

# DERIVATIVES

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## HEARING

BEFORE THE  
SUBCOMMITTEE ON SELECT REVENUE MEASURES  
OF THE  
COMMITTEE ON WAYS AND MEANS  
U.S. HOUSE OF REPRESENTATIVES  
ONE HUNDRED TENTH CONGRESS  
SECOND SESSION

MARCH 5, 2008

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## **DERIVATIVES**

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**WEDNESDAY, MARCH 5, 2008**

U.S. HOUSE OF REPRESENTATIVES,  
COMMITTEE ON WAYS AND MEANS,  
SUBCOMMITTEE ON SELECT REVENUE MEASURES,  
*Washington, DC.*

The Subcommittee met, pursuant to notice, at 10:00 a.m., in room 1100, Longworth House Office Building, Hon. Richard E. Neal (Chairman of the Subcommittee) presiding.

[The advisory announcing the hearing follows:]

# ADVISORY

FROM THE COMMITTEE ON WAYS AND MEANS

## SUBCOMMITTEE ON SELECT REVENUE MEASURES

FOR IMMEDIATE RELEASE  
February 27, 2008  
SRM-8

CONTACT: (202) 225-5522

### Neal Announces Hearing on Tax Treatment of Derivatives

House Ways and Means Select Revenue Measures Subcommittee Chairman Richard E. Neal (D-MA) announced today that the Subcommittee on Select Revenue Measures will hold a hearing on the tax treatment of certain derivatives. **The hearing will take place on Wednesday, March 5, 2008, in the main Committee hearing room, 1100 Longworth House Office Building, beginning at 10:00 a.m.**

Oral testimony at this hearing will be limited to invited witnesses only. However, any individual or organization not scheduled for an oral appearance may submit a written statement for consideration by the Committee and for inclusion in the printed record of the hearing.

#### FOCUS OF THE HEARING:

The hearing will focus on various forms of derivatives. Interest in certain types of derivatives has increased over the last few years as many innovative structures have reached the financial markets. The hearing will examine the tax treatment of some of these products.

#### BACKGROUND:

A derivative is a financial instrument which derives its value from the value of an underlying asset. Generally, two parties place a bet about a particular stock price, interest rates, or some other financial fact. Derivatives are used to spread risk through hedging or speculating about a specific contingency, and may take the form of an option, forward contract, swap, or contingent bond.

In the case of an option, the holder receives the right, but not the obligation, either to buy or to sell the underlying property for a specified price during a specified period. A "call" is an option to buy and a "put" is an option to sell. Unlike an option, a forward contract obligates the parties to either buy or sell the underlying property for a specified price during a specified period as reflected in the contract. Under a prepaid forward contract, the contract buyer generally makes a payment at the time the contract is executed and is not required to make any additional payment when the contract expires. A swap is in effect a series of cash-settled forward contracts. In some swaps, differences in the value of the underlying property are settled up every governing period while in other swaps, these changes are not taken into account until a final, nonperiodic payment is made at the maturity date. Under a contingent debt instrument, the borrower pays interest (and sometimes a portion of the principal) based on some financial fact. From an economic perspective, contingent debt is sometimes viewed as the synthesis of a standard loan with a derivative such as an option.

The tax consequences for different derivative instruments can be very different even though the instruments are economically similar. The hearing will examine whether there is a need for more uniform tax treatment for various derivative structures.

In announcing the hearing, Chairman Neal stated, “**The expanding derivatives market is already a \$516 trillion global enterprise, only some of which is subject to regulation and transparency. I think it is appropriate for Congress to review the tax rules as they apply to these complex financial products and determine whether changes may be necessary.**”

#### **DETAILS FOR SUBMISSION OF WRITTEN COMMENTS:**

**Please Note:** Any person(s) and/or organization(s) wishing to submit testimony for the hearing record must follow the appropriate link on the hearing page of the Committee website and complete the informational forms. From the Committee homepage, <http://waysandmeans.house.gov>, select “110th Congress” from the menu entitled, “Committee Hearings” (<http://waysandmeans.house.gov/Hearings.asp?congress=110>). Select the hearing for which you would like to submit, and click on the link entitled, “Click here to provide a submission for the record.” Once you have followed the online instructions, completing all informational forms and clicking “submit” on the final page, an email will be sent to the address which you supply confirming your interest in providing a submission for the record. You **MUST REPLY** to the email and **ATTACH** your submission as a Word or WordPerfect document, in compliance with the formatting requirements listed below, by close of business **Wednesday, March 19, 2008. Finally**, please note that due to the change in House mail policy, the U.S. Capitol Police will refuse sealed-package deliveries to all House Office Buildings. For questions, or if you encounter technical problems, please call (202) 225-1721.

#### **FORMATTING REQUIREMENTS:**

The Committee relies on electronic submissions for printing the official hearing record. As always, submissions will be included in the record according to the discretion of the Committee. The Committee will not alter the content of your submission, but we reserve the right to format it according to our guidelines. Any submission provided to the Committee by a witness, any supplementary materials submitted for the printed record, and any written comments in response to a request for written comments must conform to the guidelines listed below. Any submission or supplementary item not in compliance with these guidelines will not be printed, but will be maintained in the Committee files for review and use by the Committee.

1. All submissions and supplementary materials must be provided in Word or WordPerfect format and **MUST NOT** exceed a total of 10 pages, including attachments. Witnesses and submitters are advised that the Committee relies on electronic submissions for printing the official hearing record.
2. Copies of whole documents submitted as exhibit material will not be accepted for printing. Instead, exhibit material should be referenced and quoted or paraphrased. All exhibit material not meeting these specifications will be maintained in the Committee files for review and use by the Committee.
3. All submissions must include a list of all clients, persons, and/or organizations on whose behalf the witness appears. A supplemental sheet must accompany each submission listing the name, company, address, telephone and fax numbers of each witness.

Note: All Committee advisories and news releases are available on the World Wide Web at <http://waysandmeans.house.gov>.

The Committee seeks to make its facilities accessible to persons with disabilities. If you are in need of special accommodations, please call 202-225-1721 or 202-226-3411 TTD/TTY in advance of the event (four business days notice is requested). Questions with regard to special accommodation needs in general (including availability of Committee materials in alternative formats) may be directed to the Committee as noted above.

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Chairman NEAL. Let me call this meeting to order, and I would invite all to take their seats. I want to welcome everyone to this hearing on the taxation of derivatives by the Subcommittee on Select Revenue Measures.

This topic is not for the faint of heart. Just explaining the different types of derivatives can fill volumes, plus the market is con-

stantly evolving and growing. The Bank for International Settlements recently estimated that the market for derivatives has now exceeded \$500 trillion in notional amounts just for the first half of last year. For those taking notes, \$500 trillion is half a quadrillion.

Complexity is the name of the game in the derivatives market, but I believe that it is important for Congress to understand how this market operates and for the Committee to understand how these products are taxed. In that sense, this is a learning opportunity for all today.

It would be easy for us to assume the regulators are taking care of this. Some of us who have long-term memories in Congress, we know that that is not always the case. It would be easy for us to dismiss these products as ones that only sophisticated investors use, minimizing any impact to our economy. It has been said that the road to success is dotted with many tempting parking places. But this morning, we plan to keep on driving.

No doubt, derivatives play an important role for businesses and investors to minimize or control risk. But they are also an attractive tool for speculators. Warren Buffett has referred to derivatives as “financial weapons of mass destruction.” If we think back to the collapse of Enron, or even farther back to long-term capital management, we understand how the abuse of derivatives can have a negative impact not only on the parties to the contract but also on the market and the economy.

Just last Friday, the market took a hit when one insurer devalued its holdings by \$5 billion in one derivative, the credit default swap. As we will hear today in testimony, investors and regulators deserve some certainty and, perhaps more importantly, clarity with respect to derivatives. I believe we set up inherent conflicts when derivatives enjoy a better tax treatment than the underlying asset.

The first panel today will discuss the area of derivatives more broadly, while the second panel will focus on prepaid forward contracts. I believe we have assembled a diverse group of witnesses today to help us navigate this complex area. There is an African proverb that says that smooth seas do not always make skillful sailors. I expect the testimony today will show some divergent viewpoints, but hopefully at the end Mr. English and I will be more skillful sailors.

With that, I would like to recognize my friend Mr. English for his opening statement.

Mr. ENGLISH. Mr. Chairman, I first of all want to thank you for calling this hearing today. I am looking forward to another active year for this Subcommittee dealing with many of the extraordinary issues confronting Congress with respect to the Tax Code. I want to thank you in advance, Mr. Chairman, for remaining receptive to input from our side of the aisle on the Subcommittee’s agenda, as you were all last year.

While I look forward to the nuances of all the testimony today, I am particularly interested in the second panel’s framing of the complex issue of exchange traded notes, as well as their views on whether the current tax treatment of these products is appropriate or warrants change.



Mutual funds have sought for some time the ability to defer some or all of the gains that currently must be distributed and taxed at the investor level, and I have been sympathetic with that project.

Additionally, some of the same companies that offer mutual funds have developed a product that provides many of the benefits of a mutual fund, including diversification and exposure to a variety of types of risk, without requiring annual distributions of income. In my view, this demonstrates that clever minds can always find a way through and around the Tax Code to achieve a desired result.

In light of this, it may prove in the long run perhaps more fruitful to look at the labyrinth of rules currently on the books for financial products generally and determine whether wholesale revision is needed. Yet today's hearing, I think, in embarking on the narrower mission of determining whether a change in our Tax Code relative to ETNs is warranted, is a worthwhile endeavor.

Given the fundamental difficulty of undertaking a more complicated reform, I sympathize with the Chairman's desire to examine this narrower tax issue on its own. Nevertheless, I want to raise the concern, having reviewed the legislative approach favored by the Chairman, that we not simply serve to replace one area of examination for another. After all, the same ingenuity and creativity that creates innovative financial products in capital markets will continue to evolve.

I favor solutions philosophically that provide for less taxation on capital overall rather than more. In the 109th Congress, I joined many of my Ways and Means colleagues in cosponsoring the GROWTH Act, introduced by Representative Paul Ryan, that would allow some deferral of gains on mutual funds for investors who reinvest those amounts.

Generally speaking, if an issue of equity between two functionally similar financial products arises, I tend to favor reducing taxes on one rather than raising taxes on the other. But I do think the notion of tax equity is something that we can fruitfully pursue today.

With that, Mr. Chairman, I look forward to the testimony and I look very much forward to getting the guidance from these panels that we will need to parse this issue.

Chairman NEAL. Thank you, Mr. English.

Let me welcome our witnesses today. On the first panel we will hear from Michael Desmond, Tax Legislative Counsel in the Office of Tax Policy at the Treasury Department. Mr. Desmond is a veteran of Ways and Means hearings, and we look forward to his comments today.

Next we will hear from two tax law experts, Professor Alex Raskolnikov from Columbia Law School and Professor Reuven Avi-Yonah from the University of Michigan Law School.

Finally, on Panel 1 we will hear from Keith Styracula, Chairman of Structured Products Association, a trade group with expertise in derivatives.

With that, I would call upon Mr. Desmond to proceed.

**STATEMENT OF MICHAEL J. DESMOND, TAX LEGISLATIVE  
COUNSEL, UNITED STATES DEPARTMENT OF THE TREASURY**

Mr. DESMOND. Mr. Chairman, Ranking Member English, and distinguished Members of the Subcommittee, thank you for the opportunity to discuss with you today the Federal tax treatment of certain derivative products, including prepaid forward contracts.

With the growing complexity and sophistication of our financial markets, the tax treatment of derivatives plays an increasingly important role in the efforts of the Treasury Department and the IRS to administer the Nation's tax laws. We appreciate the Subcommittee's focus on these important issues.

The tax treatment of prepaid forward contracts is of particular current interest to the Treasury Department. Last December we issued a formal notice announcing that we are considering the subject and requesting public comments. Although we have not determined how to proceed with respect to the notice, for purposes of today's hearing I thought it would be helpful to describe the context in which we have seen the tax issues associated with prepaid forward contracts arise, and some of the challenges that we see in addressing those issues.

Historically, forward contracts developed as a means for parties to hedge against the risk of price fluctuations in their ordinary business transactions. By fixing the price at which some asset will be acquired or sold in the future, a forward contract can reduce the business risk of adverse price movements.

Forward contracts have grown beyond their historical origins as business hedges, however, and are now commonly used not only to manage risk but also by investors to speculate on the future value of a referenced asset.

A traditional forward contract is an agreement in which one party agrees to purchase and the other party agrees to sell and deliver a specific referenced asset at a specific time for a specific price. So-called prepaid forward contracts require the purchasing party to pay the purchase price upon execution of the contract rather than on the later delivery date.

Because the buyer pays in advance, the price is less than it would be in a standard forward contract. A question for the tax system is whether the buyer of a prepaid forward contract should recognize ordinary income over the period of the contract on the grounds that the prepayment is analogous to a loan from the buyer to the seller.

The Federal tax law contains a number of specific rules governing the tax treatment of stock, debt, options, traditional forward contracts, futures contracts, certain swaps, and various other financial instruments. Different rules may apply to identical instruments depending on the circumstances, including whether the taxpayer that is a party to the contract is an investor, a trader, a dealer, or a business hedger; whether the taxpayer is domestic or foreign; and whether the referenced asset triggers specific tax treatment, as happens with foreign currency.

The resulting set of complex rules reflects various policy choices that Congress and the Treasury Department have made over the years with respect to the timing, character, and source—that is, foreign or domestic—of income or loss.

Financial innovation challenges the current system of taxing derivatives because that system has historically approached new financial instruments by assigning them to various categories or cubbyholes for which there are established rules.

Without clear guidance about which category is appropriate for a new transaction, taxpayers are left to deal with uncertainty in structuring their affairs, and the IRS is presented with challenges in administering the tax law.

Because this cubbyhole approach often responds not to the substance of the transaction but to its formal attributes, the approach results in different tax consequences for economically equivalent transactions.

