TESTIMONY OF
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SECURITIES INDUSTRY AND FINANCIAL MARKETS ASSOCIATION
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THE COMMITTEE ON WAYS AND MEANS
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Chairman Neal, Ranking Member English, and Members of the Subcommittee, thank you for inviting me to testify. I am a lawyer in private practice with the firm of Cleary Gottlieb Steen & Hamilton LLP, and I am testifying today on behalf of the Securities Industry and Financial Markets Association ("SIFMA").[1] I am here today to discuss the tax treatment of prepaid derivative contracts.

On behalf of SIFMA, I would like to thank Chairman Neal for holding this hearing to facilitate a dialogue on the appropriate tax treatment of prepaid derivative contracts and comparable financial instruments. We welcome the opportunity to provide our views on the development of a comprehensive set of rules for taxation of prepaid derivative contracts that are consistent, administrable, fair and certain. The Treasury Department and Internal Revenue Service have commenced a similar review of this very complex area as announced in Notice 2008-2, and we are actively working with them on this review.

For the reasons discussed below, SIFMA has serious concerns with H.R. 4912. In particular, we are concerned that H.R. 4912 would impose an overly complex tax regime that

[1] The Securities Industry and Financial Markets Association brings together the shared interests of more than 650 securities firms, banks and asset managers. SIFMA's mission is to promote policies and practices that work to expand and perfect markets, foster the development of new products and services and create efficiencies for member firms, while preserving and enhancing the public's trust and confidence in the markets and the industry. SIFMA works to represent its members' interests locally and globally. It has offices in New York, Washington D.C., and London and its associated firm, the Asia Securities Industry and Financial Markets Association, is based in Hong Kong.

would single out prepaid derivative contracts for unfavorable treatment by requiring that investors include amounts in income that they have no right to receive and may never receive. In some cases, investors will be taxed on phantom income even when the value of the prepaid derivative contract is falling. SIFMA is also concerned that H.R. 4912 adopts a "one-size-fits-all" approach that would impose an unfavorable tax regime on many prepaid financial instruments that, under current law, are tax neutral or even tax disadvantaged compared to a hypothetical investment in the referenced property directly or through another financial instrument.

1. The Prepaid Derivative Contract Market is Not New. The recent publicity regarding exchange-traded notes may have created an impression that prepaid derivative contracts are a new financial market development. On the contrary, complex derivative contracts with returns linked to the performance of equities and other risky assets have been in existence for more than 15 years. American Express issued the first publicly-traded variable prepaid forward contracts (so-called DECS) in October 1993. An investor in those DECS would make money or lose money depending on whether the underlying stock rose or dipped in value and was paid a fixed-rate coupon that was treated as ordinary income. Investors bought DECS rather than buying the stock of the underlying company because they wanted current income and the stock paid no dividends.

In subsequent years, the capital markets have seen an explosive growth in the number, volume, and variety of prepaid derivative contracts. These instruments have grown in popularity because they give investors convenient and cost-efficient access to sophisticated financial strategies and enable them to take financial positions with respect to a vast selection of referenced financial assets and cash flows. Like DECS, many prepaid derivative contracts provide risks and returns that are different from a direct investment in the referenced asset. Prepaid derivative instruments are a common and important financing and investment tool.

2. <u>The Emergence of Exchange-Traded Notes</u>. Recent media attention has focused on a relatively new type of prepaid derivative contract commonly referred to as an exchange-traded note, or ETN. ETNs, which represent a small subset of the prepaid derivative market, are actively traded on an exchange. The idea behind ETNs is to give "Main Street" retail investors access to sophisticated investment strategies and liquidity on a cost and tax efficient basis.

Some members of the mutual fund industry have expressed concern that the availability of exchange-traded notes to retail investors reduces the relative attractiveness of mutual funds and puts them at a competitive disadvantage. In November 2007, the Investment Company Institute ("ICI") encouraged the Committee on Ways and Means to change the current tax treatment of retail ETNs because, the ICI argued, such ETNs are similar to mutual funds but enable investors to benefit from tax deferral in a manner that is far superior to investors in mutual funds. SIFMA believes that these arguments (that ETNs are substantially similar to mutual funds and that they benefit from far superior tax treatment) are oversimplified and not helpful to moving forward the debate on the tax treatment of prepaid derivatives.

