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Taxation of Financial Products:
Options for Fundamental Reform

By Alex Raskolnikov

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The following is testimony given at the joint hearing of the House Ways and Means and Senate Finance committees on December 6. It discusses three benchmarks for evaluating the taxation of capital income in general and financial instruments in particular. It also summarizes three broad-based approaches to reforming the tax treatment of financial products, evaluates the impact of other fundamental reforms on the urgency of reforming the taxation of derivatives, and urges Congress to encourage the IRS to make detailed tax return data available for empirical research of revenue costs and other losses arising from derivatives-based tax planning.

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Statement Of Alex Raskolnikov
Charles Evans Gerber Professor Of Law
Columbia Law School
Before The Joint Hearing Of The
U.S. House Committee On Ways And Means
U.S. Senate Committee On Finance
December 6, 2011

Chairman Camp, Chairman Baucus, Ranking Members Levin and Hatch, distinguished Members of the Committees,

Thank you for inviting me to testify at this historic joint hearing.

I would like to make four main points:

First, the JCT Report your Committees receive today is an important first step in reforming taxation of financial products (or derivatives). But it cannot be the last step. Our knowledge of revenue losses from derivatives-based tax reduction strategies is largely anecdotal, wholly unsystematic, and woefully incomplete. More research can and should be done and Congress can play a critical role in facilitating it.

Second, in the absence of comprehensive reform, it is impossible to tax financial derivatives in a manner that meets any accepted benchmark of an effective and efficient capital income tax. As long as the patchwork of current rules remains in place, symmetry, consistency, and balance will all remain unattainable.

Third, the fundamental reform alternatives are limited, reasonably well-understood, and even partly reflected in the current law. They include anticipatory taxation, retroactive taxation, and accrual-based (or mark-to-market) taxation. Each of these approaches involves tradeoffs, and the adoption of each approach for all financial products would amount to a significant change in the current law.

Finally, it is important to keep in mind how any significant reform unrelated to financial products (such as corporate integration or a switch to territorial taxation) is likely to affect the stakes in reforming the taxation of derivatives. These effects vary from substantial to insignificant to uncertain.

I elaborate on each of these points below.

A. Challenges of Taxing Financial Instruments

It is difficult to overstate how poorly our tax system deals with financial products. The rules are incredibly complex,\(^1\) under- and over-inclusive,\(^2\)

\(^1\)The proposed Treasury regulations for the taxation of contingent swaps are perhaps the most egregious example. See Prop. Treas. Reg. section 1.446-3(g)(6), 69 Fed. Reg. 8,886 (Feb. 26, 2004).

\(^2\)Certain aspects of the wash sale rules of section 1091 are examples of over-inclusiveness. For instance, these rules cover transactions where a depreciated share of stock sold at a loss is replaced by an option (including an out-of-the-money option) on the same stock even though such option is very different economically from the share itself and, therefore, the transaction does not come close to leaving taxpayer in the same position with respect to the stock as he was before selling it — an abuse targeted by the wash sale rules. The anti-extinguishment regime of section 1234A is under-inclusive, arguably not extending to derivatives that, while capital assets themselves, reference assets that are not capital assets.
ineffective in some respects and outdated in others. They give rise to wasteful tax planning, revenue losses, and unappealing distributional consequences. They may impede legitimate business hedging transactions, and they certainly fail to stop aggressive tax reduction strategies. This disappointing state of affairs hardly reflects a lack of attention from Congress, the Treasury Department, and the Internal Revenue Service. While more legislation and administrative guidance could have been issued to deal with individual abuses discovered from time to time, it would hardly stem the tide of derivatives-based tax planning that has risen at least two decades ago and shows no sign of abating. We need a fundamental rethinking of the taxation of financial products. And in order for that rethinking to be well-informed, we need to know much more about the problem at hand.

There is no doubt that the existing patchwork of rules for the taxation of derivatives is full of holes. Most knowledgeable observers would agree that derivatives-based tax reduction strategies lead to serious revenue losses and endless wasteful efforts by sophisticated taxpayers and their advisors to stay one step ahead of the regulators. Beyond this general statement, however, little can be said with any confidence. This is because while any study of taxpayer responses to tax rules and their changes is difficult, the difficulty increases by orders of magnitude when the focus turns to derivatives.