In my written testimony, I give three examples to illustrate this inconsistency in the context of prepaid forward contracts. The first example in my written testimony involves a simple purchase of stock for \$100, and the sale of that stock 2 years later when the price has risen to \$125.

In the second example, there are two separate agreements entered into by the investor. In the first agreement, the investor buys a zero coupon bond for \$100. That bond matures 2 years later for \$112, reflecting an interest rate of approximately 6 percent.

In the second agreement in that second example, also entered into on the first day, X, the taxpayer, enters into a cash-settled forward contract to purchase a share of stock in 2 years for \$112. In that second example, X receives \$125 after 2 years, consisting of \$112 from redemption of the bond and \$13 from settlement of the forward contract on the stock which has risen in value to \$125.

In the third example, involving a prepaid forward contract, on day one X enters into a prepaid forward contract, to purchase a share of stock in 2 years. Under the contract, the taxpayer pays \$100 on the first day and receives, after 2 years, \$125.

These three examples each involve economically equivalent transactions. In each case, the investor or the taxpayer paid \$100 on the first day and received \$125 2 years later for an economic return of \$25. However, on an aftertax basis, the transactions differ considerably.

In the first example, the taxpayer pays tax on its entire \$25 economic return on a deferred basis at the long-term capital gain rate.

In the second example, our tax rules require the taxpayer to accrue \$12 in interest income into taxable income on a current basis and pay tax on those accruals in the first and second year at ordinary tax rates. The taxpayer pays an additional \$13 attributable to the forward contract on a deferred basis at long-term capital gain rates.

In attempting to assign the third example to one of the traditional cubbyholes for which the tax system has prescribed rules, investors in the taxpayer's position often conclude that the transaction is not debt under common law tax principles since there is no guaranteed return of principal.

Investors in that taxpayer's position often also conclude that their counter party in the transaction is not required to hold any stock, and the counter party is therefore not acting as their agent holding the stock on their behalf. These taxpayers, rejecting both debt and agency characterizations, generally assert that the trans-

action should be treated as a forward contract taxed on a deferred basis only upon realization.

The Treasury Department and IRS have been aware for some time of the difficult issues raised with respect to the tax treatment of prepaid forward contracts. To date, we have not issued published guidance on these contracts with referenced assets other than foreign currency.

In 2006, we began to learn of significant growth in the number of prepaid forward contracts, often referred to as exchange traded notes or ETNs, being offered to retail investors. The growth of ETNs and the migration of prepaid forward contracts into the portfolios of retail investors was an occasion for us to revisit the core issue presented, that is, whether the Federal Income Tax System should require a current accrual of income on these instruments.

Although it would be very desirable for us to clarify the law in this area, and we are actively looking to do so in the context of the notice we published, to date we have reached no conclusion about how to proceed, about what the right result is, and about whether that result can be researched through administrative guidance or through legislative action.

Thank you, Mr. Chairman, Ranking Member English, and Members of the Subcommittee for providing an opportunity for us to participate in today's hearing on this important subject. I am pleased to take any of your questions on this important issue.

[The prepared statement of Michael J. Desmond follows:]



## **U.S. TREASURY DEPARTMENT OFFICE OF PUBLIC AFFAIRS**

EMBARGOED UNTIL 10 A.M. EST March 5, 2008  
CONTACT Andrew DeSouza (202) 622-2960

### **PREPARED TESTIMONY OF TREASURY TAX LEGISLATIVE COUNSEL MICHAEL DESMOND BEFORE THE SUBCOMMITTEE ON SELECT REVENUE MEASURES OF THE HOUSE COMMITTEE ON WAYS AND MEANS**

**Washington, DC**--Mr. Chairman, Ranking Member English, and distinguished Members of the Subcommittee:

Thank you for the opportunity to discuss with you today the Federal tax treatment of certain derivative products, including prepaid forward contracts. With the growing complexity and sophistication of our financial markets, the tax treatment of derivatives plays an increasingly important role in the efforts of the Treasury Department and the Internal Revenue Service ("IRS") to administer the nation's tax laws, and we appreciate this Subcommittee's focus on these issues.

The tax treatment of prepaid forward contracts is of continuing interest to the Treasury Department. Last December, we issued Notice 2008-2 (the "Notice"),<sup>1</sup> announcing that we are considering the subject and requesting public comments with respect to a number of specific issues. The period for submitting formal comments remains open, and the Notice has generated significant discussion on this important issue.

Although it is premature to offer any conclusions or positions with respect to how we might move forward with respect to the issues raised by the Notice, we look forward to continuing to work with this Subcommittee as you consider proposals that would affect the tax treatment of derivatives and, in particular, proposals to change the tax law with respect to prepaid forward contracts. To that end, it may be productive to describe the context in which we have seen this issue arise and some of the challenges we see in addressing it. It may also be helpful to provide some background regarding the Notice in order to clarify the context in which we are considering the issue and to develop a mutual understanding of the issues presented.

#### **General Background Regarding Forward Contracts**

Historically, forward contracts developed as a means for parties to hedge against the risk of price fluctuations in ordinary business operations. For example, a manufacturer might enter into a forward contract on steel that is used as a component in its production process to hedge against the risk that the

<sup>1</sup> 2008-2 I.R.B. 252 (Jan. 14, 2008).

price of steel will rise. For similar reasons, an airline might enter into a forward contract on jet fuel to hedge against the risk of fuel price increases. By fixing the price at which some asset will be acquired (or sold) in the future, a forward contract can reduce the risk of adverse price changes and, thereby, reduce the cost of doing business. Forward contracts, however, are not solely used in hedging transactions. Parties can (and do) use forward contracts to speculate on the future value of a reference asset.

A traditional forward contract is an agreement in which one party (in the “long position”) agrees to purchase, and the other party (in the “short position”) agrees to sell and deliver, a specific asset (the “reference asset”) at a specific time for a specific price (the “forward price”). Generally, the party in the long position will profit from an increase in the price of the reference asset, while the party in the short position will profit from a decrease in the price.

Parties to a forward contract often settle their obligations under the contract with a single, net, cash-settlement payment (rather than through physical delivery of the reference asset and payment of the full forward price). In typical “cash-settled” contracts, at the time the contract settles, the forward price set forth in the contract is compared to the then-current (or “spot”) price of the reference asset. If that spot price is less than the forward price, then the long position pays the difference; if that spot price is more than the forward price, then the short position pays the difference.

The forward price for a nonperishable commodity or a financial instrument generally equals the reference asset’s spot price at the time the contract is executed, plus the “cost to carry” (or hold) the asset for the term of the contract. “Cost to carry” represents interest (and other costs) that a party would have to pay if it were to borrow to purchase and “carry” the reference asset during the term of the arrangement.<sup>3</sup> Consequently, the forward price implicitly includes a component that is calculated by reference to the time value of money – that is, interest. If the time value of money were not properly factored in to the forward price, arbitrageurs would be able to earn risk-free profits.<sup>4</sup>

Some contracts (referred to as “prepaid forward contracts”) require the party in the long position to pay the purchase price upon execution of the contract, rather than on the later delivery date. In these circumstances, the amount paid typically reflects only the spot price of the asset to which the contract refers (plus any warehousing or similar expenses), but does not reflect a time value component. Again, if this were not the case, arbitrageurs could earn a risk-free profit.

#### **General Background Regarding Taxation of Derivatives**

The Internal Revenue Code and Treasury regulations contain a number of specific rules governing the Federal tax treatment of stock, debt, options, traditional forward contracts, futures contracts, certain

<sup>2</sup> For example, the “cost to carry” includes any warehousing, insurance, and similar expenses that a party would have to pay if it were to hold (or “carry”) the asset during the term of forward contract. These costs arise more frequently in the context of forward contracts on commodities.

<sup>3</sup> Any expected cash yield on the asset underlying the forward contract (for example, dividends on stock) is typically subtracted from the forward price. (Because it is a benefit, rather than a cost, of holding the asset over the term of the contract, it is like a negative “cost to carry.”)

<sup>4</sup> For example, if the forward price were too high (i.e., if it were in excess of the spot price plus the cost to carry, including this time value component), an arbitrageur could borrow at market interest rates to purchase the reference asset at its spot price today and simultaneously take the short position on the forward contract. Similarly, if the forward price were too low (i.e., if it were below the spot price plus the cost to carry, including this time value component), an arbitrageur could short sell the reference asset today (i.e., borrow the asset and sell it in the market for its current price) to generate cash proceeds to purchase a bond paying market interest rates and simultaneously take a long position on the forward contract.

swaps, and various other financial instruments. Different rules may apply to identical instruments in different contexts. Thus, for example, a forward contract may be taxed differently if it is executed by an investor,<sup>5</sup> a trader,<sup>6</sup> a dealer,<sup>7</sup> or a business hedger.<sup>8</sup> An identical forward contract may also be taxed differently depending on whether it is executed by a domestic or a foreign person,<sup>9</sup> or whether it derives its value from certain reference assets (such as foreign currency).<sup>10</sup> In addition, a single forward contract may involve different types of taxpayers as counterparties on opposite sides of the same contract. Thus, a single forward contract often generates asymmetrical tax consequences for the parties.

The resulting set of complex rules reflects various policy choices that Congress and the Treasury Department have made over the years with respect to the timing of income and loss, the character (capital or ordinary) of income and loss, and the source (domestic or foreign) of income and loss.

Financial innovation challenges the current system of taxing derivatives, because the system generally approaches new financial transactions by attempting to assign them to various categories (of the nature described above) for which there are clearly established rules. These categories are often colloquially referred to as “cubbyholes.” Absent clear guidance as to which category a new transaction might fit in to, taxpayers are left to deal with uncertainty in structuring their affairs and the IRS is presented with difficulties in administering the tax law.

Unavoidably, this “cubbyhole” approach results in different tax consequences for economically equivalent transactions. For example, if a “triple-A” rated company issues preferred stock that is required by its terms to be redeemed on a specific date, that stock may be economically

<sup>5</sup> If an investor executes a traditional forward contract with respect to an asset that is a capital asset for that investor, the contract is treated as an “open transaction” for tax purposes — that is, it has no tax effect until the transaction is ultimately settled. *See, e.g., Lucas v. North Texas Lumber Co.*, 281 U.S. 11 (1930). If the forward contract is settled by physical delivery of the reference asset, the seller (that is, the short position) recognizes capital gain or loss at the time it delivers the asset. The amount of gain or loss is determined by reference to the seller’s basis in the asset and the forward price received. Likewise, the buyer (that is, the long position) takes a basis in the asset equal to the forward price it pays, and realizes capital gain or loss upon its ultimate disposition of the asset. If, instead, the forward contract is cash settled (that is, the “losing” party makes a cash payment), the recipient recognizes capital gain and the payor recognizes a commensurate amount of capital loss at the time the payment is made. *See* section 1234A. Special rules change these results in certain circumstances (e.g., if the forward contract is part of a straddle (section 1092), a conversion transaction (section 1258), a constructive sale (section 1259), or a constructive ownership transaction (section 1260)).

<sup>6</sup> A “trader” that elects to have section 475(f) apply must “mark to market” the forward contract (that is, treat the position as if it is sold for its fair market value at the end of each tax year) and treat the resulting gain or loss as ordinary (rather than capital) in character.

<sup>7</sup> A “securities dealer” must “mark to market” forward contracts with respect to securities (that is, treat the position as if it is sold for its fair market value at the end of each tax year) and treat the resulting gain or loss as ordinary (rather than capital) in character. A “commodities dealer” may elect this treatment. *See* section 475.

<sup>8</sup> A “hedger” must match the timing of the gain or loss recognition on the forward contract with the timing of the gain or loss recognition on the item being hedged. *See* Treas. Reg. §1.446-4. The gain or loss is typically ordinary, so long as appropriate identifications are made. *See* section 1221(a)(7).

<sup>9</sup> For example, foreign persons are taxed at graduated rates on net income that is “effectively connected” with a U.S. trade or business. *See* sections 871(b) and 882. In the absence of a U.S. trade or business, foreign persons are generally taxed at a flat 30-percent rate on certain gross income from U.S. sources. *See* sections 871(a) and 881. Tax treaties often change these results. If the foreign person is a “controlled foreign corporation,” the tax consequences to U.S. shareholders depend on a number of complicated variables, such as whether the asset underlying the forward contract is a commodity, and whether it is a hedging transaction.

<sup>10</sup> In certain circumstances, a forward contract on foreign currency is “marked to market.” *See* section 1256. Gain or loss on these contracts is typically ordinary in character, but, in certain circumstances, taxpayers can elect to treat the gain or loss as capital. *See* section 988.

indistinguishable from that company's subordinated debt with the same maturity date. For both the company and its investors, however, these two transactions are taxed differently. Financial innovation amplifies this phenomenon (that is, different tax treatment of economically equivalent transactions) by increasing the number of situations in which it materializes. A single "hybrid" instrument that cannot be easily classified under the existing taxonomy may combine traditional instruments such as stock and debt. Alternatively, combinations of separate transactions may produce net cash flows that replicate a traditional instrument, thus creating a "synthetic" version of the traditional one, but with different tax consequences.

The following three examples illustrate this phenomenon in the specific context of prepaid forward contracts:

Example 1. On date 1, X (a hypothetical domestic investor) buys a share of stock of ABC Inc. for \$100. Two years later (on date 2), X sells the stock for its fair market value of \$125.

Example 2. On date 1, X buys a "zero coupon bond"<sup>11</sup> (the "bond") for \$100. The bond was issued by Corp Q on date 1 and matures in two years (on date 2) for \$112, reflecting an interest rate of approximately 6%. On date 1, X also enters into a cash-settled forward contract to purchase a share of stock of ABC Inc. from Y in two years (on date 2) for \$112. Two years later (on date 2), the fair market value of a share of stock of ABC Inc. is \$125. On date 2, X receives a total of \$125, consisting of \$112 from Corp Q in redemption of the bond, and \$13 from Y in settlement of the forward contract.

