taxpayer receives a foreign dividend of $100, subject to a $30 dividend withholding tax, but the portfolio also suffers a $100 mark-to-market loss that offsets the dividend income. That taxpayer would not be entitled to a U.S. foreign tax credit in the first year because the taxpayer would have insufficient worldwide income. That taxpayer would be permitted an indefinite carryforward of the foreign tax credits generated by his mark-to-market property.

The author is grateful to Kimberly Blanchard for pointing out those issues.

[122]*See* Statements of Financial Accounting Standards No. 115, *available at* http://www.fasb.org/pdf/fas115.pdf (May 1993) [hereinafter, FAS 115]. Under FAS 115, a holder is not subject to mark-to-market treatment if the holder holds more than 20 percent of the stock. *See also* Keinan, Book Tax Conformity, *supra* note 21, at 734. ("Equity securities, on the other hand, will be subject to cash or accrual method, unless the taxpayer holds less than 20 percent of the issuing corporation, and the securities are marketable.")

[123]For a discussion of the reasons for excluding REMIC residuals from mark-to-market treatment, see Kleinbard and Evans, "The Role of Mark-to-Market Accounting in a Realization-Based Tax System," 75 *Taxes* 788 (December 1997).

[124]*Cf.* Treas. reg. section 4.954-2(e)(3).

[125]GAAP requires that all derivatives (both assets and liabilities) be recognized in the statement of financial position at fair value. *See generally* FAS 115.

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swap or the debt. Finally, a mark-to-market taxpayer would be permitted to identify one mark-to-market position (including a component of a financial instrument that is subject to mark-to-market treatment) as a hedge of another and mark the two positions as a unit so long as the integration reflects economic income at least as clearly as separate marks.

J. Intrayear Transfers

If a mark-to-market taxpayer ceases to be the owner of a mark-to-market position at any time during the year (including by reason of death), the taxpayer would immediately recognize gain or loss on the property as if it were sold for its fair market value immediately before the taxpayer ceased to be the owner (even if the transfer would not be subject to tax under current law). Thus, mark-to-market taxpayers would recognize gain or loss immediately on the contribution of mark-to-market property to a partnership or corporation, or on a gift of mark-to-market property.[126]

K. Reporting by Entities

Under the proposal, a mark-to-market taxpayer would be required to mark to market its distributive share of the mark-to-market property held by any non-publicly-traded non-mark-to-market trust, partnership, S corporation, RIC, REIT, qualified electing fund (QEF), PFIC, CFC, or foreign insurance company (even if the foreign insurance company is not a PFIC).

Also, mark-to-market taxpayers would be required to mark to market their distributive share of the mark-to-market property of any non-mark-to-market domestic C corporation that satisfies the asset or income test for a PFIC,[127] or is organized (or is marketed) with a principal purpose to avoid mark-to-market treatment. Shareholders in those domestic C corporations would be taxable on those mark-to-market gains at the mark-to-market rate (that is, 15 percent for individuals) and would be permitted to deduct mark-to-market losses to the extent of prior mark-to-market gains from the corporation. Mark-to-market gains from those corporations would increase (and mark-to-market losses would decrease) the shareholder's basis in the stock.[128]

Those domestic entities would be required to supply each of their mark-to-market shareholders, partners, and beneficiaries their distributive shares of the entity's mark-to-market gains and losses; however, mark-to-market shareholders would be required to obtain that information from foreign entities. A mark-to-market taxpayer that fails to obtain monthly marks would be taxable at ordinary income rates and would be subject to a deferral interest charge, based on the constructive ownership rules, on their share of the gain on sale that is attributable to mark-to-market property (and all gain would be presumed to be attributable to mark-to-market property unless the taxpayers could demonstrate some lesser amount).

Two aspects of those reporting requirements are particularly controversial. First, the proposal imposes a modified QEF regime for the mark-to-market taxpayers of any non-publicly-traded foreign insurance company, even if the foreign insurance company would otherwise qualify for the exception for PFIC treatment for insurance companies engaged in an active trade or business.[129] Thus, under the rule, mark-to-market taxpayers would be required to report their distributive share of the mark-to-market gains of the foreign insurance company (but unless the foreign corporation is a PFIC, no other undistributed income or gain).[130] Without that rule, the tax law would effectively encourage mark-to-market taxpayers to invest in foreign insurance companies that rely on the active insurance company exception from the PFIC rules because, through that investment, the mark-to-market taxpayer could avoid mark-to-market treatment for the mark-to-market property of the insurance company.

Second, mark-to-market taxpayers would be required to mark to market their distributive share of the mark-to-market gains of any non-mark-to-market domestic corporation that satisfies the asset or income test for a PFIC or is formed (or marketed) with a principal purpose to avoid mark-to-market treatment for its shareholders. That rule would add administrative costs and complexity for those C corporations and their shareholders, and would discourage U.S. taxpayers from investing in them.

However, in the absence of a rule of that type, individual mark-to-market taxpayers with more than $5 million of assets could hold them through multiple private domestic C corporations (none of which satisfies the mark-to-market asset threshold for corporations), or a promoter could offer interests in a C corporation that holds publicly traded securities and has a value of less than $50 million to multiple mark-to-market investors to permit them to avoid mark-to-market treatment. Although the individuals would be mandatory mark-to-market taxpayers, because the stock of the privately held C corporation would not be publicly traded property, the stock would not be subject to mark-to-market treatment and, because the C corporation would have less than $50 million of assets, it would not be a mark-to-market

[126] An exception could (but need not necessarily) be made for donations of mark-to-market property to tax-exempt organizations.

[127] In general, a corporation is considered a PFIC if (a) at least 75 percent or more of the corporation's gross income for the tax year is passive income or (b) at least 50 percent of the corporation's assets measured by value on a quarterly average basis produce or are held for the production of passive income. Section 1297(b) and (f).

[128] A de minimis exception would exempt those entities and shareholders from the reporting and mark-to-market provisions if the only mark-to-market property, derivative, or liability of the entity is publicly traded debt held or issued by the corporation, and interest rate or currency swaps.

[129] *See* section 1297(b)(2)(B) ("Passive income does not include income, derived in the active conduct of an insurance business by a corporation which is predominantly engaged in an insurance business and which would be subject to tax under subchapter L if it were a domestic corporation.").

[130] For instance, if a foreign insurance company earns non-subpart F income from non-mark-to-market assets, the mark-to-market shareholders of the foreign insurance company would not be required to report that income.

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taxpayer. (For those taxpayers, subjecting the publicly traded property to a corporate level of tax may result in a significantly lower effective tax rate than mark-to-market treatment. Moreover, subsequent conversion to an S corporation might avoid even corporate-level tax.)

Use of the PFIC asset and income tests as the requisite threshold strikes a balance between the administrative costs of compliance and potential revenue and abuse prevention. That mechanism is not perfect, and adds complexity, but is preferable to a series of antiabuse rules designed to prevent mark-to-market taxpayers from holding their publicly traded property in non-mark-to-market domestic C corporations.[131]

L. Administration and Valuation

Under the proposal, a financial institution would be designated as the "position mark provider" for each mark-to-market position and would provide valuations to mark-to-market taxpayers. Also, each mark-to-market taxpayer could designate one or more "taxpayer mark providers" to value their mark-to-market positions under alternative valuation conventions, or on a hedged or portfolio basis. A taxpayer that relies on the valuation of a mark provider in good faith would be subject to tax on any gain resulting from the misvaluation, and interest at a market rate, but would not be subject to penalties.

Dealers in securities, traders in securities electing under section 475(f), mutual funds, qualified institutional buyers,[132] and other large taxpayers that receive approval from the IRS would be permitted to value their own positions. However, those taxpayers could be subject to penalties for improper valuation.

1. Annual valuations by mark providers. Under the proposal, a position mark provider would be designated (as described below) for each mark-to-market position issued by a U.S. taxpayer, marketed to U.S. persons, or for which a U.S. withholding agent exists, unless monthly valuations are widely available to the public. Position mark providers would be required to provide annual calendar-year valuations to mark-to-market holders and, on request, monthly valuations.[133] Mark-to-market taxpayers would report the values determined by the position mark provider unless the mark-to-market taxpayer is permitted to value its own positions or has designated a taxpayer mark provider that values the taxpayer's position under some other acceptable method. Position mark providers would include financial institutions described in Treas. reg. section 1.165-12(c)(iv) and other approved persons.

Although the issuer of a compound debt instrument would be responsible for deconstructing it into its components, the position mark provider for the instrument would be responsible for valuing the components. As mentioned above in Part II.K., a financial institution that enters into a derivative with a non-financial-institution mark-to-market counterparty would be the position mark provider for the derivative. Since the financial institution would also be the mark provider for that position, the financial institution would be responsible both for decomposing the derivative into its components and valuing them.

Specific rules would determine the proper position mark provider for any particular mark-to-market position. Those rules would be designed so that they are (i) efficient (that is, the mark provider would be the financial institution that is in the best position to value the position, and one mark provider would provide marks for all positions that are identical or substantially identical); (ii) consistent (that is, the mark provider would value the position under the same method each year, and holders of economically identical positions would report identical values, or would report values under identical method); and (iii) symmetric (that is, holders and issuers would report identical values, or values under identical methods).

For example, it would be expected that the issuer of a mark-to-market security would designate the position mark provider for that security (which would normally be the underwriter) and the issuer and holders would report marks on a consistent basis. The financial institution that is the counterparty to a derivative would generally be the mark provider for that derivative.

Flow-through and reporting entities would designate a single mark provider for their equity interests (unless monthly valuations are widely available to the public) so that all mark-to-market holders of an interest in the entity would report valuations under an identical method. Any mark provider that believes there are other mark providers valuing identical or substantially identical positions would be required to disclose the other mark providers.

Position valuations would be based on fair market value, with specific adjustments. For example, the values of "long" positions would not be permitted to take into

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[131]An alternative regime to prevent mark-to-market taxpayers from organizing a private C corporation, contributing their publicly traded property to the corporation, and maintaining the private corporation's net asset level below the $50 million threshold would require that, for purposes of determining whether a corporate taxpayer has satisfied the $50 million threshold, the corporation would include all of the assets of all of the corporations in the "controlled group of corporations" (as defined in section 1563) that include the corporation. For that purpose, the 80 percent threshold in section 1563 might be reduced from 80 percent to 50 percent and insurance companies would be included. Thus, if an individual with $75 million of net assets were to contribute them equally to two C corporations, each of the C corporations would be treated as having $50 million of net assets, and therefore, each of them would be mandatory mark-to-market taxpayers.

That mechanism was rejected because it would lead to structures under which C corporations are organized to permit their mark-to-market shareholders to avoid mark-to-market. The proposal is designed to eliminate the possibility of tax planning to avoid mark-to-market treatment.

[132]In general, a qualified institutional buyer includes an institution that manages at least $100 million in securities and a registered broker-dealer owning and investing, on a discretionary basis, $10 million in securities of nonaffiliates. *See* 17 C.F.R. section 230.144A(a)(1).

[133]In other words, if an instrument has a single calendar-year holder, the position mark provider would be required to value the mark-to-market position each calendar quarter.

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account blockage, minority, marketability (or illiquidity), fragmentation, or investment company discounts.[134]

Also, each mark-to-market taxpayer could designate one or more taxpayer mark providers. Taxpayer mark providers would value (i) positions for which no position mark provider has been designated (for example, foreign securities not offered to U.S. persons), (ii) hedged positions, and (iii) positions on a portfolio basis.

Taxpayers would be permitted to instruct their taxpayer mark providers to use some averaging conventions (for example, over the 30-day period preceding the tax year) that are consistent with the method used by the position mark provider and do not systematically understate or overstate value. If a taxpayer adopts an averaging convention other than closing value on the last day of the taxpayer's tax year, the taxpayer would be required to use the method consistently. Taxpayer mark providers also would not be permitted to take into account blockage, minority, marketability (or illiquidity), fragmentation, or investment company discounts.

Dealers in securities, traders in securities electing under section 475(f), mutual funds, qualified institutional buyers, and other large taxpayers that receive approval from the IRS would be permitted to value their own positions.

The IRS would establish broad principles by revenue procedure or other guidance to value derivatives, and methods could be subject to specific approval by the IRS (analogous to advance pricing agreements).[135] For example, it would be anticipated that the method described in Part II.K.2. (GAAP with adjustments) could also be used for taxpayers that are not GAAP reporters.[136]

As long as a taxpayer relies in good faith on a mark provider's valuation, the taxpayer would not be subject to penalties for reporting an inaccurate value; instead, the taxpayer would be subject only to additional tax based on the correct value and a market rate of interest on any deferral. However, a taxpayer could not rely in good faith on the valuations provided by a mark provider that represents or implies that its valuation method results in lower tax liability than a competitor. Taxpayers that value their own positions could be subject to penalties for improper valuation.

A mark provider (or a taxpayer valuing its own positions) that complies in good faith with the published guidance or an approved method would not be subject to penalties, even if a valuation is inaccurate. However, a mark provider would be presumed to be acting in bad faith if it attempted to gain a competitive advantage by claiming or implying that its valuation method results in a lower tax liability than a competitor.

Mark providers (and taxpayers valuing their own positions) would be required to disclose to the IRS any differences between the methods used to determine valuations for mark-to-market purposes and the valuations used for the mark provider's (or taxpayer's) own internal purposes (for example, compensation), for purposes of the mark provider's financial reports under GAAP, or other mark providers' valuations of the same or substantially similar positions. The disclosure of the differences would permit the IRS to choose between competing valuation methods, but those differences would not imply bad faith.

2. Taxpayers maintaining 'reliable financials.' Under the proposal, any taxpayer maintaining "reliable financials" could elect to use GAAP valuations (subject to specific adjustments) in lieu of using the valuations provided by a mark provider to value any position that is marked to market both for tax and GAAP purposes.[137] An election to use GAAP valuations would be irrevocable and would apply to all of the taxpayer's mark-to-market positions that are marked to market both for tax and GAAP purposes. A taxpayer that makes a GAAP valuation election would be required to disclose differences between the GAAP valuation and the valuation provided by the taxpayer's mark provider.

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[134]*See* H.R. Conf. Rep. 103-213 at 616 (legislative history to section 475; providing that valuation is generally determined on an individual security basis without taking any blockage discounts into account); Staff of the Joint Comm. of Taxation, *Options to Improve Tax Compliance and Reform Tax Expenditures*, JCS-02-05 396-399 (Jan. 27, 2005) (proposing to disregard minority, marketability, fragmentation, and investment company discounts for purposes of estate tax valuations). *Cf.* Treas. reg. section 1.83-2(a) (disregarding lapse restrictions in valuing property).

[135]The proper valuation of derivatives has received increasing attention from a variety of regulatory bodies, each of which are developing principles of valuation. *See, e.g.*, Floyd Norris, "U.S. Rejects Cisco Plan on Options," *The New York Times*, Sept. 10, 2005, at C1 (quoting Christopher Cox, chair of the Securities Exchange Commission: "Over time, as issuers and accountants gain more experience in valuing employee stock options for financial accounting purposes, particular approaches may begin to emerge as best practices, and the range of potential methodologies will likely narrow."); Staff, SEC, *Implications of the Growth of Hedge Funds* (September 2003) (recommending that the SEC consider mandating the specific procedures that a hedge fund must follow in valuing its assets); International Organization of Securities Commissions, Technical Committee, *Regulatory Approaches to the Valuation and Pricing of Collective Investment Schemes* (May 1999) (listing various pricing methods in different jurisdictions).

[136]*See* Ann. 2003-35, 2003-21 IRB 956, *Doc 2003-12903, 2003 TNT 101-8*; Part II.K.2.

[137]*Cf.* prop. Treas. reg. section 1.475(a)-4(b)(2) (use of GAAP valuations available only for positions that are properly marked to market under section 475). Under FAS 115, securities purchased from customers and intended to be held to maturity and commodities are not marked to market. In addition, an issuer does not mark to market its debt unless the debt contains an embedded derivative. FAS 115; *see* Keinan, Book Tax Conformity, *supra* note 52, at 725. That approach is analogous to the approach adopted by the United Kingdom in the U.K. Finance Act 2002. Under the Finance Act 2002, some derivatives that are marked to market for accounting purposes are also marked to market for tax purposes.

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The proposal embraces the approach of prop. Treas. reg. section 1.475(a)-4.[138] Thus, mark-to-market taxpayers could use the valuations reported on "applicable financial statements" (as adjusted) for purposes of marking their securities to market for tax purposes.[139]

M. Penalty for Failure to Mark

Any mark-to-market taxpayer that did not report a mark-to-market position on a mark-to-market basis would be required to report any gain as ordinary income and would be subject to a deemed interest charge based on the amount of interest (at the underpayment rate) that would have resulted if the gain had accrued at a constant rate equal to the AFR over the taxpayer's holding period.[140]

N. Illiquidity Loans

Under the proposal, the government would make or guarantee loans to permit taxpayers to pay their taxes on illiquid or restricted mark-to-market property. The loans would be administered by mark providers for a standard fee. The loans would bear market rates of interest (or market rate plus a spread); in all events, that rate of interest would be less than the penalty rate for deferral. The loans would be secured by the publicly traded property.

O. Taxpayers That Flip In and Flip Out

A taxpayer that becomes subject to mark-to-market taxation in a particular year would be subject to mark-to-market treatment for that entire tax year. The taxpayer would have until the date its tax return is due to designate mark providers for the taxpayer's mark-to-market property and liabilities; the mark provider would be required to mark the taxpayer's mark-to-market property as of the first day and the last day of the tax year.

A taxpayer that was a mark-to-market taxpayer in a previous year but is no longer subject to mark-to-market treatment would return to realization taxation at the beginning of the tax year with an adjusted basis in its assets that reflects prior mark-to-market taxation.[141]

P. Grandfathering

The grandfathering aspect of the proposal is one of the most important variables affecting revenue, complexity, and political acceptability. Three different forms of grandfather rules are suggested. Under each form, a mark-to-market taxpayer's mark-to-market securities would be valued (in accordance with the valuation methods described above) on the effective date of the proposal.[142]

Under the weak form, mark-to-market taxation would apply only to changes in value after the date of enactment.[143] Preenactment gain and loss would remain on the realization system. However, carryover basis would apply to property received from a decedent.[144]

Under the moderate form of the proposal, all preenactment built-in gains would be required to be recognized over a period of years (for example, 10 percent of any aggregate net built-in gain as of the first valuation date could be required to be recognized in each tax year over a specified period (for example, 10 years)), or on a specified date in the future (for example, 5 or 10 years),[145]

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[138]On May 22, 2005, the IRS proposed regulations that would permit taxpayers to use the valuations they report on certain financial statements for section 475 purposes. *See* prop. Treas. reg. section 1.475(a)-4.

FAS 133 generally requires all derivatives to be recorded on the balance sheet at "fair value" (that is, marked to market). Unrealized gains and losses on speculative derivatives and hedges of assets, liabilities, and firm commitments are recorded in net income. Unrealized gains and losses of hedges of the variable cash flows of forecasted transactions are recorded in equity as part of comprehensive income. In addition, the hedged item associated with a "fair value hedge" also must be marked to market to the extent the fair value of the hedged items are attributable to the risk being hedged. *See generally* FAS 133 para. 4 and summary; Keinan, Book Tax Conformity, *supra* note 52, at 740.

[139]An applicable financial statement includes any financial statement prepared in accordance with U.S. GAAP and that is required to be filed with the SEC or another federal agency, or is given to creditors for the purposes of making lending decisions, provided to equity holders for purposes of evaluating their investments in the taxpayer, or for other substantial nontax purposes, and which the taxpayer anticipates will be directly relied on for the purposes for which it was created, if the financial statement (i) contains values for eligible positions, and (ii) is significantly used by the taxpayer in most of the significant management financials in a manner that is related to the management of all or substantially all of the taxpayer's business.

[140]*Cf.* section 1260(b) (imposing interest charge on deferral of gain recognition for a "constructive ownership transaction" under that method).

[141]*Cf.* prop. Treas. reg. section 1.475(a)-2.

[142]That valuation date may present a hardship for some hard-to-value derivatives. Assume that the proposal is enacted on Nov. 1, 2005, and a taxpayer that is party to a hard-to-value derivative has a calendar year. Under the proposal, the derivative would be required to be valued as of Nov. 1, 2005. However, under the proposal, the mark provider would have until Dec. 31, 2006, to have its valuation method in place. Therefore, on Dec. 31, 2006, the mark provider would be faced with the difficult task of retroactively determining the value of the derivative as of Nov. 1, 2005.

An alternative would require the initial valuation on the last day of the taxpayer's tax year that includes the date of enactment. That would be simpler. However, under the weak and middle approaches, the "grandfathering" would depend on the taxpayer's tax year, which is unfair.

[143]*See generally* Mark L. Louie, Note, "Realizing Appreciation Without Sale: Accrual Taxation of Capital Gains on Marketable Securities" [hereinafter Realizing Appreciation], 34 *Stan. L. Rev.* 857, 873 (1982); Shakow, Taxation Without Realization, *supra* note 43, at 1178.

[144]Alternatively, in lieu of an estate tax, all unrealized gain of all property of a mark-to-market taxpayer would be required to be recognized at death.

[145]There are innumerable variations of the moderate form (which requires deferred recognition of some or all of the preenactment mark-to-market gain). For example, all preenactment mark-to-market gain could be recognized on a date certain (for example, five years) after enactment or the gain recognition could be spread over a shorter or longer period.

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and any assets inherited by a mark-to-market taxpayer would immediately become subject to mark-to-market for all gain.

Under the strong form of the proposal, mark-to-market taxpayers would be subject to mark-to-market taxation on all of their mark-to-market property on a date certain (for example, the second succeeding tax year after the date of enactment). However, the rate of tax on preenactment built-in gains might be subject to a reduced rate.[146]

III. Addressing the Critics

This part attempts to anticipate and address criticisms of the proposal.

A. Political Viability

The proposal would directly affect the high-net-worth individuals who serve as the financial base of the Republican party. That fact alone could doom the proposal.

However, the other proposals for tax reform suffer far more serious political infirmities. The tax reform panel's proposals to reduce or eliminate deductions for state and local taxes, mortgage interest, and charitable deductions are widely viewed as unenactable. A VAT or national sales tax lacks political support and would affect far more taxpayers.[147]

Thus, although the proposal affects a key Republican constituency, which instantly renders its prospects slim, it would adversely affect a very small number of taxpayers, and therefore it shines alongside the other alternatives.

B. Economic Inefficiency

One of the most forceful criticisms of a partial mark-to-market system is that, by subjecting only publicly traded securities to mark-to-market treatment, the tax law would discourage mark-to-market taxpayers from investing in publicly traded property and artificially encourage them to invest in "private" property.[148] For example, Edward Zelinsky has suggested that if only publicly traded securities are subject to mark-to-market treatment and, as a result, their effective tax rate is higher than nontraded securities, resources would "flee" the publicly traded assets for privately held ones.[149] David Schizer has made a similar point, arguing that, under a partial mark-to-market system, mark-to-market taxpayers might be expected to shift their equity investments from publicly traded securities to private "Rule 144A" securities to avoid mark-to-market treatment.

Those concerns, while valid at the margins, should not be overstated. First, the higher effective rate of tax would apply to only a very small percentage of taxpayers. While the wealthiest 0.1 percent of taxpayers control a meaningful portion of the wealth in the nation, more than a third of all publicly traded securities are held by pension plans and other tax-exempt holders.

Second, the benefits to investors of liquidity (and to issuers of access to the capital markets), which would be available only for mark-to-market securities, will outweigh the tax costs of a higher effective rate on gains. For example, Google's initial public offering (IPO) was apparently driven by the venture capital funds that financed it: The incentive mechanisms of those funds operate to encourage pretax return maximization, which generally occurs following an IPO. It is unlikely that enactment of a mark-to-market regime would alter those incentives.[150]

In no small measure, our tax system already discourages public offerings because operating companies may avoid a corporate level of tax only if they remain private and limit trading in their interests.[151] Nevertheless, companies regularly choose liquidity for their shareholders and access to the capital markets despite the corporate income tax. For example, Goldman Sachs voluntarily incurred a corporate income tax after its 1999 IPO, and this year Lazard subjected its U.S. operations to a U.S. corporate tax in connection with its public offering.[152]

Third, while nontraded Rule 144A securities would be exempt from mark-to-market treatment, any listing on a general system of circulation (such as Bloomberg), could cause the security to be subject to mark-to-market treatment. Thus, in some sense, the inefficiencies would be self-limiting. Moreover, mark-to-market treatment could not be avoided by imposing restrictions on trading.

In the end, as long as the marginal benefits of liquidity comfortably outweigh the higher effective rate of tax for mark-to-market taxpayers, and while the proposal will create some artificial incentives, the level of inefficiency in the marketplace should remain acceptable.

If the proposal is implemented, mark-to-market corporations will have a disincentive to offer more than 50 percent of the stock of their subsidiaries to the public

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[146]*Cf.* section 965 (granting a dividend received deduction for some repatriations from foreign subsidiaries).

[147]*See* Kirkpatrick, Talk of Taxes, *supra* note 10, at 22.

[148]*See* Edward S. Zelinsky, For Realization, *supra* note 46, at 861; Louie, Realizing Appreciation, *supra* note 143, at 870 n. 7; Weisbach, A Partial Mark-to-Market Tax System, *supra* note 47, at 103-5 n. 5.

[149]*See* Zelinsky, For Realization, *supra* note 46, at 915.

[150]*See* Saul Hansell, "A Quirky Brilliance vs. the Dreams of Venture Capitalists," *The New York Times*, Apr. 26, 2004, at C1 ("'Venture capitalists want to cash out' said George Bell, the chief executive of Upromise and former chief executive of Excite@Home, two companies backed by Kleiner Perkins. 'This is life. People have to deal with the fact that if you start a company and ask a venture capitalist to take a risk, they are going to want to secure a financial outcome that is highly desirable.'").

[151]Under section 7704, a publicly traded partnership with more than 10 percent of "active" (that is, nonpassive) income is treated as a corporation. To avoid publicly traded partnership status, the partnership must prohibit its interests from being traded on an established securities market or the substantial equivalent thereof. The regulations contain a number of safe harbors from treatment as being traded on the substantial equivalent of an established securities market. A common safe harbor provides that a partnership with 100 or fewer partners is not treated as traded on the substantial equivalent of an established securities market. *See* Treas. reg. section 1.7704-1(h).

[152]*See* Lazard's prospectus *available at* http://www.lazardnet.com/lam/us/funds/pdfs/LGI_Red_Herring_Prospectus.pdf (last visited June 12, 2005).

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because the corporation would be required to immediately recognize its built-in gain. However, that threshold is significantly higher than the 20 percent threshold of consolidated returns (which discourages IPOs of more than 20 percent).

The proposal will also give rise to inefficiencies to the extent taxpayers at the margin of the $5 million threshold convert their publicly traded securities into a larger home or collectibles to remain below the asset thresholds. However, those marginal inefficiencies should remain modest; also, those taxpayers would forgo liquidity.

By subjecting mark-to-market gains to tax at the existing tax rates, the proposal differs from the proposal offered by David Weisbach. In his article on a partial mark-to-market system of taxation, Weisbach proposed that, to maintain efficiency, the nominal tax rate on mark-to-market assets should equal the average effective rate on realization assets.[153]

However, the "average" effective rate on realization assets is not a meaningful number,[154] and setting the effective rate on mark-to-market gains at the average effective rate on realization assets will not necessarily improve efficiency. Moreover, although a reduced rate of tax for mark-to-market gains is not inconsistent with the proposal, it would reduce the revenue the proposal generates, and could frustrate its progressive effect.

C. Valuation

The primary criticism of any mark-to-market system is the difficulty of valuing mark-to-market positions.[155] But those concerns are undercut by the existing requirement that publicly traded securities be marked to market under GAAP (and for purposes of U.K. corporate taxation) and by dealers and traders under section 475.[156] Valuation is increasingly relevant for federal income tax purposes,[157] and both mandatory and voluntary mark-to-market taxation have increasingly appeared in the code and the regulations.[158]

Second, the proposal addresses valuation concerns directly. First, it permits taxpayers to use their GAAP valuations and thereby relies on the check and balance of conflicting incentives to arrive at proper valuations (that is, the incentive to overvalue for book purposes and undervalue for tax). Second, in all other cases, the proposal places valuation responsibilities on the financial institutions that are best positioned to undertake the valuation, and adopts a process-based approach that looks primarily to the integrity of the valuation method rather than the specific dollar valuation of a position. Third, the proposal accepts variation in actual valuations, and imposes no more than a market-based interest charge on taxpayers that rely in good faith on an incorrect valuation to pay their tax.

D. Complexity

Critics will charge that the proposal, by deconstructing some financial instruments, and by requiring annual valuations of mark-to-market property, fails to reduce complexity but merely replaces existing complexity with new complexity.

There is some merit to those charges. Deconstructing and valuing derivatives is complex, but derivatives remain relatively rare instruments generally used only by sophisticated taxpayers and those deconstructions generally reflect the economics of the derivatives and the method used by financial institutions to price and hedge them. Thus, the case could be made that this is precisely the complexity that should be present in a tax system that accurately measures income in an economically complex world. Moreover, although the proposal would introduce some complexity, because it eliminates planning for mark-to-market positions and effectively exempts them from a number of existing provisions, on the whole, the proposal should significantly simplify federal tax law "to reduce the cost and administrative burden of compliance," as the president has directed.[159]

E. 'Second Best'

Partial mark-to-market systems are sometimes dismissed as "second best" under the theory that only ideal

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[153]*See* Weisbach, "A Partial Mark-to-Market Tax System," *supra* note 47, at 101. Prof. Weisbach drew on a paper written by Jane Gravelle suggesting that at a time when the capital gains rate was 28 percent (the average on noncorporate capital gains in 1994 was about 20 percent) the average rate on mark-to-market gains should be 20 percent (but would be higher for high-income individuals and lower for low-income individuals).

[154]Short-term gains are subject to a significantly greater effective rate than long-term capital gains.

[155]*See* Schenk, A Positive Account, *supra* note 44, at 359-60, 383 (2004); Evans, The Realization Doctrine, *supra* note 46, at 898 ("an attempt to repeal the realization doctrine on a wholesale basis for individual taxpayers would create such a firestorm of political opposition that few politicians would seriously consider such a proposal"); Zelinsky, For Realization, *supra* note 46, at 893-900 (discussing resistance to taxation of paper gains); Schizer, Realization, *supra* note 46, at 1607, 1595; Potter, Mark to Market, *supra* note 46, at 881 ("a partial mark-to-market system would be unsaleable.").

[156]*See* section 475; *see also* Treas. reg. section 1.148-6(e)(5) (requiring mark-to-market for some commingled funds with longer-term investment portfolios); Treas. reg. section 1.1296-1 (providing mark-to-market election by "eligible RICs" for some marketable stock in a PFIC); Treas. reg. section 1.988-2(b)(15) (mark-to-market treatment for hyperinflationary foreign currency debt instruments); *cf.* temp. Treas. reg. section 1.1297-3T (deemed sale election for a shareholder in a PFIC that fails to be treated as a PFIC).

[157]*See* TAM 200513027, *Doc 2005-6737, 2005 TNT 63-8* (publicly traded company valued based on trading price of stock at time of merger to determine section 382 limitation); LTR 200513018, *Doc 2005-6728, 2005 TNT 63-19* (foreign corporation uses fair market value election for interest allocation purposes).

[158]For example, the recent "contingent swap" regulations would permit any taxpayer to elect mark-to-market treatment for their contingent swaps so long as their counterparty is a mark-to-market taxpayer that is willing to value the swap. *See* prop. Treas. reg. section 1.446-3(i); *see also* prop. Treas. reg. section 1.988-5(f) (permitting a mark-to-mark election for foreign currency transactions so long as the treatment is consistent with the taxpayer's financial accounting treatment).

[159]*See* Part IV.D., below (outlining simplification).

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or "first best" proposals should correct existing distortions.[160] However, as Deborah Schenk has suggested, dismissal of second best is appropriate only in a first best world.[161] Otherwise, reform proposals should be evaluated against existing law and the alternatives.[162]

F. Too Harsh

In his 1992 article, Daniel Shaviro proposed to expand realization and impose a tax on loan proceeds in excess of the basis of any assets pledged as loan security, or otherwise when the proceeds from a taxpayer's loans exceed the basis of all of the taxpayer's noncash assets.[163]

> ***As Deborah Schenk has suggested, dismissal of second best is appropriate only in a first best world.***

Shaviro's proposal would address the valuation and liquidity concerns of a mark-to-market proposal because a taxpayer's gain would be measured by cash borrowed and the cash would always be available to pay the tax. However, such a proposal would not meaningfully accelerate realization; by permitting taxpayers to borrow the amount of their basis before being subject to tax, wealthy individuals would enjoy long periods of deferral. Moreover, the proposal is easily avoided and the countermeasures are burdensome.[164]

G. Increased Debt Financing

The proposal, by eliminating the deferral that currently exists for stock, would increase the relative cost of equity financing and would tend to make debt financing even more attractive than it is today.[165]

However, our current tax system already favors debt over equity, but there is no shortage of IPOs or equity investors. Although a marginal effect might result, the large number of tax-exempt, foreign, and realization investors should moot any significant effect. And, if the effect is meaningful, reducing the deduction for interest expense would moderate the debt advantage.

H. Difficulties of Estimating Revenue

Government revenue under a mark-to-market system would rely to a greater extent on changes in market values and therefore revenue would be more susceptible to changes in market valuations and more difficult to estimate for planning purposes.[166] However, securities market values already have a tremendous effect on the economy, and the relationship between incremental market changes and tax revenue under the proposal should be predictable.[167]

I. Market Flooding

If taxpayers are subject to mark-to-market taxation on an annual or quarterly basis, the market could be flooded with securities as mark-to-market taxpayers sell to pay their tax. However, it is far more likely that the sophisticated taxpayers subject to mark-to-market treatment would time their market sales and hedges so as not to disrupt the market. And the proposal would permit valuations based on averaging conventions.

J. Resistance From Financial Institutions

The proposal imposes responsibility for valuations on financial institutions, and in some circumstances imposes penalties on them if the valuation is incorrect. Financial institutions are likely to strongly resist that added cost, expense, and potential liability. Under the proposal, insurance companies would be subject to mark-to-market taxation on their reserves. It would be expected that those two groups of influential taxpayers would lobby against the proposal.

IV. Benefits of the Proposal

A progressive mark-to-market system would achieve all of the president's objectives — it would permit a new federal tax system that is simpler, more efficient, and progressive; eliminate loopholes; better encourage saving and investment; and retain home mortgage interest and charitable donation deductions. It would be revenue-neutral, and help fix the AMT, but not deny deductions, raise rates, or impose new taxes. It could be implemented immediately without the monumental transitional issues of a VAT or national sales tax and it could serve as an element of any fundamental reform proposal that retains an income tax element (such as the tax reform panel's "Plan B" or Prof. Graetz's hybrid VAT/income tax).

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[160]*See, e.g.*, Boris I. Bittker, "'A Comprehensive Tax Base' as a Goal of Income Tax Reform," 80 *Harv. L. Rev.* 925, 983-84 (1967); Walter Hettich and Stanley Winer, "Blueprints and Pathways: The Shifting Foundations of Tax Reform," 38 *National Tax J.* 423, 428 (1985).

[161]Deborah H. Schenk, "Efficiency Approach," 57 *Tax L. Rev.* 503, 518-519 n. 55 (2003).

[162]David Shakow, "Taxation Without Realization," *supra* note 43, at 1183 (comparing proposal to current law); Reed Shuldiner, "A General Approach to the Taxation of Financial Instruments," 71 *Tax. L. Rev.* 243, 245 (1992) (reform proposals should be compared to other alternatives).

[163]*See* Daniel N. Shaviro, "An Efficiency Analysis of Realization and Recognition Rules Under the Federal Income Tax," 48 *Tax L. Rev.* 1, 39-41 (1992-93) [hereinafter Efficiency Analysis].

[164]First, taxpayers could enter into prepaid forward contracts, rather than borrow funds, and avoid tax. To prevent that, prepaid forward contracts would have to be treated as loans. Second, taxpayers would oversecuritize their loans with high-basis assets. To prevent that, the IRS would need the power to disregard assets that are not needed as security, or impose tax on all appreciation in the assets securing the loan. Finally, taxpayers might also create contingent security interests. To prevent that, rules would have to distinguish between abusive and legitimate arrangements.

[165]*See* Louie, Realizing Appreciation, *supra* note 143, at 868 (detailing reasons why debt financing is beneficial).

[166]*See id.*

[167]*See generally* Douglas Holtz-Eakin, *The Tax Code's Impact on the Reliability of Revenue Projections before the Committee on the Budget*, U.S. House of Representatives (July 27, 2004), *available at* http://www.cbo.gov/showdoc.cfm?index56758sequence=0.

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A. Economic Efficiency

The realization rule is radically inefficient.[168] The proposal would instantly improve the economic efficiency of the federal tax system in five different ways.

1. Elimination of deferral. A mark-to-market system eliminates the principal inefficiency of a realization-based system of taxation — the deferral of tax on economic gains.[169] Deferral creates inefficiency because taxpayers retain property to avoid the tax on appreciation and enter into hedging transactions to reduce their economic exposure to appreciated property without triggering a realization event.[170] That ability to reduce economic exposure to appreciated assets and preserve deferral is available only to high-net-worth individuals and public and large corporations.

2. Elimination of the 'timing option.' The realization rule also permits strategic trading: Not only may taxpayers retain their appreciated assets and defer their gains, but they also may sell their depreciated assets and take their losses.[171] The proposal would eliminate the ability of mark-to-market taxpayers to strategically trade their depreciated assets and avoid tax on their appreciated mark-to-market assets.

3. Elimination of lock-in and lock-out. The deferral potential and timing options inherent in a realization-based system spawn two other inefficiencies: the lock-in and lock-out effects. Because reduced rates for long-term capital gains are available only after an asset has been retained for more than a year, and deferral maximizes a taxpayer's after-tax yield, realization imposes a strong economic incentive on taxpayers to retain and not sell their appreciated assets. Thus, realization locks a taxpayer into an appreciated asset.[172] In extreme situations, the lock-in effect contributes to other inefficiencies. For example, by discouraging large shareholders from selling their stock, the realization system reduces the liquidity of the capital markets. However, in a mark-to-market system, a taxpayer's decision to retain an asset or sell it would be made without tax considerations.

While the timing option encourages taxpayers with depreciated assets to sell them, and claim their loss (and, if the asset has not been held for a year, to sell it quickly), the wash sale rules deny a taxpayer a loss on the sale of a security if it is reacquired within 30 days. That incentive to sell, and not reacquire, locks the taxpayer out of an investment.[173] The proposal would eliminate the lock-out effect for publicly traded property, and mark-to-market taxpayers' buy-and-sell decisions would not be distorted by the tax laws.

4. Elimination of bias toward growth and risky assets. As David Schizer has pointed out, because realization defers tax on appreciation but not on periodic payments such as interest and dividends, realization favors "growth" stocks over "income" stocks.[174] Also, because the timing option permits taxpayers to accelerate their losses and defer their gains, realization encourages riskier investments.[175] The proposal would eliminate those distortions.

5. Reduction in taxpayer and government transaction and audit costs. The inefficiencies of the realization system, in turn, employ an entire industry of professionals to construct, promote, and describe the financial products that exploit them, and an equal legion of government agents to sniff them out.[176] The proposal, by eliminating virtually all domestic tax planning, would significantly reduce transaction costs for taxpayers and audit costs for the government (other than audits of valuation methods), and would eliminate the planning opportunities and therefore the private and public costs of our tax system.

B. Fairness

The realization requirement (which permits deferral and strategic trading) favors capital-investing taxpayers over wage earners (for whom only limited deferral is available). The enhanced ability of capital-investing taxpayers to reduce their effective rate of tax creates "vertical inequity." The proposal would level the playing field between wage earners, on one hand, and high-income and high-net-worth capital investors, on the other.

Wealthy taxpayers have a superior ability over low-net-worth taxpayers to exploit the realization system by hiring sophisticated advisers to help them defer their gains, take their losses, and engage in strategies that reduce economic risk without realization. That ability creates "horizontal inequity." Moreover, because wealthy taxpayers earn a disproportionate amount of their income from capital gains, the vertical inequities of the realization system magnify the horizontal ones.[177] A mark-to-market system for publicly traded positions and derivatives would significantly reduce those inequities.

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[168]*See* Schenk, A Positive Account, *supra* note 44, at 355. Parts IV.A. and B. draw heavily on Prof. Schenk's article.

[169]*See id.* at 384 (referring to deferral as "[o]ne of the most serious problems with the realization rule").

[170]For example, a high-net-worth taxpayer may quite readily eliminate 80 percent of its economic exposure to a publicly traded security and defer its tax liability for 20 years or more with a longer-term forward contract. A forward contract of that type does not appear to give rise to a "constructive sale" under section 1259. *See* section 1259(c)(1)(C) and (d)(1) (constructive sale provisions apply only to a forward contract to deliver a substantially fixed amount of property (including cash) for a substantially fixed price).

[171]*See* Weisbach, "A Partial Mark-to-Market Tax System," *supra* note 47, at 131-32.

[172]*See* Schenk, A Positive Account, *supra* note 44, at 388-89.

[173]*See generally id.* at 388-91; Daniel Halperin, "Saving the Income Tax: An Agenda for Research," *Tax Notes*, Nov. 10, 1997, p. 967 at 971; Louie, Realizing Appreciation, *supra* note 143, at 864; Weisbach, "A Partial Mark-to-Market Tax System," *supra* note 47, at 132.

[174]*See* Schizer, Realization, *supra* note 6, at 1612. ("As a result, realization causes investors to favor appreciation over periodic payments, and thus 'growth' stocks over debt instruments or 'income' stocks.")

[175]*See id.*

[176]Schenk, A Positive Account, *supra* note 44, at 391-92.

[177]*See* Fred B. Brown, "'Complete' Accrual Taxation," 33 *San Diego L. Rev.* 1559, 1574 (1996); Louie, Realizing Appreciation, *supra* note 143, at 862-64; Schenk, A Positive Account, *supra* note 44, at 355 n.7.

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C. Abuse Prevention

Once a reliable system of valuation is established for mark-to-market positions, abuse is all but impossible.[178] To test that statement, consider the application of the proposal to the six categories of transactions corresponding to prominent tax shelter cases that the JCT would subject to an "enhanced" economic substance doctrine.[179]

1. Offsetting position transactions. The JCT defined an offsetting position transaction as a transaction in which (a) the taxpayer holds offsetting positions that substantially reduce the risk of loss and (b) tax benefits would result from differing tax treatment of the positions. That category includes classic straddles,[180] as well the bull/bear note described in Rev. Rul. 2000-12[181] and the "pass-through straddle" loss generator described in Notice 2002-65.[182] Under the proposal, offsetting position transactions consisting of mark-to-market positions cannot generate losses (because the offsetting position would generate a gain).

2. Basis/fair market value disparity transactions. The JCT described a basis/fair market value disparity transaction as a transaction that is structured to result in a disparity between basis and fair market value that in turn creates or increases a loss or reduces a gain. Those transactions include income stripping, duplicated loss transactions, transactions in which a distribution represents a return of the taxpayer's investment, and transactions in which basis does not adequately account for an "economic" liability.[183] None of those results are possible on mark-to-market property.

3. Artificial gain transactions. An artificial gain transaction is a transaction that is structured to create or increase a gain in an asset, any portion of which would not be recognized for federal income tax purposes (for example, by reason of section 1032) if the asset were sold at fair market value by the taxpayer (or a related person). Enron's "Tomas" transaction was an artificial gain transaction.[184] An artificial gain transaction is impossible under the proposal if all of the relevant property is marked to market (and compound positions are deconstructed into section 1032 positions and non-section 1032 positions). Although artificial gain transactions will remain possible even under a mark-to-market system with respect to non-mark-to-mark property (as was the case in the Tomas transaction), section 732(f) effectively prevents Tomas transactions with respect to nontraded assets held in a partnership.

4. Tax-indifferent-party transactions. The JCT defined a tax-indifferent-party transaction as a transaction that is structured to result in income for federal income tax purposes to a tax-indifferent party for any period that is materially in excess of any economic income to that party with respect to the transaction for the period. That category is designed to capture the *ACM* transaction.[185] Under the proposal, it is impossible to generate gain in excess of economic income with respect to mark-to-market property. Therefore, under the proposal, the *ACM* transaction and similar tax-indifferent-party transactions with respect to publicly traded property cannot generate losses.

5. Short holding period transactions. A short holding period transaction is a transaction in which the taxpayer disposes of property (other than inventory, receivables, or stock or securities regularly traded on an established securities market) that the taxpayer held for a period less than 45 days. That category is designed to capture the "Compaq"- type situations in which a taxpayer claimed a foreign tax credit in respect of stock held for a very short period.[186] Although the proposal would not affect short holding period transactions,[187] the result in *Compaq* was reversed by section 246(c)(3) and (4).

6. Permanent book/tax difference transactions. A permanent book/tax difference transaction is a transaction that is structured to result in a deduction or loss that is

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[178]One abuse would remain possible. Under the proposal, because interest earned by individuals would be taxable at ordinary income rates but mark-to-market gains would be taxable at long-term capital gains rates, taxpayers could attempt to construct fixed-income equivalents with straddles. The proposal retains section 1258 to prevent that strategy.

[179]*See generally* Staff of the Joint Comm. on Taxation, *Options to Improve Tax Compliance and Reform Tax Expenditures*, JCS-02-05 (Jan. 27, 2005).

[180]*See, e.g., Knetsch v. United States*, 364 U.S. 361 (1960) (borrowing to purchase a deferred annuity); *Goldstein v. Commissioner*, 364 F.2d 734 (2d Cir. 1966) (borrowing to purchase Treasury securities); *Sheldon v. Commissioner*, 94 T.C. 738 (1990) (same); *Yosha v. Commissioner*, 861 F.2d 494 (7th Cir. 1988) (commodity straddles).

[181]2000-1 C.B. 744, *Doc 2000-5720, 2000 TNT 40-21*.

[182]2002-2 C.B. 690, *Doc 2002-21181, 2002 TNT 187-9*.

[183]In an income-stripping transaction, a taxpayer purchases income-producing property for $100, retains the right to an income stream (worth, say, $95), disposes of the right to the corpus (that is, worth $5), and claims a $95 loss.

[184]The category of artificial gain transactions was intended to include Enron's Tomas transaction. In Enron's Tomas transaction, the taxpayer contributed low-basis but high-value property, as well as all of the stock of a corporation, to a partnership. The other partners (affiliates of Bankers Trust) contributed cash, and the corporation that was contributed to the partnership received notes receivable from a Bankers Trust affiliate. The taxpayer was redeemed from the partnership by receiving all of the stock of the contributed corporation. Although that stock had a low basis, the taxpayer liquidated it under section 332, which permitted the taxpayer to acquire the corporation's high-basis receivable without a reduction in basis. Section 732(f) effectively prevents Tomas-type transactions.

[185]*See ACM Partnership v. Commissioner*, 157 F.3d 231, *Doc 98-31128, 98 TNT 202-7* (3d Cir. 1998). In *ACM*, the taxpayer used the ratable basis recovery rules under temp. Treas. reg. section 15a.453-1(c) on a sale of short-term notes to generate an uneconomic gain that was largely allocated to a foreign partner. After the foreign partner was redeemed, the corresponding loss was allocated almost entirely to Colgate.

[186]*See Compaq Computer Corp. v. Commissioner*, 113 T.C. 21, *Doc 1999-30659, 1999 TNT 183-7* (1999), *rev'd* 277 F.3d 778, *Doc 2002-184, 2002 TNT 1-5* (5th Cir. 2001).

[187]Congress has since amended section 901(k)(3) to deny the tax credit that was claimed in *Compaq*.

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allowable for federal income tax purposes but is not allowable for financial reporting purposes. That category is intended to cover Enron's Tanya, Valor, Steele, Condor, and Teresa transactions,[188] which were intended to produce losses (or duplicated losses) for tax purposes but earnings for financial accounting purposes. By largely matching book and tax treatment for mark-to-market property, the proposal would reduce the situations in which permanent book/tax differences are possible.

D. Simplification

The proposal permits dramatic simplification at three levels. First, it uses revenue generated by a mark-to-market system to eliminate the AMT. Second, the proposal would eliminate much of the domestic tax planning for mark-to-market taxpayers.[189] Finally, by eliminating realization for mark-to-market property, the proposal would eliminate the need for the series of provisions that are designed to prevent abuse of realization. What follows is a list of provisions that would become moot for mark-to-market property.[190]

1. Holding period for reduced capital gains rates. The proposal would eliminate the requirement that mark-to-market property of an individual be held for more than a year to achieve a 15 percent rate. Under the proposal, all mark-to-market gains of mandatory mark-to-market individuals would be taxable at the 15 percent rate.

2. Character issues and the loss limitation rules. Current law denies corporate taxpayers the ability to use their capital losses to offset ordinary income and permits individuals to offset only $3,000 of ordinary income with capital losses each year. Those limitations are necessary under a realization-based system to prevent selective realization of losses,[191] but are not necessary under a mark-to-market system in which all gains and losses for mark-to-market property are recognized annually.[192] Therefore, under the proposal, mark-to-market losses would be fully available to offset the ordinary income of corporate taxpayers and, subject only to a percentage limitation designed to equate the marginal rates, would be fully available to offset the ordinary income of individual taxpayers.

3. Wash sale rules. The wash sale rules are designed to prevent taxpayers from selling property and claiming a tax loss and then, within a short period, reestablishing the position and maintaining their economic position. Wash sale limitations would not exist under the proposal — the realized tax loss would be permitted even if the position is maintained.

4. Straddle rules. The straddle rules (and section 263(g)) are designed to prevent taxpayers from claiming losses and deductions in respect of positions in actively traded personal property before recognizing the untaxed gains in offsetting positions.[193] Those rules would be unnecessary if all of the gain and loss in all of the positions are recognized under mark-to-market treatment.[194]

5. Accounting for swaps, IO interests, and other derivatives. The IRS has an extraordinarily difficult time determining the proper tax treatment of complex financial instruments under our realization-based system,[195] and its attempts to do so have been criticized.[196] The proposal would subject virtually all complex financial instruments to mark-to-market treatment, would eliminate the complex rules for those instruments, and would tax them economically. Moreover, once corporations and extremely high-net-worth and high-income individuals report their derivatives on a mark-to-market basis, there may be greater tolerance for simpler rules that would apply to other taxpayers (even though the simpler rules might not necessarily measure economic income perfectly).

6. Constructive sales/constructive ownership. Section 1259 prevents taxpayers from deferring built-in gain recognition after they hedge away all or substantially all of the economic risks and rewards from the appreciated position. Section 1260 prevents taxpayers from using derivatives to obtain all or substantially all of the economic benefits and burdens from particular positions, and deferring their tax and converting income from

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[188]Tanya and Valor were contingent liability loss generators. *See* Notice 2001-17, 2001-1 C.B. 730, *Doc 2001-2017, 2001 TNT 13-4*. In Condor, Enron attempted to use a partnership to shift basis from Enron stock held by the partnership to some depreciable assets. Steele involved the transfer of high-basis assets in exchange for high-basis stock to generate two deductions (one at the corporate level and another at the shareholder level). In Teresa, low-basis assets were contributed to a partnership, and dividend income was generated that was intended to qualify for the dividends received deduction and would increase the partnership's basis in the low-basis assets, producing greater depreciation deductions.

[189]If the proposal were adopted, tax planning would be limited to avoiding the regime by remaining under the asset and income thresholds and avoiding mark-to-market assets.

[190]The list borrows from Weisbach, "A Partial Mark-to-Market Tax System," *supra* note 47, at 122-28.

[191]*See id.* at 124 (mark-to-market taxation eliminates selective realization and, therefore, the capital loss regime would not be necessary for assets (or liabilities) in the mark-to-market base).

[192]Brown, Complete Accrual Taxation, *supra* note 43, at 1589.

[193]*See* Weisbach, "A Partial Mark-to-Market Tax System," *supra* note 47, at 124. ("For example, the straddle rules prevent taxpayers from claiming losses on positions in traded property to the extent there is unrealized gain in related positions.")

[194]*See* Treas. reg. section 1.263(g)-1(b) (section 263(g) does not apply to securities to which the mark-to-market accounting method provided by section 475 applies). The straddle rules may continue to have some vitality for grandfathered positions when preenactment gain has not yet been recognized.

[195]For example, in February 2004 the IRS proposed exceedingly complicated rules for taxing "contingent swaps" and requested comments on their application. *See* 64 *Federal Register* 8886 (Feb. 26, 2004). In Ann. 2004-75, *supra* note 6, the IRS requested help in constructing a tax regime for REMIC IO interests and, in Notice 2004-52, *supra* note 6, the IRS opened up a project to characterize and determine the tax treatment of credit derivatives.

[196]*See, e.g.*, New York State Bar Association Tax Section, *Report on Proposed Notional Principal Contract Regulations* (June 4, 2005).

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ordinary income to long-term capital gains. Each of those sections are unnecessary for market-to-market positions under the proposal.

7. Foreign antideferral rules. The CFC and PFIC rules act to prevent taxpayers from deferring tax on offshore passive income (and converting it from ordinary income to long-term capital gains). The PFIC rules already exempt stock that is marked to market. Similar rules could apply to marked-to-market CFCs.[197]

8. Foreign currency gain or loss. Under current law, complicated rules determine gain or loss in respect of foreign currency, and foreign currency gain or loss generally is treated as ordinary income or loss. Under the proposal, publicly traded foreign currency would be treated the same as all other publicly traded property: It would be marked to market, and any gain would be taxable at reduced rates.

9. Sections 301, 302, and 305, and the other shareholder provisions of subchapter C. Sections 301, 302, and 305 contain the rules that determine whether a distribution from a corporation is a dividend or a redemption. Those sections will have little effect for mark-to-market individuals because all qualified dividends and marked-to-market gains would be taxable at the 15 percent rate. Moreover, the proposal would render all of the shareholder provisions of subchapter C instantly irrelevant for individual mark-to-market taxpayers, who will be entirely indifferent whether the consideration they receive in a merger or acquisition is "tax-free stock" or taxable boot.[198]

10. Section 1001. Section 1001 and its regulations contain the rules for determining when the modification to a debt instrument or other property is treated as a taxable exchange for tax purposes.[199] Section 1001 would be irrelevant for the mark-to-market positions of mark-to-market taxpayers.

11. Section 163(l). Section 163(1) provides, in general, that no interest deductions are permitted for any indebtedness if (i) a substantial amount of the principal or interest of the indebtedness is required to be paid or converted, or at the option of the issuer or a related party is payable in, or convertible into the equity; (ii) a substantial amount of the principal or interest is required to be determined, or at the option of the issuer or a related party is determined, by reference to the value of the equity; or (iii) the indebtedness is part of an arrangement that is reasonably expected to result in a transaction described in (i) or (ii).

Under the proposal, any mark-to-market debt instrument (other than "plain vanilla" convertible debt) that references the issuer's equity would be bifurcated into a plain vanilla debt instrument that does not reference the issuer's or a related party's indebtedness and one or more other derivatives. Interest would accrue only on the plain vanilla debt component; any mark-to-market loss on the section 1032 components would not be deductible. (In other words, the proposal would transform a section 163(l) security into its equivalent unit and permit interest deductions only on the indebtedness that would not be described in section 163(l).[200]) Thus, section 163(l) will have no effect for a mark-to-market issuer, and safely could be repealed for those taxpayers.

E. Systemic Efficiency

Recent academic literature has sought to evaluate reform proposals based on their "systemic efficiency."[201] More specifically, Prof. Schenk has suggested that proposals that increase accrual or realization events should be evaluated based on the extent to which they (i) change (preferably decrease) the elasticity of income (that is, make it harder for taxpayers to shift into other methods of enjoying economic gains without recognizing income),[202] (ii) change (preferably decrease) marginal administrative and compliance costs,[203] and (iii) result in "signaling" benefits (that is, signal that the government is serious about preventing abuse).[204]

Progressive mark-to-market taxation fares well under that test. First, the proposal would decrease the elasticity of income because both publicly traded securities and the derivatives that reference them would be subject to mark-to-market, and private equity is not an adequate

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[197]However, as discussed in Part II.H., the proposal would not require 50-percent-and-greater-owned CFCs to be marked to market.

[198]However, because corporations are entitled to a dividends received deduction under the proposal, sections 301, 302, and 305 (and section 1059) will continue to be relevant for them. Sections 301, 302, and 1059.

[199]For example, Treas. reg. section 1.1001-3 contains a set of rules to determine when a modification to the terms of a debt instrument is so "significant" so that the unmodified debt instrument is deemed exchanged in a taxable transaction. Treas. reg. section 1.1001-3.

[200]*Cf.* Rev. Rul. 2003-97, 2003-34 IRB 380 (the debt component of a "Feline PRIDES" is not subject to section 163(l)).

[201]*See, e.g.*, Schenk, Efficiency Approach, *supra* note 161, at 503; David A. Weisbach, "An Economic Analysis of Anti-Tax Avoidance Doctrines," 4 *Am. L. & Econ. Rev.* 88 (2002); Shaviro, Efficiency Analysis, *supra* note 163. The term systemic efficiency is used here (but not in the literature) to distinguish it from economic efficiency.

[202]The elasticity of income is affected by the availability of acceptable substitutes, and the ability of taxpayers to shift their investments to the substitutes, which may be affected by the presence of "frictions," or restraints on tax planning external to the tax law. For example, as the desire to maximize book income (which tends to frustrate tax minimization strategies). *See* Schenk, Efficiency Approach, *supra* note 161, at 509-11.

[203]Prof. Schenk identifies four categories of costs: (i) administrative costs borne by the government, (ii) taxpayer compliance costs, (iii) "avoidance costs" (that is, the voluntary costs incurred by taxpayers to search for and adopt substitute nontaxed transactions), and (iv) the "deadweight loss" that results when taxpayers switch to untaxed transactions. *Id.*at 514-17.

[204]*See id.* at 516-18. Prof. Schenk suggests that the potential benefits of signaling depends on three variables: (i) the nature of the fix (that is, if the government attempts to shut down an aggressive transaction and succeeds, others may be less likely to try similar strategies; however, government failure may have the opposite effect), (ii) knowledge (that is, the extent that taxpayers are aware of the fix), and (iii) the effect of the fix on compliance (that is, if taxpayers believe that others (particularly the wealthy) are forced to comply with their obligations, they may be more likely to comply with theirs).

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substitute for publicly traded stock.[205] Administrative costs would increase to the extent that mark providers would be required to value thinly traded securities and derivatives, and deconstruct and value their components. However, now that many securities and derivatives are required to be valued under GAAP, and the methods exist to conduct those valuations, the marginal administrative costs are already significantly less than they were five years ago. And costs would relate only to the corporations that are unable or unwilling to use their GAAP valuations and the relatively few households that meet the income or wealth thresholds.

The proposal would decrease administrative costs to the extent that shelters are no longer available for publicly traded property. While the proposal would give rise to avoidance costs to the extent that taxpayers invest in privately held securities rather than publicly traded property, as discussed above in Part III.B., experience — albeit anecdotal — suggests that the benefits of liquidity will outweigh the tax costs of mark-to-market and will not lead to a flight from the public capital markets.

F. Increased Liquidity

By eliminating the lock-in effect and imposing tax before realization, mark-to-market shareholders might be expected to sell a greater amount of their securities to pay their tax. Thus, the proposal could reasonably be expected to cause a greater number of securities to float on the public markets, which will generally reduce volatility in the capital markets.

G. Greater Book-Tax Conformity

Because GAAP now requires mark-to-market treatment for most publicly traded securities and many derivatives, the proposal would tend to increase book-tax conformity. Conformity alone has many benefits. For example, it tends to encourage more accurate book valuations (because the incentive to value highly for book purposes is balanced by the desire to book low for tax), reduces compliance and avoidance costs, and eliminates an entire class of tax shelters.[206]

H. Global Conformity

The United Kingdom has adopted book-tax conformity regimes, and similar approaches have been suggested for Spain and Australia.[207] If the proposal is adopted, the United States would join those countries and move toward a consistent global tax system for mark-to-market taxpayers.

I. Consumption Tax Transition

One of the most difficult challenges of switching our current income tax to a consumption tax are the transition issues.[208] For example, consider two taxpayers, A and B, who each have $200 worth of stock with a $100 basis. Immediately before the conversion, taxpayer A sells his stock and is left with $165 of cash after tax, but taxpayer B retains her $200 of appreciated stock. Under a consumption tax without transition rules, taxpayer A will be taxed twice (first under the income tax and then under the consumption tax), but taxpayer B only once (she will escape tax on her $100 of built-in gain).[209] By taxing appreciation in mark-to-market property, the proposal would at the very least prevent the potential problem from worsening. If the moderate or strong form of the proposal — which would require recognition of the built-in gain — is adopted, transition would be easier.

J. Inherent Flexibility

The proposal is presented as a complete plan that satisfies all of the president's objectives for tax reform, but the mark-to-market component is inherently flexible, could serve as a component of any reform that retains the income tax, and is entirely consistent with most of the alternative income tax systems that have been proposed.

For example, Prof. Michael Graetz has proposed the enactment of a 10 percent-15 percent VAT, coupled with a reduction of the personal income tax rate to 25 percent on income over $100,000, wage subsidies for low-income workers, a reduction of the corporate income tax to 25 percent, greater book-tax conformity, and a 25 percent wealth transfer tax.[210] The proposal could form a component of the income tax under Prof. Graetz's proposal. It would advance the progressivity objectives of his proposal and help to conform book and tax treatment.

V. Conclusion

President Bush is expected to offer his proposals for fundamental tax reform in his State of the Union address this January. The President's Advisory Panel on Federal Tax Reform offered him suggestions on November 1, but they are widely viewed as unenactable. A progressive system of mark-to-market taxation would achieve all of the president's objectives for fundamental tax reform in a more politically viable manner.

First, the proposal would help eliminate the AMT but would adversely affect fewer than 400,000 households. It is enactable.

Second, the proposal would not increase rates, deny deductions, or impose new taxes. Therefore, it does not violate the president's "no new taxes" pledge.

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[205] *See* Schenk, Efficiency Approach, *supra* note 161, at 530.

[206] *See generally* Keinan, Book Tax Conformity, *supra* note 52, at 683-88 (cataloging the benefits of book-tax conformity); George K. Yin, "Business Purpose, Economic Substance, and Corporate Tax Shelters: Getting Serious About Corporate Tax Shelters: Taking a Lesson from History," 54 *SMU L. Rev.* 209, 225 (2001) (book-tax conformity eliminates tax shelters that are designed to generate tax losses without book losses).

[207] *See* Keinan, Book Tax Conformity, *supra* note 52, at 676.

[208] *See* David Stout, "Greenspan Urges Tax Code Simplification," *The New York Times*, Mar. 3, 2005, at C3 (quoting Alan Greenspan, a consumption tax "raises a challenging set of transition issues, notably how to protect taxpayers who have long arranged their financial affairs based on the old regulations and the assumptions surrounding them").

[209] *See, e.g.*, Alan D. Viard, "The Transition to Consumption Taxation, Part 1: The Impact on Existing Capital," *Economic and Financial Review* 2 (Third Quarter 2000).

[210] *See* Michael J. Graetz, "100 Million Unnecessary Returns: A Fresh Start For the U.S. Tax System," 112 *Yale L. J.* 261 (2002) Mark-to-market would tend to accomplish one of Prof. Graetz's objectives of greater book-tax conformity.

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Third, the proposal would offer significant simplification. It would permit the repeal of the AMT and would eliminate the straddle rules, the wash sale rules, the constructive ownership and constructive sale provisions, and the capital loss limitations for mark-to-market property.

And, finally, mark-to-market taxation would prevent nearly all abuse and eliminate virtually all loopholes for mark-to-market property, and would help to create a "fair" tax system under the president's definition.

The irony is, of course, that a proposal by the administration to tax the appreciation in the stock holdings of the very wealthiest taxpayers is unimaginable. But because Democrats and Republicans agree that the tax reform panel's recommendations will never become law, the president ultimately will have to decide between the unimaginable and the unenactable. Mark-to-market may be unimaginable, but it is enactable.

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The Shelf Project

Revenue-Raising Proposals to Defend the Tax Base

A Progressive System of Mark-to-Market Taxation

David S. Miller
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A Progressive System of Mark-to-Market Taxation

By David S. Miller

David S. Miller is a partner with Cadwalader, Wickersham and Taft LLP in New York. He wishes to thank his colleague Jennifer Wetzel for her help preparing the proposal.

Under this mark-to-market proposal, large companies and wealthy individuals would pay tax on publicly traded securities and derivatives on the securities as if they had sold the position at year-end. No actual sales would be required.

The proposal is made as a part of the Shelf Project, a collaboration by tax professionals to develop and perfect proposals to help Congress when it needs to raise revenue. Shelf Project proposals are intended to raise revenue, defend the tax base, follow the money, and improve the rationality and efficiency of the tax system. The tax community can propose, follow, or edit proposals at http://www.taxshelf.org. A longer description of the Shelf Project is found at "The Shelf Project: Revenue-Raising Proposals That Defend the Tax Base," *Tax Notes*, Dec. 10, 2007, p. 1077, *Doc 2007-22632, 2007 TNT 238-37*.

Shelf Project proposals follow the format of a congressional tax committee report in explaining current law, what is wrong with it, and how to fix it.

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This proposal would require our largest corporations and wealthiest taxpayers to mark to market their publicly traded securities and derivatives on those securities. The taxpayers subject to mark to market would pay tax on the appreciation as if they had sold the securities and derivatives at year-end. It would also allow these taxpayers immediate deductions for unrealized depreciation in publicly traded securities and their derivatives.

A. Current Law

Our current system of federal income taxation is based on realization. Under a realization-based system, tax is not imposed on a taxpayer until that taxpayer actually realizes a gain or loss by selling property for cash or exchanging the property for property that differs materially, either in kind or extent.[1]

B. Reasons for Change

There are good reasons for the realization requirement. First, before a sale or exchange, taxpayers may not have the cash to pay the tax, but after a sale for cash, cash to pay the tax is available. (This is the liquidity concern.) Second, the value of the property is obvious on a sale for cash, but the property may be difficult to value before sale. (This is the valuation concern.) Third, even if a taxpayer has cash to pay a tax and the value of his property is clear before sale, it is regarded as unfair to impose a tax on "paper gains" that may evaporate. (This is the psychological concern.) These three concerns apply with greatest force to low- and middle-income taxpayers who do not have liquid cash to pay tax liabilities absent a sale, and to all taxpayers that have unique or thinly traded property that is not susceptible to ready valuation.

The realization requirement has an inadvertent benefit for taxpayers — deferral. Under a realization system, because tax is not paid until property is sold, the longer a taxpayer waits before selling his property, the less tax the taxpayer pays on a present value basis.[2]

The deferral benefits of our realization system of taxation are not lost on taxpayers with appreciated property. All other things being equal, taxpayers with appreciated assets hold that property and avoid paying tax rather than sell the assets. Moreover, almost since the beginning of our tax code, sophisticated (and usually

[1]*See* reg. section 1.1001-1(a). All references to section numbers are to the Internal Revenue Code of 1986, as amended, or the Treasury regulations proposed or promulgated thereunder.

[2]Thus, to take a very simple example, assume that an individual taxpayer is subject to tax at the long-term capital gains rate of 15 percent and can borrow money at a 7 percent interest rate. The taxpayer buys some property for $50 and, after a year, the property has increased in value to $150. If the taxpayer sells the property for cash at that time, he will be required to pay $15 in tax and the present value of the tax is $15 (leaving aside the fact that the taxpayer may not owe the tax until April 15 of the following year). However, assume that the taxpayer does not sell the property and holds it for another year. If, after that second year, the property is still worth $150 and the taxpayer then sells it, the taxpayer would pay $15 in tax, but the present value of that tax, discounting back to the prior year at the taxpayer's cost of funds, is only $14.02. Thus, the taxpayer would have saved $0.92 (or 7 percent) of tax in present value terms by waiting a year to sell. If the taxpayer waits 10 years before selling, the net present value of the tax will be only $7.13 and, by waiting, the taxpayer will have reduced his tax by more than 50 percent (to 7.13 percent on a present value basis). Finally, if the taxpayer does not sell the property until death, the basis of the property is stepped up to fair market value and the taxpayer avoids all income tax.

wealthy) taxpayers enter into transactions that eliminate or reduce the risk in their appreciated property without giving rise to a sale (or constructive sale) for tax purposes.

This disincentive to sell, referred to as the lock-in effect, is one inefficiency of our realization system of taxation. There are others. Taxpayers in a realization system can engage in strategic trading: That is, they may hold appreciated assets and defer gains but sell depreciated assets and claim their losses. This, in turn, encourages taxpayers to make riskier investments, because the government subsidizes realized losses but doesn't tax unrealized gains. Moreover, because a realization system imposes immediate tax on interest and dividends but allows deferral for appreciation, our realization system of taxation inadvertently encourages taxpayers to invest in growth stocks (which tend to pay lower dividends) over "income" stocks.[3]

Also, because our realization system of taxation does not measure "economic" gains and losses, it is susceptible to manipulation. Thus, almost since the beginning of the tax code, taxpayers have attempted to eliminate their risk on appreciated property and monetize that property without triggering realization. Conversely, taxpayers have attempted to sell their depreciated property and claim tax losses without changing their economic exposure. This conduct, in turn, has led to a slew of antiabuse rules, including the capital loss limitation rules, wash sale rules, straddle rules, conversion transaction rules, and constructive sale rules, as well as complicated sets of accounting rules for contingent payment debt instruments and contingent swaps. Those rules create enormous complexity in our tax code.

Despite those rules, the uneconomic nature of our realization system invites tax planning to develop new financial instruments and transactions that capitalize on realization.

Exchange-traded notes are the latest financial product to attract attention because of their deferral properties. Other financial instruments permit taxpayers to reduce their risk in appreciated property and extract cash without triggering realization (and, consequently, tax). A third category of transaction permits taxpayers to trigger realization in depreciated property and claim their losses without changing their economic position.

Our federal income tax system is often said to be progressive, meaning that taxpayers in higher-income tax brackets are subject to a higher rate of tax on their realized income, and President Bush has called progressivity "fundamental to fairness in taxation."[4] But, because no tax is imposed on unrealized gains, our realization-based tax system also has the effect of imposing a much higher effective rate of tax on wage earners than on investors, calling into question the fundamental fairness of the tax system and its progressive nature.

Consider two taxpayers. The first is a wage earner who is subject to tax at a 15 percent rate.[5] The second is a billionaire investor who earns no wages. His long-term capital gains are also subject to tax at a 15 percent rate. Assume that the wage earner earns $18,000 and the billionaire's investments increase in value by $18,000 but he does not sell them. Economists would conclude that the economic (or Haig-Simons) income of those two taxpayers for the year is the same — $18,000. However, only one of those taxpayers will pay any tax. The wage earner will pay $2,700 in tax and will be left with $15,300. The investor will pay no tax and will keep all $18,000 of his economic income. Moreover, the investor could enter into derivatives that eliminate at least 80 percent of his economic risk regarding his investments, and provide him with $18,000 in cash, all without triggering realization.[6] And, as illustrated above, if the billionaire waits 10 years before selling his property, he could reduce the present value of his tax rate to 7.13 percent (or, if he waited long enough, zero). Thus, the present value of the billionaire's effective tax rate would be less than half the tax rate of a wage earner with an $18,000 salary.[7]

That disparity exists because low-income taxpayers earning wages are taxable on all of their economic income (except what they are able to contribute to a 401(k) or other retirement plan), but wealthy taxpayers benefit from deferral on their unrealized gains, and this deferral dramatically reduces the effective rate of tax on their economic income.

Moreover, although the tax system ignores unrealized appreciation, generally accepted accounting principles now require mark-to-market treatment for most publicly traded securities and many derivatives. Thus, corporations may treat appreciation in the derivatives they hold as earnings for accounting purposes but exclude them for tax purposes.

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[3]*See generally* David M. Schizer, "Realization as Subsidy," 73 *N.Y.U. L. Rev.* 1549, 1576, and notes 108-110 (1998).

[4]Office of the Press Secretary, "President Bush Provides Leadership on Tax Reform" (Sept. 2, 2004), *available at* http://www.whitehouse.gov/news/releases/2004/09/20040902-7.html (description of Bush's tax agenda).

[5]That rate was available in 2007 for taxpayers whose taxable income was $18,450 or less.

[6]A recent article in *The Wall Street Journal* explained how several executives used derivatives with respect to their stock to receive hundreds of millions of dollars tax free. *See* Jesse Drucker, "IRS Targets Billionaire's Lucrative Tax Strategy," *The Wall Street Journal*, A1 (June 9, 2008), *available at* http://online.wsj.com/article/SB121297088214955885.html. The IRS has challenged an aggressive form of this transaction, but concedes that derivatives do indeed allow executives to hedge their holdings and receive cash without tax. Rev. Rul. 2003-7, 2003-1 C.B. 363, *Doc 2003-1634, 2003 TNT 12-13*.

And Larry Ellison, the founder of Oracle Corp., borrowed more than $1 billion against his Oracle shares back in 2000. He clearly paid no tax on his loan. Carrie Kirby, "Inside Look at a Billionaire's Budget," SF Gate (*San Francisco Chronicle* Web site) (Jan. 31, 2006), *available at* http://www.sfgate.com/cgi-bin/article.cgi?file=/c/a/2006/01/31/MNG62H06991.DTL.

[7]Warren Buffet recently remarked that he paid tax at a lower rate than his secretary. Had he compared the effective tax rate on his economic income with that of his secretary, he might have been surprised to learn that his secretary pays tax at an effective rate of tax that is many times Buffet's effective rate.

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An income tax need not be based on realization. Many economists agree that a theoretically perfect income tax would annually value each taxpayer's assets and liabilities and would tax each person's Haig-Simons income, or their net accretion to wealth. Such a tax would certainly be constitutional.[8] In fact, Congress has demonstrated an increasing willingness to depart from realization.

For example, section 1256 imposes tax on the gains from some options and futures contracts as if they were disposed of for fair market value on the last business day of the year and then immediately repurchased.[9]

Section 475 provides that securities dealers must mark to market their securities at the end of the tax year. Section 475 was enacted, in part, because Congress concluded that the "lower of cost or market" method of accounting used by securities dealers tended to understate their income.[10]

Finally, in 1997, Congress enacted section 1259, which requires a taxpayer to recognize gain if the taxpayer eliminates substantially all of the economic benefits and burdens in some appreciated financial positions, even if the position is not sold.[11]

The president and Barack Obama believe that the federal tax system should be progressive and the president, John McCain, and Barack Obama all believe that our federal tax system should be fair.[12] A progressive and fair system means, at the very least, that the very wealthiest investor should pay tax on his economic income at the same effective rate as the poorest wage earner.

However, that is not true under our current system of tax. Deferral under our current realization system of taxation permits the wealthiest taxpayers to avoid all tax on the appreciation in their securities. This ability permits them to lower their effective rate of tax on their economic income below that of the very poorest taxpayers, which undermines the fairness of our tax system and its progressive nature. The proposal would level the playing field by assuring that the wealthiest taxpayers pay tax on their economic income at the same effective rate as the poorest wage earner, and enhance the progressivity and fairness of our federal tax system.

Fairness also means that wealthy taxpayers and corporations cannot exploit the tax rules to reduce their taxes. Even with the various antiabuse rules, wealthy taxpayers and large corporations can still use stocks, securities, and derivatives to exploit the realization tax system and obtain deferral and tax savings that are not available to lower-income taxpayers. Because the proposal would tax economic income, abuse is all but impossible.

Deferral also permits large corporations to report earnings to their shareholders, but avoid tax on those earnings. The proposal would ensure that large corporations pay tax on the earnings reported to their shareholders from publicly traded securities and derivatives.

McCain and Obama each call for a simpler tax system. Our realization system of taxation requires no fewer than five separate regimes of antiabuse rules, and several complicated accounting systems to address manipulation of our realization system of taxation. The proposal would render moot those antiabuse provisions for the highest-income taxpayers and large corporations (who would be on mark to market) and permit significant simplification.[13]

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[8]*See Helvering v. Horst*, 311 U.S. 112 (1940) (realization requirement is "founded on administrative convenience"); *supra* note 3, 73 *N.Y.U. L. Rev.* 1549, 1576, and notes 108-110 (1998) (the realization requirement is merely an administrative and not a constitutional rule); and Marvin A. Chirelstein, *Federal Income Taxation* 71 (7th ed. 1994) ("Realization is strictly an administrative rule and not a constitutional, much less an economic, requirement of 'income'").

[9]Section 1256 contracts include regulated futures contracts, foreign currency contracts, nonequity options, dealer equity options, and dealer securities futures contracts. Section 1256(a).

[10]*See* H.R. Rep. No. 103-213, 111 Cong. 1st Sess. at 661 ("The Committee believes that the cost method and the LCM method generally understate the income of securities dealers") (May 25, 1993).

[11]H.R. Rep. 105-148 (Taxpayer Relief Act of 1997), 105th Cong. (1997).

[12]*Supra* note 4, *available at* http://www.whitehouse.gov/news/releases/2004/09/20040902-7.html (description of Bush's tax agenda) (simpler and fairer); Obama: "Make the Tax System More Fair and Efficient," *available at* http://www.barackobama.com/issues/fiscal/#fair-tax; and McCain: "John McCain Believes Taxes Should be Low, Simple, and Fair," *available at* http://www.johnmccain.com/informing/issues/ob8e4db8-5b0c-459f-97ea-d7bj42a7835.htm.

[13]For example, section 1001 would be irrelevant for mark-to-market taxpayers because property would be taxed every year, rather than only on the occurrence of a taxable event. Also, holding periods for reduced capital gains rates would be unnecessary, as all mark-to-market gains would be taxed at a 15 percent rate. Tax accounting rules for swaps, derivatives, and other complex financial instruments, which are complicated and have often been criticized — *see, e.g.*, New York State Bar Association Tax Section, Report on Proposed Notional Principal Contract Regulations (June 4, 2005) — would no longer be necessary because the majority of complex financial instruments would be subject to mark-to-market treatment. Finally, sections 301, 302, and 305, which determine whether a distribution from a corporation is a dividend or redemption, as well as other shareholder provisions of subchapter C, would no longer be needed for mark-to-market taxpayers because both dividends and mark-to-market gains would be taxable at a 15 percent rate.

