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Frictions as a Constraint on Tax Planning

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^{*} Associate Professor, Columbia University School of Law. Helpful comments were received from Ann Alstott, William Andrews, Joseph Bankman, Daniel Budofsky, Marvin Chirelstein, Melvin Eisenberg, David Hariton, Robert Jacobs, Louis Kaplow, Bruce Kayle, Robert Gordon, Michael Graetz, William Gentry, David Leebron, Ronald Pearlman, Diane Ring, Meredith Wolf Schizer, Daniel Shaviro, Robin Shifrin, Reed Shuldiner, Lewis Steinberg, Jeffrey Strnad, Alvin Warren, David Weisbach, Bernard Wolfman, Lawrence Zelenak, and Eric Zolt, as well as from participants at the Harvard Seminar for Current Research in Taxation, the Tax Club, a Columbia Law School Faculty Workshop, and the annual meeting of the National Tax Association. Valuable research assistance was provided by Craig Lee. Please do not cite this draft without permission. Copyright © David M. Schizer. All Rights Reserved. The author may be contacted at (212) 854-2599 or at dschiz@law.columbia.edu.

Abstract: David Schizer, Frictions as a Constraint on Tax Planning

In recent years, the government has enacted a series of narrow tax reforms targeting specific planning strategies. Sometimes these reforms stop the targeted planning, but sometimes they merely prompt a new, more wasteful variation. The difference often lies in so-called frictions, which are constraints on tax planning other than the tax law, such as fees, accounting or regulatory treatment, credit risk, and the like. While frictions are important, reformers often lack key information, and legal academics should help provide it. This Article offers general observations about frictions that deter end runs. Most promising are strong “discontinuous” frictions that impose significant costs when taxpayers depart, even in subtle ways, from the transaction covered by the reform. Costs of relying on frictions are also considered, including information costs and distributional effects. Two case studies also are offered involving tax-motivated use of derivative financial securities. These reforms use essentially 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-through entity) without the usual adverse tax consequences (i.e., less deferral and a higher tax rate). Theoretically, taxpayers can avoid either rule through relatively modest changes in the derivative’s economic return. This strategy is commonly used to avoid Section 1259, a reality that was understood by government and taxpayers alike when the measure was enacted. In contrast, this strategy is *not* commonly used to avoid Section 1260. The difference, which was not well understood by Section 1260’s drafters, is that securities dealers cannot supply the derivative that theoretically avoids the rule.

For years, the tax system has wrestled with the problem of wasteful tax planning. Because the tax law often treats similar transactions differently, restructuring can significantly reduce the tax burden. Aggressive planning is pervasive 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. Ambitious reforms, such as mark to market accounting or a consumption tax, could eliminate many discontinuities in the tax law and associated planning opportunities. But these steps are politically unattainable, at least for now.¹ Instead, in recent years the government has

¹Under 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, e.g., David Shakow, Taxation Without Realization: A Proposal for Accrual Taxation, 134 U. Pa. L. Rev. 1111 (1986) (proposing broader use of mark-to-market taxation). Under a consumption tax, investment returns generally would not be taxed. See, e.g., William D. Andrews, A Consumption-Type or Cash Flow Personal Income Tax, 87 Harv. L. Rev. 1113 (1974). Political

used a less satisfying strategy: narrow reforms that target specific planning strategies. In these transactional responses, as they are called here, the tax treatment of a particular transaction is modified to restore the customary result.²

This Article emphasizes that, in crafting transactional responses, reformers must consider constraints on tax planning other than the tax law. Even if a tax planning strategy is legally permissible, taxpayers may still abandon it as practically unworkable. Transaction costs may be too high, financial accounting or regulatory treatment may be unappealing, and the like. Borrowing from the economics literature, and specifically from Professors Scholes and Wolfson, this Article uses the term “frictions” to describe constraints on tax planning other than the tax law.³ An understanding of these nonlegal constraints reveals which tax planning merits an immediate legal response – and thus a commitment of administrative resources and political capital – and which planning is theoretical only. If a legal response is needed, frictions inform how broad the legal rule must be *to actually stop* the planning, instead of merely spawning a new variation.

The stakes are high, whether one cares about equity or efficiency. For instance, a reform

and other obstacles to either reform are thoroughly explored elsewhere. See generally, e.g., *Uneasy Compromise: Problems of a Hybrid Income-Consumption Tax* (Henry Aaron et al. eds. 1988).

² For instance, since sales of appreciated assets trigger capital gains tax, a recent transactional response discussed in this Article, Section 1259, imposed tax on previously untaxed “hedging” transactions that closely resemble sales. In addition to the other case study discussed in this Article, the constructive ownership rule of Section 1260, other recent transactional responses include limits on the so-called “Morris trust” spin-off, see Section 355(e), the legislative response to the Seagrams transaction, Section 1059, holding period rules for claiming foreign tax credits, see Section 901(k), denial of interest deductions on debt that converts mandatorily into equity, see Section 163l, the Treasury’s unsuccessful proposal to deny interest deductions for “MIPS” and other instruments treated as equity for accounting purposes, and the unsuccessful proposal to deny interest deductions on certain convertible OID instruments such as LYONS.

³ See Myron Scholes & Mark A. Wolfson, *Taxes and Business Strategy* 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 accountant.

will not raise revenue or increase the tax burden on wealthy taxpayers if they can substitute other strategies not covered by the reform, a process here called “avoidance.” Likewise, if a reform merely makes planning more expensive, but fails to stop anyone, social waste increases. In some cases, then, a narrow reform will be counterproductive. To avoid this outcome, the reform must cover close substitutes, as Professors Shaviro and Weisbach have emphasized.⁴ Yet when does one transaction substitute for another? For 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 legal academics are well positioned to explore. Even though these issues do not bear directly on a taxpayer’s ability to pay – a core issue in tax policy – they can be vital to the success or failure of incremental reforms.

Many government reformers (and tax planners) appreciate the significance of frictions. Yet reformers often lack key information. How hard will it be to avoid a particular reform? What frictions will stand in the way, if any, and will taxpayers be deterred? Empirical work is needed, especially because frictions are constantly changing. Many have become weaker due to globalization, deregulation, and financial engineering. Indeed, it is well understood that these developments pose new challenges to the tax system. To meet these challenges, we need to know

⁴ See Daniel N. Shaviro, An Efficiency Analysis of Realization and Recognition Rules Under the Federal Income Tax, 48 Tax L. Rev. 1, 31 (1992) (“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 (1999) (emphasizing relevance of cross-elasticity to line-drawing). This Article extends efforts of Professors Shaviro and Weisbach to apply optimal tax principles to incremental tax reform. Legal distinctions would be based 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 can package cash flows in different ways that are all equally appealing, but are taxed differently. See Herwig J. Schlunk, Little Boxes: Can Optimal Commodity Tax Methodology Save the Debt-Equity Distinction? (draft of Nov. 5, 2000). While Professor Schlunk’s argument may 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.

which frictions are still significant.⁵ While accountants on business school faculties have produced empirical work on frictions, legal academics largely have not. Their absence is notable because legal regimes other than the tax law are an important source of frictions.⁶

Part I offers general observations about frictions that deter end runs.⁷ Most promising are strong “discontinuous” frictions. These impose significant costs when taxpayers depart, even in subtle ways, 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. Balanced against this advantage are costs of relying on frictions, including the need to learn esoteric institutional details, the instability of frictions over time, and effects on behavior other than tax planning.

⁵ 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., Alvin C. Warren, Jr., *Financial Contract Innovation and Income Tax Policy*, 107 *Harv. L. Rev.* 460, 467 (1993) (“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.”); David F. Bradford, *Fixing Realization Accounting: Symmetry, Consistency and Correctness in the Taxation of Financial Instruments*, 50 *Tax L. Rev.* 731, 732 (1995) (“I focus on a world with no transactions costs.”). This assumption is helpful in dramatizing long-term threats to the system. But the assumption is less helpful in crafting narrow transactional reforms (which, 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.

⁶For a survey of the accounting literature, see Douglas A Shackelford & Terry Shevlin, *Empirical Tax Research in Accounting*, *J. Accounting & Econ.* (forthcoming 2000). 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 brief exception of Mark Gergen, *Apocalypse Not?*, 50 *Tax L. Rev.* (1995). As “transaction cost engineers,” lawyers have a comparative advantage in probing legal regimes and transaction costs. See Ronald J. Gilson, *Value Creation by Business Lawyers: Legal Skills and Asset Pricing*, 94 *Yale L. J.* 239, 255 (1984) (arguing that “lawyers function as transaction cost engineers”).

⁷ 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 and Paula Schmitz, *The Influence of Tax Law on Securities Innovation in the United States, 1981-1997*, 52 *Tax L. Rev.* 119 (1997). In my experience, uncertainty about tax treatment will not necessarily keep a tax-advantaged deal from catching on. As Professor Bankman has emphasized, corporate taxpayers are quite tolerant of tax risk because auditing of sophisticated transactions is cursory. See Joseph Bankman, *The New Market in Corporate Tax Shelters*, 83 *Tax Notes* 1775 (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 Report*, March 2000, at 10 (noting that the tax treatment of DECS is uncertain, but transaction is quite common).

Parts II and III consider two recent statutory provisions that highlight the significance of frictions. Both target a tax-motivated use of derivative financial securities.⁸ 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 fund⁹ (or other pass-through entity) without the usual adverse tax consequences (i.e., less deferral and a higher tax rate). 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 that was understood by government and taxpayers alike when the measure was enacted. In contrast, as discussed in Part III, this strategy is *not* commonly used to avoid Section 1260. The difference, which was not well understood by Section 1260’s drafters, is that securities dealers cannot supply the derivative that theoretically avoids the rule. This is not to say that Section 1260 is *never* avoided. Instead of derivatives, insurance contracts and investments in offshore insurance firms have attracted taxpayer interest, although these strategies are impeded by other frictions and tax rules, and probably could be blocked entirely by surgical responses from the Treasury Department. In any event, the essential point of these case studies is that even the *same* statutory language can induce different taxpayer responses, depending upon the frictions involved. Thus, frictions deserve careful attention from reformers and scholars.

⁸ A derivative financial security is a contract whose value derives from some financial fact. For instance, an option to buy stock is a derivative. 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.”).

⁹Hedge funds are investment vehicles for wealthy individuals and institutions. Because these funds are not registered under the Investment Company Act of 1940, and thus need not comply with regulatory and disclosure requirements applicable to mutual funds, these ventures are available only to investors meeting minimum wealth requirements. Managers generally are compensated by a share of profits above a minimum return (e.g., 20% of all returns above 15%) instead of by a fixed share of assets under management, which is the norm for mutual funds.

I. BACKSTOPPING NARROW RULES WITH FRICTIONS

A limit on tax planning is seldom appealing if it merely prompts taxpayers to plan in a different, more wasteful way, as Section A observes. Although this outcome is less likely if the reform is broad in scope, narrow measures sometimes will be used for substantive and political reasons, as discussed in Section B. A narrow measure's appeal depends, to a considerable degree, on whether end runs will be blocked by frictions. Section C offers general observations about which frictions will be most effective, and also lists examples. Yet reliance on frictions is not cost-free. Section D identifies common pitfalls.

A. Policy Goals in Targeting Tax Planning

Reasons to curtail tax planning are familiar. Obviously, more revenue is collected. In addition, social waste is reduced as taxpayers refrain from tax-motivated behavior.¹⁰ Since wealthy and well-advised taxpayers have an edge in planning, limiting this advantage can lead to a fairer distribution of tax burdens.¹¹ If other taxpayers believe the system is stacked against them, they may be less likely to comply voluntarily, and tax collection would become more expensive.¹²

Yet not every attack on tax planning is advisable. Planning functions as a tax reduction, and in some cases taxes *should* be reduced.¹³ It is usually better, though, to reduce the rate or even repeal the undesirable tax, thereby eliminating the need for wasteful taxpayer self-help.¹⁴ Since explicit tax reductions are relatively easy to implement, this Article focuses instead on challenges in *maintaining* or *increasing* the tax burden. In other words, the targeted planning is

¹⁰ See Harvey S. Rosen, *Public Finance* 284 (5th ed.1999) (noting that a tax is efficient if it raises revenue with a minimum of behavioral distortions and other sources of dead weight loss).

¹¹ This conclusion assumes 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.

¹² See Joel Slemrod, *Trust in Public Finance* (working paper on file with author).

¹³ See Weisbach, *supra* note 4, at 1679 (listing as 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”).

¹⁴ The “check the box” rules are an example of this approach. See *Treas. Reg. 1.7701-4*.

assumed to yield an inappropriately low tax.

Even when such planning is targeted, it is well understood that reforms can be costly. They consume administrative resources, raise compliance costs, and may also undermine “good” transactions that are not tax-motivated.¹⁵ Most importantly for our purposes, half-hearted efforts may merely add to the cost of planning without stopping anyone, thereby increasing social waste without collecting more revenue.¹⁶ 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.¹⁷ If the reform cannot be made more effective (e.g., due to political or administrability constraints), it may be better to do nothing, or even to make the targeted planning easier. Although 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 (e.g., 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, this assumption is plausible in the short run, but less so in the long run.

The appeal of any effort to curtail planning depends upon the particular balance of all

¹⁵See David Weisbach, *An Economic Analysis of Tax Avoidance Doctrines* (working paper) (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.

¹⁶ This point has recently been emphasized in Daniel N. Shaviro, *Economic Substance, Corporate Tax Shelters, and the Compaq Case*, 88 *Tax Notes* 221 (2000).

¹⁷ Professor Kaplow has emphasized this tradeoff between welfare gains from deterring marginal taxpayers, on one hand, and welfare costs from inducing more waste by infra-marginal taxpayers. See Louis Kaplow, *Optimal Taxation With Costly Enforcement and Evasion*, 43 *J. Public Econ.* 221 (1990).

these benefits and costs.¹⁸ 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 symbolism?

