

## Mark-to-Market for Derivatives

By Yoram Keinan

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Taxation of derivatives is incoherent under current law, Keinan argues, because the rules try to follow too many inconsistent models and also are subject to complicated antiabuse overrides. Keinan proposes a single, coherent approach under which most positions in derivatives would be marked to market, and gains and losses are ordinary and are sourced to the residency of the recipient.

The proposal is made as a part of the Shelf Project, a collaboration among tax professionals to develop proposals to raise revenue. The Shelf Project is intended to raise revenue without a VAT or a rate hike

in ways that will improve the fairness, efficiency, and rationality of the tax system. Now is the time for congressional staff work to be done to prevent the impending revenue crisis. An overview of the Shelf Project is found in "How to Raise \$1 Trillion Without a VAT or a Rate Hike," *Tax Notes*, July 5, 2010, p. 101, *Doc 2010-13081*, or *2010 TNT 129-4*. Congress adopted its first Shelf Project in March 2010. New section 871(1), enacted in the Hiring Incentives to Restore Employment Act (P.L. 111-147), is based on the Shelf Project proposal by Reuven Avi-Yonah, "Enforcing Dividend Withholding on Derivatives," *Tax Notes*, Nov. 10, 2008, p. 747, *Doc 2008-22806*, or *2008 TNT 219-34*.

Shelf Project proposals follow the format of a congressional tax committee report in explaining current law, what is wrong with it, and how to fix it.

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### A. Introduction

#### 1. Definitions and economics.

**Derivatives:** There is no tax definition of the term "derivative." A derivative is generally a "contract between two parties that specifies conditions — in particular, dates and the resulting values of the underlying variables — under which payments, or payoffs, are to be made between the parties."<sup>1</sup> Derivatives generally include options, forwards, futures, and notional principal contracts (NPCs).<sup>2</sup>

**Option:** An agreement under which the option buyer has the right but not the obligation to buy from, or to sell to, the option writer a specified number of units of underlying property, for a specified strike price at or before the expiration date.<sup>3</sup> The buyer pays a premium for the option because the writer must be compensated for its risk.

A call option allows the option buyer to buy a specified quantity of underlying property from the writer at

the strike price.<sup>4</sup> A put option allows the option buyer to sell a specified quantity of underlying property to the writer at the strike price.<sup>5</sup> European-style options have a single exercise date, while American-style options may be exercised at any time during their term. A modified-American (Bermuda) style option can be exercised on specified dates from the issue date to expiration.<sup>6</sup> Options may be physically or cash settled.<sup>7</sup> Some options are standardized and trade on exchanges.

**Forward Contract:** A privately negotiated contract that provides for the sale of the underlying property for a specified forward price on a specified forward date.<sup>8</sup> In recent years, several variations of forward contracts have emerged, including, for example, variable prepaid forward contracts (discussed below).

<sup>4</sup>See Alvin C. Warren Jr., "Commentary, Financial Contract Innovation and Income Tax Policy," 107 *Harv. L. Rev.* 460, 464 (1993).

<sup>5</sup>See *Federal Home Loan Mortgage Corporation v. Commissioner*, 125 T.C. 248, 258 (2005), *Doc 2005-23670*, 2005 TNT 224-10.

<sup>6</sup>See Noel Cunningham and Deborah Schenk, "Taxation Without Realization: A 'Revolutionary' Approach to Ownership," 47 *Tax L. Rev.* 725, 779-786 (1992).

<sup>7</sup>See section 1234(c)(2).

<sup>8</sup>See *Glass v. Commissioner*, 87 T.C. 1087, 1101 (1986).

<sup>1</sup>Mark Rubinstein, *Rubinstein on Derivatives*, section 1 (1999).

<sup>2</sup>Charles T. Plambeck, David H. Rosenbloom, and Diane M. Ring, "General Report," in 80b *Cahiers de Droit Fiscal International [C.D. Fisc. Int'l]* 653 (1995). David A. Weisbach, "A Partial Mark-to-Market Tax System," 53 *Tax L. Rev.* 95, n.21 (1999).

<sup>3</sup>See *Elrod v. Commissioner*, 87 T.C. 1046, 1067 (1987).

## COMMENTARY / SHELF PROJECT

**Futures Contract:** Economically similar to a forward contract except that it is (1) standardized, (2) traded at regulated exchanges, (3) used by clearing organizations, (4) marked to market daily, and (5) can be closed before maturity.<sup>9</sup> A regulated futures contract is a contract “with respect to which the amount required to be deposited and the amount which may be withdrawn depends on a system of marking to market, and . . . which is traded on or subject to the rules of a qualified board or exchange.”<sup>10</sup>

**NPC:** A financial instrument that provides for the payment of amounts by one party to another at specified intervals calculated by reference to a specified index on a notional amount in exchange for specified consideration or a promise to pay similar amounts.<sup>11</sup>

**Swap:** An NPC under which the parties agree to exchange payments calculated by reference to a notional amount.<sup>12</sup> Examples include interest rate, foreign currency, commodity, and equity swaps. A swap is economically equivalent to a series of cash-settled forward contracts.<sup>13</sup> A total return swap provides an investor with an economic return similar to ownership of the underlying stock.<sup>14</sup> The investor pays its counterparty (an investment bank) an amount equal to what it would pay to purchase the underlying property. The bank pays the investor (i) a payment based on the appreciation or depreciation in the underlying stock’s value over the term of the swap; and (ii) payments of amounts equal to dividends paid on the underlying stock.<sup>15</sup> Recent legislative changes will treat the substitute dividends as actual dividends for withholding purposes. Two variations of swaps have emerged, namely contingent swaps<sup>16</sup> and credit default swaps (CDSs) (both discussed below).<sup>17</sup>

**Caps:** A cap seller makes periodic payments equal to the product of a notional principal amount and any excess of a specified index over the agreed cap rate. The cap buyer pays a single premium or makes a series of fixed periodic payments. Caps and floors are economically equivalent to a series of cash-settled option contracts.

**Floors:** A floor seller makes periodic payments equal to the product of a notional principal amount and any amount by which a specified index falls below the floor rate. The floor buyer pays a single premium or makes a series of fixed periodic payments.

**Collars:** Combinations of caps and floors whereby one party purchases a cap and sells a floor, or purchases a floor and sells a cap. Collars can also be built from a combination of call and put options.

## B. Current U.S. Tax Rules for Derivatives

### 1. Timing.

**a. General.** Income, gains, losses, and deductions from derivatives are recognized in a variety of ways, including mark-to-market, accrual, cash, wait-and-see, and special regimes.

#### b. Timing rules based on the nature of the contract.

**i. Nonsection 1256 options.** Writing and buying a nonsection 1256 option does not constitute a taxable event to either party.<sup>18</sup> As the Tax Court explained, “The policy rationale for the tax treatment of an option as an open transaction is that the outcome of the transaction is uncertain at the time the payments are made. That uncertainty prevents the proper characterization of the premium at the time it is paid.”<sup>19</sup>

Section 1234(b) governs the tax treatment of the writer of nonsection 1256 options on property (for example, stock, securities, and commodities). The writer does not recognize income until the option expires, lapses, or is exercised, sold, or disposed of. Stated differently, a nonsection 1256 option constitutes an open transaction.<sup>20</sup> The exercise is a nontaxable purchase of the underlying asset, and the premium adjusts the amount realized on the sale.<sup>21</sup> In contrast, the premium is recognized as income by the writer on a sale, exchange, or expiration of the option itself or a closing transaction.<sup>22</sup>

The option buyer is not allowed a deduction for the premium and recognizes gain or loss on a sale, lapse, or termination of the option equal to the amount realized (if any) minus the premium.<sup>23</sup> If the option is exercised, the buyer recognizes no gain or loss and adds the premium to its basis in the property acquired.<sup>24</sup> The treatment of cash-settled options is different.<sup>25</sup> Section 1234(c)(2)(A) provides that a cash-settled option is treated as an option to buy or sell property.<sup>26</sup> The exercise of a cash-settled option, however, in contrast to the exercise of a physically

<sup>9</sup>Reuven S. Avi-Yonah and Linda Z. Swartz, “U.S. International Tax Treatment of Financial Derivatives,” *Tax Notes*, Mar. 31, 1997, p. 1703, *Doc 97-5985*, 97 *TNT* 61-49.

<sup>10</sup>Section 1256 (g)(1).

<sup>11</sup>Reg. section 1.446-3(c)(1)(i). See also Note, “Tax Treatment of Notional Principal Contracts,” 103 *Harv. L. Rev.* 1951, 1953 (1990) (defining the term “notional principal contract”).

<sup>12</sup>See David A. Weisbach “Tax Responses to Financial Contract Innovation,” 50 *Tax L. Rev.* 491, 498 (1995).

<sup>13</sup>See Warren, *supra* note 4, at 487. See also LTR 9730007 (Apr. 10, 1997), *Doc 97-21707*, 97 *TNT* 144-16.

<sup>14</sup>Avi-Yonah and Swartz, *supra* note 9.

<sup>15</sup>*Id.*

<sup>16</sup>See REG-166012-02 (Feb. 25, 2004), *Doc 2004-3917*, 2004 *TNT* 38-7.

<sup>17</sup>See Notice 2004-52, 2004-2 C.B. 168, *Doc 2004-14751*, 2004 *TNT* 139-8.

<sup>18</sup>*Burnet v. Logan*, 283 U.S. 404 (1931). See generally Bruce Kayle, “Realization Without Taxation? The Not-So-Clear Reflection of Income From an Option to Acquire Property,” 48 *Tax L. Rev.* 233 (1993).

<sup>19</sup>See *Federal Home Loan Mortgage Corporation*, 125 T.C. at 267.

<sup>20</sup>Rev. Rul. 78-182, 1978-1 C.B. 265; Rev. Rul. 58-234, 1958-1 C.B. 279.

<sup>21</sup>*Id.* See also Rev. Rul. 88-31, 1988-1 C.B. 302; Rev. Rul. 70-598, 1970-2 C.B. 168.

<sup>22</sup>*Id.* See Rev. Rul. 78-182, *supra* note 20. Gain or loss will equal the amount of the premium minus any payment to the transferee of the grantor’s obligations, or, on termination, minus any payment by grantor to terminate.

<sup>23</sup>See section 1234(a); Rev. Rul. 78-182.

<sup>24</sup>See Rev. Rul. 88-31.

<sup>25</sup>Section 1234(c)(2)(B).