Also, the proposed system would eliminate the need for a series of provisions designed to prevent the abuse of realization. For instance, loss limitation rules for capital losses could be eliminated for mark-to-market taxpayers, as those taxpayers would no longer be able to selectively realize losses. The controlled foreign corporation and passive foreign investment company rules, which aim to prevent taxpayers from deferring tax on offshore passive income, could be held inapplicable to mark-to-market corporations. The rules treating foreign currency gain or loss as ordinary income could also be eliminated for publicly traded foreign currency, which would be marked to market. The wash sale rules and straddle rules would be equally unnecessary for mark-to-market taxpayers because all gains and losses would be taxed, even if no sale or exchange occurred. The constructive sales and constructive ownership rules, which are designed to prevent deferral of tax on economic gains, would similarly be rendered moot for mark-to-market positions under

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The historic reasoning underlying our realization system of taxation — illiquidity, valuation, and psychology — does not apply to the publicly traded securities and derivatives of the highest-earning and wealthiest individuals, and large corporations. Those taxpayers are fully capable of borrowing against their liquid securities and derivatives and therefore do not usually have liquidity concerns. Also, because publicly traded securities are easy to value, valuation concerns are not present. And, finally, there is less of a psychological concern for those liquid and sophisticated taxpayers who have access to derivatives to hedge their market risk and lock in their paper gains, and can borrow against or otherwise monetize their appreciated securities.

Thus, the proposal, by eliminating deferral on publicly traded securities and derivatives for the wealthiest individuals and corporations, would help make our tax system fairer, simpler, and more progressive, without raising current tax rates.

By imposing mark-to-market taxation on high-income and high-net-worth taxpayers only and retaining the realization system for all other taxpayers, the proposal would use the incidence of tax on investment assets to achieve progressivity. In short, the proposal would expressly use realization as a subsidy for those who need it and deny it to those who do not. By eliminating deferral, lock-in/lock-out, and strategic trading for mark-to-market taxpayers, the proposal would enhance the efficiency of the tax system and the capital markets. And, by conforming the tax and GAAP treatment of most publicly traded securities and derivatives, the United States would join the United Kingdom in what is likely to become a global trend toward increased book-tax conformity.

C. Explanation of Proposal

1. Overview. Under the proposal, all public companies, all private companies with $50 million or more of net assets, and all individuals and married couples with $1.6 million of adjusted gross income or $5 million of publicly traded property would be required to mark to market their publicly traded property, derivatives of publicly traded property, and some publicly traded debt and other liabilities. All other taxpayers would remain on the realization system. Realization taxpayers would be permitted to elect mark-to-market treatment for any publicly traded property they hold.[14]

Mark-to-market gains of corporations would be subject to tax at the current marginal ordinary income rate (35 percent). Mark-to-market losses of corporations would be fully deductible against ordinary income or capital gain. Mark-to-market gains (and qualified dividends) of individuals would be subject to tax at the long-term capital gains rates (15 percent), and the interest and other ordinary income of individuals would remain subject to tax at the ordinary income rate (35 percent). Individuals who are securities dealers, or who receive allocations of gains for performing investment services, and key employees who received their securities as compensation would not benefit from the reduced rates of tax.

Individuals' mark-to-market losses would be fully deductible to the extent of prior mark-to-market gains, they could then be used to offset capital gains, and then (under current rates) could offset 43 percent (15 percent/35 percent) of ordinary income or could be carried forward indefinitely. Securities dealers and employees who are taxable on gains at ordinary income rates would receive a full offset for mark-to-market losses.

The proposal would generally bifurcate financial instruments into a debt component and a nondebt mark-to-market component and, for corporations, isolate any section 1032 component. The proposal would also generally accelerate the recognition of deferred compensation that is measured by reference to publicly traded property.

The proposal would apply to all changes in value in publicly traded property that occur after the date of enactment.

2. Mandatory Mark-to-Market Taxpayers.

a. Public corporations. Under the proposal, publicly traded corporations would be subject to mark-to-market taxation on their publicly traded securities and derivatives. Publicly traded companies are required under GAAP to annually mark to market their marketable equity securities, debt securities that are not intended to be held until maturity, and some of their derivatives, and use those valuations to report their earnings or other comprehensive income.[15]

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that proposal. Finally, section 163(l), which disallows interest deductions for some types of indebtedness, would no longer be necessary for mark-to-market debt instruments because section 163(l) securities would be bifurcated and interest deductions would be allowed only on the indebtedness that is not currently covered under section 163(l).

[14]A more complete explanation of the proposal is given by David S. Miller, "A Progressive System of Mark-to-Market Taxation," *Tax Notes*, Nov. 21, 2005, p. 1047, *Doc 2005-22691*, *2005 TNT 224-38*.

[15]*See* Financial Accounting Standard No. 115, para. 7 (investments in debt securities for which the investor has a positive intent and the ability to hold until maturity are accounted for as held-to-maturity securities and are not marked to market); FAS 115, paras. 12.a and 13 (marketable equity securities and all debt securities that are bought and held principally for the purpose of selling them in the near-term (thus held for only a short period of time) are carried at fair value and changes in fair value are recognized in earnings on the income statement); FAS 115, paras. 12.b and 13 (marketable equity securities and all debt securities that are not held-to-maturity or trading securities are classified as available for sale securities; in this case the mark-to-market gains and losses are reflected in "other comprehensive income," which is reflected as equity on the balance sheet); FAS 133 (requiring derivatives to be marked to market); FAS 149 (modifying FAS 133); FAS 150 (establishing standards for classifying and measuring instruments that may be both liabilities and equity). *See generally* Alvin D. Knott and Jacob D. Rosenfeld, "Book and Tax (Part One): A Selective Exploration of Two Parallel Universes," *Tax Notes*, May 12, 2003, p. 865, *Doc 2003-11781*, or *2003 TNT 97-29*; Yoram Keinan, "Book-Tax Conformity for Financial Instruments," 6 *Florida T. Rev.* 676 (2004).

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b. Large private C corporations. Mark-to-market taxpayers would also include large private subchapter C corporations that report shareholder equity of $50 million or more on audited financials, or have net assets with a fair market value of $75 million or more. Those thresholds correspond roughly to the requirements for listing on the NASDAQ and Amex stock exchanges.[16]

c. Mark-to-market thresholds for individual taxpayers and trusts. The proposal would impose mandatory mark-to-market treatment on any individual, married couple, or trust with annual AGI (including tax-exempt income) in excess of $1.6 million, and on any individual, married couple, or trust with $5 million or more of publicly traded property, cash, or cash-equivalent investment assets. The $1.6 million threshold roughly corresponds to the highest 0.1 percent income-earning individual taxpayers and married couples (roughly 290,000 households), and would be adjusted annually in sizable increments (for example, $500,000) to track the taxable income of the 0.1 percent highest-income individuals and married couples.[17]

The $5 million threshold roughly corresponds to the wealthiest 0.1 percent of taxpayers and also mirrors the $5 million threshold that establishes a "qualified purchaser" under the Investment Company Act of 1940.[18] Under the proposal, the threshold would be presumed to be satisfied for any taxpayer in any tax year if the taxpayer claims (or is the beneficiary of a trust or the 10-percent-or-greater equity holder of any vehicle that represents) that it is a qualified purchaser for purposes of the Investment Company Act of 1940 in connection with the purchase of a security and the security is not directly used in, and reasonably necessary for, an active trade or business.

Also, for purposes of determining whether an individual satisfies the $5 million gross asset test, assets in qualified retirement plans (for example, 401(k)s, HR10s, and IRAs) and assets generated by up to $1 million of premiums paid for insurance policies or annuities would be excluded from the asset test. However, if an individual had paid more than $1 million in insurance or annuity premiums, a proportionate amount of the assets corresponding to the excess would be included for purposes of the asset threshold.[19]

For purposes of determining whether a taxpayer satisfies the gross asset test, a taxpayer would be treated as owning her distributive share of the publicly traded assets held through a subchapter S corporation or any nonpublicly traded partnership, trust, regulated investment company, real estate investment trust, and any non-mark-to-market domestic C corporation that satisfies the asset or income test for a passive foreign investment company or is organized (or marketed) with a principal purpose to avoid mark-to-market treatment. Those vehicles would be required to provide each mark-to-market partner, shareholder, and beneficiary with her share of the gross value of her publicly traded property. (Those vehicles are referred to as reporting vehicles.)

d. Realization taxpayers. All taxpayers that are not mandatory mark-to-market taxpayers would remain realization taxpayers. Realization taxpayers would be permitted to irrevocably elect mark-to-market treatment for any of their publicly traded property.

e. Administration and valuation. Under the proposal, a financial institution would be designated as the "position mark provider" for each mark-to-market position and would provide valuations to mark-to-market taxpayers. Also, each mark-to-market taxpayer could designate one or more "taxpayer mark providers" to value their mark-to-market positions under alternative valuation conventions, or on a hedged or portfolio basis.

Dealers in securities, traders in securities electing under section 475(f), mutual funds, qualified institutional buyers,[20] and other large taxpayers that receive approval from the IRS would be permitted to value their own positions. However, those taxpayers could be subject to penalties for improper valuation.

Position valuations would be based on fair market value, with specific adjustments. For example, the values of "long" positions would not be permitted to take into account blockage, minority, marketability (or illiquidity), fragmentation, or investment company discounts.[21]

The IRS would establish broad principles by revenue procedure or other guidance to value derivatives, and methods could be subject to specific approval by the IRS

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[16]*See* NASDAQ Rule 4450(b) ($50 million market value of listed securities or $50 million of total assets and total revenue for continued listing; $75 million for initial listing); Amex Standard 3 ($50 million total market capitalization and other requirements) and Standard 4 ($75 million total market capitalization and other requirements).

[17]In 2001 the threshold was approximately $1.5 million (approximately 107,000 taxpayers, out of 104.16 million total returns filed), *available at* http://www.irs.gov/pub/irs-soi/01in35mt.xls.

[18]*See* Kopczuk and Saez, "Top Wealth Shares," 47 *National Tax Journal* 445-487 (June 2004) (9 percent of wealth concentrated in the wealthiest 0.1 percent of taxpayers).

[19]For example, assume that an individual had paid $3 million in life insurance premiums and the cash value of the insurance policy was $6 million. In that case, $4 million (($3 million premiums - $1 million exclusion amount)/$3 million premiums) x $6 million value) would be included in determining whether the individual passed the $5 million asset threshold.

(Footnote continued in next column.)

[20]In general, a qualified institutional buyer includes an institution that manages at least $100 million in securities and a registered broker-dealer owning and investing, on a discretionary basis, $10 million in securities of nonaffiliates. *See* 17 C.F.R. section 230.144A(a)(1).

[21]*See* H.R. Conf. Rep. 103-213 at 616 (legislative history to section 475, providing that valuation is generally determined on an individual security basis without taking any blockage discounts into account); Staff of the Joint Committee on Taxation, "Options to Improve Tax Compliance and Reform Tax Expenditures," JCS-02-05 396-399 (Jan. 27, 2005) (proposing to disregard minority, marketability, fragmentation, and investment company discounts for purposes of estate tax valuations). *Cf.* reg. section 1.83-2(a) (disregarding lapse restrictions in valuing property).

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(analogous to advance pricing agreements).[22] For example, it would be anticipated that the method used for GAAP reports could also be used for taxpayers that are not GAAP reporters.[23]

As long as a taxpayer relies in good faith on a mark provider's valuation, the taxpayer would not be subject to penalties for reporting an inaccurate value; instead, the taxpayer would be subject only to additional tax based on the correct value and a market rate of interest on any deferral. However, a taxpayer could not rely in good faith on the valuations provided by a mark provider that represents or implies that its valuation method results in lower tax liability than a competitor. Taxpayers that value their own positions could be subject to penalties for improper valuation.

A mark provider (or a taxpayer valuing its own positions) that complies in good faith with the published guidance or an approved method would not be subject to penalties, even if a valuation is inaccurate. However, a mark provider would be presumed to be acting in bad faith if it attempted to gain a competitive advantage by claiming or implying that its valuation method results in a lower tax liability than a competitor's.

Mark providers (and taxpayers valuing their own positions) would be required to disclose to the IRS any differences between the methods used to determine valuations for mark-to-market purposes and the valuations used for the mark provider's (or taxpayer's) own internal purposes (for example, compensation), for purposes of the mark provider's financial reports under GAAP, or other mark providers' valuations of the same or substantially similar positions. The disclosure of the differences would permit the IRS to choose between competing valuation methods, but those differences would not imply bad faith.

f. Penalty for failure to mark. Any mark-to-market taxpayer that does not report a mark-to-market position on a mark-to-market basis would be required to report any gain as ordinary income and would be subject to a deemed interest charge based on the amount of interest (at the underpayment rate) that would have resulted if the gain had accrued at a constant rate equal to the applicable federal rate over the taxpayer's holding period.[24]

g. Illiquidity loans. Under the proposal, the government would make or guarantee loans to permit taxpayers to pay their taxes on illiquid or restricted mark-to-market property. The loans would be administered by mark providers for a standard fee. The loans would bear market rates of interest (or market rate plus a spread); in all events, that rate of interest would be less than the penalty rate for deferral. The loans would be secured by the publicly traded property.

h. Taxpayers that flip in and flip out. A taxpayer that becomes subject to mark-to-market taxation in a particular year would be subject to mark-to-market treatment for that entire tax year. The taxpayer would have until the date its tax return is due to designate mark providers for the taxpayer's mark-to-market property and liabilities; the mark provider would be required to designate the taxpayer's mark-to-market property as of the first day and the last day of the tax year.

A taxpayer that was a mark-to-market taxpayer in a previous year but is no longer subject to mark-to-market treatment would return to realization taxation at the beginning of the tax year with an adjusted basis in its assets that reflects prior mark-to-market taxation.[25]

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[22]The proper valuation of derivatives has received increasing attention from a variety of regulatory bodies, each of which are developing principles of valuation. *See, e.g.*, Floyd Norris, "U.S. Rejects Cisco Plan on Options," *The New York Times*, Sept. 10, 2005, at C1 (quoting Christopher Cox, chair of the Securities and Exchange Commission: "Over time, as issuers and accountants gain more experience in valuing employee stock options for financial accounting purposes, particular approaches may begin to emerge as best practices, and the range of potential methodologies will likely narrow"); SEC, "Implications of the Growth of Hedge Funds" (Sept. 2003) (recommending that the SEC consider mandating the specific procedures that a hedge fund must follow in valuing its assets); International Organization of Securities Commissions, Technical Committee, *Regulatory Approaches to the Valuation and Pricing of Collective Investment Schemes* (May 1999) (listing various pricing methods in different jurisdictions).

[23]*See* Announcement 2003-35, 2003-21 IRB 956, *Doc 2003-12903, 2003 TNT 101-8*.

[24]*Cf.* section 1260(b) (imposing interest charge on deferral of gain recognition for a constructive ownership transaction under that method).

[25]*Cf.* prop. reg. section 1.475(a)-2.

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New Tax Issues Arising From Derivatives Regulatory Reform

By Erika W. Nijenhuis

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This report examines an array of new tax questions that have arisen, or are about to arise, as a result of changes in market practice and the legal rules governing over-the-counter derivative financial instruments (swaps). The changes to the regulatory laws governing swaps are still a work in progress, but will almost certainly require both the clearing of many swaps through regulated central clearinghouses and the trading of those swaps on regulated markets such as an exchange.

The first tax question addressed by this report is whether clearing and trading of swaps causes or should cause them to become section 1256 contracts required to be marked to market annually. Section 1256 treatment for swaps would clearly be disadvantageous for many taxpayers. It could also be quite advantageous for others, as a result of the favorable tax rules for long-term capital gains. This report concludes that swaps should not as a policy matter be treated as section 1256 contracts, whether or not they are cleared or exchange-traded, unless and until Congress affirmatively provides for section 1256 treatment.

The report then turns to how an initial payment on a swap — a fact pattern that is common for cleared swaps and other swaps that have "standardized" coupons — should be taxed, and in particular whether under current law such a payment can or should give rise to a debt obligation between the parties. This part of the report identifies several questions that would have to be answered before a taxpayer could ascertain with confidence whether indebtedness arises, and if so what its terms might be.

Because current law is unclear regarding both of these issues, that clarification is needed from official sources, whether through regulatory guidance or legislation, so that financial reform legislation does not open the door to tax whipsaws and arbitrage. The report suggests several ways that either legislative amendments or regulatory guidance could address these issues.

The manner in which the over-the-counter and credit default swaps (CD) markets operate is complex and evolving. Every effort has been made to describe them correctly by consulting with experts, but it is possible that some aspect of market practice or the legal rules governing those instruments described herein is inaccurate since the author is not a banker or an expert in the nontax rules governing those markets and instruments. Any errors are the author's.

The author advised one of the U.S. CDS clearinghouses on tax issues in connection with clearing CDSs and represents the Securities Industry and Financial Markets Association and members thereof regarding some of the tax issues discussed in this report.

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The regulatory framework for derivative financial instruments is on the brink of more dramatic change than has been seen for decades. The over-the-counter (OTC) market in which trillions of dollars of swaps and other exotic and not-so-exotic financial instruments have been negotiated and traded will soon be a shadow of its former self if the pending financial reform legislation becomes law. Oddly, the bellwether of this historic change has not been one of the financial instruments that dominates this market, like interest rate swaps or foreign currency instruments. Instead it has been a once obscure financial instrument, the credit default swap (CDS). Accordingly, while this report discusses issues relevant to many financial instruments, it focuses on CDSs.

CDSs continue to attract much attention in the popular press, on Wall Street, in Washington, and in European capitals, as one of the much-vilified financial products of the moment. The significance given to the role of CDSs in triggering the near-collapse of the U.S. financial system and other near-catastrophes — most recently, their alleged role in deepening the Greek financial crisis — have led to a modern sort of land-grab under which multiple regulators have vied to stake their claim as the primary regulator of CDSs. One government agency, however, has taken the opposite tack, shying away from any attempt to shape the realm in which CDSs will exist in the new regulatory environment, despite pleas for guidance from those it regulates. That agency is the IRS.

The sole official statement that the IRS has made on CDSs is an acknowledgment in Notice 2004-52[1] that the characterization of CDSs for U.S. federal income tax purposes is uncertain, and a request for comments on that issue. Notice 2004-52 describes four possible characterizations of CDSs: as notional principal contracts (NPCs) or options, or in some cases as insurance or guarantees. There are many thoughtful and insightful comments and articles on the characterization question, both predating and following the notice.[2] It is fair to say that the ball has been in the IRS's court for some time.

[1]2004-2 C.B. 168, *Doc 2004-14751, 2004 TNT 139-8.*

[2]Articles discussing the tax considerations relevant to CDSs include John N. Bush and Ahron H. Haspel, "Deciphering the Taxation of Credit Derivatives," *J. Tax'n Inv.* 33 (Autumn 1996); Bruce Kayle, "Will the Real Lender Please Stand Up: The

(Footnote continued in next column.)

Federal Income Tax Treatment of Credit Derivative Transactions," 50 *Tax Law.* 568 (1997); David Z. Nirenberg and Steven L. Kopp, "Credit Derivatives: Tax Treatment of Total Return Swaps, Default Swaps, and Credit-Linked Notes," 87 *J. Tax'n* 82 (Aug. 1997); S. Conlon, "U.S. Tax Issues Relating to Credit Derivatives," *Derivatives* 203 (May/June 1998); David S. Miller, "An Overview of the Taxation of Credit Derivatives," 13 *Tax Strategies for Corporate Acquisitions*, ch. 229 (1999); Viva Hammer and Frank Kuriakuz Jr., "The Tax Treatment of Credit Default Swap Proceeds," *Derivatives & Financial Instruments* 210 (July/Aug. 1999); David S. Miller, "Credit Derivatives: Financial Instrument or Insurance? And Why It Matters," *J. Tax'n Fin'l Prods.* 31 (Winter 2002); David S. Miller, "Distinguishing Risk: The Disparate Treatment of Insurance and Financial Contracts in a Converging Marketplace," 55 *Tax Law.* 481 (Winter 2002); Edward D. Kleinbard, "Competitive Convergence in the Financial Services Market," *Taxes* 225 (Mar. 2003); Erika W. Nijenhuis, "Notice 2004-52 — One Small Step Forward on Credit Default Swaps," *Tax Notes*, Sept. 13, 2004, p. 1287, *Doc 2004-17503*, or *2004 TNT 178-29*; Bruce Kayle, "The Federal Income Tax Treatment of Credit Derivative Transactions," 21 *Tax Strategies for Corporate Acquisitions*, ch. 429 (2004), reprinted in updated form in 22 *Tax Strategies for Corporate Acquisitions*, ch. 332 (2009); Alexander F. Peter, "Characterization of Credit Default Swaps for Tax Purposes," *Derivatives & Financial Instruments* 3 (Jan./Feb. 2006); Nicholas Bogos, "A Risk-Based Analysis of Credit Derivatives Under SSRP Standard" (Part 1), *Tax Notes*, Aug. 14, 2006, p. 587, *Doc 2006-13303*, or *2006 TNT 157-92*; (Part 2), *Tax Notes*, Aug. 21, 2006, p. 655, *Doc 2006-13328*, or *2006 TNT 162-21*; (Part 3), *Tax Notes*, Aug. 28, 2006, p. 759, *Doc 2006-13335*, or *2006 TNT 167-106*; Kevin Liss, "Are Credit Default Swaps Really Swaps or Options for Tax Purposes? An Economics-Based Approach," 7 *J. Tax'n Fin'l Prods.* 23 (2008); Ari Joshua Brandes, "Toward a New Framework and a Better Understanding of Credit Default Swaps," *Derivatives & Financial Instruments* 75 (May/June 2008); Ari Joshua Brandes, "A Better Way to Understand the Speculative Use of Credit Default Swaps," 14 *Stan. J.L. Bus. & Fin.* 263 (2008-2009); Andrea S. Kramer, Alton B. Harris, and Robert A. Ansehl, "The New York State Insurance Department and Credit Default Swaps: Good Intentions, Bad Idea," 22 *J. Tax'n & Reg'n Fin'l Instn's* 22 (Jan./Feb. 2009); David S. Miller and Shlomo Boehm, "New Developments in the Federal Income Tax Treatment of CDSs," 7 *J. Tax'n Fin'l Prods.* 9 (2009); Lawrence Lokken, "Taxation of Credit Derivatives," Tax Policy Center (Nov. 19, 2009); Alan B. Munro, "Revisiting Tax Considerations Regarding Credit Default Swaps," *Derivatives & Financial Instruments* 9 (Jan./Feb. 2010).

For comments submitted in response to Notice 2004-52 and other subsequent requests for guidance, see letter from David Garlock, Howard Leventhal, and Alan Munro to IRS Commissioner Mark W. Everson (Jan. 7, 2005), *Doc 2005-1525* or *2005 TNT 16-21*; letter from Managed Funds Association to Everson (Apr. 26, 2005), *Doc 2005-9428* or *2005 TNT 87-20*; New York State Bar Association Tax Section, Report on Credit Default Swaps (Sept. 9, 2005), *Doc 2005-18713* or *2005 TNT 176-21*; letter from New York State Society of Certified Public Accountants (Nov. 7, 2005), *Doc 2005-22692* or *2005 TNT 215-12*; letter from Securities Industry and Financial Markets Association (SIFMA) to Steven A. Musher, associate chief counsel (international) (May 26, 2009), *Doc 2009-12516* or *2009 TNT 105-22*.

For a number of requests for guidance (or, in one case, no guidance) on CDSs before Notice 2004-52, see letter from Capitol Tax Partners to the IRS (May 1, 2002), *Doc 2002-11750* or *2002 TNT 96-20*; letter from Capitol Tax Partners to Rob Hanson, tax legislative counsel, and Barbara Angus, international tax counsel (July 2, 2002), *Doc 2002-17703* or *2002 TNT 148-34*; letter

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Whether because the IRS and Treasury's Office of Tax Policy (Treasury) were distracted by the need to issue guidance relating to the credit crisis, or whether they have other reasons for preserving their silence, no guidance of any kind has been forthcoming.[5]

This report does not directly address the characterization question. Instead it examines new questions that have arisen, or are about to arise, as a result of changes in market practice and the legal rules governing CDSs and other OTC derivative financial instruments (which, for convenience, will generally be referred to in this report as swaps). The principal changes in market practice are that the terms of conventional CDS contracts and, of particular importance for this report, the coupon payments on those CDSs have been standardized, and that some CDS contracts are now cleared on regulated clearinghouses, as a result of a Federal Reserve Bank of New York (New York Fed) initiative. The changes to the regulatory laws governing CDSs and other swaps are still being made, but they will almost certainly require clearing, and it appears that they will also typically require cleared CDSs to be traded on exchanges regulated by the Commodity Futures Trading Commission (CFTC) or the SEC, or on other regulated markets. At the same time, however, CDSs that are virtually identical to cleared/traded CDSs exist, and at least to some degree will continue to exist, in the OTC market. Other types of swaps are taking or are likely to take similar paths, from standardization to clearing to regulated trading.[4]

The first tax question addressed here is whether the clearing of swaps on regulated clearinghouses or the trading of swaps on regulated exchanges causes or should cause those swaps to become section 1256 contracts, which must be marked to market annually.[5] Gain or loss from a section 1256 contract generally is treated by statute as 60 percent long-term capital gain or loss and 40 percent short-term capital gain or loss (the 60/40 rule).

The section 1256 issue arises because the definition of regulated futures contract (RFC) by its terms applies to "a contract" that (1) is subject to daily variation margin rules of a kind that can be expected generally to apply to cleared swaps, and (2) is "traded on or subject to the rules of" a qualified board or exchange (QBE) (generally meaning a CFTC-designated contract market or an SEC-regulated national securities exchange). The definition of nonequity option, which would cover many types of options now traded in the OTC markets if they were exchange-traded, and may also be relevant to CDSs, is similarly broad. If applied literally, these broad definitions could sweep many or most cleared and QBE-traded swaps into section 1256. Moreover, as discussed in more detail below, while there are several elections out of section 1256 treatment, they generally are available only for hedges of ordinary property or liabilities. Accordingly, it appears that it could be relatively easy to bring a swap within the scope of section 1256, if desired, but hard to take it out.

As discussed in more detail in Part III.A.1 below, section 1256 treatment for swaps would be disadvantageous for many taxpayers. It could also be quite advantageous for others as a result of the legislatively mandated 60/40 rule and because the section 1256(f)(4) limitations on taxpayers' ability to share the benefit of statutorily mandated long-term capital gains with others apply only to specific classes of historic section 1256 contracts.[6]

This report concludes that swaps should not as a policy matter be treated as section 1256 contracts, whether or not they are cleared or QBE-traded, unless or

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from Gregory May and Robert Scarborough to Angus and Helen Hubbard, acting tax legislative counsel (Oct. 1, 2002), *Doc 2002-26091, 2002 TNT 226-21*, reprinted in 2 *J. Tax'n Global Transactions* 72 (2002-2003); letter from International Swaps and Derivatives Association (ISDA) to the IRS (Oct. 24, 2002), *Doc 2002-26050* or *2002 TNT 232-21*; letter from ISDA to Angus (Nov. 21, 2003), *Doc 2003-25649* or *2003 TNT 232-17*; letter from ISDA to the IRS (May 2, 2003), *Doc 2003-14610* or *2003 TNT 118-26*.

[3]It appears that the first likely venue for guidance on the characterization issue may be the reproposal of the long-pending proposed regulations on NPCs with contingent nonperiodic payments, a project aimed at a very different class of financial instruments. Prop. reg. section 1.446-3. These regulations are discussed in Part I.B.2, below. The timing of any such guidance is uncertain.

All citations to sections are to the Internal Revenue Code of 1986, as amended, or to the Treasury regulations promulgated thereunder, other than references to sections of this report.

[4]As has happened with CDSs, regulators are driving this process by encouraging the clearing of interest rate swaps. *See* Scott Patterson, "Fannie, Freddie Touch Off Swaps Scrap," *The Wall Street Journal*, Apr. 6, 2010, at C1 (reporting that the Federal Housing Finance Agency expects Fannie Mae and Freddie Mac to start clearing their interest rate swaps by year-end, regardless of whether Congress adopts financial reform legislation, and that several exchanges are seeking that business).

[5]This issue has been discussed at several recent bar association meetings and is now the subject of discussion in other

(Footnote continued in next column.)

settings as well. *See* Lee A. Sheppard, "Tax Administrator Also Copes With Credit Meltdown," *Tax Notes*, Sept. 22, 2008, p. 1132, *Doc 2008-19876* or *2008 TNT 182-3*; Sheppard, "ABA Discusses Financial Meltdown Issues," *Tax Notes*, Oct. 5, 2009, p. 50, *Doc 2009- 21416*, or *2009 TNT 185-14*; Sheppard, "Derivatives Regulation and Big Bang, Part 2," *Tax Notes*, Oct. 19, 2009, p. 263, *Doc 2009-22708*, or *2009 TNT 199-1* (reporting on Financial Transactions Committee panel at the September 2009 American Bar Association Section of Taxation meeting); Sheppard, "Financial Meltdown Miasma," *Tax Notes*, Feb. 1, 2010, p. 581, *Doc 2010-2111*, *2010 TNT 20-3* (reporting on a Financial Transactions Committee panel at the January 2010 ABA tax section meeting); *see also* Sheppard, "An Analysis of Blanche Lincoln's Derivatives Proposal," *Tax Notes*, May 10, 2010, p. 611, *Doc 2010-10022*, or *2010 TNT 89-3*.

[6]The Congressional Budget Office and the Joint Committee on Taxation have recently drawn attention to the potential cost to the fisc of not providing clear rules mandating the continuation of current law treating swaps as nonsection 1256 contracts. Letter from the CBO to Sen. Christopher J. Dodd, D-Conn. (May 3, 2010), *Doc 2010-9893*, *2010 TNT 86-26* (analyzing effects on direct spending and revenues of the Lincoln-Dodd substitute bill, and projecting an estimated revenue loss of more than $1 billion from the possible section 1256 treatment of derivative financial instruments required to be cleared and traded as provided in the bill, noting "considerable uncertainty" about the size of the expected revenue losses).

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until Congress affirmatively provides for section 1256 treatment. The report lays out a substantial, although far from definitive, body of law and history that supports the conclusion that clearing or QBE-trading does not cause swaps to become section 1256 contracts under current law.

The report then turns to how a large initial payment on a swap — a fact pattern common for CDSs and other swaps that have standardized coupons, whether or not they are cleared through a regulated clearinghouse — should be taxed, and in particular whether under current law that payment can give rise to a debt obligation between the parties. This issue is relevant because a deemed loan would give rise to deemed interest income on the debt instrument, which interest would be subject to reporting, withholding, and other U.S. federal income tax rules applicable to debt instruments. The existence of a deemed loan might also raise questions under section 956 for some taxpayers.[7]

The treatment of significant upfront payments on interest rate swaps and most other swaps as deemed loans for U.S. federal income tax purposes is a rule that has applied for some time but does not in practice affect most actual OTC contracts. Thus, for most swaps, taxpayers' concerns have to do with the substantial expansion of an existing regime. These concerns are partly legal — primarily that current law does not provide clear rules for when a deemed loan arises — and partly practical, because compliance in a world in which significant upfront payments may be the rule rather than the exception would require taxpayers to develop automated systems to distinguish between NPCs vs. options and other types of derivatives not subject to the deemed loan rules, as well as to modify reporting and withholding rules. Further, the application of section 956, which can have career-ending consequences, could be greatly expanded in a context in which there is no policy reason for section 956 to apply because any upfront payment made under a cleared swap is immediately offset as a cash flow matter by an equivalent amount of cash collateral. It seems fair to expect the government to clarify the rules as to when a deemed loan arises before taxpayers build the necessary systems to track them. And it seems reasonable to hope that the government would clarify that it would not choose to apply section 956 in the offsetting payment case described above.

For CDSs, there are very significant uncertainties as to whether these rules apply at all, and if so how they apply. The question whether a deemed loan or deemed interest arises under current law as a result of a large initial premium on a standard coupon CDS cannot be answered without first answering whether a CDS is properly characterized as an option or NPC. As that issue has been exhaustively discussed elsewhere, this report focuses instead on whether, assuming a CDS is properly treated as an NPC, current law could deem one party to lend money to the other in a transaction treated for U.S. federal income tax purposes as giving rise to indebtedness. This part of the report identifies several questions that would have to be answered before a taxpayer could ascertain with confidence whether indebtedness arises and, if so, what its terms might be. The report also discusses the special payment and collateral arrangements involved in clearing swaps, and argues in that context that section 956 should not apply to upfront payments made on cleared swaps generally.

Because current law is unclear regarding both of the issues discussed herein, clarification is needed from official sources, whether through regulatory guidance or legislation, so that financial reform legislation does not open the door to tax whipsaws and arbitrage. Congress could of course address the section 1256 problems through a general reconsideration of whether to narrow, maintain, or expand the scope of section 1256 — an issue that this report does not venture to address. Assuming, however, that the need right now is to preserve the *status quo ante*, if only to give Congress time to consider the issues more fully, some suggestions follow.

Regarding the section 1256 question, regulatory guidance could take the form of a notice stating that regulations will be issued to the effect that NPCs and other nonoption contracts (and CDSs) will not be treated (or will be treated, if the arguments made herein are rejected) as RFCs. In the case of CDSs and ideally options generally, guidance should also be provided stating that they do not constitute nonequity options under section 1256. The basis for that guidance is discussed in more detail in Part III below.

Alternatively, pending a true overhaul of section 1256, legislative amendments could (1) revise section 475 so that the current rule to the general effect that a contract that can be both a section 1256 contract and a section 475 "security" is subject to section 1256 and not section 475 is made elective,[8] (2) revise section 1256 expressly to exclude NPCs and CDSs,[9] (3) revise section 1256(e) to permit taxpayers to elect out of section 1256 treatment for hedges of a capital asset other than a traditional section

[7]These issues are briefly discussed in a submission made by SIFMA in a letter to Treasury and the IRS requesting guidance on these issues, in particular the potential application of section 956 to deemed loans arising from large initial premium payments on CDSs. *See* SIFMA letter, *supra* note 2. One of my partners and I represented SIFMA in preparing that letter.

[8]An amendment of this kind would address the character whipsaw issues faced by section 475 dealers in securities and traders that elect section 475 treatment, assuming that the amendment had the effect of overriding the character rule of section 1256, but it would not alleviate the timing problems to which section 1256 treatment would give rise for other taxpayers.

[9]An amendment of this kind would mean that CDSs and other swaps would not have to be treated as section 1256 contracts, but it would not cover all derivative financial instruments now traded in the OTC market that may be required under new legislation to be cleared or traded, such as options. Since some interest rate swaps now trade as futures contracts, as discussed in Part III.B.1 below, a policy decision would have to be made whether those contracts should be treated like other futures contracts or like other interest rate swaps.

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1256 contract,[10] or some combination of the above. Legislation or regulatory guidance also should address so-called alternative swap execution facilities, so that there is no tax (dis)advantage to trading on such a facility compared with a CFTC-designated contract market or an SEC-regulated national securities exchange.[11] Consideration could also be given to modifying the rules of section 1256 that limit the ability to pass long-term capital gain treatment through to limited partners of dealers organized as partnerships (section 1256(f)(4)), because those rules now apply only to dealer equity options and dealer securities futures contracts.

Regarding the deemed loan question, regulatory guidance could be provided in the form of a notice stating that absent abuse, nonperiodic payments on swaps, including CDSs, will not be treated as investments in U.S. property for section 956 purposes to the extent that they are immediately as a contractual or legal matter offset by an equivalent amount of cash. Guidance could also take the form of a revenue procedure stating that absent abuse, the IRS will not assert that taxpayers are obligated to treat upfront payments on CDSs as deemed loans until guidance is issued to that effect or on other swaps until the meaning of the term "significant" is clarified. Legislative amendments could address the section 956 issue by adding a reference to cash collateral in section 956(c)(2)(J) and by stating an expectation in that legislative history that the IRS will act as described in the second half of the preceding sentence.

Part I of the report provides a brief overview of what a CDS is, how parties transact in swaps in the OTC market, the tax treatment of NPCs and options, and the basics of section 1256 treatment. Part I is intended as background for readers not already familiar with CDSs, NPCs, or section 1256. Part II of the report describes broadly the proposals pending in Congress to require clearing and/or exchange trading of swaps, and the manner in which CDSs are being cleared on ICE Trust U.S. and the Chicago Mercantile Exchange (CME), the two U.S. clearinghouses for CDSs. Part II also discusses how the initial premium on a standard coupon CDS is priced. Part III then considers the section 1256 question, and Part IV discusses the issues arising from large initial payments on standardized swaps, whether or not they are cleared or traded.

I. Background to Current Tax Issues

A. Description of Terms of CDSs and Other Swaps

Probably the most common type of swap is an interest rate swap. Under the terms of a standard interest rate swap, one party agrees to pay amounts determined by reference to a fixed rate — for example, 6 percent — and the other party agrees to pay amounts on the same payment dates determined by reference to a floating rate, usually the London Interbank Offered Rate (LIBOR). Both payments are determined by multiplying the applicable rate by the same notional principal amount, a hypothetical amount used to determine the parties' payment obligations but that is not paid or otherwise transferred between the parties. Interest rate swaps are widely used to hedge interest rate risks, for example by an issuer that issues debt or a company with assets or nondebt liabilities that are interest-rate sensitive. An interest rate swap entered into with at-market terms will not have an upfront payment. An interest rate swap entered into with off-market terms — for example, with a 5 percent rate when the market is 6 percent — generally will have an upfront payment compensating the party receiving the below-market payment (or paying an above-market payment).

A conventional foreign currency swap is similar to an interest rate swap, except that one party's obligations are denominated in one currency and the other party's obligations are denominated in a second currency. Usually both parties make payments at fixed rates, multiplied by a notional principal amount denominated in that party's payment currency. Foreign currency swaps are a common hedging instrument and also generally are not entered into with upfront payments unless the terms of the swap are off-market.

Interest rate and foreign currency risks also can be hedged through options, forward contracts, and other, more tailored financial instruments. Other asset classes, such as commodities, equities, and more exotic risks such as volatility, similarly trade in the form of swaps, options, and other derivative financial instruments.

A conventional single-name CDS is a financial contract to transfer credit risk with respect to debt instruments, such as bonds or loans, of a single named issuer (the reference entity), typically for a five-year term. Like other swaps, CDSs in the OTC market are generally documented using the standardized documentation for derivatives transactions developed by the International

[10]An amendment of this kind would have to be evaluated to ensure that it does not open the door to some of the problems section 1256 was enacted to prevent. One possible approach might be to limit the election to hedges of assets that constitute actively traded personal property under section 1092, so that the straddle rules would operate to prevent acceleration of losses and conversion of character.

It may also be useful to clarify that hedging credit risk comes within the ambit of a hedging transaction under section 1221 or any capital asset hedge, since for an asset hedge the term "hedging transaction" is generally defined under section 1221(b)(2)(A)(i) as a transaction that manages "risk of price changes." While that term is fairly broad, it was not written with the intent of capturing default risk.

As described in Part II.B below, the pending bills would limit the use of CDSs by end-users to hedging transactions. Consequently, it would also be helpful if any such legislation or its legislative history provided that a requirement of that kind does not transform the CDS into insurance for U.S. federal income tax purposes.

[11]There are now various types of trading markets that did not exist when section 1256 was enacted and that are not QBEs (SEC-regulated national securities exchanges or CFTC-designated contract markets) but that may still be subject to some form of regulation by securities or commodities regulators. There are likely to be more categories of those markets under the pending legislation, including swap execution facilities. It appears that a swap execution facility would not be a section 1256 QBE. If that is right, it could lead to swaps traded on a regulated securities exchange or designated contract markets being treated differently for tax purposes than swaps traded through a swap execution facility.

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Swaps and Derivatives Association (ISDA).[12] CDSs are commonly used to hedge the risk of owning bonds or loans of a particular issuer or other credit risk to that reference entity. CDSs also are widely used to take on credit risk, whether of a particular issuer or a segment of the fixed income market. Therefore, like all the other financial instruments described above, they can be used to either reduce risk or create it.

The parties to a CDS contract are referred to as the protection buyer and the protection seller. The contract frequently refers to a specific senior debt instrument (the reference obligation) of the reference entity.[13] The protection buyer makes one or more payments to the protection seller based on a specified notional principal amount. Ordinarily the payments take the form of a stream of periodic payments in a fixed amount, generally referred to as fixed, premium, or coupon payments.

The protection seller in turn agrees that in a default on the reference obligation, or during other specified credit events indicating a decline in the creditworthiness of the reference entity, it will buy from the protection buyer an obligation of the reference entity for its face value (physical settlement by delivery of a deliverable obligation) or will make a cash payment to the protection buyer in an amount that represents the decline from par in the fair market value of that obligation as a result of the credit event (cash settlement by reference to the value of a valuation obligation).[14] The protection buyer is not required to have suffered a loss on, or to have owned, any obligation of the reference entity at any time to receive payment. For a cash settlement, a valuation obligation's FMV is determined through bids from dealers in that obligation under standard procedures. While market practice has evolved over time, cash settlement for CDSs is now the norm.

Before the standardization process described below, there were several common variations in the terms of conventional CDSs, depending on many factors, including the nature of the reference entity and the local CDS market. Those variations included the list of credit events (some CDSs included a restructuring credit event, which in turn had multiple definitions used in different contexts), whether they provided for physical or cash settlement, and various mechanics and critical dates such as the termination date of the CDS. One of the most important variations in terms related to the coupon on a single-name CDS. Generally, the coupon on a single-name CDS was determined when the parties entered into the contract, in much the same way the coupon on a newly issued bond would be determined. (This process is described in more detail in Part II.C below.) Consequently, the coupon on a CDS on a particular reference entity entered into on any given day could and generally did differ from the coupon on an otherwise identical CDS entered into on a different day. Similarly, while the most common tenor for a CDS was five years, the clock started running when the parties entered into the CDS, so there were no standardized maturity dates.[15]

Like other swaps, CDSs historically were entered into on the OTC market. That is, a swap dealer and another party, which might be an end-user or another dealer, negotiated the terms of the CDS on a private bilateral basis. Ordinarily the parties would have in place an ISDA master agreement setting out standard legal provisions, and a schedule to that agreement setting out representations and warranties and making elections. The parties would enter into the CDS under a confirmation setting forth just the economic terms of the transaction. Because each dealer had different standard documents and every counterparty could negotiate the terms of those documents, and, as described above, the coupons and maturities of CDSs varied, historic CDSs were not identical to or fungible with each other, although their core terms were set forth in standard ISDA definitions.

Like other swaps, a CDS remained for its life a private bilateral contract. The principal information publicly available about outstanding CDSs was derived from the published financial statements of swap dealers and from reports by industry organizations, regulators, and credit rating agencies. This public information therefore reflected aggregated information at a high level. Bank regulators and other regulators of major CDS participants had access to more information as part of their regulatory oversight, but no one regulator or government agency had a complete picture of the market. Moreover, some major participants were essentially unregulated or very lightly regulated, most notably AIG Financial Products (AIG FP), an affiliate of a major insurance company.

One other important characteristic of the historic CDS market was that while customers generally were required to provide collateral to secure a dealer's credit exposure to the customer, some highly rated participants in the market, such as insurance companies, were not required to provide collateral to their counterparties unless their credit rating dropped below a specified level. AIG FP, for example, apparently fell into the latter category; as a result, when doubts arose about its ability to pay and a credit downgrade appeared imminent, those doubts were reinforced by the realization that AIG FP would be required to post to its counterparties' billions of dollars of collateral that it did not have.

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[12]The ISDA website is a font of information about swaps in general. It includes standardized documentation for many different kinds of swaps, including not only the core transactional documentation (the ISDA Master Agreement and a form of schedule to the agreement), but also standardized definitions, credit support documents, and related information. *See* http://www.isda.com.

[13]An electronic data vendor active in the CDS market offers a standardized list of reference obligations for more than 2,000 reference entities. *See* Markit RED, *available at* http://www.markit.com. Markit also provides a wide range of market information about CDSs and many other kinds of derivatives.

[14]More technically, the determination of whether a credit event has taken place is made by reference to any "obligation" of the reference entity, which term includes the reference obligation.

[15]The coupons and maturities of CDSs on indices of reference entity obligations, *e.g.*, bonds or loans, were more standardized. CDSs of this kind are briefly described in note 33, *infra*.

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Unfortunately, AIG FP was also a major participant in the market, so the potentially disruptive consequences of its demise led to the universal conclusion, at least by governments, that CDSs must be brought into a comprehensive regulatory scheme. (It is ironic, at least to some observers, that the CDS trades entered into by AIG FP were highly customized CDSs on asset-backed securities, of enormous size and a kind that would not currently be clearable, and, it appears, would not have to be cleared or traded under the pending legislation.) There has, however, been a lengthy gestation period during which multiple regulators and other players have made proposals for how that regulatory scheme should operate. Pending the enactment of legislation, a New York Fed initiative has led to significant changes in the CDS market, notably (1) a reduction in the outstanding amount of CDSs through an industrywide process of netting CDSs entered into by multiple dealers against each other,[16] (2) the standardization of terms for conventional CDSs, and (3) the initiation of clearing of CDSs. These initiatives were an outgrowth or a continuation of earlier New York Fed efforts to improve the workings of the CDS market.

The industrywide netting process began in the fall of 2008. It was referred to as portfolio compression and evidenced the difficulties of trying to net CDS transactions against each other when they had different terms.

The standardization of terms took place in several steps under a process led by ISDA starting in the spring of 2009. For parties who have adhered to the relevant protocols, CDSs entered into since that time have standard terms, including standard coupons (100 basis points or 500 basis points for CDSs on North American corporate reference entities), maturities, settlement mechanisms, definitions, and many other mechanically and economically significant terms. Standardization is discussed in more detail in Part II.A.1 below.

Finally, the third of these steps was the initiation of clearing of standardized CDSs in the fall of 2009. The clearing process is described in more detail in Part II.A.2 below. Pending legislation on CDSs and other swaps is discussed in Part II.B below.

B. Overview of Taxation of Options and NPCs

An interest rate or foreign currency swap of the kind described above is an NPC. Although technically a different set of timing and character rules apply to interest rate swaps than to foreign currency swaps, those differences are not significant for purposes of this discussion.

The characterization of a CDS for U.S. federal income tax purposes is unclear. Among the leading contenders are option treatment and NPC treatment. Except where otherwise stated, this report assumes that those are the only two relevant alternatives. The characterization of a CDS affects each of the issues discussed in the remaining parts of this report. Accordingly, Part I.B provides an overview of the tax rules applicable to options and NPCs.

1. Taxation of options. An option may be either an option to buy property at a stated strike price (a call option) or an option to sell property at a stated strike price (a put option). The value of the call option in the hands of the purchaser will increase if the value of the underlying property rises above the strike price. The value of a put option in the hands of the purchaser will increase if the value of the underlying property drops below the strike price. The writer of the option is in the opposite economic position. Because the purchaser has the right to profit from the option and the writer may be obligated to lose money on the option, the purchaser pays the writer a premium to compensate the writer for the risk that the latter is taking. For a conventional option, the premium is usually paid in a single lump sum amount, although it may be paid over time.

In general, gain or loss from options is recognized on a wait-and-see (open transaction) basis.[17] The purchaser capitalizes the cost of the option premium, and the option writer does not immediately include it in income. If the option is exercised by delivery of the underlying property in exchange for payment of the strike price (physical settlement), for tax purposes the party that buys the property acquires it for an amount equal to the strike price paid plus or minus the option premium. That amount is also the amount realized for the seller of the property. If the option is exercised through cash settlement, no property is delivered and gain or loss is measured by reference to the difference between the cash settlement amount and the premium paid or received. The option may also expire unexercised, in which case the purchaser will have a loss and the writer will have income equal to the premium.

Gain or loss recognized by the purchaser of an option is considered to have the same character as the property to which the option relates in the hands of the option purchaser (or would have if acquired by the purchaser).[18] Thus, for a purchaser of an option on a bond that is or would be held as an investment, gain or loss will be capital. For an option writer, gain or loss from delivery is typically capital. In the termination of an option other than through delivery of the underlying property, the writer's gain or loss typically is treated as short-term capital gain or loss, regardless of the term of the contract.[19]

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[16]A Fitch report released in 2009 indicates that the outstanding notional principal balance of credit derivatives fell in 2009 for the first time since Fitch began keeping track in 2003. Fitch Ratings, Credit Market Research, "Global Credit Derivatives Survey: Surprises, Challenges and the Future" 5 (Aug. 20, 2009) (hereinafter Fitch report). The report attributes the decline to efforts of market participants and regulators to reduce notional outstandings by compressing trades, as well as the virtual absence of new structured credit deals. The report also notes that the market is now dominated by single-name CDSs and index CDSs, with a decline in CDSs relating to outstanding collateralized debt obligations and other complex products.

[17]*See* reg. section 1.263(a)-4(d)(2)(i)(C)(7); Rev. Rul. 58-234, 1958-1 C.B. 279; Rev. Rul. 78-182, 1978-1 C.B. 265.

[18]Section 1234(a).

[19]Section 1234(b).

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Different rules apply if the taxpayer is a dealer in securities, if the taxpayer is using the option to hedge another position, if the option is a foreign currency option or a section 1256 contract (see below), or if other special rules apply. Options may also have terms that vary from those described above.

2. NPCs. "Notional principal contract" is a tax term of art. The closest term used by nontax lawyers is "swap," but there are swaps that do not qualify as NPCs. To further confuse matters, the NPC timing regulations described below classify NPCs into swaps, caps, and floors. The quintessential NPC is an interest rate swap.

The term "notional principal contract" and variants on that term are defined in several places in the code and regulations.[20] The only comprehensive definition is in reg. section 1.446-3, which provides timing rules for NPCs. It defines an NPC as "a financial instrument that provides for the payment of amounts by one party to another at specified intervals calculated by reference to a specified index upon a notional principal amount in exchange for specified consideration or a promise to pay similar amounts."[21] Because this definition is very broad, the regulation excludes from its scope a section 1256 contract, a futures contract, a forward contract, an option, and debt. Accordingly, if a swap constitutes a section 1256 contract or a CDS constitutes an option, it cannot be an NPC for purposes of these timing rules.

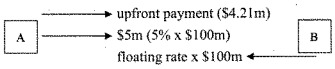
A cap or floor is a series of options — for example, a contract to make a payment on any interest payment date over a specified number of years if market interest rates rise above X percent, equal to (the market rate minus X percent) times a notional principal amount. If a CDS constitutes a series of options, it could be an NPC even though a single option cannot be an NPC.

The regulations classify payments under NPCs into three categories: periodic payments, like coupons; nonperiodic payments, such as an upfront payment; and termination payments, which generally are payments to extinguish or assign all or part of an NPC. Technically, a nonperiodic payment is any payment other than a periodic payment or a termination payment.

Periodic payments are deductible or includable on a current accrual basis.[22] Termination payments are taken into account in the year in which an NPC is extinguished, assigned, or exchanged.[23]

Nonperiodic payments are subject to more complicated rules that are conceptually similar to the original issue discount rules but operate differently. To prevent front-loading or backloading of payments under an NPC, the regulations require that taxpayers recognize a nonperiodic payment "over the term of a notional principal contract in a manner that reflects the economic substance of the contract."[24] The regulations then elaborate by providing that an upfront periodic payment on an NPC must generally be spread over the life of the NPC in accordance with forward rates (or, in the case of a cap or floor, option premiums) or, more frequently, as a series of level payments over the term of the NPC. Thus, if the market rate for an NPC fixed payment is 6 percent, and the NPC provides for payments at a 5 percent rate and an upfront payment from the fixed rate payer to compensate the fixed rate payee for the below-market coupon, under the level payment method the upfront payment would be spread over the life of the NPC in amounts equal to a 1 percent periodic payment, and the principal recovery component of that payment would be treated as a periodic payment on the NPC. A back-end payment is first converted into an initial payment through present valuation, after which the same rule applies.

Under a special rule for NPCs that are swaps (but not for caps and floors), if a nonperiodic payment is "significant," the upfront payment is treated as an amortizing loan providing for level principal and interest payments over the life of the NPC, and the NPC is treated as entered into at market rates.[25] Using the example in the prior paragraph, if the upfront payment was significant, it would be treated as a loan from the payer to the payee that is repaid in installment payments equal to 1 percent periodic payments on the swap, which installment payments are paid at the same time as deemed 6 percent payments on the NPC. In a simplified example,[26] while the actual cash flows would be:



the deemed cash flows would be:

[20]*See, e.g.*, section 1259(d)(2) (defining "offsetting notional principal contract"); reg. section 1.863-7(a)(1). The latter was the first official guidance to use the term "notional principal contract."

[21]Reg. section 1.446-3(c)(1)(i).

[22]Reg. section 1.446-3(e). Different timing rules may apply if the NPC is part of a hedge, straddle, or other multiple-position transaction.

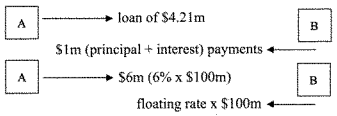
[23]Reg. section 1.446-3(h)(2).

[24]Reg. section 1.446-3(f)(2)(i).

[25]Reg. section 1.446-3(g)(4). The regulation states: "The loan must be accounted for by the parties to the contract independently of the swap. The time value component associated with the loan is . . . recognized as interest for all purposes of the Internal Revenue Code."

[26]The example assumes that the parties enter into a five-year interest rate swap with annual payments when a market rate swap would provide for payments at 6 percent versus a floating rate, multiplied by a $100 million notional principal amount. At market rates, the fixed rate payer, Party A, would pay $6 million annually in exchange for the floating rate payment. Because Party A will pay only $5 million annually, Party A will pay Party B an upfront payment of $4.21 million (= the present value, using a 6 percent discount rate, of $1 million/year). Under the rules described in the text, (a) Party A would be treated as lending $4.21 million to Party B, in exchange for annual payments from Party B of principal and interest totaling $1 million/year; and (b) Party A would be treated as making annual swap payments of $6 million.

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Consequently, the recipient of the upfront payment in this example is treated as paying interest to the payer. Moreover, the commissioner may treat any nonperiodic swap payment, whether or not it is significant, as one or more loans under section 956.

As the example above illustrates, these rules were written with interest rate swaps in mind. In an interest rate swap, the relationship between the upfront payment and the forgone or extra payments on the swap is mathematically straightforward once one knows the appropriate discount rate: The upfront payments are simply the present value of the forgone or extra payments on the swap as compared with an at-market swap. These timing rules for nonperiodic payments were initially adopted to prevent taxpayers from refreshing net operating losses by accelerating income through the receipt of upfront payments.[27] The interest characterization rule is, to the best of my knowledge, intended to prevent related parties from using upfront payments on swaps as a way for a non-U.S. affiliate in a nontreaty country to lend money to a U.S. affiliate without suffering U.S. withholding tax on the imputed interest.

Under these rules, if a CDS were classified as an NPC, an upfront payment on the CDS would be treated as a nonperiodic payment that must be amortized somehow over the life of the CDS. If the CDS were considered a swap (and not a cap or floor) and the upfront payment were a significant nonperiodic payment, then one party to the swap would be treated as lending money, and the other would be treated as paying interest. These rules apply today for interest rate swaps and other swaps, although it has historically been relatively rare for a nonperiodic payment to rise to the level of being "significant." Deemed loan treatment has implications for many provisions of the code, as discussed below in Part IV.

The rules described to this point envision that any nonperiodic payment would be a fixed amount known when entering into the NPC. Total return swaps on assets, such as equity swaps, however, typically provide for a final payment that is contingent on any change in value of the asset over the life of the swap. A further complication in assessing the possible application of the NPC rules to CDSs is that regulations were proposed in 2004 that would provide specific timing rules for swaps with contingent nonperiodic payments.[28] The proposed regulations were not drafted with CDSs in mind, and it is unclear whether CDSs will be included in the scope of the regulations when they are finalized or reissued in proposed form.

The proposed regulations would require a taxpayer that enters into a swap with a contingent nonperiodic payment to accrue income (or expense) in respect of that final payment. If these regulations applied to a CDS, they could require a protection buyer to accrue income because the protection buyer might receive a settlement payment if there is a credit event with respect to the reference entity. Conversely, the regulations could require a protection seller to accrue expense because it might have to make a future settlement payment. Among the uncertainties about whether and how these regulations might apply to a CDS are (1) whether a CDS is an NPC, (2) if it is, whether it would be subject to the proposed regulations, (3) whether the cash settlement payment should be viewed as a nonperiodic payment rather than a termination payment, and (4) if so, how the regulations should be applied in view of the fact that a settlement payment is uncertain not only in amount (which the regulations envision) but also as to timing (which the regulations do not envision) — or, for that matter, whether the settlement payment will occur at all (the regulations do not envision a nonpayment of a contingent amount).[29] Some of these issues are discussed further in Part IV.D below.

C. Section 1256 — the Basics

Section 1256 was enacted in 1981 as part of a package of rules intended to shut down tax straddle transactions in which taxpayers sought to obtain timing and character advantages from taking largely offsetting positions in futures contracts generally. As enacted, section 1256 required that RFCs be marked to market at year-end, meaning that gain or loss on the RFC had to be taken into account as if the RFC had been sold at year-end. To reduce the mark-to-market blow, section 1256 also provided that gain or loss on RFCs would be treated as 60 percent long-term and 40 percent short-term, even though futures contracts typically have a term of no more than three months.

For this purpose, an RFC was defined as a contract (1) that requires delivery of personal property or an interest therein, (2) with respect to which the amount required to be deposited and the amount that may be withdrawn depends on a system of marking to market, and (3) that is traded on, or subject to the rules of, a domestic board of trade designated as a contract market by the CFTC or specific other exchanges. At the time, that definition caused no confusion, since it was tailored to the terms of futures contracts trading on CFTC-approved exchanges.

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[27]*See* Notice 89-21, 1989-1 C.B. 651 (requiring that upfront payments on NPCs be taken into account over the life of the contract under a reasonable method of amortization).

[28]Prop. reg. section 1.446-3(g)(6).

[29]For materials addressing the potential application of these regulations to CDSs, see letter from the Investment Company Institute to Gregory F. Jenner, acting assistant secretary for tax policy, and Donald Korb, chief counsel (July 21, 2004), *Doc 2004-15585*, or *2004 TNT 147-14*; Lee A. Sheppard, "Retail Credit Derivatives," *Tax Notes*, Nov. 15, 2004, p. 926, *Doc 2004-21875*, or *2004 TNT 221-6*; Munro, *supra* note 2.

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Generally, a futures contract of that kind was a contract with standardized terms for the future delivery of a commodity, with a single payment made at maturity in exchange for the delivery of the commodity. The contract was traded on an exchange through open outcry (traders standing in pits and signaling each other through hand movements) under CFTC rules. Under the exchange rules, a clearinghouse then interposed itself between the two parties to the contract effectively as a guarantor of the parties' obligations. As a legal matter, the clearinghouse became the legal counterparty to each side of the transaction. The credit support provided by the clearinghouse was derived from collateral and guarantees provided by the futures commission merchants (the equivalent of brokers in the commodities world) acting for each party, as well as a small amount of initial margin required from both parties to the contract. Daily, as the contract gained or lost value as a result of changes in commodities prices and market expectations, the "losing" party was obligated to put up additional variation margin in the form of cash, which was deposited in the account of the "gaining" party.[30]

The definition of RFC as originally enacted was short-lived. In 1982 section 1256 was amended to delete the delivery requirement for RFCs and to add a new category of financial instruments subject to section 1256: foreign currency contracts. A foreign currency contract was defined as a contract that requires delivery of a foreign currency in which positions are also traded through RFCs, that is traded in the interbank market, and that is entered into at a price determined by reference to interbank market prices.

Section 1256 was again amended in 1984 and 2000 to add three more categories of contracts subject to section 1256: nonequity options, dealer equity options, and dealer securities futures contracts. Dealer equity options are options on single stocks, such as an option on IBM stock, that are traded by options market makers on securities exchanges. The term "nonequity option" is misleading; it is defined as any listed option that is not an "equity option," a term that has a narrower meaning than might initially appear. As a result of the historical division of responsibility between the SEC (single stocks and narrow-based equity indices) and the CFTC (broad-based equity indices), the term covers listed options on broad-based stock indices, like the S&P 500, as well as options on truly nonequity risks like options on commodity futures contracts, options on Treasury bond futures, and options on foreign currency futures. Dealer securities futures contracts are futures contracts on single stocks, and options thereon, that are traded by taxpayers who are treated for tax purposes as dealers therein. Like RFCs, nonequity options and dealer securities futures contracts are traded on CFTC-regulated exchanges. Collectively, the contracts subject to section 1256 are now categorized as section 1256 contracts. The history of several of these provisions is discussed in more detail in Part III below.

[30]The clearing and trading of futures contracts is described in more detail in Part II.A below.

II. Regulatory and Legislative Initiatives

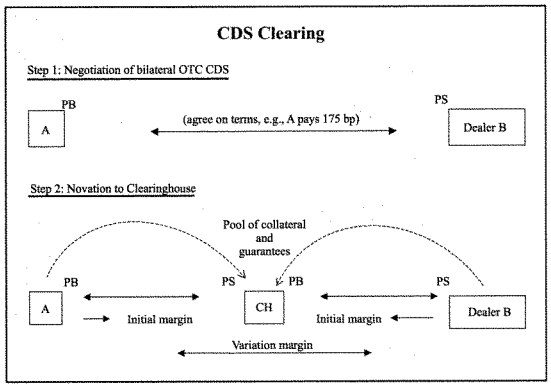
As described earlier, several events, most notably the federal government's emergency rescue of AIG in the fall of 2008, led many government regulators and other policymakers to conclude that the CDS market, and more generally the OTC market for derivative financial instruments, must be transformed so it poses less of a risk to the financial system. Among the improvements sought were to enhance market transparency, to improve operational processes, to reduce the level of outstanding trades, and to create a single central counterparty for swaps.[31] It was also envisioned that there would be a single regulator for CDSs that would have oversight over the entire system. Some of those goals were part of a larger program for the derivatives market as a whole, and some were CDS-specific.

Since that time, the CDS market, principally through ISDA, has taken several steps to achieve the goals laid out by regulators. The two of interest for purposes of this report are the standardization of CDS terms in the spring of 2009, which was a prerequisite for the clearing of CDS, and the commencement of clearing of CDSs by two U.S. clearinghouses in the fall of 2009. CDSs are now also being cleared by several European clearinghouses. The markets for interest rate swaps are now moving in the same direction. To date, all of these steps have been nominally voluntary, although as a practical matter the active involvement of the New York Fed and other regulators has meant that the changes have been adopted industrywide by swap dealers.

The House and the Senate have each passed a bill, still to be reconciled, that would impose mandatory requirements for regulating and trading derivative financial instruments. While that process is ongoing, the bills share so many significant components that some outcomes seem inevitable. For example, it seems likely that most (if not all) swaps ultimately will be regulated, some by the SEC and some by the CFTC; that most swaps will be cleared through one or more central clearinghouses; and that most swaps will be traded on regulated exchanges (or alternative swap execution facilities) rather than being negotiated in the OTC market. As described in more detail below, however, the legislation would not require that all swaps be cleared and traded; it would permit trading on markets that do not appear to constitute a QBE; and it would allow some types of parties to swaps to elect whether to clear their swaps. Accordingly, it also seems inevitable that identical swaps will be traded on a qualified board or exchange in some cases and in other cases will exist in the bilateral OTC derivatives or other market.

[31]*See* "New York Fed Welcomes Further Industry Commitments on Over-the-Counter Derivatives" (Oct. 31, 2008), *available at* http://www.newyorkfed.org/newsevents/news/markets/2008/an081031.html.

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A. Standardization and Clearing

As noted above, standardization of terms is a prerequisite for clearing swaps. This section discusses the standardization and clearing process as it has affected CDSs.

1. Standardization. In April 2009 ISDA announced the successful implementation of the 2009 ISDA Credit Derivatives Determinations Committees and Auction Settlement CDS Protocol (the Big Bang protocol).[32] Practically speaking, the Big Bang protocol amended ISDA's 2003 Credit Derivatives Definitions (which are part of the ISDA standard documentation for a CDS) to provide for the establishment of (1) committees empowered to make final decisions about contract interpretation issues, including those regarding credit events, settlement procedures, and acceptable deliverable obligations; (2) a standardized CDS settlement procedure; and (3) a standard look-back window during which a party can claim the occurrence of a credit event or other relevant event, resulting in a standard effective date for CDS transactions.

Because the Credit Derivatives Definitions are part of the standard terms for any party that uses the ISDA standard documentation, the terms of the protocol automatically apply to transactions entered into after the protocol's effective date. Adoption of the protocol by a market participant meant that, with some exceptions, all of its CDSs entered into before that date with another party that had adopted the protocol also would incorporate the terms of the protocol.

Also, ISDA also announced that, while not hardwired into documentation like the Big Bang protocol, a new contract for CDSs on North American corporate issuers with standardized terms would be introduced starting in April 2009. The new contract would (1) provide for a 100 basis point coupon for investment-grade credits and a 500 basis point coupon for high-yield credits; (2) provide a calendar of quarterly scheduled termination dates; (3) eliminate restructuring as a credit event; and (4) modify the accrual start date for coupons and provide that all coupons, including the first coupon, would be paid as full coupons regardless of whether the parties entered into the CDS in the middle of a coupon accrual period (similar to buying a bond with preissuance accrued interest). Those changes were expected to be the primary method for trading North American corporate CDSs in the future. Unlike with the Big Bang protocol, the changes did not affect historic trades, although parties were free to amend existing trades to conform to those terms.

As described in more detail in Part II.C below, because the market-quoted level for a CDS coupon was not affected by these changes — that is, the market's perception of the risk associated with buying or writing protection on a reference entity did not change — the advent of standardized coupons for single-name CDSs also brought with it the need for one party to the CDS to make an upfront payment to keep the other party whole. This practice was common in the market for CDSs on an index of reference entities, which already traded with standardized coupons because the coupon for any particular series of the index is fixed when the composition of the series is fixed. A new CDS on an existing series will be entered into with the same coupon even if that coupon is no longer at market, in which case one party will need to compensate the other through an upfront payment.[33]

[32]According to the ISDA, more than 2,000 parties had adhered to the new protocol by the time it closed on April 7, 2009. *See* "ISDA Announces Successful Implementation of 'Big Bang' CDS Protocol; Determinations Committees and Auction Settlement Changes Take Effect," *available at* http://www.isda.org/press/press040809.html.

[33]An example of such an index is the CDX.NA.IG, an index of 125 North American investment-grade issuers. Information about this index is available through Markit. *See* http://indices.markit.com/default.asp. In the case of CDSs on an index of reference entities, typically the index is reformulated every six months to adjust the relative weightings of the index names or to add or subtract reference entities so that the index continues to reflect the relevant segment of the fixed income market — much like the process followed for rebalancing and reconstituting standard equity indices. Each reformulation is a new series of the index. CDS trades on the index may reference any series created to that point, although more typically they reference the most recent series.

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2. The clearing process.[34]

a. In general. Standardization was an essential prerequisite to clearing and netting CDSs and may be a prerequisite for clearing and netting other swaps. Clearing in turn is, at least in practice, a prerequisite to the exchange trading of CDSs that is contemplated by the legislative proposals. To understand those changes, it is important to first understand the differences between clearing through a centralized clearinghouse and trading on a regulated exchange. To that end, this section discusses the different mechanisms governing futures contracts (which are both exchange-traded and cleared) and CDSs (which may be cleared, but are not currently exchange-traded). Broadly speaking, trading has to do with how the parties agree on a price for entering into or terminating a transaction. Clearing has to do with the centralization and management of risk and the transmittal of payments after the trade is entered into.

Futures contracts are traded on regulated exchanges. Their terms are standard and are set out in the rules of the exchange. Mechanically, a customer wishing to acquire the right to buy corn sometime in the future may go to its broker that is a member of a regulated exchange. The broker will take the client's order (along with orders from other clients and perhaps some on its own behalf) and go to the exchange, where the broker will create electronic buy and sell positions. Each position represents one side's willingness to either accept the obligation to deliver, say, 5,000 bushels of a specified type and grade of corn on the specified date at the specified price, or to pay the specified price and receive the corn on the specified date. The exchange's proprietary matching engine then connects individual buy positions with matching sell positions. Once a match is found, the contract is executed, with the brokers on either side as counterparties.

This relationship does not last, however, as the brokers are required to clear their trades through the exchange's central clearinghouse.[35] The clearinghouse becomes the party responsible for both the actual delivery of the 5,000 bushels of corn to Broker A and the payment for the corn to Broker B. At the same time, each broker now has a responsibility, not to its original counterparty, but to the clearinghouse, to either deliver the corn (in the case of Broker B) or provide the payment (in the case of Broker A). By interposing itself between the brokers, the clearinghouse assumes the risk that one party to the transaction will not perform.

The clearinghouse manages this risk through several mechanisms: (1) it nets the broker's position in the contract, as described below; (2) it takes initial margin (usually a small percentage of the purchase price) and later variation margin, as described below, determined by reference to the broker's then-outstanding trades with the clearinghouse, which change daily; and (3) it requires that the broker provide additional collateral (which becomes part of a guaranty fund) and guarantees (essentially, contingent collateral) to cover the clearinghouse's risks. In a default by a clearinghouse member — generally only members can be counterparties to the clearinghouse — the clearinghouse attempts to cover any resulting losses by looking first to that member's margin and collateral. Should that be insufficient, however, the clearinghouse can draw on the collateral provided by other members. If that too proves inadequate, the clearinghouse can call on the guarantees. The risk of a member's failure is thus reduced through the use of netting and the requirement that the member provide margin and collateral, and it is mutualized through the clearinghouse's right to appropriate the assets of other members.

Netting contracts is possible because the contracts have standardized terms. For example, if on the day after the transaction described above another customer of Broker A wishes to sell 15,000 bushels of corn under a futures contract that, but for the quantity and price, has terms identical to the first transaction, Broker A will execute that trade with Broker C. Once this contract has been cleared, the clearinghouse will automatically net Broker A's right to receive 5,000 bushels against its obligation to deliver 15,000 bushels into a single obligation to deliver 10,000 bushels in exchange for payment. As a result, at the end of a trading day, Broker A will always have a single net position with the clearinghouse on any one type of futures contract, although it will have multiple actual positions because it transacts in multiple types of futures contracts.

Unlike futures contracts, CDSs are not traded on exchanges. Instead, a CDS is entered into OTC in a private agreement between two parties. As a result of the standardization process described above, the number of variables to be negotiated is limited primarily to the market-quoted level for the coupon — that is, the coupon that the market would have agreed to prestandardization — and the maturity (tenor) of the CDS.

On reaching agreement on the terms of their CDS, if the CDS is subject to clearing, each party novates its contract with the central clearinghouse, which (as in the futures context) steps between and becomes the counterparty to both parties.[36] As in the futures context, this

[34]*See* the above diagram illustrating the clearing process for a CDS negotiated in the OTC market.

[35]Centralized clearing is not new. In 1925 the Chicago Board of Trade (CBOT) Clearing Corp., formed to become a counterparty to all transactions then carried out on the CBOT (generally trade in grain futures), was the first U.S. clearinghouse, and some form of central clearinghouse existed in Europe before that time. Federal Reserve Governor Randall S. Kroszner, "Central Counterparty Clearing: History, Innovation, and Regulation" (Apr. 3, 2006), *available at* http://www.federalreserve.gov/newsevents/speech/kroszner20060403a.htm#f5.

[36]The statement in the text is a simplified explanation of the actual process, which differs from the process for futures contracts in several respects. Unlike with futures, the brokers (dealers) who face customers in the CDS market are not always clearinghouse members. Consequently, to clear a CDS, the customer, the executing broker (the swap dealer), and the designated clearing member (which may or may not be the same legal entity as the broker, or an affiliate of the broker) must all cooperate because the customer-broker transaction will be replaced by a customer-clearing member-clearinghouse transaction. The process for dealing with failures to clear a trade is also different in the futures and CDS markets. In the futures market,

(Footnote continued on next page.)

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allows the clearinghouse to net out each party's overall exposure to CDSs, resulting in a single net position on any particular CDS (for example, a CDS on a specified reference entity or a specified series of an index with a specified maturity). In exchange for using the clearinghouse's services in this way, each party must provide collateral and adjust the amount of that collateral daily to reflect the party's net exposure.

There is at least one significant economic difference between clearing CDSs and clearing futures contracts. Futures contracts provide for only a single payment at maturity, so the payment made or received when entering into a futures contract reflects simply the difference between the price specified in the futures contract and the market price at that time. The upfront payment on a CDS is more complicated; see Part II.C below for discussion. Also, in a CDS clearing transactions, both dealers and some other major participants in the CDS market benefit from the credit support of the clearinghouse. Those arrangements are intended to provide assurance that if a clearing member fails, a customer's CDS positions will be transferred to another clearing member and the customer's margin will be available to transfer together with the customer's CDS positions. The mechanics of these arrangements differ from clearinghouse to clearinghouse.[37]

As mentioned above, there are two U.S. clearinghouses clearing CDSs — ICE Trust U.S. and the CME — as well as ICE Clear Europe, Eurex, and most recently LCH.Clearnet in Europe. For tax purposes, there are potentially significant differences between how the two U.S. CDS clearinghouses are organized and operate. Other types of swaps could be cleared through additional clearinghouses, which may also have different legal and functional structures.

b. ICE Trust U.S. ICE Trust U.S. is organized as a New York trust company and is regulated by the Federal Reserve and the New York State Banking Department.[38] It is one of several subsidiaries of ICE, which operates exchanges in Canada, Europe, and the United States and also operates several OTC markets. ICE Trust is a standalone clearinghouse for clearing CDSs. That is, its sole function is to clear, and the only contracts that it clears are CDSs.

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the parties simply keep trying to clear a trade. If it fails, no trade exists. In the CDS market, dealer-dealer trades clear weekly on ICE Trust and daily on the CME, although both are working on more rapid clearing cycles. In the interim between agreeing to a transaction and clearing it, a bilateral OTC contract exists between the dealers, and if the trade fails to clear, that contract continues in existence. Dealer-customer CDS trades work differently. If a trade of that kind fails to clear, there are several possible outcomes: (1) the designated clearing member may be replaced; (2) the trade may remain a bilateral OTC contract, but likely with different pricing because the credit risk, margin requirements, and possibly the regulatory capital requirements are different for OTC-only versus cleared CDSs; or (3) the trade may be broken. *See* "Recommended Common Principles for Relationships Between Customer and Executing Broker (EB) and Clearing Member (CM)" (Nov. 2009), on the ISDA website, *available at* http://www.isda.org/credit/docs/Recommended-Common-Principles.pdf. All of this is subject to change as the markets continue to develop.

One tax question raised by the clearing process is whether the clearing of a swap will be treated under section 1001 as a taxable disposition of the swap for property differing materially in kind or extent. For newly originated swaps that are intended from the outset to be cleared, this issue appears trivial, particularly if, as suggested above, the terms may change if the swap ultimately is not cleared. Under the step transaction doctrine, the cleared swap should be treated as the same swap agreed to by the parties. *See* the discussion of Rev. Rul. 87-43 in Part III.C.3 below.

The analysis may be different for preexisting swaps. If preexisting swaps were submitted for clearing one would have to consider whether reg. section 1.1001-4 or some other basis for nonrecognition treatment applies. The regulation treats an assignment as a nonevent for the nonassigning party if the assignment is from one swap dealer to another and is permitted under the contract. An interesting question is whether a clearinghouse could be considered a dealer for this purpose. Typically it would not be, but in other contexts novation to a clearinghouse has been essentially disregarded for U.S. federal income tax purposes so that no consideration has been given to that issue. In this context, one might argue that a clearinghouse serves a function sufficiently similar to that of a dealer to be treated as such under this rule. However, voluntary submission of existing swaps to a clearinghouse would not appear to be permitted by the terms of a standard ISDA, which requires consent by a counterparty to assign a swap except in limited situations. If the economic terms of the swap were modified in connection with the novation, that also would pose an obstacle to tax-free treatment. A final concern might be that the regulation applies by its terms only to NPCs, and so does not literally apply to options and other types of derivative financial instruments. Leaving aside whether economic terms of a swap would change when it is cleared, a more satisfying answer to the nonrecognition question could be that the clearinghouse is in essence simply a guarantor and so there has been no disposition of a swap when it is cleared. *See infra* discussion in note 114.

Similar issues could arise in connection with the transfer of a customer's positions from one clearing member to another during a failure of the original clearing member. One would have to consider whether the CME-type agency model for clearing customer trades would be less likely to give rise to a taxable disposition than the ICE Trust-type principal model. *See infra* note 43 for discussion of these two regimes.

[37]For extensive discussion of proposals by U.S. and European central clearinghouses for protecting CDS customers when a clearing member fails, see "Report to the Supervisors of the Major OTC Derivatives Dealers on the Proposals of Centralized CDS Clearing Solutions for the Segregation and Portability of Customer CDS Positions and Related Margin" (June 30, 2009) (the Buy-Side report), *available at* http://www.isda.org/credit/docs/Full-Report.pdf. These arrangements are briefly described in note 43, *infra*.

[38]In November 2008 the SEC, the CFTC, and the Fed executed a memorandum of understanding (MOU) under which they agreed to cooperate and coordinate in their respective approval, supervision, and oversight of central counterparties (CCP) for CDS. The MOU notes that one or more of the following may be a CCP for CDSs: a state-chartered bank that is a member of the Fed, a derivatives clearing organization (DCO) regulated by the CFTC, or a clearing agency regulated by the SEC. The MOU is *available at* http://www.ustreas.gov/press/releases/reports/finalmou.pdf.

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ICE Trust received regulatory approval from the New York State Banking Department in December 2008, and in March 2009 it received regulatory approval from the New York Fed to provide central counterparty services by clearing CDSs and from the SEC to perform the functions of a clearing agency for cleared CDSs.[39] ICE Trust began clearing CDSs in March 2009, and it clears both single-name CDSs and index CDSs. According to ICE, the volume of gross notional amount cleared by ICE Trust exceeded $5.5 trillion by May 2010.[40]

ICE Trust operates under a set of rules that describe conditions for membership, the terms of the CDSs that it clears, the details of how clearing takes place, how determinations of various kinds are made, and other related topics. These rules are also stand-alone, meaning that they relate solely to ICE Trust.

ICE reports daily settlement prices, daily trading volume, and end-of-day open interest for each CDS contract it trades. ICE does not provide other price information for cleared swaps, but bid/ask quotes can be obtained by calling a market participant.

c. The CME clearinghouse. The CME is a subsidiary of the CME Group, which is a holding company for the CME, the Chicago Board of Trade (CBOT), the New York Mercantile Exchange (NYMEX), and the Commodity Exchange (COMEX). Each of these is a separate legal entity that is designated as a contract market by the CFTC (a designated contract market or DCM) and operates as a futures exchange.

The CME's clearing operations are separate from the exchange but are housed in the same legal entity as the CME exchange. The CME clearinghouse is separately regulated by the CFTC as a derivatives clearing organization (DCO).[41] CME Clearing clears for both the CME and CBOT. Once a CDS contract submitted for clearing has been accepted, the CME becomes the legal counterparty to the contract in its capacity as a clearinghouse.

In December 2008 the CME certified plans to provide clearing services for CDS, and in March 2009 temporary regulatory approval (since renewed) was granted to allow the CME to perform the functions of a clearing agency for cleared CDSs, subject to conditions.[42] The CME began clearing CDSs in December 2009, and it now clears index CDSs. Margin provided by clearing members in respect of CDSs is held in a segregated account.[43] The CME has submitted a request for permission to commingle this margin with margin-securing other types of derivatives traded by the CME.