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.¹⁹ In a more modest strategy, broad anti-abuse rules would target particular planning strategies, covering not only the current version, but 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.²⁰ These concerns should not be overstated. The tax bar often will help flag overbroad applications, and also may “save” good transactions through creative interpretations.²¹ Even so, such self-help is expensive.²² Nor does it work in all cases.

¹⁸ See generally Joel Slemrod & Shlomo Yitzhaki, The Costs of Taxation and the Marginal Efficiency Cost of Funds, 43 IMF Staff Papers 172 (Mar. 1996) (noting that tax reforms are efficient in adding the least social waste per dollar of additional revenue and listing five potential sources of social waste: the costs of substitution effects, avoidance, compliance, administration, and evasion).

¹⁹ See Reed Shuldiner, A General Approach to the Taxation of Financial Instruments, 71 Tex. L. Rev. 243, 245 (1992) (“Most, if not all of these problems [with taxing financial instruments] could be solved by abandoning our current realization system and adopting mark-to-market accounting for financial instruments. While there has been some movement in this direction, it is unlikely that Congress (or the financial community) will accept wholesale use of mark-to-market accounting.”); see also David M. Schizer, Sticks and Snakes: Derivatives and Curtailing Aggressive Tax Planning, 73 S. Cal. L. Rev. 1339, 1343 n. 10 (2000) (citing various commentators who have concluded that comprehensive mark-to-market taxation is unlikely to be enacted soon).

²⁰ See Louis Kaplow, Rules versus Standards: An Economic Analysis, 42 Duke L.J. 557 (1992) (noting tradeoff between cost of formulating more detailed rules and waste from overbroad applications or from amending the rule later).

²¹ For example, the contingent debt rules of Treas. Reg. 1.1275-4, which offer unfavorable treatment to holders, apply to any debt not eligible for an enumerated exception. 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, 97 TNT 147-82 (July 31, 1997) (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

Aggressive taxpayers have an advantage, and the I.R.S. has discretion that may not be used responsibly.²³

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. Responses to planning draw political strength in providing “revenue raisers” to fund other initiatives.²⁴ In addition, media coverage of the targeted abuse can ensure *some* response. Yet affected taxpayers often can keep the measure narrow. They rely heavily on rhetoric about overbreadth. 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, the general public lacks the sophistication to judge whether a reform targeting complex commercial transactions will be effective. As a result, a narrow measure can yield symbolic benefits. At the same time, 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).²⁵

opinions. For instance, Section 355(d) was meant to keep corporations from attaining tax-free treatment for certain spinoffs that would otherwise be taxable sales. As Professor Ginsburg has 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).” Martin D. Ginsburg & Jack S. Levin, 1 *Mergers, Acquisitions, and Buyouts* 10-79 (Nov. 2000 ed.). To solve this problem, the legislative history authorized regulations excluding from the provision “transactions that do not violate the purposes of this provision,” including distributions that do not increase ownership in distributing or controlled or provide a basis step-up. See 1990 Conference Report, *reprinted in* CCH Standard Federal Tax Reporter, at 16,460. Yet tax advisors did not wait nine years for regulations before applying these principles. 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.* 479-80 (2000).

²²Edward Kleinbard has described the costliness and time-intensiveness of giving tax advice. See Edward D. Kleinbard, *Equity Derivatives Products: Financial Innovation’s Newest Challenge to the Tax System*, 69 *Tex. L. Rev.* 1319 (1991).

²³See Colin S. Diver, *The Optimal Precision of Administrative Rules*, 93 *Yale L. J.* 65, 75 (1983) (imprecise rules allow discretion to the administrator, the desirability of which depends upon the trustworthiness of this agent).

²⁴ See Elizabeth Garrett, *Harnessing Politics: The Dynamics of Offset Requirements in the Tax Legislative Process*, 65 *U. Chi. L. Rev.* 501 (1998).

²⁵ In some cases, of course, keeping the reform narrow will not rescue planning opportunities – that is, where

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 omits 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?²⁶ Taxpayer preferences about the friction must be inelastic,²⁷ 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? Obviously, the larger it is, the more persuasive the friction must be. Is the tax benefit deferral or forgiveness? What tax rate applies? Is it the rate for capital gain or ordinary income? Are the relevant taxpayers individuals or corporations? How much income is at stake? Has this income

frictions block these opportunities, as discussed below. Once a narrow rule will block any abusive transaction that would be viable, it might not be *more* difficult politically to pass a broader rule. Affected interest groups would not object to the broader version if, from their perspective, it has exactly the same effect as a narrow rule – that is, if there is no abusive transaction to save by keeping the rule narrow. However, there may be *nonabusive* transactions to save. Thus the political analysis merges with the substantive analysis of overbreadth described above (i.e., in which narrow rules have the virtue of infringing less on “good” transactions).

²⁶ Wasteful planning can arise not only when taxpayers *avoid* a reform, but also when they deliberately qualify. As I have addressed this issue elsewhere, I do not focus on it here. See generally Schizer, *supra* note 19. 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.

²⁷ See Shavero, *supra* note 4 (emphasizing importance of elasticity); Weisbach, *supra* note 4 (same).

already been earned economically (e.g., built-in gain), or does the tax strategy apply only to (potentially speculative) future gains?

Second, how “strong” is the friction? In other words, how much do taxpayers care about it? 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.²⁸ To judge the strength of this friction, we must know how much time taxpayers must devote, 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 a day a week to do so (instead of, say, a week a year in a sunny locale).

In addition to the strength of the friction, we must understand how difficult it is for the taxpayer to attain (or avoid) the benefits (or costs) of the friction while still achieving the tax objective.²⁹ Since many frictions are quite important to taxpayers, this third question is often crucial. For instance, taxpayers are concerned about the level of economic risk required to attain a tax benefit. Yet if the government specifies a minimum amount, many will bear just a modicum more. On the other hand, what if a regulatory regime prevents taxpayers from taking this extra risk? A much greater sacrifice is required to get the tax benefit, and many more will be deterred.

To put the point more generally, there are two kinds of frictions. With a “discontinuous” friction, such as the regulatory regime in our example, a minor change in the transaction can have a dramatic effect on taxpayer utility.³⁰ Such a friction can help a narrow reform to be effective: If

²⁸ See Section 469 (disallowing losses from passive activities, which are defined as activities in which the taxpayer does not “materially participate”).

²⁹ Cf. Shaviro, *supra* note 4, at 32 (in determining elasticity, we must ask ‘how strongly is the taxpayer constrained by the friction’ and ‘what alternative routes with different tax consequences could the taxpayer use’).

³⁰In an insightful article, Professor Strnad has used the concept of continuity to describe tax rules (i.e., to indicate whether minor changes in the transaction trigger major changes in tax treatment). See Jeff Strnad, *Taxing New Financial Products: A Conceptual Framework*, 46 *Stan. L. Rev.* 569, 584 (1994). The concept is extended 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 (1984). Yet Professor Cooter’s terminology works better for regulatory regimes, in that some authority is *imposing* the sanction. Discontinuous

the reform fails to block a substitute, the friction will block it (assuming, of course, that the friction is strong enough).³¹ In contrast, with a “continuous” friction, such as risk for the average taxpayer, minor changes in the transaction (e.g., 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.³²

Finally, reformers must consider the “position” of the friction – that is, who is affected by it. Frictions that affect taxpayers themselves obviously are relevant, but so are frictions affecting advisors or the likely counterparty.³³ For instance, if the taxpayer must have a legal opinion (e.g., to avoid penalties), frictions that discourage counsel from rendering the opinion impede planning.³⁴ 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.³⁵ Reformers should learn about frictions that affect

frictions arise not only from regulatory regimes, but also from imperfect markets or technological limitations.

³¹ If the friction is not strong enough, even a discontinuous friction will not stop the planning. Assume, for instance, that a narrow reform applies to every version of a planning strategy but one, and the omitted one violates a regulatory regime (but others do not). This friction is discontinuous in that the regulatory penalty applies to this substitute alone, causing a jump in the nontax cost of this substitute, compared to the others. Yet if this nontax cost is lower than the tax savings – for instance, if the regulatory penalty is \$100,000 but the tax savings is \$1 million – the planning will continue. Thus, social waste increases but no new revenue is collected.

³² I thank Reed Shuldiner for this metaphor.

³³ 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 3, at 2. Likewise, *nontax* constraints of all parties are relevant.

³⁴ Recognizing the importance of legal opinions, the government recently tightened up standards for rendering them. See IRS Issues Proposed Circular 230 Regs, 2001TNT 9-6 (Jan. 12, 2001). Similarly, the government has proposed enhanced disclosure and registration requirements for tax shelters. For a discussion, see N.Y. State Bar Association Tax Section, Comments on the New Tax Shelter Regulations, 90 Tax Notes 1447 (Dec. 11, 2000).

³⁵ In a sense, the position of a friction is merely an aspect of its strength and continuity, since the party that

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?

2. *Some Usual Suspects*

To sum up, a narrow rule can still stop a planning strategy as long as frictions prevent end runs: Strong, discontinuous frictions must burden a key player in any transaction not covered by the legal rule. While this is a fact-specific inquiry, it is worth listing three categories of frictions that commonly affect sophisticated transactions: preferences of taxpayers regarding real 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 “Real” Activity

Taxpayers share a variety of nontax preferences regarding their business activities. For example, in addition to risk,³⁶ timing can be important (e.g., how long must taxpayers hold an asset³⁷ or wait before taking a particular step),³⁸ as can the extent of a taxpayer’s participation in a venture.³⁹ Whether weak or strong, these frictions tend to be continuous. One can always take a

nominally is affected by the friction will seek to pass the burden on to the taxpayer through a higher fee.

³⁶Some rules impose a tax when taxpayers take risk-reducing measures, presumably on the theory that risk-reducing behavior is inelastic. See Daniel N. Shaviro, Risk-Based Rules and the Taxation of Capital Income, 50 Tax L. Rev. 643 (1995). Likewise, some tax rules deny a tax benefit to taxpayers who fail to take risk, on the theory that this non-tax “price” allocates the tax benefit to those who should receive it (e.g., because they have non-tax reasons for engaging in the benefit-generating behavior). See Shaviro, *supra*. 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 the distinction. See Warren, *supra* note 5, at 460.

³⁷ See Section 901(k) (prescribing 15-day holding period for claim of foreign tax credit); Shaviro, *supra* note 16 (discussing 901(k) and *Compaq* case).

³⁸See Section 355(e) (control of distributing or controlled may not change hands within two years of spin-off); Section 1091 (taxpayer may not repurchase asset within 30 days before or after sale at a loss).

³⁹See Section 469 (requiring “material participation”).

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 real activity may be discontinuous. For instance, taxpayers have strong preferences about the control they exert over the investment⁴⁰ and the political jurisdiction in which relevant activity occurs (e.g., inside or outside the United States).⁴¹ Yet the sharpness and location of the discontinuity will vary with the facts. For example, control may technically require 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 (e.g., 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*.⁴² 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 our case studies.⁴³ Of particular relevance are the state of financial technology and completeness of financial markets.⁴⁴ For instance, assume a special tax is imposed where markets

⁴⁰For 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., Section 355(e).

⁴¹Along with jurisdictional considerations, this friction helps explain why U.S. tax applies only to earnings that are effectively connected to the United States. See Section 864(c). To the extent that economic actors have strong non-tax reasons to do business in the United States, the U.S. government can tax them without fear that they will substitute business activities offshore.

⁴²For 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 (2000). Likewise, development of new financial instruments has created planning opportunities. See Warren, *supra* note 5.

⁴³As discussed in Parts II and III, the “constructive ownership” provision is fairly effective, notwithstanding its narrow scope, because dealers lack the ability to hedge the security that theoretically could avoid the rule, and thus will not supply this transaction at tolerable cost. In contrast, the “constructive sale” provision is less effective – even though this rule uses essentially the same statutory test – because dealers are able to hedge more effectively in this context. They often can supply the requisite security for a price lower than the tax benefit from avoidance.

⁴⁴For 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 financial transactions cannot be done 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

are relatively complete (e.g., on publicly traded assets). Although the tax theoretically could be avoided (e.g., by investing in private assets), taxpayers may pay the tax in order to enjoy benefits of public trading.⁴⁵

c. Accounting and Legal 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.

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.⁴⁶ Ineligible parties cannot use these contracts in tax planning.

ceases to be profitable). Yet there currently is no insurance or derivatives market for wages of individuals, or even for wages of professional groups (e.g., attorneys, doctors, carpenters, etc.). As Professor Shiller has observed, although financial markets are far more developed than ever before, individuals still cannot hedge human capital, as well as nonfungible assets such as closely-held businesses, investments in real property, and the like. Robert Shiller, *Irrational Exuberance* (2000); see also Shaviro, *supra* note 36. 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.

⁴⁵ Benefits of public trading are well understood. See, e.g., Rebecca Rudnick, *Who Should Pay the Corporate Tax in a Flat Tax World*, 39 *Case W. Res.* 965 (1989) (supplying liquidity); Bagehot, *The Only Game in Town*, *Fin. Analysts J.* Mar-Apr. 1971, at 12 (reducing information disparity between buyers and sellers, and thus curing lemons problem, by creating a pool of monitors and, more generally, by forming a price that incorporates available information); See Ronald J. Gilson & Bernard Black, *Does Venture Capital Require an Active Stock Market*, *J. App. Corp. Fin.* 36 (Winter 1999) (facilitating venture capital investments); See Fama & Jenson, *Separation of Ownership and Control*, 26 *J. L. & Econ.* 301, 313 (1983) (facilitating use of equity compensation for management).

⁴⁶ Under the Commodities Exchange Act, so-called futures contracts generally are enforceable only if conducted through an organized exchange. The Commodities Futures Trading Commission has spared investors who meet minimum wealth requirements from these constraints. As a result, over-the-counter derivatives are clearly enforceable for wealthy investors. See James Hamilton et al, *A Guide to Federal Regulation of Derivatives* (1998). Congress recently developed and codified these exceptions in December 2000 legislation. See the Commodity Futures Modernization Act of 2000. Constraints also arise under the federal securities laws. 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 and Rule 144, respectively, as well as by Section 16 of the Securities Exchange Act.

