



# How Tax Pros Make the Code Less Fair and Efficient: Several New Strategies and Solutions

Report of the Senate Finance Committee Democratic Staff

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## Introduction

Have you ever heard of a collar? Or a basket option? Or a wash sale? Most people haven't. But many taxpayers use these sophisticated transactions to cut the taxes they could owe in half, often paying effective rates far lower than people who earn a regular paycheck.

This report describes each of these little known tax avoidance strategies identified for Senator Wyden by the nonpartisan staff of the Joint Committee on Taxation (JCT) and outside independent experts, relying on memoranda, examples, and descriptions.<sup>1</sup> A preliminary analysis indicates that reforms to rein in some of these strategies could reduce the amount of taxes avoided by tens of billions of dollars over the next decade while making the tax code fairer and simpler overall.

Certain taxpayers can use derivative contracts like options, forwards, and swaps to place bets on the future values of stocks and other investments.<sup>2</sup> Unlike simply holding a stock for example, these taxpayers can tailor derivatives to lock in a stock's gains (or losses) *while also manipulating the timing of any taxes paid and minimizing the amount of tax that does get paid*. Derivatives create tax wins for those who know how to use them, and it is all perfectly legal. The fact is that tax rules and Treasury guidance have failed to keep pace with the multiplying varieties of tax avoidance strategies that can be used to shelter income from taxation. The IRS also lacks the resources to properly monitor and audit large partnerships that engage in these tax games, which allows these taxpayers to become even more aggressive in their use of such games to avoid taxes. Meanwhile, the vast majority of taxpayers can neither defer paying taxes nor minimize the amounts they do pay, and generally have to ride the ups and downs of the market on their investments.

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<sup>1</sup> Unless cited otherwise, tax avoidance strategies and examples have been described to us by the staff of the Joint Committee on Taxation.

<sup>2</sup> As a more formal definition, a derivative is a contract in which the amount of at least one contractual payment is calculated from the change in value of something (or a combination of things) that is fixed only after the contract is entered into. The thing that fixes the payment amount(s) and hence the derivative's value is called the underlying; examples include assets, liabilities, indices, and events. The most common forms of derivative are options, forwards, futures, and swaps. The taxation of derivatives has developed over a long period without a consistent underlying policy. The tax rules apply differently depending on the form of the derivative, the type of taxpayer entering into it, the purpose of the transaction, and other factors. The rules are complex and may be uncertain in their application. (Source: Joint Committee on Taxation, Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2015 Budget, December 2014, JCS-2-14). In the technical explanation of Ways and Means Chairman Dave Camp's financial product reform discussion draft, JCT elaborated further on the above: "A derivative is (1) any evidence of an interest in, or any derivative instrument with respect to, any (a) share of stock in a corporation, (b) partnership interest or beneficial ownership interest in a partnership interest or trust, (c) note, bond, debenture, or other evidence of indebtedness, (d) certain real property, (e) actively traded commodity, or (f) currency; (2) any notional principal contract; and (3) any derivative instrument with respect to any interest or instrument described above."

## Tax Avoidance through Financial Products and Deferred Compensation

Below are the latest tax avoidance games that outside experts and JCT identified for Senator Wyden involving financial products or deferred compensation. (Also, included at the end of this report is some general background on income taxation and types of derivatives).

1. Using “collars” to avoid paying capital gains taxes. Taxpayers who own appreciated stocks may lock in the gain by using a “collar” that involves purchasing simultaneous options to buy and sell the stock at set prices to hedge against any stock price fluctuation. In this way, taxpayers are able to lock in a capital gain while bearing little economic risk for a change in value in the security and without constructively selling it. If there is no constructive sale then no capital gains taxes are owed. Congress tried to address this practice back in the 1990s by forcing taxpayers to recognize gains on securities that were entirely hedged using such derivative transactions, but Treasury never followed through with writing and enforcing regulations regarding options and collars.

