

**Statement of Andrea S. Kramer  
to the  
U.S. Senate Committee On Finance  
and the  
U.S. House Committee On Ways & Means**

**Tax Reform and the Tax Treatment of Financial Products**

**December 6, 2011**

Chairman Baucus, Chairman Camp, Ranking Members Hatch and Levin, and distinguished members of the Committees, thank you for the opportunity to appear this morning as your Committees consider Tax Reform and the Tax Treatment of Financial Products. I am here today at the request of the Committees.

I am a partner in the law firm of McDermott Will & Emery LLP, where I am head of its Financial Products, Trading & Derivatives Group. My legal practice focuses on the use, regulation, and taxation of derivatives. I principally represent derivatives users who engage in risk management transactions, as opposed to the dealers that sell such products to them. I am also an Adjunct Professor of Law at Northwestern University School of Law, where I teach “Taxation of Financial Derivatives” in the graduate tax program. I am here on my own behalf and the views I express are entirely my own.<sup>1</sup>

**BASIC STRUCTURE OF DERIVATIVES TAXATION**

Often in discussing the tax treatment of derivative transactions, the focus is on their inappropriate or illegitimate uses to game the tax system. The reality is that derivatives are an economically valuable financial products and are principally used for legitimate risk management and hedging purposes. As was reported in the

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<sup>1</sup>I am the author of *Financial Products: Taxation, Regulation & Design*, which is now in its third edition. I regularly speak at tax seminars across the country. I have developed and have presented 14 training courses and full day workshops for the IRS, typically for Financial Product Specialists as part of their annual training programs. I was a founding member of FISC/WISC (Financial Innovation Study Committee/Weird Instrument Study Committee), a group of attorneys, accountants, regulators, and economists that met in the 1990s in Washington, D.C., to study, on an interdisciplinary basis, financial products and derivatives. A list of my professional activities and publications is available at <http://www.mwe.com/info/bios/andreakramer.pdf>.

recent GAO report *Financial Derivatives: Disparate Tax Treatment and Information Gaps Create Uncertainty and Potential Abuse*,<sup>2</sup> “over 94 percent of the largest companies worldwide use financial derivatives to manage and hedge risks.”<sup>3</sup> In addition, the GAO Report notes that “[t]he market for financial derivatives has grown considerably in size over the past two decades...”<sup>4</sup>

Yet despite the enormous size of the derivatives market and American businesses’ use of it primarily for entirely appropriate and economically beneficial purposes, there continues to be a lot of talk about abusive derivative transactions and the need to close “tax loopholes.” A variety of proposals have been put forward to do this, including proposals to move to a mark-to-market system for all derivatives. I believe that these proposals are the result of a misguided perspective on the derivatives market, and I believe more specifically that a move to a more pervasive system of marking-to-market would be a fundamental mistake. Quite simply, we should not go there.

The problem, as I see it, is *not* that there are serious loopholes in the taxation of derivatives — at least, not with respect to taxpayers who use derivatives to manage their risks. The real tax problem with respect to derivatives is that the basic rules are far too restrictive and as a result are inhibiting legitimate commercial and financial activities. Let me explain.

Each provision of the Code that addresses derivative products was specifically enacted to prevent a perceived tax abuse. These abuses include unjustified deferral of income, inappropriate transformation of the tax character of income, and the elimination of taxation all together. But whatever the perceived abuse, every one of our derivative tax rules is an anti-abuse provision. Of course, once you have an entire system of taxation designed to prevent abuse, you need exceptions to assure that appropriate transactions can continue. And so, what we now have in the derivatives tax area are matched pairs of tax rules: anti-abuse rules and rules that provide exceptions to them. It is as though in the derivatives area there are “thou shalt not do that rules,” matched with “in these specific circumstances you can do that” rules.

This is hardly an ideal tax structure but it is the one we have. And I believe it can be substantially improved through relatively modest changes to the “exceptions” portion of our derivatives tax structure. All of my suggestions have

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<sup>2</sup> U.S. GAO, Report to Congressional Requesters, GAO-11-750, Sept. 2011.

<sup>3</sup> *Id.*, at 6, *citing* to a 2009 report by the International Swaps and Derivatives Association.

<sup>4</sup> *Id.*

to do with changes in the various definitions of “hedging” in the Code and the Treasury regulations, and, I believe that in principle, at least, they are non-controversial, even if their details may pose technical difficulties. What I hope to show is that the definitions of hedging are too limited and that the substance of these hedging definitions needs to be expanded. I am convinced that these changes would make our system of taxing derivatives both simpler and fairer - - without opening up any “loopholes.”