<sup>26</sup>The purpose of section 1234(c)(2)(A) is “to clarify that gain or loss on the sale, exchange, lapse, or exercise of the [cash settlement] option is capital gain or loss with respect to grantors or holders.” H.R. Rep. No. 98-861 (1984), 1984-3 (vol. 2) C.B. 158.

settled option, is a taxable event.<sup>27</sup> Nevertheless, no gain or loss is recognized by a corporation on lapse or acquisition of an option or futures contract to buy or sell its own stock.<sup>28</sup>

**ii. Forward contracts.** A nonsection 1256 forward contract also constitutes an open transaction.<sup>29</sup> Thus, until the contract is sold or exchanged, or settles, any gain or loss to the parties is deferred.<sup>30</sup> If the contract is exercised, the recipient of the property is not taxed until a further disposition of the underlying property, and the recipient's basis in the forward contract becomes its basis in the property. However, section 1259 provides that if a taxpayer holds an appreciated financial position and enters into a fixed price forward contract to sell that stock (or substantially identical property), the taxpayer will be treated as having made a constructive sale of the property and will realize gain as if the position had been sold.<sup>31</sup> Variable forward contracts were developed mainly to avoid the constructive sale rules while still providing some level of protection against a decline in the stock's value.<sup>32</sup> The consideration received is fixed, but the number of shares to be delivered is variable.<sup>33</sup> Thus, because of the significant variation under the contract terms, the contract does not result in a constructive sale.<sup>34</sup>

**iii. Mark-to-market.** Section 1256 was added to the code in 1981<sup>35</sup> and harmonized the tax treatment of regulated futures contracts (RFCs) with the marketplace

under what Congress referred to as the doctrine of constructive receipt.<sup>36</sup> Under section 1256(a), each section 1256 contract<sup>37</sup> held by a taxpayer at the close of the year is deemed sold at its fair market value on that day, and the taxpayer must recognize gain or loss on the deemed sale.<sup>38</sup> Congress later expanded the scope of section 1256 to some foreign currency contracts and options.<sup>39</sup>

**iv. NPCs.** Reg. section 1.446-3 groups all payments under NPCs into three categories: periodic, nonperiodic,<sup>40</sup> and termination payments. A party to an NPC must annually include any net income from the contract and is allowed to deduct any net cost.<sup>41</sup> All taxpayers, regardless of their method of accounting, must recognize the ratable daily portion of a periodic payment and a nonperiodic payment for the year to which those portions relate.<sup>42</sup> A nonperiodic payment must be amortized and recognized over the contract's term in a manner that reflects its economic substance.<sup>43</sup> A termination payment is a payment made or received to extinguish or assign all or a portion of the remaining rights and obligations of

<sup>36</sup>S. Rep. No. 97-144, 156-157 (1981).

<sup>37</sup>An RFC is defined in section 1256(g)(1) as "a contract (A) with respect to which the amount required to be deposited and the amount which may be withdrawn depends on a system of marking to market, and (B) which is traded on or subject to the rules of a qualified board or exchange."

<sup>38</sup>Section 1256(a)(1).

<sup>39</sup>Congress believed that foreign currency contracts were economically similar to RFCs, used interchangeably with RFCs by traders, and therefore should be subject to the same tax treatment. Although foreign currency contracts are not subject to daily cash margin settlement or a mark-to-market system, Congress believed that the expansion of section 1256 treatment to the interbank market for currency futures was appropriate under the principle of treating similar transactions in different markets similarly. See H.R. Conf. Rep. No. 97-986, 24-27 (1982) (1982 conference report); Sen. Rep. No. 97-592, 25-28 (1982); and H.R. Rep. No. 97-794, 22-24 (1982). The legislative history of the Deficit Reduction Act of 1984 (DEFRA) explains the expansion of section 1256 treatment to nonequity and dealer equity options without a policy discussion of the appropriateness of taxing income from those products before realization. The discussion centers instead on uncertainties arising from the enactment of the previous mark-to-market rules under section 1256. Doubt concerning the application of those rules to the tax treatment of other products created ambiguity in which taxpayers could whipsaw the government as to the proper tax treatment. At the same time, Congress was concerned about disparity in the treatment of options market makers on securities exchanges and professional traders on commodity exchanges. See H.R. Conf. Rep. No. 98-861, 898-917 (1984); S. Rep. No. 98-169, 284-297 (1984); and H.R. Rep. No. 98-432, 1262-1271 (1984) (1984 House report).

<sup>40</sup>Examples include upfront payments made to enter into an off-market swap, cap, or floor.

<sup>41</sup>Reg. section 1.446-3(d).

<sup>42</sup>Reg. sections 1.446-3(e)(2)(i) and -3(f)(2)(i).

<sup>43</sup>Reg. section 1.446-3(f). In this regard, nonperiodic swap payments generally would be allocated based on values of a series of cash-settled forwards written on a specified index at the notional principal amount.

<sup>27</sup>If the option is exercised (settles in cash), the transaction is treated as a sale or exchange of the option.

<sup>28</sup>Section 1032(a).

<sup>29</sup>See *Lucas v. North Tex. Lumber*, 281 U.S. 11 (1930). See also Steven M. Rosenthal and Liz. R. Dyor, "Prepaid Forward Contracts and Equity Collars: Tax Traps and Opportunities," 2 *J. Tax'n Fin. Prod.* 35 (2001).

<sup>30</sup>*Id.*

<sup>31</sup>Dana L. Trier and Lucy W. Farr, "Constructive Sales Under Section 1259: The Best Is Yet to Come," in 16 *Practising Law Institute, Tax Strategies for Corporate Acquisitions, Dispositions, Spin-Offs, Joint Ventures, Financings, Reorganizations & Restructurings* 1217, 1223 (2002).

<sup>32</sup>See Edward D. Kleinbard and Erika W. Nijenhuis, "Everything I Know About New Financial Products I Learned From DECS," in 16 *Practising Law Institute, Tax Strategies for Corporate Acquisitions, Dispositions, Spin-Offs, Joint Ventures, Financings, Reorganizations & Restructurings* 485, 491-493 (2002).

<sup>33</sup>The formula for the number of delivered shares is: (i) a specified maximum number of shares if the price of the stock is at or below the floor price; (ii) a specified fraction of that number of shares if the stock appreciates above the cap price; and (iii) if the stock is between the floor price and the cap price, the shares to be delivered will have a fair market value equal to the consideration. The fraction is the ratio of the floor price to the cap price. The floor price is typically the initial value of the stock.

<sup>34</sup>See Joint Committee on Taxation, "General Explanation of Tax Legislation Enacted in 1997," JCS-23-97 (Dec. 17, 1997), *Doc 97-33838, 97 TNT 244-12*, at 176. The legislative history mentions "significant variation" and "substantially fixed," but does not provide examples relating to forward contracts.

<sup>35</sup>P.L. 97-34, section 503 (1981).



any party under an NPC,<sup>44</sup> and it is recognized by the original party to the contract as income or deduction when the contract is terminated.<sup>45</sup>

In 2004 Treasury issued proposed regulations on the timing and character of NPCs with contingent nonperiodic payments.<sup>46</sup> Before 2004 taxpayers took the view that for those contracts, they could deduct the periodic payments as they accrued and include in income the amount of the contingent payment only in the year of payment.<sup>47</sup> The proposed method was a variation of the noncontingent swap method described in Notice 2001-44 (analogous to the noncontingent bond method for contingent payment debt instruments),<sup>48</sup> which requires (1) projecting initially what the contingent payment will be; (2) accounting annually for the appropriate portions of the projected contingent amounts; (3) reprojecting the contingent amounts annually; and (4) reflecting amounts attributable to the difference between projected and reprojected amounts through adjustments that are spread over a one-year period.<sup>49</sup> As an alternative, the proposed regulations provided an elective mark-to-market method.<sup>50</sup>

A different version of contingent swaps that was not addressed in the 2004 proposed regulations is a CDS,<sup>51</sup> under which the CDS seller would pay the CDS buyer in the event of a default<sup>52</sup> by a third-party obligor on a reference obligation. The buyer pays either a lump sum or periodic payments<sup>53</sup> and has the right to either (i) receive a cash payment equal to the difference between the reference obligation's value on the purchase date and its value on default, or (ii) deliver the reference obligation to the seller for cash equal to its face amount.<sup>54</sup> A CDS can cover the credit risk of a single debt, various obligations of a single entity, or a group of obligations issued by

different issuers.<sup>55</sup> The IRS indicated that the economic aspects of CDSs resemble four contracts: options, guarantees, insurance, and NPCs.<sup>56</sup>

**c. Timing rules based on the identity of the taxpayer: Mark-to-market for dealers and traders in securities.** Section 475's objective is achieving clear reflection of income under section 446.<sup>57</sup> Under section 475(a), all securities held by a dealer, including derivatives, are marked to market unless they are identified as being excluded from mark-to-market treatment in the following situations: (1) any security held for investment<sup>58</sup>; (2) any debt instrument acquired or originated by the taxpayer in the ordinary course of its trade or business that is not held for sale<sup>59</sup>; and (3) any hedge on either a security not subject to the mark-to-market rules or on any position, right to income, or liability that is not a security.<sup>60</sup>

Whether one is a dealer in securities is determined based on all facts and circumstances.<sup>61</sup> A dealer in securities regularly purchases securities from, or sells securities to, customers in the ordinary course of a trade or business, or regularly offers to enter into, assume, offset, assign, or otherwise terminate positions in securities with customers in the ordinary course of a trade or business.<sup>62</sup> Some categories of taxpayers who would otherwise be dealers in securities are exempt from dealer status.<sup>63</sup>

The term "security" is very broad and includes: (1) a share of stock in a corporation; (2) a partnership or beneficial ownership interest in a widely held or publicly traded partnership or trust; (3) a note, bond, debenture, or other evidence of indebtedness; (4) an interest rate, currency, or equity NPC; (5) evidence of an interest in, or a derivative financial instrument in, any security described above, or any currency, including any option, forward contract, short position, and any similar financial instrument in that security or currency (excluding

<sup>44</sup>Reg. section 1.446-3(h)(1).

<sup>45</sup>Reg. section 1.446-3(h)(2).

<sup>46</sup>See REG-166012-02, *supra* note 16.

<sup>47</sup>*Id.*

<sup>48</sup>See reg. section 1.1275-4 (regulations applicable to contingent payment debt instruments).

<sup>49</sup>As David Garlock wrote, "With its annual redeterminations, the Noncontingent Swap Method is a hybrid between the Basic Noncontingent Swap Method and a mark-to-market method." David C. Garlock, "The Proposed Notional Principal Contract Regulations: What's Fixed? What's Still Broken?" *Tax Notes*, Mar. 22, 2004, p. 1515, *Doc 2004-5397*, 2004 *TNT* 56-26, at 1525.

<sup>50</sup>*Id.* See prop. reg. section 1.446-3(i).

<sup>51</sup>See David Garlock et al., "Proposals Regarding the Taxation of Credit Default Swaps," 18 *J. Tax'n & Reg. Fin. Inst.* 5 (2005).

<sup>52</sup>*Id.* A default constitutes an issuer's failure to make payments on any of its obligations, typically on insolvency or bankruptcy, or a specified price change in the reference entity's debt or a rating downgrade.

<sup>53</sup>*Id.* The periodic payments generally consist of a fixed number of basis points applied to a notional principal amount, which is equal to the reference obligation's value. *Id.* Normally, the buyer will stop making payments when the default occurs.

<sup>54</sup>*Id.* Physical settlement generally reflects the net economics of cash settlement because the protection buyer is compensated for the reduction in the reference obligation's value by allowing it to sell the reference obligation to the protection seller at par.