Example 3. On date 1, X enters into a cash-settled prepaid forward contract to purchase a share of stock of ABC Inc. in two years (on date 2). Pursuant to the contract, X pays Y \$100 on date 1. In exchange, Y agrees to pay X on date 2 the fair market value on that date of a share of stock of ABC Inc. The contract does not require Y to own or acquire any stock of ABC Inc. Two years later (on date 2), the fair market value of a share of stock of ABC Inc. is \$125. On date 2, X receives \$125 from Y in settlement of the forward contract.

Aside from their tax consequences, these transactions are economically equivalent. In each case, X paid \$100 on date 1 and received \$125 on date 2, for an economic return of \$25. However, on an after-tax basis, these transactions differ considerably.

In Example 1, X pays tax on its entire \$25 economic return on a deferred basis (on date 2) at the long-term capital gains rate. This result follows from the current realization-based system of taxation.

In Example 2, X accrues \$12 (attributable to the bond) into taxable income on a current basis and pays tax on these accruals in years 1 and 2 at ordinary income rates. X pays tax on the \$13 attributable to the forward contract on a deferred basis at long-term capital gain rates. This result follows from the respect the current tax system generally affords to the separate transactions (the bond and the forward) and the specific tax rules that apply once each is assigned to a separate category.

What do these principles say about the manner in which Example 3 (the prepaid forward contract) should be taxed? In particular, does current law require X to bifurcate (or does it prevent X from bifurcating) the single contract into separate economic components for tax purposes? As a matter of market practice, investors in X's position in Example 3 typically do not bifurcate. Instead, they

<sup>11</sup> A zero-coupon bond is a debt security that does not pay interest on a current basis but instead, is issued at a discount to its nominal (or "face") value. (The discount generally reflects the prevailing market interest rate.) For U.S. tax purposes, all holders of bonds that are originally issued with such a discount (such as X, in Example 2) must generally accrue the "original issue discount" into income as interest over the term of the bond. Thus, the holders will have an income tax liability based on this accrued income even though they do not have any current cash flow from the bond. See section 1272.



generally attempt to assign the transaction to only one of the traditional categories for which the tax system has prescribed rules. Investors in X's position often conclude that the transaction is not indebtedness under common law tax principles. They emphasize that, unlike traditional debt, which guarantees a return of principal, there is a meaningful likelihood that a significant portion of the \$100 amount advanced may not be repaid because the value of ABC Inc. stock may go down. Furthermore, investors in X's position often conclude that their counterparty in the transaction is not acting as their agent, holding ABC Inc. stock on their behalf, stressing that X cannot be sure whether its counterparty (Y) even owns stock of ABC Inc. during the term of the transaction.

Having concluded that neither the debt nor the agency characterization is proper, investors in X's position generally assert that the transaction should be treated as a forward contract, taxed only upon realization. This result in Example 3 is consistent with the result in Example 1 (where tax is not paid until realization), but not with the result in Example 2 (where the investor is required to pay tax on accrued but unpaid income), even though all three examples involve economically equivalent transactions.

#### **Notice 2008-2**

The Treasury Department and the IRS have been aware for some time of the difficult issues raised with respect to the tax treatment of prepaid forward contracts. In 1993, in a preamble to regulations dealing with certain swap transactions, the Treasury Department and IRS first announced that they were studying the tax treatment of prepaid forward contracts and requested public comments. Specific projects to address prepaid forward contracts were placed on the administrative guidance "business plan" in 1993 and again in 2001. To date, however, published guidance has not been issued.<sup>12</sup>

In 2007, the Treasury Department and IRS became aware of an instrument that was beginning to be offered to retail investors in the capital markets that purported to be a prepaid cash-settled forward contract with respect to foreign currency. The offering materials filed with the Securities and Exchange Commission (SEC) suggested that for Federal tax purposes the instrument did not require current income inclusions by investors and had the potential of generating long-term capital gains. In response, Revenue Ruling 2008-1, 2008-2 I.R.B. 248 (Jan. 14, 2008), was released in December 2007, holding that these instruments are foreign-currency-denominated debt under general tax principles, and that investors must accrue currently interest income.

In 2006, we also learned of recent significant growth in the number of prepaid forward contracts being offered to retail investors with respect to reference assets other than foreign currency. Language in the offering documents filed with the SEC with respect to these instruments suggested that they are not debt under general tax principles. In the retail space, these instruments are sometimes referred to as exchange traded notes ("ETNs"). Typically, ETNs differ from the simple situation described in Example 3, above, in that they reference large portfolios of stocks and/or commodities rather than a single stock or asset. These portfolios are periodically redefined and, in the case of stock indices, may pay dividends which are credited to the contract, but are not currently paid to the holder of the contract. These features present unique questions as to whether deferral of tax is appropriate.

<sup>12</sup> The IRS and Treasury Department have addressed a very different tax issue in connection with a transaction called a "variable prepaid forward contract." That transaction involves a situation similar to Example 3, except that X plays the role of seller, not buyer, of ABC Inc. stock under a contract. Because X separately owns appreciated ABC Inc. stock, the key tax issue presented is whether the contract and other aspects of the transaction amount to a current sale (or constructive sale) of the stock. (There are meaningful differences between the simplified prepaid forward contract described in Example 3 and typical variable prepaid forward contracts that bear on this key tax issue.) Revenue Ruling 2003-7, 2003-1 C.B. 363 (Feb. 3, 2003), holds that no such sale results from the arrangement described in the ruling. A matter of current controversy between the IRS and certain taxpayers is whether particular transactions are within the scope of the revenue ruling.

Because of the large number of taxpayers potentially affected and their relative level of sophistication, the migration of prepaid forward contracts into the portfolios of retail investors served as an occasion for us to revisit the core issue related to prepaid forward contracts — whether or not a current accrual of income should be required. We issued the Notice to inform the public that we are continuing to examine this issue and to solicit comments. As the popularity of prepaid forward contracts grows, more taxpayers are affected by the current lack of clarity and need guidance regarding how to compute their tax liability. We were also mindful of the fact that the market segment into which these transactions is expanding is one that is, perhaps, less capable of appreciating the risks associated with this uncertainty.

Although it would be very desirable for us to clarify this area, we have reached no conclusion about how to proceed, about what result should be reached, or about whether we are able to reach that result with administrative guidance.

Thank you Mr. Chairman, Ranking Member English and Members of the Subcommittee for providing an opportunity for us to participate in today's hearing on this important subject. I would be pleased to respond to your questions.

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Chairman NEAL. Thank you, Mr. Desmond.  
Mr. Raskolnikov.

**STATEMENT OF ALEX RASKOLNIKOV, ASSOCIATE PROFESSOR  
OF LAW, CO-CHAIR, CHARLES E. GERBER TRANSACTIONAL  
STUDIES PROGRAM, COLUMBIA LAW SCHOOL**

Mr. RASKOLNIKOV. Mr. Chairman, Ranking Member English, Members of the Committee, thank you for inviting me to testify here today on the increasingly important subject of taxation of derivatives.

The debate about taxation of derivatives is largely the debate about income tax and consumption tax. There is hardly any doubt that derivatives are business-driven, socially useful products of financial innovation.

Yet they also have an undesirable side effect. They offer unprecedented opportunities to reduce or eliminate taxation of capital income. Without it, an income tax will become a consumption tax. If the United States were to switch to a consumption tax, Congress and not individual taxpayers or groups of taxpayers should make this decision.

So, what could be done about taxation of derivatives? In the absence of comprehensive reform, the options are limited. Three criteria have been developed as benchmarks of an effective and efficient capital income tax.

Unfortunately, symmetry, a system in which both sides of every transaction are taxed under the same timing rule and rate; consistency, a system in which economically similar transactions are taxed the same regardless of the labels attached by taxpayers; and balance, a system in which gains and losses from each derivative are treated alike, are all unattainable without a fundamental revision of the existing rules.

This does not mean, however, that Congress shouldn't act. When financial innovation creates a potential for a self-made consumption tax reform, Congress should defend its choice of the tax base. In evaluating proposed legislation, three inquiries should be the focus of congressional analysis, while two other commonly raised considerations are less important.

First, and quite obviously, Congress should focus on the amount of revenue at stake. What is the tax effect of a particular derivative? Is it deferral of income, conversion of high taxed returns into low taxed ones, or both? Are there non-tax constraints that limit the number of taxpayers who can take advantage of this tax planning? In short, not all tax abuses should be pursued. Rather, it is worth focusing on the largest ones.

Second, Congress should ensure that new legislation is effective in constraining tax planning, or in other words, is difficult to game. Otherwise taxpayers will expend even more resources to reduce their tax bills and little new revenue will be raised.

Of course, opponents of any new rule will argue that it will be easy to avoid. These arguments should be put to a serious test. Congress should require these opponents to demonstrate with some specificity how this easy avoidance will take place. If they do, Congress will have an opportunity to improve the proposed legislation. If it can't be improved, the proposal should be abandoned.

Third, policymakers should consider administrative and compliance costs of any proposal. These are real social costs, even when they are incurred by private parties and are invisible in the budget

process. The factors here are the complexity of the new legislation, the number and financial sophistication of the taxpayers involved, and the existence of relevant information in the marketplace.

On the other hand, Congress should take reasoning by analogy and arguments about additional complexity with a grain of salt, especially in this area. As for complexity, tax rules for derivatives are already extremely complex. Adding yet another regime not entirely consistent with what we have now may not make much of a difference. As for reasoning by analogy to the existing instruments or investments, this approach does not illuminate any of the three important issues I just raised, so it only confuses the debate.

These suggestions about incremental reforms should not obscure the larger issue. All such reforms leave much to be desired. In contrast, a comprehensive yet limited reform is possible, and I urge this Committee to give it serious consideration. All derivatives, with the exception of business hedges, should be subject to a mark to market regime, and gains and losses from derivatives should be taxed at the top individual or corporate marginal rate.

If adopted, this regime will create balance in taxation of derivatives, assure appropriate taxation of labor income and time value returns disguised as risky returns, put an end to the mind-numbing complexity of the current rules, end the waste of time and effort currently spent on devising new ways to game the system, and eliminate the need for Congress, the Treasury, and the IRS to endlessly monitor and respond to financial innovation.

As all reforms, this mark to market regime will come with some costs. Yet some of these costs are not as serious as they may first appear. In any case, these costs are well worth incurring in light of the great benefits this reform will bring.

Thank you, and I look forward to your questions.

[The prepared statement of Alex Raskolnikov follows:]

**STATEMENT OF ALEX RASKOLNIKOV,  
ASSOCIATE PROFESSOR OF LAW, COLUMBIA LAW SCHOOL  
AT A HEARING OF THE HOUSE COMMITTEE ON WAYS AND MEANS,  
SUBCOMMITTEE ON SELECT REVENUE MEASURES  
ON THE TAX TREATMENT OF DERIVATIVES  
MARCH 5, 2008**

Mr. Chairman and Members of the Committee—

Thank you for inviting me to testify here today on this increasingly important subject.

I would like to make four main points:

First, as long as Congress believes that income tax should remain a part of our revenue collection system, it is important to assure continuing taxation of income from capital. Without it, an income tax will become a consumption tax. Financial derivatives offer unprecedented opportunities to reduce or eliminate capital income taxation. If the United States were to stop taxing this income and adopt a consumption tax, Congress—and not individual taxpayers or groups of taxpayers—should make this decision.

Second, in the absence of a comprehensive income tax reform, it is impossible to tax financial derivatives in a manner that meets any accepted benchmark of an effective and efficient capital income tax. As long as the current rules are in place, symmetry, consistency, and balance will all remain unattainable.

Third, Congress should continue to intervene when financial innovation threatens to eliminate substantial amounts of capital income from the tax base even though these interventions will produce imperfect results. In doing so, Congress should strive to enact legislation that cannot be easily avoided and does not impose large administrative and compliance costs.

Fourth, a comprehensive—yet limited—reform is possible, and I urge the Committee to give it serious consideration. All derivatives should be subject to a mark-to-market regime, and gains and losses from derivatives should be taxed at the top individual or corporate ordinary income rate.

I elaborate on each of these points below.

### 1. Defend the Income Tax . . . or Replace It

Taxation of capital income is what makes an income tax different from a consumption tax. In an income tax system, both labor income and capital income are taxed. In a consumption tax regime, only labor income (and, in some cases, unique, abnormally high economic returns) are included in the tax base. Taxation of capital income makes a significant contribution to our tax system's progressivity.<sup>1</sup>

Generally, returns to capital consist of three components: a risk-free (or time value) return, a risk premium, and inflationary gain (or deflationary loss). Our system often under-taxes the first two components and over-taxes the third one. Because the question of incorporating inflationary gains and losses into the income tax goes well beyond the taxation of derivatives, I will limit this discussion to the risk-free return and risk premium.

Even without considering derivatives, our tax system does a mediocre job of reaching capital income. The realization requirement allows taxpayers to accelerate losses on depreciated assets while deferring gains on appreciated ones. The basis step-up at death often eliminates these gains from the tax base altogether. Special provisions exempt from taxation time value and risk-based returns from home sales, pension savings, life insurance, municipal bonds, and so on. The tax law did not appropriately account for simple interest accrual until 20 years after we sent a man into space. Thus, in evaluating the effect of derivatives, it is important to remember that a significant portion of capital income from "traditional" investments is under-taxed.

Derivatives exacerbate the problem dramatically. These innovative and socially useful products of financial engineering have an undesirable side effect: They give rise to remarkably potent tax reduction strategies. Without repeated Congressional intervention over the past two decades, derivatives would have allowed taxpayers to disguise high-taxed time value returns (interest income) as low-tax risk-based returns (long-term capital gains),<sup>2</sup> convert high-taxed risk-based returns (dividends and short-term capital gains) into low-taxed ones (long-term capital gains),<sup>3</sup> effectively sell appreciated assets without

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<sup>1</sup> This is true because on average high-income households receive a higher fraction of their income in the form of capital income.