Financial products are constantly evolving, often highly complex, largely hidden from the public and the regulators, and exceedingly lucrative for their designers and promoters. Each of these considerations would impede a rigorous study of derivatives-based tax planning. Taken together, these considerations make any such study extremely difficult.

This difficulty is compounded further by the IRS reluctance to share detailed tax return data with researchers. This reluctance is not limited to the study of financial products, but it is particularly problematic in this context. Leading public finance economists are pleading with the IRS for more—and more detailed—data. They are capable, skilled, and motivated. They can help us gain crucial knowledge at no cost to the public fisc. It is beyond doubt that tax return data may be made available while preserving utmost taxpayer privacy and following the letter and the spirit of the taxpayer protection laws. A nudge or two from each of the tax writing Committees to induce the IRS to share detailed return data with researchers is likely to make an enormous difference in our understanding of derivatives-based tax planning. While the time to consider a fundamental reform of derivatives taxation is certainly now, gaining a better understanding of the existing problem and the reform’s impact will remain essential for years to come.

B. Evaluating Tax Systems — the Three Benchmarks

In order to evaluate any given fundamental change in the taxation of financial products one needs to understand how to evaluate alternative proposals. Legal tax academics and public finance economists have been searching for decades for comprehensive and principled ways of evaluating possible regimes for taxing capital income in general and income from financial products in particular. Three benchmarks have emerged as a result of this search.

The first benchmark is symmetry. If both sides to every transaction are taxed under the same timing rule and rate, they face equal and opposite incentives, which allows the system to police itself. In a fully symmetric system the government collects no net revenue from the taxation of derivatives. Importantly, the government does not lose any revenue either. In other words, derivatives cannot be used to shelter income from real investment and labor.


The taxation of credit default swaps, for instance, has remained highly uncertain for years. See Notice 2004-52, 2004-1 C.B. 973 (offering several possible ways to characterize credit default swaps for U.S. federal income tax purposes and requesting comments). Proposed regulations aimed at resolving this uncertainty have been issued just a few months ago and they will not become effective for some time, See Prop. Treas. Reg. 1.1446-3(c)(iii), 76 Fed. Reg. 57,684 (Sept. 16, 2011).

The challenge of separating the former from the latter exists today and will continue to exist in any alternative regime of financial products taxation. Most fundamental reform proposals (including those by two members of today’s panel) expressly state that derivatives used in business hedging should be subject to special tax rules different from those applying to all other derivatives. See David S. Miller, A Progressive System of Mark-to-Market Taxation, 109 Tax Notes 1047 (2008) (referring to the need for a separate regime for business hedging while suggesting that many derivatives and other property become subject to a mark-to-market regime); David A. Weisbach, A Partial Mark-to-Market Tax System, 53 Tax L. Rev. 95, 129 (1999) (making a similar suggestion); Columbia Law School Professor Suggests Derivatives Be Subject to Mark-to-Market Regime, 2008 TNT 45-55 (making a similar suggestion in my 2008 Congressional testimony).

See, e.g., David Card, Raj Chetty, Martin Feldstein & Emmanuel Saez, Expanding Access to Administrative Data for Research in the United States (a response to the National Science Foundation call for white papers on “Future Research in the Social, Behavioral & Economic Sciences”).
Unfortunately, symmetry is unattainable without a dramatic overhaul of the Internal Revenue Code. Tax-exempt entities and foreigners often pay no U.S. income tax. Securities dealers may be thought of as tax-exempt as well because their derivative trades with clients are hedged, and mark-to-market accounting assures that only dealers’ fees are taxable.7 The presence of these tax-indifferent counterparties means that the taxation of derivatives will remain asymmetric as long as taxable taxpayers are on the other side of trades.

Consistency is another recognized benchmark. The tax treatment of derivatives is consistent if all economically comparable transactions (or sets of transactions) are taxed the same, regardless of the labels attached by taxpayers. For instance, an equity forward, an equity futures contract, and an equity swap on the same stock all have identical tax consequences in a consistent tax system, as does a leveraged purchase of that stock. Because tax treatment is independent of transactional form in a fully consistent regime, it is impossible to game the system by choosing one form or the other.