<sup>55</sup>*Id.* A CDS may reference multiple obligations. The seller will pay the buyer in the event one or more of those obligations default, regardless of whether the buyer actually holds any of the defaulting obligations.

<sup>56</sup>See Notice 2004-52.

<sup>57</sup>JCT, "Tax Reform Proposals: Accounting Issues," JCS-39-85 (Sept. 13, 1985), at 6.

<sup>58</sup>Section 475(b)(1)(A).

<sup>59</sup>Section 475(b)(1)(B).

<sup>60</sup>Section 475(b)(1)(C).

<sup>61</sup>Reg. section 1.475(c)-1(a); reg. section 1.475(c)-1(a)(2)(ii), examples 2 and 3.

<sup>62</sup>Section 475(c)(1).

<sup>63</sup>For example, taxpayers whose principal activity consists of selling nonfinancial goods and services for which they extend credit to the purchasers of those goods and services are not dealers even if they later sell the debt. Reg. section 1.475(c)-1(b). Also, a taxpayer that regularly purchases securities from customers in the ordinary course of business is not a dealer in securities unless it sells more than a negligible portion of the securities. Reg. section 1.475(c)-1(c)(1). A negligible amount of sales results from either (a) selling all or part of fewer than 60 loans or (b) selling all or part of loans, the total adjusted basis of which is less than 5 percent of the total basis of the securities acquired in the year. Reg. section 1.475(c)-1(c)(2).

any contract to which section 1256(a) applies); and (6) a position that (i) is not a security described in (1), (2), (3), (4), or (5); (ii) is a hedge on such a security; and (iii) is clearly identified in the dealer's records as being described in this subparagraph, before the close of the day on which it was acquired or entered into (or such other time as the secretary may by regulations prescribe).<sup>64</sup> Some items are excluded from the definition of a security.<sup>65</sup> Finally, a trader in securities or a dealer or a trader in commodities may elect to be governed by section 475.<sup>66</sup> If that election is made, the electing taxpayer follows most of the rules of section 475.<sup>67</sup>

**d. Timing rules based on the purpose of the transaction: Hedging.** In 1994 Treasury issued regulations concerning the treatment of hedges, including timing (reg. section 1.446-4) and character rules (reg. section 1.1221-2). The definition of a hedging transaction (contained in the character rules but equally applicable to the timing rules) includes a transaction entered into in the normal course of the taxpayer's trade or business, primarily to manage the risk of interest rate changes, price changes, or currency fluctuations, and the risk being managed relates to ordinary obligations incurred or to be incurred or borrowings made or to be made by the taxpayer.<sup>68</sup>

Under the hedging timing rules, the taxpayer's method of accounting for the hedge must clearly reflect income<sup>69</sup>; the method must reasonably match the timing of income, deduction, gain, or loss from the hedge with those on the hedged item.<sup>70</sup> When the hedged item is marked to market, marking the hedge to market clearly reflects income.<sup>71</sup> Reg. section 1.446-4(c) acknowledges,

<sup>64</sup>Section 475(c)(2).

<sup>65</sup>Those items include: (1) a security if section 1032 prevents the taxpayer from recognizing gain or loss (includes stock of the taxpayer and any options on the stock, e.g., a mutual fund would not be treated as a dealer in securities because it sells and redeems its own shares); (2) liabilities of the taxpayer; (3) a real estate mortgage investment conduit residual interest acquired on or after January 4, 1995, and negative value REMIC residuals acquired before January 4, 1995; (4) synthetic debt that is treated as integrated debt under reg. section 1.1275-6; and (5) nonfinancial customer paper as defined in section 475(c)(4). Reg. section 1.475(c)-2.

<sup>66</sup>Sections 475(e) and (f). A commodity may be: (A) actively traded; (B) an NPC with respect to a commodity; (C) an evidence of an interest in a derivative in a commodity such as an option, forward contract, futures contract, short position, or similar instrument in a commodity; and (D) any position that is not a commodity described in (A), (B), or (C), but is a hedge of that commodity. Section 475(e)(2).

<sup>67</sup>Rev. Proc. 99-17, 1999-1 C.B. 503, *Doc 1999-5430*, 1999 TNT 26-20, provides guidance for taxpayers wishing to make the election.

<sup>68</sup>Reg. section 1.1221-2(b).

<sup>69</sup>Reg. section 1.446-4(b).

<sup>70</sup>See Diane Ring, "Risk-Shifting Within a Multinational Corporation: The Incoherence of the U.S. Tax Regime," 38 *B.C. L. Rev.* 667, 675-676 (1997).

<sup>71</sup>Reg. section 1.446-4(e)(2).

however, that "there may be more than one method of accounting that satisfies the clear reflection requirement."

#### e. Statutory antiabuse rules that affect timing.

**i. Wash sales.**<sup>72</sup> Section 118<sup>73</sup> (the predecessor of section 1091) was enacted in 1921 in response to cases in which taxpayers sold securities at a loss in one day and repurchased the same securities within the next day or so (but at a different tax year).<sup>74</sup> A wash sale occurs when a taxpayer sells stock or securities at a loss and acquires, within a 61-day period, substantially identical stock or securities.<sup>75</sup> Any loss sustained from the sale (including contracts or options to acquire or sell stock or securities) is not allowed for the year of sale if the taxpayer has acquired (or entered into a contract or option to acquire) substantially identical<sup>76</sup> stock or securities within the 61-day period.<sup>77</sup> The amount of loss is added to the basis in the newly acquired stock or security, and the holding period is also carried over. The scope of section 1091 was later expanded several times.<sup>78</sup>

**ii. Straddles.** Congress adopted the straddle rules in response to concerns that the wash sales and short sales rules were inadequate to prevent abuse.<sup>79</sup> Section 1092(a) generally provides that losses on one or more positions in a straddle may not be allowed to the extent of the taxpayer's unrecognized gain<sup>80</sup> in the offsetting position,

<sup>72</sup>H.R. Rep. No. 67-350, 11 (1921); S. Rep. No. 67-275, 14 (1921).

<sup>73</sup>26 U.S.C. section 118.

<sup>74</sup>See, e.g., *Shoenberg v. Commissioner*, 77 F.2d 446, 449-450 (8th Cir. 1935). As Congress explained, in those cases, the taxpayer has not changed its economic position and the claimed loss is fictitious.

<sup>75</sup>Section 1091(a).

<sup>76</sup>Substantially identical property is stock, securities, "when issued" securities, and commodity futures transactions but not written options or the purchase of a call option. Substantial identity covers something less than a precise correspondence. See *Hanlin v. Commissioner*, 108 F.2d 429 (3d Cir. 1939), *aff'g* 38 BTA 811 (1938), *nonacq.* 1939-1 C.B. (1) 55. A focus is generally placed on differences in economic terms that would affect an investor's decision to acquire or hold the property. See, e.g., Rev. Rul. 85-87, 1985-1 C.B. 268; Rev. Rul. 56-406, 1956-2 C.B. 523.

<sup>77</sup>The 61-day period begins 30 days before the date of the sale or disposition and ends 30 days after the date of the sale or disposition.

<sup>78</sup>Section 1091 was amended in 1988 to provide that the phrase "stock or securities" includes options or contracts to acquire or sell stock or securities. H.R. Rep. No. 100-1104, Vol. II at 131-132 (1988). The Community Renewal Tax Relief Act of 2000 added section 1091(f) under which a contract or option that is cash settled is an option to acquire property for this purpose.

<sup>79</sup>P.L. 97-34, sections 501-507 (1981).

<sup>80</sup>Unrecognized gain is defined in section 1092(a)(3) as "the amount of gain which would be taken into account with respect to such position if such position were sold on the last business day of such taxable year at its fair market value."

and the disallowed loss is carried forward to the succeeding tax year.<sup>81</sup> Thus, similar to the wash sale rules, the straddle rules constitute a departure from the normal realization principle under which losses should be deductible when incurred. A straddle is an offsetting position<sup>82</sup> in actively traded personal property.<sup>83</sup> Under section 263(g), straddle interest expense and carrying charges are required to be capitalized.<sup>84</sup> The straddle rules were expanded in 1984,<sup>85</sup> 1986,<sup>86</sup> and 2004, but maintained the same concepts.

**iii. Constructive sales.** Another departure from the normal realization principle (with a focus on the gain side) is section 1259(a)(1), which provides that if there is a constructive sale of an appreciated financial position,<sup>87</sup> the taxpayer must recognize gain as if that position were sold, assigned, or otherwise terminated at its FMV on the date of that constructive sale. A taxpayer is treated as having made a constructive sale if the taxpayer (or a related person) enters into a short sale of the same or substantially identical property, an offsetting NPC for the same or substantially identical property, or a futures or forward contract to deliver the same or substantially identical property.<sup>88</sup> The term “substantially identical” is also used in connection with the short sale and wash sale rules<sup>89</sup> and has the same meaning for constructive sale purposes.<sup>90</sup>

## 2. Character rules.

**a. General.** The classification of an item as ordinary or capital is crucial in U.S. tax law because capital gains are

taxed at preferred rates.<sup>91</sup> The distinction between short-term and long-term capital gains is also critical since only long-term capital gains receive the preferred rates.<sup>92</sup> There are four types of payments under a derivative, the character of which must be determined: (i) payments on physical settlement according to the contract’s terms; (ii) periodic and nonperiodic payments under the contract’s terms; (iii) payments on early termination of the contract by a negotiated settlement between the parties; and (iv) payments on sale or exchange of the contract to a third party (including an assumption payment).

### b. Character based on the character of the underlying property.

**i. Nonsection 1256 options.** A complex set of rules governs the character of income from options. Section 1234 addresses the general taxation rules for the writer and buyer. Section 1234A applies to some options that are subject to neither section 1234 nor section 1256. Finally, section 1256 applies to dealer equity options and non-equity options.<sup>93</sup> While the first two rules apply a look-through approach, the latter determines the character of gains and losses regardless of the underlying property.

**ii. Section 1234.** Under section 1234(a) — which applies to the option buyer — gain or loss from the sale, exchange, or lapse of an option constitutes gain or loss from the sale or exchange of property that has “the same character as the property to which the option relates in the hands of the taxpayer (or would have in the hands of the taxpayer if acquired by him).”<sup>94</sup> Thus, the character of gains and losses on the option is determined in accordance with the character of the underlying property. The same look-through applies if the holder fails to exercise the option, in which case the option is deemed to be sold on the expiration date and the loss is treated under the general look-through rule.<sup>95</sup>

Physical settlement of an option is treated as a purchase of the underlying asset. When the option buyer exercises a call option (that is, purchasing the underlying property), the premium is added to the property’s basis. The holding period of the acquired property begins on the day after the exercise.<sup>96</sup> When the option buyer exercises a put option (that is, sells the underlying property), its premium reduces the amount realized on

<sup>81</sup>According to section 1092(d)(2), the term “position” means “an interest (including a futures or forward contract or option) in personal property.”