Second, 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 principal of economics, so-called 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.⁴⁷ 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.⁴⁸ Yet the dramatic erosion he predicts in the corporate tax base has been blocked so far by significant frictions, including credit risk. 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 (e.g., if they are sold to the same investor, cannot be legally separated, and have the same maturity date).⁴⁹ To avoid this recharacterization, the corporation theoretically could sell the debt and forward to separate investors.⁵⁰ 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

⁴⁷A forward contract is a contract for one party to buy a designated 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 (i.e., 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 5.

⁴⁸ See Schlunk, *supra* note 4.

⁴⁹See Notice 94-47 (debt that is mandatorily convertible is taxed as equity); Section 163I. The legislative history of section 163I says that interest is disallowed if “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.” Comm. Rep. P.L. 103-34, *reprinted in* CCH Standard Federal Tax Reporter, at 23,019..

⁵⁰ Cf. Prv. Ltr. 200052027 (Jan. 8, 2001) (Section 163I does not apply to issuer that issues notes and buys put options from separate investors).

unworkable.⁵¹ 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 (nondeductible) fee (e.g., 2%).⁵² This expense, coupled with the cost of two public offerings, renders the transaction uncommon.⁵³

Third, agency costs can impede tax planning. Self-interested agents may choose not to pursue otherwise promising strategies that are complex or risky, or take considerable time and effort to develop. For instance, evidence of success may be required before an arbitrary date (e.g., the cutoff date for an investment banker's annual bonus). Likewise, pursuit of the tax-reducing 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.

Finally, the regulatory regime might be relevant in determining, not whether the

⁵¹ To avoid this problem, the issuer theoretically could enter into the forward contract with a securities dealer. 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" for purposes of Section 5 of the Securities Act. The dealer would thus have to deliver a prospectus, a step that 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).

⁵² The fee is not deductible as interest. Although the taxpayer might deduct it as a business expense, the fee arguably should be capitalized under *Indopco* as a cost of the offering. See *Indopco Inc. v. Commissioner*, 503 U.S. 79 (1992). Yet basis in the equity being sold has no value to the issuer, since section 1032 provides nonrecognition treatment.

⁵³ I am aware of only two public transactions using this structure. See *Browning Ferris Industries, Inc. 7.25% Automatic Common Exchange Securities* (June 23, 1995); *MCN 5,100,000 8.75% PRIDES* (Apr. 22, 1996). The more common alternative, *Feline Prides*, is somewhat less costly but involves more tax risk. See, e.g., *Conseco, Inc. Conseco Financing Trust IV 10,000,000 Feline Prices* (Dec. 8, 1997). 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 case 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, although many transactions have been done. An understanding of the credit-risk constraint would enable the government to block the transaction with a narrow rule, such as a notice or regulation interpreting section 163I. The rule would disallow the deduction of interest from any debt that *collateralizes* a forward contract for the issuer's equity. The only structure that would avoid this rule is the one described in text, and issuers are unlikely to use it.

transaction itself can be done, but how the transaction would affect 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.⁵⁴

Unappealing financial accounting or adverse treatment by rating agencies can also have a chilling effect on 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.⁵⁵ For instance, it can be expensive for investors to look through these conventions (e.g., if the investor must value particular assets or liabilities on her own). Nor is it profitable to develop more accurate numbers if other investors, who set the market price, will continue to be influenced (or, indeed, misled) by the old ones.⁵⁶ In any event, managers and their advisors jealously guard

⁵⁴Under 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. Activities that reduces 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. Not only is no interest deduction available. More importantly, the return expected by equity investors is considerably higher than a dealer's borrowing cost. Regulatory capital charges feature in the discussion of both Section 1259 and Section 1260. See *infra* Parts II and III. See also Myron Scholes et al, *Tax Planning, Regulatory Capital Planning, and Financial Reporting Strategy for Commercial Banks*, *Rev. Fin. Stud.* 625 (1990) (analyzing commercial bank investment portfolio management to discern tradeoff between regulatory capital and tax planning); A. Beatty et al, *Managing Financial Reports of Commercial Banks: The Influence of Taxes*, 33 *J. Accounting Res.* 231 (1995) (focusing on categories of decisions by banks, including loan charge-offs, issuance of new securities, pension settlement, etc.); J. Collins et al, *Bank Differences in the Coordination of Regulatory Capital, Earnings and Taxes*, 33 *J. Accounting Res.* 263 (studying decisions of particular banks over time).

⁵⁵ See generally Sanford J. Grossman, *On the Efficiency of Competitive Stock Markets When Traders Have Diverse Information*, 31 *J. Fin.* 573 (1976); Sanford J. Grossman & Joseph Stiglitz, *On the Impossibility of Informationally Efficient Markets*, 70 *Am Econ. Rev.* 393 (1980).

⁵⁶An analogy may be drawn to the “noise trader” literature. If unsophisticated investors (or “noise” traders) are paying too much for tulips or Internet stocks, sophisticated investors should engage in short sales that yield a profit once the bubble bursts and, indeed, should help it to burst. Why, then, do bubbles ever occur? The “noise trader” literature contends that 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) the noise traders will recognize their error, arbitrage becomes very risky, and less of this service is supplied. See generally J. Bradford De Long, et al., *The Size and Incidence of the Losses from Noise Trading*, 44 *J. Fin.* 681 (1989); J. Bradford De Long, et al., *Noise Trader Risk in Financial Markets*, 98 *J. Pol. Econ.* 703 (1990); Andrei Shleifer & Lawrence H. Summers, *The Noise Trader Approach to Finance*, *J. Econ. Persp.*, Spring 1990, at 19.

accounting and rating agency treatment.⁵⁷ These efforts are documented in empirical studies,⁵⁸ and also in anecdotal evidence from equity research analysts,⁵⁹ and from investment bankers who develop tax and accounting arbitrages.⁶⁰ 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 Strategy

When frictions are sufficiently strong and hard to avoid, they enable narrow tax rules to be effective, thereby averting 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 can be counterproductive because planning will continue in more wasteful form. In addition, four other problems can undermine reliance on frictions.

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 regulation. 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

⁵⁷For discussion of these issues, see David M. Schizer, *Tax Constraints on Indexed Options*, U. Pa. L. Rev. (forthcoming 2001).

⁵⁸ See, e.g., Ellen Engel et al., *Debt-Hybrid Securities*, 37 J. Accounting Res. 249 (1999) (studying MIPS and other securities treated as debt for tax purposes but not for rating agency and accounting purposes; noting that firms incur extra expenses totaling approximately 4% of offering price, or \$10 million in the average offering, to secure better accounting treatment for otherwise comparable securities). See also Shackelford & Shevlin, *supra* note 6. (describing studies of tradeoff between accounting and tax reduction in use of LIFO, compensation, depreciation, income shifting, capital structure, acquisitions, etc.).

⁵⁹To emphasize the costliness of looking through accounting conventions, Andrew Steiner, a research analyst at Bear Stearns, asked, “When you read an academic paper, do you read all the sources cited in the footnotes?”

⁶⁰As one put it, “If the market were truly efficient, I could not make so much money doing this – but have you seen my house?”

must, in effect, prove a negative. There must be no viable way to avoid the narrow rule.⁶¹ 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).

Admittedly, perfect foresight is not realistic. But some success at uncovering the relevant information should be possible. Nor is this effort always more daunting than the administrability and political challenges of 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. Organizations such as the New York State Bar Association may also be fruitful sources of information. To some extent, reformers already are asking about frictions, although in an ad hoc manner that often depends on which officials are working on the reform, what experience they have, and whom they know.⁶²

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, to ask the SEC about a securities law issue or the Federal Reserve about a bank regulatory issue. To some extent, this coordination already occurs. Yet turf battles can impede cooperation. Seeking input can lead to delay and loss of control. The success of cooperation often depends on personalities and relationships of particular staffers.⁶³ 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 potentially greater costs of a tax reform

⁶¹ I thank Diane Ring for this observation.

⁶² I am indebted to Ron Pearlman for this insight.

⁶³ Professor Pearlman is also the source of this observation.

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 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.⁶⁴ Of course, this process can work the other way as well. A friction that seems unimportant today can become more daunting over time.⁶⁵ Yet the trend is toward less effective frictions, due to globalization, deregulation, and more complete financial markets. In response, 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 could transfer wealth from dealers to insurers. Likewise, if a tax benefit is conditioned on adverse accounting,⁶⁶ the benefit may be claimed only by firms that are relatively unconcerned

⁶⁴See, e.g., Warren, *supra* note 5; Avi-Yonah, *supra* note 42.

⁶⁵For instance, under the wash sale rules of Section 1091, taxpayers who sell a security at a loss cannot recognize it currently unless they wait 30 days before repurchasing the security. 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.

⁶⁶For 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 Gergen & Schmitz, *supra* note 7.

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, if the cost of the friction rises with the size of the transaction (e.g., a regulatory penalty or fee to a counterparty that is scaled to the size of the transaction), wealthier taxpayers will not have a particular edge.

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 discourages useful transactions that are not tax motivated.⁶⁷ 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). 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?”

On the other hand, what if the friction serves a useful nontax function? It would be undesirable for the tax law to undermine the 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 benefits to third parties of liquid markets (so-called positive externalities). 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

⁶⁷ The rule requires certain hedges to be marked to market. For a discussion, see *infra* Part II. A number of commentators, including Alan Greenspan, have voiced concern about the nontax effects of this rule.

securities is raised? Ideally, no one would stop trading in these markets (i.e., because the nontax benefits outweigh the tax savings). But if taxpayers do stop trading, they personally lose the benefits of these transactions, as do third parties (e.g., if assets are priced less efficiently).

Similarly, it is undesirable for the tax law to create political pressure to repeal a socially valuable friction. For instance, assume a regulated financial institution cannot claim a tax deduction without triggering adverse regulatory treatment (e.g., accounting losses that require regulators to take over the institution). If this tough regulatory treatment is socially useful (e.g., in ensuring the solvency of regulated institutions), it would be undesirable for regulators to weaken their standards solely to make the tax deduction easier to claim.⁶⁸ In light of these risks, reformers should prefer a friction that is so persuasive that taxpayers generally will not be swayed by competing tax considerations to ignore it in a particular case or to seek its repeal.

* * *

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 persuasive frictions are not present, a narrow rule may not be worth doing. Even if it is, a broader rule is likely to be better. On the other hand, what if strong discontinuous frictions are present? A narrow rule is more likely to be worth doing. Indeed, a narrow rule sometimes will be *better* than a broader rule, although costs and benefits of each alternative must be compared (e.g., the cost of learning about and monitoring the friction vs. 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

⁶⁸ See *Cottage Savings Association v. Commissioner*, 111 S. Ct. 1503 (1991) (through Memorandum R-49, Federal Home Loan Bank Board 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, initially at least, 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. Banking experts question whether the decision was consistent with sound banking practices and international agreements such as the Basil accord. Nevertheless, the Federal Reserve apparently was eager to give banks access to better tax treatment. See Tom Pratt, *Fed Gives Go-Ahead for New Form of Tier 1 Capital*, *Investment Dealer’s Digest*, May 27, 1996.

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 policy making is less satisfying than 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, broker-dealer regulation and credit risk seem far removed from classic tax policy measures such as the Haig Simons definition of income,⁶⁹ 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, the following Parts 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. This strategy is commonly used to avoid the constructive sale rule of Section 1259. As Part II shows, the targeted transaction, use of derivatives in effect to sell appreciated assets without paying tax, remains pervasive. In contrast, frictions keep 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. As Part III shows, taxpayers have stopped using derivatives to attain the relevant tax objective, better tax treatment of hedge fund returns, although other strategies involving insurance are coming into wider use. While each reform raises

⁶⁹ In widely cited works, Robert Haig and Henry Simons defined income as the sum of consumption and the market value of increases in the value of the taxpayer's property. See 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).

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 thirty conversations during 2000 and 2001 with investment bankers, tax and securities lawyers. 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 will not be identified.

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.⁷⁰ The measure was a response to growing use of short sales against the box⁷¹ and other hedging strategies involving derivatives.⁷² These transactions

⁷⁰“Hedging” in this context means the asset’s owner enters into a separate transaction that, in effect, cancels out the economic return in the appreciated asset (e.g., when one goes up, the other goes down). See footnotes 71 and 72, *infra*, for descriptions of short sales against the box and forward contracts.

⁷¹A short sale is a bet that the stock price will decline, implemented by selling borrowed shares. The seller promises to return shares to the lender in the future, and hopes declines in the stock price will make these “replacement” shares cheaper. What distinguishes a short sale “against the box” is that the short-seller already owns stock identical to the stock she is borrowing. 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 losses 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.

⁷²For 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 (i.e., because the ability to sell for \$115 becomes correspondingly more valuable as the market price declines).

offered benefits of a sale, including reduced risk and cash proceeds, but for formalistic reasons were not taxed as sales.⁷³ Even though short sales against the box date back at least to 1932,⁷⁴ it became easier in the last two decades to borrow the stock needed for this transaction.⁷⁵ Tax legislation in 1978 protected stock lenders from adverse tax consequences.⁷⁶ Brokers also had more stock to lend because investors were keeping shares in brokerage accounts (e.g., instead of in bank vaults).⁷⁷ Also, substitutes for short sales against the box became available in the over-the-counter derivatives market during the 1980s and 1990s. These hedges could be used, for instance, when a short sale would violate the securities laws.⁷⁸

⁷³The 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., in returning shares to the party that who lent the shares used in the short sale). See generally Peter L. Faber, Andrea S. Kramer and William R. Pomierski, *The Ownership and Disposition of Property: New Rules for Old Problems*, Taxes 768, 775 (Dec. 1997); Edward Kleinbard, *Risky and Riskless Positions in Securities*, Taxes 783, 793 (Dec. 1993).

⁷⁴See, e.g., *Bingham v. Commissioner*, 27 B.T.A. 186 (1932).