Yet complete consistency is impossible without fundamental tax reform. The U.S. tax law has always relied on familiar cubbyholes such as debt and equity, ownership and non-ownership.8 Basic derivatives-like options have a long-established tax treatment. As new financial products emerged, some were subjected to unique tax regimes while others were taxed by analogy to the well-established “precedents.” The result is a patchwork of rules that imposes significant planning and compliance costs. While some of these rules have been quite effective in constraining tax planning, others have done little to impede it. Overall, this patchwork is anything but consistent. Adjusting, reforming, or even repealing one or a few of these rules will do little to diminish the overall inconsistency.

The problem is more fundamental than it may first appear. As long as the tax system continues to rely on cubbyholes, consistency is impossible. This is because basic instruments such as a coupon bond, a share of common stock, and put and call options on that stock are inextricably linked — a relationship established by the so-called put-call parity theorem.9 A share of stock and the two options may be used to produce an economic return equivalent to the interest on a bond. A share of stock and a put are equivalent to a bond and a call. Many other combinations may be constructed. As long as debt, stock and options continue to be taxed inconsistently, the fundamental economic equivalence established by the put-call parity theorem will assure that similar cash flows with the same risk profile will continue to receive dissimilar tax treatment — the hallmark of an inconsistent regime.

The third and final benchmark for taxing derivatives is balance, which is achieved if gains and losses from derivatives are treated alike (taxed at the same time and at the same rate). If this criterion is met, the government loses no revenue due to tax planning involving derivatives even if their tax treatment is neither symmetrical nor consistent. This is because a taxpayer who enters into a “pure” derivative (that is, a derivative that involves a risky bet that has neither a time value element nor a return to labor) cannot know whether he will win or lose the bet. If he wins, he would prefer a lower tax rate and a deferral of gains. If he loses, however, he would prefer a higher tax rate (making a loss deduction more valuable because it offsets highly-taxed income) and an acceleration of losses. If this taxpayer has to choose the form of derivative bet before knowing whether he will win or lose it, this basic market uncertainty provides a powerful constraint on tax planning in a balanced system.

Only fundamental reform will move the U.S. tax system to a balanced regime. The realization requirement that is deeply embedded in our system gives taxpayers a timing option — a choice of triggering tax consequences after they have learned whether a transaction produced a gain or a loss. Capital loss limitations, the progressive marginal rate structure, and the nonrefundability of losses produce unequal tax rates on gains and losses (with gains taxed at a higher rate).10 As long as these features remain in place, no incremental revisions will assure balance in the taxation of derivatives.11

7This is because any taxable gain from a client’s position is offset by an equal loss on the hedge and vice versa (setting aside the fee built into the price of the client’s position). The character of this gain and loss is always ordinary. The mark-to-market regime for securities and commodities dealers is set forth in section 475.
10The tax motivated use of financial products may reduce or eliminate this disparity and even reverse the relationship between tax burdens on gains and losses altogether for particular taxpayers.
C. Options for Fundamental Reform of Taxation Of Financial Products

Policymakers, academics, and tax practitioners have devoted considerable effort to devising possible reforms of taxation of capital income in general and financial products in particular. Reforms consistent with one or more of the recognized benchmarks have attracted particular attention. Perhaps surprisingly, the variety of reform proposals may be distilled to just three alternative approaches: anticipatory taxation, retroactive taxation, and mark-to-market (or accrual) taxation.\(^8\) Most of the specific regimes in each category need not be limited to the taxation of derivatives. The broader the scope of the reform proposal, however, the more objections it would need to overcome.

1. Anticipatory taxation. Anticipatory taxation gives rise to income and deductions based on one’s anticipation of a return from an investment or a financial bet. In a tax system based on anticipatory taxation, tax liability arises before a contingency underlying a financial instrument is resolved and before any payments under this instrument are made or even fixed. This approach could be used to reach only the time value return (if any) embedded in a derivative or a risky return as well. The ultimate goal is to eliminate or reduce the benefit of deferring income that is available in a realization-based regime. Because time value returns are currently taxed at a higher rate than returns to risk, another benefit of the anticipatory approach is eliminating an opportunity to convert high-taxed ordinary income into low-taxed capital gains.

Interest imputation regimes for prepaid derivatives are examples of anticipatory taxation of the time value of money. One such regime is already used for taxation of contingent debt — a financial instrument combining an ordinary bond with a derivative such as an equity call option.\(^9\) A similar methodology has been proposed for prepaid forwards as well as long-dated and deep-in-the-money options.\(^9\) More generally, interest imputation can be considered for all derivatives that provide for upfront payments. The logic behind this approach is that a party making a payment at the inception of a contract expects to receive at least an interest-like return on its investment, so the pricing of the instrument must reflect this expectation. If so, the tax system should do so as well, and it should do so regardless of the actual cash flows (or absence of any cash flows) during the term of the derivative.

