STATEMENT OF ALEX RASKOLNIKOV,

ASSOCIATE PROFESSOR OF LAW, COLUMBIA LAW SCHOOL

AT A HEARING OF THE HOUSE COMMITTEE ON WAYS AND MEANS, SUBCOMMITTEE ON SELECT REVENUE MEASURES

ON THE TAX TREATMENT OF DERIVATIVES

MARCH 5, 2008

Mr. Chairman and Members of the Committee—

Thank you for inviting me to testify here today on this increasingly important subject.

I would like to make four main points:

> First, as long as Congress believes that income tax should remain a part of our revenue collection system, it is important to assure continuing taxation of income from capital. Without it, an income tax will become a consumption tax. Financial derivatives offer unprecedented opportunities to reduce or eliminate capital income taxation. If the United States were to stop taxing this income and adopt a consumption tax, Congress—and not individual taxpayers or groups of taxpayers—should make this decision.
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> Second, in the absence of a comprehensive income tax reform, it is impossible to tax financial derivatives in a manner that meets any accepted benchmark of an effective and efficient capital income tax. As long as the current rules are in place, symmetry, consistency, and balance will all remain unattainable.
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> Third, Congress should continue to intervene when financial innovation threatens to eliminate substantial amounts of capital income from the tax base even though these interventions will produce imperfect results. In doing so, Congress should strive to enact legislation that cannot be easily avoided and does not impose large administrative and compliance costs.
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> Fourth, a comprehensive—yet limited—reform is possible, and I urge the Committee to give it serious consideration. All derivatives should be subject to a mark-to-market regime, and gains and losses from derivatives should be taxed at the top individual or corporate ordinary income rate.

I elaborate on each of these points below.

1. Defend the Income Tax . . . or Replace It

Taxation of capital income is what makes an income tax different from a consumption tax. In an income tax system, both labor income and capital income are taxed. In a consumption tax regime, only labor income (and, in some cases, unique, abnormally high economic returns) are included in the tax base. Taxation of capital income makes a significant contribution to our tax system's progressivity.[1]

Generally, returns to capital consist of three components: a risk-free (or time value) return, a risk premium, and inflationary gain (or deflationary loss). Our system often under-taxes the first two components and over-taxes the third one. Because the question of incorporating inflationary gains and losses into the income tax goes well beyond the taxation of derivatives, I will limit this discussion to the risk-free return and risk premium.

Even without considering derivatives, our tax system does a mediocre job of reaching capital income. The realization requirement allows taxpayers to accelerate losses on depreciated assets while deferring gains on appreciated ones. The basis step-up at death often eliminates these gains from the tax base altogether. Special provisions exempt from taxation time value and risk-based returns from home sales, pension savings, life insurance, municipal bonds, and so on. The tax law did not appropriately account for simple interest accrual until 20 years after we sent a man into space. Thus, in evaluating the effect of derivatives, it is important to remember that a significant portion of capital income from "traditional" investments is under-taxed.

Derivatives exacerbate the problem dramatically. These innovative and socially useful products of financial engineering have an undesirable side effect: They give rise to remarkably potent tax reduction strategies. Without repeated Congressional intervention over the past two decades, derivatives would have allowed taxpayers to disguise high-taxed time value returns (interest income) as low-tax risk-based returns (long-term capital gains),[2] convert high-taxed risk-based returns (dividends and short-term capital gains) into low-taxed ones (long-term capital gains),[3] effectively sell appreciated assets without

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[1] This is true because on average high-income households receive a higher fraction of their income in the form of capital income.

[2] This was accomplished by a so-called conversion transaction that involved a purchase of an asset and its forward sale. Congress responded in 1993 by enacting section 1258 of the Internal Revenue Code.

[3] This was the purpose of the so-called hedge fund derivatives, addressed in section 1260 added to the Code in 1999.

recognizing taxable gains,[4] and circumvent long-standing rules designed to assure the taxation of capital income.[5]

Congressional efforts to curb tax planning using derivatives are well-advised. Left unchecked, this planning has the potential to eliminate capital income from the tax base, essentially converting our income tax system into a consumption tax. Moreover, derivatives may be also used to disguise labor income (wages) as risky returns—an inappropriate result even in a consumption tax regime. While the tax-advantaged fruits of financial innovation were for some time available only to a privileged few, the current trend may be described as "derivatives for the masses." These masses, to be sure, still represent a small (and wealthy) fraction of U.S. taxpayers. Nevertheless, these happen to be the taxpayers who receive most of the capital income that Congress intends to tax.