Example 1:<sup>3</sup> A taxpayer owns 100,000 shares of XYZ stock which is currently trading at \$100 per share. The taxpayer now purchases a type of option called a “put” from a bank which allows the taxpayer to sell 100,000 shares of XYZ to the bank in three years for \$10 million. At the same time, the taxpayer sells a “call” option to the bank, which gives the bank the right to purchase 100,000 shares from the taxpayer in three years for \$11 million.<sup>4</sup> Thus, in this example, the taxpayer locks in \$10 million of sale proceeds and, potentially, may receive \$11 million.<sup>5</sup> But the taxpayer avoids paying any tax now even though it has locked in the income.<sup>6</sup>

By comparison, a married couple earning \$100,000 might pay a 25 percent income tax rate plus a 15.3 percent payroll tax rate (which counts the employee plus employer portions) on the wages they receive, or a combined 40.3 percent tax rate<sup>7</sup> on each additional dollar of wages.

2. Using wash sales to time the recognition of capital income. A central tax challenge posed by the current treatment of capital gains is that such gains are only taxed when realized. Thus,

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<sup>3</sup> Provided by Steven Rosenthal, Senior Fellow, Urban Institute, Washington, DC.

<sup>4</sup> In addition, the options may be physically or cash settled. So, if XYZ is trading at \$130 on the settlement date, the taxpayer may either deliver the 100,000 shares of XYZ to the bank in exchange for \$120 million or make a cash payment of \$1 million (i.e., the difference between the \$120 strike price and the \$130 market price of XYZ on the date of settlement multiplied by the number of shares underlying the option).

<sup>5</sup> The collar in this example is a 10 percent collar in that the \$11 million strike price for the call option (the right for the bank to purchase the shares) is 10 percent higher than the \$10 million strike price for the put option (the right for the taxpayers to sell the shares). Treasury Department guidance that accompanied the enactment of the constructive sale rules in tax code section 1259 suggested that any collar below 15 percent was abusive, but additional guidance from Congress or Treasury is still needed.

<sup>6</sup> In addition, the taxpayer in this example could in three years, defer the tax further by settling the option in cash rather than physically acquiring the underlying asset. The taxpayer might extend its contract, but the extension could be a taxable event (the extension issue is being litigated in the tax courts now).

<sup>7</sup> The effective tax rate is actually slightly less than 40.3 percent because employers get to exclude the employer-portion of payroll taxes from employees’ taxable incomes.

taxpayers can defer realizing capital gains but can realize capital losses at will without changing their economic position, by terminating a security that has lost money at the end of the tax year and then immediately repurchasing a substantially similar security. While selling the first security triggers the realization of the loss, purchasing the second security does not undo this loss realization.

In this way, some taxpayers can selectively recognize losses to offset capital gains income that would otherwise be taxed and then perpetuate the same loss position to offset gains at another time – thus, they effectively pay no taxes on the capital gains they do realize. While current “wash sale” rules do prevent taxpayers who sell securities at a loss from recognizing the loss if they acquire a substantially identical security within 30 days of the first loss sale, these rules were not designed to recognize similar games played with more modern financial instruments like forward contracts and swaps (which obscure constructive sales of the underlying security) and do not apply to other assets like commodities and currencies.

Example 2:<sup>8</sup> A taxpayer owns a portfolio that contains stocks with unrealized gains and stocks with unrealized losses. The taxpayer would like to realize the losses to offset other income. So, the taxpayer sells the losing stocks in the market and, at the same time, enters into a derivative contract with a bank. Under the derivative, the bank pays the taxpayer the economic-equivalent return of the stocks that have been sold plus the return of additional stocks that the taxpayer was planning to buy. Because the derivative references a basket of stocks that is somewhat different from the stocks that have been sold, the taxpayer can take the losses on the stocks that have been sold. After 31 days, the taxpayer terminates the derivative and rebuys the stocks that had been sold. After these transactions, the taxpayer owns the same portfolio she had previously, but she now has income losses that reduce her taxable income and thus her tax bill *and* she does not have to pay tax on her stock gains.

By comparison, the married couple on a \$100,000 salary would pay a 40.3 percent total tax rate on that earned income. To the extent these taxpayers have capital income, they would pay capital gains taxes (a 15 percent rate for the example), most likely on gains from mutual fund investments rather than on individual stocks or commodity and currency derivatives. It would not be economically feasible for typical taxpayers to enter a derivative contract with a bank to successfully skirt existing wash sale rules and avoid paying capital gains taxes on the securities they own.