## HEDGING AND RISK MANAGEMENT

Let me begin by offering a few comments about the meaning of hedging, why taxpayers do it, and how taxpayers use derivative transactions to accomplish it. Hedging is quite simply the process of changing or reducing an economic risk associated with commercial or investment activities. Hedging and risk management are sometimes characterized as different: hedging being the reduction or elimination of risk, and risk management being the alteration of the scope or nature of risk. In my view, this is a false distinction and I will treat the two terms as synonymous.

The risks that taxpayers seek to manage or hedge through the use of derivative transactions are various: price risk, interest rate risk, supply risk, liquidity risk, credit risk, revenue risk, weather risk, counterparty risk, foreign currency risk, and on and on. And the types of derivative products that taxpayers use to manage or hedge such risks are also various: futures contracts, options, forwards, swaps, and combinations of these products with one another or with traditional types of securities. Let me give you a very simple hedging example. A taxpayer has a foreign currency receivable. It has the risk that the value of the dollar will go down before it receives the foreign currency. To protect itself against this risk, the taxpayer could (1) buy a futures contract on that foreign currency (which would go up in value if the value of the dollar went down); (2) buy an option on the foreign currency (which would also go up in value if the foreign currency appreciated relative to the dollar); or (3) enter into a swap in which it received payment if the dollar went down and make payments if the dollar went up.

With that as background let me give some slightly more elaborate examples of real world risk management or hedging activities.

- A textile manufacturer agrees to sell cotton goods in the future, which contract requires more cotton than the amount of cotton on hand or that can be immediately purchased at a favorable price. To protect itself against a

rising cotton market (during the period between the cotton goods order and the agreed delivery date), the manufacturer enters into long futures contracts for cotton. As the manufacturer buys spot cotton from time to time to manufacture the goods specified in its orders, it closes out the long futures contract. This is a buying hedge.

- A manufacturer buys quantities of spot cotton that will be on hand for some months before being manufactured into goods and sold. To protect itself from losses if the cotton market declines during this period, the manufacturer sells futures contracts for the delivery of equivalent amounts of cotton a few months in the future. From time to time, as the cotton is used to manufacture cotton goods, the short futures contracts are concurrently disposed of by closing transactions. This is a selling hedge.
- A construction company needs to borrow a fixed amount of money in the future and wants to lock in an interest rate for the loan it must obtain. To eliminate the risk of rising interest rates, the company can either sell futures contracts or purchase a put option position. This is a selling hedge.

## THE HEDGING EXEMPTION FROM THE STRADDLE RULES AND SECTION 1256 TREATMENT

Two of the basic anti-abuse rules applicable to derivative products are the “Straddle Rules”<sup>5</sup> and “Section 1256 Treatment.”<sup>6</sup> Both of these provisions are designed to prevent taxpayers from creating artificial losses in one year and “pushing” gains into a future tax year. There is a fundamental assumption, however, that if a taxpayer’s derivative transactions are true “hedged,” then those transactions should be taxed in the normal manner without regard to either of these anti-abuse rules. This is an entirely sensible approach. If a taxpayer is actually using derivative transactions to manage its business or investment risks, it does not

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<sup>5</sup> The Straddle Rules include the loss deferral rule at I.R.C. § 1092(a)(1), which requires a taxpayer who holds “offsetting positions” in “actively traded” “personal property,” where the value of one position moves inversely to the other, to defer losses taken on one position to the extent of unrecognized gain on offsetting positions. This is a one-way whipsaw against taxpayers. The Straddle Rules also require at I.R.C. § 263(g) that interest and carrying charges with respect to personal property that is part of straddle cannot be deducted and instead must be added to the basis of the position to which the interest and carrying charges relate.

<sup>6</sup> Section 1256 Treatment provides two rules for “section 1256 contracts,” as defined at I.R.C. § 1256(g). For contracts that qualify as Section 1256 Contracts, the following anti-abuse provisions at I.R.C. § 1256 apply. First, each contract that is open at the close of the tax year is treated as if sold for its fair market value on the last business day of the taxable year, that is, section 1256 contracts are marked to market. I.R.C. § 1256(a)(1). Second, for those section 1256 contracts that are capital assets in the taxpayer’s hands, any gain or loss is treated as 60 percent long-term and 40 percent short-term capital gain or loss. I.R.C. § 1256(a)(3).

make sense to force those transactions to be marked-to-market or for the losses and gains on the transactions to be taxed other than in a manner that clearly reflects the taxpayer's overall income.

Excepting derivatives hedging transactions from the Straddle Rules and Section 1256 Treatment results in modern, sensible tax results with the tax character and tax timing matched. I think that everyone familiar with the taxation of derivatives, the IRS included, should agree with this as good tax policy. The problem, of course, is how to define "hedging." The current definition of hedging, in my view, is seriously deficient because it does not encompass many entirely appropriate risk management transactions. This problem arises in the Treasury regulations adopted to implement I.R.C. §1221(a)(7).

