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Elective Taxation of Risk-Based Financial Instruments: A Proposal.

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ELECTIVE TAXATION OF RISK-BASED FINANCIAL INSTRUMENTS: A PROPOSAL

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I. INTRODUCTION

The current state of taxation of financial instruments is a mess.[1] The rules are complicated, unfair, inconsistent, and patchwork; there is no underlying policy or vision guiding the development of the rules.

In general, when a financial instrument comes to the attention of the Department of the Treasury (the "Treasury"), it solicits input on the appropriate treatment, before determining how that instrument will be taxed.[2] Although the world of financial instruments moves quickly, the steps involved in writing and enacting new regulations can become a drawn-out process.[3] Credit default swaps present a case study of much that is wrong with the extant method of rule-promulgation as it relates to the taxation of financial instruments. In 2004, the Treasury asked for taxpayer comments on terms and details of credit default swaps in order to issue regulations on the appropriate tax treatment of such financial instruments.[4] In essence, a credit default swap is "a financial contract in which the protection buyer pays a periodic amount that is a fixed

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1. *See, e.g.*, Reuven S. Avi-Yonah & Linda Z. Swartz, *U.S. International Tax Treatment of Financial Derivatives*, 97 TNT 61-49 (Mar. 31, 1997) ("To date, [the] Treasury has failed to propose a single, workable set of tax rules to govern the use of derivative products either between domestic parties or domestic and foreign parties."); *see also* David F. Bradford, *Fixing Realization Accounting: Symmetry, Consistency and Correctness in the Taxation of Financial Instruments*, 50 TAX L. REV. 731, 732-33 (1995); James R. Hamill & Joel S. Sternberg, *Linking Tax and Economic Aspects of Convertible Financial Instruments*, 23 J. TAX'N OF INVESTMENTS 232, 232-33 (2006); David M. Hasen, *A Realization-Based Approach to the Taxation of Financial Instruments*, 57 TAX L. REV. 397, 398-401 (2004); Yoram Keinan, *Book Tax Conformity for Financial Instruments*, 6 FLA. TAX REV. 676, 681 (2004); Michael S. Knoll, *Put-Call Parity and the Law*, 24 CARDOZO L. REV. 61, 61-63 (2002); David S. Miller, *Reconciling Policies and Practices in the Taxation of Financial Instruments*, 77 TAXES—THE TAX MAGAZINE 236, 237-38 (March 1999); David M. Schizer, *Balance in the Taxation of Derivative Securities: An Agenda for Reform*, 104 COLUM. L. REV. 1886, 1888-90 (2004); Reed Shuldiner, *A General Approach to the Taxation of Financial Instruments*, 71 TEX. L. REV. 243, 245-46 (1993); Jeff Strnad, *Taxing New Financial Products: A Conceptual Framework*, 46 STAN. L. REV. 569, 569-70 (1994); Alvin C. Warren, Jr., *Financial Contract Innovation and Income Tax Policy*, 107 HARV. L. REV. 460, 461 (1994).

2. *See* Jacob Goodwin, *Treasury Wants Input on New Foreign Investment Regs*, GSN MAGAZINE, Oct. 11, 2007, *available at* http://www.gsnmagazine.com/cms/features/news-analysis/101.html.

3. *See, e.g.*, David Cay Johnston, *I.R.S. Letting Tax Lawyers Write Rules*, N.Y. TIMES, Mar. 9, 2007, at C1 ("The I.R.S. staff has been cut by a fifth in the last decade . . . . The agency, in a formal notice, said it lacked the resources to issue as much guidance as taxpayers are seeking.").

4. *See* I.R.S. Notice 2004-52, 2004-32 I.R.B. 168 (Aug. 9, 2004). For purposes of this Article, "financial instrument" and "derivative" may be used interchangeably. A financial instrument is essentially a contract to make or receive payments based on the value of some underlying financial data. *See* Investopedia, *Financial Instrument*, http://www.investopedia.com/terms/f/financialinstrument.asp (last visited Nov. 19, 2007).

number of basis points applied to a notional principal amount[5] and the protection seller pays the decline in value below par of a reference security of the same notional amount if" a credit event occurs.[6] A "credit event" can be any event defined as such, but usually includes the "bankruptcy or insolvency of a reference credit or the reference credit's failure to make payments on any of its obligations when due."[7]

There are at least four existing categories in which a credit default swap could be reasonably placed for tax purposes: economically, it is analogous in certain respects to a contingent put option, a notional principal contract,[8] a guarantee, and a form of insurance.[9] The tax and withholding consequences of each of these potential treatments is significantly different, and, until Congress or the Treasury clarifies the appropriate treatment, investors in credit default swaps must determine which analogy fits their instruments best.[10]

And how significant is the problem? The market for credit default swaps has exploded over the last decade, from approximately "$200 billion in outstanding notional value in

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5. "Notional principal amount" is essentially the size of the bet entered into by the parties. *See* Investopedia *Notional Principal Balance,* http://www.investopedia.com/terms/n/notionalprincipalamount.asp (last visited Nov. 19, 2007).

6. David Z. Nirenberg and Steven L. Kopp, *Credit Derivatives: Tax Treatment of Total Return Swaps, Default Swaps, and Credit-Linked Notes*, 87 J. TAX'N 82, 88 (1997); *see also id.* at 88, 90.

7. *Id.* at 88. For a simple illustrated explanation of how credit default swaps work, featuring monkeys and crocodiles, see Christoph Niemann, *Fun With Swaps*, CONDÉ NAST PORTFOLIO 328, Mar. 29, 2007, http://www.portfolio.com/slideshows/2007/03/Fun-With-Swaps/.

8. A "notional principal contract" is defined in the Treasury regulations as a contract that "provides for the payment of amounts by one party to another at specified intervals calculated by reference to a specified index upon a notional principal amount in exchange for specified consideration or a promise to pay similar amounts." Treas. Reg. § 1.446-3(c)(1) (2007). Even though all notional principal contracts are swaps, not all financial instruments denominated swaps necessarily meet the tax definition of a notional principal contract; therein lies the confusion as to the proper treatment of a credit default swap. *See* Lee A. Sheppard, *Credit Derivatives, Guarantees, and the Ponies*, 79 TAX NOTES 1220, 1221-22 (Jun. 8, 1998). Under a credit default swap, the protection seller only has to pay the protection buyer when and if default occurs. *Id.* The final payment may not occur, if the reference security remains credit-worthy. *Id.*

9. *See* I.R.S. Notice 2004-52, 2004-32 I.R.B. 168 (Aug. 9, 2004) (concluding that CDS analogies could fit into several categories as analyzed by the IRS).

10. Lee A. Sheppard, *ABA Mulls Over Treatment of Credit Default Swaps*, 105 TAX NOTES 156, 156-57, Oct. 7, 2004. Furthermore, in February 2004, the Treasury released proposed regulations for contingent swaps, which would require holders of contingent swaps to accrue for the contingency; holders of credit default swaps, which would arguably be encompassed within the proposed regulations, objected that contingent default swaps should not be treated in the same manner as total return swaps, toward which the regulations were directed. *Id.*

1999 to $12.5 trillion in June 2005."[11] And yet the Treasury only asked for comments in 2004[12] and, as of the writing of this Article, has issued no guidance.

The lack of guidance is bad enough when only sophisticated investors, who can afford the necessary tax advice, invest in financial instruments. But it is no longer merely institutions and wealthy individual investors who are purchasing financial instruments.[13] Financial instruments are moving to the retail market, and are being sold in denominations affordable by everyday investors.[14] As less sophisticated investors, who do not have the same access to tax advice as wealthy and institutional investors, enter the derivatives market, the uncertainty on how to treat existing and new financial instruments for tax purposes will lead to ever-more acute problems in the implementation and general trust of the tax system.[15]

In spite of the obvious and numerous problems with the taxation of financial instruments, high-level reform does not appear to be on the table any time soon. In January 2005, President George W. Bush organized the President's Advisory Panel on Federal Tax Reform and commissioned it to recommend ways to make the tax code "simpler, fairer, and more conducive to economic growth."[16] The panel recommended a "Simplified

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11. Alex Raskolnikov, *The Cost of Norms: Tax Effects of Tacit Understandings*, 74 U. CHI. L. REV. 601, 623 n.105 (2007).

12. *See* I.R.S. Notice 2004-52, 2004-32 I.R.B. 168 (Aug. 9, 2004).

13. *Compare* Schizer, *supra* note 1, at 1893 ("Various regulatory restrictions . . . prevent investors from using derivatives unless they satisfy minimum wealth tests."), *with* sources cited *infra* note 14.

14. *See, e.g.*, FSA, Speech by Callum McCarthy, Chairman, FSA Financial Services Forum, Feb. 9, 2006, http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2006/0210_cm.shtml (concerning the retail market of financial products in the U.K.); *see also* Samia Farooqui, *Korea Opens Retail Market*, ASIA RISK MAGAZINE, Apr. 2003, http://www.asiarisk.com.hk/public/showPage.html?page=11142 (reporting that South Korea has opened certain derivatives to retail market); Rhea Wessel, *Global Boom in Retail Structured Products Continues; Future Looks Bright for Germany*, FIN. ENG'G NEWS, Sept.-Oct. 2006, at 1, 6, *available at* http://www.fenews-digital.com/fenews/20060910/?pg=6 (reporting that, in Germany, "[s]tructured products have opened this asset class [commodities] to retail investors since direct investing in commodities is still barred to most of them."). In the United States, the Commodities Futures Trading Commission (the "CFTC") has permitted HedgeStreet, Inc. to sell derivative products, which it has dubbed "Hedgelets," to retail consumers. These Hedgelets permit investors to bet changes in, for example, gasoline costs and mortgage rates in increments of not more than $10. Ann Saphir, *HedgeStreet to Woo Individuals to Derivatives Market*, BLOOMBERG, July 16, 2004, *available at* http://www.hedgestreet.com/abouthedgestreet/newsreleases/Bloomberg.071604.pdf.

15. *See infra* Part II.B.

16. THE PRESIDENT'S ADVISORY PANEL ON FEDERAL TAX REFORM, SIMPLE, FAIR, & PRO-GROWTH: PROPOSALS TO FIX AMERICA'S TAX SYSTEM, xi (2005) *available at* http://www.taxreformpanel.gov/final-report.

Income Tax Plan" ("a streamlined version of our current tax system that would reduce the size and costs of the tax code") and a "Growth and Investment Tax Plan" (essentially a consumption tax rather than an income tax).[17] Neither proposal addressed the taxation of financial instruments in any significant way; the Simplified Income Tax Plan advocated eliminating taxing capital gains from the sale of stock in U.S. corporations and taxing all other income at regular rates,[18] while the Growth and Investment Tax Plan would distinguish between financial and non-financial business transactions, generally excluding "financial transactions by non-financial firms from the business tax base."[19] While the Advisory Panel recommended solutions to a number of complexities and problems with the current income tax, its recommendations do not address the problems inherent in the taxation of financial instruments.

This Article proposes a unified regime for taxing financial instruments, one that will not require further amendment to the Internal Revenue Code (the "Code") or to the Treasury regulations every time a new instrument is introduced, minimizes inefficiencies that lead to tax planning, and is simple to understand and implement. Section II of this Article will describe the current tax treatment of a number of financial instruments, will evaluate the problems with the current overall method for taxing financial instruments, and will discuss why it

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17. *Id.* at 59.

