STATEMENT OF WILLIAM M. PAUL
BEFORE THE SUBCOMMITTEE ON SELECT REVENUE MEASURES
OF THE
COMMITTEE ON WAYS & MEANS
OF THE
U.S. HOUSE OF REPRESENTATIVES
ON THE SUBJECT OF
DRAFT PROPOSALS FOR FINANCIAL PRODUCTS TAX REFORM

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Chairman Tiberi, Ranking Member Neal and Members of the Committee:

My name is William M. Paul. I am a partner with the law firm of Covington and Burling LLP. Thank you for inviting me to testify here today on Chairman Camp's draft proposals for financial products tax reform. I appear before you today on my own behalf. Although I represent clients that have an interest in the draft proposals -- specifically as they relate to exchange-traded options and mutual funds -- I am not appearing on their behalf here today. My testimony should not be construed as reflecting their views or those of my law firm or of any other organization with which I am affiliated.

Before I begin, I would like to add my voice to the chorus of praise that Chairman Camp has received for the open and transparent process he is following in developing comprehensive tax reform legislation. I also applaud the Committee for holding this hearing today as part of the effort to receive input on the draft proposals in an open and public manner. This approach leads not only to more well-informed legislative decision-making, but also to higher public confidence in the integrity of the legislative process.

My testimony today is divided into two parts. Part I provides some background observations relating to derivatives and their taxation under current law. Part II focuses on the draft proposal for uniform taxation of derivatives (the "Draft Proposal") and identifies technical and practical issues that I believe will need to be addressed, or at least carefully considered, as the legislative process moves forward.

I. Derivatives and Their Taxation under Current Law

Generally speaking, a derivative is a financial instrument the value of which is determined by reference to one or more financial assets, such as stocks, bonds or commodities (sometimes referred to as "physicals"). Traditional derivatives include options, forward contracts, and futures contracts. Nontraditional derivatives, that is, derivatives that have been developed more recently, include a wide variety of swaps, such as interest-rate swaps, equity swaps, total return swaps and credit default swaps. Nontraditional derivatives also include structured notes and exchange-traded notes ("ETNs"), which are generally viewed as a form of prepaid forward contracts.

In addition to new forms of derivatives, the nature of the "underlier," that is the referenced property that determines the value of the derivative, has expanded significantly in recent years. Underliers are no longer limited to assets such as stocks, bonds and commodities. Underliers now include a wide variety of indexes or other objective information that affects finance or commerce in one or more respects. For example, there are a variety of derivatives with respect to weather-related data and events, such as rainfall, snowfall, temperature levels, hurricanes, and the like. There are even derivatives tied to the mortality pay-offs on pools of life insurance contracts.

One of the factors contributing to the development of new derivatives is the desire of participants in the capital and financial markets to gain more targeted exposure to specific risks. For example, if an institution wants exposure solely to the credit risk of a corporate issuer, holding bonds of that issuer is not sufficient because it entails both interest-rate risk and credit risk. Credit default swaps were developed to enable market participants to isolate pure credit risk from interest-rate risk. Other factors driving innovation in financial products are a desire to avoid regulatory and other restrictions and to reduce inefficiencies associated with existing alternatives. Generally, tax treatment is not the driving force behind the development of a new derivatives or financial transaction. Taxes are, however, often a significant factor in determining the specific features of a derivative.

Developing appropriate regimes for taxing new financial products is a daunting process in many respects. The products are often complex and difficult to understand economically, and they can be used by market participants in various ways. For these and other reasons, Treasury and IRS are often slow to respond to financial product innovation. In the last twenty-five years or so, Treasury has struggled mightily and with mixed success to issue much-needed guidance in this area. The contingent debt regulations were issued in proposed form and modified and withdrawn several times over a ten-year period before the ultimate approach was finally adopted. Treasury has been thinking about the taxation of prepaid forward contracts since at least 1993[1] and had a guidance project on its business plan for several years, but has never issued guidance. After an 11-year hiatus following the issuance of the notional principal contract regulations in 1993, Treasury finally addressed swaps with contingent nonperiodic payments in 2004 by issuing proposed regulations that have proved to be highly controversial. Treasury has been studying credit default swaps now for a number of years. Treasury's ability to respond to new financial products is also often hampered by questions regarding the scope of Treasury's authority.