<sup>82</sup>A taxpayer holds an offsetting position “if there is a substantial diminution of the taxpayer’s risk of loss from holding any position with respect to personal property by reason of his holding 1 or more positions with respect to personal property” — the contrary position. Section 1092(c)(2).

<sup>83</sup>“Personal property” is any personal property of a type that is actively traded. Property is actively traded if there is an established financial market for the personal property (e.g., a national securities exchange, interdealer quotations system, or interbank market).

<sup>84</sup>This rule applies to interest and other carrying charges that are allocable to a leg in a straddle. The effect of this rule is to defer any interest or carrying charges until the positions are terminated and to reduce the gain or increase the loss.

<sup>85</sup>P.L. 98-369, sections 101-108 (1984) (DEFRA).

<sup>86</sup>P.L. 99-514, section 1808(c) (stock exclusion does not apply to “any interest in stock”).

<sup>87</sup>“Appreciated financial position” is any position with respect to any stock, debt instrument, or partnership interest if there would be gain were that position sold, assigned, or otherwise terminated at its FMV. Section 1259(b). A “position” is an interest, including a futures or forward contract, short sale, or option.

<sup>88</sup>Section 1259(c)(1).

<sup>89</sup>See sections 1233 and 1091.

<sup>90</sup>In general, the phrase “substantially identical” is applied according to the facts of each case. See reg. section 1.1233-1(d). Substantial identity covers something less than a precise correspondence. See *Hanlin*, 108 F.2d 429. For example, an equity index future has not been viewed as substantially identical to a nonidentical basket of stocks.

<sup>91</sup>See section 1(g). See Noel Cunningham and Deborah Schenk, “The Case for Capital Gains Preference,” 48 *Tax L. Rev.* 319 (1993).

<sup>92</sup>See sections 1222 and 1223.

<sup>93</sup>A dealer equity option is an equity option purchased or granted by an option dealer in the normal course of its dealer activity and listed on a qualified board or exchange on which that dealer is registered. Section 1256(g)(4). An equity option is an option to buy or sell stock or whose value is determined, directly or indirectly, by reference to any stock, group of stocks, or stock index. Section 1256(g)(6). A nonequity option is a listed option that is not an equity option.

<sup>94</sup>Section 1234(a) does not apply to options that constitute inventory and to writers of options in the course of the writer’s trade or business, both of which are ordinary under section 1221(a)(1) and (2).

<sup>95</sup>Reg. section 1.1234-1(b).

<sup>96</sup>See Rev. Rul. 88-31, 1988-1 C.B. 302; Rev. Rul. 70-598, 1970-2 C.B. 168.



sale of the underlying property. If the underlying property is a capital asset, any gain or loss on the underlying property is treated as short-term or long-term capital gain, depending on the holding period in the hands of the original owner. In contrast, whether gain or loss will be short or long term on the disposition of the option itself is determined by the length of time the option buyer held the option.<sup>97</sup>

As to the writer, if the option is on stock, securities, commodities, or commodities futures, and it lapses or is part of a closing transaction, the gain or loss is treated as short term regardless of the holding period.<sup>98</sup> Reg. section 1.1234-1(b) provides, however, that for all other options, gain to the writer arising from the failure to exercise it is ordinary.

Physical exercise of the option is subject to the general holding period rules. When a call option is exercised, the writer (the seller of the underlying property) adds the premium to the amount realized on the sale of the underlying property. Any gain or loss is treated as short-term or long-term capital gain or loss depending on the seller's holding period of the underlying property. When a put option is exercised, the writer (the purchaser of the underlying property) decreases its basis in the property by the amount of premium received. The holding period during which the writer held the option is not tacked to the underlying property's holding period; it begins on the day after exercise.<sup>99</sup>

When a cash-settled option is settled, the transaction is treated as a sale or exchange of the option. Thus, if the underlying property is a capital asset, gain or loss on the transaction is considered gain or loss from the sale or exchange of a capital asset.

**iii. Section 1234A.** Section 1234A, which governs the character of gain or loss from some terminations of financial positions, also adopts a look-through approach.<sup>100</sup> Gain attributed to the option's termination is gain from the sale of a capital asset. When the option buyer accepts the difference between the underlying property's FMV and the exercise price on termination, the gain or loss equals the amount received less the basis in the option.

**iv. Forward contracts.** Section 1234A applies to the settlement of forward contracts. In accordance with the

same look-through principle, gain or loss recognized on the settlement of the forward contract is capital if the underlying property is capital. Thus, a taxpayer holding a forward contract as a capital asset recognizes capital gain or loss on settlement or disposition of the contract. Under prop. reg. section 1.1234A-1(c), a payment on a forward contract or a bullet swap<sup>101</sup> would be treated as a termination payment for purposes of section 1234A (that is, as capital). The IRS explained that, as opposed to NPCs, bullet swaps and forward contracts do not have ordinary income or expense arising from periodic or nonperiodic payments and that since all payments are at or near the maturity date, section 1234A may treat all gains and losses on the contract as capital gains or losses.

**c. Character rules based on the character of the position itself.**

**i. Section 1256 contracts.** As opposed to the look-through principle, section 1256 focuses on the character of the position itself. Holders of section 1256 contracts as capital assets recognize capital gains and losses on market-to-market gains and losses and on actual dispositions.<sup>102</sup> Regardless of the holding period, 60 percent of the gain or loss is long term and 40 percent is short term.<sup>103</sup>

**ii. NPCs.** There are no statutory or regulatory character rules for NPCs. In LTR 9730007,<sup>104</sup> in determining that periodic payments, including the final periodic payment, are ordinary, the IRS reasoned:

Although an NPC is economically similar to a series of cash-settled forward contracts, an NPC is a single, indivisible financial instrument. . . . Periodic payments made pursuant to an NPC are more similar to dividends on stock or interest on securities, which items are treated as ordinary income or expense rather than amounts received on the sale or exchange of the underlying instrument. . . .

A periodic payment on an NPC does not give rise to a capital gain or loss because there is no sale or exchange of a capital asset. . . . A periodic payment, however, does not terminate an NPC.

. . .

Periodic payments under a swap agreement are not gain or loss attributable to the cancellation, lapse, expiration, or other termination of a right or obligation with respect to personal property within the meaning of Section 1234A. They are simply payments made according to the original terms of the single instrument. The final periodic payment on a swap is accounted for in the same manner as all other periodic payments made or received on a swap.

<sup>97</sup>Under the general principles of sections 1222 and 1223, if the option is held for one year or less, the resulting gain or loss from a sale or exchange will be short term. If the option is held for more than one year, the gain or loss on the sale or exchange of the option will be long term.

<sup>98</sup>Section 1234(b)(1). Section 1234(b)(2)(A) defines a closing transaction as "any termination of the taxpayer's obligation under an option in property other than through the exercise or lapse of the option."

<sup>99</sup>See Rev. Rul. 78-182, 1978-1 C.B. 265, citing section 1222 and Rev. Rul. 58-234, 1958-1 C.B. 279; Rev. Rul. 88-31, 1988-1 C.B. 302; Rev. Rul. 70-598, 1970-2 C.B. 168.

<sup>100</sup>In 1997 Congress expanded section 1234A to apply to a right or obligation with respect to any property. Section 1234A, however, applies only to rights and obligations with respect to property if that property (not the position) is a capital asset in the hands of the taxpayer.

<sup>101</sup>A bullet swap is a financial instrument (other than a futures contract, forward, option or debt instrument) "that provides for the computation of an amount or amounts due from one party to another by reference to a specified index upon a notional principal amount, and that provides for settlement of all the parties' obligations at or close to maturity of the contract." See reg. section 1.1234A-1(c)(2).

<sup>102</sup>Section 1256(a)(3).

<sup>103</sup>*Id.*

<sup>104</sup>See LTR 9730007, Doc 97-21707, 97 TNT 144-16.

The IRS further observed that “periodic payments under a swap are not gain or loss attributable to the cancellation, lapse, expiration or other termination of a right or obligation with respect to personal property within the meaning of section 1234A.”<sup>105</sup>

Prop. reg. section 1.162-30 clarifies that the net periodic and nonperiodic payments on NPCs are deductible by the payer under section 162 as ordinary and necessary business expenses. Further, reg. section 1.446-3(d) states that the net periodic payments are net income or a net deduction in that year, that is, ordinary.<sup>106</sup>

As for a termination payment, the IRS ruled that if a taxpayer has positive value in an NPC and it sells the position to a third party, the gain realized is from the sale or exchange of property (that is, capital) unless the NPC is held as ordinary property.<sup>107</sup> The case of an early termination rather than a sale of the position is more complex.<sup>108</sup> The fundamental question is whether the NPC is a “right or obligation. . . with respect to property” under section 1234A because, unlike an option or a forward contract, an NPC is not always a contract to buy or sell specific property.<sup>109</sup>

The 2004 proposed regulations contain a regulation under section 1234A that (i) would clarify that “termination payment” has similar meaning for purposes of section 1234A and the NPC regulations and (ii) provides that any other payments or deemed payments terminate or cancel a right or obligation.<sup>110</sup> When an NPC is payable according to its terms, however, all amounts arising from the contract are ordinary.<sup>111</sup>

**d. Character rules based on the purpose: Hedging character rules.** Before 1994 the tax treatment of hedging transactions was entirely a matter of case law and administrative practice. In *Corn Products*, gains and losses on hedging transactions were held to be ordinary, which matched the character of the gain or loss on the hedged item.<sup>112</sup> The Supreme Court clarified in *Arkansas Best* that gain or loss on the sale or exchange of an asset is capital unless the asset falls within one of the enumerated exceptions in section 1221.<sup>113</sup> In *Fannie Mae* the IRS argued that *Arkansas Best* required the taxpayer to treat its hedging losses as capital, but the Tax Court disagreed. A year later, Treasury issued the hedging regulations.

The primary purpose of the hedging character rule is to match the character of gains and losses from the hedge with the character of gains and losses from the hedged items. Thus, gains and losses on derivatives used as a

hedge are ordinary if they arise from hedging activities.<sup>114</sup> To qualify for tax hedging treatment, the taxpayer must satisfy both substantive and procedural requirements. First, the hedged items must be ordinary (or borrowings),<sup>115</sup> and the hedge must be entered into in the taxpayer’s normal course of business to manage enumerated risks. Second, the hedge and hedged items must be properly and timely identified. If both requirements are met, gains and losses on the hedge are ordinary.<sup>116</sup> The significance of this rule is that taxpayers can match ordinary gains with ordinary losses, thereby avoiding a character mismatch.

**e. Character rules based on the taxpayer’s identity: Dealers and traders.** Section 475 simply provides for ordinary treatment for securities, including derivatives, that are being held, other than as investments, by security dealers, electing security traders, and electing commodities dealers and traders.<sup>117</sup> Gain or loss recognized before the close of the year (for example, because the dealer disposed of the security during the year) is also ordinary.