18. *Id.* at 126. Although it does not refer to financial instruments, presumably gains and losses on financial instruments would be taxed at ordinary rates. While the rate of taxation should not matter to investors, *see infra* notes 157-61 and accompanying text, the timing option would still permit holders of financial instruments to choose when to recognize gain and loss. *See infra* note 141.

19. PROPOSALS, *supra* note 16, at 245. As a rule, the tax base of a consumption tax does not include income from financial transactions. *See* David A. Weisbach, *The (Non) Taxation of Risk*, 58 TAX L. REV. 1, 24 (2004). However, the Advisory Panel recognized that incentive would exist for taxpayers to recharacterize non-financial transactions as financial transactions:

> Another area where there may be an incentive to recharacterize non-financial transactions is the treatment of derivatives. Purchases and sales of commodities generally are cash flows subject to the cash flow tax. Derivatives on commodities, in contrast, are generally thought of as financial in nature, the gains and losses on which generally should not be treated as cash flows subject to the business cash flow tax. However, there may be circumstances in which purchases and sales of these derivatives should be subject to the cash flow tax. For example, a derivative entered into to hedge a non-financial business asset or liability should be treated similarly to the underlying asset as a non-financial business transaction subject to the cash flow tax. Absent special rules, businesses would be able to use combinations of derivatives to create deductions without offsetting income.

PROPOSALS, *supra* note 16, at 245. In spite of recognizing the problem, the Advisory Panel made no recommendations as to possible solutions.

is not possible *or* necessary for the Code to delineate bright-line borders between different financial instruments. Section III will discuss policy criteria that need to be considered in evaluating or designing a proposed tax system, and how the current taxation of financial instruments measures up to the policy criteria. Section IV proposes that investors be permitted to elect, *ex ante*, which of two tax treatments will apply to their portfolio of financial instruments. It first discusses two other elective regimes, and then makes specific proposals for how an elective regime taxing financial instruments would work. It finally measures such a regime against the policy criteria that need to be considered. Section IV discusses some practical issues that could arise in reforming the taxation of financial instruments, and why the proposed reforms should be palatable to members of Congress on both sides of the aisle.

II. CURRENT TAXATION OF FINANCIAL INSTRUMENTS

Rather than resulting from a unified tax policy, the current system of taxing financial instruments has been assembled in a haphazard manner, generally reacting to financial innovation either by creating a new taxing regime for the new instrument,[20] or by analogizing it to an existing instrument, as the Treasury appears to be doing with respect to credit default swaps. Both approaches, however, have significant problems.

A. *Current Derivative Regimes*

In taxing financial instruments, there are two major variables that must be considered: timing and character.[21] There are three main timing options with which to tax income: it can be taxed upfront, on a "wait and see" (or realization) basis, or on a mark-to-market basis.[22] Under the current federal income tax, income can have one of two characters: it is either ordinary income or capital gain.[23] The current taxation of financial instruments incorporates all three timings and both characters, depending on the instrument. This Section will summarize the current tax treatment of some financial instruments.[24]

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20. Miller, *supra* note 1.

21. *See* Shuldiner, *supra* note 1, at 247-49 (1992) (discussing timing generally); I.R.C. § 64 (2000) (discussing character generally); I.R.C. § 1222.

22. *See* Shuldiner, *supra* note 1, at 247-49.

23. I.R.C. § 64.

24. This Section will not attempt to be exhaustive; for a more exhaustive treatment of the current regimes for the taxation of derivatives, *see generally* KEVIN M. KEYES, FEDERAL TAXATION OF FINANCIAL INSTRUMENTS AND TRANSACTIONS (2003).

1. Regular Options and Forwards

When an investor purchases an option, she pays an option premium for the right to purchase (in the case of a call option) or sell (in the case of a put option) property on or before a specified date at a specified price.[25] The tax law uses a wait-and-see approach to the taxation of options; until the option is exercised, expires, or is sold, neither the seller nor the buyer recognizes any gain or loss, including on the option premium.[26] When a realization event occurs, the seller recognizes the option premium, as well as any gain or loss on the property sold.[27] The gain or loss will be capital if the underlying asset was held as a capital asset.[28]

Forward contracts are contracts for the purchase or sale of property on a specified date in the future.[29] Forward contracts can be physically settled, through the delivery of the property, or cash-settled, by paying the difference between the purchase price and the current market price.[30] As with options, forward contracts are taxed when a realization event, such as the sale, exchange, or settlement of the contract occurs, and the character of gain and loss depends on the character of the underlying asset.[31]

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25. In an American option, the optionee can exercise her option at any point up to and including the exercise date; in a European option, the optionee can only exercise on the exercise date. *See generally* SHELDON NATENBERG, OPTION VOLATILITY & PRICING 4 & 6 (1994). However, economically, it generally does not make sense to exercise an option early, so, for all practical purposes, there is no substantive difference between American and European options. *Cf. id.* ch. 12 (discussing early exercise of American options).

26. *See* Va. Iron Coal & Coke Co. v. Comm'r, 37 B.T.A. 195, 198 (1938) ("Thus it is necessary to exclude such [option] payments from the income of the year in which received and to include them for the later year when, for the first time, a satisfactory determination of their character for income tax purposes can be made.), *aff'd*, 99 F.2d 919 (4th Cir. 1938); Rev. Rul. 58-234, 1958-1 C.B. 279, 283 ("It is manifest, from the nature and consequences of 'put' or 'call' option premiums and obligations, that there is no Federal income tax incidence on account of either the receipt or the payment of such option premiums . . . unless and until the options have been terminated . . . .").

27. I.R.C. § 1234(b); Rev. Rul. 78-182, 1978-1 C.B. 265.

28. I.R.C. § 1234(a)(1).

29. *See* BLACK'S LAW DICTIONARY 345 (8th ed. 2004).

30. *See* Norman Menachem Feder, *Deconstructing Over-The-Counter Derivatives*, 2002 COLUM. BUS. L. REV. 677, 698.

31. *See, e.g.*, Warren, *supra* note 1, at 464 (stating that "there are no tax consequences until gain or loss is realized on performance or disposition of the [forward] contract.").

2. Section 1256

Certain types of options and futures contracts are taxed under § 1256 of the Code.[32] If a financial instrument is a "§ 1256 contract," it is marked-to-market annually, and the investor pays tax on any appreciation or deducts any depreciation that has occurred over the course of the prior year.[33] The character of any gain or loss on a § 1256 contract is idiosyncratic: a taxpayer must treat sixty percent of the gain or loss as long-term and forty percent as short-term capital gain or loss.[34]

3. Swaps[35]

Very generally, swaps call for periodic and non-periodic payments between counterparties, based on the movement of an objective financial reference.[36] Although the regulations are not clear on the character of swap payments, periodic payments are generally treated as ordinary income or loss in the year in which they are made.[37] Termination payments are generally treated as capital gain or loss.[38]

4. Anti-Abuse Provisions

Because of the gaps in the treatment of financial instruments and the economic flexibility that inheres in them, Congress has also had to pass several anti-abuse provisions. Among these anti-abuse provisions are the constructive sale and straddle provisions.[39] Under the constructive sale regime, an investor who sufficiently hedges an "appreciated financial position," to the degree that she has (virtually) no upside or downside risk remaining in the investment,[40] will be treated as if

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32. I.R.C. § 1256(a)-(b).

33. *Id.* § 1256(a)(1).

34. *Id.* § 1256(a)(3).

35. Actually, it is more accurate to say "notional principal contract." As discussed *supra*, it is not clear that every instrument denominated a "swap," even if it is written on the International Swaps and Derivatives Association ("ISDA") contract, qualifies as a notional principal contract for tax purposes. *See supra* text accompanying notes 4-6, 8; *see also* Treas. Reg. § 1.1234A-1(c) (proposed Feb. 26, 2004).

36. Miller, *supra* note 1, at 242.

37. *Id.*

38. *Id*; *see also* I.R.C. § 1234; Treas. Reg. § 1.1234-1.

39. *See* KEYES, *supra* note 24, at ¶ 14.05.

40. I.R.C. § 1259(b)(1). The simplest example is an investor who purchased XYZ stock at $20 several years ago. Today, XYZ is worth $100. Our investor thinks that it has essentially peaked, but for whatever reason does not want to sell it. In order to cash out, then, she enters into the short side of a swap on XYZ stock, which requires her to pay to the counterparty any appreciation on the stock while receiving payment for any depreciation of the stock. On entering into the swap, she has no economic interest left in

she had sold it. She will be treated as if she made a sale even if she still technically owns the investment, and she will be required to recognize any gain (but not loss) on the constructive sale.[41]

Where an investor holds "offsetting positions with respect to personal property" and those positions substantially diminish the investor's risk of loss, the investor is subject to the straddle rules.[42] Under the straddle rules, an investor can realize loss on one leg of a straddle only to the extent that it exceeds gain on the other leg.[43] However, in spite of the relative simplicity of the examples of constructive sales and straddles offered in this Article, the rules are complex and difficult to parse; for example, there is no clear answer as to how much exposure to gain and loss removes an investor from these anti-abuse rules.[44] Although they are necessary to prevent aggressive and abusive behavior under the current tax regime, these rules only add to the complexity and inefficiency of the current taxation of financial instruments.

B. *Problems with the Current Regime*

The necessity of creating a new taxing regime for each financial instrument suffers from two major problems: it increases the complexity of the Code, and because there is a lag between the introduction of an instrument and its tax classification, it creates inefficiencies. These inefficiencies are a drain on the market and diminish taxpayers' confidence in the tax system.[45]

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her XYZ stock; prior to the enactment of the constructive sale rules, she would be taxed as the periodic payments were made, but would not be taxed on the $80 of appreciation she had locked in until she actually sold her XYZ stock. KEYES, *supra* note 24, at ¶ 14.05[6].

41. *See* I.R.C. § 1259.

42. *See* KEYES, *supra* note 24, at ¶ 17.02.

43. I.R.C. § 1092(a); KEYES, *supra* note 24, at ¶ 17.02[2][a]. Suppose that an investor owns a share of XYZ stock worth $100, this time with a basis of $100. On July 1, 2007, she enters into a forward contract to sell XYZ stock at $100 in one year. Her ownership of the stock and her short position in the forward contract are offsetting positions: if the value of her XYZ stock diminishes by $20, the value of her position in the forward contract increases by $20. On December 1, 2007, XYZ stock has fallen to $80. Under the straddle rules, if she were to sell the stock but stay in the forward contract, she would not be permitted to recognize the $20 loss in 2007, unless she also sold her position in the forward contract. Otherwise, if she stayed in the forward contract until maturity, she would be able to deduct her $20 loss against any gain in 2008. *See, e.g.*, KEYES, *supra* note 24, at ¶ 17.02[2][a].

44. David M. Schizer, *Frictions as a Constraint on Tax Planning*, 101 COLUM. L. REV. 1312, 1345-46 n.110 (2001).

45. Knoll, *supra* note 1, at 90-91 & n.104.

1. Complexity

The potential number of financial instruments that can be created is limitless. As has been discussed, there already exist a number of regimes in the Code purporting to regulate the tax treatment of various transactions,[46] as well as a number of anti-abuse regimes on top of the regular treatment.[47] Economically similar financial instruments can have wildly varying tax treatments because each category has been created independently, in response to a perceived need by Congress,[48] the Treasury,[49] or tax practitioners.[50] If the tax treatment of financial innovation continues to be regulated in such a haphazard "cubbyhole"[51] approach, the Code's complexity will only continue to balloon.[52]

In the period between the introduction of a new instrument and a consensus (whether official or informal) about its appropriate tax treatment, inconsistent treatment can "encourage waste and create a perception of unfairness."[53] The time that lawyers and accountants spend figuring out how a taxpayer should report income from an instrument and the time spent figuring out how to arbitrage inconsistencies in the treatment of economically similar instruments is waste.[54] This economic waste, measured in money and time spent avoiding taxes,[55] could be better spent in socially and economically

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46. *See* discussion *supra* Part II.A. Miller enumerates "more than a dozen . . . cubbyholes" for financial instruments. Miller, *supra* note 1, at 237. However, a number of the instruments he refers to are debt instruments or other investments that do not meet the definition of "financial instrument" being used in this Article. *See id.* Nonetheless, there are enough cubbyholes, as well as anti-abuse regimes, to keep the taxation of financial instruments complicated, even defining "financial instrument" in such a way that it only includes risk-based returns.