Congressional action in the financial products area tends to be in the form of responding to new financial products or financial transactions that are viewed as posing a threat to the fisc. Every few years, Congress focuses on a product or transaction that is viewed as abusive, or at

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[1] *See* preamble to T.D. 8491, 58 Fed. Reg. 53125, 53126 (Oct. 14, 1993).

least as something that may be receiving inappropriately favorable treatment under current law. In my experience, when these situations arise members of Congress and Congressional staff typically start out with the view that Congress should address the perceived problem systemically, *i.e.*, by imposing some rational order on the broader taxation of financial products. However, the Herculean nature of that task and the need to move the legislative process forward ultimately result in the decision to address the perceived problem at hand and move on. As a consequence, the rules governing the taxation of financial products and financial transactions are a hodgepodge of specific rules that are flawed and can interact with each other in unintentional ways.

II. Draft Proposal for the Taxation of Derivatives

A. Description of the Draft Proposal

The Draft Proposal would require that all derivatives be marked to market -- treated as sold -- on the last day of the taxable year. All gain and loss on derivatives, whether as a result of year-end marking to market or termination during the course of the year, would be treated as ordinary income or loss. Special rules would apply to "physicals" such as stock, bonds, and commodities, that are held in conjunction with a derivative that is an offsetting position, *i.e.*, where the derivative substantially reduces the risk of holding the physical or vice versa. The Draft Proposal refers to such combinations of derivatives and physicals as a "mixed straddle." An example of a mixed straddle would be 100 shares of GM stock and a put option to sell 100 shares of GM stock. Physicals that are part of a mixed straddle are essentially taxed like derivatives while the mixed straddle is in place. For example, the physical is marked to market at the end of the year and the resulting gain/loss is treated as ordinary. The physical is also marked to market when the derivative is terminated or expires, and again the gain/loss is ordinary. Finally, if a physical has appreciated in value (*i.e.*, has unrealized gain) before the offsetting derivative position is established, the physical is treated as sold at that time. This rule does not apply if the physical has declined in value (*i.e.*, has unrealized loss) when the offsetting derivative position is established. Rather, the loss is suspended until the physical is ultimately sold.

The definition of derivative in the Draft Proposal is very broad. It includes any evidence of an interest in -- and any derivative financial instrument with respect to -- stocks, bonds, partnership interests, trust interests, commodities, foreign currency, and even real property. Derivative financial instruments are defined to include options, forward contracts, futures contracts, short positions, and swaps. Notional principal contracts ("NPCs") are treated as a separate category of derivative with respect to which a broader definition of underliers applies. Under this separate definition, an NPC is a contract with two or more payments determined by reference to a "specified index," which is defined to mean (i) a rate, price or amount, (ii) any index based on any information (including the occurrence or nonoccurrence of an event) not within the control of, or unique to the circumstances of, any party to the contract, and (iii) any other index Treasury may prescribe. The definition of derivative is not limited to instruments that are publicly traded or to underliers that are publicly traded.

The definition of derivative includes derivatives embedded in instruments treated as debt for tax purposes, such as the conversion feature in a bond convertible into stock of the issuer. A debt instrument is not treated as having an embedded derivative merely because it is denominated in a foreign currency or because it is a contingent payment debt instrument.

B. Technical and Practical Issues

It is indisputable that legislation -- or Treasury guidance -- regarding the taxation of certain derivatives, such as credit default swaps, is needed. A threshold decision to be made is whether legislation should be targeted at derivatives for which there are no current rules (or for which the current rules are inadequate) or, alternatively, should address the taxation of all derivatives. The Draft Proposal essentially adopts the latter approach.[2]

The broad definition of derivative in the Draft Proposal may sweep in a variety of situations that are not intended to be covered. Examples include: (i) securities loans subject to section 1058; (ii) American Depository Receipts, which represent beneficial ownership of stock of foreign corporations; (iii) employee stock options and other stock-based compensation; (iv) variable annuities; and (v) interests in unit instrument trusts. In this regard, it would probably be helpful if a list of instruments or interests that are not intended to be covered were added to the legislative language.