Several chapters of the CME rulebook deal with clearing. Those rules provide that the exchange shall maintain and operate a clearinghouse. Chapter 8F of the

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[39]For the New York State Banking Department approval, see http://www.banking.state.ny.us/pr081204.htm. The New York Fed approval was granted as a board order, dated March 4, 2009. For the SEC approval, see SEC Release No. 34-59527 (Mar. 6, 2009), 74 *Fed. Reg.* 10,791 (Mar. 12, 2009). The SEC order was temporary and has since been renewed. As these approvals indicate, ICE Trust operates, as contemplated by the MOU, as a state-chartered bank and as a clearing agency.

[40]*See* https://www.theice.com/ice_trust.jhtml.

[41]The CFTC regulates several different types of entities, of which DCMs and DCOs are only two examples. Other regulated trading markets include derivatives transaction execution facilities (DTEFs), which are trading facilities with a lower level of regulation; exempt boards of trade (EBOTs), which limit transactions to selected participants and commodities; and exempt commercial markets (ECMs), which limit trading to principal-to-principal transactions between selected participants on selected commodities. *See generally* http://www.cftc.gov/IndustryOversight/TradingOrganizations/index.htm; *see also* Andrea S. Kramer, *Financial Products: Taxation, Regulation and Design*, para. 4.02 (types of commodities markets), section 62.01 (discussion of qualified boards or exchanges) (3d ed. 2006); William R. Pomierski, "Special Rules for Certain Energy Futures Contracts and Options," *Energy and Environmental Trading: US Law and Taxation*, ch. 18 (May 2008). Additional types of trading markets and related acronyms no doubt will be added by the pending financial reform legislation.

[42]*See* http://www.cftc.gov/pressroom/pressreleases/2008/pr5592-08.html.knew (CFTC press release, Dec. 23, 2008); SEC Release No. 34-59578 (Mar. 13, 2009), 74 *Fed. Reg.* 11,781 (Mar. 19, 2009). As these approvals indicate, the CME clearinghouse operates, as contemplated by the MOU, as a DCO and as a clearing agency.

[43]Generally speaking, customers clearing CDSs through the CME maintain a clearing relationship with a futures commission merchant (FCM), which serves as the customers' agent and guarantor in respect of cleared CDSs. From the CME's perspective, its counterparty for cleared CDSs consists of each clearing member, with the clearing member acting as agent for unidentified principals — *e.g.*, the customers. Under applicable law, FCMs generally must segregate any property received from a customer as margin for various categories of derivatives and hold it in an account identified as a customer account at a qualified financial institution. CFTC regulations and CME rules impose this segregation requirement on margin provided by CDS customers.

ICE Trust has a different structure. Clearing members under ICE Trust's clearing framework act as principals vis-à-vis both the clearinghouse and customers, rather than as agents. If a customer executes a CDS trade with its clearing member that both parties agree to clear through ICE Trust, the result of the clearing process is that the clearing member will have three principal trades open: a "customer" trade with ICE Trust (that is, a clearing member-ICE Trust trade that is designated as relating to a customer transaction) that is offset by a back-to-back or mirror trade with the actual customer, and a "house" trade with ICE Trust that is the real risk position for the clearing member. (If the clearing member is not the executing dealer, these arrangements involve four parties rather than three.) Thus, from ICE Trust's perspective, it deals with the clearing member as a principal, and from the customer's perspective it too deals with the clearing member as a principal. The margin that the clearing member collects from its customer under the mirror trade with the customer can be on-pledged to ICE Trust as customer margin under the customer trade that the clearing member has with ICE Trust. As with the CME, this margin is segregated for the benefit of the customer.

For discussion of the operation of these rules and open issues under current law as to how effective they are in protecting CDS customers, see Part III.A.1 (CME) and Part III.A.2 (ICE Trust) of the Buy-Side report, *supra* note 37; letter from CME Group to the SEC (Dec. 14, 2009), *available at* http://www.sec.gov/rules/exorders/2009/34-61164-incoming.pdf; and letter from ICE Trust to the SEC (Dec. 4, 2009), *available at* http://www.sec.gov/rules/exorders/2009/34-61119-incoming.pdf.

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CME rulebook, "Over-the-Counter Derivative Clearing," sets forth rules for submitting an OTC trade on ClearPort, rules providing for the substitution of the CME as counterparty to each side of the trade, and rules for the clearinghouse's guarantee of cleared trades. Chapter 801 of the CME rulebook deals specifically with clearing CDSs.

The CME Group reports daily settlement prices, daily volume, open interest, and net changes therein for OTC swaps. The CME Group does not provide bid/ask prices for cleared swaps, as they are not part of the open outcry or electronic trading platform available for futures; instead they can be obtained by calling a market participant.

B. Pending Legislation Governing Derivatives

1. General overview of legislative proposals. Federal and state governments have proposed legislative regulatory reform of the OTC derivatives market. Some of the most recent proposals have come from the House,[44] the Senate (the Lincoln-Dodd compromise bill),[45] and the insurance industry. Although the proposals are many, the problems they seek to address are relatively few: too much exposure, too much opacity, too much concentration,[46] and too much risk. The general solutions are well-accepted: more transparency through trading and reporting, less exposure and risk through clearing, capital and margin requirements, and more security through increased regulation. It seems likely that whatever legislative proposal is ultimately selected, it will result in the central clearing of most conventional CDSs and other swaps and the trading of those cleared swaps through exchanges or approved alternative trading facilities.

Generally, the legislative proposals are similar to the extent relevant to the tax issues discussed herein. Each provides that the previously existing standard, under which swaps like CDSs were subject to regulation by neither the SEC nor the CFTC, must be changed, and that instead regulation must be split between the two agencies with security-based swaps (including CDSs whose reference entities are single issuers and issuers of securities in a narrow-based security index) regulated by the SEC and all other swaps (including broad-based index CDSs) regulated by the CFTC.[47] Also, the proposals all provide for the clearing of swaps in standardized form through designated clearing organizations or clearing agencies and the trading of those swaps on national securities exchanges, DCMs, or alternative swap execution facilities, subject to exemptions.[48]

The term "swap" is broadly defined for this purpose, although it excludes certain specified categories of transactions such as options on securities (as determined for securities law purposes) and certain foreign currency-linked instruments. It seems possible and perhaps likely, though, that at least some "swaps" subject to the new rules will be treated as something other than NPCs for tax purposes.

2. Exemptions to clearing and trading requirements. Generally, if a swap fits into specified exemptions, it is not subject to the mandatory clearing and trading requirements. Probably the most important exemption is that, subject to an important caveat discussed below, only swaps accepted by a designated clearing organization or clearing agency must be cleared. That is, the determination of which swaps are subject to the mandatory clearing requirement is left in the first instance to the clearing organizations themselves, which can be expected to take into account various economic characteristics of the swap, including whether there is a sufficiently liquid market for the swap and whether the swap can be readily valued. If there is no clearing organization willing to accept a particular swap for clearing, that swap generally will not have to be cleared.[49] Here, however, some complexity is added because under both the House bill and the Lincoln-Dodd compromise bill, the agencies are required (under the House bill) or permitted (under the Lincoln-Dodd compromise bill) to designate specific swaps or classes of swaps as being subject to the mandatory clearing requirement, even if no clearinghouse is then willing to accept them for clearing.

Also, a swap may be exempted from the mandatory clearing and trading requirements if one of the counterparties qualifies for exclusion as an end-user. The tests provided for determining whether an end-user qualifies for exemption differ between the House bill and the Lincoln-Dodd compromise bill, although in each case one component of the test is that the party is not a swap dealer or "major swap participant" (generally, a person that is not a swap dealer but nevertheless maintains a

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[44]Wall Street Reform and Consumer Protection Act, H.R. 4173, 111th Cong. (2010) (the House bill), *available at* http://docs.house.gov/rules/finserv/111_hr_finsrv.pdf.

[45]Restoring American Financial Stability Act of 2010, S. 3217, 111th Cong. (2010) (the Dodd bill), *available at* http://banking.senate.gov/public/_files/TheRestoringAmericanFinancialStabilityActof2010AYO10732_xml0.pdf; Wall Street Transparency and Accountability Act of 2010, Senate Amendment No. 3739 to S. 3217, 111th Cong. (2010) (the Lincoln-Dodd compromise bill), *available at* http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=111_cong_bills&docid=f:s3217as.txt.pdf. This Senate bill was subsequently replaced by the Senate's version of H.R. 4173.

[46]Fitch report, *supra* note 16, at 7. ("The top 10 counterparties comprised 67 percent of total exposure in terms of number of times cited [and] the top five institutions [provided] 88 percent of the total notional amount [of CDx] bought and sold.")

[47]House bill, at section 3101; Lincoln-Dodd compromise bill, at section 721. To keep the discussion simple, this part will hereafter use the term "swap" to refer to both "swaps" and "security-based swaps" as defined by the relevant legislative proposal and will refer to "regulator" to mean either the SEC or the CFTC, as applicable.

[48]The proposals all provide for the establishment of (potentially) multiple central clearinghouses. It is unclear how the operation of multiple central clearinghouses will interact with the desire to net multiple positions. It is unlikely that positions could be netted if they are on different clearinghouses, and one concern may be that multiple clearinghouses undermine the goal of transparency by disaggregating market information.

[49]House bill, at section 3103(a); Lincoln-Dodd compromise bill, at section 723(a).

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substantial (net) position in outstanding swaps, or whose outstanding swaps create systemic risk, or, under the Lincoln-Dodd compromise bill, is highly leveraged and maintains a substantial position in swaps). The House bill and the Lincoln-Dodd compromise bill would require that the end-user use the swap to hedge or mitigate commercial risk.[50] Under those legislative proposals, it appears that all speculative CDSs that are accepted for clearing would have to be cleared and traded. Even if a swap qualifies for the end-user exemption, the end-user may still opt to clear the swap if a clearinghouse will accept it.[51] Swaps that are exempted from the clearing and trading requirements would still be subject to increased regulatory oversight under all of the legislative proposals, including reporting, record keeping, and position limit requirements.

3. Regulation by insurance regulators. While it seems likely at the time of this writing that some form of the legislative proposals described above will become law, the federal government is not the only authority with an interest in regulating CDSs. Insurance regulators have also made proposals addressing the legality of CDSs and the parties permitted to enter into them. The approach taken by insurance regulators generally has been (1) to define CDSs that are used to hedge risks as insurance; (2) to prohibit any other CDSs, that is, to ban "naked" or speculative CDSs; and (3) to require that a permitted CDS be written by an insurance company.

Historically, CDSs have not been treated as insurance, based largely on a June 2000 opinion from the State of New York Office of the General Counsel (NYOGC), which examined a particular type of CDS and determined that the absence of an insurable risk rendered the CDS not insurance.[52] In late 2008, however, the NYOGC announced that it was reconsidering the issue, and testimony from Eric Dinallo, New York's superintendent of insurance, before the House Committee on Agriculture (which oversees the CFTC) suggested that CDSs used for hedging purposes may ultimately be linked to an insurable interest and thus may be regulated as insurance.[53] The insurance regulators of some other states also asserted jurisdiction over CDSs. State insurance regulators have since drafted a model law that if adopted and not preempted by federal law, would ban CDSs unless used to hedge another position and would require all permitted CDSs to be written by insurance companies.[54]

The House bill and the Lincoln-Dodd compromise bill would expressly preempt regulation of swaps as insurance under state insurance law, but they do not draw a clear distinction between swaps on the one hand and insurance products on the other.

C. Standardization of Coupons[55]

As discussed earlier, one significant consequence of the move toward standardization of the terms of CDSs is that coupon payments for CDSs that are cleared or are eligible for clearing — meaning most "ordinary" CDS transactions, whether or not actually cleared through a regulated clearinghouse — are now either 100 basis points or 500 basis points multiplied by the notional principal amount.[56] Despite that, coupon levels are still quoted by reference to the market level — for example, 175 basis points, as they were before standardization. Because it will happen only by chance that the market-quoted level for a CDS is equal to the standardized 100 or 500 basis points, one party to a standard coupon CDS must make an upfront payment to the other (and receive back an equivalent amount as collateral — more on this below).

It remains to be seen whether other types of cleared swaps will also have standardized coupons. For swaps that have or will have standardized coupons, one can expect upfront payments to be made for the same reasons. Upfront payments on swaps other than CDSs are relatively straightforward as an economic matter, however, because they generally are equal to the present value of the difference between the standard coupon and the market coupon over the stated term of the swap. As described below, determining an upfront payment on a standard coupon CDS is more complex. In understanding the calculation of upfront payments on standard coupon CDSs, it is helpful to start by discussing the pricing of prestandardized CDSs, because upfront payments are determined by converting the difference between standard coupons and market-level coupons into a single lump sum payment.

1. Coupons on prestandardized CDSs. The coupon level for a prestandardized CDS was struck at the market-quoted level and determined in a manner similar to determining the yield at which a bond trades. A bond at

[50]*Id.*

[51]*Id.*

[52]*Funding Agreement Securitizations*, NYOGC (Apr. 18, 2000), *available at* http://www.ins.state.ny.us/ogco2000/rg004181.htm.

[53]"Best Practices for Financial Guaranty Issuers," Insurance Department, Circular Letter No. 19 (Sept. 22, 2008), *available at* http://www.ins.state.ny.us/circltr/2008/cl08_19.htm; testimony to the U.S. House of Representatives Committee on Agriculture, hearing on the role of credit derivatives in the economy, by Superintendent Eric Dinallo (Nov. 20, 2008), *available at* http://agriculture.house.gov/testimony/110/h91120/Dinallo.pdf. For a discussion of the actions taken by the New York State Insurance Department, see Kramer et al., *supra* note 2.

[54]National Conference of Insurance Legislators (NCOIL), "Proposed Credit Default Insurance Model Legislation," *available at* the NCOIL website, http://www.ncoil.org.

[55]I am indebted to Biswarup Chatterjee of Citigroup Global Markets for his insights into the pricing of CDSs and the operation of the converter described below, for the examples set forth below, and for reviewing this section of the report. Any errors in the discussion are of course mine. Possibly it would help if I had understood calculus.

[56]This is true for North American corporate reference entities and for emerging market corporate and sovereign reference entities. There are more standard coupon levels for European reference entities. The discussion in this part assumes that the CDS described is a CDS on a single North American corporate reference entity.

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issuance might have a coupon of 6 percent, for example, in which case one would expect the coupon level for a CDS on that bond to reflect the credit spread on the bond, say 4 percent (400 basis points). If the issuer's financial condition weakened, the bond would trade at a discount, that is, with a yield greater than 6 percent, and a new CDS entered into at that time would have a higher coupon. The reverse would be true if the issuer's financial condition improved. Consequently, a CDS entered into on any given day on a particular reference entity could and often did have a coupon different from a CDS on the same reference entity on any other day. Other terms of the CDS, such as the maturity date, also could differ.

As described earlier, the coupons would be paid over the life of the trade or until the date of a credit event, if any. Daily, at least one party to the trade (the dealer) would mark the CDS to market by reference to the present value of the difference between the original coupon and the now-current market level on which the same CDS could be executed. Again, this mark-to-market valuation was similar to determining the current price for a bond by discounting the cash flows on the bond by current interest rates and credit spreads. The CDS had a zero mark-to-market value on the trade date, meaning that the present value of the coupons was equal to the value of the protection provided by the CDS. Most CDS trades matured without ever having credit event settlement payments.[57]

2. Calculating the upfront payment on a standardized CDS. A standardized CDS also provides for periodic coupon payments, at the 100 basis points or 500 basis points level. If the current market-quoted level for a CDS with a standard 500 basis points coupon is 400 basis points, the protection seller will make an upfront payment to the protection buyer to compensate the protection buyer for overpaying coupons by 100 basis points as compared with the market level. If the market coupon for the CDS is 550 basis points, the protection buyer will make an upfront payment to the protection seller to compensate the protection seller for the 50 basis point shortfall in standard coupon payments as compared with the market-quoted level. Thus, an upfront payment may be made by either party to a standardized CDS.

Before turning to the calculation of the upfront payment, it is worth discussing how the market-quoted level for a CDS is generally determined primarily by reference to (1) an estimate of the probability of default by the reference entity, and (2) an appropriate (interest rate) discount curve.[58] The first of these variables is not a single number, since pricing models estimate the probability of default at different times during the term of the CDS, and those estimates are path-dependent. For example, it may be very unlikely that issuer X will default in years 1 and 2, much more likely in year 3 because the issuer has outstanding debt coming due in that year, and then less likely in year 4 because the issuer will survive to year 4 only if it can manage its liabilities in year 3.

The two parties to a CDS ordinarily will have different judgments about these variables. The reason one party is willing to buy protection and the other is willing to sell protection at a specified market-quoted level is because they have different views about what the right market level should be. Also, the fact that a CDS on Reference Entity X has the same market-quoted level as a CDS on Reference Entity Y does not mean that the probabilities of default are the same for X and Y. Even if all other variables are held constant, if X (as above) is at greatest risk for default in year 3 while Y is at greatest risk for default in year 2 but perhaps is considered overall more creditworthy, the shape of the survival curve for X and Y will differ.

The parties to a CDS will therefore first agree on a market-quoted level for a CDS in the same manner as they did before CDS standardization. They will then convert the difference between the agreed market-quoted level and the standardized coupon into a single lump sum payment. (The upfront payment also adjusts for the coupon amount that has accrued before entering into the trade — a detail that will be ignored for purposes of this discussion.)

Calculating the upfront payment is not for the faint of heart. To avoid disputes, the market has developed a standard converter that can be used to convert market coupons into an upfront payment.[59] The converter is based on several simplifying assumptions regarding both the terms of a CDS and key economic variables.[60] As a

[57]I have been advised that historically a very small percentage of the reference entities for which CDSs are traded have experienced credit events, and that this is true even taking the credit crisis and recession into account, because (1) CDSs exist on only a limited number of reference entities, which do not include all of the companies that have failed; and (2) an issuer may be perceived by the market to have failed without triggering a CDS credit event, for example if the issuer is rescued from actual failure by being acquired. As of May 11, 2010, ISDA lists six reference entities as having active credit events, and over 40 reference entities with prior credit events, in both cases for CDSs (that is, not including loan-only CDS) on U.S. and non-U.S. reference entities, including both corporates and sovereigns.

[58]This discussion does not address a CDS on a reference entity considered highly likely to default soon. The upfront payment on that CDS would be determined primarily by reference to the expected recovery in bankruptcy for a holder of the issuer's debt. In the market's jargon, a CDS of this kind would be "quoted upfront" or quoted as "points upfront," rather than quoted using a par spread.

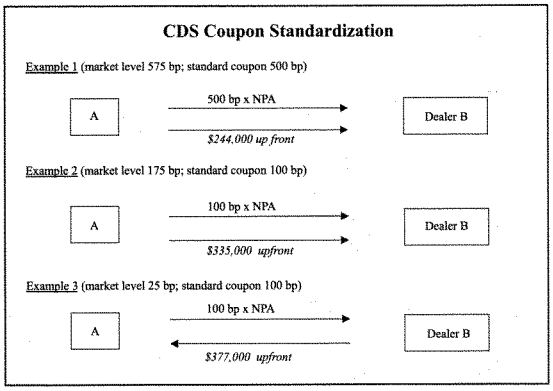
The upfront payment generally does not take into account the creditworthiness of the parties. In the case of cleared CDSs, that is because the clearinghouse becomes the legal counterparty to the trade. In the case of OTC-only CDSs, the parties typically manage credit risk by taking or providing collateral.

[59]The standard upfront calculator was developed by the ISDA. Markit helpfully provides a converter on its website that requires entering only the variables described in the text above. *See* http://www.markit.com/cds.

[60]In particular, the converter uses a yield curve derived from specified money market deposits and interest rate swaps maturing at different times and using flat forward rates to determine the yield for interpolated dates (dates on which no deposit or swap matures). The converter also derives an assumed

(Footnote continued on next page.)

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result, using the converter for a standardized CDS is mechanically straightforward. One simply inputs the trade date; whether one is acting as protection buyer or seller; the standardized coupon, maturity date, and recovery rate[61]; the notional principal amount; and the currency — and out pops a number.

Note that the simplified assumptions used by the converter for the discount and survival curve are likely to differ from the inputs used by the parties when agreeing on the market-quoted level. For example, because the market-quoted level for CDSs on reference entities X and Y described above is the same, the converter would assume that the survival curve for X and Y is also the same. This divergence from more realistic assumptions does not matter on the trade date but, as discussed below, can affect the amount of variation margin paid during the term of the CDS. With an OTC-only CDS, the parties are not bound to use the same assumptions or method as the converter described above to determine initial margin for the CDS, but typically will follow the ISDA-recommended guidelines.

3. Examples. It is helpful in understanding how the standard converter described above works to see some examples.[62] In each of these examples, Party A buys protection from Bank (and so pays coupons to Bank) on XYZ Corp. as Reference Entity; the notional amount is $10 million; the CDS has a term of five years; and the market coupon and the standard coupon differ by 75 basis points.

Example 1 (standard coupon 75 basis points below market level):

- Underlying market level 575 basis points, standard coupon 500 basis points
- Party A1 (buyer of CDS) pays $244,000 upfront, and pays 500 basis points per year

Example 2 (standard coupon 75 basis points below market level):

- Underlying market level 175 basis points, standard coupon 100 basis points
- Party A2 (buyer of CDS) pays $335,000 upfront, and pays 100 basis points per year

Example 3 (standard coupon 75 basis points above market level):

- Underlying market level 25 basis points, standard coupon 100 basis points
- Party A3 (buyer of CDS) receives (not pays) $377,000 upfront, and pays 100 basis points per year

If we compare examples 1 and 2, which both involve cases in which the market-quoted level is 75 basis points above the standard coupon, we see that the upfront payment is less for CDS 1 when the standard coupon is 500 basis points than for CDS 2 when the standard coupon is 100 basis points. That is because the implied risk that there will be a credit event with respect to the reference entity during the term of the CDS is higher for CDS 1 than for CDS 2. Because coupon payments will cease to be paid if there is a credit event, the value of the right to receive the missing stream of 75 basis point periodic payments is less for CDS 1 than for CDS 2.

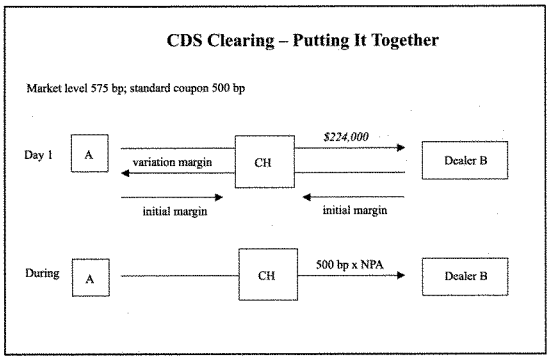
To put this differently, as an economic matter one cannot simply translate the upfront payments on these CDSs into a five-year annuity paying 75 basis points periodically, because the risk that the annuity will be cut short is significant enough to affect the value of the annuity. Moreover, given the path-dependent nature of the default probability curve, it would be a simplification to treat the upfront payment as representing the present value of a stream of 75 basis point amounts to a fixed

probability of default for a series of specified dates (the survival curve) — analogous to looking at interest rates for specified dates — and assumes that the probability of default is constant between those dates. The probability of default is determined by reference to the ratio between the risk-free interest rate and the credit spread for the reference entity. The assumed yield curve and survival curve are then input into a formula that is beyond me to describe, having cheerfully forgotten all the calculus I ever knew.

[61]The recovery rate is the amount that a holder of a debt instrument would recover in bankruptcy. For purposes of the upfront calculator, the recovery rate input for senior debt is assumed to be 40 percent, and for subordinated debt it is assumed to be 25 percent.

[62]These examples assume that the risk-free interest curve is the same in each case — another "unrealistic" assumption. *See* diagram on the next page for illustrations of these examples.

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date, say year 3 for CDS 1 and year 4 for CDS 2. Consider the example referred to above of Issuer X, which may fail in year 3 but if it survives is likely to be stronger in year 4. Given those facts, the foregone right to receive 75 basis points in year 4 will have some current value for both CDS 1 and 2, but a different value.

Examples 2 and 3 demonstrate the same point. Because the risk of a credit event for CDS 3 is considered low, the value of the upfront payment is higher for CDS 3 than for CDS 2. Moreover, because the coupons Party A3 will pay are higher than the true cost of the protection Party A3 is buying, Party A3 will receive rather than pay the upfront amount. This last point is not unique to CDSs; the same would be true if Party A3 were a party to an interest rate swap and had agreed to pay an above-market coupon. It is less intuitive, however, because one tends to think of Party A3 as buying the right to a potential future cash settlement payment on the CDS, and therefore as a payer rather than a payee before a credit event.

4. Mark-to-market; collateral. As described earlier, once the parties have entered into a standardized CDS and it has been accepted for clearing, the CDS will be marked to market daily. The mark-to-market value of each trade is calculated by estimating the value of the difference between the standard coupon and the underlying market-quoted level at which the same trade could be executed on the current date, using the converter to determine the then-value of the CDS. The mark to market is the same for both parties, positive to one party (treated as the in-the-money party) and negative to the other (treated as the out-of-the-money party). As described above, variation margin will be paid daily by the out-of-the-money party to the in-the-money party.

Less obvious is that the need to exchange variation margin (collateral) is created immediately when the parties enter into a standard coupon CDS — that is, variation margin for a standard coupon CDS reflects not merely changes in value in the future, but also the terms of the CDS at the moment when entered into. Returning to Example 1 above, the CDS is off-market by $244,000 when entered into. Ignoring the upfront payment, the CDS is in the money to Party A1 (that is, the CDS has gained value for Party A1 compared to a CDS with market-level coupons), because Party A1 is only required to pay 500 basis points while the market level is 575 basis points. Conversely, the CDS is out of the money to Bank (that is, the CDS has lost value for Bank). Consequently, the day 1 mark to market requires Bank to provide $244,000 of collateral to Party A1. The day 1 cash flows — the upfront payment and the corresponding variation margin — thus net to zero, assuming that the CDS is valued at the end of the day at the same market level at which it was executed during the day.[63]

Another way to understand this is if Bank were to go bankrupt immediately after receiving Party A1's upfront payment of $244,000, Bank would neither return the foregone stream of 75 basis point payments nor provide any protection to Party A1. Party A1 would have a claim against Bank based on the unwind value or mark-to-market value of the CDS contract. Party A1 therefore has $244,000 of credit risk to Bank, which Bank must collateralize by providing initial variation margin. Over time, assuming no other changes to the market or the reference entity, Party A1 would repay that collateral to Bank. Because the repayment is determined by reference to daily marks to market, and, as described above, as a practical matter the default probabilities for an issuer vary during the term of the CDS, the repayment would not be paid in level 75 basis point amounts. Rather, in the case of Issuer X described above, relatively small amounts of collateral would be repaid in years 1 and 2, and a larger amount in year 3 if the issuer survives. Of course, in reality, the collateral would be adjusted daily to take actual changes in the value of the CDS into account.

Similarly, if other types of swaps with standardized coupons are submitted to a clearinghouse, one can expect that upfront payments will also give rise to an immediate and offsetting payment of initial variation margin.

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[63]If the CDS value has changed by the end of the day, the cash flows will not net perfectly.

For purposes of the discussion in the remainder of the report, it is assumed that despite this circular flow of cash, the upfront payment is treated as "real," unless otherwise stated.

A diagram illustrating the cash flows described in the text is shown above.

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III. Section 1256 Analysis

The advent of clearing and the future exchange-trading of derivative financial instruments currently traded in the OTC market raise the question whether those contracts constitute or should constitute section 1256 contracts. It is tempting to answer that by examining the face of the statute (there are no relevant regulations). As described in more detail below, however, the government has consistently — and appropriately, in my view — answered questions about the scope of section 1256 by reference to the congressional intent in enacting and amending section 1256. This part therefore embarks on a description of the history of section 1256 as relevant to answering whether cleared or exchange-traded swaps should fall within its scope. Part III.A first examines how swaps would be taxed if they were subject to section 1256, and the effect on different classes of taxpayers. Part III.B then takes a closer look at the statutory language defining specific types of section 1256 contracts and discusses how they might apply to CDSs and other swaps. Part III.C discusses the history of the government's interpretation of section 1256.

A. Effect of Section 1256 Treatment

The effect of treating a swap as a section 1256 contract varies with the method of accounting a taxpayer uses for swaps, and it also depends on whether the swap is characterized as an option. Taxpayers can broadly be divided into those that currently use a realization method of accounting for swaps and those that use a mark-to-market method of accounting for swaps. The characterization of a swap as an NPC, option, or some other type of financial derivative most obviously affects the treatment of the periodic coupon payments, although, as discussed above, it may affect the treatment of an upfront payment or settlement payment as well.

Of course, the effect of bringing a swap within the scope of section 1256 depends on what rules one thinks the swap is subject to. (Except where otherwise stated, this discussion assumes that the taxpayer is an end-user that has made no special elections such as a section 475(f) trader mark-to-market election or a section 1221 hedging election.) A swap characterized as an NPC ordinarily would be treated as giving rise to current income or deductions in the amount of the periodic coupon payments and a portion of any upfront payment made or received to enter into the NPC. Absent an early termination of the swap, therefore, all income and expense from a conventional swap ordinarily are treated as ordinary income and expense.

A CDS characterized as an NPC may also be taxed in that manner, although there is some uncertainty in that regard.[64] The discussion below assumes such treatment. If a cash settlement payment is made on a CDS, the IRS's position appears to be that the payment gives rise to capital gain or loss, although there is room for doubt on that question.[65] The tax treatment of an option or a CDS characterized as an option is much simpler: no income or deduction for upfront or periodic payments, and capital gain or loss on a cash settlement payment in an amount that takes into account prior payments. This simple approach can become more complex if the CDS is an index CDS under which periodic payments relate to multiple reference obligations and for which multiple cash settlement payments are possible, but those nuances will be disregarded for this purpose.

1. Taxpayers. For a taxpayer that uses a conventional realization method of accounting for swaps, section 1256 affects the timing of income or loss, it may affect the character, and it is likely to affect the holding period of gain or loss. For taxpayers that use a mark-to-market method of accounting for swaps, section 1256 primarily affects character.

As described above, interest rate and foreign currency swaps are widely used by corporate and other taxpayers to hedge assets and liabilities, including debt, that have interest rate terms or are otherwise interest-rate-sensitive. These taxpayers will typically use a realization method of accounting for the swap. A taxpayer that uses the realization method of accounting for a CDS may be an insurance company, a bank, or other investor that has entered into the CDS to hedge a bond, loan, or other exposure to the reference entity, or a taxpayer that has entered into a CDS as a way of synthetically investing in the reference obligation(s), such as a credit derivatives product company or a special purpose vehicle being used to issue a synthetic credit-linked note. In the case of a swap or CDS entered into as a hedge, the taxpayer is likely to wish that the timing of its income and expense from the swap correspond with the timing of the related income and expense from the hedged position. In the case of a CDS entered into as a synthetic investment in the underlying credit, the taxpayer is likely to expect its synthetic debt position to be subject to rules similar to those applicable to an actual debt obligation. Both kinds of taxpayers are likely to be unhappy about being required by law to use a mark-to-market method of accounting.

The taxpayer that is hedging its position is also likely to find itself subject to the tax straddle rules of section 1092. That taxpayer would be taxable on mark-to-market gain from the swap but would likely be unable to deduct mark-to-market losses as a result of economically offsetting gains on the hedged position. Assuming the hedged position is a capital asset, the taxpayer could not make a section 1221 hedging transaction election or a section 1256(e) election to remove the swap from the application of section 1256. In some cases, for example for many CDSs, the taxpayer would be unable to make an integration election under reg. section 1.1275-6, because the

[64]The uncertainty arises because CDSs are potentially subject to the proposed regulations on NPCs with contingent nonperiodic payments described in Part I.B.2 above. It is common, however, to assume that the proposed regulations or their principles do not currently apply to CDSs. Timing issues are discussed in more detail in Part IV below.

[65]*See* prop. reg. section 1.1234A-1(a) (gain or loss from NPC termination payment is treated as gain or loss from termination of the NPC). As discussed in Part IV below, there is some uncertainty as to whether a cash settlement payment on a CDS would constitute a termination payment for this purpose.

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precision in matching timing and amounts of cash flows required by that section would not be satisfied. The taxpayer could make one of various elections under the straddle rules, including the identified straddle election of section 1092(a)(2), the straddle-by-straddle identification election of section 1092(b)(2)(A)(i)(I) for mixed straddles, or the mixed straddle account election of section 1092(b)(2)(A)(i)(II). But each of these elections have complexities, limitations, and disadvantages that make them imperfect solutions. The taxpayer's best option may often be a mixed straddle election under section 1256(d) to remove the contract from the scope of section 1256, since section 1256(d) imposes relatively modest conditions.

There is no discernible tax policy reason that would favor subjecting taxpayers of this kind to a mark-to-market regime for swaps. Indeed, that an onerous anti-abuse rule may well apply if the taxpayer could *elect* to use a mark-to-market method of accounting for a swap suggests that uncertainty over the scope of section 1256 should be resolved in favor of not *requiring* taxpayers to mark their swaps to market. Moreover, because the advent of standardization means that identical swaps exist in the OTC-only market and as cleared swaps, subjecting the latter to section 1256 could give taxpayers electivity of a kind that is not necessarily problematic, but that policymakers should make an informed judgment to permit.[66] Note that Congress in the past has disfavored the existence of mixed straddles, as discussed below, which would suggest that congressional intent would militate against expanding the scope of section 1256 contracts to swaps in this backdoor manner.

The other general class of taxpayers is those who are already marking swaps to market — as dealers in securities under section 475(a), as electing traders in securities under section 475(f), or possibly as a form of self-help under section 446's clear reflection of income rules under the general ambit of prop. reg. section 1.446-3(i).[67] Securities dealers generally do, and electing traders must, treat the mark-to-market gain or loss as ordinary under section 475.[68]

Section 475 provides, however, that a section 1256 contract generally does not qualify as a security to which section 475 applies,[69] presumably because when section 475 was enacted, commodity dealers and traders lobbied to remain outside its scope.[70] (This section 1256 priority rule does not apply to interest rate swaps, foreign currency swaps, and equity swaps.) As a result, absent the hedging rules described below or another special rule, a dealer or trader that generally recognizes ordinary gain or loss from its securities activities may be required to recognize capital gain or loss from any section 1256 contracts that it holds. The potential adverse consequences are obvious.

There is a possible escape from this unhappy state of affairs, because a section 1256 contract that hedges a section 475 security may itself be treated as a section 475 security.[71] However, this hedging election is available only if the hedge is clearly identified on the dealer's records as a section 475 hedge before the close of the day on which it was entered into. As a practical matter, a swap may not hedge a section 475 security, or it may be difficult to determine whether it does so with any certainty, or it may be difficult to do so in a manner that satisfies the close-of-day identification requirement. Consider, for example, a CDS dealer that regularly buys and sells protection with customers, so that many of its CDS positions hedge each other. The dealer hedges the residual risk from its customer positions by holding a pool of debt obligations that tends to fluctuate in value in a manner that is inverse to the residual customer risk but does not precisely match the reference obligations in its net CDS positions. Similarly, a dealer's interest rate swap book may also include options to enter into swaps

[66]This electivity would be even greater if legislation is enacted that allows some taxpayers to choose whether to clear a CDS they enter into, as appears likely.

[67]Prop. reg. section 1.446-3(i) generally would permit a taxpayer to mark an NPC to market, if the NPC is actively traded, the taxpayer marks the NPC to market for financial accounting purposes, or the counterparty agrees to provide its tax marks. Some taxpayers have maintained that the proposed regulations, while not currently in effect, demonstrate that marking an NPC to market clearly reflects income from the NPC, and that a taxpayer therefore may mark to market NPCs of the kind that would fall within the proposed regulations even if the taxpayer is not subject to section 475.

[68]Section 475(d)(3) (generally providing that dealer gain or loss from securities subject to section 475 is ordinary); section 475(f)(1)(C) (rules similar to rules of section 475(d) apply to electing traders).

[69]Section 475(c)(2)(E) and the flush language at the end of section 475(c)(2).

Section 475 applies to securities and, on an elective basis, commodities. The term "security" is defined in section 475(c)(2).

[70]The development of the definition of the term "security" as Congress was considering section 475 is consistent with the presumption in the text. As originally introduced in the House in February 1992, the term was defined to include (1) any derivative financial instrument in securities, but not including any futures contracts, and (2) any NPC other than a commodity-linked NPC. WMCP No. 35, 102d Cong. 2d Sess., H.R. 4287, Technical Explanation of Tax Fairness and Economic Growth Bill of 1992 (Feb. 24, 1992). A month later, after consideration by the Senate, the NPC language was unchanged, but the catchall provision now referred to a derivative financial instrument in any security otherwise described, but not including any contract to which section 1256(a) applies. S. Prt. No. 77, 102d Cong. 2d. Sess., H.R. 4210, Family Tax Fairness, Economic Growth, and Health Care Access Bill of 1992 (Mar. 6, 2002). The legislative history gives no explanation for the change from "futures contract" to "any contract to which section 1256(a) applies," but it seems plausible that the change was intended to clarify that the definition excluded futures contracts subject to section 1256, and not other futures contracts. Finally, in the conference bill passed later that month (and vetoed by the president), the NPC clause had been revised to read as it now does, referring to interest rate, currency, or equity NPCs. H.R. Rep. No. 461, 102d Cong. 2d Sess., H.R. 4210, Tax Fairness and Economic Growth Bill of 1992 (Mar. 20, 1992).

[71]Section 475(c)(2)(F); *see also* section 1256(e) for a broadly similar hedging election.

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("swaptions"), forward rate agreements, and other non-"interest rate swaps" as well as long and short positions in treasuries and other debt instruments, with no precise matching of individual positions. This type of dynamic hedging on an overall book basis is more likely to be the norm than the exception.[72]

As described above, the principal purpose of section 1256 is to require taxpayers to mark section 1256 contracts to market, and the mandate that gain or loss from section 1256 contracts be treated as long-term and short-term capital gain was a sweetener intended to reduce the effects of marking to market. Given that history, it would not merely serve a tax policy goal to require taxpayers currently marking CDSs and other swaps to market under section 475 to mark them to market instead under section 1256, it would be counterproductive.

Moreover, while the exclusion of section 1256 contracts from the definition of the term "security" for section 475 purposes may have originally served to ensure that commodities dealers and traders were not subject to section 475, those taxpayers later had a change of heart and lobbied successfully for an election into section 475 treatment. The IRS could therefore conceivably exercise its regulatory authority under section 475(g) to apply the section 1256 carveout to the definition of security in a more limited manner. For example, the carveout could be applied, as it is today, for purposes of determining whether a taxpayer such as a market-maker on a commodities exchange or a dealer in fixed income instruments was a section 475 dealer in securities that would be subject to the same rules as today (treating section 1256 contracts as non-"securities" for this purpose). The carveout could cease to apply once the fixed income dealer was treated as a dealer in securities, however, with the result that any section 1256 contracts the dealer entered into would be treated as section 475 securities. An approach of this kind does not square with the statutory definition of security, but in view of the historic and current connection between section 1256 and the commodities markets, it is again unreasonable that electing dealers and traders in *commodities* treat gain or loss from section 1256 contracts as ordinary under section 475, while dealers and electing traders in *securities* generally must apply the capital gain/loss rules of section 1256.[73]

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[72]There are some other possible avenues for relief from capital treatment, under section 1256(f)(2) and/or section 1256(f)(3), but as discussed below, they do not seem to change the overall picture in any significant way.

Section 1256(f)(2) provides that section 1256(a)(3) (requiring 60/40 capital gain/loss) does not apply to any gain or loss that, but for that paragraph, would be ordinary income or loss. This provision was enacted when the *Corn Products* doctrine, which treated business assets, including hedges, as ordinary rather than capital assets, was considered good law. *Corn Products Refining Co. v. United States*, 350 U.S. 46 (1955). When section 1256 was enacted, a taxpayer using a futures contract to hedge its inventory could treat the gain or loss from the hedge as ordinary, because it would be ordinary absent section 1256 under the *Corn Products* doctrine and thus was exempt under section 1256(f)(2) from capital gain/loss treatment. However, the *Corn Products* doctrine was repudiated in *Arkansas Best Corp. v. Commissioner*, 485 U.S. 212 (1988), and has effectively been replaced by the hedging transaction rules of section 1221(b)(2) and hedging transaction regulations under section 446. The hedging transaction regulations apply to hedges of ordinary assets and liabilities and suffer from practical obstacles to use in the dealer CDS context similar to the problems described above with the section 475 hedging exception. (Some taxpayers also have expressed concern about whether a CDS hedging credit risk technically qualifies as a hedge of a "risk of price changes" under section 1221(b)(2)(A)(i). Because the price of a fixed income asset reflects its credit risk, the "right" answer to that question seems clear.)

Section 1256(f)(3) also has a complicated history. Before the amendment of section 1256 in 1984, market-makers in equity options traded on securities exchanges maintained that they were entitled to ordinary income and loss from their options transactions. The 1984 amendment was intended to limit that treatment to the fact pattern in which the taxpayer was also, independently of its option transactions, a dealer in the underlying property. This was accomplished by (1) adding "dealer equity options" as a category of section 1256 contracts; and (2) adding section 1256(f)(3), which provides that gain or loss from "trading" (this phrase evidently was intended to include market-making) section 1256 contracts is treated as capital gain or loss, unless the section 1256 contract is held to hedge property loss from which would be ordinary in the taxpayer's hands. Accordingly, if a dealer in swaps is also a dealer in the underlying property, and the swaps hedge that property, it may be possible under this rule for the dealer to have ordinary rather than capital gains and losses from its swap transaction.

The relationship between section 1256(f)(2) and section 1256(f)(3) is not clear. They were enacted at different times, for different purposes, and thus it is possible that both are available to swap dealers. If that were the case, section 1256(f)(2) could provide considerable relief. For example, it could allow dealers to treat the character of gains and losses for swaps entered into in connection with their dealer business as ordinary, under section 475(d)(3). Separately, it might alleviate concerns for an option or a CDS properly classified as an option, because under section 1234(a)(1) gain or loss from purchased options would be ordinary if the underlying property would give rise to ordinary gain or loss in the taxpayer's hands, and under section

(Footnote continued in next column.)

1234(b)(3) gain or loss from writing options is ordinary if granted in the ordinary course of the taxpayer's trade or business of granting options. Consequently, under section 1234 gain or loss from dealing in exchange-traded options could be ordinary in the absence of section 1256(a)(3). However, section 1256(f)(3)(A), providing that gain or loss from trading section 1256 contracts is capital gain or loss, was enacted precisely to prevent options market-makers from taking that position. Moreover, section 1256(f)(2) merely provides that section 1256(a)(3) does not apply, while section 1256(f)(3)(A) states that it applies "for purposes of this title." Accordingly, it seems possible that section 1256(f)(3) overrides section 1256(f)(2) and that relief is available only if a swap hedges an asset (not a liability) that would give rise to ordinary loss in the taxpayer's hands. *See Beverly Gordon*, T.C. Memo. 1997-193 (Apr. 24, 1997), *Doc 97-11645, 97 TNT 80-11* (rejecting taxpayer argument that hedging rule of section 1256(f)(3) applies because of failure of proof); FSA 1999-1130, *Doc 1999-2570, 1999 TNT 100-83* (concluding hedging rule of section 1256(f)(3) does not apply to hedges of anticipated liabilities).

[73]Electing dealers and traders in commodities mark "commodities" to market. Section 475(e) and (f). The definition of this term includes futures contracts and, not surprisingly, does not

(Footnote continued on next page.)

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Of course, section 1256 treatment is not always disadvantageous. In 1984, when dealer equity options were added to the list of section 1256 contracts, Congress took care to ensure that options market-makers could not set themselves up as limited partnerships and pass the benefits of 60/40 treatment on to limited partners. Section 1256(f)(4) provides that gain or loss from dealer equity options allocable to limited partners is always short term. When dealer securities futures contracts became section 1256 contracts, section 1256(f)(4) was amended to apply to them as well. A natural conclusion is that, absent similar legislative action, traders in swaps treated as section 1256 contracts will be able to use partnerships to allow investors to share in long-term capital gains generated from a trading or dealing business. Some existing hedge funds might find such an opportunity attractive. Mutual funds might also welcome the opportunity to derive additional long-term capital gain; however, absent certainty on whether section 1256 applies, mutual funds might be more concerned by uncertainty about the timing of income than they are attracted by the potential for long-term capital gain. And query whether taxpayers' annual year-end quest to accelerate capital losses to offset realized capital gains (or, after a down market, the search for capital gains to offset expiring capital losses) might be facilitated by the existence of similar swaps, some of which are section 1256 contracts and some of which are not.

The Congressional Budget Office and the Joint Committee on Taxation apparently believe the fisc has more to lose than to gain from section 1256 treatment of cleared and exchange-traded swaps, possibly because if there is uncertainty about whether section 1256 applies, taxpayers will use that uncertainty to their advantage.[74] Similarly, if section 1256 applies to some financial instruments but not to very similar ones, arbitrage (and whipsaw) potential exists. To illustrate a type of uncertainty briefly referred to above, section 475 includes as "securities" interest rate NPCs and some other NPCs, as well as options and other derivative financial instruments in securities. However, the section 1256 carveout applies differently to those instruments. If a swap is, for example, both an interest rate NPC and a section 1256 contract, it appears that section 475 and not section 1256 applies, but there may be some uncertainty in that regard.[75] An interest rate futures contract, by contrast, is clearly a section 1256 contract.

2. Application of section 1256 to periodic swap payments. Section 1256 does not address how periodic payments on a section 1256 contract should be treated. This is hardly surprising given that no contract expressly intended by Congress to be subject to section 1256 provides for periodic payments. One must therefore exercise some conjecture.

As mentioned above, most swaps are clearly NPCs. With CDSs, however, it is unclear whether they should be treated as options, NPCs, or some other class of financial instrument. The discussion below therefore uses CDSs as an illustration of how section 1256 might apply, considering both the option and NPC alternatives.

a. CDS as option. It is simpler to start with the alternative under which a CDS treated as a section 1256 contract is an option. Absent a rule to the contrary, periodic payments of CDS option premiums presumably would continue to be nondeductible/nonincludable payments when made, because section 1256's rules apply only at year-end or on the termination of the taxpayer's obligation or rights under the contract.[76] For a section 1256 contract held at year-end, any option premium paid or received during that year presumably would be taken into account in determining the gain or loss on the contract, as would be the case if the option were actually, rather than deemed, sold at year-end. The only difference between a CDS-as-option and an option expressly subject to section 1256 is that the CDS has multiple premium payments, which may complicate bookkeeping but should not change the fundamental principles.

For example, assume that a CDS with a notional value of $100 calls for annual coupon payments of $5 and that it has an initial mark-to-market value of zero. On or just before the last day of year 1, Party A pays $5 to Party B. For purposes of illustration, assume that there has been no change to any market variable affecting the value of the CDS other than that a coupon payment has been made. Because the quoted market level for the CDS has not changed, the CDS has not changed in value. Party A effectively now has a $5 basis in the CDS, however, while Party B must increase any gain or decrease any loss by the $5 option premium it has received. Accordingly, when the CDS is marked to market (at zero), Party A will have a $5 capital loss and Party B will have a $5 capital gain. Not surprisingly, parties A and B have the same gain or loss as if they had actually sold the CDS.

If the CDS has changed in value, that change will give rise to increased or offsetting capital gain or loss. Consequently, the gain or loss from the coupon effectively becomes part of the overall capital gain or loss, which is again the same result as if the CDS had been sold.

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exclude section 1256 contracts. Section 475(e)(2). Electing dealers and traders in securities mark "securities" to market, which, as discussed in the text, generally excludes section 1256 contracts.

[74]*See supra* note 6.

[75]An interest rate NPC is defined as a security in section 475(c)(2)(D). The catchall for derivative financial instruments such as options and forwards on securities is in section 475(c)(2)(E). The flush language at the end of section 475(c)(2) provides that subparagraph (E) shall not include any contract to which section 1256(a) applies. That flush language does not by its terms affect the application of subparagraph (D). Thus, as long as an interest rate swap that is also a futures contract still qualifies as an NPC under subparagraph (D), subparagraph (D)

(Footnote continued in next column.)

should be the operative provision — unless, of course, section 1256(f)(3)(A) overrides. See the discussion of section 1256(f)(3) in note 72, *supra*. Having illustrated the web of statutory provisions that can apply, the resolution of this question is left for another day.

[76]Section 1256(a) (section 1256 contracts held at year-end); section 1256(b) (section 1256 contracts that terminate during the year).

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b. CDS or other swap as NPC. Under current law, the analysis of how section 1256 would apply to CDSs or other swaps that, absent section 1256, would be classified as NPCs appears to be relatively straightforward in some respects. As described in Part II.B.2 above, the definition of an NPC in the NPC timing rules excludes any section 1256 contract.[77] Consequently, if a CDS that would otherwise be treated as an NPC is classified as a section 1256 contract, it appears that the CDS would not be subject to the NPC timing rules, including the rules that create deemed loans and deemed interest. The same would be true for an interest rate swap or other NPC treated as a section 1256 contract. This makes perfect sense from a timing perspective, since both section 1256 and the NPC timing rules deal with timing and there is no reason to apply multiple sets of rules. As discussed below, however, the government has previously taken a different view in some contexts.

Assuming that the NPC timing rules do not apply, the timing of income or expense with respect to periodic payments would be governed by the general rules of the code. Because the NPC timing rules, which are clear reflection of income rules, provide for current accrual of NPC periodic payments, one likely answer would be to conclude that a periodic payment on a swap or CDS should be accrued on a current basis. As a current income/expense item, the payment would not affect the basis of the swap or CDS for purposes of determining gain or loss. Further, as with a bond with accrued interest, for example, the mark to market of the swap or CDS at year-end should not take into account accrued ordinary income or expense. Otherwise that amount would be double counted, once as income/expense and once as an increase/decrease in value.

To take an interest rate swap example, assume that parties A and B enter into a conventional at-market swap under which Party A agrees to pay 6 percent x $100 million and Party B agrees to pay LIBOR x $100 million, annually (for ease of calculation) for five years. During the first year, LIBOR is 4 percent and a net 2 percent coupon accrues. At or just before year-end, that coupon is paid. Party A therefore has $2 million of swap expense, and Party B has $2 million of swap income. If the swap has not changed in value at year-end, the parties will take those amounts into income/expense and nothing else. If, however, the swap also has changed in value in Party A's favor, say by $10 million, Party A will have $2 million of ordinary deduction and $10 million of capital gain, while Party B will have $2 million of ordinary income and $10 million of capital loss.

Similarly, returning to the example of the CDS under which a $5 payment was made in year 1 by Party A to Party B, the result could also be most unfortunate for Party B. Party B would have $5 of ordinary income from the periodic payment. If the CDS has lost value to Party B, however, the mark-to-market loss would be capital loss. Party A would be in the reverse position, with $5 of ordinary expense and mark-to-market capital gain. Thus, unlike the CDS-as-option alternative, the coupon payments on this CDS are items separate from the mark-to-market gain or loss. This is highly unusual, since mark-to-market typically arises either under section 475 for a dealer or trader for whom any gain or loss is ordinary,[78] or under section 1256 with respect to contracts that do not give rise to ordinary income or expense. One broadly comparable fact pattern is a mixed straddle in which at least one position is ordinary and at least one position is capital. In that case, Congress has granted Treasury authority to write regulations reducing the whipsaw potential.[79]

An alternative in the case of the CDS would be for coupon payments made to be capitalized, under the section 263(a) regulations dealing with the capitalization of amounts paid to create or acquire intangibles. Those rules provide that amounts paid to create or acquire a "financial interest," including an NPC, futures contract, forward contract, or "any other financial derivative" must be capitalized.[80] There is an example in those regulations to the effect that, but for the application of the NPC timing regulations, an upfront payment on a swap would be subject to those rules.[81] It is less clear whether periodic payments would be subject to the same rules. Because the CDS would already exist when the periodic payments are made (so no apparent "creation" is taking place) and would not be changing hands (so no apparent "acquisition" is taking place), applying the section 263(a) regulations to those payments would not seem to be what the drafters of the regulations contemplated. The counterargument would be that the payments are made to keep the CDS in existence and thus function like premium payments on a series of options — although this seems not entirely in harmony with the premise of this analysis that the CDS is an NPC and not an option.

If the regulations did apply, the result would presumably be the same as under the option example above for the party making the coupon payments. The section 263(a) regulations would not in any event affect the party receiving coupon payments, so they would not alleviate the character mismatch problem described above.

Only mischief, whether for the government or for taxpayers, could result from rules under which periodic payments give rise to ordinary income/expense while mark-to-market payments give rise to capital gain/loss. It is hoped that the government will take the view that an

[77]Reg. section 1.446-3(c)(1)(ii).

[78]It is possible for mark-to-market gain or loss to be capital for a dealer in securities, if the securities are not held in connection with the dealer's activities as a dealer in securities. Section 475(d)(3)(B)(ii). Dealers generally maintain, however, that all or most of their activities are connected to their securities dealer activities.

[79]Section 1092(b)(2)(D).

[80]Reg. section 1.263(a)-4(c)(1)(iii) (acquisition of financial instrument); reg. section 1.263(a)-4(d)(2)(i)(C) (creation of financial instrument).

[81]Reg. section 1.263(a)-4(b)(4)(ii), example. The section 263(a) regulations generally do not override other provisions of the code or Treasury regulations, which is why the NPC timing rules govern the treatment of the upfront payment in this example.

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express congressional mandate is necessary before taxpayers that will be required by law to transact in swaps in this manner will be subject to arbitrary and capricious rules reminiscent of the treatment of hedging transactions before the *Fannie Mae* case and the issuance of reg. sections 1.1221-2 and 1.446-4.[82]

It is possible to imagine an even worse scenario, based on rules the government has adopted or proposed in other contexts that could first apply "normal" timing rules and then impose mark-to-market rules on top of those normal rules.[83] The principal reason for concern is that the NPC timing rules that require the creation of deemed loans and deemed interest when a significant nonperiodic payment is made are not, as I understand it, motivated by timing concerns. Rather, they exist because of concern that related parties could use NPCs to lend money and pay economic interest to each other without being subject to U.S. withholding tax — that is, in a situation in which the party making the upfront payment (the lender) is resident in a country that has no income tax treaty with the United States providing for a zero rate of withholding tax on interest. Because cleared and traded swaps have a clearinghouse as their counterparty and neither of the existing U.S. clearinghouses would, to the best of my knowledge, be considered related parties to any swap dealer, it is hoped that if section 1256 applies to swaps, any issued guidance would clarify that the principles of the NPC timing rules will not be imported into that regime. That should be the law today, since the NPC timing rules do not apply to section 1256 contracts.

Having paraded the potential horribles, this report turns next to whether cleared and traded swaps are or will become subject to section 1256.

B. Statutory Language

1. Could a swap be an RFC? An RFC is defined under current law as:

> a contract —
>
> (A) with respect to which the amount required to be deposited and the amount which may be withdrawn depends on a system of marking to market; and
>
> (B) which is traded on or subject to the rules of a qualified board or exchange.[84]

A qualified board or exchange is defined as a national securities exchange registered with the SEC; a domestic board of trade designated as a contract market by the CFTC; or any other exchange, board of trade, or other market that the Treasury secretary determines has rules adequate to carry out the purposes of section 1256.[85]

On its face, this definition is broad, as it requires only that a "contract" be traded on a CFTC- or SEC-regulated exchange and be subject to daily variation margin requirements. As discussed in more detail below, this breadth has previously raised questions as to whether nonfutures contracts, in particular commodity options, constitute RFCs. That Congress resolved the issue by amending section 1256 to specify when commodity options will and will not be treated as section 1256 contracts suggests that whatever the definition of RFC, it should not apply to every contract traded on a CFTC-approved exchange. Also, that Congress amended section 1256 to include foreign currency contracts and nonequity (including foreign currency) options suggests that the RFC definition should not include contracts linked to foreign currencies. Instead the definition should apply to some subset of traded contracts. The logical way to narrow the scope of the definition is to read into the term "contract" the implied qualification that it is a commodity futures contract, since those were the only contracts to which the RFC definition applied when it was enacted. As discussed in more detail below, however, while the IRS

[82]*Federal National Mortgage Association v. Commissioner*, 100 T.C. 541 (1993), resolved an issue raised by *Arkansas Best Corp. v. Commissioner*, 485 U.S. 212 (1998), namely whether *Arkansas Best*'s general repudiation of the business assets doctrine also overturned the specific holding of *Corn Products* that a hedge of inventory could itself be treated as an ordinary asset. If that were the case, taxpayers would be subject to unmanageable whipsaw risk, because hedges sometimes produce losses that would be capital under a broad reading of *Arkansas Best*. The *Fannie Mae* case concluded that Congress had effectively legislatively adopted the *Corn Products* doctrine. Treasury and the IRS then threw in the towel and issued reg. sections 1.1221-2 and 1.446-4 to provide specific rules for hedging transactions. And Congress then endorsed that result by enacting section 1221(a)(7) and (b)(2), providing statutory rules treating hedging transactions as noncapital assets. Congress thus both implicitly and explicitly endorsed the harmonization of character from transactions that hedge ordinary assets or liabilities.

[83]Under the current NPC timing rules, if a taxpayer that is a party to an NPC is subject to section 475 mark-to-market rules, those rules generally override the NPC timing rules for periodic and nonperiodic payments. Reg. section 1.446-3(c)(1)(iii) (to the extent the rules of reg. section 1.446-3(e) (dealing with periodic payments) or (f) (dealing with nonperiodic payments) are inconsistent with the rules that apply to any NPC governed by section 475, the rules of section 475 govern). However, this regulation does not specifically refer to reg. section 1.446-3(g). It is unclear whether this silence means that reg. section 1.446-3(g)(4), which provides the rules that create a deemed loan if there is a significant nonperiodic payment, applies to a section 475 taxpayer, or whether the section 475 override of the "(f)" rules dealing with nonperiodic payments means no rules applicable to nonperiodic payments are relevant for a section 475 taxpayer.

Proposed regulations express the apparent principle that one first creates deemed loans and then applies mark-to-market on top. *See* prop. reg. section 1.446-3(g)(i) (mark-to-market election; part of proposed rules for swaps with contingent nonperiodic payments, discussed in Part I.B.2 above) and reg. section 1.446-3(g)(6) (requiring creation of deemed loans and then the application of a complex quasi mark-to-market regime whose principal purpose seems to be to encourage taxpayers to elect to use the "real" mark-to-market regime in subsection (i)); *see also* prop. reg. section 1.475(a)-1(a) through 1(e) (taxpayers required to accrue OID and bond premium before marking debt instruments held as assets to market), proposed in 1995. Taxpayers have strongly objected to both of these proposed regulations as unnecessarily cumbersome and serving no purpose.

[84]Section 1256(g)(1).

[85]Section 1256(g)(7).

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appears to have taken that position, there is no authoritative guidance to that effect.

Uncertainty also arises because an RFC is defined as a contract "traded on or subject to the rules of" a QBE. The "subject to" language is ambiguous. To focus attention on that ambiguity, it may be helpful to review some of the different kinds of existing transactions that have or may have some connection to a QBE but are not expressly within or outside the scope of section 1256. The list below mostly describes a number of contracts that have some connection to the CME or its affiliate exchanges, the CBOT, or the NYMEX.[86]

a. The mutual offset system. Since 1984, the CME and the Singapore Exchange (formerly the Singapore International Monetary Exchange, or SIMEX) have been parties to an agreement that allows traders to open a futures contract on one exchange and have it automatically transferred overnight to the other exchange. For example, during SIMEX business hours a trader could enter into a Eurodollar futures contract on SIMEX and, when the CME opened, send it to the CME. Once accepted, the SIMEX trade is offset and the trade becomes a position on the CME. The futures contract is then identical to any other Eurodollar futures contract on the CME.

b. Exchange for physical. An exchange for physical (EFP) transaction is a privately negotiated (that is, OTC rather than exchange-traded) and simultaneous exchange of a position in a physical asset for a related futures contract. For example, a party owning live cattle, natural gas, or foreign currency may exchange that asset for a futures contract on the same product, if the asset satisfies specified conditions. Once accepted, the futures contract is identical to any other futures contract traded on the exchange. The general rule for those transactions is rule 538 of the CBOT's rulebook.

c. Exchange for swap.[87] An exchange for swap (EFS) transaction on NYMEX is like an EFP, except that the parties exchange a futures contract versus a swap rather than a physical asset. Typically, those transactions are submitted for clearing within one hour of the parties' agreement to the terms. In the energy markets, where there are many EFSs, a standard confirmation states that if the transaction is not accepted for clearing, it will be void. Those transactions are also subject to CBOT rule 538.

d. Cleared agricultural swaps.[88] A cleared agricultural swap is a privately negotiated contract that is submitted to the CME for clearing, as a result of which the CME becomes the legal counterparty to both sides of the contract. These swaps are listed on the CBOT for clearing only. That is, unlike the transactions described above, the contract does not become a futures contract.

There are several variations on these swaps, all of which provide for cash settlement on expiration in an amount determined in part by reference to the settlement price for a specified futures contract. CBOT rules set forth the terms for each type of swap. Not surprisingly, given the pricing connection to futures contracts, these terms generally mimic those of the related futures contract.[89] The swaps are also subject to the general provisions of CME rule 8F, which deals with clearing OTC derivative contracts.

Because most of the terms of the swaps, once cleared, are fixed under the rules described above, negotiations are generally limited to the price, settlement date, and in some cases one or two other terms. The parties understand that the swap is entered into for clearing, and market practice is to submit the swap for clearing immediately after agreeing to its terms. There is no separate documentation such as a confirmation for the swap before it is cleared.

e. Cleared interest rate swaps.[90] A cleared interest rate swap is a privately negotiated contract that is submitted to a clearinghouse. The oldest such clearinghouse, LCH.Clearnet, has cleared interest rate swaps since 1999 and now clears about one-third of the interest rate swap market. According to those rules, parties enter into interest rate swaps first under bilateral ISDA documentation; when the swap is cleared by LCH.Clearnet, the economic terms are preserved but the legal terms become LCH.Clearnet standard terms. LCH.Clearnet's rules specify payment dates and calculation methods for payments and margin determinations.

LCH.Clearnet is an independent clearinghouse. It clears for many exchanges and also clears non-exchange-traded contracts like interest rate swaps.

A more recent entrant to the market is the International Derivatives Clearing Group (IDCG), a Nasdaq subsidiary.[91] IDCG offers interest rate futures contracts on Nasdaq OMX, a designated contract market that trades many other types of futures contracts. IDCG's clearinghouse subsidiary carries out EFS transactions similar to those described above, except that bilateral interest rate swaps are exchanged for the futures contracts, which have identical terms. IDCG first offered this service in December 2008. The current volume of open

[86]The information described below is taken primarily from the CME Group's website, *available at* http://www.cmegroup.com.

[87]*See* Pomierski, *supra* note 41, at section I.F.5; Kramer, *supra* note 41, at para. 62.01[B][1]. Pomierski and Kramer conclude that these contracts constitute RFCs. It appears that NYMEX also takes that position.

[88]ICE also clears agricultural swaps under similar arrangements. Pomierski describes cleared energy swaps on ICE that appear to work like the cleared agricultural swaps described in the text. Pomierski, *supra* note 41, at section I.F.5; *see also* Kramer, *supra* note 41, at para. 62.01[B][2].

[89]For example, in a calendar swap, one party agrees to pay a fixed price per bushel and the other agrees to pay an amount determined by reference to the settlement price for the futures contract expiring in the stated month of the contract. The CBOT rules set forth the expiration date, the unit of clearing (number of bushels), the minimum price increments, position limits (*e.g.*, number of contracts net long or net short in any single contract month), the time at which the contracts will be cash settled, and the settlement terms.

[90]The information under this heading comes from the LCH.Clearnet website, *available at* http://www.lchclearnet.com.

[91]The information under this heading comes from the IDCG website, *available at* http://www.idcg.com.

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interest appears to be very low. The CME has expressed interest in offering a similar product.

f. Cleared CDSs — CME. A CME-cleared CDS is a privately negotiated contract that is submitted to the CME for clearing in the same manner as described above for cleared agricultural swaps. It does not become a futures contract. Cleared CDS contracts are subject to CME rule 8F, described above, and specific rules addressing the clearing and settlement of CDS contracts. The CME permits parties to submit already outstanding bilateral CDS transactions for clearing, although the terms of those CDSs will be restated in standardized terms.

g. Cleared CDSs — ICE Trust. An ICE Trust-cleared CDS is similar to a CME-cleared CDS. However, ICE Trust U.S. is a stand-alone clearinghouse — unlike the CME clearinghouse, its only function is to clear CDSs.[92]

The tax treatment of these various contracts as traded on or subject to the rules of a QBE is clear only for a few of the contracts on the list. For the mutual offset system, Rev. Rul. 87-43 concludes that contracts traded on SIMEX and transferred to the CME are RFCs.[93] The revenue ruling is discussed in more detail in Part III.C.3 below. The gist of the ruling is that under step transaction principles, the taxpayer has entered into an RFC in that case. These principles would seem to apply to EFPs and EFSs that result in futures contracts as well, and market participants apparently take that view, although no authority addresses the issue.

Conversely, the CDSs cleared by ICE Trust are traded on an OTC basis and are "subject to the rules of" a clearinghouse only. Those rules are independent of any exchange rules. A QBE, as described above, means an SEC-regulated national securities exchange, a domestic board or trade designated as a contract market by the CFTC, or any other market that Treasury determines has rules adequate to carry out the purposes of section 1256. A stand-alone clearinghouse fits neither of the first two categories, and ICE Trust has not been designated by the Service as a QBE. Accordingly, CDSs cleared by ICE Trust are not subject to the rules of an exchange and are therefore not section 1256 contracts.[94]

Interest rate swaps cleared by LCH.Clearnet are not section 1256 contracts for the same reason, and I am aware of no debate over that. Admittedly, the lack of interest in this topic could have something to do with lack of awareness in the tax community that many interest rate swaps are cleared.

After examining the other contracts on the list, my principal conclusion is that the statutory language needs some gloss. For example, what does it mean to be "traded" on a QBE? That word ordinarily connotes the purchase and sale of an asset. RFCs, however, are not bought and sold in the usual sense. An RFC is a contract that a taxpayer enters into. When the taxpayer wishes to dispose of its interest in the RFC, it enters into an offsetting RFC, and its original RFC is terminated. This has the same effect as if the taxpayer had sold its original RFC to its counterparty in the closeout transaction, but it is technically an offset and not a sale or assignment. The definition of foreign currency contract, discussed below, requires that the contract be traded in the interbank market, a market in which contracts again typically are not assigned but instead are entered into and closed out with the original counterparty. That definition also requires that a foreign currency contract be entered into at arm's length at a price determined by reference to the interbank market price, which could be read to suggest that there is a difference between trading a contract and entering into a contract.

One is therefore led to conclude either that futures contracts and foreign currency forward contracts are not section 1256 contracts because they are not traded in the traditional sense (which would hardly be a popular position), or that the term "traded" includes entering into a contract, at least under some circumstances. Or perhaps trading does not refer to how an interest in a contract is acquired or disposed of, but rather contemplates an active market in which contracts can readily be entered into, closed out, and valued — that is, trading has to do with liquidity and valuation.[95] There are, however, futures contracts that trade on an exchange in very low volume, and it is hard to believe that that would affect their status as section 1256 contracts.[96] What then does it mean to be "traded on" a QBE — that is, does the word "traded" have any independent significance, and if so, what is it?

Another question is what it means to be traded "subject to the rules of" a QBE. The phrase could apply to any contract that is treated as a futures contract on a QBE, even if not originally entered into as such; it could also apply to any contract that has economic terms that depend on the rules that apply to futures contracts; and

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[92]ICE Trust is a joint venture between the Intercontinental-Exchange (ICE) and a consortium of dealers. ICE operates a number of exchanges, but their operations are separate from those of ICE Trust.

[93]Rev. Rul. 87-43, 1987-1 C.B. 252.

[94]Some commentators have speculated whether this issue was considered when ICE Trust was formed. As the principal tax adviser on issues relating to the clearing process, I can confirm that it was.

[95]*Cf.* Reg. section 1.1092(d)-1(c) (interest rate swaps treated as "personal property of a type that is actively traded" if contracts based on similar indices are "purchased, sold or entered into" on an established financial market, including an interbank market). This regulation was issued to resolve a similar conundrum. Section 1092 and, at the time, section 1234A applied to personal property of a type that is actively traded. The market for interest rate swaps is deep and liquid, but interest rate swaps are not typically assigned from party to party. Rather, parties enter into them and close them out. The regulation provides that entering into those swaps in the interbank market qualifies as active trading under the relevant statutory provisions.

[96]To take a random example, according to the CME website, at the close on April 27, 2010, open interest in soybean oil futures expiring in January 2012, March 2012, and May 2012 were 16, 8, and 16 contracts, respectively, and none of those contracts traded on that day. Other long-dated futures contracts had as few as one or five open contracts on that day. *See* http://www.cmegroup.com/daily_bulletin/preliminary_voi/VOIREPORT.pdf.

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it could apply to any contract that is subject to any rule that is in the rulebook of a QBE; or it could apply to only some of those or conceivably apply even more broadly. The first of these seems right, as the discussion of Rev. Rul. 87-43 below indicates. History may provide further indirect support. Although the legislative history of section 1256 does not say where the "subject to" language comes from, a likely source is the Commodity Exchange Act (CEA). I have been advised by commodity law experts that when section 1256 was enacted, EFP transactions existed and were governed by the CEA. The "subject to" language therefore may have been intended to refer to futures contracts that are not traded on an exchange but that are otherwise identical to other futures contracts and are subject to all the rules governing those contracts. That would not answer the question of how much further the term reaches.[97]

Conversely, the meaning of the term QBE is clear but may need some rethinking. As described above, the CFTC now regulates many different kinds of markets (DCMs, derivatives transaction execution facilities, exempt boards of trade, and exempt commercial markets, as well as DCOs), and new ones are likely to appear once the legislation now pending in Congress becomes law.[98] As a policy matter, it is undesirable to treat contracts traded on a DCM as (possible) section 1256 contracts and to treat identical contracts traded on swap execution facility or another type of regulated market as nonsection 1256 contracts. The IRS can address this problem by determining that these other markets should be treated as QBEs, but that decision would be better made by Congress.

Returning to an analysis of the type of contracts on the list above, one could conclude that cleared agricultural swaps should be treated as section 1256 contracts in light of (1) their close economic connection to futures contracts, (2) the fact that they essentially do not exist before being cleared, and (3) the technical point that they are subject to the rules of an exchange because the legal entity that is the CME is both an exchange and a clearinghouse. The last fact becomes considerably less attractive, however, when one considers that it also applies to CME-cleared CDSs. Surely CME-cleared CDSs could not be section 1256 contracts when ICE Trust-cleared CDSs are not. At least it would not be so in a rational world.

Despairing of any technical conclusion to this question, the report turns below to an examination of the history of section 1256. That history is far more illuminating than the statute itself. As discussed in more detail below, its teaching is that the government has consistently respected congressional intent when it enacted each of the statutory provisions despite flaws in the statutory drafting. Before doing so, however, the report briefly considers one other type of section 1256 contract.

2. How should options be treated? As described earlier, the bills pending in Congress apply to "swaps," which are defined to exclude certain types of options. It is not clear, however, whether the distinctions made for regulatory purposes will match those made for tax purposes. As it appears possible that an instrument treated as an option for tax purposes might constitute a "swap," this section of the report considers the application of section 1256 to such an instrument.

Options are one of the fundamental types of contracts traded in the OTC derivatives market. Once those options migrate to an exchange, it would be necessary to consider whether the contract could qualify as a nonequity option that is a section 1256 contract (or, in the case of dealers, a "dealer equity option"). A "nonequity option" is defined as "any listed option which is not an equity option."[99] A "listed option" means any option, other than a warrant, that is "traded on (or subject to the rules of)" a QBE.[100] An equity option means any option to buy or sell stock, or certain other stock-linked options. The term "option" for this purpose presumably means an instrument that is taxed as an option rather than one that is regulated as an option, although that is not clear. This discussion assumes that the term "option" for section 1256 purposes refers to that term for tax purposes.

As described in the introduction to this report, a CDS could be characterized as an option or a series of options. A nontrivial number of taxpayers maintain that option treatment is appropriate under current law.[101]

An option or CDS that is traded at a future date on an approved exchange will qualify as listed. CDS and many other options would not be equity options. A CDS that is cleared under current market practice may or may not satisfy the "subject to" language in the definition of listed, depending on the meaning of that language. Accordingly, for traded options and possibly for cleared CDSs, the critical question is again whether the statutory language is to be read literally, or whether it should be understood to imply a gloss on its meaning that would narrow it to exclude such options or CDSs.

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[97]The pending legislation does not seem destined to clarify this issue. In the Lincoln-Dodd compromise bill, for example, the section that imposes the mandatory clearing and trading requirements (section 723) does not use the term "traded on or subject to the rules of." The closest it comes is the phrase "entered into on, or subject to the rules of, a [designated contract market]," which is used in a rule banning all swaps other than those satisfying certain requirements. Lincoln-Dodd compromise bill, section 723(a)(2). The phrase or very close variants of it are used in several other places in the bill, but not ones bearing directly on the issues discussed herein. *See* Lincoln-Dodd compromise bill, section 210(c)(8)(D)(iii)(IV) (definition of "commodity contract"), section 730 (modifying large swap trader reporting requirements under Commodity Exchange Act); section 737 (modifying position limits under Commodity Exchange Act).

[98]*See supra* note 41.

[99]Section 1256(g)(3).

[100]Section 1256(g)(5).

[101]*See, e.g.*, Liss, *supra* note 2; the 2008 annual report for Primus Guaranty Ltd., a "credit derivatives product company," stating on page 16 that "we have determined that the credit swaps sold by Primus Financial are best treated as the sale of options for U.S. federal income tax purposes."

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Having thus established (hopefully) the need to look beyond the bare statutory language to determine whether a traded or cleared swap constitutes a section 1256 contract, Part III.C next turns to a discussion of the history of section 1256 and the government's interpretation of the section 1256 definitions.

C. A Discourse on the History of Section 1256

As it happens, whether the statutory definitions mean what they appear to say has been the subject of repeated inquiry. Strikingly, the government's answer has consistently — with one apparent and temporary oversight to the contrary — been no. As described below, the government has interpreted the statutory definitions in light of congressional intent, with the result that they have been read to apply more narrowly than a literal reading would suggest. The one court that has reviewed an issue of this kind has heartily endorsed this narrow approach.

1. The 1983 controversy over the scope of the RFC definition.[102] As described above, when enacted in 1981 and as amended in 1982, section 1256 applied only to RFCs. After the 1982 amendment, section 1256 applied to an RFC, defined as a contract that was subject to mark-to-market margin requirements and was traded on or subject to the rules of a DCM or other QBE.

New contracts then began to trade that raised both technical and policy questions about the scope of section 1256, including cash-settled options such as options on a stock index, options on stock index futures contracts, and commodity options. As described in more detail below, Congress revised section 1256 in 1984 to address those issues. Among the important goals of the amendments was to ensure that similar products that traded on different kinds of exchanges (stock index options versus stock index futures options) were subject to the same rules, and to avoid the proliferation of mixed straddles (transactions in which one position is a section 1256 contract and an offsetting position is not). Before those amendments were passed, a vigorous debate took place regarding how the law applied to these new contracts and how it should apply.

The part of the debate most relevant here concerned whether commodity options constituted RFCs under existing law. A commodity option is a contract under which the writer grants the holder the right to enter into a futures contract to buy (or sell) a designated commodity for future delivery at the strike price during the option period. If the option is exercised, the purchaser of a call commodity option enters into a long RFC (an RFC to buy a commodity), and the writer of that option enters into the corresponding short RFC (an RFC to sell the commodity). The purchaser and writer of a put commodity option correspondingly enter into a short or long RFC, respectively, on exercise. Like other options, a commodity option may also expire unexercised.

Commodity options were traded on CFTC-regulated exchanges and thus satisfied the second clause in the definition of RFC. Their margin arrangements were more complicated. The grantor of a commodity option must post "good faith" margin, a fixed amount negotiated at the outset, and "premium" margin, an amount equal to the current premium for the margin, marked to market daily. The purchaser of the option is not required to deposit additional funds during the life of the contract. Also, the purchaser is not entitled to receive collateral posted by the grantor during the life of the contract, regardless of any variation in the value of the contract. Rather, the collateral remains the property of the grantor, who is entitled to a return on the collateral. Thus, the commodity option margin system resembled in some respects the mark-to-market system for futures contracts insofar as grantors of options are concerned, but not insofar as purchasers of options are concerned. So it was possible that written commodity options were RFCs but purchased commodity options were not.

The New York Coffee, Sugar and Cocoa Exchange Inc. (CSCE), a commodity exchange, maintained that commodity options should be taxed like the futures contracts that underlie those options. The CSCE argued that the commodity option margin system for option writers was a system of marking to market that fell within the definition of a mark-to-market system for RFCs. The CSCE conceded that purchased commodity options were not subject to such a mark-to-market system and were not RFCs, but argued that gain or loss on commodity options held by a taxpayer nevertheless should be subject to 60/40 treatment.[103]

Treasury disagreed. In testimony submitted for a hearing before the House Ways and Means Committee, Treasury Assistant Secretary for Tax Policy John Chapoton said, "In our view, commodity options are taxed under the same rules that apply to physical options." He then summarized the arguments made by the commodities exchanges and said, "Irrespective of policy considerations that may favor this result, we believe that this interpretation of current law cannot be sustained under

[102]For a contemporary description of the issues and the various proposals made to resolve them, see James W. Wetzler, "The Tax Treatment of Securities Transactions Under the Tax Reform Act of 1984," *Tax Notes*, Oct. 29, 1984, p. 453; *see also* Kramer, *supra* note 41, at para. 62.03[C] (describing the positions taken by different groups of taxpayers).

[103]The CSCE argued that under the general option rules of section 1234, gain or loss from the sale or exchange of an option has the same "character" as the property underlying the option (RFCs), and that because section 1256 determined the character — technically, the holding period — of gain or loss on futures contracts (as 60 percent long-term and 40 percent short-term capital gain or loss), the character of gain or loss on purchased commodity options should also be governed by section 1256. These arguments were made in a May 1982 ruling request to the IRS and in a September 1982 memorandum to Treasury, copies of which became part of the legislative history of the 1984 amendments to section 1256. Letter and supporting memorandum on the tax treatment of options on commodity futures contracts, from Donald Schapiro on behalf of the Coffee, Sugar and Cocoa Exchange to John Chapoton, Treasury assistant secretary (Sept. 29, 1982), *Doc 82-9883*. Several securities exchanges submitted memorandums criticizing those arguments and making alternative proposals.