47. *See* KEYES, *supra* note 24, at ¶ 14.05.

48. *See* Schizer, *supra* note 44, at 1343-44.

49. I.R.S. Notice 2004-52, 2004-32 I.R.B. 168 (Aug. 9 2004).

50. *See, e.g.*, Letter from Thomas Prevost, Chair of the ISDA North American Tax Committee, to Barbara Angus, International Tax Counsel, Treasury (Nov. 21, 2003) *in* 2003 TNT 232-17; Letter from Thomas Prevost, Chair of ISDA North American Tax Committee, to Internal Revenue Service (May 2, 2003) *in* 2003 TNT 118-26; Letter from Gregory May and Robert Scarborough, Freshfields Buckhaus Derringer LLP, to Helen Hubbard, Acting Tax Legislative Counsel, and Barbara Angus, International Tax Counsel, Treasury (Oct. 1, 2002) *in* 2002 TNT 226-21.

51. *See* Miller, *supra* note 1, at 237-38.

52. *See* Warren, *supra* note 1, at 460 (describing the financial innovation of the last 20 years through disaggregation, recombination, etc.).

53. Knoll, *supra* note 1, at 90.

54. *Id.* For purposes of this Article, "waste" is defined as "[t]ransactions which do not create wealth." Donald Rutherford, ROUTLEDGE DICTIONARY OF ECONOMICS 599 (1992).

55. *See* Knoll, *supra* note 1, at 91.

productive ways. Also, because only the wealthy can afford to discover and exploit the inconsistencies (and, indeed, only the wealthy could potentially gain enough in tax savings to offset the cost), only the wealthy reap the advantages of these tax inconsistencies. Thus, similarly-situated taxpayers, with similar economic investments, will be treated differently, adding to a general perception that the tax system is unfair and favors the wealthy.[56]

2. Economic Substance

Taxation by analogy is likewise an ineffective way to determine the appropriate tax treatment of new financial instruments. Financial instruments allow a taxpayer to synthetically create the income flow that the taxpayer desires.[57] This correspondence is referred to as "put-call parity" which, although essential to the argument that follows, has been extensively described in other places.[58] Essentially, put-call parity states that an investor can synthesize the ownership of a share of stock by buying a zero-coupon bond, selling a put, and buying a call at the current stock price.[59] The option premium paid by the investor for the call should be the same as the premium received from selling the put.[60] If the stock were to increase in value above the strike price, the put would expire unexercised, and the investor's profit on the call would equal the increase in value of the stock.[61] If the stock price were to go down, the call would expire unexercised and the investor's loss on the put would be the same as her loss on the share of stock would have been.[62] The only differences between such a synthetic share of stock and an actual share of stock are that the actual shareholder has the right to receive dividends and to vote.[63] An investor could contract for the right to direct a shareholder's vote, however, and can also contract to receive dividends, thereby synthetically creating an instrument with all of the rights inherent in a share of stock.[64]

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56. *See id.*

57. *See id.* at 62.

58. *Id.* at 63; *see also* Warren, *supra* note 1, at 465-67.

59. *See* Knoll, *supra* note 1, at 72.

60. *See* Warren, *supra* note 1, at 464.

61. *See* Knoll, *supra* note 1, at 65.

62. *See id.*

63. WILLIAM L. CLARK, JR. & I. MAURICE WORMSER, HANDBOOK OF THE LAW OF PRIVATE CORPORATIONS 418 (3d ed. 1916).

64. This is assuming a tax-free world; the qualified dividend income rate would not apply to the artificial dividends, creating a friction. I.R.C. § 1(h)(11). Financial

Because financial instruments can synthetically recreate any cash flow an investor desires, there is no perfect economic analogy for a given instrument. Rather, tax advisors tweak the instruments, leaving a twenty percent band of risk, for example,[65] so that investors achieve the most advantageous tax treatment possible without significantly sacrificing their economic goals.

For the previously-mentioned reasons, in the world of financial products, it is a near-impossible task to create bright lines delineating where one instrument ends and the next begins. There is simply insufficient economic difference between the potential instruments, and there are infinite possible variations on each theme. Even demarcating the difference between debt and equity has proven virtually impossible,[66] although the tax law clearly delineates the distinct tax results of an investment in debt and an investment in equity.[67] Although "interest" has been judicially defined as "compensation for the use or forbearance of money,"[68] it has not proven so easy to define "instruments that pay interest." Rather, the courts use a balancing test that involves up to sixteen criteria, with no indication of the weight accorded to any one criterion.[69]

C. *The Current Regime's Bright Lines Are Unnecessary*

Provided that the tax system can differentiate risk-based returns from wage income and returns based on the time value of money, it is unnecessary to draw distinct lines between different financial instruments.[70] Financial instruments are zero-sum

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instruments are not just good for creating artificial stocks and bonds, however—an investor can use a swap or credit-linked bond to replicate the return of an index, of a hedge or mutual fund, a commodity, or just about any other return an investor wants.

65. *See, e.g.*, Schizer, *supra* note 44, at 1345 ("The typical way to avoid [§] 1259, understood by the government and taxpayer alike, is to retain some exposure to the hedged asset's return.").

66. *See* Weisbach, *supra* note 19, at 1627. The Supreme Court has, numerous times, declined to offer a rigorous definition of "interest." *See* William T. Plumb, Jr., *The Federal Income Tax Significance of Corporate Debt: A Critical Analysis and a Proposal*, 26 TAX L. REV. 369, 370 (1971). Congress has similarly refused to act; instead it "passed the ball to the Treasury" in enacting § 385 of the Internal Revenue Code (the "Code") in 1969. *Id.* at 370 nn.9-10. The Treasury issued proposed regulations, but later withdrew the proposed regulations, and, as of the writing of this Article, has not advanced any further attempt to define "interest." *See* T.D. 7747, 1981-1 C.B. 141; T.D. 7920, 1983-2 C.B. 69.

67. Plumb, *supra* note 66, at 369.

68. Deputy v. DuPont, 308 U.S. 488, 498 (1940).

69. *See* Plumb, *supra* note 66, at 407, *et seq.*

70. *See, e.g.*, Schizer, *supra* note 1, at 1900 ("Although this reform strategy can be effective for risky bets, it is not effective for time-value returns or wages. Because these sources of income are expected to be positive (so market uncertainty is not a factor), and

investments, essentially bets on the movement of an underlying financial referent.[71] If an investor correctly predicts the direction of the underlying referent, the investor "wins" the bet; if she is wrong, she loses. However, *ex ante*, she cannot know whether she will win or lose.[72] If she wins her bet, she will receive $X. If she loses, she will pay her counterparty $X. As Professor Schizer has demonstrated, *ex ante*, the taxpayer is indifferent to how she is taxed, provided that her gain is taxed at the same rate and in the "same manner as her loss."[73] If she expects to either receive or pay $100, at a 15% rate, she will either owe $15 of tax or have a $100 loss which will shelter $15 of gain from taxation.[74]

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because they cannot be scaled up costlessly, inconsistencies still inspire planning, even if the gain-loss ratio is set at one.").

71. *See, e.g., id.* at 1896.

72. It would make sense that investors generally expect to win; such expectation need not be held universally, however—a deductible loss can shelter other gains from tax. But even if every investor expects to win every bet, half of the investors in two-party financial instruments have to lose. This is the reason that time-value and wage returns must be excluded in order to fairly tax financial instruments: an investor is not betting on receiving such returns; rather, they are essentially assured. *See id.* at 1890.

73. Of course, for her to be truly indifferent, it is necessary that losses be fully deductible. *Id.* at 1908-12. ("The first prong of the reform agenda is to set the gain-loss ratio at one for all derivatives so that taxpayers will have little incentive to game inconsistencies."). Currently, for a corporation or an individual who is considered a trader or a dealer, losses are fully deductible, provided the taxpayer has sufficient income to be offset. *Id.* at 1911. However, investment losses are deemed "miscellaneous itemized deductions" for individuals who are not traders or dealers, I.R.C. § 67(b), and are subject both to the 2% floor (*i.e.*, deductions are permissible only to the extent that they exceed 2% of the taxpayer's adjusted gross income), I.R.C. § 67(a), and to a phase-out at certain income levels. I.R.C. § 68(a). Essentially, the gain-loss ratio for an individual investor is 1:0.98, meaning that, before she knows how the bet will turn out, an investor can expect to pay $100 in taxes if she wins, but can only expect to be able to deduct $98 if she loses. *See* Schizer, *supra* note 1, at 1898-99. This, combined with the fact that an investment in a financial instrument, while requiring credit-worthiness, does not generally require a significant initial outlay of cash, both make it impossible to costlessly scale up the bet, *id.*, and produces inconsistencies that can be exploited. *Id.* at 1898-99, 1908.

74. This sounds like partnership theory of tax, in which taxes are justified because the government gets its share for supplying a system that allows taxpayers to make money. For a general description of this partnership theory of income taxation, *see generally*, Joseph M. Dodge, *Theories of Tax Justice: Ruminations on the Benefit, Partnership, and Ability-to-Pay Principles*, 58 TAX L. REV. 399, 444-48 (2005). But, in the case of financial instruments, the purpose of taxing is not income, but rather discouraging slippage from other types of income. Schizer, *supra* note 1, at 1924-25. In a practical sense, it becomes a partnership, but, whether or not one accepts the partnership theory underlying the government's right to tax, for risk-based income, it functions economically as a partnership: the government gets a portion of the investor's gain, and absorbs that same portion of the investor's loss. Thus, this Article does not intend to justify or contest taxation on any moral or policy theory; rather, this Section is intended to be descriptive of the economics underlying the taxation of financial instruments.

At a 35% rate, she will owe $35 or shelter $35 of gain from taxation.[75] Professor Schizer then argues that consistency in the treatment of financial instruments is both unattainable and unnecessary, and that the rate does not matter, provided that an investor's gain and loss will be treated the same.[76] He calls his policy goal "balance."[77] If an instrument's tax treatment is balanced, and an investor knows in advance what that treatment will be, she should be able to costlessly scale up her investment in order to achieve her desired after-tax result; specifically, if she knows the tax rate will be 15% and she wants a $100 after-tax return (and is willing to accept a $100 after-tax loss), then she should invest in an instrument with an expected return of $117.65. If she accurately predicts the direction of the underlying, she will have $100 after tax.[78] If she loses, she will pay $117.65, but will be able to offset $117.65 of income, resulting in a tax savings of $17.65, giving her an after-tax loss of $100. If, however, the tax rate is 50% and she wants the same result, she will invest such an amount that the expected pre-tax return is $200. If she wins, after taxes she will have $100, and if she loses, she will be able to offset $200 of gains, resulting in a tax savings of $100.[79] Provided gains and losses are treated in the same manner, an investor is indifferent to the tax treatment of risk-based return.[80] Bright-line delineation between different instruments is unnecessary as long as all of an investor's financial instrument income is taxed in the same manner as her financial instrument deductible loss.