3. Using derivatives to convert ordinary income to capital gains or convert capital losses to ordinary losses. Taxpayers trigger capital gains taxes through the sale or exchange of capital assets. However, if contracts on capital assets are held to maturity, the income flowing from the contracts will usually be taxed at ordinary rates even if the character of the income from the property that is the subject of the contract is capital. Derivatives such as swaps are

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<sup>8</sup> Provided by Steven Rosenthal, Senior Fellow, Urban Institute, Washington, DC.

property: they are contracts between two parties in that they confer a right to receive or make a payment based on the price of a security at a set future date. Even while the underlying asset referenced by a swap might have a capital gain, the payments required by the derivatives contract are generally taxed as ordinary income *if the contract is held to maturity*.<sup>9</sup> However, if these contracts are terminated before maturity by a sale of the underlying asset, then the proceeds are generally treated as a capital gain (or loss). Because these swap contracts can be used to toggle the character of the underlying investment to maximize the tax benefit – terminating the derivative early to generate capital gains or losses or holding it to maturity to generate ordinary income or losses – some taxpayers can use them to significantly alter when they pay taxes and at what rates.<sup>10</sup> By contrast, typical wage earners must pay income tax plus the employer and employee portions of payroll taxes out of every paycheck. Such taxpayers do not have the choice of when to pay taxes or at what rate, and do not have access to these types of financial products or the related tax planning advice. The fees to enter into these transactions are prohibitive for most taxpayers.

4. Using derivatives to avoid constructive ownership rules for partnership interests.<sup>11</sup> In the 1990s, some taxpayers purchased swaps (or other derivative instruments) mimicking ownership of an investment partnership rather than directly purchasing an interest in said partnership. Taxpayers used such tax games to report long-term capital gain (taxed at 23.8 percent today), rather than the ordinary income and short-term capital gain (taxed at 43.4 percent today) that would have resulted from ownership of the actual partnership interest. In 1999, Congress tried to end this practice by limiting (in tax code section 1260) the amount of long-term capital gain a taxpayer could recognize from derivative contracts that referenced partnership interests as the underlying asset. Congress identified “constructive ownership” transactions as swaps, forward contracts, option collars, and, to the extent Treasury provided in future regulations, other transactions with substantially the same effect. Unfortunately, Treasury never wrote these regulations, so some taxpayers continue to use derivatives on investment partnerships that mimic ownership of an interest while avoiding the higher tax liability that goes with actual ownership.

Example 3: On January 1, 2012, a taxpayer entered into a “deep-in-the-money” three-year option contract<sup>12</sup> with a securities dealer with respect to a partnership interest. Under the

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<sup>9</sup> Note that for forward contracts and so-called bullet swaps (swaps in which a single payment is exchanged at settlement, similar to a forward) the final payment at maturity would be treated as long-term capital gains if the underlying asset is capital *under proposed regulations for tax code section 1234A*. Some believe the proposed regulations have sufficiently discouraged taxpayers from using these derivatives to toggle gains and losses.

<sup>10</sup> Note that individual investors who enter into derivative contracts cannot usually deduct ordinary payments because of the limitations on miscellaneous itemized deductions (section 67 of the tax code). Capital losses of individuals also are limited to \$3,000 against ordinary income). But taxpayers like hedge funds that buy and sell financial instruments in the course of a trade or business generally can fully deduct ordinary payments.

<sup>11</sup> Provided by Steven Rosenthal, Senior Fellow, Urban Institute, Washington, DC.

<sup>12</sup> A deep-in-the-money option is an option with an exercise price, or strike price, significantly above (usually at least twice the value of) the market price of the underlying asset (for a put option in this example). For example, if the

terms of the option, the dealer agrees to pay the taxpayer the difference between the market price of the partnership interest and the “strike” price of the option (i.e., the price at which the option can be exercised) at the settlement date of January 1, 2015. Suppose the partnership interest was initially worth \$200, but the strike price on the option was \$100 (and the taxpayer paid \$100 for the option, which is her basis). Also, suppose at settlement, the partnership interest is worth \$400. By holding the option as opposed to holding an actual partnership interest, the taxpayer gets to treat the \$300 payoff (\$400 minus \$100) as long-term capital gain in 2015, taxable at 23.8 percent instead of receiving a gain of just \$200, taxable at 43.4 percent. (The taxpayer also does not recognize any short term gain or ordinary income – and therefore, no tax liability – before the 2015 settlement date).