⁷⁵SEC and 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 NYSE Rule 440C; NASD Rule 3370(b)(2). For a discussion of this “locate” requirement, see Martin Shubik, Michael Powers, and David Schizer, *Sin, Short Selling, Taxes, Bubbles, and the Price of Shares* (working draft on file with author). 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? A revenue ruling cautioned that such behavior would trigger tax. 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.”).

⁷⁶Taxable investors worried that, in lending their stock, they would be treated as making a taxable sale. But see Section 1058 (providing nonrecognition to lender of stock when certain conditions are satisfied). Tax-exempt investors feared that fees earned from lending stock would be taxable as “unrelated business taxable income.” But see section 512(a)(5) (providing that income from securities loans is not UBTI); see also Committee Report on P.L. 95-345 (1978), reprinted in CCH, at 22,830.14 (describing Congress’s concern that securities lending not trigger adverse tax consequences).

⁷⁷Indeed, if the stock is held in a margin account, the broker does not need permission to lend the shares. See SEC Rules 15c3-3; see also House Rep. No. 102-414 (Jan. 22, 1992). While permission is needed to lend stock in “cash” accounts, such permission is routinely granted. Indeed, this is often a condition the broker requires in setting up the account.

⁷⁸For instance, securities laws bar senior corporate officers and large shareholders from engaging in short sales, see Section 16(c) of the Securities Exchange Act, but allow “synthetic” short sales with derivatives. See Rule 16c-4. See David M. Schizer, *Executives and Hedging: The Fragile Legal Foundations of Incentive Compatibility*, 100 Colum. L. Rev. (2000). Section 5 of the 33 Act would also prevent sales of restricted stock, but hedging this stock

Notwithstanding this erosion of frictions, a lot of capital gain was still taxed. For instance, individuals realized \$170.4 billion of net capital gain in 1995.⁷⁹ 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 were (and are) ranked on *pretax* returns,⁸⁰ fund managers have an incentive to maximize this return – as opposed to after-tax returns. As a result, managers trade 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.⁸¹ In response, the Treasury persuaded Congress to enact the “constructive sale” rule in 1997. Under Section 1259, taxpayers recognize gain (but not loss), as if they have made a sale,⁸² whenever they use a short sale, forward contract, swap, or comparable

with collars is sometimes thought to be permissible.

⁷⁹ See Therese Cruciano, Individual Income Tax Returns 1995, available on www.irs.gov.

⁸⁰The most important of these rankings is sponsored by *Morningstar*. In my view, there is no satisfying answer to the puzzle of *why* funds are ranked in this imprecise way, since the more relevant number for taxable investors should be after-tax return. The usual answer is that investor’s tax positions are so varied that an after-tax ranking is not feasible. Although this is true to an extent, an after-tax ranking based on plausible assumptions should be feasible (e.g., 20% long-term capital gains rate, 39.6% short-term capital gains rate, etc.). Vanguard has been trying to develop such a ranking system, presumably because its passively managed funds do not trade as frequently and thus would fare well. Yet their ranking has not become the market standard, at least for now.

⁸¹Particular 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. The *New York Times* followed up with coverage of various other large hedging transactions. See Henriques & Norris, *Rushing Away from Taxes: The Capital Gains Bypass – A Special Report*, N.Y. Times, Dec. 1, 1996, at A1.

⁸²For consequences of a constructive sale, see Section 1259(a) (“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 realized with respect to such position for any gain or loss subsequently realized with respect to such position for any gain taken into account by reason of paragraph (1), and (B) the holding period of such position shall be determined as if such position were originally acquired on the date of such constructive sale.”).

transaction to eliminate “substantially all” of the risk of loss and opportunity for gain in an appreciated security.⁸³

This language reflects a political compromise. Many in the Treasury would have preferred a broader measure, but did not believe one could be enacted. Since members of Congress were thought to be committed to the realization rule,⁸⁴ the measure is limited to hedges that closely resemble sales. The securities industry was also lobbying to keep the reform narrow. 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

⁸³For a detailed discussion of the statutory language and technical issues it raises, see David M. Schizer, Hedging Under Section 1259, Tax Notes (July 1998). 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 as appreciated stock, debt, or partnership interests in 1259(b)(1)] 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 provided 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.

The common theme of these enumerated transactions, according to widely-cited legislative history, is that these “financial transactions . . . have the effect of eliminating substantially of the taxpayer’s risk of loss and opportunity for income or gain with respect to the appreciated financial position.” Comm. Rep. on P.L. 105-34, *reprinted in* CCH Standard Federal Tax Reporter, at 31,130.

⁸⁴Under the realization rule, tax is not due until appreciated property is sold.

then analyzes the strength, discontinuity, 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 tax benefit from hedging is deferral.⁸⁵ The longer the hedge lasts, the greater this benefit. Tax is avoided altogether if the hedge lasts until the taxpayer dies, since the basis in appreciated property “steps up.”⁸⁶ The higher the capital gains tax rate, the greater the benefit of delaying or avoiding the tax. In the same tax bill that enacted 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 main 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).⁸⁷ This combination of owning a put and selling a call is known as a “collar.”⁸⁸ Other

⁸⁵By deferring a tax, taxpayers can continue to invest, and earn a return on, money that otherwise would fund the tax. For a discussion, see David M. Schizer, *Realization as Subsidy*, 73 N.Y.U. L. Rev. 1549 (1998).

⁸⁶If 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 Section 1014.

⁸⁷The “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. The market convention is to use a spread equal to twenty percent of the hedged asset’s fair market value on the date of the hedge. This practice derives from a report of the New York State Bar Association. See New York State Bar Association Tax Section, *Comments on H.R. 846 3 (May 21, 1997)*, reprinted in 97 TNT 103-11. In the interests of full disclosure, I was a principal drafter of that report, but the 20% test reflects the consensus of the organization’s executive committee.

⁸⁸The legislative history directs the Treasury to develop standards for collars in prospective regulations:

derivatives, such as swaps and forward contracts, can offer the same result.⁸⁹

In some cases, taxpayers 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.⁹⁰ Under Section 1259, in contrast, a portion of the taxpayer's deferred 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, if the taxpayer has *no* confidence in the hedged asset, a taxable sale may be preferable. In my experience, though, investors usually accord *some* value to the retained exposure. For many, risk functions here as a weak, continuous friction. A key question is whether other frictions burden partial hedges.

3. Other Frictions

Four types of investors are considered. For those with stock worth less than \$1 million,

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. See Comm. Rep. on P.L. 105-34.

⁸⁹ See Schizer, *supra* note 83, at 351-53.

⁹⁰ In return, the taxpayer paid a modest (deductible) fee for borrowing the stock (e.g., less than one percent of the hedged asset's value), while foregoing any return on the five percent of proceeds that could not be withdrawn.

frictions are strongest. While short sales against the box were feasible for this group, over-the-counter derivatives are not. Under the commodities laws, these transactions are not enforceable for those with less than \$1 million of assets.⁹¹ Nor is deferral of only \$300,000 of tax⁹² enough to justify fixed costs, including fees of the legal advisor and securities dealer. At leading investment banks, “private client services” investment bankers, whose core business is to arrange hedges for individuals, generally will not undertake a transaction of this size. Since they cannot use over-the-counter derivatives, retail investors might use options transactions in public markets (e.g., to construct collars).⁹³ Yet in recent years, the term of most publicly-traded options (e.g., one year or less) has been too short to provide meaningful deferral, even if the taxpayer is willing to pay for tax advice.⁹⁴ This transaction will become more common as the market for long-term exchange-traded options (e.g., LEAPS and FLEX options) becomes cheaper and more liquid. In addition, vehicles may be formed in which small investors hedge together. For now, though, frictions can be meaningful for this group.⁹⁵

⁹¹ See supra note 46.

⁹² The taxpayer is assumed to have a basis of zero, a federal tax rate of 20%, and a state tax rate of 10%.

⁹³ For a discussion of the difference between over-the-counter and publicly-traded derivatives, see supra note 46 and accompanying text.

⁹⁴ Taxpayers can enter into a series of hedges, though. For instance, when the stock is at \$100, they 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 exception applies. See Section 1092(c)(4). The problem is that 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 put (where it is short-term capital gain).

⁹⁵ Since Section 1259 has an exception for short-term hedges (i.e., those covered within 30 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. 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, supra note 83.

In contrast, taxpayers with positions worth \$1 million to \$60 million are the core private client services clientele. Every major investment bank, as well as numerous boutiques, have active hedging desks for such clients. The necessary derivative can be supplied at a reasonable cost – a key difference between Sections 1259 and 1260, as discussed in Part III.⁹⁶ At two to three percent of the hedged asset’s value, the fee may seem high. But it is rarely paid in cash. Instead, clients give the dealer opportunity for gain (worth relatively more) to pay for protection from risk of loss (worth relatively less). As a result, clients pay in a currency, opportunity for gain, that they do not especially value.⁹⁷ Nor are the commodities laws an obstacle, since wealthier clients typically are exempt.⁹⁸ Taxpayers often also can receive up to 85% of the hedged asset’s value in cash, which can be reinvested.⁹⁹ Given the weakness of these frictions, these transactions are very common. The precise volume is difficult to ascertain. 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 the smaller ones, suggest that the volume is extremely high, perhaps on the order of \$100 billion a year or

My sense is that few are using this strategy.

⁹⁶The key difference is that dealers can use “dynamic” hedging to hedge these securities, but not ones needed to avoid Section 1260. For a discussion, see Part III.B.2, *infra*.

⁹⁷For example, assume the hedged asset is worth \$100; the right to put the asset for \$95 is worth \$10; the right to buy the asset for \$120 is also worth \$10; and the right to buy the asset for \$115 is worth \$13. In return for the put, the taxpayer will give the dealer – not a call at \$120 (worth \$10) but a call at \$115 (worth \$13). The dealer thus receives an extra \$3 of value, but in a form the client privately values at less than \$3. Dealers value this exposure at \$3, though, because they can convert it to cash through dynamic hedging, a process explained in Part III.B.2.

⁹⁸See *supra* note 46.

⁹⁹Theoretically, the margin rules could keep the taxpayer from extracting more than 50% of the hedged asset’s value in cash. This regime, which dates from the 1930’s, keeps investors from borrowing more than 50% of their securities’ value in certain circumstances. The theory is that too much margin borrowing can cause markets to crash, as investors sell in a falling market to pay their lenders. But this regime does not apply if the loan is not a “purpose” loan (i.e., to buy margin securities). Taxpayers also 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

more.

Positions worth more than \$60 million can be too large for securities dealers.¹⁰⁰ An alternative is to hedge in the public market. 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 (i.e., so the taxpayer keeps enough to avoid a constructive sale).¹⁰¹ 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.¹⁰² 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. Investment banks served this function in early transactions but a friction, the regulatory capital regime for securities dealers, has slowed this practice.¹⁰³ Instead, trusts are formed for this purpose. But frictions burden this

thought not to apply. For a discussion, see Appendix A.

¹⁰⁰ The dealer may be unable to hedge its own exposure on such a large transaction. For instance, a short squeeze becomes a greater concern.

¹⁰¹ 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. For instance, 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 some opportunity for gain (i.e., enough 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, *supra* note 7.

¹⁰² 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. "It would be unheard of," reported Daniel Budofsky, a partner at Davis Polk & Wardwell.

¹⁰³ In these so-called "rent the balance sheet" deals, the individual would issue a security, such as the one described above in footnote 101, *through* the investment bank, using its ability to register securities under the securities laws. The regulatory capital treatment is unfavorable, though. The dealer is "charged" for the public security (i.e., the public security is treated as a liability under the regulatory capital regime). But the private security obtained from the client is not "credited" (i.e., the dealer's supply of regulatory capital is not increased through holding this asset) because of the asset's illiquidity. Thus, by entering into these deals, dealers lose the ability to conduct other

variation as well. The trust may have to be registered as an investment company,¹⁰⁴ and large fees must be paid to organize and administer it.¹⁰⁵ As a result, although a significant volume of these transactions are done (approximately \$429 million in 1999), they are often abandoned for private transactions (including collars and forwards with securities dealers). As Appendix C shows, of twenty trust transactions filed with the SEC in 1999, only five were finalized.

Finally, public corporations sometimes have appreciated stock in other public corporations. Tax deferral is especially appealing because the federal corporate tax rate is high (i.e., 35% instead of the 20% long-term capital gains rate for individuals). Unlike individuals, who must interpose a trust, corporations can easily hedge by issuing public securities. In 1999, approximately five billion dollars of these securities were issued.¹⁰⁶ Fees to financial and legal advisors usually will be higher than if the underlying stock were sold (e.g., a three percent fee to the investment bank). 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. These regimes often (naively) treat these securities as debt, even though the return closely tracks the underlying equity.

business. Once this cost is factored into the fee, the transaction ceases to be attractive. For a discussion of the regulatory capital regime, see *supra* note 54.

¹⁰⁴See, e.g., *DECS Trust V*, Aug. 9, 1999 (describing status as nondiversified under Investment Company Act). Compare *Targets Trust IV*, Sept. 29, 1999, at 31 (indicating that trust need not register under Investment Company Act).

¹⁰⁵For instance, 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. See *DECS Trust V*, Aug 9, 1999, at 30.

¹⁰⁶A list of 1999 transactions is included in Appendix A. Their economic terms often are like those described in footnote 101, at least in the case of so-called “DECS.” In the 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, *supra* note 7.

Although hedging by corporations has been common, a change in the accounting rules has introduced an important new friction. Since July 1, 2000, FASB 133 has required corporations to mark derivatives to market, including these hedging securities.¹⁰⁷ This mark-to-market rule does not apply, though, to the underlying stock being hedged. Thus, if the hedged asset appreciates by 50%, this gain is not reflected in earnings, but the corresponding loss on the derivative would be.¹⁰⁸ This prospect of artificially volatile earnings has discouraged some corporations from hedging.¹⁰⁹ Yet it is too soon to assess this friction's influence. For some firms, accounting earnings are less important than cash flow or volume of customers.¹¹⁰ If earnings are important, firms may respond by issuing two figures: one following FASB 133, and the other correcting for it (e.g., by marking the hedged asset to market as well).¹¹¹

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

¹⁰⁷Mark-to-market accounting would not apply if so-called "hedge" accounting applied. Yet in many cases, hedge accounting reportedly would be unavailable. See generally Price Waterhouse Coopers, *A Guide to Accounting for Derivative Instruments and Hedging Activities* (1998).

