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of the U.S. House Committee on Ways and Means

“Financial Products Tax Reform Discussion Draft”
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Chairman Tiberi, Ranking Member Neal, and distinguished Members of the Subcommittee, thank you for allowing me the opportunity to share my views on the Ways & Means Committee (the “Committee”) financial products tax reform discussion draft (the “Discussion Draft”). I commend the Committee for releasing a draft that announced bold steps to reform the taxation of financial products; I believe these steps have the potential to simplify tax rules, reduce manipulation, minimize compliance burdens, and improve tax administration. The Discussion Draft accomplishes these benefits by simplifying the myriad of choices that confront taxpayers. In my view, these choices stem from our tax rules accommodating too many interests. There is a constituency for virtually every provision in the Code, but there are very few constituencies for simplification. I am pleased to see the Committee pursue that less-travelled path.

My testimony today will focus on the Discussion Draft’s proposals to reform the tax rules for derivatives and securities investments. My comments will follow the order of the draft: (1) provide uniform tax treatment of financial derivatives, (2) permit identifications of hedges that have been made for financial accounting to be used for tax, (3) require investors to use average basis to calculate the gains and losses on sale of their securities, and (4) extend the wash sale rules to repurchases by related parties. I will not comment on the debt proposals, which I support, and which are being addressed by other witnesses today, and other groups later.²

I wholeheartedly endorse the Committee’s Discussion Draft and believe the Committee could further advance its goals by

- requiring swaps dealers to report derivative valuations to their counterparties and, perhaps, to the IRS, to help determine the mark-to-market valuations,
- requiring investors to use first-in, first-out (“FIFO”) as the method to calculate stock basis,

¹ The views and any mistakes herein are my own and not necessarily those of the Tax Policy Center, the Urban Institute, the Brookings Institution, or any other entity or person.

² The debt proposals largely track options from the American Bar Association Section of Taxation in the report “Options for Tax Reform Relating to Financial Transactions” dated Dec. 2, 2011, which I helped review. <http://www.americanbar.org/content/dam/aba/administrative/taxation/120211comments-2.authcheckdam.pdf> The Section is now preparing further comments on the Discussion Draft that I expect to be submitted soon.

- requiring brokers (and taxpayers) to calculate stock basis by combining multiple accounts at a firm into one account, rather than reporting each account separately, and
- revising the related party rule for the wash sale of stock to make the suspended loss temporary, not permanent, and using the same related party rule for transactions governed by other tax provisions.

1) Provide Uniform Tax Treatment of Financial Derivatives

Derivatives are contracts that are valued by reference to other assets or indices. They include forward contracts, futures, options, notional principal contracts, and many other arrangements. The term “swaps” often is used to encompass this broad range of derivatives, as, for example, in the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (“Dodd-Frank”).³

Investors can enter derivatives either on an exchange or off (i.e., over-the-counter or “OTC”). Historically, derivatives have been traded on both markets but, under Dodd-Frank, will shift increasingly to exchanges and clearinghouses. This legislation requires, eventually, the clearing of most OTC derivatives through a regulated central counterparty (a clearinghouse) and the trading of these contracts on a regulated exchange.⁴ However, many OTC transactions are not centrally cleared yet.⁵

The current taxation of derivatives is complicated and inconsistent. There are different rules for different derivatives, for different uses of the same derivative, and for different taxpayers owning the same derivative. As a result, two derivatives that are economically the same may be taxed quite differently. Investors often use these tax differences to manipulate the character, timing, or source of their income in order to reduce their tax liability. For example, investors continue to use exchange-traded “notes” to wrap derivatives around investment strategies in order to convert ordinary income and short-term capital gains into long-term capital gains, thus deferring taxes and paying lower rates.

Financial accountants and regulators have made a lot of progress with these problems in the past 15 years, by shifting to mark-to-market for derivatives. In 1998, the Financial Accounting Standards Board (“FASB”) issued Statement of Financial Accounting Standards No. 133, *Accounting for Derivative Instruments and Hedging Activities* to address two key accounting problems for derivatives: (1) the effect of derivatives was not transparent in basic financial statements; (2) the accounting guidance for derivative instruments and hedging activities was incomplete, inconsistent, and difficult to apply.⁶ The FAS 133 rules required companies to measure all derivatives on their balance sheet at “fair value,” which is very similar

³ Public Law No. 111-203.