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the present statute."[104] Unfortunately, the basis for Treasury's conclusion was not explained.

The JCT prepared a pamphlet for the same hearing that discusses the parties' various positions. It states that "the staff does not believe that [the treatment of written commodity options as RFCs] was intended by Congress in 1981." It also expresses similar concerns about the argument that purchased commodity options were entitled to 60/40 treatment.[105]

As this history indicates, it was clearly Treasury's position, and it appears to have been the JCT's position, that despite the broad definition of RFCs, all commodity options were subject to the rules applicable to conventional options. Thus, Treasury rejected the conclusion that a contract (option) traded on a QBE that required parties (writers) to that contract to provide daily margin if the contract lost value and to receive it back if the contract gained value constituted an RFC. Moreover, Treasury reached this conclusion as a technical matter under then-current law.

Possible bases for Treasury's position may include: (1) the 1981 legislation clearly did not contemplate options; (2) the daily margin rules applicable to writers of commodity options did not result in the passing through of that margin to option purchasers and could never give rise to the net receipt of margin by the option writer, and so was not the type of mark-to-market system contemplated by Congress in 1981; or (3) the argument made by the commodities exchanges strained credibility because it treated commodity options as RFCs for option writers but not for option purchasers. Treasury was also concerned about the potential for arbitrage under then-current law because of the uncertainty about how commodity options should be treated, and it wanted to ensure that commodity options were subject to the same rules as RFCs to avoid future arbitrage. Treasury's discussion of arbitrage concerns is separate from its discussion of technical issues, however, which is consistent with the quote above stating that it considered the policy issues separately from its technical analysis.

2. History of 'foreign currency contracts.' While not directly relevant to the scope of the RFC definition, the government's position on the scope of the definition of another type of section 1256 contract, foreign currency contracts, is also instructive. Foreign currency contracts were added to section 1256 in 1982. A foreign currency contract is defined as:

> a contract
>
> (A) which requires delivery of [, or the settlement of which depends on the value of,] a foreign currency which is a currency in which positions are also traded through regulated futures contracts,
>
> (B) which is traded in the interbank market, and
>
> (C) which is entered into at arm's length at a price determined by reference to the price in the interbank market.[106]

The legislative history makes clear that the reason for adding this new class of contract subject to section 1256 was that some taxpayers were trading in both foreign currency futures and foreign currency forward contracts with banks on the same currencies. The amendment was intended to eliminate mismatches in timing and character for taxpayers trading in both markets — that is, to avoid mixed straddles.[107]

In 1988 the IRS issued LTR 8818010, which concluded that a currency swap on a currency traded through the futures market did not fall within the definition of foreign currency contract. The letter ruling first concluded that the swap satisfied the requirement of clause (A) cited above. The letter ruling then turned to the legislative history of the 1982 amendment and said that Congress intended to bring bank OTC forward contracts within the scope of section 1256 because "they are economically comparable to and used interchangeably with" RFCs. The letter ruling went on to conclude that currency swaps do not meet that standard, because they account for interest rate differentials through current and continuing exchanges of payments rather than through a single payment at maturity. The letter ruling also noted that Congress in 1982 and in later amendments to section 1256 did not refer to currency swaps. On that basis, the letter ruling concluded that the swap failed to satisfy the requirements of clauses (B) and (C) and that it therefore did not constitute a foreign currency contract.

This conclusion is remarkable as a technical matter. Currency swaps are entered into between banks in the interbank market and thus are priced by reference to interbank market prices, which is what clauses (B) and (C) require on their face. LTR 8818010 simply determined that those clauses must be read in light of the legislative history of the term "foreign currency contract," and that Congress's purpose for, and its silence on, currency swaps (for which no market existed in 1981) properly lead to the conclusion that those swaps are outside the scope of section 1256. Perhaps one way to restate the analysis in the letter ruling is that it effectively read the statutory language "a contract" to mean a bank forward contract.

Many practitioners believed that the conclusion in the letter ruling was correct and that its reasoning could be extended to support the further conclusion that foreign currency options traded in the OTC market also did not constitute section 1256 contracts even though they too are traded between banks in the interbank market and priced

[104]"Federal Tax Treatment of Capital Gains and Losses," Ways and Means Committee hearing, 98th Cong. 1st Sess. 31, 32 (Serial 98-53, Nov. 2, 1983).

[105]JCT, "Taxation of Capital Gains and Losses," 23 (Nov. 1, 1983), JCS-52-83.

[106]This definition, as amended in 1984, is now found in section 1256(g)(2). The bracketed language was added in 1984, as discussed in more detail below.

[107]*See* Technical Corrections Act of 1982, S. Rep. No. 592, 97th Cong. 2d Sess. 25-28 (Sept. 27, 1982); H.R. Conf. Rep. No. 986, 97th Cong. 2d Sess. 24-26 (Dec. 21, 1982).

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by reference to interbank market prices. The government addressed that question first in Notice 2003-81 and later in Notice 2007-71.[108]

Notice 2003-81 designated some transactions in which taxpayers took offsetting positions in foreign currency options as listed transactions. A key part of the transactions' intended operation was that some of the options were on currencies traded through RFCs and were treated by the taxpayers as foreign currency contracts, and some were on currencies not traded through RFCs and thus clearly were not foreign currency contracts. The notice stated as fact that the OTC foreign currency options on RFC-traded currencies constitute foreign currency contracts. The notice contains no analysis of the issue, and it appears likely that its drafters did not realize the significance of that statement.[109]

A mild uproar ensued, as practitioners questioned this offhand conclusion.[110] In 2007 the IRS reversed its position and in Notice 2007-71, which modified Notice 2003-81, described the earlier notice's statement about foreign currency options as a mistake. Notice 2007-71 said that the IRS and Treasury did not believe a foreign currency option on a currency traded although RFCs fall within the definition of foreign currency contract and that they will challenge taxpayers who take that position.

The notice's technical reasoning is tortuous. The analysis begins by referring to the definition of the term as enacted in 1982, at which time clause (A) quoted above stated that a foreign currency contract "requires delivery of" an RFC-traded currency — that is, there was no reference to cash settlement. The notice then says that an option does not "require" delivery of anything, because of the possibility that the option might not be exercised. This is an interesting point of view, because an option does create legally binding obligations on the writer, even though the writer might not have to perform on exercise. A hypertechnical reader might wonder whether under this analysis, a call (but not a put) option becomes a section 1256 contract on exercise, because at that point the obligation to deliver foreign currency ceases to be contingent.

In any event, the notice goes on to address the 1984 amendment to the definition that modifies the delivery requirement by adding the language "or the settlement of which depends on the value of," as shown above. The legislative history makes clear that this amendment was intended to bring cash-settled OTC foreign currency forwards on RFC-traded currencies within the scope of section 1256. The notice says that there is no indication in the legislative history — again reasoning by reference to silence — that this amendment also was intended to broaden the scope of foreign currency contract to foreign currency options.[111] Finally, the notice cites the legislative history of specific 1986 amendments to section 988 — which is not technically the legislative history to a 1982 amendment to section 1256 — as confirmation of Congress's understanding of the definition as not covering foreign currency options.

In short, the notice also effectively reads the statutory definition as applying to a bank forward contract, despite the apparently broad scope of the statutory definition of foreign currency contract. The notice thus demonstrates the crucial nature of legislative history and congressional intent in the government's interpretation of the scope of section 1256.

The conclusion reached in the Notice has recently been adopted by the Tax Court in *Mark D. Summit*, 134 T.C. No. 12 (May 20, 2010). In a remarkable feat of vision, the court reaches its conclusion based on the plain meaning of the statute, and consults legislative history only to confirm its conclusion. The "plain meaning" in this case includes the statutory changes made to the definition, thus suggesting that a similar historical view is appropriate with respect to regulated futures contracts. The case helpfully also states that "when Congress has specified the types of contracts that come within the definition of a section 1256 contract, exclusion of others from its operation may be inferred."[112] *Summit* thus provides at least moral support for the narrow interpretation of section 1256 that this report advocates.

3. Other IRS guidance on the scope of the RFC definition. There are a few guidance items addressing the scope of section 1256's definitional provisions. To the extent one can extract something from them, they too suggest that the IRS has interpreted that definition by starting with a sensible conclusion and working backward to find support in the statutory language.

The only published guidance on the scope of the RFC definition is Rev. Rul. 87-43, which as briefly described above considers whether futures or option contracts established under the mutual offset system between the CME and a foreign exchange then known as SIMEX are considered "traded on or subject to the rules of" a QBE.[113] The ruling concludes that contracts executed on

[108]Notice 2003-81, 2003-2 C.B. 1223, *Doc 2003- 25811, 2003 TNT 234-4*; Notice 2007-71, 2007-2 C.B. 472, *Doc 2007-18700, 2007 TNT 156-2*.

[109]The IRS had taken the opposite position in FSA 200025020 (Mar. 17, 2000), *Doc 2000-17350, 2000 TNT 123-74*, reasoning that Congress intended to extend section 1256 treatment only to foreign currency forward contracts, and noting that the legislative history to the 1984 amendments to the nonequity option rules states that only "certain" foreign currency contracts are treated as RFCs. The field service advice also notes that reading "foreign currency contract" broadly to include foreign currency options would effectively override the limitations of section 1256(g)(3) and (g)(4), dealing with options listed on a QBE.

Field service advice officially have no authoritative weight, and the chief counsel's office has stopped issuing them.

[110]*See* Michael J. Feder, L.G. "Chip" Harter, and Daniel H. Shapiro, "Notice 2003-81: Are OTC Currency Options Section 1256 Contracts?" *Tax Notes*, Dec. 22, 2003, p. 1470, *Doc 2003-26876*, or *2003 TNT 246-33*.

[111]*See* Tax Reform Act of 1984, H.R. Rep. No. 432, 98th Cong. 2d Sess. 1646 (Mar. 5, 1984). The notice could also have stated that this change was a technical amendment.

[112]*See Mark D. Summit*, 134 T.C. No. 12 (May 20, 2010), at pages 28-29.

[113]Rev. Rul. 87-43, 1987-1 C.B. 252. The options were "nonequity options" of a kind subject to section 1256(g)(3) and (g)(5) if traded on the CME. Section 1256(g)(3) and (g)(5) provide that any option, other than a right to acquire stock from an issuer,

(Footnote continued on next page.)

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one exchange and transferred to the other should be analyzed by reference to the second exchange. Thus, futures contracts executed on SIMEX and transferred to the CME constitute RFCs, and futures contracts executed on the CME and transferred to SIMEX do not.

The ruling is based on the step transaction doctrine. Because a customer wishing to enter into a futures contract that ultimately will be a CME futures contract originally contacts a CME clearing member, the ruling concludes that since the first step in the transaction and the end result are the same as for a contract executed on the CME, the intervening steps should be ignored. The ruling suggests that the basis for this conclusion is that the futures contract is subject to the rules of the CME as if it had originally been executed on the CME because that is how the contract is described in the facts. But the analysis portion of the ruling does not make clear whether the futures contract is deemed traded on the CME even though it is actually executed on SIMEX, or whether the ruling relies on the "subject to the rules of" part of the regulated futures contract definition.

The ruling says that in determining whether the "traded on or subject to" condition is satisfied, "it is necessary to ascertain the legal relationships that exist between the parties to the transaction." That statement seems reasonable. The ruling goes on, however, to describe "the parties" in a way that does not shed much light on larger issues.

Key in the ruling's reasoning is a statement that in a conventional CME futures contract transaction, the fact that an exchange clearinghouse is interposed between the original parties to the transaction should be ignored because "the legal relationship between the investor and the broker remains unchanged." The meaning of this statement is unclear, particularly given that the interposition of the clearinghouse between the clearing members has significant real-world consequences. It is also unclear why the statement focuses on the relationship between the investor and the clearing member, because generally the investor is treated for tax purposes as if it had directly entered into the futures contract on the exchange rather than as entering into an independent contract with the clearing member or the clearinghouse.[114] By analogy, it would be unusual to give controlling weight to the taxpayer's relationship with its broker if one were analyzing the effects of a purchase of exchange-traded stock, except in rare circumstances.

The statement could simply be intended to convey that for tax purposes, the preclearing and postclearing arrangements should not be treated as two separate contracts and that the preclearing contract should instead be viewed as a temporary state of affairs that has no independent significance in analyzing the overall transaction.[115] However, the ruling seems to view the original parties to the transaction as the two clearing members, which would suggest the reverse, namely that it is the first step rather than the ultimate result that determines whether the transaction is within the scope of section 1256. Again, it is hard to square treating the clearinghouse members as the true parties to the transaction with the tax law's treatment of the investor as the party that enters into the futures contract.

Like other section 1256 rulings, therefore, the ruling appears to reach the right result through technical reasoning that does not provide a basis for drawing conclusions regarding other types of contracts or transactions. The best explanation of the ruling's conclusion may simply be that it makes sense to treat all CME futures contracts the same way regardless of whether they were executed on or off the CME, which is a less formal way of expressing the step transaction doctrine.

A field service advice issued in 2000 discusses the meaning of the terms "regulated futures contract" and "foreign currency contract."[116] Unfortunately, it does not describe the transactions carried out by the taxpayer, except to say that they were foreign currency contracts in the colloquial sense. The field service advice also appears to use the term "futures contract" to include what many people would refer to as a forward contract, which does not add to its clarity. In any event, the field service advice appears to maintain that only a futures contract can qualify as an RFC and that a futures contract must be subject to CFTC regulation to qualify as an RFC.

Another 2000 field service advice analyzes whether OTC foreign currency futures, forwards, and options constitute RFCs, and it concludes that they do not.[117] Although that is hardly a surprising result, the field service advice's analysis is of interest because it turns on the meaning of the "on or subject to" language in the RFC and nonequity option definitions. The field service advice interprets the statutory definition to mean that a contract must be (1) traded on an exchange, apparently testing this at the instant when the contract is executed; or (2) traded in a manner that causes the contract to be subject to the rules of the exchange on an ongoing basis,

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that is traded on or subject to the rules of a QBE is a section 1256 contract as long as it is not an equity option (generally, a single-stock option or an option on a narrow-based stock index).

[114]Every other reference to a clearinghouse that I am aware of treats the clearinghouse as a mere intermediary or guarantor. *See* Rev. Rul. 85-158, 1958-2 C.B. 175 (clearing corporation guarantees payment); LTR 8811053 (clearing organization plays role of intermediary), LTR 8718008 (refers to Options Clearing Corporation as guaranteeing options, and treats stock index options as having no issuer), LTR 8328005 (assumes that clearinghouse links buyers and sellers); GCM 37233 (Aug. 25, 1977) (treats clearing organization as merely a mechanism to link buyers and sellers, and not as a real party to a cleared listed option); *cf.* reg. section 1.6045-1(b), Example 2, generally excluding clearinghouses from treatment as a broker. It is also my understanding that clearinghouses do not treat themselves for purposes of filing their own tax returns as parties to the transactions they clear.

[115]A private letter ruling issued in the same time frame analyzing the same transactions adds this gloss, stating that the steps involved in the typical exchange clearing process are not analyzed separately but are viewed as parts of a single transaction. LTR 8739051 (June 30, 1987).

[116]FSA 200025020, *supra* note 109.

[117]FSA 200041006 (June 23, 2000), *Doc 2000-26366, 2000 TNT 200-24.*

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identifying the required use of a clearinghouse and the required use of mark-to-market as evidence of the "continuing nature of [the] relationship between the commodity futures contract that was, at one time, traded on the exchange, and the exchange."

It isn't surprising that this analysis is based on legislative history. The field service advice takes as its premise that Congress "created section 1256 based on the actual operation of the futures markets," and then cites a sentence in a JCT report that futures contracts are "subject to the rules" and regulations of the exchange where they are traded. The IRS's position thus appears to be that only futures contracts traded on an exchange can be RFCs.

If that continued to be the IRS's position, CDSs that were cleared but not exchange-traded would not be treated as section 1256 contracts. This technical analysis does not fully address the issues at hand, however, because the IRS has never had to consider a contract that is not traded on an exchange but that might still be considered subject to an exchange's rules. Indeed, the field service advice's emphasis on *clearing* as satisfying the requirement that a contract be subject to the rules of an *exchange* could point toward a conclusion that CME-cleared CDSs are subject to the rules of an exchange. The more significant lesson from the field service advice seems to be that the IRS will faithfully adhere to what it sees as congressional intent in enacting section 1256.

In summary, while there is no guidance on point, in the almost 30 years that section 1256 has existed, it has always been interpreted in a manner intended to bring within its scope only those instruments that Congress specifically identified in the legislative history. As noted by the Tax Court in *Summit*, Congress has implicitly approved this approach by leaving the definition of RFC unchanged and adding more categories of section 1256 contracts as it thought proper. Congress has also made clear that it considers it bad tax policy to create or permit a tax regime in which some contracts are subject to section 1256 while other very similar contracts are not (such as cleared/traded swaps versus bilateral OTC-only swaps with standardized terms). Extending that approach here would give rise to a simple conclusion, namely that neither cleared swaps nor exchange- traded swaps constitute section 1256 contracts, until and unless Congress speaks to the contrary.

IV. Initial Payments

Part IV now turns to the other principal issue that is the subject of this report — the possibility that the upfront payment on a swap such as a CDS that results from coupon payments at the standardized level rather than the market-quoted level might be treated as a loan for U.S. federal income tax purposes, with the result that payments of interest are deemed to be made between the parties. Myriad issues must be resolved before one could determine whether such a loan arises, and if so, how much interest is deemed paid. The purpose of this part is to establish that given the many uncertainties about whether a deemed loan arises under current law and if so, what its terms are, it would be an appropriate exercise of discretion on the part of the government to announce that except in cases of abuse or cases that clearly fall within existing law, it will not require taxpayers to treat an upfront payment on a swap as a deemed loan until guidance is issued that resolves these uncertainties.

In the case of most swaps, it is clear that a significant upfront payment will give rise to a deemed loan. The applicable regulations do not, however, clearly delineate when an upfront payment will be treated as significant, which will become a critical issue if non-CDS swaps are routinely traded with upfront payments.[118] Also, as discussed below, deemed loan treatment raises potential section 956 issues. To date these issues have not been problematic because it was rare for an upfront payment on a swap to be paid, or if so, for it to breach the "significance" threshold, whatever that may be. Consequently, taxpayers have not developed the internal systems that would be necessary to monitor whether a deemed loan arises and instead have dealt with the issue on a case-by-case basis. Building the systems to deal with the issue on an automatic basis is complicated by the fact that the deemed loan rules apply only to NPCs, and not to instruments characterized for tax — but not necessarily business or documentation — purposes as options, forwards or other non-NPC derivatives. As described below, additional complications arise when dealing with a cleared swap that also raise questions about how to apply current law.

As described above, a deemed loan would arise under a CDS only if (1) it is characterized for U.S. federal income tax purposes as an NPC, which is uncertain; (2) assuming that the CDS is an NPC, that it is characterized as a swap rather than a cap or floor, which is a likely outcome for a single-name CDS; and (3) the upfront payment was treated as real for tax purposes and as "significant." In Notice 2004-52, the IRS described five possible ways of analyzing CDSs, including analogies to four types of financial instruments. It concludes by saying that the economic similarity of a CDS to various financial transactions tends to blur the distinctions between possible analogies, and by requesting additional information about CDSs. Thus, the only official statement from the government on CDSs effectively acknowledges that there are many possible ways to categorize a CDS and takes no position on which is correct. Subsequent unofficial statements by IRS and Treasury officials have been no more definitive. One could therefore stop here on the theory that it is premature to discuss the deemed loan issue for CDSs until guidance is provided that treats CDSs as NPCs.

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[118]In Example 5 of Treasury regulation section 1.446-3(f)(4), an upfront payment equal on a present value basis to 10 percent of the at-the-money fixed rate payments on an interest rate swap (or equivalently, the actual fixed payments plus or minus the upfront payment) is not treated as "significant." In Example 3 of Treasury regulation section 1.446-3(g)(6), an upfront payment equal on a present value basis to 40 percent of the at-the-money fixed rate payments on an interest rate swap (or equivalently, the actual fixed payments plus or minus the upfront payment) is treated as "significant." The gap between 10 percent and 40 percent is wide.

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While the government has the luxury of biding its time, taxpayers must file annual tax returns. For taxpayers that treat CDSs as NPCs, the question whether they have current obligations to report and withhold on interest is not abstract. Deemed loan/interest treatment implicates information reporting rules; withholding tax rules; a variety of rules dealing with interest expense, such as the foreign tax credit rules, reg. section 1.882-5, addressing the allocations of interest expense by foreign banks and other foreign persons doing business in the United States in branch form, and the unrelated business taxable income rules for tax-exempt organizations; the section 475 prohibition on marking one's own debt to market; and, for some taxpayers that enter into standardized CDSs with their affiliates, section 956. The discussion below therefore assumes that a CDS is properly treated as an NPC and that except when specifically addressed, the upfront payment, if respected as such, meets the standard for being a *significant* nonperiodic payment.

A. Is There a Payment?

First we should consider whether, as a matter of economic substance, the upfront payment is a payment at all for U.S. federal income tax purposes. Although this report does not attempt to assess how the *Danielson* doctrine would apply, this question may not be determinative because taxpayers may be held to their form if it is adverse to them. But even if taxpayers are held to their form here, the question is still worth asking, because it may affect the equities involved in how the government approaches the technical questions discussed below, and because it also is relevant to the section 956 issue mentioned above. That the form in this case has not been chosen by taxpayers in the usual sense, but is the result of guidance (albeit nonbinding) from regulators, also may affect the equities. And once clearing is required by law, the equities appear to me to shift towards allowing taxpayers a reasonable period of time to adjust to the tax consequences that follow.

As described in Part II.C, an upfront payment on a CDS due from Party A to Party B is immediately and automatically reversed as a cash flow matter by a transfer of cash variation margin in the same or a similar amount from Party B to Party A. This is not the result of some tax-driven structured arrangement or the result of combining two unrelated or loosely related transactions. Rather, it is inherent in the economics of the transaction and in the fundamentals of the structure developed by the industry in response to regulatory imperatives in order to reduce and manage risk. The amounts are the same because one is intended to offset the other as a credit risk matter. In other contexts, one would not doubt that a circular flow of cash, envisioned by the parties and required by the legal documents, would be ignored for U.S. federal income tax purposes even if it were respected for some other purposes such as a foreign tax regime.

This is not a typical (if there is such a thing) circular flow of cash, however. The initial variation margin is a posting of collateral, which ordinarily is not treated as a contractual payment. Rather, it is a temporary transfer of assets from one party to another that is provided solely for credit support reasons and is expected to be reversed during the course of the transaction. It is economically a loan. Thus, if one treated an upfront payment as giving rise to a deemed loan from Party A to Party B, and the variation margin as a loan in an equivalent amount from Party B to Party A, the question would be whether, in the absence of abuse, those offsetting loans between the same parties, made at the same time and as integral parts of the same transaction, should be respected as such or should be netted against each other. Another way to put the question is whether a 100 percent cash-collateralized loan gives rise to indebtedness for U.S. federal income tax purposes, given that there has been no extension of credit.

One relevant consideration might be that if the two flows of cash were disregarded, the swap would in the first instance appear to be off-market. For example, if the market-quoted level for a CDS is 175 basis points, the standardized coupon level is 100 basis points, and Party A consequently pays a $335,000 upfront payment to Party B and receives initial variation margin from Party B in the same amount, disregarding the two cash flows of $335,000 and leaving a CDS whose terms provide for coupon payments of 100 basis points. However, that swap is only apparently off-market, because there is another cash flow that has not yet been taken into account. The variation margin provided by Party B will be marked to market daily, and if no credit event materializes, it will be paid back to Party B over time. Economically, this would seem to be the equivalent of a coupon that is partly fixed and partly floating, with the floating amount determined by reference to changes in the value of the CDS. This would be an unusual animal, but using objective financial information to determine the amount of a periodic swap payment is not new.[119]

The argument that the upfront payment should be netted to zero or something close to it is particularly compelling when one considers the possible application of section 956. In the example above, if one assumes that Party A is a controlled foreign corporation and Party B is its U.S. parent, it can hardly be argued that CFC has made any net assets available to Parent.

Section 956 generally provides that an investment in U.S. property by a CFC may give rise to an inclusion by its U.S. shareholder under subpart F if the CFC has earnings and profits that have not yet been included in the shareholder's income. U.S. property for this purpose generally includes any obligation of a U.S. person, with exceptions for obligations of unrelated parties. Less technically, section 956 gives rise to a potential deemed dividend from a CFC if the CFC lends money, or is deemed to make a loan, to a related U.S. person.

Section 956 expressly provides two exceptions for transactions in which it is customary to provide collateral. Section 956(c)(2)(J) provides that U.S. property does not include an obligation of a U.S. person to the extent

[119]*See* reg. section 1.446-3(c)(4)(ii) (defining objective financial information as any current, objectively determinable financial or economic information that is not within the control of any of the parties to the contract and is not unique to one of the parties' circumstances).

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that the principal amount of the obligation does not exceed the FMV of readily marketable securities posted or received as collateral for the obligation in the ordinary course of its business by a U.S. or foreign person that is a dealer in securities. Thus, if Parent provided variation margin in the form of readily marketable securities with a value of $335,000 and CFC was a CDS dealer, there would be no U.S. property for section 956 purposes. (In the typical case in which the section 956 issue arises, both Parent and CFC will be swap dealers.) A rational tax regime would not provide a worse result if the variation margin is in a form — cash — that completely offsets the obligation in the first place.

Now let us reverse the facts and assume that Parent makes a $335,000 upfront payment to CFC, and on the same day CFC provides $335,000 variation margin to Parent. Section 956(c)(2)(I) provides that U.S. property does not include "deposits of cash made or received on commercial terms in the ordinary course of a United States or foreign person's business as a dealer in securities . . . but only to the extent that such deposits are made or received as collateral or margin for (i) a . . . notional principal contract [or] options contract." It should be clear in this case, regardless of the netting argument, that there is no U.S. property.

The remainder of the discussion below assumes that even if an upfront payment is not treated as an obligation of a U.S. person for section 956 purposes, it is treated in accordance with its form for other purposes.

B. Is There a Loan?

The general rule for taking nonperiodic payments under an NPC into account is as follows:

> All taxpayers . . . must recognize the ratable daily portion of a nonperiodic payment for the taxable year to which that portion relates. Generally, a nonperiodic payment must be recognized over the term of a notional principal contract *in a manner that reflects the economic substance of the contract.*[120]

The remainder of this section of the regulation elaborates on the government's view as to what amortization methods reflect the economic substance of an NPC. As described above, for a swap, the general (but often unused) rule is that the nonperiodic payment is allocated in accordance with forward rates, and taxpayers other than dealers in NPCs can elect to allocate it instead under a level payment method. If the nonperiodic payment is "significant," the taxpayer must use a level payment method to determine the periodic amounts of deemed principal and deemed interest.

Note that these regulations have been issued under section 446, a method of accounting rule. Its function is to ensure that taxpayers take income and expense into account in a manner that clearly reflects their income. These are timing rules, not characterization rules. Does the IRS have the authority as a statutory matter to characterize a payment under an NPC as debt under section 446 (as opposed, say, to section 7701(*l*) or other antiabuse powers)?[121] Assuming that the answer is yes in the conventional case when the separately stated upfront payment and (deemed) repayments would constitute debt under the common law, does that power extend to a case in which it is highly doubtful or at best uncertain that the payment flows would constitute debt? (See below for more on this.)

Another way to ask this question is to reexamine the implications of the general rule that an upfront payment on an NPC must be taken into account in accordance with its economic substance. As discussed above, there is no extension of credit to the extent that the upfront payment is matched by the transfer of initial variation margin in an equivalent amount, and the motive for the payment and margin transfer is regulatory and credit-driven rather than tax avoidance, so the economic substance here cannot plausibly be considered indebtedness for tax purposes.

One might also ask whether any specific rule regarding the amortization of nonperiodic payments should be read in a manner that is consistent with the general economic substance rule in the regulations. Turning back to the three examples described in Part II.C. above, each involved a CDS in which market-quoted level differed by

[120]Reg. section 1.446-3(f)(2)(i) (emphasis added).

[121]The recent decision in *Schering-Plough v. United States*, 651 F. Supp.2d 219 (D.N.J. 2009), *Doc 2009-19512, 2009 TNT 167-3*, might be relevant to this question. In *Schering-Plough*, a U.S. taxpayer tried to repatriate cash from a foreign subsidiary without triggering immediate dividend treatment under section 956, through a structured swap transaction in which the taxpayer first entered into an interest rate swap with a bank and then assigned one leg of the swap to the subsidiary. As a result of the assignment, the subsidiary was then obligated to pay variable amounts (the floating leg of the swap) to the parent. The taxpayer maintained that the transaction constituted the sale of the swap leg to the subsidiary, and under the timing rules then applicable to NPCs the lump sum payment it received from the subsidiary was a nonperiodic NPC payment that should be included over time. The IRS argued that the transaction constituted a loan. The IRS prevailed.

The case can be distinguished on many grounds. One significant distinction is that the question in the case was how to characterize a series of actual cash flows, rather than whether a nonexistent series of cash flows could be deemed to exist. Moreover, *Schering-Plough* was decided as an economic substance case in the first instance — Was the transaction a loan versus a sale? Were the transactions shams? — and only secondarily as a case about whether the NPC timing rules (which in those days did not deem loans to exist) could affect a recharacterization of the transaction. That question was answered — in the negative — on the grounds that applying the NPC timing rules to this transaction would undermine the congressional intent in enacting section 956. For the reasons discussed in Part IV.A above, it would be ironic to conclude that the case stands for the proposition that the current NPC timing rules can cause section 956 to apply to a transaction that does not give rise to repatriation issues of the kind section 956 is intended to address. In any event, while the case certainly stands for the proposition that the IRS has the power under common law to recharacterize a transfer to cash to a related party in a tax-motivated transaction in which it is expected that the cash will be repaid, and is repaid, as a loan, it should have no general application to a transaction whose economic substance is not that of indebtedness, as argued in the text.

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75 basis points from the standardized coupon. However, the upfront payment on each of them was a different amount, because the market does not assume an equal likelihood that the notional stream of 75 basis points would be made for the entire tenor of the CDS. It is difficult to conclude, therefore, that each of those three different upfront payments should be treated as the equivalent of an annuity or installment loan consisting of a stream of 75 basis points to maturity.

That is not to say that the government has no power to write rules requiring exactly that. Those rules presumably would be issued over the usual measured time frame, first in proposed form and then in final form with a delayed effective date to allow taxpayers to modify their computer systems and get their paperwork in order. That is very different, however, from whether current law *requires* such an approach.

C. If There Is a Loan, What Are Its Terms?

In the case of a CDS, if one assumed that the best answer is to reverse engineer what the market has done and to treat the upfront payment as repaid in 75 basis point increments over some period, new questions arise that would also have to be addressed in guidance.[122] Because the upfront payments are in different amounts, would each case result in a stream of 75 basis point deemed payments for a different period? Or would each be treated as giving rise to deemed 75 basis point payments for the full tenor of the CDS?

Let us assume that in the former case, the upfront payment in Example 1 ($244,000) would be treated as equivalent to an annuity paying 75 basis point coupons for three years, the upfront payment in Example 2 ($335,000) would be treated as equivalent to a similar annuity but for four years, and the upfront payment in Example 3 ($377,000) would be treated as equivalent to a similar annuity but for four and a half years. What happens if the CDS in Example 1 survives for more than three years? Does the deemed annuity continue, or is the CDS treated as reissued at year 3?

Some support for this approach — same payment amount, over different periods — can be found in the NPC timing regulations, because they provide that for purposes of recognizing a nonperiodic payment over the term of an NPC, the term of an NPC that is subject to termination is the reasonably expected term of the contract.[123] However, the deemed loan rule provides that the deemed at-market swap must provide for level payments, which would not be the case if the swap in Example 1 remained in existence for more than three years unless the swap were treated as reissued at year 3. This approach does not seem like the likely right answer.

Now let us consider the alternative, under which the annuity is deemed payable in all three examples over the full five-year term of the CDS. We know that there is uncertainty about whether the annuity will in fact be paid over the entire term, with the highest risk in Example 1. Given the uncertainty whether the "lender" will be "repaid" in full, does the deemed loan give rise to contingent payment debt subject to reg. section 1.1275-4 (one hopes not)? More significantly, is this debt at all? It can be compared to a credit-linked note with a payout of zero if the credit event arises. Or it could be compared to an interest-only obligation (IO) on a prepayable debt instrument, when the trigger for terminating payments is not repayment of debt but a credit event.

There are, as it happens, some tax rules for IOs. For example, IOs issued under the real estate mortgage investment conduit rules are statutorily treated as debt, like other regular interests in the REMIC.[124] IOs can also arise under the bond stripping rules of section 1286. Most IOs under current market practice probably provide for payments based on pools of prepayable debt instruments, and thus either explicitly or by analogy can be handled to at least some extent under the rules of section 1272(a)(6). That would not be the case for an annuity deemed to arise under a CDS. Moreover, the rules for taxing IOs are not themselves a model of clarity, as evidenced by the IRS's request in 2004 for comments from taxpayers on several issues.[125] The request says in its introduction that "REMIC IOs present novel and difficult questions in the application of tax rules that were designed primarily to account for instruments that qualify as debt under traditional tax principles." Similarly, the rules for contingent payment debt instruments reserve how to treat most timing contingencies.[126]

In short, while it is quite possible to come up with a scheme under which an upfront payment is reconverted back into an annuity of some kind, and to devise a method for determining what portions of the annuity payments constitute principal and what portions constitute interest, there are no rules that do so. Equally significant for taxpayers that might hazard the attempt, there are no real analogies — or at least none with tax treatment that is certain — that can reassure the taxpayer that its invented method clearly reflects income. In the absence of any guidance from the government on even the most basic of questions on the taxation of CDSs, and acknowledging that these issues are difficult to resolve, it is hard to believe any court would hold taxpayers accountable for not divining what those rules should be, in the absence of some obviously abusive transaction.

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[122]Another possibility, of course, is to reconvert each upfront payment into a stream of X (not 75) basis points over the maximum life of the CDS, in an amount that would differ for each example because each of them reflects the present value of a different stream of payments.

Without knowing how to determine the amount of the notional payments, it may be impossible to determine whether the upfront payment is significant. It appears, however, that that will frequently be the case.

[123]Reg. section 1.446-3(f)(3). The regulation does not specify who determines what the reasonably expected term is, leading to the possibility that different parties to a NPC will take different positions.

[124]Section 860B(a) (REMIC regular interest taxed as debt); section 860G(a)(1)(B)(ii) (providing authority to treat IOs as REMIC regular interests).

[125]Announcement 2004-75, 2004-2 C.B. 580, *Doc 2004-19463, 2004 TNT 192-16.*

[126]Reg. section 1.1275-4(b)(9)(iii).

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D. What About the Proposed Swap Regulations?

A recent article has pointed out another uncertainty about how to treat an upfront payment on a CDS, concerning the possible application of the proposed regulations dealing with swaps with contingent nonperiodic payments that are described above in Part I.B.2.[127] As the article explains, if CDSs are subject to those rules and if the effect of that treatment were to require the protection seller to impute an expense because the protection seller might have to make a settlement payment sometime in the future, the amount of the upfront payment for tax purposes might differ from the cash amount. Returning to the example of a CDS in which Party B as protection seller receives an upfront payment of $335,000, if these rules applied, Party B would be required to accrue some expense in respect to the contingent future settlement payment. Depending on how that expense is allocated, either the upfront payment might be treated as less than $335,000 or the deemed at-market swap might be treated as paying less to Party B than would otherwise be the case. Either of these would complicate the effort to determine how to reconvert the upfront payment into an annuity.

Also, the proposed regulations would apply only if a cash settlement payment were treated as a nonperiodic payment and not as a termination payment, which is unclear. A termination payment is defined generally as a payment to assign or extinguish an NPC. However, proposed regulations make clear (sensibly) that a periodic payment that happens to be paid at the maturity of an NPC is not a termination payment.[128] It is also evident from the proposed regulations that a contingent nonperiodic payment made at the maturity of an NPC such as an equity swap is not treated as a termination payment. A termination payment is therefore not just any payment that happens to be made when the taxpayer terminates its interest in an NPC. Rather, the concept seems to be that a termination payment is an unscheduled payment not provided for in the terms of the NPC.

It has become common, however, for equity swaps to provide express terms under which a counterparty may terminate the swap early. Since dealers typically permit their customers to terminate swaps early in any event, the purpose of this provision is primarily to set out the terms under which the early termination payment will be calculated. Market practice is to treat these payments as termination payments, which seems right. Coming back to CDSs, then, how should one treat an unscheduled settlement payment that is provided for in the terms of the CDS? It seems closer to a termination payment than a nonperiodic payment, but the answer is unclear.

[127]Munro, *supra* note 2.

[128]Prop. reg. section 1.1234A-1(b).

E. What About Cleared CDSs (or Other Swaps)?

Most of the discussion in Part IV to this point has addressed standardized CDSs that are not cleared. If one now considers some of the special aspects of cleared swaps, yet more issues arise as a result of the daily netting process described in Part II.A.1 above. Assume a dealer on day 1 sells protection under the CDS described in Example 1 in connection with a customer transaction, and receives the $244,000 upfront payment. On the next day, the dealer buys protection under an identical CDS in connection with a second customer transaction. Because the market's perception of the creditworthiness of the reference entity has changed, the dealer makes a $250,000 upfront payment. The clearinghouse will net the two transactions, with the result that the dealer has no outstanding CDS and has paid $6,000 on a net basis. (If in the second transaction the dealer paid $240,000, the transactions would also net, but the dealer would have paid $4,000 on a net basis.[129])

Because dealers routinely enter into many transactions and the clearinghouses net positions daily or more frequently, it is impossible to determine what period any upfront payment will actually relate to. The only thing one could be reasonably sure about is that whatever the analysis might be on day 1, it will be modified by the next day's transaction. Similarly, in the case of dealers that operate in such a manner that one affiliate enters into transactions with some customers but a different affiliate faces the clearinghouse, so that the first affiliate routinely enters into multiple CDSs with the other to hedge its position, upfront payments made and received on different days also will regularly net as an economic matter and may net as a legal matter. One might conclude that in this setting it is inappropriate to impute a loan or to impute interest. That raises the more general question of why it is appropriate to do so for NPCs in the first place. If the principal reason for the deemed loan construct is to prevent related parties from avoiding withholding tax on interest, a more narrowly targeted rule could serve that purpose without raising all the questions listed above. In any event, for all of the reasons discussed in Part IV, it seems difficult to believe that any court would fault a taxpayer for not treating an upfront payment as giving rise to a deemed loan or deemed interest expense, in the absence of abuse or specific guidance. Because there is much uncertainty about these issues, however, it would be good practice for the government to issue formal guidance saying that it will not, absent abuse, require taxpayers to report or withhold on those amounts until substantive guidance is issued.

[129]These examples ignore the variation margin paid and received by the dealer.

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ARTICLES

New Tax Issues Arising From the Dodd-Frank Act and Related Changes to Market Practice for Derivatives

Erika W. Nijenhuis[*]

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The author advised one of the U.S. CDS clearinghouses described below on tax issues in connection with clearing CDS, and has represented the Securities Industry and Financial Markets Association and members thereof regarding the tax issues discussed in this article.

The manner in which the derivatives markets operate is complex and evolving. Every effort has been made to describe them correctly as of December 2010 by consulting with experts, but it is possible that some aspect of either market practice or the legal rules governing those instruments described herein is inaccurate, as the author is a not a banker or an expert in the non-tax rules governing these markets and instruments. Any errors are those of the author.

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On July 21, 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") was enacted into law.[1] Dodd-Frank mandates the most sweeping changes to the U.S. markets for derivative financial instruments in decades. This article discusses a number of U.S. federal income tax issues raised by Dodd-Frank and related changes to market practice for derivatives.

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[1] Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, Pub. L. No. 111-203, 124 Stat. 1376. European authorities also are considering sweeping reforms of the European derivatives markets. *See, e.g.*, Report on Derivatives Markets: Future Policy Actions, EUR. PARL. DOC. (2010), *available at* http://tinyurl.com/LangenReport2010; Proposal for a Regulation of the European Parliament and of the Council on OTC derivatives, central counterparties and trade repositories, EUR. COMM. DOC. (2010), *available at* http://tinyurl.com/OTCRegulation.

All citations to sections are to the Internal Revenue Code of 1986, as amended (the "Code"), or to the Treasury regulations promulgated thereunder, other than references to sections of Dodd-Frank or to sections of this article.

As discussed in more detail in Section II.B, below, Dodd-Frank requires that most over-the-counter ("OTC") derivatives, colloquially referred to as swaps, be cleared through a regulated central counterparty (a "clearinghouse") and traded on a regulated exchange. Historically, OTC derivatives generally have been taxed under the conventional realization method of accounting used for stocks, bonds and other securities, while exchange-traded derivatives generally have been taxed under the special rules of § 1256. Section 1256 generally requires that contracts within its scope be marked-to-market on an annual basis, and provides that gain or loss from such contracts is capital gain or loss with a 60% long-term and 40% short-term holding period. The most obvious tax question raised by Dodd-Frank, therefore, is whether the migration of OTC derivatives onto exchanges will cause them to become subject to § 1256.

At the very last hour of Dodd-Frank's marathon progress through Congress, this issue was partially addressed through the adoption of an amendment to § 1256 that clarifies that certain types of OTC swaps will not become subject to § 1256. Notwithstanding this amendment, many questions remain, as the scope of the amendment is not clear. In addition, decisions still to be made by regulators and the market as to how derivatives will be traded are likely to affect the impact of the amendment. Factors that may be relevant include (i) which swaps will migrate onto exchanges when; (ii) the effect of what appears to be a forthcoming wider range of products offered by exchanges that constitute "futures contracts" that may compete with swaps; (iii) whether swaps will be traded on traditional securities and commodities exchanges or instead on "swap execution facilities," a new type of exchange created by Dodd-Frank; (iv) whether end-users will choose to clear the swaps they enter into; and (v) where the line between "bespoke" swaps not required to be centrally cleared and traded and standardized swaps subject to those requirements will be drawn. Those issues generally are outside the scope of this article, but they are briefly adverted to in connection with a discussion of possible guidance on the scope of the § 1256 amendment.

This article discusses a range of possible interpretations of the Dodd-Frank amendment to § 1256, and argues in favor of an interpretation that the amendment covers all notional principal contracts and possibly certain closely related contracts. The article also urges that the Treasury Department and Internal Revenue Service ("Treasury" and "the Service," respectively) provide prompt guidance on this issue, because the scope of the amendment affects not only OTC derivatives that migrate in the future to regulated clearing and trading, but potentially also certain kinds of swaps that were being cleared by a central counterparty prior to Dodd-Frank.[2]

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[2] The current Treasury/IRS "business plan" for the 2010-2011 year includes an item described as "Guidance on the application of § 1256 to certain derivative contracts." Department of the Treasury, Office of Tax Policy, and Internal Revenue Service, *2010-2011 Priority Guidance Plan* (Dec. 7, 2010), *available at* http://www.irs.gov/pub/irs-utl/2010-2011_pgp.pdf. Comments by government officials indicate that this item relates to the Dodd-Frank amendment. *See* Amy Elliott, *IRS May Restrict Definition of Swap to Notional Principal Contracts* (Dec. 15, 2010), 2010 TNT 240-3; Diane Freda, *IRS May Hold to Narrow View of Futures Under Dodd-Frank Wall Street Reform* (Dec. 15, 2010), 239 DTR

The article also suggests some further amendments to the Internal Revenue Code that could alleviate pressure on the guidance process.

The second set of tax issues addressed by this article are those stemming from the fact that the move towards regulated clearing and trading has and can be expected to have the effect of increasing substantially the number of swaps that are entered into, or deemed entered into, with upfront payments. In the OTC markets, most swaps were entered into at-market – that is, with payments required to be made at the then-market level – so that it was relatively rare for a swap to have an upfront payment. (This is not true for options, of course, or for certain specific types of swaps.) Because centralized clearing both requires and encourages standardization of terms and a ready ability to transfer contracts from one party to another, the move towards centralized clearing results in more frequent upfront payments or possible deemed upfront payments between swap parties.

There are long-standing rules governing the treatment of upfront payments on swaps that are classified as "notional principal contracts" ("NPCs"). Under those rules, such a payment can give rise to a debt obligation between the parties if the payment is "significant." This issue is of relevance because a deemed loan would give rise to deemed interest income on the debt instrument, which interest would be subject to reporting, withholding and other U.S. federal income tax rules applicable to debt instruments. The existence of a deemed loan might also raise issues under § 956 for some taxpayers.[3]

The treatment of significant upfront payments on interest rate swaps and most other swaps as deemed loans for U.S. federal income tax purposes is a rule that has been on the books for many years, but has not in practice affected most actual OTC contracts. Thus, for most swaps, taxpayers' concerns now have to do with the substantial expansion of an existing regime. These concerns are partly legal—primarily that current law does not provide clear rules for when a deemed loan arises, and does not take into account the special characteristics of centrally cleared swaps—and partly practical, because compliance in a world in which significant upfront payments may be the rule rather than the exception would require taxpayers to modify reporting and withholding practices, and to develop automated systems to distinguish between NPCs and options and other types of derivatives not subject to the deemed loan rules.

G-3, *available at* www.bna com: John Herzfeld, *Guidance on Section 1256 Contracts Under Study, IRS Legal Official Says* (Oct. 25, 2010), 204 DTR G-2, *available at* www bna.com.

[3] These issues are briefly discussed in a submission made by the Securities Industry and Financial Markets Association ("SIFMA") in a letter to Treasury and the Service requesting guidance on these issues, in particular the potential application of § 956 to deemed loans arising from large initial premium payments on credit default swaps. *See* Letter from SIFMA to Steven A. Musher, Associate Chief Counsel (Int'l), IRS (May 26, 2009), *reprinted in* 1 TAXATION OF FINANCIAL PRODUCTS AND TRANSACTIONS 2010, Ch. 1 (Practising Law Institute 2010). The author and one of her partners represented SIFMA in preparing that letter.

For credit default swaps ("CDS"), there are very significant uncertainties as to whether these rules apply at all, and if so how they apply. The question of whether a deemed loan or deemed interest arises under current law as a result of a large initial premium on a standard coupon CDS cannot be answered without first answering the question of whether a CDS is properly characterized as an option or NPC. As that issue is unclear under current law and has been exhaustively discussed elsewhere, this article focuses instead on whether, assuming that a CDS is properly treated as an NPC, current law could deem one CDS counterparty to lend money to the other in a transaction treated for U.S. federal income tax purposes as giving rise to indebtedness.

Finally, as noted above, the application of § 956, which can have career-ending consequences, could potentially be vastly expanded. This would be unfortunate, to say the least, given that the context is one in which there is no policy reason for § 956 to apply because any upfront payment made under a cleared swap is immediately offset as a cash flow matter by an equivalent amount of cash collateral.

It seems fair to expect the government to clarify the rules as to when a deemed loan arises before taxpayers build the necessary systems to track them. And it seems reasonable to hope that the government would clarify that it would not choose to apply § 956 in the offsetting payment case described above.

This article therefore recommends a number of areas in which the Treasury and Service should provide guidance before taxpayers make the investment to build such systems, including (i) clarifying whether and how the rules apply to centrally cleared swaps, (ii) how a deemed loan that arises when a "significant" upfront payment is made on an NPC should be taken into account for a centrally cleared swap, (iii) more detailed guidance on when an upfront payment is "significant", and (iv) whether credit default swaps are subject to these rules. In the interim, regulatory guidance could be provided in the form of a Notice stating that nonperiodic payments on swaps, including CDS, will not be treated as investments in United States property for § 956 purposes to the extent that they are immediately as a contractual or legal matter offset by an equivalent amount of cash, absent abuse, and a Revenue Procedure stating that the Service will not take the position that taxpayers are obligated to treat upfront payments on CDS as deemed loans until guidance is issued to that effect or on other swaps until the meaning of the term "significant" is clarified, again absent abuse. Legislative amendments could address the § 956 issue by adding a reference to cash collateral in § 956(c)(2)(J), and by stating an expectation in legislative history that the Service will act as described in the second half of the preceding sentence.

Part I of the article provides an overview of the financial products discussed herein and the tax rules currently applicable to OTC derivatives and under § 1256. Readers familiar with these products and rules can skip over or skim this part of the article. Part II of the article discusses Dodd-Frank and other changes to the law and market practice for derivatives. Part III of the article then turns to the § 1256 issue, and Part IV of the

article discusses the issues arising from upfront payments on centrally cleared swaps.

I. OVERVIEW OF PRODUCTS AND TAX RULES.

As noted above, OTC derivative financial products historically have been subject to the conventional realization method of accounting. When applied to derivatives, those rules can become quite complex, as the basic rules have been overlaid with a hodgepodge of special rules intended to take into account the fact that many derivative financial products resemble, or are comprised of, other such products, the liquidity of many derivatives, and their widespread use as hedges for business risks. Part I briefly describes several derivatives that will be referred to throughout this article and the basic rules applicable to them, as well as some discussion of special hedging and mark-to-market rules affecting derivatives. Part I also provides an overview of the rules of § 1256.

A. Description of Certain Common Derivative Financial Instruments.

1. *Interest Rate Swaps.* Probably the most common type of swap is an interest rate swap. Under the terms of a standard interest rate swap, one party agrees to pay amounts determined by reference to a fixed rate, e.g., 6%, and the other party agrees to pay amounts on the same payment dates determined by reference to a floating rate, usually the London Interbank Offered Rate ("LIBOR"). Both payments are determined by multiplying the applicable rate by the same "notional principal amount," a hypothetical amount used to determine the parties' payment obligations but that is not paid or otherwise transferred between the parties. The sole payments on an at-market interest rate swap are these periodic payments, which typically are made semi-annually, and are netted so that only the difference between the fixed and floating amounts is paid.

Interest rate swaps are widely used to hedge interest rate risks, for example by an issuer that issues debt or a company with assets or non-debt liabilities that are interest rate-sensitive. Because the cost of money is so fundamental an economic factor, and because different parts of the fixed income market operate on the basis of different rate bases, the interest rate swap markets are very liquid, very competitive, and very large. According to the most recent authoritative market survey, there are over a hundred trillion dollars (notional principal amount) of U.S. dollar-denominated interest rate swaps outstanding.[4]

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[4] The Bank for International Settlements reported $347.5 trillion notional principal amount of interest rate swaps outstanding globally at the end of June 2010. While there is no break-out of U.S. dollar-denominated interest rate swaps, if such swaps represented the same percentage of total interest rate swaps as U.S. dollar-denominated interest rate derivatives represented of all interest rate derivatives, there would be about $126 trillion notional principal amount of U.S. dollar-denominated interest rate swaps. Karsten von Kleist & Carlos Mallo, Bank for Int'l Settlements, TRIENNIAL AND SEMIANNUAL SURVEYS: POSITIONS IN GLOBAL OVER-THE-COUNTER (OTC) DERIVATIVES MARKETS AT END-JUNE 2010, 16, 18 tbls.1 & 3 (Nov. 2010), *available at* www.bis.org/publ/otc_hy1011.pdf.

A foreign currency swap is similar to an interest rate swap, except that one party's payments are denominated in and determined by reference to one currency and the other party's payments are denominated in and determined by reference to a second currency. The payments are both fixed rate, and the parties will exchange the principal amount at the end and sometimes at the beginning of the transaction. A swap may combine interest rate and foreign currency risk by providing for the payments in one or both currencies to be based on that currency's appropriate floating rate, e.g., Party *A* pays 6 percent x $100 million notional principal amount and Party *B* pays a yen floating rate on an amount of yen equivalent at the inception of the trade to $100 million. Another common type of foreign currency derivative used to hedge currency risk is a foreign currency forward contract, which generally is a relatively short-term instrument that provides at maturity for a payment determined by reference to the change in value of two specified currencies.

An interest rate swap entered into with at-market terms will not have an upfront payment. An interest rate swap entered into with off-market terms, for example with a 5% rate when the market is 6%, generally will have an upfront payment compensating the party receiving the below-market payment (or paying an above-market payment). For example, if a taxpayer wishes to hedge a $100 million debt instrument that it has issued with a 5% coupon into an effective floating rate instrument, it will enter into an interest rate swap with a dealer under which it receives 5% x $100 million and pays LIBOR x $100 million on the interest payment dates for the debt instrument. In addition, the dealer will make an upfront amount to the taxpayer equal to the present value of the foregone stream of 1% payments (6% minus 5%) over the life of the swap.

As with other swaps, the market for interest rate swaps historically has been the "over-the-counter" market. The OTC market is a modern version of the historic market as a place where parties come to buy and sell their wares. Unlike the historic wares offered in securities and other markets, an OTC derivative is a contract, negotiated by and entered into between two parties, typically pursuant to standard documentation made available by the International Swaps and Derivatives Association ("ISDA"). An OTC derivative remains for its life a private bilateral contract. This private aspect of OTC derivatives had considerable consequences when the credit crisis arose.

The principal information publicly available about outstanding OTC derivatives is derived from the published financial statements of swap dealers, and from reports by industry organizations, regulators and credit rating agencies. This public information reflects aggregated information at a high level. Bank regulators and other regulators of major swap participants have access to more information as part of their regulatory oversight, but no one regulator or government agency has a complete picture of the market. Moreover, some major participants in the market have been essentially unregulated or very lightly regulated, most notably AIG Financial Products ("AIG FP"), an affiliate of a major insurance company, which for many years was a very large player in the credit default swap ("CDS") market. Hedge funds, which are also major market

participants in the swap market, are also largely outside the scope of regulatory oversight.

One other important characteristic of the historic swap market is that while customers generally are required to provide collateral to secure a dealer's credit exposure to the customer, some highly rated participants in the market such as insurance companies were not required to provide collateral to their counterparties unless their credit rating dropped below a specified level. AIG FP, for example, apparently fell into the latter category; as a result, when doubts arose as to its ability to pay and a credit downgrade appeared imminent, those doubts were reinforced by the realization that AIG FP would be required to post billions of dollars of collateral to its counterparties that it did not have.

Unfortunately, AIG FP was also a hugely significant player in the CDS market, so that the potentially disruptive consequences of its demise led to the universal conclusion, at least by governments, that CDS and other swaps must be brought into a comprehensive regulatory scheme. The near-collapse of AIG-FP was thus one of the more significant reasons for the enactment of Dodd-Frank. (It is ironic in this regard that, at least in the view of some observers, the CDS trades entered into by AIG FP were highly customized CDS on asset-backed securities, in enormous size, of a kind that are not currently clearable and, it appears, will not be required to be cleared or traded under Dodd-Frank.)

2. *Options, Including Swaptions*. Options come in a number of different forms. In a conventional option to purchase (or sell) property, one party, typically called an "option writer" or "option grantor," grants to another party, an "option holder" or "option purchaser," the right but not the obligation to compel the option writer to deliver (or purchase) designated property for a particular price (the "strike price") prior to the option's expiration. In exchange for this right, the option holder pays a premium, typically, though not necessarily, in the form of an up-front payment. The premium may also be paid over time, usually in equal amounts, although this is less common in the securities markets.

The options described in the preceding paragraph are physically settled options — that is, they are written for the sale or purchase of a designated item of property which, if the option is exercised, is delivered or purchased by the writer, and purchased or sold by the holder. Options may also be cash settled, defined under the Code as "any option which on exercise settles in (or could be settled in) cash or property other than the underlying property."[5] They may also be "net share settled" if the underlying property is shares of stock, in which case the option writer will deliver shares equal in value to the difference between the value of the underlying shares and the option's strike price.[6]

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[5] I.R.C § 1234(c)(2) (2010)

[6] For example, assume that A writes a call option on 100 shares of X pursuant to which B has the right to purchase those shares within the next year for a strike price of $10/share ($1000). At the end of the year, the X shares are trading for $12/share. The option may be settled by (i) A delivering 100 shares to B in exchange for $1000 (physical

A "swaption" is an option to enter into a swap with the terms provided for in the option. For example, a swaption might provide the holder the right within the next three months to enter into a 5-year interest rate swap under which the holder would pay semi-annual fixed coupons at a 5.5% rate versus LIBOR, on a notional principal amount of $1 million. A swaption is a common type of derivative in the interest rates market. Like other options, a swaption may be physically settled, in which case the parties will enter into the designated swap, or may be cash settled, in which case the option writer will pay the option holder an amount equal to the excess of the value of the swap over a similar swap with then-current market terms. A forward-starting swap is similar, except that it is a forward contract to enter into a swap with specified terms rather than an option to do so.

3. *Credit Default Swaps*. A conventional single-name CDS is a financial contract to transfer credit risk with respect to debt instruments, such as bonds or loans, of a single named issuer (the "reference entity"), typically for a five-year term. Like other swaps, CDS in the OTC market are generally documented using the standardized documentation for derivatives transactions developed by the International Swaps and Derivatives Association ("ISDA").[7] CDS are commonly used to hedge the risk of owning bonds or loans of a particular issuer, termed the "reference entity," or other credit risk to that reference entity. CDS also are widely used to take on credit risk, whether of a particular issuer or a segment of the fixed income market. Like all of the other financial instruments described above, therefore, they can be used either to reduce risk or to create it. The merits or demerits of that state of affairs is outside the scope of this article.

The parties to a CDS contract are referred to as the "protection buyer" and the "protection seller." The contract frequently but not invariably refers to a specific senior debt instrument (the "reference obligation") of the reference entity.[8] The protection buyer makes one or more payments to the protection seller based on a specified notional principal amount. Ordinarily the payments take the form of a stream of periodic payments in a fixed amount, generally referred to as fixed or "premium" or coupon payments.

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settlement, or "gross" physical settlement), (ii) A paying B $200 ($1200 value of X shares minus $1000 strike price), or (iii) A delivering 16 X shares plus $8 of cash to B (net share settlement; the $8 is the cash value of a 0.67 fractional share).

[7] The ISDA website is a font of information about swaps in general. It includes standardized documentation for many different kinds of swaps, including not only the core transactional documentation (the ISDA Master Agreement and a form of Schedule to the Agreement) but also standardized definitions, credit support documents, and related information. *See* ISDA, http://www.isda.org (last visited Dec 30, 2010).

[8] An electronic data vendor active in the CDS market offers a standardized list of reference obligations for approximately 3000 reference entities. *See* Markit, MARKIT CREDIT INDICES: A PRIMER (Oct. 2010), http://www.markit.com/assets/en/docs/products/data/indices/credit-index-annexes/Credit_Indices_Primer_October%202010.pdf (last visited Dec. 31, 2010) Markit also provides a wide range of market information about CDS and many other kinds of derivatives.

The protection seller in turn agrees that in the case of a default on the reference obligation, or in the case of other specified credit events indicating a decline in the creditworthiness of the reference entity, it will buy from the protection buyer an obligation of the reference entity for its face value ("physical settlement," by delivery of a "deliverable obligation") or will make a cash payment to the protection buyer in an amount that represents the decline from par in the fair market value of such an obligation as a result of the credit event ("cash settlement," by reference to the value of a "valuation obligation").[9] The protection buyer is not required to have suffered a loss on, or to have owned, any obligation of the reference entity at any time in order to receive payment. In the case of cash settlement, a valuation obligation's fair market value is determined through bids from dealers in that obligation under standard procedures. While market practice has evolved over time, cash settlement for CDS (technically, auction settlement) is now the norm.

Prior to the standardization process described below, there were a number of common variations in the terms of conventional CDS, depending on a number of factors including the nature of the reference entity and the local CDS market. Such variations included the list of credit events (some CDS included a "restructuring" credit event, which in turn had multiple definitions used in different contexts), whether they provided for physical or cash settlement, and various mechanics and critical dates such as the termination date of the CDS. One of the most important variations in terms related to the coupon on a single-name CDS. Broadly speaking, the coupon on a single-name CDS was determined at the time the parties entered into the contract, in much the same way that the coupon on a newly-issued bond would be determined. (This process is described in more detail in Section II.C, below.) Consequently, the coupon on a CDS on a particular reference entity entered into on any given day could and generally did differ from the coupon on an otherwise identical CDS entered into on a different day. Similarly, while the most common tenor for CDS was five years, the clock started running when the parties entered into the CDS, so that there were no standardized maturity dates.[10]

As described above, the Fed did not wait for the enactment of Dodd-Frank in order to initiate the restructuring of the CDS market. This initiative has led to dramatic changes in the CDS market, notably (i) a reduction in the outstanding amount of CDS through an industry-wide process of netting CDS entered into by multiple dealers against each

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[9] More technically, the determination of whether a credit event has taken place is determined by reference to any "Obligation" of the reference entity, which term includes but need not be limited to the reference obligation.

The text simplifies the description of CDS settlement provisions in a number of ways. Prior to the "Big Bang" discussed *infra* note 12, the legal terms of single-name CDS in the U.S. markets generally provided for physical settlement, although I understand that in practice the parties usually agreed to cash settlement when a credit event arose. Since the "Big Bang," auction settlement—that is, cash settlement where the cash price is determined via an auction run by ISDA—has become the standard form of settlement for most CDS.

[10] The coupons and maturities of CDS on indices of reference entity obligations, e.g., bonds or loans, were more standardized. For a brief description of CDS of this kind, see *infra* note 73

other,[11] (ii) the standardization of terms for conventional CDS, and (iii) the initiation of clearing of CDS. These initiatives were an outgrowth of, or a continuation of, earlier Fed efforts to improve the workings of the CDS market.

The industry-wide netting process began in the fall of 2008. It was referred to as "portfolio compression," and made evident the difficulties of trying to net CDS transactions against each other when they had different terms.

The standardization of terms took place in several steps pursuant to a process led by ISDA starting in the spring of 2009.[12] For parties who have adhered to the relevant protocols, the result is that CDS entered into since that time have standard terms, including standard coupons (100 basis points or 500 basis points, for CDS on North American corporate reference entities), maturities, settlement mechanisms, definitions and many other mechanically and economically significant terms.[13] Standardization is discussed in more detail in Section II.C.2, below.

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[11] A Fitch report released in 2009 indicates that outstanding notional principal balance of credit derivatives fell in 2009, for the first time since Fitch began keeping track in 2003. Fitch Ratings, Credit Market Research, GLOBAL CREDIT DERIVATIVES SURVEY: SURPRISES, CHALLENGES AND THE FUTURE 5 (Aug. 2009) (hereinafter "Fitch Report"). The report attributes the decline to collective efforts of market participants and regulators to reduce notional outstandings by compressing trades, as well as the virtual absence of new structured credit deals. The report also notes that the market is now dominated by single-name CDS and index CDS, with a decline in CDS relating to outstanding collateralized debt obligations and other complex products

[12] The most significant of these steps was the "Big Bang," meaning the implementation of a protocol amending ISDA's 2003 Credit Derivatives Definitions (which are part of the ISDA standard documentation for a CDS) to provide for the establishment of (i) committees empowered to make final decisions about contract interpretation issues including with respect to credit events, settlement procedures and acceptable deliverable obligations: (ii) a standardized CDS settlement procedure, and (iii) a standard look-back window during which a party can claim the occurrence of a credit event or other relevant event, resulting in a standard effective date for CDS transactions While adherence to the protocol was voluntary, it was widespread. *See* ISDA, *ISDA Announces Successful Implementation of 'Big Bang' CDS Protocol; Determinations Committees and Auction Settlement Changes Take Effect* (Apr. 8, 2009), http://www.isda.org/press/press040809.html (over 2000 parties adhered to the new protocol by the time it closed on April 7, 2009). A "Small Bang" protocol was made available a few months later. Adoption of these protocols had the effect not only of setting market standards for new CDS but also of amending old CDS between adhering parties.

[13] The standardization of coupons was not hardwired into documentation like the Big Bang Protocol. Instead, ISDA announced that starting in April 2009 a new contract for CDS on North American corporate issuers with standardized terms would be introduced. The new contract would (a) provide for a 100 basis point coupon for investment grade credits and a 500 basis point coupon for high yield credits, (b) provide a calendar of quarterly scheduled termination dates, (c) eliminate Restructuring as a credit event, and (d) modify the accrual start date for coupons and provide that all coupons, including the first coupon, would be paid as full coupons regardless of whether the parties entered into the CDS in the middle of a coupon accrual period (similar to buying a bond with pre-issuance accrued interest). These changes were expected to be the primary method for trading North American corporate CDS going forward. Unlike the Big Bang Protocol, these changes did not affect historic trades, although parties were free to amend existing trades to conform to those terms.

Finally, the third of these steps was the initiation of clearing of standardized CDS in the fall of 2009. The clearing process is described in more detail in Section II.A.2, below.

4. *Futures Contracts.* Futures contracts are among the oldest types of derivative financial instrument. Historically, a futures contract was a contract for the sale of a specified amount of grain or another agricultural commodity, of a specified grade, for delivery at a date several months later. They were developed in order to allow farmers and commodity purchasers to hedge their price risk between the date the contract was entered into and the delivery date. Historically they have in practice been very short-dated, with liquidity centered in contracts with a remaining term of one month, two months and three months. In recent decades, the risk classes underlying futures contracts have broadened dramatically, and now include foreign currency, oil and gas and other energy products, metals, stock indices, interest rates, emission allowances and other "environmental" products, real estate indices, and weather indices.

Unlike OTC derivatives, futures contracts are traded on commodities exchanges. Thus, a party who wishes to enter into or close out a futures contract does so on a public market where participants can see every trade. Futures contracts are also subject to clearing through a central counterparty, which results in the clearinghouse becoming the counterparty to every trade. This process is described in more detail in Section III.A.1, below. Clearing is a way of managing credit risk. It also makes it very easy to close out transactions, so that futures contracts in active maturities are very liquid. Dodd-Frank's reforms of the derivatives market are intended to expand the transparency, credit risk management and liquidity of the futures markets to include what have been to date OTC derivatives.

These features come at a price, of course—it can be more expensive to transact through the futures markets than the OTC market, and market participants may prefer to negotiate their trades without the full spotlight of the market on them. The latter point has led to a sort of hybrid contract in recent years, in which parties negotiate a contract privately and then submit it to a central counterparty (a clearinghouse that may or may not be associated with a particular exchange) for clearing. That is, such contracts are centrally cleared but not exchange-traded. Energy swaps and CDS are perhaps the most active contracts of this kind.

B. Overview of Taxation of Common OTC Derivatives.

1. *Notional Principal Contracts.* An interest rate or foreign currency swap of the kind described above is a "notional principal contract," or NPC. Although technically a different set of timing and character rules apply to interest rate swaps than foreign currency swaps, those differences are not significant for purposes of this discussion. The term "notional principal contract" is a tax term of art. The closest term used by non-tax lawyers is "swap," but there are swaps that do not qualify as NPCs. To further confuse matters, the NPC timing regulations described below classify NPCs into swaps, caps and floors.

The term "notional principal contract" or variants on that term are defined in several places in the Code and regulations.[14] The only comprehensive definition of the term is in Treasury Regulation § 1.446-3, which provides timing rules for NPCs. It defines an NPC as "a financial instrument that provides for the payment of amounts by one party to another at specified intervals calculated by reference to a specified index upon a notional principal amount in exchange for specified consideration or a promise to pay similar amounts."[15] Because this definition is very broad, the regulation goes on to exclude from its scope a section 1256 contract, a futures contract, a forward contract, an option and debt. Accordingly, if a swap constitutes a section 1256 contract or an option, it cannot be an NPC for purposes of these timing rules.

A cap or floor is a series of options, for example a contract to make a payment on any interest payment date over a specified number of years if market interest rates rise above X percent, equal to [the market rate minus X percent] times a notional principal amount.

The regulations classify payments under NPCs into three categories: periodic payments, like coupons; nonperiodic payments, such as an upfront payment; and termination payments, which generally are payments to extinguish or assign all or part of an NPC. Technically, a nonperiodic payment is any payment other than a periodic payment or a termination payment.

Periodic payments are deductible or includible on a current accrual basis.[16] Termination payments are taken into account in the year in which an NPC is extinguished, assigned or exchanged.[17]

Nonperiodic payments are subject to more complicated rules that are conceptually similar to the OID rules but operate differently. In order to prevent front-loading or back-loading of payments under an NPC, the regulations require that taxpayers recognize a nonperiodic payment "over the term of a notional principal contract in a manner that reflects the economic substance of the contract."[18] The regulations then elaborate on this requirement by providing that an upfront periodic payment on an NPC generally be spread over the life of the NPC in accordance with forward rates (or, in the case of a cap or floor, option premiums) or, more frequently, as a series of level payments over the term of the NPC. Thus, if the market rate for an NPC fixed payment is 6%, and the NPC in fact provides for payments at a 5% rate and an upfront payment from the fixed rate payor to compensate the fixed rate payee for the below-market coupon, under the level payment method the upfront payment would be spread over the life of the NPC in amounts equal to a 1% periodic payment, and the

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[14] *See, e g*, I.R.C. § 1259(d)(2) (2010) (defining "offsetting notional principal contract"); Treas. Reg § 1.863-7(a)(1) (1991). The latter was the first official guidance to use the term "notional principal contract."

[15] Treas. Reg. § 1.446-3(c)(1)(i) (1994)

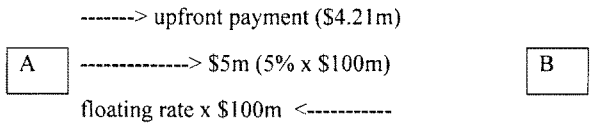
[16] Treas. Reg. § 1.446-3(e) (1994). Different timing rules may apply if the NPC is part of a hedge, straddle or other multiple-position transaction.

[17] Treas. Reg. § 1.446-3(h)(2) (1994).

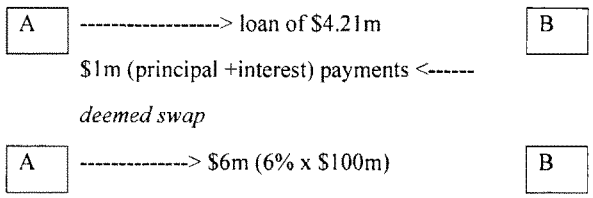
[18] Treas. Reg. § 1.446-3(f)(2)(i) (1994)

"principal recovery component" of that payment would be treated as a periodic payment on the NPC. A back-end payment is first converted into an initial payment through present valuation, after which the same rule applies.

Under a special rule for NPCs that are swaps (but not for caps and floors), if a nonperiodic payment is "significant," the upfront payment is treated as an amortizing loan providing for level principal and interest payments over the life of the NPC, and the NPC is treated as entered into at market rates.[19] Using the example in the prior paragraph, if the upfront payment were significant, it would be treated as a loan from the payor to the payee that is repaid in installment payments equal to 1% periodic payments on the swap, which installment payments are paid at the same time as deemed 6% payments on the NPC. To take a simplified example,[20] while the actual cash flows would be:



the deemed cash flows would be:



[19] Treas. Reg. § 1.446-3(g)(4) (1994). The regulation states: "The loan must be accounted for by the parties to the contract independently of the swap. The time value component associated with the loan is . recognized as interest for all purposes of the Internal Revenue Code." The same rule for currency swaps applies via a cross-reference in the relevant regulations. Treas. Reg. § 1.988-2(e)(3)(iv) (2004).

[20] The example assumes that the parties enter into a 5-year interest rate swap with annual payments at a time when a market rate swap would provide for payments at 6% vs. a floating rate, multiplied by a $100 million notional principal amount. At market rates, the fixed rate payor, Party A, would pay $6 million annually in exchange for the floating rate payment. Because Party A will in fact pay only $5 million annually, Party A will pay Party B an upfront payment of $4.21 million (the present value, using a 6% discount rate, of $1 million/year). Under the rules described in the text, (a) Party A would be treated as lending $4.21 million to Party B, in exchange for annual payments from Party B of principal and interest totaling $1 million/year, and (b) Party A would be treated as making annual swap payments of $6 million.

Consequently, the recipient of the upfront payment in this example is treated as paying interest to the payor. Moreover, the Commissioner may treat any nonperiodic swap payment, whether or not it is significant, as one or more loans for purposes of § 956.

As the example above illustrates, these rules were written with interest rate swaps in mind. In the case of an interest rate swap, the relationship between the upfront payment and the foregone, or extra, payments on the swap is mathematically straightforward, once one knows the appropriate discount rate: the upfront payment is simply the present value of the foregone, or extra, payments on the swap as compared to an at-market swap. These timing rules for nonperiodic payments were adopted initially to prevent taxpayers from refreshing net operating losses by accelerating income through the receipt of upfront payments.[21] The interest characterization rule is, to the best of the author's knowledge, intended to prevent related parties from using upfront payments on swaps as a way for a non-U.S. affiliate in a non-treaty country to lend money to a U.S. affiliate without suffering U.S. withholding tax on the imputed interest.

The rules described to this point envision that any nonperiodic payment would be a fixed amount known when entering into the NPC. Total return swaps on assets, such as equity swaps, however, typically provide for a final payment that is contingent upon the change in value, if any, of the asset over the life of the swap. Regulations were proposed in 2004 that would provide specific timing rules for swaps with contingent nonperiodic payments.[22] The proposed regulations would require a taxpayer that enters into a swap with a contingent nonperiodic payment to accrue income (or expense) in respect of that final payment. The methodology provided for in the proposed regulations is complex, but essentially requires a taxpayer to determine a hypothetical future contingent payment, to convert that future payment into an upfront payment, and then to treat the upfront payment under the rules described above.

2. *Taxation of Options*. An option may be either an option to buy property at a stated "strike" price (a "call" option) or an option to sell property at a stated strike price (a "put" option). The value of the call option in the hands of the purchaser will increase if the value of the underlying property rises above the strike price. The value of a put option in the hands of the purchaser will increase if the value of the underlying property drops below the strike price. The writer of the option is in the opposite economic position. Because the purchaser has the right to profit from the option, and the writer may be obligated to lose money on the option, the purchaser pays the writer a premium to compensate the writer for the risk that the latter is taking. For a conventional option, the premium is usually paid in a single lump sum amount, although it may instead be paid over time.

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[21] *See* I.R.S. Notice 89-21, 1989-1 C.B. 651 (requiring that upfront payments on NPCs be taken into account over the life of the contract under a reasonable method of amortization).

[22] Prop. Treas. Reg. § 1.446-3(g)(6), 69 Fed. Reg. 8,886 (Feb. 26. 2004).

In general, gain or loss from options is recognized on a wait-and-see (open transaction) basis.[23] The purchaser capitalizes the cost of the option premium, and the option writer does not immediately include it in income. If the option is exercised by delivery of the underlying property in exchange for payment of the strike price (physical settlement), for tax purposes the party that buys the property acquires it for an amount equal to the strike price paid plus or minus the option premium. That amount is also the amount realized for the seller of the property. If the option is exercised through cash settlement, no property is delivered, and gain or loss is measured by reference to the difference between the cash settlement amount and the premium paid or received. The option may also expire unexercised, in which case the purchaser will have a loss and the writer will have income equal to the premium.

Gain or loss recognized by the purchaser of an option is considered to have the same character as the property to which the option relates in the hands of the option purchaser (or would have if acquired by the purchaser).[24] Thus, in the case of a purchaser of an option on a bond that is or would be held as an investment, gain or loss will be capital. In the case of an option writer, gain or loss from delivery is typically capital. In the case of the termination of an option other than through delivery of the underlying property, the writer's gain or loss typically is treated as short-term capital gain or loss, regardless of the term of the contract.[25]

Different rules apply if the taxpayer is a dealer in securities, if the taxpayer is using the option to hedge another position, if the option is a foreign currency option or a "section 1256 contract" (see below), or if other special rules apply. Options may also have terms that vary from the fact patterns described above.

3. *Taxation of CDS.* CDS are important to the issues discussed in this article for several reasons. First, as noted above, the extraordinary significance attributed to the role of CDS in triggering the near-collapse of the U.S. financial system and other near-catastrophes—most recently, their alleged role in deepening the financial crisis of the Greek economy—has made these once highly exotic and obscure financial instruments the impetus for reform of the derivatives markets in the United States and similar efforts in Europe. Second, for those same reasons, when the Federal Reserve Bank of New York (the "Fed") determined that reform of the U.S. derivatives markets should move forward without waiting for legislation, it encouraged swap dealers to start by clearing CDS.[26] The

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[23] *See* Treas Reg. § 1 263(a)-4(d)(2)(i)(C)(7) (2004); Rev Rul. 58-234, 1958-1 C B 279; Rev. Rul. 78-182, 1978-1 C.B. 265.

[24] I.R.C. § 1234(a) (2010).

[25] I.R.C. § 1234(b) (2010).

[26] The second financial product to attract regulatory attention was interest rate swaps. *See* Scott Patterson, *Fannie, Freddie Touch Off Swaps Scrap*, WALL ST. J., Apr. 6, 2010, at C1, *available at* http //online.wsj.com/article/SB10001424052702304620304575166292806663502.html (reporting that the Federal Housing Finance Agency expects Fannie Mae and Freddie Mac to start clearing their interest rate swaps by year-end, regardless of whether Congress adopts financial reform legislation, and that several exchanges are seeking that business).

resulting changes to market practice in the CDS market and the tax issues that arose as a byproduct of these changes provide insight into the path ahead. For those same reasons, perhaps, there is reportedly now a renewed interest by the Treasury and Service in addressing long-standing questions about the tax treatment of CDS.

The tax rules applicable to CDS are unclear, primarily because the proper characterization of CDS for U.S. federal income tax purposes is unclear. The Service officially acknowledged this uncertainty in Notice 2004-52.[27] Notice 2004-52 describes four possible characterizations of CDS: as notional principal contracts ("NPCs"), options, or in some cases as insurance or guarantees. There are many thoughtful and insightful comments and articles on the characterization question, both predating and following the Notice.[28] It is fair to say that the ball has been in the

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[27] I.R.S. Notice 2004-52, 2004-2 C.B. 168.