3. <u>Comparison Between ETNs and Mutual Funds</u>.

a. <u>ETN Investors Have No Right to Receive Cash Distributions Currently</u>. There are important differences in the economic terms of ETNs and mutual funds. These differences explain and justify the respects in which they are treated differently for tax purposes. Most notably, investors in mutual funds have a current right to receive cash; holders of ETNs do not.

The difference between the tax treatment of ETNs and mutual funds is based on a fundamental rule of tax law that an investor who has the full right to take cash income, but elects not to, is subject to taxation on that cash as if it were received. Taxpayers cannot avoid tax on cash they could put in their pockets simply by using it for other purposes. This is why investors in

mutual funds are taxed currently on distributions from the mutual fund even if they choose to reinvest the cash. In short, investors in mutual funds are taxed on distributions because they have the choice of keeping the cash or reinvesting it.

Holders of ETNs are subject to the same treatment. When they have the right to receive cash (because the ETN provides for current payments), they are taxed on that cash, generally at rates less favorable than the rates that apply to mutual fund investors. Similarly, a holder of an ETN that has appreciated in value is treated the same as the holder of shares in a mutual fund. In either case, unrecognized gain that does not correspond to any entitlement to receive cash distributions currently is taxed only when the shares or ETNs are sold. An investor in an ETN remains fully at risk during the term of the contract and must wait to maturity to determine whether there will be gain or loss on its original investment. This treatment is the same as the treatment of an investor in a mutual fund.

In considering the taxation of prepaid derivatives, it is also important to recognize that many prepaid derivative contracts require periodic cash payments. For example, when interest rates were very low, investors bought these instruments in order to get an above-market coupon. Issuers have generally required investors to treat such coupons as ordinary income, even if the coupons economically are tied to tax-favored income like qualified dividend income. An investor in the underlying stock or a mutual fund holding the stock would pay tax on that income at the lower qualified dividend income rate. Under current law, U.S. taxable investors in these coupon-paying instruments are actually *tax-disadvantaged* compared to buying the underlying stock or the mutual fund.

b. <u>*ETNs Do Not Represent Ownership of Any Assets*</u>. Another important difference between mutual funds and prepaid derivative contracts is that investors in mutual funds effectively own the underlying securities held by the mutual funds. Upon a liquidation of a mutual

fund, investors will receive their pro rata share of securities held by the fund. In contrast, a prepaid derivative is an unsecured contract between the investor and the issuing company that provides for a payment at maturity determined by an objective formula that generally references the performance of securities, commodities or financial indices and, in certain cases, payment of periodic amounts. (Under the terms of a derivative contract, the investor has no special right in respect of referenced assets; in fact, the issuing company has no obligation to own the referenced assets.) Because a prepaid derivative contract is merely an unsecured promise to pay, investors in prepaid derivative contracts are exposed to the risk that the issuer will not pay them if its own financial condition declines. We understand that the recent wave of write-downs by many financial institutions is affecting both pricing and willingness of some investors to invest in prepaid derivative contracts. By contrast, investors in mutual funds are not subject to this type of credit risk.

4. Many Investors Purchase Prepaid Derivatives for Non-Tax Reasons. The decision to invest in prepaid derivative contracts (including ETNs) rather than directly in the underlying asset is based on a number of criteria and not only tax considerations. Many investors choose prepaid derivative contracts because they meet a variety of important financial needs unrelated to tax considerations.

For example, many prepaid derivatives provide returns that **do not** mimic direct ownership of underlying assets, but instead replicate the performance of sophisticated investment strategies that incorporate buying and selling options, entering into short sales, and employing leverage. Prepaid derivative transactions make these complex strategies available to a broad base of investors, including individuals, tax-exempt entities, retirement plans, mutual funds, and other institutional investors. Because of the legal form and economic characteristics of these prepaid derivative transactions, they are permitted investments for those investors who cannot legally enter

directly into options or other derivative transactions on a stand-alone basis or who can do so but are required under applicable investment guidelines to treat them less favorably.