A second key definitional decision relates to the types of "underliers" that are covered. For reasons that are unclear, the Draft Proposal has a different set of underliers for NPCs than for all other derivatives. For example, a forward contract tied to a weather-related event would apparently not be a derivative under the draft proposal while an NPC on the same weather-related event would be. Since an NPC is economically equivalent to a series of forward contracts, and given the goal of consistency and uniformity underlying the Draft Proposal, consideration could be given to using a uniform list of underliers.[3]

The broad definition of derivatives includes derivatives embedded in instruments treated as debt for tax purposes, such as the conversion feature in a convertible debt instrument. The

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[2] While there is much to be said in favor of treating all derivatives consistently, there are different senses in which "consistency" can be obtained. For example, an alternative approach could be to apply a uniform rule to derivatives with similar economics and different rules to derivatives with other economics. It may also be reasonable to have different regimes for different types of derivatives as long as the tax treatment of the parties to the derivative is balanced, *i.e.*, gains and losses are treated consistently so that the fisc is protected. *See* David M. Schizer, *Balance in the Taxation of Derivative Securities*, 104 Colum. L. Rev. 1888 (2004)

[3] The broad definition of underliers for an NPC would apparently encompass wagers on sporting events (such as the outcome of the World Series) and the like. It is unclear if this broad scope is intended.

draft legislative language states that a debt instrument does not have an embedded derivative "merely because" it is a contingent payment debt instrument ("CPDI"). This language appears to mean that if the contingent features of a CPDI are not in the nature of one or more derivatives, the CPDI will not be treated as having an embedded derivative.[4] Given the different underliers for NPCs and underliers for other derivatives, as mentioned above, the determination of whether a CPDI has an embedded derivative may depend on whether the relevant derivative is an NPC or a forward contract. Again, since an NPC is equivalent to a series of forwards, and given the broad range of underliers in the definition of NPCs, it appears that many CPDIs could be found to have an embedded derivative.

It is also worth noting that the definition of embedded derivative is limited to derivatives embedded in debt instruments. The definition does not include derivatives embedded in stock, such as convertible preferred stock, or in partnership interests, as in UPREIT structures. It is unclear if these omissions are intentional.

The Draft Proposal would not apply mark-to-market, ordinary treatment to direct ownership of stocks, bonds or commodities. This conclusion is understandable. However, it will mean that the goal of uniform treatment for economically similar positions will not be achieved in significant respects. To take the most obvious example, direct ownership of stock will be taxed differently from "synthetic" ownership of stock through a combination of derivatives (such as a long call option and short put option with the same strike price coupled with a zero-coupon bond). This difference of tax treatment will result in "clientele" effects, as taxpayers who want ordinary income and loss treatment will use "synthetic stock" and taxpayers preferring capital gain/loss treatment will own the stock directly.

The exclusion of stocks and bonds also raises questions about how to deal with transactions that in form are not derivatives but are economically equivalent to derivatives. For example, an equity swap is economically equivalent to a fully leveraged stock purchase. If *A* lends *B* $1,000, which *B* uses to buy stock from *A*, the cash flows are essentially the same as if *A* and *B* entered into an equity swap. Similar issues arise with regard to nonrecourse debt. For example, if *A*'s loan to *B* is nonrecourse, *B* has the equivalent of long stock and a put option. And long stock coupled with a forward contract to sell the stock on a specified date in the future is equivalent to a zero-coupon bond.

As yet another example, consider a two-person partnership that holds dividend-paying stock. The partnership allocates the dividend income to one partner and gain or loss on the stock

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[4] Another possible interpretation is that CPDIs are *per se* not treated as having embedded derivatives. Such an approach could be justified based on the view that the CPDI rules in Treas. Reg. § 1.1275-4 work reasonably well and do not need to be over-ridden by the legislation. If this is the intent, the statutory language should be clarified. In addition, consideration should be given to limiting such a carve out to CPDIs that are subject to the noncontingent bond method.

is allocated to the other partner.[5] On these facts, these partnership interests -- and other partnership interests that "slice and dice" economic returns from stocks, bonds and other underliers -- can be viewed as very similar to derivatives.