[28] Articles discussing the tax considerations relevant to credit default swaps include John N. Bush & Ahron H. Haspel, *Deciphering the Taxation of Credit Derivatives*, 14 J. TAX'N INVESTMENTS 33 (1996); Bruce Kayle, *Will the Real Lender Please Stand Up The Federal Income Tax Treatment of Credit Derivative Transactions*, 50 TAX LAW. 568 (1997), David Z. Nirenberg & Steven L. Kopp, *Credit Derivatives: Tax Treatment of Total Return Swaps, Default Swaps, and Credit-Linked Notes*, 87 J. TAX'N 82 (1997); Steven D. Conlon, *U.S. Tax Issues Relating to Credit Derivatives*, DERIVATIVES 203 (May/June 1998); David S. Miller, *An Overview of the Taxation of Credit Derivatives*, *in* 13 TAX STRATEGIES FOR CORPORATE ACQUISITIONS, SPIN-OFFS, JOINT VENTURES, FINANCINGS, AND REORGANIZATIONS ch. 229 (Practising Law Institute 1999), Viva Hammer & Frank Kuriakuz, *The Tax Treatment of Credit Default Swap Proceeds*, 1 DERIVATIVES & FIN. INSTRUMENTS, July/August 1999, at 210; David S. Miller, *Credit Derivatives: Financial Instrument or Insurance? And Why It Matters*, 3 J. TAX'N FIN. PRODUCTS 31 (Winter 2002); David S. Miller, *Distinguishing Risk: The Disparate Treatment of Insurance and Financial Contracts in a Converging Marketplace*, 55 TAX LAW. 481 (Winter 2002); Edward D. Kleinbard, *Competitive Convergence in the Financial Services Markets*, 81 TAXES 225 (Mar. 2003); Erika W. Nijenhuis, *Notice 2004-52—One Small Step Forward on Credit Default Swaps*, 104 TAX NOTES 1287 (2004); Bruce E. Kayle, *The Federal Income Tax Treatment of Credit Derivative Transactions*, 21 TAX STRATEGIES FOR CORPORATE ACQUISITIONS, SPIN-OFFS, JOINT VENTURES, FINANCINGS, AND REORGANIZATIONS ch. 429 (Practising Law Institute 2004), *reprinted in updated form in* 22 TAX STRATEGIES FOR CORPORATE ACQUISITIONS, SPIN-OFFS, JOINT VENTURES, FINANCINGS, AND REORGANIZATIONS ch. 429 (Practising Law Institute 2009); Alexander F. Peter, *Characterization of Credit Default Swaps for Tax Purposes*, 8 DERIVATIVES & FIN. INSTRUMENTS 3 (Jan/Feb. 2006); Nicholas Bogos, *A Risk-Based Analysis of Credit Derivatives under SSRP Standard* (pts. 1-3), 112 TAX NOTES 587, 655, 759 (Aug. 2006); Kevin J. Liss, *Are Credit Default Swaps Really Swaps or Options for Tax Purposes? An Economics-Based Approach*, 7 J. TAX'N FIN. PRODUCTS 23 (2008); Ari J. Brandes, *Toward a New Framework and a Better Understanding of Credit Default Swaps*, 10 DERIVATIVES & FIN. INSTRUMENTS 75 (May/June 2008); Ari J. Brandes, *A Better Way to Understand the Speculative Use of Credit Default Swaps*, 14 STAN. J.L. BUS. & FIN. 263 (2009); Andrea S. Kramer, Alton B. Harris & Robert A. Ansehl, *The New York State Insurance Department and Credit Default Swaps: Good Intentions, Bad Idea*, 22 J. TAX'N & REG. FIN. INST. 22 (Jan./Feb. 2009); David S. Miller & Shlomo Boehm, *New Developments in the Federal Income Tax Treatment of CDSs*, 7 J. TAX'N FIN. PRODUCTS 9 (2009); LAWRENCE LOKKEN, TAXATION OF CREDIT DERIVATIVES, *available at* http://www taxpolicycenter.org/UploadedPDF/1001350_credit_derivatives.pdf; Alan B. Munro, *Revisiting Tax Considerations Regarding Credit Default Swaps*, 12 DERIVATIVES & FIN. INSTRUMENTS 9 (Jan./Feb. 2010).

For comments submitted in response to Notice 2004-52 and other subsequent requests for guidance, see Letter from David Garlock, Howard Leventhal & Alan Munro to Mark W. Everson, IRS Comm'r (Jan. 7, 2005), *reprinted in* 106 TAX NOTES 855 (Feb. 14, 2005), Letter from Managed Funds Association to Mark W. Everson, IRS Comm'r, re:

Service's court for some time. Unofficial comments by officials of the Service suggest that the first likely venue for guidance on the characterization issue may be the reproposal of the long-pending proposed regulations on NPCs with contingent nonperiodic payments, a project aimed a very different class of financial instruments. These regulations are discussed in Section I.B.1, above. The timing of any such guidance is uncertain. This article does not directly address the characterization question but assumes that option and NPC are the relevant treatment alternatives.

If a CDS contract is properly treated as an NPC, then the periodic premium payments would be periodic payments, generally required to be taken into account currently on an accrual basis. It is uncertain whether a cash settlement payment ought to be viewed as a termination payment or as a nonperiodic payment, although the author believes that most market participants treat it as a termination payment.[29]

Under these rules, an upfront payment on the CDS contract would be treated as a nonperiodic payment that must be amortized in some fashion over the life of the CDS. If the CDS were considered a swap (and not a cap or floor) and the upfront payment were a significant nonperiodic payment,

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Notice 2004-52 (Credit Default Swaps) (Apr. 26, 2005), *available at* 2005 TNT 87-20; New York State Bar Association Tax Section, *Report on Credit Default Swaps* (Sept. 9, 2005), *available at* http://www.nysba.org/Content/ContentFolders20/TaxLawSection/TaxReports/1095Report.pdf, *reprinted in* 109 TAX NOTES 347 (Oct. 17, 2005); Letter from New York State Society of Certified Public Accountants re: *Statement on Credit Default Swaps Provided in Response to IRS Notice 2004-52* (Nov. 7, 2005), *available at* 2005 TNT 215-12; Letter from SIFMA to Steven A. Musher, Assoc. Chief Counsel (Int'l) (May 26, 2009), *reprinted in* 1 TAXATION OF FINANCIAL PRODUCTS AND TRANSACTIONS 2010 ch. 1 (Practising Law Institute 2010)

For a number of requests for guidance (or, in one case, no guidance) on credit default swaps prior to Notice 2004-52, see Letter from Capitol Tax Partners to IRS re *Notice 2002-22 (Guidance Priority List)* (May 1, 2002), *available at* 2002 TNT 96-20, Letter from Capitol Tax Partners to Rob Hanson, Tax Legislative Counsel & Barbara Angus, Int'l Tax Counsel, re: *Follow-up Letter on Credit Default Swaps* (July 2, 2002), *available at* 2002 TNT 148-34; Letter from Gregory May & Robert Scarborough to Helen Hubbard, Acting Tax Legislative Counsel & Barbara Angus, Int'l Tax Counsel, re: *Guidance on Credit Default Swaps* (Oct. 1, 2002), *reprinted in* 2 J. TAX'N GLOBAL TRANSACTIONS 72 (2002-2003); Letter from ISDA to IRS re: *Withholding Taxes on Credit Default Swaps* (Oct. 24, 2002), *available at* 2002 TNT 232-21; Letter from ISDA to Barbara Angus, Int'l Tax Counsel (Nov. 21, 2003), *available at* 2003 TNT 232-17; Letter from ISDA to IRS re: *Notice 2003-26 Comments on Recommendations for the 2003-2004 Guidance Priority List* (May 2, 2003), *available at* 2003 TNT 118-26.

As discussed in Section IV.C.1, below, the tax characterization of "pay as you go" CDSs has been raised as an issue in the bankruptcy of a major financial guarantee insurance company.

[29] Treas. Reg. § 1.446-3 defines a "termination payment" as a payment made or received to extinguish or assign all or a proportionate part of the remaining rights and obligations of any party under an NPC, and defines a "nonperiodic payment" as any payment other than a periodic payment or a termination payment. Treas. Reg. § 1.446-3(h)(1), (f)(1) (1994). The Service also has taken the position, however, that a "final scheduled payment" is not a termination payment even though it by definition extinguishes the parties' rights and obligations under the NPC. Prop. Treas. Reg. § 1.1234A-1(b), 69 Fed. Reg. 8886 (Feb. 26, 2004). It is unclear how a final payment that is provided for in the terms of a contract, but that is not scheduled, such as the cash settlement payment on a CDS, fits into this framework.

then one party to the swap would be treated as lending money, and the other would be treated as paying interest.

In addition, if a cash settlement payment were treated as a nonperiodic payment and not as a termination payment, then it seems likely that the proposed regulations addressing swaps with contingent nonperiodic payments would apply, unless CDS are carved out of their scope. As described above, the proposed regulations would require a taxpayer that enters into a swap with a contingent nonperiodic payment to accrue income (or expense) in respect of that final payment. If these regulations applied to CDS, they could require a protection buyer to accrue income as a result of the possibility that the protection buyer may receive a settlement payment if there is a credit event with respect to the reference entity. Conversely, the regulations could require a protection seller to accrue expense as a result of the possibility that it will have to make a future settlement payment.

The proposed regulations clearly were not drafted with CDS in mind, however, and it is uncertain whether CDS will be included or excluded from the scope of the regulations if and when finalized or reissued in proposed form. Among the uncertainties about whether and how these regulations might apply to CDS are (a) whether a CDS contract is an NPC, (b) if so, whether the CDS contract would be subject to these proposed regulations, (c) whether the cash settlement payment should be viewed as a nonperiodic payment, rather than a termination payment, and (d) if so, how the regulations should be applied in view of the fact that a settlement payment is uncertain not only in amount (which the regulations envision) but also as to timing (which the regulations do not envision), or for that matter whether it will occur at all (the regulations do not envision a nonpayment of a contingent amount).[30] Some of these issues are discussed further in Section IV.D, below.

If, conversely, a CDS contract is properly characterized as an option or series of options, it generally would be subject to the rules described in Section I.B.2, above.[31]

C. *Overview of Section 1256.*

Section 1256 was enacted in 1981, as part of a package of rules intended to shut down "tax straddle" transactions in which taxpayers sought to obtain timing and character advantages from taking largely offsetting positions in, generally, futures contracts. As enacted, § 1256 required that "regulated futures contracts" ("RFCs") be marked to market at year-end,

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[30] For materials addressing the potential application of these regulations to credit default swaps, see Letter from the Investment Company Institute to Gregory F. Jenner, Acting Assistant Secretary for Tax Policy, U S. Dep't of the Treasury, and Donald Korb, Chief Counsel, IRS (July 21, 2004) (on file with author) (letter concerning Proposed Regulations on Notional Principal Contracts with Contingent Nonperiodic Payments), 2004 TNT 147-14; Lee A. Sheppard, *Retail Credit Derivatives*, 105 TAX NOTES 126 (2004); Munro, *supra* note 28.

[31] Because NPCs include interest rate caps and floors, which consist of multiple options, it is conceivable although unlikely that if a CDS contract constitutes a series of options, it could be an NPC even though a single option cannot be an NPC.

meaning that gain or loss on the RFC was required to be taken into account as if the RFC had been sold at year-end. To soften the mark-to-market blow, § 1256 also provided that gain or loss on RFCs would be treated as 60% long-term and 40% short-term, notwithstanding the fact that futures contracts typically have a term of no more than three months.

For this purpose, an RFC was defined as a contract (i) that requires delivery of personal property or an interest therein, (ii) with respect to which the amount required to be deposited and the amount which may be withdrawn depends on a system of marking to market, and (iii) that is "traded on or subject to the rules of" a domestic board of trade designated as a contract market by the Commodity Futures Trading Commission ("CFTC") or certain other exchanges. At the time, this definition gave rise to no confusion, as it was tailored to the terms of futures contracts trading on CFTC-approved exchanges.

Very generally, a futures contract of this kind was a contract with standardized terms for the future delivery of a commodity, with a single payment made at maturity in exchange for the delivery of the commodity. The contract was traded on an exchange through "open outcry" (traders standing in pits and signaling each other through hand movements) under CFTC rules. Under the exchange rules, a clearinghouse then interposed itself between the two parties to the contract as effectively a guarantor of the parties' obligations. As a legal matter, the clearinghouse became the legal counterparty to each side of the transaction. The credit support provided by the clearinghouse was derived from collateral and guarantees provided by the futures commission merchants (the equivalent of brokers in the commodities world) acting for each party, as well as a small amount of initial margin required from both parties to the contract. On a daily basis, as the contract gained or lost value as a result of changes in commodities prices and market expectations, the "losing" party was obligated to put up additional "variation margin" in the form of cash, which cash was deposited in the account of the "gaining" party.[32]

The definition of RFC as originally enacted was short-lived. In 1982, § 1256 was amended to delete the delivery requirement for RFCs, and to add a new category of financial instruments subject to § 1256, "foreign currency contracts." A foreign currency contract was defined as a contract that requires delivery of a foreign currency in which positions are also traded through RFCs, that is traded in the interbank market, and that is entered into at a price determined by reference to interbank market prices.

Section 1256 was again amended in 1984 and 2000 to add three additional categories of contracts subject to § 1256—nonequity options, dealer equity options, and dealer securities futures contracts. Dealer equity options are options on single stocks, such as an option on IBM stock, that are traded by options market makers on securities exchanges. The term "nonequity option" is somewhat misleading; it is defined as any listed option that is not an "equity option," a term that has a narrower meaning

[32] The clearing and trading of futures contracts is described in more detail in Section II.A.1, below

than might initially appear. As a result of the historical division of responsibility between the Securities & Exchange Commission ("SEC") (single stocks and narrow-based equity indices) and the CFTC (broad-based equity indices), the term covers listed options on broad-based stock indices, like the S&P 500, as well as options on truly nonequity risks like options on commodity futures contracts, options on Treasury bond futures, and options on foreign currency futures. Dealer securities futures contracts are futures contracts on single stocks, and options thereon, that are traded by taxpayers treated for tax purposes as dealers therein. Like RFCs, nonequity options and dealer securities futures contracts are traded on CFTC-regulated exchanges. Collectively, the contracts subject to § 1256 are now categorized as "section 1256 contracts." The history of several of these provisions is discussed in more detail in Part III below.

D. Overview of Other Special Tax Rules for Derivatives

1. *Hedging Transactions.* A very common purpose for entering into a derivative financial instrument is to hedge a risk or exposure deriving either from an asset held or to be held by a taxpayer or a liability issued or to be issued by a taxpayer. While the history of the tax rules for hedging transactions is long and not always untroubled, under current law the tax rules for hedging ordinary business assets or liabilities is fairly straightforward.

Section 1221(a)(7) provides that the term "capital asset" does not include any "hedging transaction" clearly identified as such no later than the close of the day it was entered into. Section 1221(b)(2) defines a "hedging transaction" generally to mean any transaction entered into by the taxpayer in the normal course of the taxpayer's trade or business primarily to manage risk of price changes, currency fluctuations, or, in the case of liabilities, interest rate risk, with respect to ordinary property or liabilities of the taxpayer. Treas. Reg. § 1.1221-2 provides more detailed guidance on the implementation of these rules. Thus, generally, if a taxpayer enters into a "hedging transaction" and properly identifies it as such, the taxpayer's gain or loss from the transaction will be ordinary rather than capital. This allows the taxpayer to match the character of its gain or loss from the hedged item and the hedge.

Corresponding timing rules are provided in Treas. Reg. § 1.446-4. They generally conform the timing of income or expense from a hedging transaction to the timing of corresponding expense or income from the hedged item.

Foreign currency hedges generally do not fall within the ambit of § 1221, as they already give rise to ordinary income or loss.[33] There are timing and character distinctions, however, between foreign currency swaps, foreign currency forward contracts and foreign currency futures

[33] Treas. Reg. § 1.1221-2(a)(4) (2007) (this section does not apply to determine the character of gain or loss from section 988 transactions). Section 988 generally provides rules for taxing foreign currency gain or loss from transactions in foreign currency, foreign currency-linked debt and foreign currency-linked derivatives.

contracts, which are respectively subject to ordinary character/realization method, ordinary character/mark-to-market and capital character/mark-to-market rules in the absence of any elections.[34] Accordingly, it may be necessary or useful to make a hedging election for one of these transactions, depending on the item being hedged.[35]

The tax rules for hedging capital assets are more limited and less favorable. Treas. Reg. §§ 1.1275-6 and 1.988-5 permit taxpayers to "integrate" certain hedges of debt instruments issued or held by the taxpayer with the debt itself.[36] Apart from these rules, the principal rules governing hedges of capital assets are the straddle rules of §§ 1092 and 263(g), which are anti-abuse rules of a complex and uncertain nature. Additional rules addressing hedges of capital assets are found in other statutory provisions, including §§ 1092(e), 1256(e) and (f)(1), and 475(d)(2)(F), but they generally are narrower in scope and have less specific guidance implementing them than the "hedging transaction" rules described above, or are also anti-abuse rules unfavorable to taxpayers.[37] Thus, for taxpayers hedging capital assets, it is more difficult to ensure that the timing and character of gains and losses from a hedge match those from the hedged item. Consequently, for taxpayers that wish to have such matching, it is more important that the basic tax rules for the hedge and hedged item give rise to similar timing and character results.

Some taxpayers use derivatives to bridge a gap between their assets and liabilities, typically in cases where the assets are fixed income assets that pay on a different basis or have a different duration or timing of payments than their liabilities, e.g., fixed rate liabilities vs. floating rate assets. In the *Federal National Mortgage Association* case, for example, the principal factor in determining the taxpayer's profit or loss was the spread between the average net yield on its mortgage portfolio and the

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[34] *See* I.R.C. § 988(a)(1) (2010) (general rule that foreign currency gain or loss attributable to any "section 988 transaction" is ordinary income or loss); I.R.C. § 1256(b)(1), (2) (2010) (defining any "regulated futures contract" and "foreign currency contract" as section 1256 transactions generally subject to mark-to-market treatment and to capital gain/loss rules unless character otherwise would be ordinary); I.R.C. § 988(c)(1)(B)(iii) (2010) ("section 988 transactions" include any forward contract, futures contract or similar financial instrument that is denominated in or determined by reference to nonfunctional currency); I.R.C. § 988(c)(1)(D)(i) (2010) (I.R.C. § 988(c)(1)(B)(iii) does not apply to regulated futures contracts); I.R.C. § 988(b)(3) (2010) (all gain or loss from section 988(c)(1)(B)(iii) transactions is ordinary).

[35] I.R.C. § 988(d) (2010) also provides for special hedging rules for foreign currency. For a discussion of the special rules applicable to foreign currency transactions used as hedges, see John D. McDonald, Ira G. Kawaller, L.G. "Chip" Harter & Jeffrey P. Maydew, *The Devil is in the Details. Problems, Solutions and Policy Recommendations with Respect to Currency Translation, Transactions and Hedging*, 89 TAXES (forthcoming Mar. 2011).

[36] Treas. Reg. § 1.988-5 (1992) also provides favorable rules for certain hedges of foreign currency payables and receivables.

[37] By its terms, the § 1256(e) hedging exception is more limited than the very similar exception under § 1221. For a discussion of a recent ruling illustrating that point, see Michael (Wei-Chin) Mou & David H. Shapiro, *Does Section 1256 Incorporate an Inadvertent Error Exception*, 128 TAX NOTES 1159 (Sept. 13, 2010). The conclusion reached in that ruling was later modified to take into account other provisions of the Code *See* Chief Counsel Advice 201046015 (July 14, 2010).

average cost of its outstanding debt.[38] The taxpayer entered into several types of derivatives in order to hedge its interest rate and duration risk. Another type of taxpayer that may use derivatives in this manner is a life insurance company, which may face a gap between the rates or duration on its investment assets and the cash flows it expects to need to pay out on its policies. As the *FNMA* case illustrates, it is crucial for a taxpayer of this kind to be able to treat gains and losses on its hedges as ordinary rather than capital.

2. *Mark-to-Market Rules*. A taxpayer using a "mark-to-market" method of tax accounting treats assets or other positions subject to that method as if sold at year-end, generally solely for purposes of determining gain or loss with respect to that position. Future gain or loss, whether from a subsequent mark or from disposition, are adjusted to take the recognized gain or loss into account.

As anyone with even a cursory understanding of U.S. tax rules knows, mark-to-market is not a customary method of accounting for most taxpayers. That is true even for assets that are easy to value and readily turned into cash, like publicly traded stock. Rather, mark-to-market rules generally apply in one of two situations: a taxpayer election or prevention of abuse. Examples of mark-to-market rules include §§ 877A (expatriates), 1256, 1260 (constructive ownership rules), and 1296 (modified mark-to-market rules for passive foreign investment companies).[39]

A taxpayer that is a "dealer in securities," however, generally is required to mark its securities to market, under § 475. Unlike § 1256, under § 475 gain or loss from positions held in connection with a dealer's activities as such give rise to ordinary gain or loss. This is to be expected, as gain or loss from ordinary business activities generally is ordinary.

In the case of a dealer in securities who transacts in section 1256 contracts as part of the normal course of its business, there is a potential conflict between the general capital gain/loss rules of § 1256 and the general ordinary income/expense rules of § 475. Sections 475 and 1256 contain several rules intended to clarify when each rule applies. As discussed in more detail in Section III.A, below, however, these rules may work imperfectly. Since a corporate taxpayer generally has no benefit from capital gains under current law, but cannot deduct capital losses except to the extent of capital gains, dealers in securities typically prefer for derivatives that they enter into to be subject to § 475 rather than § 1256.

II. DEVELOPMENTS IN THE MARKETS AND THE LAW.

As described earlier, a number of events, most notably the emergency rescue of AIG by the federal government in the fall of 2008, led many government regulators and other policymakers to the conclusion that

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[38] Fed. Nat'l Mortg. Ass'n v. Comm'r, 100 T.C. 541 (1993).

[39] Mark-to-market is also permitted or required by various regulations, including Treas. Reg. §§ 1 148-6(e)(5) (internal commingled funds), 1.148-9(c)(1)(iv)(B) (allocation rules for refunding issues), 1.1092(b)-3T(b)(6) (identified mixed straddles), and 1.1092(b)-4T(c)(5) (mixed straddle accounts).

the CDS market, and more generally the OTC market for derivative financial instruments, must be transformed so it poses less of a risk to the financial system. Among the improvements sought were enhanced market transparency, improved operational processes, a reduction in the level of outstanding trades, and the creation of a single central counterparty for swaps.[40] It was also envisioned that there would be a single regulator that would have oversight over the entire system. Some of these goals were part of a larger program addressed to the derivatives market as a whole and some were CDS-specific.

In the United States, the Fed took an active role in encouraging dealers in CDS to take several steps to advance these goals. The two steps of interest for purposes of this article are the standardization of CDS terms in the spring of 2009, which was a prerequisite for the clearing of CDS, and the commencement of clearing of CDS by two U.S. clearinghouses in the fall of 2009. CDS are now also being cleared by several European clearinghouses. The U.S. markets for interest rate swaps are moving in the same direction. To date, all of these steps have been nominally voluntary, although as a practical matter the active involvement of the Fed and other regulators has meant that the changes have been adopted on an industry-wide basis by swap dealers.

Dodd-Frank now requires that similar steps be taken for other classes of swaps. As described in more detail below, under Dodd-Frank, most swaps will be regulated, some by the SEC and some by the CFTC. In addition, most swaps will be cleared through one or more central clearinghouses and most swaps will be traded on regulated exchanges (or "swap execution facilities") rather than being negotiated in the OTC market. As described in more detail below, however, Dodd-Frank does not require that all swaps be cleared and traded. Rather, it permits trading on markets that do not appear to constitute a "qualified board or exchange" for § 1256 purposes, and it allows certain types of parties to swaps to elect whether to clear their swaps or not. Accordingly, it seems inevitable that there will exist identical swaps that will be traded on a qualified board or exchange in some cases and that will in other cases exist in the bilateral OTC derivatives or other market.

A. The Clearing Process.[41]

As has been made clear, the clearing of swaps through a central counterparty is now a critical part of the regulatory framework for swaps. It is also critical to understanding the tax issues described in this article. Accordingly, before turning to a description of Dodd-Frank, this Section II.A of the Article describes the clearing process. Because the transformation of the CDS market from an OTC market to a market with

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[40] *See New York Fed Welcomes Further Industry Commitments on Over-the-Counter Derivatives*, FED. RESERVE BANK OF N.Y. (Oct 31, 2008), http://www.newyorkfed.org/newsevents/news/markets/2008/an081031.html (last visited Dec. 31, 2010)

[41] See attached diagrams illustrating the clearing process for an interest rate swap or CDS negotiated in the OTC market.

trillions of dollars of cleared contracts may provide insights into future developments for other classes of swaps, the new CDS clearinghouses are also described in some detail. The current and imminent state of clearing for interest rate swaps is also briefly described.

It is important, as a preliminary matter, to understand the differences between clearing through a centralized clearinghouse and trading on a regulated exchange. To that end, this section discusses the different mechanisms governing futures contracts (which are both exchange-traded and cleared), CDS, and interest rate swaps (which may be cleared, but are not currently exchange-traded). Very broadly speaking, "trading" has to do with how the parties agree on a price for entering into or terminating a transaction. "Clearing" has to do with the centralization and management of risk and the transmittal of payments after the trade is entered into.

1. *Clearing Futures Contracts.* Futures contracts are traded on regulated exchanges. Their terms are standard and are set out in the rules of the exchange. Mechanically, a customer wishing to acquire the right to buy corn at some point in the future may go to its broker—technically, a "futures commission merchant," or FCM—who is a member of a regulated exchange. The FCM will take the client's order and go to the exchange, where the FCM will agree with another FCM to create electronic "buy" and "sell" positions. Each position represents one side's willingness to either accept the obligation to deliver, say, 5000 bushels of a specified type and grade of corn on the specified date at the specified price or to pay the specified price and receive the corn on the specified date. The exchange's proprietary matching engine then connects individual "buy" positions with matching "sell" positions. Once a match is found, the contract is executed, with the parties on either side as counterparties.

It should be noted that while the FCM in this example is carrying out customer transactions, the exchange deals only with the FCM and not with the customer. One can analogize this to a stockbroker dealing with a stock exchange on behalf of a client, but the relationship is more complicated because a futures contract is a contract, not an investment in a third party as to which legal and beneficial ownership can readily be split. Depending on the circumstances, one may acknowledge the role played by the FCM as the face to each of the exchange and the customer. For most tax purposes, however, the FCM is ignored and the customer is treated as if it were executing the trade on the exchange. That convention will be followed here except where the role of the FCM needs to be distinguished from that of the customer or the exchange. Thus, once a futures contract has been executed, the parties to the trade are the customers who are respectively willing to buy and sell corn.

This relationship does not last, however, because the trade then must be cleared through the exchange's central clearinghouse.[42] The

[42] It should be noted that centralized clearing is not a new idea. In 1925, the Chicago Board of Trade Clearing Corp. was the first United States clearinghouse, formed to become a counterparty to all transactions then carried out on the Chicago Board of Trade

clearinghouse steps into the shoes of each side of the trade and becomes the party responsible for both the actual delivery of the 5000 bushels of corn to Party *A* and the payment for the corn to Party *B*. At the same time, each party now has a responsibility, not to its original counterparty, but to the clearinghouse, to either deliver the corn (in the case of Party *B*) or provide the payment (in the case of Party *A*). By interposing itself between the parties, the clearinghouse assumes the risk that one party to the transaction will not perform.

The clearinghouse manages this risk through several mechanisms: (i) it takes initial margin (usually a small percentage of the purchase price) and subsequently variation margin, as described below, determined by reference to the party's then-outstanding trades with the clearinghouse, which changes daily; (ii) it nets the FCM's position in the particular contract, as described below; and (iii) it requires that the FCM provide additional collateral (which becomes part of a "guaranty fund") and has the right to assess FCMs for additional guaranty fund contributions (essentially, contingent collateral) to cover the clearinghouse's risks.[43] In the case of a default by a clearinghouse member—generally only members can be counterparties to the clearinghouse—the clearinghouse attempts to cover any resulting losses by looking first to that member's margin and collateral. Should that be insufficient, however, the clearinghouse can draw upon the collateral provided by other members. If that, too, proves inadequate, the clearinghouse can call upon the guarantees. The risk of failure by a member is thus reduced, through the use of netting and the requirement that the member provide margin and collateral, and mutualized, through the clearinghouse's right to appropriate the assets of other members.

The netting of contracts is possible because the contracts have standardized terms. For example, if on the day after the transaction described above, another customer of FCM *A* wishes to sell 15,000 bushels of corn pursuant to a futures contract that, but for the quantity and price, has terms identical to the first transaction, FCM *A* will execute that trade with FCM *C*. Once this contract has been cleared, the clearinghouse will automatically net FCM *A*'s right to receive 5000 bushels against its obligation to deliver 15,000 bushels into a single obligation to deliver 10,000 bushels in exchange for payment. As a result, at the end of a trading

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(generally trade in grain futures), and some form of central clearinghouses existed in Europe prior to that time. Federal Reserve Governor Randall S Kroszner, Central Counterparty Clearing: History, Innovation, and Regulation, Address at the European Central Bank and Federal Reserve Bank of Chicago Joint Conference on Issues Related to Central Counterparty Clearing (Apr. 3, 2006), http://www.federalreserve.gov/newsevents/speech/kroszner20060403a htm#f5 (last visited Dec. 30, 2010).

[43] The initial margin and variation margin requirements apply in the first instance to customers, who pay or receive these amounts to/from their FCMs, who in turn generally pay/receive these amounts to/from the clearinghouse. Thus, if a futures contract increases in value, one customer will pay variation margin to its FCM, which will pay it to the clearinghouse, which will pay it to the other FCM, which will pay it to the second customer. The netting and additional collateral requirements apply to FCMs, not customers, however, although the cost of the additional collateral requirements may be passed on to customers in the form of pricing.

day, FCM *A* will always have a single net position with the clearinghouse with respect to any one type of futures contract, although it will have multiple actual positions because it transacts in multiple types of futures contracts.

2. *Clearing CDS.* In contrast to futures contracts, CDS are not traded on exchanges. Instead, a CDS is entered into over-the-counter in a private agreement between two parties. As a result of the standardization process described below, the number of variables to be negotiated is limited, primarily to the market quoted level for the coupon—that is, the coupon that the market would have agreed to pre-standardization—and the maturity ("tenor") of the CDS.

Upon reaching agreement on the terms of their CDS, if the CDS is of a kind subject to clearing, each party novates its contract with the central clearinghouse, which (as in the futures context) steps between and becomes the counterparty to both parties.[44] As in the futures context, this allows the

[44] The statement in the text is a highly simplified explanation of the actual process, which differs from the process for futures contracts in several regards. Unlike the case with futures, the brokers (dealers) who face customers in the CDS market are not always clearinghouse members. Consequently, in order to clear a CDS, the customer, the executing broker (that is, the swap dealer), and the designated clearing member (which may or may not be the same legal entity as the broker, or an affiliate of the broker) must all cooperate, as the customer-broker transaction will be replaced by a customer-clearing member-clearinghouse transaction. The process for dealing with failures to clear a trade is also different in the futures and CDS markets. In the futures market, the parties simply keep trying to clear a trade. If it fails, no trade exists. In the CDS market, dealer/dealer trades clear weekly on ICE Trust and daily on the CME, although both are working on more rapid clearing cycles. In the interim between agreeing to a transaction and clearing it, a bilateral OTC contract exists between the dealers. If the trade fails to clear, the bilateral OTC contract continues in existence. Dealer/customer CDS trades work differently. If a trade of that kind fails to clear, there are several different possible outcomes: (i) the designated clearing member may be replaced, (ii) the trade may remain a bilateral OTC contract, but likely with different pricing because the credit risk, margin requirements, and possibly regulatory capital requirements are different for OTC-only vs. cleared CDS, or (iii) the trade may be broken. *See* ISDA, *Recommended Common Principles for Relationships between Customer and Executing Broker ("EB") and Clearing Member ("CM")*, http://www.isda.org/credit/docs/Recommended-Common-Principles.pdf (last visited Dec. 30, 2010). All of this is subject to change as the markets continue to develop.

One tax question raised by the clearing process is whether the clearing of a swap will be treated as a taxable disposition of the swap for property differing materially in kind or extent, under § 1001. In the case of newly originated swaps that are intended from the outset to be cleared, this issue appears to be trivial, particularly if as suggested above the terms may change if the swap ultimately is not cleared. Under the step transaction doctrine, it should be the case that the cleared swap is treated as the same swap agreed to by the parties. *See* discussion *infra* Section III.B.3 (concerning Revenue Ruling 87-43). Rev. Rul. 87-43, 1987-1 C.B. 252.

The analysis may be different for pre-existing swaps. If pre-existing swaps were submitted for clearing, one would have to consider whether Treas. Reg. § 1.1001-4 or some other basis for non-recognition treatment applies. The regulation treats an assignment as a non-event for the non-assigning party if the assignment (i) is from one swap dealer to another and (ii) is permitted by the terms of the contract. It is an interesting question whether a clearinghouse could be considered a dealer for this purpose. Typically, they would not be, but in other contexts novation to a clearinghouse has been essentially disregarded for U.S. federal income tax purposes so that no consideration has been given to that issue. In this context one might perhaps argue that a clearinghouse serves a function sufficiently similar to that of a dealer to be treated as such for purposes of this rule.

clearinghouse to net out each party's overall exposure to CDS, resulting in a single net position with respect to any particular CDS (e.g., a CDS on a specified reference entity or a specified series of an index with a specified maturity). In exchange for using the clearinghouse's services in this way, each party must provide collateral and adjust the amount of that collateral on a daily basis to reflect the party's net exposure.

There is, however, at least one significant economic difference between clearing CDS and clearing futures contracts. Futures contracts provide for only a single payment at maturity, so the payment made or received when entering into a futures contract reflects simply the difference between the price specified in the futures contract and the market price at that time. CDS and other swaps, by contrast, provide for periodic payments. Also, CDS generally are, and other swaps may well be, entered into with an upfront payment, or are deemed to do so for tax purposes. Upfront payments on cleared swaps are described in more detail in Section II.C, below. One last point worth understanding is that in the case of CDS clearing, both dealers and certain other major participants in the CDS market benefit from the credit support of the clearinghouse. Those arrangements are intended to provide assurance that if a clearing member fails, a customer's CDS positions will be transferred to another clearing member and the customer's margin will be available to transfer together with the customer's CDS positions. The mechanics of these arrangements differ from clearinghouse to clearinghouse.[45]

As mentioned above, there are currently two U.S. clearinghouses clearing CDS, ICE Trust U.S. and the Chicago Mercantile Exchange ("CME"), in addition to ICE Clear Europe, Eurex, and now LCH.Clearnet in Europe. For tax purposes, there are potentially significant differences between how the two U.S. CDS clearinghouses are organized and operate. Other types of swaps can be expected to be cleared through additional

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Voluntary submission of existing swaps to a clearinghouse would not, however, appear to be permitted by the terms of a standard ISDA, which require consent by a counterparty to assign a swap except in very limited situations. If the economic terms of the swap were modified in connection with the novation, that also would pose an obstacle to tax-free treatment. A final concern might be that the regulation applies by its terms only to NPCs, and so does not literally apply to options and other types of derivative financial instruments. Leaving aside for the moment the question of whether economic terms of a swap would change when it is cleared, a more satisfying answer to the non-recognition question could be to conclude that the clearinghouse is essentially simply a guarantor, and consequently that there has been no disposition of a swap when it is cleared. *See* discussion *infra* note 132.

Similar issues could arise in connection with the transfer of a customer's positions from one clearing member to another in the event of the failure of the original clearing member. One would have to consider in that regard whether the CME-type agency model for clearing customer trades would be less likely to give rise to a taxable disposition than the ICE Trust-type principal model. See the text below for discussion of these two regimes

[45] For extensive discussion of proposals made by U.S. and European central clearinghouses for protecting CDS customers in the event that a clearing member fails, see ISDA, *Report to the Supervisors of the Major OTC Derivatives Dealers on the Proposals of Centralized CDS Clearing Solutions for the Segregation and Portability of Customer CDS Positions and Related Margin*, http://www.isda.org/credit/docs/Full-Report.pdf (last visited Dec 30, 2010) [hereinafter *The Buy-Side Report*]. These arrangements are briefly described *supra* note 43.

clearinghouses, which may also have different legal and functional structures.

(a) *ICE Trust U.S.* ICE Trust U.S. is organized as a New York trust company, and is regulated by the Federal Reserve and the New York State Banking Department.[46] ICE Trust is one of several subsidiaries of IntercontinentalExchange ("ICE"), which operates exchanges in the United States, Canada, and Europe and also operates several OTC markets. ICE Trust is a standalone clearinghouse for clearing CDS. That is, its sole function is to clear, and the sole contracts that it clears are CDS.

ICE Trust received regulatory approval from the New York State Banking Department in December 2008. In March 2009, it received regulatory approval from the Fed to provide central counterparty services by clearing CDS and from the SEC to perform the functions of a clearing agency for cleared CDS.[47] ICE Trust began clearing CDS in March 2009, and clears both single name CDS and index CDS. According to ICE, the volume of gross notional amount cleared by ICE Trust exceeded $7 trillion by the end of September 2010, and open interest in cleared CDS was just under $500 billion.[48]

ICE Trust operates under a set of rules that set out conditions for membership, the terms of the CDS that it clears, the details of how clearing takes place, how determinations of various kinds are made, and other related topics. These rules are also standalone, meaning that they relate solely to ICE Trust.

ICE reports daily settlement prices, daily trading volume, and end-of-day open interest for each CDS contract that it trades. ICE does not provide other price information for cleared swaps, but bid/ask quotes can be obtained by calling a market participant.

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[46] In November 2008, the SEC, the CFTC and the Fed executed a Memorandum of Understanding under which they agreed to cooperate and coordinate in their respective approval, supervision, and oversight of Central Counterparties (a "CCP") for CDS. The MOU notes that a CCP for CDS may be one or more of the following: a state-chartered bank that is a member of the Fed, a derivatives clearing organization ("DCO") regulated by the CFTC, or a "clearing agency" regulated by the SEC. *Memorandum of Understanding Between the Board of Governors of the Federal Reserve System, the U.S. Commodity Futures Trading Commission, and the U.S. Securities and Exchange Commission Regarding Central Counterparties for Credit Default Swaps*, U.S. DEP'T OF THE TREASURY, http://www.treasury.gov/resource-center/fin-mkts/Documents/finalmou.pdf (last visited Dec 30, 2010).

[47] For the New York State Banking Department approval, see *Banking Department Approved Intercontinental Exchange, Inc. to Form Trust Company to Clear Credit Derivatives*, STATE OF N.Y. BANKING DEP'T, http://www.banking.state.ny.us/pr081204.htm (last visited Dec. 31, 2010). The Fed approval was granted as a Board order, dated March 4, 2009. For the SEC approval, see Securities Exchange Act Release No. 34-59527 (Mar. 6, 2009), 74 Fed. Reg. 10791 (Mar. 12, 2009). The SEC order was a temporary order that has since been renewed. As these approvals indicate, ICE Trust operates, as contemplated by the MOU, as a state-chartered bank and as a clearing agency.

[48] *See Clearing ICE Trust*, INTERCONTINENTALEXCHANGE, https://www.theice.com/ice_trust.jhtml (last visited Dec. 30, 2010).

(b) *The CME Clearinghouse*. The CME is a subsidiary of the CME Group, which is a holding company for the CME, the Chicago Board of Trade ("CBOT"), the New York Mercantile Exchange ("NYMEX"), and the Commodity Exchange ("COMEX"). Each of these is a separate legal entity that is a contract market designated as such by the CFTC (a "designated contract market," or "DCM") and operates as a futures exchange.

The CME's clearing operations are a separate division from the exchange, but are housed in the same legal entity as the CME exchange. The CME clearinghouse is separately regulated by the CFTC as a "derivatives clearing organization" (a "DCO").[49] CME Clearing clears for both the CME and CBOT. Once a CDS contract submitted for clearing has been accepted, the CME becomes the legal counterparty to the contract in its capacity as a clearinghouse.

In December 2008 the CME certified plans to provide clearing services for CDS, and in March 2009, temporary regulatory approval (since renewed) was granted to allow the CME to perform the functions of a clearing agency for cleared CDS, subject to various conditions.[50] The CME began clearing CDS in December 2009, and it now clears index CDS. As of the end of September 2010, the CME reported total open interest in cleared CDS of $35 million.[51] Margin provided by clearing members in respect of CDS currently is held in a segregated account.[52] The CME has

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[49] A point that may be worth noting in this regard is that the CFTC regulates a number of different types of entities, of which DCMs and DCOs are only two examples Other regulated trading markets include derivatives transaction execution facilities ("DTEFs"), which are trading facilities with a lower level of regulation; exempt boards of trade ("EBOTs"), which limit transactions to selected participants and commodities; and exempt commercial markets ("ECMs"), which limit trading to principal-to-principal transactions between selected participants on selected commodities. *See generally Trading Organizations*, U S. COMMODITY FUTURES TRADING COMM'N, http://www cftc.gov/IndustryOversight/TradingOrganizations/index.htm (last visited Dec 31, 2010); *see also* ANDREA S. KRAMER, FINANCIAL PRODUCTS: TAXATION, REGULATION, AND DESIGN § 4 02 (types of commodities markets). § 62.01 (discussion of qualified boards or exchanges) (CCH 3d ed. 2006); WILLIAM R. POMIERSKI, *Special Rules for Certain Energy Futures Contracts and Options*, *in* ENERGY AND ENVIRONMENTAL TRADING. US LAW AND TAXATION ch. 18 (Andrea S. Kramer & Peter C Fusaro eds., Cameron 2008). Additional types of trading markets and related acronyms can be expected to be added as a result of the enactment of Dodd-Frank.

[50] *See CFTC Announces That CME Has Certified a Proposal to Clear Credit Default Swaps* (Dec. 23, 2008), http://www cftc.gov/PressRoom/PressReleases/pr5592-08.html (last visited Dec. 31, 2010), Order Granting Temporary Exemptions Under the Securities Exchange Act of 1934 in Connection With Request of Chicago Mercantile Exchange Related to Central Clearing of Credit Default Swaps. 74 Fed. Reg. 11781 (Mar. 19, 2009) As these approvals indicate. the CME clearinghouse operates, as contemplated by the MOU, as a DCO and as a clearing agency

[51] *See* CME Group, *CDS Market Data Reports*, http://www.cmegroup com/trading/cds/cds-data.html (last visited Dec. 31, 2010).

[52] Very generally speaking, customers clearing CDS through the CME maintain a clearing relationship with a futures commission merchant (an "FCM"), which serves as the customers' agent and guarantor in respect of cleared CDS. From the CME's perspective, its counterparty for cleared CDS consists of each clearing member, with the clearing member acting as agent for unidentified principals—e g., the customers. Thus, the CME clearing arrangements for CDS resemble those for futures contracts. Under applicable law, FCMs

submitted a request for permission to commingle this margin with margin securing other types of derivatives traded by the CME.

Several chapters of the CME Rulebook deal with clearing. Those rules provide that the Exchange shall maintain and operate a clearing house. Chapter 8F of the CME Rulebook deals with "Over-the-Counter Derivative Clearing." Chapter 8F provides rules for submitting an OTC trade on ClearPort and rules providing for the substitution of the CME as counterparty to each side of the trade and the clearing house's guarantee of cleared trades. Chapter 801 of the CME Rulebook deals specifically with clearing CDS.

The CME Group reports daily settlement prices, daily volume, open interest and net changes therein for OTC swaps. The CME Group does not provide bid/ask prices for cleared swaps, as they are not part of the open outcry or electronic trading platform available for futures; instead, bid/ask quotes can be obtained by calling a market participant.

3. *Clearing Interest Rate Swaps.*[53] Like a cleared CDS, a cleared interest rate swap is a privately negotiated contract that is submitted to a clearinghouse. The oldest such clearinghouse is known as LCH.Clearnet. LCH.Clearnet is an independent clearinghouse. It clears for many exchanges as well as clearing non-exchange-traded contracts like interest rate swaps.

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generally must segregate any property received from a customer as margin for various categories of derivatives and hold it in an account identified as a customer account at a qualified financial institution. CFTC regulations and CME rules impose this segregation requirement on margin provided by CDS customers.

ICE Trust has a different structure. Clearing members under ICE Trust's clearing framework act as principals vis-a-vis both the clearinghouse and customers, rather than as agents. If a customer executes a CDS trade with its clearing member that both parties agree to clear through ICE Trust, the result of the clearing process is that the clearing member will have three principal trades open – a "customer" trade with ICE Trust (that is, a clearing member-ICE Trust trade that is designated as relating to a customer transaction) that is offset by a back-to-back or mirror trade with the actual customer, and a "house" trade with ICE Trust that is the real risk position for the clearing member (If the clearing member is not the executing dealer, these arrangements involve four parties rather than three.) Thus, from ICE Trust's perspective it deals with the clearing member as a principal, and from the customer's perspective it too deals with the clearing member as a principal. The margin that the clearing member collects from its customer under the mirror trade with the customer can be on-pledged to ICE Trust, as customer margin, under the "customer" trade that the clearing member has with ICE Trust. As in the case of the CME, this margin is segregated for the benefit of the customer.

For discussion of the operation of these rules and open issues under the law prior to Dodd-Frank as to how effective they are to protect CDS customers, see *The Buy-Side Report*, *supra* note 45, pts. III.A.1 (CME) & III.A.2 (ICE Trust); Letter from CME Group to Securities & Exchange Commission re: *Request for Order Exempting Certain Persons from Broker-Dealer Registration and Related Requirements, and from Clearing Agency Registration and Related Requirements* (Dec. 14, 2009), *available at* http://www.sec.gov/rules/exorders/2009/34-61164-incoming.pdf; Letter from ICE Trust to Securities & Exchange Commission re: *Supplemental Request for Exemption from Certain Provisions of the U.S. Securities Exchange Act of 1934 with Respect to ICE Trust U.S. LLC and its Clearing Members and Request for Extension of the March 6, 2009 Order* (Dec. 4, 2009), *available at* http://www.sec.gov/rules/exorders/2009/34-61119-incoming.pdf.

[53] The information under this heading comes primarily from the websites of LCH.Clearnet, http://www.lchclearnet.com; and IDCG, http://www.idcg.com.

LCH.Clearnet has cleared interest rate swaps since 1999, and currently clears about forty percent of the global interest rate swap market, in fourteen different currencies. According to LCH.Clearnet's rules, parties enter into interest rate swaps first under bilateral ISDA documentation; when cleared by LCH.Clearnet, the economic terms are preserved but the LCH.Clearnet becomes the legal counterparty to each trade and the legal terms of the trade become LCH.Clearnet standard terms. Accordingly, unlike cleared CDS, the periodic payments made under interest rate swaps cleared by LCH.Clearnet are not standardized. LCH.Clearnet's rules specify payment dates and calculation methodologies for payments and margin determinations.

A more recent entrant to the market is the International Derivatives Clearing House ("IDCH"), a clearinghouse owned by the International Derivatives Clearing Group ("IDCG"), a subsidiary of NASDAQ. Like the CME, the IDCH is regulated by the CFTC. IDCG offers trading in interest rate futures contracts on NASDAQ OMX, a designated contract market that trades many other types of futures contracts. In addition, IDCH offers to clear interest rate swaps through exchange for swap transactions in which bilateral interest rate swaps are exchanged for futures contracts that have economic terms identical to the bilateral interest rate swaps. Thus, as with LCH.Clearnet, the cleared instruments do not have standardized terms. Unlike LCH.Clearnet, however, a party that transacts with IDCH winds up with a contract that is a futures contract as a regulatory matter even though its payment terms are those of a typical interest rate swap.

IDCH first offered this service in December 2008, although it appears that trading has begun only very recently.[54] This may reflect the fact that IDCH currently has only four clearing members, none of whom are swap dealers; rather, IDCH appears to be oriented primarily towards major participants on the "buy side" or in the futures market. The current volume of open interest appears to be very small.[55] IDCH nets outstanding contracts only if they have the same fixed rate payment and the same maturity.[56]

The CME began clearing interest rate swaps on October 18, 2010.[57] The CME also offers a "swap futures" contract that is similar to its other futures contracts except that the settlement at expiration is determined by

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[54] *See* Jeremy Grant, *Newedge Swaps Deal Uses IDCH for Clearing*, FINANCIAL TIMES, Sept. 15, 2010, *available at* http://www.ft.com/cms/s/0/600c9bd0-c0ad-11df-94f9-00144feab49a.html (reporting that Newedge, a futures broker, had brought interest rate swap trades of over $100 million to IDCH for clearing).

[55] The IDCH website listed nearly 3900 open contracts as of the end of December 2010, but it is not clear to this observer what type of contracts they are. *See* International Clearinghouse Derivatives Group, *IDCG Swap Drop*, http://www.swapdrop.com/MarketReport.aspx (last visited Dec. 31, 2010).

[56] IDCH Notice to Members (June 25, 2010), *available at* http://www.idcg.com/pdfs/idch_bulletins/20100625Noticetomembers.pdf.

[57] *See CME Group Begins Clearing OTC Interest Rate Swaps* (Oct. 18, 2010), http://cmegroup.mediaroom.com/index.php?s=43&item=3073&pagetemplate=article (last visited Dec. 31, 2010) (announcing the beginning of clearing of interest rate swaps, in conjunction with a "group of premier swap dealers, clearing firms, and buy-side market participants")

reference to the value of an interest rate swap that pays a 4 percent coupon vs. 3-month LIBOR and has a specified maturity and other terms.

B. Summary of Dodd-Frank's Provisions Relating to Derivatives.

Dodd-Frank repeals existing restrictions on the substantive regulation of OTC derivatives and establishes a regime of substantially parallel regulation for swaps involving single non-exempt securities, loans and narrow-based security indices—to be administered by the SEC—and swaps involving other financial interests and commodities—to be administered by the CFTC.[58] Important questions affecting the tax consequences of these new rules include (i) the types of "swaps" that are subject to these rules, (ii) the types of exchanges that swaps will be required to trade on, and (iii) the parties that are subject to or exempt from these rules,

Under Dodd-Frank, swaps and the market participants that enter into them will be subject to comprehensive regulation, in some ways more restrictive than existing regulation of the securities markets. Requirements will include: registration and capital, margin and business conduct requirements for swap dealers and major swap participants; mandatory clearing and trading requirements for potentially all standardized swaps; real-time public transaction reporting; and a provision limiting the scope of permitted swap activities that may be conducted by certain swap entities that receive Federal assistance. Notwithstanding the many complex definitional and other issues that will need to be resolved in order to implement these new rules, they will, for the most part, come into effect roughly one year after enactment.

1. *Definition of "Swap"* The term "swap" is broadly defined to include most widely traded types of OTC derivatives, although it excludes certain specified categories of transactions such as options on securities (as determined for securities law purposes). More specifically, the statutory definition of the term "swap" generally includes puts, calls, collars, forwards, a list of 22 specified types of swaps, and any transaction that is or in the future becomes commonly known to the trade as a swap.[59] As the list may be relevant to the analysis of the scope of Dodd-Frank's amendment to § 1256, it is provided here:

(I) an interest rate swap;

(II) a rate floor;

(III) a rate cap;

(IV) a rate collar;

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[58] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 721, 124 Stat. 1376, 1658-72 (2010) (amendments to the Commodity Exchange Act, including the definition of "swap"); § 761, 124 Stat. 1376, 1754-59 (2010) (amendments to the Securities Exchange Act of 1934, including the definition of "security-based swap")

[59] The definition of "swap" takes four single-spaced pages in the official printed version of Dodd-Frank

(V) a cross-currency rate swap;

(VI) a basis swap;

(VII) a currency swap;

(VIII) a foreign exchange swap;

(IX) a total return swap;

(X) an equity index swap;

(XI) an equity swap;

(XII) a debt index swap;

(XIII) a debt swap;

XIV) a credit spread;

(XV) a credit default swap;

(XVI) a credit swap;

(XVII) a weather swap;

(XVIII) an energy swap;

(XIX) a metal swap;

(XX) an agricultural swap;

(XXI) an emissions swap; and

(XXII) a commodity swap.[60]

Technically, a "swap" is subject to the CFTC's jurisdiction and a "security-based swap" is subject to the SEC's jurisdiction. For purposes of this article, since the clearing and trading rules applicable to these two categories are parallel, both will be referred to as "swaps."

The definition of "swap" excludes futures contracts, although the distinction between a swap and a futures contract is not entirely clear. It also excludes any foreign currency contract traded on an exchange, presumably to preserve the current regulatory treatment of various foreign currency-linked products now trading on commodities exchanges, and grants authority to Treasury to exclude foreign exchange swaps and/or foreign exchange forwards from certain provisions of Dodd-Frank.[61] Given the breadth of these definitions, it is clear that at least some "swaps" subject

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[60] Dodd-Frank Wall Street Reform and Consumer Protection Act. Pub. L. No. 111-203, § 721(a)(16), 124 Stat. 1376, 1663 (2010) (adding new paragraph 47 to § 1a of the Commodity Exchange Act, 7 U.S C. 1a).

[61] *Id* The Treasury Department has requested public comment on whether to exercise this authority. Determination of Foreign Exchange Swaps and Forwards, 75 Fed. Reg. 66426 (Oct. 28, 2010). A number of financial industry associations and market participants have submitted letters recommending that such contracts be excluded from "swap" treatment to the extent permitted by Dodd-Frank

to the new rules will be treated as something other than NPCs for tax purposes.

Dodd-Frank expressly pre-empts regulation of swaps as insurance under state insurance law, but does not draw a clear distinction between swaps, on the one hand, and insurance products, on the other.[62] This prohibition is of particular relevance for CDS, as there were a number of efforts by state insurance regulators and legislators after AIG FP's bailout to define CDS that are used to hedge risks as insurance, to prohibit any other CDS, *i.e.*, to ban "naked" or speculative CDS, and to require that a permitted CDS be written by an insurance company.[63]

2. *Clearing and Exchange-Trading Requirements.* Swaps subject to mandatory clearing through a central counterparty will be designated by the CFTC or SEC, as applicable.[64] Ordinarily it is likely that a clearinghouse will propose that a category of swap be so designated. The agencies may also act on their own initiative, in which case if a clearinghouse does not then decide to clear the swap, transactions in that product would effectively be prohibited. In determining whether a swap should be required to be cleared, the relevant agency must consider various factors, including liquidity, adequate pricing data, effect on mitigation of systemic risk and legal certainty in the event of the insolvency of the clearinghouse. Swaps in existence at the time of Dodd-Frank's enactment

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[62] *Id.* § 722(b), 124 Stat. 1376, 1673 (2010) (a "swap" shall not be considered to be insurance and shall not be regulated as an insurance contract under any state law), § 767, 124 Stat. 1376, 1799-800 (2010) ("security-based swaps" may not be regulated as insurance under state law).

[63] Historically, CDS were not treated as insurance, based largely on a June 2000 opinion from the State of New York Office of the General Counsel ("NYOGC") that examined a particular type of CDS and determined that the absence of an insurable risk rendered CDS not insurance. *Funding Agreement Securitizations*, State of New York Office of General Counsel (Apr. 18, 2000), *available at* http://www.ins.state.ny us/ogco2000/rg004181 htm. In late 2008, however, the NYOGC announced that it was reconsidering the issue, and testimony from Eric Dinallo, New York's Superintendent of Insurance, before the House Committee on Agriculture (which oversees the CFTC) suggested that CDS used for hedging purposes might be regulated as insurance. STATE OF NEW YORK, INSURANCE DEP'T, OFFICE OF GEN. COUNSEL, "BEST PRACTICES" FOR FINANCIAL GUARANTY ISSUERS, CIRCULAR LETTER NO. 19 (Sept. 22, 2008), *available at* http://www ins.state.ny.us/circltr/2008/cl08_19.htm; *Hearing to Review the Role of Credit Derivatives in the U S Economy, Hearing Before the H Comm. on Agriculture*, 110th Cong. 79-81 (2008) (statement of Eric Dinallo, Superintendent, Insurance Department, State of New York), *available at* http //agriculture.house.gov/testimony/110/h91120/Dinallo.pdf. For a discussion of the actions taken by the New York State Insurance Department, see A. Kramer, A. Harris & R. Ansehl, *supra* note 28 The insurance regulators of some other states also asserted jurisdiction over CDS. State insurance regulators subsequently drafted a model law that, if adopted and not preempted by federal law, would have banned CDS unless used to hedge another position and would have required all permitted CDS to be written by insurance companies. National Conference of Insurance Legislators, *Proposed Credit Default Insurance Model Legislation*, *available at* http //www.ncoil.org/schedule/200930Day/Annual30Day/CDIModel pdf.

[64] The clearing requirements for swaps are in Section 723 of Dodd-Frank. There are parallel rules for security-based swaps in Section 763 of Dodd-Frank. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 723, § 763, 124 Stat. 1376, 1675-82 (2010).

are not subject to mandatory clearing and trading, but may be subject to the margin requirement described below.

Margin for cleared swaps will be subject to requirements generally similar to those that currently apply to FCMs for futures, and a dealer in swaps (but not security-based swaps) will be required to register as a FCM in order to accept such margin.[65] Swaps that are not cleared also will be subject to initial margin and variation margin requirements imposed by regulators. The level of margin that will be required for such swaps is unclear, but colloquies on the floor of Congress indicate that they are intended to be less onerous than the margin requirements for cleared swaps.

Swaps subject to the mandatory clearing requirement will be required to be traded on a national securities exchange, a designated contract market or new type of regulated trading facility called a "swap execution facility," unless no exchange or swap execution facility makes the swap available to trade. A swap execution facility is defined as a trading system in which multiple participants have the ability to execute or trade swaps by accepting bids and offers made by multiple participants in the system.[66] The agencies are currently considering what types of arrangements will be treated as satisfying this standard.

The "unless" clause above may be significant. The CFTC and SEC are required to prescribe rules defining the universe of swaps that "can" be executed on a swap execution facility.[67] The standard to be used in applying this provision is not clear. However, swaps falling outside this universe will be permitted to be executed through any other available means of interstate commerce. Thus, it may be the case that some categories of swaps are subject to mandatory clearing but not mandatory trading requirements.

3. *Swap Dealers, Major Swap Participants and End-Users.* Dodd-Frank provides specific rules for categories of persons termed swap dealers, major swap participants and end-users.[68] Swap dealers and major swap participants are subject to the mandatory clearing and trading requirements described above. They must register with the CFTC and SEC, and are subject to new capital and disclosure requirements.

The term "swap dealer" generally includes any person who is a dealer or market maker in swaps or who "regularly enters into swaps with counterparties as an ordinary course of business for its own account", but not someone who enters into swaps other than as part of a regular business. A non-dealer will be treated as a "major swap participant" if (i) it maintains

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[65] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 724, 124 Stat. 1376 (2010) (adding subsection (f) to § 4d of the Commodity Exchange Act, 7 U.S.C. 1a).

[66] *Id.* § 721, 124 Stat. 1376 (2010) (adding paragraph (50) to § 1a of the Commodity Exchange Act, 7 U.S.C. 1a).

[67] *Id.* § 733, 124 Stat. 1376 (2010) (adding subsection (d) to § 5h of the Commodity Exchange Act, 7 U.S.C. 1a).

[68] *Id.* § 721, 124 Stat. 1376 (2010) (adding paragraph (49) to § 1a of the Commodity Exchange Act, 7 U.S.C. 1a).

a substantial position in swaps, other than positions held for hedging or mitigating commercial risk, (ii) its outstanding swaps create "substantial counterparty exposure that could have serious adverse effects on the financial stability of the United States banking system or financial markets," or (iii) it is a "financial entity" that is "highly leveraged relative to the amount of capital it holds" and maintains a "substantial position" in swaps (whether or not such swaps are held for hedging purposes), unless it is subject to bank capital requirements.[69]

Dodd-Frank exempts an "end user" from the mandatory clearing (and therefore mandatory trading) requirements.[70] The end user exemption was intended for operating companies that use derivatives to hedge their business risks. An "end user" is defined as a person who (a) is not a "financial entity," (b) is using swaps to hedge or mitigate commercial risk and (c) notifies the CFTC or SEC, as applicable, how it generally meets its financial obligations associated with entering into non-cleared swaps. End users may, however, require that a swap be cleared, in which case they may designate the clearinghouse to which the swap is to be submitted.

Parties that do not fall into these three categories presumably are subject to the mandatory clearing and trading requirements, but not the other regulatory rules applicable to swap dealers and major swap participants.

C. Upfront Payments.

An unexpected byproduct of clearing swaps is that it can, and has in the case of CDS, give rise to regular upfront payments on those swaps, or potential deemed upfront payments for tax purposes. As described in Section I.B.1, above, under the timing rules applicable to NPCs, an upfront payment on an NPC is required to be taken into account over the life of the NPC, will be treated as a deemed loan for U.S. federal income tax purposes if the amount of the upfront payment is "significant," and may be treated as an investment in United States property whether or not it is "significant." Accordingly, it is useful to understand the causes of upfront payments and the corresponding cash flows that they give rise to.

1. *Standardization of Coupons – In General.* If the coupons on a swap eligible for clearing are permitted to be set only at prescribed levels, there will ordinarily be an upfront payment on the swap in order to bring the cash flows of the swap as a whole back to a market level. This was illustrated in Section I.B.1, above, for interest rate swaps, where it was assumed that the market level for the fixed leg of an interest rate swap was 6 percent but that the periodic payment on the swap was 5 percent. In the case of interest rate swaps, an upfront payment will be equal to the present value of the difference between the standard coupon and the market coupon over the stated term of the swap. Accordingly, determining

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[69] *Id.* § 721, 124 Stat. 1376 (2010) (adding paragraph (33) to § 1a of the Commodity Exchange Act, 7 U.S.C. 1a).

[70] *Id.* § 723, 124 Stat. 1376 (2010) (adding paragraph (7) to § 2(h) of the Commodity Exchange Act, 7 U.S.C. 1a).

the upfront payment is relatively straightforward, as long as the parties agree on the appropriate discount rate.

As described above, currently no clearinghouse clearing interest rate swaps requires standardized coupons. Even if a clearinghouse does not require standardized coupons, however, individual trades may be entered into off-market for hedging or other purposes, or conceivably a segment of the market might choose regularly to enter into swaps with standardized coupons in order to more easily net their outstanding swaps and to reduce the costs of maintaining their swap portfolio. For interest rate swaps, therefore, it is uncertain how common it will be for cleared swaps to be entered into with an upfront payment but it does not seem to be an unlikely possibility.

As described earlier, the CDS market historically traded with market-level coupons in the case of single-name CDS, and with a fixed coupon in the case of index CDS. As a prelude to the beginning of clearing of CDS in the fall of 2009, it was necessary to standardize the legal terms of CDS. Coupons also were standardized for new CDS, as part of the same process. Because the process and its results may be relevant for other classes of swaps, that transformation is described below in more detail.

2. *Standardization of CDS Coupons.*[71] As discussed earlier, one significant consequence of the move towards the standardization of the terms of CDS is that coupon payments for CDS are now either 100 basis points or 500 basis points multiplied by the notional principal amount.[72] Although the standardization of coupons was adopted as a prelude to clearing CDS through a regulated clearinghouse, bilateral CDS in the OTC market also now use these standardized coupons. It seems reasonable to think that this phenomenon – the adoption by the OTC market of conventions used for cleared swaps – will recur, in order to accommodate parties transacting in both markets.

This change to the payment terms of CDS did not affect the market's perception of the risk associated with buying or writing protection on a particular reference entity. In more technical terms, the market quoted level for a CDS coupon was not affected by the standardization of coupons. As a result, the advent of standardized coupons for single-name CDS also brought with it the need for one party to the CDS to make an upfront payment to keep the other party whole. To give an example, if the market quoted level of a particular CDS was 175 basis points, and the standardized coupon for that swap is 100 basis points, the party that will be making the below-market coupon payments will be obligated to make an upfront

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[71] I am indebted to Biswarup Chatterjee of Citigroup Global Markets for his insights into the pricing of CDS and the operation of the converter described below, for the examples set forth below, and for reviewing this section of the article. Any errors in the discussion are of course mine. Possibly it would help if I had understood calculus.

[72] This is true for North American corporate reference entities and for emerging market corporate and sovereign reference entities There are more standard coupon levels for European reference entities. The discussion in this Section II.C assumes that the CDS described is a CDS on a single North American corporate reference entity.

payment to the other party in order to keep it whole. (The payor will receive back an equivalent amount as collateral – more on this below.)

Upfront payments in the CDS market are not entirely new. A CDS on an index of reference entities ordinarily fixes a coupon for each series of the index when the composition of the series is fixed. Any trades entered into at a later time on that same series of the index will be entered into with the same coupon even if that coupon is no longer at market, in which case one party will need to compensate the other through an upfront payment.[73] Since most indices create a new series semi-annually, and since the market tends to prefer the "on the run" series, it seems likely that upfront payments were smaller for index CDS than is now the case for single-name CDS, although there is no information publicly available to confirm this point.

Unlike interest rate swaps, the determination of an upfront payment on a standard coupon CDS is quite complex. It is helpful in understanding the calculation of upfront payments on standard coupon CDS to start by discussing the pricing of pre-standardized CDS, since upfront payments are determined by "converting" the difference between standard coupons and market-level coupons into a single lump sum payment.

(a) *Coupons on Pre-Standardized CDS.* The coupon level for a pre-standardized CDS was struck at the market quoted level, determined in a manner similar to determining the yield at which a bond trades. A bond at issuance might have a coupon of 6 percent, for example, in which case one would expect the coupon level for a CDS on that bond to reflect the credit spread on the bond, say 4 percent (400 basis points). If the issuer's financial condition weakened, the bond would trade at a discount, *i.e.*, with a yield greater than 6 percent, and a new CDS entered into at that time would have a higher coupon; the reverse would be true if the issuer's financial condition improved. Consequently, a CDS entered into on any given day on a particular reference entity could and often did have a coupon different from a CDS on the same reference entity on any other day. Other terms of the CDS, for example maturity date, also could differ.

As described earlier, the coupons would be paid over the life of the trade, or until the date of a credit event, if any. On a daily basis, at least one party to the trade (the dealer) would mark the CDS to market by reference to the present value of the difference between the original coupon and the now-current market level on which the same CDS could be executed. Again, this mark-to-market valuation was similar to determining the current

[73] An example of such an index is the CDX.NA.IG. which is an index of 125 North American investment grade issuers. Information about this index is available through Markit. *See Markit Indices*, http://indices.markit.com/default.asp (last visited Dec. 31, 2010). In the case of CDS on an index of reference entities, typically the index is reformulated every 6 months to adjust the relative weightings of the index names and/or to add or subtract reference entities so that the index continues to reflect the relevant segment of the fixed income market—much like the process followed for rebalancing and reconstituting standard equity indices. Each reformulation is a new "series" of the index. CDS trades on the index may reference any series created to that point, although more typically they reference the most recent series.

price for a bond by discounting the cash flows on the bond by current interest rates and credit spreads. The CDS had a zero mark-to-market value on the trade date, meaning that the present value of the coupons was equal to the value of the protection provided by the CDS. Most CDS trades matured without ever having credit event settlement payments.[74]

(b) *Calculating the Upfront Payment on a Standardized CDS.* A standardized CDS also provides for periodic coupon payments, at the 100 basis points or 500 basis points level. If the current market quoted level for a CDS with a standard 500 basis points coupon is 400 basis points, the protection seller will make an upfront payment to the protection buyer to compensate the protection buyer for overpaying coupons by 100 basis points as compared to the market level. If the market coupon for the CDS is 550 basis points, the protection buyer will make an upfront payment to the protection seller to compensate the protection seller for the 50 basis points shortfall in standard coupon payments as compared to the market quoted level. Thus, an upfront payment may be made by either party to a standardized CDS.

Before turning to the calculation of the upfront payment, it is worth discussing how the market quoted level for a CDS is determined. Very generally speaking, the market quoted level for a CDS is determined primarily by reference to (a) an estimate of the probability of default by the reference entity, and (b) an appropriate (interest rate) discount curve.[75] The first of these variables is actually not a single number, as pricing models estimate the probability of default at multiple times during the term of the CDS, and those estimates are path-dependent. For example, it may be very unlikely that issuer X will default in years 1 and 2, much more likely in year 3 because the issuer has outstanding debt coming due in that year, and then less likely in year 4 because the issuer will survive to year 4 only if it can manage its liabilities in year 3.

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[74] I have been advised that historically, a very small percentage of the reference entities for which CDS are traded have experienced credit events, and that this is true even taking the credit crisis and recession into account, because (a) CDS exist on only a limited number of reference entities, which do not include all of the companies that have failed, and (b) an issuer may be perceived by the market to have failed without triggering a CDS credit event, for example if the issuer is rescued from actual failure by being acquired. As of the end of December 2010, ISDA listed 4 reference entities as having active credit events, and over 50 reference entities with prior credit events, for CDS (including loan-only CDS) on corporate reference entities. By way of comparison between healthy and troubled markets, there are only 6 credit events listed for the years 2007 (0), 2006 (3) and 2005 (3), which is as far back as the ISDA information goes, with all of the remainder arising in 2008, 2009 and 2010. *See ISDA Credit Derivatives Determinations Committees*, http://www.isda.org/credit (last visited Dec. 31, 2010).

[75] This discussion does not address a CDS on a reference entity considered highly likely to default in the near term. The upfront payment on such a CDS would be determined primarily by reference to the expected recovery in bankruptcy for a holder of the issuer's debt. In the market's jargon, a CDS of this kind would be "quoted upfront" or quoted as "points upfront," rather than quoted using a par spread.

The upfront payment generally does not take into account the creditworthiness of the parties. In the case of cleared CDS, that is because the clearinghouse becomes the legal counterparty to the trade. In the case of OTC-only CDS, the parties typically manage credit risk by taking or providing collateral.

It is in the nature of things that the two parties to a CDS ordinarily will have different judgments about these variables. That is, the reason one party is willing to buy protection and the other is willing to sell protection at a specified market quoted level is because they have different views as to what the "right" market level should be. Furthermore, the fact that a CDS on reference entity X has the same market quoted level as a CDS on reference entity Y does not mean that the probabilities of default are the same for X and Y. Even if all other variables are held constant, if X (as above) is at greatest risk for default in year 3 while Y is at greatest risk for default in year 2 but perhaps is considered overall more creditworthy, the shape of the "survival curve" for X and Y will differ.

The parties to a CDS will, therefore, first agree on a market quoted level for a CDS, in the same manner as they did prior to CDS standardization. They will then "convert" the difference between the agreed market quoted level and the standardized coupon into a single lump sum payment. (The upfront payment also adjusts for the coupon amount that has accrued prior to entering into the trade, a refinement that will be ignored for purposes of this discussion.)

Calculating the upfront payment is not for the faint of heart. Fortunately, in order to avoid disputes, the market has developed a standard "converter" that can be used to convert market coupons into an upfront payment.[76] The converter is based on a number of simplifying assumptions with respect to both the terms of a CDS and key economic variables.[77] As a result, using the converter for a standardized CDS is mechanically straightforward – one simply inputs the trade date; whether one is acting as protection buyer or seller; the standardized coupon, maturity date and recovery rate;[78] the notional principal amount; and the currency – and out pops a number.

Note that the simplified assumptions used by the converter with respect to the discount and survival curve are likely to differ from the inputs used by the parties when agreeing on the market quoted level. For example, because the market quoted level for CDS on reference entities X and Y described above is the same, the converter would assume that the survival curve for reference entities X and Y is also the same. This

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[76] The standard upfront calculator was developed by ISDA. Markit helpfully provides a "converter" on its website that requires inputting only the variables described in the text above. *See Markit CDS*, http://www.markit.com/cds (last visited Dec. 31, 2010).

[77] In particular, the converter uses a yield curve derived from certain money market deposits and interest rate swaps maturing at different times and using flat forward rates to determine the yield for interpolated dates (dates on which no deposit or swap matures). The converter also derives an assumed probability of default for a series of specified dates (the survival curve)—analogous to looking at interest rates for specified dates—and assumes that the probability of default is constant between those dates. The probability of default is determined by reference to the ratio between the risk-free interest rate and the credit spread for the particular reference entity. The assumed yield curve and survival curve are then input into a formula that is beyond me to describe, having cheerfully forgotten all the calculus I ever knew.

[78] The "recovery rate" is the amount that a holder of a debt instrument would recover in bankruptcy. For purposes of the upfront calculator, the recovery rate input for senior debt is assumed to be 40%, and for subordinated debt it is assumed to be 25%.

divergence from more realistic assumptions does not matter on the trade date, but as discussed below can affect the amount of variation margin paid during the term of the CDS. In the case of an OTC-only CDS, the parties are not bound to use the same assumptions or methodology as the converter described above in order to determine initial margin for the CDS, but typically will in fact follow the ISDA-recommended guidelines.

(c) *Examples.* It is helpful in understanding how the standard converter described above works to see some examples.[79] In each of these examples, Party A buys protection from Bank (and so pays coupons to Bank) on XYZ Corp. as reference entity; the notional amount is $10 million; the CDS has a term of 5 years; and the market coupon and the standard coupon differ by 75 basis points.

Example 1 (standard coupon 75 basis points below market level)

- Underlying market level 575 basis points, standard coupon 500 basis points
- Party A1 (buyer of CDS) pays *$ 244,000* upfront, and pays 500 basis points per year

Example 2 (standard coupon 75 basis points below market level)

- Underlying market level 175 basis points, standard coupon 100 basis points
- Party A2 (buyer of CDS) pays *$ 335,000* upfront, and pays 100 basis points per year

Example 3 (standard coupon 75 basis points above market level)

- Underlying market level 25 basis points, standard coupon 100 basis points
- Party A3 (buyer of CDS) receives (not pays) *$ 377,000* upfront, and pays 100 basis points per year

It is worth dwelling on these examples for a few minutes. First, if we compare examples 1 and 2, which both involve cases where the market quoted level is 75 basis points above the standard coupon, we see that the upfront payment is less for CDS #1, where the standard coupon is 500 basis points than for CDS #2, where the standard coupon is 100 basis points. That is because the implied risk that there will be a credit event with respect to the reference entity during the term of the CDS is higher for CDS #1 than for CDS #2. Since coupon payments will cease to be paid if there is a credit event, the value of the right to receive the "missing" stream of 75 basis point periodic payments is less for CDS #1 than for CDS #2.

To put this differently, as an economic matter one cannot simply translate the upfront payments on these CDS into a 5-year annuity paying 75 basis points on a periodic basis, because the risk that the annuity will be

[79] These examples assume that the risk-free interest curve is the same in each case, another "unrealistic" assumption. See attached diagram for illustrations of these examples.

cut short is significant enough to affect the value of the annuity. Moreover, given the path-dependent nature of the default probability curve, it would be a simplification to treat the upfront payment as representing the present value of a stream of 75 basis point amounts to a fixed date, say year 3 for CDS #1 and year 4 for CDS #2. Consider the example referred to above of issuer X, which may fail in year 3 but if it survives is likely to be in stronger condition in year 4. Given those facts, the foregone right to receive 75 basis points in year 4 will have some current value for both CDS #1 and #2, but a different value.

Examples 2 and 3 demonstrate the same point. Because the risk of a credit event for CDS #3 is considered very low, the value of the upfront payment is higher for CDS #3 than for CDS #2. Moreover, since the coupons Party A3 will pay are higher than the true cost of the protection Party A3 is buying, Party A3 will receive rather than pay the upfront amount. This last point is not unique to CDS; the same would be true if Party A3 were a party to an interest rate swap and had agreed to pay an above-market coupon. It is less intuitive, however, as one tends to think of Party A3 as buying the right to a potential future cash settlement payment on the CDS, and therefore as a payor rather than a payee prior to a credit event.

(d) *Mark-to-Market; Collateral.* As described earlier, once the parties have entered into a standardized CDS and it has been accepted for clearing, on a going-forward basis the CDS will be marked to market on a daily basis. The mark-to-market value of each trade is calculated by estimating the value of the difference between the standard coupon and the underlying market quoted level at which the same trade could be executed on the current date, using the converter to determine the then-value of the CDS. The mark-to-market is the same for both parties, positive to one party (treated as the "in-the-money" party) and negative to the other (treated as the "out-of-the-money" party). As described above, variation margin will be paid on a daily basis by the out-of-the-money party to the in-the-money party.

A less obvious point is that the need to exchange variation margin (collateral) is created immediately when the parties enter into a standard coupon CDS – that is, variation margin for a standard coupon CDS reflects not merely changes in value on a going-forward basis, but also the terms of the CDS at the very moment when entered into. Returning to example 1 above, the CDS is off-market by $244,000 when entered into. Ignoring the upfront payment, the CDS is in-the-money to Party A1 (i.e., the CDS has "gained" value for Party A1 compared to a CDS with market level coupons), because Party A1 is only required to pay 500 basis points while the market level is 575 basis points. Conversely, the CDS is out-of-the-money to Bank (*i.e.*, the CDS has "lost" value for Bank). Consequently, the day 1 mark-to-market requires Bank to provide $244,000 of collateral to Party A1. *The day 1 cash flows—the upfront payment and the corresponding variation margin—thus net to zero*, assuming that the CDS is valued at the end of the day at the same market level that it was executed

at during the day.[80] This point is potentially of great significance for tax purposes, since in at least some observers' minds it calls into question whether the conventional rules for upfront payments on NPCs should apply to upfront payments on cleared swaps.

Another way to understand the reason for the immediate and offsetting variation margin payment is that if Bank were to go bankrupt immediately after receiving Party A1's upfront payment of $244,000, Bank would neither return the foregone stream of 75 basis point payments nor provide any protection to Party A1. Party A1 would have a claim against Bank based on the unwind value or mark-to-market value of the CDS contract. Party A1 therefore has $244,000 of credit risk to Bank, which Bank must collateralize by providing initial variation margin. Over time, assuming no other changes to the market or the reference entity, Party A1 would repay that collateral to Bank. Because the repayment is determined by reference to daily marks to market, and as described above as a practical matter the default probabilities for a particular issuer vary at different times during the term of the CDS, the repayment would not be paid in level 75 basis point amounts. Rather, in the case of issuer X described above, relatively small amounts of collateral would be repaid in years 1 and 2, and a larger amount in year 3 if the issuer survives. Of course, in reality, the collateral would be adjusted daily to take actual changes in the value of the CDS into account.

Similarly, if other types of swaps with standardized coupons are submitted to a clearinghouse, one can expect that upfront payments will also give rise to an immediate and offsetting payment of initial variation margin.

There are two other aspects of the collateral arrangements described in this Section II.C2(b) that have larger implications. The first is that while the bilateral OTC market historically has required collateral, usually from a customer to a dealer but not vice versa, except in unusual circumstances, actual collateral arrangements varied from customer to customer, depending on the sophistication of the customer, the level of credit risk it posed and the dealer's willingness to please the customer. The OTC market is now moving towards collateral arrangements that are much closer to those for cleared swaps. Accordingly, while upfront payments are becoming more common, the actual net cash flows associated with them may not be.

The second is that clearinghouses net outstanding cleared contracts daily, in a manner similar to the netting of futures contracts described in Section II.A.1, above. Accordingly, if a dealer enters into a CDS today with a notional principal amount of $100 and makes an upfront payment of $7, and tomorrow it enters into an identical but offsetting CDS with a

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[80] If the CDS value has changed by the end of the day, the cash flows will not net perfectly. For purposes of the discussion in the remainder of the article, it is assumed that notwithstanding this circular flow of cash, the upfront payment is treated as "real," unless otherwise stated.

A diagram illustrating the cash flows described in the text is attached.

notional principal amount of $25 and receives an upfront payment of $2, the clearinghouse will net the dealer's outstanding contracts so that at the end of the second day it has a single contract with the clearinghouse with a notional principal amount of $75. Under these circumstances, it seems reasonable to treat the dealer as having received back $2 of its original $7 on the second day, rather than—as assumed by the NPC regulations—over the life of the CDS.