**f. Character rules based on the contract’s denominated currency.** Section 988 governs the tax treatment of transactions, the payments on which are denominated in, or tied to, the value of nonfunctional currency.<sup>118</sup> Gain or loss realized on a section 988 transaction is ordinary to the extent it is attributable to changes in exchange rates.<sup>119</sup> A section 988 transaction includes a forward or futures contract, option, or a similar instrument if the amount that the taxpayer is entitled to receive or required to pay is denominated in nonfunctional currency or is determined by value of one or more nonfunctional currencies.<sup>120</sup> A taxpayer may elect capital gain treatment if the contract is a capital asset in the taxpayer’s hands and is not part of a straddle.<sup>121</sup>

Foreign currency gain or loss is recognized under section 988 only on a realization event regarding settlement or termination of the transaction.<sup>122</sup> The regulations provide that “exchange gain realized from the sale or

<sup>114</sup>Gregory May, “The U.S. Taxation of Derivative Contracts,” 95 *TNI* 189-8. (An updated version of the national report published in 85b *Cahiers de Droit Fiscal International* 615 (1995) for the 49th Congress of the International Fiscal Association on September 17-21, 1995.)

<sup>115</sup>Reg. section 1.1221-2(b).

<sup>116</sup>Section 1221(a)(7).

<sup>117</sup>Section 475(d)(3)(A).

<sup>118</sup>Also, the transaction must fall within one of four categories: (1) acquiring a debt instrument or becoming obligated under a debt instrument; (2) acquiring or otherwise taking into account any item of expense, gross income, or receipts to be paid or received after the date on which it is taken into account; (3) entering into or acquiring any forward contract, futures contract, option, or similar financial instrument; or (4) disposing of nonfunctional currency. Section 988(c)(1)(B) and (C).

<sup>119</sup>Section 988(a)(1)(A). See also reg. section 1.988-3(a).

<sup>120</sup>Section 988(c)(1). In general, a taxpayer’s functional currency is the currency of the business’s economic environment and the currency in which the books and records are kept. See reg. section 1.988-1(c) referencing the definition in section 985 and reg. section 1.985-1.

<sup>121</sup>See section 988(a)(1)(B) and reg. section 1.988-3(b).

<sup>122</sup>Reg. section 1.988-2(a)(1)(i).

<sup>105</sup>*Id.*

<sup>106</sup>See, e.g., preamble to prop. reg. section 1.446-3; and JCT, “General Explanation of the Tax Reform Act of 1986.”

<sup>107</sup>See FSA 1999-985 (Aug. 6, 1992), *Doc* 1999-2426, 1999 *TNT* 122-105.

<sup>108</sup>Edward D. Kleinbard, “Equity Derivative Products: Financial Innovation’s Newest Challenge to the Tax System,” 69 *Tex. L. Rev.* 1319 (1991).

<sup>109</sup>See Garlock, *supra* note 49.

<sup>110</sup>*Id.*, discussing REG-166012-02.

<sup>111</sup>*Id.*

<sup>112</sup>Edward D. Kleinbard and Suzanne F. Greenberg, “Business Hedges After *Arkansas Best*,” 43 *Tax L. Rev.* 393 (1988).

<sup>113</sup>*Arkansas Best Corp. v. Commissioner*, 485 U.S. 212 (1988).



other disposition of nonfunctional currency shall be the excess of the amount realized over the adjusted basis of such currency.<sup>123</sup> The adjusted basis of the currency is determined based on the spot rate on the day of purchase.<sup>124</sup> The amount realized is generally determined based on the spot rate on the day of disposition.<sup>125</sup>

For section 1256 contracts that are also section 988 contracts, the character of the gain is governed by section 988, while timing is subject to section 1256.<sup>126</sup> Thus, the contract is marked to market, but resulting gain or loss is ordinary.<sup>127</sup>

#### g. Antiabuse rules that affect the character of derivatives.

**i. Short sales.** A short sale is “a contract for the sale of shares which the seller does not own or the certificates for which are not within his control so as to be available for delivery at the time when, under the rules of the Exchange, delivery must be made.”<sup>128</sup> A short sale is treated as an open transaction until the short seller closes it by purchasing property similar to that borrowed and returning it to the lender.<sup>129</sup> In a short against the box, the taxpayer sells a security short while holding a substantially identical security.<sup>130</sup>

Before 1950, some taxpayers used short sales as a technique to circumvent the holding period rules.<sup>131</sup> Congress enacted section 1233(b) and (d) to prevent those abuses.<sup>132</sup> Section 1233 contains three antiabuse rules that can affect the treatment of gains and losses realized on short sales; they apply only if the gain or loss from the short sale is capital. The rules (1) prevent the aging of short-term capital gain into long-term gain,<sup>133</sup> (2) restart

specified holding periods,<sup>134</sup> and (3) prevent turning long-term losses into short-term losses.<sup>135</sup>

**ii. Conversion transactions.** Section 1258 recharacterizes as ordinary income (by imputing interest) a portion or all of an otherwise capital gain recognized from the disposition or termination of any position in a transaction consisting of two or more positions taken regarding the same or similar property, when substantially all of the taxpayer’s return is attributable to the time value of the taxpayer’s net investment in the transaction.<sup>136</sup> The amount of gain recharacterized is the lesser of the entire amount of the gain or the applicable imputed income amount.<sup>137</sup>

**iii. Constructive ownership transactions.** Section 1260 limits the amount of long-term capital gain that a taxpayer can recognize on some financial assets. A taxpayer enters into a constructive ownership transaction regarding any financial asset if it holds a long position under an NPC on that financial asset.<sup>138</sup> A financial asset is (1) an equity interest in a passthrough entity, and (2) to the extent provided in regulations, any debt or stock of a corporation that is not a passthrough entity.<sup>139</sup>

**h. Character issues pertaining to derivatives with negative value.** A taxpayer holding a position in a derivative with a negative value may want to be relieved from its liability by paying a third party so the latter will assume the liability. It is unclear whether the amount so paid is an ordinary expense or a capital loss. In FSA 1999-763 (May 22, 1992), *Doc 1999-2881*, 1999 TNT 40-34; FSA 1999-985 (Aug. 6, 1992), *Doc 1999-2426*, 1999 TNT 122-105; and FSA 1998-237 (Mar. 22, 1993), *Doc 98-24924*, 98 TNT 182-58, the IRS ruled that an interest rate swap constitutes property because it is a bundle of rights and obligations.<sup>140</sup> In *Bank One*, the Tax Court noted that a

<sup>123</sup>Reg. section 1.988-2(a)(2)(i).

<sup>124</sup>Reg. section 1.988-2(a)(2)(iii).

<sup>125</sup>Reg. section 1.988-2(a)(2)(ii)(A).

<sup>126</sup>Section 988 treatment does not apply to any foreign currency contract that would be marked to market under section 1256. Reg. section 1.988-1(a)(7). However, a taxpayer may elect to have section 988 apply to the section 1256 contracts. Section 988(c)(1)(D)(ii); reg. section 1.988-1(a)(7)(ii).

<sup>127</sup>Section 988(a)(1)(A) and (a)(3).

<sup>128</sup>*See Provost v. United States*, 269 U.S. 443, 450-451 (1926). *See also Commissioner v. Levis’ Estate*, 127 F.2d 796, 797 (2d Cir. 1942).

<sup>129</sup>Reg. section 1.1233-1(a)(1). Gain or loss from the short sale is determined only when the sale is closed, not when the short sale takes place. Reg. section 1.1233-1(a)(4).

<sup>130</sup>Edward D. Kleinbard, “Risky and Riskless Positions in Securities,” 71 *Taxes* 783, 788-792 (1993). Economically, that is equivalent to a forward sale of the box security with a delivery date for a price equal to the security’s FMV at the time of the short sale.

<sup>131</sup>*See Smith v. Commissioner*, 78 T.C. 350, 373 (1982).

<sup>132</sup>H.R. Rep. No. 81-2319, 55 (1950); S. Rep. No. 84-1255, 2 (1955).

<sup>133</sup>If on the date of the short sale substantially identical property has been held by the taxpayer for not more than one year, the gain or loss from closing the short sale is short term. This rule also applies if the taxpayer acquires substantially identical property after the short sale and holds that property for more than one year and then closes the short sale with that property.

<sup>134</sup>The holding period of the substantially identical property begins on the earlier of the date of the closing of the short sale or the date of a sale, gift, or other disposition of the property. The holding period rule applies only to the amount of substantially identical property sold short.

<sup>135</sup>If, for more than one year, a short seller has held substantially identical property to the property that was sold short, any capital loss realized on the short sale is long-term capital loss. This amount is limited to the amount of the substantially identical property held as of the date of the short sale.

<sup>136</sup>Section 1258(c).

<sup>137</sup>Section 1258(b). A conversion transaction is one of the following: (i) holding property (whether or not actively traded), and entering into a contract to sell that property (or substantially identical property) at a price determined in accordance with the contract, but only if that property was acquired and the contract was entered into on a substantially contemporaneous basis; (ii) an applicable straddle; (iii) any other transaction that is marketed or sold as producing capital gains from a transaction when substantially all of a taxpayer’s expected return is attributable to the time value of money; or (iv) any other transaction specified in regulations.

<sup>138</sup>Section 1260(d)(1)(A).

<sup>139</sup>Section 1260(c).

<sup>140</sup>Relying on *Commissioner v. Ferrer*, 304 F. 2d 125, 131 (2d Cir. 1962). The IRS said that forward and futures contracts also constitute property and should be treated similarly.

## COMMENTARY / SHELF PROJECT

swap becomes a liability when it is underwater.<sup>141</sup> A related question is whether a swap is a capital asset because the character rules that apply to assets do not easily apply to liabilities, and derivatives do not fall under any of the eight exceptions to capital assets enumerated in section 1221(a) unless they constitute either hedges or inventory. In the above field service advice memorandums, the IRS's main support for the property treatment was that the contract's value fluctuates because of market forces (that is, interest rates).

Economically, a payment made to be relieved from a burdensome contract reflects the present value of the expected cash flows from the contract if it remains outstanding to maturity.<sup>142</sup> Thus, to support ordinary treatment, it could be asserted that the payment substitutes a stream of ordinary payments to be paid or received by the taxpayer.<sup>143</sup> There are only a few authorities on the treatment of the payer in an assignment of an underwater contract. In *Stavisky v. Commissioner*,<sup>144</sup> the Tax Court held that in the context of "when issued" contracts, a payment to be relieved from the contract is ordinary. Until today, however, *Stavisky* has not been applied outside the when-issued contracts context.<sup>145</sup> The Tax Court held that a payment made to a third party to be relieved from a guarantee is an ordinary expense. Several cases involving the treatment of the payee (assignee) of an underwater contract reached a similar conclusion.<sup>146</sup>

Further, to be eligible for capital treatment, the taxpayer must show a sale or exchange.<sup>147</sup> Generally, a sale occurs when the taxpayer receives consideration in exchange for property. A payment to be relieved from a contract is not a sale or exchange. Even assuming that the contract constitutes property, the assigning party does not receive consideration for the property, but rather pays to be relieved from the contract. Further, it is hard to establish a basis and amount realized associated with such an assignment. Another question is whether an assignment of a contract should be treated similarly to a cancellation or termination of a contract under section 1234A. Congress added section 1234A to establish that the gain or loss resulting from the cancellation of a

contract is capital.<sup>148</sup> The omission of an assignment from the scope of section 1234A may indicate that assignments should not be subject to section 1234A.<sup>149</sup>

### 3. Source rules.

**a. Overview.** Even though cross-border derivatives are very common, the source rules pertaining to income and deductions thereon are unsatisfactory. In fact, the only specific source rule is the source of periodic payments on NPCs. Further, while some types of payments are sourced in accordance with the residency of the recipient, others are generally sourced in accordance with the residency of the payer.