Typical taxpayers do not own interests in partnerships or have access to derivative contracts that enable them to convert capital gains income into ordinary income. The married couple earning \$100,000 from the previous example would pay a 40.3 percent tax rate on each additional dollar of income – or nearly twice the tax rate as the taxpayers who make use of this particular tax game.

5. Using “basket options” to convert short-term gains into long-term gains. A number of hedge funds have used a complex financial structure to convert short term capital gains (taxed at 43.4% today) to long-term capital gains (taxed at 23.8%). The strategy uses a combination of options called colloquially “basket options.” Clearly a tax shelter, basket options purportedly allow ultra-high income investors to reduce their tax bill below that required by current law.<sup>13</sup>

Basket option transactions occur between hedge funds and banks. A bank establishes an account in its own name or that of a subsidiary. This account is used to maintain a portfolio of securities, making the account a “basket” of securities. The bank then enters into a “basket option contract” with a hedge fund. As the option holder, the hedge fund may exercise the option and receive a payoff equal to the profits generated by the basket of securities.

Though the account and the securities within it are technically owned by the bank, the hedge fund acts as an investment advisor and manages the assets within the account. The bank sets several basic parameters but otherwise gives the hedge fund wide discretion as to the

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current price of the underlying stock were \$10, a put option with a strike price of \$20 would be considered deep-in-the-money. Arguably, a deep-in-the-money option is little different from a constructive sale because the holders of such options are highly likely to exercise them.

<sup>13</sup> For example, in July of 2014, the U.S. Senate Permanent Subcommittee on Investigations of the Committee on Homeland Security and Government Affairs published a report titled “Abuse of Structured Financial Products: Misusing Basket Options to Avoid Taxes and Leverage Limits.” The report detailed the arrangements under which hedge funds collaborating with Deutsche Bank AG and Barclays Bank PLC – the institutions selling the so-called basket options – were able to amass over \$35 billion in trading profits, of which \$34 billion came from options exercised after more than one year and taxable at the lower long-term capital gain rate even while the underlying assets were typically held for less than one year (and sometimes for even as short a span as a few minutes) and normally taxable at higher ordinary income tax rates.

investment strategy. Profits remain in the account until the option is exercised. The value of the option rises as the value of the assets in the account rise. When the hedge fund exercises the option, it collects the profits associated with the account. The bank profits by collecting fees from the hedge fund.

By characterizing the transaction as a derivative, a hedge fund is able to defer gains and losses from high-frequency trading and recast short-term capital gains as long-term capital gains. This is because the trading account (the basket) serves as the underlying asset for the derivative, not the assets within the account (which are a larger sum and often include leveraged amounts); so the value of the basket determines the value of the derivative, and not the actual value of the assets in the basket. A derivative is not taxed until a realization event occurs. Realization occurs when the hedge fund exercises or sells the option. Thus, when the hedge fund waits 12 months before exercising or selling the option, gains on the option will be long-term capital gains, taxed at 23.8 percent. Had the hedge fund directly traded the assets within the basket, the holding period for almost all of the assets would be less than 12 months and gains from the assets would be taxed as short-term capital gains, which are taxed as ordinary income at a marginal rate of 43.4 percent today. Banks entering into these transactions usually set three-year terms on their basket options, though hedge funds generally exercise their options a little over 12 months after entering into them.

In 2010, the IRS issued an Office of Chief Counsel Internal Revenue Service Memorandum (Generic Legal Advice Memorandum (GLAM) 2010-005) – an internal memorandum providing that these basket options were not options at all, but rather an account of securities owned by the hedge fund. Accordingly, profits from trades of assets held for less than a year would be subject to the higher short term capital gains rate. Unfortunately, GLAMs have no legal authority and hedge funds – and the banks that sell these “basket options” – could disregard the IRS guidance and continue to sell this product, without penalty for disregard of a rule or regulation (sec. 6662(a)).

In July, the U.S. Senate Permanent Subcommittee on Investigations of the Committee on Homeland Security and Government Affairs (PSI) completed an investigation on the misuse of basket options to avoid taxes. The basket options examined by the PSI Subcommittee were used by at least 14 hedge funds to conduct over \$100 billion in securities trades. The Subcommittee estimated that the largest basket option user exercised this strategy to avoid paying more than \$6 billion in taxes between 2000 and 2013.