<sup>2</sup> This was accomplished by a so-called conversion transaction that involved a purchase of an asset and its forward sale. Congress responded in 1993 by enacting section 1258 of the Internal Revenue Code.

<sup>3</sup> This was the purpose of the so-called hedge fund derivatives, addressed in section 1260 added to the Code in 1999.

recognizing taxable gains,<sup>4</sup> and circumvent long-standing rules designed to assure the taxation of capital income.<sup>5</sup>

Congressional efforts to curb tax planning using derivatives are well-advised. Left unchecked, this planning has the potential to eliminate capital income from the tax base, essentially converting our income tax system into a consumption tax. Moreover, derivatives may be also used to disguise labor income (wages) as risky returns—an inappropriate result even in a consumption tax regime. While the tax-advantaged fruits of financial innovation were for some time available only to a privileged few, the current trend may be described as “derivatives for the masses.” These masses, to be sure, still represent a small (and wealthy) fraction of U.S. taxpayers. Nevertheless, these happen to be the taxpayers who receive most of the capital income that Congress intends to tax.

There is a considerable and ongoing debate about the relative merits of income and consumption taxation. Without taking a position in this debate, I would like to emphasize the obvious: The choice of tax system is for Congress to make. Difficulty of taxing capital income in the presence of derivatives is one consideration pointing towards a consumption tax. There are others, as well as serious arguments going the other way.<sup>6</sup> But it can hardly be disputed that allowing a self-help switch to a consumption tax by the wealthiest taxpayers in the nation in contravention of Congressional intent to tax capital income is not good tax policy. Therefore, Congress should continue its efforts to constrain tax planning using derivatives.

## 2. The Patchwork of Rules — Unsatisfying Yet Inescapable?

It has long been understood that derivatives present a serious challenge to our tax system. Lawmakers, academics, and practitioners have been searching for comprehensive and conceptually satisfying responses to this challenge for decades. Three benchmarks have emerged as a result of this search.

The first benchmark is *symmetry*. If both sides to every transaction are taxed under the same timing rule and rate, they face equal and opposite incentives, which allows the system to police itself. In a fully symmetric system the government collects no net revenue from the taxation of derivatives. Importantly, the government does not *lose* any

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<sup>4</sup> The constructive sale rules of section 1259 were enacted in 1997 to limit this kind of planning.

<sup>5</sup> For instance, cash settlement derivatives were used to circumvent the wash sale rule of section 1091. While Congress responded by adding subsection 1091(f) in 2000, some continue to argue that cash settlement notional principal contracts remain outside the scope of section 1091. See David M. Schizer, *Scrubbing the Wash Sale Rules*, Taxes, Mar. 2004.

<sup>6</sup> Compare Daniel Shavito, *Beyond the Pro-Consumption Tax Consensus*, 60 Stan. L. Rev. 745 (2007) with Joseph Bankman & David A. Weisbach, *The Superiority of an Ideal Consumption Tax Over an Ideal Income Tax*, 58 Stan. L. Rev. 1413 (2006) and Joseph Bankman & David A. Weisbach, *Consumption Taxation Is Still Superior to Income Taxation*, 60 Stan. L. Rev. 789 (2007).

revenue either. In other words, derivatives cannot be used to shelter income from real investments and labor.

Unfortunately, symmetry is unattainable. Tax-exempt entities and foreigners often pay no U.S. tax. Securities dealers may be thought of as tax-exempt as well because their derivative trades with clients are hedged and mark-to-market accounting assures that only dealers' fees are taxable.<sup>7</sup> The presence of these tax-indifferent counterparties means that the taxation of derivatives will remain asymmetric as long as taxable taxpayers are on the other side of trades.

*Consistency* is another recognized benchmark. The tax treatment of derivatives is consistent if all economically comparable transactions (or sets of transactions) are taxed the same, regardless of the labels attached by taxpayers. For instance, an equity forward, an equity futures contract, and an equity swap on the same stock all have identical tax consequences in a consistent tax system, as does a leveraged purchase of that stock. Because tax treatment is independent of transactional form in a fully consistent regime, it is impossible to game the system by choosing one form or the other.

Yet complete consistency is impossible without fundamental tax reform. Our tax system has always relied on familiar cubbyholes such as debt and equity, ownership and non-ownership. Basic derivatives like options have a long-established tax treatment. As new financial products emerged, some were subjected to unique tax regimes while others were taxed by analogy to the well-established "precedents." The result is a patchwork of rules that imposes significant planning and compliance costs. While some of these rules have been quite effective in constraining tax planning, others have done little to impede it. Overall, this patchwork is anything but consistent. Adjusting, reforming, or even repealing one or a few of these rules will do little to diminish the overall inconsistency.

The problem is more fundamental than it may first appear. As long as the tax system continues to rely on cubbyholes, consistency is impossible. This is because the "basic" instruments such as a coupon bond, a share of common stock, and put and call options on that stock are inextricably linked—a relationship established by the so-called put-call parity theorem.<sup>8</sup> Shares of stock and options may be used to produce an economic return equivalent to the interest on a bond. A share of stock and a put are equivalent to a bond and a call. Many other combinations may be constructed. As long as debt, stock and options continue to be taxed inconsistently, the fundamental economic equivalence established by the put-call parity theorem will assure that similar cash flows with the

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<sup>7</sup> This is because any taxable gain from a client's position is offset by an equal loss on the hedge and vice versa (setting aside the fee build into the price of the client's position). The character of gain and a loss is always ordinary. The mark-to-market regime for securities and commodities dealers is set forth in section 475.

<sup>8</sup> See Alvin C. Warren, Jr., *Financial Contract Innovation and Income Tax Policy*, 107 Harv. L. Rev. 460, 465-70 (1993).



same risk profile will continue to receive dissimilar tax treatment—the hallmark of an inconsistent regime.

The third and final benchmark for taxing derivatives is *balance*, which is achieved if gains and losses from derivatives are treated alike (taxed at the same time and at the same rate). If this criterion is met, the government loses no revenue due to tax planning involving derivatives even if their tax treatment is neither symmetrical nor consistent. The intuition is that when a taxpayer enters into a “pure” derivative (that is, a derivative that involves a risky bet that has neither a time value element nor a return to labor), he cannot know whether he will win or lose the bet. If he wins, he would prefer a lower tax rate and a deferral of gains. If he loses, however, he would prefer a higher tax rate (making a loss deduction more valuable) and an acceleration of losses. If this taxpayer has to choose the form of derivative bet *before* knowing whether he will win it or lose it, this basic market uncertainty provides a powerful constraint on tax planning in a balanced system.

Only a fundamental reform will bring us a balanced regime. The realization requirement that is deeply embedded in our tax system gives taxpayers a timing option—a choice of triggering tax consequences *after* they have learned whether a transaction produced a gain or a loss. Capital loss limitations, the progressive rate structure, and the nonrefundable nature of our system produce unequal tax rates on gains and losses (with gains taxed at a higher rate). As long as these features remain in place, no incremental revisions will produce balance in the taxation of derivatives.<sup>9</sup>

While assuring symmetry, consistency, or balance is desirable, incremental reform may be the only—or the only realistic—policy option at a given moment. How should policymakers evaluate whether a new derivative merits Congressional action and, if so, what form this action should take?

### 3. Responding to Financial Innovation with Incremental Reforms

When a novel financial instrument creates a tax planning possibility, Congress should consider taking action. Given where our tax system is today, three inquiries should be of great importance, while two other factors should be given much less credence.

First, and most importantly, Congress needs to ascertain the magnitude and nature of the potential problem. What is the tax effect of a new derivative instrument? Is it deferral of income, conversion of high-taxed returns into low-taxed ones, or both? Do non-tax constraints (such as market frictions or securities, bank regulatory and other laws) limit the number of taxpayers who can take advantage of this tax planning? Overall, how much revenue is at stake?

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<sup>9</sup> For a fuller discussion of symmetry, consistency, and balance, see David M. Schizer, *Balance in the Taxation of Derivative Securities: An Agenda for Reform*, 104 Colum. L. Rev. 1888, 1893-1901 (2004).

Second, in evaluating legislative proposals, Congress should ensure that new legislation is effective in constraining future tax planning—in other words, it is difficult to game.<sup>10</sup> Otherwise, taxpayers will expend even more resources in order to reduce their tax bills, yet little new revenue will be raised. Of course, opponents of any given reform will argue that it will be easy to avoid. These arguments should be put to a serious test. Congress should require these opponents to demonstrate with some specificity how this easy avoidance will take place. If they do, Congress will have an opportunity to remedy the weaknesses of the proposal. If the weaknesses are incurable, the proposal should be abandoned.

Third, policymakers should consider the administrative and compliance costs of any proposed legislation. These are real social losses, even when they are incurred by private parties and are “invisible” in government budgets. Of course, most new rules will produce *some* increase in administrative and compliance costs. The question is how substantial it is compared to the expected revenue raised by the proposed legislation.<sup>11</sup> The key factors affecting these costs are the complexity of legislation, the number and financial sophistication of taxpayers affected by it, and the existence of relevant information in the marketplace.

For instance, compare the constructive ownership regime of section 1260 with that currently proposed for prepaid derivatives. The former is much more complex. It requires tracking of long-term capital gains realized from the underlying investment, spreading of ordinary income backwards over the derivative’s term, and the addition of an interest charge based on this look-back. The proposed prepaid derivatives bill is much simpler, requiring only an imputation of interest at a standard rate. This difference in complexity is justified. Only the wealthiest and most sophisticated taxpayers can invest in the hedge fund derivatives addressed by section 1260. In contrast, prepaid derivatives (such as exchange-traded notes, or ETNs) are mass-marketed, so Congress should be more reluctant to enact highly complex rules in this context. Finally, the financial institutions that issue hedge fund derivatives and prepaid instruments such as ETNs are certainly capable of tracking information that is required by the constructive ownership rule and may be needed to comply with the proposed prepaid derivatives legislation. They may (and should) be required to supply this information to the IRS as well. Granted, each regime requires some initial system development costs, but these costs are likely to be modest, especially compared to the amount of capital income that may go untaxed if Congress fails to act. As long as financial institutions assemble information and provide it to taxpayers, the compliance burden borne by taxpayers should be reasonable.

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<sup>10</sup> Effective legislation in this case is also efficient in the technical sense of that word. See David A. Weisbach, *Ten Truths About Tax Shelters*, 55 Tax L. Rev. 215, 231-39 (2002).

<sup>11</sup> For the formal analysis of this insight, see Joel Slemrod & Shlomo Yitzhaki, *The Costs of Taxation and the Marginal Efficiency Cost of Funds*, 43 IMF Staff Papers 172 (1996).

In sum, in evaluating new legislation, Congress should focus on the magnitude of the problem, the resistance of the proposed rule to future gaming, and the administrative and compliance costs imposed by it. Two other commonly raised considerations, discussed next, are less important.

Adding further complexity to the tax law is hardly desirable. Yet, charges that proposed legislation would add to the tax law's inconsistencies should be taken with a grain of salt. Tax rules for derivatives are already extremely complex. Adding yet another regime not entirely consistent with the existing patchwork of rules may not make much of a difference. For the same reason, just about any legislative proposal is likely to be consistent with some of the current provisions, or at least some of their features. In short, although overall consistency is a worthy goal, adding some further inconsistency will not necessarily do a lot of additional harm. Whatever harm may result should be balanced against allowing significant amount of capital income to escape the tax base.

In addition, and perhaps counterintuitively, Congress should eschew reasoning by analogy. This mode of analysis is appropriate for courts interpreting legislation and judicial precedents, but not for Congress when it enacts new rules. Whether a novel derivative is more "like" debt, equity, or some other existing instrument or investment (such as a commodities or securities index) does not tell us a lot about the derivative's tax reduction potential or a legislative proposal's capacity to constrain it.<sup>12</sup>

For example, inquiries into whether short sales and equity forwards entered into by taxpayers holding appreciated equity positions were really more "like" selling these position or retaining them produced little useful information in evaluating the merits of the constructive sale rules. The same is true of the debates about whether entering into hedge fund derivatives was really "like" becoming an owner of the underlying hedge fund or not, debates that took place when the constructive ownership regime was under consideration. These inquiries did little to ascertain the magnitude of the problems in question. And they failed to predict that one of these regimes would prove to be substantially more effective than the other. The difference, it turned out, has nothing to do with what ownership "truly" means, but is due to the fact that financial intermediaries could hedge derivatives that avoid the constructive sale regime much more easily than they could hedge derivatives that would escape the reach of the constructive ownership rules.<sup>13</sup>

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<sup>12</sup> *Unhelpful* reasoning by analogy in deciding whether tax planning using a given derivative should be stopped should not be confused with *helpful* arguments that a proposed solution is unlikely to work because if it is enacted, taxpayers will find close tax-favored substitutes (analogies) to the strategy foreclosed by the new legislation. The latter argument is really about effectiveness of the proposal (its resistance to gaming), an important factor discussed above.

<sup>13</sup> For a detailed explanation, see David M. Schizer, *Frictions as a Constraint on Tax Planning*, 101 Colum. L. Rev. 1312 (2001).

In sum, as long as the fundamental reform of derivatives taxation remains unlikely, Congress should not let the perfect be the enemy of the good. When a new derivative creates a potential for large amount of capital income to disappear from the tax base, Congress should respond by enacting legislation that is effective (difficult to game) and does not impose high administrative and compliance costs, while paying less attention to arguments about consistency and analogies based on the “true” nature of things.

