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FRICTIONS AS A CONSTRAINT ON TAX PLANNING

David M. Schizer*

The government often uses narrow tax reforms to target specific planning strategies. Sometimes the targeted transaction is stopped. But in other cases, taxpayers press on, tweaking the deal just enough to sidestep the reform. The difference often lies in transaction costs, financial accounting, and other "frictions," which are constraints on tax planning external to the tax law.

This Article contributes a methodology for determining whether frictions will block end runs, and illustrates the effect of frictions by comparing the constructive sale rule of section 1259 with the constructive ownership rule of section 1260. These reforms use the same statutory language to target tax motivated derivatives transactions, but taxpayers have responded differently. Theoretically, taxpayers can avoid either rule through relatively modest changes in economic return. Although the strategy is common for section 1259, however, it is rarely used for section 1260 because securities dealers cannot supply the necessary derivative. Thus, if a friction blocks a transaction, the tax law does not have to block it, too. More attention to frictions is warranted, and legal academics should offer greater assistance. Without a grounding in frictions, narrow reforms are unlikely to play a constructive role.

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INTRODUCTION

For years, the tax system has wrestled with the problem of wasteful tax planning. Because similar transactions are taxed differently, taxpayers rearrange their affairs to qualify for the lowest tax. They do so not only in so called tax shelters, which are not the focus of this Article, but also in real business deals such as sale of an asset or financing of a venture. These efforts would cease if all transactions were taxed consistently. Yet there is no political appetite for ambitious reforms that theoretically offer consistency, such as mark-to-market accounting or a consumption

tax.¹ Instead, in recent years the government has used a less satisfying strategy: narrow reforms that target specific planning strategies.² Sometimes these transactional responses stop the targeted transaction. But in other cases taxpayers press on, tweaking the deal just enough to sidestep the reform.³ These avoidable measures cannot raise revenue or increase the tax burden on wealthy taxpayers. Instead, end runs consume resources and warp transactions, yielding social waste.⁴

A key question, therefore, is why some narrow rules are easily avoided, but others are not. The central theme of this Article is that the answer lies outside the tax law itself. For example, taxpayers abandon end runs because of high transaction costs, adverse financial accounting, or unappealing regulatory treatment. This Article borrows from the economics literature, and specifically from Professors Scholes and Wolfson, in using the term "frictions" to describe constraints on tax planning external to the tax law.⁵ When the right kind of friction reinforces a narrow reform, end runs will be uncommon. This Article contributes a method-

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1. Under mark-to-market accounting, investment returns are taxed annually based on changes in the asset's fair market value, regardless of whether the property has been sold. See generally David J. Shakow, *Taxation Without Realization: A Proposal for Accrual Taxation*, 134 U. Pa. L. Rev. 1111, 1111-18 (1986) (proposing broader use of mark-to-market taxation). Under a consumption tax, investment returns generally would not be taxed. See generally William D. Andrews, *A Consumption-Type or Cash Flow Personal Income Tax*, 87 Harv. L. Rev. 1113, 1113-23 (1974) (arguing that a consumption tax would be more simple, fair, and efficient than an accretion-type tax). Political and other obstacles to either reform are thoroughly explored elsewhere. See generally *Uneasy Compromise: Problems of a Hybrid Income-Consumption Tax* (Henry J. Aaron et al. eds., 1988).

2. These "revenue raisers" have figured prominently in recent tax legislation. This Article focuses on the constructive sale rule of section 1259, I.R.C. § 1259, and the constructive ownership rule of section 1260, id. § 1260, which are discussed in Parts II and III, respectively. There are many other recently enacted transactional responses. See, e.g., id. § 355(e) (placing limits on the so called "Morris trust" spin-off); id. § 1059 (responding to the Seagrams transaction); id. § 901(k) (prescribing holding period rules for claiming foreign tax credits); id. § 163(l) (denying interest deductions on debt that converts mandatorily into equity). Unless otherwise indicated, the phrase "section" refers to sections of the Internal Revenue Code of 1986 (I.R.C.) as amended and codified at 26 U.S.C. (1994 & Supp. V 1999). The phrase "regulation" refers to regulations promulgated by the U.S. Department of the Treasury (the Treasury) to implement the Internal Revenue Code.

3. Professor Yin has described this process as the "Tax Avoidance game." George K. Yin, *Getting Serious About Corporate Tax Shelters: Taking a Lesson From History*, 54 SMU L. Rev. 209, 216-17 (2001) (describing taxpayer efforts to evade incremental reform, and resulting inefficiency caused by this process).

4. See generally Joel Slemrod & Shlomo Yitzhaki, *The Costs of Taxation and the Marginal Efficiency Cost of Funds*, 43 Int'l Monetary Fund Staff Papers 172, 179-82 (1996) (listing five potential sources of social waste from tax reforms: the costs of substitution effects, avoidance, compliance, administration, and evasion).

5. Myron S. Scholes & Mark A. Wolfson, *Taxes and Business Strategy: A Planning Approach* 7 (1992) ("By frictions we mean transaction costs incurred in the marketplace that make implementation of certain tax-planning strategies costly."). Professor Scholes is a Nobel Prize winning economist, and Professor Wolfson is a distinguished academic

ology for determining whether the right kind of friction is present, and offers examples to enhance the empirical understanding of frictions.

While many government officials recognize the significance of frictions, they lack key information. In general, reforms should cover close substitutes, as Professors Shaviro and Weisbach have shown.⁶ Yet when does one transaction substitute for another? The question is difficult and underexplored. The argument here is that in sophisticated commercial transactions, the answer lies not so much in murky notions of consumer taste, but in accounting conventions, securities laws, and other frictions that are unfamiliar to many government tax reformers. Empirical work is especially important because many frictions have weakened in recent years, due to globalization, deregulation, and financial engineering; indeed, it is well understood that these developments pose new challenges to the tax system.⁷ But certain frictions endure, a helpful reality that

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accountant. Another respected economist, Joseph Stiglitz, has also emphasized the key role of transaction costs and capital market imperfections in constraining tax avoidance:

In a perfect capital market, these principles of tax avoidance are so powerful as to enable the astute taxpayer to eliminate all taxation on capital income, and possibly all taxation on wage income as well. The fact that the tax system raises revenue is thus a tribute to the lack of astuteness of the taxpayer and/or the lack of perfection of the capital market.

This in turn has an important implication: one should treat with some skepticism models which attempt to analyze the effects of taxation *assuming* rational, maximizing taxpayers working within a perfect capital market.

Joseph E. Stiglitz, *The General Theory of Tax Avoidance*, 38 *Nat'l Tax J.* 325, 335 (1985).

6. Daniel N. Shaviro, *An Efficiency Analysis of Realization and Recognition Rules Under the Federal Income Tax*, 48 *Tax L. Rev.* 1, 31 (1992) [hereinafter Shaviro, *Realization and Recognition Rules*] ("It is a standard optimal tax insight that we want to tax high-rent, relatively inelastic events . . ."); David A. Weisbach, *Line Drawing, Doctrine, and Efficiency in the Tax Law*, 84 *Cornell L. Rev.* 1627, 1663 (1999) (emphasizing relevance of cross elasticity to line drawing). This Article extends the efforts of Professors Shaviro and Weisbach to apply optimal tax principles to incremental tax reform. They seek to base legal distinctions on the cross elasticity of taxpayer demand for various substitutes. Yet Professors Shaviro and Weisbach do not explore the specifics of what cross elasticity means in sophisticated commercial transactions. Professor Schlunk has recently questioned their recommendation by asserting that elasticity is not a meaningful concept in such transactions. He argues that, through financial engineering, taxpayers typically can package cash flows in different ways that are all equally appealing, but are taxed differently. Herwig J. Schlunk, *Little Boxes: Can Optimal Commodity Tax Methodology Save the Debt-Equity Distinction?*, 80 *Tex. L. Rev.* (forthcoming 2002) (manuscript at 2-3, on file with the *Columbia Law Review*). While Professor Schlunk's argument could well apply in the long run, depending upon the evolution of financial engineering and deregulation, his claim often does not hold under current conditions. A main point of this Article is that, in some commercial transactions, elasticity is a meaningful concept because of frictions. An important challenge for reformers is to understand when frictions are sufficiently meaningful to constrain planning, and when they are not.

7. See, e.g., Office of Tax Policy, U.S. Dep't of the Treasury, *The Deferral of Income Earned Through U.S. Controlled Foreign Corporations* 75 (2000) [hereinafter *The Deferral of Income*] ("The ability of taxpayers to provide services (as well as goods) over the Internet and through other electronic media will present further challenges to the current subpart F regime."); Reuven S. Avi-Yonah, *The Structure of International*

some commentators have assumed away.⁸ Although over long periods of time some frictions will dissipate, many will remain relevant in the next decade or more, and it is vital to identify these. While accountants on business school faculties have produced empirical work on frictions, legal academics largely have not, though they are well positioned to do so because legal regimes other than the tax law are an important source of frictions.⁹ Studying frictions thus should become a priority for legal commentators.

This Article has three parts, a general discussion followed by two case studies. After outlining the values at stake in targeting tax planning, Part I explains which frictions constrain end runs.¹⁰ Most promising are “dis-

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Taxation: A Proposal for Simplification, 74 Tex. L. Rev. 1301, 1304 (1996) (arguing that principles of international tax are obsolete because of “the growth of internationally mobile capital markets for portfolio investment and the rise of integrated multinational enterprises”); David F. Bradford, Fixing Realization Accounting: Symmetry, Consistency and Correctness in the Taxation of Financial Instruments, 50 Tax L. Rev. 731, 736 (1995) (investigating “the frictionless world” because “[o]ne of the most striking developments in financial markets in recent years has been a steady decline in transactions costs,” and so “[t]he Article thus can be read as exploring problems that can be expected to get worse, absent redesign of the [tax] rules”); Schlunk, *supra* note 6 (manuscript at 3) (“For as financial innovation becomes cheaper and cheaper (and in the limit becomes costless), inconsistent tax categories can and will be ever more quickly exploited in a ‘race to the bottom’ yielding, in the end, an effectively elective (but therefore consistent) tax structure for all income items.”); Alvin C. Warren, Jr., Commentary, Financial Contract Innovation and Income Tax Policy, 107 Harv. L. Rev. 460, 461 (1993) (“Continuous disaggregation, recombination, and risk reallocation have produced a changing array of new financial contracts that pose a serious challenge for the income tax.”).

8. For example, financial innovation is known to create tax planning opportunities. In making this important point, commentators typically assume away transaction costs and other frictions. See, e.g., Bradford, *supra* note 7, at 733 (“I focus on a world with no transactions costs.”); Warren, *supra* note 7, at 467 (“To simplify the exposition, we have made some assumptions that the reader may regard as unrealistic. For example, we have ignored transaction costs and credit risks.”). This assumption is useful in dramatizing long term challenges to the system, but less helpful in crafting narrow transactional reforms that, for now, are the only ones that are politically viable. These measures work best when reinforced by frictions, and so we need to know where the frictions are.

9. For a survey of the accounting literature, see Douglas A. Shackelford & Terry Shevlin, Empirical Tax Research in Accounting, 31 J. Acct. & Econ. (forthcoming 2001) (manuscript at 7–35, on file with the *Columbia Law Review*). The role of securities and commodities laws, incomplete markets, credit risk, and other frictions remains largely unexplored. The legal academy generally has not joined in this inquiry, with the exception of Mark Gergen, whose insightful but brief article emphasizes “the down-to-earth factors of transaction costs, credit risk and legal risk as constraints on financial contracting.” Mark P. Gergen, Afterword: Apocalypse Not?, 50 Tax L. Rev. 833, 834 (1995). As “transaction cost engineers,” lawyers have a comparative advantage in probing legal regimes and transaction costs. Ronald J. Gilson, Value Creation by Business Lawyers: Legal Skills and Asset Pricing, 94 Yale L.J. 239, 255 (1984).

10. In highlighting frictions as a constraint on tax planning, this Article parts company with Mark Gergen and Paula Schmitz, who emphasize tax uncertainty. See Mark P. Gergen & Paula Schmitz, The Influence of Tax Law on Securities Innovation in the United States: 1981–1997, 52 Tax L. Rev. 119, 121 (1997). Yet uncertainty about tax treatment will not always keep a tax advantaged deal from catching on. As Professor

continuous" frictions that impose unavoidable and significant costs when taxpayers depart from the transaction covered by the reform. When supported by these frictions, even a narrow reform can be effective, a term used here to describe success in stopping the targeted planning. Yet reformers must learn esoteric institutional details, and must consider both the instability of frictions over time and the effects on behavior other than tax planning.

To illustrate Part I's generalizations, Parts II and III compare two recent statutory provisions. Both target a tax motivated use of derivative financial securities.¹¹ These reforms use the same statutory language, but taxpayers have responded differently, and frictions explain this difference. The first reform, the "constructive sale" rule of section 1259, targets use of derivatives in effect to sell an appreciated asset without paying tax. The second, the "constructive ownership" rule of section 1260, targets use of derivatives in effect to invest in a hedge fund (or other pass-thru entity) without the usual adverse tax consequences (i.e., less deferral and a higher tax rate).¹² Theoretically, taxpayers can avoid either rule through relatively modest changes in the derivative's economic return. As discussed in Part II, this strategy is commonly used to avoid section 1259, a reality understood by government officials when the measure was enacted, and tolerated for reasons of politics and administrability. In contrast, it is considerably more difficult, and thus much less common, for taxpayers to use this strategy to avoid section 1260. As Part III shows, the difference, which was not well understood by section 1260's drafters, is that it is hard for securities dealers to supply derivatives that theoretically avoid the rule. This is not to say that section 1260 is *never* avoided. Securities dealers are constantly exploring ways to crack this nut. Meanwhile, taxpayers have substituted insurance contracts and investments in offshore insurance firms for derivatives, although these strategies are impeded by other frictions and tax rules, and could be blocked entirely by surgical responses from the Treasury.

The case studies offer three general lessons. First, even the *same* statutory language can induce different taxpayer responses, depending upon

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Bankman has emphasized, corporate taxpayers often are tolerant of tax risk because the odds of an audit are low. Joseph Bankman, *The New Market in Corporate Tax Shelters*, 83 *Tax Notes* 1775, 1776 (1999). Likewise, several structures have thrived notwithstanding uncertain tax treatment. See, e.g., David Schizer, *Debt Exchangeable for Common Stock: Electivity and the Tax Treatment of Issuers and Holders*, *Derivatives Rep.*, Mar. 2000, at 10, 10, 18 [hereinafter Schizer, *Debt Exchangeable for Common Stock*] (noting that the tax treatment of DECS is uncertain, but transaction is common).

11. A derivative financial security is a contract whose value derives from some financial fact. See generally Global Derivatives Study Group, *Derivatives: Practices and Principles* 28 (1993) ("In the most general terms, a derivatives transaction is a bilateral contract or payments exchange agreement whose value derives, as its name implies, from the value of an underlying asset or underlying reference rate or index."). For instance, an option to buy stock is a derivative.

12. For a description of hedge funds, see *infra* note 203.

the frictions involved. Second, the dealer's difficulties in hedging can be a key friction in derivatives transactions. Finally, when a tax reform impedes use of derivatives to pursue a planning strategy, taxpayers are likely to try insurance and offshore investments. The government should anticipate this predictable response in crafting reforms. Indeed, the growing economic convergence between derivatives and insurance—while their tax treatment remains thoroughly inconsistent—is a salient capital markets trend that warrants greater attention from reformers and commentators.

I. BACKSTOPPING NARROW RULES WITH FRICTIONS

This Part offers general guidance about which narrow tax reforms can easily be avoided, and which cannot. In other words, what sort of frictions will prevent end runs? Moreover, what pitfalls are likely to arise when reformers rely on frictions? Before these issues are explored, two threshold questions require attention. First, why should the government strive to curtail tax planning and, relatedly, why should we be concerned when taxpayers circumvent these efforts? Second, if such avoidance is undesirable, why not broaden the reform's scope so that end runs can be blocked without relying on frictions?

A. Policy Goals in Targeting Tax Planning

The reasons for curtailing tax planning are familiar and can be stated briefly. Obviously, more revenue is collected, so the government is funded without need for other taxes that are less appealing. In addition, social waste is reduced as taxpayers refrain from tax motivated behavior.¹³ Since wealthy and well advised taxpayers have an edge in planning, limiting this advantage can lead to a more equitable distribution of tax burdens.¹⁴ The average taxpayer's faith in the system is preserved, promoting voluntary compliance and the attendant savings in enforcement costs.¹⁵

Yet not every attack on tax planning is advisable. Planning functions as a tax reduction, and in some cases taxes *should* be reduced.¹⁶ It is

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13. See generally Harvey S. Rosen, Public Finance 284–303 (5th ed. 1999) (noting that a tax is efficient if it raises revenue with a minimum of behavioral distortions and other sources of deadweight loss).

14. This conclusion assumes that the benefits of planning are not fully capitalized into pretax prices, and also that other features of the Tax Code, such as the rate structure, have not already been adjusted to account for the planning.

15. See Joel Slemrod, Trust in Public Finance 2 (Jan. 2001) (unpublished manuscript, on file with the *Columbia Law Review*) (discussing “whether taxpayers’ evaluations of government expenditures or the fairness of the tax system affect their willingness to comply with the tax law”). See generally Taxpayer Compliance (Jeffrey A. Roth et al. eds., 1989) (offering empirical and theoretical discussions of taxpayer compliance).

16. See, e.g., Weisbach, *supra* note 6, at 1679 (stating that one of the “most important factors” in deciding where to draw a line in the tax law is “whether transactions are taxed appropriately when considered by themselves”).

usually better, though, to reduce the rate or even repeal the undesirable tax, thereby eliminating the need for wasteful taxpayer self help.¹⁷ Since explicit tax reductions are relatively easy to implement (or, at least, they present different issues), this Article focuses instead on challenges in maintaining or increasing the tax burden. In other words, the targeted planning is assumed to yield an inappropriately low tax.

Even so, targeting planning can be costly. Reforms add complexity to the law, consume administrative resources, raise compliance costs, and may also undermine "good" transactions that are not tax motivated.¹⁸ Most importantly for our purposes, halfhearted efforts may merely add to the cost of planning without deterring anyone, thereby increasing social waste without collecting more revenue.¹⁹ Indeed, even if some planning is stopped, total planning waste could still increase if those who continue to plan face higher costs. The added waste from their continuing efforts sometimes will outweigh the savings from those who stop.²⁰ If political or administrability constraints keep a reform from being effective, it may be better to do nothing, or even to make the targeted planning easier. Al-

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17. The "check the box" rules are an example of this approach. See Treas. Reg. § 301.7701-3 (2001). Under these regulations, taxpayers are able to choose whether designated entities will be treated as corporations or pass-thru entities for tax purposes. Under prior law, this status turned on a four factor test. Since the test was malleable, taxpayers often could attain the status they desired, but had to tweak their transactions to get there. The "check the box" rules spare them the trouble. An unexpected effect has been to prompt sophisticated cross border tax planning, in which taxpayers use so called hybrids (which are corporations for foreign tax purposes but pass-thru entities for U.S. tax purposes) to reduce their foreign tax burdens without increasing their U.S. burden. See *The Deferral of Income*, supra note 7, at 62-64 (illustrating use of hybrids to avoid rules for controlled foreign corporations). A key issue with explicit repeals and tax reductions of this kind, then, is to ensure that they are used only as intended. This issue is beyond this Article's scope.

18. See David A. Weisbach, *An Economic Analysis of Anti-Tax Avoidance Doctrines*, 4 *Am. L. & Econ. Rev.* (forthcoming 2002) (manuscript at 19-21, on file with the *Columbia Law Review*) (describing tradeoffs in anti-avoidance measures, including concerns about "error," i.e., application to transactions that are not tax motivated). The meaning of "good" depends on the context and normative value being pursued. For instance, we may wish to impose a tax increase or other penalty only when taxpayer demand for the transaction is inelastic or when the transaction is motivated primarily by tax considerations. Likewise, we may deny a tax preference if the transaction does not generate positive externalities, or if the taxpayer has too high an income.

19. Professor Shaviro has recently emphasized this point. See Daniel N. Shaviro, *Economic Substance, Corporate Tax Shelters, and the Compaq Case*, 88 *Tax Notes* 221, 223 (2000) [hereinafter Shaviro, *Economic Substance*] (stating that the desirability of economic substance doctrine depends in part on "the extent to which it succeeds in generating such deterrence rather than simply inducing taxpayers to jump through a few extra hoops before getting the desired tax consequences anyway").

20. Professor Kaplow has emphasized this tradeoff between welfare gains from deterring marginal taxpayers, on one hand, and welfare costs from inducing more waste by inframarginal taxpayers, on the other. Louis Kaplow, *Optimal Taxation with Costly Enforcement and Evasion*, 43 *J. Pub. Econ.* 221, 233 (1990).

though revenue would not be raised, at least planning waste would be reduced.

Nevertheless, even relatively ineffective efforts to curtail planning sometimes yield symbolic benefits. By responding to highly publicized planning, the government signals to average taxpayers that everyone, including wealthy taxpayers, must pay tax. Average taxpayers thus may be encouraged to comply voluntarily with other tax rules (for example, to pay tax on untraceable cash receipts). Ironically, this benefit can arise even if the measure is toothless—as long as average taxpayers lack the sophistication to *see* that it is toothless. For sophisticated transactions, average taxpayers could well be fooled in this way for some period of time, but eventually they are likely to learn the truth, for instance, through media coverage of avoidance.²¹

The appeal of any effort to curtail planning depends upon the particular balance of all of these benefits and costs.²² This Article focuses on a key component of this inquiry: whether a narrow reform will *actually stop* the targeted planning. In other words, when will a measure offer benefits beyond the symbolic?

B. *Impediments to Use of Broad Legal Responses*

A broad response is more likely to stop the targeted planning, but often is not feasible. Indeed, fundamental tax reform, such as universal mark-to-market accounting, could eliminate planning by treating all equivalent transactions consistently and accurately. But obstacles to this step are well known.²³ In a more modest strategy, broad anti-abuse rules would target particular planning strategies, covering not only the current version, but also every imaginable mutation. Yet to avoid burdening “good” transactions, we sometimes will need detailed exceptions or subtle tests that are expensive to draft and enforce.²⁴ While the tax bar often will help flag overbroad applications, and also may “save” good transac-

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21. Cf. Daniel Shavero, *When Rules Change* 19–21 (2000) (assuming, based on rational expectations methodology, that it is difficult for the government consistently to deceive taxpayers).

22. See generally Slemrod & Yitzhaki, *supra* note 4, at 174 (noting that tax reforms are efficient in creating the least social waste per dollar of additional revenue).

23. See, e.g., David M. Schizer, *Sticks and Snakes: Derivatives and Curtailing Aggressive Tax Planning*, 73 S. Cal. L. Rev. 1339, 1343 n.10 (2000) [hereinafter Schizer, *Sticks and Snakes*] (citing various commentators who have concluded that comprehensive mark-to-market taxation is unlikely to be enacted soon); Reed Shuldiner, *A General Approach to the Taxation of Financial Instruments*, 71 Tex. L. Rev. 243, 246 (1992) (“Most, if not all of these problems [with taxing financial instruments] could be solved by . . . adopting mark-to-market accounting for financial instruments . . . [but] it is unlikely that Congress (or the financial community) will accept wholesale use of mark-to-market accounting.”).

24. See generally Louis Kaplow, *Rules Versus Standards: An Economic Analysis*, 42 Duke L.J. 557, 562–70 (1992) (noting tradeoff between cost of formulating more detailed rules and waste from overbroad applications or from amending the rule later).

tions through creative interpretations,²⁵ such self help is expensive²⁶ and does not work in all cases. Aggressive taxpayers have an advantage, and the Internal Revenue Service (IRS) has discretion that may not be used responsibly.²⁷

On the merits, then, broad rules are not appropriate in all cases. Even when a broad response is desirable—and, in my view, it often is—politics can stand in the way. Ironically, even though politics may motivate government officials to respond to tax planning, politics may also impel them to respond *ineffectively*. The impetus to respond in some way—effectively or not—derives in part from the need for “revenue raisers” to fund other initiatives.²⁸ In addition, when the press focuses popular attention on an abusive strategy, politicians feel pressure to respond.

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25. For example, the contingent debt rules of Treasury Regulation section 1.1275-4, which offer unfavorable treatment to holders, apply to any debt not eligible for an enumerated exception. Treas. Reg. § 1.1275-4 (as amended in 1999). Under a literal reading, the regulations could apply to a fixed rate bond of a foreign issuer, merely because the coupon would be increased if a foreign jurisdiction were to begin withholding tax on interest. Although no exception quite fits these bonds, opinions are consistently given that the contingent debt rules do not apply. See NYSBA Urges IRS to Issue Revenue Ruling on Contingent Payment Debt Regs., *Tax Analysts*, *Tax Notes Today*, July 31, 1997, LEXIS, 97 TNT 147-82 (seeking ruling that contingent debt rules are not triggered by gross-ups). I thank Robin Shifrin for this example.

Likewise, when legislative history directs the Treasury to remedy overbreadth through regulations, advisors often do not wait for regulations before issuing favorable opinions. For instance, section 355(d) was meant to keep corporations from attaining tax free treatment for certain spin-offs that would otherwise be taxable sales. I.R.C. § 355(d). As Professors Ginsburg and Levin have observed, “Because Code § 355(d) is broadly drafted, it facially encompasses a variety of Code § 355 distributions that do not appear to raise the concerns that prompted Congress to enact Code § 355(d).” 1 Martin D. Ginsburg & Jack S. Levin, *Mergers, Acquisitions, and Buyouts* ¶ 1009.9, at 10–79 (Nov. 2000). To solve this problem, the legislative history authorized the Treasury to issue regulations excluding from the provision “transactions that do not violate the purposes of this provision,” including distributions that do not increase ownership in the distributing or controlled firm or provide a basis step-up. H.R. Comm. on Ways and Means, 101st Cong., Conference Committee Report 101-964 (Comm. Print 1990), [2001] 6 *Stand. Fed. Tax Rep.* (CCH) ¶ 16,460, at 32,390–91. Yet tax advisors applied these exceptions years before these regulations were issued. I thank Michael Schler for this example. For another, see the discussion of unbalanced straddles in David M. Schizer, *Executives and Hedging: The Fragile Legal Foundation of Incentive Compatibility*, 100 *Colum. L. Rev.* 440, 478–80 (2000) [hereinafter Schizer, *Executives and Hedging*].

26. Edward Kleinbard has described the costliness and time intensiveness of giving tax advice. See generally Edward D. Kleinbard, *Equity Derivative Products: Financial Innovation's Newest Challenge to the Tax System*, 69 *Tex. L. Rev.* 1319 (1991).

27. See Colin S. Diver, *The Optimal Precision of Administrative Rules*, 93 *Yale L.J.* 65, 75 (1983) (arguing that imprecise rules allow discretion to the administrator, the desirability of which depends upon the trustworthiness of this agent).

28. See, e.g., Elizabeth Garrett, *Harnessing Politics: The Dynamics of Offset Requirements in the Tax Legislative Process*, 65 *U. Chi. L. Rev.* 501, 515–18 (1998) (describing demand created for “revenue raisers” by “pay-as-you-go” offset requirements). The key is not how much revenue actually will be raised, but how much congressional staffers *can claim*. The incentive to manipulate revenue estimates, and the feasibility of doing so, are well documented. See, e.g., Michael J. Graetz, *Paint-By-Numbers Tax*

Yet countervailing pressure comes from affected taxpayers. They try to keep the measure narrow, for instance, with warnings about overbreadth (especially if a narrow measure would be easy to avoid). In response, overworked and inexperienced government drafters sometimes narrow the measure more than they realize by agreeing to subtle changes in language or legislative history. Or reformers may realize what is being given up, but see no other way to get the measure enacted. Either way, a narrow measure can yield symbolic benefits because the general public lacks the sophistication to judge whether a reform targeting complex commercial transactions will be effective. For the same reason, self interested legislators can use narrow measures to placate affected interest groups (by leaving alternatives open), while claiming exaggerated credit with the general public (who do not yet know that planning will continue).

C. *In Search of Effective Frictions*

In sum, broad legal responses sometimes are not viable for substantive and political reasons. Yet narrow rules can still be effective, especially in reinforcing other anti-abuse measures that already are on the books. Even if a narrow rule does not cover a particular avoidance strategy, taxpayers will not use this "out" if key business and legal objectives cannot be satisfied. How can reformers anticipate whether frictions will prevent end runs?²⁹ Taxpayer preferences about the friction must be inelastic,³⁰ but this merely restates the inquiry. Likewise, the cost imposed by the friction must outweigh the tax benefit, but this generalization gives no specific guidance.

1. *General Guidance.* — Four factors make the inquiry more concrete. First, how large is the tax benefit that planning can provide? Obviously, the larger it is, the more persuasive the friction must be. Thus, is the tax benefit deferral or forgiveness? The latter is a greater prize, so a stronger friction is needed. Likewise, what tax rate applies? Is it the rate for capital gain or ordinary income? Since the ordinary rate is higher for individ-

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Lawmaking, 95 Colum. L. Rev. 609, 613 (1995) (faulting revenue process for reliance on "misleading or wrongheaded mathematical straightjackets").

29. Wasteful planning can arise not only when taxpayers *avoid* a reform, but also when they deliberately qualify. For instance, sometimes a reform imposes treatment that is unfavorable in the context that reformers are considering, but is unduly generous in some other context unknown to reformers. The reform thus prompts taxpayers to change their behavior *to become eligible* for a regime, not to avoid it. As I have addressed this issue elsewhere, I do not focus on it here. See generally Schizer, *Sticks and Snakes*, *supra* note 23, at 1345–46. A (partial) response is to use so called one-way rules that, in most cases, serve only to increase the tax burden (e.g., in accelerating gains but not losses) and are less likely to offer taxpayers a result they could not otherwise attain. The case studies in this Article, sections 1259 and 1260, are one-way rules. They accelerate gains only, without affecting losses. As a result, they are less likely to offer new tax reduction strategies. For taxpayers who want to accelerate gain, there are cheaper ways than triggering these rules.

30. See Shavero, *Realization and Recognition Rules*, *supra* note 6, at 31 (emphasizing importance of elasticity); Weisbach, *supra* note 6, at 1656–59 (same).

uals but not for corporations, which type of taxpayer is involved? How much income is at stake? Has this income already been earned economically (e.g., built-in gain), or does the tax strategy apply only to future gains? In the latter case, the tax benefit is less alluring because it may never materialize if no pretax profit is earned, so weaker frictions can still be effective.

Second, how "strong" is the friction? In other words, how much do taxpayers care about it? In seeking to avoid a tax rule, will they face slight inconvenience or real pain? For instance, assume that a reform shuts down a planning strategy with one exception. The tax benefit is still available to taxpayers who "materially participate" in the venture that generates the tax benefit.³¹ To judge the strength of this friction, we must know how much time taxpayers must devote to qualify as "materially participating," and how different the venture is from their usual activities. Mink farmers will not mind raising minks in order to claim generous depreciation deductions, but dentists are likely to feel differently, especially if they would have to spend one day per week to do so (instead of, say, one week per year in a sunny locale).

Not only must the friction matter in the abstract, but it also must be hard to avoid. Taxpayers must be forced to *choose* between the friction and tax benefit. In addition to the strength of the friction, then, we must understand how difficult it is for the taxpayer to attain the benefits of the friction, or to avoid the costs it imposes, while still achieving the tax objective.³² Since many frictions are quite important to taxpayers, this third question—the "malleability" of a friction—is often crucial. For example, corporate taxpayers often care about the earnings reported to shareholders, so financial accounting is a "strong" friction. To maintain impressive reported earnings, corporate managers may well abandon a transaction that offers a tax benefit but also would depress earnings. Issuance of a simple debt security, for instance, creates interest expense that is tax deductible but also would reduce earnings. But what if the best of both worlds is available? Can the deal be tweaked so the expense no longer depresses accounting earnings, but still generates a tax deduction?³³ If so, the accounting friction is malleable and will not stop the tax planning.

Thus, the friction must be both strong and rigid (i.e., not malleable). If only one of these conditions holds, planning will continue. This is the case if the friction is strong but malleable, as the preceding example

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31. E.g., I.R.C. § 469 (disallowing losses from passive activities, which are defined as activities in which taxpayer does not "materially participate").

32. Cf. Shavero, *Realization and Recognition Rules*, supra note 6, at 32 (observing that in determining elasticity, we must ask "how strongly . . . the taxpayer [is] constrained" by the friction and "what alternative routes with different tax consequences . . . the taxpayer [could] use").

33. See generally Ellen Engel et al., *Debt-Equity Hybrid Securities*, 37 J. Acct. Res. 249 (1999) (studying Monthly Income Preferred Shares (MIPS) and other securities that were treated as debt for tax purposes, but not for rating agency and accounting purposes).

shows. The same is true if the friction is rigid but weak. Assume, for instance, that a narrow reform blocks a widely used planning strategy. To find a new way to do the transaction, the taxpayer must incur a legal fee. This fee is unavoidable, since the deal cannot be modified without extensive expert consultations. While the fee is thus a rigid friction, it may not be strong enough. Assume the fee will be \$100,000, but the tax savings is \$1 million. Since the fee is less than the tax savings, the friction is too weak to stop the tax planning. Hence, no new revenue is collected by this reform and, assuming the payment to counsel is not an efficient allocation of resources, social waste increases.

In addition to considering the size of the tax benefit at issue, and the strength and rigidity of the relevant friction, reformers must consider the "position" of the friction—that is, who is affected by it.³⁴ Frictions that affect taxpayers themselves obviously are relevant, but so are frictions affecting advisors or likely counterparties.³⁵ For instance, if the taxpayer must have a legal opinion in order to avoid penalties, frictions that discourage counsel from rendering the opinion will impede planning.³⁶ Likewise, if the taxpayer needs a securities dealer for a planning strategy, frictions that prevent the dealer from supplying the requisite security can stop planning as effectively as frictions that govern the taxpayer directly. Reformers should learn about frictions that affect likely tax accommodation parties such as dealers, foreign banks, insurance companies, pension funds, Indian tribes, and charities. If a friction affects only some of these potential counterparties, reformers should consider whether other counterparties would step in. For instance, if a securities dealer cannot supply an avoidance transaction, can an insurance company supply it?

In sum, end runs are unlikely if, in changing the transaction to avoid the reform, the taxpayer or an irreplaceable counterparty would suffer a dramatic and unavoidable decline in utility, and this cost would exceed the tax benefit at issue. In other words, a minor tweak would carry a major cost. In this Article, a friction with this effect is called a "discontinuous" friction.³⁷ Such a friction can help a narrow reform to be effective:

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34. In a sense, the position of a friction is merely an aspect of its strength and malleability, since the party that nominally is affected by the friction will seek to pass the burden on to the taxpayer through a higher fee.

35. This point is an extension of Professors Scholes and Wolfson's observation that the tax constraints of all parties must be considered. See Scholes & Wolfson, *supra* note 5, at 2. Likewise, *nontax* constraints of all parties are relevant.

36. Recognizing the importance of legal opinions, the government recently tightened up standards for rendering them. See IRS Issues Proposed Circular 230 Regs., Tax Analysts, Tax Notes Today, Jan. 12, 2001, LEXIS, 2001 TNT 9-6. Similarly, the government has proposed enhanced disclosure and registration requirements for tax shelters. See Temp. Treas. Reg. § 1.6011-4T, 66 Fed. Reg. 41,133, 41,135 (Aug. 7, 2001); Temp. Treas. Reg. § 301.6011-2T, 66 Fed. Reg. 41,133, 41,136 (Aug. 7, 2001).