Example 4:<sup>14</sup> A hedge fund deposits \$10 million in an account that is held by a bank. The bank loans another \$90 million to the account. The hedge fund directs the bank to use the \$100 million to trade a basket of stocks (i.e., to frequently buy and sell stocks for the basket). But the bank, nominally, owns the stocks in the account. As part of the arrangement, the bank

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<sup>14</sup> Provided by Steven Rosenthal, Senior Fellow, Urban Institute, Washington, DC.

enters a derivative contract with the hedge fund to pay at a future date the gains and losses from the sale of stocks in the basket. So, if the basket of stocks is worth \$130 million at the end, the bank will pay the hedge fund \$30 million. The hedge fund typically keeps the derivative contract for more than 12 months so that when it reports its gains, it gets long-term gains treatment (taxable at 23.8 percent) on the income instead of short-term gains treatment (taxable at 43.4 percent).

Basket options purportedly allow ultra-high income investors of hedge funds to reduce their tax bill below that required by current law. Basket options also allow for greater returns for the underlying fund (and thus the high-income investor) because the hedge fund is not paying taxes on short term capital gains. Typical individual taxpayers don't have access to direct investment in a hedge fund and therefore, don't receive these benefits.

6. Avoiding income taxes by deferring compensation. Other tax avoidance strategies can be used to delay paying taxes for years. Generally, this benefit allows executives and management employees to delay recognizing income to a future year, allowing investment returns on that deferred income to compound tax free until the income is finally paid out. Such strategies are not necessarily new, but the opportunities for manipulation are substantial and warrant discussion in this report.

Under current law, it is common for employers to provide executives and management employees with the choice of receiving some of their compensation currently or deferring it to a later date. On the other hand, rank-and-file employees only have the opportunity to defer compensation within very prescribed statutory limits, such as under a 401(k) plan or by contributing to an IRA.

One way executives and management employees can defer compensation is through a nonqualified deferred compensation (NQDC) plan. Under an unfunded NQDC arrangement, in general, the employee does not include the compensation in income until it is actually or constructively received in the future (assuming certain requirements are met). The employer's deduction for this compensation is postponed until the future date as well.

For example, as provided in a November 14, 2014 memorandum from JCT, "an individual who expects to earn \$500,000 in compensation that would otherwise be includible in gross in[come for] the following taxable year can be allowed to elect (before the beginning of the following taxable year) to defer a portion of that compensation (such as \$100,000) to be payable at a specified time in the future (such as in 20 years or, if earlier, upon the individual's death) and include in income for the following year only compensation reduced by the amount elected to be deferred (\$400,000 if the amount elected is \$100,000), rather than \$500,000."

NQDC raises a number of issues of fairness. First, this benefit generally is provided to highly compensated employees. Furthermore, although the rules have been tightened somewhat,

these high-income taxpayers still have some control over the timing of the inclusion of income and, therefore, the taxation. In the example, the high-income earner can choose to avoid paying taxes on compensation for 20 years or even longer. It also provides highly compensated employees with the compounding benefit of accruing earnings tax-free during the deferral period.

By contrast, rank and file employees generally do not have access to NQDC arrangements. These taxpayers only have the opportunity to defer compensation within limits, such as under a 401(k) plan or by contributing to an IRA. For example, in 2015, the employee elective deferral limit for a 401(k) plan is \$18,000. Contrast that with a NQDC arrangement, which has no limitations on the amount of deferral.

### **Inconsistent Taxation of Financial Products Reduces Equity and Efficiency**

Over \$2.2 trillion of options were traded or exercised on U.S. exchanges in 2009 (or nearly 8 times 2002 levels) and another \$2.7 trillion of single-stock futures traded (or nearly 9 times 2002 levels).<sup>15</sup> These figures do not even encompass the entire derivatives market. Understanding the gaps in tax rules and getting taxation right in this sector grows more crucial by the year.

As should be clear from the examples above, derivatives can be used to replicate the cash returns of virtually any underlying asset, allowing some taxpayers to structure a portfolio of underlying securities and derivatives to achieve the desired combination of risk and return as well as the desired timing of cash flows. However, our inefficient and outdated tax code does not provide equal tax treatment for economically equivalent portfolios of underlying assets and/or derivatives. Differences in tax treatment of economically equivalent portfolios may allow taxpayers to some extent to elect the timing, character, or source of income for tax purposes that is most advantageous. Inefficiencies and inequities arise when economically equivalent transactions are taxed in different ways.

