Testimony on Financial Products Tax Reform Discussion Draft

Subcommittee on Select Revenue Measures

Committee on Ways and Means

United States House of Representatives

Viva Hammer

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Chairman Tiberi, Honored Ranking Member Neal and distinguished members of the Subcommittee -

I am here to discuss the mark to market section of the Financial Products Tax Reform Discussion Draft. I have practiced U.S. tax law in Washington, New York and all over these United States for 22 years, serving in the Office of Tax Policy at the Treasury Department, and in private practice, serving all manner of taxpayers. Today I speak only for myself.

Derivatives are contracts agreed to between free parties, ever nimble and changing. Laws taxing derivatives are enacted after long contemplation by Congress, and are rarely discarded.

What happens when mostly fixed, ever accumulating tax rules govern ever nimble, changing derivatives?

Conventions to ease tax collection that worked satisfactorily for almost a century adapt poorly to derivatives. Tax liability is measured annually after formal realization events and there is a sharp distinction between ordinary income and capital gains. Derivatives are flexible about when and how often payments are made; they make a mockery of the ancient dividing line between capital and ordinary assets, with the arbitrary moment capital gains become taxable,[i] and derivative income and gains can easily be realized or avoided.

Aware of its inadequacy, the tax law lags behind the derivatives market, accreting through lightning-bolt attacks on disfavored transactions. The result is a jumble of rules lacking unifying principles. Well-advised taxpayers navigate the rules to suit their purposes, but for most people, the taxation of financial products is incomprehensible. The rules don't follow any other economic, accounting, or regulatory system and significant tax differences can result from minor differences in form. There is confusion about the tax consequences even of mundane and

certainly of esoteric transactions - the courts have only recently resolved the treatment of common foreign currency transactions, which have some of the highest volumes of all derivative contracts in the market.[ii]

Taxes are necessary for civilized society,[iii] but civilized tax laws should intrude into society as little as possible. They should apply to similarly situated taxpayers similarly; they should apply equivalently to economically equivalent transactions; they should be certain in application and easy to administer. And they should be flexible enough to accommodate new transactions as they develop. Today's derivative tax laws fail all these principles.

Timing

The Financial Products Tax Reform Discussion Draft marks a new beginning. The general rule – requiring marking to market of derivatives – is clear. It is makes an attempt at complying with the other tax principles too, applying to all taxpayers and almost all derivatives.

The financial products tax community is one marked by divided opinions,[iv] but based on the published record, support for extending the scope of mark to market taxation is strong.

Popularity alone is insufficient reason to make radical changes in the law, even if well-grounded in theory. We might be exchanging one set of uncertainties – in the meaning and application of existing law, for another set – in valuation. Valuation was the subject of protracted litigation in the *Bank One* case[v] which makes some people nervous.[vi] But the controversy was over derivatives early in their evolution, and the markets and models are more sophisticated today. Moreover, there was litigation over the constitutionality of the income tax soon after its birth and the imperative for finding a system to pay for our civilized society overcame beginners' nerves. Income tax law is still in its infancy compared to our other systems of law, and continues to mature. Marking to market is one much-anticipated adjustment to the system.

Supporting the expansion of mark to market are thirty years of smooth operation of section 1256, both for exchange traded derivatives and the non-exchange traded foreign currency contracts covered by section 1256(b)(1)(B).[vii] We also have twenty years of experience with section 475, which despite ominous predictions has worked reasonably well for dealers in securities. It is also elective now for traders in securities and dealers and traders in commodities as well – an option created at the industries' requests.[viii] Does anyone advocate reverting to a pre-section 475 regime for any of these types of taxpayers?

In addition to this useful experience is the ability to share mark to market intelligence with other disciplines. When we labor under current law to classify a credit derivative as an option, swap, guarantee, insurance, or financial instrument otherwise unidentified, the struggle is not for any

greater good, merely the unfortunate consequence of a dearth of rules. When we inquire regarding mark to market, we do so with accountants, financial engineers, risk managers, credit evaluators, economists, regulators, and traders whose compensation is based on the marking value. Experts in many fields are working on a common problem.

The recent financial crisis brought the propriety of mark to market techniques into question. Is it proper to blame the crisis on a measurement technique? The real causes are well-known and are rooted in basic principles of civilized society. Valuation of the derivatives that were at the visible tip of the iceberg cannot be blamed for the iceberg. The difficulty in writing rules that work equally well in crisis and in calm must not deter us from proposing rules adequate for a range of normal conditions. If necessary, Congress can delegate authority to adjust the rules when markets are in distress - as it did for the AHYDO and COD rules in 2009.[ix]

As a final justification for mark to market, let it be stated that if any derivative is so complex and elaborate that it cannot easily be valued then undoubtedly its current tax treatment is uncertain as well.