There is a considerable and ongoing debate about the relative merits of income and consumption taxation. Without taking a position in this debate, I would like to emphasize the obvious: The choice of tax system is for Congress to make. Difficulty of taxing capital income in the presence of derivatives is one consideration pointing towards a consumption tax. There are others, as well as serious arguments going the other way.[6] But it can hardly be disputed that allowing a self-help switch to a consumption tax by the wealthiest taxpayers in the nation in contravention of Congressional intent to tax capital income is not good tax policy. Therefore, Congress should continue its efforts to constrain tax planning using derivatives.

2. The Patchwork of Rules — Unsatisfying Yet Inescapable?

It has long been understood that derivatives present a serious challenge to our tax system. Lawmakers, academics, and practitioners have been searching for comprehensive and conceptually satisfying responses to this challenge for decades. Three benchmarks have emerged as a result of this search.

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

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[4] The constructive sale rules of section 1259 were enacted in 1997 to limit this kind of planning.

[5] For instance, cash settlement derivatives were used to circumvent the wash sale rule of section 1091. While Congress responded by adding subsection 1091(f) in 2000, some continue to argue that cash settlement notional principal contracts remain outside the scope of section 1091. See David M. Schizer, *Scrubbing the Wash Sale Rules*, Taxes, Mar. 2004.

[6] Compare Daniel Shaviro, *Beyond the Pro-Consumption Tax Consensus*, 60 Stan. L. Rev. 745 (2007) with Joseph Bankman & David A. Weisbach, *The Superiority of an Ideal Consumption Tax Over an Ideal Income Tax*, 58 Stan. L. Rev. 1413 (2006) and Joseph Bankman & David A. Weisbach, *Consumption Taxation Is Still Superior to Income Taxation*, 60 Stan. L. Rev. 789 (2007).

revenue either. In other words, derivatives cannot be used to shelter income from real investments and labor.

Unfortunately, symmetry is unattainable. Tax-exempt entities and foreigners often pay no U.S. tax. Securities dealers may be thought of as tax-exempt as well because their derivative trades with clients are hedged and mark-to-market accounting assures that only dealers' fees are taxable.[7] The presence of these tax-indifferent counterparties means that the taxation of derivatives will remain asymmetric as long as taxable taxpayers are on the other side of trades.

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

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

The problem is more fundamental than it may first appear. As long as the tax system continues to rely on cubbyholes, consistency is impossible. This is because the "basic" instruments such as a coupon bond, a share of common stock, and put and call options on that stock are inextricably linked—a relationship established by the so-called put-call parity theorem.[8] Shares of stock and options may be used to produce an economic return equivalent to the interest on a bond. A share of stock and a put are equivalent to a bond and a call. Many other combinations may be constructed. As long as debt, stock and options continue to be taxed inconsistently, the fundamental economic equivalence established by the put-call parity theorem will assure that similar cash flows with the

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[7] This is because any taxable gain from a client's position is offset by an equal loss on the hedge and vice versa (setting aside the fee build into the price of the client's position). The character of gain and a loss is always ordinary. The mark-to-market regime for securities and commodities dealers is set forth in section 475.

[8] See Alvin C. Warren, Jr., *Financial Contract Innovation and Income Tax Policy*, 107 Harv. L. Rev. 460, 465-70 (1993).

same risk profile will continue to receive dissimilar tax treatment—the hallmark of an inconsistent regime.

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

Only a fundamental reform will bring us a balanced regime. The realization requirement that is deeply embedded in our tax system gives taxpayers a timing option—a choice of triggering tax consequences *after* they have learned whether a transaction produced a gain or a loss. Capital loss limitations, the progressive rate structure, and the nonrefundable nature of our system produce unequal tax rates on gains and losses (with gains taxed at a higher rate). As long as these features remain in place, no incremental revisions will produce balance in the taxation of derivatives.[9]

While assuring symmetry, consistency, or balance is desirable, incremental reform may be the only—or the only realistic—policy option at a given moment. How should policymakers evaluate whether a new derivative merits Congressional action and, if so, what form this action should take?

3. Responding to Financial Innovation with Incremental Reforms

When a novel financial instrument creates a tax planning possibility, Congress should consider taking action. Given where our tax system is today, three inquiries should be of great importance, while two other factors should be given much less credence.