#### 4. A Limited Fundamental Reform

The preceding suggestions about incremental reforms should not obscure the larger issue: All such reforms leave much to be desired. They fail to produce a tax system that is symmetric, consistent, or balanced. There is, however, a reform that will overcome the numerous shortcomings of the existing rules governing taxation of derivatives. It will produce a balanced system. It will result in symmetry in most cases. And it will eliminate the need for the endless (and ultimately fruitless) efforts to prevent taxpayers from disguising time value returns and wages as risky gains and losses. This reform is fundamental because it involves the overhaul of *all* rules applying to the taxation of derivatives. Yet it is limited because it applies *only* to the taxation of derivatives and, therefore, is both much less drastic and more realistic than a switch to, or an addition of, a consumption tax.

If this Committee is prepared to revisit the entire regime applying to the taxation of financial instruments, it should give serious consideration to subjecting all derivatives to a mark-to-market system similar to that currently applying to securities and commodities dealers under section 475.<sup>14</sup> Under this regime, all gains and losses will be taxed as if each position in a derivative is terminated (sold) at the end of the taxable year and re-entered into at the beginning of the next year. Losses from derivatives will be deductible only against gains from derivatives, and excess losses will be fully available to reduce gains from derivatives in other tax years.<sup>15</sup> Importantly, the rate applying to gains and losses will be flat and equal to the top marginal rate, individual or corporate, as appropriate.<sup>16</sup>

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<sup>14</sup> Others share this view. See Schizer, note 9 above, at 1920; Warren, note 8 above, at 492. For similar proposals, see Daniel Halperin, *Saving the Income Tax: An Agenda for Research*, 77 Tax Notes 967 (1997); David J. Shakow, *Taxing Without Realization: A Proposal for Accrual Taxation*, 134 U. Pa. L. Rev. 1111 (1986); David A. Weisbach, *A Partial Mark-to-Market Tax System*, 53 Tax L. Rev. 95 (1999).

<sup>15</sup> Alternatively, a net loss from derivatives in a given year will be refundable. In addition, business hedging will be subject to an integration regime similar to the current one.

<sup>16</sup> A more precise approach would set the rate at the top individual or corporate rate applying to any given taxpayer in any particular tax year. In other words, the taxpayer’s rate determined without regard to gains and losses from derivatives will automatically apply to these gains and losses. For the reasons discussed below, this complication is probably not worth pursuing, because the additional complexity it entails will not be justified by either revenue or fairness considerations.

Let me briefly outline the benefits of this regime, and address some of its drawbacks. The benefits are considerable.

1. The proposed mark-to-market regime will assure that the taxation of derivatives is balanced: Pure risky bets will raise no revenue but will also not be used to shelter other income.
2. The mind-numbing complexity of the current rules, the considerable compliance costs they impose, and the need for Congress to continually monitor and respond to financial innovation will all disappear. The same is true of the time and effort expended on devising and analyzing ways to circumvent current rules.
3. Because gains from derivatives will be taxed at the top marginal rate, an incentive to disguise riskless returns and labor income as risk-based returns will disappear. Derivatives that do reflect wages or time value returns (and some of them do) will produce positive tax revenues.

Of course, the proposal has drawbacks. None of them appear to be compelling.<sup>17</sup>

1. The proposed regime will not affect non-derivative positions. Therefore, it will become important to separate derivatives from non-derivatives. This will be a line-drawing exercise familiar to any lawyer. While I would argue for a broad definition of a derivative, the more important point is that it will be much easier (and cheaper) to draw and maintain just one line—between derivatives and non-derivatives—than it is to continually delineate equity from debt from forwards from swaps from options from futures from (now) prepaid derivatives and so on.<sup>18</sup>
2. Arguably, the suggested regime will result in a less favorable tax treatment of derivatives than the existing treatment of “plain vanilla” investments such as stocks, bonds, and real estate. This, the argument goes, will be both unfair and inefficient. This criticism is not particularly convincing. “Equal treatment” is certainly not the hallmark of our tax system. Growth stocks are treated more favorably than dividend-paying stocks. Bonds (especially discount bonds) have a particularly disadvantageous tax treatment (accrual of income before its receipt) while real estate and municipal bonds are especially tax-favored. Some derivatives are currently taxed less heavily than other economically similar financial instruments. Rather than adding to the number of tax-favorable and unfavorable regimes, the proposed reform will *reduce* it by taxing all derivatives the same.

Moreover, a mark-to-market system may not in fact render derivatives tax-disadvantaged. Capital loss limitations will be replaced with unlimited (in time)

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<sup>17</sup> For a thorough analysis of costs and benefits of combining a mark-to-market regime with a realization-based system, see Weisbach, note 14 above.

<sup>18</sup> This list does not mention the need to delineate various *transactions* involving derivatives, such as straddles, constructive sales, constructive ownership, several integration regimes and the like.

carry-forwards, carry-backs, or even refunds. Straddle rules, wash sale rules, constructive sale and ownership rules will not apply to derivatives. On balance, it is far from clear that the mark-to-market regime will result in an overall tax disadvantage (or advantage) for derivatives.

3. Taxing gains at the top marginal rate may seem unfair and arbitrary, but, in fact, it is neither. Many (if not most) taxpayers who enter into derivative trades are already in the top bracket. To the extent the proposed regime will result in taxation of time value returns and disguised wages at the top rate, it will merely assure their appropriate taxation. Although risky gains from derivatives will be taxable at a higher rate than long-term capital gains from “traditional” investments, risky losses will be deductible at a higher rate as well. These will net out to zero, giving rise to no additional tax liability.

4. Another typical critique of mark-to-market proposals is that they introduce exceedingly costly complexity, requiring annual valuation of hard-to-value assets. Clearly, this criticism does not apply to derivatives. Most over-the-counter derivatives are sold by financial intermediaries who already mark them to market for internal control, accounting, and tax purposes. Under the proposal advanced here these entities will merely be required to share this information with taxpayers (and the IRS). For publicly-traded derivatives (such as ETNs), the concern simply does not arise.

5. Finally, a liquidity argument is often marshaled to defeat proposals for mark-to-market reforms. How will a middle-class taxpayer come up with the money to pay the tax bill for an appreciating asset that she wants to keep? In the context of traditional investments, this concern is quite serious. But when we focus on derivatives, the liquidity concern is greatly diminished. Middle class taxpayers don’t buy derivatives (or, at least, not nearly in the amounts they buy common stocks, real estate, etc.). Even if the managers of the mutual funds these taxpayers own purchase derivatives, these funds are mostly held in IRAs, 401(k)s, and other tax-sheltered accounts. Owners of these accounts recognize no gains or losses until withdrawing money during retirement, so they will be largely unaffected by the mark-to-market regime. Thus, the relevant taxpayer population even for publicly-traded derivatives is much smaller—and wealthier—than for investments in general. Over-the-counter products are available only to the wealthiest few. Most likely, these taxpayers have plenty of liquidity to pay taxes arising from the limited mark-to-market regime.

Needless to say, this testimony is not the place for an exhaustive analysis. The proposed reform will surely raise some thorny issues and require some difficult balancing. My point here is to emphasize that the proposed mark-to-market system is viable and has many attractive features. If Congress is ready to revisit the taxation of derivatives as a whole, this reform has much to be said in its favor. While it inevitably will give rise to some costs, it will eliminate much more numerous and significant costs of the current regime for taxation of derivatives—a regime that, to put it bluntly, is a mess.

**STATEMENT OF REUVEN S. AVI-YONAH, IRWIN I. COHN  
PROFESSOR OF LAW, UNIVERSITY OF MICHIGAN LAW SCHOOL**

Mr. AVI-YONAH. Thank you, Chairman Neal, and thank you, Representative English and Members of the Subcommittee, for inviting me to testify before you today.

Professor Raskolnikov has addressed two of the three aspects of derivatives that are of interest, namely, the character of the income and the timing of the income. I want to focus on the third characteristic mentioned by Mr. Desmond earlier, namely, the source of the income.

It has been well known for a long period of time that derivatives can be used in some circumstances to avoid the U.S. withholding tax that is applied to foreigners who invest in our markets. The combination of treaty rules and exemptions in the Code, in particular the portfolio interest exemption that was enacted in 1984, mean that the main type of income on which we levy the withholding tax are dividends, and it is that type of income that can be—that type of tax that can be avoided by using derivatives.

In particular, there is a derivative called the total return equity swap, which involves a foreigner entering into an agreement with a U.S. investment bank under which there is an investment up front, and at the end of the contract there is a return either of the capital appreciation or a payment by the foreigner of the depreciation of the instruments, that is linked to the performance of a particular U.S. stock.

But in addition to that, there is an agreement that the U.S. investment bank will pay a dividend equivalent amount to the foreigner every time that the U.S. corporation pays an actual dividend. Then the investment bank turns around and makes an investment in the actual stock of the company.

The tax result is, as opposed to a direct investment in the stock of the company where there will be withholding tax of at least 15 percent and sometimes 30 percent of the dividend, in this case the payment by the company to the investment bank is not subject to withholding tax because it is not to a foreigner, and the payment by the investment bank to the foreigner is not subject to withholding tax because, under regulations issued in the early 1990s, those payments are sourced to the residence of the recipient, and the recipient being a foreigner, the taxation does not apply.

A more modern version of this is the type of more complicated derivative that was issued in the recent deals involving the sovereign wealth funds of Abu Dhabi and China, investing respectively in Citigroup and in Morgan Stanley. What those deals involved are a combination of investment that is denominated in notes, that instrument, as a unit, with what is essentially a prepaid forward contract that is convertible into stock at the end of some period.

Even though these investments are denominated, for example, for bank regulatory purposes and also for purposes of the scrutiny of foreign investment into the U.S. as equity, for tax purposes the IRS has issued the ruling in 2003 that results in bifurcating the instrument into two. One is simply a forward contract that has no consequences until it is executed; and the other one is a debt instrument that results in current interest being paid, and that interest is exempt from tax under the portfolio interest exemption.

So, the question is: What can be done about these kind of circumstances? Well, one, a possibility is simply to close these particular loopholes. For example, in the case of payments on securities lending transaction, the IRS knows very well to treat dividend equivalents as equivalent to dividends and subject to the withholding tax. In the case of the Citigroup and Morgan Stanley transactions, it is possible to, instead of bifurcating and treating a unit as a single instrument, treat it as an equity investment consistent with its treatment for banking purposes.

But the problem is that stopping these particular loopholes and only focusing on them will then lead to other loopholes. You can imagine, for example, a total return equity swap that links to a basket of stocks rather than a particular stock. I am sure you can invent derivatives that will bypass any loophole-closing device that applies specifically to the unit investments.

So, what can be done more broadly? Well, one possibility for this Subcommittee to consider is to change a source rule that was adopted by the Treasury in the early 1990s. I don't know of any other example where a major source rule was adopted by regulation. Most of the source rules are in the Code, and they are considered by Congress and thought out. This particular one, which involved a potential avoidance of tax on billions of dollars of investment, was adopted by regulation. I think the Committee should consider aligning the source rule for derivative payments to the source rule for dividends and interest, both of which are taxed based on the residence of the payor.

More extensively, I think, because derivatives can be used to convert equity into that and vice versa, the Committee should think about a possibility of looking at the portfolio interest exemption, at least in situations where the payment is made to a country with which we don't have a tax treaty or a tax haven. In that circumstance, there is already authority in the Code that is given to the Treasury to suspend the portfolio interest exemption if there is not adequate exchange of information, and I think the Committee might look into that as well.

Thank you very much.

[The prepared statement of Reuven S. Avi-Yonah follows:]

**Prepared Statement of Reuven S. Avi-Yonah,  
Irwin I. Cohn Professor of Law, University of Michigan Law School**

My name is Reuven S. Avi-Yonah. I am the Irwin I. Cohn Professor of Law and Director of the International Tax Master of Law Program at the University of Michigan Law School. I hold a JD (*magna cum laude*) from Harvard Law School and a PhD in History from Harvard University. I have 19 years of full and part time experience in the tax area, and have been associated with or consulted to leading law firms like Cravath, Swaine & Moore, Wachtell, Lipton, Rosen & Katz and Cadwalader, Wickersham & Taft. I have also served as consultant to the U.S. Treasury Office of Tax Policy and as member of the executive committee of the NY State Bar Tax Section. I am currently Chair of the ABA Tax Section Committee on VAT, a member of the Steering Group of the OECD International Network for Tax Research, and a Nonresident Fellow of the Oxford University Center on Business Taxation. I have published 11 books and over 80 articles on various aspects of U.S. domestic and international taxation, and have 14 years of teaching experience in the tax area (including basic tax, corporate tax, international tax and tax treaties) at Harvard, Michigan, NYU and Penn Law Schools.

I would like to thank Chairman Neal and the Committee staff for inviting me to testify today on the international aspects of the tax treatment of derivatives.



### 1. The Use of Derivatives To Avoid Withholding Taxes

Since the beginning of the income tax, the U.S. has imposed a withholding tax (currently 30 percent) on payments of “fixed or determinable, annual or periodical” (FDAP) U.S. source income to nonresidents. However, recent developments such as the rise of derivative financial instruments have seriously undermined our ability to tax FDAP at source, which frequently means that it is not subject to tax at all. This is true even if the income ultimately inures to the benefit of U.S. residents.

The major categories of FDAP are dividends, interest, royalties and rents. Of these, royalties and rents are typically not subject to source-based taxation because of our tax treaties. Interest is likewise rarely subject to tax at source because of the portfolio interest exemption (IRC 871(h)), which exempts most payments of interest to nonresidents from withholding tax. Interest payments that do not qualify for the portfolio interest exemption are frequently exempt by our tax treaties. Thus, the main category of FDAP that is still subject to withholding tax is dividends. Generally, even dividends paid to residents of countries with whom we have a tax treaty are subject to tax at 15 percent, while dividends paid to residents of countries with which we do not have a tax treaty are subject to the full tax of 30 percent.<sup>1</sup>

How can derivatives be used to avoid the withholding tax on dividends? A simple example involves a derivative called a total return equity swap (TRES). In a TRES, a foreign investor enters into a contract with a U.S. investment bank under which the investor pays the bank an initial amount, say 100. In return, the bank agrees to pay the investor an amount equal to the dividends paid by a U.S. corporation in a given period of time (e.g. 5 years). In addition, the bank agrees at the end of the 5 years to pay the investor any appreciation in the value of the U.S. corporation's stock over 100, and the investor agrees to pay the bank if the stock declines under 100. The bank then turns around and invests the 100 in the stock of the U.S. corporation.