When one of the parties to the derivative is a non-U.S. resident, the source of income is important because it will determine if that income earned by the nonresident can be taxed in the United States.<sup>150</sup> The United States uses "a residence-based sourcing rule to waive source-based claims on the derivative instrument income of nonresident foreign persons."<sup>151</sup> Thus, in general, unless the gain on a derivative is connected with a U.S. trade or business, it is not subject to U.S. tax.<sup>152</sup>

**b. NPCs.** The source rule for periodic payments on NPCs was introduced in 1987,<sup>153</sup> reintroduced in temporary regulations in 1989,<sup>154</sup> and finalized in 1991 in reg. section 1.863-7(b).<sup>155</sup> Under the regulation, if the foreign counterparty is not engaged in a U.S. trade or business, a U.S. payer of periodic payments is not required to withhold on those payments because the source of the periodic payments is the residence of the recipient of the income.<sup>156</sup> Payments on NPCs other than periodic payments are subject to the general source and withholding

<sup>141</sup>*Bank One Corp. v. Commissioner*, 120 T.C. 174 (2003), Doc 2003-11185, 2003 TNT 86-3.

<sup>142</sup>*Cf.* David A. Weisbach, "Reconsidering the Accrual of Interest Income," 78 *Taxes* 36 (2000); Reed Shuldiner, "A General Approach to the Taxation of Financial Instruments," 71 *Tex. L. Rev.* 243 (1992).

<sup>143</sup>This argument is consistent with arguments made by taxpayers in cases such as *Corn Products Refining Co. v. Commissioner*, 350 U.S. 46 (1955); *Federal National Mortgage Association v. Commissioner*, 100 T.C. 541 (1993); and *Ferrer*, 304 F.2d at 131.

<sup>144</sup>34 T.C. 140 (1960), *aff'd*, 291 F.2d 48 (2d Cir. 1961).

<sup>145</sup>*See* Kirk Van Brunt, "Tax Aspects of REMIC Residual Interests," 2 *Fla. Tax Rev.* 149 (1994), n.193, citing the New York State Bar Association Tax Section, "Report on Proposed Regulations on Methods of Accounting for Notional Principal Contracts" (Jan. 6, 1992).

<sup>146</sup>*See, e.g., Mansfield Journal Co. v. Commissioner*, 274 F.2d 284, 286 (6th Cir. 1960); *General Artists Corp. v. Commissioner*, 205 F.2d 360 (2d Cir. 1953).

<sup>147</sup>*See* section 1001.

<sup>148</sup>S. Rep. 97-144, 170 (1981).

<sup>149</sup>In the above three field service advice memorandums, the IRS argued that section 1234A was intended to clarify existing law and not to create a new rule.

<sup>150</sup>The United States limits the tax liability of nonresident individuals (section 2(d)) and foreign corporations (section 11(d)) to U.S.-source income by reference to sections 871 or 877 (individuals) and section 882 (corporations).

<sup>151</sup>*See* May, *supra* note 114.

<sup>152</sup>Nonresidents are generally taxed on all income that is effectively connected with the conduct of a trade or business in the United States. *See* section 864(c)(4). A foreign person is engaged in a U.S. trade or business if her activities (or the activities of a dependent agent acting on her behalf) are considerable, continuous, and regular. *See Pinchot v. Commissioner*, 113 F.2d 718, 719 (2d Cir. 1940). Foreign persons engaged in a U.S. trade or business are taxed at graduated rates on income effectively connected with that trade or business. Section 864(c); reg. section 1.864-3 through -7.

<sup>153</sup>*See* Rev. Rul. 87-5, 1987-1 C.B. 180.

<sup>154</sup>Temp. reg. section 1.863-7T. Temp. reg. section 1.988-4T contained a similar source rule for section 988 transactions.

<sup>155</sup>Although not stated formally, the reason for the special rule was to permit cross-border NPCs without the impediment of a withholding tax. *See* H. David Rosenbloom, "Source Basis Taxation of Derivative Financial Instruments: Some Unanswered Questions," 50 *U. Miami Bus. L. Rev.* 597 (1996).

<sup>156</sup>Reg. section 1.863-7(a). The definition of an NPC under reg. section 1.863-7(a) is the same as that under reg. section 1.446-3(c). *See also* reg. section 1.1441-4(a)(3), under which payments with respect to an NPC are not subject to U.S. withholding tax.

rules.<sup>157</sup> For example, significant nonperiodic payments that are treated as embedded loans are sourced according to the residence of the payer, and payments by a U.S. person to a foreign holder that are attributable to an embedded loan are subject to withholding tax.<sup>158</sup>

In September 2008 the Senate Homeland Security and Governmental Affairs Permanent Subcommittee on Investigations issued a scathing report on total swaps and securities lending transactions under the title “Dividend Tax Abuse.”<sup>159</sup> On March 18, 2010, President Obama signed the Hiring Incentives to Restore Employment Act (HIRE Act, P.L. 111-137) into law. Section 541 of the HIRE Act added a new provision to the code, denominated as section 871(l). Under prior law, taxpayers took the view that the substitute dividend payments made under a total return swap are not subject to U.S. withholding tax because the source of those payments is the residency of the recipient. The new provision will treat the dividend-based amount under the swap as a payment even though the actual payment under the swap is a net amount. Thus, the counterparty may be obligated to withhold and remit tax on the gross amount of a dividend-equivalent payment even though, as a result of netting, the counterparty would not be required to make an actual payment to the foreign investor. So this provision effectively distinguishes between the source payments on equity swaps (which will follow the source rules for dividends) and all other NPCs.

**c. Options, forwards, and futures contracts.** There are no specific U.S.-source rules for gains or losses on options, forwards, and futures contracts.<sup>160</sup> Thus, under the normal source rules for sales of property, the source of gain from those derivatives is similar to the source of capital gain.<sup>161</sup>

### C. The Reason for Change

The U.S. tax rules pertaining to timing, character, and source rules for derivatives have become complex and incoherent. Taxpayers and their advisers are frequently puzzled by the possible alternative treatments for transactions that have equal economic returns. The rules are not only inconsistent with each other, but also contain many overlaps, which add to the growing confusion.

Regarding timing, income and deductions are recognized in a variety of ways, including mark-to-market, accrual, cash, wait-and-see, and special timing regimes. Non-section-1256 options and forward contracts are subject to a wait-and-see timing regime. Derivatives held by dealers and electing trades are marked to market under section 475, while section 1256 contracts are marked to

market under section 1256 regardless of who holds them.<sup>162</sup> Also, special timing rules apply to NPCs, under which periodic payments are taxed using accrual principles, termination payments are taxed when realized, and nonperiodic payments are subject to a unique set of rules. Further, Congress and Treasury have added anti-abuse rules on timing to address particular situations. Those rules have become not only complex, but also inconsistent with established tax principles (such as the realization principle).

The character rules are just as complex as the timing rules. Adding these alternative treatments to the variety of timing rules, the result is an enormous uncertainty. The character rules that apply to options illustrate this complexity. Buyers and writers of options are potentially subject to four different character regimes: ordinary, long-term capital gain, short-term capital gain, and the 60/40 rule. To add to the confusion, buyers and writers may be subject to different character rules for the same transaction. For nonsection 1256 contracts, the character of gains and losses is determined in accordance with the character of the underlying property. In contrast, gains and losses from a section 1256 contract are capital (60 percent long-term gain and 40 percent short-term), regardless of the character of the underlying property. Nevertheless, if the contract is a section 988 contract, the gain or loss that is attributed to the changes in exchange rate is generally ordinary. Sections 475 and 1221(a)(7) further mandate ordinary treatment for derivatives held by dealers and electing traders and for derivatives used for hedging, respectively. Another uncertain distinction applies to writers. If the option is on stock, securities, commodities, or commodities futures, and it lapses or is part of a closing transaction, the gain or loss is treated as short-term regardless of the holding period; but for all other options, gain to the writer arising from the failure to exercise it is ordinary. Finally, specific character rules apply to derivatives in accordance with antiabuse rules.

Regarding source rules, while payments on options, forwards, and futures contracts are sourced under general source rules, income from periodic payments on NPCs is sourced in accordance with the residence of the recipient. Nevertheless, recently enacted section 871(l) would change the source of some payments on equity swaps to be similar to the source rules for dividends (that is, residency of the payer). Also, the source of foreign currency gain or loss on a section 988 transaction is generally the residence of the taxpayer. Further, the source of income on derivatives that are part of the taxpayer’s trade or business is generally the United States.

In conclusion, the tax rules for derivatives in the United States do not follow a consistent pattern and should be simplified. The following section of this article sets forth a simple and coherent approach for taxation of derivatives in the United States.

<sup>162</sup>To add to the confusion, each of these regimes is subject to different character treatment.

<sup>157</sup>See Avi-Yonah and Swartz, *supra* note 9.

<sup>158</sup>*Id.* Special rules apply to payments on NPCs that are classified as embedded loans.

<sup>159</sup>Staff Report, United States Senate Permanent Subcommittee on Investigations, “Dividend Tax Abuse: How Offshore Entities Dodge Taxes on Stock Dividends” (Sept. 11, 2008), *Doc 2008-19344*, 2008 TNT 178-27.

<sup>160</sup>*Id.* Section 865(j)(2) gave the IRS the authority to issue regulations on the source of income from forward contracts, but those regulations have yet to be issued.

<sup>161</sup>Section 865.



**D. Proposed Rules****1. Timing: Mark-to-market treatment for derivatives.**

Under the proposed timing rule for derivatives, gains and losses from derivatives — regardless of the nature of the underlying property, the identity of the parties, and the purpose for which the transaction was entered into — will be mandatorily marked to market by taxpayers that mark those gains and losses to market for purposes of generally accepted accounting principles. Taxpayers not subject to GAAP will be allowed to elect mark-to-market for tax purposes.

**a. Theoretical framework.** Commentators have been praising the Haig-Simons principle of income as a superior method of taxation.<sup>163</sup> As David Weisbach observed, “In Haig-Simons taxation, a taxpayer’s income in each tax period is equal to consumption plus change in wealth for the period. To measure change in wealth, the taxpayer values all of its assets and includes in income (or deducts from income) the change in value plus any cash received.”<sup>164</sup>

Mark-to-market taxation is based on the Haig-Simons concept.<sup>165</sup> The mark-to-market principle applies in U.S. tax law only in limited circumstances. My proposed timing rule will expand the application of the mark-to-market principle to most derivatives.<sup>166</sup> While many commentators have advocated a mark-to-market approach for taxation of derivatives, some of them have also warned of the potential drawbacks, particularly the liquidity and valuation concerns.<sup>167</sup> Still, many other commentators agreed that the valuation and liquidity concerns should not prevent the implementation of a mark-to-market regime.<sup>168</sup> As I explain below, these concerns should not prevent the application of the mark-to-market timing rules for derivatives.

