Testimony to the Senate Finance Committee and the House Ways and Means Committee on the Taxation of Financial Products

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Chairman Baucus, Ranking Member Hatch, Chairman Camp, Ranking Member Levin, and members of the committees: Thank you for giving me the opportunity to speak to you today.

I am here to talk about the federal income tax treatment of financial instruments. But I am going to start with Claudius Ptolemy.

Our Ptolemaic System of Realization Taxation: Its Fundamental Flaw and its Corrective Ellipses.

Claudius Ptolemy was the second century astronomer who created a model of the heavens that predicted the positions of the sun, moon and planets, and was used for over 1,400 years.

There was just one problem with his universe: The earth was in the middle.

How could a model that was just plain wrong provide sufficient accuracy to be used by Western civilization for over 14 centuries?

With a great deal of complexity.

To explain and predict heliocentric planetary patterns in a geocentric model, Ptolemy's planets traveled in a series of ellipses or epicycles around the earth. But this alone was insufficient. To correct further, Ptolemy had the planets move closer and then further away from the earth, and even slow down and reverse in their orbits.

Our federal system for taxing financial instruments is truly Ptolemaic. As Ptolemy's system was geocentric, our federal tax system is based on the equally archaic system of realization – the concept that income is not earned, and therefore not taxed, until a taxpayer actually sells property for cash or exchanges it for materially different property.

In the 1920s-1930s, two American economists, Robert Haig and Henry Simons, recognized that true economic income is measured by the increase in the value of assets, regardless of when they are sold.[1] Our modern capital markets understand this, and taxpayers are free to borrow against and spend the unrealized appreciation in their publicly-traded property. And yet our tax system remains grounded in the antiquated system of realization.

Like Ptolemy with his ellipses, Congress and the IRS have tried to correct for our fundamentally-flawed system of taxation. The wash sale rules, the straddle rules, the capital loss limitation rules, the original issue discount rules, the contingent payment debt instrument rules, the conversion transaction rules, the constructive ownership and sale rules, and the contingent swap rules are the ellipses of our tax system. And yet we retain our realization tax system as stubbornly as Europe through the middle ages retained Ptolemy's geocentric system.

And so we are left with a system as complicated as Ptolemy's. We have over a dozen cubbyholes for various financial instruments, each with their own set of rules, many of them inconsistent. Because our system of taxation has no basis in the reality of economics,

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1 *See* Robert M. Haig, *The Concept of Income–Economic and Legal Aspects*, *in* THE FEDERAL INCOME TAX (Robert M. Haig ed., 1921); Henry C. Simons, PERSONAL INCOME TAXATION: THE DEFINITION OF INCOME AS A PROBLEM OF FISCAL POLICY 206 (1938).

sophisticated taxpayers are free to choose a tax treatment that minimizes their taxes. And choose they do. I offer three examples.

The Taxation of Credit Default Swaps

First, credit default swaps can be structured as options for tax purposes or they can be structured as "notional principal contracts". If they are structured as options, the taxpayer can defer tax on the premiums. If they are structured as notional principal contracts, the taxpayer can rely on the "contingent swap" regulations proposed by the IRS to claim immediate ordinary losses when the risk of default increases. Some taxpayers initially took the position that credit default swaps are options and deferred the premiums, and then, after the market turned downward, changed their minds and treated the very same credit default swaps as notional principal contracts to claim immediate ordinary losses.

The Use of "Variable Prepaid Forward Contracts" To Monetize Appreciated Stock

Second, as was recently reported in a *New York Times* article by David Kocieniewski and a *Bloomberg* story by Jesse Drucker,[2] wealthy individuals with appreciated stock are able to enter into variable prepaid forwards that hedge their downside risk, and provide them with cash, all tax-free. Hundreds of millions of dollars of cash. Although the IRS has challenged one variant of this transaction, it has issued a Revenue Ruling declaring the basic technique completely legal.[3] In fact, in June, Ronald Lauder entered into a variable prepaid forward contract on his Estée Lauder shares and received over $72 million in cash tax-free.

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[2] *See* David Kocieniewski, *A Family's Billions, Artfully Sheltered*, N.Y. TIMES, Nov. 26, 2011, at A1; Jesse Drucker, *Buffett-Ducking Billionaires Avoid Reporting Cash Gains to IRS*, BLOOMBERG, Nov. 21, 2011.

[3] Revenue Ruling 93-7, 2003-1 C.B. 363.

These are not transactions available to working-class Americans, but our realization-based tax system permits them.

Structured Notes and the "Open Transaction" Doctrine

And finally, in the past 10 years, over $200 billion in structured notes have been issued in public transactions registered with the SEC. Among these structured notes is a type that promises its holders a relatively secure principal amount at maturity plus contingent interest tied to the return of an equity index like the S&P 500. Notes like these resemble contingent payment debt instruments that would subject an investor to annual original issue discount accruals and ordinary income at maturity. But these notes are structured as prepaid forwards. Under the "open transaction" doctrine of our realization-based tax system, holders pay no tax until maturity and then, at maturity, are eligible for long-term capital gains rates.

These notes are not tax shelters in any nefarious sense. They are registered with the SEC in public documents, and their beneficial tax treatment is simply the natural consequence of our realization tax system.

The deferral that these three different products permit is an artifact of our realization system. The ability of taxpayers to choose their tax treatment arises because there is no single guiding principle governing the taxation of financial instruments. And our system is numbingly complex because Congress and the IRS must again and again correct for a system that has no basis in reality.

