Making Camp a Marking Man

By Viva Hammer


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The remarks are on work undertaken for the JCT staff. Because members of both parties and both houses of Congress comprise the JCT, this work should not be construed to represent the position of any member of the committee.

The income tax has made a problem for itself. It wants you to measure your tax obligation every year at the gong of a bell that rings at the same time each year. But some things the tax law calls income don't answer to the gong of a bell. They happen whenever, and the tax law must decide what to do with income that behaves in a whenever kind of way.

Most wages are paid at the gong of a bell and most people eat their wages and can't put off their hunger too long. So, wages that are consumed can be taxed at the gong of a bell. Taxes on wages constitute the vast majority of the tax receipts of the United States.[1] It is a great luck for the tax system that people who eat what they earn still walk the earth.

Then there are increases and decreases in wealth — a kind of income — that don't feed hungry mouths and can be made to happen any time — deferred or accelerated, hidden, eliminated. And the tax law has a hard time deciding *whether* to tax these changes in wealth, *how* to tax them, and *when* to tax them.

And so — mark to market.

Mark to market is a tax gong for transactions that generate cash at odd moments: whenever it's convenient for everyone. If taxpayers entering into derivatives can ensure they'll collect cash with interest on their transaction then they mostly don't care when they receive it (especially if changing the day of receipt saves taxes).

Take for example a swap,[2] a contract that normally requires payment of amounts on a regular schedule. But in practice as long as collateral is posted and rights can be enforced, a party can fulfill its obligations under the contract at the inception of the contract or at its completion or every second Tuesday except if it's a British Bank holiday. Then the tax law needs to decide if the payments should be taxed whenever they're paid or some other time.

Take another example, a forward contract,[3] which normally requires a payment at termination. But to take advantage of tax rules, people invented prepaid forwards, and variable prepaid forwards, so that parties to forward contracts can control when they receive payments and how much tax they pay on those payments.

If everything else is equal it shouldn't matter which year tax is paid or who pays the tax, but everything else is never equal and Congress cares when tax is paid and who pays; it doesn't like taxpayers sharing their income and losses between each other nor does it like taxpayers moving their income and losses backwards and forwards in time

[1]Statistics about the individual income tax, including wages (reported on Form 1040), are *available at* http://www.irs.gov/uac/SOI-Tax-Stats-Individual-Income-Tax-Returns-Publication-1304-%28Complete-Report%29, in particular Table 1.4. For individual income taxes, it is possible to calculate wages as a percent of total income, or as a percent of AGI. For payroll taxes, see Social Security Annual Trust fund report, *available at* http://www.ssa.gov/history/pdf/tr11summary.pdf.

[2]"Notional principal contract" is the term used in the tax law that is closest to what is colloquially known as "swap." The tax term covers a narrower range of contracts than the colloquial term. An example of a contract that is encompassed within the term "swap" is a bullet swap, which is a single payment swap. Whether it constitutes a notional principal contract under current law is uncertain, see Joint Committee on Taxation, "Technical Explanation of the Tax Reform Act of 2014, A Discussion Draft of the Chairman of the House Committee on Ways and Means to Reform the Internal Revenue Code: Title III — Business Tax Reform," JCX-14-14, at 146 (Feb. 26, 2014).

[3]*Id.*, page 144.

too much. But derivatives allow taxpayers to reduce their taxes by timing when they recognize income and loss, for example, to use up net operating losses, or expiring capital losses.

And even when Congress decides to advantage one type of income over another, such as long term capital gains over earned income, it doesn't intend to make tax rates elective by using complex transactions for which the tax rules are unclear, like bullet swaps and prepaid forwards.

So plebeians pay tax regularly at ordinary income tax rates on the easy target of wages and the others choose when and how and how much tax they pay, if they know how to arrange the bits and pieces of tax rules to suit them.

And so — mark to market.

When you mark something to market you pretend you sell that something at the end of your tax year for the value it would have gotten if it had really been sold. It's a fiction that makes sure when you hear the gong you pay your tax, or at least calculate how much tax you owe.

People always complain about mark to market in the same ways: that they don't have the cash to pay the tax (liquidity) and they don't know what price to use in the pretend sale (valuation).

As to the first complaint — liquidity — mark to market is just another example of a rule that makes people pay tax even when they have no cash, such as the original issue discount rules. OID has been in the code a long time and no one has lost life, limb, or a good business over it. And over the 20 years section 475 has been in the code, no dirge has been sung for a securities dealer because it had to mark its portfolio to market for tax purposes.

As to the second complaint — valuation — which price to use in the pretend sale — for that we can get help from every financial discipline. It's simply disingenuous to say you don't know what mark to use. The accountants are required to mark a vast number of things. The risk managers mark, the regulators mark. People use guesstimations in tax all the time, for estate tax and for like-kind exchanges and for charitable donations.

And I have a challenge: taxpayers get your mark to market *wrong*, try it! Because 3 years later you're going to have to justify how you got the mark number on the tax return when the next year turned out to be so different. The marvelous thing about mark to market is that it's self correcting, and fast.

Tax is moving in the direction of everyone else: if it doesn't want to be left behind, mark to market is inevitable. Tax has required more and more things to be marked for tax in the last 33 years, starting with futures contracts on U.S. exchanges then over the counter foreign exchange contracts then securities by dealers and so on.

The Chair of the Ways and Means Committee Dave Camp decided early in his tenure that financial transactions were a poster child for disorganized tax law in need of good policy. The taxation of derivatives has not been addressed in a coherent manner by Congress.