⁴ See Nijenhuis, *New Tax Issues Arising from the Dodd-Frank Act and Related Changes to Market Practice for Derivatives*, 2 Columbia Journal of Tax Law 1, 3 (2011).

⁵ Certain interest rate swaps and credit default swaps currently are cleared on central exchanges. Other swaps are expected to be cleared later. Foreign exchange swaps are exempt.

⁶ FAS 133 now has been codified into Accounting Standards Codification (“ASC”) 815.

to the mark-to-market method of tax accounting for these positions.⁷ Although these rules were widely considered the most complex accounting standards ever issued by the FASB, these rules now have been widely implemented and are generally familiar to the accounting community.

Congress has long recognized that a mark-to-market accounting method can address many problems of transparency and consistency for tax. But Congress has applied mark-to-market only to property that has been either exchange-traded (with market valuations that were readily available) or valued for financial reporting. In 1981, Congress first required mark-to-market for futures contracts that were exchange-traded.⁸ Most recently, in 1993, Congress required mark-to-market for securities of dealers because, in large part, the dealers valued their securities at market for financial accounting purposes.⁹

The Discussion Draft has proposed a unified approach to the taxation of derivatives: the mark-to-market method of accounting that now applies to the securities of dealers. For tax purposes, the Discussion Draft would treat each derivative (other than business hedges) as if it were sold at the end of each year, and it would require any gains or losses to be recognized annually. These gains and losses would be ordinary. The Discussion Draft's goal is to make the taxation of derivatives straightforward, which would disentangle taxpayers from various special rules and exceptions and eliminate most opportunities to manipulate income from derivatives.

A uniform mark-to-market of derivatives has long been the “holy grail” of tax policy for financial products.¹⁰ The Committee is almost there. And, I believe the Committee can get there, with a little help on the valuation of derivatives, which is possible as a result of the evolution of financial accounting and the enactment of Dodd-Frank.

The Discussion Draft acknowledges the critical element of valuation for the mark-to-market method of accounting for derivatives. It authorizes the IRS to issue regulations to permit taxpayers to establish fair market value from the valuations they use for financial reporting or credit purposes. However, to help the mark-to-market proposal succeed, I believe the Committee should offer more help with the valuation of derivatives.

I recommend the Committee require swap dealers to send information returns annually on the valuation of their derivatives to their counterparties (and to the IRS). I recommend the counterparties' use of these valuations be presumed correct, unless the IRS could establish otherwise. The proposal also should accept market conventions, like mid-market pricing (i.e., between a bid and ask price), which I believe adequately reflects fair market value (although, technically, is not the price a dealer or a customer could “buy” or “sell” a derivative.)

⁷ I first compared the financial and tax accounting for derivatives in Rosenthal and Price, *Tax and Accounting for Derivatives: Time for Reconciliation*, Tax Notes 895 (1999).

⁸ Sec. 1256(a), which requires regulated futures contracts and other exchange-traded derivatives to be marked to market, and the gains and losses treated as 60 percent long-term and 40 percent short-term capital.

⁹ Sec. 475, which requires securities of securities dealers to be marked to market, and the gains and losses treated as ordinary. H.R. Rep. No. 103-111, at 661 (1993).

¹⁰ See, for example, Daniel Halperin, *Saving the Income Tax: An Agenda for Research*, 77 Tax Notes 967 (1997), p. 967; Alvin C. Warren, Jr., *Commentary: Financial Contract Innovation and Income Tax Policy*, 107 Harvard Law Review 460 (1993).

In 2012, pursuant to Dodd-Frank, the Commodities Futures Trading Commission (“CFTC”), **required** swap dealers to provide their clients with a daily mark for both cleared and uncleared swaps, a broadly-defined term.¹¹ For cleared swaps, a dealer must generally notify the counterparty of the counterparty’s right to receive, upon request, a daily mark from the appropriate derivatives clearing organization.¹² For uncleared swaps, a dealer must provide the counterparty with a daily mark, which is the mid-market mark of the swap.¹³