## RISK MANAGEMENT TRANSACTIONS UNDER I.R.C. §1221

Risk management transactions that fall within I.R.C. §1221(a)(7) are exempt from the Straddle Rules and Section 1256 Treatment. This exemption was added to the Code in 1999. In this Code section, "hedging transaction" is defined as "any transaction" entered into by a taxpayer in the normal course of its trade or business "primarily to *manage* risks. . . ."<sup>7</sup>

In enacting I.R.C. §1221(a)(7), Congress made clear it intended to "broaden" the existing standard for transactions qualifying as hedges from a requirement that the transactions "reduce risk" to one that they "manage risk." According to the Report of the Senate Finance Committee, Congress believed that the risk management standard "better describes modern business hedging practices that should be accorded ordinary character treatment." In the Congress' view, to continue to require "risk reduction" to qualify for a hedging transaction would adversely affect "modern business hedging practices that should be accorded [exemptions from the anti-abuse rules]."<sup>8</sup>

In 2002, the Treasury issued regulations purportedly to "carry out the purposes of" I.R.C. §1221(a)(7), but it did so by basically ignoring the "management of risk" language and reverting to the older "reduction of risk" approach. The Final 2002 Regulations state that, except as determined in public guidance or by a private letter ruling, a transaction is not a hedging transaction unless it is specifically described in the regulations. And, to simplify somewhat — but only somewhat — the only transactions that the Treasury has been willing to

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<sup>7</sup> I.R.C. §1221(b)(2)(A).

<sup>8</sup> S. Rep. No. 106-201 (1999) (LEXIS-NEXIS 17).

explicitly describe as hedging transactions are those that (1) are “risk reducing”; (2) transform an interest rate from a fixed to a floating rate or from a floating to a fixed rate; or (3) cancel a pre-existing hedging transaction. To say that the Treasury approach to hedging has “chilled” legitimate hedging activities would be an understatement.

Let me give you just a few examples of common risk management transactions that do not qualify as tax hedges but clearly should.

- A company uses derivative transactions to convert the price of its inventory from fixed to floating. This is clearly a risk management transaction but it does not qualify as a hedging transaction.
- A company purchases a debt security with interest payments denominated in a foreign currency. The company enters into a derivative to manage its currency risk for a portion of the security’s term. This is not a tax hedge.
- An electric utility earns a significant portion of its yearly revenue in the summer months. It enters into a “cooling degree day” weather derivative to protect itself against the risk that summer temperatures will be lower than expected. This is not a tax hedge.<sup>9</sup>
- A company enters into a derivative contract to hedge the value of the capital equipment it uses in its trade or business. This is not a tax hedge.<sup>10</sup>

I could provide many more examples but I believe you get the point. The current definition of a hedging transaction exempt from the Straddle Rules and Section 1256 Treatment is simply far too narrow. And it is so because the Treasury refused to follow Congress’ clear direction in I.R.C. §1221. In making this point, I don’t want to minimize the complications that would be involved in bringing the Treasury’s hedging standard into line with modern, non-abusive business practices.

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<sup>9</sup> There are many such “volume” or “revenue hedges,” none of which qualify as tax hedges. They include, among other things, the use of various types of weather derivatives, including heating degree days; maximum and minimum temperature events; cumulative average temperature indexes; perceived temperature or chill indexes; precipitation and rainfall; humidity indexes; wind speeds; frost; water flow; drought; and sunshine indexes. See Andrea S. Kramer and William R. Pomierski, *Energy and Environmental Hedging and Risk Management: The Risks and How They are Managed and Taxed in the United States*, Chapter 18 in *ENERGY AND ENVIRONMENTAL PROJECT FINANCE LAW AND TAXATION: NEW INVESTMENT TECHNIQUES* (Andrea S. Kramer and Peter C. Fusaro eds., Oxford University Press 2010).

<sup>10</sup> The definition of a hedging transaction should not be limited to transactions generating ordinary income and loss. When the hedge timing rule of clear reflection of income is applied to a risk management transaction, it should not matter whether the item or risk being hedged generates capital gain or loss.

But it would be well worth the effort. Until changes are made with respect to both tax character and tax timing in the definition of hedging transactions, we as a country will continue to inhibit the legitimate economic activities of our most dynamic and entrepreneurial businesses.

The first step to be taken in this reform effort would be for the Treasury to acknowledge that when taxpayers enter into derivative transactions that change their exposure to economic risks of any type, those transactions should be regarded as legitimate tax hedges exempt from the Straddle Rules and Section 1256 Treatment. I have written extensively on this subject and would be prepared to submit a detailed memorandum with suggested statutory or regulatory language. But until the Treasury acknowledges the need to move forward in this area, or Congress expresses a willingness to legislate in a manner that forces the Treasury to do so, I am afraid that such a detailed memorandum would fall on deaf ears.