37. In an insightful article, Professor Strnad uses the concept of continuity to describe tax rules and, specifically, to explore whether minor changes in the transaction trigger major changes in tax treatment. Jeff Strnad, Taxing New Financial Products: A Conceptual Framework, 46 Stan. L. Rev. 569, 597-99 (1994). The concept is extended

Even if the reform fails to block a substitute, the friction will block it. For example, assume that a tax benefit can be attained if the taxpayer bears some risk in a transaction, even a modest amount. If taking this risk violates a regulatory regime—so that the taxpayer would lose the ability to conduct all business—the taxpayer will prefer to pay the tax. The regulatory regime serves here as a discontinuous friction. In contrast, with a “continuous” friction, such as risk for the average taxpayer, minor changes in the transaction (a modicum of extra risk) have a proportionally modest effect on taxpayer welfare. Such frictions are less likely to prevent avoidance of a narrow rule. Instead, the rule must be broader so the cumulative effect of the continuous friction (e.g., the need to take *a lot* more risk) is an adequate deterrent. To change the metaphor, in the first case the taxpayer is standing on the edge of a cliff and cannot move over (i.e., to avoid tax) without falling off. In the other case, the taxpayer is on a slope, and so a step to one side, although perhaps unwelcome, is likely to be feasible.³⁸

2. *Some Usual Suspects.* — Thus, a narrow rule can still stop a planning strategy as long as discontinuous frictions prevent end runs. This state of affairs will exist in some cases, but not in others. While fact-specific inquiries are needed, it is worth listing three categories of frictions that commonly affect sophisticated transactions: taxpayer preferences regarding business activity, the state of technology and markets, and legal and regulatory constraints other than tax. Each category contains both continuous and discontinuous frictions, and, depending upon the facts, the same friction can have either quality.

a. *Taxpayer Preferences Regarding Business Activity.* — Taxpayers share a variety of nontax preferences regarding their business activities. In addition to risk,³⁹ timing can be important (for example, how long taxpayers

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here to frictions. The difference between discontinuous and continuous frictions also resembles Professor Cooter's distinction between sanctions and prices, in that a sanction causes a dramatic change in utility, whereas a price does not. See Robert Cooter, *Prices and Sanctions*, 84 *Colum. L. Rev.* 1523, 1552 (1984). Yet Professor Cooter's terminology works better for regulatory regimes, in that some authority is *imposing* the sanction. Discontinuous frictions arise not only from regulatory regimes, but also from imperfect markets or technological limitations.

38. I thank Reed Shuldiner for this metaphor.

39. Some rules impose a tax when taxpayers take risk-reducing measures, presumably on the theory that risk-reducing behavior is inelastic. Daniel N. Shavero, *Risk-Based Rules and the Taxation of Capital Income*, 50 *Tax L. Rev.* 643, 647–51 (1995) [hereinafter Shavero, *Risk-Based Rules*]. Likewise, some tax rules deny a tax benefit to taxpayers who fail to take risk, on the theory that this nontax “price” allocates the tax benefit to those who should receive it (e.g., because they have nontax reasons for engaging in the benefit-generating behavior). *Id.* at 650. More generally, the tax system has tried to distinguish between risk based and time-value based returns, although developments in the financial markets have undermined this distinction. Warren, *supra* note 7, at 460–61.

must hold an asset⁴⁰ or wait before taking a particular step⁴¹), as can the extent of a taxpayer's participation in a venture.⁴² Whether weak or strong, these frictions tend to be continuous. One can always take a little more risk, wait a little longer, or participate a bit more, and so marginal changes are less likely to be significant. In contrast, other preferences about business activity may be much more significant. For instance, taxpayers often have strong preferences about the control they exert over the investment⁴³ and the political jurisdiction in which relevant activity occurs (e.g., inside or outside of the United States).⁴⁴ Yet the strength and malleability of these frictions will vary with the facts. For example, control may technically require more than 50% of the voting power, and so a change from 50.01% to 49.99% may be quite significant. In some cases, though, 40% (or less) can represent effective control, such as in a public firm with no other large shareholders.

b. *The State of Technology and Markets.* — Tax planning is constrained not only by economic attributes that taxpayers demand, but also by limits on what can be supplied.⁴⁵ If planners need a particular security, but securities dealers cannot supply it at reasonable cost, the planning will not occur. This reality features prominently in the case studies discussed in this Article.⁴⁶ Of particular relevance are the state of financial technol-

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40. See, e.g., I.R.C. § 901(k) (prescribing fifteen day holding period for claim of foreign tax credit); Shaviro, *Economic Substance*, supra note 19, at 222 (discussing section 901(k)).

41. See, e.g., I.R.C. § 355(e) (providing that control of distributing or controlled corporation may not change hands within two years of spin-off); id. § 1091 (providing that taxpayer may not repurchase asset within thirty days before or after sale at a loss).

42. See, e.g., id. § 469 (requiring "material participation").

43. For instance, taxpayers may have a relatively inelastic preference for owning more than 50% of an enterprise, and so tax consequences might vary based on such control. See, e.g., id. § 355(e) (taxing certain spin-offs as sales if they are part of a plan or series of transactions to acquire a 50% or greater interest in controlled or distributing corporation).

44. Along with jurisdictional considerations, this friction explains why the United States is more likely to tax earnings that are "effectively connected" to the United States. See id. § 864(c) (determining whether income, gain, or loss is treated as effectively connected with the conduct of a trade or business within the United States). To the extent that economic actors have strong nontax reasons to do business in the United States, the U.S. government can tax them without fear that they will substitute business activities offshore.

45. For instance, improvements in communications technology have made it easier for U.S. taxpayers to move income generating operations to low tax jurisdictions. See Reuven S. Avi-Yonah, *Globalization, Tax Competition, and the Fiscal Crisis of the Welfare State*, 113 Harv. L. Rev. 1573, 1590–91 (2000). Likewise, development of new financial instruments has created planning opportunities. See Warren, supra note 7, at 460–61.

46. As discussed in Parts II and III, the "constructive ownership" provision (section 1260) has largely stopped the targeted derivatives transaction, notwithstanding the rule's narrow scope, because dealers have difficulty hedging the derivative that theoretically could avoid the rule. In contrast, the "constructive sale" provision (section 1259) is less effective—even though this rule uses essentially the same statutory test—because dealers are able to hedge more effectively in this context.

ogy and the completeness of financial markets.⁴⁷ For instance, assume a special tax is imposed on publicly traded assets, where markets are relatively complete. Although the tax theoretically could be avoided by investing in private assets, many taxpayers will pay the tax in order to enjoy benefits of public trading.⁴⁸

c. *Legal and Accounting Constraints.* — A transaction that yields a tax benefit is considerably less appealing if prohibited, or rendered more costly or risky, by a legal or regulatory regime other than the tax law. Legal regimes are an especially fruitful source of discontinuous frictions because they often use arbitrary distinctions. Legal frictions can be influential in at least four ways.

i. *Substantive Preconditions.* — First, such regimes impose substantive preconditions. Some step is required for the transaction to be legally binding or for parties to avoid legal penalties. For instance, so called over-the-counter derivatives transactions (i.e., derivatives acquired from a securities dealer, instead of an organized exchange) are not legally enforceable unless the relevant parties satisfy certain wealth tests.⁴⁹ Ineligi-

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47. For instance, although taxpayers frequently hedge publicly traded securities, why don't they hedge the value of their future salary earnings, and then borrow against this hedged wealth? Under current law, a cash-basis taxpayer arguably would not be taxed until the wage was actually earned, even though this money would be enjoyed far earlier through the loan. Yet a tax rule is not needed to foreclose this strategy, since the relevant transactions cannot be implemented at reasonable cost. Lenders will not lend at a reasonable interest rate—and may not lend at all—unless the future wages are guaranteed (e.g., against the risk of being fired or having an expertise that ceases to be profitable). Yet there currently is no insurance or derivatives market for wages of individuals, or even for wages of professional groups. As Professor Shiller has observed, although financial markets are far more developed than ever before, individuals still cannot hedge human capital or nonfungible assets such as closely held businesses, investments in real property, and the like. See Robert J. Shiller, *Macro Markets: Creating Institutions for Managing Society's Largest Economic Risks* 3 (1993) ("It is odd that there appear to have been no practical proposals for establishing a set of markets to hedge the biggest risks to standards of living."); see also Shaviro, *Risk-Based Rules*, *supra* note 39, at 656–59 (noting that financial markets are still incomplete with respect to privately owned businesses, real estate, and the like). However regrettable the incompleteness of these markets may be for the economy as a whole, the silver lining is that certain tax planning strategies are meaningfully constrained.

48. Benefits of public trading are well understood. See, e.g., Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, 26 J.L. & Econ. 301, 312 (1983) (arguing that markets enable the use of equity compensation for management); Rebecca Rudnick, *Who Should Pay the Corporate Tax in a Flat Tax World?*, 39 Case W. Res. L. Rev. 965, 1103–06 (1989) (noting that public markets supply liquidity); Walter Bagehot, *The Only Game in Town*, *Fin. Analysts J.*, Mar.–Apr. 1971, at 12, 14 (stating that public markets reduce the information disparity between buyers and sellers by creating a pool of monitors and, more generally, by forming a price that incorporates available information); Bernard S. Black & Ronald J. Gilson, *Does Venture Capital Require an Active Stock Market?*, *J. Applied Corp. Fin.*, Winter 1999, at 36, 36, 44–45 (emphasizing public markets' role in facilitating venture capital investments).

49. Under the Commodities Exchange Act, 7 U.S.C. § 2(i) (1994), so called futures contracts generally are enforceable only if conducted through an organized exchange. The Commodity Futures Trading Commission (CFTC) has spared investors who meet

ble parties cannot use these contracts in tax planning. Likewise, state laws regulating gambling sometimes must be considered.⁵⁰ Breaches of the federal securities laws, whether in derivatives transactions or in other planning strategies, could expose the taxpayer to private lawsuits or an action by the Securities and Exchange Commission (SEC).⁵¹ Similar constraints are posed by "position limits" for options,⁵² and by laws governing pensions and investment companies, including ERISA⁵³ and the Investment Company Act of 1940.⁵⁴

ii. *Agency Costs.* — Second, agency costs can impede tax planning. Self interested agents may choose not to pursue otherwise promising strategies that are complex or risky, or that take considerable time and effort to develop. For instance, evidence of success may be required before an arbitrary date, such as the cutoff date for an investment banker's annual bonus. Or agents may be more wary of a particular friction than their principals would be. A tax strategy might oblige a firm to bear business risks, for example, and managers may be more averse to these risks than are shareholders.⁵⁵ Likewise, pursuit of the tax reducing

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minimum wealth requirements from these constraints. As a result, over-the-counter derivatives are clearly enforceable for wealthy investors. See *Commodity Futures Trading Comm'n, OTC Derivative Markets and Their Regulation* (1993), reprinted in *A Guide to Federal Regulation of Derivatives* ¶ 1004, at 193 (James Hamilton et al. eds., 1998) (noting that CEA exemptions "generally are based on the status or resources of the counterparties" and "provide broad relief"). Congress recently developed and codified these exceptions in December 2000 legislation. See *Commodity Futures Modernization Act of 2000*, Pub. L. No. 106-554, 114 Stat. 2763A-365.

50. For this reason, Congress provided in 1982 that derivatives listed on an exchange could not be invalidated under the gambling laws. See *Securities Exchange Act of 1934* § 28(a), 15 U.S.C. § 78bb (1994); Louis Loss & Joel Seligman, *Fundamentals of Securities Regulation* 273 (4th ed. 2001) (discussing amendment to section 28(a) of the *Securities Exchange Act of 1934*). The remainder of this Article will refer to the *Securities Exchange Act of 1934* as the "Exchange Act."

51. For instance, the derivatives transactions of issuers and so called affiliates and insiders are constrained by registration and holding period requirements of section 5 of the *Securities Act of 1933*, 15 U.S.C. § 77(e) (1994), and SEC Rule 144, 17 C.F.R. § 230.144 (2001), respectively, as well as by section 16 of the *Exchange Act*, 15 U.S.C. § 78(p). These issues are discussed in *infra* text accompanying notes 133–139. The remainder of this Article will refer to the *Securities Act of 1933* as the "Securities Act."

52. For a discussion of position limits, see *infra* note 140.

53. 29 U.S.C. §§ 1001–1461 (1994). See generally Steven Lofchie, *A Guide to Broker-Dealer Regulation* 129–49 (2000) (discussing issues that ERISA creates for securities dealers).

54. 15 U.S.C. §§ 80a-1 to -52 (1994); see also *Investment Advisers Act of 1940*, *id.* §§ 80b-1 to -21. See generally Loss & Seligman, *supra* note 50, at 40–51 (giving overview of regime).

55. A recently litigated tax shelter supplies an example. *Compaq Computer Corp. v. Comm'r*, 113 T.C. 214 (1999). *Compaq Computer Corporation* ("Compaq") tried to claim a tax benefit—a generous foreign tax credit—by being record owner of a particular stock (in an unrelated firm) when this stock paid a dividend. *Id.* at 219. If Compaq had been willing to hold the stock for a month or more, its claim to the tax benefit would have been quite strong. Instead, Compaq held the stock for a matter of moments only. *Id.* at 217–18. As a result, the government successfully denied the tax benefit, on the theory that Compaq

strategy may require an organizational form that is less effective at constraining agency costs (e.g., a limited partnership instead of a corporation). In some cases, taxpayers will choose better governance over tax reduction.

iii. *Credit Risk*. — Third, enforcement of a legal right can be costly, especially against someone with no assets. The risk of incurring these costs, so called “credit risk,” can deter tax planning. For example, since corporate taxpayers have a tax based preference for debt (which generates deductible interest) instead of equity (which generates nondeductible dividends), why is equity so pervasive? Indeed, a basic principle of economics, “put-call parity,” is that a share of stock has the same cash flow as a debt security coupled with a forward contract to buy stock in the future.⁵⁶ Given this equivalence, why don’t corporations replace stock with debt and forward contracts? According to Professor Schlunk, we should expect a high volume of these transactions.⁵⁷

Yet the erosion he predicts in the corporate tax base has been tempered so far by frictions, including credit risk, that have reinforced the narrow tax rules blocking this strategy. Specifically, the interest deduction will be denied if the debt and forward are too closely related. These two instruments would be treated as a single equity security for tax purposes, for instance, if they were sold to the same investor, could not be legally separated, and had the same maturity date.⁵⁸ To avoid this recharacterization, the corporation theoretically could sell the debt and

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had no valid business purpose in purchasing the stock. Why did Compaq elect not to hold the stock longer? Admittedly, Compaq could have lost money if the unrelated firm’s stock price declined. Yet this risk presumably was more daunting to Compaq’s undiversified managers than to its diversified shareholders. But see *IES Indus., Inc. v. United States*, 253 F.3d 350, 354 & n.4 (8th Cir. 2001) (upholding tax benefit on similar facts and distinguishing *Compaq*).

56. A forward contract is a contract for one party to buy a stated amount of property from another for a designated price on a specified future date. An example of the financial equivalence described above is that a share of stock worth \$100 generates the same cash flow as the following unit: a bond that sells for \$100 and pays \$123 in three years, and a forward contract to buy stock in three years for \$123. After three years, assume the stock is worth \$223. Investment in the stock obviously yields a profit of \$123. So too does the bond and forward. The bond yields a profit of \$23 (in yielding \$123 on a bond that cost \$100). The forward yields a profit of \$100 (in permitting the investor to buy stock worth \$223 for only \$123). For a discussion of put-call parity, see Warren, *supra* note 7, at 465–67.

57. Schlunk, *supra* note 6 (manuscript at 29–31) (predicting that equity will “at an ever increasing rate, disappear,” and will be replaced by debt combined with equity derivatives such as swaps).

58. See I.R.C. § 163(l); I.R.S. Notice 94-47, 1994-1 C.B. 357 (stating that debt that is mandatorily convertible is taxed as equity). The legislative history of § 163(l) says that interest cannot be deducted from an instrument that is “part of an arrangement designed to result in such payment of the instrument with or by reference to . . . stock, such as in the case of certain issuances of a forward contract in connection with the issuance of debt.” H.R. Rep. No. 105-148 (1997), [2001] 3 Stand. Fed. Tax Rep. (CCH) ¶ 9102, at 23,019.

forward to separate investors.⁵⁹ Yet it is not practical to sell a forward contract by itself. What assurance is there that a public investor will honor it if the stock price declines? The expense of suing each public investor renders a "naked" forward unworkable. Instead, the forward contract must be secured by collateral, such as a Treasury bond. Yet an investor seeking an equity return usually is not satisfied with the low yield of a Treasury bond, and so the issuer must kick in a significant (non deductible) fee (e.g., 2%).⁶⁰ This expense, coupled with the cost of two public offerings, renders the transaction uncommon.⁶¹

A more common alternative, a transaction called "FELINE PRIDES," is somewhat less costly but involves more tax risk.⁶² Indeed, note the pattern, which recurs throughout this Article: In some cases, an effort to avoid a friction will weaken the tax analysis and, correspondingly, an attempt to improve the tax treatment will founder on frictions. In FELINE PRIDES, the debt and forward are sold to the same investor (averting the cost of a second offering) and the debt serves as collateral for the forward. Three features discourage recharacterization as equity for tax purposes, although the outcome is not free of doubt. First, holders may sell the debt upon pledging a Treasury bond as collateral (at which point the issuer begins incurring a fee, but this cost arises in only the rare case when holders sell the bond). Second, the bond matures six months after the forward, and holders may elect to settle the forward with cash while retaining the bond. Third, in some offerings, the bond's interest rate resets when the forward matures to encourage holders to keep the bond. To an extent, complexity and tax uncertainty have kept this structure from becoming pervasive,⁶³ although many transactions have been done.⁶⁴ An understanding of the credit risk constraint would enable the government to block the transaction with a narrow rule. The interest

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59. Cf. Priv. Ltr. Rul. 2000-52-027 (Dec. 29, 2000) (holding that section 163(l) does not apply to issuer that issues notes and buys put options from separate investors).

60. The fee is not deductible as interest. Although the taxpayer might deduct it as a business expense, the fee arguably should be capitalized as a cost of the offering. Cf. *Indopco, Inc. v. Comm'r*, 503 U.S. 79, 88-90 (1992) (holding that investment banking fees incurred by a corporation when it was being acquired are not deductible because the takeover generates significant future benefits to the firm in subsequent years). Yet basis in the equity being sold has no value to the issuer, since section 1032 provides nonrecognition treatment. I.R.C. § 1032.

61. Based on conversations with practitioners and my own experience advising investment banks in the development of new debt-equity hybrids, I am aware of only two public transactions using this structure. See *Browning-Ferris Indus., Inc.*, 10,000,000 Automatic Common Exchange Securities 7.25%, Prospectus dated June 23, 1995; MCN Corp., 5,100,000 PRIDES (SM) 8.75%, Prospectus dated Apr. 22, 1996.

62. See, e.g., *Conseco, Inc. Conseco Financing Trust IV*, 10,000,000 FELINE PRIDES (SM), Prospectus dated Dec. 8, 1997.

63. Cf. Gergen & Schmitz, *supra* note 10, at 121 (emphasizing tax uncertainty as a constraint on tax planning).

64. While I have not conducted a study to determine the precise volume of these transactions, a LEXIS search of the EDGARPlus(R) database of "feline w/4 prides" yields a large number of matches.

deduction could be disallowed for interest from any debt that *collateralizes* a forward contract for the issuer's equity.⁶⁵ The only public security that would avoid this rule is the one described above,⁶⁶ and issuers are unlikely to use it.⁶⁷

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65. This step could be taken through a notice or regulation interpreting section 163(l). See I.R.C. § 163(l)(5).

66. It is worth monitoring whether issuers may begin issuing publicly traded forward contracts through the futures market. Previously, it was illegal for futures exchanges to list futures based on a single stock. But these securities were authorized by Congress in December 2000 and presumably will begin trading in late 2001 or in 2002. See Commodity Futures Modernization Act of 2000, Pub. L. No. 106-554, §§ 201-210, 251-53, 114 Stat. 2763A-365, 2763A-413 to -449. Investors in these publicly traded forward contracts will still have to pledge collateral, but less of it (i.e., some multiple of the amount owed on the forward on a given date, adjusted on a mark-to-market basis). An important question is how the securities laws will apply if issuers sell futures on their own stock. For instance, must a prospectus be delivered? How feasible will this be? What would the issuer's accounting treatment be? Will these futures have long enough terms? I suspect these frictions will be formidable, but an exploration of this question is beyond this Article's scope.

67. The above discussion is meant to illustrate the role of credit risk, and not to provide an exhaustive analysis of debt-forward transactions. At the risk of a brief digression from credit risk, it is worth mentioning three other alternatives and the frictions that constrain them. First, a securities dealer theoretically could supply a naked forward contract, while the issuer borrows from a third party. Yet, although credit risk is less of a concern, the securities laws make this transaction impractical. The dealer will hedge through short sales in the public markets. These sales will probably render the dealer an "underwriter" under the securities laws, thereby requiring the dealer to deliver a prospectus. See Securities Act § 2(a)(11), 15 U.S.C. § 77b(a)(11) (1994); cf. Loss & Seligman, *supra* note 50, at 285-301 (discussing significance of qualifying as "underwriter" under section 2(a)(11) of the Securities Act, and describing scope of definition). Yet this step is impractical, especially if the dealer is hedging dynamically through a perpetual stream of short sales, and thus would have to provide constantly updated disclosure.

Second, another private market alternative would be to find a creditworthy counterparty, such as an offshore fund, that wants to invest in the firm, and thus would not hedge the forward contract. But this investor would demand a discount because a private forward contract would be less liquid. In addition, the pool of creditworthy investors—who would not have to pledge collateral, or at least would not have to be compensated with extra yield for doing so—is probably not large enough, given the volume of equity that theoretically could be turned into forward contracts. Some public securities would have to remain outstanding, moreover, or the private forward contract could not be valued easily.

Finally, as Robert Scarborough has emphasized, a firm could lever in a somewhat different way by using derivatives to hedge certain risks (e.g., currency, raw materials, weather, and the like). A hedged firm can borrow more without risking insolvency. See Robert H. Scarborough, *How Derivatives Use Affects Double Taxation of Corporate Income 1* (Mar. 29, 2001) (unpublished manuscript, on file with the *Columbia Law Review*), available at <http://www.law.nyu.edu/tppf/taxforum542.pdf> ("A corporation that hedges business risks with derivatives can increase its debt-to-equity ratio without increasing the riskiness of its debt."). There is empirical evidence that firms hedge to increase borrowing capacity. See John R. Graham & Daniel A. Rogers, *Do Firms Hedge in Response to Tax Incentives?*, 57 J. Fin. (forthcoming 2002) (manuscript at 3, on file with the *Columbia Law Review*) ("Our results indicate that hedging leads to greater debt capacity."). Yet another friction, financial accounting, limits this strategy. In some cases, hedging leads to volatility in reported earnings. See *infra* Part 11.B.3.d (discussing Statement of Financial Accounting Standards No. 133, and its effects on reported earnings). Interest expense also depresses

iv. *Regulatory and Financial Accounting.* — As the prior discussion shows, legal and regulatory regimes can block a tax planning strategy through substantive preconditions, agency costs, and credit risk. Finally, these regimes also can chill planning indirectly—not by stopping the transaction itself, but by causing this transaction to undermine the taxpayer's *other* business. For instance, regulators require securities dealers and banks to have minimum levels of capital. These institutions may be unwilling to engage in a tax reducing transaction—whether for themselves or for a client—if they would incur a “capital charge” under these regimes, and thus would need more liquid capital to satisfy regulators.⁶⁸ On the other hand, sometimes dealers can avoid regulatory capital constraints through sophisticated planning, for instance, by routing transactions offshore.⁶⁹

Unappealing financial accounting or adverse treatment by rating agencies can also chill tax planning. In an efficient market, these constraints would not matter. Investors simply would look beyond accounting or rating-agency conventions to the underlying financial reality. But these conventions do matter when the market is not perfectly efficient. It can be expensive for investors to look through these conventions, for instance, if the investor must value particular assets or liabilities on her own.⁷⁰ Nor is it profitable to develop more accurate numbers if other

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reported earnings. The significance of accounting earnings to managers is discussed below. See *infra* text accompanying notes 70–74.

68. Under the regulatory capital regime for securities dealers, the liabilities they may incur—including indebtedness and dealer activities such as short sales—are limited by the amount of “regulatory capital” the dealers have. See generally SEC Rule 15c3-1, 17 C.F.R. § 240.15c3-1 (2001) (prescribing net capital requirements for brokers or dealers). Activities that reduce the amount of regulatory capital bear a significant opportunity cost. The main way to refresh the supply of regulatory capital is to issue common stock, but this method of funding is more expensive than debt. No interest deduction is available and, more importantly, the return expected by equity investors is considerably higher than a dealer's borrowing cost. See generally Lofchie, *supra* note 53, at 387–442 (discussing net capital requirements); Anne Beatty et al., *Managing Financial Reports of Commercial Banks: The Influence of Taxes, Regulatory Capital, and Earnings*, 33 J. Acct. Res. 231 (1995) (focusing on categories of decisions by banks, including loan charge-offs, issuance of new securities, and pension settlements); Julie H. Collins et al., *Bank Differences in the Coordination of Regulatory Capital, Earnings, and Taxes*, 33 J. Acct. Res. 263 (1995) (studying decisions of particular banks over time); Myron S. Scholes et al., *Tax Planning, Regulatory Capital Planning, and Financial Reporting Strategy for Commercial Banks*, 3 Rev. Fin. Stud. 625 (1990) (analyzing commercial bank investment portfolio management to discern tradeoff between regulatory capital and tax planning).

69. See Lofchie, *supra* note 53, at 393 (“[T]he effect of the net capital rule, for better or worse, is not to eliminate the financial risks that result from derivative transactions, but rather to force this risk into entities that are regulated by agencies other than the SEC, if they are regulated at all.”).

70. See generally Sanford J. Grossman, *On the Efficiency of Competitive Stock Markets when Traders Have Diverse Information*, 31 J. Fin. 573, 574 (1976) (“If there is no noise and information collection is costly, then a perfect competitive market will break down because no equilibrium exists where information collectors earn a return on their information, and no equilibrium exists where no one collects information.”).

investors, who set the market price, will continue to be influenced (or, indeed, misled) by the old ones.⁷¹ In any event, managers and their advisors jealously guard accounting and rating agency treatment. These efforts are documented in empirical studies,⁷² in anecdotal evidence from equity research analysts,⁷³ and by investment bankers who develop tax and accounting arbitrages.⁷⁴ Likewise, in my experience as a tax practitioner, a tax reducing strategy often is "dead" if the accounting treatment is unappealing. A caveat, though, is that accounting rules can prove malleable. Often, a transaction can be modified to attain both tax and accounting goals.

D. Potential Pitfalls of Frictions Based Strategies

When frictions are sufficiently strong and hard to avoid, they enable narrow tax rules to stop the targeted transaction, thereby averting the political, overbreadth, and administrability problems of a broader rule. On the other hand, if the friction is too weak or easy to avoid, reliance on it may well be counterproductive because planning will continue in more wasteful form. In addition, four other problems can undermine reliance on frictions, and reformers must take into account these pitfalls.

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71. An analogy may be drawn to the "noise trader" literature. If unsophisticated investors (or "noise traders") overvalue tulips or Internet stocks, sophisticated investors should engage in short sales that will be profitable once the bubble bursts and, indeed, should help it to burst. Why, then, do bubbles ever arise? According to the noise trader literature, sophisticated investors will do these short sales only if they expect the market to decline in the near term. If there is doubt about when (or whether) noise traders will recognize their error, arbitrage becomes very risky, and less is supplied. See David M. Schizer, *Tax Constraints on Indexed Options*, 149 U. Pa. L. Rev. 1941, 1949 & n.31 (2001) (invoking noise trader literature to explain the relevance of accounting); see also J. Bradford De Long et al., *Noise Trader Risk in Financial Markets*, 98 J. Pol. Econ. 703, 705 (1990) ("The unpredictability of noise traders' beliefs creates a risk in the price of the asset that deters rational arbitrageurs from aggressively betting against them."); J. Bradford De Long et al., *The Size and Incidence of the Losses from Noise Trading*, 44 J. Fin. 681, 688 (1989) (arguing that noise trading can impose substantial costs on rational investors); Andrei Shleifer & Lawrence H. Summers, *The Noise Trader Approach to Finance*, J. Econ. Persp., Spring 1990, at 19, 19-20 (describing "an alternative to the efficient market paradigm that stresses the roles of investor sentiment and limited arbitrage in determining asset prices").

72. See, e.g., Engel et al., *supra* note 33, at 263 (noting that firms offering MIPS, which were treated as debt for tax purposes but not for accounting and rating agency purposes, used to incur extra expenses totaling approximately 4% of the offering price, or \$9.3 million in the average offering, to secure better accounting treatment for otherwise comparable securities); Shackelford & Shevlin, *supra* note 9, at 11-41 (describing studies of tradeoff between accounting and tax reduction in use of LIFO, compensation, depreciation, income shifting, capital structure, acquisitions, etc.).

73. To emphasize the costliness of looking through accounting conventions, Andrew Steinerman, a research analyst at Bear Stearns & Co., asked, "When you read an academic paper, do you read all the sources cited in the footnotes?"

74. As one put it, "If the market were truly efficient, I could not make so much money doing this—but have you seen my house?"

1. *Information Costs.* — First, tax reformers must learn a wide range of institutional details, including the securities and commodities laws, the state of financial technology, accounting, and broker-dealer regulations. This seems like a tall order for government officials who already are overworked, underpaid, and may have limited transactional experience. The challenge, moreover, is to ensure that frictions block not just a *particular* avoidance strategy, but *all* avoidance strategies. Tax reformers must, in effect, prove a negative. There must be no viable way to avoid the narrow rule.⁷⁵ For instance, assume a reform is meant to stop a tax motivated use of derivatives. Once reformers accomplish this mission, which is no easy task (as the first case study shows), they must consider whether the same tax benefit can be attained *without* derivatives—for instance, with insurance contracts and offshore corporations (which feature prominently in the second case study).

Perfect foresight admittedly is not realistic, but some success in uncovering the relevant information should be possible. Nor is this challenge always more daunting than the administrability and political burdens imposed by broader rules. For narrow transactional responses, reformers need to understand *all* aspects of the targeted transaction, not just the tax analysis. Although the transaction's promoter will be reluctant to share this information, competitors are often willing to offer anonymous tips.⁷⁶ Organizations such as the New York State Bar Association (NYSBA) may also be fruitful sources of information.⁷⁷ To some extent, reformers already are asking about frictions, although in an ad hoc man-

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75. I thank Diane Ring for this observation.

76. Cf. Bankman, *supra* note 10, at 1781 ("A commonly reported source of 'leakage' [about corporate tax shelters] is from a prospective purchaser, to one of its advisors, to another company, or, even worse, from the advisor to a competitor and then to another company.").

77. The NYSBA is the oldest and largest voluntary state bar association in the United States, with more than 67,000 members. The New York State Bar Association, at <http://www.nysba.org> (last visited Aug. 6, 2001) (on file with the *Columbia Law Review*). The NYSBA has numerous subgroups or "Sections," organized by specialty. The Tax Section includes many of the most prominent tax lawyers in New York. Its various committees study existing law and proposed reforms, offering recommendations in the form of letters or reports. The focus usually is on technical issues of implementation, instead of on broader political questions, such as what tax rates should be. Although the NYSBA is an organization of private lawyers, its mission is not to lobby for the private interests of taxpayers and tax advisors. Rather, the stated purpose of the group is "to support, promote and initiate desirable tax reforms, and to oppose changes in the tax laws and administration which would not be in the public interest." New York State Bar Association, Tax Section Purpose, at <http://www.nysba.org/sections/tax/mission.html> (last visited Aug. 6, 2001) (on file with the *Columbia Law Review*). My sense is that the NYSBA Tax Section is more "pro-government" than other organizations of tax professionals, and thus is more likely than others to endorse government efforts to curtail planning. In the interests of full disclosure, I should state that I serve on the Tax Section's executive committee.

ner that often depends on which officials are working on the reform, what experience they have, and whom they know.⁷⁸

Commentators can provide valuable assistance here in identifying and evaluating significant frictions. In addition, more systematic and sustained government efforts are needed. Tax reformers should coordinate with other federal agencies, for instance, by asking the SEC about a securities law issue or the Federal Reserve about bank regulatory concerns. To some extent, this coordination already occurs. Yet turf battles can impede cooperation, and seeking input can lead to delay and loss of control. The success of cooperation often depends on personalities and relationships of particular staffers.⁷⁹ It would be useful to institutionalize such coordination so an appropriate level is always supplied and the process is smoother. Although these steps are not always easy or cheap, the government often will avoid the potentially greater costs of a tax reform that is ineffective or, alternatively, very broad. (I say "often" because in some cases a reliable friction will not be present.)

2. *Instability.* — Another disadvantage of relying on frictions is that they may prove unstable. Although a legal or accounting rule may *seem* to constrain avoidance, the relevant rule may change, or creative advisors may circumvent this obstacle. Likewise, even if the financial markets are unable to supply a particular security today, tomorrow may be different. Indeed, two pressing academic debates about the future of taxation—the impact of financial innovation and tax competition—derive from erosion of frictions.⁸⁰ Of course, this process can work the other way as well. A friction that seems unimportant today can become more daunting over time.⁸¹ Yet the trend is toward less effective frictions, due to globalization, deregulation, and more complete financial markets.⁸² In response,

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78. I am indebted to Ron Pearlman for this insight. His distinguished career in government includes service as Assistant Secretary of the Treasury for Tax Policy and as Chief of Staff of the Congressional Joint Committee on Taxation.

79. Professor Pearlman is also the source of this observation.

80. See, e.g., Avi-Yonah, *supra* note 45, at 1575–76 (stating that improvements in communications technology have enabled taxpayers to shift income to low tax jurisdictions); Warren, *supra* note 7, at 460–61 (arguing that development of new financial instruments has undermined taxation of capital).

81. For instance, under the wash sale rules of section 1091, taxpayers who sell a security at a loss cannot recognize it currently unless they wait thirty days before repurchasing the security. I.R.C. § 1091. While such a long period may have been needed when section 1091 was enacted, a shorter interval would be sufficient in today's volatile markets.

82. Professor Schlunk has emphasized a related point about the *sequence* in which financial markets become complete. As each new instrument is developed, the government will try to group it with the closest existing substitute. Order matters here. For instance, assume A is taxed one way, and Z is taxed another. K is closer to A (i.e., ten letters away), so if K is the next new instrument, the A rule will apply. What if P is developed next? It is closer to K than Z so, again, the A/K rule will apply. But what if P arises before K? Since P is closer to Z than A, the Z rule would have applied instead. See Schlunk, *supra* note 6 (manuscript at 4) (discussing path dependence inherent in commodity tax methodology).

reformers must assess the relevant friction's durability. They also must monitor the friction even after the reform is enacted. This process is helped if tax reformers coordinate with other parts of the government (e.g., the SEC, CFTC, etc.), but the information costs are real.

3. *Distributional Effects.* — Rules that depend on frictions can redistribute tax burdens in random or undesirable ways. The problem is that some taxpayers may be uniquely able to avoid the friction. For instance, if securities dealers cannot supply a particular avoidance transaction, but insurance companies can, a reform may transfer wealth from dealers to insurers. Likewise, if a tax benefit is conditioned on adverse accounting,⁸³ the benefit may be claimed only by firms that are relatively unconcerned about this regime. Since indifference to the friction has little to do with ability to pay, normatively comparable firms will be taxed differently.

In many cases, wealthier taxpayers will have an advantage. For instance, regimes that protect investors (including the securities and commodities laws, broker-dealer regulations, and the like) usually have exceptions for wealthy investors, who are thought to need less protection. Moreover, if a fixed cost is needed to circumvent a friction, such as a fee to an expert, wealthy taxpayers can amortize this cost over greater tax savings. On the other hand, wealthier taxpayers will not have a particular edge if the cost of the friction rises with the size of the transaction, as is the case with a regulatory penalty or fee that is scaled to the size of the transaction.