As noted earlier, the tax law currently requires securities dealers to mark-to-market their derivatives in order to determine their income. Presumably, dealers would use the same valuations for their reports to customers and their own tax returns (which would allow the IRS to audit the value). And, if both parties to a derivative use the same valuations, the potential for over- or under-valuation (or whipsaw of the IRS) is reduced. Securities dealers might object to reporting valuations for tax purposes but, in my view, requiring such reporting advances the transparency goal for derivatives of the Discussion Draft and Dodd-Frank.¹⁴

Perhaps as an alternative, the Committee could limit the scope of its proposal to derivatives that are exchange-traded (or centrally cleared) or valued for financial accounting purposes. Although Dodd-Frank expressly declined to apply mark-to-market to exchange-traded swaps, I believe this step is warranted now.¹⁵ In addition, expanding mark-to-market for derivatives that are marked for financial accounting would add relatively little administrative burden. It could also alleviate the audit burden of these taxpayers by the IRS, permitting the IRS to rely more heavily on financial reporting to check the accuracy of tax reporting.

In sum, I support the broader application of mark-to-market for derivatives, which I expect will reduce the amount of both taxpayer and IRS resources devoted to the taxation of derivatives, an enterprise that has been demanding increasing amounts of effort in recent years. However, as mark-to-market is applied more broadly, I believe the Committee should offer more help on valuation.

2) Permit Identifications of Hedges for Financial Accounting to be Used for Tax

I support the Discussion Draft’s proposal to permit tax identifications that are based on financial accounting. As I noted in the discussion above, the goals of financial and tax

¹¹ CFTC Rule 23.431(d). <http://www.cftc.gov/LawRegulation/FederalRegister/FinalRules/2012-1244> The term swap may not cover some of the derivatives included in the Discussion Draft. I still recommend the Committee require tax reporting of valuation by dealers in most of these cases (e.g., in structured notes), as the dealers are quite capable of doing so. Alternatively, the Committee could exclude these derivatives, unless they are exchange-traded or marked by the taxpayer for financial accounting.

¹² Id. A dealer does not need to issue reports to another swap dealer, a major swap participant, a security-based swap dealer, or a major security-based swap participant.

¹³ The mid-market mark of the swap does not include amounts for profit, credit reserve, hedging, funding, liquidity, or any other costs or adjustments. The daily mark must be provided to the counterparty during the term of the swap as of the close of business or such other time as the parties agree in writing.

¹⁴ And a dealer can disclose that the valuation may not necessarily be the price at which the swap dealer would agree to replace or terminate the swap, which is permitted by the CFTC.

<http://www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2012-1244a.pdf>

¹⁵ Dodd-Frank added Code sec. 1256(b)(2)(B), which expressly excluded swaps and similar agreements are from the mark-to-market requirements of section 1256 of the Code.

accounting often are the same: to measure and time income correctly. Both financial and tax accounting require derivatives being treated as hedges to be identified at the time the derivatives are entered. A company that identifies its hedges and hedged positions upfront cannot use hindsight to identify them differently later to manipulate earnings or income.¹⁶ If the financial accounting identification is unambiguous, it can serve this purpose for tax.¹⁷

3) Require Average Cost Basis for Securities

Under present law, taxpayers may elect several different methods to calculate basis on the sale of securities, including first-in-first-out (“FIFO”), average basis, and specific identification. These methods may generate very different results, leading some sophisticated taxpayers to plan carefully. For example, suppose an investor purchased 100 mutual fund shares at \$10/share on February 1, 2012, 100 shares for \$10.50 on April, 1, 2012, and 100 shares for \$11 on June 1, 2012. If the investor sells 100 shares for \$12/share on March 1, 2013, she could recognize \$200 of gain on a FIFO basis, \$150 on an average basis, or \$100 on a specific identification basis (if she specified the last lot).

The Discussion Draft would require investors to use average basis to calculate their gains and losses, and would repeal FIFO, specific identification, or any other method, for sales on or after January 1, 2014, the effective date. Investors would use this average basis method for each account separately. Capital gains and losses would be long or short-term, depending on how long the investment is held (which would be determined on a FIFO basis). The Discussion Draft would require taxpayers to calculate separately their average basis for securities acquired on or after the effective date and their average basis for securities acquired before the effective date.