Not only does this state of affairs lose money for the Treasury, it does so in a way that is unfair to taxpayers, both those who use derivatives and don't understand the laws, and those who are paying taxes on wages and have no opportunities for planning, the ones who bear the heaviest tax burden.

So on January 24, 2013, Mr. Camp released a Discussion Draft proposing mark to market for derivatives — only derivatives — not stocks, bonds or anything else. The tax community had talked so long about this idea it was almost a homecoming but also a surprise. The witnesses in the Hearing following the release were in favor, even though they came from sectors that you would not expect to support such an idea.[4]

But would Congress have the courage, the vision to implement mark to market?

People enjoying the benefits of the current unfair, disorganized system got upset.

Nevertheless, after significant revisions (including a new elegant definition of derivative), the Ways and Means draft Tax Reform Act of 2014 also required derivatives to be marked to market, with ordinary income treatment for all gain and loss.

I have some questions about Mr. Camp's Draft:

- What do you do with the premium on an option? Is it included in the mark in the first year the option is written, in the year the option ceases to be, or should the premium be spread over all the years the option is in existence?
- Has the Draft proposed the best method to tax hybrids — contracts that combine elements of derivatives and non-derivatives?
- Is the Draft's bifurcated method the best way to tax portfolios that mix derivatives and non-derivatives, one for straddles and one for hedges?
- Does the Draft subject the correct instruments to mark to market — the definition of derivatives has been greatly improved from the 2013 to the 2014 proposals — but there is still

[4]The testimony focusing on mark to market is *available at* http://waysandmeans.house.gov/uploadedfiles/viva_hammer_testimony_updated.pdf; http://waysandmeans.house.gov/uploadedfiles/william_paul_testimony.pdf; and http://waysandmeans.house.gov/uploadedfiles/shawn_travis_testimony.pdf.

uncertainty as to whether some contracts like repos and securities lending fit into the definition of derivatives.
- How should derivatives be taxed when one counterparty is outside the United States?
- What kinds of problems will arise when derivatives and the underlying are taxed in different ways, particularly when there's such a gulf between ordinary income rates and long-term capital gains rates?
- Might book tax conformity be the best solution, begun with book tax conformity for hedge identification?

Now I'm going to be devil's advocate and say that a theory with unanimous support is probably wrong which is true of mark to market too. Markets are so imperfect — how do we declare a price before something is actually sold in an arm's length transaction? Perhaps we should get rid of all tax fictions including interest expense accrual and depreciation and mark to market and stick to cash. That's at least provable, findable, and objective. Or so we thought till Bitcoin was invented.

Some people in the Capitol are disappointed that Dave Camp didn't introduce his draft Tax Reform Act of 2014 as an actual bill on the floor of the House of Representatives. Aren't lawmakers supposed to enact laws? But in raising their eyebrows these observers have revealed Camp's real achievement, and it isn't in the words of the excruciatingly detailed reform he released as a mere Draft.

It's found in the singular title: Draft.

You have to admit it's odd: the Ways and Means committee isn't normally in the role of think tank. Big ideas come from academics, from the President and Treasury Department, from the tanks paid to think. But when Dave Camp became Chair of the Ways and Means Committee after 20 years in Congress, he had 4 years to redo the tax code and he would have to do it with whatever resources he alone had. The vision was his, alone.

And his achievement was making it a shared vision, using new methods. Mr. Camp is a litigator and he knows that to win you have to be the best prepared. He was a junior member on Ways and Means when welfare reform failed twice before it was signed by a Democratic President. Big ideas can't just be thrown onto the floor of the House of Representatives with the prayer that they'll stick.

Hiring a dedicated tax reform staff, and harnessing the skills and experience of the House Legislation Counsel and the Joint Committee on Taxation, Camp began the journey to the thousand pages of reform, with three goals: reducing rates, while keeping distribution and revenue neutral. It was an almost impossible task.

But it happened: Mr. Camp has released a complete tax reform package, including legislative language, revenue tables, and technical explanation. I don't think any chair of the Ways and Means Committee has invested so many resources in such a manner, without any promises of support from the White House or Congress. People down the Hill call to tell me (in secret of course) that if the financial products Draft were enacted into law tomorrow it would *work*, and better than the law does today. It's not a high praise perhaps: the law today sets a low standard.[5]

Throughout the process of creating his Draft, Mr. Camp listened to the ideas of anyone who believed in tax reform. Regularly briefing the members of his Committee, he took on the role of educator — explaining the trade offs and reminding everyone that to reach good goals, there had to be sacrifices. In the several hearings held before the final release, Members and stakeholders observed the working out of the hard decisions needed for reform.

And in the final product, we got to see the tax law as it might be, before the mark-ups and the battles in Committee. For now, it will sit, be observed, and improved upon.

Already, people around the world are taking note. The United States has now written words to implement the acknowledged ideal for the taxation of derivatives. Antibiotics and personal computers and iPhones, and Google and Facebook were created in the United States and now we have the most innovative model for the taxation of derivatives.

Well, not quite. It hasn't gone to the Committees or the Chamber of the House of Representatives or the Senate or the White House.

Heard melodies are sweet, but those unheard

Are sweeter; therefore ye soft pipes play on.

John Keats
Ode on a Grecian Urn

[5]For a fuller discussion of the problems with current law, see my testimony on the 2013 tax reform discussion draft, *available at* http://waysandmeans.house.gov/uploadedfiles/viva_hammer_testimony_updated.pdf.