Mark to market means that taxpayers can take losses as well as gains without having to sell their positions. Many will welcome that.

Marking derivatives to market does not promise a perfect result, but it is better than the baseline: a jumble of inconsistent rules out of step with other systems relied on by taxpayers.

Mixed Straddles

The Discussion Draft offers new approaches for a taxpayer that has derivatives linked to other assets and liabilities in its portfolio. The government's fear is the straddle shelter, which unhinged the commodity and Treasury markets in the 1970s.[x] The conditions that allowed straddle shelters to arise – annual income measurement; the realization requirement; the gulf between ordinary income and capital gains rates – were left untouched. Instead, Congress developed multiple targeted fixes with exceptions for hedging and other favored transactions. Those fixes and their exceptions are the root of most of the complexity in the taxation of financial products today.

Imposing mark to market taxation with a uniform tax character eliminates most straddle shelter opportunities. If a taxpayer recognizes all change in value on all positions in its portfolio, there is no possibility to defer losses, accelerate gains or make conversions between ordinary and capital income. The general rule in the Discussion Draft imposes mark to market on all derivatives but does not change the treatment of other portfolio items such as stock and debt unless there are straddles. The hedging exception is also left intact.

The Discussion Draft is to be lauded for tackling the difficult issues of portfolios with a mix of derivatives and non-derivatives. But it lacks a unifying theory that answers both the government's need to protect against straddles and taxpayers' need to manage risk. For example, the mixed straddle proposal in the Discussion Draft still penalizes taxpayers who prudently hedge capital assets compared to those who do not.

One alternative approach would be to offer taxpayers an election to mark to market *all* their positions - derivative and non-derivative, pre- and post- the effective date of legislation. For corporate taxpayers, an election for character might also be feasible, because there is no capital rate advantage. For individuals, the current capital gains advantage is so great that no character election would be possible; Congress would have to impose one, as hopefully as part of a comprehensive review of capital and ordinary character questions.

Hybrids

Instruments that wrap derivative and non-derivative parts into one package - hybrids - will be difficult to tackle in the leap from the old rules to the new world of mark to market. So many tax regimes govern the treatment of hybrids and they are so deeply embedded into the economy - particularly convertible debt - that wrangling over these instruments could destroy the proposal. My suggestion is that if debate over hybrids becomes heated, they be struck from the proposal and retain legacy treatment. Taxpayers may then circumvent the mark to market rule by embedding derivatives in traditional instruments. In anticipation, Congress could append a rule penalizing those who devise or enter into hybrid instruments with a principal purpose of avoiding the mark to market provisions. Anti-abuse rules are poor substitutes for substantive rules and I hope better solutions will be found to bridge the gulfs between modern and legacy laws.

Character

The difference in taxation between ordinary and capital income is a vexed one. Derivative contracts exacerbate the pernicious consequences of a divide in search of justification. Reflecting Congress' concern with capital gains taxation, a joint hearing of the House of Representatives and the Senate was held on capital gains taxes in September 12, 2012.[xi] If after due contemplation Congress chooses to retain the ordinary - capital division, it is hoped that the carving up reflects contemporary finance and business practice.

Burdened by obsolete definitions and requirements meanwhile, the tax system must decide how to characterize payments that flow from derivatives.

While drafting Notice 2001-44[xii] addressing the treatment of swaps, I looked particularly at the question of character. At the time, some advisors opined that payments made at early

termination of a contingent payment swap were capital and payments made at maturity were ordinary. This was not a sensible result and at Treasury, we were searching for an alternative.

The literature offered little comfort.[xiii] Individuals obtained significant rate advantage for capital gains, purportedly to encourage investment and to compensate for inflation while holding appreciating capital assets. Corporates obtained no rate benefits for capital gains and were penalized with capital losses because they could not offset them against ordinary income, purportedly to prevent cherry-picking.

None of these explanations for the character rules were applicable to swaps, which did not require capital investment and were mostly held for short periods. How could they justify character electivity of final swap payments based on the time of termination? The character of payments flowing from other derivatives – such as forwards and options – was equally arbitrary and unrelated to any enunciated policy.

Treasury has made little headway on characterizing the flows from derivatives. Statutes, case law and tradition limit the Administration's authority to make systemic changes.