An Alternative: Mark-to-Market Taxation

But there is an alternative that matches economic income precisely. It is simple to apply and all but foolproof. It is called mark-to-market.

For instruments subject to a mark-to-market system of taxation, the taxpayer would simply compare the value of the instrument at the end of year with its tax basis and pay tax on the difference, regardless of whether the instrument is sold.

I have proposed a system that would require all public companies, all private companies with $50 million or more of net assets, and the 1/10th of 1% of the wealthiest and highest-earning individual taxpayers to mark-to-market all of their publicly-traded property, derivatives of publicly-traded property (other than business hedges), and some publicly-traded debt and liabilities. (A copy of my proposal is attached.)

Mark-to-market gains of individuals would be taxable at long-term capital gains rates and losses would be deductible (and the tax refundable) to the extent of prior mark-to-market gains.

This system would at once abandon our geocentric tax system and finally match tax and economics. It would help level the playing field between middle-class wage earners who pay tax on all of their economic income and the billionaires who pay no tax on their appreciated stock, and it would eliminate the need for the tax ellipses, permitting tremendous simplification. But it is radical because it would apply to stock and securities as well as derivatives.

But incremental change is also possible: Mark-to-market treatment could be applied selectively to derivatives. This selective treatment would require more line drawing, but still would be an improvement over our current system. In an appendix to my testimony, I have outlined how a mark-to-market system of taxation for derivatives might work.

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Thirteen hundred years after Ptolemy proposed his earth-centered model of the skies, Nicolaus Copernicus challenged it with a competing and radical but infinitely simpler view that happened to correspond to reality: it is the earth, the moon and the planets that revolve around the sun.

Our own tax system was conceived at the beginning of the last century when economic income could be measured only by cash, and the effect of a tax deferred was little understood. Our markets are now liquid, our taxpayers sophisticated. To bring our system for taxing financial instruments into the twenty-first century, tax must match the reality of economic income. Only a mark-to-market system of taxation does that.

Thank you. I welcome your questions.

A Mark-to-Market System of Taxation for Publicly-Traded Derivatives and Derivatives With Respect to Publicly-Traded Property

1. All publicly-traded derivatives, and derivatives with respect to publicly-traded property for which there is a reasonable basis to determine fair market value, would be subject to mark-to-market treatment, and all taxpayers would report mark-to-market gains as ordinary income or loss.[1]

2. Other derivatives would remain subject to the current rules, except that an interest charge would apply to prepaid derivatives. Thus, nontraded derivatives could give rise to capital gains and losses and no tax would be paid by a taxpayer that receives nontraded property upon the exercise of an option or upon the maturity of a forward contract until the underlying property is sold or exchanged (although interest would accrue on prepayments). For example, taxpayers that purchase options on real estate and private businesses would not be subject to mark-to-market treatment. It is not practical to apply mark-to-market treatment to illiquid and hard-to-value derivatives.

3. Broker-dealers would be required to conduct the mark-to-market valuations. The IRS would establish or approve industry-wide valuation guidelines and would audit broker-dealer valuation methodologies, but would not challenge individual valuations that are made in good faith. Taxpayers that do not enter into mark-to-market derivatives with broker-dealers would have to designate an approved broker-dealer to value their derivatives or face a penalty in the nature of an interest charge.

4. An exception to mark-to-market taxation would exist for taxpayers that use derivatives to hedge their ordinary assets and liabilities under existing regulations sections 1.1221-2 and 1.446-4, and for taxpayers that integrate their interest-rate and currency swaps into debt instruments under existing regulations section 1.1275-6. So mark-to-market taxation would not apply to a farmer that uses derivatives to hedge her risk on the next crop, or to an energy company that hedges fuel costs.

5. Partnerships, trusts, and tracking stock can be used to create derivatives, and mark-to-market derivatives can be embedded in nontraded derivatives. An anti-abuse rule would allow the IRS to treat any portion of a nontraded derivative, nonderivative security, or any other arrangement (including stock, and interests in partnerships and trusts) as a derivative potentially subject to mark-to-market treatment if a principal purpose of the arrangement is to avoid mark-to-market treatment. So, for example, assume that a taxpayer contributes $10 to a partnership and an investment bank contributes $90; the partnership uses the $100 to buy

[1] If retention of long-term capital gains rules is desirable, mark-to-market treatment would not begin until the second December 31 after acquisition, and long-term capital gains rates would apply to gains on actual dispositions occurring after a year, and for mark-to-market gains thereafter. For prepaid derivatives, an ordinary-income interest charge could be applied to the prepayment; long-term capital gains rates would apply to gains in excess of the interest charge.

publicly-traded XYZ stock and allocates all dividends, loss and the first $10 of gain to the investment bank, and all gain in excess of $10 to the taxpayer. Under the anti-abuse rule, the IRS could treat the taxpayer's partnership interest as a derivative (i.e., an option on XYZ stock) that is subject to mark-to-market treatment. Variable-rate debt instruments, contingent payment debt instruments, and conventional convertible and exchangeable debt and stock would not ordinarily be deconstructed.

6. The 60% long-term/40% short-term capital gain treatment for section 1256 contracts would be repealed. There is no policy justification for reduced rates of tax for short-term section 1256 contracts.

7. Mandatory mark-to-market treatment under section 475 would apply to commodities dealers. There is no policy reason why commodities dealers enjoy more favorable tax treatment than securities dealers.

8. Investors (and not only dealers and traders) would have the ability to elect mark-to-market treatment under section 475 for all of their securities.