Another question that arises is how the Draft Proposal, if adopted, would affect constructive ownership and agency principles of current law. There is a substantial body of law that treats a taxpayer as the beneficial owner of property, including stock, if the facts and circumstances indicate that the person who ostensibly owns the property should be viewed as holding the property as the taxpayer's agent. Similarly, section 1260 applies constructive ownership principles when a taxpayer has a long position in an NPC or forward contract with respect to equity interests in entities such as partnerships and passive foreign investment companies ("PFICs"). Presumably, the Draft Proposal would generally override constructive ownership principles as they may apply to derivatives, but it is not clear this would be the result in all cases.

The final "scope" issue I wish to raise today relates to valuation. The Draft Proposal is not limited to publicly traded derivatives or even to derivatives (whether traded or not) with respect to underlying property that is publicly traded. It is not clear how the parties will determine fair market value or how the IRS will efficiently and effectively audit the valuations the parties come up with. In this regard, it is worth noting that in the 1990's, the IRS attempted to develop software to assist it in valuing derivatives. This effort was known as the "Los Alamos project" because nuclear physicists at Los Alamos Laboratories were engaged in the project. Even though the project went on for several years, and focused on interest rate swaps, which are much less complex than many derivatives, the project failed.[6] This is not to say that a similar effort would necessarily fail again, but it is critical that the IRS be consulted to determine the extent to which a broad mark-to-market approach to derivatives will be administrable.

I'd like to turn now from the scope of the definition of derivatives to the rules that would apply with respect to derivatives. The first rule I'd like to address is character. Under the Draft Proposal, all gain or loss from derivatives would be ordinary instead of capital. This would be a significant change from current law for taxpayers who are not dealers or electing traders subject to the mark-to-market rules of section 475.

The general approach of current law, as found in sections 1234 and 1234A, is to match the character of a derivative with the character that the underlying property would have in the hands of the taxpayer. The change to ordinary treatment would in many cases result in character whipsaws for taxpayers with capital losses on their direct positions in stocks and bonds and ordinary income from their derivatives transactions. For example, a taxpayer with a diversified

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[5] Such allocations may be permissible under subchapter K. *See* Treas. Reg. § 1.701-2(d) (example 5).

[6] *See* Clarissa Potter, *Mark-to-Market Taxation As the Way to Save the Income Tax - A Former Administrator's View*, 33 Val. U. L. Rev. 879, 898 (1999).

portfolio of securities might enter into a short futures contract on the S&P 500 index to hedge against general market risk.[7] If the market declines, the taxpayer would have ordinary income on the futures contract but capital losses from sales of portfolio securities that could not be offset. This character mismatch issue is a serious concern.

It may be that the decision to use ordinary income and loss treatment for derivatives is based on the approach in section 475. However, ordinary income and loss treatment under section 475 applies not only to derivatives, but also to stocks and bonds (and physical commodities for commodities dealers and traders). Thus, all of the positions that are part of a securities dealer's dealer activity, or an electing trader's trader activity, give rise to ordinary income and loss and the character mismatch issue is generally not present. Under the Draft Proposal, in contrast, stocks, bonds and other physicals would continue to generate capital gains and losses. As a result, section 475 does not provide a solid precedent for ordinary income and loss treatment under the Draft Proposal.

Another significant aspect of the Draft Proposal is the treatment of so-called "mixed straddles." Because derivatives would be marked to market and given ordinary income or loss treatment while direct positions in stock, bonds, commodities, and other physicals would not, the Draft Proposal provides rules for situations in which a taxpayer holds stock, for example, and a short derivative position in the stock, such as a forward contract to sell the stock. It would not make sense to treat gain or loss on the stock as capital gain or loss while treating gain or loss on the forward contract as ordinary when the gains and losses are the result of the same change in the economic value of the stock. Similarly, it could not make sense to mark the forward contract to market at year-end while ignoring the offsetting change in the value of the stock. The Draft Proposal deals with these issues essentially by treating stock as if it were a derivative for the period the taxpayer holds an offsetting derivative position.