3. *Other Types of Upfront Payments.* Upfront payments made be made, or possibly deemed made, on cleared swaps for reasons other than standardization. Three such circumstances are closing out cleared swaps, "backloading," and clearing member default.

To close out a cleared swap, a party engages in the same process as to enter into one. That is, it agrees with another party on a private bilateral basis to enter into a swap and to submit the swap for clearing. The swap will have terms that offset its existing swap, e.g., if the first swap calls for the party to pay 6 percent x $100 million for five years, the second swap will call for the party to receive 6 percent x $100 million for five years. As described above, the clearinghouse will net those two swaps, leaving the party with a zero net position. If the value of the swap has changed in the party's favor since the party entered into the first swap, it will have received variation margin on the first swap, which in effect it will be entitled to keep once the swap is closed out. That is, the variation margin will have turned into realized gain.

Because the new swap offsets the first swap, the party also will be obligated to make an upfront payment on the second swap (which it will get back as variation margin, as described above).[81] As a result, although the second swap just closes out the first swap, it looks like a new transaction with a new upfront payment. As a practical matter, it may be difficult to keep track of when a new swap is really a new transaction as opposed to the closing out of an old transaction. And since a swap is likely to have changed in value when it is closed out, upfront payments on close-out swaps are expected to be common.

Backloading and clearing member defaults may or may not give rise to deemed upfront payments. Backloading is the process of moving historic bilateral swaps into a central clearing system. Since those swaps will be off-market when cleared, there will be an immediate variation margin payment made. Posting cash collateral is a type of deposit or loan (although not an investment in United States property, under § 956(c)(2)(I), at least for dealers). Moreover, if the clearing of the swap is treated as a "section 1001 event," the "new" swap would be deemed to have an upfront

[81] That is, assuming that the original swap is now $5 in the money to this party, the party will have received $5 of variation margin on the first swap, will make a $5 upfront payment on the second swap and will receive back $5 of variation margin on the second swap. When all is said and done, the party has $5 that it is entitled to keep outright.

payment.[82] A clearing member default raises similar issues, because the defaulting member's swaps may be transferred to another clearing member.

With apologies to the reader for the lengthy and meandering prelude, Part III next turns to the first principal issue discussed in this article, namely the meaning and implications of Dodd-Frank's amendment to § 1256.

III. THE DODD-FRANK AMENDMENT TO SECTION 1256.

Dodd-Frank has sixteen titles covering 849 pages in the official printed version. On the very last of those pages, there is an amendment to § 1256. As this placement suggests, the § 1256 amendment was added to Dodd-Frank very late in the legislative process, during the conference between the House and Senate to reconcile their differing versions of the bill. The legislative history to this amendment consists of a single sentence. The operative provision in the amendment and the legislative history are as follows:

Amendment:

> The term 'section 1256 contract' shall not include—
>
> . . . .
>
> ''(B) any interest rate swap, currency swap, basis swap, interest rate cap, interest rate floor, commodity swap, equity swap, equity index swap, credit default swap, or similar agreement.''.[83]

Legislative history:

> [Title 16] contains a provision to address the recharacterization of income as a result of increased exchange-trading of derivatives contracts by clarifying that section 1256 of the Internal Revenue Code does not apply to certain derivatives contracts transacted on exchanges.[84]

At a high level, the questions raised by this amendment are (i) what financial instruments are within its scope – more specifically, what constitutes a "similar agreement," and (ii) whether OTC financial instruments outside the amendment's scope that are traded on an exchange pursuant to Dodd-Frank currently constitute section 1256 contracts. The

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[82] See *supra* note 44, for a discussion of the potential for a deemed exchange of swaps under § 1001 when an existing swap is cleared by a regulated clearinghouse.

[83] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 1601, 124 Stat 2223 (2010), *amending* § 1256(b). Section 1256(b) defines the term "section 1256 contract" and provides certain exclusions to that term.

[84] H R. REP. NO 111-517, at 879 (2010) (Conf. Rep.).

rather limited legislative history does not provide a great deal of insight into these questions, but when one takes into account the history of § 1256 and the backdrop to this amendment, some answers suggest themselves. In view of the magnitude of the stakes and the scanty legislative history, however, it is highly desirable that answers be forthcoming from a more authoritative source, meaning the Treasury and Service. Service officials have unofficially acknowledged the importance of these issues and the utility of guidance, so it is possible that enlightenment will be forthcoming.

Before turning to a discussion of the questions set forth above, therefore, it is worth stopping to consider what policy considerations might inform any such guidance. Those considerations might include (i) the Administration's clear preference to limit the scope of § 1256,[85] (ii) the reasonably consistent approach taken by Congress, the government and the courts over time to interpret the definition of "regulated futures contract" and other types of section 1256 contracts in a manner that limits the definition to the type of financial instruments under consideration by Congress when that term was added to the Code – this history is discussed in Section III.B, below, (iii) more broadly, the general lack of interest by lawmakers to require taxpayers to mark assets to market notwithstanding the policy arguments that can be made in favor of a broader mark-to-market regime,[86] and (iv) the lack of any intent on Congress's part to change the

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[85] *See, e g*., DEP'T OF THE TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION'S FISCAL YEAR 2011 REVENUE PROPOSALS 32 (February 2010) (proposing to eliminate 60/40 treatment for dealers in commodities and commodities derivatives), *available at* https://www treas.gov/offices/tax-policy/library/greenbk10.pdf.

[86] Arguments for and against a broader mark-to-market regime have been made by a number of academics and other commentators over the years. *See, e g*., Yoram Keinan, *Mark-to-Market for Derivatives*, 128 TAX NOTES 1269 (Sept. 20, 2010); David S. Miller, *A Progressive System of Mark-to-Market Taxation*, 121 TAX NOTES 213 (2008); Clarissa Potter, *Mark-to-Market Taxation as the Way to Save the Income Tax—A Former Administrator's View*, 33 VAL. U. L. REV. 879 (1999); Robert H. Scarborough, *Different Rules for Different Players and Products: The Patchwork Taxation of Derivatives*, 72 TAXES 1031 (1994); David J. Shakow, *Taxation Without Realization: A Proposal For Accrual Taxation*, 134 U. PA. L. REV 1111 (1986); David A. Weisbach, *Tax Responses to Financial Contract Innovation*, 50 TAX L REV 491 (1995); Edward D. Kleinbard & Thomas L. Evans, *The Role of Mark-to-Market Accounting in a Realization-Based Tax System*, 75 TAXES 788 (1997). The most common arguments raised against a mark-to-market tax regime are concerns about valuation and liquidity. A mark-to-market regime requires the periodic valuation of assets, which can be difficult to value (the valuation concern). The second concern is that taxpayers may not have the cash to pay the tax on property that is marked-to-market until they sell the property (the liquidity concern). Miller, *supra* note 86, at 213; Potter, *supra* note 86, at 882; Shakow, *supra* note 86, at 1118; Weisbach, *supra* note 86, at 511

Advocates of a mark-to-market regime argue that it would combat the perceived inadequacies of realization-based taxation. They argue that the realization requirement creates inequity between taxpayers in the same economic position by applying different rules based on the form rather than the substance of a transaction. The complex rules required to define realization invite abuse, leading to anti-abuse provisions and increasing the overall complexity of the system. A mark-to-market regime, it is said, would decrease the complexity caused by the realization rule. It would also increase the overall fairness of the tax system by more closely approximating the Haig-Simons measure of income, which equates a taxpayer's income in each period to consumption plus change in wealth for the period and is seen by many as a superior method of taxation. Keinan, *supra* note 86, at 1279-

tax treatment of OTC derivatives in enacting Dodd-Frank. These considerations would suggest a broad reading of the amendment and/or guidance limiting the scope of § 1256 with respect to derivatives not covered by the amendment.

Relevant considerations might also, however, include (v) acknowledgement that the rationale for imposing § 1256's mark-to-market rules on the first type of section 1256 contract, regulated futures contract, was based on the existence of daily variation margin – giving rise to ready cash available to pay taxes on a known amount of gain – and that when other contracts become subject to daily variation margin payments similar treatment may be appropriate, and (vi) the lack of any intent on Congress's part to change the tax treatment of contracts now traded on commodities exchanges in enacting Dodd-Frank. These considerations would suggest a narrower reading of the amendment and/or guidance to the effect that § 1256 does apply to some or all derivatives not covered by the amendment. Another consideration that surely should be taken into account are the benefits of having as many derivatives as possible subject to the same tax rules, to prevent whipsaw and arbitrage, although it is unclear whether that militates in favor or against a broad reading of the amendment.

80; Miller, *supra* note 86, at 213-14; Potter, *supra* note 86, at 879; Scarborough, *supra* note 86, at 1048; Kleinbard & Evans, *supra* note 86, at 790

Of more direct concern to the issues discussed herein, some of those in favor of mark-to-market agree that because of the valuation and liquidity concerns, a pure mark-to-market regime for measuring all economic gain or loss would be administratively untenable and instead argue for a limited mark-to-market regime for derivatives. One proposal is to require taxpayers who mark gains and losses to market for purposes of GAAP to do the same for tax purposes, and allow taxpayers not subject to GAAP to elect mark-to-market. Because companies subject to GAAP have been required to value their derivatives for book purposes since the issue of FAS 133 in 1998, such a proposal would not raise the standard valuation concerns. Another proposal is to require high-income and high-net-worth taxpayers to mark-to-market derivatives and publicly traded securities. It is argued that concerns about liquidity are not as strong for taxpayers who are capable of borrowing against their securities and derivatives. Keinan, *supra* note 86, at 1279-81; Miller, *supra* note 86, at 213, 216-18, Scarborough, *supra* note 86, at 1048; Kleinbard & Evans, *supra* note 86, at 790.

Other commentators have argued against such limited mark-to-market regimes for derivatives on the basis that they create a lack of consistency, which is unjustified given that the failure of realization-based taxation to deal with deferral is not generally considered to be unacceptable. In addition, if derivatives were marked to market, valuation costs would increase, and the models used to value certain derivatives would be difficult for the Service to monitor. Others argue that the line between what is and what is not subject to a limited mark-to-market regime would be difficult, if not impossible to draw It is cautioned that if publicly traded stocks were marked to market, and derivatives based on them were not, taxpayers would simply 'substitute' one for the other and shift from positions in stock and securities to derivative positions. Further, if some derivatives were subject to mark-to-market and others were not, a new form of derivative not subject to the system would be easily substituted. Potter, *supra* note 86, at 888-99; Deborah H. Schenk, *An Efficiency Approach to Reforming a Realization-Based Tax*, 57 TAX L. REV. 503, 527-29 (2004); Reed Shuldiner, *Consistency and the Taxation of Financial Products*, 70 TAXES 781-83 (1992). Thus, no harmony has been reached in or outside the academy on the merits of a general mark-to-market regime for derivatives. It is probably fair to say that, to date, tax administrators and legislators have evinced even less interest in such a regime.

A final consideration is that wherever the line is drawn, it will be "wrong." That is, it appears impossible given the current state of the law and the many complexities of Dodd-Frank to avoid a situation where similar financial instruments may be subject to different tax regimes. Such differences may arise, for example, (a) if similar swaps are traded on a designated contract market or national securities exchange, on the one hand, and a swap execution facility, on the other, because the former are and the latter are not, QBEs; (b) if one class of swaps is required to be cleared and traded on a regulated market while a class of similar or related swaps is not – examples of this are discussed in Section III.A.1, below; (c) if commodities exchanges offer products subject to § 1256 that compete with similar products covered by the amendment; (d) if similar swaps are entered into by an end-user that does not clear its swaps and another party that does; and (e) if "bespoke" swaps not subject to clearing and trading on regulated markets are hedged with swaps that are subject to those requirements.[87] Differences of this kind exist today, of course, but it is unfortunate that Dodd-Frank seems to have multiplied them, as the tools available under the Code to mitigate mismatches or prevent taxpayers from taking advantage of them have limitations, as described in Section III.A, below. And these differences are in at least some respects within the power of the government to address, for example by using its power under § 1256(g)(7)(C) to designate swap execution facilities as QBEs. But the general point remains that it is difficult to see how to avoid an arbitrary line-drawing of some kind. If that is correct, then a further consideration that may affect guidance is the desirability of drawing a line that is easy to see, for example by declaring that any financial instrument designated by the CFTC as a futures contract constitutes a section 1256 contract and that no other financial instruments traded on Dodd-Frank exchanges, other than certain options and dealer contracts specified in the statute, qualify as such.

A better course of action would be for Congress to act to alleviate as much of the line-drawing pressure as possible. Probably the best solution would be for a considered reevaluation of what the proper scope of § 1256 should be, as that question is properly for Congress in the first instance rather than for Treasury and the Service. Alternatively, pending a true overhaul of § 1256, legislative amendments could (a) revise § 475 so that current rule to the general effect that a contract that can be both a section 1256 contract and a § 475 "security" is subject to § 1256 and not § 475 is made elective,[88] (b) revise § 1256(d) or (e) to permit taxpayers to elect out of § 1256 treatment for hedges of a capital asset other than a

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[87] Another possibility is that swaps cleared or traded by U S. taxpayers or controlled foreign corporations on non-U.S. clearinghouses and exchanges may be subject to different rules than those cleared or traded in the United States. Issues relating to non-U.S clearing and trading call deserve further consideration, but will not be addressed in this article

[88] Assuming that the amendment had the effect of overriding the character rules of § 1256, an amendment of this kind would address the character whipsaw issues faced by § 475 dealers in securities and traders who elect § 475 treatment, but would not alleviate the timing problems that § 1256 treatment would give rise to for other taxpayers.

"traditional" section 1256 contract,[89] or some combination of the above.[90] Legislation could address swap execution facilities, so that there is no tax (dis)advantage to trading on such a facility compared to a CFTC designated contract market or a SEC-regulated national securities exchange.[91] Consideration could also be given to modifying the rules of § 1256 that limit the ability to pass long-term capital gain treatment through to limited partners of dealers organized as partnerships (§ 1256(f)(4)), as those rules now apply only to dealer equity options and dealer securities futures contracts.

Section III.C, below, lists and evaluates a number of different interpretations of the scope of the amendment, from narrow to broad, and concludes that the most plausible interpretations of the amendment are that it covers either (i) NPCs and CDSs, but not other derivatives, or (ii) NPCs, CDSs, and derivatives so closely connected to those instruments that they should be subject to the same tax rules. It also argues that derivatives outside the scope of the amendment should be treated as section 1256 contracts only if they are clearly instruments of a kind that Congress intended to be subject to § 1256, and possibly derivatives so closely connected to those instruments that they should be subject to the same tax rules. Those conclusions are informed by reflection on the consequences of drawing the line in various possible places, and by the history of § 1256. Before turning to a detailed discussion of the amendment, therefore, Sections III.A and III.B explore those considerations.

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[89] An amendment of this kind would have to be evaluated to make sure that it does not open the door to some of the problems that § 1256 was enacted to prevent. One possible approach might be to limit the election to hedges of assets that constitute "actively traded personal property" within the meaning of § 1092, so that the straddle rules would operate to prevent acceleration of losses and conversion of character

It may also be useful to clarify that hedging credit risk comes within the ambit of a hedging transaction within the meaning of § 1221 or any capital asset hedge, as the term "hedging transaction" for an asset hedge is generally defined under § 1221(b)(2)(A)(i) as a transaction that manages "risk of price changes." While that term is fairly broad, it was not written with the intent of capturing default risk.

[90] A prior version of this article suggested that § 1256 be amended expressly to exclude NPCs and CDS. *See* Nijenhuis, *supra* note 1, at 1238, at note 9 As discussed *infra* Section III.C, this is one plausible reading of the Dodd-Frank amendment to § 1256. The article noted, however, that an amendment of this kind would mean that while CDS and other NPCs would not be treated as section 1256 contracts, it would not cover all derivative financial instruments now traded in the OTC market that may be required under Dodd-Frank to be cleared and/or traded, such as options. *Id.* This implicit call for broader legislative change obviously failed to have any immediate effect. The author understands that it was not possible under Congressional rules to consider any broader changes to the Code than the § 1256 amendment without bringing Dodd-Frank under the jurisdiction of the tax-writing committees. It may be possible, therefore, for future tax legislation to address these issues.

[91] There are now various types of trading markets that did not exist when § 1256 was enacted, and that are not QBEs—that is, SEC-regulated national securities exchanges or CFTC-regulated designated contract markets—but that may nevertheless be subject to some form of regulation by securities or commodities regulators. These markets may become obsolete with the passage of Dodd-Frank. If that is not the case, they too should be addressed.

A. Effect of Section 1256 Treatment for OTC Derivatives.

The impact of § 1256 treatment depends partly on the type of financial instrument and partly on the tax characteristics of the taxpayer. For example, is the taxpayer an individual that can benefit from 60/40 treatment or a corporation? Is the taxpayer using a realization method of accounting or does the taxpayer mark its positions to market for tax purposes? In order to illustrate what is at stake, this Section III.A considers two hypothetical situations. The first is a taxpayer who is considering one of a number of financial instruments that have the payment terms of an interest rate swap or an economic equivalent thereof and who does not use a mark-to-market method of accounting. The second is a dealer in securities who has a rates book that includes a variety of U.S. dollar interest rate-linked financial instruments. In both of these examples, § 1256 treatment is unfavorable. Section III.A ends with a brief comment on situations where broader § 1256 treatment could be favorable.

1. *Interest Rate Swaps and Swap Futures Contracts.* A taxpayer interested in interest rate swap economics can of course enter into a conventional privately negotiated bilateral OTC interest rate swap. Other alternatives, described in Section II.A.3, above, would be to enter into a interest rate swap futures contract of the kind offered by the IDCG, whether directly or as a result of an exchange of an interest rate swap for such a futures contract through the IDCH, or to enter into a swap futures contract of the kind offered by the CME. As described above, the IDCG contract has payment terms similar to those of an interest rate swap, that is, periodic exchanges of fixed for floating payments determined by reference to a notional principal amount, while the CME futures contract provides for a single payment determined by reference to the value of a hypothetical interest rate swap.[92]

Under current law, the interest rate swap is subject to the accrual rules described in Section I.B.1, above, and as a result of the Dodd-Frank amendment to § 1256, that will continue to be the case regardless of whether the swap is cleared and/or traded on a regulated market. There is no express guidance on the CME futures contract, but it presumably qualified as a "regulated futures contract" prior to the Dodd-Frank amendment, and for purposes of this discussion, it is assumed that that treatment continues post-Dodd-Frank. The puzzle, therefore, is how to characterize the IDCG contract post-Dodd-Frank. Is an "interest rate swap" within the meaning of the Dodd-Frank amendment, or is it a futures contract that qualifies as a "regulated futures contract" subject to § 1256?

It is immediately obvious that this question is one that has no "right" answer, or at least no right answer that does not raise new questions.

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[92] One non-tax question raised by the IDCG contract is what defines a "futures" contract as a regulatory matter? Is it simply a matter of obtaining CFTC approval for such characterization, and subjecting the contract to all the regulatory rules that apply to futures contract? From the uninformed perspective of a tax lawyer, this seems to be the equivalent of sprinkling CFTC pixie dust over the contract, particularly if one compares it to an interest rate swap that is cleared and perhaps traded on a similar regulated market.

If the IDCG contract is not a section 1256 contract, then there will be a divergence between the tax rules applicable to some futures contracts and to other futures contracts, raising questions about how those lines should be drawn. On the other hand, if the IDCG contract is a section 1256 contract, then two contracts that are essentially identical from an economic perspective – the interest rate swap and the IDCG contract – will be subject to radically different tax rules, with all of the potential for whipsaw and arbitrage that that raises. It can be expected in that case that taxpayers for whom § 1256 treatment is attractive would migrate to the IDCG contract and taxpayers who wish to avoid § 1256 treatment would enter into the interest rate swap. In part for that reason, and in part because of the technical reasons described in Section III.C, below, to this observer the better answer is that the IDCG contract should be treated as an "interest rate swap" and not as a section 1256 contract.

That conclusion is also based on the fact that § 1256 does not address how periodic payments on a section 1256 contract should be treated. This is hardly surprising in light of the fact that no contract expressly intended by Congress to be subject to § 1256 provides for periodic payments. As described below, the application of § 1256 to such a contract would appear to have potentially unfortunate results.

As described in Section I.B.1, above, under the timing regulations for NPCs, a swap characterized as an NPC ordinarily would be treated as giving rise to current income or deductions in the amount of the periodic coupon payments and a portion of any upfront payment made or received to enter into the NPC. Absent an early termination of the swap, therefore, all income and expense from a conventional swap ordinarily is treated as ordinary income and expense. Because the definition of an NPC in the NPC timing rules excludes any section 1256 contract, however, a swap that is classified as a section 1256 contract is not subject to the NPC timing rules, including the rules that create deemed loans and deemed interest.[93] This makes perfect sense for method of accounting purposes, since both § 1256 and the NPC rules deal with timing and there is no reason to apply multiple sets of rules.[94]

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[93] Treas. Reg. § 1.446-3(c)(1)(ii) (1994).

[94] However, the government has in the past taken the view in certain contexts that both the "normal" timing rules and also mark-to-market rules should apply to the same financial instruments. Under Treasury Regulation § 1.446-3, § 475 generally overrides the timing regulations' rules for periodic and nonperiodic payments It is not clear, however, whether § 475 also overrides the rules that create a deemed loan if there is a significant nonperiodic payment. It may well be the case that it does not, since the author's understanding is that the principal reason for the deemed loan rule was a withholding tax concern, namely that related parties could use NPCs to lend money/pay economic interest to each other without being subject to U.S withholding tax, *i.e.*, in a situation where the party making the upfront payment (the "lender") is resident in a country that does not have an income tax treaty with the United States providing for a zero rate of withholding tax on interest *See also* Treas. Reg. §§ 1.475(a)-1(a)-1(e), 60 Fed. Reg. 397, 401 (Jan. 4, 1995) (taxpayers required to accrue OID and bond premium before marking debt instruments held as assets to market); Treas. Reg. § 1.446-3(g)(1), 69 Fed. Reg. 8886, 8892 (Feb. 26, 2004) (mark-to-market election; part of proposed rules for swaps with contingent nonperiodic payments, discussed in Section I.B.1, above), Treas. Reg. § 1.446-3(g)(6), 69 Fed. Reg.

Consequently, the timing of income or expense with respect to periodic payments would be governed by the general rules of the Code. In view of the fact that the NPC timing rules, which are clear reflection of income rules, provide for current accrual of NPC periodic payments, one likely answer would be to conclude that a periodic payment on a swap should be accrued on a current basis. As a current income/expense item, the payment would not affect the basis of the swap for purposes of determining gain or loss. Furthermore, as in the case, for example, with a bond with accrued interest, the mark-to-market of the swap at year-end should not take into account accrued ordinary income or expense. Otherwise, that amount would be double-counted: once as income/expense and once as an increase/decrease in value.

Assume for example that Parties A and B enter into a conventional at-market swap under which Party A agrees to pay 6 percent multiplied by $100 million and Party B agrees to pay LIBOR multiplied by $100 million, annually (for ease of calculation) for 5 years. During the course of the first year, LIBOR is 4 percent and a net 2 percent coupon accrues and, at or just before year-end, is paid. Party A therefore has $2 million of swap expense and Party B has $2 million of swap income. If the swap has not changed in value at year-end, the parties will take those amounts into income/expense and nothing else. If, however, the swap also has changed in value in Party A's favor, say by $10 million, Party A will have $2 million of ordinary deduction and $10 million of capital gain, while Party B will have $2 million of ordinary income and $10 million of capital loss. That is, the coupon payments on this swap are items separate from the mark-to-market gain or loss.

This is a highly unusual fact pattern, since typically mark-to-market arises either under § 475 for a dealer or trader for whom any gain or loss is ordinary,[95] or under § 1256 with respect to contracts that do not give rise to ordinary income or expense. One very broadly comparable fact pattern is a mixed straddle in which at least one position is ordinary and at least one position is capital; in that case, Congress has granted authority to Treasury to write regulations mitigating the whipsaw potential.[96]

A taxpayer in this situation may be concerned not only about ordinary/capital mismatches from the swap itself, but also with timing and possibly character mismatches with and asset or liability that the swap hedges. As described above, interest rate and foreign currency swaps are widely used by corporate and other taxpayers to hedge assets and liabilities,

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8886, 8892 (Feb 26, 2004) (requiring creation of deemed loans and then the application of a complex quasi-mark-to-market regime whose principal purpose seems to be to encourage taxpayers to elect to use the "real" mark-to-market regime in subsection (i)). Taxpayers have strongly objected to both of these proposed regulations as unnecessarily cumbersome and serving no purpose.

[95] It is possible for mark-to-market gain or loss to be capital for a dealer in securities, if the securities in question are not held in connection with the dealer's activities as a dealer in securities. I.R.C. § 475(d)(3)(B)(ii) (2010). Dealers generally take the position, however, that all or most of their activities are connected to their securities dealer activities

[96] I.R.C. § 1092(b)(2)(D) (2010).

including debt, that have interest rate terms or are otherwise interest rate-sensitive. In any case where a swap is entered into as a hedge, the taxpayer is likely to wish the timing of its income and expense from the swap to correspond to the timing of the related income and expense from the hedged position. The taxpayer is likely to be unhappy about being required by law to use a mark-to-market method of accounting.

The taxpayer that is hedging its position is also likely to find itself subject to the tax straddle rules of § 1092. Such a taxpayer would be taxable on mark-to-market gain from the swap, but likely would not be able to deduct mark-to-market losses as a result of economically offsetting gains on the hedged position. Assuming that the hedged position is a capital asset, the taxpayer could not make a § 1221 hedging transaction election or a § 1256(e) election to remove the swap from the application of § 1256. Depending on the facts, the taxpayer also might not be able to make an integration election under Treasury regulation § 1.1275-6, for example because the precision in matching timing and amounts of cash flows required by that section may not be satisfied. The taxpayer could potentially make one of various elections under the straddle rules, including the "identified straddle" election of §1092(a)(2), the "straddle-by-straddle identification" election of § 1092(b)(2)(A)(i)(I) for mixed straddles, or the "mixed straddle account" election of § 1092(b)(2)(A)(i)(II), but each of these elections have complexities, limitations and disadvantages that make them generally highly imperfect solutions. In many cases, the taxpayer's best option may be a "mixed straddle" election under § 1256(d) to remove the contract from the scope of § 1256, as § 1256(d) imposes relatively modest conditions.

There is no discernible tax policy reason that would favor subjecting taxpayers of this kind to a mark-to-market regime for swaps. Indeed, the fact that an onerous anti-abuse rule may well apply if the taxpayer could *elect* to use a mark-to-market method of accounting for a swap suggests to this observer that uncertainty over the scope of § 1256 should be resolved in favor of not *requiring* taxpayers to mark their swaps to market.

In practice, if a taxpayer's treasury department consults in advance with its tax department (which should not be assumed to take place as a matter of course), these issues will not be a problem for interest rate swaps, because the taxpayer can always choose to enter into a non-futures interest rate swap. However, the discussion above illustrates the potential problems that could arise if other types of derivatives with periodic income/expense payments were treated as section 1256 contracts. Only mischief, whether for the government or for taxpayers, could result from rules under which periodic payments give rise to ordinary income/expense while mark-to-market payments give rise to capital gain/loss. It is fervently to be hoped that the government will take the view that an express Congressional mandate is necessary before taxpayers who will be required by law to transact in swaps in this manner will be subject to arbitrary and capricious rules reminiscent of the treatment of hedging transactions prior to the

Fannie Mae case and the issuance of Treasury Regulation §§ 1.1221-2 and 1.446-4.[97]

2. *Interest Rate Swaps and Hedges Thereof.* A second fact pattern that illustrates the anomalies that may arise in a world in which the scope of § 1256 is expanded involves a dealer in securities, within the meaning of § 475, that enters into all of the following types of financial instruments in the ordinary course of its dealer business in interest rate swaps: long and short positions in Treasuries, Treasury futures contracts and exchange-traded options thereon, the IDCG and CME swap futures described above, forward rate agreements, and swaptions. Similar issues may arise for electing traders in securities under § 475(f), or possibly for taxpayers who have taken the view that they can elect mark-to-market as a form of self-help under § 446's clear reflection of income rules, under the general ambit of proposed Treasury regulation § 1.446-3(i).[98] Securities dealers generally do, and electing traders must, treat the mark-to-market gain or loss as ordinary under § 475.[99]

Section 475 provides, however, that a section 1256 contract generally does not qualify as a "security" to which § 475 applies,[100] presumably because at the time § 475 was enacted commodity dealers and traders lobbied to remain outside its scope.[101] (This § 1256 priority rule

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[97] The *Fannie Mae* case resolved an issue raised by *Arkansas Best*, namely whether *Arkansas Best*'s general repudiation of the business assets doctrine also overturned the specific holding of *Corn Products* that a hedge of inventory could itself be treated as an ordinary asset. Corn Prod. Ref. Co. v. Comm'r (Corn Products), 350 U.S. 46 (1955); Fed. Nat'l Mortg Assoc. v. Comm'r (Fannie Mae), 100 T.C. 541 (1993); Ark. Best Corp. v. Comm'r, 485 U S. 212 (1998). If that were the case, taxpayers would be subject to unmanageable whipsaw risk, because it is in the nature of hedges that sometimes they produce losses that would be capital under a broad reading of *Arkansas Best*. The *Fannie Mae* case concluded that Congress had effectively legislatively adopted the *Corn Products* doctrine. Treasury and the Service then threw in the towel and issued Treasury Regulation §§ 1.1221-2 and 1.446-4 to provide specific rules for hedging transaction. Congress then endorsed that result by enacting § 1221(a)(7) and (b)(2), providing statutory rules treating hedging transactions as non-capital assets. Congress thus both implicitly and explicitly endorsed the harmonization of character from transactions that hedge ordinary assets or liabilities.

[98] Prop. Treas. Reg. § 1.446-3(i) 69 Fed. Reg. 8886, 8892 (Feb. 26, 2004). Treas. Reg. § 1 446-3(i) generally would permit a taxpayer to mark an NPC to market, provided that the NPC is actively traded, or the taxpayer marks the NPC to market for financial accounting purposes, or the counterparty agrees to provide its tax marks. Some taxpayers have taken the position that the proposed regulations, while not currently in effect, demonstrate that marking an NPC to market clearly reflects income from the NPC, and that taxpayers therefore may mark to market NPCs of the kind that would fall within the proposed regulations even if the taxpayer is not subject to § 475

[99] I.R.C. § 475(d)(3) (2010) (generally providing that dealer gain or loss from securities subject to § 475 is ordinary); I R.C § 475(f)(1)(C) (2010) (rules similar to rules of § 475(d) apply to electing traders).

[100] I.R.C. § 475(c)(2)(E) and the flush language at the end of § 475(c)(2).

Section 475 applies to securities and, on an elective basis, commodities. The term "security" is defined in § 475(c)(2)

[101] The development of the definition of the term "security" as § 475 was being considered by Congress is consistent with the presumption in the text. As originally introduced in the House in February 1992, the term was defined to include (i) any derivative financial instrument in securities, but not including any futures contracts, and (ii) any

does not apply to interest rate swaps, foreign currency swaps and equity swaps.) As a result, absent the hedging rules described below or another special rule, a dealer or trader that generally recognizes ordinary gain or loss from its securities activities may be required to recognize capital gain or loss from any section 1256 contracts that it holds. The potential adverse consequences of that are obvious.

Of the various types of positions described above, the interest rate swaps and the long and short positions in Treasuries clearly are not section 1256 contracts; the Treasury futures and options thereon and presumably the CME swap futures are section 1256 contracts; and it is uncertain whether the IDCG futures contract and, if traded on an exchange, the forward rate agreement and the swaption are section 1256 contracts. The forward rate agreement potentially could be a regulated futures contract, if that term were interpreted broadly, and the swaption could be a non-equity option, unless either constituted a "similar agreement" within the meaning of the Dodd-Frank amendment to § 1256. Thus, a substantial portion of the dealer's book may consist of section 1256 contracts with the potential for capital losses.

There is an escape from this unhappy state of affairs, because a section 1256 contract that hedges a § 475 "security" may itself be treated as a § 475 "security."[102] However, this hedging election is available only if the hedge is clearly identified on the dealer's records as a § 475 hedge before the close of the day on which it was entered into. As a practical matter, a swap may not hedge a § 475 security, or it may be difficult to determine whether it does so with any certainty, or it may be difficult to do so in a manner that satisfies the close-of-day identification requirement. That is because dealers generally hedge their positions on an aggregate basis rather than on a position-by-position basis. Also, the higher the portion of a dealer's book that consists of section 1256 contracts, the more

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notional principal contract other than a commodity-linked notional principal contract DANIEL ROSTENKOWSKI, COMM. OF CONFERENCE, TECHNICAL EXPLANATION OF TAX FAIRNESS AND ECONOMIC GROWTH BILL OF 1992, H.R. 4287, 102d Cong. (as introduced in the House on Feb 22, 1992). A month later, after consideration by the Senate, the NPC language was unchanged but the catch-all provision now referred to a derivative financial instrument in any security otherwise described, but not including any contract to which § 1256(a) applies FAMILY TAX FAIRNESS, ECONOMIC GROWTH, AND HEALTH CARE ACCESS BILL OF 1992, H.R. 4210, 102d Cong. (as reported in the Senate Mar. 9, 1992). The legislative history gives no explanation for the change from "futures contract" to "any contract to which § 1256(a) applies," but it seems plausible that the change was intended to clarify that the definition excluded futures contracts subject to § 1256, and not other futures contracts Finally, in the conference bill passed later that month (and vetoed by the President), the NPC clause was revised to read as it now does, referring to interest rate, currency or equity NPCs. DANIEL ROSTENKOWSKI, COMM. OF CONFERENCE, TAX FAIRNESS AND ECONOMIC GROWTH BILL OF 1992, H.R. REP. NO. 102-461 (1992) (Conf. Rep.).

[102] I R C. § 475(c)(2)(F) (2010); see also § 1256(e) for a broadly similar hedging exception

difficult it may be to establish that any one such contract hedges a non-section 1256 contract.[103]

As described above, the principal purpose of § 1256 is to require taxpayers to mark section 1256 contracts to market, and the mandate that gain or loss from section 1256 contracts be treated as long-term and short-term capital gain was a sweetener intended to mitigate the blow of marking

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[103] There are some other possible avenues for relief from capital treatment, under § 1256(f)(2) and/or § 1256(f)(3), but as discussed below they do not seem to change the overall picture in any significant way.

Section 1256(f)(2) provides that § 1256(a)(3) (requiring 60/40 capital gain/loss) does not apply to any gain or loss which, but for such paragraph, would be ordinary income or loss. This provision was enacted at a time when the *Corn Products* doctrine, which treated business assets, including hedges, as ordinary rather than capital assets, was considered good law. *Corn Products*, 350 U.S. at 53-54. At the time § 1256 was enacted, therefore, a taxpayer using a futures contract to hedge its inventory could treat the gain or loss from the hedge as ordinary, because it would be ordinary absent § 1256 under the *Corn Products* doctrine and thus was exempt under § 1256(f)(2) from capital gain/loss treatment. However, the *Corn Products* doctrine was repudiated in *Ark. Best* and has effectively been replaced by the hedging transaction rules of § 1221(b)(2) and hedging transaction regulations under § 446 *Ark Best Corp*., 485 U.S. at 212-13. The hedging transaction regulations apply to hedges of ordinary assets and liabilities and suffer from practical obstacles to utilization in the dealer context similar to the problems described above with the § 475 hedging exception.

Section 1256(f)(3) also has a complicated history. Prior to the amendment of § 1256 in 1984, market-makers in equity options traded on securities exchanges took the position that they were entitled to ordinary income and loss from their options transactions The 1984 amendment was intended to limit such treatment to the fact pattern where the taxpayer was also, independently of its option transactions, a dealer in the underlying property. This was accomplished by (i) adding "dealer equity options" as a category of section 1256 contracts, and (ii) adding § 1256(f)(3), which provides that gain or loss from "trading" (this phrase evidently was intended to include market-making in) section 1256 contracts is treated as capital gain or loss, unless the section 1256 contract is held to hedge property loss from which would be ordinary in the taxpayer's hands. Accordingly, if a dealer in swaps is also a dealer in the underlying property, and the swaps hedge that property, it may be possible under this rule for the dealer to have ordinary rather than capital gains and losses from its swap transaction.

The relationship between § 1256(f)(2) and § 1256(f)(3) is not entirely clear. They were enacted at different times, for different purposes, and thus it is possible that both are available to swap dealers. If that were the case, then § 1256(f)(2) could provide considerable relief. For example, it could allow dealers to treat the character of gains and losses for swaps entered into in connection with their dealer business as ordinary, under § 475(d)(3). Separately, it might alleviate concerns for an option, because under § 1234(a)(1) gain or loss from purchased options would be ordinary if the underlying property would give rise to ordinary gain or loss in the taxpayer's hands, and under § 1234(b)(3) gain or loss from writing options is ordinary if granted in the ordinary course of the taxpayer's trade or business of granting options. Consequently, under § 1234 gain or loss from dealing in exchange-traded options could be ordinary in the absence of § 1256(a)(3). However, § 1256(f)(3)(A), providing that gain or loss from trading section 1256 contracts is capital gain or loss, was enacted precisely to prevent options market-makers from taking that position. Moreover, § 1256(f)(2) merely provides that § 1256(a)(3) does not apply, while § 1256(f)(3)(A) states that it applies "for purposes of this title." I.R.C. § 1256(f)(3)(A) (2010). Accordingly, it seems quite possible that § 1256(f)(3) overrides § 1256(f)(2), and that relief is available only if a swap hedges an asset (not a liability) that would give rise to ordinary loss in the taxpayer's hands. *See* Beverly Gordon v. Comm'r, 73 T.C.M. (CCH) 2638 (1997) (rejecting taxpayer argument that hedging rule of § 1256(f)(3) applies because of failure of proof); I.R.S. F.S.A. 1999-1130 (concluding hedging rule of § 1256(f)(3) does not apply to hedges of anticipated liabilities).

to market. Given that history, it would not merely serve no tax policy goal to require taxpayers currently marking derivatives to market under § 475 to mark them to market instead under § 1256, it would be positively perverse.

Moreover, while the exclusion of section 1256 contracts from the definition of the term "security" for § 475 purposes may have originally served to ensure that commodities dealers and traders were not subject to § 475, those taxpayers subsequently had a change of heart and lobbied successfully for an election into § 475 treatment. Conceivably, therefore, the Service could exercise its regulatory authority under § 475(g) to apply the § 1256 carve-out to the definition of "security" in a more limited manner. For example, the carve-out could be applied, as it does today, for purposes of determining whether a taxpayer such as a market-maker on a commodities exchange or a dealer in fixed income instruments is a § 475 dealer in securities and would be subject to the same rules as is the case today (treating section 1256 contracts as non-"securities" for this purpose). The carve-out could cease to apply once the fixed income dealer was treated as a dealer in securities, however, with the result that any section 1256 contracts the dealer entered into would be treated as § 475 securities. An approach of this kind does not square too easily with the statutory definition of "security," but in view of the historic and current connection between § 1256 and the commodities markets it is again perverse that electing dealers and traders in *commodities* treat gain or loss from section 1256 contracts as ordinary under § 475, while dealers and electing traders in *securities* generally must apply the capital gain/loss rules of § 1256.[104] In any event, this hypothetical also demonstrates the benefits of taking a narrow view of the scope of § 1256 going forward.

3. *Benefits of Section 1256 Treatment.* Of course, § 1256 treatment is not always disadvantageous. For individuals who trade derivatives, or who are investors in pass-through entities that trade derivatives, § 1256 treatment can be highly desirable, since it provides 60% long-term capital gain for short-term positions. The significance of this is not trivial, since 60/40 treatment was viewed as the carrot to balance the mark-to-market stick when § 1256 was enacted, and the desire to preserve parity with existing section 1256 contracts has been the principal reason why the list of section 1256 contracts has grown over time. Therefore, for taxpayers who can live with mark-to-market treatment, particularly for short-term contracts like most contracts traded on commodities exchanges today, the balance may favor § 1256 in the case of individuals.

Congress has from time to time acted to limit the extent to which 60/40 treatment is available. For example, in 1984, when dealer equity options were added to the list of section 1256 contracts, Congress took care to ensure that options market-makers could not set themselves up as limited partnerships and pass the benefits of 60/40 treatment on to limited partners.

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[104] Electing dealers and traders in commodities mark "commodities" to market. I.R.C. §§ 475(e)-(f) (2010). The definition of this term includes futures contracts and does not exclude section 1256 contracts. I.R.C. § 475(e)(2) (2010). Electing dealers and traders in securities mark "securities" to market, which as discussed in the text does generally exclude section 1256 contracts

Section 1256(f)(4) provides that gain or loss from dealer equity options allocable to limited partners is always short-term. When dealer securities futures contracts became section 1256 contracts, § 1256(f)(4) was amended to apply to them as well. A natural conclusion is that, absent similar legislative action, traders in swaps treated as section 1256 contracts will be able to use partnerships in order to allow investors to share in long-term capital gains generated from a trading or dealing business. Some hedge funds might find such an opportunity attractive. Mutual funds might also welcome the opportunity to derive additional long-term capital gain, although absent certainty about whether § 1256 does or does not apply, mutual funds might be more concerned about the lack of certainty about the timing of income than attracted to the potential for long-term capital gain. And query whether taxpayers' annual year-end quest to accelerate capital losses to offset realized capital gains, or, after a down market, the search for capital gains to offset expiring capital losses, might be facilitated by the existence of similar swaps, some of which are section 1256 contracts and some of which are not.

Interestingly, it appears that the Congressional Budget Office and Joint Committee on Taxation were of the view that the fisc had more to lose than to gain from § 1256 treatment of cleared and exchange-traded swaps, possibly on the theory that if there is uncertainty about whether § 1256 applies, taxpayers will use that uncertainty to their advantage.[105] Presumably, the Dodd-Frank amendment to § 1256 was intended to eliminate that uncertainty and the corresponding revenue loss. And it is certainly the case that the amendment makes clear that large portions of the derivatives market will not be subject to § 1256. It is unclear how large the remaining part of the market is, or how the market will develop in the future.

Accordingly, Section III.B. next reviews the history of § 1256, with a view to persuading the reader that uncertainty of this kind has historically been resolved by construing § 1256 narrowly. Section III.C. will then argue that a similar approach is appropriate today.

B. A Discourse on the History of Section 1256.

The need to look to the history of § 1256 becomes evident if one tries to determine how § 1256 applies to derivatives currently in the market that are not traditional exchange-traded contracts but have some link to an exchange or clearinghouse. Since the Dodd-Frank amendment to § 1256 will take effect for taxable years after the year of enactment, meaning in

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[105] *See* Letter from Congressional Budget Office to Senator Christopher Dodd (May 3, 2010), *available at* http://www.cbo.gov/ftpdocs/114xx/doc11476/s3217amendmt.pdf (analyzing effects on direct spending and revenues of the Dodd-Lincoln substitute bill, projecting an estimated revenue loss of over $1 billion from the possible § 1256 treatment of derivative financial instruments required to be cleared and traded as provided in the bill, and noting "considerable uncertainty" as to the size of the expected revenue losses); *see also* Congressional Budget Office, Cost Estimate, *H.R. 4173, Restoring American Financial Stability Act of 2010*, at 7 (June 9, 2010), *available at* http://www.cbo.gov/ftpdocs/115xx/doc11560/hr4173senatepassed.pdf (same estimate).

2011 for most taxpayers, and since its scope is uncertain, being able to ascertain whether § 1256 applies to such derivatives remains important today and will have some significance in the future. This Section III.B therefore begins by ignoring the Dodd-Frank amendment and attempting to determine whether § 1256 applies to such derivatives, and in particular whether any of them might constitute a "regulated futures contract."

1. *Construing "Regulated Futures Contract".* An RFC is defined under current law as:

> "a contract –
>
> (A) with respect to which the amount required to be deposited and the amount which may be withdrawn depends on a system of marking to market, and
>
> (B) which is traded on or subject to the rules of a qualified board or exchange."[106]

A "qualified board or exchange" is defined as a national securities exchange registered with the SEC, a domestic board of trade designated as a contract market by the CFTC, or any other exchange, board of trade, or other market which the Secretary determines has rules adequate to carry out the purposes of § 1256.[107]

On its face, this definition is very broad, as it requires only that "a contract" be traded on a CFTC- or SEC-regulated exchange and be subject to daily variation margin requirements. As discussed in more detail below, this very breadth has raised questions in the past as to whether non-futures contracts, in particular "commodity options," constitute RFCs. The fact that Congress resolved that issue by amending § 1256 to specify when commodity options will and will not be treated as section 1256 contracts suggests that whatever the definition of RFC, it should not apply to every contract traded on a CFTC-approved exchange. Similarly, the fact that Congress amended § 1256 to include foreign currency contracts and nonequity (including foreign currency) options suggests that the RFC definition should not include contracts linked to foreign currencies. Instead, the definition should apply to some subset of traded contracts. The logical way to narrow the scope of the definition is to read into the term "a contract" the implied qualification that it is "a [commodity futures] contract," since those were the only contracts to which the RFC definition applied when it was enacted. As discussed in more detail in Section III.B.3, below, however, while the Service appears to have taken that position, there is no authoritative guidance to that effect.[108]

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[106] I.R.C. § 1256(g)(1) (2010).

[107] I.R.C. § 1256(g)(7) (2010).

[108] Recent remarks by Service officials suggest that guidance to this effect may be forthcoming. *See* Amy S. Elliott, *IRS May Restrict Definition of Swap to Notional Principal Contracts* (Dec. 15, 2010), *available at* 2010 TNT 240-3; Diane Freda, *IRS May Hold to Narrow View of Futures Under Dodd-Frank Wall Street Reform* (Dec 15, 2010), 239 DTR G-3, *available at* www.bna.com

A further source of uncertainty arises because an RFC is defined as a contract "traded on or subject to the rules of" a qualified board or exchange ("QBE"). The "subject to" (or is it "traded ... subject to"?) language is ambiguous. To focus attention on that ambiguity, it may be helpful to review some of the different kinds of transactions that currently exist that have or may have some connection to a QBE but are not expressly within or outside the scope of § 1256. Primarily because it is convenient to do so, the list below mostly describes a number of contracts that have some connection to the CME or its affiliate exchanges, the Chicago Board of Trade ("CBOT") or the New York Mercantile Exchange ("NYMEX").[109]

> The mutual offset system. Since 1984, the CME and the Singapore Exchange (formerly the Singapore International Monetary Exchange, or SIMEX) have been parties to an agreement that allows traders to open a futures contract on one exchange and have it automatically transferred overnight to the other exchange. For example, during SIMEX business hours, a trader could enter into a Eurodollar futures contract on SIMEX; when the CME opens, the trader may send the contract to the CME, in which case, once accepted, the SIMEX trade will be offset and the trade will become a position on the CME. From that point forward, the futures contract is identical to any other Eurodollar futures contract on the CME.
>
> Exchange for physical. An exchange for physical ("EFP") transaction is a privately negotiated (that is, OTC rather than exchange-traded) and simultaneous exchange of a position in a physical asset for a related futures contract. For example, a party owning live cattle, natural gas or foreign currency may exchange that asset for a futures contract on the same product, provided that the asset satisfies specified conditions. Once accepted, the futures contract is identical to any other futures contract traded on the exchange. The general rule for such transactions is in Rule 538 of the CBOT's Rulebook.
>
> Exchange for swap.[110] An exchange for swap ("EFS") transaction on NYMEX is like an EFP, except that the parties exchange a futures contract vs. a swap rather than a physical asset. Typically, such transactions are submitted for clearing within one hour of the parties' agreement to the terms. In the energy markets, where there are many EFS, a standard confirmation states that if the transaction is not accepted for clearing it will be void. Such transactions are also subject to CBOT Rule 538.

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[109] The information described below is taken primarily from the CME Group's website, www.cmegroup.com.

[110] *See* Pomerski, *supra* note 49, § I F 5; Kramer, *supra* note 49, § 62.01[B][1]. Pomerski and Kramer conclude that these contracts constitute RFCs. It appears that NYMEX also takes that position.

Cleared agricultural swap. A cleared agricultural swap is a privately negotiated contract that is submitted to the CME for clearing, as a result of which the CME becomes the legal counterparty to both sides of the contract. These swaps are listed, for clearing only, on the CBOT. That is, unlike the transactions described above, the contract does not become a futures contract.

There are several variations of such swaps, all of which provide for cash-settlement on expiration in an amount determined in part by reference to the settlement price for a specified futures contract. For each type of swap, CBOT rules set forth their terms. Not surprisingly, given the pricing connection to futures contracts, these terms generally mimic those of the related futures contract.[111] Such swaps are also subject to the general provisions of CME Rule 8F, which deals with clearing OTC derivative contracts.

Because most of the terms of the swaps, once cleared, are fixed under the rules described above, negotiations are limited, generally to the price, settlement date, and in some cases, one or two other terms. It is understood by the parties that the swap is entered into for clearing, and market practice is to submit the swap for clearing immediately after agreeing to its terms. There is no separate documentation such as a confirmation for the swap before it is cleared.

Cleared interest rate swap. As described in Section II.A.3, above, a cleared interest rate swap is a privately negotiated contract that is submitted to a clearinghouse such as the CME or LCH.Clearnet (which does not give rise to a futures contract) or IDCH (which does).

Cleared CDS – CME. As described in Section II.A.2(b), a CME cleared CDS is a privately negotiated contract that is submitted to the CME for clearing in the same manner as described above for cleared agricultural swaps. It does not become a futures contract. Cleared CDS contracts are subject to CME Rule 8F, described above, and specific

[111] For example, in a "calendar" swap, one party agrees to pay a fixed price per bushel and the other agrees to pay an amount determined by reference to the settlement price for the futures contract expiring in the stated month of the contract. The CBOT rules set forth the expiration date, the unit of clearing (the number of bushels), the minimum price increments, position limits (e.g., the number of contracts net long or net short in any single contract month), the time at which the contracts will be cash settled, and the settlement terms.

ICE also clears agricultural swaps under similar arrangements. Pomierski describes cleared energy swaps on ICE that appear to work similarly to the cleared agricultural swaps described in the text. Pomierski, *supra* note 49, at § I F.5; *see also* Kramer, *supra* note 49, § 62.01[B][2].

> rules addressing the clearing and settlement of CDS contracts. The CME permits parties to submit already outstanding bilateral CDS transactions for clearing, although the terms of those CDS will be restated in standardized terms.
>
> Cleared CDS – ICE Trust. As described in Section II.A.2(a), above, an ICE Trust cleared CDS is similar to a CME cleared CDS. However, ICE Trust U.S. is a stand-alone clearinghouse – that is, unlike the CME clearinghouse, its only function is to clear CDS.[112]

The § 1256 tax treatment of these various contracts as "traded on or subject to the rules of" a QBE is clear only with respect to a few of the contracts on the list. In the case of the mutual offset system, Revenue Ruling 87-43 concludes that contracts traded on SIMEX and transferred to the CME are RFCs.[113] The Revenue Ruling is discussed in more detail in Section III.B.3, below. The gist of the Ruling is essentially that under step transaction principles, the taxpayer has entered into an RFC in such a case. These principles would seem to apply to EFPs and EFSs that result in futures contracts as well. Market participants apparently take that view, but no authority addresses the issue.

Conversely, the CDSs cleared by ICE Trust are traded on an OTC basis and are "subject to the rules of" a *clearinghouse* only. Those rules are independent of any rules of any exchange. A QBE, as described above, means an SEC-regulated national securities exchange, a domestic board of trade designated as a contract market by the CFTC, or any other market that the Treasury determines has rules that are adequate to carry out the purposes of § 1256. A stand-alone clearinghouse fits neither of the first two categories, and ICE Trust has not been designated by the Service as a QBE. Accordingly, CDSs cleared by ICE Trust are not "subject to" the rules of an exchange, and are therefore not section 1256 contracts.[114]

Interest rate swaps cleared by LCH.Clearnet are not section 1256 contracts for the same reason, and the author is aware of no debate over that issue. Admittedly, it is possible that the lack of interest in this topic has something to do with historic lack of awareness in the tax community that many interest rate swaps are cleared.

The principal conclusion from examining the other contracts on the list is that the statutory language is in need of some gloss. For example, what does it mean to be "traded" on a QBE? That word ordinarily connotes the purchase and sale of an asset. RFCs, however, are not bought and sold in the usual sense. An RFC is a contract that a taxpayer enters into. When

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[112] ICE Trust is a joint venture between the IntercontinentalExchange ("ICE") and a consortium of dealers. ICE operates a number of exchanges, but their operations are separate from those of ICE Trust

[113] Rev. Rul 87-43, 1987-1 C.B. 252.

[114] Some commentators have speculated about whether this issue was considered when ICE Trust was formed As the principal tax advisor on issues relating to the clearing process, I can confirm that it was.

the taxpayer wishes to dispose of its interest in the RFC, it enters into an offsetting RFC, and its original RFC is terminated. This has very much the same effect as if the taxpayer had sold its original RFC to its counterparty in the close-out transaction, but it is technically an offset and neither a sale nor assignment. The definition of "foreign currency contract," discussed below, also requires that such a contract be "traded in the interbank market," a market in which contracts also typically are not assigned but instead are entered into and closed out with the original counterparty. That definition also requires that a foreign currency contract be "entered into" at arm's length at a price determined by reference to the interbank market price, which could be read to suggest that there is a difference between "trading" a contract and "entering into" a contract.

One is driven, therefore, to the conclusion that (1) futures contracts and foreign currency forward contracts are not section 1256 contracts because they are not "traded" in the traditional sense, which would hardly be a popular position, (2) that the term "traded" includes entering into a contract, at least under some circumstances, or (3) perhaps that trading does not refer to how an interest in a contract is acquired or disposed of but rather contemplates an active market in which contracts can readily be entered into, closed out and valued—that is, trading has to do with liquidity and valuation.[115] There are, however, futures contracts that trade on an exchange in very low volume, and it is hard to believe that would affect their status as section 1256 contracts.[116] What then does it mean to be "traded on" a QBE—that is, does the word "traded" have any independent significance, and if so, what is it?

Another question is what it means to be "[traded] subject to the rules of" a QBE. The phrase could, for example, apply to any contract that is treated as a futures contract on a QBE, even if not originally entered into as such; it could also apply to any contract that has economic terms that depend on the rules that apply to futures contracts; it could also apply to any contract that is subject to any rule that is in the rulebook of a QBE; or it could apply only to some of those or conceivably even more broadly. The first of these seems clearly right, as the discussion of Revenue Ruling 87-43 below indicates. Further indirect support may come from history. While the legislative history of § 1256 does not say where the "subject to"

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[115] *Cf* Treas. Reg. § 1.1092(d)-1(c) (1993) (interest rate swaps treated as "personal property of a type that is actively traded" if contracts based on similar indices are "purchased, sold or entered into" on an established financial market, including an interbank market). This regulation was issued to resolve a similar conundrum. Section 1092 and, at the time, section 1234A applied to personal property of a type that is actively traded. The market for interest rate swaps is deep and liquid, but interest rate swaps are not typically assigned from party to party. Rather, parties enter into them and close them out. The regulation provides that entering into such swaps in the interbank market qualifies as active trading within the meaning of the relevant statutory provisions.

[116] To take a random example, according to the CME website, at the close of business on November 12, 2010, open interest in soybean oil futures expiring March 2012, May 2012 and July 2013 were 6, 8 and 26 contracts, respectively, and none of those contracts traded on that day. CME GROUP, http://www.cmegroup.com/daily_bulletin/preliminary_voi/VOIREPORT.pdf (last visited Dec. 31, 2010).

language comes from, a likely source is the Commodity Exchange Act. The author has been advised by commodity law experts that at the time § 1256 was enacted, exchange for physical transactions existed and were governed by the CEA. The "subject to" language therefore may have been intended to refer to futures contracts that are not traded on an exchange but are otherwise identical to, and subject to all the rules governing, other futures contracts. That would not answer the question of how much further the term reaches.[117]

Conversely, the meaning of the term QBE is clear, but may be in need of some rethinking. As described above, the CFTC now regulates many different kinds of markets (DCMs, DTEFs, EBOTs and ECMs, as well as DCOs).[118] As a policy matter, it is undesirable to treat contracts traded on a DCM as (possible) section 1256 contracts and to treat identical contracts traded on a swap execution facility or another type of regulated market as non-section 1256 contracts. The Service has the authority to address this problem by determining that these other markets should be treated as QBEs, but that decision surely would be better made by Congress.

Returning to an analysis of the type of contracts on the list above, one could reach the conclusion that cleared agricultural swaps ought to be treated as section 1256 contracts in view of their very close economic connection to futures contracts, the fact that they essentially do not exist prior to being cleared, and the technical point that they are in fact subject to the rules of an exchange because the legal entity that is the CME, as it happens, is both an exchange and a clearinghouse. The last point becomes considerably less attractive, however, when one considers that it is also true of CME-cleared CDS. Surely it cannot be the case that CME-cleared CDS could be section 1256 contracts when ICE Trust-cleared CDS are not? At least it would not be so in a rational world.

Despairing, therefore, of any technical conclusion to this question, the article turns below to an examination of the history of § 1256. That history is far more illuminating than the statute itself. As it happens, the question of whether the statutory definitions mean what they appear to say has been the subject of repeated inquiry. Strikingly, the government's

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[117] The Dodd-Frank Act does not directly address the issue, but there is at least one provision that suggests that clearing alone may not be the equivalent of "traded on or subject to" the rules of an exchange. That provision is part of the definition of the key term "swap" in § 721 of the Dodd-Frank Act. It provides that "[a]ny foreign exchange swap and any foreign exchange forward that is listed and traded on or subject to the rules of a designated contract market or a swap execution facility, or that is cleared by a derivatives clearing organization" is subject to the Dodd-Frank Act. The phrase or very close variants of it are used in several other places in the bill, but not ones bearing directly on the issues discussed herein *See* See Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, §§ 721, 124 Stat. 1376, 1683-84 (2010), 210(c)(8)(D)(iii)(IV), 124 Stat. 1376, 1483-84 (2010) (definition of "commodity contract"), 730, 124 Stat. 1376, 1701-03 (2010) (modifying large swap trader reporting requirements under Commodity Exchange Act), & 737, 124 Stat. 1376, 1722-25 (2010) (modifying position limits under Commodity Exchange Act).

[118] *See supra* note 49.

answer has consistently, with one apparent and temporary oversight to the contrary, been "no." As described below, the government has interpreted the statutory definitions in light of Congressional intent, with the result that they have been read to apply more narrowly than a literal reading would suggest. The one court that has reviewed an issue of this kind has heartily endorsed this narrow approach.

2. *The 1983 Controversy over the Scope of the RFC Definition.*[119] As described above, when enacted in 1981 and as amended in 1982, § 1256 applied only to regulated futures contracts. After the 1982 amendment, § 1256 applied to a "regulated futures contract," defined as "a contract" that was subject to mark-to-market margin requirements and traded on or subject to the rules of a DCM or other qualified board or exchange.

New contracts that then began to trade raised both technical and policy questions about the scope of § 1256, including cash-settled options such as options on a stock index, options on stock index futures contracts and "commodity options." As described in more detail below, Congress revised § 1256 in 1984 to address these issues. Among the important goals of these amendments were to ensure that similar products traded on different kinds of exchanges (stock index options as opposed to stock index futures options) were subject to the same rules, and to avoid the proliferation of "mixed straddles" (transactions in which one position is a section 1256 contract but an offsetting position is not). An active debate took place prior to those amendments on both the question of how then-current law applied to these new contracts, and also the question of how the law should apply.

The part of the debate that is most relevant here concerned whether "commodity options" constituted RFCs under then-current law. A commodity option is a contract under which the writer grants to the holder the right to enter into a futures contract to buy (or sell) a designated commodity for future delivery at the strike price during the option period. Accordingly, if the option is exercised, the purchaser of a "call" commodity option enters into a "long" RFC (an RFC to buy a commodity), and the writer of that option enters into the corresponding "short" RFC (an RFC to sell the commodity); the purchaser and writer of a "put" commodity option correspondingly enter into a "short" or "long" RFC, respectively, on exercise. Like other options, a commodity option may also expire unexercised.

Commodity options were traded on CFTC-regulated exchanges and thus satisfied the second clause in the definition of RFC. Their margin arrangements were more complicated. The grantor of a commodity option must post "good faith" margin, a fixed amount negotiated at the outset, and "premium" margin, an amount equal to the current premium for the margin,

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[119] For a contemporary description of the issues and the various proposals made to resolve them, see James W. Wetzler, *The Tax Treatment of Securities Transactions Under the Tax Reform Act of 1984*, 25 TAX NOTES 453 (1984); *see also* Kramer, *supra* note 49, § 62.03[C], pages 62,027-31 (describing the positions taken by different groups of taxpayers).

marked to market daily. The purchaser of the option is not required to deposit additional funds during the life of the contract. In addition, the purchaser is not entitled to receive collateral posted by the grantor during the life of the contract, regardless of any variation in the value of the contract. Rather, the collateral remains the property of the grantor, who is entitled to a return on the collateral. Thus, the commodity option margin system resembled in some respects the mark-to-market system for futures contracts insofar as grantors of options are concerned, but not insofar as purchasers of options are concerned. Thus, it was possible that written commodity options were RFCs but purchased commodity options were not.

The New York Coffee, Sugar and Cocoa Exchange, Inc. (the "CSCE"), a commodity exchange, took the position that commodity options should be taxed like the futures contracts that underlie these options. The CSCE argued to the Treasury Department that the commodity option margin system for option writers was a system of marking to market that fell within the definition of a mark-to-market system for RFCs. The CSCE conceded that purchased commodity options were not subject to such a mark-to-market system and were not RFCs, but argued that gain or loss on commodity options held by a taxpayer nevertheless should be subject to 60/40 treatment.[120]

Treasury disagreed with that conclusion. In testimony submitted for a hearing before the House Ways & Means Committee, Assistant Secretary for Tax Policy John Chapoton stated "In our view, commodity options are taxed under the same rules that apply to physical options." He then summarized the arguments made by the commodities exchanges, and stated "Irrespective of policy considerations that may favor this result, we believe that this interpretation of current law cannot be sustained under the present statute."[121] Unfortunately, the basis for Treasury's conclusion was not explained.

The Joint Committee on Taxation (the "JCT") prepared a pamphlet for this same hearing that discusses the positions taken by various parties. The pamphlet states "[t]he staff does not believe that [the treatment of

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[120] The CSCE argued that under the general option rules of section 1234, gain or loss from the sale or exchange of an option has the same "character" as the property underlying the option (i.e., RFCs), and that because § 1256 determined the character—technically, the holding period—of gain or loss on futures contracts (as 60% long-term and 40% short-term capital gain or loss), the character of gain or loss on purchased commodity options should also be governed by § 1256. These arguments were made in a May 1982 ruling request to the Internal Revenue Service, and a September 1982 memorandum to Treasury, copies of which became part of the legislative history of the 1984 amendments to § 1256. Letter and Supporting Memorandum on the Tax Treatment of Options on Commodity Futures Contracts, from Donald Schapiro on behalf of the Coffee, Sugar and Cocoa Exchange to John Chapoton, Assistant Secretary of the Treasury (Sept. 29, 1982), *reprinted as* Tax Notes Document No. 82-9883. Several securities exchanges submitted memoranda criticizing these arguments and making alternative proposals.

[121] *Federal Tax Treatment of Capital Gains and Losses: Hearing Before the H Comm. on Ways and Means*, 98th Cong. 1st Sess., 31, 32 (1983) (statement of John E. Chapoton, Assistant Secretary for Tax Policy, Dept. of the Treasury).

written commodity options as RFCs] was intended by Congress in 1981."[122] The pamphlet also expresses similar concerns about the argument that purchased commodity options were entitled to 60/40 treatment.[123]

As this history indicates, it was clearly Treasury's position and it appears to have been the JCT's position that notwithstanding the broad definition of RFCs all commodity options were subject to the rules applicable to conventional options. Thus, Treasury expressly rejected the conclusion that a contract (option) traded on a QBE that required parties (writers) to that contract to provide daily margin if the contract lost value and to receive it back if the contract gained value constituted a RFC. Moreover, Treasury reached this conclusion as a technical matter under then-current law.

Possible bases for Treasury's position may include: (i) the 1981 legislation clearly did not contemplate options, (ii) the daily margin rules applicable to writers of commodity options did not result in the passing through of that margin to option purchasers, and could never give rise to the net receipt of margin by the option writer, and so was not the type of mark-to-market system contemplated by Congress in 1981, or (iii) the argument made by the commodities exchanges strained credibility because it treated commodity options as RFCs for option writers but not option purchasers. Treasury clearly also was concerned about the potential for arbitrage that existed under then-current law because of the uncertainty as to how commodity options should be treated, and wanted to ensure that commodity options were subject to the same rules as RFCs going forward to avoid future arbitrage. Treasury's discussion of arbitrage concerns is separate from its discussion of technical issues, however, which is consistent with the statement quoted above stating that it considered the policy issues separately from its technical analysis.

3. *History of "Foreign Currency Contracts.* While not directly relevant to the scope of the RFC definition, the government's position on the scope of the definition of another type of section 1256 contract, foreign currency contracts, is also instructive. Foreign currency contracts were added to § 1256 in 1982. A "foreign currency contract" is defined as:

> "a contract
>
> (A) which requires delivery of[, or the settlement of which depends on the value of,] a foreign currency which is a currency in which positions are also traded through regulated futures contracts,
>
> (B) which is traded in the interbank market, and

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[122] STAFF OF JOINT COMM. ON TAXATION, TAXATION OF CAPITAL GAINS AND LOSSES: SCHEDULED FOR HEARINGS BEFORE THE COMM. ON WAYS AND MEANS 23, JCS-52-83 (Nov. 1, 1983).

[123] *See id.*

(C) which is entered into at arm's length at a price determined by reference to the price in the interbank market."[124]

The legislative history makes clear that the reason for adding this new class of contract subject to § 1256 was that there were taxpayers trading in both foreign currency futures and foreign currency forward contracts with banks on the same currencies, and that the amendment was intended to eliminate mismatches in timing and character for taxpayers trading in both markets – that is, to avoid mixed straddles.[125]

In 1988, the Service issued Private Letter Ruling 8818010, which concluded that a currency swap on a currency that is traded through the futures market did not fall within the definition of "foreign currency contract." The PLR first concludes that the swap in question satisfies the requirement of clause (A) cited above. The PLR then turns to the legislative history of the 1982 amendment, and states that Congress intended to bring bank OTC forward contracts within the scope of § 1256 because "they are economically comparable to and used interchangeably with" regulated futures contracts. The PLR goes on to conclude that currency swaps do not meet this standard, because they account for interest rate differentials through present and continuing exchanges of payments rather than through a single payment at maturity. The PLR also notes that Congress in 1982 and in later amendments to § 1256 did not refer to currency swaps. On this basis, the PLR concludes that the swap fails to satisfy the requirements of clauses (B) and (C), and that the swap therefore does not constitute a "foreign currency contract."

This conclusion is rather remarkable as a technical matter. Currency swaps are entered into between banks in the interbank market, and thus are priced by reference to interbank market prices, which is what clauses (B) and (C) require on their face. The PLR simply determines that those clauses must be read in light of the legislative history of the term "foreign currency contract," and that Congress's purpose and its silence with respect to currency swaps (for which no market existed in 1981) properly lead to the conclusion that such swaps are outside the scope of § 1256. Perhaps one way to restate the analysis in the PLR is that it effectively reads the statutory language "a contract" to mean "a [bank forward] contract."

Many practitioners believed that the conclusion in the PLR was correct and that its reasoning could be extended to support the further conclusion that foreign currency options traded in the OTC market also did not constitute section 1256 contracts notwithstanding the fact that they too are traded between banks in the interbank market and priced by reference to interbank market prices. The issue was, however, uncertain. The

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[124] This definition, as amended in 1984, is now found in I.R.C. § 1256(g)(2) (2010) The bracketed language was added in 1984, as discussed in more detail below.

[125] S. REP. NO. 97-592, at 25-28 (1982); H.R REP NO. 97-986, at 24-26 (1982) (Conf. Rep.)

government formally addressed that question first in Notice 2003-81, and subsequently in Notice 2007-71.[126]

Notice 2003-81 designates certain transactions in which taxpayers took offsetting positions in foreign currency options as "listed transactions." A key part of the intended operation of the transaction was that some of the options were on currencies traded through RFCs, and were treated by the taxpayers described in the Notice as "foreign currency contracts," and some were on currencies not traded through RFCs and thus clearly were not "foreign currency contracts." The Notice states as fact that the OTC foreign currency options on RFC-traded currencies constitute foreign currency contracts. The Notice contains no analysis of the issue, and it appears likely that at least some of the drafters of the Notice did not realize the significance of this statement.[127]

A mild uproar ensued, as practitioners questioned this off-hand conclusion.[128] In 2007, the Service reversed its position in Notice 2007-71, which modifies Notice 2003-81, describes the statement in the earlier Notice about foreign currency options as a mistake, and states that the Service and Treasury do not believe that a foreign currency option on a currency traded though RFCs falls within the definition of "foreign currency contract" and will challenge taxpayers who take that position.

The Notice's technical reasoning is somewhat tortuous. The analysis begins by referring to the definition of the term as enacted in 1982, at which time clause (A) quoted above stated that a foreign currency contract "requires delivery of" an RFC-traded currency – that is, there was no reference to cash settlement. The Notice then states that an option does not "require" delivery of anything, because of the possibility that the option might not be exercised. This is an interesting point of view, since an option does create legally binding obligations on the writer, notwithstanding the possibility that the writer may not have to perform on exercise. A hypertechnical reader might wonder whether under this analysis a call (but not a put) option becomes a section 1256 contract upon exercise, since at that point the obligation to deliver foreign currency ceases to be contingent.

In any event, the Notice then goes on to address the 1984 amendment to the definition that modifies the delivery requirement by adding the language "or the settlement of which depends on the value of," as shown above. The legislative history makes clear that this amendment

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[126] I.R.S. Notice 2003-81, 2003-2 C.B. 1223; I.R.S. Notice 2007-71, 2007-35 I.R.B. 472.

[127] The Service had taken the opposite position in I.R.S. F.S.A. 200025020 (June 23, 2000), reasoning that Congress intended to extend § 1256 treatment only to foreign currency forward contracts, and noting that the legislative history to 1984 amendments to the nonequity option rules states that only "certain" foreign currency contracts are treated as RFCs. The FSA also notes that reading "foreign currency contract" broadly to include foreign currency options would effectively override the limitations of §§ 1256(g)(3) and (g)(4), dealing with options listed on a QBE.

FSAs officially have no authoritative weight whatsoever, and the Chief Counsel's office has ceased to issue them.

[128] *See* Michael J. Feder, L.G. "Chip" Harter & David H. Shapiro, *Notice 2003-81 Are OTC Currency Options 1256 Contracts?*, 101 TAX NOTES 1470 (2003).

was intended to bring cash-settled OTC foreign currency forwards on RFC-traded currencies within the scope of § 1256. The Notice states that there is no indication in the legislative history—again reasoning by reference to silence—that this amendment also was intended to broaden the scope of "foreign currency contract" to foreign currency options.[129] Finally, the Notice cites to the legislative history of certain 1986 amendments to § 988—which is not technically legislative history to a 1982 amendment to § 1256—as confirmation of Congress's understanding of the definition as not covering foreign currency options.

In short, the Notice also effectively reads the statutory definition as applying to "a [bank forward] contract," notwithstanding the apparently broad scope of the statutory definition of "foreign currency contract." The Notice thus demonstrates the crucial nature of legislative history and Congressional intent in the government's interpretation of the scope of § 1256.

The conclusion reached in the Notice was adopted by the Tax Court in *Summitt*. In a remarkable feat of vision, the court reaches its conclusion based on the plain meaning of the statute, and looks to legislative history only to confirm its conclusion. The "plain meaning" in this case includes the statutory changes made to the definition, thus suggesting that a similar historical view is appropriate with respect to regulated futures contracts. The case helpfully also states that "[w]hen Congress has specified the types of contracts that come within the definition of a section 1256 contract, exclusion of others from its operation may be inferred."[130] *Summitt* thus provides at least moral support for the narrow interpretation of § 1256 that this article advocates.

4. *Other Service Guidance on the Scope of the RFC Definition*. Turning from legislation to regulatory guidance, there are a handful of items of guidance addressing the scope of § 1256's definitional provisions. To the extent one can extract something from them, they too suggest that the Service has interpreted that definition by starting with a sensible conclusion and working backwards to find what support there is in the statutory language.

The only published guidance on the scope of the RFC definition is Revenue Ruling 87-43, which as briefly described above considers whether futures or option contracts established pursuant to the mutual offset system between the CME and a foreign exchange then known as SIMEX are considered "traded on or subject to the rules of" a qualified board or exchange.[131] The Ruling concludes that contracts executed on one

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[129] *See* H.R. REP. NO. 98-432, at 1646 (1984). The Notice could also have noted that this change was a technical amendment.

[130] *See* Summitt v. Comm'r, No. 13893-07, 2010 WL 2010950, at *12 (134 T.C. No. 12, May 20, 2010).

[131] Rev. Rul 87-43, 1987-1 C.B. 252. The options were "nonequity options" of a kind subject to sections 1256(g)(3) and 1256(g)(5) if traded on the CME. Sections 1256(g)(3) and 1256(g)(5) provide that any option, other than a right to acquire stock from an issuer, that is "traded on or subject to the rules of" a qualified board or exchange is a

exchange and transferred to the other exchange should be analyzed by reference to the second exchange. Thus, futures contracts executed on SIMEX and transferred to the CME constitute regulated futures contracts, and futures contracts executed on the CME and transferred to SIMEX do not.

The Ruling is based on the step transaction doctrine. Because a customer wishing to enter into a futures contract that ultimately will be a CME futures contract originally contacts a clearing member of the CME, the Ruling concludes that since the first step in the transaction and the end result are the same as for a contract executed on the CME. Under the step transaction doctrine, the intervening steps should be ignored. There is a suggestion in the Ruling that the basis for this conclusion is that the futures contract is "subject to the rules of" the CME as if it had originally been executed on the CME because that is how the contract is described in the facts, but the analysis part of the Ruling does not make clear whether the futures contract is deemed "traded on" the CME, notwithstanding the fact that it is actually executed on SIMEX, or whether the Ruling relies on the "subject to the rules of" leg of the regulated futures contract definition.

The Ruling states that in determining whether the "traded on or subject to" condition is satisfied, "it is necessary to ascertain the legal relationships that exist between the parties to the transaction." That statement seems perfectly reasonable. The Ruling goes on, however, to describe "the parties" in a way that does not shed much light on larger issues.

A key point in the Ruling's reasoning is a statement that in a conventional CME futures contract transaction, the fact that an exchange clearing house is interposed between the original parties to the transaction should be ignored, because "the legal relationship between the investor and the broker remains unchanged." The meaning of this statement is unclear, particularly given the fact that the interposition of the clearing house between the clearing members has significant real-world consequences. It is also unclear why the statement focuses on the relationship between the investor and the clearing member, since generally the investor is treated for tax purposes as if it had directly entered into the futures contract on the exchange rather than as entering into an independent contract with the clearing member or the clearing house.[132] By analogy, it would be rather

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section 1256 contract as long as it is not an "equity option" (generally, a single-stock option or an option on a narrow-based stock index)

[132] Every other reference to a clearing house that the author is aware of treats the clearinghouse as a mere intermediary or guarantor. *See* Rev. Rul. 85-158, 1958-2 C.B. 175 (clearing corporation guarantees payment); I.R.S. Priv. Ltr. Rul. 88-11-053 (Dec. 22, 1987) (clearing organization plays role of intermediary), I.R.S. Priv. Ltr. Rul. 87-18-008 (Jan. 14, 1987) (refers to Options Clearing Corporation as guaranteeing options, and treats stock index options as having no issuer), I.R.S. Priv Ltr. Rul. 83-28-005 (Mar 23, 1983) (assumes that clearing house links buyers and sellers), I R.S. Gen. Couns. Mem. 37,233 (Aug. 25, 1977) (treats clearing organization as merely a mechanism to link buyers and sellers, and not as a real party to a cleared listed option); *cf.* Treas. Reg. § 1.6045-1(b) (Example 2) (2006) (generally excluding clearing houses from treatment as a broker) It is also our

unusual to give controlling weight to the taxpayer's relationship with its broker if one were analyzing the effects of a purchase of exchange-traded stock, except in highly unusual circumstances.

It is possible that the statement is simply intended to convey that for tax purposes the pre-clearing and post-clearing arrangements should not be treated as two separate contracts, and that the pre-clearing contract should instead be viewed as a temporary state of affairs that has no independent significance in analyzing the overall transaction.[133] The Ruling seems to view the "original parties" to the transaction as the two clearing members, however, which would suggest the reverse, namely that it is the first step rather than the ultimate result that determines whether the transaction is within the scope of § 1256. Again, it is hard to square treating the clearing house members as the true parties to the transaction with the tax law's treatment of the investor as the party that enters into the futures contract.

Like other § 1256 rulings, therefore, the Ruling appears to reach the "right" result through technical reasoning that does not provide a basis for drawing conclusions with respect to other types of contracts or transactions. The best explanation of the Ruling's conclusion may simply be the common sense observation that all CME futures contracts should be treated in the same way regardless of whether they were executed on or off the CME. This is a less formal way of expressing the step transaction doctrine.

A field service advice issued in 2000 discusses the meaning of both the terms "regulated futures contract" and "foreign currency contract."[134] Unfortunately, the FSA does not describe the actual transactions carried out by the taxpayer, except to say that they were foreign currency contracts in the colloquial sense. The FSA also appears to use the term "futures contract" to include what many people would refer to as a forward contract, which does not add to its clarity. In any event, the FSA appears to take the position that only a "futures contract" can qualify as a RFC, and that a futures contract must be subject to CFTC regulation in order to qualify as a RFC.

Another FSA from 2000 analyzes whether OTC foreign currency futures, forwards and options constitute RFCs, and concludes that they do not.[135] While this result is hardly surprising, the analysis in the FSA is of interest because it turns on the meaning of the "on or subject to" language in the RFC and nonequity option definitions. The FSA interprets the statutory definition to mean that a contract must be (a) traded on an exchange, apparently testing this at the instant in time when the contract is executed, or (b) traded in a manner that causes the contract to be subject to

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understanding that clearing houses do not treat themselves for purposes of filing their own tax returns as parties to the transactions they clear.

[133] A private letter ruling issued in the same timeframe analyzing the same transactions adds this gloss, stating that the steps involved in the typical exchange clearing process are not analyzed separately but are viewed as component parts of a single transaction. I.R.S. Priv. Ltr. Rul. 87-39-051 (June 30, 1987)

[134] I.R.S. F.S.A 200025020 (Mar. 17, 2000)

[135] I.R.S. F S.A. 200041006 (June 23, 2000).

the rules of the exchange on an on-going basis, identifying the required use of a clearing house and the required use of mark-to-market as evidence of the "continuing nature of [the] relationship between the commodity futures contract that was, at one time, traded on the exchange, and the exchange."