4. *Overbreadth and Nontax Effects.* — Just as a friction can be underinclusive in failing to deter the wealthiest taxpayers, so too can it be overinclusive. For example, a recent accounting rule for derivatives (inadvertently) deters tax planning, but the rule also has been criticized—by Alan Greenspan, Chairman of the Federal Reserve, among others—for discouraging useful transactions that are not tax motivated.⁸⁴ Once tax authorities begin to rely on the friction, they may become a constituency for keeping it, notwithstanding its unfortunate nontax effects (e.g., on corporate governance or capital market efficiency). Alternatively, the lifespans of the friction and tax reform can be linked in a different way: The tax reform may be harder to defend politically if it relies on an unpopular friction. Lobbyists will ask, for instance, “Why should the tax law follow the accounting rule, which is bad policy anyway?”

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83. For instance, the Treasury proposed (unsuccessfully) to deny interest deductions to MIPS and certain other securities not treated as debt for financial accounting purposes. For a description of MIPS, see John Reid, MIPS Besieged—A Solution in Search of a Problem, 77 Tax Notes 1057, 1058–59 (1997) (discussing Clinton administration's legislative proposal).

84. The rule, Statement of Financial Accounting Standards No. 133, requires certain derivatives transactions to be marked to market. For a discussion, see *infra* Part II.B.3.d. A number of commentators have voiced concern about the nontax effects of this rule. See *infra* note 164. The rule obviously has defenders as well, including Arthur Levitt, former Chairman of the SEC. See *infra* note 161.

Problems can arise not only if the friction has adverse nontax effects, but also if it serves a useful nontax function. It would be undesirable for the tax law to undermine a useful friction. For instance, assume the relevant friction is the taxpayer's desire for public trading. Various governmental efforts support public trading, such as the SEC's registration of public securities and monitoring of trading practices. These public investments are often defended because of positive externalities, or the benefits that liquid markets provide to third parties. For instance, more accurate pricing of assets provides valuable guidance even for people who are not currently trading. What if the tax burden on publicly traded securities is raised? Ideally, the nontax benefits of trading would always outweigh the tax savings, so no one would stop trading in these markets. But, in contrast, if the tax savings outweigh these nontax benefits, causing taxpayers to stop trading, taxpayers and third parties would no longer enjoy the benefits of these transactions.

Similarly, it is undesirable for the tax law to create political pressure to repeal a helpful friction. For instance, assume that a regulated financial institution cannot claim a tax deduction without triggering adverse regulatory treatment, as when accounting losses require regulators to take over the institution. If this tough regulatory treatment ensures the solvency of regulated institutions, it would be undesirable for regulators to weaken their standards solely to make the tax deduction easier to claim.⁸⁵ In light of these risks, reformers should prefer a friction that is important enough to persuade taxpayers not to ignore it or to seek its repeal.

E. All Narrow Reforms Are Not Created Equal

To sum up, the appeal of a narrow tax rule—whether compared with the status quo, or with a broader measure—depends to a significant extent on frictions. If discontinuous frictions are not present, a narrow rule may not be worth instituting. Even if it is, a broader rule is likely to fare better. On the other hand, what if discontinuous frictions are present? A narrow rule is much less likely to be counterproductive. In addition, the narrow measure may even fare *better* than a broader rule, although costs and benefits of each alternative must be compared; for instance, the cost of learning about and monitoring the friction should be balanced against

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85. See, e.g., *Cottage Savs. Ass'n v. Comm'r*, 499 U.S. 554, 557 (1991) (noting that through Memorandum R-49, the Federal Home Loan Bank Board had weakened its regulatory accounting standards to enable savings and loan associations to claim tax losses without triggering losses for regulatory accounting purposes). A similar dynamic played out when banks petitioned the Federal Reserve to designate so called trust-preferred securities as "tier one" capital. These securities were eligible for a tax deduction, but their debt-like features rendered them, at least initially, an insufficiently reliable source of core capital for regulated banks. Eventually, though, the Federal Reserve relaxed its standards enough to offer these securities a "tier one" designation. Tom Pratt, *Fed Gives Go-Ahead for New Form of Tier 1 Capital*, *Inv. Dealers' Dig.*, May 27, 1996, at 9, 9.

the cost of introducing enough nuance in a broad rule to avoid overbreadth.

In short, all narrow reforms are not created equal. Given their pervasiveness, it is important for reformers to predict, through fact specific inquiries, which of the above results is most likely for a given reform. Admittedly, this inquiry can be difficult. Yet these efforts are needed to ensure that narrow reforms, the day-to-day grist of tax reform, are playing a constructive role. While this genre of policymaking is less satisfying than crafting more fundamental reforms, ambitious alternatives are politically unrealistic for now. Thus, in addition to studying first-best solutions, commentators should offer guidance about more modest reforms that are under active consideration. More information is needed, and legal academics should help gather it. Admittedly, commodities laws and credit risk seem far removed from classic tax policy measures, such as the Haig-Simons definition of income,⁸⁶ and are sometimes more obscure and inaccessible. Yet it is hard to craft normatively appealing transactional responses without understanding these ingredients of elasticity.

II. CONSTRUCTIVE SALES: WHEN FRICTIONS ARE WEAK

To illustrate the importance of frictions, Parts II and III compare two recent transactional responses involving the taxation of derivative financial instruments. These reforms use essentially the same statutory language. Under each, favorable tax treatment is still available as long as subtle changes are made in the derivative's economic return. As Part II shows, this strategy is commonly used to avoid the constructive sale rule of section 1259. Consequently, the targeted transaction, use of derivatives in effect to sell appreciated assets without paying tax, remains pervasive. In contrast, as Part III demonstrates, frictions discourage taxpayers from using the same strategy—a derivative with a modified economic return—to avoid the constructive ownership rule of section 1260, which was enacted two years later. The volume of hedge fund derivatives is relatively modest, although other strategies involving insurance are coming into wider use. While each reform raises a number of normative and political issues, a comprehensive exploration is beyond this Article's scope. Rather, the emphasis here is on avoidance of these seemingly similar measures, and frictions that stand in the way.

Given the private nature of these transactions, reliable and detailed information is not easy to acquire. I draw on my practice experience in this area, as well as on more than fifty conversations during 2000 and

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86. In widely cited works, Robert Haig and Henry Simons define income as the sum of consumption and the market value of increases in the value of the taxpayer's property. Robert Murray Haig, *The Concept of Income—Economic and Legal Aspects*, in *The Federal Income Tax* 1, 7 (Robert Murray Haig ed., 1921); Henry C. Simons, *Personal Income Taxation* 50 (1938).

2001 with investment bankers and tax and securities lawyers.⁸⁷ This research focuses on major Wall Street investment banks, which have been the leading innovators in over-the-counter derivatives, rather than on smaller institutions elsewhere in the country. A condition of these conversations was that persons and institutions would not be identified. Since financial innovation is a fast-paced business, a caveat is that research for this Article was finalized in August 2001, and the transactions discussed here can be expected to evolve over time.

For each case study, the first Section describes the targeted transaction and statutory response. To evaluate various methods of avoiding these measures, the second Section describes the relevant tax benefit from such avoidance, the effect of requiring taxpayers to accept a modified economic return, and the impact of other frictions. The third Section briefly considers normative implications of these empirical findings.

A. Targeted Transaction

Under section 1259, capital gains tax is due not only when appreciated assets are sold, but also when they are *hedged* in some cases.⁸⁸ The

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87. I practiced actively in this area from 1995 through 1998. As co-chair of the Committee on Financial Instruments of the NYSBA Tax Section, I remain familiar with the details of various transactions described in this Article. To supplement and update my knowledge for this Article, I have spoken with numerous experts between May of 2000 and August of 2001. Thus, I have spoken to nine investment bankers, all based in New York City. Two work on both private and public transactions, at boutiques specializing in tax planning. Since they work with a range of other investment banks, they are intimately familiar with market practice. Six work at top-tier, internationally known investment banks, and one works at a smaller investment bank but until recently worked at a top-tier firm. Of the seven with top-tier firm experience, four are "private client" bankers who have relationships with wealthy clients and propose various transactions to them. For a discussion of "private client" bankers, see *infra* note 125. The remaining three are derivatives specialists who are called in to implement these transactions. One specializes in over-the-counter transactions and the other two in public transactions. In addition, I also have spoken with a tax lawyer who used to trade options on public options markets and has remained familiar with the trading practices on these markets, including those involving LEAPS and other long term options. For a discussion of LEAPS, see *infra* note 122 and accompanying text.

During the same period, I have spoken to five corporate attorneys who specialize in derivatives transactions, including standard documentation used in over-the-counter and public deals, as well as common issues that arise under securities laws, commodities laws, regulatory capital rules, and broker-dealer regulations. Finally, I have spoken to approximately thirty tax lawyers who give advice about these transactions, including some who helped devise the relevant transactions and others who served in government while the relevant rules were being crafted. Most are based in New York City, but some are based in Washington, D.C., and Chicago. Some of these conversations occurred over the telephone, and others were in person.

88. "Hedging" in this context means that the asset's owner enters into a separate transaction that, in effect, cancels out the economic return in the appreciated asset. When one goes up, the other goes down.

measure was a response to growing use of short sales against the box⁸⁹ and other hedging strategies involving derivatives.⁹⁰ These transactions offered the benefits of a sale, including reduced risk and cash proceeds, but for formalistic reasons were not taxed as sales.⁹¹ Even though short sales against the box date back at least to 1932,⁹² it became easier in the last two decades to borrow the stock needed for this transaction.⁹³ Tax legislation in 1978 protected stock lenders from adverse tax consequences.⁹⁴ Brokers also had more stock to lend because investors were

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89. A short sale is a bet that the stock price will decline, implemented through sale of stock that the taxpayer does not own. To effect such a sale, the taxpayer's broker typically borrows shares and sells them on the taxpayer's behalf. The taxpayer promises to deliver shares to the broker in the future, and hopes declines in the stock price will make these "replacement" shares cheaper. For a discussion, see generally Edward D. Kleinbard & Erika W. Nijenhuis, *Short Sales and Short Sale Principles in Contemporary Applications*, 53 *Inst. on Fed. Tax'n* § 17 (1995). What distinguishes a short sale "against the box" is that the short seller already owns stock identical to the stock she is selling. By holding two offsetting positions—the short sale (a bet that the price will decline) and shares of stock (a bet that the price will rise)—the taxpayer is perfectly hedged. If the stock price declines, any loss on the stock she owns is offset by an equivalent gain on the short sale. Thus, subsequent volatility in the stock price does not affect her, and she also can spend the cash proceeds she receives from the short sale. For all practical purposes, the taxpayer feels as if she has sold the stock.

90. For instance, assume the appreciated asset has a zero basis and a \$100 fair market value. Instead of selling the asset and paying tax on \$100 of gain, the taxpayer enters into a forward contract committing her to sell the stock in three years at \$115. If the stock declines to \$90, she loses \$10 on the stock but makes \$10 on the forward because the ability to sell at \$115 becomes correspondingly more valuable as the market price declines.

91. The theory was that, for fungible property, a transfer of title or control was needed to identify the shares being sold, and thus their basis—a necessary function as taxpayers traditionally have been permitted to designate the shares being sold. Thus, tax was not owed unless and until the taxpayer delivered her appreciated shares to "cover" the short (i.e., by returning shares to the party who lent the shares used in the short sale). For a discussion, see Peter L. Faber et al., *The Ownership and Disposition of Property: New Rules for Old Problems*, 75 *Taxes* 768, 775 (1997); Edward Kleinbard, *Risky and Riskless Positions in Securities*, 71 *Taxes* 783, 793–94 (1993).

92. See, e.g., *Bingham v. Comm'r*, 27 B.T.A. 186, 189–90 (1932) (applying open transaction treatment to a short sale, even though taxpayer held substantially identical stock).

93. New York Stock Exchange (NYSE) and National Association of Securities Dealers (NASD) rules generally prevent a broker-dealer from even offering to make a short sale before locating a source from which to borrow stock. See N.Y. Stock Exch. Rule 440C, reprinted in *N.Y.S.E. Guide* (CCH) 3793 (1995); Nat'l Ass'n of Sec. Dealers Rule 3370(b)(2), reprinted in *N.A.S.D. Manual* (CCH) 4690 (2001). For a discussion of this "locate" requirement, see Martin Shubik, Michael Powers & David Schizer, *Sin, Short Selling, Taxes, Bubbles, and the Price of Shares* 18–19 (May 22, 2001) (unpublished manuscript, on file with the *Columbia Law Review*). The reader may wonder why it was necessary to borrow stock since the taxpayer already had some. Why not simply lend your own lot to your broker, so the broker could use these shares to execute your short sale? The favorable tax treatment would be lost. See Rev. Rul. 72-478, 1972-2 C.B. 487; *infra* note 148.

94. Taxable investors had worried that a loan of stock would be taxed as a sale. But see I.R.C. § 1058 (providing nonrecognition to lender of stock when certain conditions are satisfied). Tax-exempt investors had feared that fees earned from lending stock would be

keeping shares in brokerage accounts instead of in bank vaults.⁹⁵ Also, substitutes for short sales against the box, including equity swaps, options, and forward contracts, became more widely available in the over-the-counter derivatives market during the 1980s and 1990s.⁹⁶ These hedges could be used, for instance, when a short sale would violate the securities laws.⁹⁷ Since a short sale against the box did not trigger tax, these alternatives were thought to give the same result (although, in retrospect, a 2000 IRS ruling has introduced some doubt on this question).⁹⁸

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taxable as unrelated business taxable income (UBTI). But see I.R.C. § 512(a)(5) (providing that income from securities loans is not UBTI); see also S. Rep. No. 95-762 (1978), [2001] 9 Stand. Fed. Tax Rep. (CCH) ¶ 22,830, at 42,362 (describing Congress's concern that securities lending not trigger adverse tax consequences).

95. Indeed, if the stock is held in a margin account, the broker does not need permission to lend the shares. See SEC Rule 15c3-3, 17 C.F.R. § 240.15c3-3 (2001); H.R. Rep. No. 102-414, at 4 (1991). While permission is needed to lend stock in "cash" accounts, such permission is routinely granted. This is often a condition the broker requires in setting up the account.

96. A swap is a two-party contract that binds each party to make periodic payments based on an objective indicator, such as an interest rate or (in the case of an equity swap) a stock price. For a description, see Global Derivatives Study Group, *supra* note 11, at 31. An option contract entitles the holder to buy or sell stock for a given price, but does not obligate her to do so; in contrast, forward contracts require a commitment. *Id.* at 30-32. The volume of derivatives contracts sold privately by securities dealers in the over-the-counter market grew dramatically during the 1980s and 1990s. See, e.g., Stephen Labaton & Timothy L. O'Brien, *Financiers Plan to Put Controls on Derivatives*, N.Y. Times, Jan. 7, 1999, at C1 (noting that \$37 trillion worth of privately traded derivatives contracts were outstanding in January 1999, compared to only \$865 billion in 1987).

97. For instance, securities laws bar senior corporate officers and large shareholders from engaging in short sales. See Exchange Act § 16(c), 15 U.S.C. § 78p(c) (1994). Yet "synthetic" short sales with derivatives are sometimes allowed. See SEC Rule 16c-4, 17 C.F.R. § 240.16c-4 (2001) (allowing certain "put equivalent" positions). For a discussion of regulatory relief provided for hedging under Rule 16c-4, see Schizer, *Executives and Hedging*, *supra* note 25, at 463-64. Section 5 of the Securities Act, 15 U.S.C. § 77e(a)-(c) (1994), would also prevent sales of restricted stock, but hedging this stock with derivatives is sometimes thought to be permissible. For discussion of this issue, see *infra* text accompanying notes 133-139.

98. Priv. Ltr. Rul. 2001-11-011 (Dec. 6, 2000) concludes that a hedging transaction is a sale under common law. (The ruling does not discuss the constructive sale rule, the tax reform discussed in text below; apparently, the transaction at issue in this ruling predates the rule.) The taxpayers, controlling shareholders in a publicly traded firm, entered into a physically settled forward contract. To an extent, the taxpayers were still affected by fluctuations in the stock price through changes in the number of shares to be delivered. In treating the forward contract as a current sale, the field service advice said the taxpayers were irrevocably committed to delivering their appreciated shares. While the transaction resembles variable delivery forward contracts currently used to avoid section 1259, there are two differences. First, unlike current deals, the forward contract could not be cash settled (presumably because of commodities law concerns that since have faded). With a cash settled forward contract, the taxpayer might *never* part with *any* shares, and so it is more persuasive to delay sale treatment until she actually delivers shares. Second, the taxpayers in the ruling had voting control even without the hedged shares. Hence, voting the hedged shares was not meaningful evidence of continued ownership. This fact pattern presumably is not common. Thus, while the ruling has introduced some uncertainty,

Notwithstanding the permissive tax rule and erosion of frictions, a lot of capital gain was still taxed. For instance, individuals realized \$170.4 billion of net capital gain in 1995.⁹⁹ In some cases, taxpayers presumably were not willing to incur the relatively low transaction costs to use short sales against the box, including fees for lawyers and for borrowing stock. Taxable gain also derived from the growing popularity of mutual funds. Because these funds traditionally have been ranked on *pretax* returns, fund managers have an incentive to maximize this return—as opposed to after-tax returns.¹⁰⁰ As a result, managers traditionally have traded actively, leaving investors with high tax bills. In effect, agency costs have inflated taxes.

Even so, hedging was becoming increasingly common and well publicized. High profile articles were appearing in the press.¹⁰¹ In response, Congress enacted the constructive sale rule in 1997.¹⁰² Under section 1259, taxpayers recognize gain (but not loss), as if they have made a sale,¹⁰³ whenever they use a short sale, forward contract, swap, or compa-

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many advisors believe it reads the law incorrectly and, in any event, should not apply to cash settled forward contracts popular today.

99. Therese Cruciano, *Individual Income Tax Returns, 1995*, Stat. Income Bull. (Internal Revenue Serv.), Fall 1997, at 9, 9. It is not clear how much of this gain comes from liquid publicly traded assets, as opposed to real estate, closely held firms, collectibles, and other nonfungible assets that could not be hedged tax free.

100. In response, the SEC recently required mutual funds to disclose after-tax returns in certain instances. See *Disclosure of Mutual Fund After-Tax Returns*, Securities Act Release Nos. 33-7941, 34-43857, 66 Fed. Reg. 9002 (Feb. 5, 2001) (issuing final regulation concerning disclosure of mutual fund after-tax returns).

101. Particular attention was focused on a public offering of stock in Estee Lauder. Instead of selling their own shares, family members borrowed each other's stock, thereby rendering the public offering a short sale against the box. As the family members did not plan to "cover" the short until after they died, the tax deferral ordinarily offered by a short sale against the box would become tax forgiveness. See Sheryl Stratton, *Treasury Targets Capital Gains Tax-Deferral Strategies*, 70 *Tax Notes* 347, 348 (1996) ("You have the well-publicized Lauder transaction," which brought the tax-avoidance aspect of the short sale against the box into the national limelight." (quoting Steven Rosenthal, former legislation counsel for the Joint Committee on Taxation)). The *New York Times* followed up with coverage of various other large hedging transactions. Diana B. Henriques & Floyd Norris, *Rushing Away from Taxes: The Capital Gains Bypass—A Special Report*, *N.Y. Times*, Dec. 1, 1996, at A1.

102. Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 1001, 111 Stat. 788, 903 (codified as amended at I.R.C. § 1259).

103. Section 1259(a) provides the consequences of a constructive sale:

If there is a constructive sale of an appreciated financial position—

- (1) the taxpayer shall recognize gain as if such position were sold, assigned, or otherwise terminated at its fair market value on the date of such constructive sale (and any gain shall be taken into account for the taxable year which includes such date), and
- (2) for purposes of applying this title for periods after the constructive sale—
  - (A) proper adjustment shall be made in the amount of any gain or loss subsequently realized with respect to such position for any gain taken into account by reason of paragraph (1), and

able transaction to eliminate "substantially all" of the risk of loss and opportunity for gain in an appreciated security.¹⁰⁴

This language reflects a political compromise. Many in the Treasury would have preferred a broader measure, but did not believe one could be enacted.¹⁰⁵ Since members of Congress were thought to be committed to the realization rule,¹⁰⁶ the measure is limited to hedges that closely resemble sales. The securities industry was also lobbying to keep the re-

(B) the holding period of such position shall be determined as if such position were originally acquired on the date of such constructive sale. I.R.C. § 1259(a).

104. For a detailed discussion of the statutory language and technical issues it raises, see generally David M. Schizer, *Hedging Under Section 1259*, 80 *Tax Notes* 345 (1998) [hereinafter Schizer, *Hedging Under Section 1259*]. Section 1259(c)(1) offers the statutory definition of a constructive sale:

(c) Constructive Sale

For purposes of this section—

(1) In general

A taxpayer shall be treated as having made a constructive sale of an appreciated financial position [defined generally in section 1259(b)(1) as appreciated stock, debt, or partnership interests] if the taxpayer (or a related person)—

- (A) enters into a short sale of the same or substantially identical property,
- (B) enters into an offsetting notional principal contract with respect to the same or substantially identical property,
- (C) enters into a futures or forward contract to deliver the same or substantially identical property,
- (D) in the case of an appreciated financial position that is a short sale or a contract described in subparagraph (B) or (C) with respect to any such property, acquires the same or substantially identical property, or
- (E) to the extent prescribed by the Secretary in regulations, enters into 1 or more other transactions (or acquires 1 or more positions) that have substantially the same effect as a transaction described in any of the preceding subparagraphs.

I.R.C. § 1259(c)(1). The common theme of these enumerated transactions, according to widely cited legislative history, is that these "financial transactions . . . have the effect of eliminating substantially all of the taxpayer's risk of loss and opportunity for income or gain with respect to the appreciated financial position." Joint Comm. on Tax'n, 105th Cong., General Explanation of Tax Legislation Enacted in 1997 (Comm. Print 1997) [hereinafter *Tax Legislation Enacted in 1997*], [2001] 13 *Stand. Fed. Tax Rep.* (CCH) ¶ 31,130, at 56,715.

105. Three tax lawyers who worked in the Treasury during this period have indicated to me that they would have preferred a broader measure but believed that the political obstacles were too great.

106. Under the realization rule, tax is not due until appreciated property is sold. The principle is fundamental to the U.S. tax system, and was once thought to be constitutionally ordained. See *Eisner v. Macomber*, 252 U.S. 189, 214–15 (1920) (ruling that congressional efforts to tax a stock dividend are unconstitutional and reasoning that "enrichment through increase in value of capital investment is not income in any proper meaning of the term"); see also David M. Schizer, *Realization as Subsidy*, 73 *N.Y.U. L. Rev.* 1549, 1593–1600, 1606–09 (1998) [hereinafter Schizer, *Realization as Subsidy*] (discussing deep political and administrability roots of realization rule).

form narrow.¹⁰⁷ A narrow measure could still offer symbolic benefits, which were important to many officials in the Treasury and Congress. But to what extent has section 1259 stopped hedging?

B. *Frictions and Avoidance*

To answer this question, this Section briefly considers the tax benefit from hedging, and then analyzes the strength, malleability, and position of relevant frictions. Hedging proves difficult for positions worth less than \$1 million, but viable, although not cost free, for larger positions.

1. *Tax Benefit.* — The main tax benefit from hedging is deferral.¹⁰⁸ The longer the hedge lasts, the greater this advantage. An additional tax benefit, available for at least another decade, is that income tax is avoided altogether if the hedge lasts until the taxpayer dies, since the current rule is that basis in appreciated property “steps up” at death.¹⁰⁹ These benefits—i.e., deferral and forgiveness—are especially appealing when the capital gains tax rate is high since, from the taxpayer’s perspective, avoiding a high tax is even better than avoiding a low one. In the same tax bill that contained section 1259, Congress reduced the individual long term capital gains rate for stock from 28% to 20%, thereby reducing the tax benefit from hedging.

2. *Derivatives with Modified Return.* — The typical way to avoid section 1259, understood by the government and taxpayer alike, is to retain some exposure to the hedged asset’s return—in other words, to use a partial hedge. For example, if an asset is worth \$100, the taxpayer can accept risk of loss from \$100 to \$95 (by buying a put at \$95), while retaining opportunity for gain from \$100 to \$115 (by selling a call at \$115).¹¹⁰ This

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107. See Lee Sheppard, *Rethinking DECS, and New Ways to Carve Out Debt*, 83 Tax Notes 347, 349 (1999) (discussing influence of “Wall Street lobbying” on the scope of section 1259).

108. By deferring a tax, taxpayers can continue to invest, and earn a return on, money that otherwise would fund the tax. For a discussion, see Schizer, *Realization as Subsidy*, *supra* note 106, at 1555.

109. For example, if a taxpayer dies holding property worth \$100 with a zero basis, the heir takes the property with a \$100 basis. Thus, the income tax never reaches this appreciation. See I.R.C. § 1014. This rule is scheduled to change for transfers after December 31, 2009, in connection with repeal of the estate tax, although it is possible that Congress will decide not to follow through with these changes. For a discussion, see *infra* note 198.

110. The “put” option offers the taxpayer the right, but not the obligation, to sell at \$95, thereby guaranteeing her at least that price. In selling the call option, the taxpayer gives her counterparty the right, but not the obligation, to buy at \$115. Thus, the taxpayer will not benefit from any appreciation above \$115. Taxpayers usually prefer to retain as little exposure as possible, but the government has not offered clear guidance about precisely how much is needed. The answer is expected when regulations are promulgated under section 1259.

Numerous authorities construe the meaning of “substantially all” in other contexts. See, e.g., Rev. Proc. 77-37, 1977-2 C.B. 568, 569 (indicating that “substantially all” means, in the context of reorganizations, 70% of gross value and 90% of net value); Treas. Reg. § 1.731-2(c)(3)(i) (as amended in 1997) (providing that “substantially all” means 90% in

combination of owning a put and selling a call is known as a "collar."¹¹¹ Other derivatives, such as swaps and forward contracts, can offer the same result.¹¹²

In some cases, the taxpayer would rather make a taxable sale than remain exposed, even in this limited way. The point of tax deferral, after all, is to earn a return on money that otherwise would fund the tax. This benefit is especially appealing if this money can be invested in *any* asset, as under prior law. A short sale against the box yielded 95% of the hedged asset's value as cash, which could be invested in anything.¹¹³ Under section 1259, in contrast, a portion of the taxpayer's deferred

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determining whether marketable securities or cash constitute "substantially all" of an entity's assets); Treas. Reg. § 1.448-1T(e)(4) (as amended in 1993) (indicating that "substantially all" means 95% in determining whether personal services constitute substantially all of a corporation's activities); see also Schizer, *Hedging Under Section 1259*, supra note 104, at 352 (discussing meaning of "substantially all").

In the interim, the market convention generally has been a spread equal to 10% or 20% of the hedged asset's fair market value on the date of the hedge. See Thomas J. Boczar, *Stock Concentration Risk Management After TRA '97*, *Trusts & Estates*, Mar. 1998, at 45, 48 [hereinafter Boczar, *Stock Concentration Risk Management*] (noting that need for a 15% spread is common advice, and that this spread derives from example in legislative history). The 20% spread derives from a report of the NYSBA. See New York State Bar Association Tax Section, *Comments on H.R. 846*, *Tax Analysts*, *Tax Notes Today*, May 21, 1997, LEXIS, 97 TNT 103-11 [hereinafter NYSBA Tax Section, *Comments on H.R. 846*]. In the interests of full disclosure, I should state that I was a principal drafter of that report, but the 20% test reflects the consensus of the organization's executive committee. For a description of the NYSBA, see supra note 77. Since the NYSBA is a private organization, its recommendations obviously do not constitute legal authority. However, in the absence of clear guidance from the government, practitioners often read NYSBA reports with interest because the Treasury and Congress accept NYSBA recommendations with some frequency, and because the NYSBA's executive committee includes many of the nation's most prominent tax lawyers.

111. The legislative history directs the Treasury to develop standards for collars in prospective regulations:

It is anticipated that the Treasury regulations, when issued, will provide specific standards for determining whether several common transactions will be treated as constructive sales. One such transaction is a "collar." . . .

. . . In order to determine whether collars have substantially the same effect as the transactions specified in the provision, it is anticipated that Treasury regulations will provide specific standards that take into account various factors with respect to the appreciated financial position, including its volatility. Similarly, it is expected that several aspects of the collar transaction will be relevant, including the spread between the put and call prices, the period of the transaction, and the extent to which the taxpayer retains the right to periodic payments on the appreciated financial position (e.g., the dividends on collared stock). The Committee expects that the Treasury regulations with respect to collars will be applied prospectively, except in cases to prevent abuse.

Tax Legislation Enacted in 1997, supra note 104, at 56,716.

112. See Schizer, *Hedging Under Section 1259*, supra note 104, at 351-53.

113. See Boczar, *Stock Concentration Risk Management*, supra note 110, at 45. In return, the taxpayer paid a modest (deductible) fee for borrowing the stock (e.g., less than 1% of the hedged asset's value), while foregoing any return on the 5% of proceeds that could not be withdrawn.

tax—and, indeed, of her entire position—must remain invested in the hedged asset. If this asset appreciates, a collar is usually better than a taxable sale. But as Appendix A shows, if the hedged asset declines in value, a taxable sale may be better, especially if the tax rate is low and sale proceeds are invested profitably. Thus, a taxpayer who has *no* confidence in the hedged asset may prefer a taxable sale. In my experience, though, investors usually accord *some* value to the retained exposure.¹¹⁴ For many, risk functions as a weak, continuous friction.¹¹⁵ A key question is whether other frictions burden partial hedges.¹¹⁶

3. *Other Frictions: Four Types of Investors.* — In general, there are no discontinuous frictions supporting section 1259, making constructive sales a difficult problem to target with a narrow rule. To illustrate the point, four types of investors are considered: individuals with positions worth less than \$1 million, who face the most daunting frictions and are least likely to hedge; individuals with positions worth between \$1 million and \$75 million, who face only weak frictions and have become the core clientele of a thriving hedging industry; individuals with positions worth more than \$75 million, whose larger positions create frictions that have proved manageable so far, although narrow tax rules could be crafted to

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114. Indeed, one hedging boutique, Derivium, uses this retained exposure as part of a sales pitch, describing it as a valuable feature without mentioning the tax benefit this retained exposure offers:

Our tools enable you to preserve, in the words of financial managers, “upside potential.” We offer tactical, structured transactions that provide a confluence of benefits—including the ability to retain ownership of the investments that have helped create your wealth, so you can continue to take advantage of their long-term potential.

Derivium Capital, Opportunity, at <http://www.derivium.com/Benefits/Opportunity.cfm> (last visited Aug. 6, 2001) (on file with the *Columbia Law Review*).

115. Some may consider risk not to be a friction here, but a normatively appropriate basis for distinguishing a collar from a hedge. For discussion of this perspective, see *infra* Part II.C.1.

116. The transaction is also burdened by another tax regime, the straddle rules of sections 1092 and 263(g). Congress enacted these rules to address other abuses. For instance, taxpayers were using offsetting positions, such as contracts to buy and sell silver, to engineer an artificial timing benefit by closing out the loss on December 31 (and thus deducting the loss that year) while closing out the gain on January 1 (and deferring the taxable gain until the next year). Kevin M. Keyes, *Federal Taxation of Financial Instruments and Transactions* ¶ 17.01, at 17-3 (1997). In response, the straddle rules impose three adverse consequences. First, the deduction for certain losses is deferred until offsetting gain is recognized. I.R.C. § 1092(a)(1). Second, taxpayers may not deduct interest expense “incurred . . . to purchase or carry” a straddle position. *Id.* § 263(g)(1)–(2)(A)(i). Third, taxpayers generally cannot attain the long term capital gains holding period for property that is part of a straddle. Treas. Reg. § 1.1092(b)-2(T)(a)(1) (as amended in 1986). In hedging transactions, therefore, interest may not be deductible, hedging losses may be deferred, and hedging gains may be taxed as short term capital gain even if the hedge lasts for more than one year. Yet well advised taxpayers can sometimes avoid these results, depending upon the particular facts. Application of the straddle rules to a hedging transaction is, therefore, a complex topic that is beyond this Article’s scope.

exploit these frictions; and, finally, corporate taxpayers, for whom hedging also has been relatively easy, although a recent change in financial accounting rules has added a potentially important friction.

a. *Individuals with Positions Worth Less than \$1 Million.* — For those with stock worth less than \$1 million, frictions are strongest. Before section 1259 was enacted, this group used short sales against the box. Now, these taxpayers would want to use over-the-counter derivatives, but generally cannot do so. Under the commodities laws, these transactions are not enforceable for those with less than \$1 million of investable assets.¹¹⁷ Nor is deferral of only \$300,000 of tax¹¹⁸ likely to be enough to justify fixed costs, including fees of the legal advisor and securities dealer. These costs are fixed because experts must devote a minimum amount of time, regardless of the transaction's size. As a result, leading investment banks generally will not undertake a transaction below the \$1 million threshold.¹¹⁹ Since over-the-counter derivatives usually are not available, retail investors might use options transactions in public markets to construct collars.¹²⁰ Yet in recent years, the term of most publicly traded options—one year or less—has been too short to provide meaningful deferral, even if the taxpayer is willing to pay for tax advice.¹²¹ This transaction presumably is becoming more common as the market for long term exchange traded options, such as LEAPS and E-FLEX options, be-

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117. See *supra* note 49.

118. The taxpayer is assumed to have a basis of zero, a federal tax rate of 20%, and a state tax rate of 10%.

119. A position worth \$1 million was described as the approximate cutoff point by three bankers in the relevant department of three different banks—the so called private client group, whose role is discussed *infra* note 125. Each also said that exceptions sometimes are made for particularly valued clients. Others suggest a higher threshold, such as \$1.5 million or even \$2 million. See, e.g., Thomas J. Boczar, *Conceptualizing & Implementing a Stock Concentration Risk Management Program*, Trust & Investments, Nov.–Dec. 1998, at 23, 24 [hereinafter Boczar, *Risk Management Program*] (noting that over-the-counter options are appropriate only for positions worth \$2 million or more); AdvisorTeam, *Frequently Asked Questions*, at <http://www.equitycollar.com/faq.htm> (last visited Aug. 6, 2001) (on file with the *Columbia Law Review*) (providing \$1.5 million as a minimum, “[k]eep[ing] in mind that pooling of a few smaller positions of the same stock to achieve the \$1,500,000 minimum can be done”).

120. For a discussion of the difference between over-the-counter and publicly traded derivatives, see *supra* note 49 and accompanying text.

121. The taxpayer can enter into a series of hedges, though. For instance, when the stock is at \$100, she can enter into a \$100–\$120 one-year collar. If the stock is worth \$150 after a year, the taxpayer can settle the collar with a \$30 cash payment, without selling the stock. Then the taxpayer can enter into a new one-year collar. There are two tax costs here, though. Under the straddle rules, losses in settling the short call will not be deductible unless the “qualified covered call option” exception applies. See I.R.C. § 1092(c)(4). This exception does not apply if the stock is already part of a straddle, as it arguably is (i.e., the stock and the put). Second, if the stock price declines, the taxpayer's profit will shift from the stock (where it was long term capital gain) to the cash settled put (where it is short term capital gain).

comes cheaper and more liquid.¹²² In addition, vehicles may someday be formed in which small investors hedge together, and some players may eventually develop new ways to tap this market.¹²³ For now, though, frictions are meaningful for this group.¹²⁴

b. *Individuals with Positions Worth \$1 Million to \$75 Million.* — In contrast, taxpayers with positions worth \$1 million to \$75 million face much weaker frictions, and thus are the core clientele for “private client” investment bankers who implement these transactions.¹²⁵ Every major invest-

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122. The acronym LEAPS stands for Long Term Equity Anticipation Securities, and the acronym E-FLEX stands for Equity Flexible Exchange Options. Currently, LEAPS are available only for a subset of listed equities. The website of the Chicago Board Options Exchange indicates that LEAPS are offered for “over 300 equities.” Chi. Bd. Options Exch., Options Products, at http://www.cboe.com/OptProd/understanding_products.asp (last visited Aug. 6, 2001) (on file with the *Columbia Law Review*). Unlike most exchange traded options, which have standard terms, “FLEX options allow users to custom tailor most contract terms.” *Id.* E-FLEX options are not available to would-be hedgers of small positions because there is a minimum size requirement of at least 25,000 shares. Chi. Bd. Options Exch., Flex Options, at <http://www.cboe.com/Institutional/Flex.asp> (last visited Aug. 6, 2001) (on file with the *Columbia Law Review*).

