U.S. Analyzes ‘Great Difficulties’ of Taxing Financial Products
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By Richard Rubin
    Dec. 6 (Bloomberg) -- U.S. lawmakers seeking to overhaul
the Internal Revenue Code are examining how derivatives and
other financial products should be treated and how investors can
structure transactions for more favorable tax results.
    Financial instruments, including exchange-traded notes and
options, are susceptible to manipulation, according to a report
by the nonpartisan Joint Committee on Taxation. Taxpayers can
structure transactions to defer income, accelerate deductible
losses and take advantage of lower capital gains rates.
    The “ability to combine basic instruments and to create
new instruments represents financial innovation that might lower
the cost of capital,” the report said. “The flexibility of
financial instruments also creates great difficulties in the
taxation of financial instruments.”
    The report was prepared for a hearing today of the House
Ways and Means Committee and Senate Finance Committee. The
session will be the two panels’ second joint hearing since 1940.
The first, on treatment of debt and equity, was held in July.
    The committees are holding the hearing as part of a series
of discussions on a tax-code overhaul. Ways and Means Chairman
Dave Camp, a Michigan Republican, wants to restructure the tax
code to reduce the corporate and individual tax rates to 25
percent without lowering tax collections.
    Achieving that goal will require eliminating tax breaks or
changing underlying tax rules, such as the way derivatives are
taxed.

                     ‘Heading Someplace’

    “It means that they are heading someplace,” Bruce
Thompson, vice president at Van Scoyoc Associates Inc., a
Washington lobbying firm, said of the hearing. “Now where they
are, I’m not sure.”
    Thompson, former senior director of global government
relations at Merrill Lynch & Co., said financial institutions
that benefit from the current tax system should be wary.
    “Ten years ago, they were invulnerable in Washington.
They’re not that way now,” he said. “There’s obviously
continued anger at the industry. That certainly hasn’t gone
away, and it’s from both the left and the right.”
    Several features of the U.S. revenue system make it
difficult to tax financial products. Those include the ability
to defer taxation using some financial instruments and the
preferential 15 percent rate for long-term capital gains, said
Viva Hammer, a former Treasury Department official who was
responsible for tax policy related to financial institutions and
products.
    “The ability to toggle in and out of capital treatment
allows tremendous flexibility in planning your taxes,” she
said.

                        Mark to Market

    Hammer said Congress should require mark-to-market taxation
of derivatives at ordinary income tax rates.
    “Everyone knows what the right answer is, but no one has
the courage to impose it,” she said.
    Mark-to-market accounting is intended to require companies
to assign fair value to financial instruments and to limit the
benefits of deferring realization of gains.
    David Miller, one of the witnesses set to speak at today’s
hearing, in 2008 proposed that large companies and wealthy
individuals face a mark-to-market tax regime on publicly traded
securities and derivatives. Miller is a partner at Cadwalader,
Wickersham & Taft LLP in New York.
    Alex Raskolnikov, a professor at Columbia Law School in New
York who is scheduled to testify today, supports mark-to-market
treatment of derivatives at ordinary income tax rates.

                    ‘Mind-Numbing’ Rules

    “The mind-numbing complexity of the current rules, the
considerable compliance costs they impose, and the need for
Congress to continually monitor and respond to financial
innovation will all disappear,” he told a Ways and Means
subcommittee in 2008.
    The global over-the-counter swaps market is $708 trillion,
according to the Basel-based Bank for International Settlements.
Derivatives, including swaps, are financial contracts tied to
interest rates, currencies or events, such as a company default.
    Ken Bentsen, the executive vice president for public policy
and advocacy at the Securities Industry and Financial Markets
Association, a trade group in Washington, said he welcomed the
committee’s discussion.
    “These are very good information-gathering opportunities
for the members of the committee that will help them as they
hopefully ultimately move toward broad-based tax reform,” he
said.
    Bentsen said he would caution lawmakers about the potential
unintended consequences of any changes in the tax treatment of
financial products.
    “They’re underpinnings of the economy that we have
today,” he said.

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