Taxpayers have long struggled to calculate and report their stock gains correctly.¹⁸ In 2008, Congress required brokers (including mutual funds) to help taxpayers calculate their gains and losses from the sale of stock, mutual fund shares, debt, and other securities to be specified by the IRS.¹⁹ Congress phased in the effective dates for basis reporting, reserving the most complicated reporting for last.²⁰ Brokers began reporting basis for stock that was acquired on or after January 1, 2011. Next, brokers began reporting basis for mutual fund shares (and stock acquired in connection with a dividend reinvestment plan) that was acquired on or after January

¹⁶ “Concurrent designation and documentation of a hedge is critical; without it, an entity could retroactively identify a hedged item, a hedged transaction, or a method of measuring effectiveness to achieve a desired accounting result.” ASC 815-20-25-3.

¹⁷ Some small differences in the scope of hedges for financial and tax accounting (some financial accounting hedges are not tax hedges and some tax hedges are not financial accounting hedges), might result in inadvertent classifications, which should be accommodated through the “inadvertent error” rule that works well in present law.

¹⁸ In 2006, the GAO estimated that 38 percent of taxpayers with securities transactions misreported their gains and losses. GAO, *Capital Gains Tax Gap: Requiring Brokers to Report Securities Cost Basis Would Improve Compliance if Related Challenges are Addressed* (GAO-06-603, June 2006) at 11. See also Dodge and Soled, *Inflated Tax Basis and the Quarter-Billion-Dollar Revenue Question*, 106 Tax Notes 453 (Jan. 24, 2005) (estimating the misreporting of gains and losses—from all assets—resulted in the loss of \$250 billion in tax revenue over 10 years).

¹⁹ I summarized the history of basis reporting in Rosenthal, *Basis Reporting: Lessons Learned and Direction Forward*, Tax Notes 353 (April 16, 2012). <http://www.urban.org/UploadedPDF/901497-Basis-Reporting.pdf>

²⁰ Sec. 6045(g)(3)(C).

1, 2012. Brokers must report for debt and options acquired on or after January 1, 2014.²¹ Finally, the IRS can require reporting for “other specified securities” at “such later date” determined by the IRS.

Brokers must solicit and maintain customer basis choices, which may be changed at designated times, and use that method to report basis to customers. These multiple choices encourage tax planning, undermine the simplicity of basis reporting, and confuse taxpayers. For example, for mutual fund shares, taxpayers must now decide whether to provide standing instructions to determine the order in which their shares should be sold (for example, highest basis first), whether to identify specific lots of shares to be sold at the time of sale, whether to elect average basis for their shares (separately for each account), and whether to revoke or change their average basis elections.

The Discussion Draft would eliminate that babel of calculations and allow only average cost basis. This approach would cut administrative costs for brokers and make life simpler for investors. Customers would receive standardized reports with no confusing choices, which relatively few investors pursue. (How many of us have ignored the requests by our brokers to make basis elections, and accepted the broker’s default choice for us?)

The Discussion Draft continues to permit basis to be calculated account-by-account. So, if a taxpayer owns the same stock in more than one account, the taxpayer will compute average basis for the stock separately for each account. This approach will permit some tax planning, if a taxpayer maintains multiple accounts.

In general, I think the existence of multiple accounts across brokers is consistent with the goals of reducing compliance burdens for taxpayers and improving administration for the IRS. And we cannot ask brokers to adjust their basis reports to reflect holdings at other brokers. However, I am concerned that some brokers will encourage their customers to open multiple accounts at the same firm, possibly pressuring other brokers to accommodate multiple accounts (and incur needless administrative costs). So, I recommend the Committee require basis be calculated by combining accounts within the same firm, for purposes of both brokerage and taxpayer reporting.

While I applaud the Committee’s decision to permit only one method to determine basis, I believe FIFO would be simpler for investors than average cost. FIFO is more familiar to investors (having been permitted for a longer time, and for both stock and mutual fund shares) than average cost.²² FIFO is the default choice for investors, if they have not elected another method. FIFO establishes the order in which securities are sold to determine holding period (i.e., short- or long-term gains or losses).²³ FIFO is used to identify the securities to which a wash sale basis adjustment is to be made, as described in the next section.²⁴ FIFO calculations require only addition, while average cost calculations require addition and division, which is more challenging arithmetically.

²¹ Notice 2012-34.

²² The IRS first permitted average cost for mutual fund shares in 1971. Treas. Reg. sec. 1.1012-1(e).