123. For instance, one hedging boutique, Derivium, claims on its website that “Derivium Capital provides wealthy individuals—investors, entrepreneurs, and executives—with the benefits of sophisticated, structured financial transactions that were once exclusively the province of large institutional and professional investors.” Derivium Capital, Powerful Products Backed by Exceptional Service, at <http://www.derivium.com/Services/index.cfm> (last visited Aug. 6, 2001) (on file with the *Columbia Law Review*). Their marketing materials claim that in some instances they will help hedge positions as small as \$100,000. See Derivium Capital, 90% Stock Loan^{SM}: Basic Mechanics, at http://www.derivium.com/Services/Stock_Loan.cfm (last visited Aug. 6, 2001) (on file with the *Columbia Law Review*) (“You transfer an equity position (or positions) of \$100,000 or more to Derivium Capital; we establish hedging transactions to protect the value of your collateral and subsequently provide you with 90% of the hedged value of your shares for a minimum term of three years.”).

124. Since section 1259(c)(3) offers an exception for short term hedges (i.e., those covered within thirty days of the end of the taxable year), retail investors can still use the short sale against the box for short term hedging. Yet the strategy is less viable for long term hedging. While the taxpayer can do a series of short term hedges, she must accept total exposure (i.e., no hedging except for market risk) for sixty days between these hedges. See I.R.C. § 1259(c)(3)(A). Another disadvantage of this strategy is that it may convert what otherwise would be long term capital gain into short term capital gain or give rise to losses that may not be deducted currently. For a discussion of this issue, see Schizer, Hedging Under Section 1259, *supra* note 104, at 348–49.

125. The “private client” group advises “high net worth” clients who have investable assets above a threshold level (e.g., \$1 million). These groups are important businesses. See, e.g., Merrill Lynch & Co., 2000 Annual Report 3 (2001) [hereinafter Merrill Lynch, Annual Report] (describing “Private Client” group as one of its “three complementary businesses,” the others being “Corporate and Institutional” and “Investment Managers”), available at <http://www.ml.com/woml/annrep00/pdfs/ar2000Edit.pdf> (on file with the *Columbia Law Review*); Morgan Stanley Dean Witter & Co., Annual Report 2000: Letter to Shareholders (2001) (“We also are taking steps to expand our business with high net worth individuals and to increase further the productivity of our financial advisors.”), available at <http://www.morganstanley.com/ar2000/letter/printableletter.htm> (on file with the *Columbia Law Review*). A core function is to provide hedging transactions. See Merrill Lynch & Co., *supra*, at 15 (highlighting role of “[s]pecially trained advisors” who “offer

ment bank, as well as numerous boutiques, have active hedging desks for such clients.¹²⁶ The necessary derivative can be supplied at a reasonable cost—a key difference between section 1259 and section 1260, as discussed in Part III.¹²⁷ While the dealer's compensation is high—often 1% of the hedged asset's initial value for each year of the hedge—clients do not pay it in cash. Instead, they typically give the dealer opportunity for gain to pay for protection from risk of loss, and the opportunity for gain has a higher fair market value.¹²⁸ As a result, clients pay in a currency, opportunity for gain, that they do not especially value and, in some cases, are not adept at quantifying.¹²⁹ Nor are the commodities laws an obsta-

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sophisticated tax and estate planning, together with concentrated stock strategies"); see also Boczar, Risk Management Program, *supra* note 119, at 11 ("Low-cost basis stock might be viewed as a 'hidden profit center' at most banks and trust companies.").

126. According to one boutique's website:

Not surprisingly, competition between Wall Street firms is fierce, especially in soliciting companies that have just gone public. Generally, investment banks will send their private client service ("PCS") brokers to make presentations to the officers and board members in an attempt to parley the investment banking relationship into other forms of business. Besides offering general brokerage services and money management, these firms offer "Equity Collars." All of the major Wall Street Firms have derivative underwriting capabilities.

AdvisorTeam, *supra* note 119.

127. The reason for this difference is that dealers can use "dynamic" hedging to hedge these securities, but not the securities needed to avoid section 1260. For a discussion, see *infra* Part III.B.2.

128. According to the managing director of Sanford C. Bernstein & Co.'s Family Wealth Group:

A number of factors relating to both the options and the underlying stock go into pricing a cashless collar, but the key is that the sold call is usually worth more than the purchased put. And so by equilibrating the call and put premiums, dealers are expecting to realize a profit on the collar. Typically, this implicit cost is in the range of 1% per year on the initial value of the stock, which investors may well consider reasonable.

Alan R. Feld, High Exposure to Low-Basis Stock: Too Much of a Good Thing?, CPA J., Nov. 1999, at 60, 64.

129. For example, assume the hedged asset is worth \$100. The client's protection from risk of loss below \$100 (the put option) is worth approximately \$18.50. An even trade would allow the dealer opportunity for gain above \$151 (since a call option with a \$151 exercise price is also worth approximately \$18.50). Instead, the dealer might claim opportunity for gain above \$120, which is worth approximately \$26. The dealer thus receives an extra \$7.50 of value as a fee, but in a form that, in many cases, the client privately values at less than \$7.50. Dealers value this exposure at \$7.50, though, because they can convert it to cash through dynamic hedging, a process explained in Part III.B.2. The numbers in this hypothetical transaction presume a volatility of .4, an interest rate of 5%, a right to exercise options only at maturity (so called European-style options), and a term of three years, using Numerical Algorithms Group's option calculator. Numerical Algorithms Group, Demonstration Black Scholes Calculator, at <http://www.nag.com/numeric/CL/Financial/StdBlack-Scholes.asp> (last visited Aug. 6, 2001) (on file with the *Columbia Law Review*), [hereinafter NAG Option Calculator] (estimating value of European-style and American-style call options). As I have not done a comprehensive survey of exercise prices and volatilities in the typical private transaction, I do not mean to assert that a 7.5% fee is typical. I suspect the fee is usually lower.

cle, since wealthier clients typically are exempt.¹³⁰ Theoretically, the margin rules could limit the cash proceeds a taxpayer could claim from a hedging transaction, but, as a practical matter, taxpayers often can receive up to 90% of the hedged asset's value in cash, which can be reinvested.¹³¹ Of course, the transaction requires time, effort, and legal fees, but these demands are not prohibitive.¹³²

These deals are somewhat more difficult, but often still manageable, for taxpayers who hedge stock received in a private placement or who serve as senior officers, directors, or major shareholders (so called "affiliates").¹³³ Various provisions of the federal securities laws limit these taxpayers' ability to sell the stock in public markets.¹³⁴ Technically, there is

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130. See *supra* note 49.

131. The margin rules limit the amount of credit that dealers can extend to clients, both to protect the client from taking overly risky bets, and to protect the economy from a market crash as investors sell in a falling market to pay their lenders. See generally Loss & Seligman, *supra* note 50, at 803 (describing rationales for margin rules). Section 7 of the Exchange Act, 15 U.S.C. § 78g(c)(2)(B) (1994), authorizes the Federal Reserve to set the relevant limits, and the Fed has implemented this mandate primarily in Regulation T, 12 C.F.R. § 220 (2001). In certain circumstances, this regulation prevents investors from borrowing more than 50% of the value of securities that serve as collateral for the loan. For a discussion, see generally Lofchie, *supra* note 53, at 458–72. These rules create legal issues for taxpayers who wish to extract cash from a hedging transaction. If taxpayers borrow money, they could trigger the 50% limitation. Instead, taxpayers use prepaid forwards to avoid this regime. Technically, the payment they receive represents sale proceeds, rather than a loan, and so the margin rules are thought not to apply. See, e.g., Schwab Institutional, Investment Strategies to Reduce the Risk of Concentrated Positions 5–8 (2000) (noting, in marketing literature, that a collar paired with a loan offers cash proceeds up to 50% of the hedged asset's value, but a prepaid forward offers 90%); Burns Matteson Capital Mgmt., Equity Hedging, at http://www.burnsmatteson.com/c_coming.htm (last visited Aug. 6, 2001) (on file with the *Columbia Law Review*) (indicating in marketing materials that prepaid forwards offer immediate access to up to 90% of proceeds).

132. According to one private client services banker, "The paperwork involved with establishing a monetising collar transaction is about as voluminous as the documents used in obtaining real-estate mortgage financing. Collars can be set up in about 10 days to two weeks, or longer." John C. Braddock, Risk Primer: Zero-Cost Collars, Risk, Nov. 1997, at 50, 51, available at http://www.jcbraddock.com/other/risk_text.html (on file with the *Columbia Law Review*). John C. Braddock is an Executive Director-Investments at CIBC Oppenheimer, the Private Client Division of CIBC World Markets Corporation.

133. See Paul Beckett, SEC May Rein in Lucrative Hedging of Restricted Stock, Wall St. J., Apr. 15, 1998, at B15 (noting that hedging restricted stock "is increasingly common as restricted stock has become a favored currency in mergers and acquisitions, particularly in the high-technology sector").

134. Section 5 of the Securities Act generally requires every offer and sale of a security to be "registered," such that adequate disclosure about the security is available. 15 U.S.C. § 77e (1994). There is an exception in section 4(1) for ordinary trading, so the average investor does not have to provide disclosure. *Id.* § 77d(1). Yet to keep this exception from swallowing the rule, this relief does not apply to the issuer or to an "underwriter." *Id.* Registration also is not required for so called "private placements," which are not conducted through public markets. *Id.* § 77d(2). For this exception to apply, the buyer often must satisfy certain wealth requirements, and thus is presumed not to need the protection of registration. Likewise, the buyer can resell the securities to someone else

no public sale in this private transaction with a derivatives dealer. But as soon as this private transaction is completed, the *dealer* will sell stock in the public markets. As in any private hedging transaction, the dealer is left with most of the hedged asset's economic return. Since the dealer is not in the business of betting on the market, the dealer must transfer this return to someone else, usually through short sales in public markets.¹³⁵ An important securities law concern, then, is that the SEC might view the dealer's short sales as a public offering because of the presence, behind the scenes, of privately placed stock or an affiliate. If so, the dealer would have to deliver a prospectus with the short sales, a cumbersome step that often is impractical.¹³⁶ There is no clear law here, although the SEC has been considering the issue for some time.¹³⁷ In this legal vacuum, investment banks have somewhat different views about which transactions are permissible, but many transactions are done.¹³⁸ Nonaffiliates usually face

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who satisfies these requirements. SEC Rule 144A, 17 C.F.R. § 230.144A (2001). But the buyer cannot resell the securities in the public markets unless specified conditions have been satisfied, the most important of which is a minimum holding period. SEC Rule 144, 17 C.F.R. § 230.144 (2001). Similar conditions also apply to persons with a sufficiently close relationship to the issuer, including senior officers, directors, and shareholders who own more than 10% of the firm. These "affiliates" also cannot sell in the public markets without satisfying the requirements spelled out in Rule 144. *Id.* For securities law constraints that may apply to affiliates under sections 16(b) and 16(c) of the Exchange Act, 15 U.S.C. § 78p(b)–(c), see *infra* note 139. Finally, the insider trading rules of SEC Rule 10b-5, 17 C.F.R. § 240.10b-5 (2001), obviously could apply if the taxpayer has inside information.

135. Since there will be an economic mismatch between the derivative sold to the client, on one side, and the short sale, on the other, the dealer will adjust the size of the short sale. Such "dynamic" hedging strategies are discussed at *infra* Part III.B.2.

136. Relatedly, the dealer might refuse to accept restricted securities as collateral, although, as the website of one investment bank indicates, the collateral issue can be managed so that the derivative will not expire before the holding period required in SEC Rule 144 is satisfied. Protection for Restricted Holdings, XXI Tailored Solutions: Persp. for the Prof. Investor (Twenty-First Securities Corp.), May 1999, available at http://www.twenty-first.com/newsletter/newsletter_may1999-4.htm (on file with the *Columbia Law Review*).

137. See Revision of Rule 144, Rule 145 and Form 144, Securities Act Release No. 33-7391, 62 Fed. Reg. 9246, 9251–53 (Feb. 28, 1997) (soliciting comments on appropriate treatment of hedging by affiliates).

138. For instance, some dealers are willing to hedge the stock as soon as the client receives it. See Beckett, *supra* note 133 ("But some banks recently have begun to include restricted-stock hedging services in merger negotiations, and some hedges are now effective simultaneously with the issuance of the restricted stock."); Boczar, Stock Concentration Risk Management, *supra* note 110, at 52–54 (noting that collars can be used to hedge restricted stock as long as term of hedge lasts at least until end of applicable holding period, and also noting that affiliates are not prohibited from using collars). Other advisors want the client to have held for at least some period of time before hedging (e.g., thirty days).

In addition to the holding period, advisors also consider the economic correlation between the stock and the hedge. A mismatch is considered helpful to show that the dealer's short sale is economically distinct from the derivative, and thus should not be attributed to the client. In other words, the tactic for avoiding section 1259—retaining some exposure to the hedged stock—also serves a securities law purpose. Observations in

more lenient requirements than affiliates.¹³⁹

For individuals with positions worth less than \$75 million, then, the relevant frictions usually are weak or malleable. As a result, over-the-counter hedging transactions are very common. The precise volume is difficult to ascertain, because these transactions are not publicly reported, and investment banks are secretive about their revenue sources. Yet in off the record conversations, private client services bankers at several of the leading players, as well as the smaller ones, suggest that the volume is extremely high, perhaps on the order of \$150 billion a year or more.

c. Individuals with Positions Worth More than \$75 Million. — Positions worth more than \$75 million are more difficult, though not impossible, for securities dealers to accommodate. The main problems arise when the dealer tries to hedge such a large derivative.¹⁴⁰ Short sales become more difficult because the dealer may be unable to borrow enough shares cheaply.¹⁴¹ In addition, dumping so many shares at once can cause a temporary dip in the price.¹⁴² These problems can be solved, but other costs or tax risks arise—a tradeoff that is a familiar theme in this Article.

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this note derive not only from the sources cited above, but also from conversations during 2000 and 2001 with five securities lawyers who commonly advise on these transactions.

139. Not only are affiliates subject to more rigorous requirements on this issue, but they also face three additional securities law issues under section 16 of the Exchange Act, 15 U.S.C. § 78p. First, section 16(c) would prevent affiliates from engaging in certain short sales, although SEC Rule 16c-4 generally permits hedging with derivatives. See *id.* § 78p(c); SEC Rule 16c-4, 17 C.F.R. § 240.16c-4 (2000) (permitting insiders to hedge, or take so called “put equivalent position[s],” as long as their derivative short position is not larger than the number of shares they own). Second, section 16(b) requires affiliates to disgorge certain short term trading profits, and in some circumstances hedging could trigger this penalty. 15 U.S.C. § 78p(b). Third, affiliates generally would have to disclose these transactions to shareholders. *Id.* § 78p(a). For discussions of these issues, see Schizer, *Executives and Hedging*, *supra* note 25, at 461–65.

140. Another issue, unrelated to the dealer’s hedge, derives from so called “position limits” on options. To prevent any single trader from cornering the market, options exchanges and over-the-counter markets limit the size of certain option contracts. See Nat’l Ass’n of Sec. Dealers Conduct Rule 2860(a), (b)(3)(A)(vi)–(vii), reprinted in N.A.S.D. Manual (CCH) 4711, 4718 (2001) (describing NASD’s position limits); Saul S. Cohen, *The Challenge of Derivatives*, 63 *Fordham L. Rev.* 1993, 2000 (1995) (“Exchange-traded and OTC options are limited as to position size out of concern, derived from the physical or commodity markets that they originated in, that someone could corner a market, thereby exacting monopolistic profits from other traders.”). Yet some lawyers believe that position limits can be avoided if the derivative is structured as a swap instead of an option. *Id.* at 1997–98 (describing transaction that otherwise would violate position limits as “home free all” if treated as equity swap). Position limits also do not apply to exchange traded E-FLEX options.

141. The dealer may face a “short squeeze,” in which the supply of stock available for borrowing is too small to accommodate demand. As a result, the cost of borrowing the stock increases, sometimes dramatically.

142. Boczar, *Risk Management Program*, *supra* note 119, at 7 (noting that over-the-counter transactions are “attractive alternative[s]” for “investors holding appreciated stock of a relatively inodest size (less than \$75 million)” but over-the-counter hedges are less

For instance, instead of a transaction with a derivatives dealer, the taxpayer can hedge by issuing a security in the public markets. The investment bank thus serves as an underwriter instead of a dealer. The taxpayer in effect borrows money from public investors and repays an amount based on the hedged asset's value. The effect is to transfer most of the hedged asset's return. Public investors usually bear full risk of loss in the underlying stock, while receiving only a portion of the opportunity for gain, leaving the taxpayer with enough to avoid a constructive sale.¹⁴³ But this hedge is harder for individuals than corporations. Under the securities laws, it is not feasible for individuals to issue securities to the public.¹⁴⁴ Instead, an intermediary is needed. The intermediary buys the hedging security from the taxpayer in a private transaction, and then issues an identical security to public investors.¹⁴⁵ For instance, a trust can be formed for this purpose. But frictions burden this variation as well, including the large fees that must be paid to organize and administer the trust.¹⁴⁶ As a result, although there has been a significant volume of these transactions, it is not uncommon for taxpayers to explore them pre-

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feasible for a large block because of "the borrowability and liquidity of the stock, option position limits, etc.").

143. For example, assume the hedged stock is currently worth \$100 per share. The taxpayer issues a security that pays, in three years, an amount of stock (e.g., between .8 shares and one share) that varies with the stock price in three years. If the price declines below \$100, one share is delivered. The effect is to transfer the full risk of loss to the public investor. If the price falls to \$10, the taxpayer can settle the public obligation for only \$10. If the underlying stock price rises, less than one share is delivered. The effect is for the taxpayer to keep enough opportunity for gain to avoid a constructive sale, while transferring the rest to the public. Since public investors receive less than all the opportunity for gain, they are compensated with a periodic payment that is higher than the dividend on the underlying stock. For a discussion of these securities, see Schizer, *Debt Exchangeable for Common Stock*, *supra* note 10, at 10.

144. While it is not technically illegal for an individual to serve as a registrant under the securities laws, expert practitioners report that, to their knowledge, no individual has ever done so. One described such a transaction as "unheard of."

145. Investment banks served this function in a few early transactions, but this practice has become less common. The investment banks have been reluctant to clutter the balance sheet of the entity authorized to issue public securities, typically the holding company that otherwise holds stock of the bank's various subsidiaries. Investment banks have been concerned that if they list numerous such transactions on the holding company's balance sheet, investors would view these deals as an unexpected and somewhat confusing use of the holding company's capital. Another risk is that regulators might treat the holding company as a broker-dealer, an untenable status since the holding company (unlike the dealer subsidiary) is not registered as a dealer and would not comply with numerous regulatory requirements for dealers.

146. Thus, in a \$95 million offering, approximately \$600,000 of up-front expenses were incurred to organize and administer the trust, including fees to the administrator, custodian, paying agent, and to each of three trustees, and further annual payments were projected. *DECS Trust V, 5,000,000 DECS (SM)*, Prospectus dated Aug. 9, 1999, at 30.

liminarily, and then to abandon them for private transactions, such as collars and forwards with securities dealers.¹⁴⁷

How, then, can a dealer implement a large private transaction of \$100 million or more? How can the dealer be sure to have borrowed shares needed for the short sale? The dealer borrows the *client's* stock—that is, the stock being hedged. How is the dealer protected if the (very large) short sale depresses the market price? The amount the dealer owes the client on the derivative is tied to the dealer's proceeds from the short sale.

Although these responses are common, they weaken the client's tax analysis—ironically, not under section 1259, but under other tax rules. If the client's return depends on the dealer's short sale, this sale might seem, under general substance over form principles, to be a sale by the *client herself*, with the dealer serving as agent. This impression is reinforced if the client's own stock is used in the dealer's short sale. Indeed, under a 1972 revenue ruling, short sales against the box were not taxed as sales—but only if the taxpayer's *own* stock was not delivered to the purchaser.¹⁴⁸ Moreover, when the client lends stock to the dealer, this step itself might trigger tax. For a stock loan to be tax free to the stock lender under section 1058, the “agreement shall . . . not reduce the risk of loss or opportunity for gain of the transferor of the securities in the securities transferred.”¹⁴⁹ Yet in the hedging transaction, the stock lender's (the taxpayer's) risk of loss in the stock *is in fact reduced* by the borrower (the investment bank), seemingly in violation of section 1058. How do taxpayers still claim to comply with this rule? Their risk is not reduced by “the agreement” (i.e., the stock loan agreement itself, which literally is the subject of section 1058), but by a formally separate transaction—a collar or variable delivery forward. Also, these two steps are likely to be separated in time so, it is hoped, they would not be viewed as a single transaction under step transaction principles. Whatever the merits of this reading of section 1058, the government presumably could override it through regulations (or, obviously, legislation).¹⁵⁰ This step would discourage use of the over-the-counter market for very large hedging trans-

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147. See *infra* Appendix C (noting that of twenty trust transactions filed with SEC in 1999, only five were finalized; volume of finalized transactions in 1999 was approximately \$429 million).

148. See Rev. Rul. 72-478, 1972-2 C.B. 487 (“A transaction is a valid short sale which will not be considered consummated until securities are delivered to close the sale where the broker did not borrow identical securities held in the taxpayer's accounts for delivery to the purchaser.”).

149. I.R.C. § 1058(b)(3); see also Prop. Treas. Reg. § 1.1058-1(b)(3), 48 Fed. Reg. 33,912 (July 26, 1983) (reiterating statute's risk-reduction requirement).

150. For example, a notice could define the phrase “agreement” in section 1058 to include not only the stock loan agreement itself, but also related transactions in which the stock borrower is reducing the stock lender's risk of loss. To illustrate the meaning of “related,” the notice could include an example in which the taxpayer lends stock to its collar counterparty (or an affiliate), and then a week later the counterparty shorts the borrowed stock to hedge a collar in which the stock lender is counterparty.

actions. The broader lesson, featuring prominently in the next case study, is that the dealer's ability to hedge is the soft underbelly of tax advantaged derivatives transactions. So far, the government has not taken advantage of this vulnerability to reinforce section 1259; the reason, I suspect, is that the government has not focused on the dealers' difficulties in borrowing stock.

d. *Public Corporations with Stock in Unrelated Firms.* — The preceding discussion has focused on individual taxpayers. Public corporations sometimes also have appreciated stock in other public corporations, and hedging has been relatively easy for these taxpayers. Tax deferral is especially appealing because the federal corporate tax rate is high (35% instead of the 20% long term capital gains rate for individuals).¹⁵¹ Even though tax deferral is valuable, hedging arguably is not necessary because another way to attain tax deferral is to hold the stock unhedged. While the firm must bear risk of loss in this asset, diversified shareholders may not be overly concerned about this risk. In other words, a public corporation with appreciated stock may have less need to hedge than a wealthy entrepreneur whose personal wealth is concentrated in a single firm. On the other hand, the public corporation can reduce its risk of bankruptcy by hedging,¹⁵² and risk averse corporate managers may find hedging appealing for similar reasons.¹⁵³

The mechanics of hedging are easier for a corporation than for individuals. Unlike the latter, who must interpose a trust, corporations can easily hedge by issuing public securities. In 1999, approximately \$6 billion of these securities were issued.¹⁵⁴ Costs include a 3% underwriting fee to the investment bank, as well as legal fees.¹⁵⁵ These transactions

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A further question is whether section 1058 is the exclusive way to avoid sale treatment, or a safe harbor. The legislative history implies the latter in calling the measure a clarification of existing law. S. Rep. No. 95-762, *supra* note 94, at 42,362. But the Treasury arguably could write regulations deeming section 1058 the exclusive avenue for nonrecognition. A detailed exploration of the Treasury's regulatory authority is beyond this Article's scope.

151. See I.R.C. § 11(b)(1)(D) (providing 35% tax rate for corporations with taxable income in excess of \$10 million).

152. Since the firm will want cash for other operations, an alternative is to borrow against the appreciated asset without hedging it. Such borrowing will increase the riskiness of the firm's equity.

153. This is an example in which agency costs encourage the tax motivated transaction. For a discussion of situations in which agency costs can discourage tax planning, see *supra* Part I.C.2.c.ii.

154. A list of 1999 transactions is included in Appendix B. Their economic terms often are like those described in *supra* note 143, at least in the case of so called Debt Exchangeable for Common Stock (DECS). In the Participating Hybrid Option Note Exchangeable Securities (PHONES) structure, in contrast, the taxpayer in effect sells a thirty-year at-the-money call option. For a description of the DECS and PHONES structures, see Schizer, *Debt Exchangeable for Common Stock*, *supra* note 10, at 10.

155. In a separate study, I am collaborating with Professor William Gentry, an economist at Columbia Business School, to offer quantitative measurements of various frictions associated with tax motivated hedging by corporations. See William Gentry &

also tend to depress the price of the underlying stock temporarily, which reduces the proceeds received in the hedging transaction.¹⁵⁶ Investors also receive a periodic payment to compensate them for the appreciation retained by the issuer.¹⁵⁷ While investors theoretically could demand a premium for such complex securities, legal frictions have reduced the need for one by creating a loyal pool of buyers: Insurance companies and pension funds use these securities to circumvent state law limits on the amount of equity they can hold.¹⁵⁸ These regimes often (naively) treat these securities as debt, even though the return closely tracks the underlying equity.¹⁵⁹

Although hedging by corporations has been fairly common, a change in the accounting rules has introduced an important new friction. This new rule responds to recent high profile losses that firms sustained in derivatives transactions, catching investors off guard.¹⁶⁰ To provide investors with more complete disclosure about a firm's exposure to derivatives, the Financial Accounting Standards Board (FASB), the nation's governing body for the accounting profession, has implemented Finan-

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David Schizer, *Taxes and Financial Innovation: The Case of Exchangeable Debt* 10–11 (June 11, 2001) (unpublished manuscript, on file with the *Columbia Law Review*).

156. See *id.* at 13–14 (studying this effect). The same price decline might also occur if the firm simply sold its stock position either because of a temporary lack of liquidity in the market, or because the sale was viewed as a negative signal.

157. Although the tax treatment of these payments is not clear, firms often have deducted them as interest expense. See Schizer, *Debt Exchangeable for Common Stock*, *supra* note 10, at 12–13 (noting that issuers usually treat DECS as a forward contract paired with an interest-bearing deposit). A recent proposed regulation would deny a current deduction, instead adding this expense to the hedged stock's basis. See Prop. Treas. Reg. § 1.1092(d)-1(d), 66 Fed. Reg. 4751 (Jan. 18, 2001) (deeming equity-linked debt instrument to be "position with respect to personal property" and thus eligible to be part of straddle); Prop. Treas. Reg. § 1.263(g)-3(c), 66 Fed. Reg. 4749, 4749–50 (Jan. 18, 2001) (treating "[i]ndebtedness or other financing the payments on which are determined by reference to payments with respect to . . . the value of . . . personal property" as "indebtedness . . . incurred or continued to purchase or carry" straddle property); see also Field Serv. Adv. 2001 31 015 (May 2, 2001), *Tax Analysts*, *Tax Notes Today*, Aug. 6, 2001, LEXIS, 2001 TNT 151-15 (concluding that periodic payments on DECS-type security are subject to capitalization under section 263(g)).

158. Schizer, *Sticks and Snakes*, *supra* note 23, at 1384 n.173 (discussing regulatory reasons why insurance companies and pension funds favor contingent notes).

159. Another regulatory constraint on hedging by corporations is that the taxpayer usually will want the security it is issuing to be listed on an exchange—not only to provide liquidity for investors, but also to ensure that the transaction does not violate state gaming laws. See Exchange Act § 28(a), 15 U.S.C. § 78bb(a) (1994) (providing that state gaming laws do not invalidate derivatives traded pursuant to the rules of an exchange or other self regulatory organization). Novel securities may not clearly comply with exchange listing requirements, and some effort may be required to arrange for listing. For instance, the exchange may have to ask the SEC to change its requirements. See *id.* § 78s(b)(1) (authorizing exchanges and other self regulatory organizations to request changes in their rules).

160. See Jill Dutt, *Battle of the Bean Counters*, *Inv. Dealers' Dig.*, Oct. 27, 1997, at 16, 17.

cial Accounting Standard No. 133 (FAS 133).¹⁶¹ This measure, which became effective on July 1, 2000, requires corporations periodically to report on accounting statements the fair market value of certain derivatives positions.¹⁶² Since firms could either owe or be entitled to a payment, this value could be negative or positive.

Depending upon the rule's precise application, it could introduce undesirable volatility in the earnings of a firm that hedges an appreciated stock position—volatility that does not accurately reflect the firm's true economic position. The concern is that the firm would have to report changes in the hedging security's value, but would not also be able to report offsetting changes in the underlying stock being hedged. As an illustration of this accounting mismatch, assume the hedged stock appreciates by 50%. This gain is not reflected in earnings (because the stock is not being marked to market), but the corresponding loss on the derivative would be (because it *is* being marked to market).¹⁶³ The firm would thus appear unprofitable, even though no economic loss has occurred.¹⁶⁴ To avoid this mismatch, firms will want their transactions to qualify for so called "hedge accounting," a special rule within FAS 133 that, in effect, allows both positions—the hedge and the hedged asset—to be marked to market.¹⁶⁵ In the example above, losses on the hedging transaction would be offset by gains on the hedged asset, so no accounting loss would

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161. Accounting for Derivative Instruments and Hedging Activities, Statement of Financial Accounting Standards No. 133 (Financial Accounting Standards Bd. 1998) [hereinafter FAS 133]. The FASB is a privately funded independent agency that sets accounting standards for public companies. Theoretically, the SEC could overrule the FASB, but rarely does. See Dutt, *supra* note 160, at 18–19 (describing the FASB's role). In this case, Arthur Levitt, the former Chairman of the SEC, was a vocal supporter of FAS 133. *Id.* at 18 ("My lifetime of work in the securities industry tells me that the FASB has gotten this about right." (quoting Arthur Levitt)).

162. For a detailed discussion of FAS 133, see generally PriceWaterhouseCoopers LLP, *A Guide to Accounting for Derivative Instruments and Hedging Activities* (1998). For a comparison of this accounting rule with the tax law, see generally John J. Ensminger, *Concerto for Piano vs. Orchestra: Can Tax and Financial Accounting Harmonize on Hedges?*, 16 *Akron Tax J.* 23 (2001).

163. For instance, the stock might appreciate from \$100 to \$150, but this gain would not be reflected in earnings until the stock is sold. On the derivative, the corporation will have lost only, say, \$30 (since the first 20% of appreciation is retained). Yet even though the corporation has a net profit of \$20, FAS 133—in focusing only on the derivative loss—will reduce earnings by \$30.

164. This result could also arise in hedging transactions that are not tax motivated. As a result, the rule has attracted considerable opposition based on this risk of mismatches, difficulties in valuing derivatives, and inconsistencies with European and Asian accounting rules. See, e.g., Melanie Tringham, *Hedging Cut Down to Size*, *Times* (London), Sept. 21, 2000, at 10 (noting concern of experts that FAS 133 "could lead to increasing volatility in company financial records and huge updating of computing systems"). For instance, Alan Greenspan has been a vocal critic. See *Hedge Rows*, *The Economist*, Aug. 16, 1997, at 56, 57 (noting that Greenspan "fired off an unusual public letter to the FASB urging it to reconsider its proposal").

165. See generally FAS 133, *supra* note 161, at FAS 133.18 (describing timing rules for various types of hedges).

be recorded. Yet hedge accounting is not always available. For example, one prerequisite for hedge accounting is a relatively close correlation between the hedge and the hedged asset.¹⁶⁶ For tax reasons, however, the taxpayer will not want the correlation to be too close, or the hedge will trigger a constructive sale. While an exhaustive analysis of FAS 133 and hedge accounting is beyond the Article's scope, anecdotal evidence suggests that the prospect of artificially volatile earnings has discouraged some corporations from hedging appreciated stock.¹⁶⁷ Yet it is too soon to assess the influence of this friction. More firms may conclude that hedge accounting is available for these transactions, especially if the FASB provides favorable guidance on the issue. Alternatively, firms may respond by issuing two figures: one following FAS 133, and the other correcting for it (i.e., by marking the hedged asset to market as well).¹⁶⁸ In any event, for some firms accounting earnings are less important than cash flow or volume of customers.¹⁶⁹

C. Normative Implications

The main purpose of these case studies is positive, rather than normative: to describe differences in frictions affecting two similar provisions, rather than to assess definitively whether either is good policy. Others have outlined normative issues raised by section 1259, and so a detailed exploration is not attempted here.¹⁷⁰ Yet the insights here do have normative implications. In general, a transactional reform that actu-

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166. See generally FAS 133, *supra* note 161, at FAS 133.20(b) (requiring, as condition for qualifying as fair value hedge, that "the hedging relationship is expected to be highly effective in achieving offsetting changes in fair value"). For a discussion of the criteria that must be met in order to qualify for hedge accounting, see PriceWaterhouseCoopers LLP, *supra* note 162, at 63-176.

167. Volatility is introduced because FAS 133 also can *increase* reported earnings, for instance, if the stock price declines, triggering unreported losses matched by reported gains on the derivative. Although risk neutral corporate managers could be indifferent to this volatility, given the similar probabilities of increases and decreases, managers reportedly have not reacted in this way.

168. According to one tax lawyer, others are discussing issuance of hedging securities through special purpose vehicles whose earnings would not be consolidated with the rest of the issuer's earnings.

169. The same tax lawyer mentioned in *supra* note 168 also noted that cable companies have continued to engage in these transactions, as their strength usually is judged by the number of subscribers. This assertion finds support in Appendix B, which shows that Comcast, a cable company, was responsible for two of the five largest such offerings in 1999. Although FAS 133 did not become effective until July 1, 2000, firms no doubt were aware in 1999 of their impending obligation to mark outstanding derivatives to market.

170. See, e.g., Deborah L. Paul, Another Uneasy Compromise: The Treatment of Hedging in a Realization Income Tax, 3 Fla. Tax Rev. 1, 50 (1996) (critiquing proposed section 1259); Deborah H. Schenk, Taxation of Equity Derivatives: A Partial Integration Proposal, 50 Tax L. Rev. 571, 574-79 (1995) (analyzing policy issues presented by hedging); David A. Weisbach, Should a Short Sale Against the Box Be a Realization Event?, 50 Nat'l Tax J. 495, 503-04 (1997) (same).

ally stops the targeted planning is better than one that merely induces a more wasteful variation. Application of this idea to the case studies depends on one's premises, though, as well as on empirical issues that warrant further research.

1. *Is Risk More than a Friction?* — One premise, as to which there is disagreement, is whether taxpayers who bear risk *deserve* a different tax treatment than those who do not. If risk is normatively significant in this way, short sales against the box *should* be treated differently from collars and other partial return hedges. Under this line of reasoning, a collar is not a method of avoidance, but a different transaction for which tax deferral is justified. The theory is that in a realization based system, as long as taxpayers retain enough risk, they have not made a sale and thus should not be taxed. This reasoning implicitly judges a rule by its consistency with our system's formal logic, especially the realization rule. The view is popular among tax practitioners, a reality that helps explain why section 1259 permits collars.