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75. As Professor Schizer explains, the investor essentially partners with the government. At the 15% rate, the investor takes home 85% of the gain, and the government takes its 15% share. If the investment is a loser, however, the investor only loses $85, and the government absorbs the other $15 of loss. Schizer, *supra* note 1, at 1893-95.

76. *Id.* at 1895-96.

77. *Id.* at 1896.

78. 117.65 x 0.85 = 100. In order to earn an after-tax return of Y, an investor must invest 1/(1-r) x Y, where r = rate of tax.

79. *See* Schizer, *supra* note 1, at 1898-99; *see also* Weisbach, *supra* note 20, at 8-11.

80. Note that this result no longer holds once the investor knows what the end result will be; at that point, if she will have a loss, she would rather lock in an ordinary loss (currently at a 35% rate) immediately. If she will have gain, she would prefer it to be long-term capital gain, at a current 15% rate, and would prefer to defer its taxation. One significant problem with uncertainty in the tax treatment of financial instruments is that such uncertainty makes it possible for investors to attempt to classify their investments *ex post*, once they know if they won or lost. As Congress reacts to such re-characterization occurrence by occurrence, the tax code becomes needlessly more complicated, while not gaining any coherent overall direction. *See, e.g.*, *supra* Part II.A. (discussing current tax treatment of various financial instruments). But as long as it continues to take three, six, or nine years to create rules for financial instruments, even where significant use of the instrument already exists, such cracks will continue both to exist and to be exploited.

III. POLICY CONSIDERATIONS

Although there are many and varied criteria that can be used to evaluate a tax regime, in general, three essential criteria—equity, efficiency, and some combination of simplicity, transparency, and administrability—are generally considered the most important.[81] However, these criteria often conflict with each other, and people differ on how to weigh each criterion. Nonetheless, these criteria offer a valuable standard against which to measure a new tax regime.

A. *Equity*

In analyzing whether a tax is equitable, it is worth assessing the taxpayer's ability to pay.[82] Ability-to-pay considerations undergird a realization-based system of taxation, such as the federal income tax.[83] In general, income is not taxed when it economically accrues; rather, the tax system waits until money has changed hands.[84] Subsets of ability-to-pay are horizontal and vertical equity.[85] Horizontal equity requires that similarly-situated taxpayers be taxed in a similar manner.[86] In the world

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81. *See* PROPOSALS, *supra* note 16, at 5-35, 64.

82. *Id.* at 30.

83. *Id.*

84. For example, say I bought a second apartment as an investment 10 years ago on the Upper West Side of Manhattan for $300,000. (For the sake of this example, assume that the apartment is not, and has never been, my primary residence.) In the ensuing 10 years, the neighborhood has become gentrified, and apartments like mine are now in demand. Apartments like mine are selling today for $800,000. I know this because a broker showed up at my door this morning, check in hand, and told me that his client would like to buy my apartment for $800,000. Economically, I am $500,000 better off today than I was 10 years ago. I will not be taxed on that $500,000, however, until I actually sell the apartment. One reason is that, while my apartment may be worth $500,000 more than it was when I bought it, that $500,000 is illiquid; I may well not have $75,000 (a long-term capital gain rate of 15% on a $500,000 gain) floating around with which to pay my taxes. Note, however, that certain regimes permit the taxation of unrealized gains; many are punitive (*e.g.*, the passive foreign investment company rules of I.R.C. §§ 1291-1298 (2000)), some are intended to prevent an investor from deferring taxes by restructuring an investment (*e.g.*, the original issue discount rules of § 1273), and some assume that a taxpayer does have access to liquid funds (*e.g.*, the § 475 mark-to-market rules for dealers in securities).

85. PROPOSALS, *supra* note 16, at 9.

86. "Taxing similar activities differently causes behavioral distortions and unfairness." David A. Weisbach, *Line Drawing, Doctrine, and Efficiency in the Tax Law* 9 (Chicago Working Papers in Law and Economics (2d Series), Working Paper No. 62, 1998), *available at* http://www.law.uchicago.edu/Lawecon/WkngPprs_51-75/62.Weisbach.Line.complete.pdf.

> Targeted tax expenditures, such as deductions and credits, could affect horizontal equity throughout the tax system because they may favor certain types of economic behavior over other by taxpayers with similar financial conditions. For example, two taxpayers with the same income and identical

of taxing financial instruments, the goal of horizontal equity is generally termed "consistency, meaning that the same tax treatment should apply to economically comparable bets."[87] Vertical equity is concerned with the difference in ability to pay by taxpayers in different financial circumstances.[88]

B. *Efficiency*

An economically efficient tax creates minimal economic distortions.[89] This means, essentially, that the imposition of a given tax will not cause taxpayers to alter their behavior.[90] In the case of financial instruments, an economically efficient tax is one that will not, for example, cause a taxpayer to purchase structured notes when, in a tax-free world, she would rather own swaps.[91] As with the other criteria, a good tax regime does not

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houses may be taxed differently if one owns his or her house and the other rents because mortgage interest on owner-occupied housing is tax deductible.

Yair Holtzman, *Challenges in Achieving Transparency, Simplicity, and Administering of the United States Tax Code*, 26 J. MGMT. DEV. 418, 424 (2007).

87. Schizer, *supra* note 1, at 1889. Please note that Professor Schizer, in his article, is not advocating consistency as such, but rather explaining the difficulties with consistency, explaining that "familiar political and administrative barriers stand in the way, rendering consistency unattainable for now." *Id.* at 1890.

88. This is essentially the distinction between progressive versus regressive tax rates. See Holtzman, *supra* note 87, at 424. *See also* PROPOSALS, *supra* note 16, at 30-34 (describing current progressive rate scheme; providing statistics of proportional total tax revenues as derived from taxpayers of various income levels).

89. *Id.* at 36.

90. *Id.*

91. Credit-linked notes and swaps were chosen deliberately. On December 16, 2005, the Internal Revenue Service (the "IRS") released Rev. Rul. 2006-1, 2006-2 I.R.B. 261, which announced that commodity swaps (essentially, swaps that replicate the return of a commodity index) did not produce qualifying income for mutual funds. A number of "commodity" mutual funds had come into existence over the previous several years, and were generally investing in commodity swaps (because direct investments in commodities also did not produce qualifying income. I.R.C. § 851(b)(2)). *See, e.g.*, Rydex Series Funds, Definitive Materials (Form 497) (Dec. 27, 2005), http://www.sec.gov/Archives/edgar/data/899148/000093506905003461/g20940_seriesfunds497e.txt (explaining, in an SEC filing soon after the release of Rev. Rul. 2006-1, that "the Fund currently gains most of its exposure to the commodities markets by entering into swap agreements on a commodities index"). The revenue ruling gave mutual funds six months to change their investments; any commodity mutual fund that continued after that point to invest in commodity swaps would lose its regulated investment company status, essentially causing it to lose its tax-advantaged status. So the commodity mutual funds turned to commodity-linked structured notes (which likewise replicate the returns of a commodity index, essentially producing the same economics as a commodity swap); Rydex Series Funds, Definitive Materials (Form 497) (Apr. 12, 2006), http://www.sec.gov/Archives/edgar/data/899148/000093506906001076/g32657_sticker.txt ("The Fund has received a private letter ruling . . . that concludes that certain commodities-linked notes held by the Fund will produce qualifying income for purposes of the RIC qualification tests. The Advisor believes it can continue to successfully operate the Fund . . . by investing in these commodities-linked structured notes."). Although the economics of swaps and credit-

need to entirely eliminate distortions caused by the tax, but the distortions must be kept in mind and weighed against the other criteria.

C. *Simplicity, Transparency, and Administrability*

Simplicity, transparency, and administrability are interrelated and desirable features of a tax system.[92] A simple tax regime makes it easier for taxpayers to comply.[93] The compliance burden of a tax includes time and money spent keeping records, understanding taxes, planning,[94] preparing and filing tax returns, and engaging in audits.[95] "A transparent tax system is one that taxpayers are able to understand."[96] Because a transparent system leads to less uncertainty, taxpayers can better plan their employment, consumption, and investment.[97] Finally, an administrable tax system is one that allows taxes to be collected in the most cost-effective manner possible.[98] Nina Olson, the National Taxpayer Advocate, testified before the Senate Finance Sub-Committee on Taxation and Internal Revenue Service Oversight, saying, "[f]or taxpayers who generally will go to great lengths to comply [with the tax law], the likely source of noncompliance is the complexity of the tax code. . . . For taxpayers who will comply if doing so is easy enough, our main emphasis should be on simpler laws and procedures."[99]

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linked structured notes are similar, and although both allow investors exposure to the same commodities risk, Rev. Rul. 2006-1 created a distortion, causing certain investors to invest in one financial instrument where, absent the revenue ruling, they would prefer to invest in another.

92. *See* PROPOSALS, *supra* note 16, at xi-xiii; *see generally* Holtzman, *supra* note 86.

93. *See* Holtzman, *supra* note 86, at 425.

94. "Tax planning" is often the result of tax system inefficiencies. Investors require resources to understand the implications of structuring an investment in different ways. They also require resources to structure their investments to produce the desired tax structure. *See, e.g.*, David M. Schizer, *Sticks and Snakes*, 73 S. Cal. L. Rev. 1339, 1352-53 (2000).

95. *See* Holtzman, *supra* note 86, at 425.

96. *Id.* at 418.

97. *Id.*

98. *Id.* at 419.

99. Nina Olsen, National Taxpayer Advocate, Written Statement Before the Senate Finance Sub-Comittee on Taxation and IRS Oversight, at 3 (July 26, 2006), *available at* http://www.irs.gov/pub/irs-utl/ntatestimonysfctax_gap072606.pdf. She continued with respect to taxpayers who are actively trying to avoid payment of taxes: "I think IRS employees generally should focus on trying to induce the taxpayers to comply prospectively." *Id.*

D. *Policy Failures of the Current Regime*

The current methods of taxing financial instruments fail under all of these criteria. The taxation of financial instruments is not horizontally equitable—two similarly situated investors may both take a long position in the same corporation's stock, but the tax results of their investments may differ. Similarly, they are not vertically equitable, because often only the wealthy can engage in tax planning using financial instruments due to financial and regulatory concerns.[100] As a result of the haphazard approach to the development of systems with which to tax financial instruments, the various regimes are economically inefficient; they allow a sophisticated investor to change the way she is taxed without making significant changes to the actual economics of her investment.[101] Again, because of the haphazard way the tax system has developed, it is not simple, transparent, or easily administrable.[102]

IV. ELECTIVE TAXATION

What this Article proposes, then, is an elective regime for the taxation of risk-based returns on financial instruments. An elective regime may not satisfy all tax policy concerns with respect to financial instruments.[103] However, the advantages of the certainty that such an elective regime would provide, as well as the inefficiencies and unfairness of the current system, outweigh objections that may arise under the complicated and theoretical doctrinal concerns that traditionally guide tax policy.[104] Particularly, where a line must be drawn, the doctrines that traditionally guide tax policy are unhelpful.[105] Line drawing requires a tax-writer to determine what the essential qualities of

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100. Hasen, *supra* note 1, at 399; Schizer, *supra* note 1, at 1893.