*Disparate tax treatment of financial products decreases economic efficiency.* If two investments are economically equivalent in terms of risk, pretax return, rights, obligations, and timing, an investor should be indifferent between the two. However, if the after-tax returns of two investments are different because two economically equivalent investments are subject to different rules, taxpayers will choose the form of the investment that results in the lower tax bill. This outcome is economically inefficient in two key ways. First, these taxpayers will likely expend additional resources on tax planning to achieve the same economic outcome, which is an inefficient allocation of resources. Second, if enough taxpayers take this course of action, Treasury receipts will decline, putting pressure on the government to increase taxes overall, which distorts economic incentives for a potentially broad swath of the population.

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<sup>15</sup> Joint Committee on Taxation, Present Law and Issues Related to the Taxation of Financial Instruments and Products, December 2, 2011, JCX-56-11.

*Disparate tax treatment of financial products decreases taxpayer equity.* Tax treatment that differs for economically-equivalent financial products can reduce horizontal and vertical equity.

In the context of an income tax, the principle of horizontal equity means that taxpayers with similar incomes ought to pay similar amounts of tax. But certain financial products enable taxpayers receiving the same pre-tax incomes from two economically-equivalent investments to pay different amounts of tax.

The principle of vertical equity (also known as “progressivity”) means that those with higher incomes ought to pay more in tax than those with lower incomes. However, to the extent that some taxpayers can pay lower tax rates on investments than other taxpayers because they have greater ability (through access to sophisticated tax planning) to structure financial products in the way that is most tax advantageous, the vertical equity (progressivity) of the tax system is reduced.

*To be clear though*, derivatives serve important purposes, particularly risk management. The intent of this report and its recommendations is not to discourage the use of derivatives for legitimate economic purposes, but to *discourage their use as a vehicle for sheltering income from taxation.*

## **Recommendations**

Below, Finance Committee Democratic staff offer broad policy and regulatory recommendations to curtail current tax avoidance strategies that financial products and deferred compensation allow. Implementing these recommendations would require making significant refinements and addressing many complex details and realities of taxation and financial markets. Implementation would also require accounting for the behavioral responses of certain taxpayers who seek to exploit weaknesses in the rules that govern both. Also included are estimates of revenue loss due to these tax avoidance strategies where available.

- 1. Collars.** Congress enacted section 1259 to force taxpayers to recognize gain on assets whose risk was hedged when entering into certain derivative transactions, such as collars. Section 1259 gave Treasury authority to write rules determining which kinds of collars would constitute constructive sales. But Treasury never wrote any regulations and so taxpayers can be nearly totally hedged on their positions using collars without triggering a constructive sale. Therefore, a straight-forward solution is to require Treasury to write regulations defining such use of collars as a constructive sale.
- 2. Wash sales.** Congress could enact legislation updating tax code section 1091 wash sale rules so that they apply to forward contracts, swaps, and also derivatives involving commodities and currencies. Additional legislation or regulations could consider how to identify and limit the extent to which taxpayers can reconstitute expired positions with substantially similar positions (e.g., replacing a position holding a stock with a position that primarily holds that same stock combined with lesser amounts of other stocks).

3. Derivatives. A comprehensive solution to ending the manipulation of timing and character of income that derivatives allow is legislation that marks-to-market all derivative instruments, and taxes the resulting gains or losses as ordinary income, regardless of whether the contract is held to maturity or disposed of early. Marking derivatives to market means that each derivative held by a taxpayer is treated as if it were sold on the last business day of the year for its fair market value, and any gain or loss is included in income for that taxable year. A proposal in the Administration's FY 2015 budget and a February 26, 2014 Ways & Means tax reform discussion draft are recent proposals to require mark-to-market and ordinary taxation of derivatives. JCT scored the Ways & Means proposal in 2013 as raising \$30.9 billion over ten years and scored the Administration's proposal in 2014 as raising \$14.4 billion over ten years.