A competing view, however, is that this focus on risk neglects the tax system's underlying goal: to raise revenue equitably and efficiently. As Professor Shaviro has emphasized, all else being equal, tax liabilities should be based on the level of a taxpayer's income or consumption, and not on the level of risk she takes.¹⁷¹ For reasons of administrability, our system traditionally has tested enrichment only when an asset is sold, and so risk becomes a part of the inquiry—but only to make the system more administrable, not because risk itself is normatively significant.¹⁷² Once we depart from the realization rule for hedging, there is no obvious reason to distinguish between partial and total return hedges, assuming administrability burdens are similar. Consistent with this view, the balance of this Part analyzes retained risk as a friction, instead of as an independent justification for tax deferral. Those who do not accept this premise, though, would assess section 1259 more favorably.

2. *Cost-Benefit Analysis.* — The benefits offered by section 1259 should be compared with the costs. Assuming the tax on investments should be maintained or increased—a core assumption of this Article, as noted above—a contribution of section 1259 is to persuade would-be hedgers to make taxable sales because, in some cases, the need to retain risk is a sufficiently strong friction.¹⁷³ These sales can advance vertical

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171. See Shaviro, *Risk-Based Rules*, *supra* note 39, at 708–23.

172. *Id.* at 646–47.

173. A threshold question, beyond this Article's scope, is whether investment returns should be taxed at all—or, at least, whether the rate should be lower. Under a consumption tax, such returns generally would not be taxed. Difficulties with taxing capital, illustrated anecdotally here, reinforce the case for a consumption tax. On the other hand, assuming the same revenue must be raised, taxes on labor would rise. This would cause other distortions and avoidance, for instance, as owners of businesses claim lower salaries and higher investment returns. Since wealthy taxpayers have more investments, their share of the tax burden could decline. While there are strong arguments on either side of this longstanding debate, the question for our purposes is

equity in raising the tax burden on wealthy investors.¹⁷⁴ Since sales are cheaper than hedges, efficiency is enhanced as taxpayers forego wasteful hedging costs.¹⁷⁵ Revenue raised in this way eliminates the need for other taxes, which themselves would produce waste. While empirical research on the magnitude of these benefits is needed, it is likely that many investors are induced to sell, especially those with positions worth less than \$1 million. Indeed, in the three bull market years after section 1259 was enacted, the volume of short sales against the box probably would have grown dramatically if not for the reform. Instead, individuals realized \$424.3 billion of net capital gain in 1998.¹⁷⁶ Robust receipts in later years contributed to a budget surplus. Although some of this taxable gain stems from actively managed mutual funds, a significant amount presumably comes from taxpayers who can no longer hedge.¹⁷⁷

As noted above, section 1259 also offers symbolic benefits. Average taxpayers may be more inclined to pay tax voluntarily if they believe a wealthy taxpayer cannot avoid tax through a short sale against the box. While the culture of compliance is worth protecting, section 1259's contribution is hard to assess. An important question is whether average taxpayers know that wealthy taxpayers can still hedge without paying tax. While they probably do not know now, they may learn eventually, and so the symbolic benefits would not last.

Balanced against these benefits are significant costs. In addition to adding complexity and imposing new administrative and compliance costs, section 1259 probably also has intensified lock-in, as some would-be hedgers choose to keep their investment unhedged. The size of this effect warrants further study. As demonstrated here, moreover, section 1259 has induced many taxpayers to hedge in a more elaborate and wasteful way. The volume of hedging among wealthy individuals and

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easier. If the tax burden on investments should be lower, this goal should be implemented directly through rate reductions or changes in the tax base, not through wasteful taxpayer self help.

174. It is assumed here that the rate structure and other features of the tax system do not already attain the desired distribution of tax burdens.

175. At first blush, it is tempting to claim a further efficiency advantage for section 1259: By encouraging sales, the measure seems to reduce lock-in. Yet although a sale does indeed free taxpayers from lock-in, so does a hedge. Thus, when inducing taxpayers to substitute sales for hedges, section 1259 does not necessarily ease lock-in.

176. Therese Cruciano, *Individual Income Tax Returns, Preliminary Data, 1998*, Stat. Income Bull. (Internal Revenue Serv.), Spring 2000, at 147, 148.

177. The revenue estimate for section 1259 is modest: \$367 million in 1998; \$121 million in 1999; \$68 million in 2000; \$73 million in 2001; \$79 million in 2002; \$85 million in 2003; \$91 million in 2004; \$98 million in 2005; \$105 million in 2006; \$112 million in 2007. The total thus was \$708 million in the first five years and \$1.199 billion in the first ten. Joint Comm. on Tax'n, 105th Cong., *Comparison of the Estimated Budget Effects of the Revenue Provisions of H.R. 2014 as Passed by the House and Senate* 8 (Comm. Print 1997). This estimate may not have assumed a continuation of the bull market through the beginning of 2000. In any event, revenue estimates are often unreliable, at least in forecasting the effect of a single provision. See Graetz, *supra* note 28, at 670.

public corporations is still quite high. Vertical equity concerns also arise because the wealthiest taxpayers are least affected by the rule.¹⁷⁸ Nor could the Treasury stop this avoidance without further legislation, a politically difficult step.¹⁷⁹

Ultimately, the case for section 1259 turns on the empirical magnitude of these competing effects. My guess is the balance is close but favorable. Yet a definitive conclusion is not possible without further empirical research. The contribution of this Article is to show that avoidance has been relatively easy for wealthy taxpayers, and to offer an explanation that can be generalized: There is no discontinuous friction shoring up this narrow rule, as there is for the equally narrow rule, section 1260, discussed in Part III.

3. *Alternatives to Section 1259.* — Notwithstanding this handicap, could the Treasury have done better? Is there a more desirable alternative that also is politically and practically feasible? As emphasized above, the government should focus more on dealers' costs in borrowing stock. Beyond this observation, the question of superior alternatives is too broad to be explored here, although three possibilities warrant brief discussion. The first two are broader rules that theoretically would be more effective, but are probably not politically or practically feasible. The third is more practical, and might serve as an effective complement to section 1259, or even a plausible substitute, although a definitive assessment is beyond this Article's scope.

a. *Straddle Standard.* — First, the test for a constructive sale could be based on "substantial diminution" instead of "substantial elimination": that is, whether the hedge "substantially diminishes" risk of loss and opportunity for gain. This broad formulation, borrowed from the straddle

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178. There may be an efficiency reason to favor wealthy taxpayers. In deciding whether it is efficient to tax hedging, we must see how would-be hedgers will respond to the tax. If wealthy taxpayers are more likely to keep the asset unhedged, instead of selling, we might as well let them hedge. No revenue is lost, and social waste from lock-in is avoided. Nevertheless, I suspect that many wealthy taxpayers would sell if they could not hedge. In my experience, taxpayers with positions large enough to hedge under section 1259 often feel quite undiversified. Further empirical work on this question, however, is needed.

179. While regulatory authority could be used to require a somewhat larger band of retained exposure (e.g., 30% instead of 20%), further broadening of the rule—for instance, use of the "substantial diminution" test discussed below—would probably require legislation.

rules,¹⁸⁰ is much harder to avoid, and my guess is few would try.¹⁸¹ The main problem, though, is that this test is so much broader than the current section 1259 that the Treasury could not implement it through regulations. Just as broader legislation was politically unattainable at the time,¹⁸² I suspect it remains so today.

Assuming the political hurdle could be overcome, a broader rule poses two other problems. First, it could intensify lock-in, as would-be hedgers choose to hold the asset unhedged instead of selling. In addition, this straddle type rule could undermine "good" transactions. For instance, when shareholders sign a contract agreeing to sell the firm, this step might conceivably satisfy the substantial diminution test, even if the contract is subject to significant closing conditions (and perhaps even if nonrecognition treatment would apply when the acquisition is consummated).¹⁸³ Likewise, very short term hedges arguably should not trigger tax. If appetite for them is elastic, taxing them will simply terminate the practice without inducing realizations. Yet exceptions can be offered to avert such overbreadth, and the tax bar will help with this process. In-

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180. See I.R.C. § 1092(c)(1) ("The term 'straddle' means offsetting positions with respect to personal property."); *id.* § 1092(c)(2)(A) ("A taxpayer holds offsetting positions with respect to personal property if there is a substantial diminution of the taxpayer's risk of loss from holding any position with respect to personal property by reason of his holding 1 or more other positions . . ."). For background on the straddle rules, see *supra* note 116. In general, the rules apply whenever one position "substantially diminishes" risk of loss in another. This test would apply even when the taxpayer retains considerable exposure. For instance, assume the appreciated asset is worth \$100. To avoid the rule, the taxpayer no longer would use a put at \$90 and a call at \$110. Instead, the put might be at \$50 and the call at \$200. Given the breadth of the "substantial diminution" test, it is not clear that a 50–200 spread is sufficient. In fact, in my experience, major law firms are generally unwilling to opine about how much exposure must be retained to avoid "substantial diminution" when the question arises under the straddle rules. That diversification alone does not trigger this test is one of the few points on which there is certainty. See H.R. Rep. No. 97-201 (1981), [2001] 12 *Stand. Fed. Tax Rep.* (CCH) ¶ 30,200, at 55,081. In contrast, opinions about "substantial elimination" under section 1259 are commonplace.

181. Professor Schenk has offered another alternative that is harder to avoid than section 1259. See Schenk, *supra* note 170, at 583–90. Her proposal is somewhat broader in scope, and narrower in effect. Gain recognition is triggered merely by eliminating risk of loss, even if opportunity for gain is retained. Thus, if a taxpayer has a zero basis in an asset worth \$100, purchase of a put with a \$40 exercise price would trigger gain. Yet the amount of gain recognized is based, not on the hedged asset's fair market value, but on the amount of gain that is protected from loss (e.g., \$40 instead of \$100). *Id.* at 586–87.

182. See *supra* note 105 and accompanying text.

183. If a firm is going to be acquired, and the acquisition contract promises that target shareholders will receive consideration of a specified value (e.g., in acquiror shares and/or cash), their shares in the target company generally will not decline in value below the amount they have been promised (assuming the market expects the acquisition to be consummated). Such a contract could plausibly satisfy a "substantial diminution" test and trigger a constructive sale—an odd result if consummation of the transaction would itself qualify as a tax free reorganization. On the other hand, the point should not be overstated. To my knowledge, tax lawyers do not generally advise target shareholders that such a contract creates a straddle under section 1092.

deed, when section 1259 was proposed, exceptions were added for certain acquisitions of a business¹⁸⁴ and for certain short term hedges.¹⁸⁵ Other refinements would also be needed, but this topic is too extensive to be addressed here.

b. *Delta Standard.* — Another broad alternative is to treat a partial hedge as a constructive sale—but only of a *portion* of the hedged shares. In other words, instead of an “all or nothing” test that asks *whether* there has been a constructive sale, a “part sale” test would always find a constructive sale, and would ask instead *how much* has been constructively sold. For instance, a \$90–\$110 collar could be a constructive sale of 85% of the hedged shares (i.e., for the shares’ fair market value), while a wider \$80–\$120 collar could be a constructive sale of only 70%. The percentage would depend on a relationship called “delta,” which measures how much the value of a hedge changes when the underlying stock price changes by one dollar.¹⁸⁶ For example, assume that, as the stock price declines from \$100 to \$99, a \$90–\$110 collar appreciates—not by a full dollar, but by \$.85.¹⁸⁷ For a hedge of one million shares, then, the \$1

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184. The NYSBA raised this issue, see NYSBA, Comments on H.R. 846, *supra* note 110, and Congress later enacted section 1259(c)(2). For a discussion of issues presented by this exception, see Schizer, Hedging Under Section 1259, *supra* note 104, at 349.

185. In response to taxpayer lobbying, Congress added the short term hedging exception of section 1259(c)(3). See Lee A. Sheppard, Taxwriters Hijack Constructive Sale Rule, 75 Tax Notes 1798, 1803 (1997) (noting that taxwriting committees added measure “to accommodate short-term portfolio hedging by corporate treasurers and traders”). As proposed by the taxwriting committees, the original short term exception was too broad. After the NYSBA flagged this problem, NYSBA Tax Section, Comments on H.R. 846, *supra* note 110, Congress narrowed the exception. Sheppard, *supra*, at 1803 (noting that, in evaluating an early version of the short term safe harbor, “the NYSBA Tax Section warned that this hedging exception would become the exception that eats the rule,” and noting that the taxwriting committees revised the rule “to address the Tax Section’s concerns”); see also William M. Paul, Constructive Sales Under New Section 1259, 76 Tax Notes 1467, 1474–78 (1997) (describing various versions of constructive sale proposal and their treatment of short term hedges); Schizer, Hedging Under Section 1259, *supra* note 104, at 348–49 (analyzing measure as it was enacted).

If section 1259 is modified to adopt the “substantial diminution” test recommended here, there will be more interest in using the short term exception as a long term strategy. Hence, more restrictions should be placed on it—for instance, the asset should not be hedged more than a minimum total number of days in any taxable year (e.g., 90, as opposed to the 300 permitted under current law).

186. See John C. Hull, Options, Futures, and Other Derivative Securities 298 (2d ed. 1993) (defining delta of a derivative security as “the rate of change of its price with respect to the price of the underlying asset”).

187. At first blush, it may seem surprising that the collar appreciates at all. After all, the collar will not actually yield a payment at maturity unless the stock price falls below \$90. (The collar entitles the holder to sell at \$90, and this step is not profitable unless the stock price is below \$90.) Nevertheless, the collar grows more valuable as the stock price declines from \$100 to \$99. At this price, even though the collar would not yield a profit if exercised (so the collar has no so called “intrinsic value”), the collar still has value because of the *possibility* that the stock price will fall below \$90 before the collar expires. Options have this so called “time value” before they expire just as lottery tickets have value before a drawing. See *id.* at 140 (defining intrinsic value and time value); see also Ronald J. Gilson

million loss in the stock (i.e., \$1 for each share) is partially offset by \$850,000 of appreciation on the collar (i.e., \$.85 per share). The hedge thus offers similar protection as a complete hedge of 85% of the shares, such as a short sale of 850,000 shares. Under a delta approach, then, this hedge would be treated as a constructive sale of 850,000 shares. This approach avoids the stark discontinuity between total and partial hedges and revokes the latter's tax advantage.

Notwithstanding this benefit, this broader formulation could exacerbate lock-in. In addition, this approach is even more daunting to administer than the straddle test. Computing delta is a difficult task that is beyond the abilities of most taxpayers, advisors, and IRS auditors. Although a computer can help with the complex formula,¹⁸⁸ taxpayers would still have to input the stock's volatility, a subjective assessment that itself calls for mathematical expertise.¹⁸⁹ Not only is delta hard to compute, but it also is somewhat unreliable: Delta constantly changes—for instance, as the price of the underlying stock fluctuates, and as time passes¹⁹⁰—but

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& Bernard S. Black, *The Law and Finance of Corporate Acquisitions* 238–43 (2d ed. 1995) (noting that value of call option depends on various factors, including exercise price, time remaining until maturity, and volatility of underlying asset price). Thus, a \$90–\$110 collar appreciates as the stock price declines from \$100 to \$99. Yet this appreciation is less than dollar-for-dollar because the stock may never actually fall below \$90.

188. Computing delta involves elaborate mathematical formulas. For a discussion, see Hull, *supra* note 186, at 298–307 (discussing delta hedging). Various Internet websites compute delta for single call options. See, e.g., FTS Black Scholes Calculator, at <http://mscf.gsia.cmu.edu/bsop.html> (last visited Aug. 8, 2001) (on file with the *Columbia Law Review*) (computing the price, delta, gamma, and vega for European-style call options). I could not, however, find a site that computes delta for a complex derivative such as a collar, although this service presumably would become more available if the tax law created demand for it. To spare taxpayers the need to do computations, the government could offer presumptions based on typical facts. For instance, a \$90–\$110 collar with a term of three years could be presumed to trigger a constructive sale of 85% of the position. Yet such presumptions may be attacked as inaccurate, weakening the government's political and legal case for the delta methodology—a case that presumably would rest to a considerable degree on the method's nuance and accuracy.

189. There are various ways to compute volatility, including use of past volatility or of the volatility implied by the current price of publicly traded options. See Nassim Taleb, *Dynamic Hedging: Managing Vanilla and Exotic Options* 88, 95 (1997) (defining “actual” and “implied” volatility, and noting that use of data from different time periods can lead to different assessments of volatility).

190. Hull, *supra* note 186, at 299. For instance, a call option with a \$100 exercise price will appreciate only modestly (e.g., by one cent) when the stock price increases from \$5 to \$6—based on the marginally improved chance that the stock will reach \$100. In contrast, the call option will appreciate far more (e.g., by a dollar) when the stock price increases from \$500 to \$501. The difference is that the option holder can actually collect these gains by exercising the option. Thus, delta increases as an option becomes more “in the money” (i.e., as it becomes increasingly profitable to exercise the option). *Id.* at 301 (explaining that delta approaches one as the option becomes deep-in-the-money, while it approaches zero as the option becomes deep-out-of-the-money). As the expiration date approaches, moreover, the stock price becomes less likely to change enough to transform an out-of-the-money option (i.e., one that would not yield a profit if exercised) into an in-the-money option (i.e., one that would yield a profit if exercised). For out-of-the-money

the tax law would test for a constructive sale only once, when the taxpayer enters into the hedge. A hedge's initial effectiveness is not a sure indicator of its ultimate effectiveness at maturity.¹⁹¹ Indeed, certain hedges become less effective (i.e., delta shrinks) as the stock price declines.¹⁹² Yet if the delta test is used only for hedges with relatively stable deltas,¹⁹³ taxpayers will begin favoring less stable hedges that presumably would still be subject to a permissive all-or-nothing test.

A delta standard is also likely to encounter effective taxpayer opposition. A shift from the all-or-nothing inquiry to a "part sale" test would surprise experts in the area, and arguably would be inconsistent with the statutory language and legislative history.¹⁹⁴ The delta methodology rests on an analogy that is unfamiliar to most taxpayers, as well as to members of Congress: Although a \$90–\$110 hedge of 100% of the position may be

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and at-the-money options, then, delta declines over time. See *id.* at 301 (showing that delta of out-of-the-money and at-the-money options grows with time remaining). Other influences on delta include interest rates and the stock's volatility. See *id.* at 315–17 (discussing "rho," which reflects the influence of interest rates, and "vega," which reflects the influence of volatility).

191. Compare a taxpayer who sells 85% of her one million shares ("the Seller") with one who uses a \$90–\$110 collar with an initial delta of .85 ("the Collar-holder"). If the stock price drops from \$100 to \$90, the Seller will suffer a \$10 loss only on the 150,000 shares he kept (\$1.5 million). The Collar-holder will be in a similar position if she sells (or terminates) the collar right away at a profit: The collar will have appreciated because of the increased probability of further declines in the stock price. See *supra* note 187. Yet if the stock never actually falls below \$90, the collar will expire without making a payment. If the Collar-holder keeps the collar until maturity, she will lose \$10 *for each* of her one million shares (\$10 million).

192. For example, one way to hedge stock worth \$100 is to sell to someone else the right to buy the stock for a lower price such as \$70 (i.e., selling an in-the-money call). The premium for this call (e.g., \$45) will help offset depreciation in the stock. This hedge initially will have a high delta (.84). However, if the stock declines to \$50 after six months, delta will decline precipitously (to .45) because the call has become significantly *out-of-the-money*. If the stock declines to \$30, delta would fall even further (to .17). See *supra* note 190 (describing relationship between delta and stock price). These computations assume a volatility of .5 and a three-year term, using the FTS Black Scholes Calculator, *supra*.

193. For instance, the delta on a collar is relatively stable. The reason is that as the price moves in either direction, the collar becomes more deep-in-the-money. For example, assume the collar's delta is .85 when the stock price is \$100. If the stock price declines to \$30, any further declines are likely to cause dollar-for-dollar appreciation in the collar (because the collar will be exercised as long as the stock price is below \$90). Yet, although changes in stock price are unlikely to reduce a collar's delta, other factors can depress delta, such as the passage of time or changes in the stock's volatility. See *supra* note 190.

194. For instance, the statute indicates that a forward contract triggers a constructive sale only if it provides for delivery of a "substantially fixed amount of property" at a "substantially fixed price." I.R.C. § 1259(d)(1). The legislative history reinforces the point by providing that there is no constructive sale if the amount of property to be delivered is "subject to significant variation." Tax Legislation Enacted in 1997, *supra* note 104, at 56,715. Yet under a "part sale" approach, such a forward would still trigger a constructive sale of *some* portion of the position. On the other hand, the Treasury's regulatory authority is quite broad here, under the mandate to promulgate regulations for transactions having "substantially the same effect" as those listed in the statute. I.R.C. § 1259(c)(1)(E).

economically similar to a total hedge of 85% of the position, these two deals are formally different. Moreover, this economic parallel is not perfect, as opponents of this methodology will be quick to point out.¹⁹⁵ Therefore, although a delta approach is theoretically intriguing, it is probably not practical.

c. *Basis Step-Up*. — Significant political and administrability problems burden the two broader alternatives discussed above. These problems are largely avoided if the government instead focuses on a different aspect of the problem. The high profile hedging transactions that prompted section 1259 exploited two tax rules: not just the realization rule, but also section 1014's step-up in basis at death. It is possible that targeting the latter rule, which is widely acknowledged as a policy monstrosity,¹⁹⁶ would have made better use of the political opportunity created by the media's focus on hedging. For instance, Congress could have revoked the basis step-up for any property that was hedged (e.g., under a broad "substantial diminution" standard) within three years of the taxpayer's death.¹⁹⁷

The question may have been rendered moot by a recent change in law—the scheduled repeal in 2010 of the estate tax, and with it the basis step-up for certain large estates—although uncertainty remains about whether these changes will actually be finalized.¹⁹⁸ In any event, a rule

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195. As shown in *supra* note 191, the parallel breaks down if the taxpayer holds the hedge until maturity.

196. See, e.g., Jerome Kurtz & Stanley S. Surrey, *Reform of Death and Gift Taxes: The 1969 Treasury Proposals, the Criticisms, and a Rebuttal*, 70 Colum. L. Rev. 1365, 1381 (1970) (calling step-up in basis at death the "most serious defect in our federal tax structure").

197. Section 1259 narrows section 1014 in a much more limited way, revoking the basis step-up for certain grandfathered constructive sales. See Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 1001(d)(3), 111 Stat. 788, 908. For a discussion, see Paul, *supra* note 185, at 1478–79 (describing conditions in which grandfathered constructive sales are denied basis step-up).

198. The new rule will limit the step-up in basis to \$1.3 million worth of property (or \$3 million for property passing to a spouse). This change does not take effect until 2010, and automatically expires (along with the estate tax repeal) a year later. Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, § 541, 115 Stat. 38, 76 (providing that basis will not step-up at death for certain decedents dying after December 31, 2009) (amending I.R.C. § 1014); *id.* § 901(a)(2), 115 Stat. at 150 (providing that repeal of basis step-up is in turn repealed for decedents dying after December 31, 2010). In other words, as the law now stands, carryover basis would apply only to taxpayers who die during 2010, unless Congress chooses to extend the provision's life. Congress may well decide not to keep the carryover basis rule, given difficulties with administering such a rule (e.g., forcing heirs to ascertain what the decedent's basis was), as well as budgetary pressures that could drain Congress's enthusiasm for the new basis rule's companion measure, estate tax repeal. Indeed, Congress repealed the basis step-up once before, only to reinstate it. Lawrence Zelenak, *Taxing Gains at Death*, 46 Vand. L. Rev. 361, 365 (1993) (discussing enactment of carryover basis rule in 1976 and repeal of this change in 1980 before it went into effect). Even if the repeal is not reversed, the rule will endure for thirteen years after section 1259's enactment, and indefinitely for taxpayers with smaller estates. Thus, an opportunity may have been missed when the constructive sale rule was passed.

barring the basis step-up for hedged assets would raise many issues, such as the administrability of a carryover basis rule or of taxing gains at death,¹⁹⁹ interaction with the estate tax, and the possibility of worsening lock-in. A comprehensive analysis is beyond this Article's scope.

III. CONSTRUCTIVE OWNERSHIP: WHEN FRICTIONS ARE STRONG

Two years after section 1259 was enacted, Congress added section 1260.²⁰⁰ Although the latter aims at a different planning opportunity, the bill had the same sponsor in the House of Representatives, Barbara Kennelly of Connecticut, and borrowed liberally from section 1259's statutory language.²⁰¹ Yet the common method of avoiding section 1259—using a derivative with a modified economic return—is not viable for section 1260. This difference, which derives from frictions, was not anticipated by government officials who crafted the reform. Since it is difficult to use derivatives to avoid section 1260, taxpayers have turned to other methods of avoidance involving insurance and offshore corporations. Yet these strategies have also been impeded by frictions, as well as by other tax rules. Unlike avoidance strategies for section 1259, moreover, these strategies probably could be shut down through regulations, or even a notice that regulations will be written with a retroactive effective date. After a description of the targeted transaction in Section A, Section B describes avoidance strategies for section 1260, and frictions that undermine their appeal. Section C briefly considers normative implications.

A. Targeted Planning

In cutting the long term capital gains rate from 28% to 20% in 1997,²⁰² Congress reduced the attractiveness of investment strategies that involve frequent trading, and thus do not generate this tax-preferred return. Most hedge funds use such strategies to earn impressive pretax returns.²⁰³ As partnerships for tax purposes, though, they pass their profits

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199. For an insightful discussion of implementation issues associated with taxing gains at death, see generally Zelenak, *supra* note 198 (analyzing technical issues associated with treating death as realization event).

200. Tax Relief Extension Act of 1999, Pub. L. No. 106-170, § 534, 113 Stat. 1860, 1931 (codified at I.R.C. § 1260).

201. See Sheppard, *supra* note 185, at 1798 (noting that Barbara Kennelly sponsored an early version of section 1259); Lee Sheppard, *Constructive Ownership of a Bag of Dead Cats*, 17 Tax Notes Int'l 1329, 1330-31 (1998) (noting that Barbara Kennelly sponsored an early version of section 1260). After Congresswoman Kennelly left the House for an unsuccessful gubernatorial bid in Connecticut, Richard Neal of Massachusetts became the chief sponsor of the bill. *Id.* at 1331.

202. Marvin A. Chirelstein, *Federal Income Taxation* 323 (8th rev. ed. 1999).

203. Hedge funds are investment vehicles for wealthy individuals and institutions. Because these funds are not registered under the federal securities laws as investment companies, broker-dealers, or public corporations, and thus need not comply with regulatory and disclosure requirements applicable to mutual funds, these ventures generally are available only to investors meeting minimum wealth requirements. See

through to investors as short term capital gains, taxable in the current year. In response, investment bankers and their tax advisors developed a way to convert these appealing pretax returns into deferred long term capital gains: a derivative, such as a forward contract or swap, whose return was based on the hedge fund's value.²⁰⁴ No tax was due until the derivative was settled, and gains were taxed at long term rates if the taxpayer held the derivative for the requisite holding period (eighteen months at the time, and currently one year).²⁰⁵ When selling such a derivative to a client, the investment bank would hedge its "short" derivative position by investing in the hedge fund. In essence, the investment bank would become a partner in the fund, and would use a derivative to transfer the economic return to clients.²⁰⁶

President's Working Group on Financial Markets, Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management B-1 (April 1999) [hereinafter *Lessons of LTCM*] (noting that U.S. hedge funds "rely on the 'private' investment company exclusions in Sections 3(c)(1) and 3(c)(7) of the Investment Company Act," 15 U.S.C. §§ 80a-3(c)(1), (c)(7) (1994)). Managers generally are compensated with a fixed fee and a share of profits above a minimum return (e.g., 20% of all returns above 15%). *Id.* at 1-12. Hedge funds generally rely on "active trading," which "is a practice in which investment positions are changed with high frequency"—sometimes "to maintain a desired risk-return profile as market prices fluctuate," and sometimes "to profit from short-term changes in prices." *Id.* at 5.

204. See E.S. Browning, *Where There's a Tax Cut, Wall Street Finds a Way*, *Wall St. J.*, Oct. 21, 1997, at C1 (describing development of hedge fund derivatives by Wall Street investment banks).

205. Unlike a partner in a partnership, who is treated as engaging in a pro rata share of all the partnership's transactions, the holder of a derivative is not deemed to engage in the underlying activity. Rather, the derivative is simply taxed as a free-standing contract, and the holding period is the length of time before the contract is terminated. See I.R.C. § 1234A. While this analysis clearly holds for a forward contract, there is some disagreement within the tax bar about whether a swap gives rise to ordinary income or capital gain at maturity. Yet even for swaps, the law is clear that an unscheduled termination gives rise to capital treatment. See Lewis R. Steinberg, *Using OTC Equity Derivatives for High-Net-Worth Individuals*, in *The Use of Derivatives in Tax Planning* 211, 230 n.72 (Frank J. Fabozzi ed., 1998) ("[S]ome taxpayers attempt to buttress their claim for capital gain treatment by terminating the swap, prior to its stated maturity [date].").

206. The transaction had to be structured with care to ensure that the client was not deemed the tax owner of the hedge fund interest held by the dealer. For instance, the derivative typically had to be settled in cash and the investment bank typically was contractually barred from sharing fund data or consulting on voting issues with the client. For a discussion, see New York State Bar Association Tax Section, Comments on H.R. 3170, *Tax Analysts*, *Tax Notes Today*, July 16, 1998, LEXIS, 98 TNT 136-38 [hereinafter *NYSBA Tax Section, Comments on H.R. 3170*]. Not all advisors agreed that the transaction worked under prior law. Assuming it did, the transaction would make no sense if the investment bank would suffer the same adverse consequences from investing in the fund as the client. Yet because investment banks mark all their securities to market under section 475, they suffer no adverse consequences, and thus can serve as tax accommodation parties: Gains from the hedge fund are matched by mark-to-market (ordinary) losses on the derivative. For a discussion, see Schizer, *Sticks and Snakes*, *supra* note 23, at 1367-72. The preceding analysis assumes that dealers can apply mark-to-market accounting to hedge fund interests; while practitioners generally have taken this

After the transaction attracted media attention,²⁰⁷ Congress responded (with lukewarm support from the Treasury²⁰⁸) by enacting the constructive ownership rule of section 1260. Closely based on section 1259,²⁰⁹ section 1260 applies to derivatives that simulate the return of a hedge fund or other pass-thru entity²¹⁰ by offering the holder substantially all of the risk of loss and opportunity for gain from the underlying asset.²¹¹ If this hauntingly familiar test is satisfied, certain long term capital gain earned on settlement of the derivative is recharacterized as ordinary income,²¹² and an interest charge is imposed to compensate the government for tax deferral.²¹³

position, some technical issues must be resolved. See *id.* at 1371–72 (discussing whether a hedge fund interest is a “security” under section 475).

207. See, e.g., Browning, *supra* note 204.

208. A tax lawyer who worked in the Treasury at the time reported this ambivalence to me in a conversation during 2001, as did two tax lawyers in private practice who had closely followed the legislative process on behalf of clients.

209. See Barbara M. Flom, *Constructive Ownership Transactions: The Sound of One Shoe Dropping*, J. Tax’n Fin. Products, Summer 2000, at 19, 28 n.5 (“[T]he drafters viewed ‘constructive ownership’ as the mirror image of ‘constructive sale.’”).

210. Other pass-thru entities include regulated investment companies, real estate investment trusts, S corporations, passive foreign investment corporations, and foreign personal holding companies. I.R.C. § 1260(c)(2).

211. The definition of a constructive ownership transaction is based on, and closely tracks, section 1259’s definition of a constructive sale, discussed in *supra* note 104. Under section 1260(d)(1):

The taxpayer shall be treated as having entered into a constructive ownership transaction with respect to any financial asset if the taxpayer—

- (A) holds a long position under a notional principal contract with respect to the financial asset,
- (B) enters into a forward or futures contract to acquire the financial asset,
- (C) is the holder of a call option, and is the grantor of a put option, with respect to the financial asset and such options have substantially equal strike prices and substantially contemporaneous maturity dates, or
- (D) to the extent provided in regulations prescribed by the Secretary, enters into one or more other transactions (or acquires one or more positions) that have substantially the same effect as a transaction described in any of the preceding subparagraphs.

Id. § 1260(d)(1).

212. Specifically, gain is recharacterized to the extent it exceeds “net underlying long-term capital gain,” which essentially is the long term capital gain that would have been earned from investing in the underlying property. Section 1260(a) provides:

If the taxpayer has gain from a constructive ownership transaction with respect to any financial asset and such gain would (without regard to this section) be treated as a long-term capital gain—(1) such gain shall be treated as ordinary income to the extent that such gain exceeds the net underlying long-term capital gain . . . .

Id. § 1260(a)(1).

213. *Id.* § 1260(b) (imposing interest charge on recharacterized gain). Two other tax motivated uses of hedge fund derivatives were not explicitly addressed. First, tax-exempt hedge fund investors can potentially earn taxable UBTI. *Id.* § 512(a)(1). In addition, foreign hedge fund investors can potentially earn two types of income that would be subject to U.S. tax, either “fixed or determinable annual or periodical gains, profits, and income” (FDAP), or “effectively connected income” (ECI). *Id.* § 871(a)(1)(A) (defining

B. Frictions and Avoidance

Notwithstanding the similarity of the two statutory formulae, section 1260 is harder to avoid.²¹⁴ To develop the contrast with section 1259, this Section begins with the tax benefit from avoiding the measure and then considers the strength, discontinuity, and position of relevant frictions.

1. *Tax Benefit.* — Avoiding section 1260 often yields less of a tax benefit than avoiding section 1259, and so taxpayers may not try as hard.²¹⁵ Although each transaction offers deferral, and the possibility of tax forgiveness if the taxpayer dies (for the next decade, at least), deferral opportunities are greater in hedging appreciated assets. The reason is that these assets are *already* appreciated when the derivatives transaction begins, so tax would otherwise be due immediately, and deferral erodes this tax burden from the outset. In contrast, a hedge fund derivative is not appreciated from the start. Since it allows taxpayers to pay the current market price for the fund,²¹⁶ the derivative becomes valuable if, and only if, the underlying fund appreciates during the period after the taxpayer acquires the derivative. Thus, tax is not deferred from the beginning, but only on gains earned *after* the transaction starts.²¹⁷ Even so, avoiding section 1260 offers a benefit, in addition to deferral, that does not arise from avoiding section 1259: halving of the relevant tax rate from almost 40% to 20%.²¹⁸

In assessing the tax benefit of avoiding section 1260, there is an important caveat: Deferral and reduction of the rate are benefits *only if the hedge fund appreciates*. If instead the fund has losses, deferring these deductions and converting them from short to long term would *increase* the

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FDAP); id. §§ 864(c), 897(a)(1)(B) (defining ECI). By investing instead in derivatives, these investors can avoid these consequences in some cases. Section 1260 does not recharacterize gain as either UBTI or ECI. See Flom, *supra* note 209, at 19, 25–26 (arguing that section 1260 is unlikely to reach UBTI-avoiding strategies of tax-exempt organizations, but could conceivably reach FDAP- and ECI-avoiding strategies for foreign taxpayers, for instance, through regulations or case law).

214. See Flom, *supra* note 209, at 26 (noting that “much effort has been expended . . . in designing structures which would escape taxation as COTs [constructive ownership transactions],” but also noting that “the author is unaware of any new-style transactions that have been effectuated”).

215. For a numerical example illustrating the tax benefit offered by avoiding section 1260, see *infra* Appendix D.

216. To be precise, this price would be increased to account for the time value of money if the taxpayer does not have to pay the purchase price today.

217. For discussion of this difference, see *supra* Part I.C.1.

218. Short term capital gains are not eligible for the 20% rate provided in section 1(h)(1)(C) for long term capital gains, I.R.C. § 1(h)(1)(C), and thus are taxed at the same rate as ordinary income, which is subject to a maximum rate of over 39% for individuals. *Id.* § 1(a). Under the Economic Growth and Tax Relief Reconciliation Act of 2001, this maximum rate will be gradually reduced over a six-year period—for instance, from 39.6% to 39.1% in 2001—and is scheduled to be 35% in 2006 and thereafter. See Joint Comm. on Tax’n, Summary of Provisions Contained in the Conference Agreement for H.R. 1836 (2001), [2001] 1 Stand. Fed. Tax Rep. (CCH) ¶ 3620, at 14,815-2 to -3.

tax burden. Even so, taxpayers can head off this adverse result by settling the derivative before the termination date (e.g., before the end of the first tax year).²¹⁹ Ultimately, then, the hedge fund derivative offers a tax reduction in the gain scenario that is not offset by a corresponding tax increase in the loss scenario. Ex ante, this strategy is expected to reduce the tax burden, but the expected benefit must be discounted for arising only if the fund appreciates.