Interest imputation regimes may use a variety of rates for imputation purposes. One alternative would be to impute income at a rate determined by the government from time to time (such as the so-called Applicable Federal Rate determined regularly by the IRS). This rate may be the same for all taxpayers and all financial instruments entered into during any given relevant period (a day, a month, etc.). Alternatively, this rate may be floating rather than fixed, varying for each outstanding prepaid derivative each time the government-announced rate changes. Another option would be to use a rate that is specific to each taxpayer. This is the approach chosen in the contingent debt regulations that require imputation at the so-called comparable yield — a rate that the issuer of a contingent bond would pay on a debt instrument that is similar to that contingent bond but does not have a derivative attached to it.

An anticipatory approach for risky (rather than time value) returns would require taxpayers to determine the expected value of every contingency (perhaps disaggregating a complex financial instrument to produce several instruments each with a single contingency) and to include in income the difference between this expected value and the derivative’s cost on a yield-to-maturity basis.\(^7\) If the actual gain or loss turns out to be different from the expected one, that difference would be taken into account when the contingency is resolved.\(^\text{11}^{\text{a}}\)

The weaknesses of all anticipatory approaches are not hard to see. Imputing time value returns raises questions about the appropriate rate of imputation. Imputing contingent returns is based on

\(^7\) Other categorizations are possible. See, e.g., Warren, supra note 9, at 474-475.
\(^8\) See Treas. Reg. Sec. 1.1275-4.


\(^{11}^b\) For example:
\[J\text{ pays } J \text{ $100 today; in exchange, } J \text{ promises to pay } J \text{ either } $166 \text{ or } $100 \text{ in three years depending on the toss of a coin at that time. The expected value of the contract in year 3 is } $133, \text{ because there is a 50% probability of receiving } $100 \text{ and a 50% probability of receiving } $166. \text{ That expected gain of } $33 \text{ and a yield-to-maturity of } 10\%, \text{ because } \frac{100x}{100} = 0.1 = 10\% \text{ and } \frac{166-100}{166} = 0.40 \text{ and } 40\% \text{ for the } 10\%. \text{ Then expected gain would then be } $133, \text{ and gain or loss on the coin toss would be taken into account in year 3. } \text{ Warren, supra note 9, at 479, based on Shuldiner, supra note 15.}

\[\text{The expected value implies an expected gain of } \frac{100x}{100} = 0.5x166 = 133 \text{ and gain or loss on the coin toss would be taken into account in year 3. } \text{ Warren, supra note 9, at 479, based on Shuldiner, supra note 15.} \]
uncertain expectations about possible resolutions of future contingencies. Both types of imputations give rise to phantom income that is currently taxed yet may never be received.\textsuperscript{17} No imputation regime bases tax liability on actual gains and losses incurred by taxpayers as they accrue.

2. Retroactive taxation. Retroactive taxation avoids most weaknesses of anticipatory taxation (with the exception of one specific regime discussed at the end of this section). The returns are taxed retroactively — at the end of the transaction when gain or loss is known with certainty and when the payment is received by the taxpayer who ended up winning the financial bet.\textsuperscript{18} The key feature of retroactive taxation regimes is to spread this gain (or loss) backward and allocate it over the term of the derivative. Once this allocation is accomplished, gain deemed realized in earlier years gives rise to tax liability that accrues interest over the derivative’s term.\textsuperscript{19} As a result of this retroactive allocation combined with interest accrual, the benefit of deferring taxable gain until maturity is reduced.

Proposals differ on how to spread the gain over the term of the instrument, and even how to calculate the gain in the first place. An early proposal based a retroactively-imposed tax liability on the actual pattern of gain accrual.\textsuperscript{20} An approach adopted in the Internal Revenue Code for taxation of the so-called constructive ownership transactions presumes that the realized gain accrued at a constant rate over the term of the derivative.\textsuperscript{21} A simpler solution adopted in a different part of the Code is a ratable allocation achieved by dividing the realized gain by the number of days a financial interest was held by a taxpayer and attributing the resulting daily gains to taxable years that include each given day.\textsuperscript{22} The first of these allocation approaches requires annual valuation of positions. The other two introduce obvious deviations from actual changes in value, producing unintended winners and losers.\textsuperscript{23}