101. Hasen, *supra* note 1, at 399 ("Inconsistency arises when the tax treatment of a single economic return depends solely on the form in which it is received. Here the problem results from the dramatically enhanced capability that financial contract innovation affords taxpayers to replicate economic returns subject to tax on an accrual basis with instruments taxed (in whole or in part) on a realization basis, and vice-versa.").

102. *See* Holtzman, *supra* note 86, at 418.

103. It is relevant to note that, even if an elective regime does not meet all of the policy considerations discussed *infra* in Part III, neither does the current regime. This Article is intended to demonstrate that an elective regime for the taxation of financial instruments better meets the criteria for a good tax than the current system, and than other systems that have been proposed.

104. David A. Weisbach has argued that "line drawing in the tax law can and should be based on the efficiency of competing rules" rather than on "[d]octrinal concerns . . . or traditional tax policy . . . [which] are neither helpful nor relevant to most disputes." Weisbach, *supra* note 86, at 2.

105. *See id.* at 1643.

a financial instrument are, and requires the taxpayer to figure out which essence her financial instrument most resembles.[106] The problem with drawing lines for the taxation of financial instruments, however, is that there is essentially no metaphysical difference between them—put-call parity demonstrates that the economics of any financial instrument can be replicated through some combination of other instruments.[107]

When a taxpayer can elect *ex ante* how her investment in derivatives will be taxed, and such election is locked in *before* she enters into the derivative contract, the only question is whether she will have gain or loss. As long as she can no longer choose the tax treatment of her investment after she knows what the result will be,[108] she will not have an incentive to engage in planning. The tax code already contains multiple elective regimes: a description of two of these regimes, the mark-to-market election of § 475(f) of the Internal Revenue Code for investors and the check-the-box regulations of Treasury Regulation § 1.7701-3, will be illustrative for purposes of this Article.

A. *Current Elective Regimes*

1. Mark-to-Market for Traders

Under Code § 475, a dealer in securities or commodities is required to mark its positions in securities or commodities to the market.[109] Under a mark-to-market system, a taxpayer annually takes into account the change in value in her property without regard to whether or not she has monetized that investment.[110]

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106. *Id.* ("The typical approach to line drawing is platonic. It searches for the essential meaning of words, such as corporation, partnership, debt, equity, selling, or holding, and draws lines accordingly.").

107. *See supra* Part II.B.2.

108. Take, for example, an investor who has entered into a forward contract that settles January 6, 2007, and on December 28, 2006, it is clear that she bet wrong. Under the current system, she can sell or settle her investment early to lock in a loss in the current year. If, however, she were in a gain position on December 28, she would wait until the settlement date and defer her gain for a year, thus effectively electing her tax treatment, or at least the timing of that treatment *ex post facto*.

109. I.R.C. § 475(f) (2000).

110. Although mark-to-market violates (in some instances) ability-to-pay concerns, it essentially contravenes the current realization-based system of taxation. *See supra* Part II.A.1. Mark-to-market is probably the most accurate and best way to account for financial instruments, under the Haig-Simons definition of income. David S. Miller, *A Progressive System of Mark-to-Market Taxation*, 109 TAX NOTES 1047, 1053 (2005). Under Code § 475, at the end of each year a dealer in securities would determine the value of each of its securities and compare that value to the value of the same security a year earlier (or, if the dealer has not held the security for a year, the value at the time of

In 1997, Congress enacted Code § 475(f),[111] which permits traders (but not investors)[112] to mark-to-market their investments in securities.[113] In order to elect mark-to-market treatment, a trader that is an entity must file a statement on its books and with the IRS either the year before the election is to become effective or within three months of the formation of the entity, whichever is later.[114] An individual must file the election with her tax return in the year before it is to become effective.[115] Once the election has been made, it is effective for all securities held by the trader, unless the trader designates an investment as not being marked-to-market *on the day she makes the investment.*[116] Although it is not completely clear who may make the election (*i.e.*, whether any given security holder is an investor or a trader), and although the manner of making the election is not crystal clear (*i.e.*, the regulations do not spell out what exactly must be said in the statement that is to be attached to the trader's tax return), by allowing traders to elect to be taxed on a mark-to-market basis, traders gain some amount of certainty and simplicity.[117]

2. Check-the-Box Entity Classification

Under the check-the-box regulations, most business entities can choose how they will be treated for tax purposes.[118] By

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purchase). I.R.C. § 475(f)(1)(A)(i). The dealer aggregates the gains and losses and takes the net result as an ordinary gain or loss. I.R.C. § 475(d)(3)(A)(i).

111. Act of Aug. 5, 1997, Pub. L. 105-34, 111 Stat. 978 (election of mark-to-market for marketable stock) (codified as amended at I.R.C. § 475(f)).

112. The exclusion of investors from I.R.C. § 475(f) mark-to-market accounting creates a line-drawing problem: the difference between a trader and an investor is not made clear in the Code or in the regulations; rather, a court-created balancing test is used to weigh whether a person or entity is a trader or an investor, and even still, the answer is not always clear. *See, e.g.*, Purvis v. Comm'r, 530 F.2d 1332, 1334 (9th Cir. 1976) (stating that, to distinguish traders from investors, courts should examine "the frequency, extent, and regularity of petitioner's securities transactions as well as his intent to derive profit from relatively short-term turnovers").

113. *See* I.R.C. § 475(f).

114. Rev. Proc. 99-17, 1999-1 C.B. 503, 504-05.

115. *Id.*

116. *See* I.R.C. § 475(f)(1)(B).

117. If a trader engages in hundreds or thousands of trades each year, it may be difficult to keep track of the movement of each individual security's tax basis, when it was bought, and when it was sold. *See* Jim Forrester, *Mark to Market Accounting*, http://www.traderslog.com/mark-to-market.htm (last visited Nov. 19, 2007). Under mark-to-market, a trader only has to keep track of what the value of its portfolio was at the end of the previous year, how much it has sold and bought in the ensuing year, and what the value of its portfolio is at the end of the current year. *Id.*

118. Treas. Reg. § 301.7701-3(a) (2006). The exceptions are essentially state-law corporations and certain foreign entities, which are treated as corporations in all instances. *See generally* T.D. 8697, 1997-1 C.B. 215 (summarizing tax treatment of

default, a non-corporate domestic entity is classified as a partnership "if it has two or more members . . . disregarded as an entity separate from its owner if it has a single owner."[119] A foreign entity that is not on the de facto corporation list is classified as an "association if all of its members have limited liability" and as a partnership "if it has two or more members and at least one member does not have limited liability" for the debts and liabilities of the entity.[120] However, regardless of the entity's default classification, it can file an IRS Form 8832 in which it elects whether it will be treated as an association taxable as a corporation, a partnership, or a disregarded entity.[121]

However, "[p]rior to [the enactment of] the check-the-box regulations, the determination of whether an entity was treated as a corporation subject to the double tax, or a partnership subject to only a single tax, was based on four factors that described platonic notions of partnership and corporations."[122] In *Morrissey v. Commissioner*,[123] the Supreme Court was asked to determine whether a real estate trust could be taxed as an association (which for tax purposes is treated as a corporation) even though it was formally a trust.[124] The Supreme Court stated that "classification cannot be said to require organization under a statute"[125] and proceeded to ask what were "the salient features of a trust . . . which may be regarded as making it analogous to a corporate organization?"[126] The Supreme Court then enumerated the essential elements of a corporation,[127] and applied the criteria to the case before it, holding that the real estate trust had more corporate properties than trust properties and was therefore to be taxed as an association.[128]

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domestic and foreign entities as related to their election of partnership or association status).

119. Treas. Reg. § 301.7701-3(b)(1) (2006).

120. *Id.* § 301.7701-3(b)(2).

121. *Id.* § 301.7701-3(a), (c)(1)(i). The Treasury's authority to promulgate such regulations has been challenged; the court held that it was within the Treasury's authority to issue interpretive regulations under Code § 7805(a). *See* Littriello v. United States, No. Civ.A.3:04CV-143-H, 2005 WL 1173277, at ¶ 3 (W.D. Ky. May 18, 2005).

122. David A. Weisbach, *Line Drawing, Doctrine, and Efficiency in the Tax Law*, 84 CORNELL L. REV. 1627, 1628 (1999).

123. 296 U.S. 344 (1935).

124. *See id.* at 346-47.

125. *Id.* at 357.

126. *Id.* at 359.

127. *See id.* at 359-60.

128. *Id.* at 360.

Over the next 20 years, as more individuals began filing income tax returns, professional groups began "to create associations and file corporate tax returns."[129] The IRS opposed such filings and, when it became apparent that it was going to lose the war on corporate associations, it issued the "Kintner Regulations."[130] Under the Kintner Regulations, the six characteristics of a corporation were: "(1) associates, (2) an objective to carry on business and divide the gains therefrom, (3) continuity of life, (4) centralization of management, (5) liability for corporate debts limited to corporate property, and (6) free transferability of interests."[131] Because characteristics (1) and (2) are "common to both partnerships and corporations," the court stated that "they are generally disregarded in distinguishing between the two."[132] Entities that had enough of these corporate factors were deemed to be corporations for tax purposes "because they were closer to the platonic notion of a corporation than to the notion of a partnership."[133] Even prior to the check-the-box regulations, "[t]axpayers could manipulate the four factors," so that they could "choose their classification," but the costs were "significant."[134]

B. *Proposed Elective Regime for Financial Instruments*

The similarity between the pre-check-the-box method of determining entity classification and the current method of determining the proper method of taxing financial instruments is striking. In both cases, the classification must be made by analogy. However, the entity/instrument to which taxpayers are analogizing is itself slippery and without literal existence. This creates both uncertainty and opportunity to try to game the system by choosing the form that is most tax-advantageous, and trying to design the entity/instrument in a way that fits as closely to the desired tax result as possible while fulfilling the desired business purpose.

Given the similarities between pre-1996 entity classification and current taxation of financial instruments, this Article proposes an elective tax regime, similar to the check-the-box regime.

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129. Zuckman v. United States, 524 F.2d 729, 733 (1975).

130. The Kintner Regulations were Treas. Regs. §§ 301.7701-1 through -11, and appeared in T.D. 6503, 1960-2 C.B. 412. *Zuckman*, 524 F.2d at 734.

131. *Id.* at 733 (citing Treas. Reg. § 301.7701-2(a)(1)).

132. *Id.* (citing Treas. Reg. § 301.7701-2(a)(2)).

133. Weisbach, *supra* note 122, at 1628.

134. *See id.* at 1629; *see also supra* Part III.B (discussing efficiency).