2. *Derivatives with a Modified Return: Difficulty of Dynamic Hedging.* — Since section 1260 uses essentially the same statutory standard as section 1259, we might expect a similar avoidance strategy: use of derivatives that offer most, but not all, of the fund's return. For a fund interest worth \$100, for instance, the taxpayer might bear the full risk of loss below \$95 by selling a put with a \$95 exercise price, while enjoying opportunity for gain above \$115 by purchasing a call with a \$115 exercise price. In fact, these "partial return" strategies reportedly are uncommon.

Although frictions ultimately account for the difference, disparities in statutory language should be considered first. Unlike section 1259, section 1260 does not have legislative history deeming the rule inapplicable when the return on the derivative differs sufficiently from the return on the underlying property.²²⁰ The reason, I suspect, is that the point was well understood because the standard was consciously lifted from section 1259. Even so, the two provisions treat forward contracts differently. Unlike section 1259, section 1260 covers *any* forward contract, even one that omits a portion of the underlying fund's economic return, and so such forwards are not a viable means of avoidance.²²¹ Nevertheless, like section 1259, section 1260 excludes options and equity swaps that do not

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219. If taxpayers could not accelerate losses in this way, the value of the hedge fund transaction, ex ante, would be diminished considerably. Fortunately for the taxpayers, if the fund depreciates, the dealer will be willing to settle the derivative early. Of course the dealer would be unwilling to provide this accommodation if the dealer was subject to the same tax rule as the customer, since early settlement would accelerate not just the customer's losses, but also the dealer's gain. Indeed, the dealer's tax bill would increase by the same amount that the customer's tax bill declined, assuming the same rate applied. Yet the dealer is required to mark the derivative to market under section 475. I.R.C. § 475(a)(1). Thus, early termination has no effect on the dealer's tax bill. For a discussion, see Schizer, *Sticks and Snakes*, supra note 23, at 1372.

220. For citations to this legislative history under section 1259, see supra notes 104, 111, & 194. No such references appear in the legislative history for section 1260. See S. Rep. No. 106-201, at 32-35 (1999).

221. See I.R.C. § 1260(d)(4) (defining forward contract as "any contract to acquire in the future (or provide or receive credit for the future value of) any financial asset"). In contrast, section 1259 does not cover forward contracts in which the amount of property delivered varies significantly with the value of the underlying property. See *id.* § 1259(d)(1) (defining forward contract as "a contract to deliver a substantially fixed amount of property (including cash) for a substantially fixed price"). Section 1260 covers such variable delivery forward contracts, but regulatory authority is provided to exclude them. *Id.* § 1260(g)(2). The Treasury has not yet used this authority.

sufficiently track the underlying asset.²²² If these derivatives are used, avoidance strategies like those employed for section 1259 would pass legal muster for section 1260.

The relative difficulty of avoiding section 1260, then, derives not from the tax law itself, but from frictions—in particular, frictions affecting the dealer counterparty's ability to hedge. Before section 1260 was enacted, the dealer could easily hedge by holding the fund interest. But now that the derivative must convey *less than all* of the hedge fund's economic return—a requirement for avoiding section 1260—holding the fund interest is no longer a perfect hedge. For instance, assume the investment bank is asked to sell a call for \$115 and buy a put for \$95. If the fund appreciates from \$100 to \$115, this profit goes to the dealer. Yet if the price declines from \$100 to \$95, the dealer cannot pass this loss on to the client through the put.

Why is it important for securities dealers to hedge? Their business is to provide a service—derivatives to those who want them—not to place bets on hedge funds.²²³ It is not usually derivatives dealers, but specially trained and monitored proprietary traders, that invest an investment bank's own capital. Dealer subsidiaries must avoid unhedged risk because their creditworthiness is essential to their business. No one would buy derivatives from an entity with poor credit, because of uncertainty about whether the dealer could honor the contract.²²⁴ In a world of perfect information, dealers could take intelligent unhedged risks, such as bets that are priced favorably because a client is sharing a tax benefit with the dealer. Yet it would be difficult for prospective customers of a dealer

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222. With a pair of options, the regime is avoided as long as their exercise prices are not "substantially equal." *Id.* § 1260(d)(1)(C) (providing that regime is triggered by holding a call and selling a put, but only if "such options have substantially equal strike prices and substantially contemporaneous maturity dates"). Similarly, section 1260 clearly applies only to swaps offering the entire return (i.e., "substantially all" risk of loss and opportunity for gain) of the hedge fund—but not to swaps offering only some of this return. See *id.* § 1260(d)(3)(A), (B) (providing that a person has a "long position under a notional principal contract," and thus is covered by statute, if the person has "the right to be paid (or receive credit for) all or substantially all of the investment yield (including appreciation) on such financial asset for a specified period," and "is obligated to reimburse (or provide credit for) all or substantially all of any decline in the value of such financial asset"). The standard under section 1259 is identical in all relevant respects. See *id.* § 1259(d)(2)(A), (B) (defining "offsetting notional principal contract" as any agreement which "includes . . . a requirement to pay (or provide credit for) all or substantially all of the investment yield (including appreciation) on such property for a specified period," and a "right to be reimbursed for (or receive credit for) all or substantially all of any decline in the value of such property").

223. Cf. Hull, *supra* note 186, at 323 (noting that financial institutions that fail to hedge their exposure properly on derivatives sold to clients are "subject to an unacceptable level of risk").

224. See Morgan Stanley Dean Witter & Co., Form 10-Q: Quarterly Report 31 (Feb. 28, 2001) ("[T]he Company's debt ratings can have a significant impact on certain trading revenues, particularly in those businesses where longer term counterparty performance is critical, such as over-the-counter derivative transactions.").

(or, for that matter, shareholders) to distinguish sensible bets from less sensible ones. Nor can employees, whose pay is tied to volume, be trusted to take only well compensated risks. In response, major investment banks generally have very strict risk management policies for derivatives dealers.²²⁵ These policies render it quite difficult for dealers to supply the derivative needed to avoid section 1260. Usually, no mismatch is permitted between derivative and fund returns. Put another way, when it is the dealer that must bear unhedged risk, as opposed to the investor (as in the case of section 1259), risk becomes a discontinuous friction.

Given this difficulty, why are dealers able to supply derivatives for avoidance of section 1259? After all, a dealer that offers customers a collar on one share cannot perfectly hedge by selling one share short, since the economic returns do not match perfectly.²²⁶ The key difference is that for section 1259, but not section 1260, the relevant derivative is based on a publicly traded asset. As a result, dealers can use hedging strategies that rely on delta, the correlation of the derivative's value with underlying stock prices.²²⁷ To see such correlation, assume a share of stock is worth \$10, and someone has the right to buy the stock for \$100. Since this call option would not be used unless the stock price rises above \$100, a \$1 increase in the stock price, from \$10 to \$11, will not generate a full dollar of appreciation in the option. Instead, the option might appreciate by only a penny, reflecting the marginally increased likelihood that the stock price will reach \$100.

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225. See, e.g., Merrill Lynch & Co., Form 10-Q: Quarterly Report 5 (May 11, 2001) ("As part of its trading activities, Merrill Lynch uses derivatives to facilitate customer transactions, to take proprietary positions and as a means of risk management. The Corporate Risk Management group monitors and manages these risks in accordance with established risk management policies and procedures that include risk tolerance levels."). These policies are considered sufficiently important that banks refer to them in public disclosure. See, e.g., Merrill Lynch, Annual Report, *supra* note 125, at 25 ("Other risk management objectives include . . . limiting proprietary risk-taking; and closely monitoring our long-term exposure to illiquid assets."); Morgan Stanley Dean Witter & Co., *supra* note 224, at 34 ("The risks associated with the Company's derivative activities, including market and credit risks, are managed on an integrated basis with associated cash instruments in a manner consistent with the Company's overall risk management policies and procedures."); see also Morgan Stanley Dean Witter & Co., Form 10-K: Annual Report 53 (Feb. 16, 2001) (noting that Morgan Stanley assigns market risk limits to each major trading division worldwide, as well as to smaller subdivisions of the firm, and noting that "[t]rading division risk managers, desk risk managers and the Firm Risk Management Department monitor market risk measures against limits in accordance with policies set by senior management").

226. Assume the dealer sells a \$95 put and buys a \$115 call, giving the dealer most, but not all, of the return from owning the stock: risk of loss below \$95, and opportunity for gain above \$115. A short sale of a single share does not offer complete protection. The problem is that the dealer will lose \$15 on the short sale as the stock rises from \$100 to \$115, but will not make this money back on the collar because opportunity for gain on the call begins only at \$115.

227. See *supra* notes 186-195 and accompanying text.

This sensitivity of a derivative to changes in the underlying stock's value is used by dealers in so called "dynamic" hedging.²²⁸ For instance, assume a collar leaves a dealer exposed to risk of loss below \$90 and opportunity for gain above \$110 on 1000 shares of a publicly traded stock currently worth \$100. For every dollar change in the underlying stock's value, the collar's value will change by an observable number of cents, which will be less than a dollar. The reason for this divergence is that the collar does not cover the full range of stock returns.²²⁹ There is a gap between \$90 and \$110. As a result, since the collar is based on 1000 shares, the dealer would not hedge by shorting a full 1000 shares, but an amount *fewer than* 1000 shares. If a \$1 change in the asset price induces an \$.85 change in the collar's value, the dealer's offsetting short would be 85% as large (i.e., shorting 850 shares to hedge a collar on 1000 shares).²³⁰ Delta will vary as the underlying stock price changes, reflecting different probabilities that the derivative will yield a profit or loss.²³¹ Thus, the dealer must constantly monitor delta and make corresponding adjustments in the size of the hedge.²³²

For two reasons, then, dynamic hedging is feasible only for publicly traded assets, and not for hedge fund positions. First, computation of delta requires data about the relationship between derivatives and the underlying asset, and such a rich supply of data is available only for a publicly traded asset.²³³ Second, constant adjustments in the size of the

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228. See generally Hull, *supra* note 186, at 298–324 (describing dynamic hedging strategies); Taleb, *supra* note 189, at 115–31 (discussing role of delta in hedging strategies).

229. For a discussion, see *supra* note 187 and accompanying text.

230. If delta is .85, then as the price of the underlying stock falls from \$100 to \$99, the dealer would lose \$.85 per share on the collar (because of the reduced likelihood of profiting from the \$110 call the dealer has purchased, and the increased likelihood of having loss on the \$90 put the dealer has sold). Total loss on the collar would be \$850 (i.e., .85 * 1000 shares). To make up for this loss, the dealer must short 850 shares, thereby earning \$1 per share, or \$850.

231. For instance, if the stock price is \$100, the stock price must climb to \$110 before the dealer will begin to profit from the call it owns with a \$110 exercise price. An increase from \$100 to \$101 thus will not induce a full \$1 of appreciation on the option, given the less-than-100% probability that the price will attain the \$110 level. On the other hand, a price increase from \$210 to \$211 will have a much greater influence on the \$110 call option's value, since the option holder can collect this gain by exercising the option. Hence, the option is likely to appreciate by almost a full dollar.

232. See Hull, *supra* note 186, at 299–300 (noting that "delta changes with both changes in the stock price and the passage of time," so "the hedge has to be adjusted periodically," a process known as "rebalancing" the hedge).

233. If the dealer knew the details of the fund's trading strategy, the dealer might be able to use this information to hedge. Yet funds are secretive about their trading strategies, a trade secret that justifies high management fees. See Lessons of LTCM, *supra* note 203, at D-5 ("Hedge funds view banks as competitors . . . . Therefore, most hedge funds are very reluctant to share information on their trading strategies [with banks] . . . ."). This secretiveness creates an additional friction for hedge fund derivatives, which also existed before the enactment of section 1260: According to tax lawyers involved in structuring these deals, some hedge funds do not allow a securities dealer to be a fund investor.

hedge are feasible only in an extremely liquid market—and certainly not with a hedge fund, which might allow redemptions only once a month.

Although delta hedging is not feasible for a hedge fund derivative, one investment bank was once willing to sell such a derivative without perfectly hedging it—a notorious exception that proves the rule. In 1996, Union Bank of Switzerland (UBS) provided this service to the principals of Long Term Capital Management (LTCM). Specifically, UBS sold an at-the-money call option and hedged (imperfectly) by investing in the fund.²³⁴ Thus, UBS gave up opportunity for gain in LTCM, but remained fully exposed to risk of loss.²³⁵ Even in 1996, when LTCM's value was soaring, UBS reportedly was the only securities dealer willing to do this transaction (except for Credit Suisse First Boston, which took a much smaller stake); senior UBS executives apparently were eager to invest in LTCM—both on behalf of UBS and personally—and hoped this transaction would give them access to an otherwise closed fund.²³⁶ In any event, the economic disparity between the derivative and underlying fund interest helped the client's tax analysis,²³⁷ but proved disastrous for UBS when LTCM failed three years later. The dealer's \$800 million position to hedge the derivative became essentially worthless.²³⁸ UBS also lost the \$300 million option premium, which it had invested in LTCM for its own account.²³⁹ This transaction is well known on Wall Street and, in my ex-

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234. The transaction reportedly was devised by Myron Scholes, a founder of LTCM. Nicholas Dunbar, *Inventing Money* 170–71 (2000). Professor Scholes's insightful work on frictions is discussed above. See *supra* note 5 and accompanying text.

235. Dunbar, *supra* note 234, at 171–72.

236. *Id.* at 168–69, 172–73 (describing desire of UBS's CEO to cement closer relationship with LTCM).

237. This transaction predated enactment of section 1260. So why was an economic mismatch needed between the derivative and fund? After all, transactions were commonly done without a mismatch under prior law. See *supra* Part III.A. The difference is that those transactions usually involved *passive* investors, who did not have access to information about the fund's trading strategy. Passive investors thus were less likely to be regarded as owners of the fund under tax common law because they lacked a key attribute of tax ownership—so called “dominion and control” over the partnership interests, including the ability to vote, inspect partnership books, obtain an accounting, and otherwise to monitor and help govern the partnership. See Rev. Rul. 77-137, 1977-1 C.B. 178 (holding that control over “residual powers” affects which party is viewed as partner in partnership); NYSBA Tax Section, Comments on H.R. 3170, *supra* note 206 (concluding based on analysis of authorities predating section 1260 that “dominion and control” and residual rights determine ownership of a partnership for tax purposes). But this argument is not available when the taxpayers run the fund, as in the UBS-LTCM transaction. As a result, an economic mismatch was thought to be necessary.

238. UBS reportedly had the right to convert its equity stake into debt, but this feature ultimately proved unhelpful. Dunbar, *supra* note 234, at 172. (“The economic effect of this clause was insidious . . . . For Meriwether and his partners, the clause transformed what looked like a call option into a put option—the right to sell their deferred stake at its current price.”).

239. *Id.*

perience, investment bankers often mention it in explaining why securities dealers are wary of taking risks on these transactions.²⁴⁰

3. *Responses.* — Although the language of section 1259 was transplanted into section 1260, methods of avoiding section 1259 are not so easily borrowed, due to the dealers' difficulty in supplying the necessary derivative. With this simple route closed, taxpayers have explored other possibilities. This subsection describes eight alternatives, and the frictions and tax rules constraining them. The first six structures involve variations on the return, location, or subject matter of the derivative. Anecdotal evidence suggests that these six are relatively rare, either because of daunting frictions or the risk of an adverse tax result. Considerably more common are the last two, which do not use derivatives at all: purchase of an insurance contract or of stock in an offshore insurance company. Yet frictions and tax risks burden these as well and, unlike the avoidance techniques for section 1259, these insurance structures probably could be halted with targeted regulatory responses.

a. *Responses Involving Derivatives.* — Taxpayers have attempted to use modified derivatives to avoid section 1260, with only limited success. The first four structures attempt to salvage the derivative with a modified return. The fifth still uses a derivative, but moves it offshore instead of changing the economic return. The sixth changes the subject matter of the derivative.

i. *Call Options.* — One alternative, pursued recently by Bear Stearns, is to sell call options. Specifically, Bear Stearns has organized a so called "fund of funds" that invests in six funds run by Bear Stearns investment managers.²⁴¹ Not only can clients invest directly in this master fund, but they also can buy a cash settled call option based on the fund's value.²⁴²

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240. A recent development dramatizes this point. During the market decline of 2000 and 2001, a limited number of financial intermediaries began selling exchangeable notes that provide the "upside" of a hedge fund, while protecting holders from risk of loss. For instance, the investor pays \$100, receives no coupon, and in five years receives the greater of \$100 or the value of a specified fund (currently worth \$100). The intermediary hedges by investing in the fund. Notably, although the intermediary seems to be bearing risk of loss in the fund, this is not the case. If the fund declines below a threshold, the investor loses the right to share in fund appreciation, receiving only \$100 at maturity (i.e., even if the fund is worth more). This "knock out" feature lets the intermediary sell a fund that is losing value, while salvaging enough to buy a Treasury bond that pays \$100 at maturity. I learned these details in August 2001 from an investment banker familiar with these deals. Incidentally, the transaction is not tax motivated. Although it avoids section 1260, it is subject to accelerated timing and ordinary tax rates under the contingent debt regulations of Treasury Regulation section 1.1275-4. Treas. Reg. § 1.1275-4 (as amended in 1999). See Schizer, *Sticks and Snakes*, supra note 23, at 1379-80, 1383-84 (describing tax treatment under regulations and noting that taxable holders generally avoid contingent debt).

241. In other words, this "master" fund will buy interests in each of the other funds. Thus, investors in the master fund will have pro rata investments in each of the six funds.

242. Geraldine Fabrikant, *For the Rich, a Hedge Fund with an Eye on Taxes*, N.Y. Times, July 1, 2001, at BU 7 (describing warrants that Bear Stearns is offering on its fund of funds).

The call option sells for one-third the price of a direct investment, has an exercise price of 120% of a direct investment's initial value, and has a term of seven and a quarter years.²⁴³ Since this transaction resembles the LTCM option described above, on which UBS incurred sizable losses, it is surprising that Bear Stearns is willing to offer this deal. The difference is that Bear Stearns manages the underlying fund—a fact that presumably enables the bank to hedge satisfactorily, or to tolerate an imperfect hedge.²⁴⁴

Yet although this relationship may help Bear Stearns to hedge, the tie weakens the client's tax analysis—not under section 1260, but under tax common law principles of ownership. Once again, there is a tension between avoiding a friction and ensuring a tax result, a recurring theme in this Article. The concern here is that the client might be taxed as owner of a partnership interest (with annual inclusions of short term capital gain) instead of as owner of an option. Since the derivatives dealer and hedge fund manager are related, it is easier for the government to treat the client's payments to the dealer for an option as, in substance,

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243. *Id.* For instance, assume a fund interest currently costs \$1 million. The investor pays \$330,000 for the option. After seven and a quarter years, if the fund has appreciated above \$1.2 million, the investor receives a cash payment of this excess. Thus, if the fund's value is \$2 million, the investor receives \$800,000 (for a profit of \$470,000, net of the premium). But if the fund does not appreciate (or, indeed, declines in value), the investor receives no payment and loses the premium. Thus, if the fund is worth only \$1 million when the option matures, the investor loses \$330,000. For the investor to break even, the fund must appreciate to \$1.53 million (i.e., a 53% return) before the option matures.

244. I do not know how Bear Stearns hedges this position, but three possibilities come to mind. First, after selling a call to an investor, the derivatives dealer might, in turn, buy an identical call option from the underlying fund. Obviously, it is easier for the dealer to secure this accommodation from a fund run by Bear Stearns, as opposed to an unaffiliated fund. The net effect would be that direct investors in the fund receive a call premium in exchange for sharing gains above 20% with optionholders.

Alternatively, the derivatives dealer might use its knowledge of the funds' trading practices to hedge dynamically. The dealer would have to track the trading practices of each fund, establish offsetting positions, and then adjust these offsetting positions as prices (and thus deltas) change and as the funds' portfolios change. The trick is that the dealer must have adequate information about the funds' trading practices—something that is not usually possible. See *supra* note 233. Yet this strategy might be feasible here because the fund manager is a Bear Stearns affiliate.

Finally, if the derivatives dealer simply holds the underlying fund interests, the call premium protects the dealer from losses of up to one-third of the fund interests' value. For instance, if the master fund's value declines from \$1 million to \$700,000, Bear Stearns will lose \$300,000 on the fund, but will keep the \$330,000 call premium, for a net gain of \$30,000. This cushion obviously would not be adequate for a more dramatic decline in value, as UBS discovered. Yet Bear Stearns has the advantage of diversification here, since the option is based on the value of six funds. In choosing which funds to include, moreover, Bear Stearns could have chosen funds that are less volatile and do not correlate with each other. For added protection, Bear Stearns could add a "knock out" feature in which the call option would expire upon declining below a certain threshold (e.g., 70%) unless the investor were to pay an additional premium.

payments to the fund manager for a partnership interest.²⁴⁵ Even aside from this tax risk, a call option offers less of a tax benefit—specifically, less tax deferral—than the derivatives used before section 1260 was enacted. The difference is that options do not generate any deductions until they expire or are terminated (e.g., seven and a quarter years later), whereas other derivatives, such as equity swaps, can yield deductible payments every year.²⁴⁶

Not only do these call options offer less appealing tax treatment, but they also are burdened by significant frictions. Instead of choosing which fund she prefers, the taxpayer can invest only in the six funds selected by Bear Stearns. More importantly, call options are costly. The taxpayer must pay a large premium, and will not break even unless the fund appreciates by 53% (so the taxpayer can recover the 33% premium and 120% exercise price).²⁴⁷ Given these tax risks and frictions, the volume of these transactions reportedly is modest.²⁴⁸

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245. In other words, the dealer would be viewed as an agent for its fund manager affiliate. Although the taxpayer's economic return—a share of gains above 120%—diverges from the economic return on other partnership interests, the government could argue that the taxpayer's claim is still a partnership interest, but one of a different type (e.g., a "profits" interest). Inclusion of a "knock out" feature would further weaken the tax analysis by creating an even closer economic connection between the option and the underlying partnership interest: Since the client could only keep her investment by paying extra cash as the fund depreciates, the arrangement would closely resemble an investment in the partnership funded by a margin loan.

246. Options generally yield a capital loss when they expire, see I.R.C. § 1234(a)(2) (treating option as if it had been sold on the day it expired), or when they are terminated, see *id.* § 1234(a)(1) (providing capital loss upon termination). In contrast, equity swaps provide for annual interest type payments. These "periodic payments" generally are deductible in the year accrued. See Treas. Reg. § 1.446-3(e)(2)(i) (as amended in 1994) (providing that taxpayer must recognize ratable daily portion of periodic payment for tax year to which portion relates). To see the difference, assume a taxpayer has \$1 million. Instead of investing directly in a hedge fund, she acquires either an option or a swap, while putting the rest of her money in interest-bearing bonds. If she buys the option, she will not have any current deductions to shelter interest income from these bonds. In contrast, the swap arguably does provide deductions. Appendix D offers a numerical example involving a swap and bonds. However, this advantage of swaps does not actually materialize if, as some practitioners claim, such periodic swap payments are not in fact deductible. See generally Steinberg, *supra* note 205, at 229 (describing view of some practitioners that, when swaps provide for periodic interest type payments and a single contingent payment at maturity, deduction of periodic payments should be deferred under the "'clear reflection of income' principle" (quoting Treas. Reg. § 1.446-3(b))).

247. According to one expert:

Bear Stearns seem[s] to be offering leverage and tax avoidance, and we would not necessarily advise our clients to make an investment decision based on tax ramifications or leverage, but rather on the underlying funds. If they are compelling enough, why risk placing a leveraged bet on hedge funds, many of which are already leveraged, and why risk unknown tax ramifications?

Fabrikant, *supra* note 242 (quoting James R. Hedges IV, head of L.J.H. Global Investments, a hedge fund research and advisory firm).

248. According to an investment banker familiar with the transaction, these Bear Stearns call options have not proven to be popular with investors, who instead usually

ii. *Reduced Opportunity for Gain.* — Aside from call options, what else can securities dealers offer? Theoretically, they could sell a derivative in which they retain opportunity for gain, without taking on risk of loss—on the theory that losses are especially troubling to dealers. Thus, assume a dealer sells the client a \$120 call, takes a \$100 put in return, and hedges by purchasing a fund interest for \$100. The dealer's net exposure would be to profit from appreciation between \$100 and \$120. Yet although dealers will not object to this exposure, they reportedly will not pay for it, at least at major investment banks.²⁴⁹ As a result, clients are charged for the *full* opportunity for gain, without a discount for the \$20 of appreciation kept by the dealer. For example, assume a direct investment in the fund would cost \$100. For the derivative, the client would pay approximately \$103 (i.e., the price of the hedge fund plus a 3% fee).²⁵⁰ While the tax treatment is better, no pretax profit is earned until the underlying fund appreciates by 20%. This deal makes sense only if a very high pretax return (and thus a high tax bill) is expected on the fund. Anecdotal evidence suggests this transaction is rare.

Eventually, dealers may start paying for this 20% of retained exposure, since this bet clearly has positive value. For instance, less well known investment banks might do so to attract new business, although these dealers would have to consider the effect of a risky hedge fund portfolio on their creditworthiness. If this transaction becomes common, it will illustrate the point that frictions can prove unstable. My research suggests, however, that at the present time, this friction remains effective.

iii. *Catch-Up Structures.* — Instead of paying for this exposure, dealers have looked for ways to give this return to the client. For example, the client could receive no payment for the fund's first 20% appreciation, while receiving double credit for the next 20%. As the fund appreciates from \$120 to \$121, the client receives not one, but two dollars. When the fund reaches \$140, the client claims \$40 of appreciation (i.e., \$2 for each dollar of appreciation between \$120 and \$140). As long as the fund appreciates to \$140, the client benefits from *all* appreciation in the underlying fund, sharing none with the dealer.

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invest directly in the Bear Stearns master fund. Many clients apparently believe the cost of the option premium outweighs the (uncertain) tax benefit.

249. This observation is based in part on my experience advising investment banks about section 1260 while this measure was pending. To update this knowledge, I discussed the issue with two investment bankers at major institutions who are seeking to develop transactions to avoid section 1260, more than a dozen New York tax lawyers familiar with such efforts, and one investment banker at a smaller institution who had recently surveyed market practices on this issue. These conversations occurred between April 2000 and August 2001.

250. Here the dealer would want a fee paid in cash, instead of in the form of extra option value on the derivative (i.e., the method used in collars that avoid section 1259, as noted above). See *supra* notes 128–129 and accompanying text. The difference is that a dealer cannot convert this option value into cash here because dynamic hedging is not feasible.

Yet again, accommodating the friction weakens the tax argument. To avoid section 1260, the return on the derivative and underlying fund must diverge in a meaningful way. In this transaction, a difference arises only if the fund's maturity value is between \$100 and \$120 (and, to some extent, between \$120 and \$140). For some funds, the end value is reasonably likely to be in this range. Yet for many funds, the likelihood is remote. As a result, although some investment banks have considered offering this transaction, the volume reportedly is limited.²⁵¹

iv. *Inclusion of a Third Party.* — Since the dealer does not value the exposure between \$100 and \$120 and, for tax reasons, the client should not take it, another approach is to transfer this exposure to an unrelated third party.²⁵² The dealer would thus sell the right to this appreciation as a separate "stub" security. Because the dealer will collect payment for the stub, the dealer can reduce the price of the main derivative.

Nevertheless, several investment bankers describe this strategy as impractical. Since the dealer will not tolerate unhedged exposure for any amount of time, the dealer cannot keep the stubs as inventory, to be sold whenever a suitable customer is found. Rather, two unrelated customers must appear simultaneously, and must want to invest in the same fund. In addition, if one customer wishes to terminate the derivative prior to maturity (e.g., to claim tax losses), the other must be compelled to do so because the dealer cannot hedge one without the other. In effect, the stub must have an uncertain term, terminating whenever the main derivative terminates. This requirement would reduce the price an investor would pay.

Even if these problems could be solved—for instance, by forming a fund that regularly buys stubs—individual investment bankers might not consider the task worthy of their time. Cultivating a stubs market would be a slow process with an uncertain return. Investment bankers, however, usually have a short time horizon: They want results in time for their annual bonus and, in this mobile market, may leave the firm after a year or less. In other words, agency costs are impeding an avoidance strategy. In addition, as with any innovation, the innovator bears all the risks and expenses (for instance, in educating the market), but shares the rewards

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251. The sources for this observation are described in *supra* note 249. Advisors vary in their assessment of this "catch-up" structure. Some believe it can never work, while others believe that the answer depends upon the fund and, in particular, the likelihood that the fund's end date value will fall between \$100 and \$140.

252. The two customers must be unrelated so the government cannot treat the two as one person and deem them, jointly, to be subject to section 1260. Notably, however, section 1260, unlike section 1259, grants no explicit authority to consider the activities of related parties. Compare I.R.C. § 1259(c)(1) (defining constructive sale to include specified actions by either "the taxpayer (or a related person)"), with *id.* § 1260(d)(1) (defining constructive ownership to include specified transactions by the "taxpayer," while not mentioning related parties). The Treasury should use its regulatory authority to fill this gap.

with competitors. If the stubs market catches on, others will sell them too, thereby reducing the innovator's expected profits.

v. *Offshore Vehicles*. — Instead of changing the derivative's economic return, the taxpayer can hold the derivative through an offshore corporation. As a result, the taxpayer will no longer own a derivative, at least not directly. Instead, she will own common stock in a corporation, an investment not explicitly covered by section 1260. Nor will section 1260 apply to the corporation itself, as long as the entity is not subject to U.S. tax (as a foreign corporation with no business effectively connected to the U.S.).²⁵³ Foreign tax is not a concern if the corporation is in a tax haven, nor are costs of setting up an offshore vehicle prohibitive. Even so, this structure has two potential vulnerabilities. First, passive investments in offshore corporations can trigger other anti-abuse rules, including the passive foreign investment company (PFIC)²⁵⁴ and controlled foreign corporation (CFC)²⁵⁵ rules. While a comprehensive examination of these regimes is beyond this Article's scope, the bottom line is that careful planners often can thread these needles.²⁵⁶

The real vulnerability is caused by section 1260 itself. In addition to covering a list of derivatives transactions, which admittedly does not include this structure, section 1260 provides regulatory authority to cover "transactions . . . that have substantially the same effect" as the listed ones.²⁵⁷ The government could easily shut down this structure through a

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253. In general, firms that are not incorporated in the United States do not pay U.S. tax unless their profits are from U.S. investments or are effectively connected to a U.S. trade or business. See Joseph Isenbergh, *International Taxation* 25 (2000) ("A domestic corporation is subject to U.S. tax on its worldwide income; a foreign corporation only on income derived from U.S. investment or business.").

254. I.R.C. §§ 1291, 1293–1298.

255. *Id.* §§ 951–962, 964.

256. For instance, the CFC rules can be avoided if the taxpayer owns less than 10% of the vehicle. See *id.* § 951(b) (providing that taxpayers qualify as "United States shareholders" under the CFC rules only if they own at least "10 percent or more of the total combined voting power of all classes of stock entitled to vote"). To avoid adverse results under the PFIC regime, the taxpayer could make a so called qualified electing fund (QEF) election. *Id.* § 1295. The election waives the usual PFIC penalties—ordinary character and an interest charge—and instead taxes the corporation on a pass-thru basis. Because section 1260 does not trigger any tax consequences until the derivative is settled, there is no income to pass through to the taxpayer until the derivative is settled. What if, a month before the derivative matures, the U.S. taxpayer sells her PFIC stock at a gain? While as an economic matter, a portion of this gain would derive from the derivative, the profit arguably would not be recharacterized because section 1260 has not been triggered yet.

257. *Id.* § 1260(d)(1)(D). Before section 1260 was enacted, the NYSBA suggested clarification that the "substantially the same effect" catch-all covered this offshore structure. New York State Bar Association Tax Section, *Comments on Constructive Ownership and H.R. 1703*, *Tax Analysts, Tax Notes Today*, July 15, 1999, LEXIS, 99 TNT 135-33. No language or legislative history was added, presumably because the drafters already thought the point was clear. In the interests of full disclosure, I should state that I was the principal author of the NYSBA report.

notice that retroactive regulations will cover it. Indeed, the possibility of this action should already be a fairly effective deterrent.²⁵⁸

vi. *Managed Accounts*. — Still another possibility is to change the subject matter of the derivative.²⁵⁹ For instance, what if the derivative is based not on a hedge fund, but on the performance of a specified portfolio of securities held by an investment bank (a so called “managed account”)? Section 1260 applies only to derivatives based on “financial assets,” defined as “any equity interest in any pass-thru entity.”²⁶⁰ The term is arguably not broad enough to include a free-standing portfolio (even if managed by a hedge fund manager or, for that matter, by the taxpayer herself).²⁶¹ The portfolio is not held in an entity such as a partnership or trust, the argument goes, and so section 1260 should not apply.²⁶² Whatever the merits of this technical argument,²⁶³ the Treasury could

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258. Taxpayers can strengthen their argument that retroactive regulations should not apply by differentiating the economic return on their common stock from the economic return on the derivative. For instance, the offshore corporation could hold other assets, such as mortgages. Yet addition of these other assets would increase transaction costs. Moreover, the regulations might still apply, as long as the government undertakes to bifurcate or look through the common stock.

259. Mark Fichtenbaum emphasizes that section 1260 does not apply to derivatives based on plain vanilla common stock. See Mark Fichtenbaum, *Tax Planning Opportunities Still Exist Even After the Enactment of the Constructive Ownership Rules*, J. Tax'n Fin. Products, Summer 2000, at 30, 32 (“[I]nvestment activities with respect to the stock of any corporation that is not a ‘pass-thru entity’ continues to avoid the constructive ownership rules.”). He also advocates section 1256 contracts, as well as certain options and other contracts subject to mark-to-market accounting. As he points out, gains on these contracts offer 60% long term capital gain, even if held for less than one year. *Id.* at 31.

260. I.R.C. § 1260(c)(1)(A). The term also means: “to the extent provided in regulations—(i) any debt instrument, and (ii) any stock in a corporation which is not a pass-thru entity.” *Id.* § 1260(c)(1)(B).

261. In a similar strategy, the derivative could be based on an “index” that reflects the trading strategy of a particular hedge fund. Jeffrey J. Lonsdale, *What LIES Beneath the Investor's Quest for a Scalable Capital Gain Holding Period?*, J. Tax'n Fin. Products, Spring 2001, at 5, 8 (analyzing transaction in which taxpayer invests with hedge fund and the investment is not for a partnership interest, but for “an index investment tied to a mathematically defined, market neutral hedging strategy”).

262. According to one well respected practitioner who expressed skepticism about this strategy, sometimes the portfolio actually *is* held in an entity, but the entity is disregarded under the “check the box” rules. He felt that this was not a helpful fact, especially with an unsympathetic judge.

263. Even without section 1260, the government might argue that the client is the real tax owner of the managed account. While the merits of this argument turn on the particular facts, the government's case is strengthened considerably if the client is giving directions about how the account should be traded (as is sometimes the case). This transaction has been described to me both by investment bankers and by tax advisors. In the latter group, some believe it “works” and some do not.

override it through retroactive regulations,²⁶⁴ a reality that should reduce the volume of this transaction.²⁶⁵

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264. Under section 1260(g), “[t]he Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of this section.” I.R.C. § 1260(g). Section 1260(c)(1)(B) authorizes the Secretary to expand the definition of “financial asset” to include debt and common stock. *Id.* § 1260(c)(1)(B). Further authority can be found in section 1260(d)(1):

[A] taxpayer—enter[s] into a constructive ownership transaction with respect to any financial asset if the taxpayer . . .