Note that financial accounting rules already require marking most derivative instruments to market,<sup>16</sup> so this generally does not impose any new compliance burdens on taxpayers. Also, note that derivatives are contracts, and net payments resulting from these contracts are generally taxed at ordinary rates, even while the character of the gains and losses from the underlying asset may be taxed at lower long-term capital gains rates. Finally, the gains (and losses) from derivative contracts formally designated as hedges are taxed at ordinary rates. As a policy judgment then, it is not clear that taxpayers who employ derivatives to reduce investment risk should receive preferential tax treatment that is properly meant to reward other taxpayers who actually *assume market risk* by holding securities or pass-through interests<sup>17</sup> without hedging instruments.

4. Constructive ownership rules. In 1999, Congress enacted section 1260 of the tax code to limit the amount of long-term capital gain a taxpayer could recognize from specified derivative contracts that referenced partnership interests as the underlying asset. While section 1260 labeled a number of derivative transactions (such as swaps, forward contracts, option collars, and other transactions) as "constructive ownership," it did not cover all such transactions, leaving the door open to further tax avoidance. Congress could specify additional derivative transactions in section 1260, such as holders of one-sided put or call options and/or Treasury could finish drafting and finalizing regulations that extend the transactions list begun in 1260.
5. Basket Options. As noted above, in 2010, the IRS issued GLAM 2010-005 in an attempt to shut down basket option arrangements. However, because this IRS memo lacks legal authority, hedge funds and banks could at some point choose to ignore the IRS guidance and resume using these products.

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<sup>16</sup> For example, see FASB Accounting Standards Codification (ASC) 815 – Derivatives and Hedging.

<sup>17</sup> "Pass-through interests" are interests in businesses like partnerships or S corporations, where profits, losses, and their tax consequences "pass-through" to partners and shareholders instead of being recognized and taxed first at the business entity level, as is the case with C corporations.

The law is very clear in this area – basket options are a tax shelter. Legislation is not necessary to address this problem – IRS and Treasury have clear authority to shut down these transactions today. Therefore, Democratic Finance Committee staff has encouraged IRS and Treasury to issue stronger guidance. For example, the Committee staff has suggested that IRS and Treasury issue a tax shelter notice, which would notify taxpayers that this is a tax shelter and taxpayers will be penalized if they continue using this financial structure. Tax avoidance strategies using basket options have likely cost the Treasury billions of dollars over time, based on data from a July 2014 report by the Senate Permanent Subcommittee on Investigations (see footnote 13).

6. **Nonqualified Deferred Compensation.** Employers should certainly have the discretion to pay their employees in the manner they see fit. However, the tax code should treat all taxpayers fairly and not include rules that allow executives and management employees to receive favorable tax treatment of their compensation that is not available to all employees. New loopholes such as circumventing the section 162(m) deduction limit also should be closed.

Therefore, a number of lawmakers have introduced legislation rolling back the NQDC rules. For example, Ways and Means Committee Chairman Camp's tax reform discussion draft provides that under a NQDC plan, all compensation deferred under the plan would be included in gross income for the taxable year of vesting. When estimated as a part of Chairman Camp's tax reform plan, this NQDC proposal would raise \$9.2 billion over ten years by stemming the practice.

Furthermore, from a fairness perspective, current law includes limits on the ability of employees to defer income through qualified retirement plans, such as 401(k) plans. Why does the tax code lift those limits for the highly paid and allow them to defer income over and above the limits to which most rank-and-file employees are subject? Therefore, some also have proposed limiting the permitted amount of NQDC (e.g., a cap of \$1 million).

Finally, NQDC arrangements can be used to circumvent the section 162(m) deduction limit in the tax code on executive compensation. Under 162(m), subject to a number of limitations, compensation paid to certain senior executives in excess of \$1 million is nondeductible by the employer. However, if an employee's compensation is deferred until retirement when the employee is no longer a senior executive, the compensation will not be subject to the \$1 million cap. This is because 162(m) only applies to compensation paid during a year if the employee is a senior executive on the last day of the year. Policymakers also should explore closing this abusive loophole.<sup>18</sup>

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<sup>18</sup> A provision to close this loophole was included in the February 26, 2014 Ways & Means tax reform discussion draft.