First, and most importantly, Congress needs to ascertain the magnitude and nature of the potential problem. What is the tax effect of a new derivative instrument? Is it deferral of income, conversion of high-taxed returns into low-taxed ones, or both? Do non-tax constraints (such as market frictions or securities, bank regulatory and other laws) limit the number of taxpayers who can take advantage of this tax planning? Overall, how much revenue is at stake?

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[9] For a fuller discussion of symmetry, consistency, and balance, see David M. Schizer, *Balance in the Taxation of Derivative Securities: An Agenda for Reform*, 104 Colum. L. Rev. 1888, 1893-1901 (2004).

Second, in evaluating legislative proposals, Congress should ensure than new legislation is effective in constraining future tax planning—in other words, it is difficult to game.[10] Otherwise, taxpayers will expend even more resources in order to reduce their tax bills, yet little new revenue will be raised. Of course, opponents of any given reform will argue that it will be easy to avoid. These arguments should be put to a serious test. Congress should require these opponents to demonstrate with some specificity how this easy avoidance will take place. If they do, Congress will have an opportunity to remedy the weaknesses of the proposal. If the weaknesses are incurable, the proposal should be abandoned.

Third, policymakers should consider the administrative and compliance costs of any proposed legislation. These are real social losses, even when they are incurred by private parties and are "invisible" in government budgets. Of course, most new rules will produce *some* increase in administrative and compliance costs. The question is how substantial it is compared to the expected revenue raised by the proposed legislation.[11] The key factors affecting these costs are the complexity of legislation, the number and financial sophistication of taxpayers affected by it, and the existence of relevant information in the marketplace.

For instance, compare the constructive ownership regime of section 1260 with that currently proposed for prepaid derivatives. The former is much more complex. It requires tracking of long-term capital gains realized from the underlying investment, spreading of ordinary income backwards over the derivative's term, and the addition of an interest charge based on this look-back. The proposed prepaid derivatives bill is much simpler, requiring only an imputation of interest at a standard rate. This difference in complexity is justified. Only the wealthiest and most sophisticated taxpayers can invest in the hedge fund derivatives addressed by section 1260. In contrast, prepaid derivatives (such as exchange-traded notes, or ETNs) are mass-marketed, so Congress should be more reluctant to enact highly complex rules in this context. Finally, the financial institutions that issue hedge fund derivatives and prepaid instruments such as ETNs are certainly capable of tracking information that is required by the constructive ownership rule and may be needed to comply with the proposed prepaid derivatives legislation. They may (and should) be required to supply this information to the IRS as well. Granted, each regime requires some initial system development costs, but these costs are likely to be modest, especially compared to the amount of capital income that may go untaxed if Congress fails to act. As long as financial institutions assemble information and provide it to taxpayers, the compliance burden borne by taxpayers should be reasonable.

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[10] Effective legislation in this case is also efficient in the technical sense of that word. See David A. Weisbach, *Ten Truths About Tax Shelters*, 55 Tax L. Rev. 215, 231-39 (2002).

[11] For the formal analysis of this insight, see Joel Slemrod & Shlomo Yitzhaki, *The Costs of Taxation and the Marginal Efficiency Cost of Funds*, 43 IMF Staff Papers 172 (1996).

In sum, in evaluating new legislation, Congress should focus on the magnitude of the problem, the resistance of the proposed rule to future gaming, and the administrative and compliance costs imposed by it. Two other commonly raised considerations, discussed next, are less important.

Adding further complexity to the tax law is hardly desirable. Yet, charges that proposed legislation would add to the tax law's inconsistencies should be taken with a grain of salt. Tax rules for derivatives are already extremely complex. Adding yet another regime not entirely consistent with the existing patchwork of rules may not make much of a difference. For the same reason, just about any legislative proposal is likely to be consistent with some of the current provisions, or at least some of their features. In short, although overall consistency is a worthy goal, adding some further inconsistency will not necessarily do a lot of additional harm. Whatever harm may result should be balanced against allowing significant amount of capital income to escape the tax base.