The Financial Products Tax Reform Discussion Draft makes the bold move of designating the character of the income or loss recognized on the mark to market of derivatives as ordinary. This has the advantage of relieving corporations of the risk of capital losses on non-hedging derivatives. It has the disadvantage of denying individuals the benefit of long term capital gains rates. Its greatest attraction is simplicity.

Source

The Financial Products Tax Reform Discussion Draft does not include a rule governing withholding of flows from derivatives. This is unfortunate. Recent attention has focused on transactions used to avoid U.S. withholding tax relying on the source of swap payments, which resulted in complex anti-avoidance laws lacking a policy foundation.

The United States has long held the view that certain types of income - fixed or determinable annual or periodical (FDAP) income - should be withheld on when locally sourced and flowing out to nonresidents. Responding to the question of whether swap flows should be subject to withholding, the IRS issued Notice 87-4, providing that interest rate swap payments are sourced to the residence of the recipient of the income, unless such payments constituted effectively connected income.[xiv] The rule was so favorable to the industry that it requested and received an expansion of the rule to interest rate swaps, caps, floors, collars, and similar instruments that pay periodically by reference to an interest rate index and the taxpayer's functional currency.[xv]

Eventually flows from other types of swaps were also blessed with the exemption from withholding by way of the sourcing rule.[xvi]

Even at the time commentators questioned the appropriateness of the sourcing rule for equity swaps and suggested it might jeopardize the withholding tax on dividends.[xvii] Others proposed a limited exemption from FDAP for swap payments as a better way to encourage the swap market without endangering the withholding tax.

The swap market matured, dividends increased after the drop in tax rates on dividends,[xviii] and banks marketed equity swaps that gave nonresidents dividend-substitutes withholding tax free, relying on a plain reading of the swap sourcing regulation. These transactions attracted press attention.[xix]

At that moment, Congress had the opportunity to consider the purpose of withholding tax and the kinds of flows that should be subject to withholding, but instead, it passed a complex anti-abuse regime targeted at these transactions. Needless to say, the original swap sourcing regulation remains in place.

The history of the swap sourcing rule and its repercussions is a model for the development of the taxation of derivatives. A tax rule is drafted when a market in its infancy; the rule becomes obsolete as the market develops; practitioners take advantage of the old rule, and – then lawmakers pass a narrowly-targeted elimination of the perceived abuse instead of attempting to develop rules to reconcile new market realities and enduring tax principles.

I trust that as the discussion of tax reform progresses, rules for withholding on derivative flows is considered in the context of a comprehensive theory on withholding.

Conclusion

I applaud the Committee on Ways and Means' Comprehensive Tax Reform initiative. I support its goal in simplifying the taxation of financial products, grounding proposed rules in sound tax principles and in modern business practice.