What are the tax consequences of this arrangement? The capital gain or loss at the end of the 5 years is not subject to U.S. tax even in the absence of a TRES because we generally do not tax capital gains of nonresidents. However, the TRES does make a difference to the taxation of any dividends paid during the 5 years. If the investor had invested directly in the stock of the U.S. corporation, any dividends would have been subject to tax at a rate of at least 15 percent. However, dividends paid by the U.S. corporation to the U.S. investment bank are not subject to withholding tax because they are not paid to a nonresident. The investment bank does include them in income, but it gets an offsetting deduction for paying the dividend equivalent to the foreign investor. The dividend equivalents in turn are not subject to withholding tax because under a regulation adopted in the early 1990s, payments on “notional principal contracts” (such as the TRES) are sourced at the residence of the recipient.<sup>2</sup> Thus, because the investor is foreign, the dividend equivalents are not U.S. source and therefore are not subject to withholding tax.

Recent press stories have suggested that the use of TRES to avoid withholding tax on portfolio dividends has increased exponentially since the arrival of hedge funds. Disturbingly, the stories suggested that some of the TRES held by hedge funds ultimately inure to the benefit of U.S. residents, but are not reported to the IRS under the cover of tax haven bank secrecy. Recent reports that U.S. residents have been discovered to hold secret accounts in Liechtenstein and the Isle of Man highlight this concern.

Using TRES to avoid the withholding tax on portfolio dividends is an old technique, although the amounts involved seem to be growing dramatically in recent years. A newer version involves using derivatives to convert dividends (subject to withholding tax) to interest (not subject to tax because of the portfolio interest exemption). A good example is the recent investment by the sovereign wealth funds of Abu Dhabi in Citigroup (\$7.5 billion) and of China in Morgan Stanley (\$5 billion).

It has been reported that “under the terms of the Citigroup transaction, [Abu Dhabi Investment Authority] agreed to purchase \$7.5 billion of equity units. The equity units are structured using Citigroup's patent-pending Upper DECS strategy. **Citigroup** has agreed to pay an 11 percent yield on the units, with slightly over 6.5 percent classified as interest payments. The remaining payment is a contract payment on the purchase contract. The result to **Citigroup** is a tax savings in the neighborhood of \$175 million per year for the 3 years before the conversion to common shares begins. Morgan Stanley sold \$5 billion of equity units through its PEPS structure to China Investment Corp., and will pay a total annual rate of 9 percent on them. Morgan Stanley classifies 6 percent of the payments as interest on a debt

<sup>1</sup> Dividends paid to controlling shareholders are generally subject to tax under treaties at 5%, but some of our recent treaties reduce this tax to zero.

<sup>2</sup> Treas. Reg. 1.863-7.

and will benefit from a tax savings of approximately \$100 million per year during the preconversion period of the deal.”<sup>3</sup>

Both of these transactions rely on the IRS’ feline PRIDES ruling of 2003.<sup>4</sup> Feline PRIDES is Merrill Lynch’s version of the Citigroup Upper DECS and the Morgan Stanley PEPS. In all three transactions, the U.S. entity issues “equity units consisting of a forward contract for the purchase of equity shares and notes equivalent to the price of the stock. The amount of stock deliverable under the forward contract is determined on the settlement date and has a market value equal to the settlement price. The forward contract and the notes are treated as separate transactions, and the purchase price is allocated between them according to their fair market values on the settlement date. The holder of the investment units may, but is not required to, separate the obligations of the units. The holder is also obliged to remarket the notes. The issuer will make regular payments under the terms of the transaction and treat the lion’s share of the payments as interest payments on the notes.”<sup>5</sup>

Under the 2003 Revenue Ruling, the IRS treats the forward contract and the notes as two separate instruments. As a result, the payments on the notes are treated as interest, and when the notes are held by a foreign investor, they are entitled to the portfolio interest exemption and not subject to withholding tax even though they are mandatorily convertible into stock, and even though the investment is treated as equity for bank regulatory purposes. Presumably, the foreign investors intend to sell the units to a U.S. party before conversion to equity.

## 2. What Can Be Done?

The immediate response to both the TRES and feline PRIDES structures is to suggest that the IRS should revise its rules to close the relevant loopholes. In the case of TRES, the IRS could revise the regulations and treat dividend equivalent amounts under the TRES as dividends for withholding tax purposes, just like it does in the case of securities loans from a foreign lender to a U.S. borrower, where payments of dividend equivalents from the U.S. to the foreign person are treated as dividends and subject to withholding tax.<sup>6</sup> In the case of feline PRIDES, the IRS could revoke its 2003 ruling and treat the structure as equity, as suggested by Prof. David Weisbach.<sup>7</sup>

However, the problem with adopting such narrow loophole-closing measures is that they invite taxpayers to find new ways to achieve the same goals. For example, if dividend equivalent amounts under a TRES linked to a specific stock are treated as dividends, the investment banks will issue TRES linked to a basket of stocks that will behave similarly to the targeted stock. The IRS may then adopt “substantially similar or related property” rules, and the game will go on. Likewise, if the feline PRIDES ruling were revoked, I have no doubt that other, more complex instruments could be invented that achieve the same goal.<sup>8</sup>

A more ambitious reform proposal would be to revise the regulations and treat the source of all payments on notional principal contracts as the residence of the payor, rather than the residence of the recipient. This would align the source rule for derivatives with the source rule for dividends and interest. However, as long as the portfolio interest exemption is in the Code, derivatives could still be used to convert dividends into interest, and then the source would not matter because the payment would be exempt.

In general, it seems strange to insist on levying withholding tax on dividends, which are not deductible, while not levying it on interest and royalties, which are. The payment of a dividend does not reduce our ability to tax the underlying corporate income, but the payment of deductible interest and royalties does.

Thus, one possible response to the use of derivatives to avoid withholding tax is to say “who cares?” As noted above, most forms of FDAP are already not subject to withholding, and if derivatives are used to avoid the withholding tax on portfolio dividends and our treaties are revised to eliminate withholding on direct dividends, perhaps the time has come to give up on the withholding tax altogether. It collects negligible revenue while imposing high transaction costs on withholding agents, as

<sup>3</sup>David D. Stewart, *Sovereign Wealth Fund Deals Take Advantage of IRS Ruling*, 2008 TNT 41–5 (Feb. 29, 2008).

<sup>4</sup>Rev. Rul. 2003–97, 2003–34 IRB 1.

<sup>5</sup>Stewart, *supra*.

<sup>6</sup>For a discussion of the different treatment of TRES and securities loans see Reuven Aviyonah and Linda Z. Swartz, *U.S. International Treatment of Financial Derivatives*, 74 Tax Notes 1703 (1997).

<sup>7</sup>Stewart, *supra*.

<sup>8</sup>For some ideas see Gregory May, *Flying on Instruments: Synthetic Investments and the Avoidance of Withholding Tax*, 96 TNT 239–32 (1996).

indicated by the voluminous regulations governing withholding under IRC 1441–1446.

### 3. A Possible Solution<sup>9</sup>

Nevertheless, it seems unlikely that Congress will give up on withholding taxes on foreigners. And there is one compelling argument in favor of imposing such taxes: They may be our best chance to prevent U.S. residents from avoiding tax on U.S. source income earned through foreign intermediaries.

The basic problem stems from the portfolio interest exemption. In 1984, the United States unilaterally abolished its withholding tax (of 30 percent) on foreign residents earning “portfolio interest” income from sources within the United States. “Portfolio interest” was defined to include interest on U.S. Government bonds, bonds issued by U.S. corporations (unless the bondholder held a 10 percent or more stake in the shares of the corporation), and interest on U.S. bank accounts and certificates of deposit. This “portfolio interest exemption” is available to any nonresident alien (that is, any person who is not a U.S. resident for tax purposes), without requiring any certification of identity or proof that the interest income was subject to tax in the investor’s country of residence.

The result of enacting the portfolio interest exemption has been a classic race to the bottom: One after the other, all the major economies have abolished their withholding tax on interest for fear of losing mobile capital flows to the United States. The table below shows current withholding rates in EU member countries and in the United States on interest paid on bank accounts, securities (government and corporate bonds), and dividends paid to foreign residents in the absence of a treaty.

Country	Bank Accounts	Securities	Dividends
Belgium	0	10	15
Denmark	0	0	15
France	0	0	15
Germany	0	0	15
Greece	10	10	0
Ireland	0	0	0
Italy	10	10	15
Luxembourg	0	0	15
Netherlands	0	0	15
Portugal	15	15	15
Spain	0	0	15
United Kingdom	0	0	15
United States	0	0	30

As the table indicates, most developed countries impose no withholding tax on interest paid to nonresidents on bank deposits and government and corporate bonds. Withholding taxes are imposed on dividends, despite the fact that dividends (unlike interest) are not deductible and, therefore, the underlying income has already been taxed once.

The standard economic advice to small, open economies is to avoid taxing capital income at source, because the tax will be shifted forward to the borrowers and will result in higher domestic interest rates. However, the countries in the table include large economies (the United States, Germany, and the United Kingdom) in which the tax is not necessarily shifted forward. Rather, the principal reason for the lack of withholding taxes in most of the countries included in the table above is the fear that if such taxes were imposed, capital would swiftly move to other locations that do not impose a withholding tax. Thus, the Ruding Committee, writing about the European Community, concluded in 1992 that “recent experience suggests that any

<sup>9</sup>This section is based in part on Avi-Yonah, Memo to Congress: It’s Time to Repeal the U.S. Portfolio Interest Exemption, 17 Tax Notes Int’l 1817 (Dec. 7, 1998).

attempt by the [European Union] to impose withholding taxes on cross-border interest flows could result in a flight of financial capital to non-EC countries.”<sup>10</sup>

The experience of Germany is a case in point: In 1988, Germany introduced a (relatively low) 10 percent withholding tax on interest on bank deposits, but had to abolish it within a few months because of the magnitude of capital flight to Luxembourg. In 1991, the German Federal Constitutional Court held that withholding taxes on wages, but not on interest, violated the constitutional right to equality, and the government therefore was obligated to reintroduce the withholding tax on interest, but made it inapplicable to nonresidents. Nevertheless, nonresidents may be German residents investing through Luxembourg bank accounts and benefiting from the German tradition of bank secrecy vis-a-vis the government.<sup>11</sup>

The current situation is a multiple-player prisoner’s dilemma: All developed countries would benefit from reintroducing the withholding tax on interest, because they would then gain revenue without fear that the capital would be shifted to another developed country. However, no country is willing to be the first one to cooperate by imposing a withholding tax unilaterally; thus they all defect (that is, refrain from imposing the tax) to the detriment of all.

In global terms, this outcome would make no difference if residence jurisdictions were able to tax their residents on foreign-source interest (and dividend) income, as required by a global personal income tax on all income “from whatever source derived.” However, as Joel Slemrod has written, “although it is not desirable to tax capital on a source basis, it is not administratively feasible to tax capital on a residence basis.”<sup>12</sup> The problem is that residence country fiscal authorities in general have no means of knowing about the income that is earned by their residents abroad. Even in the case of sophisticated tax administrations like the IRS, tax compliance depends decisively on the presence of either withholding at source or information reporting. When neither is available, as in the case of foreign-source income, compliance rates drop dramatically.

In the case of foreign-source income, withholding taxes are not imposed for the reasons described above. As for information reporting, even though tax treaties contain an exchange of information procedure, it is vitally flawed in two respects: First, the lack of any uniform worldwide system of tax identification numbers means that most tax administrations are unable to match the information received from their treaty partners with domestic taxpayers. Second, there are no tax treaties with traditional tax havens, and it is sufficient to route the income through a tax haven to block the exchange of information. For example, if a Mexican national invests in a U.S. bank through a Cayman Islands corporation, the exchange of information article in the U.S.-Mexico tax treaty would not avail the Mexican authorities. The IRS has no way of knowing (given bank secrecy) that the portfolio interest that is paid to the Caymans is beneficially owned by a Mexican resident covered by the treaty.

The resulting state of affairs is that much income from portfolio investments overseas escapes income taxation by either source or residence countries. Latin American countries provide a prime example: It is estimated that following the enactment of the portfolio interest exemption, about US \$300 billion fled from Latin American countries to bank accounts and other forms of portfolio investment in the United States. Most of these funds were channeled through tax haven corporations and therefore were not subject to taxation in the country of residence. For all developing countries, various estimates of the magnitude of capital flight in the 1980s average between US \$15 billion and US \$60 billion per year. Nor is the problem limited to developing countries: Much of the German portfolio interest exemption benefits German residents who maintain bank accounts in Luxembourg, and much of the U.S. portfolio interest exemption benefits Japanese investors who hold U.S. treasuries and do not report the income in Japan. Even in the case of the United States, it is questionable how much tax is actually collected on portfolio income earned by U.S. residents abroad other than through mutual funds. One estimate has put capital flight from the United States in 1980–82 as high as US \$250 billion. More recently, Joseph Guttentag and I have estimated the “international tax gap” (the tax owed by U.S. residents on income earned through foreign tax havens) at \$50 billion.<sup>13</sup>

<sup>10</sup>Report of the Committee of Independent Experts on Company Taxation (Commission of the European Communities, 1992), p. 201.

<sup>11</sup>As indicated by recent press reports, since Luxembourg is now subject to exchange of information under the Savings Directive (discussed below), German capital has shifted to Liechtenstein.

<sup>12</sup>Joel Slemrod, Comment, in Vito Tanzi, *Taxation in an Integrating World* (1995), 144.