¹⁰⁸For 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, FASB 133 – in focusing only on the derivative loss – will reduce earnings by \$30.

¹⁰⁹Volatility is introduced because FASB 133 also can *increase* earnings (e.g., if the stock price declines, triggering unreported losses matched by reported gains on the derivative). Whereas 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.

¹¹⁰Thus, cable companies have continued to engage in these transactions, as they are usually judged by the number of subscribers.

¹¹¹Others are discussing issuance of hedging securities through special purpose vehicles whose earnings would not be consolidated with the rest of the issuer's earnings.

detailed exploration is not attempted here.¹¹² Yet the insights here do have normative implications. In general, a transactional reform that actually 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.

However, 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 – not on the level of risk she takes.¹¹³ For reasons of administrability, our system traditionally has tested enrichment only when

¹¹²See Deborah H. Schenk, Taxation of Equity Derivatives: A Partial Integration Proposal, 50 Tax L. Rev. 571 (1995); Deborah L. Paul, Another Uneasy Compromise: The Treatment of Hedging in a Realization Income Tax, 3 Fla. Tax. Rev. 1 (1996); David A. Weisbach, Should a Short Sale Against the Box Be a Realization Event? 50 Nat. Tax J. 495 (1997).

¹¹³ See Shaviro, *supra* note 36.

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. 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. Thus, 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

More fundamentally, 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 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.

On the other hand, if the goal is to maintain or increase the tax on investments – a core assumption of this Article, as noted above – a contribution of Section 1259 is to persuade would-be-hedgers to make taxable sales (i.e., because, in some cases, the need to retain risk is a sufficiently strong friction). These sales can advance vertical equity in raising the tax burden on

wealthy investors.¹¹⁴ Since sales are cheaper than hedges, efficiency is enhanced as taxpayers forgo wasteful hedging costs.¹¹⁵ 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 positions worth less than \$1 million. Indeed, in 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 1998.¹¹⁶ Robust receipts in later years have contributed to the current 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.¹¹⁷

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

¹¹⁴It is assumed here that the rate structure and other features of the tax system do not already attain the desired distribution of tax burdens.

¹¹⁵Nor are these sellers "locked in" to investments they would not keep in the absence of taxes (although, if they were hedging, they also would not be "locked in").

¹¹⁶Therese Cruciano, Individual Income Tax Returns, Preliminary Data, 1998, available on www.irs.gov.

¹¹⁷The revenue estimate for Section 1259 is surprisingly modest: \$ 367 million in 1998; \$ 121 million in 1999; \$ 68 million in 2000; \$ 73 million in 2001; \$ 79 million 2001; \$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 first five years an \$ 1,199 million in the first ten. See Jt. Comm. Taxation, Comparison of the Estimated Effects of the Revenue Provisions of H.R. 14 as Passed by the House and Senate. 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 Michael J. Graetz, Paint-By-Numbers Tax Lawmaking, 95 Colum. L. Rev. 609, 670 (1995).

may learn eventually, and so the symbolic benefits would not last.

Balanced against these benefits are significant costs. In addition to 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 public corporations is quite high. Vertical equity concerns also arise because wealthiest taxpayers are least affected by the rule.¹¹⁸ Nor could the Treasury stop this avoidance without further legislation, a politically difficult step.¹¹⁹

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

It is worth noting, though, that a broader rule would block far more hedging. For instance, the test might be – not whether the hedge “substantially eliminates,” but whether it

¹¹⁸There 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 is needed, though.

¹¹⁹While 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, to use the “substantial diminution” test discussed below -- would require legislation.

“substantially diminishes” – risk of loss and opportunity for gain. This formulation, borrowed from the straddle rules,¹²⁰ is much harder to avoid, and my guess is few would try.¹²¹ Even so, a broader rule 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, signing a contract to be acquired probably satisfies 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). Likewise, we may not want very short-term hedges to 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. Indeed, when Section 1259 was proposed, exceptions were added for certain acquisitions of a business¹²² and for certain short-

¹²⁰See Section 1092(c)(1) (“The term ‘straddle’ means offsetting positions with respect to personal property.”); Section 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 with respect to personal property (whether or not of the same kind).”). The straddle rules were passed to deal with a somewhat different transaction. If a taxpayer has offsetting positions (e.g., contracts to buy and sell silver), the realization rule would allow her to generate an artificial timing benefit by closing out the loss on December 31 (and thus deducting the loss this year) while closing out the gain on January 1 (and deferring the taxable gain until next year). In response, the straddle rules defer the loss until the offsetting gain is recognized. 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. 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. One of the few points on which there is certainty is that diversification alone does not trigger this test. See Conf. Rep. on P.L. 97-34, *reprinted in* CCH Standard Federal Tax Reporter, at 55,081. In contrast, opinions about “substantial elimination” under Section 1259 are commonplace.

¹²¹Professor Schenk has offered another alternative that is harder to avoid than Section 1259. 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 basis of \$0 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).

¹²²The New York State Bar Association raised this issue, see NYSBA *supra* note 87, and the Treasury responded with Section 1259(c)(2). For a discussion of issues presented by this exception, see Schizer, *supra* note 83, at 349.

term hedges.¹²³ Other refinements would also be needed, but this topic is too extensive to be addressed here.

In any event, a broad rule was considered politically unattainable by reformers, and my sense is they were correct. Could the political capital devoted to Section 1259 have yielded a different reform with a more favorable balance sheet? This question is too far-reaching to be explored here, but one point should be noted. The high-profile hedging transactions that prompted Section 1259 were exploiting two tax rules: not just the realization rule, but also the step up in basis at death of Section 1014. It is possible that targeting the latter rule, which is widely acknowledged as a policy monstrosity,¹²⁴ would have made better use of the political opportunity created by the media's focus on hedging. For instance, the basis step-up could have been revoked for any property that was hedged (e.g., under a broad "substantial diminution" standard) within three years of the taxpayer's death.¹²⁵ Of course, such a proposal raises many issues (e.g., the administrability of a carryover basis rule or of taxing gains at death, interaction with the estate tax, the possibility of worsening lock-in, etc.), but a comprehensive analysis is

¹²³In response to a lobbying effort by the securities industry, the government added the short term hedging exception of Section 1259(c)(3). As proposed by the government, the original short-term exception was too broad. After the New York State Bar Association flagged this problem, see NYSBA *supra* note 87, the government narrowed the exception. See Schizer, *supra* note 83, at 348-49. 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 than more than a minimum total number of days in any taxable year (e.g., 90, as opposed to the 300 permitted under current law).

¹²⁴ See, e.g., Stanley Surrey & Jerome Kurtz, *Reform of Death and Gift Taxes: The 1969 Treasury Proposals, the Criticisms, and a Rebuttal*, 70 *Colum. L. Rev.* 1365, 1381 (calling step-up in basis at death the "most serious defect in our federal tax structure").

¹²⁵ Section 1259 narrows Section 1014 in a much more limited way. The reform revokes the basis step-up for property subject to constructive sales that are not closed within a minimum amount of time after the date of enactment.

beyond this Article's scope.¹²⁶

III. CONSTRUCTIVE OWNERSHIP: WHEN FRICTIONS ARE STRONG

Two years after Section 1259 was enacted, Congress added Section 1260. 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.¹²⁷ Yet the common method of avoiding Section 1259 – 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 derivatives cannot be used 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 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, Congress reduced the attractiveness of investment strategies that involve frequent trading, and thus do not generate this tax-preferred return. Most hedge funds¹²⁸ use such strategies to earn impressive pretax returns. As partnerships for tax purposes, though, they pass their profits through to investors as short-term capital gain, taxable in the current year. In response, investment bankers and their tax

¹²⁶For an insightful discussion of implementation issues associated with taxing gains at death, see Lawrence Zelenak, *Taxing Gains at Death*, 46 *Vand. L. Rev.* 361 (1993).

¹²⁷After Congresswoman Kennelly left the House for an unsuccessful gubernatorial bid in Connecticut, Representative Neal of Massachusetts became the chief sponsor of the bill.

¹²⁸For a description of hedge funds, see *supra* note 9.

advisors developed a way to convert these appealing pre-tax 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. No tax was due until the derivative was settled, and gains were taxed at long-term rates if the taxpayer held the derivative for at least a year.¹²⁹ 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, then, the investment bank would become a partner in the fund, and would use a derivative to transfer the economic return to clients.¹³⁰

After the transaction attracted media attention,¹³¹ Congress responded (with lukewarm support from the Treasury) by enacting the constructive ownership rule of Section 1260. Closely based on Section 1259, Section 1260 applies to derivatives that simulate the return of a hedge fund or other pass-through entity¹³² by offering the holder substantially all of the risk of loss and opportunity for gain from the underlying asset.¹³³ If this hauntingly familiar test is satisfied,

¹²⁹Unlike 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 Section 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 Steinberg, *Over-the-Counter Derivatives for High Net Worth Individuals*, in *Derivatives in Tax Planning* (Frank Fabrozzi ed. 1998).

¹³⁰The 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, *reprinted in* 98 TNT 136-38 (July 16, 1998). 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 in 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-marked (ordinary) losses on the derivative. For a discussion, see Schizer, *supra* note 26.

¹³¹See, e.g., E.S. Browning, *Where There's a Tax Cut, Wall Street Finds a Way*, *Wall St. J.*, Oct 21, 1997, at C1.

¹³²Other pass-through entities include RICS, REITS, S Corporations, passive foreign investment corporations, and foreign personal holding companies. See Section 1260(c)(2).

¹³³The definition of a constructive ownership transaction is based on, and closely tracks, Section 1259's definition of a constructive sale (found in *supra* note 83). Under Section 1260(d)(1):

The taxpayer shall be treated as having entered into a constructive ownership transaction with respect to any

certain long-term capital gain earned on settlement of the derivative is recharacterized as ordinary income, and an interest charge is imposed to compensate the government for tax deferral.¹³⁴

B. Frictions and Avoidance

Notwithstanding the similarity of the statutory formula, the result has been different. 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. Although each transaction offers deferral, and the possibility of tax forgiveness if the taxpayer dies, deferral opportunities are greater in hedging appreciated assets. For these, significant built-in gains are already present when the transaction begins. With a derivative based on an investment fund, in contrast, only gains earned *after* the transaction begins can be deferred. 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 (i.e., from 39.6% to 20%).¹³⁵

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.

¹³⁴Specifically, 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. In imposing the interest charge, Section 1260 assumes that the gain accrued ratably. See Section 1260(a) (“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 . . .”); Section 1260(b) (imposing interest charge on recharacterized gain).

¹³⁵See Appendix D for a numerical example illustrating the tax benefit offered by Section 1260.

In assessing the tax benefit of avoiding Section 1260, a caveat is important: These benefits, deferral and reduction of the rate, are appealing *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 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).¹³⁶ 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: 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 (e.g., by selling a put with a \$95 exercise price), while enjoying opportunity for gain above \$115 (e.g., 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, legal disparities 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.¹³⁷ The statutes themselves are also different in their treatment of forward

¹³⁶If taxpayers could not accelerate losses in this way, the value of the hedge fund transaction, ex ante, would be diminished considerably. Cf. Joseph Bankman & Thomas Griffith, *Is the Debate Between an Income and a Consumption Tax a Debate About Risk? Does it Matter?*, 47 *Tax L. Rev.* 377, 396-400 (1992) (arguing that, under assumed conditions, tax burden on return to risk is irrelevant because taxpayers will offset tax by increasing riskiness of the portfolio). If the fund depreciates, the dealer will be willing to settle the derivative early. Were the dealer governed by the same tax rule as the customer, early settlement would accelerate – not just the customer's losses – but also the dealer's gain. The dealer's tax bill would increase by the same amount the customer's tax bill declines, assuming the same rate applied. Yet the dealer is required to mark the derivative to market under Section 475. Thus, early termination has no effect on the dealer's tax bill. For a discussion, see Schizer, *supra* note 26, at 1372.

¹³⁷ For citations to this legislative history under Section 1259, see *supra* notes 83 and 88. No such references

contracts. Indeed, 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.¹³⁸ Nevertheless, the statute is more generous with options and equity swaps.¹³⁹ If these derivatives are used, the relevant statutory test is sufficiently similar to Section 1259 that comparable avoidance strategies 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. These frictions affect the securities dealer counterparty. First, even the transaction that prompted enactment of Section 1260, a derivative offering the *entire* fund return, had an important strike against it. To hedge the derivative, the dealer would hold the fund interest. But this illiquid position is treated unfavorably under regulatory capital rules for dealers. Because the capital invested in the fund is deemed unavailable to meet other obligations, the dealer may have to raise additional equity capital.¹⁴⁰ This cost does not arise to the same extent

appear in the legislative history for Section 1260. See Comm. Rep. P.L. 106-170. The reason, I believe, is that the bounds of this test were reasonably well understood, since the standard was consciously lifted from Section 1259.

¹³⁸See Section 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 omits forward contracts in which the amount of property delivered varies significantly with the value of the underlying property. See Section 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. The Treasury has not yet used this authority.

¹³⁹With a pair of options, the regime is avoided as long as their exercise prices are not “substantially equal.” See Section 1260(d)(1)(C) (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 Section 1260(d)(3) (person has “long position under 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 asset”). The standard under Section 1259 is identical in all relevant respects. See Section 1259(d)(2) (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”).

¹⁴⁰Specifically, the derivative issued to the customer was treated as a liability, but the hedge fund held by the dealer was not “credited” in full as regulatory capital. As a result, the transaction drained the dealer's supply of regulatory capital for other activities. For a discussion of this problem, see *supra* note 54.

for derivatives based on publicly-traded assets, such as those used to avoid Section 1259, because these are hedged with liquid positions in the public market.