Furthermore, all of these solutions expose the government to the credit risk of taxpayers entering into derivative contracts. Because pure derivatives are zero-sum bets, one side’s win is always equal to the other side’s loss. In a retroactive tax regime, the losing side would rest assured that it would eventually collect overpaid taxes from the government, with interest. The government, however, cannot be similarly certain that the winning side would be able to pay a very large tax, which may be much larger than the tax resulting from the same gain in a realization-based system. The reason for this difference is that in a retroactive regime the payment would include not just the tax on gain, but also interest on earlier deemed tax underpayments. That interest would accrue over many years for a long-term derivative, possibly producing a very large total tax obligation.\textsuperscript{24}

Another retroactive taxation approach determines tax liability on the basis of presumed, rather than actual, gain.\textsuperscript{25} As with other retrospective proposals, the tax would be imposed when the derivative is settled, and the amount realized would be equal to the payment actually made. The gain would be calculated, as in a realization-based system, by subtracting cost (or basis) from the amount realized. However, that cost would be an imaginary

\textsuperscript{17}Most imputation proposals (and the actual contingent debt regime) provide for adjustments when the contingency is resolved. Such delayed reconciliations are a small consolation for taxpayers who overpay their taxes in earlier years, unless the government compensates taxpayers for such overpayments with interest. On the other hand, the government loses out if the actual payment at maturity turns out to be larger than expected, unless the taxpayer pays interest for the deferral of her tax liability.

\textsuperscript{18}Unlike cash settlement, a physical settlement of derivatives does not lead to the receipt of a cash payment by the winning counterparty. Yet liquidity concerns do not loom particularly large in this case either because that counterparty (i) had enough cash to purchase the underlying asset (unless the contract was prepaid, in which case the party had the requisite amount of cash at the contract’s inception) and (ii) acquired an asset that could be sold (in whole or in part) or monetized in other ways (for example, by being used as collateral for a loan).

\textsuperscript{19}If the derivative ends up producing a deductible loss, then (at least in balanced proposals) this loss is similarly allocated to prior years, giving rise to deductions and interest payable to the taxpayer for the overpayment of tax on account of not taking these deductions in earlier years.

\textsuperscript{20}See I.R.C. section 1291 describing taxation of the so-called passive foreign investment companies.

\textsuperscript{21}For instance, a taxpayer whose position in a ten year forward appreciated substantially in the first year and then remained unchanged would be better off under either the second or the third regime than under a mark-to-market system that would tax the large gain in the first year of the contract. A taxpayer whose position in a ten year forward did not change in value for nine years and appreciated a lot in the last year would be worse off under either retroactive regime than he would be in a mark-to-market system.


\textsuperscript{23}See Alan J. Auerbach & David F. Bradford, Generalized Cash-Flow Taxation, 88 J. Pub. Econ. 957 (2004). As the titles of these papers suggest, this approach is not limited to derivatives.
number determined by discounting the actual amount realized at the risk-free rate over the term of the derivative.\textsuperscript{26} The beauty of this approach is that, under certain assumptions, it is equivalent to an accrual-based (or mark-to-market) regime from an ex ante perspective. Yet this retroactive method avoids valuation and liquidity problems associated with mark-to-market taxation, does not give taxpayers an opportunity to defer gains and accelerate losses, and does not lock taxpayers into their investments.\textsuperscript{27} From an ex post perspective, however, the results under this method are very different from an accrual-based tax as this regime clearly ignores actual gains and losses. Moreover, the ex ante equivalence obtains only if investors are fully rational and make optimal portfolio choices — assumptions of questionable validity in the real world.

3. Mark-to-market taxation. In a mark-to-market system, all gains and losses are taxed as if each position is terminated (or sold) at the end of each taxable year and re-entered (re-acquired) at the beginning of the next year. Thus, this system would base tax liability on annual fluctuations in value, whether or not any given asset is sold or retained by a taxpayer.\textsuperscript{28} Losses from derivatives would be deductible only against gains from derivatives. Excess losses would be either immediately refundable or available to reduce gains from derivatives in other tax years — either in the future or with a limited carryback. Importantly, the rate applying to gains and losses would be flat.\textsuperscript{29} If one believes that most derivatives users are either high net worth individuals or large corporations, one would set that rate at the top marginal rate, individual or corporate, as appropriate. A more precise approach would set the rate at the top individual or corporate rate applying to any given taxpayer in any particular tax year.\textsuperscript{30} As in many versions of the anticipatory and retroactive tax regimes, business hedges would be excluded from mark-to-market rules and subject to a special treatment.

