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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