<sup>13</sup>Guttentag and Avi-Yonah, *Closing the International Tax Gap*, in Max B. Sawicky (ed.), *Bridging the Tax Gap: Addressing the Crisis in Federal Tax Administration*, 99 (2005).

Thus, in the absence of withholding taxes or effective information exchange, income from foreign portfolio investments frequently escapes being taxed by any jurisdiction. This is particularly significant because the flows of portfolio capital across international borders have been growing recently much faster than either world gross domestic product or foreign direct investment. It is currently estimated that international capital flows amount to US \$1 trillion a day; although this figure is much larger than income from capital, it gives a sense of the magnitude at stake.

This situation has led knowledgeable observers like Richard Bird to write that “the weakness of international taxation calls into question the viability of the income tax itself. . . . If something is not done to rectify these problems soon, the future of the income tax is bleak.”<sup>14</sup> Other authors have written papers like “Can Capital Income Taxes Survive in Open Economies?” and “Is There a Future for Capital Income Taxation?” Unless something is done about this situation, the answer to those questions is likely to be “no.”

However, the present may present a unique opportunity to remedy this state of affairs because of the EU’s adoption in 2003 of a “Savings Directive.” Under the Directive, the EU adopted a “coexistence” model based on two options, only one of which can be chosen by a member state: Either to cooperate in an exchange of information program, or to levy a 20 percent withholding tax on interest payments made by paying agents within its territory to individual residents of another member state. Under the exchange of information system, the member state agrees to provide automatically, at least once a year, information on all interest payments made by paying agents in its territory in the preceding year to individual beneficial owners residing in every other member state. Under the withholding tax system, the member state agrees to impose a 20 percent withholding tax on all interest payments made by paying agents within its territory to individual beneficial owners residing within the European Union. However, the withholding tax is not imposed if the beneficial owner provides a certificate drawn up by his country’s tax authorities attesting that they have been informed of the interest to be received. The withholding tax must be credited against the tax liability in the beneficial owner’s country of residence.

The EU Savings Directive only applies to payments within the EU. However, its adoption presents a golden opportunity. As explained above, the problem of nontaxation of cross-border interest flows stems to a large extent from the unilateral enactment of the portfolio interest exemption by the United States in 1984. As observed above, the nontaxation of cross-border interest flows is a repeated prisoner’s dilemma: Each player (the European Union, the United States, and Japan) refrains from taxing for fear of driving investment to the others, even though they would all benefit from imposing the tax. However, it is well established that such repeat prisoner’s dilemmas can be resolved if parties can signal to each other in a credible fashion their willingness to cooperate.

The EU Directive represents just such a signal. The European Union is telling the United States that it is willing to go forward with taxing cross-border interest flows. Thus, if the United States were to commit itself to taxing cross-border interest by repealing the portfolio interest exemption, the prisoner’s dilemma could be resolved and a new, stable equilibrium of taxing—rather than refraining from tax—would be established.

The prospects for agreement in this area are particularly good because only a limited number of players need to be involved. The world’s savings may be parked in tax havens, but the cooperation of such tax havens is not needed. To earn decent returns without incurring excessive risk, funds have to be invested in an OECD member country (and more particularly, in the European Union, the United States, Japan, or Switzerland). Thus, if the OECD member countries could agree to the principles adopted by the European Union in its Savings Directive, most of the problem of taxing cross-border portfolio interest flows could be solved.

My proposal is therefore as follows: The United States should move within the OECD for a coordinated implementation of the principles contained in the EU Savings Directive. However, while in the European Union context, exchange of information could play a large role, because there are few traditional tax havens in the European Union, in a global context withholding taxes have to be the primary means of enforcement. As noted above, tax havens with strong bank secrecy laws render it very difficult to have effective exchange of information among OECD member countries. If the investment is made through a tax haven intermediary, exchange of information is likely to be useless unless the tax authorities in the payor’s coun-

<sup>14</sup> Richard Bird, *Shaping a New International Tax Order*, 42 *Bulletin for International Fiscal Documentation* 292 (1988), 303.

try can know the identity of the beneficial owner of the funds that are paid to the tax haven intermediary.

I would therefore propose that instead of the “co-existence” model of the European Union, the United States, and following it the OECD, should adopt a uniform withholding tax on cross-border interest flows, which should also be extended to royalties and other deductible payments to portfolio investments (for example, all payments on derivatives). To approximate the tax rate that would be levied if the payment were taxed on a residence basis, the uniform withholding tax rate should be high (at least 40 percent). However, unlike the withholding taxes that were imposed before the current “race to the bottom” started in 1984, the uniform withholding tax should be completely refundable. To obtain the refund, as in the EU Directive, a beneficial owner need only show the tax authorities in the host countries a certificate attesting that the interest payment was reported to the tax authorities in the home country. No actual proof that tax was paid on the interest income is required: from an efficiency, equity, and revenue perspective, it is sufficient that the home country authority has the opportunity to tax the income from overseas investments in the same way as it taxes domestic-source income. Thus, even if the home country has a generally applicable low tax rate on its residents (or even a zero tax rate, as long as it applies to all bona fide residents), the resident could obtain a refund by reporting the income to the tax authorities in his home country.

Both the proposed withholding tax and the refund mechanism would not require a tax treaty. However, it would be possible for countries to reduce or eliminate the withholding tax in the treaty context when payments are made to bona fide residents of the treaty partner. In those cases, the exchange of information in the treaty should suffice to ensure residence-based taxation. Because most OECD members have tax treaties with most other OECD members, the proposed uniform withholding tax would in general apply only to payments made to non-OECD member countries (including the tax havens).

Were this type of uniform withholding tax enacted by OECD members, it would go a very long way toward solving the problem of under-taxation of cross-border portfolio investments by individuals. Such under-taxation is unacceptable from an efficiency, equity, or administrability perspective. Moreover, unlike the under-taxation of direct investment, this type of under-taxation is illegal (which is why it is so hard to assess its magnitude). By adopting a uniform withholding tax, the OECD could thus strike a major blow at tax evasion, which (as described above) is a major problem for the U.S. as well.

#### **4. Conclusion**

Under current conditions, the U.S. collects remarkably little revenue from the withholding tax on non-residents. That is because most forms of FDAP other than dividends are exempt, while the withholding tax on dividends can be avoided by the use of derivatives, in the ways described above.

One possible reaction to this state of affairs is to repeal the withholding tax. However, even if it were acceptable for the U.S. not to tax foreigners on passive income from U.S. sources, the risk of doing so is that it will enhance the ability of U.S. residents to derive income from U.S. sources through foreign intermediaries located in tax havens.

Narrower fixes to the problem posed by derivatives are possible, but as long as the portfolio interest exemption remains in the Code, they are unlikely to address the fundamental problem. Thus, in my opinion the best course to pursue is to repeal the portfolio interest exemption in coordination with the OECD, and instead impose a refundable withholding tax, along the lines set out above.

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Chairman NEAL. Thank you.  
Mr. Styracula.

#### **STATEMENT OF KEITH A. STYRCULA, CHAIRMAN, ON BEHALF OF STRUCTURED PRODUCTS ASSOCIATION**

Mr. STYRCULA. Thank you. Good morning, Chairman Neal, Ranking Member English, Members of the Subcommittee. I am grateful for the opportunity to testify today on this exceptionally important matter.

I am the founder and Chairman of the Structured Products Association, a 6-year-old professional trade group that includes approximately 3,000 financial services professionals among its membership. In addition to my responsibilities as Chairman, I have 15 years of experience as a senior-level structured products and derivatives professional with firms such as JPMorgan, UBS, and Credit Suisse.

I am here before you this morning to discuss the rapidly growing financial derivatives and structured products market here in the U.S., and to express our concerns over the potential impact a disadvantageous tax treatment may have on our industry's ability to remain competitive with foreign counterparts.

Given the importance of financial derivatives and economic innovation to the American economy, both here and abroad, as well as its growing contribution to the revenues of Treasury, it is absolutely imperative that all parties have an opportunity to contribute to an open dialogue on this matter. So, we appreciate the opportunity to be here today.

We fully recognize the challenge of determining the appropriate tax treatment of new financial instruments. It can often be daunting. Such is clearly the case with financial derivatives and structured products. Nevertheless, the positive impact the industry has had on the American economy over the last two decades should not be underestimated.

In a 1999 speech, former Federal Reserve Chairman Alan Greenspan described the extraordinary development and expansion of financial derivatives as "by far the most significant event in finance during the last decade."

In 2000, U.S. financial institutions has 40 percent of the global market share of the business that at the time was \$33 trillion. As Chairman Neal had indicated, that amount now, according to the BIS, is \$516 trillion as of June 2007.

By all measures financial derivatives are integral to the health of a global economy, and in particular, the American economy. So, it is imperative for us to acknowledge, however, that the U.S. is in jeopardy of losing its standing as the dominant global force in financial derivatives due to burdensome regulations in the post-Sarbanes-Oxley world.

I would like to turn now to the progeny of derivatives that are called structured products, which includes exchange traded notes. As noted in many of the financial mainstream media accounts over the last year, structured products represents the fastest-growing investment class of all financial services. The structured products market in the U.S. grew from \$64 billion in 2006 to \$114 billion in 2007, a 78-percent increase in just 1 year. The dramatic increase in popularity is linked to the fact that structured products, in many but not all cases, offer a superior value proposition to direct or managed investments, not simply by tax advantages.

Capital-guaranteed structured products are a perfect example, and we believe a cautionary tale to where taxation could have an adverse impact on financial innovation. Capital-guaranteed structured products are to European investors what mutual funds are to American investors. They provide the best of both worlds. They

protect investors against a significant market decline while providing exposure to upside potential.

Capital-guaranteed products would have the potential to be a dominant investment vehicle for protecting millions of American investors from market declines if it weren't for a significant drawback, and that is an exceptionally disadvantageous tax regime for it.

The SPA believes that the current tax treatment of capital-guaranteed structures is a cautionary tale for all interested parties. A capital-guaranteed structured note in the U.S. taxes on phantom income even though no payment has been received on the securities until maturity by the investor. As a result of this unduly burdensome and disadvantageous tax treatment, the United States is a poor competitor with Europe. In 2006, for example, Europe captured \$193.38 billion in capital-guaranteed structured products. The U.S. only managed \$7 billion.

I submit that Treasury would be far better off with a more advantageous tax treatment of capital-guaranteed notes and would raise far more revenues than the current tax regimes, as investors are often reluctant to purchase capital-guaranteed notes in taxable accounts.

We appeal to the Subcommittee to recognize the exceptional challenges the financial derivatives and structured products industries face against our global competitors. The United States is just now catching up with Europe in structured products sales after a decade-long period of lagging behind.

After trailing for those decades, the ascendancy of the U.S. growth has, for the first time, started approaching the striking range of Europe, which was \$316 billion last year versus the U.S.'s \$114 billion. So, it is \$3 to every \$1, whereas from 2006 it was \$6 to \$1.

With regard to exchange traded notes, the equivalent in Europe and Asia are called certificates and warrants. Almost without exception, the local jurisdictions treat any profit as capital gains if held for 1 year or longer. Any attempt to put ETNs at a tax disadvantage would have devastating consequences on structured products, which we believe are the greatest financial innovation since convertible securities and exchange traded funds.

In conclusion, we wholeheartedly agree with the Subcommittee that new legislation on the taxation of retail financial instruments is in order. Such legislation, however, should analyze all investment vehicles at the ground level to arrive at a fair and consistent approach to the taxation of financial instruments.

We respectfully submit that any attempt to single out financial derivatives in the absence of a full consideration of all financial instruments is a potentially dangerous precedent that could have vast, unforeseen consequences in our ability to compete in the global environment during an exceptionally competitive paradigm shift as we struggle to compete against Europe and Asia in a rapidly changing global economy.

I thank you for your time, and I look forward to taking your questions.

[The prepared statement of Keith A. Styracula follows:]



**Prepared Statement of Keith A. Styracula, Chairman,  
on behalf of Structured Products Association**

Good morning. I am grateful to Chairman Neal, Ranking Member English, and Members of the Subcommittee for providing me with the opportunity to testify on this exceptionally important matter. I am the Founder and Chairman of the Structured Products Association (the "SPA"),<sup>1</sup> a 6-year-old professional trade organization that includes approximately 3,000 financial services professionals among its membership. In addition to my responsibilities as Chairman of the SPA, I have 15 years of experience as a senior-level structured products and derivatives professional with firms such as JPMorgan, UBS and Credit Suisse. I am here before you this morning to discuss the rapidly-growing U.S. structured products market. We also appreciate the opportunity to express our concerns over the potential impact a disadvantageous tax treatment on financial derivatives may have on the American financial services industry's ability to remain competitive with foreign counterparts. We are also concerned about the possible adverse impact such treatment may have on prepaid derivative contracts on retail investors as well as the American economy.

On behalf of our members and of those in the industry whose view the SPA represents, I would like to thank Chairman Neal for recognizing the importance of initiating a comprehensive dialogue on the proper tax treatment of innovative financial instruments. Given the importance of financial derivatives, structured products and economic innovation to the American economy both here and abroad—as well as its growing contribution to the revenues of Treasury—it is imperative that all parties have an opportunity to contribute to an open dialogue on the matter. The SPA appreciates the privilege and opportunity to present a perspective today that reflects those of its professional members.

We fully recognize that the challenge of determining the appropriate tax treatment of new financial instruments is frequently daunting. Such is clearly the case with financial derivatives and structured products. These often-misunderstood financial instruments have been mischaracterized as "risky" and "complex." Nevertheless, the positive impact the industry has had on the American economy over the last two decades should not be underestimated.