The main objections to mark-to-market taxation are valuation and liquidity concerns. The former highlights informational demands of obtaining valuations of all derivatives as well as administration and enforcement concerns with verifying these valuations. The latter reflects unease with forcing taxpayers to pay tax on “paper gains” before they receive any cash related to these gains.

4. Why Single Out Derivatives? In addition to objections unique to each fundamental reform proposal, any such proposal limited to financial instruments encounters arguments about its scope. Why single out derivatives? Without providing an exhaustive answer to this question, the following observations suggest a partial response.

Any reform introducing a special regime for derivatives raises a line drawing problem. If derivatives are taxed differently from everything else, taxpayers must know how to distinguish a derivative from a non-derivative. In my view, a broad definition of a derivative is appropriate, although one’s conclusion about the optimal breadth may be affected by one’s choice of the new treatment for derivatives. In any case, if all derivatives are treated the same, it will be much easier (and cheaper) to draw and maintain just one line — between derivatives and non-derivatives — than it is to continually delineate forwards from swaps from options from futures from prepaid derivatives and so on, as the existing tax rules attempt to do.\textsuperscript{31} That is, while a line drawing exercise will still be needed, the number of lines will be dramatically reduced.

It may also turn out that the new regime will result in a less favorable tax treatment of derivatives compared to that of “plain vanilla” investments such as stocks, bonds, and real estate. This, one might argue, will be both unfair and inefficient. The criticism is not particularly convincing. “Equal treatment” is certainly not the hallmark of our tax system today. For example, growth stocks are

\textsuperscript{26}For example, “[c]onsider an asset that is sold for $100 when the riskless rate of return is 10% and the tax rate is 30%. If the asset had been held for one year, the tax would be $2.70, which is 30% of an amount of gain determined by subtracting from the amount realized ($100) a hypothetical cost ($91) based on the assumption of a 10% return ($91 = $100/1.1). If the asset had been held for two years, the tax would be 30% of $100 - [$100/(1.1)^2] = $3.21.” Warren, supra note 9, at 481.

\textsuperscript{27}Because the gain is calculated by assuming that the entire return from a derivative is based on a risk-free rate compounded over the derivative’s term, only the riskless return is taxed under this approach. If one believes that an ideal income tax does not tax risky returns in any case, this result is not particularly problematic. See, e.g., David A. Weisbach, The (Non) Taxation of Risk, 58 Tax L. Rev. 1 (2004).

\textsuperscript{28}For discussions of a mark-to-market regime, see Daniel Halperin, Saving the Income Tax: An Agenda for Research, 77 Tax Notes 967 (1997); Miller, supra note 5; David J. Shakow, Taxation Without Realization: A Proposal for Accrual Taxation, 134 U. Pa. L. Rev. 1111 (1986); Warren, supra note 9, at 474; Weisbach, supra note 5.

\textsuperscript{29}Otherwise, gains will be subject to a higher rate than losses because gains would push taxpayers into higher brackets while losses would have the opposite effect. See Schizer, supra note 11, at 1908-1909.

\textsuperscript{30}In other words, the taxpayer’s rate determined without regard to gains and losses from derivatives would automatically apply to these gains and losses.

\textsuperscript{31}This list does not mention the need to delineate various transactions involving derivatives, such as straddles, constructive sales, constructive ownership, several integration regimes and the like.
treated more favorably than dividend-paying stocks. Bonds (especially discount bonds) have a particularly disadvantageous tax treatment for holders (acual of income before its receipt) while real estate and municipal bonds are especially tax-favored. Some derivatives are currently taxed less heavily than other economically similar financial instruments. Rather than adding to the number of tax-favorable and unfavorable regimes, a reform following any of the approaches laid out above will reduce this number by taxing all derivatives the same.

The choice between the anticipatory approach, the retroactive approach, and the mark-to-market approach is not an obvious one. If one thinks, for example, that derivative counterparties are rational and sophisticated taxpayers who make optimal portfolio decisions and are influenced only by expected returns, retroactive taxation based on presumed returns may have some appeal. If, on the other hand, one views ex post outcomes as important and believes that market values may be determined for most derivatives rather easily, mark-to-market is an attractive solution.