Under this proposed regime, a taxpayer will choose between two treatments for her financial instruments: mark-to-market or "Stated Term" taxation.[135] Until she makes an election, an investor will, by default, be taxed using the Stated Term method. Although mark-to-market accounting is economically the most accurate way to tax financial instruments because it presents liquidity and valuation issues, mark-to-market taxation of financial instruments is best implemented on an opt-in basis. By making Stated Term the default, these difficulties in mark-to-market taxation will only apply to investors who believe they have access to the information and liquid assets mark-to-market requires. The election will be effective for all financial instruments entered into in taxable years following the year in which an investor makes the election.[136] Under this election,

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135. Note that these are not the only possible ways to treat financial instruments. For example, requiring taxpayers to conform the book and tax treatment of financial instruments would eliminate certain planning opportunities. *See* Keinan, *supra* note 1, at 681. However, book-tax conformity does not solve the current problems with the taxation of financial instruments. Generally accepted accounting principles in the United States ("GAAP") generally require taxpayers to mark-to-market their positions in financial instruments. *See id.* at 683-84. In addition, some taxpayers may not have the information or liquidity to do so. *See supra* note 82 and accompanying text. The same frictions between book and tax treatment, especially for individuals and closely-held corporations that do not have to produce financial statements for the general public, do not exist between debt and equity; a publicly-held corporate taxpayer would rather have debt for tax purposes so that it can deduct interest paid, but equity for book purposes so that its capitalization appears better. Keinan, *supra* note 1, at 701-02. Additionally, and perhaps most importantly, by imposing book-tax conformity, the Treasury and the IRS would be forced to cede control of the tax treatment of financial instruments to the financial accountings standards board ("FASB"), and would be required to decide whether to interpret FASB rules itself or to follow FASB's interpretation. *Id.* at 690. Also, financial instruments could be taxed in any of the ways they are currently taxed. For example, among other possible methods, the tax law could impose a zero tax rate. *See generally* Schizer, *supra* note 1, at 1924-25 (discussing issues relating the zero rate approach). Another method could be to tax the expected value of a transaction. *See* Shuldiner, *supra* note 1, at 283-284. Lastly, tax law could even impute interest based on a reference and tax date and, after realization, make any necessary adjustments. *See* Bradford, *supra* note 1, at 770. However, for reasons to be discussed *infra* Part IV.B, mark-to-market and stated term seem to be the simplest, most easily administered methods that prevent taxpayers from exploiting inefficiencies.

136. The check-the-box election can be made effective up to 75 days prior to or 12 months subsequent to a taxpayer's filing IRS Form 8832. Treas. Reg. § 301.7701-3(c)(1)(iii) (2006). If an investor in financial instruments had that option, however, it would allow her one opportunity to wait 75 days to determine how her portfolio was doing and which election was most advantageous. It seems unlikely that an investor, or at least an investor who expected to invest in financial instruments again in the future, would elect tax treatment based on a one-time advantageous treatment of her portfolio, but that is a possibility. The mark-to-market election, by contrast, permits an entity to make the election in its first year of existence by making a notation in its books and filing a statement with its first income tax return; otherwise, an entity or individual taxpayer may elect to mark-to-market in the subsequent year. Rev. Proc. 99-17, 1999-1 C.B. 503, 504-5. For purposes of elective taxation of financial instruments, it makes sense for the

losses from financial instruments will be fully deductible for all taxpayers.[137]

1. Stated Term

Under the proposed elective regime, upon entering into a financial instrument, an investor will be indifferent to the timing rules and the rate of tax, provided they are known in advance and are the same for gains and losses. The indifference can only exist, however, if timing and rates are clearly understood. The timing rule of the Stated Term approach[138] requires taxpayers "to precommit to a date on which they will recognize their gains and losses."[139] Presumably, such date would be the settlement date of the contract. On that date, and not before or after, the taxpayer will include her gain into income or will deduct her loss. Even if she settles the contract early, or sells it (at a gain or loss) to a third party, she will not recognize her gain or loss on the financial instrument until the settlement date.[140]

Under the Stated Term approach, gain and loss will be capital in character. Under the current tax system, long-term

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election to take effect in the taxable year following the year in which an investor files her election.

There would also be a transition period; the elective regime should become effective for financial instruments entered into in the taxable year following the effective date of the enacting legislation. That would allow investors a transition year in which they could make the election, allowing their election to be effective at the earliest possible taxable year. Any instrument entered into before the new regime that became effective would continue to be taxed under the rules that applied to it before.

137. *See infra* notes 162-69 and accompanying text.

138. This Article comes to the term and concept "Stated Term" via Professor Schizer, who mentions that it is similar to Bradford's suggestion. *See* Schizer, *supra* note 1, at 1920 (citing Bradford, *supra* note 1, at 770-71). However, Professor Schizer's version, without imputed interest and redetermination of basis after the fact, is easier to understand and easier to comply with. In addition, financial instruments are zero sum, and the purpose in taxing them is to discourage people from trying to recast wage and time-value returns as risk-based returns. *Id.* at 1924-25. Therefore, rather than raising revenue, it does not matter that the taxpayer manages to delay the potential payment of tax because she is also forced to delay the possible use of a deduction; in this situation she does not know when she enters into the transaction if she will have a gain or a loss. *See supra* Part II.C.

139. *See* Schizer, *supra* note 1, at 1920.

140. Example: Taxpayer enters into the long side a cash-settled forward contract for widgets on January 1, 2008, with a termination date of January 1, 2011. The contract is for 50 widgets at $100 per widget. Under a realization system, if, on December 28, 2010, the value of widgets has dropped to $95, she would terminate the contract in order to take a $250 loss ($5 loss on each of 50 widgets) on her 2010 tax return. If, however, widgets are worth $105, she will wait until the termination date, and take the $250 into income on her 2011 tax return. The stated term approach eliminates her timing option. Even if she were to settle the contract for a loss on December 28, 2009, she would not realize the loss for tax purposes until January 1, 2011.

capital gain[141] is generally taxed at a rate of 15%.[142] Short-term capital gain[143] is taxed at ordinary income rates.[144] The Stated Term approach would use the standard long-term and short-term rules, except that, rather than being based on how long an investor holds the instrument, the determination of whether an instrument is long-term or short-term would be based on the length of time between an investor's entering into the instrument and the settlement date.

Although generally the simpler of the two possible elections, a taxpayer electing to treat her financial instruments under the Stated Term regime would, in some cases, be required to separate her return into a risk-based component and a non-risk-based[145] component.[146] Commentators have generally recognized this problem, and have suggested a number of solutions on how to separately account for risk-based and nonrisk-based income.[147]

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141. A long-term capital gain is a capital gain on assets held for more than one year. *See* I.R.C. § 1222(3) (2000).

142. *Id.* § 1(h)(1)(C) (Supp. IV 2004).

143. A short-term capital gain is a capital gain on assets held for one year or less. *See id.* § 1222(1) (2000).

144. *Id.* § 1(h); Michelle Arnopol Cecil, *Toward Adding Further Complexity to the Internal Revenue Code: A New Paradigm for the Deductibility of Capital Loss*, 99 U. ILL. L. REV. 1083, 1120, 1129 (1999) (giving examples of tax treatment for capital gains and losses). It is important, too, that, both under this and the mark-to-market approach, income and losses on financial instruments not be included in a taxpayer's adjusted gross income. If gains and losses were includible in adjusted gross income, "gains [could] shift taxpayers into a higher bracket (increasing the government's share), while losses [could] shift taxpayers into a lower bracket (reducing the government's share)." Schizer, *supra* note 1, at 1908 (citing Alvin C. Warren, Jr., *The Deductability by Individuals of Capital Losses Under the Federal Income Tax*, 40 U. Chi. L. Rev. 291, 305 (1973)). This potential shifting would mean that a taxpayer's upside and downside were not exactly equivalent.

145. Typically, a non-risk-based return on a financial instrument would be a time-value-of-money return (*e.g.*, interest income), although it is conceivable that an investor would attempt to disguise her wage income as a return on a financial instrument. For these purposes, however, the difference is of minimal, if any, importance. *See* Schizer, *supra* note 1, at 1921.

146. A non-risk-based return cannot be scaled up without cost. Thus, the idea that, *ex ante*, a taxpayer is indifferent to how the return is taxed does not hold where it is non-risk-based. This is because both wage and time value income have positive expected values. *See supra* note 79 and accompanying text. Therefore, there is some incentive for an investor, who has elected Stated Term treatment, to try to re-characterize her non-risk as risk-based. In doing so, she will be delaying the inclusion of income with no corresponding risk that she could instead be delaying a loss. Furthermore, the income will be eligible to be taxed at the more-favorable long-term capital gain rate. Note, however, that an investor who had elected mark-to-market treatment would not have any incentive to re-characterize income because all of her income, both risk- and non-risk-based, would be recognized annually and taxed at ordinary rates. *See infra* text accompanying notes 162-67.

147. *See, e.g.*, Warren, *supra* note 1, at 473-82 (discussing possible tax policy responses, including mark-to-market, integration of positions, limitations on expenses, disaggregation, and formulaic taxation of contingent returns); Shuldiner, *supra* note 1, at 283-90 (advocating the use of the "expected value transaction" approach).

Bifurcating the return into risk-based and non-risked based income is sensible given the tendency of the ordinary investor to select the Stated Term regime. Using the current original issue discount rules,[148] a taxpayer would take into income annually over the life of the instrument a portion of the guaranteed return, while delaying inclusion of any risk-based component.[149]

To ensure the international competitiveness of U.S. financial markets, gains and losses on financial instruments will be sourced to the jurisdiction of the payee.[150] Conceptually, this generally follows the current treatment of swaps.[151] There are certain ambiguities in the sourcing rules for swaps, however, this Article proposes to resolve these for purposes of Stated Term taxation.

Under the swap sourcing rules, it is potentially unclear, where an investor is a multinational entity, which jurisdiction is most relevant for tax purposes.[152] The confusion can arise thusly: German Bank has its U.S. Subsidiary enter into a financial product. U.S. Subsidiary also operates in Bermuda and uses a Bermudian bank account to receive and make payments on the interest. The question becomes, is the payee (and thus the source) the German Bank, the U.S. Subsidiary, or the Bermuda bank?[153] For purposes of the Stated Term approach, if the investor is an individual, financial instrument income or loss would be sourced to the United States if the investor is a citizen or resident of the United States. If the investor is a corporation, financial instrument income will be sourced to the United States

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148. *See* I.R.C. § 1273.

149. It could be argued that a portion of the return, even on an instrument that appears entirely risk-based, is actually the result of inflation. *See* Weisbach, *supra* note 19, at 30. Although that is true, the current tax law (sensibly) ignores that portion of a return—the sheer complexity of determining what portion of the return on a financial instrument was attributable to inflation would be staggering. In addition, because financial instruments generally do not continue for more than three years, the effects of inflation should be negligible (as opposed, for example, to the holding of a share of IBM for 40 years—some portion of that return is not really gain, and probably should not be taxed). *See id.* at 31. However, this is beyond the scope of this article.

150. *See, e.g.*, Avi-Yonah & Swartz, *supra* note 1 ("For portfolio investors in countries without U.S. tax treaties, avoiding the 30 percent withholding tax on dividends is a powerful incentive to forego the voting rights associated with a direct investment in stock [by entering into a swap replicating dividend payments on the swap].").

151. *See* Treas. Reg. § 1.863-7(b)(1) (2006); *see also* I.R.C. § 988(a)(3)(B)(i).

152. *See* Treas. Reg. § 1.863-6 (2006).

153. Note that, for U.S tax purposes, this would not be an issue if the subsidiary were, for example, Swiss. Our sourcing rules are binary—the source is either domestic or foreign. Nonetheless, a rule which assigns the source to a jurisdiction allows the binary judgment to be made.

if the corporation is engaged in trade or business in the United States.[154]

If the investor is a non-U.S. partnership or other pass-through entity (or a hybrid entity), the Stated Term approach can adopt an approach used in several tax treaties. Under this approach, for any U.S. member of the pass-through entity, if the member is treated as the owner of the entity's income for U.S. purposes, the income will be domestic source income. But if the income is treated as belonging to the entity, it will be foreign-source income for U.S. tax purposes.[155]

2. Mark-to-Market

As alluded to *supra*, mark-to-market taxation requires an investor to annually determine the value of her investments—she would pay tax on any increase in value from the prior year, or if her investments lose value, she would take a deduction.[156] Mark-to-market accounting is broadly recognized as the most accurate system of accounting for income.[157] In spite of its theoretical superiority, however, mark-to-market accounting is not widely used, for two significant reasons. First, it is difficult to accurately value positions in derivatives.[158] Second, even where

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154. *See* I.R.C. § 864(c)(2) (stating the rule for US-sourced income for corporations); *see also id.* § 864(c)(1) (defining effectively-connected income for individuals). If the corporation's only contact with the U.S. is trading stocks and securities and it has no fixed place of business in the U.S., and it will not be deemed to be engaged in trade or business in the United States. *Id.* § 864(b)(2); Treas. Reg. § 1.864-2(c) (2006).