The reader will not be surprised to hear that this analysis is based on legislative history. The FSA takes as its premise that Congress "created § 1256 based on the actual operation of the futures markets," and then cites a sentence in a JCT report that futures contracts are "subject to the rules" and regulations of the exchange where they are traded. The Service's position thus appears to be that only futures contracts traded on an exchange can be RFCs.

If that continued to be the Service's position, CDS that were cleared but not exchange-traded would not be treated as section 1256 contracts. This technical analysis does not fully address the issues at hand, however, because the Service has never had occasion to consider a contract that is not traded on an exchange but that might nevertheless be considered to be subject to an exchange's rules. Indeed, the FSA's emphasis on *clearing* as satisfying the requirement that a contract be subject to the rules of an *exchange* could point towards a conclusion that CME-cleared CDS are "subject to" the rules of an exchange. The more significant lesson from the FSA seems to be that the Service will faithfully adhere to what it sees as Congressional intent in enacting § 1256.

In summary, while there is no guidance on point, in the almost thirty years that § 1256 has been on the books, it has always been interpreted in a manner intended to bring within the scope of that section those instruments that Congress specifically identified in legislative history, and to exclude all other instruments. As noted by the Tax Court in *Summitt*, Congress has implicitly approved this approach by leaving the definition of RFC unchanged, and adding additional categories of section 1256 contracts as it thought proper. Congress also has made clear that it considers it bad tax policy to create or permit a tax regime in which some contracts are subject to § 1256 while other very similar contracts—here, cleared/traded swaps versus bilateral OTC-only swaps with standardized terms—are not. Extending that approach here would give rise to a simple conclusion, namely that neither cleared swaps nor exchange-traded swaps constitute section 1256 contracts, until and unless Congress speaks to the contrary.

Returning to the present, the task that still remains undone now that Congress has spoken is to divine its meaning. Section III.C. endeavors to do so.

C. The Dodd-Frank Amendment to Section 1256.

The Dodd-Frank amendment lists nine specific types of derivatives and states that they and "any similar agreement" do not constitute section 1256 contracts. Because the precise composition of the list may be important, the list is repeated here, along with two other potentially relevant lists:

Dodd-Frank definition of swap	*Dodd-Frank amendment*	*NPC definition*
(I) interest rate swap	interest rate swap	interest rate swaps
(VII) currency swap	currency swap	currency swaps
(VIII) foreign exchange swap		
(VI) basis swap	basis swap	basis swaps
(III) rate cap	interest rate cap	interest rate caps
(II) rate floor	interest rate floor	interest rate floors
(IV) rate collar		
(V) cross-currency rate swap		
(XXII) commodity swap	commodity swap	commodity swaps
(IX) total return swap		
(XII) equity swap	equity swap	equity swaps
(X) equity index swap	equity index swap	equity index swaps
(XII) debt index swap		
(XIII) debt swap		
(XIV) credit spread		
(XV) credit default swap	credit default swap	
(XVI) credit swap		
(XVII) weather swap		
(XVIII) energy swap		
(XIX) metal swap		
(XX) agricultural swap		
(XXI) emissions swap		
agreement known as swap	similar agreement	similar agreements

The Dodd-Frank definition of swap is both broader and narrower than what is described above. It is broader because the list is only one component of the definition. But it is also narrower, because there are

various carve-outs to the definition. Those refinements are for the most part not relevant to this discussion.

The NPC definition comes from Treasury regulation § 1.446-3(c)(1)(i). That regulation defines an NPC functionally, as a financial instrument with certain payment terms. It then goes on to say "[n]otional principal contracts governed by this section include" the list above. Thus, in the NPC context, the list is illustrative only, although the illustration helps to illuminate the meaning of the definition.

It is obvious from a quick glance at these lists that the Dodd-Frank definition of swap contains many types of swaps not included in the Dodd-Frank § 1256 amendment, and has some minor differences in wording. It is also obvious that the composition, the wording and the ordering of the list in the amendment precisely tracks the list in the NPC regulations, except for the addition of CDSs. A natural conclusion that could be drawn is that the § 1256 amendment was intended to refer to NPCs and CDSs. However, other alternatives have been suggested. Among the alternative interpretations of the scope of the § 1256 amendment are:

(a) the nine contracts enumerated in the amendment and no others; a "similar" agreement is one essentially identical to one of the nine enumerated contracts;

(b) NPCs and CDSs; a "similar" agreement is an NPC that is not specifically enumerated;

(c) NPCs, CDSs and agreements that are similar in that they are based on NPCs or CDSs, for example a forward or option to enter into an NPC;

(d) "modern" contracts, *i.e.*, contracts historically traded on commodities exchanges should remain section 1256 contracts, but more recently developed types of derivatives should not become section 1256 contracts; or

(e) any swap listed in the definition of Dodd-Frank; a "similar" agreement is one that is a Dodd-Frank "swap." Since the Dodd-Frank definition of swap excludes futures contracts, this should be understood to mean all derivatives other than futures contracts and other types of contracts specifically excluded from the Dodd-Frank definition of swap.[136]

Other alternatives are possible. For example, another possibility would be that the § 1256 amendment applies to any specifically enumerated swap and any other derivative on the same underlying risk.

To this observer, the most likely of these alternatives is that the core of the amendment is that it applies to NPCs, meaning that alternatives (b) and (c) are the most likely possibilities. To explain this conclusion, a

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[136] For some discussion of these various alternatives, see Amy S Elliott, *IRS May Restrict Definition of Swap to Notional Principal Contracts* (Dec. 15, 2010), *available at* 2010 TNT 240-3.

few observations are in order before considering what additional insight the legislative history may provide.

The first alternative offers the impression of simplicity but suffers from the fact that it seems entirely arbitrary. Why include an equity swap but not a swap on debt instruments? What is the difference between a currency swap and a foreign exchange swap? In view of the fact that agricultural products and natural resources are commodities, what would it mean to include commodity swaps but exclude agricultural swaps, energy swaps and metal swaps? The fact that slightly different wording is used in the § 1256 amendment and the Dodd-Frank swap definition for interest rate caps and floors also suggests that the drafter of the amendment was not looking to the swap definition.

The second alternative has the virtues that on its face it corresponds to existing law (the NPC definition) and can be interpreted by reference to well-known rules; it is principled in that it takes into account that § 1256 has no rules for derivatives with periodic payments; and it covers a large part of the derivatives market, which seems like a necessary condition in view of the fact that the amendment eliminated the estimated revenue loss from the derivatives Part of Dodd-Frank.[137] However, it is not possible to prove that the correspondence with the NPC definition was deliberate.[138] This alternative also would exclude derivatives that one might believe should be within the scope of the amendment, as for example swaptions.

The third alternative treats the specifically named contracts as NPCs and CDSs, but takes a broader view of what constitutes a "similar agreement." The principal difficulty with this interpretation is that it is difficult to articulate the outer boundaries of what constitutes a similar agreement. This is of particular concern when trying to ensure that the definition does not inadvertently turn derivatives that were section 1256 contracts prior to the enactment of Dodd-Frank into non-section 1256 contracts. If the government were to adopt this alternative, an incremental approach of identifying contracts as they begin to trade on a regulated market as within or outside the scope of the amendment might be the most feasible approach, although that would provide less guidance to taxpayers anticipating the onset of such trading.

The fourth alternative would be comforting: "Chicago" products would be subject to § 1256, while "New York" products would not. But alas the distinction is not so easy to make. As has been described above, the range of products offered by commodities exchanges has expanded greatly over time. For that matter, so has the range of products available in

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[137] *See* Congressional Budget Office, Cost Estimate, *H.R 4173, Dodd-Frank Wall Street Reform and Consumer Protection Act*, at 4 (June 28, 2010), *available at* http://www.cbo.gov/ftpdocs/115xx/doc11596/hr4173.pdf (showing virtually no effect on budget revenues or outlays from Title VII of Dodd-Frank).

[138] As noted earlier, a prior version of this article, published a few weeks before the amendment appeared in the Dodd-Frank bill, recommended amending § 1256 to exclude NPCs and CDSs, among other proposed changes to the Code. The author's views on the proper interpretation of the § 1256 amendment are inevitably affected by this chain of events. Readers may draw different conclusions.

the OTC market. The result is that even before Dodd-Frank there were overlaps in products or competing products in both markets. For example, it is possible to take risk positions not only in commodities, interest rates and foreign currency but also in weather and real estate both on commodities exchanges and in the OTC markets. The starkest examples of the overlap are the CME and IDCG swap futures contracts described above, which offer exchange-traded alternatives to OTC interest rate swaps. All of these products existed prior to the enactment of Dodd-Frank. And it can be expected that the commodities exchanges will continue to develop new products. The distinction between "modern" and "historic" products thus does not provide either a clear or a principled line between contracts that are and are not subject to § 1256.

The fifth alternative also offers the promise of simplicity. However, it seems wrong to this observer for several reasons. The first is that if the § 1256 amendment was intended to apply to all Dodd-Frank swaps, it would have been easier to draft it with a cross-reference. The decision instead to enumerate a list implies that some Dodd-Frank swaps were not intended to be covered. The fact that the ordering and wording of the list in the amendment and in the definition are different also suggests a different meaning for the amendment. Lastly, and perhaps most seriously, this approach is the one most likely to cause derivatives that were thought to be section 1256 contracts prior to Dodd-Frank into non-section 1256 contracts. There is no reason to believe that Dodd-Frank was intended to have that effect.

Indeed, the evidence we have indicates the contrary. As quoted earlier, the single sentence of legislative history to the amendment describes it as "a provision to address the recharacterization of income as a result of increased exchange-trading of derivatives contracts by clarifying that section 1256 of the Internal Revenue Code does not apply to certain derivatives contracts transacted on exchanges." The most important word in this sentence is "clarifying." It seems clear that the amendment was intended to ensure that exchange-trading of what is now an OTC contract does not in and of itself cause the contract to become a section 1256 contract. That is, it was intended to freeze the status quo for derivatives not currently traded on exchanges. It also seems clear that the amendment was not intended to change the current law tax treatment of any derivative currently traded on an exchange, as such a change would constitute more than a clarification. Treating the amendment as freezing the status quo is also consistent with what the author understands to have been the deliberately very limited effect that the amendment was intended to have as a result of the Congressional rules governing the process for moving the Dodd-Frank bill through Congress.[139]

If the analysis above is correct, it has a number of implications for derivatives outside the scope of the amendment. First, if it is a "clarification" to provide that an interest rate swap will not become a section 1256 contract if the swap is traded on a regulated market, that

[139] *See supra* note 90.

implies that the interest rate swap did not become a regulated futures contract by reason of that trading. That logic in turn confirms that the term "regulated futures contract" should be given a very limited meaning, as argued earlier based on the prior history of § 1256.

A second important implication has to do with the effect under current law of clearing a derivative through a regulated clearinghouse. If it is a "clarification" to provide that trading CDSs does not cause them to become section 1256 contracts, it seems likely that CDSs do not today constitute section 1256 contracts. After all, if cleared CDSs were section 1256 contracts today, then there would be no reason to include them in the amendment. Thus, the mere fact that a CDS is cleared through a regulated clearinghouse—even one like the CME clearinghouse whose rules are integrally connected to the rules of an exchange—should not cause it to become a section 1256 contract.

Having extracted this much from the single operative sentence of the § 1256 amendment and the single sentence of legislative history, let us return to some of the conundra we considered earlier in the article. The first was the potential disparities in the tax rules applicable to an interest rate swap, and IDCG interest rate swap futures contract and a CME futures contract. The second was the treatment of various instruments in a dealer's interest rate swap book. A third interesting question is how the § 1256 amendment affects energy swaps.

The IDCG contract is both a futures contract and an interest rate swap, since no rule tells us that the two are mutually inconsistent.[140] The pre-Dodd-Frank status quo is uncertain, since while the contract is a futures contract it is not a contract of the kind Congress envisioned when § 1256 was enacted. Indeed, as noted above, the IDCG swap futures contract illustrates that the issues raised by the migration of OTC contracts into regulated clearinghouses and onto exchanges is not solely the result of Dodd-Frank. These issues also arise because of the initiatives taken by commodities exchanges to expand the scope of their products. That is, the status quo pre-Dodd Frank was a moving rather than static object, and thus not easy to freeze.

Neither statutory language nor legislative history definitively answer the question of how an IDCG swap futures contract should be treated. On balance, this author would come to the conclusion that the § 1256 amendment's statement that an interest rate swap does not constitute a section 1256 contract should be read to override the rules otherwise applicable to futures contracts, at least in a case like this one where the

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[140] This is a slight overstatement. As Bill Paul has commented to me several times, the definition of NPC in Treasury Regulation § 1 446-3 excludes a futures contract. If that priority rule applied more generally, the sprinkling of CFTC pixie dust over a contract to make it a futures contract could mean that such a contract fell outside the scope of the § 1256 amendment, at least if one believes that that amendment is intended primarily to cover NPCs. While acknowledging the technical point, the author does not believe that an obscure regulatory rule intended to ensure that only one set of timing rules applied to a particular contract should be viewed as informing Congress's judgment as to which of those rules should take priority

futures contract is not of a kind envisioned by Congress. That conclusion is based on the history of interpreting § 1256 narrowly, the similarly restrictive intent of the § 1256 amendment, the lack of any rules in § 1256 for contracts with periodic payments, and the desirability of having consistent rules for all interest rate swaps. Given the uncertainty of this or any other conclusion with respect to IDCG interest rate swap futures contracts, this contract is a prime example of the need for regulatory guidance.

If one concludes that the IDCG contract is not a section 1256 contract, one might wonder also about the CME swap futures contract. If the § 1256 amendment covers NPCs and agreements that are similar because they are linked economically to NPCs, even the CME swap futures contract might not qualify as a section 1256 contract.

Turning to the hypothetical dealer book consisting of interest rate swaps, long and short positions in Treasuries, Treasury futures and options thereon, CME swap futures, ICDG swap futures, forward rate agreement and swaptions, it turns out that certainty is similarly elusive. If the forward rate agreement were cleared and/or traded on a regulated market, without more, it would appear to be outside the scope of the § 1256 amendment except under one of the broader readings, because it is not an enumerated contract and also not an NPC. However, if an RFC is limited to contracts that constitute futures contracts, a cleared/traded forward rate agreement would also not come within any of the definitions of a section 1256 contract. If we change the facts and assume that it trades as a forward rate agreement futures contract, then it would be hard to see how the contract could be anything other than a section 1256 contract.

The swaption raises a different technical issue. If traded on a regulated exchange, on its face it would appear to constitute a "non-equity option," a type of section 1256 contract. The legislative history of that definition does not indicate any particular Congressional interest in limiting the term "non-equity option" to any specified class of non-equity options, so the history of § 1256 does not provide a basis for excluding it from that definition. A swaption also is not an NPC. Thus, in order to conclude that a swaption traded on a regulated exchange would not constitute a section 1256 contract, it would be necessary to conclude both that it is a "similar agreement" within the meaning of the § 1256 amendment and that in that case the amendment overrides the definition of non-equity option. This goes beyond the argument made above, that the amendment is intended to address unclear situations and clarify them in favor of non-§ 1256 treatment. Here too, regulatory guidance would be welcome.

Finally, turning to energy swaps, the author confesses some trepidation, as the energy derivatives market is a highly specialized one that the author ventures into only from time to time. Accordingly, rather than trying to answer any questions, this discussion will simply point out some relevant considerations. First, in the case of energy swaps that are exchanged for futures contracts, it is hard to see why the Dodd-Frank § 1256 amendment would have any effect, at least as those contracts are structured today—that is, with a single bullet payment rather than with a

payment stream like that of a NPC. The only interpretation of the amendment that could change what the author understands to be the current law treatment of such futures contracts as section 1256 contracts is the broadest one, because energy swaps are included in the Dodd-Frank definition of swap. As noted earlier, however, that definition excludes a contract of sale of a commodity for future delivery. Moreover, if pre-Dodd-Frank law was fairly clear that energy futures acquired in exchange for an energy swap were section 1256 contracts, then it would seem to go beyond the scope of the amendment to change that.

The treatment of energy swaps that are cleared by a regulated clearinghouse but not exchanged for futures contracts is much less certain. The arguments made above with respect to cleared CDSs suggest that clearing alone does not cause a contract to become a section 1256 contract. CDSs are however specifically enumerated in the § 1256 amendment. The argument may become more tenuous for other contracts. A potentially contrary argument would be that a contract that looks and smells like a futures contract, but for the fact that it does not trade as one, ought to be subject to the same rules as futures contracts. This argument also has its pitfalls. For example, the "fixed" leg of the IDCG's interest rate swap futures contracts is not actually a fixed amount. Instead, it is based on futures prices for a contract with a specified maturity, such as one month or three months. Tying the tax treatment of a derivative to whether it has payment terms linked to futures thus does not seem likely to reduce the amount of confusion over how to classify derivatives that share some characteristics of both the OTC and exchange-traded markets.

In short, any attempt to make sense of the distinction between section 1256 contracts and non-section 1256 contracts seems to be doomed to failure if the goals are to adopt rules that are principled, simple to apply and avoid whipsaw and arbitrage. If one scales back the goals by conceding that it will be impossible to write rules that treat all similar contracts in the same way, so that whipsaw and arbitrage will have to be addressed through some means apart from drawing that line, it may be possible to construct rule that are faithful to the history and, to the extent determinable, policy of the rules of § 1256 along the following lines:

Rule 1: NPCs and CDSs do not constitute section 1256 contracts.

Rule 2: Subject to Rule 1 (meaning that Rule 1 trumps where both Rules could apply), futures contracts do constitute section 1256 contracts.

Rule 3: Options on Rule 1 contracts are not section 1256 contracts; options on Rule 2 contracts are section 1256 contracts.

Rule 4: Other types of contracts (not specifically treated as section 1256 contracts pre-Dodd-Frank) generally are not section 1256 contracts. One might want to modify this to provide that contracts of a kind eligible to be exchanged for Rule 2 contracts and that are cleared by a regulated clearinghouse should be taxed as section 1256 contracts.

If these rules applied, IDCG interest rate swap futures, forward rate agreements (if not futures contracts), and swaptions would not be section 1256 contracts; CME swap futures would be section 1256 contracts; and energy swaps not exchanged for futures contracts either would or would not constitute section 1256 contracts depending on how Rule 4 was applied.

IV. INITIAL PAYMENTS.

This Part IV now turns to the other principal issue that is the subject of this article, namely the possibility that the upfront payment on a swap might be treated as a loan for U.S. federal income tax purposes, with the result that payments of interest are deemed to be made between the parties. As discussed in Section II.C, above, it appears likely that there will often be upfront payments, or deemed upfront payments, under cleared swaps for a number of different reasons. An obvious one is that in the case of a swap such as a CDS that provides for coupon payments at the standardized level rather than the market quoted level, there will always be an upfront payment in order to bring the aggregate payments under the swap back to a market level. Other potential causes of an upfront payment, or deemed upfront payment, are closing out cleared swaps, transfers of existing OTC swaps into a clearinghouse, and transfers of existing cleared swaps if an FCM defaults.

As described in Section I.B.1, above, under Treasury Regulation § 1.446-3(g)(4), a "significant" nonperiodic payment on a notional principal contract is recharacterized for U.S. federal income tax purposes as a deemed loan from the party making the payment to the recipient that is paid back in installments over the life of the contract. In the case of most OTC swaps, these rules are (fairly) clear and have not been problematic for day-to-day business transactions, because it was rare for an upfront payment on interest rate swaps, foreign currency swaps or most other common types of swaps to be paid, or if so, for it to breach the "significance" threshold, whatever that may be. Consequently, taxpayers have not developed the internal systems that would be necessary to monitor whether a deemed loan arises and instead have dealt with the issue on a case-by-case basis.

In the case of cleared swaps, not only is it more likely that upfront payments will be made on a swap, there are also a number of aspects of clearing that raise additional technical questions about when and whether a deemed loan arises, and if so what its terms are. Existing law does not, of course, address those issues. Section IV.A discusses whether an upfront payment on a cleared swap is in fact a "payment" for U.S. federal income tax purposes, and if so, to whom it should be considered paid. Section IV.B discusses a number of issues having to do with when a deemed loan arises on a cleared swap and if so what its terms are. Section IV.C then discusses a number of additional issues that come in to play for cleared CDS. In the course of discussion, this Part IV also makes a number of suggestions for areas in which guidance would be useful.

As this discussion will demonstrate, there are many uncertainties as to whether a deemed loan arises under current law and if so, what its terms are. Since taxpayers must file annual tax returns, whether taxpayers that enter into cleared swaps with upfront payments must treat them as giving

rise to deemed loans and the determination of how much interest is deemed paid when are not abstract issues. More specifically, deemed loan/interest treatment implicates information reporting rules; withholding tax rules; a variety of rules dealing with interest expense, such as the foreign tax credit rules, Treasury Regulation § 1.882-5, addressing the allocation of interest expense by foreign banks and other foreign persons doing business in the United States in branch form, and the unrelated business taxable income rules for tax-exempt organizations; the § 475 prohibition on marking one's own debt to market; and for some taxpayers that enter into off-market swaps, like standardized CDS, with their affiliates, potentially § 956. In the view of this author, in view of the fact that taxpayers have found themselves in this uncertain new world as a result of an extraordinary and rapid reshaping of the financial markets, and pursuant to changes in non-tax law and regulatory mandates, it would be an appropriate exercise of discretion on the part of the government to announce that it will not, except in cases of abuse or cases that clearly fall within existing law, require taxpayers to treat an upfront payment on a cleared swap as a deemed loan for U.S. federal income tax purposes until guidance is issued that resolves these uncertainties.

A. Payment Issues

Before turning to more technical issues, it is worth stopping to consider whether as a matter of economic substance the upfront payment is in fact a "payment" at all for U.S. federal income tax purposes. While this article does not attempt to assess how the *Danielson* doctrine would apply, that question may not be determinative because taxpayers may be held to their form, if adverse to them.[141] But even if taxpayers are held to their form here, this question is still worth asking, because it may affect the equities involved in how the government approaches the technical questions discussed below, and because it also is highly relevant to the § 956 issue mentioned above. The fact that in this case taxpayers have not chosen the form in the usual sense, but rather it is the result of guidance, albeit non-binding to date, from regulators also may affect the equities.

As described in Section II.C, an upfront payment on a swap due from Party A to Party B is immediately and automatically reversed as a cash flow matter by a transfer of cash variation margin in the same or a very similar amount from Party B to Party A. This is not the result of some tax-driven structured arrangement or the result of combining two unrelated or loosely related transactions. Rather, it is inherent in the economics of the transaction and in the fundamentals of the structure developed by the industry in response to regulatory imperatives in order to reduce and manage risk. The amounts are the same because one is intended to offset the other as a credit risk matter. In other contexts, one would not doubt that a circular flow of cash, envisioned by the parties and required by the legal

[141] *See* Comm'r v. Danielson, 378 F.2d 771 (3d Cir. 1967). The *Danielson* case generally stands for the proposition that taxpayers will be held to the form they have chosen, absent proof that a different treatment is more appropriate. The level of proof required varies in different Circuits.

documents, would be ignored for U.S. federal income tax purposes, even if it were respected for some other purposes such as a foreign tax regime.

This is not a typical (if there is such a thing) circular flow of cash, however. The initial variation margin is a posting of collateral, which ordinarily is not treated as a contractual payment. Rather, it is a temporary transfer of assets from one party to another that is provided solely for credit support reasons and is expected to be reversed during the course of the transaction. It is economically a loan. Thus, if one treated an upfront payment as giving rise to a deemed loan from Party A to Party B, and the variation margin as a loan in an equivalent amount from Party B to Party A, the question would be whether, in the absence of abuse, these offsetting loans between the same parties, made at the same time and as integral parts of the same transaction, should be respected as such or should be netted against each other. Another way to put the question is whether a 100 percent cash collateralized loan gives rise to indebtedness for U.S. federal income tax purposes, in view of the fact that there has been no extension of credit.

One relevant consideration might be that if the two flows of cash were disregarded for tax purposes, the swap would in the first instance appear to be off-market. For example, if the market quoted level for an interest rate swap is 6 percent, but the parties enter into an interest rate swap with a 5 percent coupon, and Party A consequently pays a $4,210,000 upfront payment to Party B and receives initial variation margin from Party B in the same amount, disregarding the two cash flows of $4,210,000 leaves an interest rate swap whose terms provide for off-market coupon payments of 5 percent. However, that swap is only apparently off-market, because there is another cash flow that has not yet been taken into account. The variation margin provided by Party B will be marked to market on a daily basis going forward, and will be paid back to Party B over time. These daily margin payments are "real," in the sense that over time they will cause Party A to pay the economic equivalent of $4,210,000 to Party B. Economically speaking, therefore, the periodic payments that Party A makes to Party B would seem to be the equivalent of a coupon that is partly fixed and partly floating, with the "floating amount" determined by reference to changes in the value of an interest rate swap and potentially either positive or negative on any particular day. This would be an unusual animal, but the concept of using objective financial information to determine the amount of a periodic swap payment is not new.[142] On the other hand, there may be taxpayers who would not view the transformation of a simple 6 percent vs. LIBOR interest rate swap into an instrument with a fixed 5 percent coupon and a variable market-based coupon as an improvement over respecting the form of the cash flows.

Treating the daily margin cash flows in this manner may be a bridge too far. It is one thing to take the view that, at least for some

[142] *See* Treas. Reg. § 1.446-3(c)(4)(ii) (1994) (defining objective financial information as "any current, objectively determinable financial or economic information that is not within the control of any of the parties to the contract and is not unique to one of the parties' circumstances").

purposes, offsetting flows of cash should be disregarded. It is a very different thing to take the view that every transfer of margin with respect to a cleared swap should be treated as a payment under the swap. Since margin transfers will be made daily, reflecting incremental changes in value of the swap, an approach of that kind would effectively mean that the swap would be marked to market for U.S. federal income tax purposes. While there may be some sympathy for that result – after all, the taxpayer in fact has additional cash in its hands, or has paid out additional cash, and the extent to which swap payments and margin payments are netted by a clearinghouse is more far-reaching than in the OTC context – treating a cleared interest rate swap as subject to an effective mark-to-market regime because of margin cash flows seems clearly contrary to Congress's intent in enacting the amendment to § 1256, which was intended to ensure that interest rate swaps and other swaps covered by the amendment continue to be taxed as they were in the OTC market. As a general matter, therefore, for a variety of reasons it seems appropriate to treat the upfront payment as "real" for tax purposes.

Notwithstanding that point, the argument that the upfront payment should be netted to zero or something close to it is particularly compelling when one considers the possible application of § 956. In the example above, if one assumes that Party A is a CFC and Party B is a U.S. affiliate, it can hardly be argued that the CFC has made any net assets available to the U.S. affiliate.

Section 956 generally provides that an investment in "United States property" by a controlled foreign corporation may give rise to an inclusion by its U.S. shareholder under subpart F if the CFC has earnings and profits that have not yet been included in the shareholder's income. "United States property" for this purpose generally includes any obligation of a United States person, with exceptions for obligations of unrelated parties. Less technically, § 956 gives rise to a potential deemed dividend from a CFC if the CFC lends money, or is deemed to make a loan, to a related U.S. person. Accordingly, if a CFC makes an upfront payment on a swap to a U.S. affiliate there is a potential for a § 956 inclusion. One possible avenue for concluding that there is no investment in United States property could be to conclude that even if a "payment" from the CFC to its U.S. affiliate has taken place, there is no "obligation" of a United States person within the meaning of § 956 because the U.S. affiliate has already transferred a like amount of cash back to the CFC.[143]

Another possible path to that conclusion would be to look to the statutory exceptions to the term "United States property." Section 956 expressly provides two exceptions for transactions in which it is customary to provide collateral. Section 956(c)(2)(J) provides in relevant part that United States property does not include an obligation of a U.S. person to the extent that the principal amount of the obligation does not exceed the fair market value of readily marketable securities posted or received as

[143] The term "obligation" is not defined in the statute. Temp. Treas. Reg. § 1.956-2T(d)(2) (2008) defines it to include any form of indebtedness.

collateral for the obligation in the ordinary course of its business by a United States or foreign person which is a dealer in securities. Thus, if the CFC made an upfront payment to a U.S. affiliate of $4,210,000 while the affiliate in turn provided variation margin in the form of readily marketable securities with a value of $4,210,000, and one of the parties was a dealer in securities acting in the ordinary course of its business, there would be no United States property for § 956 purposes. A rational tax regime would not provide a worse result if the variation margin is in a form – cash – that completely offsets the obligation in the first place.

Now let us reverse the facts, and assume that the U.S. affiliate makes a $4,210,000 upfront payment on an interest rate swap to the CFC, and on the same day the CFC provides $4,210,000 variation margin to the affiliate. Section 956(c)(2)(I) provides in relevant part that United States property does not include "deposits of cash made or received on commercial terms in the ordinary course of a United States or foreign person's business as a dealer in securities. . . ., but only to the extent that such deposits are made or received as collateral or margin for (i) a. . . .notional principal contract [or] options contract." It should be clear in this case, without regard to the netting argument, that there is no United States property.

The next question to consider is who should be treated as the recipient of an upfront payment.

As described in Section II.A.1, in practice a derivatives clearinghouse faces its clearing members. As a result, when Party A and Party B submit a swap negotiated in the OTC market to be cleared, each of Party A and Party B will act through a clearing member, usually an FCM. The flow of payments thus will be from Party A to its clearing member to the clearinghouse, and then from the clearinghouse to Party B's clearing member to Party B, and vice versa.

Economically both the clearinghouse and the clearing member are conduits, albeit ones with important legal and economic roles, so that one possible way to treat the transaction for tax purposes would be as if payments were being made from Party A to Party B. That possibility must almost immediately be rejected as a general matter, at least in the absence of abuse, because once the clearinghouse steps in between Parties A and B their economic fates are no longer linked. For example, Party B could the next day enter into an offsetting transaction with Party C, in which case the clearinghouse would close out both of Party B's swaps and leave Party A and Party C as the remaining counterparties. It would be both impossible and meaningless to try to match up the Parties A, B, C etc. on an on-going basis.

Since the status of the clearinghouse as the counterparty to all transactions has very significant economic consequences, the logical answer to the question posed above is to treat each party as making payments to and receiving payments from the clearinghouse. There is a hitch here too, though, which is that some in clearinghouse arrangements

the clearing members act as agents but in others the clearing members act as principals, for legal purposes.[144] The real distinction between these legal statuses is not clear to this author; in practice all clearing members appear to perform some agent-like functions (*i.e.*, passing through payments and margin) and some principal-like functions (*i.e.*, providing credit support to the clearinghouse, being the face to customers). Obviously it would be preferable for tax purposes to treat clearing members either always as principals or always as agents. Such guidance as there is suggests that clearing members should be treated as agents, but that guidance is neither clear nor definitive.[145] Treating a clearing member as a mere intermediary would be consistent, however, with § 1256, which implicitly treats taxpayers that transact in futures contracts as directly entering into contracts that trade on a futures exchange – *i.e.*, ignoring the fact that the futures clearinghouse is dealing legally with an FCM rather than the customer -- rather than treating them as entering into an off-exchange contract with a FCM.

The remainder of the discussion below assumes that an upfront payment on a cleared swap is treated for U.S. federal income tax purposes as a cognizable payment that is made by one party to the swap to a clearinghouse, and by the clearinghouse to the other party to the swap. The remaining discussion also ignores the payment of variation margin, except where specifically stated.

B. Deemed Loan Issues

As has been adverted to earlier in the article, there are a number of technical and practical issues that require clarification in order to determine when a deemed loan arises as a result of an upfront payment, and what the payment terms of the deemed loan are. They are (i) when an upfront payment is treated as "significant," because ordinarily only a "significant" nonperiodic payment is treated as giving rise to a deemed loan, (ii) how to distinguish between swaps that are subject to the deemed loan rules and other derivatives that are not, and (iii) how, or whether, to take into account the special characteristics of cleared swaps.

1. *"Significance"*. Treasury regulation § 1.446-3 does not define the term "significant." Rather, it illustrates the meaning of the term through two examples, which describe the cash flows on a particular swap and then state that the upfront payment is or is not significant.

Both examples concern a five-year interest rate swap entered into when the market rate for such a swap is 10 percent vs. LIBOR. In the first example, Party G agrees to pay 11 percent rather than 10 percent annually. Since Party G is paying more than the market rate, Party H makes an upfront payment to Party G equal to the present value of 1 percent over 5 years.[146] This payment is not "significant." In the second example, Party

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[144] *See supra* note 52.

[145] *See supra* note 132 and accompanying text.

[146] Treas Reg. § 1.446-3(g)(6). *Example 2* (1994).

M agrees to pay 6 percent rather than 10 percent annually. Since Party M is paying less than the market rate, Party M also makes an upfront payment to Party N equal to the present value of 4 percent over 5 years.[147] This payment is "significant."

Consequently, current law answers the question of whether an upfront payment that is either 10 percent or less than the present value of the at-market fixed leg payments on the swap, or 40 percent or more than the present value of the at-market fixed leg payments on the swap, is "significant," but it provides no guidance for any upfront payment between those two levels. For example, in the case of the interest rate swap that pays 5 percent vs. LIBOR when the market rate is 6 percent vs. LIBOR, the upfront payment is equal to the present value of 1/6, or about 17 percent, of the at-market payments on the fixed leg of the swap. Taxpayers should not have to guess whether that payment gives rise to a deemed loan. It is in the government's interest to clarify that question, to ensure that taxpayers take consistent positions.

2. *Distinguishing Between "Swaps."*. The deemed loan rules described above apply only to NPCs that are subject to Treasury regulation § 1.446-3. Actually, they apply only to a subset of such NPCs, namely NPCs that qualify as "swaps," as NPCs include caps and floors that are not subject to the deemed loan rule. As anyone familiar with derivatives knows, drawing distinctions between different kinds of derivatives is not always easy. Accordingly, the boundary between derivatives that are and are not subject to these rules is hazy.

Resolving where that boundary lies is a task beyond what it is reasonable to either discuss in this article or expect the government to provide guidance on as a general matter. It would be comforting, however, if guidance provided that the Service would not challenge a reasonable determination made by the taxpayer for purposes of applying the rules listed at the beginning of this Part IV when an upfront payment is made under a cleared swap.

3. *Special Attributes of Cleared Swaps*. The deemed loan rules assume a fairly static universe. That is, they treat an upfront payment on an interest rate swap as if it will economically be paid back over the contractual life of the swap. This is not quite accurate, since there is a special rule that says in the case of a swap subject to extension or termination one looks to the reasonably expected term of the swap rather than the stated maturity.[148] But for a swap with no stated extension or termination provisions the loan is treated as payable over the stated term of the swap. While swaps can be and are closed out early, for a swap entered into in the OTC market that seems like a reasonable, and the only practical, basis for determining the term of the deemed loan.

In the case of cleared swaps, particularly for taxpayers that regularly enter into and close out swaps in high numbers, that approach is

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[147] Treas. Reg. § 1.446-3(g)(6), *Example 3* (1994)
[148] Treas. Reg. § 1.446-3(f)(3) (1994).

not so reasonable. Under current market practice, this point is particularly relevant to CDS, but the more general issue is relevant for other types of swaps as well.

As described in Section II.A.2, above, long and short positions in cleared CDS are netted on a daily basis. To take an example, assume a dealer on day 1 sells protection under the CDS described in Example 1 in connection with a customer transaction, and receives the $244,000 upfront payment. On the next day, the dealer buys protection under an identical CDS in connection with a second customer transaction. Because the market's perception of the creditworthiness of the reference entity has changed, the dealer pays a $250,000 upfront payment. The clearinghouse will net the two transactions, with the result that the dealer has no outstanding CDS, and has paid $6,000 on a net basis. (If in the second transaction the dealer paid $240,000, the transactions would also net, but the dealer would have paid $4,000 on a net basis.)

Since dealers routinely enter into many transactions, and the clearinghouses net positions on a daily or more frequent basis, the result is that it is impossible to determine for what period of time any upfront payment actually will relate to. Indeed, the one thing one can probably be reasonably sure about is that whatever the analysis might be on day 1, it will be modified by the next day's transaction. Similarly, in the case of dealers who operate in such a manner that one affiliate enters into transactions with certain customers but a different affiliate is the one that faces the clearinghouse, so that the first affiliate routinely enters into multiple CDS with the other to hedge its position, upfront payments made and received on different days also will regularly net as an economic matter and may net as a legal matter. Hedge funds or other active market participants in the swap market also are likely to transact in a manner that results in netting of outstanding contracts on a regular basis.

A possible response to these facts would be to shrug. After all, it is not uncommon for issuers of debt to redeem it early, whether voluntarily or pursuant to the terms of the debt instrument. Moreover, it is not so easy to see what other rule should be adopted. Even if one concluded that an upfront payment for a taxpayer of this kind is really a short-term debt instrument, that would not answer the question of how to determine the amount of interest deemed to accrue on that debt instrument.

Alternatively, one might conclude that in this setting it is not appropriate to impute a loan or to impute interest, at least for taxpayers of the kind described above. That raises the more general question of why it is appropriate to do so for NPCs in the first place. If it is correct that the principal reason for the deemed loan construct is to prevent related parties from avoiding withholding tax on interest, a more narrowly targeted rule could serve that purpose without raising the many questions identified above.

C. Additional Issues for CDS.

1. *Do the Deemed Loan Rules Apply?* As noted above, the deemed loan rules apply only to NPCs that qualify as "swaps,"

and it is unclear whether a CDS is properly treated as an NPC, an option, or possibly some other kind of miscellaneous derivative financial instrument. For this reason if no other, therefore, the proper treatment of cleared CDS with upfront payments is more difficult than for other cleared swaps. As it happens, the question of whether one specific type of CDS should be treated as an NPC or as an option for U.S. federal income tax purposes has been raised in litigation in bankruptcy court, under circumstances that not only make the answer to that question a do-or-die matter for the taxpayer in question but also may have very significant financial consequences for its counterparties.

The bankrupt taxpayer is Ambac Financial Group, Inc., a "monoline" insurer. Like other U.S. monolines, Ambac's core business was historically to provide financial guarantee insurance to investors in municipal bonds. During the heyday of mortgage securitizations, however, Ambac began to write CDS on mortgage-backed securities. That expansion of its business proved ill-fated, and Ambac engaged first in a number of out-of-court settlements with its CDS counterparties and ultimately sought bankruptcy protection.

According to Ambac's financial statements, Ambac's court filings and published news reports,[149] one of Ambac's most important assets is a $700 million refund that it has received as a result of losses on a type of CDS contract known as a "pay as you go" (or PAYGO) CDS. Ambac began to write (non-PAYGO) CDS in 1999, through a non-insurance subsidiary. Ambac treated these CDS as options for tax purposes, and that treatment was reviewed and approved by the IRS through 2004. As a result, Ambac treated CDS premiums received as giving rise to income (presumably capital gain) when the contract was terminated or expired. In 2005 Ambac began to write PAYGO CDS, which it also treated as options for tax purposes. In 2007, Ambac began to experience losses on its PAYGO CDS. In 2008, Ambac adopted the position that PAYGO CDS were properly characterized not as options but instead as NPCs, and began to take losses (but not income) on those CDS on a current basis in a manner consistent with its recognition of those losses for insurance regulatory purposes. Ambac then applied for tentative carryback adjustments based on these net operating losses, and to date has received about $700 million in refunds.

In late October of 2010, Ambac was contacted by the IRS for information about its change of position on the characterization on the

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[149] The following description is based on those sources, in particular AMBAC FINANCIAL GROUP, INC. 2008 ANNUAL REPORT 157-62 (Income Tax note to Ambac's 2008 financial statements), *available at* http://www.ambac.com/pdfs/87730_ambac10K.PDF, Complaint for Injunctive Relief and Declaratory Judgment Determining Amount of Tax Relief, Ambac Financial Group, Inc. v. United States, Adversary Proceeding 10-, (U.S. Bankruptcy Court, S.D.N.Y.) (Nov. 9, 2010); Jonathan Stempel, *Ambac sues U.S and says IRS may ruin bankruptcy*, REUTERS, Nov. 9, 2010, *available at* http://www.reuters.com/article/idUSTRE6A75EW20101109; Erik Holm and Eric Morath, *Ambac Files for Chapter 11*, WALL STREET JOURNAL, Nov. 9, 2010, *available at* http //online wsj.com/article/0,,SB10001424052748703514904575602911478916800,00.html.

PAYGO CDS. The IRS also informed Ambac that it was questioning the propriety of the tax refunds and was investigating whether to seek to recoup the tax refunds. Ambac then realized that under the rules applicable to tentative carryback adjustments, the IRS could summarily assess a deficiency, without notice, and impose a levy and attachment on Ambac's assets. Ambac concluded that the effect of such a levy and attachment would be to destroy or seriously jeopardize its ability to reorganize. Ambac therefore accelerated its bankruptcy filing to early November 2010, and is seeking court orders that would allow it to keep the refunds, among other matters. Thus, it is possible that the Ambac litigation will provide the first formal insight into the U.S. federal income tax characterization of at least one type of CDS, although there are also other issues in the litigation that if resolved adversely to Ambac would mean that that issue will not be addressed.

Ambac presumably believed that it had a sound basis for originally treating the PAYGO CDS as options. The fact that the IRS had approved option treatment for its other CDS no doubt played a role in that regard. When Ambac decided to treat PAYGO CDS as NPCs in 2008, however, it did so on the basis of an opinion from one of the "Big Four" accounting firms, KPMG. The Ambac history thus vividly illustrates the uncertain tax status of CDS.

In the absence of a ruling based on principles that apply to CDS generally, uncertainty as to the tax characterization of CDS, and therefore whether the deemed loan rules apply, seems like to continue for some time. That question may be informed by the difficulty of determining what the terms of any such deemed loan would be.

2. *If There is a Loan, What are its Terms?* The difficulty in determining the terms of a deemed loan arising from an upfront payment on a cleared CDS can be illustrated by turning back to the three examples described in Section II.C.2(c), above. Each of them involved a CDS where the market quoted level differed by 75 basis points from the standardized coupon. However, the upfront payment on each of them was a different amount--$244,000 for Example 1, $335,000 for Example 2, and $377,000 for Example 3. If one now tries to convert the upfront payment back into a stream of payments on a deemed loan for tax purposes, it is difficult to conclude that each of those three different upfront payments should be treated as the equivalent of an annuity or installment loan consisting of the same stream of 75 basis point to maturity. That is, it would be surprising to conclude that if $244,000 represents the present value of a stream of 75 basis points for 5 years, $335,000 also represents the present value of that same stream of payments. As described in the discussion of these examples earlier, the explanation for this discrepancy is that the market does not assume an equal likelihood that the notional stream of 75 basis points would be made for the entire tenor of the CDS.

A possible way to deal with this inconvenient fact would be to reconvert each upfront payment into a stream of X (not 75) basis points over the maximum life of the CDS, in an amount that would differ for each example because each of them reflects the present value of a different

stream of payments. Remember, however, that the regulations that treat an upfront payment as a deemed loan also restate the terms of the related swap so that they have market terms. That would not be the case if the deemed loan payments were treated as, hypothetically, 50 basis points for Example 1, 60 basis points for Example 2 and 65 basis points for Example 3.

Moreover, treating each of these upfront payments as representing a stream of 75 basis points would have the merit of a rule anchored to the real market pricing for these CDS. If one therefore assumed that the best answer is to reverse engineer what the market has done, and to treat the upfront payment as repaid in 75 basis point increments over some period of time, new questions arise that would also have to be addressed in any such guidance. Since the upfront payments are in different amounts, would each case result in a stream of 75 basis point deemed payments for a different period of time? Or would each of them be treated as giving rise to deemed 75 basis points payments for the full tenor of the CDS?

Let us assume that the upfront payment in Example 1 ($244,000) would be treated as equivalent to an annuity paying 75 basis point coupons for 3 years, the upfront payment in Example 2 ($335,000) would be treated as equivalent to a similar annuity but for 4 years, and the upfront payment in Example 3 ($377,000) would be treated as equivalent to a similar annuity but for 4.5 years. What happens if the CDS in Example 1 survives for more than 3 years? Does the deemed annuity continue? Or is the CDS treated as reissued at year 3?

Some support for this approach—same payment amount, over different periods—can be found in the NPC timing regulations, because they provide that for purposes of recognizing a nonperiodic payment over the term of an NPC, the term of an NPC that is subject to termination is the reasonably expected term of the contract.[150] On the other hand, the deemed loan rule provides that the deemed at-market swap must provide for level payments, which would not be the case if the swap in Example 1 remained in existence for more than 3 years unless the swap were treated as reissued at year 3. This approach does not seem like the likely right answer.

Now let us consider the alternative, under which the annuity is deemed to be payable in all three examples over the full five-year term of the CDS. We know that there is uncertainty about whether the annuity will in fact be paid over the entire term, with the highest risk in Example 1. Given the uncertainty as to whether the "lender" will be "repaid" in full, does the deemed loan give rise to contingent payment debt subject to Treasury Regulation § 1.1275-4 (one fervently hopes not)? More significantly, is this debt at all? It can be compared to a credit-linked note, with a payout of zero if the credit event arises. Or it could be compared to an interest-only obligation (an "IO") on a prepayable debt instrument, where the trigger for terminating payments is not repayment of debt but a credit event.

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[150] Treas Reg. § 1.446-3(f)(3) (1994). The regulation does not specify who determines what the reasonably expected term is, leading to the possibility that different parties to an NPC will take different positions.

There are, as it happens, some tax rules for IOs. For example, IOs issued under the REMIC rules are statutorily treated as debt, like other regular interests in the REMIC.[151] IOs can also arise pursuant to the bond stripping rules of § 1286. Most IOs under current market practice probably provide for payments based on pools of prepayable debt instruments, and thus either explicitly or by analogy can be handled to at least some extent under the rules of § 1272(a)(6). That would not be the case for an annuity deemed to arise under a CDS. Moreover, the rules for taxing IOs are not themselves a model of clarity, as evidenced by a request by the Service in 2004 for comments from taxpayers on a variety of issues.[152] The request states in its introduction that "REMIC IOs present novel and difficult questions in the application of tax rules that were designed primarily to account for instruments that qualify as debt under traditional tax principles." Similarly, the rules for contingent payment debt instruments reserve on the question of how to treat most timing contingencies.[153]

In short, while it is quite possible to come up with a scheme under which an upfront payment is reconverted back into an annuity of some kind, and to devise a method for determining what portion of the annuity payments constitute principal and what portion constitute interest, there are at present no rules that do so. Equally significantly for taxpayers that might hazard the attempt, there are no real analogies, or at least none with tax treatment that is certain, to which the taxpayer might look to take comfort that its invented method clearly reflects income. In the absence of any guidance from the government on even the most basic of questions on the taxation of CDS, and acknowledging that these issues are not easy ones to resolve, it is hard to believe any court would hold taxpayers accountable for not divining what those rules should be, in the absence of some obviously abusive transaction.

That is not to say that the government is without power to write rules requiring any one of the alternatives discussed above, or perhaps another one. Such rules presumably would be issued over the usual measured timeframe, first in proposed form and then in final form with a delayed effective date to allow taxpayers to modify their computer systems and get their paperwork in order. That is very different, however, from the question of whether current law *requires* such an approach.

3. *What About the Proposed Swap Regulations?* An article published earlier this year has pointed out another uncertainty about how to treat an upfront payment on a CDS, having to do with the possible application of the proposed regulations dealing with swaps with contingent nonperiodic payments that are described above in Section I.B.1.[154] As the article explains in some detail, if CDS are subject to those rules, and if the effect of such treatment were to require the protection seller to impute an

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[151] I.R.C. § 860B(a) (2010) (REMIC regular interest taxed as debt); I.R.C.§ 860G(a)(1)(B)(ii) (2010) (providing authority to treat IOs as REMIC regular interests).

[152] I.R.S. Announcement 2004-75, 2004-2 C.B 580.

[153] Treas Reg. § 1.1275-4(b)(9)(iii) (2004).

[154] *See* Alan B. Munro, *Revisiting Tax Considerations Regarding Credit Default Swaps*, 1 DERIVATIVES & FIN. INSTRUMENTS, Jan.-Feb. 2010, at 9.

expense as a result of the possibility that the protection seller would have to make a settlement payment at some point in the future, the amount of the upfront payment for tax purposes might differ from the cash amount. Returning to the example of a CDS in which Party B as protection seller receives an upfront payment of $335,000, if these rules applied, Party B would be required to accrue some expense in respect to the contingent future settlement payment. Depending on how that expense is allocated, either the upfront payment might be treated as less than $335,000 or the deemed at-market swap might be treated as paying less to Party B than would otherwise be the case. Either of these would complicate the effort to determine how to reconvert the upfront payment into an annuity.

Note further that the proposed regulations would apply only if a cash settlement payment were treated as a nonperiodic payment and not a termination payment, which is not clear. A termination payment is defined generally as a payment to assign or extinguish an NPC. Proposed regulations make clear (sensibly), however, that a periodic payment that happens to be paid at the maturity of an NPC is not a termination payment.[155] It is also evident from the proposed regulations that a contingent nonperiodic payment made at the maturity of an NPC such as an equity swap is not treated as a termination payment. A termination payment is not, therefore, just any payment that happens to be made at the point when the taxpayer happens to terminate its interest in an NPC. Rather, the concept seems to be that a termination payment is an unscheduled payment not provided for in the terms of the NPC.

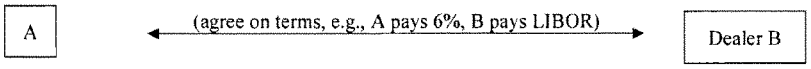
It has become common, however, for equity swaps to provide express terms under which a counterparty may terminate the swap early. Since dealers typically permit their customers to terminate swaps early in any event, the purpose of this provision is primarily to set out the terms under which the early termination payment will be calculated. Market practice is to treat these payments as termination payments, which seems right. Coming back to CDS, then, how should one treat an unscheduled settlement payment that *is* provided for in the terms of the CDS? It seems closer to a termination payment than a nonperiodic payment, but the answer is not clear.

[155] Prop. Treas. Reg § 1.1234A-1(b), 69 Fed. Reg. 8886, 8898 (Feb. 26, 2004).

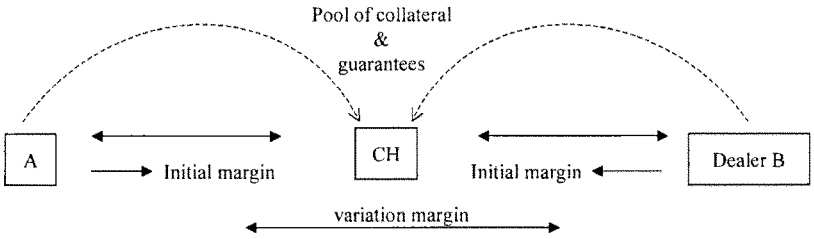
Clearing an At-Market Interest Rate Swap

Market rate is 6% vs LIBOR

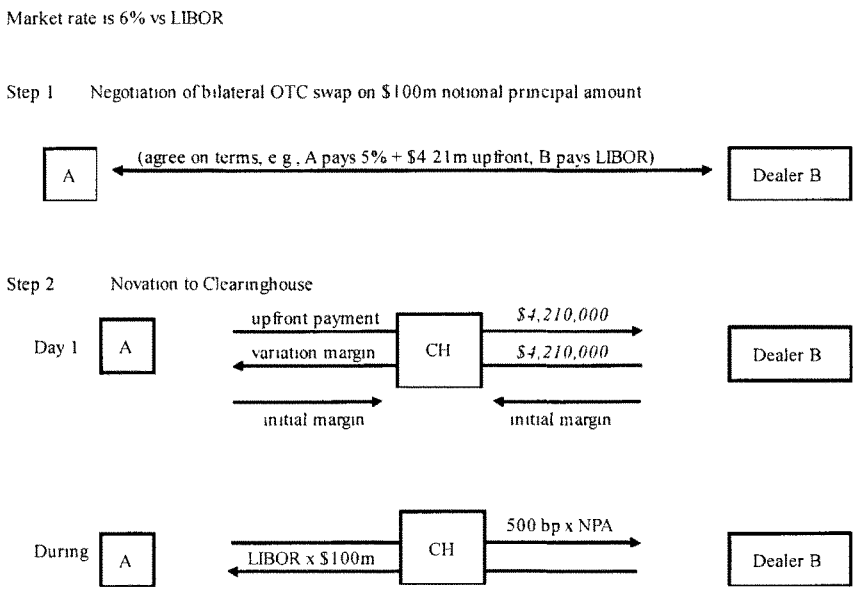
Step 1 Negotiation of bilateral OTC swap on $100m notional principal amount



Step 2 Novation to Clearinghouse

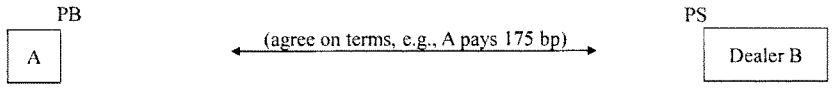


Clearing an Off-Market Interest Rate Swap

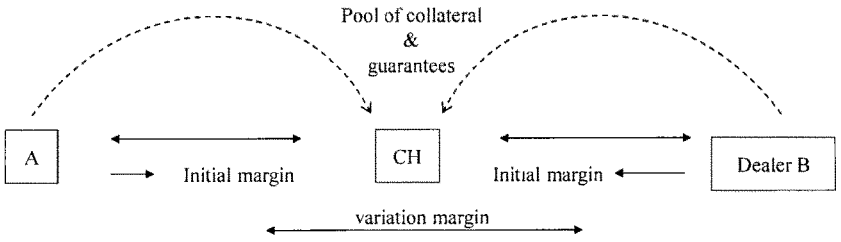


CDS Clearing

Step 1 Negotiation of bilateral OTC CDS

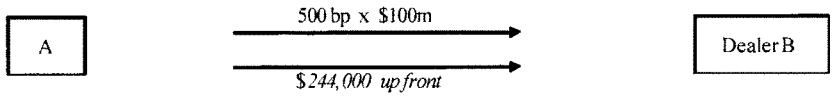


Step 2 Novation to Clearinghouse

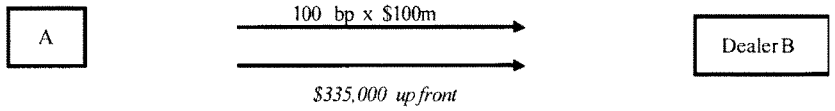


CDS Coupon Standardization

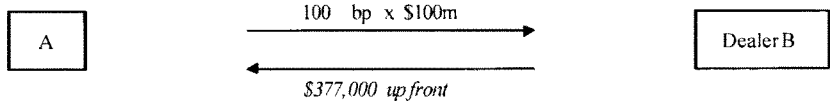
Example 1 (market level 575 bp: standard coupon 500 bp)



Example 2 (market level 175 bp, standard coupon 100 bp)

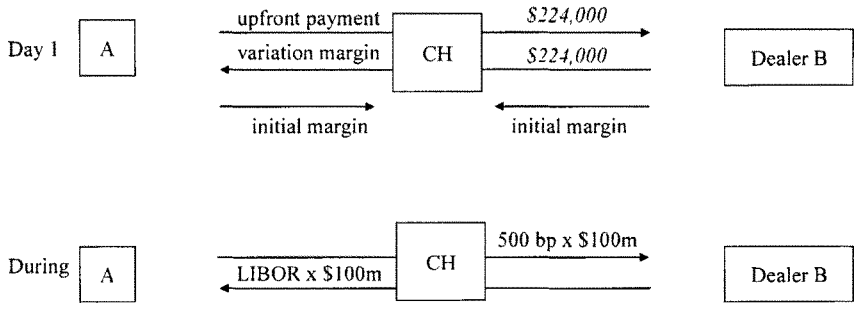


Example 3 (market level 25 bp; standard coupon 100 bp)



CDS Clearing – Putting It Together

Market level 575 bp; standard coupon 500 bp; $100m NPA



Senate Finance Committee and House Ways & Means Committee Hearing
"Tax Reform and the Tax Treatment of Financial Products"
Tuesday, December 6th, 2011

Questions for Mr. David S. Miller

Questions from Chairman Baucus

1. **There has been much discussion about regulatory reform and the desire of increased transparency, oversight, and market stability. What is less frequently discussed is whether the tax treatment of financial products contributes in a positive or negative way to these goals.**

   a. **Several witnesses at the hearing discussed how tax planners can create almost any tax consequence they desire by tinkering with and combining different financial products. For example, they can alter the timing, character, or source of income. Do the resulting financial products contribute in a positive or negative way to the goals of transparency, oversight and market stability?**

      I do not believe that the current tax laws that apply to derivatives have any significant effect on the goals of oversight of derivatives and market stability. At the margins, taxpayers who enter into derivatives to minimize their tax liability would rather hide those transactions because the greater the scrutiny, the more likely that current law is changed. So in some sense current law treatment discourages transparency. On the other hand, there are already rules in place that prohibit certain tax confidentiality agreements and require disclosure to the IRS of tax shelters. Moreover, thousands of derivatives issued each year – many with favorable tax consequences – are registered with the SEC; their terms and tax disclosure are public. For these reasons, I do not believe that the current tax rules for derivatives have a meaningful effect on the goal of transparency.

   b. **Do the tax rules for financial products encourage riskier behavior among taxpayers?**

      Yes. Our realization system of taxation allows taxpayers to engage in "strategic trading": that is, they may hold appreciated assets and defer gains, but sell depreciated assets and claim their losses. This, in turn, encourages taxpayers to make riskier investments because the government subsidizes realized losses (by allowing those losses to offset unrelated gains) but doesn't tax unrealized gains. A mark-to-market system would end strategic trading, and the subsidy for risky investments.

   c. **Does applying mark to market only to certain publicly-traded derivatives and derivatives with respect to publicly-traded property for which there is a reasonable basis to determine fair market value increase the incentive to trade over-the-counter or in less easily-valued property and, therefore, cause individuals to enter into less transparent transactions.**

My proposal would impose mark-to-market treatment on any derivative that relates to publicly-traded property, even if the derivative itself is traded over-the-counter or thinly traded. So I do not believe that my proposal will encourage individuals to enter into less transparent transactions.

My proposal would not apply mark-to-market treatment to derivatives that relate to non-traded property, so an option to buy real property would not be subject to mark-to-market taxation under my proposal. But options on real estate are illiquid, not easily monetized, and are very different investments than derivatives with respect to publicly-traded property. I do not believe that transparency would be a significant factor in investment decisions if derivatives that relate to publicly-traded property were subject to mark-to-market taxation.

2. **Many financial products serve long-standing, essential business purposes. It is important that farmers and producers are able to manage their risks.**

   At the same time, in the past few weeks there have been several news reports that suggest that high-wealth individuals are able to defer taxation for many years on appreciated stock in ways that seem like abuses of the tax code. We also are aware of other creative financial products that take advantage of character and source rules and thereby benefit from favorable tax treatment.

   There is the perception that this isn't fair. I'm trying to get a sense of the revenue loss we are talking about.

   What portion of these contracts are entered into for speculative purposes rather than managing business risk?

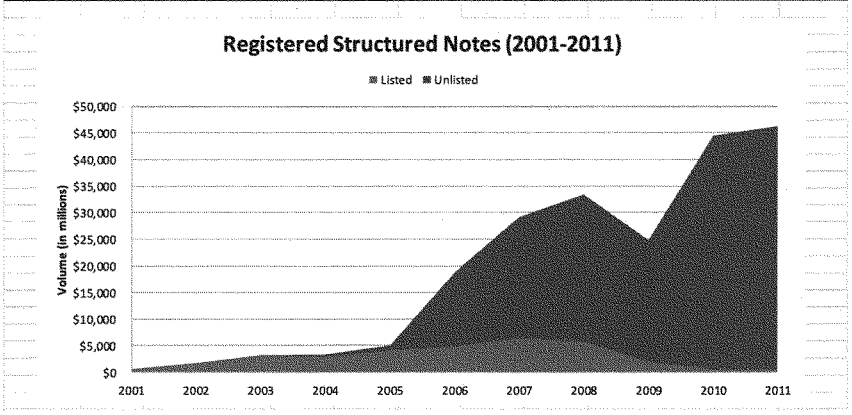
   I am not aware of any data that indicate the portion of derivative contracts that are entered into for speculative purposes as opposed to managing business risk. Nevertheless, I believe that all or virtually all structured notes are entered into for speculative purposes. The following chart indicates the rapid increase in the structured note market.[1]

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[1] This chart compiles information available on Structured Retail Products (www.structuredretailproducts.com), which aggregates statistics about global structured products for site subscribers.

VOLUME OF REGISTERED STRUCTURED NOTES (in millions)

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	TOTAL
Listed	$620	$1,766	$3,200	$2,851	$4,091	$4,795	$6,397	$5,774	$1,907	$536	$500	$32,437
Unlisted				$429	$913	$13,997	$22,718	$27,611	$22,795	$43,974	$45,755	$178,192
TOTAL	$620	$1,766	$3,200	$3,280	$5,004	$18,792	$29,115	$33,385	$24,702	$44,510	$46,255	**$210,629**



3. **The 'cubbyhole' approach of taxing financial products and the lack of timely guidance by the IRS have led to similar products being taxed inconsistently. Even if transactions have the same pre-tax economic outcome, their after-tax economic outcome can be starkly different.**

   a. **Let's assume Congress continues along with the system of incrementally fixing perceived problems in the taxation of financial derivatives (rather than legislating a more global approach). What can be done to more quickly address the development of new financial products so that the IRS is not always playing catch up?**

   I do not believe that anything can realistically be done to more quickly address the development of new financial products so that the IRS is not always playing catch up, short of a comprehensive reform that more closely aligns taxable income with economic income (such as mark-to-market taxation).

   The problem is not transparency: over $45 billion of SEC registered structured notes were issued in 2011. The tax disclosure for these notes is public so the IRS should (or could) know exactly the tax positions that are being taken.

   While it might be possible to dedicate IRS personnel to monitor these products on a real time basis and propose methods of taxing them, I don't think even this measure will help much because the problem does not lend itself to incremental solutions, and the political and regulatory process is by its nature too slow. Only a comprehensive change will solve the problem you identify.

   b. **Could a simpler system with guidelines based on the substance of a transaction rather than its form benefit both taxpayers and tax administrators? Would this require a legislative change?**

The tax law already has a significant substance-over-form doctrine. The problem is simply that there is no meaningful substantive economic difference between many financial products. To take one common example, a credit default swap can be written as a put option with periodic payments or as a swap. Each are equally plausible characterizations, but each gives rise to very different tax treatments. For this reason, we need a system of taxation that is based upon economic income, without regard to labels. Economic income is the only "substance" that matters.

c. Is part of the uncertainty on how derivatives are taxed due to inconsistent definitions used by the tax code versus those used in US securities and commodities law? Could this uncertainty be mitigated by seeking to reconcile the terminology?

No. The tax laws generally have very different purposes and reflect very different policies than the securities and commodities laws (and accounting rules, for that matter). As a general matter, conforming the definitions and rules of two or more regimes would tend to compromise the policies and purposes of one or more of the regimes. For example, the definition of a notional principal contract (or "swap") for tax purposes is designed to identify a type of contract with very specific cash flows so that those cash flows can be appropriately taxed in a manner that is consistent with the taxation of other financial products.

In contrast, Title VII of the Dodd-Frank Act revised the regulation of swaps to establish a separate but parallel regime of regulation for swaps on a single security or narrow-based security index, which are to be regulated by the SEC, and swaps on broad-based indices and swaps relating to non-securities, such as interest rates, currencies, energy and agricultural products, which are to be regulated by the CFTC. Consistent with the purpose of the Dodd-Frank Act, the definition of swap for purposes of Title VII is very expansive and, while certain interpretive issues relating to scope are still unsettled, is likely to be significantly broader than the definition for tax purposes. Conforming the tax definition of "swap" to the definition in Title VII of the Dodd-Frank Act (or vice versa) would compromise the policies underlying one of the two regimes.

4. To what extent do corporations create or invest in financial products that provide them favorable equity treatment for accounting and regulatory purposes but which allow them debt treatment for tax purposes?

Do you consider this a problem that should be addressed as part of tax reform? If so, how would you suggest we address it?

"Feline PRIDES" (Flexible equity-linked exchangeable preferred redeemable increased dividend equity securities) is the latest in a series of financial products that is designed to provide U.S. corporations with interest deductions for a security that is treated in whole or in part as equity for accounting or regulatory purposes. However, while corporations do enter into these financial products, I am not aware of data that indicates the relative use of these products as compared to traditional forms of financing (like a loan).

I think the problem is less one of "arbitrage" (that is, of companies treating a particular instrument as debt-for-tax purposes but as equity-for-regulatory/accounting purposes) but

more of ensuring that the rules of each regime accomplish the policies underlying that regime.

As a part of comprehensive tax reform, some consideration should be given to re-thinking the entire distinction between debt and equity for U.S. tax purposes because the current deduction for interest but not for dividends encourages capital raising through debt leverage, rather than equity issuances, without any evident reason. Among the proposals that are worth consideration are allowing deductions for dividends,[2] or enacting a business enterprise income tax.[3] These proposals address the fundamental issue of why companies prefer to issue debt for tax purposes rather than the secondary tax/accounting arbitrage that arises when a product is treated as debt for tax purposes but as equity for accounting purposes.

Questions from Senator Bill Nelson

Section 1256 of the Internal Revenue Code imposes "marked to market" treatment on certain financial instruments. Under the provision, section 1256 contracts are subject to tax annually based on their fair market value on the last business day of the taxable year. A portion of the income or loss on a section 1256 contract is taxed as short-term capital gain or loss, and a portion is taxed as long-term capital gain or loss. The conference report for the Dodd-Frank Wall Street Reform and Consumer Protection Act included a provision – not included in the original House-passed or Senate-passed version – which amended section 1256. The provision created a new statutory rule that excludes credit default swaps, interest rate swaps, equity swaps, commodity swaps, and other agreements from the definition of a section 1256 contract.

a. **In your view, what would have been the likely consequences of the Dodd-Frank Act on the tax treatment of derivatives transactions if this provision had not been included in the final bill?**

Subjecting swaps to section 1256 would have represented a dramatic change to current law, and would have given rise to a great number of counterintuitive consequences, and uncertainty: some taxpayers would be better off, some would suffer terrible whipsaws (which for some well advised taxpayers, could be avoided), and others would simply be unable to determine their tax consequences for many common transactions. There would be no rational tax policy that would justify these results, and it would be hard to believe that Congress intended that the Dodd-Frank Act (which has nothing to do with tax law) would produce this outcome.

Therefore, I believe that even if the Dodd-Frank Act had not specifically carved out swaps from section 1256, the Internal Revenue Service would have concluded that Congress never intended the Dodd-Frank Act to subject swaps to

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[2] See, e.g., Reuven S. Avi-Yonah and Amir C. Chenchinkski, The Case for Dividend Deduction (Draft 9/25/10).

[3] See Edward D. Kleinbard, The Business Enterprise Income Tax: A Prospectus, 106 Tax Notes, No. 97 (January 3, 2005).

section 1256, and the IRS would have issued guidance to this effect.[4] As a result, I believe that the Dodd-Frank Act would not have had any different effect on the tax treatment of swaps, even if the amendment to section 1256 had not been included.[5]

Section 1256 was originally enacted in 1981 to impose mark-to-market treatment on "regulated futures contracts" to prevent abuse and to tax the contracts "on their economic substance."[6] However, to compensate for the loss of deferral that results from mark-to-market treatment, gain and loss is taxed as if 60% of the gain or loss is long-term capital gain or loss and 40% is short-term capital gain or loss. This results in a blended rate (currently 23%).

The scope of section 1256 produces considerable controversy for contracts that did not exist at the time section 1256 was enacted, in particular because some taxpayers pay less tax if section 1256 applies to their contracts, and others pay more.[7] In part to avoid this controversy and in part because section 1256 more reflects political compromise than cogent tax policy, the Treasury Department and the IRS have consistently interpreted section 1256 narrowly, generally holding that contracts are not subject to section 1256 unless Congress clearly indicated its intention to so subject them.

For example, only after section 1256 was enacted did commodity options begin to trade on CFTC-regulated exchanges. These contracts clearly satisfied some of the requirements of a regulated futures contract, but less clearly satisfied others. The New York Coffee, Sugar and Cocoa Exchange, Inc. argued that commodity options did satisfy the definition of a regulated futures contract and should be entitled to 60/40 treatment. The Treasury Department and the Joint Committee on Taxation concluded that section 1256 did not apply to commodities options. The JCT reached this conclusion in part because it found that Congress did not intend that treatment when it enacted section 1256 in 1981.[8]

Second, when the IRS was asked to rule whether currency contracts were subject to section 1256, it concluded that they were not, in part because Congress did not specifically intend to include them.[9]

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[4] This is the view that the Congressional Budget Office expressed at the time. See Letter from Congressional Budget Office to Senator Christopher Dodd (May 3, 2010).

[5] For a comprehensive discussion of these issues, see Erika W. Nijenhuis, New Tax Issues Arising from Derivatives Regulatory Reform, Tax Notes 1235 (June 14, 2010) and Erika W. Nijenhuis, New Tax Issues Arising from the Dodd-Frank Act and Related Changes to Market Practice for Derivatives, Columbia Journal of Tax Law 1 (2011). I have attached these two articles.

[6] S. Rep. No. 144, 97th Cong., 1st Sess., reprinted in 1981-2 C.B. 412, 470.

[7] The early controversy is explained in James W. Wetzler, The Tax Treatment of Securities Transactions Under the Tax Reform Act of 1984, 25 Tax Notes 453 (1984).

[8] Joint Committee on Taxation, "Taxation of Capital Gains and Losses," 23 (November 1, 1983), JCT-52-83.

[9] See private letter ruling 8818010 (February 4, 1988) ("Given . . . the failure by Congress in the legislative history of the Technical Correction Act of 1982 and the Tax Reform Act of 1986 (the "1986 Act") to indicate its intention to include currency swaps within the definition of foreign currency contract,

Finally, the IRS applied a similar analysis in 2007 when it ruled that foreign currency options are not "foreign currency contracts" subject to section 1256.[10]

The Tax Court has endorsed the IRS's strict method of interpreting section 1256: "When Congress has specified the types of contracts that come within the definition of a section 1256 contract, exclusion of others from its operation may be inferred."[11] Therefore, it seems likely that a narrow interpretation of section 1256 by the IRS would be upheld by a court.

The case against interpreting the Dodd-Frank Act to subject swaps to section 1256 is especially compelling.

Consider a businesswoman who borrows for her business at a floating rate of interest and is worried about increasing interest rates. An interest rate swap would mitigate this risk: it would have the economic effect of converting her floating-rate loan to a fixed-rate loan. Under current law (i.e., assuming that the interest-rate swap is not subject to section 1256), the tax consequences to the businesswoman of borrowing money at a floating rate and entering into a floating-to-fixed-rate interest rate swap are roughly the same as if she had borrowed money at a fixed rate.[12]

If interest-rate swaps were potentially subject to section 1256, then only the interest rate swaps that qualify as "regulated futures contracts" would actually be subject to section 1256, and privately-negotiated OTC contracts would not generally satisfy this definition. But the businesswoman would not necessarily be aware of this distinction; if the interest rate swap she entered into was subject to section 1256, she would face a tax catastrophe: The swap would be marked-to-market (and gains and losses subject to 60/40 treatment), but the loan would not be. To put this disaster into context, let's assume that at the end of the first year, the interest rate swap has increased in value by $100,000.

In this case, the businesswoman would owe additional tax of $23,000 ($100,000 of mark-to-market gain times the 23% blended rate under section 1256). That is tax she would not have been subject to under current law (because the increase in the value of the swap would be an unrealized gain) and would not have been subject to if she had simply borrowed at a fixed rate to begin with.[13] It is hard to

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we conclude that the currency swap agreements fail to satisfy the requirements of section 1256(g)(2)(A)(ii) and (iii). Accordingly, we hold that the currency swap agreements are not section 1256 contracts.").

[10] Notice 2007-71, 2007-35 I.R.B. 472 ("There is no indication, however, that Congress intended . . . to extend the definition of foreign currency contract to foreign currency options.")

[11] Summit v. Commissioner, 134 T.C. 248, 265 (2010).

[12] There are minor differences, but under these facts, they would not normally be meaningful. There are certain tax elections that could reduce or eliminate even these minor differences (see Treasury regulations section 1.1275-6, and sections 1.446-3/1.1221-2), but these elections have to be made on the date the swap is entered into. In my experience, only the most sophisticated taxpayers make the election.

[13] As I mentioned above, there are certain tax elections that could be made to avoid this result, but they may not be available in individual cases, and they generally must be made on the date the swap is entered

believe that Congress intended this result, and therefore likely that the IRS would not interpret the Dodd-Frank Act to require it.[14]

On the other hand, if swaps were subject to section 1256, some wily taxpayers would take full advantage of that treatment and dramatically reduce their taxes.

For example, assume that a hedge fund with U.S. investors is in the business of trading credit default swaps. It currently treats its credit default swaps as notional principal contracts for tax purposes and elects to mark-them-to-market, treating all gain and loss as ordinary gain or loss. If the value of the portfolio increases by $1 million in a year, the hedge fund's U.S. investors pay tax at a 35% tax rate on the gain (or $350,000 of tax on $1 million gain). But if the credit default swaps are subject to section 1256, the tax rate would be 23% (rather than 35%), and the tax would be only $230,000, a tax savings of $120,000.

One can legitimately debate whether overall tax rates should be higher or lower and whether certain investments or taxpayers should enjoy lower rates than others, but it is very hard to imagine that Congress intended for the Dodd-Frank Act to provide this particular group of investors with such a windfall.

These are just two of many examples illustrating the very peculiar consequences that would arise if swaps were subject to section 1256. Many more taxpayers would be left wondering whether their swaps were in fact subject to section 1256 (because, as I mentioned above, even if swaps are potentially subject to section 1256, not all of them in fact would satisfy the definition of a "section 1256 contract"). It is highly likely that, in the absence of guidance, taxpayers would adopt the positions that minimize their taxes. For this reason, the CBO estimated that subjecting swaps to section 1256 under the Dodd-Frank Act would lose $1 billion in revenue (but noted that the revenue loss could be substantially greater).[15]

For all of these reasons, I believe that the IRS would have concluded that swaps are not subject to section 1256 as a result of the Dodd-Frank Act, even if Congress had not itself made that clear.

b. Are some taxpayers likely to pay less in income taxes on their derivatives transactions as a result of the provision?

As I discussed above, I believe that the IRS would not have interpreted the Dodd-Frank Act to subject swaps to section 1256, even if the Dodd-Frank Act had not

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into. As a result, many taxpayers either do not qualify to make the elections, are unaware of the elections, or simply forget to make them.

[14] This particular problem could be fixed by excluding interest rate swaps from section 1256 treatment, by liberalizing the hedging rules and allowing retroactive elections in certain cases, or by publicizing the election requirements so that taxpayers know to timely make the election. My point is simply that it is likely that Congress would have considered and addressed these issues before intentionally subjecting interest rate swaps to section 1256.

[15] This is the view that the Congressional Budget Office expressed at the time. See Letter from Congressional Budget Office to Senator Christopher Dodd (May 3, 2010) ("...there is considerable uncertainty about the size of the expected revenue losses.").

amended section 1256. Therefore, I do not believe that taxpayers will pay less in income taxes as a result of the provision.

Moreover, I do not believe that the amendment to section 1256 permits taxpayers to pay less in income taxes than they would have paid prior to the enactment of the Dodd-Frank Act. The carve-out for swaps merely preserved the status quo.

However, if swaps had been subject to section 1256, I believe that most sophisticated taxpayers would have been able to avoid adverse tax consequences, and some would have been able to dramatically reduce their taxes. However, some unsophisticated taxpayers would have been subject to additional taxes. Therefore, in a sense, unsophisticated taxpayers benefitted from the provision that excludes swaps from section 1256.

c. Which industries, sectors, or classes of taxpayers are most likely to benefit?

Unsophisticated taxpayers (generally small and midsized businesses).

d. Does the provision create new opportunities for tax avoidance?

I do not believe that the provision creates new opportunities for tax avoidance; it merely maintained the status quo.

Senate Finance Committee and House Ways & Means Committee Hearing
"Tax Reform and the Tax Treatment of Financial Products"
Tuesday, December 6th, 2011
Questions for Mr. David S. Miller

Questions from Ranking Member Hatch

1. **A number of commentators have made the point that financial instruments are unquestionably linked. For example, a share of stock plus two options may be used to produce an economic return that is the equivalent of interest on a bond. Yet, we tax these instruments differently – based on what "cubbyhole" they fit into – not their economic effect. Can you elaborate for us on how this can distort investment and lead to tax avoidance?**

   I think I can best illustrate this point with some examples.

   Example One. An investor would like to purchase for $100 a zero coupon bond that pays no interest until maturity in five years and then pays $120 (a 3.71% yield). This bond would be treated as issued with original issue discount (OID) and the investor would be required to report ordinary income (and pay tax) in each year based on the 3.71% yield (so $3.71 in year one, $3.85 in year two, $3.99 in year three, $4.14 in year four, and $4.31 in year five).

   However, if the investor bought publicly-traded non-dividend-paying stock for $100 and simultaneously entered into a forward contract to sell that stock in five years for $120, the investor would have entered into a transaction that is economically equivalent to buying a zero coupon bond, but would not be required to report original issue discount annually and therefore would not pay any tax until the forward contract matures in year five.[1] This results in a lower tax liability than had the investor bought the zero-coupon bond.

   Thus, the tax rules distort the investor's investment decision and encourage the investor to enter into a complicated transaction (i.e., purchasing stock and entering into a forward contract) rather than the straightforward transaction (buying a zero-coupon bond). The complicated transaction permits tax avoidance (because the investor can use it to avoid current income inclusions).

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[1] The investor will be subject to at least two sets of anti-abuse rules – the straddle rules and the conversion transaction rules – which together will treat a portion of the gain at maturity as ordinary income and a portion as short-term capital gain. It is possible that the IRS could assert that this entire transaction is subject to an anti-abuse rule in the OID regulations and therefore the investor must report OID the same as if the investor had bought the zero-coupon bond. However, it is unclear whether the OID anti-abuse rule would apply in this case and I'm not aware of the IRS ever having applied the OID anti-abuse rule to these facts.