Reasonable minds can certainly differ about the merits and limitations of the various fundamental reforms. The details of the three alternative approaches are important and will need to be considered with care. But it is essential to see the big picture: The available choices are fairly limited, reasonably well-understood, and may be adjusted and even combined in a variety of ways. Whatever obstacles preclude us from pursuing a fundamental reform of financial products taxation, lack of knowledge about how to move forward is not one of them.

D. Interplay Between the Tax Reform of Financial Products and Other Possible Reforms

A fundamental reform of derivatives taxation is important, but it is hardly the only important fundamental reform worth considering and being considered. Other reforms, if undertaken, will affect the need to resolve the problems with taxing financial products in a variety of ways. Some reforms will make fixing the taxation of derivatives even more urgent, some will make it less essential, and some will have uncertain effects, as the following discussion explains.

These Committees have already started to consider the problems caused by the different tax treatment of debt and equity. Any form of corporate integration that eliminates the debt-equity distinction will reduce the urgency of fixing the taxation of financial products. This is because a considerable volume of these products is designed and deployed to give corporations interest deductions for issuing equity-flavored instruments. Tax-deductible equity is the name of the game here, and this game is not worth playing if debt and equity are taxed the same. It is worth noting that financial products exploiting the debt-equity distinction will remain important if interest and dividend income is taxed in a different manner (e.g., at a different rate, as is the case today). Even if corporations become indifferent between issuing debt and equity securities, the incentives to play tax games using derivatives will remain as long as the tax treatment of these securities varies for their holders. Thus, if these Committees were to consider corporate integration leading to a uniform treatment of debt and equity on the issuer side, the Committees should certainly revisit the disparate taxation of dividend and interest income.

Another significant reform being actively debated in tax policy circles is a substantial reduction in the corporate tax rate. Whatever is one’s view about the overall merits of such a reduction, one should be aware of its implications for the taxation of derivatives. While these implications are uncertain, it is likely that the flaws in the taxation of derivatives will become even more costly if a substantial rate differential between individual and corporate tax rates is introduced. The top individual income tax rate and the corporate income tax rate have been fairly close since the early 1980s — the simpler days when financial products were not nearly as prevalent as they are now. Therefore, we can only guess how financial engineers would respond to a strong incentive to create derivatives that would shift deductions to high-tax individuals while shifting income to low-tax corporations. But our experience with derivatives-based tax planning

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33Because financial products are used not only to reduce taxes by exploiting the debt-equity distinction, but to change the character, source, and timing of income as well (as discussed below), “reducing the urgency” certainly does not mean eliminating the need to address taxation of financial products altogether.

34The so-called mandatory exchangeable securities are the prime (though by no means the only) example of these financial products. For a detailed discussion, see Edward D. Kleinbard et al., Everything I Know About New Financial Products I Learned From DÉCS, Practising Law Institute, Tax Strategies for Corporate Acquisitions, Dispositions, Spin-offs, Joint Ventures, Financing, Reorganizations & Restructurings 392 (2010).

35See Camp Proposes Switch to Territorial System, 133 Tax Notes 512 (2011) (describing the plan proposed by Chairman Dave Camp that includes a reduction of corporate tax rate to 25 percent).
certainly suggests at least two areas where such income and deduction shifting is likely to arise: executive compensation and owner-controlled taxable C-corporations.\footnote{While such corporations are relatively rare today, many more are likely to appear if the corporate rate drops substantially below the top individual rate. For an example of small business owners’ response to a tax reform that reversed the relationship between corporate and top individual rate (with the latter dropping below the former for the first time in decades), see Joel Slemrod & John Bakija, Taxing Ourselves: A Citizen’s Guide to the Debate Over Taxes 146 (3rd ed. 2004).} In each case, it will be fairly easy for the corporation and the individual to agree on the goal of minimizing their joint tax liability and share the tax savings. There is every reason to expect that derivatives will be used to accomplish this goal.