155. *See, e.g.*, Convention Between the Government of the United States of America and the Government of Japan for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion With Respect to Taxes on , U.S.-Japan, Nov. 6, 2003, art. 4, § 6, cl. b. As an example, a Bermuda exempted limited company enters into a financial instrument with German Bank on January 1, 2008, with a settlement date of January 1, 2010. The Bermuda company has two investors with equal shares, a U.S. individual and a Canadian individual. For U.S. tax purposes, the Bermuda company has elected to be treated as a partnership. *See supra* text accompanying note 91. If, at the settlement date of the contract, the German bank pays $100 to the Bermuda company, the $50 attributable to the U.S. individual's share will be sourced as U.S. income, and the U.S. individual will owe $7.50 (a long-term capital gain rate of 15%) in taxes. The other $50, however, will be considered non-U.S. source. If the Bermuda company is treated as a pass-through entity for Canadian purposes, the U.S. would source that income to Canada, and if it is treated as a corporation, it would be sourced to Bermuda. Either way, it is not taxed in the United States.

156. I.R.C. § 475.

157. Keinan, *supra* note 1, at 683-84 (quoting Bank One Corp. v. Comm'r, 120 T.C. 174, 228-30 (2003) ("Mark-to-market accounting has for decades been considered by academia and other commentators to be the most theoretically desirable of all the various systems of taxing income in that mark-to-market accounting consistently measures and levies tax on a taxpayer's economic (or Haig-Simons) income.")).

158. Miller, *supra* note 110, at 1073. Mr. Miller points out, however, that publicly-traded securities are already required to be marked-to-market under GAAP, and that dealers are required to, and traders are permitted to, mark their positions to market

an investor can accurately value her position in a financial instrument at the end of the year, she may or may not have liquid assets available to pay taxes on her appreciation.[159]

These two problems are functionally irrelevant, however, when an investor chooses to be taxed on a mark-to-market basis: "The perceptional and political issues surrounding the imposition of a mark-to-market regime are not presented if it is voluntary. . . . Voluntary mark-to-market treatment achieves economic taxation, neutrality, and financial instrument consistency, but only for the taxpayers so electing."[160] Presumably, only taxpayers who believe that they could both accurately and cheaply value their positions in financial instruments, and believed that they would have the liquid assets to pay taxes on those positions, would elect to mark their positions in financial instruments to market.[161]

A taxpayer who has elected mark-to-market treatment of her financial instrument income will include the returns annually as ordinary income or loss. Treating the income as ordinary eliminates the incentive to reclassify wage and time-value returns as financial instrument income.[162] Investors should be

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under I.R.C. § 475. *Id.* An election that allows even investors to mark-to-market their positions in financial instruments presumably will carry with it the market incentive to make such valuations available to all investors. However, as is discussed *infra*, it is not necessary to the election regime that mark-to-market data be voluntarily made available to all investors (for free or at a fee).

159. *See id.* at 1053. Imagine a worst-case scenario: our investor has elected to be taxed on a mark-to-market basis; she purchases a futures contract on oil in January 2008, with a settlement date of January 1, 2011. Nine months after entering into the contract, Venezuela and the Middle East agree to stop selling oil to the United States. Overnight, the value of her futures contract quadruples, and at the end of the year, our investor experiences huge paper gains. However, as of December 31, 2008, her tax liability is 35% of the huge paper gains. At this point, she has limited choices: she can sell her futures contract, realize the gain, and pay her taxes, but if the Middle East situation does not appear to be clearing up, she loses the next two years' potential appreciation. She can sell other investments or property, but, unless she intended to sell, her tax liability forces her to do something that she did not intend to do. She can borrow against her equity in the investment. Or she can evade taxes, breaking the law and face huge penalties and, potentially, jail time.

160. Miller, *supra* note 1, at 257-58.

161. This is the principal reason that Stated Term would serve as the default for taxpayers. Professor Schizer sees similar approaches with Stated Term and mark-to-market. *See* Schizer, *supra* note 1, at 1920 & n.117. However, for purposes of the proposed elective regime, the two are different enough to appeal to a full spectrum of taxpayers. While mark-to-market reflects generally accepted corporate financial accounting standards and the economic value of a transaction, Stated Term gives an investor certainty and liquidity. *See id.* at 1920 & n.117, 1942-43; Miller, *supra* note 110 at 1055.

162. *See* Herbert Stein, Op-Ed., *Common Sense on Capital Gains*, WALL ST. J., Aug. 23, 1989 (explaining that the difference in the capital gains and income tax rates causes "some people [to pay] less tax than other people with the same income" due to the fact

indifferent to the rate, since they can scale up their investment in order to achieve the desired real-dollar return with little or no cost.[163] Because an investor can determine her desired after-tax return, and at little or no extra upfront cash outlay, enter into a financial instrument in that amount,[164] she should not mind that her tax rate is higher.

Furthermore, in a loss position, taxation at ordinary rates is advantageous to investors. Generally, capital losses can only be deducted against capital gains.[165] A mark-to-market taxpayer, however, will net all of her gain and loss positions in financial instruments; in a loss position she may have no capital gain to offset.[166] Most investors will have ordinary income from wages every year. An investor in financial instruments is partnering de facto with the government in her gains and losses,[167] but the partnership is not perfect. While the government takes its own portion of gains, it does not refund the taxpayer its portion of losses.[168] When an investor in financial instruments deducts her losses, even against wage income, she is not sheltering her wage income.[169] Instead, the government is absorbing its portion of the taxpayer's loss.

C. *Policy Concerns in an Elective Regime*

Permitting elective tax treatment of financial instruments means that the tax treatment of the same financial instrument may be different for similarly situated taxpayers. Consistency will solely be at the level of each discrete taxpayer.[170] The fact that the two parties may treat the same instrument differently is not a significant change from the current treatment of financial instruments, and should not be troubling from a policy

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that "capital gains already are taxed less than most other forms of income."). If the Government began treating financial instrument income as ordinary income, taxpayers would realize no tax savings at all by reclassifying one type of income to another.

163. *See* Schizer, *supra* note 1, at 1898-99; *see also id.* at 1891 n.11 (on the bet-scaling idea "elaborated in an extensive literature").

164. *See id.*

165. I.R.C. § 1211(b) (2000) (an individual can deduct up to $3000 of capital losses annually against ordinary income).

166. It is possible that she will have realized capital gain from, for example, the sale of securities or the sale of a home, but she is unlikely to have significant amounts of such capital gain on an annual basis.

167. *See* Dodge, *supra* note 74, at 444-45.

168. *See id.* at 445.

169. *See id.*

170. It is important to keep in mind that "inconsistencies in the taxation of risky bets do not prompt planning as *long as taxpayers precommit to their treatment.*" Schizer, *supra* note 1, at 1911.

perspective. Under current tax law, if a taxpayer is an investor[171] and enters into a financial instrument with a counterparty that is foreign, tax-exempt,[172] a dealer,[173] or an electing trader,[174] the tax treatment of the investor and the counterparty is likely already different. Furthermore, Congress and the Treasury have presumably recognized the difference in treatment and, for policy or other reasons, intended that the treatment be different.[175]

Furthermore, such elective treatment is consistent with horizontal equity. Although similarly situated taxpayers will be treated differently on the same investment, each investor has the possibility of being treated identically. If there is a difference in the tax treatment of investors, such difference is of their own choosing.

V. TAX REFORM

The difficulty in fundamental reform of the taxation of financial instruments is the same as the fundamental reform of any portion of the tax system: fundamental reform is generally politically unpalatable unless and until the general public becomes fed up with the current system.[176] Because of its complicated and obscure nature, the general public is unlikely to mobilize against the current problems with the taxation of financial instruments.[177] Commentators are pessimistic about

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171. *See* I.R.C. § 475(f); Purvis v. Comm'r, 530 F.2d 1332, 1333-34 (9th Cir. 1976); *see also supra* note 84 (a party is already required to know if it is an investor, trader, or dealer, and the judicial test is not completely clear).

172. Tax-exempt taxpayers are taxed on their "unrelated business taxable income," which is generally active business income and income financed by debt. I.R.C. § 512(a)(1), (b)(4); *see also* Treas. Reg. § 1.512(b)-1(a)(1) (as amended in 1992).

173. *See* I.R.C. § 475(a) (providing rules which "apply to securities held by a dealer in securities").

174. *See id.* § 475(f).

175. For example, there is value in exempting certain organizations from tax; in order for the U.S. to be a market for financial transactions, which technically do not depend on a location, it is important not to tax foreign counterparties.

176. Even an unpopular tax, such as the alternative minimum tax, can be difficult to eliminate. National Taxpayer Advocate Nina E. Olson discussed her abortive attempt to have the alternative minimum tax repealed. In 2006, she said she felt like Congress would "wait until the very last minute, when we do have the crisis, and that will be the driver. You know, basically, people standing up like in the movie 'Network' saying, 'I'm mad as heck and I won't take it anymore!'" *Nina Olson on Taxpayer Advocacy at the Internal Revenue Service*, Tax Foundation's "Tax Policy Podcast," Sept. 19, 2006, 2006 TNT 182-25, *available at* http://www.taxfoundation.org/podcast/show/1837.html.

177. If the perceived abuse involving financial instruments is sufficiently egregious, however, the public may clamor for change. In the 1990s, several high-wealth, high-profile individuals used shorts-against-the-box to cash out of appreciated stock positions while deferring (possibly forever) tax on their gains. *See* Knoll, *supra* note 1, at 88 n.90

the likelihood of achieving major reform and prefer to offer small achievable reforms.[178] The advantage of the elective regime suggested by this Article is that it is an incremental rather than major reform. It could be implemented by Congress' passage of a single new section of the Code. Congress would not be required to determine the underlying economics of each existing financial instrument and foretell what potential instruments have yet to arise. Yet, in spite of its incremental nature, it could fundamentally consolidate and simplify the taxation of financial instruments.[179]

Still, even though the proposed reform is simple, is it necessary? This Article has put a premium on simplicity and administrability. It would seem simplest and most easily administrable to not impose any tax on financial instruments. Although counterintuitive, because an investor can scale up her investments in financial instruments to achieve the after-tax return she wants,[180] a zero rate on financial instruments creates precisely the same tax consequences for the investor and the government as any other rate.[181] In order to earn an expected after-tax return on $100 at a zero rate, a taxpayer would have to invest $100.[182] Also, where the government is an economically rational actor, the government is in the same position regardless of whether there is a 50% rate or a zero rate on financial

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(citing Diana B. Henriques with Floyd Norris, *Wealthy, Helped by Wall St., Find New Ways to Escape Tax on Profits*, N.Y. TIMES, Dec. 1, 1996, § 1, at 1) (giving examples of this strategy). Although the tax advantages of shorts-against-the-box had been around for over 75 years, press reports of the wealthy individuals avoiding taxes finally compelled Congress to act. William M. Paul, *Constructive Sales under New Section 1259*, 77 TAX NOTES 1467 (Sept. 15, 1997) (discussing the notable example of the use of this strategy by the Estee Lauder family). Also, as part of the Tax Reform Act of 1997, Congress added § 1259 to the tax code, creating the constructive sale rules. Knoll, *supra* note 1, at 88.