The Draft Proposal uses the definition of "straddle" in section 1092, with certain modifications, to determine whether the special rules for physicals that are part of a mixed straddle apply. Unfortunately, it is often difficult to determine if a taxpayer has a straddle. The definition of a straddle requires that the taxpayer have substantially diminished his or her risk of loss from holding a position by entering into an offsetting position. While in some cases it is clear that there is a substantial diminution of risk, in other cases it is not. For example, if a taxpayer holds a bond and enters a long derivative on the consumer price index, has the taxpayer substantially diminished risk of loss from owning the bond? If a taxpayer owns stock trading at $100 and buys a 30-day put option to sell the stock for $70, has the taxpayer substantially diminished risk of loss of owning the stock? What if there is less than 5% chance that the stock would drop by $30 in a month?

In addition, if a straddle does exist, it is often difficult to determine exactly what

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[7] Doing so would typically not create a straddle.

positions are part of the straddle. As a simple example, consider a taxpayer who holds 200 shares of AT&T stock and buys a put option to sell 100 shares. Does the straddle include all 200 shares or just 100 shares? If just 100 shares, which 100 shares?[8] The Draft Proposal would exacerbate this problem by repealing the rule in section 1092 allowing taxpayers to identify the positions that make up a straddle.

In addition to treating physicals like a derivative while they are part of a mixed straddle, the Draft Proposal also walls off appreciation or depreciation in the physical before it becomes part of a mixed straddle because such gain or loss is treated as capital rather than ordinary. If a taxpayer holds appreciated stock, bond or commodity and enters into an offsetting derivative that creates a mixed straddle, the stock, bond or commodity is treated as sold at that time for fair market value. Under current law, a taxpayer who enters into a transaction that eliminates substantially all risk of loss and substantially all opportunity for gain in an appreciated financial position is treated as having sold the appreciated financial position.[9] The tax policy rationale for this treatment is plain. However, it will be difficult to explain to taxpayers why they are treated as having sold their appreciated stock if they merely buy a put option on the stock to limit downside risk or write an out-of-the-money covered call to generate income.[10] In contrast to the rule treating an appreciated physical as sold when the taxpayer enters into an offsetting derivative, if the physical has declined in value, the physical is not treated as sold and the loss is deferred until the physical is disposed of. This disparate treatment of appreciated and depreciated physicals may strike some as unfair.[11]

I would like to note one additional technical and practical issue raised by treating an appreciated physical as sold when a taxpayer enters into an offsetting derivative that creates a mixed straddle. If a taxpayer holds appreciated stock and buys a put option on the stock at, say, 10:30 in the morning, is the relevant value of the stock for computing gain/loss its fair market value at that time (*i.e.*, 10:30) or is it some other value (such as the closing price for the day or weighted average price for the day)? Obviously the price of a stock can change substantially during the course of a trading day, but the practical and administrative burdens associated with using the value at the time the put was purchased may be excessive.

Let me close by noting that numerous coordination issues will need to be addressed to integrate the myriad rules of existing law with the Draft Proposal. The conforming amendments

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[8] Note that even if the average basis proposal is adopted, the shares could be held in different accounts or 100 shares could have been acquired before the effective date and 100 shares after that date.

[9] *See* § 1259.

[10] The Draft Proposal would repeal the qualified covered call exception to the straddle rules.

[11] A more balanced rule applies under the Draft Proposal if a taxpayer physically settles a derivative. For example, if a taxpayer has a long forward contract to acquire a commodity, the forward contract is treated as sold for fair market value at the time it is physically settled and the gain or loss in the forward contract is taken into account at that time.

in the draft bill language are a first step in this direction. Some additional coordination issues will be easy to resolve, such as the need to repeal sections 1234 and 1234A as they apply to derivatives covered by the Draft Proposal. Others may not be so easy, such as (i) whether sections like section 1092 and section 1259 can be repealed in their entirety or whether portions of these sections should be preserved, and (ii) whether the current accrual for income and deduction on NPCs and the bifurcation of NPCs with significant nonperiodic payments[12] should be retained even if NPCs are marked to market.

[12] *See* Treas. Reg. §1.446-3.