In addition, and perhaps counterintuitively, Congress should eschew reasoning by analogy. This mode of analysis is appropriate for courts interpreting legislation and judicial precedents, but not for Congress when it enacts new rules. Whether a novel derivative is more "like" debt, equity, or some other existing instrument or investment (such as a commodities or securities index) does not tell us a lot about the derivative's tax reduction potential or a legislative proposal's capacity to constrain it.[12]

For example, inquiries into whether short sales and equity forwards entered into by taxpayers holding appreciated equity positions were really more "like" selling these position or retaining them produced little useful information in evaluating the merits of the constructive sale rules. The same is true of the debates about whether entering into hedge fund derivatives was really "like" becoming an owner of the underlying hedge fund or not, debates that took place when the constructive ownership regime was under consideration. These inquiries did little to ascertain the magnitude of the problems in question. And they failed to predict that one of these regimes would prove to be substantially more effective than the other. The difference, it turned out, has nothing to do with what ownership "truly" means, but is due to the fact that financial intermediaries could hedge derivatives that avoid the constructive sale regime much more easily than they could hedge derivatives that would escape the reach of the constructive ownership rules.[13]

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[12] *Unhelpful* reasoning by analogy in deciding whether tax planning using a given derivative should be stopped should not be confused with *helpful* arguments that a proposed solution is unlikely to work because if it is enacted, taxpayers will find close tax-favored substitutes (analogies) to the strategy foreclosed by the new legislation. The latter argument is really about effectiveness of the proposal (its resistance to gaming), an important factor discussed above.

[13] For a detailed explanation, see David M. Schizer, *Frictions as a Constraint on Tax Planning*, 101 Colum. L. Rev. 1312 (2001).

In sum, as long as the fundamental reform of derivatives taxation remains unlikely, Congress should not let the perfect be the enemy of the good. When a new derivative creates a potential for large amount of capital income to disappear from the tax base, Congress should respond by enacting legislation that is effective (difficult to game) and does not impose high administrative and compliance costs, while paying less attention to arguments about consistency and analogies based on the "true" nature of things.

4. A Limited Fundamental Reform

The preceding suggestions about incremental reforms should not obscure the larger issue: All such reforms leave much to be desired. They fail to produce a tax system that is symmetric, consistent, or balanced. There is, however, a reform that will overcome the numerous shortcomings of the existing rules governing taxation of derivatives. It will produce a balanced system. It will result in symmetry in most cases. And it will eliminate the need for the endless (and ultimately fruitless) efforts to prevent taxpayers from disguising time value returns and wages as risky gains and losses. This reform is fundamental because it involves the overhaul of *all* rules applying to the taxation of derivatives. Yet it is limited because it applies *only* to the taxation of derivatives and, therefore, is both much less drastic and more realistic than a switch to, or an addition of, a consumption tax.

If this Committee is prepared to revisit the entire regime applying to the taxation of financial instruments, it should give serious consideration to subjecting all derivatives to a mark-to-market system similar to that currently applying to securities and commodities dealers under section 475.[14] Under this regime, all gains and losses will be taxed as if each position in a derivative is terminated (sold) at the end of the taxable year and re-entered into at the beginning of the next year. Losses from derivatives will be deductible only against gains from derivatives, and excess losses will be fully available to reduce gains from derivatives in other tax years.[15] Importantly, the rate applying to gains and losses will be flat and equal to the top marginal rate, individual or corporate, as appropriate.[16]

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[14] Others share this view. See Schizer, note 9 above, at 1920; Warren, note 8 above, at 492. For similar proposals, see Daniel Halperin, *Saving the Income Tax: An Agenda for Research*, 77 Tax Notes 967 (1997); David J. Shakow, *Taxing Without Realization: A Proposal for Accrual Taxation*, 134 U. Pa. L. Rev. 1111 (1986); David A. Weisbach, *A Partial Mark-to-Market Tax System*, 53 Tax L. Rev. 95 (1999).

[15] Alternatively, a net loss from derivatives in a given year will be refundable. In addition, business hedging will be subject to an integration regime similar to the current one.

[16] A more precise approach would set the rate at the top individual or corporate rate applying to any given taxpayer in any particular tax year. In other words, the taxpayer's rate determined without regard to gains and losses from derivatives will automatically apply to these gains and losses. For the reasons discussed below, this complication is probably not worth pursuing, because the additional complexity it entails will not be justified by either revenue or fairness considerations.

Let me briefly outline the benefits of this regime, and address some of its drawbacks. The benefits are considerable.

1. The proposed mark-to-market regime will assure that the taxation of derivatives is balanced: Pure risky bets will raise no revenue but will also not be used to shelter other income.

2. The mind-numbing complexity of the current rules, the considerable compliance costs they impose, and the need for Congress to continually monitor and respond to financial innovation will all disappear. The same is true of the time and effort expended on devising and analyzing ways to circumvent current rules.