178. *See, e.g.*, Schizer, *supra* note 1, at 1891 ("[T]he objective here is to provide policymakers with an agenda for incremental reform . . . ."); Strnad, *supra* note 1, at 604-05 ("Repairing the major discontinuities and inconsistencies in current law would require fundamental reform. . . . Even if Congress implements major changes, it is likely that some significant inconsistencies and discontinuities will remain. This fact, and the darker possibility that no major reform will occur, create difficult choices for the Treasury Department and the courts. . . . Perhaps the only viable alternative for dealing with new financial instruments is the traditional one of analyzing the normative stakes for each type of transaction and then crafting a detailed response.").

179. Furthermore, if Congress or the Treasury found that a new financial instrument was somehow abusive in spite of the elective regime, Congress would have the option of carving out a new rule for that derivative. However, carving out new instruments as they arise goes counter to the spirit of simplification of the elective regime. It would be better for the Treasury to designate such abusive instrument as a listed transaction under Treasury Regulation 1.6011. *See* Treas. Reg. § 1.6011-4(b)(2) (as amended in 2007).

180. *See supra* text accompanying notes 78-79.

181. *See* Schizer, *supra* note 1, at 1924.

182. *See supra* note 78. The formula can be represented thusly: 1/(1-0) x 100 = 100.

instruments. If a taxpayer is long[183] on a financial instrument, the government can hedge its potential risk by going short in the same instrument. Returning to our investor who wants a return of $100, if she knows that she will be taxed at 50%, she will double the bet she would otherwise make.[184] If she wins, she will receive $200, pay $100 in tax, and keep $100. If she loses, she will pay $200, but will get a tax deduction against other income of $100. This means that while the government can expect to receive $100 if the investor wins, it can expect to lose $100 (by means of not collecting tax it would otherwise collect) if she loses. In order to hedge its position, the government should take a short position with an expected value of $100 in the same instrument. The government's short position, however, means that if the investor wins, it will receive $100 from her, but pay $100 to its counterparty. If the investor loses, the government loses $100 of tax revenue from her, but receives $100 from its counterparty. On a net basis, the government does not earn or lose any money at a 50% rate.[185] The government's economic situation would therefore be exactly the same if it had imposed no tax on financial instruments.

While in theory a zero rate on financial instruments may be desirable, for practical purposes it is both undesirable and infeasible. A zero rate is undesirable because it would present significant motivation for taxpayers to try to repackage non-risk-based returns as financial instruments: "[w]alling off these instruments will introduce complexity, and the zero rate will give taxpayers added incentive to game this distinction."[186] While a zero rate would reduce complexity, it would create distortions for individuals with high wage income, currently taxable at a federal rate of 35%. Such individuals would find it worth significant cost in attorney's and accountant's fees to transform wage income into financial instrument income, thereby increasing the government's policing cost.[187]

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183. "Long" means that the taxpayer wins "if the market price goes up, and loses in the event of a decline in the market." Valley Waste Mills v. Page, 115 F.2d 466, 467 (5th Cir. 1940).

184. *See supra* text accompanying note 78.

185. *See* Weisbach, *supra* note 19, at 17-19.

186. Schizer, *supra* note 1, at 1924. Professor Schizer goes on to state, "We need a positive tax rate on risky bets not to collect revenue on these bets themselves, but to collect revenue from *other things* that otherwise would be repackaged to look like risky bets. Given the importance of this problem, the zero rate should be used sparingly." *Id.* at 1925.

187. *Id.* If a taxpayer made $500,000 a year in wages, taxable at a flat rate of 35%, it may be worth spending $150,000 to transform her wages into financial instrument income; she would still be $25,000 better off than if she had paid her taxes. However, the

Second, in spite of compelling arguments that risk-based returns should not be taxed if we truly want the federal income tax to adopt a Haig-Simons definition of income,[188] eliminating the tax on financial instruments would be a political and policy non-starter. There is no advantage to either side of the aisle of eliminating the tax, which would doubtless be viewed as a tax cut for the wealthy, whether or not the change actually amounted to a cut in anybody's effective tax rate. Furthermore, from a policy perspective, whether a tax regime "appears to be fair to the layperson can be as important a question as whether, under sophisticated economic or legal analysis, the proposed system is fair."[189]

For those lawmakers who favor tax cuts, there is no reason to waste their limited political capital on eliminating the taxation of financial instruments. As has been amply demonstrated, if the taxation of gains equals the taxation of losses and an investor can scale up her investments, she is indifferent to the tax rate.[190] Tax cuts would be better aimed toward taxes on wage and time-value income, to which no one is indifferent. In spite of the fact that the zero rate is the economic equivalent to a 50% rate, and because investors in financial instruments are generally corporations and wealthy individuals, an opponent of the politician voting for such a change could easily suggest that the politician was voting for tax cuts for the wealthy.[191] On the other hand, for a politician opposed to tax cuts for the wealthy, there would be no advantage to cutting the tax rate on financial instruments.

Because of the difficulties in creating and policing a zero rate, it makes sense to reform the taxation of financial

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$150,000 is essentially waste, as it was paid to avoid paying taxes, and neither the taxpayer nor the government has that money.

188. *See* Weisbach, *supra* note 19, at 1 n.1 ("[A]n ideal Haig-Simons tax taxes individuals on the change in value of their assets in each period. If an individual's assets go up in value, she owes tax, producing a tax on capital income.").

189. John K. McNulty, *Flat Tax, Consumption Tax, Consumption-Type Income Tax Proposals in the United States: A Tax Policy Discussion of Fundamental Tax Reform*, 88 CAL. L. REV. 2095, 2147 (2000).

190. *See supra* text accompanying notes 78-79.

191. Although there is a vocal consistency advocating the elimination of the estate tax, no one has yet been successful at having the estate tax repealed. *See* Kathleen Pender, *No Tax Law Changes Expected While Bush Is Still in Office*, S.F. CHRON., Nov. 12, 2006, at F1. Although the estate tax is a tax on the most wealthy (in the case of decedents who die in 2008, it is only imposed on estates exceeding $2 million in value (I.R.C. § 2010(c) (Supp. IV 2004))), even some Americans whose net worth is substantially below that amount support its repeal, possibly under the belief that if they work hard enough, it could affect them. *Id.* It is hard to envision such an egalitarian outcry for a zero rate on financial instrument income.

instruments in a manner that maintains some level of tax on income from such instruments. Furthermore, reform through the creation of an elective regime for financial instruments does not present other politically unpalatable problems that much of the other tax reform regimes present. Theoretically, effecting this elective regime should not have any cost in terms of lost revenue to the government.[192] Because every gain an investor earns is matched by a counterparty's loss, the net result of a balanced treatment of gains and losses results in no net gain or loss for the government on the taxation of financial instruments.[193] Although the counterparties to a single instrument may be treated differently on that instrument (i.e., the winner marks-to-market annually at ordinary rates, while the loser recognizes a long-term capital loss on the expiration date of the instrument), gains and losses should be distributed in similar proportions between mark-to-market and Stated Term taxpayers. Although the adoption of this elective regime will likely result in some amount of revenue gain or loss for the government, that amount should not be material. So even under rules requiring that any tax cut be offset by an equivalent spending cut, Congress would not be forced to eliminate spending to fund the reform.

Likewise, the reform will not result in a tax increase for any taxpayer.[194] It does not increase marginal rates or capital gain

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192. Practically, there may be certain costs. For example, individual investors' losses on financial instruments will be fully deductible rather than being subject to the current 2% floor. *See supra* note 73. However, if investors in financial instruments would generally get past the 2% floor even without deducting their financial instruments (e.g., by deducting mortgage interest and charitable contributions), the deduction of losses on financial instruments should not cost the government anything because those losses would, by virtue of being stacked on top of other deductions, be fully deductible anyway. Furthermore, this elective regime neutralizes the timing option whereby taxpayers accelerate losses while not realizing gain positions. Finally, certain investors are presumably taking advantage of uncertainties and inefficiencies in the current taxation of financial instruments. With those uncertainties and inefficiencies eliminated, taxpayers will pay taxes on instruments which they currently treat incorrectly.

193. This is not technically entirely true. As is currently the case, certain counterparties will continue to be tax-exempt and also foreign persons. Nonetheless, if there is a sufficiently large distribution of these non-taxpaying counterparties, their gains and losses should net to roughly zero, meaning the government continues to have no net revenue or loss on the taxation of financial instruments. *See* Schizer, *supra* note 1, at 1894.

194. For Republicans at least, the specter of tax increases (or at least non-transparent tax increases) is political suicide. The majority of Republicans in Congress, as well as President George W. Bush, have signed the "Taxpayer Protection Pledge," essentially a pledge to oppose all increases in taxes. *See* William G. Gale & Brennan Kelly, *The "No New Taxes" Pledge*, BROOKINGS INSTITUTION AND TAX POLICY CENTER, at 4 (June 4, 2004), http://www.brookings.edu/views/papers/gale/20040604.pdf. The Taxpayer Protection Pledge is "enforced" by Americans for Tax Reform, "an organization that has shown no remorse in attacking supporters of tax increases" *Id.* at 6. In addition, popular

rates on the rich, the poor, or the middle-class. Certain individuals and corporations will pay more in tax than they would under the various current rules, while others will pay less, but no group will collectively feel the pinch of additional taxes. Furthermore, if forced to sell the change to his or her constituents, a politician could explain that reform also has non-tax economic benefits: by simplifying and eliminating inefficiencies, investors will not spend the money and time currently required to understand and comply with, or plan around, the cubbyholes of current derivative taxation.

VI. CONCLUSION

This Article builds on the recent explosion of literature discussing the appropriate taxation of financial instruments, an explosion that is, itself, a result both of the explosion of new financial instruments and the current inability of the Code to deal effectively and efficiently with financial instruments. The current cubbyhole approach leads to a lag in the enactment of new rules, as well as borders between instruments that are sufficiently porous to allow significant arbitrage opportunities for taxpayers with the resources to exploit these opportunities. In addition, as financial instruments become more available to less-sophisticated investors, some greater measure of clarity will be both useful and necessary.

An elective regime ignores many of the subtle economic distinctions between different financial instruments. The purpose of this Article, however, has been to demonstrate that such subtle distinctions are unimportant in taxing financial instruments. Because of their zero-sum nature, and investors' ability to enter into instruments based on their after-tax value, the taxation of financial instruments is not a revenue-raiser for the government, nor a drain on the revenue of investors. Instead, the taxation of financial instruments serves to discourage taxpayers from trying to recharacterize non-risk-based income as financial instrument income.

Although this Article has shown that such reform is practical and painless for taxpayers *and* politicians, it has not considered practical means of bringing such reform to the forefront of the public's or Congress's attention. Commentators have been discussing the problems with the taxation of financial instruments for at least the last decade and a half, and no

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belief holds that George H.W. Bush lost his reelection bid because he violated his promise of "no new taxes." *Id.*

fundamental reform has been forthcoming. This Article has attempted to present a reform that would work, but without somebody clamoring for reform it is unlikely to happen. With a framework for reform, the next challenge will be to cause the general public (most of whom are unaffected, at least directly by financial instruments) to care.