Unlike a corporate tax rate reduction, an elimination of the special treatment of capital gains and losses is certain to reduce the urgency of fixing taxation of financial products.\footnote{The caveats stated earlier in footnote 33 apply here as well.} This conclusion does not depend on whether such elimination is accomplished by increasing the rate for capital gains or reducing the rate for ordinary income. As long as capital gains and ordinary income are taxed the same, there is no point in using derivatives to convert one type of income into another. There is no doubt that a variety of financial products have been designed and used to convert high-tax ordinary income and short-term capital gains into low-tax long-term capital gains.\footnote{These products include hedge fund derivatives partly addressed by section 1259, straddles addressed by section 1092, hedge fund derivatives partly addressed by section 1260, and exchange-traded notes that were the focus of the legislation proposed by Representative Richard Neal, see supra note 14.} These products will either disappear entirely or will lose some of their appeal if all types of income are taxed the same.

Another reform that will even more dramatically alleviate the need to rethink the taxation of derivatives is a broad shift to mark-to-market taxation, especially if that shift reflects the same approach that is currently adopted in section 475. If all gains and losses for a particular type of asset (perhaps limited to publicly traded assets) are taxed annually and at the same rate, there is no point in using derivatives to convert one type of income into another. There is no doubt that a variety of financial products have been designed and used to convert high-tax ordinary income and short-term capital gains into low-tax long-term capital gains.\footnote{These products include variable prepaid forwards partly addressed by section 1259, straddles addressed by section 1092, hedge fund derivatives partly addressed by section 1260, and exchange-traded notes that were the focus of the legislation proposed by Representative Richard Neal, see supra note 14.} This goal will be beyond the reach of financial engineers if broad categories of assets become subject to a mark-to-market regime.

A switch from world-wide to territorial taxation is yet another fundamental reform under consideration.\footnote{See Camp Proposes Switch to Territorial System, 133 Tax Notes 512 (2011).} Unfortunately (and, again, without expressing a view on the overall merits of this reform), a switch to territorial taxation is unlikely to reduce the need to reform the taxation of derivatives. In fact, the opposite may well be true. There is no doubt that financial products have been used to change the source of income in order to avoid U.S. withholding tax.\footnote{See I.R.C. section 871(m); Notice 2010-46, 2010-24 I.R.B. 757; Alex Raskolnikov, The Cost of Norms: Tax Effects of Tacit Understandings, 74 U. Chi. L. Rev. 601, 618-620 (2007).} It appears that derivatives are being deployed to avoid establishing a U.S. trade or business and earning income effectively connected to that trade or business as well. Both strategies — the re-sourcing of income and avoiding effectively connected income — will remain important (and even become more important in certain cases) in a territorial system. Furthermore, shifting taxable income offshore will have an even greater payoff following a switch to a territorial regime because it will lead to a permanent exemption from tax rather than a mere deferral of the tax liability. No doubt, greater financial benefits will lead to greater efforts to design derivatives that would accomplish these goals.

Finally, an argument in favor of replacing an income tax with a consumption tax has repeatedly appeared at the forefront of tax policy debates in the past decades. The implications of such replacement for the need to reform the taxation of financial products depend on the specifics. Certain forms of a consumption tax — such as an invoice-based value added tax popular in most OECD countries — are relatively resistant to the gaming and abuse carried out through a deployment of derivatives. Other versions — such as the so-called Flat Tax endorsed by several Presidential candidates over the years — are much more susceptible to abuse.\footnote{See David A. Weisbach, Ironing Out the Flat Tax, 52 Stan. L. Rev. 599, 624-30 (2000); Joseph Bankman & Michael L. Schler, Tax Planning Under the Flat Tax 245, 255-58, in Taxing Capital Income (Henry J. Aaron, Leonard E. Burman, C. Eugene Steuerle eds. 2007).} If a consumption tax is enacted to supplement (rather than replace) an income tax,\footnote{See Michael J. Graetz, 100 Million Unnecessary Returns 197-213 (2008).} the need to address the taxation of financial products will remain largely unchanged.
The overall implications of this discussion are quite clear. Any reform that eliminates the distinction between different types of income, eliminates taxpayers’ ability to elect one tax treatment or another, or eliminates capital income from the tax base would reduce the urgency of fixing the taxation of derivatives. Any reform that increases the disparity in the taxation of different types of income would have the opposite effect.

Yet whatever other reforms are considered today or tomorrow, a serious effort to rethink and reform taxation of financial products is critically important. The incentives to invent new derivatives-based tax reduction strategies are extremely strong. The human capital deployed in designing these strategies is considerable. The problems with the taxation of derivatives will not go away on their own. In fact, these problems are certain to persist and worsen if Congress fails to act.