....

(D) to the extent provided in regulations prescribed by the Secretary, enters into one or more other transactions (or acquires one or more positions) that have substantially the same effect as a transaction described in any of the preceding subparagraphs.

Id. § 1260(d)(1), (d)(1)(D). Some practitioners have told me that they do not view this last phrase as authority to reach a managed account. They say that this language, which is part of section 1260(d)’s definition of a “constructive ownership transaction,” does not broaden the definition of a “financial asset,” which is defined in a different section (section 1260(c)). Once the taxpayer has a derivative based on a “financial asset,” they argue, this language reaches various derivatives *of this type*, including those with slightly different forms (e.g., contingent notes) or economic returns. Yet other practitioners read this “catch all” language more broadly. Congress’s purpose, they say, is to reach transactions that have a similar effect, and Congress did not limit itself to a particular *type* of similarity. These conversations occurred during the spring of 2001.

265. Barbara Flom suggests another way of gaming the “financial asset” definition. What if the derivative is based on a hedge fund (which admittedly is a financial asset) and something that is not a financial asset (e.g., a commodity index)? She argues that such a transaction avoids the regime, although she notes that the government could reach it through regulations, for instance, by bifurcating the derivative into a constructive ownership transaction and a separate position. See Flom, *supra* note 209, at 27.

Under a plausible reading of the statute, though, this transaction is already covered, at least if a swap or forward contract is used. These derivatives are caught if they “provide credit” for changes in a financial asset’s value—presumably, even if other factors, such as a commodity index, also influence the forward’s or swap’s value. For instance, assume the hedge fund appreciates by \$100 and the commodity index appreciates by \$75, yielding a \$175 profit on the derivative. The contract has “provided credit” for the \$100 hedge fund profit. Under this reading, the derivative would be a constructive ownership transaction. While I doubt the phrase “provide credit” was meant to reach this transaction, an unsympathetic judge might well read the rule in this way. I.R.C. § 1260(d)(3) (treating notional principal contract as constructive ownership transaction if the taxpayer “(A) has the right to be paid (*or receive credit for*) all or substantially all of the investment yield . . . and (B) is obligated to reimburse (*or provide credit for*) all or substantially all of any decline in the value of such financial asset” (emphasis added)); *id.* § 1260(d)(4) (defining “forward contract” as “any contract to acquire in the future (*or provide or receive credit for the future value of*) any financial asset” (emphasis added)).

Admittedly, this reading raises knotty questions. For instance, it would seem inappropriate to recharacterize the \$75 of commodity based gain. But what theory is used to avoid this result? Is this gain deemed net underlying long term gain? See *id.* § 1260(a); *supra* note 212 (defining “net underlying long term capital gain”). Or is the derivative in effect bifurcated (i.e., so that ordinary character and an interest charge are applied only to gains attributable to the hedge fund component)? These approaches yield comparable results on the assumed facts. But the approaches diverge, for instance, if the hedge fund yields a profit but the commodity index yields a loss.

b. *Responses Not Involving Derivatives.* — Section 1260 thus has impeded the use of derivatives to attain better tax treatment for hedge fund returns. To an extent, taxpayers can still pursue this goal with deals involving insurance. Of course, avoidance is avoidance, whether taxpayers are using derivatives, insurance, or something else. Yet frictions already block insurance based end runs to a degree, and targeted tax rules could finish the job. These reforms probably would not require legislation, and its attendant political challenges, because the Treasury arguably has the necessary regulatory authority under current law. As we have seen, the same cannot be said for section 1259.

i. *Variable Life Insurance and Annuity Contracts.* — One end run—a “variable” life insurance policy or annuity whose return is based on a hedge fund²⁶⁶—is a novel twist on an old practice. Favorable treatment of life insurance and annuities is longstanding, due to sympathy for bereaved life insurance beneficiaries, administrability problems with taxing annuities and, no doubt, the political clout of insurance companies.²⁶⁷ While variable contracts based on bonds and mutual funds are a staple of middle class tax planning, contracts based on hedge fund returns are available only in private transactions for very wealthy taxpayers.²⁶⁸ To an extent, these contracts can substitute for derivatives listed in section 1260.²⁶⁹

The tax treatment of these products, however, can be less favorable than the treatment of derivatives before section 1260 was enacted. Like these early derivatives, annuities and life insurance offer deferral. Taxpayers do not owe tax while the hedge fund appreciates (as hedge fund partners do), and are taxed only upon receiving cash. But unlike these early derivatives, which offered long term capital gain, annuities yield ordinary income and, except in two scenarios, life insurance shares this dis-

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266. In a “variable” contract, the size of death benefits (for life insurance) or annual payments (for annuities) depends upon the performance of specified assets, chosen by the taxpayer from a range of options. In a “fixed” contract, these payments are preset.

267. See generally Chirelstein, *supra* note 202, at 32–39 (discussing tax treatment of insurance and annuities).

268. Thomas J. Boczar & Stephen B. Lipton, VLIP: A Vehicle for Enhancing After-tax Investment Returns, Trusts & Investments, Jan./Feb. 2001, at 36, 40 (“This structure is generally available only for wealthy families desirous of moving \$1 million or more of their assets to the next generation in a tax-efficient manner.”); Roger D. Silk, How Privately Placed Tax Advantaged Products Can Benefit Hedge Fund Investors and Managers, Hedge Fund News (Dome Capital Mgmt., Inc.), May 2000, ¶ 1 (noting that these deals “are more particularly appropriate for those with at least \$10 million available to invest in hedge funds”), available at http://www.hedgefundnews.com/news_n_info/article_detail.php?id=163 (on file with the *Columbia Law Review*).

269. Insurance companies hedge by investing directly in the fund. Their tax bill is unaffected because, like securities dealers, they are subject to mark-to-market accounting. See Edward D. Kleinbard & Thomas L. Evans, The Role of Mark-to-Market Accounting in a Realization-Based Tax System, 75 Taxes 788, 802 n.97 (1997) (discussing tax treatment of insurance companies that hold assets in segregated accounts).

advantage.²⁷⁰ The first exception is that payments are tax free when the insured dies (so tax character is irrelevant).²⁷¹ Although helpful to those who are investing for their heirs, this boon is useless to taxpayers who want to spend their gains.²⁷² Second, policy loans and certain withdrawals are sometimes available tax free, but only if the life insurance policy is not a "modified endowment contract" (MEC), and even then complex restrictions may apply.²⁷³ Esoteric details aside, the main way to avoid MEC status is by staggering the payment of policy premiums over seven years, instead of investing a single premium up front.²⁷⁴ Yet this slow pace carries a cost. Funds that have not yet been invested cannot begin enjoying tax deferred or tax free investment growth.²⁷⁵

In addition, these deals present frictions of their own. First, the taxpayer must place a mortality bet²⁷⁶ so that the contract will qualify as life

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270. Hedge fund derivatives used to yield long term capital gain, which was taxed at 20% for individuals, instead of the higher tax rate for short term capital gain and ordinary income (a maximum of 39.1% for individuals in 2001). See *supra* text accompanying note 205. In contrast, life insurance and annuities generate ordinary income because, technically, there has been no sale or exchange of a capital asset and no termination of rights with respect to a capital asset. See Treas. Reg. § 1.72-1 (as amended in 1963) (noting that section 72 provides for inclusion of life insurance and annuity payments in gross income unless other provisions provide a contrary result); see also I.R.C. § 1221 (defining capital asset); *id.* § 1234A (providing capital gain treatment for certain terminations of rights with respect to capital assets). For a description of this tax cost of life insurance and annuities, see Boczar & Lipton, *supra* note 268, at 38 ("With a [modified endowment contract] a policyholder can make withdrawals during his or her lifetime, but the withdrawals are taxable as ordinary income."). In some cases, a 10% penalty is imposed on withdrawals before the taxpayer reaches age 59.5. *Id.*

271. I.R.C. § 101 (excluding death benefit from income tax). If structured so that the policy is excluded from the taxpayer's estate, life insurance can offer the added benefit of avoiding estate tax. See Boczar & Lipton, *supra* note 268, at 41 (noting that variable life insurance could "potentially eliminate both the income tax on investment earnings, as well as estate taxes on the wealth so invested"). Scheduled repeal of the estate tax in 2010 reduces the significance of this advantage. See *supra* note 198 and accompanying text.

272. Derivatives held until death have also offered tax forgiveness under section 1014, although this basis step-up rule is scheduled for repeal in 2010. See Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, § 541, 115 Stat. 38, 76 (amending I.R.C. § 1014); *supra* note 198.

273. See I.R.C. § 7702A (defining MEC); Boczar & Lipton, *supra* note 268, at 38 (noting that non-MECs may allow policy loans and certain tax free principal withdrawal rights, but noting tax penalties associated with certain withdrawals in first fifteen years).

274. See I.R.C. § 7702A(b) (providing "7-pay" test to define MEC).

275. See Silk, *supra* note 268, ¶ 7 (noting tradeoff between a non-MEC, which allows tax free loans once the policy is paid for, and an MEC, which does not permit tax free loans but "offers the opportunity of getting the maximum amount of cash into the policy as soon as possible").

276. In other words, payments must depend to a significant degree on how long the taxpayer (or someone else) lives. Thus, life insurance generally is not payable until the taxpayer dies. An annuity, in contrast, usually *stops* making payments when the taxpayer dies. An annuity can also last for a fixed term of years, so it does not necessarily require a mortality bet. Yet annuities offer less favorable tax treatment than life insurance, as noted above. See *id.*; *supra* text accompanying note 270.

insurance for tax purposes.²⁷⁷ The extra cost and risk from this bet could prove unattractive, since the taxpayer's preferred bet on a hedge fund would be intertwined with a wager on longevity that she may not want.²⁷⁸ The latter bet may not even be available to a taxpayer who is old or in poor health.²⁷⁹ Second, significant fees and out-of-pocket costs erode the investment return. For policies issued by a U.S. insurance company, state excise taxes and a federal "deferred acquisition" (DAC) tax are approximately 4% of premiums.²⁸⁰ This cost is lower for policies issued by offshore insurers, which are subject only to a federal excise tax of 1%.²⁸¹ Not only do money managers collect a fee, as they would in a direct hedge fund investment, but so do the insurance broker, insurance company, and bank custodian.²⁸² Third, the taxpayer must accept less con-

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277. See I.R.C. § 7702 (prescribing that to qualify as life insurance, a contract must be treated as such under state law and also must satisfy either "cash value accumulation test" or "guideline premium requirements"); Gordon O. Pehrson et al., *Annuities, Life Insurance, and Long-Term Care Insurance Products A-18* (Tax Management, Portfolio No. 546, 1999) (noting that section 7702's definition of life insurance contract requires that investments or built-up cash value not be too large relative to the mortality based death benefit); AALL Variable Life Ins., *Innovative Offshore Financial Products That Are Compliant with Current U.S. Legislation*, at <http://www.aall.com/Aall/servicesvl.html> (last visited Aug. 7, 2001) (on file with the *Columbia Law Review*) ("Efficient and reliable monitoring of limitations on contributions and size of investment is critical to the maintenance of status as insurance."); see also Silk, *supra* note 268, ¶ 8 ("To qualify as life insurance under US tax law, the total death benefit of the policy must exceed the cash value by a certain amount (the exact amount varies, and is calculated according to a complex formula).").

278. See William D. Kornreich & Robert M. Burkarth III, *Offshore Life Insurance in Wealth Preservation Strategies*, *Offshore Fin. U.S.A. Mag.*, May/June 1999, ¶ 20 (noting that "the charge that has the most dramatic effect on performance" is the cost of life insurance (COI) component, which is based on the difference between the value of invested assets and the death benefit at the time), at http://www.escapeartist.com/Offshore_Finance_USA/Offshore_Life_Insurance.html (on file with the *Columbia Law Review*).

279. See AALL Int'l Deferred Variable Annuity, *Frequently Asked Questions*, at <http://www.aall.com/Aall/servicesidvafaq.html> (last visited Aug. 7, 2001) (on file with the *Columbia Law Review*) (noting that life insurance requires the investor to be insurable).

280. Grant Thornton LLP, *How to Eliminate Income and Estate Tax on Securities Investments with a Variable Life Insurance Wrapper*, at <http://www.granthornton.com/content/11023.asp> (last visited Aug. 7, 2001) (on file with the *Columbia Law Review*) (noting that the state premium tax is approximately 2% and the DAC tax is also approximately 2%).

281. I.R.C. § 4371.

282. See Alison Steed, *Wrapper May Not Be the Best Package*, *The Weekly Telegraph Globalnetwork.co.uk*, ¶ 5 (Feb. 13, 2001), at <http://www.globalnetwork.co.uk/global/01/2/13/foshor3.html> (on file with the *Columbia Law Review*) ("Commission rates on these types of investment products are high—often 7, 8 or 9 [percent] . . . ." (quoting Fiona Middlemiss of Alan Steel Asset Management)). Fees are higher for life insurance policies that allow for tax free policy loans. See Boczar & Lipton, *supra* note 268, at 38 (stating that administrative fees charged by non-MECs are thirty to forty basis points higher each year). According to practitioner Roger Silk, "[t]he average annual cost of these contracts typically ranges around 150 basis points. Organizational costs vary between a few tens of thousands to a few hundred thousand dollars." Silk, *supra* note 268, ¶ 9.

trol over invested funds. U.S. insurance companies traditionally offer a slate of approved money managers, which might not include the taxpayer's preferred manager; offshore funds are more accommodating, since the regulatory environment is more flexible.²⁸³ Yet even then, the U.S. tax analysis is stronger if taxpayers limit their role in investment decisions, and tax lawyers have told me that some deals push the envelope on this issue.²⁸⁴ Finally, although offshore insurance companies offer lower excise taxes and more flexibility, their credit may be less well established, and the regulatory environment can inspire less confidence.²⁸⁵

Notwithstanding these drawbacks,²⁸⁶ insurance is becoming an increasingly common method of securing tax advantaged hedge fund re-

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283. Boczar & Lipton, *supra* note 268, at 41 ("In a domestic VLIP [variable life insurance policy] the investor can select from an entire suite of mutual funds. In an offshore VLIP the investment managers may additionally include hedge fund and other alternative investment managers . . ."). According to one practitioner, this difference between U.S. and offshore transactions has faded because certain U.S. jurisdictions have begun allowing variable policies based on hedge funds. The relevant conversation occurred in June 2001.

284. Limiting the taxpayer's role in managing the investment and supervising the fund manager is helpful under general principles of tax ownership. The point is for the insurance company, not the taxpayer, to be regarded as the real owner of invested assets. See generally David S. Miller, *Taxpayers' Ability to Avoid Tax Ownership: Current Law and Future Prospects*, 51 *Tax Law.* 279, 303-04 (1998) (discussing law of ownership as applied to variable annuities and life insurance, and noting that favorable tax treatment is available only "so long as [the taxpayer's] ability to manage investment return is narrowly circumscribed"). Relatedly, insurance-specific authorities treat the taxpayer as the direct owner of the underlying investments—and thus deny favorable tax treatment associated with variable insurance—when the taxpayer has too much control over investment decisions. See, e.g., Rev. Rul. 81-225, 1981-2 C.B. 13 (offering series of fact patterns for purposes of determining whether mutual fund shares underlying an annuity contract are owned by contract holder or life insurance company); Boczar & Lipton, *supra* note 268, at 39 (noting that "investor control" rulings might apply). See generally Pehrson et al., *supra* note 277, at A-46 to -51 (discussing investment control authorities). During conversations in the spring of 2001, some tax advisors said that they believe some of these contracts are vulnerable to attack on these grounds.

A related issue is that the invested assets underlying the life insurance or annuity must be diversified. See I.R.C. § 817(h) (providing that annuity and life insurance are not taxed as such if underlying investments are not adequately diversified); AALL Variable Life Ins., *supra* note 277 ("Funds must be a minimum of five different investments."). But cf. Pehrson et al., *supra* note 277, at A-51 (noting technical argument as to why diversification requirement may not apply to offshore funds).

285. See Boczar & Lipton, *supra* note 268, at 40 (warning of the "looser regulatory framework of a less stringently regulated foreign jurisdiction," and noting that "investors may not have as much confidence in a foreign country's legal system or political stability"); Kornreich & Burkarth, *supra* note 278, ¶ 20 (observing that lax insurance oversight in offshore jurisdictions could lead to higher administrative charges). In the United States, funds invested in "separate accounts" generally are not available to pay the insurance company's general creditors, and are available only to pay the investor on his annuity or insurance contract. Yet not all offshore jurisdictions offer such protection. Silk, *supra* note 268, ¶ 5 ("It could be unnecessarily risky to have a policy from a company in a jurisdiction which does not have a separate account law.").

286. Other issues in these complicated transactions include:

turns. One offshore firm reportedly has issued \$450 million of these policies, and expects to raise this number to \$5 billion within three years.²⁸⁷ Even so, section 1260 arguably could extend even to insurance and annuities. The Treasury has regulatory authority to cover transactions having "substantially the same effect" as the enumerated ones.²⁸⁸ This language arguably is broad enough to reach annuities and insurance contracts that offer tax deferred hedge fund returns, although there is a credible argument to the contrary.²⁸⁹ As a practical matter, the Treasury probably could stop the practice immediately with a brief notice that regulations will be issued with a retroactive effective date.

A broader point merits emphasis here. Efforts to tax most investments can be avoided, to a degree, if insurance and annuities are not also covered. This reality is especially significant because derivatives and in-

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actuarial issues, reinsurance, choice of custodian, custody arrangements, methods of payments and cash flow management, obtaining required legal and/or tax opinions, awareness of and compliance with relevant excise taxes, communications, compliance with any relevant securities and/or insurance laws, as well as a sound economic analysis to determine whether the contemplated transaction is likely to achieve the desired goals for the client.

Silk, *supra* note 268, ¶ 19.

287. Hal Lux, *The Great Hedge Fund Reinsurance Tax Game*, Institutional Investor, Apr. 2001, at 52, 53 (discussing Cayman Islands based insurer Scottish Annuity & Life Holdings). I have no personal experience with this transaction, but press reports and practitioner articles suggest a growing trend. See, e.g., *id.* (noting that "several well-known U.S. hedge fund operations" are entering this business, "including Lee Ainslie's Maverick Capital and New York hedge fund adviser Tremont Advisors"). One practitioner reports that "[a] large and growing number of sophisticated, high net-worth individuals and families are currently taking advantage of the unique planning opportunities presented by these types of vehicles." Silk, *supra* note 268, ¶ 20. The fact that practitioners are writing articles recommending this strategy is a further indication of its popularity. See, e.g., Boczar & Lipton, *supra* note 268; Grant Thornton LLP, *supra* note 280; Kornreich & Burkarth, *supra* note 278; Silk, *supra* note 268. Likewise, an Internet search reveals references to this strategy. For instance, an instructor in an online course on estate planning emphasizes his experience in these deals. See Lawline.com Bio: James R. Cohen, at http://www.lawline.com/cle/bio_cohen.html (last visited Aug. 7, 2001) (on file with the *Columbia Law Review*) (stating that "Jim has been involved with private placement variable life insurance for many years, acting as legal counsel to insurance brokers for such policies, investors who have purchased such policies, and hedge fund managers managing funds for such policies" and has "lectured widely on tax, estates, investment fund and hedge fund life insurance issues").

288. I.R.C. § 1260(d)(1)(D).

289. The counterargument is that the effect is not "substantially the same" because the economics of the transaction are different (given the mortality risk) and because the tax result is different (the character here is ordinary). Indeed, one of section 1260's consequences—recharacterization of long term capital gain as ordinary income—applies awkwardly to contracts that yield either ordinary income or no income, although section 1260's interest charge presumably could be applied. While these objections have force, their persuasiveness depends on the scope of the regulations (e.g., whether they exempt policies with more than a requisite concentration of mortality risk) and, ultimately, on the degree of discretion the Treasury is thought to have in writing regulations. If section 1260 is not adequate authority, moreover, the Treasury might attack these contracts on other grounds, such as the degree of "investor control." For a discussion, see *supra* note 284.

insurance have become increasingly similar in function, as each can allocate risk in nuanced ways to implement both business and tax objectives.²⁹⁰ Yet significant disparities remain in the taxation of these two product groups, as illustrated above. To an extent, frictions keep taxpayers from substituting one for the other. Some of these frictions, however, such as state regulatory limits on the type of contracts insurance firms can sell, are likely to dissipate over time. Global competition, coupled with the regulators' natural sympathies for their regulated industry, are likely to expand insurance companies' market reach. Thus, greater tax consistency for these substitutes will be needed to prevent widespread planning. One institutional handicap is that, in my experience, tax lawyers who are experts in one area tend to know considerably less about the other, perhaps because each area is the product of its own history, is governed by different parts of the code, and is quite detailed and esoteric. As practitioners become more "interdisciplinary" in response to market trends, government reformers will need to do so as well. The purpose here is to emphasize the problem, and to suggest that narrow measures aimed at derivatives should be coupled, as needed, with complementary measures aimed at insurance. Broader responses are also warranted here, and further research in this area is needed.

ii. *Offshore Hedge Fund Reinsurers.* — One final alternative warrants discussion. Instead of buying an insurance policy, taxpayers can invest in an offshore insurance or reinsurance company whose assets are managed by a hedge fund manager—in effect, a hedge fund that also sells insurance. The fund is structured as a corporation rather than as a partnership. Thus, investors are not liable every year for tax on the fund's trading profits.²⁹¹ Rather, investors pay no tax until they sell their fund interest, and are taxed at long term capital gain rates if they have held the fund for at least a year. The fund itself will not pay U.S. (or other) income tax if it is incorporated in a tax haven such as Bermuda. Such offshore "incorporated pocketbooks" are an old abuse, targeted by several

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290. In addition to the example described above, potentially overlapping areas between derivatives and insurance include public securities that resemble insurance products, such as catastrophe bonds and securitized pools of credit derivatives, as well as insurance products based on financial risks. See generally Viva Hammer & Ann Singer, *Insurance Derivatives: A Tax Angle*, J. Tax'n Fin. Products, Spring 2001, at 29, 29 (noting that "[t]he capital markets and the insurance/re-insurance industry have become increasingly interrelated in recent years" and discussing tax issues associated with derivatives that substitute for insurance products, including catastrophe futures and bonds); Mark H. Leeds et al., *Avoiding Accidents at the Capital Markets/Insurance Crossroads: Legal and Tax Issues*, Derivatives Rep., Apr. 2001, at 1, 1-6 (noting that "capital markets [are] converg[ing] with the insurance industry" and discussing ways in which insurance firms are expanding their product base to include insurance of financial risks).

291. While a partnership is a pass-thru entity for tax purposes, a corporation is not. See generally Howard E. Abrams & Richard L. Doernberg, *Federal Corporate Taxation I* (3d ed. 1995) ("The basic premise underlying subchapter C is that a corporation should be a taxpayer distinct from its shareholders.").

regimes. Most relevant are the PFIC rules of 1986, which generally apply to firms, such as hedge funds, that are engaged in investing and other "passive" businesses.²⁹² If the PFIC regime applies, there is no tax advantage over a domestic partnership. Investor returns would be recharacterized as ordinary income, and an interest charge would be imposed, as under section 1260. The trick here is that the PFIC regime does not apply to insurance companies, a statutory exception not yet elaborated by regulations.²⁹³

To ensure that the fund qualifies as an insurance company for purposes of the PFIC regime, taxpayers must contend with additional frictions that will deter some taxpayers. First, the fund must sell insurance, and thus must bear some mortality or casualty risk.²⁹⁴ In some cases,

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292. See I.R.C. §§ 1291, 1293–1298 (prescribing rules for passive foreign investment companies). Other regimes include the controlled foreign corporation regime, see id. §§ 951–962, 964, and the foreign personal holding company regime, see id. §§ 551–558. But these rules generally apply only if U.S. taxpayers own more than a minimum percentage of the entity. See, e.g., id. § 951(b) (defining "United States shareholder" as "a United States person . . . who owns . . . 10 percent or more of the total combined voting power of all classes of stock entitled to vote"); id. § 957(a) (defining controlled foreign corporation as "any foreign corporation if more than 50 percent of (1) the total combined voting power of all classes of stock . . . entitled to vote, or (2) the total value of the stock . . . is owned . . . by United States shareholders"); see also id. § 552(a) (defining "foreign personal holding company" as a foreign corporation in which more than 50% of the firm, measured by vote or value, is owned directly or indirectly by five or fewer U.S. individuals, and which earns at least 60% of its income in the form of certain passive investment income known as "foreign personal holding company income"). These rules thus can be avoided if U.S. taxpayers purchase sufficiently small stakes, both individually and as a group.

293. To be precise, foreign corporations qualify as PFICs if more than a minimum percentage of their income or income-producing assets are passive. See id. § 1297(a). Income from "the active conduct of an insurance business" generally is deemed not to be passive:

Except as provided in regulations, the term "passive income" does not include any income—

....

(B) 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.

Id. § 1297(b)(2).

294. As noted above, the PFIC regime does not treat as passive "any income . . . derived in the active conduct of an insurance business" if the corporation "is predominantly engaged in an insurance business" and would be subject to tax under the Code's special regime for insurance in subchapter L. Id. Under regulations implementing subchapter L, the key factor is, in effect, whether the "primary and predominant" business of the corporation is selling insurance and annuities:

The term *insurance company* means a company whose primary and predominant business activity during the taxable year is the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies. Thus, though its name, charter powers, and subjection to State insurance laws are significant in determining the business which a company is authorized and intends to carry on, it is the character of the business actually done in the taxable

these risks can substantially erode returns.²⁹⁵ Yet because these risks are actuarially predictable, risk is likely to function here as a continuous friction, as with section 1259. Taxpayers will accept marginal increases, to a point, as the price of a lower tax. Second, the fund's ability to reinvest profits may be limited. The purpose of the fund's investments supposedly is to fund insurance liabilities. If these reserves dwarf the liabilities, it is not credible to claim that the fund is an insurance company.²⁹⁶ One solution is to sell more insurance (although this means accepting more insurance risk). Another possibility is to return taxable cash to investors.²⁹⁷ Third, to satisfy credit rating agencies and insurance regulators, firms cannot invest all their reserves in hedge funds—and the prevailing practice of 40% presumably is a less concentrated hedge fund bet than many would prefer.²⁹⁸ Fourth, the firm must set up a real infrastructure, for instance, by hiring employees to manage insurance liabilities.²⁹⁹ Finally, offshore insurance firms also face other tax issues, such as whether their insurance activities are effectively connected to the U.S., and thus subject to U.S. tax.³⁰⁰

While these costs deter some taxpayers, this transaction is becoming more common. According to an April 2001 *Institutional Investor* report,

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year which determines whether a company is taxable as an insurance company under the Internal Revenue Code.

Treas. Reg. § 1.801-3(a)(1) (as amended in 1972).

295. Lux, *supra* note 287, at 55 (noting that Stockton Re, a hedge fund reinsurer managed by a Goldman Sachs affiliate, suffered insurance related losses last year).

296. The general principle is that reserves should be consistent with the reasonable needs of the insurance business. See Treas. Reg. § 1.801-4(a) (as amended in 1972) (defining "life insurance reserves" as reserves based on actuarial predictions, reserves designed to fund insurance liabilities, and reserves required by law); see also S. Rep. No. 100-445 (1988), [2001] 13 Stand. Fed. Tax Rep. (CCH) ¶ 31,620, at 57,413-14 ("Thus, income derived by entities engaged in the business of providing insurance will be passive income to the extent the entities maintain financial reserves in excess of the reasonable needs of their insurance business.").

297. Distributions or pro rata redemptions would be treated as dividends taxable in full at ordinary rates. I.R.C. § 301 (stating that dividends are taxed as ordinary income to the extent of earnings and profits). Certain non pro rata redemptions would be taxed at capital gains rates with a basis offset. *Id.* § 302(b) (describing conditions under which redemptions are taxed as sales).

298. Lux, *supra* note 287, at 57 (noting that offshore hedge fund reinsurers currently allocate 40% of investable assets to hedge fund investments and attributing this constraint to ratings agencies). "In the U.S., even if reinsurers wanted to invest a very large portion of their assets in hedge funds, they couldn't because of the investment policies of state insurance regulators. The rules are more relaxed in Bermuda." *Id.*

299. This cost is less daunting for reinsurance companies, which tend to have lean infrastructures. *Id.* (noting that "[r]einsurance fits well with hedge fund strategies because it's a wholesale business that doesn't require large staffs for dealing with the public"). Even so, reinsurance talent is now "at a premium in Bermuda," *id.* at 53, and some players are concerned that hedge fund reinsurers are not scrutinizing insurance risks with adequate sophistication. *Id.* at 55.

300. Profits that are effectively connected to a U.S. trade or business are subject to U.S. income tax. See I.R.C. § 864.

"[b]ankers estimate that dozens of hedge fund managers have tried to launch Bermuda reinsurance companies in the past couple of years. Most have failed."³⁰¹ Even so, major investment banks and hedge funds have established such funds, presumably with more to follow.³⁰² Some of this volume arises because there are no regulations defining an insurance company under the PFIC rules. In this void, taxpayers take aggressive positions that minimize the effect of relevant frictions. For instance, some entities hedge or reinsure insurance risks, so the investor's economic return is based solely on the investment portfolio. If rigorous regulatory requirements are imposed, many of these transactions will be stopped.³⁰³ This is an easy step, mechanically, since the Treasury can issue a brief notice that retroactive regulations are forthcoming.³⁰⁴ The ease of this course should not be overstated, though. The proper regulatory standard presents difficult questions beyond this Article's scope. To an extent, the PFIC regime's distinction between active and passive entities is murky when applied to financial intermediaries. After all, a key business objective even of "real" insurance firms is to earn high investment returns, which allow for reduced premiums and more customers. The purpose here is not to develop the appropriate rule for offshore insurance companies or, for that matter, offshore investments in general.

Rather, the point is that impeding a particular tax motivated use of derivatives—a mission that section 1260 has discharged more successfully than section 1259—is not the end of the job. Planners will seek other opportunities. Two common ones, used in this context and others as well, are insurance contracts and offshore vehicles. This dynamic illustrates a familiar limitation of narrow transactional reforms. By itself, one reform will seldom be enough. On the other hand, a series of targeted measures—for instance, one aimed at derivatives, another at offshore insurance companies—sometimes can keep taxpayers from attaining a popular planning objective such as tax advantaged hedge fund returns. Simi-

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301. Lux, *supra* note 287, at 57. While I have no personal experience with these transactions, I have learned of their growing popularity through conversations with a dozen New York tax lawyers between October 2000 and May 2001.

302. Fixed income hedge fund manager William Michaelcheck has established a \$200 million Bermuda reinsurer called Select Reinsurance. A Goldman Sachs affiliate manages Bermuda reinsurer Stockton Reinsurance. Asset Alliance, a New York hedge fund firm, is establishing Asset Alliance Re in Bermuda, and J.P. Morgan is involved in Hampton Re Holdings. *Id.* at 53. "It's a relatively new idea, but it's definitely an emerging trend." *Id.* at 58 (quoting Robert Schulman, President of Tremont Advisers, a New York hedge fund adviser).

303. According to one expert, only one hedge fund reinsurer could satisfy the SEC that it truly is an insurance company. *Id.* at 58 ("[Max Re is] the one hedge fund insurance company that I know about that would satisfy U.S. securities regulators." (quoting Scott Willkomm, CEO of Cayman Islands based Scottish Annuity & Life Holdings, a competitor of Max Re)). Presumably, if the tax authorities applied similar standards, many of these players would be eliminated.

304. Indeed, *Institutional Investor* quotes an anonymous IRS source indicating that the agency might take up the issue this year. *Id.* at 55.

larly, *adding* one reform can be significant, if others already are on the books. For this incremental strategy to be effective, policymakers must know where the next hole in the dike will be—that is, where frictions are weakest.

C. Normative Implications: Cost-Benefit Analysis

As noted above, the main purpose of the case studies is to highlight the effect of frictions, rather than to judge the merits of each provision. Yet understanding frictions and avoidance contributes to better normative judgments.

Thus, section 1260 makes two contributions, again assuming the tax burden here should be maintained or increased.³⁰⁵ Like section 1259, the rule offers symbolic benefits. In addition, the measure is more effective than section 1259 at stopping the targeted derivatives transaction. Efficiency is enhanced as taxpayers invest directly in hedge funds, avoiding the higher costs of derivatives (e.g., the investment bank's 3% fee). Likewise, vertical equity is also advanced as wealthy hedge fund investors pay a higher tax. As with section 1259, this progress would not materialize if taxpayers responded, instead, by investing in slightly different derivatives not reached by the rule. The key insight of the case studies is that, unlike in the case of section 1259, this response is not likely because of a discontinuous friction: the difficulties dealers face in hedging a "partial return" hedge fund derivative.

Section 1260 is not cost free, though. It adds to the tax law's complexity, and imposes new compliance and administrative costs. The measure cannot be successful, moreover, if taxpayers disregard frictions and

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305. As with section 1259, there is a threshold question, beyond this Article's scope, as to whether investment returns should be taxed and, if so, at what rate. Indeed, much ink has been spilled over whether there *ever* should be a preferential rate for capital gains. See generally Noel B. Cunningham & Deborah H. Schenk, *The Case for a Capital Gains Preference*, 48 *Tax L. Rev.* 319 (1993) (summarizing this literature). Assuming there should be, a further question is whether the preference should apply to hedge fund returns. The answer depends in part on the rationale for the preference. For instance, the rationale might be to discourage short term transactions as socially wasteful, on the theory that speculation is a zero sum game from society's perspective. Cf. Lynn A. Stout, *Why the Law Hates Speculators: Regulation and Private Ordering in the Market for OTC Derivatives*, 48 *Duke L.J.* 701, 745, 771 (1999) (discussing whether speculation is a zero sum game). Another theory might be that short term investors do less socially useful monitoring of management. Under these rationales, the preferences should not be extended. On the other hand, hedge funds are sophisticated and often engage in useful market equilibrating arbitrage, and so concerns about speculation as a zero sum game may not be persuasive. Moreover, if the rationale for long term treatment is to favor deferred consumption, the preference ought to be extended because hedge fund investors generally reinvest their gains. As with section 1259, although arguments can be made on both sides, the question is easier for our purposes. The tax burden on hedge fund returns can be reduced more straightforwardly without wasteful self help. See, e.g., Cynthia Blum, *Rollover: An Alternative Treatment of Capital Gains*, 41 *Tax L. Rev.* 385, 399–401 (1986) (providing a "rollover rule" through which tax would be deferred on any gain that was reinvested).

respond with more drastic methods of avoidance, such as making investments in insurance contracts or offshore insurance firms—or, for that matter, indexed mutual funds or other investments unrelated to hedge funds. These responses generate new waste (for example, as taxpayers assume mortality risk they do not want) without raising revenue, and could also redistribute wealth in questionable ways (e.g., by transferring fee income from securities dealers to insurance firms). The net effect of section 1260 depends on the balance of these competing considerations.

Section 1260 is likely to merit a more favorable assessment than section 1259, although better empirical information is needed for a more definitive judgment. The constructive sale rule is commonly avoided for positions worth at least \$1 million. While the Treasury could ease this volume somewhat with regulations—for instance, by focusing on loans of stock from taxpayers to securities dealers—a significant volume of hedging is likely to continue. Only broad legislation using, for example, the “substantial diminution” standard, could halt this practice, a step that is politically unattainable for now. In contrast, the constructive ownership rule is more difficult to avoid, and many strategies have been abandoned. Of course, as long as some strategies remain, section 1260, like section 1259, induces a certain amount of planning related waste, and a comparison turns on empirical questions. A difference, though, is that the main surviving strategies for section 1260, involving insurance, probably could be blocked with regulations, or even notices of forthcoming regulations. Even though the regulatory process is not free of politics, it would not entail the frenetic lobbying sometimes associated with congressional action. Because of frictions, then, end runs are easier to block for section 1260 than for section 1259, even though the two measures employ the same statutory test. Of course, ease of avoidance is not the sole test of a provision’s worth.³⁰⁶ But it is a key factor, and frictions account for the difference.