In addition, ETNs and other prepaid derivative contracts provide "one-stop shopping" for investors, allowing an investor to make a single investment in order to obtain exposure to asset classes they could not otherwise access. For example, most individuals do not invest in commodity futures due to their complicated nature and cash flows. Mutual funds effectively cannot invest in commodities or commodity futures, except in very limited amounts. This may explain why the single largest ETN by far is based on an objective formula linked to commodity futures. Other reasons to invest in prepaid derivatives include a more favorable fee structure implied in the pricing of prepaid derivative contracts and liquidity.

5. Current Tax Law Analysis of Prepaid Derivatives. For all the variety of prepaid derivative instruments, their hallmark feature is that investors place all (or a substantial portion) of their investment in the contract at risk of loss, until the maturity of the instrument. Although many prepaid derivative contracts are issued in the nominal form of corporate notes, they are not debt instruments in the U.S. federal income tax sense of the word. Unlike traditional corporate debt, these "notes" do not entitle an investor to an unconditional return of the principal at maturity plus some amount of interest. Instead, the payment at maturity of the instrument is determined by the performance of some financial asset or strategy. Investors in prepaid derivatives not only may receive no return but also can have a significant risk of losing some or all of the original investment. This "risk of loss" feature is prominently disclosed in the offering documents.

Tax law draws a fundamental distinction between investments that constitute debt and those that do not. Investors in debt instruments are generally guaranteed an unconditional repayment of their original investment and seek pre-determined returns based on the time value of money. By comparison, for non-debt instruments, such as stock, options, forward contracts, and swaps,

investors generally assume a risk of loss of their original investment in the hope of receiving an unpredictable (but potentially greater) return.

Tax law reflects this fundamental difference between debt and non-debt instruments by requiring that investors in debt instruments (and certain swaps that have an easily identifiable debt component) recognize income on a current basis under a set of complicated accrual rules. Investors in non-debt transactions on the other hand, do not generally take any conditional returns into income until such returns become fixed. For example, if an investor buys stock of two companies, one of which distributes its earnings annually and one of which reinvests all of its earnings, the investor is subject to tax on the corporate earnings of the first company but not the second. Investors in corporate stock pay tax only on dividends distributed by the corporation and do not pay tax on any increase in value of the stock until the stock is sold, regardless of how long they choose to hold the shares, and regardless of the fact that the increase in value may be attributable to reinvested earnings. Investors that sell options are not taxed on the option premium received until the option lapses or is exercised, and buyers of options are not required to impute any interest income notwithstanding that the pricing of options takes into account the time value of money.

There are currently no statutory provisions that specifically address the tax treatment of prepaid derivative contracts. The Internal Revenue Service has given guidance on only a limited class of these derivatives. In the absence of explicit rules, leading academics and tax practitioners have undertaken an extensive analysis of these transactions under current law. This analysis has applied long-standing general tax principles to arrive at what is now a broad market consensus on how prepaid derivative contracts should be treated for tax purposes under current law.

As a general matter, the tax analysis of prepaid derivatives should be driven by the fact that a holder is exposed to the risk of loss of all or substantially all of his or her investment in a

contract. The holder does not have a claim for the return of a sum certain principal amount. Investors are seeking risk-based (as opposed to time value of money) returns from these instruments. This risk of loss exists throughout the term of the instrument.

Under the time-honored tax principles of income realization and recognition, investors should generally not be taxed on phantom returns and unrealized gains, which can evaporate at any time along with the investor's original investment. Under current law, because investors in prepaid derivative contracts genuinely put their capital at risk, under long-standing general tax principles, the returns on these instruments should not be taxed as returns on debt.

In a nutshell, investors in debt know that they will have income; the only question is *when*. Investors in prepaid derivative transactions, on the other hand, do not know *whether* they will have any income or whether they will recoup their investment. Waiting until an investor gets paid to impose the tax in this instance is not "deferral"; it is common sense. Applying tax rules developed for debt instruments where investors are entitled to a return of principal does not fit the risk profile of prepaid derivative contracts.