## INTEGRATED TAX TREATMENT FOR FOREIGN CURRENCY HEDGES

Let me turn from hedging transactions under I.R.C. §1221 to foreign currency hedging. The Code's treatment of nonfunctional currency derivative transactions is very convoluted. In simplified terms, however, if a derivative is a "Section 988 transaction," which is a derivative transaction the value of which relates to the value of a foreign currency, then the taxpayer's gain or loss on the derivative is calculated separately from any gain or loss on the underlying transaction. If, however, the derivatives transaction is a so-called Section 988(d) hedge, then the gain or loss on the transaction is integrated with the underlying transaction.<sup>11</sup> Tax integration not only eliminates a separate calculation of the derivative's gains and losses, but takes the transaction out of the Straddle Rules and Section 1256 Treatment. Gain or loss on the hedge is rolled into (that is, integrated with) the underlying transaction. As a result, when a foreign currency derivative is treated as a hedge, it and the underlying items are treated as a single transaction, eliminating mismatch possibilities.

The problem is that under Treasury regulations, the foreign currency derivatives must qualify as part of a Section 988(d) hedge. I.R.C. §988(d)(2) broadly defines a Section 988(d) transaction to mean "any transaction" that is entered into by the taxpayer "primarily to *manage* the risk of currency fluctuations" with respect to property, borrowings, or obligations. The Treasury

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<sup>11</sup> I.R.C. §988(d)(1).

regulations, however, have unnecessarily limited the transactions that are eligible for Section 988(d) integrated hedge treatment to three types: (1) executory contracts; (2) debt securities; and (3) hedges of currency risk between the trade date and settlement date for certain stocks sales. Within each of these types, Section 988(d) hedge treatment is inappropriately restricted. Let me give just three examples in the executory contract area to illustrate just how unnecessarily restrictive the Treasury's Section 988(d) definition of hedging is.

- Company A has an executory contract -- it has agreed to pay or receive foreign currency in the future in exchange for the purchase or sale of equipment used in its business. If it wants to hedge that contract, it must maintain the hedge from the date the hedge is identified to the end of the executory contract. This means that a taxpayer with such an executory contract that requires progress payments in the foreign currency cannot hedge its purchase price risk.
- If corporate policy requires members of a consolidated group to enter into all of their risk management derivative transactions with another group member (such as a Treasury Center or Hedge Center), and that Center, in turn, will execute hedges with third party dealers (a very common corporate policy), none of those transactions would qualify for Section 988(d) integrated hedge treatment. This is because the Treasury regulations require that none of the parties to a Section 988(d) hedge be related parties.
- Corporation A has an executory contract to buy equipment denominated in a foreign currency in the future. Corporation B, a member of the same consolidated tax group, enters into a derivative transaction to reduce the risk for the consolidated group of A's executory contract. B's risk reducing transaction does not qualify as a Section 988(d) hedge because the Treasury regulations require both the executory contract and the hedge to be entered into by the same corporation.

## INTEGRATED TAX TREATMENT FOR DEBT HEDGES

The last tax hedging provision I will mention is the integrated hedge rules for certain debt securities under Treas. Reg. §1.1275-6. This regulatory provision basically builds off of the tax timing and character integration concepts for foreign currency in I.R.C. §988(d). It provides that if a derivative meets the definition of a Section 1.1275-6 hedge, the taxpayer treats the gain or loss on the hedge and the underlying debt security as a single integrated transaction and neither the Straddle Rules nor Section 1256 Treatment applies. Once again, a taxpayer's derivative

transactions must meet unnecessary and far too narrow requirements to qualify for integration. I suspect that I do not need to provide examples to make my point because the pattern is similar to that for Section 988(d) hedges.

## CONCLUSION

In conclusion, I am not at all objecting to the basic approach taken by the Code and Treasury regulations of creating exceptions from the derivatives anti-abuse rules for hedging transactions. What I am objecting to is the restrictive nature of the exemptions for definitions of hedging transactions. The substance of the hedging exemption needs to be expanded. My suggestion is simple, let's identify all of the risk management transactions for which the application of the Straddle Rules and Section 1256 Treatment makes no sense. I have given several examples but there are many more. Once we have done that, let's classify them as hedges -- subject to the clear reflection of income requirement (at Treas. Reg. §1.446-4) for I.R.C. §1221(a)(7) hedges and tax integration for Section 988(d) and Section 1.1275-6 hedges -- and be done with it.

I would be happy to supply the Committees with whatever additional information they request.