Example Two. Assume that an investor wants a very safe investment for five years, but upside potential if the S&P 500 appreciates during that period. The straightforward investment to achieve this objective would be a note that provides at maturity for a return of the investor's investment plus contingent interest based on the appreciation (if any) in the S&P 500. If an investor were to buy such a note, under the "contingent payment debt instrument" rules, the investor would be subject to tax at ordinary rates each year on OID equal to the investor's investment times the issuer's cost of funds. Any contingent interest in excess of the OID already accrued by the investor would be taxable at ordinary income rates, and any gain on the sale of the note would also be taxable at ordinary income rates. This note would achieve the investor's economic objective but would not be very tax efficient.[2]

However, if the investor was willing to accept some risk on the investment (say a 10% risk of losing 10-20% of its investment, and/or a 1% chance of losing 50%), the investor could treat the note as a forward contract for tax purposes.[3] In this case, the investor would not report any income until the maturity of the note (or an earlier sale) and any gain would be long-term capital gain (assuming, in the case of a sale, that the investor had held the note for more than a year at the time of the sale).[4]

In this case also, the tax rules distort the investor's investment decision and encourage the investor to purchase the more risky forward contract because the potential tax liabilities from the forward contract are substantially less than from a contingent payment debt instrument. The difference in tax treatments allows the investor to avoid tax (because the investor pays less by investing in the forward contract).

Example Three. An investor would like to borrow $80, add $20 of her own money, and purchase an interest in a hedge fund for $100. Assume that, under the terms of the borrowing, the investor wouldn't be required to pay any interest until the loan's maturity in five years, but at that time, she would be required to pay $20 of interest (and therefore would owe $100 at maturity). The lender is also willing to make the loan on a nonrecourse basis, secured only by the investor's interest in the hedge fund. Assume

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[2] So, if the issuer's cost of funds is 3.71%, the investor would report $3.71 of income in year one, $3.85 in year two, $3.99 in year three, $4.14 in year four, and $4.31 in year five. If, in fact, the debt instrument pays $30 of contingent interest at maturity, the investor would report an additional $10 of ordinary interest income at maturity (in addition to the $20 of OID that the investor had already reported).

[3] It is unclear how much risk is required to treat the note in the example as a forward contract. Some issuers take the position that a 10% risk of losing 20%, a 20% risk of losing 10% of the investment, or a 1% chance of losing 50% (or some combination of these) is sufficient to cause a note to be treated as a forward contract for tax purposes. Some issuers say that a 10% risk of losing 10% is sufficient to cause a note to be treated as a forward contract for tax purposes.

[4] The tax savings from this treatment is substantial. Assume that the investor is subject to tax on ordinary income at a rate of 35% and on long-term capital gains at a rate of 15%, and that the note pays $30 contingent interest at maturity. If the note is subject to the contingent payment debt instrument rules, the investor would pay $10.50 of tax (and would accrue $7 of that tax over time). If the note is treated as a forward contract, the investor would pay only $4.50 of tax (and would not owe any tax until maturity).

further that the investor believes that the hedge fund will appreciate by 10% each year. However, the hedge fund rapidly trades its securities so that its entire portfolio turns over several times each year, all gains are short-term-capital gains that are taxable at ordinary income rates, and there is no unrecognized appreciation at the end of each year. If the investor borrows the money and buys an interest in the hedge fund, she estimates that she'd have to pay tax of $14.37 over the five-year term she expects to hold the hedge fund.[5]

However, if she purchased a call option with respect to the hedge fund by paying $20 for the right to purchase the hedge fund interest for $120 in five years, and had the right to cash settle the option, and the hedge fund performed according to her expectations, she would owe no tax until maturity and, at that time, she would owe only $6.16 in taxes ($41.05 x 15% long-term capital gains rate). (Her option to buy the hedge fund is the economic equivalent of a nonrecourse loan and actual ownership). So, again, the investment decision is affected by a desire to avoid tax, and an option (rather than a loan and actual ownership) substantially avoids tax.

2. **In 2004, the IRS stated that it was studying the tax treatment of credit default swaps and welcomed comments from market participants. Seven years later, Treasury issued proposed regulations addressing the tax treatment of credit default swaps. What is it about credit default swaps that makes a determination of the proper tax treatment so difficult?**

First, it is unclear how credit default swaps should be taxed under our realization tax system.

Assume that an investor believes that a foreign sovereign with a low credit rating will not in fact default. So the investor enters into a credit default swap that references $100 of the sovereign's outstanding debt. Under the terms of the swap, the investor receives $10 each year for five years so long as the sovereign does not default, but if the sovereign defaults, the investor must deliver to the counterparty $100 minus the value of $100 of sovereign debt immediately following default.

How should this investor be taxed? Perhaps the investor should pay tax each year on the $10 that the investor receives. (This first method is accrual taxation. Interest rate swaps

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Years:	Gain	Interest/OID Expense	Net Gain
Year 1	$10.00	$3.56	$6.35
Year 2	$11.00	$3.82	$7.18
Year 3	$12.10	$3.99	$8.11
Year 4	$13.31	$4.17	$9.14
Year 5	14.64	$4.38	$10.26
Total	$61.05	$20.00	$41.05

$41.05 x 35% = $14.37

are taxed under this method.) However, there is a meaningful possibility that the investor will ultimately lose that $10. For example, if there is a default in year two and $100 face amount of sovereign debt is worth $20, the investor will be required to repay the $10 received in year one plus $70, and will suffer a net loss of $70.

Alternatively, perhaps the investor should wait and see what happens at maturity before being required to pay any tax. (This second method is referred to as "wait and see"; it is how over-the-counter options and forward contracts are generally taxed.) But the investor will have received the $10 in each year and will have the right to spend that amount.

Finally, perhaps we should determine the value of the credit default swap in each year and tax the investor on the $10 received plus or minus the positive or negative value of the swap at the end of the year, under the theory that the market provides the best measure of the investor's economic income. (This third method is mark-to-market taxation).

In fact, the proper method for taxing the investor may depend upon the likelihood of default. One might say that if the risk of default is high, the investor should not be taxed until maturity because there is a greater likelihood that the annual payments will have to be returned; however, if there is a very low risk of default, then the annual payments should be reported currently because there is a low likelihood of repayment.

So the first reason why determining the tax treatment of credit default swaps is so difficult is because there are competing methods of taxing them with no obviously correct choice among the different methods and, in fact, the method to choose may depend on whether the underlying security is likely or unlikely to default.

The second reason why the proper tax treatment of credit default swaps is so difficult to determine is that credit default swaps can be structured as options for tax purposes. For instance, assume that the investor writes a put option that permits the counterparty to sell $100 face amount of the sovereign debt to the investor for $100 upon a default on the sovereign debt.[6] There is case law that provides that tax is not due on option premium until the maturity of the option or its earlier sale or termination (i.e., the "wait and see" method applies to options). In light of this case law, it is unclear whether the IRS has the authority absent Congressional action to write regulations that would require the investor to report the premium received on an option prior to sale or maturity. Finally, even if the IRS has the authority to declare that credit default swaps are not options for tax purposes (or that premiums received on credit default options are taxable before their sale or maturity), there is disagreement as to whether the IRS has the authority absent Congressional action to impose mark-to-market taxation on credit default derivatives (whether structured as options or swaps).

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[6] Although there are some questions as to the meaning of an "option" for tax purposes, it would certainly be reasonable to treat this contract as an option.

So even if the IRS could decide on the proper tax treatment of credit default swaps, it may be limited as to the method of taxation it could impose on them absent Congressional action.

3. **The United States has a classical system for taxing the earnings of a corporation. In other words, dividends paid to shareholders are not deductible to the corporation. This creates two levels of taxation of corporate earnings – once at the corporate level and a second time at the shareholder level. In 2003, Congress provided some tax relief to individual shareholders on receipt of dividends. If the United States were to integrate the corporate and individual tax systems so that corporate earnings would only be taxed once, to what extent would that impact the creation and use of financial products?**

It would depend exactly how the corporate and individual tax systems are integrated. If Congress achieved corporate integration by exempting dividend income from tax, then there would be an incentive for taxpayers to generate deductions by holding dividend paying stocks, treating the dividends received as exempt from tax, and then paying these dividends to a counterparty and claiming tax deductions for the payments. There are rules in place that would deny the exemption for taxpayers that engage in this strategy,[7] but there is also an exception to those rules.

[8] If the taxable rate on dividends dropped from 15% to zero, there would be an added incentive for taxpayers to rely on this exception to enter into transactions that permit the generation of deductions in the other hand. Congress might conclude that the existing rules strike the right balance.

4. **The United States has a worldwide tax system with deferral of earnings earned by foreign subsidiaries, and a foreign tax credit for income taxes paid to foreign countries. If the United States were to adopt a territorial tax system in the form of a dividend exemption, how would that impact the creation and use of financial products?**

If the territorial system did not limit the deduction of expenses (other than interest) allocable to foreign subsidiaries, then there would be an incentive for U.S. corporations to use derivatives, leases and other financial instruments to shift income to their foreign subsidiaries through deductible payments, or otherwise achieve leverage through non-debt derivatives.[9]

If the territorial system eliminated the foreign tax credit baskets, and did not grant an exemption to individuals for dividends from active foreign subsidiaries, individuals

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[7] See section 1(h)(11)(B)(iii).

[8] See Treasury regulations sections 1.246-5.

[9] The Ways and Means discussion draft released last year would not impose any limitation on deductions (other than interest expense) allocable to foreign-source income. The Joint Committee on Taxation proposal would disallow all expenses allocable to foreign-source income.

would have a tremendous incentive to engage in cross-crediting.[10] Derivatives and other financial instruments could be expected to play a part in that tax planning.

If the territorial system retained subpart F but repealed the exclusion for previously taxed income in section 959 and repealed section 956 (which treats loans by controlled foreign corporations to their United States shareholders (and certain other transactions) as deemed taxable repatriations), and provided for an exclusion of less than 100%, U.S. taxpayers would have an incentive to use loans and other financial instruments to effectively repatriate the earnings of their foreign subsidiaries without tax.[11]

In addition and more broadly, if the United States exempted dividends of active foreign corporations from tax (either entirely or substantially), then U.S. taxpayers would attempt to hold stock of active foreign corporations and enter into an offsetting swap or other derivatives that permits a deduction and does not jeopardize the dividend exemption. In other words, taxpayers would attempt to achieve the same benefit described in the answer to the previous question, and similar rules would have to be put in place to prevent this transaction.

Taxpayers would also have an added incentive to establish low-taxed active foreign businesses to generate tax-exempt dividends. For example, reinsurance companies are considered active businesses for certain of the deferral rules, even though they can be operated out of low-tax jurisdictions and they have a significant investment component. Therefore, if the United States established a territorial tax system, one could reasonably expect an increase in investment in offshore reinsurance companies, and one could reasonably expect that they would enter into derivative transactions to generate low-taxed income.

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[10] The Ways and Means discussion draft would eliminate the foreign tax credit baskets, and deny the exemption for individuals.

[11] The Ways and Means discussion draft would retain subpart F, repeal the tax exclusion for previously taxed income in section 959, repeal section 956, and grant only a 95% (rather than 100%) exclusion.

STATEMENT OF ALEX RASKOLNIKOV
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BEFORE THE JOINT HEARING OF THE
U.S. HOUSE COMMITTEE ON WAYS AND MEANS
U.S. SENATE COMMITTEE ON FINANCE

"TAX REFORM AND THE TAX TREATMENT OF FINANCIAL PRODUCTS"

December 6, 2011

Chairman Camp, Chairman Baucus, Ranking Members Levin and Hatch, distinguished Members of the Committees,

Thank you for inviting me to testify at this historic joint hearing.

I would like to make four main points:

First, the JCT Report your Committees receive today is an important first step in reforming taxation of financial products (or derivatives). But it cannot be the last step. Our knowledge of revenue losses from derivatives-based tax reduction strategies is largely anecdotal, wholly unsystematic, and woefully incomplete. More research can and should be done and Congress can play a critical role in facilitating it.

Second, in the absence of comprehensive reform, it is impossible to tax financial derivatives in a manner that meets any accepted benchmark of an effective and efficient capital income tax. As long as the patchwork of current rules remains in place, symmetry, consistency, and balance will all remain unattainable.

Third, the fundamental reform alternatives are limited, reasonably well-understood, and even partly reflected in the current law. They include anticipatory taxation, retroactive taxation, and accrual-based (or mark-to-market) taxation. Each of these approaches involves tradeoffs, and the adoption of each approach for all financial products would amount to a significant change in the current law.

Finally, it is important to keep in mind how any significant reform unrelated to financial products (such as corporate integration or a switch to territorial taxation) is likely to affect the stakes in reforming the taxation of derivatives. These effects vary from substantial to insignificant to uncertain.

I elaborate on each of these points below.

1. Challenges of Taxing Financial Instruments

It is difficult to overstate how poorly our tax system deals with financial products. The rules are incredibly complex,[1] under- and over-inclusive,[2] ineffective in some respects[3] and outdated in others.[4] They give rise to wasteful tax planning, revenue losses, and unappealing distributional consequences. They may impede legitimate business hedging transactions, and they certainly fail to stop aggressive tax reduction strategies.[5] This disappointing state of affairs hardly reflects a lack of attention from Congress, the Treasury Department, and the Internal Revenue Service. While more legislation and administrative guidance could have been issued to deal with individual abuses discovered from time to time, it would hardly stem the tide of derivatives-based tax planning that has risen at least two decades ago and shows no sign of abating. We need a fundamental rethinking of the taxation of financial products. And in order for that rethinking to be well-informed, we need to know much more about the problem at hand.

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[1] The proposed Treasury regulations for the taxation of contingent swaps are perhaps the most egregious example. See Prop. Treas. Reg. § 1.446-3(g)(6), 69 Fed. Reg. 8,886 (Feb. 26, 2004).

[2] Certain aspects of the wash sale rules of section 1091 are examples of over-inclusiveness. For instance, these rules cover transactions where a depreciated share of stock sold at a loss is replaced by an option (including an out-of-the-money option) on the same stock even though such option is very different economically from the share itself and, therefore, the transaction does not come close to leaving taxpayer in the same position with respect to the stock as he was before selling it—an abuse targeted by the wash sale rules. The anti-extinguishment regime of section 1234A is under-inclusive, arguably not extending to derivatives that, while capital assets themselves, reference assets that are not capital assets.

[3] See David M. Schizer, *Frictions as a Constraint on Tax Planning*, 101 Colum. L. Rev. 1312 (2001) (describing relative ineffectiveness of the constructive sale regime of section 1259).

[4] The taxation of credit default swaps, for instance, has remained highly uncertain for years. See Notice 2004-52, 2004-1 C.B. 973 (offering several possible ways to characterize credit default swaps for U.S. federal income tax purposes and requesting comments). Proposed regulations aimed at resolving this uncertainty have been issued just a few months ago and they will not become effective for some time. See Prop. Treas. Reg. 1.446-3(c)(iii), 76 Fed. Reg. 57,684 (Sept. 16, 2011).

[5] The challenge of separating the former from the latter exists today and will continue to exist in any alternative regime of financial products taxation. Most fundamental reform proposals (including those by two members of today's panel) expressly state that derivatives used in business hedging should be subject to special tax rules different from those applying to all other derivatives. See David S. Miller, *A Progressive System of Mark-to-Market Taxation*, 109 Tax Notes 1047 (2005) (referring to the need for a separate regime for business hedging while suggesting that many derivatives and other property become subject to a mark-to-market regime); David A. Weisbach, *A Partial Mark-to-Market Tax System*, 53 Tax L. Rev. 95, 129 (1999) (making a similar suggestion); *Columbia Law School Professor Suggests Derivatives Be Subject to Mark-to-Market Regime*, 2008 TNT 45-55 (making a similar suggestion in my 2008 Congressional testimony).

There is no doubt that the existing patchwork of rules for the taxation of derivatives is full of holes. Most knowledgeable observers would agree that derivatives-based tax reduction strategies lead to serious revenue losses and endless wasteful efforts by sophisticated taxpayers and their advisors to stay one step ahead of the regulators. Beyond this general statement, however, little can be said with any confidence. This is because while any study of taxpayer responses to tax rules and their changes is difficult, the difficulty increases by orders of magnitude when the focus turns to derivatives.

Financial products are constantly evolving, often highly complex, largely hidden from the public and the regulators, and exceedingly lucrative for their designers and promoters. Each of these considerations would impede a rigorous study of derivatives-based tax planning. Taken together, these considerations make any such study extremely difficult.

This difficulty is compounded further by the IRS reluctance to share detailed tax return data with researchers. This reluctance is not limited to the study of financial products, but it is particularly problematic in this context. Leading public finance economists are pleading with the IRS for more—and more detailed—data.[6] They are capable, skilled, and motivated. They can help us gain crucial knowledge at no cost to the public fisc. It is beyond doubt that tax return data may be made available while preserving utmost taxpayer privacy and following the letter and the spirit of the taxpayer protection laws. A nudge or two from each of the tax writing Committees to induce the IRS to share detailed return data with researchers is likely to make an enormous difference in our understanding of derivatives-based tax planning. While the time to consider a fundamental reform of derivatives taxation is certainly now, gaining a better understanding of the existing problem and the reform's impact will remain essential for years to come.

2. Evaluating Tax Systems—the Three Benchmarks

In order to evaluate any given fundamental change in the taxation of financial products one needs to understand how to evaluate alternative proposals. Legal tax academics and public finance economists have been searching for decades for comprehensive and principled ways of evaluating possible regimes for taxing capital income in general and income from financial products in particular. Three benchmarks have emerged as a result of this search.

The first benchmark is symmetry. If both sides to every transaction are taxed under the same timing rule and rate, they face equal and opposite incentives, which allows the system to police itself. In a fully symmetric system the government collects no net revenue from the taxation of derivatives. Importantly, the government does not lose any

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[6] See, e.g., David Card, Raj Chetty, Martin Feldstein & Emmanuel Saez, *Expanding Access to Administrative Data for Research in the United States* (a response to the National Science Foundation call for white papers on "Future Research in the Social, Behavioral & Economic Sciences").

revenue either. In other words, derivatives cannot be used to shelter income from real investment and labor.

Unfortunately, symmetry is unattainable without a dramatic overhaul of the Internal Revenue Code. Tax-exempt entities and foreigners often pay no U.S. income tax. Securities dealers may be thought of as tax-exempt as well because their derivative trades with clients are hedged, and mark-to-market accounting assures that only dealers' fees are taxable.[7] The presence of these tax-indifferent counterparties means that the taxation of derivatives will remain asymmetric as long as taxable taxpayers are on the other side of trades.

Consistency is another recognized benchmark. The tax treatment of derivatives is consistent if all economically comparable transactions (or sets of transactions) are taxed the same, regardless of the labels attached by taxpayers. For instance, an equity forward, an equity futures contract, and an equity swap on the same stock all have identical tax consequences in a consistent tax system, as does a leveraged purchase of that stock. Because tax treatment is independent of transactional form in a fully consistent regime, it is impossible to game the system by choosing one form or the other.

Yet complete consistency is impossible without fundamental tax reform. The U.S. tax law has always relied on familiar cubbyholes such as debt and equity, ownership and non-ownership.[8] Basic derivatives like options have a long-established tax treatment. As new financial products emerged, some were subjected to unique tax regimes while others were taxed by analogy to the well-established "precedents." The result is a patchwork of rules that imposes significant planning and compliance costs. While some of these rules have been quite effective in constraining tax planning, others have done little to impede it. Overall, this patchwork is anything but consistent. Adjusting, reforming, or even repealing one or a few of these rules will do little to diminish the overall inconsistency.

The problem is more fundamental than it may first appear. As long as the tax system continues to rely on cubbyholes, consistency is impossible. This is because basic instruments such as a coupon bond, a share of common stock, and put and call options on that stock are inextricably linked—a relationship established by the so-called put-call parity theorem.[9] A share of stock and the two options may be used to produce an economic return equivalent to the interest on a bond. A share of stock and a put are equivalent to a bond and a call. Many other combinations may be constructed. As long

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[7] This is because any taxable gain from a client's position is offset by an equal loss on the hedge and vice versa (setting aside the fee built into the price of the client's position). The character of this gain and loss is always ordinary. The mark-to-market regime for securities and commodities dealers is set forth in section 475.

[8] See Edward D. Kleinbard, *Equity Derivative Products: Financial Innovation's Newest Challenge to the Tax System*, 69 Tex. L. Rev. 1319 (1991).

[9] See Alvin C. Warren, Jr., *Financial Contract Innovation and Income Tax Policy*, 107 Harv. L. Rev. 460, 465-70 (1993).

as debt, stock and options continue to be taxed inconsistently, the fundamental economic equivalence established by the put-call parity theorem will assure that similar cash flows with the same risk profile will continue to receive dissimilar tax treatment—the hallmark of an inconsistent regime.

The third and final benchmark for taxing derivatives is balance, which is achieved if gains and losses from derivatives are treated alike (taxed at the same time and at the same rate). If this criterion is met, the government loses no revenue due to tax planning involving derivatives even if their tax treatment is neither symmetrical nor consistent. This is because a taxpayer who enters into a "pure" derivative (that is, a derivative that involves a risky bet that has neither a time value element nor a return to labor) cannot know whether he will win or lose the bet. If he wins, he would prefer a lower tax rate and a deferral of gains. If he loses, however, he would prefer a higher tax rate (making a loss deduction more valuable because it offsets highly-taxed income) and an acceleration of losses. If this taxpayer has to choose the form of derivative bet before knowing whether he will win it or lose it, this basic market uncertainty provides a powerful constraint on tax planning in a balanced system.

Only fundamental reform will move the U.S. tax system to a balanced regime. The realization requirement that is deeply embedded in our system gives taxpayers a timing option—a choice of triggering tax consequences after they have learned whether a transaction produced a gain or a loss. Capital loss limitations, the progressive marginal rate structure, and the nonrefundability of losses produce unequal tax rates on gains and losses (with gains taxed at a higher rate).[10] As long as these features remain in place, no incremental revisions will assure balance in the taxation of derivatives.[11]

3. Options for Fundamental Reform of Taxation of Financial Products

Policymakers, academics, and tax practitioners have devoted considerable effort to devising possible reforms of taxation of capital income in general and financial products in particular. Reforms consistent with one or more of the recognized benchmarks have attracted particular attention. Perhaps surprisingly, the variety of reform proposals may be distilled to just three alternative approaches: anticipatory taxation, retroactive taxation, and mark-to-market (or accrual) taxation.[12] Most of the specific regimes in each category need not be limited to the taxation of derivatives. The broader the scope of the reform proposal, however, the more objections it would need to overcome.

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[10] The tax motivated use of financial products may reduce or eliminate this disparity and even reverse the relationship between tax burdens on gains and losses altogether for particular taxpayers.

[11] For a fuller discussion of symmetry, consistency, and balance, see David M. Schizer, *Balance in the Taxation of Derivative Securities: An Agenda for Reform*, 104 Colum. L. Rev. 1888, 1893-1901 (2004).

[12] Other categorizations are possible. See, e.g., Warren, supra note 9, at 474-75.

A. Anticipatory taxation. Anticipatory taxation gives rise to income and deductions based on one's anticipation of a return from an investment or a financial bet. In a tax system based on anticipatory taxation, tax liability arises before a contingency underlying a financial instrument is resolved and before any payments under this instrument are made or even fixed. This approach could be used to reach only the time value return (if any) embedded in a derivative or a risky return as well. The ultimate goal is to eliminate or reduce the benefit of deferring income that is available in a realization-based regime. Because time value returns are currently taxed at a higher rate than returns to risk, another benefit of the anticipatory approach is eliminating an opportunity to convert high-taxed ordinary income into low-taxed capital gains.

Interest imputation regimes for prepaid derivatives are examples of anticipatory taxation of the time value of money. One such regime is already used for taxation of contingent debt—a financial instrument combining an ordinary bond with a derivative such as an equity call option.[13] A similar methodology has been proposed for prepaid forwards as well as long-dated and deep-in-the-money options.[14] More generally, interest imputation can be considered for all derivatives that provide for upfront payments. The logic behind this approach is that a party making a payment at the inception of a contract expects to receive at least an interest-like return on its investment, so the pricing of the instrument must reflect this expectation. If so, the tax system should do so as well, and it should do so regardless of the actual cash flows (or absence of any cash flows) during the term of the derivative.

Interest imputation regimes may use a variety of rates for imputation purposes. One alternative would be to impute income at a rate determined by the government from time to time (such as the so-called Applicable Federal Rate determined regularly by the IRS). This rate may be the same for all taxpayers and all financial instruments entered into during any given relevant period (a day, a month, etc.). Alternatively, this rate may be floating rather than fixed, varying for each outstanding prepaid derivative each time the government-announced rate changes. Another option would be to use a rate that is specific to each taxpayer. This is the approach chosen in the contingent debt regulations that require imputation at the so-called comparable yield—a rate that the issuer of a contingent bond would pay on a debt instrument that is similar to that contingent bond but does not have a derivative attached to it.

An anticipatory approach for risky (rather than time value) returns would require taxpayers to determine the expected value of every contingency (perhaps disaggregating a complex financial instrument to produce several instruments each with a single

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[13] See Treas. Reg. Sec. 1.1275-4.

[14] See *NYSBA Suggests Changes to Timing and Character Rules for Prepaid Forwards and Options*, 2001 TNT 64-23. Representative Richard Neal proposed legislation using a similar approach in 2008. See Yoram Keinan & Ray Beeman, *The Tax Treatment of Exchange-Traded Notes: Here We Go Again*, 2008 TNT 88-32 (describing and discussing proposed legislation aimed at establishing an interest imputation regime for certain prepaid derivatives).

contingency) and to include in income the difference between this expected value and the derivative's cost on a yield-to-maturity basis.[15] If the actual gain or loss turns out to be different from the expected one, that difference would be taken into account when the contingency is resolved.[16]

The weaknesses of all anticipatory approaches are not hard to see. Imputing time value returns raises questions about the appropriate rate of imputation. Imputing contingent returns is based on uncertain expectations about possible resolutions of future contingencies. Both types of imputations give rise to phantom income that is currently taxed yet may never be received.[17] No imputation regime bases tax liability on actual gains and losses incurred by taxpayers as they accrue.

B. Retroactive taxation. Retroactive taxation avoids most weaknesses of anticipatory taxation (with the exception of one specific regime discussed at the end of this section). The returns are taxed retroactively—at the end of the transaction when gain or loss is known with certainty and when the payment is received by the taxpayer who ended up winning the financial bet.[18] The key feature of retroactive taxation regimes is to spread this gain (or loss) backward and allocate it over the term of the derivative. Once this allocation is accomplished, gain deemed realized in earlier years gives rise to tax liability that accrues interest over the derivative's term.[19] As a result of this retroactive allocation

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[15] See Reed Shuldiner, *A General Approach to the Taxation of Financial Instruments*, 71 Tex. L. Rev. 243 (1992).

[16] For example, "*I* pays *J* $100 today; in exchange, *J* promises to pay *I* either $166 or $100 in three years depending on the toss of a coin at that time. The expected value of the contract in year 3 is $133, because there is a 50% probability of receiving $100 and a 50% probability of receiving $166. [0.5×$100 + 0.5×166 = 133] That expected value implies an expected gain of $33 and a yield-to-maturity of 10%, because $100×$(1.1)^3$ = $133, so the taxable income would be allocated $10 to year 1, $11 to year 2, and $12 to year 3 .... *I* would include, and *J* would deduct, those amounts each year. *I*'s basis would then be $133, and gain or loss on the coin toss would be taken into account in year 3." Warren, supra note 9, at 479, based on Shuldiner, supra, note 15.

[17] Most imputation proposals (and the actual contingent debt regime) provide for adjustments when the contingency is resolved. Such delayed reconciliations are a small consolation for taxpayers who overpay their taxes in earlier years, unless the government compensates taxpayers for such overpayments with interest. On the other hand, the government loses out if the actual payment at maturity turns out to be larger than expected, unless the taxpayer pays interest for the deferral of her tax liability.

[18] Unlike cash settlement, a physical settlement of derivatives does not lead to the receipt of a cash payment by the winning counterparty. Yet liquidity concerns do not loom particularly large in this case either because that counterparty (i) had enough cash to purchase the underlying asset (unless the contract was prepaid, in which case the party had the requisite amount of cash at the contract's inception) and (ii) acquired an asset that could be sold (in whole or in part) or monetized in other ways (for example, by being used as collateral for a loan).

[19] If the derivative ends up producing a deductible loss, then (at least in balanced proposals) this loss is similarly allocated to prior years, giving rise to deductions and interest payable to the taxpayer for the overpayment of tax on account of not taking these deductions in earlier years.

combined with interest accrual, the benefit of deferring taxable gain until maturity is reduced.

Proposals differ on how to spread the gain over the term of the instrument, and even how to calculate the gain in the first place. An early proposal based a retroactively-imposed tax liability on the actual pattern of gain accrual.[20] An approach adopted in the Internal Revenue Code for taxation of the so-called constructive ownership transactions presumes that the realized gain accrued at a constant rate over the term of the derivative.[21] A simpler solution adopted in a different part of the Code is a ratable allocation achieved by dividing the realized gain by the number of days a financial interest was held by a taxpayer and attributing the resulting daily gains to taxable years that include each given day.[22] The first of these allocation approaches requires annual valuation of positions. The other two introduce obvious deviations from actual changes in value, producing unintended winners and losers.[23]

Furthermore, all of these solutions expose the government to the credit risk of taxpayers entering into derivative contracts. Because pure derivatives are zero-sum bets, one side's win is always equal to the other side's loss. In a retroactive tax regime, the losing side would rest assured that it would eventually collect overpaid taxes from the government, with interest. The government, however, cannot be similarly certain that the winning side would be able to pay a very large tax, which may be much larger than the tax resulting from the same gain in a realization-based system. The reason for this difference is that in a retroactive regime the payment would include not just the tax on gain, but also interest on earlier deemed tax underpayments. That interest would accrue over many years for a long-term derivative, possibly producing a very large total tax obligation.[24]

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[20] See William Vickrey, *Averaging of Income for Income Tax Purposes*, 47 J. Pol. Econ. 379, 382-96 (1939).

[21] See I.R.C. § 1260.

[22] See I.R.C. § 1291 describing taxation of the so-called passive foreign investment companies.

[23] For instance, a taxpayer whose position in a ten year forward appreciated substantially in the first year and then remained unchanged would be better off under either the second or the third regime than under a mark-to-market system that would tax the large gain in the first year of the contract. A taxpayer whose position in a ten year forward did not change in value for nine years and appreciated a lot in the last year would be worse off under either retroactive regime than he would be in a mark-to-market system.

[24] If all returns from financial products are not taxed the same (e.g., if capital gains and losses are subject to different tax treatment than ordinary income and deductions), retroactive taxation regimes are further complicated by the need to police taxpayers' efforts to elect the character of gain or loss immediately before the retroactive gain or loss calculation takes place. For an example of how the current law attempts to prevent this type of planning see I.R.C. § 1260(a), (e).

Another retroactive taxation approach determines tax liability on the basis of presumed, rather than actual, gain.[25] As with other retroactive proposals, the tax would be imposed when the derivative is settled, and the amount realized would be equal to the payment actually made. The gain would be calculated, as in a realization-based system, by subtracting cost (or basis) from the amount realized. However, that cost would be an imaginary number determined by discounting the actual amount realized at the risk-free rate over the term of the derivative.[26] The beauty of this approach is that, under certain assumptions, it is equivalent to an accrual-based (or mark-to-market) regime from an ex ante perspective. Yet this retroactive method avoids valuation and liquidity problems associated with mark-to-market taxation, does not give taxpayers an opportunity to defer gains and accelerate losses, and does not lock taxpayers into their investments.[27] From an ex post perspective, however, the results under this method are very different from an accrual-based tax as this regime clearly ignores actual gains and losses. Moreover, the ex ante equivalence obtains only if investors are fully rational and make optimal portfolio choices—assumptions of questionable validity in the real world.

C. Mark-to-market taxation. In a mark-to-market system, all gains and losses are taxed as if each position is terminated (or sold) at the end of each taxable year and re-entered (re-acquired) at the beginning of the next year. Thus, this system would base tax liability on annual fluctuations in value, whether or not any given asset is sold or retained by a taxpayer.[28] Losses from derivatives would be deductible only against gains from derivatives. Excess losses would be either immediately refundable or available to reduce gains from derivatives in other tax years—either in the future or with a limited carryback.

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[25] See Alan J. Auerbach, *Retrospective Capital Gains Taxation*, 81 Am. Econ. Rev. 167 (1991); Alan J. Auerbach & David F. Bradford, *Generalized Cash-Flow Taxation*, 88 J. Pub. Econ. 957 (2004). As the titles of these papers suggest, this approach is not limited to derivatives.

[26] For example, "[c]onsider an asset that is sold for $100 when the riskless rate of return is 10% and the tax rate is 30%. If the asset had been held for one year, the tax would be $2.70, which is 30% of an amount of gain determined by subtracting from the amount realized ($100) a hypothetical cost ($91) based on the assumption of a 10% return ($91 = $100/1.1). If the asset had been held for two years, the tax would be 30% of $100 - [$100/$(1.1)^2$], or $5.21." Warren, supra note 9, at 481.

[27] Because the gain is calculated by assuming that the entire return from a derivative is based on a risk-free rate compounded over the derivative's term, only the riskless return is taxed under this approach. If one believes that an ideal income tax does not tax risky returns in any case, this result is not particularly problematic. See, e.g., David A. Weisbach, *The (Non) Taxation of Risk*, 58 Tax L. Rev. 1 (2004).

[28] For discussions of a mark-to-market regime, see Daniel Halperin, *Saving the Income Tax: An Agenda for Research*, 77 Tax Notes 967 (1997); Miller, supra note 5; David J. Shakow, *Taxation Without Realization: A Proposal for Accrual Taxation*, 134 U. Pa. L. Rev. 1111 (1986); Warren, supra note 9, at 474; Weisbach, supra note 5.

Importantly, the rate applying to gains and losses would be flat.[29] If one believes that most derivatives users are either high net worth individuals or large corporations, one would set that rate at the top marginal rate, individual or corporate, as appropriate. A more precise approach would set the rate at the top individual or corporate rate applying to any given taxpayer in any particular tax year.[30] As in many versions of the anticipatory and retroactive tax regimes, business hedges would be excluded from mark-to-market rules and subject to a special treatment.

The main objections to mark-to-market taxation are valuation and liquidity concerns. The former highlights informational demands of obtaining valuations of all derivatives as well as administration and enforcement concerns with verifying these valuations. The latter reflects unease with forcing taxpayers to pay tax on "paper gains" before they receive any cash related to these gains.

D. Why Single Out Derivatives? In addition to objections unique to each fundamental reform proposal, any such proposal limited to financial instruments encounters arguments about its scope. Why single out derivatives? Without providing an exhaustive answer to this question, the following observations suggest a partial response.

Any reform introducing a special regime for derivatives raises a line drawing problem. If derivatives are taxed differently from everything else, taxpayers must know how to distinguish a derivative from a non-derivative. In my view, a broad definition of a derivative is appropriate, although one's conclusion about the optimal breadth may be affected by one's choice of the new treatment for derivatives. In any case, if all derivatives are treated the same, it will be much easier (and cheaper) to draw and maintain just one line—between derivatives and non-derivatives—than it is to continually delineate forwards from swaps from options from futures from prepaid derivatives and so on, as the existing tax rules attempt to do.[31] That is, while a line drawing exercise will still be needed, the number of lines will be dramatically reduced.

It may also turn out that the new regime will result in a less favorable tax treatment of derivatives compared to that of "plain vanilla" investments such as stocks, bonds, and real estate. This, one might argue, will be both unfair and inefficient. The criticism is not particularly convincing. "Equal treatment" is certainly not the hallmark of our tax system today. For example, growth stocks are treated more favorably than dividend-paying stocks. Bonds (especially discount bonds) have a particularly disadvantageous tax treatment for holders (accrual of income before its receipt) while real estate and

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[29] Otherwise, gains will be subject to a higher rate then losses because gains would push taxpayers into higher brackets while losses would have the opposite effect. See Schizer, supra note 11, at 1908-09.

[30] In other words, the taxpayer's rate determined without regard to gains and losses from derivatives would automatically apply to these gains and losses.

[31] This list does not mention the need to delineate various *transactions* involving derivatives, such as straddles, constructive sales, constructive ownership, several integration regimes and the like.

municipal bonds are especially tax-favored. Some derivatives are currently taxed less heavily than other economically similar financial instruments. Rather than adding to the number of tax-favorable and unfavorable regimes, a reform following any of the approaches laid out above will reduce this number by taxing all derivatives the same.

The choice between the anticipatory approach, the retroactive approach, and the mark-to-market approach is not an obvious one. If one thinks, for example, that derivative counterparties are rational and sophisticated taxpayers who make optimal portfolio decisions and are influenced only by expected returns, retroactive taxation based on presumed returns may have some appeal. If, on the other hand, one views ex post outcomes as important and believes that market values may be determined for most derivatives rather easily, mark-to-market is an attractive solution.

Reasonable minds can certainly differ about the merits and limitations of the various fundamental reforms. The details of the three alternative approaches are important and will need to be considered with care. But it is essential to see the big picture: The available choices are fairly limited, reasonably well-understood, and may be adjusted and even combined in a variety of ways. Whatever obstacles preclude us from pursuing a fundamental reform of financial products taxation, lack of knowledge about how to move forward is not one of them.

4. Interplay Between the Tax Reform of Financial Products and Other Possible Reforms

A fundamental reform of derivatives taxation is important, but it is hardly the only important fundamental reform worth considering and being considered. Other reforms, if undertaken, will affect the need to resolve the problems with taxing financial products in a variety of ways. Some reforms will make fixing the taxation of derivatives even more urgent, some will make it less essential, and some will have uncertain effects, as the following discussion explains.

These Committees have already started to consider the problems caused by the different tax treatment of debt and equity.[32] Any form of corporate integration that eliminates the debt-equity distinction will reduce the urgency of fixing the taxation of financial products.[33] This is because a considerable volume of these products is designed and deployed to give corporations interest deductions for issuing equity-flavored instruments.[34] Tax-deductible equity is the name of the game here, and this game is not

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[32] See *JCT Describes Taxation of Business Debt*, 2011 TNT 134-14 (July 13, 2011).

[33] Because financial products are used not only to reduce taxes by exploiting the debt-equity distinction, but to change the character, source, and timing of income as well (as discussed below), "reducing the urgency" certainly does not mean eliminating the need to address taxation of financial products altogether.

[34] The so-called mandatory exchangeable securities are the prime (though by no means the only) example of these financial products. For a detailed discussion, see Edward D. Kleinbard et al., *Everything I Know About New Financial Products I Learned From DECS*, Practising Law

worth playing if debt and equity are taxed the same. It is worth noting that financial products exploiting the debt-equity distinction will remain important if interest and dividend income is taxed in a different manner (e.g., at a different rate, as is the case today). Even if corporations become indifferent between issuing debt and equity securities, the incentives to play tax games using derivatives will remain as long as the tax treatment of these securities varies for their holders. Thus, if these Committees were to consider corporate integration leading to a uniform treatment of debt and equity on the issuer side, the Committees should certainly revisit the disparate taxation of dividend and interest income.

Another significant reform being actively debated in tax policy circles is a substantial reduction in the corporate tax rate.[35] Whatever is one's view about the overall merits of such a reduction, one should be aware of its implications for the taxation of derivatives. While these implications are uncertain, it is likely that the flaws in the taxation of derivatives will become even more costly if a substantial rate differential between individual and corporate tax rates is introduced. The top individual income tax rate and the corporate income tax rate have been fairly close since the early 1980s—the simpler days when financial products were not nearly as prevalent as they are now. Therefore, we can only guess how financial engineers would respond to a strong incentive to create derivatives that would shift deductions to high-tax individuals while shifting income to low-tax corporations. But our experience with derivatives-based tax planning certainly suggests at least two areas where such income and deduction shifting is likely to arise: executive compensation and owner-controlled taxable C-corporations.[36] In each case, it will be fairly easy for the corporation and the individual to agree on the goal of minimizing their joint tax liability and share the tax savings. There is every reason to expect that derivatives will be used to accomplish this goal.

Unlike a corporate tax rate reduction, an elimination of the special treatment of capital gains and losses is certain to reduce the urgency of fixing taxation of financial products.[37] This conclusion does not depend on whether such elimination is accomplished by increasing the rate for capital gains or reducing the rate for ordinary income. As long as capital gains and ordinary income are taxed the same, there is no point in using

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Institute, Tax Strategies for Corporate Acquisitions, Dispositions, Spin-offs, Joint Ventures, Financing, Reorganizations & Restructurings 392 (2010).

[35] See *Camp Proposes Switch to Territorial System*, 133 Tax Notes 512 (2011) (describing the plan proposed by Chairman Dave Camp that includes a reduction of corporate tax rate to 25 percent).

[36] While such corporations are relatively rare today, many more are likely to appear if the corporate rate drops substantially below the top individual rate. For an example of small business owners' response to a tax reform that reversed the relationship between corporate and top individual rate (with the latter dropping below the former for the first time in decades), see Joel Slemrod & John Bakija, *Taxing Ourselves: A Citizen's Guide to the Debate Over Taxes* 146 (3rd ed. 2004).

[37] The caveats stated earlier in footnote 33 apply here as well.

derivatives to convert one type of income into another. There is no doubt that a variety of financial products have been designed and used to convert high-tax ordinary income and short-term capital gains into low-tax long-term capital gains.[38] These products will either disappear entirely or will lose some of their appeal if all types of income are taxed the same.

Another reform that will even more dramatically alleviate the need to rethink the taxation of derivatives is a broad shift to mark-to-market taxation, especially if that shift reflects the same approach that is currently adopted in section 475. If all gains and losses for a particular type of asset (perhaps limited to publicly traded assets) are taxed annually and at the same rate, there is no point in using derivatives not only to change income's character, but to shift the timing of income recognition as well. Deferral of gain is certainly one of the goals that many financial products are designed to achieve.[39] This goal will be beyond the reach of financial engineers if broad categories of assets become subject to a mark-to-market regime.

A switch from world-wide to territorial taxation is yet another fundamental reform under consideration.[40] Unfortunately (and, again, without expressing a view on the overall merits of this reform), a switch to territorial taxation is unlikely to reduce the need to reform the taxation of derivatives. In fact, the opposite may well be true. There is no doubt that financial products have been used to change the source of income in order to avoid U.S. withholding tax.[41] It appears that derivatives are being deployed to avoid establishing a U.S. trade or business and earning income effectively connected to that trade or business as well. Both strategies—the re-sourcing of income and avoiding effectively connected income—will remain important (and even become more important in certain cases) in a territorial system. Furthermore, shifting taxable income offshore will have an even greater payoff following a switch to a territorial regime because it will lead to a permanent exemption from tax rather than a mere deferral of the tax liability. No doubt, greater financial benefits will lead to greater efforts to design derivatives that would accomplish these goals.

Finally, an argument in favor of replacing an income tax with a consumption tax has repeatedly appeared at the forefront of tax policy debates in the past decades. The implications of such replacement for the need to reform the taxation of financial products

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[38] These products include hedge fund derivatives partly addressed by section 1260, conversion transactions partly addressed by section 1258, and exchange-traded notes that were the focus of the legislation proposed by Representative Richard Neal, see supra note 14.

[39] These products include variable prepaid forwards partly addressed by section 1259, straddles addressed by section 1092, hedge fund derivatives partly addressed by section 1260, and exchange-traded notes that were the focus of the legislation proposed by Representative Richard Neal, see supra note 14

[40] See *Camp Proposes Switch to Territorial System*, 133 Tax Notes 512 (2011).

[41] See I.R.C. § 871(m); Notice 2010-46, 2010-24 I.R.B. 757; Alex Raskolnikov, *The Cost of Norms: Tax Effects of Tacit Understandings*, 74 U. Chi. L. Rev. 601, 618-620 (2007).

depend on the specifics. Certain forms of a consumption tax—such as an invoice-based value added tax popular in most OECD countries—are relatively resistant to the gaming and abuse carried out through a deployment of derivatives. Other versions—such as the so-called Flat Tax endorsed by several Presidential candidates over the years—are much more susceptible to abuse.[42] If a consumption tax is enacted to supplement (rather than replace) an income tax,[43] the need to address the taxation of financial products will remain largely unchanged.

The overall implications of this discussion are quite clear. Any reform that eliminates the distinction between different types of income, eliminates taxpayers' ability to elect one tax treatment or another, or eliminates capital income from the tax base would reduce the urgency of fixing the taxation of derivatives. Any reform that increases the disparity in the taxation of different types of income would have the opposite effect.

Yet whatever other reforms are considered today or tomorrow, a serious effort to rethink and reform taxation of financial products is critically important. The incentives to invent new derivatives-based tax reduction strategies are extremely strong. The human capital deployed in designing these strategies is considerable. The problems with the taxation of derivatives will not go away on their own. In fact, these problems are certain to persist and worsen if Congress fails to act.

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[42] See David A. Weisbach, *Ironing Out the Flat Tax*, 52 Stan. L. Rev. 599, 624-30 (2000); Joseph Bankman & Michael L. Schler, *Tax Planning Under the Flat Tax* 245, 255-58, *in* Taxing Capital Income (Henry J. Aaron, Leonard E. Burman, C. Eugene Steuerle eds. 2007).

[43] See Michael J. Graetz, *100 Million Unnecessary Returns* 197-213 (2008).

Senate Finance Committee and House Ways & Means Committee Hearing
"Tax Reform and the Tax Treatment of Financial Products"
Tuesday, December 6th, 2011
Questions for Mr. Alex Raskolnikov

Questions from Chairman Baucus

1. **There has been much discussion about regulatory reform and the desire of increased transparency, oversight, and market stability. What is less frequently discussed is whether the tax treatment of financial products contributes in a positive or negative way to these goals.**

    a. **Several witnesses at the hearing discussed how tax planners can create almost any tax consequence they desire by tinkering with and combining different financial products. For example, they can alter the timing, character, or source of income. Do the resulting financial products contribute in a positive or negative way to the goals of transparency, oversight and market stability?**

Given lack of empirical research on the subject (as mentioned in the first part of my written testimony), I am reluctant to generalize. At the same time, it is easy to give examples of how tax-motivated uses of financial products reduce transparency, hinder oversight, and decrease market stability.

Example 1: dividend swaps. A foreign investor would like to invest in U.S. equities. The obvious solution of making just such an investment brings with it an undesirable tax consequence — the U.S. withholding tax on dividend payments. The solution is a total return equity swap (TRS) that provides for dividend-substitute payments arguably not subject to withholding tax. (Congress addressed this product by enacting section 871(m).)

What follows from the investor's decision to invest in a TRS rather than in U.S. equities directly? Market stability is reduced because the investor assumes counterparty risk of the financial institution on the other side of the swap. The investor may also assume a relational risk of the counterparty, see Alex Raskolnikov, *The Cost of Norms: Tax Effects of Tacit Understandings*, 74 U. Chi. L. Rev. 601, 618-620 (2007). Transparency is reduced because a simple investment in stock is replaced with a contract subject to a complex highly set of rules and legal documents. (Understanding the ISDA Master Agreement that governs most swaps requires substantial expertise.) Oversight is reduced because an investment in a publicly traded asset is replaced with an over-the-counter (OTC) contract that is negotiated, executed, and performed outside of the public eye. If disputes under this contract are subject to mandatory arbitration (not a rare occasion for OTC derivatives), disagreements about this contract are resolved entirely in private as well.

Example 2: variable prepaid forwards. An investor with a large holding of appreciated stock would like to eliminate her exposure to some of that stock and diversify her

investments. The obvious solution of selling some of her holdings leads to an undesirable tax consequence — a tax on the built-in gain. The solution is a variable prepaid forward (VPF) that is intended to provide the investor with cash in the amount close to the fair market value of the stock subject to the forward and to eliminate most of the economic exposure to the stock without triggering the gain and the tax.

What follows from the investor's decision to enter into a VPF rather than selling outright? Market stability is reduced because the investor assumes counterparty risk of the financial institution on the other side of the VPF. Market stability is also reduced because the financial institution may be exposed to the risk that investor will not allow the institution to borrow the investor's stock pledged under the VPF (as the financial institution expects to do). See Raskolnikov, *The Cost of Norms* at 614-16. Transparency is reduced because a simple stock sale is replaced with a contract subject to a complex set of rules a legal documents. (Understanding of the VPF (or even its payment formula) requires substantial expertise.) Oversight is reduced because a sale of a publicly traded asset is replaced with an OTC contract that is negotiated, executed, and performed outside of the public eye. If disputes under this contract are subject to mandatory arbitration (not a rare occasion for OTC derivatives), disagreements about this contract are resolved entirely in private as well.

These examples are not unique. Tax-motivated strategies are often executed in secret. (While formal confidentiality provisions are no longer prevalent in light of the tax shelter regulations, informal understandings regarding confidentiality very much persist. See Raskolnikov, *The Cost of Norms* at 609-11.) Because these strategies produce substantial tax savings for their users, these users are often willing to accept various risks as a price of reducing their taxes (see next answer for details). In the aggregate, these risks tend to decrease market stability.

b. Do the tax rules for financial products encourage riskier behavior among taxpayers?

Repeating the caveat about the danger of generalization given lack of solid research, and continuing with the two examples, the answer is that financial products certainly can encourage risky behavior among taxpayers.

A foreign investor who enters into a TRS assumes counterparty risk. An owner of appreciated stock who enters into a VPF not only assumes counterparty risk but retains some of the unwanted exposure to the appreciated position. Both taxpayers incur a risk of a contractual dispute, not to mention a risk of entering into a transaction that the taxpayer does not fully understand and that may produce outcomes that the taxpayer failed to contemplate.

More fundamentally, derivatives allow taxpayers to acquire economic exposure to any given asset that vastly exceeds the actual amount of this asset. A company may have only $100 million worth of stock (similarly, there may be only 100 million pounds of coffee in the world in any given year), but there may be 1.1 billion long positions on that stock accompanied by one billion short positions (the same is true for coffee futures).

While the total net exposure is, of course, limited to the amount of the underlying (be it shares of stock or coffee beans), the number of taxpayers exposed to price fluctuations of that underlying may be dramatically higher than the number of taxpayers who could possibly be so exposed in the absence of derivatives. While tax planning is certainly not the only (and probably not the main) explanation of such risk proliferation, it certainly contributes to it.

c. Does applying mark to market only to certain publicly-traded derivatives and derivatives with respect to publicly-traded property for which there is a reasonable basis to determine fair market value increase the incentive to trade over-the-counter or in less easily-valued property and, therefore, cause individuals to enter into less transparent transactions.

Subjecting financial products to mark-to-market (MTM) taxation will impede tax planning using these products. Because no similar restraint will apply to OTC derivatives, expanding MTM rules will give rise to an incentive to replace derivatives that become subject to MTM rules with those that do not. While this effect should be kept in mind, the important question is the likely magnitude of the taxpayer response to this incentive. For the following reasons, I believe that the response will be rather small if the MTM rules are broad. The narrower the rules, the easier it will be to replicate a derivative subject to MTM with another derivative that is not subject to MTM, the greater the magnitude of such replacements.

At least two reasons underlie my expectation of a limited taxpayer response. First, to the extent taxable transactions that a taxpayer wants to replicate in a non-taxable (or low-tax) manner involve publicly-traded assets (whether directly or as an underlying for a derivative), the economic differences between such assets and any non-publicly-traded asset will provide a strong friction that will impede tax planning. A foreign investor interested in investing in publicly traded U.S. equities cannot replicate this investment by a derivative based on non-publicly traded investments such as hedge funds or private equity funds, at least not without incurring a significant cost of investing in something very different from the investor's true preference. Similarly, it is impossible for an owner of a large undiversified position in a public company to hedge her exposure with a derivative whose value is based on some non-publicly traded asset. Of course, the definition of "public trading" will be crucial if the application of MTM is tied to public trading. This definition will need to be developed with care and adjusted based on subsequent financial innovation.

The second reason underlying my belief that only a limited amount of switching away from the MTM regime will take place has to do with hedging by financial institutions. Financial institutions that design most derivatives and serve as derivative counterparties almost always hedge their positions. Most derivatives require the so-called dynamic hedging that involves constant adjustments of the hedge in response to market fluctuations. Such hedging is impossible with OTC investments. This simple fact accounts for the much greater success of the constructive ownership regime (dealing with

OTC derivatives) compared to the constructive sale regime (dealing with publicly traded assets). See David M. Schizer, *Frictions as a Constraint on Tax Planning*, 101 Colum. L. Rev. 1312 (2001). In other words, even if taxpayers try to escape the broad MTM regime by seeking tax-advantaged OTC derivatives, financial institutions are unlikely to be able to meet this demand.

2. **Many financial products serve long-standing, essential business purposes. It is important that farmers and producers are able to manage their risks.**

   At the same time, in the past few weeks there have been several news reports that suggest that high-wealth individuals are able to defer taxation for many years on appreciated stock in ways that seem like abuses of the tax code. We also are aware of other creative financial products that take advantage of character and source rules and thereby benefit from favorable tax treatment.

   There is the perception that this isn't fair. I'm trying to get a sense of the revenue loss we are talking about.

   What portion of these contracts are entered into for speculative purposes rather than managing business risk?

   I have no solid basis for answering this question, and I believe no one else does either. My hunch is that the vast majority of derivatives (as determined by the notional amount) are not tax-motivated for the simple reason that the vast majority of derivatives are interest rate swaps. At least in the past decade, these swaps have not been an important component of derivates-based tax planning. On the other hand, the total notional volume of derivatives other than interest rate swaps is so large (though not by comparison to the volume of interest rate swaps), and the amounts in just a few controversies involving aggressive uses of derivatives that are currently litigated by the IRS are so substantial, that revenue losses from derivatives-based tax planning may well run into tens or even hundreds of billions of dollars. For instance, the *Ambac* case focused on the tax treatment of credit default swaps involves a contested refund of about $700 million. See Lee A. Sheppard, *News Analysis: Credit Default Swaps in Bankruptcy Court*, 132 Tax Notes 323 (2011). The amount in dispute in the *Anschutz* case involving VPFs entered into by a single individual (through a controlled entity) approaches $100 million. See *Anschutz Co. v. Comm'r*, 135 T.C. 78 (2010), aff'd -- F.3d -- (10th Cir. 2011).

3. **The 'cubbyhole' approach of taxing financial products and the lack of timely guidance by the IRS have led to similar products being taxed inconsistently. Even if transactions have the same pre-tax economic outcome, their after-tax economic outcome can be starkly different.**

   a. **Let's assume Congress continues along with the system of incrementally fixing perceived problems in the taxation of financial derivatives (rather than**

legislating a more global approach). What can be done to more quickly address the development of new financial products so that the IRS is not always playing catch up?

First, the IRS should return to its practice of issuing Notices warning taxpayers that it is aware of certain strategies or products and it disagrees with the tax consequences of these strategies or products intended by some taxpayers. For example, when the IRS learned in the late 1980s that interest rate and currency swaps were being used to inappropriately shift the timing of income and deductions, it issued Notice 89-21 years before coming to the final conclusion about the proper recognition of lump sum swap payments that is reflected in the Treasury regulations under section 446. Most importantly (and consistent with prior practice), the IRS should issue these Notices before it fully understands all the issues, before it develops a comprehensive response (usually in the form of Treasury regulations), and before Congress acts if such action is necessary.

Second, the IRS should stop blessing questionable transactions without fully understanding them. One sad example is the issuance of Revenue Ruling 2003-7 approving the intended (by taxpayers) tax consequences of a VPF that differed in critical respects from what I believe to be the vast majority of actual VPFs outstanding. When the IRS realized that an assumption about what happens to the stock being hedged with a VPF had very little to do with the prevailing market practice, it issued a Technical Advice Memorandum (TAM 200604033) and is now litigating the issue in the *Anschutz* case. In each instance the IRS (and now the courts) is burdened by the need to explain why its taxpayer-favorable position in the Revenue Ruling does not apply to the later controversies. While it is certainly possible to draw a distinction between the transaction in the Revenue Ruling and those in the TAM and the *Anschutz* case, the IRS made tax planning easier and its job more difficult by issuing the Ruling without any positive contribution to revenue, ease of administration, or any other plausible goal.

Third, the IRS should use all the help that is being offered. Inexplicably, it fails to do so. For instance, the IRS would not have revealed its misunderstanding of the role of stock lending in VPFs by issuing Revenue Ruling 2003-7 if it took advantage of the information in public domain. David Schizer explained the role of stock lending in a law review article published in 2001 and publicly available even earlier. See Schizer, *Frictions* at 1355.

Another example is Schizer's analysis of the wash sale rules. See David M. Schizer, *Scrubbing the Wash Sale Rules*, 82 Taxes 67 (2004). This article is nothing short of what should be an IRS dream. Schizer identifies seven aggressive uses of these rules (many involving derivatives), analyzes them under current law, and suggests fixes in each case. In more than one instance Schizer argues that a Revenue Ruling is all that is needed to fix the problem. What has the IRS done with this information for the past seven years? Nothing. Schizer is far from the only one offering help. Many practitioners and academics have been doing this for some time. The IRS should not ignore all these efforts to help.

b. Could a simpler system with guidelines based on the substance of a transaction rather than its form benefit both taxpayers and tax administrators? Would this require a legislative change?

The short answer is no. In the world of derivatives, it is often unclear what is the "substance" of an instrument. For example, what is the substance of a bond convertible into the bond issuer's stock? Is it a combination of a "plain vanilla" bond and a call option on the issuer's stock, or a combination of the issuer's stock with a put option on it? There is simply no conceptual way of choosing between these alternative combinations. See the discussion of the put-call parity theorem in my written testimony and the references to more detailed analyses of the same issue therein.

c. Is part of the uncertainty on how derivatives are taxed due to inconsistent definitions used by the tax code versus those used in US securities and commodities law? Could this uncertainty be mitigated by seeking to reconcile the terminology?

Inconsistent definitions increase line drawing problems, including the government's challenges of drawing the lines and the taxpayers' opportunities to game whatever lines are drawn. The most important inconsistency has been between tax and financial accounting regimes, and I address it in more detail below.

4. To what extent do corporations create or invest in financial products that provide them favorable equity treatment for accounting and regulatory purposes but which allow them debt treatment for tax purposes?

Do you consider this a problem that should be addressed as part of tax reform? If so, how would you suggest we address it?

There is no doubt that corporations issue and invest in products and transactions designed to receive different treatment for accounting (and other regulatory) and tax purposes. The unfortunate *Cottage Savings* case is one example. The infamous MIPS-type security is another. The two main problems with these activities are familiar. First, real resources (time, talents, etc.) are squandered in designing instruments and transactions that have no purpose other than to arbitrage differences between regulatory regimes. Second, taxpayers end up issuing and acquiring securities they would not have issued and acquired in the absence of a tax, accounting, or other regulatory benefit. This leads to increased risk, undesirable capital structures, and so on.

Answering the question about the extent of this activity is, again, impossible without a careful empirical study. To my knowledge, no such analysis has been performed. (Note that the mere fact that a company issues a security with varying book and tax treatment does not necessarily mean that taking advantage of this variation is the reason for the

security's existence. The security may have unique and desirable economics that just happen to have different treatment for book and tax purposes.)

Assuming the problem is serious enough, at least four possible solutions exist. I list them from the most far-reaching to the least dramatic. First, corporate integration would eliminate the distinction between debt and equity altogether. Without this distinction the financial products in question will disappear. Second, Congress may impose book/tax conformity on all companies that are produce audited financial statements. Third, a limited book/tax conformity may be instituted just for the purpose of debt/equity characterization of a financial instruments. (This is a kind of a limited anti-abuse rule whose full implications have not been studied.) Finally, a reduction in the corporate tax rate would reduce the payoff from the debt/equity characterization game.

Questions from Senator Bill Nelson

Section 1256 of the Internal Revenue Code imposes "marked to market" treatment on certain financial instruments. Under the provision, section 1256 contracts are subject to tax annually based on their fair market value on the last business day of the taxable year. A portion of the income or loss on a section 1256 contract is taxed as short-term capital gain or loss, and a portion is taxed as long-term capital gain or loss. The conference report for the Dodd-Frank Wall Street Reform and Consumer Protection Act included a provision -- not included in the original House-passed or Senate-passed version -- which amended section 1256. The provision created a new statutory rule that excludes credit default swaps, interest rate swaps, equity swaps, commodity swaps, and other agreements from the definition of a section 1256 contract.

a. **In your view, what would have been the likely consequences of the Dodd-Frank Act on the tax treatment of derivatives transactions if this provision had not been included in the final bill?**

If the provision in question were not included in the Dodd-Frank Act (DFA), some equity, commodity, and other swaps would have become subject to the section 1256 regime. It is important to keep in mind that this regime outlived its usefulness long ago. The 60/40 treatment is arbitrary and lacks any conceptual foundation. Section 1256 creates yet another idiosyncratic regime for certain kinds of derivatives, introducing yet another line drawing problem, and giving taxpayers yet another opportunity to game the system by designing financial products that fall within or without the scope of that regime. Given the uncertain legal environment created by the DFA (as I understand, many important decisions were left for the SEC and CFTC and still have not been made), it is difficult to assess the consequences of not including the provision in question in that DFA. More importantly, in light of taxpayers' ability to create derivatives that fall on either side of any particular line, any new regulatory regime (such as the DFA) — combined with the numerous unique tax regimes for various derivatives — creates opportunities to game the system. This conclusion is unchanged whether the last-minute

provision excluding swaps from the section 1256 treatment were added to the DFA or not.

b. Are some taxpayers likely to pay less in income taxes on their derivatives transactions as a result of the provision?

Some taxpayers may pay less, others may pay more. Given lack of empirical research of the revenue consequences of many long-standing decisions affecting the taxation of derivatives, and in light of the importance of the DFA-implementing guidance that will come from the SEC, the CFTC, and the IRS, it is very difficult to predict the revenue effects of the provision in question.

c. Which industries, sectors, or classes of taxpayers are most likely to benefit?

It appears that insurance companies, swap dealers, and nonfinancial corporate end-users of swaps are likely to benefit from the inclusion of the provision. See Lee A. Sheppard, *News Analysis: Dodd-Frank Bill Blows Up Section 1256*, 128 Tax Notes 693, 696 (2010). Given the current state of our tax system, many of these "benefits" are merely a relief from the arbitrary 60/40 character regime of section 1256.

d. Does the provision create new opportunities for tax avoidance?

See the answer to (a).

COMMUNICATIONS

Comments for the Record

United States Senate Committee on Finance
United States House Committee on Ways and Means

Tax Reform and the Tax Treatment of Financial Products

Tuesday, December 6, 2011, 10:00 AM
HVC-210 Capitol Visitor Center

By Michael G. Bindner
Center for Fiscal Equity

Chairmen Baucus and Camp, thank you for the opportunity to submit comments for the record on this topic. We will leave it to the invited witnesses to describe how current tax law treats financial products and will confine ourselves how such products might work under our tax and entitlement reform proposals. As you know, the Center for Fiscal Equity has a four part proposal for long term tax and health care reform. The key elements are

- a Value Added Tax (VAT) that everyone pays, except exporters,
- a VAT-like Net Business Receipts Tax (NBRT) that is paid by employers but, because it has offsets for providing health care, education benefits and family support, does not show up on the receipt and is not avoidable at the border,
- a payroll tax to for Old Age and Survivors Insurance (OASI) (unless, of course, we move from an income based contribution to an equal contribution for all seniors), and
- an income and inheritance surtax on high income individuals so that in the short term they are not paying less of a tax burden because they are more likely to save than spend – and thus avoid the VAT and indirect payment of the NBRT.

There is a great deal of literature on the tax treatment of financial operations under a VAT regime. We suggest that, should you wish to consider our proposal more fully, you invite these experts to testify. Some of these issues are particularly complex and their treatment would exceed the space allowed for comments.

From an investor point of view, how the financial instrument is treated in the tax code has less of an impact than the existence of a Value Added Tax and VAT-like Net Business Receipts Tax. Regardless of how the financial product is structured, once the cash is to be spent at the household level, taxes will be paid. This fact will likely diminish the demand for certain financial products, since tax avoidance will only go so far – particularly since we propose an income and inheritance income surtax floor of $50,000 for individuals and $100,000 for joint filers and qualifying widow(er)s.

The payroll tax provision also has no impact on the taxation of financial instruments. Of course, if the payroll tax component were used to facilitate a transition to union and employee managed personal retirement accounts holding insured employer voting stock, rather than broker managed Wall Street index funds, the need for and availability of financial products would diminish and eventually disappear as private investment provided more and more of the capital investment needs of industry. Additionally, employee-owned firms are more likely to offer credit products to their employee-owners in the areas of insurance, mortgages, consumer credit and retirement. Complex financial products to fulfill these functions will also decline in such a scenario.

We should probably not bring this fact up, as the army who get rich offering such products is likely to mount formidable resistance should our proposal ever be considered. We expect that this is why none of our comments have been given any attention by either revenue committee. Considering the hunger to restrict such paper wealth that is arising among the self-styled 99%, we don't expect you will be able to ignore these ideas forever.

The tax benefits assigned to financial products may or may not be continued in the tax reform we propose, since our intent was to include very few deductions for our high income surtax. Whether this goal is accomplished is, of course, entirely up to the congressional revenue committees. Our hope is that you will close most loopholes so that high income taxpayers no longer spend perfectly good money to game the system. In the end, they would only be competing with each other and because interest on the debt and debt repayment would be funded by the surtax, any savings they get personally will simply add up to a tax burden on their children, rather than the next generation as a whole. Indeed, taxation at much higher rates would likely be demanded by such taxpayers once this fact became clear.

Thank you again for the opportunity to present our comments. We are always available to discuss them further with members, staff and the general public.

MANAGED FUNDS ASSOCIATION
The Voice of the Global Alternative Investment Industry
WASHINGTON, DC | NEW YORK

December 20, 2011

Via Email:

Honorable Max Baucus
Chairman
Committee on Finance
U.S. Senate
Washington, D.C. 20510

Honorable Dave Camp
Chairman
Committee on Ways and Means
U.S. House of Representatives
Washington, D.C. 20515

Honorable Orrin Hatch
Ranking Member
Committee on Finance
U.S. Senate
Washington, D.C. 20510

Honorable Sander Levin
Ranking Member
Committee on Ways and Means
U.S. House of Representatives
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Re: Taxation of Financial Products and Related Transactions

Dear Messrs. Chairmen and Ranking Members:

This letter is submitted by Managed Funds Association ("MFA")[1] for the record in connection with the December 6, 2011 joint hearing by the Senate Committee on Finance and the House Committee on Ways and Means (the "Committees") on "Tax Reform and the Treatment of Financial Products" (the "Joint Hearing"). Private investment funds use financial instruments and products for a broad range of purposes, including hedging investment positions and gaining exposure to targeted segments of the capital markets.

For the reasons discussed in Part I of this letter, MFA believes that broad-based reform of the taxation of financial instruments and products should be undertaken only as part of a comprehensive review of the federal income tax system and not independently of that review. MFA does believe, however, that there are several discrete issues that arise under the current provisions of the Internal Revenue Code of 1986, as amended (the "Code") that, by reason of current economic conditions or other factors, merit attention

[1] MFA is the voice of the global alternative investment industry. Its members are professionals in hedge funds, funds of funds and managed futures funds, as well as industry service providers. Established in 1991, MFA is the primary source of information for policy makers and the media and the leading advocate for sound business practices and industry growth. MFA members include the vast majority of the largest hedge fund groups in the world who manage a substantial portion of the approximately $2.0 trillion invested in absolute return strategies. MFA is headquartered in Washington, D.C., with an office in New York.

and action in the near term. Part II of this letter contains examples to illustrate areas where near term action is warranted and MFA looks forward to working with policy makers to discuss potential solutions to these address the concerns discussed below. Finally, Part III contains comments on the proposal that some have advanced to impose an excise tax on financial transactions as that subject was addressed briefly during the Joint Hearing.

I. Overall Reform of Taxation of Financial Instruments and Products Should Be Addressed in the Context of General Income Tax Reform

Testimony presented at the Joint Hearing reflected a divided view on whether Congress should enact legislation amending the Code to reform the taxation of financial products on a comprehensive basis. Proponents of such a comprehensive approach point to the fact that different financial instruments with similar economic effects at times are nevertheless taxed differently and also suggest that some financial instruments are used by some taxpayers to secure otherwise unavailable and inappropriate tax benefits.

MFA supports in principle the objective of many Members of Congress to embark upon a process that could lead to a comprehensive reform of the federal income tax system as a whole and believes that any effort aimed at broad-scale reform of the taxation of financial instruments and products should be undertaken only as a part of a more comprehensive review of the federal income tax system and not independently of that review. Most fundamentally, MFA believes that, unless and until a broad consensus is reached on the key principles and the overall structure of a reformed federal tax system, reform of the taxation of financial instruments and products could result in a regime that proves to be inconsistent with the overall tax system. We are further concerned that a disjointed approach to tax reform is likely to lead to capital dislocations and other unintended consequences.

Moreover, MFA is concerned that some of the suggested broad based reform measures would not produce sound tax policy results in all cases and may be difficult to administer in many other situations. For example, some have recommended that Congress base the taxation of financial products on a mark-to-market system. Such a system is now applied to dealers under section 475 of the Code and to certain other transactions under section 1256 of the Code. In MFA's view, there are several fundamental concerns that such proposals raise. These include whether, as a matter of broad tax policy, such a system could be justified if income continues to be measured for most purposes under the "realization" principle and whether such a system would, if applied on a broad basis, be consistent with established ability to pay precepts. MFA recognizes that questions were raised during the Joint Hearing concerning whether consideration should be given to the near term adoption of additional anti-abuse provisions, notwithstanding the broad authority available to the IRS under existing law. In general, MFA believes that action on any such measures should be considered as part of the overall tax reform process. If Congress concludes, however, that near term action is required to address specific transactions in order to prevent tax evasion, MFA believes that any such measures should be carefully tailored to avoid (1) unintended application of

such legislation to legitimate transactions; and (2) creating further uncertainties as to the tax treatment of broad classes of investment and hedging transactions.

Moreover, while a mark-to-market regime may not present insurmountable administrative issues in the context of instruments that are publicly traded (or are based on publicly traded property) and for which the public markets are broad and liquid, this likely would not be the case where the instruments or the underlying property products are not publicly traded or are only thinly traded. To the extent that considerations of administerability prompt Congress to draw distinctions among instruments in determining which ones will and will not be subject to a mark-to-market regime, these distinctions could result in distorted capital allocations and, in the cases of hedging activities, deter certain legitimate and beneficial hedges, which serve to reduce risks in financial and other markets.

These comments illustrate, but do not fully define, the concerns that have prompted MFA to conclude that issues related to broadly reforming the taxation of financial instruments and products should generally be undertaken as part of and not independently of a comprehensive review of the income tax system as a whole. As noted above, MFA does believe that Congress can and should address certain discrete issues that arise under the current provisions of the Code and that, by reason of current economic conditions or other factors, merit action in the near term. These are illustrated by the examples discussed in Part II of this letter.

II. Comments on Selected Specific Issues Meriting Near Term Attention

A. Debt Instruments

1. *Original Issue Discount and Market Discount with Respect to Distressed Debt.* In current market conditions, which continue to be characterized by substantial volumes of underperforming or nonperforming debt instruments, current law can result in what MFA believes are inappropriate inclusions in income and inconsistent treatment of income and losses. Specifically, and as others have pointed out to the committees in substantial detail,[2] the holder of a nonperforming debt instrument can be required to accrue original issue discount ("OID") even if there is no reasonable expectation of full repayment[3] and the market discount rules can require inclusions in ordinary income when a partial payment is received even where the accrued market discount arises by reason of the market's assessment of the obligor's ability to fully pay the principal amount of the loan represented by the instrument. Moreover, if the debt is written off in a subsequent year, the holder may have a loss that is classified as capital rather than ordinary, notwithstanding the treatment of the prior inclusions as ordinary income.

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[2] See December 2, 2011 letter from the American Bar Association Section of Taxation to Chairmen Baucus and Camp, Senator Hatch and Representative Levin.

[3] For this purpose payment in kind (PIK) interest is treated as OID.

In MFA's view, such results are inappropriate as a matter of policy. There are a variety of approaches that might be taken to ameliorate such results (*e.g.*, creation of special rules for distressed debt under which income inclusions with respect to OID and market discount would not be required until payments received on the distressed instrument are sufficient to enable the holder to recover its tax basis in the instrument). MFA would be pleased to work with the Committees to consider more fully all options to address these issues.

2. *Partial Payments on Credit Default Swaps*. Questions also exist with respect to the treatment of partial payments on credit default swaps that are classified as notional principal contracts.[4] For example, in some cases a payment attributable to a credit event may be received in one year and that payment extinguishes the relevant, but not all, obligations of the protection seller under the credit default swap, and a second payment may be made to extinguish all other obligations under the swap in the succeeding year. It is at present unclear whether the first payment will be treated as a "termination" payment taxable as a capital gain or as a "non-periodic" payment that may be taxed as ordinary income. MFA believes such payments should be treated as termination payments and that this should be clarified by regulation or legislation.[5]

3. *Distressed Debt Instruments and Other Section 864(b) Issues.* Passive non-U.S. investors are active participants in the U.S. capital markets and are an important source of capital and liquidity to our markets. Many of these non-U.S. investors participate in the U.S. capital markets through non-U.S. investment funds and their participation is premised on the concept that these funds will not engage in the conduct of a trade or business within the United States as that would result in exposure of the fund (and potentially its investors) to U.S. taxation on a net income basis. Congress has recognized the importance of inbound investments to the U.S. economy and since 1966 the Code (section 864(b)) has contained specific exemptions from U.S. trade or business classification for proprietary trading in stock, securities and certain commodities by non-U.S. investors who are not dealers. Moreover, in 1998, the Department of the Treasury and Internal Revenue Service (the "IRS") issued proposed regulations to provide a similar safe harbor under section 864(b) for trading activities involving a broad range of derivatives and announced that the proposed regulations could be relied upon until final regulations are issued (which has not yet occurred).

Regrettably, substantial uncertainty exists with respect to the application of the section 864(b) safe harbors to a broad range of investments. For example, uncertainty exists with respect to the treatment of certain types of investments in debt securities, including so-called "distressed debt" where the investor knows that a future restructuring or workout, perhaps requiring additional funding, may be necessary in order to ensure

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[4] See Internal Revenue Bulletin 2011-42, Notice of Proposed Rulemaking and Notice of Public Hearing - Swap Exclusion for Section 1256 Contracts.

[5] See MFA comment letter to the Internal Revenue Service's proposed rule to exclude certain swaps from section 1256 of the Code, available at: https://www.managedfunds.org/wp-content/uploads/2011/12/MFA_commentletter_on_proposed_1256rules.pdf.

repayment of the acquired securities. In addition, questions have arisen whether certain types of investment transactions could be classified as loan originations and thus raise trade or business concerns. Finally, issues have been raised as to whether the receipt of certain fees in connection with acquisitions, or commitments to acquire, stock or securities is encompassed by the section 864(b) safe harbors.

Uncertainties such as these have prompted many passive non-U.S. investors to decline to make certain types of investments in the U.S. and to divert their funds to similar investment opportunities elsewhere in the world (*e.g.*, distressed debt funds that invest in Europe). This unwillingness to invest in U.S. markets exists even though, in many cases, such investors and their tax advisers believe such transactions should be within the scope of the existing section 864(b) safe harbors. The absence of guidance, however, coupled with undertakings by funds to their non-U.S. investors to seek to avoid investments that can be classified as U.S. trade or business, requires that many funds avoid investments that could raise such issues.

MFA has for several years worked with the U.S. Treasury and IRS, and others in the private sector, to develop guidelines to clarify the application of the section 864(b) safe harbors to these common capital markets investment transactions in the expectation that the resulting certainty would increase the flow of investment funds into the United States at a time when increased funding is urgently needed in many sectors of the economy, including but by no means limited to real estate. MFA has also spoken with policy makers about this issue and has concluded that legislative action may be necessary to facilitate the necessary clarifications of existing law. MFA looks forward to working with policy makers on ways to create the needed certainty that we believe will encourage greater investment by non-U.S. investors in U.S. markets.

B. Swap Expenses

Under current law, if a notional principal contract such as a swap is entered into by an individual or an investment partnership other than in connection with the conduct of a trade or business by the individual or partnership, any net expense resulting from the transaction is classified as a personal deduction under section 212 of the Code and, as such, is treated as a "below the line" or itemized deduction that is, like certain other itemized deductions, subject to the two percent limit on itemized deductions. As a result, the taxpayer could be subject to inconsistent tax treatment (*i.e.*, taxed on swap gains in one year but unable to deduct losses on the same swap in other years), with the result that the taxpayer's overall net income inclusion on the swap would not accurately reflect the taxpayer's income from that swap.

This treatment would not apply, however, if the individual or partnership is sufficiently active as a trader, as opposed to a mere investor, to be treated as engaged in a trade or business. In that case, expenses related to the swap would be deductible under section 162 of the Code. The dividing line between merely investing and being in a trade or business is a factual inquiry and the differing tax treatment of these expenses when

incurred by a trader rather than an investor often results in differing treatment of taxpayers who would appear to be similarly situated.

MFA recommends that Congress consider legislation that would treat all expenses that are directly related to the measurement of a taxpayer's economic income (including expenses such as those discussed above) as "above the line" deductions that are not subject to the limitation on itemized deductions.

Financial Transactions Excise Tax

Legislation has been introduced in both the House and the Senate to impose a tax on most securities and derivatives transactions.[6] MFA has consistently opposed such legislation for four principal reasons. First, it is unlikely to raise substantial revenues because, unless applied globally to virtually all financial instruments, market participants can be expected to trade in jurisdictions that do not impose such a tax and/or to trade in instruments (including newly developed instruments) that are not subject to the tax. Second, such a tax would have a negative impact on the value of many financial instruments as those instruments would be repriced to reflect the tax. This would have an adverse effect on all investors, including retail "main street" investors and those such as pension funds that invest on behalf of main street investors. Third, it would reduce the availability of credit as the increased costs resulting from the tax would inevitably be passed to businesses and investors. Fourth, it could have a negative impact on employment by increasing the cost of capital and diverting resources away from job-producing investments.

These and similar concerns were highlighted by the Congressional Budget Office (the "CBO") in its December 12, 2011 letter to Senator Hatch in which the CBO stated that a tax on financial transactions could have an adverse effect on employment in the short term and "[b]eyond the first few years, however, the tax's net impact on the economy is unclear". Such uncertainty is inevitable and it should not in MFA's view be injected into an economy that is still struggling to recover from the economic events of 2008. This is particularly true given the risks cited by the CBO that such a tax could result in increased borrowing costs for municipalities; affect the funding of State and local pension plans; and potentially impact the markets for U.S. Treasury securities.

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[6] H R. 3313 and S. 1787.

Conclusion

MFA appreciates the opportunity to provide these preliminary comments on the taxation of financial instruments and products and would welcome the opportunity to engage in a continuing dialogue with the Ways and Means and Finance Committees and their professional staffs, including the staff of the Joint Committee on Taxation. If you have questions regarding these comments, or if we can provide further information with respect to the issues affecting the taxation of financial instruments and products, please do not hesitate to contact Roger Hollingsworth or me at (202) 730-2600.

Respectfully submitted,

/s/ Richard H. Baker

Richard H. Baker
President and CEO

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