6. Our Concerns About H.R. 4912. H.R. 4912 would introduce a fundamental change in the way all prepaid derivative contracts are treated. H.R. 4912 would treat such contracts in the same way as debt by requiring a holder to accrue interest income on the amount invested and pay tax currently on such income. H.R. 4912 would require accrual of income despite the fact the holder does not receive any amounts currently and is not assured of repayment of its original investment or a return on the investment. H.R. 4912 would require a phantom income recognition for many investors in prepaid derivative contracts. As a result, these investors who will be taxed on phantom income would have to either liquidate their investment in the contracts (where such investments are liquid) or come up with cash to pay the tax by selling other investments or foregoing other investment opportunities.

We are also concerned about the complexity and administrability of H.R. 4912's rules. Under the complex calculations required by H.R. 4912, phantom income on ETNs will be calculated in a series of steps. Then investors will need to keep track of their revised adjusted basis and possibly a hypothetical adjusted basis in the ETNs. It could even be possible for an investor not to know at year-end whether or not the investor has any phantom income for that year. We are particularly concerned that retail investors will find these rules to be complex and difficult to understand. By contrast, mutual fund investors are simply taxed on the cash they receive, or are entitled to receive.

This phantom income accrual requirement of H.R. 4912 would be fundamentally different from the OID rules, which require a holder of a zero coupon bond to accrue annual interest income even in the absence of cash paid, because the holder of such a zero coupon bond is unconditionally entitled to receive at maturity its investment and a time value of money return. In short, H.R. 4912 moves the line on when phantom income should be accrued from debt to cover prepaid derivative contracts whose financial characteristics, by definition, are not debt-like. In considering whether the line should be moved, it is important to keep in mind other investments where accrual of phantom income is not required. For example, an investor in common stock where the issuer retains its earnings is not taxed until the common stock is sold. In these common fact patterns, and many others, a risk-free return is not imputed to the investor.

7. Principles for Taxing Financial Instruments. As a matter of tax policy, any new legislation on the taxation of financial instruments should follow four principles. First, any new rules should be clear and as unambiguous as possible. Second, the legislation should be consistent, which means that it should generally treat in a similar way different types of financial instruments that have similar economic and financial features. Third, the rules should be administrable and understandable by investors. Fourth, new legislation should strike an appropriate balance between

consistency with the taxation of the assets referenced in derivative contracts and recognition that financial derivatives are complex instruments that do not represent mere laundry tickets to the underlying assets. A new set of tax rules that are based on these four criteria would be a substantial improvement of the existing tax system and would be welcomed by taxpayers.

We have significant concerns that the current version of H.R. 4912 is overly broad and does not reflect the tax policy principles described above. As a result, it may create new uncertainties and new disparities at the same time it alleviates others. In this very complex area, H.R. 4912 could produce unfair and unintended results in many situations. For example, H.R. 4912 would impute phantom income at the applicable federal rate ("AFR") on a prepaid derivative whose formula refers to the S&P 500 index, even though the dividend returns on the S&P 500 index are expected to be less than the AFR. Another example is that if an ETN loses value, there would be no adjustment for prior years' phantom income inclusions until the year of the maturity or sale.

One of the reasons that the tax rules for derivatives give rise to so many different views about what is the right answer is that there are too many piecemeal rules addressing a range of financial instruments in a marketplace that is dynamic and innovative. We appreciate that this hearing has been called to start the legislative review of the current tax rules as they apply to complex financial products and determine whether changes may be necessary, taking into account the great importance that these instruments have to financial markets and tax policy objectives. The Treasury Department and Internal Revenue Service have also called for comments on the taxation of prepaid derivatives. In light of the complexity of the issues that will need to be resolved in order to arrive at fair and administrable tax rules, we respectfully suggest that the legislative review be coordinated with the Treasury's consideration of these same issues in order to permit Congress to make the most informed decisions that will reflect sound tax policy objectives. We look forward to participating in this important dialogue.