ENDNOTES

[i] For a superb discussion of capital gains taxes and derivatives, see Farber, Michael S., Capital Ideas: The Taxation of Derivative Gains and Losses," *Tax Notes*, Vol. 126, No. 12, 2010 (March 22, 2010).
[ii] See pages 16-18 of http://www.bis.org/publ/otc_hy1011.pdf. See my article, "Section 1256 and Foreign Currency Derivatives: 30 Years of Uncertainty," in *Taxation of Financial Products and Transactions* 2013, Practicing Law Institute, New York 2013, which can be accessed at http://vivahammertax.com/wp-content/uploads/2010/08/FX-update-2012.pdf also "1256 and Currency Contracts: It's a Mess Inside," in the compendium "Examining the Straddle Rules after 25 Years," *Tax Notes*, Dec. 21, 2009: 1315, Doc 2009-26203, or 2009 TNT 242-5.
[iii] "It is true…that every exaction of money for an act is a discouragement to the extent of the payment required, but that which in its immediacy is a discouragement may be part of an encouragement when seen in its organic connection with the whole. Taxes are what we pay for civilized society, including the chance to insure." Oliver Wendell Holmes *Compania General De Tabacos De Filipinas v. Collector of Internal Revenue*, 275 U.S. 87, 100, dissenting opinion (21 November 1927).
[iv] The revealing example of this can be found is in the New York State Bar Association Tax Section, *Report on Notional Principal Contract Character and Timing Issues* (May 22, 1998), reprinted in 98 *Tax Notes Today* 104 -78 (June 1, 1998).
[v] *See* Bank One Corp., 120 TC 174, Dec.55,138 (2003); 62 JPMorgan Chase & Co., CA-7, 2006-2 USTC ¶50,453 JPMorgan Chase & Co. was successor to Bank One Corporation after the merger of Bank One Corporation and JPMorgan Chase & Co. in 2004.
[vi] The nervousness lies in part in the benchmarks used to hypothesize a "market" transaction under a modeling system that may vary substantially among the market participants. Nevertheless, in a deep and functioning market, the modeling systems used by the different participants will generally converge on a sufficiently narrow range to permit calculation of accurate amounts of gain and loss by reference to publicly available data.
[vii] And defined in section 1256(g)(2).
[viii] Collinson, Dale S. and Michael E. Bauer, "Mandatory or Elective Application of Code Sec. 475(e) to Commodities Dealers – The Non-Code Sec. 1256 Consequences," *J. Tax'n of Financial Products*, Vol. 10 Issue 4 (2012):39.
[ix] "Taxation of High-Yield Debt – Beware the End of the Reprieve," *Tax Notes*, Vol. 124, No. 11 (Sept. 14, 2009).
[x] See articles cited in footnote 2 for a discussion of the straddle shelters and the government's reaction to them.
[xi] See, http://waysandmeans.house.gov/calendar/eventsingle.aspx?EventID=308360
[xii] 2001-2 C.B. 77.
[xiii] See, for example, Poterba, James M. "Capital gains tax policy toward entrepreneurship." *National Tax Journal* Vol. 42, no. 3 (1989): 375-389; Auerbach, Alan J. "Wealth Maximization and the Cost of Capital." *The Quarterly Journal of Economics* (1979): 433-446; Bull, N., J. Cilke, C. P. Giosa, and C. E. Larson. "The Persistence of Individual and Corporate Capital Gains and Losses." *NATIONAL TAX JOURNAL* Vol. 57 (2004): 525-546; Dammon, Robert M., Chester S. Spatt, and Harold H. Zhang, "Optimal consumption and investment with capital gains taxes." *Review of Financial Studies* Vol. 14, no. 3 (2001): 583-616; Keuschnigg, Christian, and Soren Bo Nielsen. "Start-ups, venture capitalists, and the capital gains tax." *Journal of Public Economics* Vol. 88, no. 5 (2004): 1011-1042; Kornhauser, Marjorie E. "Origins of Capital Gains Taxation: What's Law Got to Do with It, The." *Sw. LJ* 39 (1985): 869.

Cartee, Joseph Byron. "Historical Essay and Economic Assay of the Capital Asset Definition: The Taxpayer and Courts are Still Mindfully Guessing while Congress Doesn't Seem to (Have a) Mind, A." *Wm. & Mary L. Rev.* 34 (1992): 885.

[xiv] Rev. Rul. 87-4, 1987-1 C.B. 180.
[xv] Temp. Treas. Reg Section 1.863-7T (Allocation of Income Attributable to Certain Notional Principal Contracts Under Section 863(a)) (1989).
[xvi] Treas. Reg. Section 1.863-7; Prop. Treas. Reg. FI-16-89 (Regulations Under Section 446 of the Internal Revenue Code of 1986: Application of Section 446 With Respect to Notional Principal Contracts), 91 TNT 144-1.
[xvii] New York Bar Association Tax Section, Committee on Financial Instruments, *Report on Proposed Regulations on Methods of Accounting for Notional Principal Contracts* (1992), reprinted in 92 *Tax Notes Today* 10-36 (Jan.15, 1992).
[xviii] Jobs and Growth Tax Relief Reconciliation Act of 2003, 108th Cong. (2003); The Tax Increase Prevention and Reconciliation Act of 2005, H.R. 4297, 109th Cong. (2005) extended the lower rate through 2010 and lowered the rate on qualified dividends from 5% to 0% for individuals in the 10% and 15% income tax bracket.
[xix] Anita Raghavan, "IRS Probes Tax Goal of Derivatives," *WSJ*, July 19, 2007, at C1; Anita Raghavan, "Happy Returns: How Lehman Sold Plan to Sidestep Tax Man – Hedge Funds Use Swaps To Avoid Dividend Hit," *WSJ*, Sept. 17, 2007, at A1; Anita Raghavan, "Hedge Funds Could Lose Offshore Shelter – Senate Panel Weighs Targeting Derivatives by Change in Tax Rules," *WSJ*., Oct. 1, 2007, at C1; Anita Raghavan, "Wall Street Facing New Senate Probe – Subpoenas Seek Detail On Efforts to Sidestep Taxes on Dividends," *WSJ*, Jan. 15, 2008, at C1.