3. Because gains from derivatives will be taxed at the top marginal rate, an incentive to disguise riskless returns and labor income as risk-based returns will disappear. Derivatives that do reflect wages or time value returns (and some of them do) will produce positive tax revenues.

Of course, the proposal has drawbacks. None of them appear to be compelling.[17]

1. The proposed regime will not affect non-derivative positions. Therefore, it will become important to separate derivatives from non-derivatives. This will be a line-drawing exercise familiar to any lawyer. While I would argue for a broad definition of a derivative, the more important point is that it will be much easier (and cheaper) to draw and maintain just one line—between derivatives and non-derivatives—than it is to continually delineate equity from debt from forwards from swaps from options from futures from (now) prepaid derivatives and so on.[18]

2. Arguably, the suggested regime will result in a less favorable tax treatment of derivatives than the existing treatment of "plain vanilla" investments such as stocks, bonds, and real estate. This, the argument goes, will be both unfair and inefficient. This criticism is not particularly convincing. "Equal treatment" is certainly not the hallmark of our tax system. Growth stocks are treated more favorably than dividend-paying stocks. Bonds (especially discount bonds) have a particularly disadvantageous tax treatment (accrual of income before its receipt) while real estate and municipal bonds are especially tax-favored. Some derivatives are currently taxed less heavily than other economically similar financial instruments. Rather than adding to the number of tax-favorable and unfavorable regimes, the proposed reform will *reduce* it by taxing all derivatives the same.

Moreover, a mark-to-market system may not in fact render derivatives tax-disadvantaged. Capital loss limitations will be replaced with unlimited (in time)

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[17] For a thorough analysis of costs and benefits of combining a mark-to-market regime with a realization-based system, see Weisbach, note 14 above.

[18] This list does not mention the need to delineate various *transactions* involving derivatives, such as straddles, constructive sales, constructive ownership, several integration regimes and the like.

carry-forwards, carry-backs, or even refunds. Straddle rules, wash sale rules, constructive sale and ownership rules will not apply to derivatives. On balance, it is far from clear that the mark-to-market regime will result in an overall tax disadvantage (or advantage) for derivatives.

3. Taxing gains at the top marginal rate may seem unfair and arbitrary, but, in fact, it is neither. Many (if not most) taxpayers who enter into derivative trades are already in the top bracket. To the extent the proposed regime will result in taxation of time value returns and disguised wages at the top rate, it will merely assure their appropriate taxation. Although risky gains from derivatives will be taxable at a higher rate than long-term capital gains from "traditional" investments, risky losses will be deductible at a higher rate as well. These will net out to zero, giving rise to no additional tax liability.

4. Another typical critique of mark-to-market proposals is that they introduce exceedingly costly complexity, requiring annual valuation of hard-to-value assets. Clearly, this criticism does not apply to derivatives. Most over-the-counter derivatives are sold by financial intermediaries who already mark them to market for internal control, accounting, and tax purposes. Under the proposal advanced here these entities will merely be required to share this information with taxpayers (and the IRS). For publicly-traded derivatives (such as ETNs), the concern simply does not arise.

5. Finally, a liquidity argument is often marshaled to defeat proposals for mark-to-market reforms. How will a middle-class taxpayer come up with the money to pay the tax bill for an appreciating asset that she wants to keep? In the context of traditional investments, this concern is quite serious. But when we focus on derivatives, the liquidity concern is greatly diminished. Middle class taxpayers don't buy derivatives (or, at least, not nearly in the amounts they buy common stocks, real estate, etc.). Even if the managers of the mutual funds these taxpayers own purchase derivatives, these funds are mostly held in IRAs, 401(k)s, and other tax-sheltered accounts. Owners of these accounts recognize no gains or losses until withdrawing money during retirement, so they will be largely unaffected by the mark-to-market regime. Thus, the relevant taxpayer population even for publicly-traded derivatives is much smaller—and wealthier—than for investments in general. Over-the-counter products are available only to the wealthiest few. Most likely, these taxpayers have plenty of liquidity to pay taxes arising from the limited mark-to-market regime.

Needless to say, this testimony is not the place for an exhaustive analysis. The proposed reform will surely raise some thorny issues and require some difficult balancing. My point here is to emphasize that the proposed mark-to-market system is viable and has many attractive features. If Congress is ready to revisit the taxation of derivatives as a whole, this reform has much to be said in its favor. While it inevitably will give rise to some costs, it will eliminate much more numerous and significant costs of the current regime for taxation of derivatives—a regime that, to put it bluntly, is a mess.