Once the derivative must convey *less than all* of the hedge fund's economic return – a requirement for avoiding Section 1260 – the dealer faces an additional problem. A perfect hedge of the derivative is not available. 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 (i.e., through the put).

Why is it important for securities dealers to hedge? Their business is to provide a service (i.e., derivatives to those who want them), not to place bets on hedge funds. It is not usually 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. 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 (or, for that matter, shareholders) to distinguish such sensible bets from less sensible ones. Nor can employees be trusted to take only well compensated risks, since pay is tied to volume of business. In response, major investment banks generally have very strict risk-management policies for derivatives dealers. 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 (i.e., when avoiding Section 1259), risk becomes a strong 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.¹⁴¹ 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 the correlation of underlying stock prices with the derivative's value. To see such correlation, assume a share of stock is worth ten dollars, 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 one dollar increase in the stock price, from ten to eleven dollars, 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).

This sensitivity of a derivative to changes in the underlying stock's value, known as "delta," is used by dealers in so-called "dynamic" hedging.¹⁴² For instance, assume a collar leaves a dealer exposed to risk of loss below \$95 and opportunity for gain above \$115 on 1000 shares of a publicly traded stock. For every dollar change in the underlying's value, this 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. There is a gap between \$95 and \$115. 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 80 cent change in the collar's value, the dealer's offsetting short would be 80% as large (e.g., shorting 800 shares to hedge a collar on 1000 shares).¹⁴³ Delta will vary as the

¹⁴¹Assume 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 (i.e., because opportunity for gain on the call begins at \$115).

¹⁴²See generally, Nassim Taleb, *Dynamic Hedging: Managing Vanilla and Exotic Options* (1997); P.J. Hunt & J.E. Kennedy, *Financial Derivatives in Theory and Practice* (2000).

¹⁴³If delta is .8, then as the price of the underlying falls from \$100 to \$99, the dealer would lose 80 cents per share on the collar (because the reduced likelihood of profiting from the \$115 call the dealer has purchased, and the increased likelihood of having loss on the \$95 put the dealer has sold). Total loss on the collar would be \$800 (i.e., .80 * 1000 shares). To make up for this loss, the dealer must short 800 shares, thereby earning \$1 per share, or \$800.

underlying stock price changes, reflecting different probabilities that the derivative will yield a profit or loss.¹⁴⁴ Thus, the dealer must constantly monitor delta and make corresponding adjustments in the size of the hedge.

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, and such a rich supply of data is available only for a publicly traded asset.¹⁴⁵ Second, constant adjustments in the size of the hedge are feasible only in an extremely liquid market -- and certainly not with a hedge fund, which might allow redemptions only four times a year.¹⁴⁶

3. Responses

Notwithstanding these frictions, some transactions are still possible. Six alternatives warrant discussion. The first three attempt to salvage the derivative with a modified return. The fourth still uses a derivative, but moves it offshore instead of changing the economic return.

¹⁴⁴For instance, if the stock price is \$100, the stock price must climb to \$115 before the dealer will begin to profit from the call it owns with a \$115 exercise price. An increase from \$100 to \$101 thus will not induce a full \$1 of appreciation on the option, given the relatively low probability that the price will attain the \$115 level. On the other hand, a price increase from \$215 to \$216 will have a much greater influence on the \$115 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.

¹⁴⁵If the dealer knew the details of the fund's trading strategy, the dealer could use this information to hedge. Yet funds are secretive about their trading strategies. This trade secret justifies high management fees. An additional friction for this transaction, which also applied to the pre-1260 variety, is that some hedge funds do not allow a securities dealer to invest. They do not want the dealer to gain enough access and information to duplicate the trading strategy.

¹⁴⁶Just as Section 1260 is effective in blocking hedge fund derivatives, it also is effective in blocking derivatives based on mutual funds. These are also covered by Section 1260. There was less demand for such transactions, though. In part, many mutual fund investors are not wealthy enough to engage in over-the-counter derivatives transactions, given transaction costs and the wealth requirements of the commodities laws. In any event, Section 1260 is effective because mutual fund redemptions (e.g., once a day) generally are not frequent enough to support dynamic hedging. However, this constraint does not apply to exchange-traded funds, which are a new presence in the capital markets. For now, these funds are based on indices, and so they do not pass through enough capital gain to justify substituting a derivative. Yet in the coming years, actively-managed funds will start to be traded on exchanges. See Danny Hakim, *Market Place: Two Reports See Exchange-Traded Funds as a Logical Extension for Mutual Fund Companies*, *Wall St. J.*, July 27, 200, at C10 (most exchange-traded funds provide a set pool of stocks, but introduction of actively managed funds is expected in the next one or two years). At that point, we may see transactions designed to avoid Section 1260. The more general point is that frictions change over time.

Anecdotal evidence suggests that these four are relatively rare. 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.

a. Responses Involving Derivatives

First, while unhedged risk of loss is unacceptable to dealers,¹⁴⁷ unhedged opportunity for gain is less of a concern. For example, assume a dealer purchases a hedge fund interest for \$100. The dealer might purchase a \$100 put from a client and sell a \$120 call. 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. The reason, as discussed above, is that dealers are experts at supplying liquidity, not making investments. They also avoid holding risky assets to remain creditworthy, a necessary quality in a business of undertaking obligations. As a result, clients reportedly 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). 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 portfolio on their creditworthiness. If this transaction becomes common, it would illustrate the point that frictions can prove unstable. For now, my research suggests this friction remains effective.

¹⁴⁷For instance, an investment bank would bear significant risk of loss in selling an at-the-money call option while holding the underlying fund. If the hedge fund declined by more than the premium the bank had received, the bank would lose money on the deal. One investment bank reportedly offered this structure before Section 1260 was enacted (apparently because the tax analysis under common law was stronger, i.e., that the client did not own the underlying fund interest). Yet the investment bank suffered significant losses, and no longer offers this structure. Likewise, several investment bankers and advisors mentioned this precedent in explaining that their institution could not be exposed to risk of loss.

Instead of paying for this exposure, dealers have looked for ways of giving this return to the client. For example, the client could receive no payment as the fund appreciates 20%, 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., two dollars 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. Yet this “catch-up” structure 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.

Since the dealer does not value the exposure between \$100 and \$120 and, for tax reasons, the client should not take it, a third approach is to transfer this exposure to an unrelated third party.¹⁴⁸ The dealer would thus sell the right to this appreciation as a separate “stub” security. After collecting payment for the stub, the dealer could 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 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. The practical effect is the stub must have an uncertain term, terminating whenever the main derivative terminates. This requirement will reduce the price an investor would pay. Even if these problems could be solved

¹⁴⁸The 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, though, there is no explicit authority in Section 1260 to consider the activities of related parties, as there is in Section 1259. The Treasury should use its regulatory authority to fill this gap.

– for instance, by forming a fund that regularly buys stubs – individual investment bankers may not consider the task worth their time. Cultivating a stubs market would be a slow process with an uncertain return. Investment bankers usually have a short time horizon. They want results in time for their annual bonus. In this mobile market, bankers 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, risks and expenses are borne by the innovator, for instance, in educating the market, but rewards must be shared. If the stubs market catches on, others will sell them too, thereby reducing the innovator’s expected profits.

Instead of changing the derivative’s economic return, taxpayers could hold the derivative through an offshore corporation. As a result, the taxpayer no longer owns a derivative, at least directly. Instead, she owns common stock in a corporation, an investment not explicitly covered by Section 1260. Nor does Section 1260 apply to the corporation itself, as long as the entity is not subject to U.S. tax (e.g., if based offshore without business effectively connected to the U.S.). 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, other anti-abuse rules can impose adverse tax consequences on U.S. taxpayers who make passive investments through offshore corporations, including the passive foreign investment company (“PFIC”)¹⁴⁹ and controlled foreign corporation (“CFC”)¹⁵⁰ rules. While a comprehensive examination of these regimes is beyond this Article’s scope, it should be noted that these regimes complicate matters, but do not necessarily block the transaction.¹⁵¹ Rather, the real vulnerability is caused by Section 1260 itself. In addition to covering a list of derivatives transactions, which

¹⁴⁹See Section 1291 et seq.

¹⁵⁰See Section 951 et seq.

¹⁵¹For instance, if the entity is a PFIC, the taxpayer could make a so called qualified electing fund (“QEF”) election. See Section 1295. The corporation thus is taxed on a pass-through 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? As an economic matter, a portion of this gain would derive from the derivative. However, this gain arguably would not be recharacterized because Section 1260 has not been triggered yet.

admittedly does not include this structure, Section 1260 also provides regulatory authority to cover “transactions . . . having substantially the same effect” as the listed ones.¹⁵² The government could easily shut down this structure through a notice that retroactive regulations will cover it. Indeed, the possibility of this action is already a fairly effective deterrent. Volume reportedly is modest.¹⁵³

b. Responses Not Involving Derivatives

Section 1260 thus has been quite effective in blocking structures that use derivatives to improve the tax treatment of hedge fund returns. To an extent, though, it is still possible to improve the tax treatment of these returns – not through derivatives, but through insurance contracts and offshore insurance companies.

Before describing these strategies, a broader point should be made. Avoidance is avoidance, whether taxpayers are using derivatives, insurance, or something else. Either way, less revenue is collected, social waste could increase, and the distribution of tax burdens could be skewed. As we shall see, though, the volume of avoidance through insurance is constrained, to an extent, by other frictions. More importantly, the Treasury already has regulatory authority to shut these transactions down. Legislation, and the political challenges it entails, are not needed to make Section 1260 more effective. As we have seen, the same cannot be said for Section 1259.

One strategy for securing tax-advantaged hedge fund returns is to buy a variable life insurance policy or annuity offering one or more hedge funds as investment options.¹⁵⁴ This is, of

¹⁵²Before Section 1260 was enacted, the New York State Bar Association suggested clarification that the “substantially the same effect” catch-all covered this offshore structure. See New York State Bar Association Tax Section, Comments on Constructive Ownership and H.R. 1703, *reprinted in* 1999 TNT 135-33 (1999). No language or legislative history was added, presumably because the drafters already thought the point was clear. In the interests of full disclosure, I was the principal author of the NYSBA report.

¹⁵³Taxpayers 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 increases transaction costs. In addition, the regulations might still apply, as long as the government undertakes to bifurcate or look through the common stock.

¹⁵⁴In such a policy, the taxpayer would pay a fixed fee. The size of the death benefit or annuity payments would depend upon performance of an asset the taxpayer designates from a range of options.

course, an old planning strategy. 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.¹⁵⁵ These contracts offer a way to avoid tax burdens on any number of investments (e.g., bonds, mutual funds, and the like). Thus, these contracts can substitute for derivatives listed in Section 1260, to an extent, by offering favorable timing consequences: deferral, or even forgiveness if the contract lasts until death. As long as the tax system views the insurance company as the partner in the hedge fund,¹⁵⁶ the taxpayer does not have current inclusions as a hedge fund partner. As with a derivative, tax is deferred until payments are received.¹⁵⁷ Life insurance proceeds, moreover, are never taxed if received upon death of the insured,¹⁵⁸ a result as favorable as the basis step-up for derivatives held until death.¹⁵⁹

Nevertheless, tax treatment is not as favorable as under pre-1260 rules for derivatives because character of payments received before death is ordinary.¹⁶⁰ Indeed, a hedge fund itself yields better character, since *some* investment return will satisfy the long-term holding period. In addition, life insurance and annuities present frictions of their own. Most importantly, favorable tax treatment is available only if the taxpayer places a mortality bet. Otherwise, the contract will not qualify as life insurance or an annuity for tax purposes. The extra cost or risk associated with this bet is unattractive to some. These policies also can be subject to high excise taxes (e.g., one

¹⁵⁵See generally Marvin A. Chirelstein 29-36 (Rev. 8th ed. 1999) (discussing tax treatment of insurance and annuities).

¹⁵⁶Like securities dealers, insurance companies are subject to mark-to-market accounting on assets in so-called segregated accounts. As a result, the insurance company does not experience adverse timing consequences on its offsetting positions.

¹⁵⁷On the tax treatment of annuities, see Section 72; see also Chirelstein, *supra* note 155, at 29-32.

¹⁵⁸See Section 101. Life insurance can offer the added benefit of avoiding estate tax if the policy is held in a way that excludes it from the taxpayer's estate.

¹⁵⁹This benefit may not be available for annuities, depending upon how they are structured. Annuities often cease making payments upon the death of the annuitant.

¹⁶⁰See Section 72(a).

percent of the premium).¹⁶¹ Insurance companies are reputed to charge higher fees than investment banks, although further research on this point is warranted.¹⁶² For small insurance companies, moreover, credit risk is a concern.

Notwithstanding these frictions and the unavailability of long-term capital gain, insurance and annuity contracts are becoming an increasingly common method of securing tax-advantaged hedge fund returns. To an extent, this phenomenon is part of a broader problem. Efforts to tax most investments can be avoided, to an extent, if insurance and annuities are not also covered. The extent of this avoidance depends on the frictions described above, and more research is needed on this point. On the narrower question of hedge fund returns, though, Section 1260 arguably extends even to insurance and annuities. The Treasury has regulatory authority to cover transactions having “substantially the same effect” as the enumerated ones. In my view, this language is broad enough for regulations on annuities and insurance contracts that offer tax-deferred hedge fund returns, although the case is not free of doubt.¹⁶³ While writing a regulation could take time, the Treasury could stop the practice immediately with a brief notice that regulations will be issued with a retroactive effective date.

Alternatively, instead of buying an insurance policy, taxpayers might 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. Instead of a partnership, the fund is structured as a corporation. Thus, investors are not liable every year for tax on the fund’s trading profits.

¹⁶¹ See Section 4374 (imposing 1% excise tax on premiums paid to foreign insurers).

¹⁶² Taxpayers will also have limited choices as to which hedge fund’s return will be reflected in their policy. The tax analysis is stronger if the particular hedge fund’s return is available to *all* policy holders (since, under general substance over form principles, the insurance company is more likely to be viewed as the hedge fund partner, instead of the policy holder). Given the cost of making an investment in a particular fund generally available, insurance companies are likely to offer only certain funds, but not others.