²³ Treas. Reg. sec. 1.1012-1(e)(7)(ii).

²⁴ Treas. Reg. sec. 1.1091-1(d).

For securities sold on or after January 1, 2014 (the effective date), the Discussion Draft requires taxpayers to calculate separately their average basis for securities acquired before that date and their average basis acquired on or after that date (i.e., two buckets). Unfortunately, for the first bucket, taxpayers must calculate their gains and losses on their own, unless they can get help from their broker, who might not have maintained basis for all the taxpayer's old stock. Again, I believe the Discussion Draft should require FIFO, rather than average cost, which would save taxpayers the burden of adding and dividing without the support of their broker.

Finally, I believe the proposal should link the buckets for the new basis rule with the effective dates of broker basis reporting. For example, I believe taxpayers should determine basis separately for stock purchased before January 1, 2011 and on or after that date (and, for mutual fund shares, January 1, 2012). If the proposal coordinated the effective date of the new basis rule and the effective date of the existing basis reporting, taxpayers could receive more help from their brokers in the transition to the new basis rule.

4) Extend the Wash Sale Rules to Repurchases by Related Parties

Under sec. 1091, a loss from a “wash sale” is deferred. A “wash sale” is a loss that arises from the sale of stock or securities by a taxpayer who, within a 30-day period before or after the sale, reacquires substantially identical stock or securities. A taxpayer can recover the “wash sale” loss upon the subsequent disposition of the reacquired stock or securities (because the basis of the reacquired stock or security is increased by the disallowed loss).²⁵ Technically, a taxpayer can arrange for a party related to the taxpayer (rather than the taxpayer) to repurchase the stock to avoid the wash sale rules. However, section 267 disallows losses on direct or indirect sales to specified related parties. Under this authority, and under general tax principles, the IRS and the courts have denied a loss for a sale, directly or indirectly, to the taxpayer's wife, wholly-owned corporation, or IRA.²⁶

The Discussion Draft adds a related party rule to the wash sale rules, so the wash sale rules would be triggered by reacquisitions by parties related to the taxpayer, which would include a spouse, dependent, controlled corporation or partnership, IRA, or 529 or 401(k) plans. However, unlike present law, a loss that was prevented by a reacquisition by a related person would be permanently disallowed. Unfortunately, this disallowance creates a trap for the unsuspecting, who might accidentally be caught by its provisions, without intending to make a direct or indirect sale to a related party. For example, taxpayers might sell a stock in their regular brokerage account and, within 30 days, reacquire substantially identical stock in their IRA (perhaps through a dividend reinvestment plan). Or a taxpayer might ask his broker to sell stock for his regular account and, without the taxpayer's knowledge, his wife might ask her broker to buy the same stock for her IRA a couple of weeks later. In my view, the trap is unduly harsh: it converts the wash sale provision from a temporary to a permanent penalty.

²⁵ Sec. 1091(d).

²⁶ *McWilliams v. Comm.*, 331 U.S. 694 (1947) (sale to wife); *Schoenberg v. Comm.*, 77 F.2d 446 (8th Cir. 1935) (loss sale and simultaneous purchase by controlled corporation); *Security First National Bank of Los Angeles*, 28 BTA 289 (1933) (sale to wholly owned corporation); Rev. Rul. 2008-5, I.R.B. 2008-3 (Dec. 20, 2007) (loss sale followed by a repurchase in an IRA).

Instead, I suggest suspending a wash sale loss that arises from an acquisition by a related person, similar to the suspension rule in sec. 267(f)(2), which allows a loss that has been disallowed by a direct or indirect sale from one member of a consolidated group of corporations to another to be allowed after the property is resold to an unrelated person. The amount of the suspended loss, and the character of the loss, whether long- or short-term, should be determined at the time the stock or securities were originally sold.

I do not recommend the deferral rule in sec. 267(d), which permits a disallowed loss to be used by the related party to reduce the related party's subsequent gains (but not losses). I do not believe a loss should be shifted from the original seller to the related party.

Finally, I suggest the Committee define related party similarly for secs. 267 and 1091 (and 1092, losses deferred under the straddle rules), which accomplish similar policy objectives. I prefer the Discussion Draft's definition of related party, which has been updated to include IRAs and exclude separated spouses.