CONCLUSION

The recent record of tax reformers is sobering. Efforts to tax investments have a familiar pattern. The government learns of a transaction that exploits an inconsistency in the law, but cannot repair the inconsistency for political or administrability reasons. Instead, reformers lob a narrow response at the particular transaction. This transactional reform can yield symbolic benefits in the short run, but the system becomes more complex, and planners sometimes respond with variations that avoid the rule. Social waste often increases, while revenue from wealthy taxpayers does not.

These realities raise questions about the whole enterprise of transactional reforms. One contribution of commentators is to build political support for comprehensive measures that would be more effective. This

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306. See *supra* Part I.A (discussing normative tradeoffs in targeting tax planning).

Article's contribution, instead, is to suggest improvements in transactional responses. The latter effort is critical because, at least in the near term, these measures will remain important.

When will transactional reforms actually stop the targeted planning, instead of inducing a new variation? The answer lies in frictions, such as accounting rules, commodities laws, the risk management policies of securities dealers, and the technological limits of dynamic hedging. If a discontinuous friction blocks a transaction, the tax law does not have to block it too. For derivatives transactions, a key discontinuous friction in some cases is the dealer's inability to hedge. In these circumstances, taxpayers predictably will resort to insurance and offshore alternatives, so frictions for these strategies should be considered as well. Because the frictions separating derivatives from insurance are eroding, inconsistencies in taxation of these substitutes merit greater attention.

More generally, to rely on frictions, reformers need information about them: how much they matter to taxpayers, whether they can be avoided through restructuring, and other pragmatic issues. These facts usually are not publicly reported, and hard data is seldom available. As a result, reformers need assistance in learning about frictions. The factual intricacies of sophisticated commercial transactions, however, are not commonly detailed in law reviews. More attention to these matters is warranted, and legal academics should offer greater assistance. Without a grounding in frictions, transactional reforms are unlikely to play a constructive role.

APPENDIX A: COMPARING RETURNS FROM SELLING AND HEDGING

In discussing section 1259, Part II observes that the need to retain risk often is not a strong friction, especially if the taxpayer expects the hedged asset to appreciate.³⁰⁷ To develop this point, this Appendix compares returns from a taxable sale and various hedges. The objective is to consider the extent to which post-section 1259 hedges, such as collars, are less appealing than pre-section 1259 hedges, such as short sales against the box.

Several assumptions are needed for these sample calculations. The appreciated asset is assumed to be 100,000 shares of a publicly traded stock that does not pay dividends, with each share worth \$100 (the "hedged asset"). Current fair market value thus is \$10 million, and basis is assumed to be zero. Hedging transactions are assumed to last for three years. To simplify the comparison, it is assumed that the hedge is physically settled after three years: The taxpayer delivers the appreciated property to settle the hedge, and thus is taxed. This assumption is necessary for a clear comparison with sales, but understates the benefits of hedging. To attain greater tax deferral, the taxpayer could instead settle the hedge in cash—so that no tax would be due on the hedged asset—and then could enter into a second hedging transaction.

Assumptions about market prices and rates of return are also needed. In these hypotheticals, a risk free Treasury bond yields 5% per year, while an equity investment yields 15% per year. The taxpayer's borrowing rate is generally 8%, but the discount on a secured prepaid forward is 6.5%. The cost of borrowing stock is .5% of the shares' initial value and, for simplicity's sake, is assumed not to change. Protection from risk of loss below \$100 (i.e., a put option with a \$100 exercise price) has the same value as opportunity for gain above \$151 (i.e., a call option with a \$151 exercise price). To compensate the hedging counterparty, though, the taxpayer usually exchanges the \$100 put for a more valuable call with an exercise price of \$120. In other words, the investment bank's fee is paid in the form of the right to any appreciation between \$120 and \$151, which on assumed facts is worth 7.5% of the asset's value.³⁰⁸ For individuals, the tax on capital gains is assumed to be 30% (i.e., 20% federal and 10% state) and the tax on ordinary income is assumed to be 50% (i.e., 40% federal and 10% state). For corporations, the tax on all income is assumed to be 45% (i.e., 35% federal and 10% state).³⁰⁹ All of the figures in the following tables have been rounded to the nearest dollar at each step in the calculations.

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307. See *supra* text accompanying note 115.

308. For the assumptions behind this calculation, see *supra* note 129.

309. The assumed federal tax rates approximate the maximum rates in effect when this Article was written. See *supra* note 218 (discussing federal rates for individuals); *supra* note 151 (discussing federal rates for corporations).

A. Hedging or Sale Followed by Fixed Income Investment

Section A describes the taxpayer's return from either selling or hedging and then reinvesting in fixed income assets such as Treasury bonds. This scenario shows that the retained risk required under section 1259 sometimes is a meaningful friction. Unlike a short sale against the box, which can offer the taxpayer a fixed income yield, a collar or other partial return hedge offers a return like that of a convertible bond: principal protection and the possibility of profit if the hedged asset appreciates. As a result, this return is very appealing if the hedged asset appreciates, but less so if it does not. This effect is explored first for individual taxpayers, and then for corporations.

1. *Individuals.* — Three scenarios are compared: a taxable sale, with the after-tax value invested in Treasuries; a short sale against the box with the proceeds invested in Treasuries; and a collar with retained exposure between \$100 and \$120. The future nominal value of the taxpayer's investment after three years is compared.

a. *Taxable Sale.* — Sale of the position yields \$7 million after taxes. If this amount is invested in a taxable bond yielding 5% per year, the taxpayer will have **\$7,538,234** after three years.

TABLE 1

YEAR	JANUARY 1 VALUE	PRETAX RETURN	AFTER-TAX RETURN
1	\$7,000,000	\$350,000	\$175,000
2	\$7,175,000	\$358,750	\$179,375
3	\$7,354,375	\$367,719	\$183,859
Final	\$7,538,234		

b. *Short Sale Against the Box.* — With a short sale against the box, the taxpayer can reinvest 95% of the sale proceeds in Treasuries. After three years, she will have the after-tax return on the Treasuries plus \$7 million (i.e., the \$10 million locked in on the hedged asset minus \$3 million in taxes). This total will be reduced, though, by the fees she must pay for borrowing stock (which are assumed here to be deductible). Thus, after three years she will have **\$7,653,571**, which is \$115,337 more than if she made a taxable sale.

TABLE 2

YEAR	JANUARY 1 VALUE	BOND PRETAX RETURN	BORROW FEE	PRETAX NET RETURN	AFTER-TAX RETURN
1	\$9,500,000	\$475,000	\$50,000	\$425,000	\$212,500
2	\$9,712,500	\$485,625	\$50,000	\$435,625	\$217,813
3	\$9,930,313	\$496,516	\$50,000	\$446,516	\$223,258
Final	\$7,653,571				

c. *Collar.* — Because the collar entitles the taxpayer to sell stock for \$100 in three years, she will have a minimum of \$10 million pretax, or **\$7 million** after-tax. This minimum return is less favorable than that

yielded by the taxable sale (by \$538,234) and the short sale against the box (by \$653,571). The difference is that, in the latter two scenarios, the taxpayer receives the \$7 million at the outset and reinvests it in a profitable investment (i.e., the Treasuries). In the collar, in contrast, the taxpayer ultimately has an amount higher than \$7 million only if the hedged asset appreciates. The maximum the taxpayer can earn is \$12 million pretax, or **\$8.4 million** after-tax, which is considerably better than the return offered by the fixed income investments, but also is riskier. While the taxpayer theoretically can borrow against the collar's value to invest in a Treasury, the transaction will not yield a profit because the taxpayer's borrowing cost will exceed the Treasury yield.³¹⁰

2. Corporate Taxpayers

a. *Taxable Sale.* — Sale of the position yields \$5.5 million. If this amount is invested in a taxable bond yielding 5% per year, the taxpayer will have **\$5,966,343** after three years.

TABLE 3

YEAR	JANUARY 1 VALUE	PRETAX RETURN	AFTER-TAX RETURN
1	\$5,500,000	\$275,000	\$151,250
2	\$5,651,250	\$282,563	\$155,410
3	\$5,806,660	\$290,333	\$159,683
Final	\$5,966,343		

b. *Short Sale Against the Box.* — If the taxpayer does a short sale against the box and reinvests 95% of the proceeds in Treasuries, it will have **\$6,220,711** after three years, which is \$254,368 better than a taxable sale. The relative advantage of a deferral strategy is greater here because the tax rate on gain for corporations is higher.

310. Theoretically, the taxpayer can raise the collar's minimum return so it approximates the return in the other cases. The key is that the put option's exercise price must be higher than the stock's current value. For instance, if the put exercise price is \$109, the minimum sale proceeds are \$10.9 million, instead of \$10 million (i.e., \$109 per share, instead of \$100), yielding \$7.6 million after taxes. The problem, though, is that this put option is more valuable than one with a lower exercise price, so the dealer will demand either a cash payment (which defeats the purpose of improving the taxpayer's minimum return) or a more valuable call option. Yet the latter demand—in effect, a call option with a lower exercise price that would offer the dealer more opportunity for gain—can trigger a constructive sale because the taxpayer will not retain enough exposure. In a sense, the problem here is the dealer's fee. If the dealer were willing to take a call option that was *no more valuable* than the client's \$109 put, a call of \$129 would satisfy this requirement on the facts assumed here. This \$109–\$129 collar would expose the taxpayer to a 20% spread, presumably enough to avoid a constructive sale. However, the dealer will not agree to this transaction. The dealer's call option must be considerably *more valuable* than the client's put option. If the call's exercise price is reduced (e.g., to \$112), a 20% spread obviously will not be possible. As in *supra* note 129, these calculations assume a .4 volatility, a three year term, and a 5% interest rate, and were computed with the NAG Option Calculator, at <http://www.nag.com/numeric/CL/Financial/StdBlack-Scholes.asp>.

TABLE 4

YEAR	JANUARY 1 VALUE	BOND PRETAX RETURN	BORROW FEE	PRETAX NET RETURN	AFTER-TAX RETURN
1	\$9,500,000	\$475,000	\$50,000	\$425,000	\$233,750
2	\$9,733,750	\$486,688	\$50,000	\$436,687	\$240,178
3	\$9,973,928	\$498,696	\$50,000	\$448,696	\$246,783
Final	\$6,220,711				

c. *Collar*. — The collar ensures the taxpayer at least \$10 million pretax or \$5.5 million after-tax, which is less than in the other scenarios (i.e., \$466,343 less than the taxable sale and \$720,711 less than the short sale against the box). Yet the maximum return under the collar, \$12 million pretax or **\$6.6 million** after-tax, is more than under the other scenarios (i.e., by \$633,657 and \$379,289, respectively).

B. *Taxable Sale or Hedge Followed by Reinvestment in Equities*

Section B describes the results when the taxpayer either sells or hedges and then reinvests in equities. On the assumed facts, partial hedges will outperform a taxable sale only if the hedged asset appreciates.

1. *Individuals*. — Three scenarios are compared: a taxable sale, with the after-tax value invested in equities; a short sale against the box, with 95% of the proceeds reinvested in equities; and a collar-type prepaid forward in which proceeds are reinvested in equities. The future nominal value of the taxpayer's investment after three years is compared.

a. *Taxable Sale*. — Sale of the position yields \$7 million after taxes. If this amount is invested in equities yielding 15% per year, the taxpayer will have **\$9,552,287** after three years, assuming she realizes the gain on this reinvestment in equities after three years.

TABLE 5

YEAR	JANUARY 1 VALUE	PRETAX RETURN	TAX DUE
1	\$7,000,000	\$1,050,000	\$0
2	\$8,050,000	\$1,207,500	\$0
3	\$9,257,500	\$1,388,625	\$1,093,838
Final	\$9,552,287		

b. *Short Sale Against the Box*. — With a short sale against the box, the taxpayer can reinvest 95% of the sale proceeds in equities. After three years, she will have the after-tax return on the equities plus \$7 million, which is the guaranteed after-tax value of the hedged asset. Again, this total will be reduced by deductible fees she must pay for borrowing stock. It is assumed that the borrowing fee is financed through deductible borrowing at 8%. Thus, after three years she will have **\$10,385,779**, which is \$833,492 more than if she made a taxable sale.

TABLE 6

YEAR	JANUARY 1 VALUE	PRETAX RETURN	BORROW FEE	AFTER-TAX FEE AND INTEREST TO DATE ³¹¹	TAX DUE
1	\$9,500,000	\$1,425,000	\$50,000	\$25,000	\$0
2	\$10,925,000	\$1,638,750	\$50,000	\$51,000	\$0
3	\$12,563,750	\$1,884,563	\$50,000	\$78,040	\$4,484,494 ³¹²
Final	\$10,385,779 ³¹³				

c. *Variable Delivery Prepaid Forward*. — A taxpayer who wishes to reinvest in equities without making a sale faces a liquidity problem. How will she find cash to buy the new investment? The most straightforward way is to enter into the collar described above, and then to borrow against its value. But the margin rules are likely to limit how much she can borrow to reinvest.³¹⁴ To avoid this constraint, the taxpayer can implement the same business terms through a formally different instrument: In a variable delivery prepaid forward, the dealer pays the taxpayer an amount up front in return for delivery of stock in the future. Because this up front payment is not formally a loan, but a prepayment for a good to be delivered in the future, the margin rules are commonly considered inapplicable.³¹⁵ To avoid a constructive sale, the amount of stock to be delivered will vary with the stock price.³¹⁶ For instance, if the stock price is below \$100, the full 100,000 shares are delivered (the equivalent of exercise of a \$100 put by the taxpayer). On the other hand, if the stock price rises above \$120, the taxpayer keeps a number of shares worth \$2 million—as a way to retain appreciation between \$100 and \$120. Often taxpayers also keep a share of appreciation above \$120.

The main cost here, as with a loan, is that the taxpayer must compensate the hedging counterparty for advancing money up front. Instead of receiving \$10 million after three years, the taxpayer receives only, say, \$8.2 million up front, and receives no further payments.³¹⁷ Under this

311. Assuming the annual interest charge is 8% and is deductible, the after-tax cost is 4% if the tax rate is 50%.

312. The 30% tax on the hedged asset is \$3,000,000. The 30% tax on the \$4,948,313 gain on the equity portfolio is \$1,484,494, yielding a total tax of \$4,484,494.

313. Before it is sold, the equity portfolio is worth \$14,448,313. The taxpayer is also entitled to an additional \$500,000 of proceeds from the short sale against the box, an amount that the broker has been holding (i.e., because only 95% of the proceeds have been released). After subtracting the tax of \$4,484,494 and the borrow fee and interest of \$78,040, the taxpayer has \$10,385,779.

314. See *supra* note 131.

315. See *supra* note 131.

316. For the relevant statutory language and legislative history, see *supra* note 194.

317. Although this \$1.8 million is akin to interest, it technically does not qualify as such and thus does not offer a deduction to offset the 50% tax on ordinary income; instead, this expense offsets capital gain, which is taxed at a lower rate. See *Dupont v. Dupont*, 308 U.S. 488, 497–98 (1939) (holding that a contract to deliver securities does not qualify as a loan for tax purposes and so interest is not deductible). See generally Schizer, *Debt Exchangeable for Common Stock*, *supra* note 10 (discussing trust structure, which

structure, reinvestment is more costly than under the short sale against the box, since the time value charge here is much higher than the stock borrow fee in the latter structure (6.5% on the assumed facts here, instead of .5%). Because of this cost, the hedge outperforms a taxable sale on these assumed facts *only if the hedged asset appreciates*. By earning an extra \$2 million pretax on the hedged asset, she will earn **\$10,213,386**, which outperforms a taxable sale by \$661,099.³¹⁸ (In some deals, as noted above, the taxpayer can earn more than \$2 million as the hedged asset appreciates above \$120). Without any added yield from the hedged asset, the minimum return of **\$8,813,386** underperforms a taxable sale by \$738,901.

TABLE 7

YEAR	JANUARY 1 VALUE	PRETAX RETURN ON PORTFOLIO	TAX DUE	EXTRA PRETAX RETURN ON HEDGED ASSET	EXTRA TAX DUE
1	\$8,278,491 ³¹⁹	\$1,241,774	\$0	—	\$0
2	\$9,520,265	\$1,428,040	\$0	—	\$0
3	\$10,948,305	\$1,642,246	\$3,777,165 ³²⁰	\$2,000,000	\$600,000
Final	Between \$8,813,386 and \$10,213,386 ³²¹				

The following table compares the results from a taxable sale with a short sale against the box.

includes variable delivery prepaid forward). Prepaid forwards may thus be less tax efficient for investors than collars and loans, which generate potentially deductible interest. To an extent, the taxpayer must choose between avoidance of the margin rules (prepaid forwards) and favorable tax treatment (collars and loans). Yet the choice is not as stark as it may seem. The interest deduction on a collar and loan is severely restricted by the investment interest limitations of section 163(d) and, more importantly, by the straddle rules of section 263(g). See I.R.C. § 163(d); *id.* § 263(g). For discussion of proposed section 263(g) regulations, which render a deduction even harder to attain, see *supra* note 157.

318. Note that the fee to the investment bank—in effect, the appreciation between \$120 and \$151 on the stock—serves to reduce this maximum return by \$3.1 million pretax (or less, of course, if the taxpayer is sharing in some of this appreciation).

319. This number, which is the amount the hedging counterparty is assumed to pay on the prepaid forward, is the discounted value of \$10,000,000, assuming a 6.5% discount rate over three years.

320. The 30% tax on the \$8,278,491 received for the hedged asset is \$2,483,547. The 30% tax on the \$4,312,060 of return on the equity portfolio is \$1,293,618. The total of these amounts is \$3,777,165.

321. The equity portfolio grows to \$12,590,551. After \$3,777,165 of tax is deducted, the remaining value is \$8,813,386. The taxpayer also retains appreciation on the hedged asset, earning \$2,000,000 pretax if the stock appreciates from \$100 to \$120. After a 30% tax, this extra \$1,400,000 would increase the final value to \$10,213,386.

TABLE 8

END VALUE	TAXABLE SALE	SHORT SALE AGAINST THE BOX
Less than \$100	-\$738,901	-\$1,572,393
Greater than \$120	\$661,099	-\$172,393

2. *Corporate Taxpayers.* — The above cases are rerun here for corporate taxpayers. The key difference is that corporate taxpayers pay a higher tax on gain, and so deferral strategies are more valuable.

a. *Taxable Sale.* — Sale of the position yields \$5.5 million. If this amount is invested in equities, the taxpayer will have **\$7,075,647** after three years.

TABLE 9

YEAR	JANUARY 1 VALUE	PRETAX RETURN	TAX DUE
1	\$5,500,000	\$825,000	\$0
2	\$6,325,000	\$948,750	\$0
3	\$7,273,750	\$1,091,063	\$1,289,166
Final	\$7,075,647		

b. *Short Sale Against the Box.* — After a short sale against the box and reinvestment of 95% of the proceeds in equities, the taxpayer will have **\$8,135,389** after three years, which is \$1,059,742 better than a taxable sale.

TABLE 10

YEAR	JANUARY 1 VALUE	PRETAX RETURN	BORROW FEE	AFTER-TAX FEE AND INTEREST TO DATE ³²²	TAX DUE
1	\$9,500,000	\$1,425,000	\$50,000	\$27,500	\$0
2	\$10,925,000	\$1,638,750	\$50,000	\$56,210	\$0
3	\$12,563,750	\$1,884,563	\$50,000	\$86,183	\$6,726,741 ³²³
Final	\$8,135,389 ³²⁴				

c. *DECS.* — The corporation is assumed to issue a public security that closely resembles the variable delivery prepaid forward described above. Although funds might be used to invest in equity of a different firm, we might also assume that these funds finance the corporation's

322. Since the taxpayer is subject to a 45% tax rate, the after-tax cost of a \$50,000 borrowing fee is \$27,500 (i.e., 55% of \$50,000). Moreover, it is assumed that the fee is financed with a deductible loan. Assuming the pretax interest rate is 8% and the tax rate is 45%, the after-tax interest rate is 4.4%.

323. When the taxpayer sells the hedged asset, the tax liability will be \$4,500,000 (i.e., 45% of \$10,000,000). In addition, the pretax portfolio has appreciated by \$4,948,313, yielding a 45% tax of \$2,226,741. The total tax, therefore, is \$6,726,741.

324. The total pretax value of the equity portfolio is \$14,448,313, and the taxpayer is also entitled to \$500,000 of additional proceeds from the short sale. This total of \$14,948,313 is reduced by the tax bill of \$6,726,741, leaving \$8,221,572. This sum is further reduced by the cost of \$86,183 for borrowing stock, leaving \$8,135,389.

business opportunities and generate a return of 15% per year. Even so, the assumption here is that this profit is not taxed until the third year after the DECS is issued (consistent with an equity investment). Likewise, the interest is assumed to be deductible without limitation,³²⁵ and is funded from other borrowing (i.e., instead of through a reduction in the amount reinvested). The underwriter is assumed to collect a 3% fee, such that the taxpayer has only \$9.7 million of proceeds. On these facts, the partial hedge significantly outperforms the taxable sale if the asset appreciates, but yields a slightly lower amount if the asset does not appreciate.

TABLE 11

YEAR	JANUARY 1 VALUE	PRETAX RETURN	AFTER-TAX INTEREST TO DATE ³²⁶	TAX DUE	EXTRA PRETAX RETURN ON HEDGED ASSET	EXTRA TAX
1	\$9,700,000	\$1,455,000	\$440,000	\$0	—	\$0
2	\$11,155,000	\$1,673,250	\$899,360	\$0	—	\$0
3	\$12,828,250	\$1,924,238	\$1,378,932	\$6,773,620 ³²⁷	\$2,000,000	\$900,000
Final	Between \$6,899,936 and \$7,999,936 ³²⁸					

The following table compares the results from a taxable sale with a short sale against the box.

TABLE 12

END VALUE	TAXABLE SALE	SHORT SALE AGAINST THE BOX
Less than \$100	-\$475,711	-\$1,535,453
Greater than \$120	\$624,289	-\$435,453

325. Thus, it is assumed that the interest would not be capitalized under section 263(g). For a discussion of this issue, see Schizer, *Debt Exchangeable for Common Stock*, *supra* note 10, at 16–17. Recent proposed regulations under section 263(g) would lead to capitalization in future transactions, though. See Prop. Treas. Reg. § 1.263(g)-3(c)(3), 66 Fed. Reg. 4749, 4750 (Jan. 18, 2001); Prop. Treas. Reg. § 1.1092(d)-1(d), 66 Fed. Reg. 4751 (Jan. 18, 2001); *supra* note 157.

326. The annual coupon is assumed to be 8%, or \$800,000. Since the amount is assumed to be deductible, the after-tax cost (at a 45% tax rate) is \$440,000. Payment of this amount for three years, plus an after-tax borrowing cost to fund these amounts of 4.4%, yields a total of \$1,378,932.

327. The 45% tax on the \$5,052,488 pretax profit on the equity portfolio is \$2,273,620. The 45% tax on the hedged asset is \$4,500,000, yielding a total tax of \$6,773,620.

328. The pretax value of the equity portfolio is \$14,752,488. This amount is reduced by the \$6,773,620 of tax and the \$1,378,932 of interest expense, yielding \$6,599,936. Since the taxpayer has retained appreciation to avoid a constructive sale, the taxpayer would earn another \$2,000,000 pretax, or \$1,100,000 after-tax, if the stock appreciates from \$100 to \$120, yielding a position worth \$7,699,936.

APPENDIX B: EMPIRICAL SURVEY OF PUBLIC HEDGING TRANSACTIONS:
DECS AND PHONES

The discussion of constructive sales in Part II observes that public corporations hedge by issuing public securities.³²⁹ These securities, called by acronyms such as “DECS” and “PHONES,” are exchanged at maturity for stock in unrelated firms (i.e., the stock that the issuing corporation is hedging). This Appendix lists various such securities offerings. Specifically, the following table describes sixteen matches, filed during the 1999 calendar year, from the following search in the EDGARPlus® Database on LEXIS: “(maturity w/10 shares w/10 stock w/10 exchange!) and (contingent w/4 debt w/4 regulation).” Duplicate entries are omitted, as are so called “shelf” filings in which the issuer is not currently issuing securities, but instead is offering disclosure about potential future transactions. The rationale for this search is that, in public hedging transactions such as DECS and PHONES, the public security is exchangeable for the hedged asset, allowing the issuer to satisfy its obligation under the security by tendering the hedged stock. Disclosure for such exchangeable instruments generally mentions the contingent debt regulations of Treasury Regulation section 1.1275-4, as long as the public security is documented as a debt security. The total dollar value of these transactions—and thus the dollar amount of the stock being hedged through DECS and PHONES transactions in 1999—was \$5,940,350,366.³³⁰

TABLE 13

ISSUER	SECURITY NAME	OFFERING AMOUNT	FILING DATE	MATURITY DATE	UNDERLYING STOCK
Cox Communications, Inc.	PRIZES	\$1,106,250,000	11/16/1999	11/15/2029	Sprint PC
Comcast Corp.	ZONES	\$1,000,000,000	10/13/1999	10/15/2029	Sprint PCS
Morgan Stanley Dean Witter & Co. (MSDW)	Reset PERQS	\$17,027,300	10/12/1999	10/31/2001	FDX
MSDW	Reset PERQS	\$25,000,000	10/07/1999	12/15/2001	Oracle
Salomon Smith Barney Holdings, Inc.	ELKS	\$17,181,900	10/07/1999	10/06/2000	Hewlett-Packard
Reliant Energy, Inc.	ZENS	\$1,000,000,000	09/16/1999	09/15/2029	Time Warner
Enron Corp.	Exchangeable Notes	\$222,500,000	08/11/1999	07/31/2002	Enron Oil & Gas
MSDW	Reset PERQS	\$18,000,839	08/06/1999	08/15/2001	Qualcomm
Kerr McGee Corp.	DECS	\$287,259,450	07/29/1999	08/02/2004	Devon
MSDW	Reset PERQS	\$134,543,750	07/21/1999	08/01/2001	Cisco Systems
Southwest Securities Group, Inc.	DARTS	\$50,000,000	06/11/1999	06/30/2004	Knight/Trimark Group
MSDW	PERQS	\$29,899,212	05/21/1999	05/22/2000	Nokia
MSDW	Reset PERQS	\$95,000,025	05/18/1999	05/30/2001	Sun Microsystems
Tribune Co.	PHONES	\$1,099,000,000	04/09/1999	05/15/2029	America Online
Comcast Corp.	PHONES	\$718,293,750	03/15/1999	05/15/2029	AT&T
MSDW	Reset PERQS	\$120,394,140	03/02/1999	03/15/2001	MCI WorldCom

329. See *supra* Part II.B.3.d.

330. This amount may be slightly overstated because, in some cases, investment banks do not issue these securities to hedge appreciated positions, but to accommodate a client that wishes to hold a particular type of DECS. Yet this outcome is more likely for small transactions, which have a relatively modest impact on the overall volume reported here. Offsetting this effect, moreover, is the likelihood that some hedging transactions were omitted because the search parameters were underinclusive. For instance, transactions that do not mention the contingent debt regulations would not register in this search.

APPENDIX C: EMPIRICAL SURVEY OF PUBLIC HEDGING TRANSACTIONS:
TRUST STRUCTURES

Since individuals, family partnerships, and other family vehicles are not suitable registrants under the securities laws, these taxpayers might form investment vehicles in order to hedge through the public markets.³³¹ The following chart shows the "trust" structures that were filed in 1999, based on the following search in the EDGARPlus® Database on LEXIS: "(Treasury w/4 securit!) w/10 (forward w/4 contract) w/10 stock w/20 trust." The relevance of Treasury securities is that the trust usually has two assets: a prepaid forward contract to purchase stock from the taxpayer and Treasury securities that fund a periodic payment to public holders. This chart does not include duplicative entries (i.e., transactions that were posted more than once), or transactions that were not designed to hedge appreciated stock. Of the twenty transactions that were filed with the SEC, fifteen were never finalized. They were filed in preliminary form only, without listing prices and (in some cases) the underlying security. These deals probably were abandoned because transaction costs are relatively high in these trust transactions. As a result, many taxpayers who consider using the trust structure ultimately decide to use a private transaction instead. The transactions completed in 1999 have an aggregate value of \$428,967,264.

TABLE 14

ISSUER	SECURITY NAME	OFFERING AMOUNT	FILING DATE	MATURITY DATE	UNDERLYING STOCK
SanDisk PEPS Trust	PEPS	Never finalized (\$200,000,000)	10/13/1999	11/15/2002	SanDisk
TARGETS Trust V	TARGETS	\$32,066,014	09/29/1999	11/15/2002	Amgen
DECS Trust IV	DECS	\$95,625,000	08/09/1999	08/15/2002	Crown Castle Int'l
METS Trust	METS	Never finalized	07/20/1999	—	Not indicated
Ameritrade Automatic Common Exchange Trust	TRACES	Never finalized (\$150,000,000)	07/12/1999	—	Ameritrade Holding Class A
Eleventh Automatic Common Exchange Security Trust	TRACES	Never finalized	07/06/1999	—	Not indicated
Fourteenth Automatic Common Exchange Security Trust	TRACES	Never finalized	07/06/1999	—	Not indicated
Thirteenth Automatic Common Exchange Security Trust	TRACES	Never finalized	07/06/1999	—	Not indicated
Twelfth Automatic Common Exchange Security Trust	TRACES	Never finalized	07/06/1999	—	Not indicated
TARGETS Trust III	TARGETS	\$65,887,500	06/24/1999	08/15/2002	MCI WorldCom
Ninth Automatic Common Exchange Security Trust	TRACES	Never finalized	05/03/1999	—	Not indicated
Tenth Automatic Common Exchange Security Trust	TRACES	Never finalized	05/03/1999	—	Not indicated
Seventh Automatic Common Exchange Security Trust	TRACES	Never finalized	04/20/1999	—	Not indicated
TARGETS Trust II	TARGETS	\$72,888,750	04/12/1999	05/15/2001	Lucent
PIES Trust I	PIES	Never finalized	03/16/1999	—	Not indicated
PIES Trust II	PIES	Never finalized	03/15/1999	—	Not indicated
Eighth Automatic Common Exchange Security Trust	TRACES	Never finalized	03/03/1999	—	Not indicated
Trust Issued Required Equity Exchange Security Trust	T-REX	Never finalized	03/01/1999	—	Not indicated
DECS Trust IV	DECS	\$162,500,000	02/10/1999	02/15/2002	Maxtor
Sixth Automatic Common Exchange Security Trust	TRACES	Never finalized	01/26/1999	—	Not indicated

331. See *supra* text accompanying notes 144–146.

APPENDIX D: HEDGE FUND SWAP

Part III discusses the constructive ownership rule, which targets derivatives that simulate a direct investment in hedge funds. This Appendix uses a numerical example to show why, before section 1260 was enacted, a derivative would yield a superior after-tax return. Specifically, this discussion compares a direct investment of \$10 million in a hedge fund with investment in a hedge fund derivative of the same notional amount. The tax rate on short term capital gain and ordinary income is assumed to be 50% (i.e., 40% federal and 10% state) and the tax rate on long term capital gain is assumed to be 30% (i.e., 20% federal and 10% state).³³² The hedge fund is assumed to earn 15% a year. (The assumption is that the hedge fund earns the same 15% available on an equity investment, but is subject to less risk. As the pretax return on the fund grows, the tax advantage of a derivative over a direct investment increases.) After this comparison, results are compared on the assumption that the fund declines in value. Note that no comparison is run for corporate transactions, as corporations have much less to gain from this planning strategy because they are not eligible for the reduced rate for long term capital gains.

A. *Direct Investment: 15% Annual Return*

The hedge fund is assumed to distribute 50% of its gains each year to cover the investor's tax liability. After three years, a \$10 million investment grows to **\$12,422,969**.

TABLE 15

YEAR	JANUARY 1 VALUE	15% RETURN	TAX DUE
1	\$10,000,000	\$1,500,000	\$750,000
2	\$10,750,000	\$1,612,500	\$806,250
3	\$11,556,250	\$1,733,438	\$866,719
Final	\$12,422,969		

B. *Hedge Fund Swap: 15% Return*

Alternatively, assume the taxpayer invested \$10 million in Treasuries, which were used to secure her obligation on a swap. The swap requires the parties to measure the value of a \$10 million investment after three years (the "Value"). For computation of the Value, it is assumed that any distributions by the fund (e.g., to cover taxes) were immediately reinvested in the fund. This reinvestment is the way the swap reflects the benefits of tax deferral—the investor is allowed to reinvest dollars that otherwise would fund the tax liability. If the Value is less than \$10 million

332. Here as well, the assumed federal tax rates approximate the maximum rates in effect when this Article was written. See *supra* note 218 (discussing federal rates for individuals); *supra* note 151 (discussing federal rates for corporations).

(i.e., because the fund depreciates), the taxpayer must pay the difference. On the other hand, if the Value exceeds \$10 million (i.e., because the fund appreciates, as is assumed here), the taxpayer receives this excess, which is treated as long term capital gain. Assuming 15% annual appreciation, the Value is as follows.

TABLE 16

YEAR	JANUARY 1 VALUE	15% RETURN	TAX DUE
1	\$10,000,000	\$1,500,000	\$0
2	\$11,500,000	\$1,725,000	\$0
3	\$13,225,000	\$1,983,750	\$1,562,625
Final	\$13,646,125		

In addition, the taxpayer must pay an annual fee equal to \$10 million times the Treasury yield plus 1%. In essence, the taxpayer is paying over the return earned on the Treasury bonds, plus a 1% annual fee to the investment bank. Swap expenses generally constitute ordinary deductions under section 212.³³³ Accordingly, the taxpayer has a net pretax expense of 1% per year, which is deductible.³³⁴ Assuming the taxpayer funds these annual net payments of \$50,000 after taxes by borrowing at 8%, the total expense after three years is \$162,320. Hence, the final return, net of expenses, is \$13,646,125 minus \$162,320, or **\$13,483,805**. Compared with the \$12,422,969 earned through a direct investment, the derivative yields an extra \$1,060,836.

C. *What if the Hedge Fund Suffers Losses? Comparison of Direct Investment and Derivative*

As long as the fund appreciates, there is a tax benefit in deferring the gain and converting it from short term to long term capital gain. If the fund declines in value, deferral and conversion carry a corresponding tax penalty: a deferred deduction, converted from a short term to a long term capital loss. However, in such cases the parties can settle the swap prematurely, before the end of the taxpayer's tax year. As a result, losses

333. See I.R.C. § 212 (allowing deduction of expenses for production of income); Steinberg, *supra* note 205, at 230 (analyzing swap expenses as expenses under section 212).

334. Since swap expenses are generally considered a miscellaneous itemized deduction, the amounts are subject to the 2% limitation for such deductions under section 67 and also are not deductible under the alternative minimum tax. See I.R.C. § 67; *id.* § 56(b)(1)(A) (disallowing deduction of miscellaneous itemized deductions in computation of alternative minimum tax); see also Schizer, *Executives and Hedging*, *supra* note 25, at 485-86 (discussing limits on deducting swap expenses that are miscellaneous itemized deductions); Daniel Shaviro, *Perception, Reality and Strategy: The New Alternative Minimum Tax*, 66 *Taxes* 91, 91-95 (1988) (explaining history and rationale behind alternative minimum tax). Likewise, some practitioners believe that "clear reflection of income" principles require that the deduction of such periodic payments be deferred. See Steinberg, *supra* note 205, at 229. For simplicity's sake, these limitations on the deduction are ignored.

need not be deferred or converted to long term. Thus, while investment in the swap will not carry any tax advantage in this loss scenario, there generally will be no tax disadvantage. An exception would be if the fund has ordinary losses—for instance, from currency trading—that are converted to short term capital losses. Putting this exception aside, the main reason a direct investment would be preferable is in avoiding the fees and transaction costs associated with the derivative.