¹⁶³ The counter-argument is that the effect is not “substantially the same” for two reasons. First, the economics of the transaction are different because of mortality risk. Second, the tax result is different because the character here is ordinary. While these arguments have some force, their persuasiveness depends on the scope of the regulations (e.g., whether they exempt policies with substantial mortality risk) and, ultimately, on the degree of discretion the Treasury is thought to have in writing regulations.

Instead, investors pay no tax until they sell their fund interest. Long-term capital gain rates apply to investments of more than one year. To keep the fund itself from paying U.S. (or other) income tax, the fund is established in a tax haven (e.g., Bermuda). Such offshore “incorporated pocketbooks” are an old abuse, targeted by several 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.¹⁶⁴ 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 key here, though, is that the PFIC regime does not apply to insurance companies, a statutory exception not yet elaborated by regulations.¹⁶⁵

For the fund to qualify as an insurance company, frictions must be introduced. These will deter some taxpayers. First, the fund must bear some mortality or casualty risk.¹⁶⁶ Yet especially because these risks are actuarially predictable, risk is likely to function here as a continuous friction, as in 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

¹⁶⁴Other regimes include the controlled foreign corporation regime, see Section 951 et seq., the foreign personal holding company regime, see Section 551 et seq., and the personal holding company regime, see Section 541 et seq. But these rules generally apply only if the taxpayer owns more than a minimum percentage of the entity. These rules thus can be avoided if taxpayers purchase, for instance, interests of less than 10%.

¹⁶⁵To be precise, foreign corporations qualify as PFICS if more than a minimum percentage of their income or income-producing assets are passive. See Section 1297(a). Income from “the active conduct of an insurance business” generally is deemed not to be passive. See Section 1297(b)(2) (“Exception 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.”).

¹⁶⁶As 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. See Section 1297(b)(2). 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. See Treas. Reg. 1.801-3(a)(1) (“The term ‘insurance company’ means a company whose primary and predominant business activity during the taxable year is issuing 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 year which determines whether a company is taxable as an insurance company under the Internal Revenue Code.”).

investments supposedly is to fund insurance liabilities.¹⁶⁷ If these reserves dwarf the liabilities, it is not credible to claim that the fund is an insurance company. One solution is to sell more insurance (although this means accepting more insurance risk). Instead, in some cases the fund may have to return (taxable) cash to investors.¹⁶⁸ Third, insurance regulations and credit rating agencies may not allow some kinds of risky assets or trading strategies. But these constraints are not always strict, for instance, if offshore regulators are eager to attract new insurers. Finally, offshore insurance firms may incur a one percent excise tax on premiums, and 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.¹⁶⁹

This transaction is becoming fairly common, although I do not know exactly how common. Some of this volume reportedly 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. This is an easy step, mechanically, since the Treasury could issue a brief notice that retroactive regulations are forthcoming. 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,

¹⁶⁷The general principle is that reserves should be consistent with the reasonable needs of the insurance business. See, e.g., Treas. Reg. 1.801-4 (a) (defining "life insurance reserves" as reserves based on actuarial predictions, reserves designed to fund insurance liabilities, and reserves required by law).

¹⁶⁸Distributions or pro-rata redemptions would be treated as dividends taxable in full at ordinary rates. Certain non-pro-rata redemptions would be taxed at capital gains rates, with a basis offset.

¹⁶⁹The excise tax is four percent of premiums paid on a policy of casualty insurance or an indemnity bond, and generally one percent on all other premiums, including life insurance and reinsurance. See Section 4371. The excise tax does not apply to an amount effectively connected with the conduct of a trade or business in the U.S., unless this amount is exempted from U.S. tax under a treaty. See Section 4374.

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 key point is that stopping a particular tax-motivated use of derivatives – as was achieved in Section 1260, but not in 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 will seldom be enough. On the other hand, a series of targeted measures (e.g., one aimed at derivatives, another at offshore insurance companies, etc.) sometimes can stop a popular planning objective such as tax advantaged hedge fund returns. Similarly, *adding* one reform can be significant, if others already are on the books. For this 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.

Of course, as with Section 1259, there is a threshold question, beyond this Article's scope, whether investment returns should be taxed and, if so, at what rate. Indeed, much ink has been spilled about whether there *ever* should be a preferential rate for capital gains.¹⁷⁰ 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. The theory might be that speculation is a zero sum game from society's perspective,¹⁷¹ or that short-term investors do less socially useful

¹⁷⁰For a summary of this literature, see Noel B. Cunningham & Deborah H. Schenk, The Case for a Capital Gains Preference, 48 Tax L. Rev. 319 (1993).

¹⁷¹Cf. Lynn Stout, Why the Law Hates Speculators: Regulation and Private Ordering in the Market for OTC Derivatives, 48 Duke L.J. 701 (1999) (discussing whether speculation is a zero-sum game).

monitoring of management. Under these theories, the preference 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 are less 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.¹⁷²

On the other hand, if the objective is to maintain or increase the tax – which, again, is a core assumption of this Article – Section 1260 makes two contributions. Like Section 1259, the rule offers symbolic benefits. More than Section 1259, moreover, the rule actually stops the targeted derivatives transaction. Taxpayers no longer have a tax reason to invest in hedge funds through derivatives, instead of directly. Efficiency is enhanced because the higher costs of derivatives are avoided (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 with Section 1259, this response is unlikely because of a discontinuous friction: the ability of dealers to hedge “total return,” but not a “partial return,” hedge-fund derivative.

Section 1260 is not cost-free, though. It imposes new compliance and administrative costs. Nor is the measure successful if taxpayers respond with more drastic methods of avoidance, such as 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 (e.g., as taxpayers assume mortality risk they do not want) without raising revenue, and could also redistribute wealth in questionable ways (e.g., a transfer of fee income from securities dealers to insurance firms). The net effect of Section 1260 depends on the balance

¹⁷² Through a “rollover” rule, for instance, tax would be deferred on any gain that was reinvested. See, e.g., Cynthia Blum, Rollover: An Alternative Treatment of Capital Gains, 41 Tax L. Rev. 385 (1986).

of these competing effects, and further empirical research is needed.

To an extent, though, we know that frictions impede such avoidance. For instance, even though an indexed mutual fund provides better tax treatment, pretax returns are not comparable. Put simply, in my experience wealthy people like hedge funds. As discussed above, insurance contracts and offshore insurance companies represent more viable methods of avoidance. However, these transactions could be shut down with a surgical Treasury response – without need for legislation, and the political obstacles associated with it. With these adjustments, a narrow measure here would be effective. The contrast with Section 1259 is stark, even though the two share essentially the same statutory standard.

IV. 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. Repair of the inconsistency is off the table for political or administrability reasons. Instead, a narrow response is lobbed at the particular transaction. This transactional reform can yield symbolic benefits in the short run. But the system becomes more complex. Even worse, planners may respond with variations that avoid the rule. Thus, social waste may increase, while revenue from wealthy taxpayers may not.

These realities raise questions about the whole enterprise of transactional reforms. Yet for now, more comprehensive responses lack political support. One contribution of commentators is to build this support. Another, which is the focus of this Article, 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 strong discontinuous friction blocks a transaction, the tax law does not have to block it too. To

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

Appendix A: Comparing Return from Selling and Hedging

This Appendix compares returns from a taxable sale and various hedges. The appreciated asset is assumed to be 100,000 shares of publicly-traded stock, each 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: that is, the taxpayer delivers the appreciated property to settle the hedge (and thus is taxed). This assumption is needed to simply and clarify the comparison with sales, but understates the benefits of hedging. To attain greater tax deferral, the taxpayer could instead settle the hedge in cash (i.e., so no tax is due on the hedged asset) and then could enter into a second hedging transaction.

Assumptions are also needed about market prices and rates of return. 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%, except the discount on a secured prepaid forward is 6.5%. The cost of borrowing stock is .5% of its initial value (and, for simplicity’s sake, this amount is assumed not to fluctuate with the stock’s value). 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 \$130 (i.e., a call option with a \$130 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 \$130, which is generally worth about 3% of the asset’s value. For individuals, the tax on capital gains is 30% (i.e., 20% federal and 10% state) and the tax on ordinary income is 50% (i.e., 40% federal and 10% state). For corporations, the tax on all income is 45% (i.e., 35% federal and 10% state).

I. HEDGING / SALE FOLLOWED BY FIXED-INCOME INVESTMENT

Part I describes results when taxpayers either sell or hedge and then reinvest 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 underlying stock (i.e., 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.

A. 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.

1. Taxable Sale

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

<i>Year</i>	<i>Bond Initial Value</i>	<i>Pretax Return</i>	<i>After-tax Return</i>
1	\$7,000,000	\$350,000	\$175,000
2	\$7,175,000	\$358,750	\$179,375
3	\$7,354,375	\$367,718.80	\$183,859
4	\$7,538,234		

2. 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 earned on these Treasuries minus fees paid for borrowing stock, plus \$7 million (i.e., the \$10 million locked in on the hedged asset minus \$3 million in taxes). Thus, after three years she will have **\$7,653,570.30**, which is \$115,335.90 more than if she made a taxable sale:

<i>Year</i>	<i>Initial Value</i>	<i>Bond Return</i>	<i>Borrow Fee</i>	<i>Pretax Net</i>	<i>After-tax Return</i>
1	\$9,500,000	\$475,000	\$50,000	\$425,000	\$212,500
2	\$9,712,500	\$485,625	\$50,000	\$435,625	\$217,812.50
3	\$9,930,313	\$496,515.60	\$50,000	\$446,515.60	\$223,257.80

Total After-tax Return;	\$653,570.30
Total After-tax Value:	\$7,653,570.30
Advantage Over Taxable Sale	\$115,335.90

3. Collar

As the collar entitles the taxpayer to sell the stock for \$100 in three years, she will have a minimum of \$10,000,000 pre-tax, or **\$7,000,000** 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 \$653,570.30). The difference is that, in the latter two scenarios, the taxpayer received the \$7,000,000 million at the outset and reinvested it in a profitable investment (i.e., the Treasuries). In the collar, in contrast, the taxpayer will have an amount higher than \$7,000,000 – and, indeed, higher than the returns offered in the two other cases – 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 riskier. (While the taxpayer could borrow against the collar's value to invest in a Treasury, the transaction makes no sense because the taxpayer's borrowing cost will exceed the Treasury yield).

B. Corporate Taxpayers

1. 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:

<i>Year</i>	<i>Bond Initial Value</i>	<i>Pretax Return</i>	<i>After-tax Return</i>
1	\$5,500,000	\$275,000	\$151,250
2	\$5,651,250	\$282,562.50	\$155,409.40
3	\$5,806,659	\$290,333	\$159,683.10

Final Value: \$5,966,343

2. 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 \$254,369 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.

<i>Year</i>	<i>Initial Value</i>	<i>Bond Return</i>	<i>Borrow Fee</i>	<i>Pretax Net</i>	<i>After-tax Return</i>
1	\$9,500,000	\$475,000	\$50,000	\$425,000	\$233,750
2	\$9,733,750	\$486,687	\$50,000	\$436,687	\$240,178.1
3	\$9,973,928	\$498,696.40	\$50,000	\$448,696.40	\$246,783

Total After-tax Return;	\$720,711
Total After-tax Value:	\$6,220,771
Advantage Over Taxable Sale	\$254,369

3. Collar

The collar assures the taxpayer at least \$10 million pre-tax 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 pre-tax or \$6.6 million after-tax, is more than under the other scenarios (i.e., by \$633,657 and \$379,289, respectively).

II. TAXABLE SALE / HEDGE FOLLOWED BY REINVESTMENT IN EQUITIES

Part II describes the results when taxpayers either sell or hedge and then reinvest in equities. On the assumed facts, taxpayers will find that partial hedges outperform a taxable sale only if the hedged asset appreciates.

A. 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.

1. Taxable Sale

Sale of the position yields \$7 million. If this amount is invested in equities yielding 15% per year, the taxpayer will have **\$9,552,288** after three years (assuming she realizes the gain on this reinvestment in equities after three years):

<i>Year</i>	<i>Initial Value</i>	<i>Pretax Return</i>	<i>After-tax Value</i>
1	\$7,000,000	\$1,050,000	
2	\$8,050,000	\$1,207,500	
3	\$9,257,500	\$1,388,625	
	Total Return	\$3,646,125	\$2,555,288
	Final Value		\$9,552,288

2. 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 earned on the equities minus fees paid for borrowing stock, plus \$7 million (i.e., the \$10 million locked in on the hedged asset minus \$3 million in taxes). 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 \$833,491 more than if she made a taxable sale:

<i>Year</i>	<i>Initial Value</i>	<i>Pretax Return</i>	<i>Borrow Fee</i>	<i>After-tax BF</i>	<i>BF & Interest to Date</i>
1	\$9,500,000	\$1,425,000	\$50,000	\$25,000	\$25,000
2.	\$10,925,000	\$1,638,750	\$50,000	\$25,000	\$51,000

3.	\$12,563,750	\$1,884,562.50	\$50,000	\$25,000	\$78,040
4.	\$14,448,313				
	Total Return			\$4,948,313	
	Total After-tax Return			\$3,463,819	
	Total Fee			\$78,040	
	Total After-tax Return Net Borrow Fee:			\$3,385,779	
	Final Value			\$10,385,779	
	Advantage Over Taxable Sale			\$833,491	

3. Collar-Type Prepaid Forward

To avoid a constructive sale, the taxpayer will retain exposure between \$100 and \$120. She has locked in \$100 of value and, in this scenario, she wishes to reinvest it in equities. Some formal tinkering will be needed to avoid the margin rules, though, and the cost of doing so is that interest expense will no longer offset high-taxed ordinary income, but instead will offset low-taxed capital gain. Specifically, the most straightforward way to hedge and reinvest is to enter into the collar described above, and then to borrow against its value. Interest would thus be deductible, subject to the investment interest limitations of Section 163(d) and the straddle limitations of Section 263(g). Yet under the margin rules, if she uses the loan proceeds to purchase equities (as, indeed, is her intention), she may not borrow more than 50% of the hedged asset's value (i.e., \$50).