**b. Using GAAP as the basis.** Book and tax rules for derivatives do not conform.<sup>169</sup> Most derivatives are

marked to market for financial accounting purposes.<sup>170</sup> Financial Accounting Standard No. 133 requires recording of all derivatives on the balance sheet at fair value and sets forth specific accounting standards for (i) hedges of changes in the fair value of assets, liabilities, or firm commitments (fair value hedges), which are recorded at fair value in the balance sheet, with any unrealized gains and losses recorded in net income; (ii) hedges of the variable cash flows of forecasted transactions (cash flow hedges), which are also recorded at fair value in the balance sheet, but unrealized gains and losses are recorded in equity, as part of “other comprehensive income”; and (iii) hedges of foreign currency exposures of net investments in foreign operations (foreign currency net investment hedges), which are special cases of the above two types of hedges.<sup>171</sup> Also, if the hedge is a fair value hedge, the reporting entity must mark the hedged item to market to the extent changes in the fair value of the hedged item are attributable to the risk designated as being hedged.<sup>172</sup> Further, a derivative will be marked to market under FAS 133 even if it not used for hedging. Derivatives used for nonhedging purposes are recorded at fair value, with unrealized gains and losses recorded in net income.

I have previously advocated book-tax conformity for financial instruments, including derivatives.<sup>173</sup> The regime proposed herein will conform the book and tax timing treatment of derivatives. To achieve that conformity, the proposed rule will set forth that all derivatives that are subject to GAAP mark-to-market should be marked to market for tax purposes. This could be achieved by expanding the scope of section 475(a) to derivatives that are subject to GAAP mark-to-market. The revised section 475 will become a single workable mark-to-market timing and character rule for derivatives.

I am also proposing elective mark-to-market treatment for taxpayers not subject to GAAP. Taxpayers that are not subject to GAAP should be able to elect mark-to-market

<sup>163</sup>Weisbach, *supra* note 2; Deborah Schenk, “Taxation of Equity Derivatives: A Partial Integration Proposal,” 50 *Tax L. Rev.* 571, 629-630 (1995). See also *Cottage Sav. Ass’n v. Commissioner*, 499 U.S. 554, 559 (1991).

<sup>164</sup>David A. Weisbach, “Tax Response to Financial Contract Innovation,” 50 *Tax L. Rev.* 491 (1995). Citing Robert M. Haig, “The Concept of Income — Economic and Legal Aspects,” in *The Federal Income Tax 1* (1921), reprinted in *Am. Econ. Ass’n, Readings in the Economics of Taxation* 54 (1959); Henry C. Simons, *Personal Income Taxation* 50 (1938).

<sup>165</sup>David J. Shakow, “Taxation Without Realization: A Proposal For Accrual Taxation,” 134 *U. Pa. L. Rev.* 1111 (1986).

<sup>166</sup>David A. Weisbach, “Tax Response to Financial Contract Innovation,” 50 *Tax L. Rev.* 491 (1995). (The benefits of moving financial instruments to mark-to-market taxation would be enormous.)

<sup>167</sup>Shakow, *supra* note 165, at 1118. (An accrual tax system cannot succeed without a satisfactory method of valuing assets.) Cf. Weisbach, *supra* note 2, at 105 (the problems of valuation and liquidity are not sufficient to overcome the benefits).

<sup>168</sup>*Id.*

<sup>169</sup>For example, regarding hedging transactions, while tax hedging rules generally match the timing of income and deductions from the hedging transaction with that of the hedged item, Financial Accounting Standard No. 133 requires that all hedging derivatives be marked to market, and in some circumstances

(Footnote continued in next column.)

(fair value hedges), the timing of the hedge will be matched to the hedged item by marking both of them to market. Also, except for the timing mismatch, not all GAAP hedges are tax hedges (e.g., capital asset hedges) and not all tax hedges are GAAP hedges (e.g., some hedges that fail the GAAP effectiveness requirement).

<sup>170</sup>Yoram Keinan, “Book-Tax Conformity for Financial Instruments,” 6 *Fla. Tax Rev.* 678 (2004).

<sup>171</sup>A hedging instrument for this purpose must satisfy the following requirements: (i) cash flows or fair value from the instrument must fluctuate and vary based on changes in one or more underlying variables; (ii) the instrument must be based on one or more notional amounts and/or payments; (iii) the instrument must require no, or insignificant, initial net investment; and (iv) the instrument can readily be settled by a net cash payment. FAS 133, para. 6. “Regular way” securities trades, such as purchases or sales of securities that settle in the normal course for the particular security, do not constitute derivatives under FAS 133.

<sup>172</sup>John Ensminger, “Concerto For Piano vs. Orchestra: Can Tax and Financial Accounting Harmonize on Hedges?” 16 *Akron Tax J.* 23 (2001).

<sup>173</sup>See generally Keinan, *supra* note 170.

treatment using similar principles and procedures accorded to electing taxpayers under section 475(e) and (f). It is also proposed that in 10 years all taxpayers be required to mark their derivatives to market regardless of GAAP treatment.

**c. Valuation and liquidity.**

**i. Valuation.** Since the issue of FAS 133 in 1998, companies subject to GAAP have been required, and therefore have become more capable of, valuing their derivatives for books purposes. Those valuation methods will be used for tax purposes.<sup>174</sup> The proper tax valuation methods for derivatives have been discussed by the Tax Court and the IRS. The Tax Court decision in *Bank One* involved the appropriate valuation method of interest rate swaps (and potentially, other derivatives) for section 475 purposes.<sup>175</sup> In 2003 the IRS also issued (consistent with the court's decision in *Bank One* the same day) an advance notice of proposed rulemaking<sup>176</sup> suggesting a safe harbor that would allow the taxpayer to elect to use the same values used on its financial statements, for purposes of section 475. That election would be subject to the following eligibility standards: (i) any mark-to-market method used on the financial statement would have to be sufficiently consistent with the mark-to-market method required under section 475; (ii) the financial statement would have to be one for which the taxpayer has a strong incentive to report values fairly<sup>177</sup>; and (iii) if requested, the taxpayer would have to timely provide the information and documents necessary to verify the relationship between the values reported on the financial statement and the values used for purposes of section 475.

The proposed valuation guidance has yet to be finalized. My proposed rule would follow a similar approach. Taxpayers should be allowed to use the same values that they use for GAAP purposes to mark their derivatives to market for tax purposes. Taxpayers that are subject to

GAAP, and some taxpayers that are not subject to GAAP but elect to be subject to the proposed tax mark-to-market rules, will be allowed alternative valuation methods, as long as their methods clearly reflect income under the principles of section 446. Treasury will issue regulations that would set forth alternative valuation methods.

**ii. Liquidity.** Liquidity has also been described as another major drawback of a mark-to-market regime.<sup>178</sup> As David Shakow said: "After valuation, the second major obstacle to adopting an accrual tax system is taxpayer illiquidity: should the tax system require a person to pay a tax on the appreciation of an asset when the tax may require the person to sell the asset?"<sup>179</sup> When Congress enacted section 1256 in 1981, one of the stated reasons for mandating mark-to-market treatment for futures contracts was that the parties to the contract have access to their gains and must pay their losses daily.<sup>180</sup> Congress believed that liquidity would not be an issue for futures contracts. Nevertheless, the scope of section 1256 was later expanded to other types of contracts in which taxpayers cannot access gains and are not required to pay losses daily, such as foreign currency contracts and some dealer and equity options. Congress later enacted section 475 and mandated mark-to-market for dealers in securities. Presumably, Congress believed that dealers do not have major liquidity concerns because they hold many positions and most likely will have losses to offset the gains. Further, Congress believed that dealers could liquidate some positions if their mark-to-market tax burden requires doing it. Later on, traders in securities and dealers and traders in commodities became eligible to elect mark-to-market under section 475(e) and (f). These legislative developments signal that Congress has been willing to sacrifice taxpayers' liquidity in the case of financial instruments.

In my view, there is no reason to distinguish between taxpayers that are subject to sections 1256 and 475 and any other taxpayers holding a position in a derivative. Under my proposal, a relief from the hardship of paying taxes on gains that are not physically received could be designed using section 1291 as a guide. Under this provision, a holder of stock in a passive foreign investment company can elect not to pay current tax on its gains, but rather defer it until the time of distribution of a dividend or realization of capital gain.<sup>181</sup> The other alternative for a holder of stock in a PFIC is marking the value of the stock to market.<sup>182</sup> The proposed rule will

<sup>174</sup>See, e.g., Weisbach, *supra* note 2, at 107-108.

<sup>175</sup>Primarily, *Bank One* discussed valuation of swaps; however, in note 68 of the decision, the Tax Court said its decision may apply more broadly to other derivatives subject to section 475:

We hereinafter limit our analysis to the treatment of interest rate swaps. We believe on the basis of our understanding of the other financial derivatives at issue that the tax treatment of those derivatives follows naturally from our decision as to FNBC's interest rate swaps. If we are mistaken on that point, then either party may bring this to our attention.

<sup>176</sup>REG 100420-03 (May 2, 2003), *Doc 2003-11152*, 2003 TNT 86-93.

<sup>177</sup>*Id.* Under the advance notice for proposed rulemaking, two factors are relevant in establishing that the taxpayer has a strong incentive to report the value of securities and commodities fairly in its financial statements: (i) reporting of values on a financial statement required to be filed with the SEC (e.g., a Form 10-K) or with any other federal (or state, local, or foreign, in limited circumstances) government agencies; and (ii) significant use of reported values in the taxpayer's business, including risk management activity and employee compensation.

<sup>178</sup>See e.g., Shuldiner, *supra* note 142; cf. Deborah Schenk, "A Positive Account of the Realization Rule," 57 *Tax L. Rev.* 355, 360-362 (2004), arguing that the liquidity argument is no longer a problem but that politically, mark-to-market is not feasible; and Weisbach, *supra* note 2, at 105.

<sup>179</sup>Shakow, *supra* note 165, at 1167.

<sup>180</sup>S. Rep. No. 97-144, 156-157 (1981).

<sup>181</sup>The gain must be divided equally on the number of days the shareholder has held the shares (the holding period). Then the tax is calculated, and the applicable interest is charged on the amount of the tax that should have been paid.

<sup>182</sup>Section 1296.

similarly allow a taxpayer subject to the mark-to-market regime to defer the payment of taxes on the net mark-to-market income from the taxpayer's entire derivatives portfolio and be subject to interest on the deferred tax at the applicable federal rate.