## **ADDITIONAL BACKGROUND**

### **Background on Income Taxation**

Income can be divided into earned income and unearned income. Generally, earned income means income from labor, and includes certain business profits, self-employed income, and salaries and wages. Earned income plus rents, royalties, and interest is taxed at ordinary rates, with a top statutory tax rate of 39.6 percent in 2014 for the highest earners with taxable income above \$457,600 (\$406,750 for single filers). Earned income is also subject to payroll taxes. The employee plus employer portions of Social Security and Disability Insurance taxes equaled 12.4 percent of the first \$117,000 of wages in 2014 while the employee and employer portions of Medicare taxes equaled 2.9 percent on all earned income, plus an additional 0.9 percent Medicare tax on employee earned income above \$250,000 (\$200,000 for single filers). (Workers are commonly assumed to bear the tax burden of both the employee and employer portions of payroll taxes). The combined tax rate on ordinary taxable income (above \$457,600) is therefore 43.4 percent.

Unearned income is derived from investments. Unearned income includes capital gains, dividends, interest (exempt and taxable), rents, royalties, and distributed pension and annuity income. Unlike earned income, certain sources of unearned income are taxed at preferential rates. These sources include long-term capital gains on investments held for longer than one year and qualified dividends (23.8% tax rate) and tax-exempt interest (0% tax rate). The 23.8 percent rate is a combination of the 20 percent statutory rate plus a 3.8 percent tax on net investment income to the extent a household's modified AGI exceeds \$250,000 (\$200,000 for single filers). For taxpayers in the 15 percent tax bracket up through the 35 percent bracket (up to \$457,600 for married couples/\$406,750 for single filers), the long-term capital gains rate is 15 percent. For taxpayers with income below the 15 percent tax bracket, the long-term capital gains rate is 0 percent. All other unearned income is taxed at ordinary rates once recognized, including capital gains on investments held for under a year.

Taxpayers are allowed to reduce their ordinary income by the amount of any ordinary losses (to the extent that income is not reduced below zero) plus up to \$3,000 of capital losses (after first offsetting any capital gains). Unused ordinary and capital losses may be applied to like income in future tax years (e.g., "carried forward").

### **Background on Types of Derivatives**

A derivative is a contract in which the amount of at least one contractual payment is calculated from the change in value of something (or a combination of things) that is fixed only after the contract is entered into. The thing that fixes the payment amount(s) and hence the derivative's value is called the underlying; examples include assets, liabilities, indices, and events. The most common forms of derivative are forwards, futures, options, and swaps.

Forward Contract. In a forward contract one party to the contract obligates itself to purchase from the other party a fixed quantity of property (such as 1,000 shares of General Electric stock) at a fixed price on a fixed future date.

Futures Contract. A futures contract is a standardized forward contract that is traded on an exchange such as the Chicago Mercantile Exchange. Futures contracts historically have been for the purchase and sale of commodities.

Option. An option is a contract between two parties that gives the holder of the option the right – but not the obligation – to buy from or sell to the issuer of the option a specified amount of property (such as 100 shares of Microsoft stock) at a fixed price (the “strike price”) and specified time (the “settlement date”). The option holder pays the issuer a premium for the option.

Traditionally, most options are structured with prepaid premiums. That is, the holder pays the option premium at the inception of the contract. When the holder gives or receives the specified thing to the issuer in exchange for the premium, the holder is said to have “exercised” her rights under the option.

- A contract giving the holder the option to buy something is referred to as a call option (or a “call”). A call option can represent the holder’s expectation that the value of the underlying asset will increase.
- A contract giving the holder the option to sell something is referred to as a put option (or a “put”). A put option can represent the holder’s expectation that the price of the underlying asset will fall.

Swap. A swap or “notional principal contract” is an agreement (like a bet) between two parties to exchange payments at intervals over a specified time period (such as quarterly over two years) on the performance of an identified instrument (such as a stock or a basket of stocks), an index (such as the S&P 500 stock index), a value like an interest rate (such as a fixed or variable rate), or the outcome of a specified event (such as whether a corporation will default on its debts).

These basic financial instruments can be combined to replicate the economic returns of virtually any underlying asset or to create an economic profile that is unique. Also, because forward contracts, options, and swaps on a common underlying asset are all directly related to each other (and to the underlying asset that they reference), in practice, financial specialists can engineer one such contract from the others, or separate one component of an underlying asset’s returns from the others, and sell those separate components to different taxpayers. Such engineering is used by some taxpayers to lock-in the economic return of an asset while reducing the market risk and the tax consequences of holding the actual asset.