Taxpayers who wish to reinvest more than 50% restructure the transaction as a prepaid forward. The hedging counterparty pays 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. Thus, more than 50% may be extracted for reinvestment. To avoid a constructive sale, the amount of stock to be delivered will vary with the stock price. 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. The pretax result, then, is essentially the same as the collar paired with a loan, except that the margin rules are avoided. However, consistent with the general theme of this Article – that frictions can undermine tax planning – the prepaid forward structure imposes an added tax cost. The taxpayer must compensate the hedging counterparty for advancing money up-front, and this time-value compensation takes the form of discount. Instead of paying \$10,000,000 after three years, the hedging counterparty pays only, say, \$8.2 million up front and makes no further payments. Although this \$1.8 million is akin to interest, it technically does not qualify as such for tax purposes, and thus does not give rise to a deduction that would offset the 50% tax on ordinary income.¹⁷³ Instead, this amount serves to reduce the gain recognized on the hedged asset, as the

¹⁷³ See *Deputy v. Dupont*, 308 U.S. 488 (1939) (contract to deliver securities does not qualify as a loan for tax purposes and so interest is not deductible). See also, generally, Schizer, *supra* note 7 (discussing trust structure, which includes variable delivery prepaid-forward).

amount realized is only \$8.2 million instead of \$10 million. Thus, this expense serves to offset the (lower) 30% tax on capital gains. The silver lining for the taxpayer, though, is that investment interest limitations do not apply. The straddle rules also will not defer this tax benefit as long as the hedge is physically settled.

Under this structure, reinvestment obviously is less easy than under the short sale against the box, since a time value charge is imposed, which is much higher than the stock borrow fee in the latter structure. The discount here is set at 6.5% -- a lower number than the taxpayer's usual 8% borrowing rate, since the prepaid forward is secured. Given this cost, the taxpayer outperforms a taxable sale on these assumed facts *only if the hedged asset appreciates*. Earning the maximum \$2 million pretax on the hedged asset, she will earn **\$10,213,385**, which outperforms a taxable sale by \$661,097.¹⁷⁴ Without this added yield, though, her minimum return of **\$8,813,385** underperforms a taxable sale by \$738,903.

<i>Year</i>	<i>Initial Value</i>	<i>Pretax Return</i>
1	\$8,278,491	\$1,241,773.7
2	\$9,520,265	\$1,428,039.7
3	\$10,948,304	\$1,642,245.7

Total Pretax Return	\$4,312,059
Total Aftertax Return	\$3,018,441.
Tax Due on Hedged Asset = 30% of \$8,278,491 =	\$2,483,547
Minimum Total Position =	\$8,813,385
Additional After-tax Return if Hedged Asset	
Appreciates by \$2 million =	\$1,400,000
Maximum Total Position =	\$10,213,385

Comparison with Taxable Sale and Short Sale Against the Box

<i>End Value</i>	<i>Taxable Sale</i>	<i>Short Sale Against the Box</i>
Less than \$100	(\$738,903)	(\$1,572,394)
Greater than \$120	\$661,097.50	(\$172,393.80)

B. Corporate Taxpayers

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

1. Taxable Sale

¹⁷⁴ Note that the fee to the investment bank – in effect, the appreciation between \$120 and \$130 on the stock – serves to reduce this maximum return by \$ 1 million pretax.

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:

<i>Year</i>	<i>Bond Initial Value</i>	<i>Pretax Return</i>
1	\$5,500,000	\$825,000
2	\$6,325,000	\$948,750
3	\$7,273,750	\$1,091,063
	Total Pretax Return:	\$2,864,813
	Total After-tax Return	\$1,575,647
	Final Value	\$7,075,647

2. *Short Sale Against the Box*

If the taxpayer does a short sale against the box and reinvests 95% of the proceeds in equities, it will have **\$8,143,223** after three years, which is \$1,067,577 better than a taxable sale.

<i>Year</i>	<i>Initial Value</i>	<i>Pretax Return</i>	<i>Borrow Fee</i>	<i>After-tax BF</i>	<i>BF & Interest to Date</i>
1	\$9,500,000	\$1,425,000	\$50,000	\$25,000	\$25,000
2.	\$10,935,000	\$1,638,750	\$50,000	\$25,000	\$51,100
3.	\$12,563,750	\$1,884,562.50	\$50,000	\$25,000	\$78,348
	Total Return			\$4,948,313	
	Total After-tax Return			\$2,721,572	
	Total Fee			\$78,348	
	Total After-tax Return Net Borrow Fee:			\$2,643,223	
	Final Value			\$8,143,223	
	Advantage Over Taxable Sale			\$1,067,577	

3. *Collar*

The corporation is assumed to issue a DECS, a public security that closely resembles a collar paired with a borrowing. (Unlike an individual, a corporation generally will not face margin rule issues.) Although funds might be used to invest in equity of a different firm, we might also assume that these funds finance the corporation's 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. Likewise, the interest is assumed to be deductible without limitation,¹⁷⁵ and

¹⁷⁵ Thus, it is assumed that the interest would not be capitalized under Section 263(g). For a discussion of this issue, see Schizer, *supra* note 7. Recent proposed regulations under Section 263(g) would lead to capitalization

is funded from other borrowing (i.e., instead of by reducing 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.

<i>Year</i>	<i>Initial Value</i>	<i>Pretax Return</i>
1	\$9,700,000	\$1,455,000
2	\$11,155,000	\$1,673,250
3	\$12,828,250	\$1,924,238
Total Pre-tax Return:		\$5,052,488
Total After-tax Return		\$2,778,868
Total Interest Cost: ¹⁷⁶		\$1,378,932
Total Return Net of Costs:		\$1,399,936
Tax Due on Hedged Asset		\$4,500,000
Minimum Return (i.e., \$5,500,000 Plus Total Return)		\$6,899,936
Additional Return from Hedged Asset		\$1,100,000
Maximum Return		\$7,999,936

Comparison with Taxable Sale and Short Sale Against the Box

<i>End Value</i>	<i>Taxable Sale</i>	<i>Short Sale Against the Box</i>
Less than \$100	(\$175,710)	(\$1,243,287)
Greater than \$120	\$924,289	(\$143,287)

in future transactions, though. For a discussion, see Lee Sheppard, A Chill Wind Across the DECS, 2001 TNT 14-6 (Jan. 22, 2001).

¹⁷⁶ 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 to a total of \$1,378,932.

Appendix B: Empirical Survey of Public Hedging Transactions: DECS and PHONES

The following table describes 15 matches during 1999 from the following search on Lexis of the EDGARPlus (EDGARP) file in the COMPANY (COMPNY) library: (maturity w/10 shares w/10 stock w/10 exchange!) and (contingent w/4 debt w/4 regulation). 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 (i.e., the issuer can satisfy its obligation under the security by tendering the hedged stock). Disclosure for such exchangeable instruments generally mentions the contingent debt regulations of Treas. Reg. 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 \$4,834,100,366.¹⁷⁷

	Issuer	Security Name	Offering Amount	Filing Date	Maturity Date	Underlying
1	Comcast Corp.	ZONES	\$1,000,000,000	10/13/99	10/15/2029	Sprint stock
2	Morgan Stanley Dean Witter & Co. (“MSDW”)	Reset PERQS	\$17,027,300	10/12/99	10/31/2001	FDX stock
3	MSDW	Reset PERQS	\$25,000,000	10/7/99	12/15/2001	Oracle stock
4	Salomon Smith Barney Holdings Inc.	ELKS	\$17,181,900	10/7/99	10/6/2000	Hewlett-Packard stock
5	Reliant Energy Inc.	ZENS	\$1,000,000,000	9/16/99	9/15/2029	Time Warner stock
6	Enron Corp.	Exchangeable Notes	\$222,500,000	8/11/99	7/31/2002	Enron Oil & Gas stock
7	MSDW.	Reset PERQS	\$18,000,839	8/6/99	8/15/2001	Qualcomm stock
8	Kerr McGee	DECS	\$287,259,450	7/29/99	8/2/2004	Devon stock

¹⁷⁷ 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.

	Corp.					
9	MSDW.	Reset PERQS	\$134,543,750	7/21/99	8/1/2001	Cisco Systems stock
10	Southwest Securities Group, Inc.	DARTS	\$50,000,000	6/11/99	6/30/2004	Knight/ Trimark Group stock
11	MSDW.	PERQS	\$29,899,212	5/21/99	5/22/2000	Nokia stock
12	MSDW	Reset PERQS	\$95,000,025	5/18/99	5/30/2001	Sun Microsystems stock
13	Tribune Co.	PHONES	\$1,099,000,000	4/9/99	5/15/2029	America Online stock
14	Comcast Corp.	PHONES	\$718,293,750	3/15/99	5/15/2029	AT&T stock
15	MSDW	Reset PERQS	\$120,394,140	3/2/99	3/15/01	MCI Worldcom stock

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 often form an investment vehicle in order to hedge through the public markets. The following chart shows the “trust” structures that were filed in 1999, based on the following search on Lexis in the EDGARPlus (EDGARP) file in the COMPANY (COMPNY) library: (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., when the same transaction was posted more than once), as well as transactions that were not designed to hedge appreciated stock. Of the twenty transactions that were filed with the SEC, fifteen were never finalized. This finding is consistent with the point that transactions 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 completed transactions in 1999 have an aggregate value of \$428,967,264.

	Issuer	Security Name	Offering Amount	Filing Date	Maturity Date	Underlying
1	ScanDisk PEPS Trust	PEPS	Never finalized (\$200,000,000)	10/13/99	11/15/02	ScanDisk stock
2	TARGETS Trust IV	TARGETS	\$32,066,014.05	9/29/99	11/15/02	Amgen, Inc. stock
3	DECS Trust V	DECS	\$95,625,000	8/9/99	8/15/02	Crown Castle Intl. Corp. stock
4	METS Trust	METS	Never finalized	7/20/99	--	Not indicated
5	Ameritrade Automatic Common Exchange Trust	TRACES	Never finalized (\$150,000,000)	7/12/99	--	Ameritrade Holding Corp. Class A stock
6	Eleventh Automatic Common Exchange Security Trust	TRACES	Never finalized	7/6/99	--	Not indicated
7	Fourteenth Automatic Common Exchange Security Trust	TRACES	Never finalized	7/6/99	--	Not indicated
8	Thirteenth	TRACES	Never finalized	7/6/99	--	Not indicated

	Automatic Common Exchange Security Trust					
9	Twelfth Automatic Common Exchange Security Trust	TRACES	Never finalized	7/6/99	--	Not indicated
10	TARGETS Trust III	TARGETS	65,887,500	6/24/99	8/15/02	MCI WorldCom stock
11	Ninth Automatic Common Exchange Security Trust	TRACES	Never finalized	5/3/99	--	Not indicated
12	Tenth Automatic Common Exchange Security Trust	TRACES	Never finalized	5/3/99	--	Not indicated
13	Seventh Automatic Common Exchange Security Trust	TRACES	Never finalized	4/20/99	--	Not indicated
14	TARGETS Trust II	TARGETS	\$72,888,750	4/12/99	5/15/01	Lucent stock
15	PIES Trust I	PIES	Never finalized	3/16/99	--	Not indicated
16	PIES Trust II	PIES	Never finalized	3/15/99	--	Not indicated
17	Eighth Automatic Common Exchange Security Trust	TRACES	Never finalized	3/3/99	--	Not indicated
18	Trust-Issued Required Equity Exchange Security Trust	T-REX	Never finalized	3/1/99	--	Not indicated
19	DECS Trust IV	DECS	\$162,500,000	2/10/99	2/15/02	Maxton Stock
20	Sixth Automatic Common Exchange Security Trust	TRACES	Never finalized	1/26/99	--	Not indicated

Appendix D: Hedge Fund Swap

This discussion compares a direct investment of \$10,000,000 in a hedge fund with investment in a hedge-fund derivative. 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). The hedge fund is assumed to earn 15% a year. (The assumption is that the hedge fund earns the same 15% available in 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, which did not make use of this planning strategy because they are not eligible for the reduced rate for long-term capital gains.)

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 \$10,000,000 investment grows to \$12,422,969.

<i>Year</i>	<i>Initial Amount</i>	<i>15% Return</i>	<i>Tax</i>	<i>Amount Reinvested</i>
1	10,000,000	1,500,000	750,000	10,750,000
2	10,750,000	1,612,500	808,250	11,556,250
3	11,556,250	1,733,438	866,719	12,422,969

Hedge Fund Swap: 15% Return

Alternatively, assume the taxpayer invested \$10,000,000 in Treasuries, which were used to secure her obligation on a swap. The swap requires the parties to measure the value of a \$10,000,000 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. (Note that 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 \$10,000,000 (i.e., if the fund depreciates), the taxpayer must pay the difference. On the other hand, if the Value exceeds \$10,000,000 (i.e., if the fund appreciates, as is assumed here), the taxpayer receives this excess, and treats it as long term capital gain. Assuming 15% annual appreciation, the Value is as follows:

<i>Year</i>	<i>Initial Amount</i>	<i>Amount Reinvested After 15% Return</i>	<i>Taxable Gain</i>	<i>Tax</i>	<i>Aftertax Value</i>
1	10,000,000	11,500,000			
2	11,500,000	13,225,000			
3	13,225,000	15,208,750	5,208,750	1,562,625	13,646,125

In addition, the taxpayer must pay an annual fee equal to \$10,000,000 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 are generally thought to be ordinary deductions under Section 212. Accordingly, the taxpayer has a net pretax expense of 1% per year, which is deductible. (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. For simplicity's sake, these limitations on the deduction are ignored.) 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 – \$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.

What if the Hedge Fund Has 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 (i.e., 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 (i.e., before the end of the taxpayer's tax year). As a result, losses 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 had ordinary losses, e.g., from currency trading, that were converted to short term capital losses; yet most returns from investing are capital gain or loss). A direct investment would have been preferable only to avoid the fees and transaction costs associated with the derivative.