**d. Summary of the proposed timing rule.** Under the proposed timing rule, all taxpayers that are marking their derivatives to market for GAAP purposes will be required to do the same for tax purposes, generally using the same valuation methods that they use for book purposes. The taxpayers will be allowed to elect a different valuation method, as long as that method clearly reflects income. Taxpayers that do not mark their derivatives to market for GAAP purposes will be allowed to elect for tax purposes to mark their derivatives to market using any valuation method that clearly reflects income. Nonelecting taxpayers will continue to be subject to the current timing rules discussed herein for 10 years. After 10 years, all taxpayers will be required to mark their positions in derivatives to market.

Under this mark-to-market regime, similar to the timing rules in sections 1256 and 475, taxpayers will recognize gain equal to any appreciation in the value of the position during the tax year and will be allowed a deduction for depreciation in the value of the position. Mark-to-market gains and losses from several positions will be netted and be reported as a single item line on the return for the year. If a taxpayer has net mark-to-market gain for a tax year, it will be subject to tax in the same year. If the taxpayer would prefer not to pay tax on gains incurred during a tax year, it would be allowed to defer the tax to future years, and an interest charge will be added to the liability equal to the applicable federal rate. I suggest that the deferral not be indefinite and that Congress or Treasury set forth limitations on the ability to defer the tax. For example, if a taxpayer liquidates a significant amount of its derivatives in a specific year, it may be required to pay the deferred tax liability associated with those positions.

**2. Character: Ordinary treatment for all payments on derivatives.** Under the proposed character rule for derivatives, income, deductions, gains, and losses from derivatives — regardless of the character of the underlying property, the identity of the parties, and the purpose for which the transaction was entered into — will be ordinary. This will apply to all derivatives, regardless of whether they are marked to market.

**a. Theoretical framework.** The policy case for capital treatment for payment on derivatives is weak, whether those payments are made under the terms of the contract or on sale, exchange, or termination. As opposed to a physical long investment position in a security (such as debt or equity), there is little or no initial investment in the case of derivatives, and the taxpayer acquires only a synthetic position in the underlying property. Further, in many cases what underlies the derivative is not property, but rather an index. Thus, not only is it difficult to determine if the derivative position is per se "property," it is also impossible to determine if that "property" is capital or ordinary. Also, as opposed to traditional securities, positions in derivatives become a liability when their value drops below zero. As explained above, derivatives typically have positive value for one party to

the transaction and a corresponding negative value to the other party. For the latter party, the case for capital gains and losses is even weaker than for the party with the positive value, because a position with a negative value is generally not viewed as property; but as a liability.

**b. Summary of the proposed character rule.** The proposed character rule will simply provide that all derivatives — whether they have positive or negative value, and whether or not they are marked to market — are ordinary assets or liabilities. This approach will not only remove the incentive to obtain long-term capital gains treatment, but it will also equalize the treatment of contracts with positive and negative value. Further, treating all income and expenses under derivatives as ordinary will eliminate the unnecessary difference between payments under the terms of the contract, early terminations, and proceeds from the sale or exchange of the contract.

For this purpose, a new subsection will be added to section 1221(a), which will provide that derivatives are ordinary assets or liabilities. Another alternative would be to amend section 1221(a)(7) (hedging character rule) to apply to all derivatives and not just to hedging transactions. If such a rule is adopted in conjunction with the proposed timing rule, there will be no need to have separate character regimes under sections 1256 and 475.

For this purpose, as set forth above, a taxpayer will net all of its gains and losses from derivatives in a given year, and the net income or deduction will be added to (or subtracted from) the taxpayer's other ordinary income for the tax year. This approach will clearly eliminate many of the tax shelters that involve transforming ordinary income into capital gains.

**3. Source: Residency of recipient for all payments on derivatives.** Under the proposed source rule, income, deductions, gains, and losses from derivatives — regardless of the type of instrument, the identity of the parties, and the purpose for which the transaction was entered into — will be the residency of the recipient of income. This will apply to all derivatives, regardless of whether they are marked to market.

**a. Theoretical framework.** There is generally an "international consensus" concerning taxation of cross-border derivatives.<sup>183</sup> The International Fiscal Association's 49th Congress focused on tax aspects of derivatives and issued its recommendations to deal with cross-border aspects of derivatives.<sup>184</sup> The IFA report (1995) set forth

<sup>183</sup>See Rosenbloom, *supra* note 155, at 602-603, citing the *Tax Aspects of Derivative Financial Instruments*, 49th International Fiscal Association Cong. Res. (Cannes 1995), at 684-686 (IFA report).

<sup>184</sup>See generally IFA report, *supra* note 183. See also Rosenbloom, *supra* note 155, at 602-603:

the only 'pure' international issue raised by such instruments pertains to taxation in the country of source on a gross basis. It is here that close analysis of the special features of derivatives is required, and here, if anywhere, that derivatives place pressure on the international rules. The question posed is whether the country from which payment is made under a derivative financial instrument should have the right to impose tax on that payment.



that the source country generally does not impose tax earned by nonresidents on income from derivatives.<sup>185</sup> A policy argument for such a source rule is that in contrast to payments on stock or debt, when the recipient has invested capital in an income-producing asset in the source country, a derivative is merely a contractual arrangement that gives rise to cash flows on a notional amount.<sup>186</sup>

The United States generally followed this principle in reg. section 1.863-7(b), as set forth above. Over the years, however, many foreign taxpayers have used (and abused) this principle to synthetically invest in U.S. equity without paying U.S. tax on dividends thereon, using total return swaps. Recently enacted section 871(l) will simply add to the complexity in applying source rules to derivatives by creating a distinction between equity swaps and other derivatives.

**b. Summary of the proposed source rule.** The proposed source rule should follow the same consensus.<sup>187</sup> Under the proposed source rule for derivatives, income, deductions, gains, and losses from derivatives — whether they are periodic, nonperiodic, or made on sale exchange or early termination — will be sourced at the recipient's country, unless the income is effectively connected to a U.S. trade or business, in which case the source will be the United States. It is also suggested that the United States begin negotiating a similar provision in its tax treaties, generally allowing the country of residence full power to tax the income. It is also recommended that Treasury follow with guidance on what type of activities will result in having a U.S. trade or business with respect to derivatives.

## E. Conclusions

In 1992 Reed Shuldiner summarized the shortcomings of the taxation rules for financial instruments in the United States:

The shortcomings in the present tax treatment of financial instruments have high social costs. Uncertain rules increase compliance costs, provide opportunity for abuse, and discourage the legitimate development and use of financial instruments. Rules that are inconsistent with the underlying economics of a transaction distort behavior, lead to an inefficient allocation of resources, and have the potential of placing United States financial institutions at a competitive disadvantage in the world market.<sup>188</sup>

Eighteen years later, this statement is still valid.

Starting with the timing rules, this article proposes that derivatives be taxed on a mark-to-market basis.<sup>189</sup> This change could be achieved by conforming the book and tax rules for derivatives. GAAP would generally form the basis for timing rules for derivatives, thereby

achieving greater conformity in the tax and accounting rules' treatments of derivatives.<sup>190</sup> Taxpayers that are currently not subject to GAAP could elect to mark their derivatives to market in a similar way.

As to character, this article proposes that all income and expenses associated with derivatives be ordinary. This change would apply to all taxpayers and all derivatives and would eliminate incentives to convert ordinary income into capital gains and to convert short-term capital gains into long-term gains. Finally, I suggest a unified set of source rules under which the source of income and expenses from a derivative would be the residency of the recipient of income.

From a tax policy perspective, these proposed rules will enhance equity, certainty, neutrality, and simplicity. Equity will be enhanced because the current variety of rules for taxation of derivatives creates inequity among taxpayers that economically have the same positions but whose tax results differ.<sup>191</sup> Certainty will be achieved through a comprehensive set of rules that reflects the substance, rather than the form, of an instrument. Simplicity will be achieved because derivatives will be subject to mark-to-market rules, and, as Weisbach argues, it will significantly eliminate "complex, realization-based rules and the uncertainty created by realization-based taxation."<sup>192</sup> As described herein, current tax law that pertains to derivatives is highly complex and contains various statutory and regulatory rules, exceptions to those rules, coordination provisions, and antiabuse principles. Most of these rules could be simplified or even eliminated if mark-to-market would apply to all derivatives.<sup>193</sup> Further, when all gains are ordinary, it will reduce all character abuse incentives.<sup>194</sup> Finally, one major goal of this proposal is to reduce compliance costs by replacing complex rules with simpler rules, easing the burden on taxpayers and the IRS.<sup>195</sup>

<sup>190</sup>*Id.*

<sup>191</sup>*See, e.g.,* Schenk, *supra* note 163, at 632:

Can anyone seriously argue that a taxpayer who has entered into a short against the box has less ability to contribute to the commonwealth than one who has simply sold the underlying stock? Similarly, does a taxpayer who has purchased a put on appreciated stock he holds have less ability to pay than one who sells the stock for the strike price? In the abstract, the tax burden is distributed inequitably if the former has a lower tax burden than the latter. The rub is that, once the realization rule has been adopted, the tax burden already is distributed unequally. A taxpayer who has entered into a short against the box has approximately the same ability to pay as a taxpayer who merely holds appreciated stock, and therefore arguably should have the same tax burden.

<sup>192</sup>Weisbach, *supra* note 2, at 122, 131.

<sup>193</sup>*Id.* at 122. (Much of the complexity of current law stems from the realization requirement. Pure mark-to-market taxation potentially offers dramatic simplification because all of the realization rules could be repealed.)

<sup>194</sup>*Id.* at 123.

<sup>195</sup>*See generally* George K. Yin, "Business Purpose, Economic Substance, and Corporate Tax Shelters: Getting Serious About Corporate Tax Shelters: Taking a Lesson From History," 54 *SMU L. Rev.* 209 (2001).

<sup>185</sup>*See* IFA report, *supra* note 183, at 684-686; Rosenbloom, *supra* note 155, at 603.

<sup>186</sup>*See* Garlock et al., *supra* note 51.

<sup>187</sup>IFA report, *supra* note 183.

<sup>188</sup>Shuldiner, *supra* note 142, at 246.

<sup>189</sup>*Id.*

A neutral tax system is one that does not distort the economic decisions of taxpayers. The current realization rule for most derivatives creates inefficiency by virtue of tax planning.<sup>196</sup> In the case of derivatives, neutrality will be achieved under the proposed rules because derivatives will be subject to a single set of rules and, as a result, instruments with the same substance will be taxed consistently.<sup>197</sup>

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<sup>196</sup>Schenk, *supra* note 163, at 633-634. (The efficiency consequences of a realization-narrowing rule are much more ambiguous. The realization rule itself creates inefficiencies; for example, it encourages taxpayers to arrange their affairs to postpone the realization of gains.)

<sup>197</sup>Weisbach, *supra* note 2, at 131-132. (The other potential benefit of a partial mark-to-market regime is that it might be more efficient than current law. There are three major efficiency benefits. First, a partial mark-to-market regime with neutral rates would reduce the disparity in tax rates on capital income. Second, it would eliminate the lock-in effect for assets subject to the mark-to-market regime. Third, it would reduce behavior designed to avoid or reduce taxes.) This element can also be called consistency. *Id.*

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