In a 1999 speech, former Federal Reserve Chairman Alan Greenspan described "the extraordinary development and expansion" of financial derivatives as "[b]y far the most significant event in finance during the past decade."<sup>2</sup> Chairman Greenspan remarked that the U.S. commercial banks were the leading players in global derivatives markets, with outstanding derivatives contracts with a notional value of \$33 trillion, a rate "that has been growing at a compound annual rate of around 20 percent since 1990."<sup>3</sup>

The astounding growth of financial derivatives has not only continued its ascendancy in the new decade—it has accelerated to exceptionally compelling heights. The Bank of International Settlements noted that as of June 2007, the notional amounts of positions in financial derivatives globally was *\$516 trillion* at the end of June 2007—representing an annualized compound rate of growth of 33%.<sup>4</sup> By all measures, financial derivatives are integral to the health of the global economy—and in particular, the American economy.

It is imperative, however, to acknowledge that the U.S. is in jeopardy of losing its standing as the dominant global force in financial derivatives due to burdensome

<sup>1</sup> The Structured Products Association (SPA) is a New York-based trade group whose mission includes positioning structured products as a distinct asset class; promoting financial innovation among member firms; developing model "best practices" for members and their firms; identifying legal, tax, compliance and regulatory challenges to the business. With more than 2,000 members, the Association has members from the exchanges, self-regulatory bodies, legal compliance community financial media, investor networks, family offices, and both buy-side and sell-side structured product firms. The primary mission of the Structured Products Association is to position structured products as a distinct investment class, promote financial innovation among member firms, develop model "best practices" for member organizations, identify issues related to legal, tax, and compliance. The URL for the SPA website is [www.structuredproducts.org](http://www.structuredproducts.org).

<sup>2</sup> Chairman Greenspan's remarks on Financial Derivatives were made before the Futures Industry Association conference in Boca Raton, Florida on March 19, 1999. The full transcript appears on the Federal Reserve website at <http://www.federalreserve.gov/boarddocs/speeches/1999/19990319.htm>.

<sup>3</sup> Chairman Greenspan further commented on the leading role played by U.S. commercial and investment banks in the global OTC derivatives markets. "[T]he size of the global OTC market at an aggregate notional value of \$70 trillion, a figure that doubtless is closer to \$80 trillion today ... U.S. commercial banks' share of this global market was about 25 percent, and U.S. investment banks accounted for another 15 percent. While U.S. firms' 40 percent share exceeded that of dealers from any other country."

<sup>4</sup> See <http://www.bis.org/press/p071219.htm>.

regulation in the post-Enron/WorldCom environment. In foreign exchange derivatives, for example, the June 2007 BIS report indicates that “Among countries with major financial centres [sic], Singapore, Switzerland and the United Kingdom gained market share, while the shares of Japan and the United States dropped.”<sup>5</sup> The SPA cannot overemphasize how critical it is for the U.S. financial derivatives market to remain on a level playing field with global competitors in Europe, Asia, Australia and Canada. Any newly-imposed regulatory disadvantages introduced to our industry could impede our ability to compete on a global scale—during a time in which most reputable economists agree is a critical paradigm shift in the world economy.

I am not here before you as an expert on the treatment of prepaid forwards and financial derivatives. Accordingly, I will now speak to the issues surrounding the potential tax treatment of an emerging investment class known as “structured products” and the SPA’s serious concern that H.R. 4912—in its current form—is likely to impose a burdensome tax regime that would adversely impact a new American financial innovation that is only now competing effectively with the European marketplace.

### 1. What Is a Structured Product?

Simply put, structured products are the fastest growing investment class in the United States, and the most exciting financial innovation since exchange traded funds (“ETFs”). A structured product, generally speaking, has an embedded financial derivative that changes the “payoff profile” of a traditional asset class, such as equities, fixed income, currencies, commodities or alternative investments (hedge funds, private equity). Structured products are “synthetic *investment* instruments specially created to meet specific needs that cannot be met from the standardized financial instruments available in the markets. Structured products can be used as an alternative to a direct investment; as part of the asset allocation process to reduce risk exposure of a *portfolio*; or to utilize the current market trend.”<sup>6</sup>

As noted in the mainstream financial media, the structured products investment class represents the fastest growing investment class in all of U.S. financial services. According to SPA statistics, the structured products market in the U.S. grew from \$64 billion in 2006 to \$114 billion in 2007. As *Investment News* noted in its February 4, 2008 issue, “The structured-products industry has been relatively obscure among most U.S. investors and financial advisers, but lately, it is basking in the glow of a record-setting 78% increase in 2007 sales.”<sup>7</sup> The dramatic increase in popularity is linked to the fact that structured products—in many, but not all cases—offer a superior value proposition to direct or managed investments.

For example, a popular type of structured product might offer a “capital guarantee” function, which offers protection of principal if held to maturity. If an investor invests \$100, the issuer simply invests in a 5-year bond that today might cost \$80—but will grow to \$100 after 5 years. The remaining \$20 is invested in a financial derivative that is linked to a desirable asset class such as equity or fixed income indexes. Regardless of how markets perform, the investor is guaranteed to receive at least \$100 back upon maturity of the structured product.

Capital-guaranteed structured products are to European investors what mutual funds are to American investors. They often provide the best of both worlds—protecting investors from a significant market decline, while providing exposure to the upside potential of a reference index, basket or asset class. Indeed, it is the position of the Structured Products Association that capital-guaranteed structured products would have the potential to be the dominant investment vehicle for prudent American investors, if it weren’t for a significant drawback—an exceptionally disadvantageous tax treatment.

### 2. The Disadvantageous Tax Treatment of Capital-Guaranteed Structured Products

The SPA believes that the current tax treatment of capital-guaranteed structured products is a highly-illustrative cautionary tale for all interested parties. A typical prospectus on a capital-guaranteed structured note might note that the investment will be “treated as ‘contingent payment debt instruments’ for U.S. Federal income tax purposes. Accordingly, U.S. taxable investors, regardless of their method of accounting, will be required to accrue as ordinary income amounts based on the ‘com-

<sup>5</sup> BIS Triennial Central Bank Survey 2007 (June 2007), <http://www.bis.org/publ/rpfx07t.pdf?noframes=1>.

<sup>6</sup> Source: [http://en.wikipedia.org/wiki/Structured\\_products](http://en.wikipedia.org/wiki/Structured_products).

<sup>7</sup> Jeff Benjamin, *Investment News*, “Structured products flourish in today’s ‘choppy market,’” February 4, 2008. Source: <http://www.investmentnews.com/apps/pbcs.dll/article?AID=/20080204/REG/544709651>.

parable yield' of the securities, *even though they will receive no payment on the securities until maturity*. [Emphasis ours]. In addition, any gain recognized upon a sale, exchange or retirement of the securities will generally *be treated as ordinary interest income for U.S. Federal income tax purposes*. [Emphasis ours.]”<sup>8</sup>

As a direct result of the unduly burdensome and disadvantageous tax treatment of capital-guaranteed structured products, the United States is a poor competitor with Europe. According to the structuredretailproducts.com database, the tax disadvantage of capital-guaranteed structured products not only adversely impacts American retail investors; it results in a devastating impact on potential tax revenues to Treasury—an artificial inhibition on a potentially strong generator of tax dollars to close the gap on AMT reform. If the tax treatment were simple and reasonable to the investor, the U.S. financial services industry would be able to promote this significant, highly-advantaged vehicle to the average American retail investor while generating substantial revenue for the U.S. Treasury. Unfortunately, this tax-driven impediment has put the U.S. far behind its European competitors. In 2006, for example, Europe captured \$193.38 billion in capital-guaranteed structured products. The U.S. only managed \$7.152 billion in 2006. We attribute this directly to the unfavorable tax treatment accorded to the capital-guaranteed investment vehicle, which has been roundly criticized by all market participants who are understandably reluctant to offer the investment to taxable accounts. In the final analysis, the Treasury is deprived of revenue it might otherwise realize if the taxation of these appealing investments were simplified and comparative to the European equivalents.

### **3. The U.S. Financial Derivatives and Structured Products Markets Need Simple and Appropriate Tax Treatment to Compete Globally**

We appeal to the Ways and Means Committee to recognize the exceptional challenges the financial derivatives and structured products industries face against our global competitors. The United States is just now catching up with Europe in structured products sales—after a decade-long headstart—and imposing a singular, disadvantageous tax scheme on our industry will have vast and devastating consequences on our ability to compete on a global basis. We are struggling mightily to maintain our market share against Europe, Asia, Australia and Canada in the next decade in the financial derivatives arena.

The structured products industry, in particular, has seen a significant increase in its ability to compete against Europe in the global structured products arena. After trailing for most of the last two decades, the ascendancy of the U.S. growth has—for the first time—put us within striking range (Europe = \$316.17 billion vs. U.S. = \$114 billion, narrowing the gap from 6:1 over 2006).

The SPA is concerned that an inopportune tax treatment specifically targeting structured products could put the U.S. at a significant disadvantage against the rest of the world, a repeat scenario of what happened to capital-guaranteed structured products.

With regard to exchange traded notes (“ETNs”), the equivalent in Europe and Asia are “certificates” and “warrants.” Almost without exception, the local jurisdictions treat these instruments as long-term capital gains, if held for 1 year or longer. Any attempt to put ETNs at a tax disadvantage would have devastating consequences on structured products—the greatest financial innovation since convertible securities and exchange traded notes.

Based on the industry’s experience with capital guaranteed structured products, the SPA strongly believes that any tax-driven complexities introduced to structured products will have a highly adverse impact on the impressive growth of the U.S. structured products and financial derivatives markets over the last decade, especially given the industry’s efforts to compete with the European structured products market.

### **4. Conclusion**

We agree wholeheartedly with the Subcommittee that new legislation on the taxation of retail financial instruments is in order. Such legislation, however, should analyze all investment vehicles at the ground level—inclusive of ETFs, closed-end funds, mutual funds, convertible bonds, managed accounts, insurance products, unit investment trusts (“UITs”) and single-stock positions—to arrive at a fair and consistent approach to the taxation of financial instruments. The SPA respectfully submits that any attempt to single out financial derivatives, prepaid forwards, and structured products in the absence of a full consideration of all other financial in-

<sup>8</sup>A typical capital-guaranteed structured product issued by ABN Amro in the U.S. For more information, the EDGAR link is <http://www.secinfo.com/dRCqp.v4e.htm>.

struments is a potentially dangerous precedent that could have vast and unforeseen consequences in the global arena.

We point not only to the previous example of capital-guaranteed structured products as a cautionary tale, but to the clear and present impact of the well-intended Sarbanes-Oxley bill. Much like the proposed Neal bill, it was an exceptionally admirable piece of responsible legislation. Unfortunately, however, it had unforeseen consequences that put the U.S. at a disadvantage in the global capital markets—consequences our Nation's capital markets have yet to recover from. Sarbanes-Oxley permitted London to surpass New York as “the world's most competitive financial center,” according to a report released February 28 by the city of London, which analyzed the competitiveness of business centers around the world. The survey interviewed 1,236 senior business personnel from around the world, who ranked New York second and Hong Kong third. “While New York dominated all cities when measured by the capitalization of its listed companies and the trading volumes of its stock exchanges, the city . . . was criticized by some survey participants because of Sarbanes Oxley Act regulatory requirements.” The SPA is keen to avoid any similar impediment to the global competitiveness of the financial services industry, and respectfully asks the Subcommittee to seriously consider the consequences of an unprecedented taxation on financial derivatives, prepaid forwards and structured products.

H.R. 4912's approach to single out financial derivatives and its progeny has the real and present danger of imposing an unfavorable tax treatment on U.S. financial instruments. The direct result is a devastating impact on our industry's competitive efforts against highly formidable and well-capitalized European counterparts, many of which enjoy substantial tax advantages over us. We respectfully request that the Subcommittee fully consider our industry's intensively competitive position, and not impose any singular tax treatment that would provide further undue burden upon the American financial services industry's Herculean efforts to remain competitive against European and Asian in this rapidly-changing global economy.

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Chairman NEAL. Thank you, Mr. Styracula.

Professor Avi-Yonah, it is hard for me to understand how something called PRIDES, PEPS, DECS, or TRES could be harmful to our tax system, but that seems to be part of your testimony today. Through this derivative, an investor gets something quite close to equity ownership without actual ownership. A big plus is that a foreign investor can avoid dividend withholding tax by calling it interest.

Apparently some sovereign wealth funds have caught wind of this arrangement. Do you believe that treating this as equity or as the actual purchase of stock through a nominee would solve the tax problem?

Mr. AVI-YONAH. Yes. I do think so. I think that these products are created as equity for non-tax purposes. They are treated as equity for banking regulatory capital purposes. They are treated as equity for purposes of the regulation for investment into the U.S. In other contexts, including the exchange traded notes and the other types of derivatives that we are talking about today, it is very rare for these products to be bifurcated in this way.

I mean, basically in order to get the Federal tax results, you need to take something that is traded as a single unit and split it into two, and treat one segment as a pure note with interest and the other segment as a forward contract.

In other contexts, I think the more normal treatment would be to aggregate them together, treat them as a unit as they are sold, and that would mean treating them as equity and providing dividend treatment for the payments. That would mean collecting withholding tax, and in particular, when we are talking about in-

vestments that come from countries with which we don't have a treaty, that means a full 30 percent withholding tax.

Nor is it inconceivable to imagine that these investments would still be made. I still remember, for example, how a Saudi Prince invested in almost 10 percent of Citibank in straightforward stock in the 1990s, without bothering about the fact it was subject to a 30 percent withholding tax on the dividend.

So, it is not impossible to imagine that these investments, to the extent that we need them, would still be made. But certainly I don't see any particular reason why, just because of the structure of the derivative, this would be treated somehow as being interest and simply be exempt from the withholding tax.

Chairman NEAL. Thank you.

Professor Raskolnikov, you have listed some other investments that enjoy special tax advantages in the Code—home sales, pensions, insurance, municipal bonds. This does raise an interesting question.

If one could invest in a 30-year product with tax deferral and guaranteed capital gain treatment at the end, what current products might look less attractive in comparison other than just mutual funds?

Mr. RASKOLNIKOV. Yes, Mr. Chairman. So, it is a very advantageous tax treatment. Today, non-dividend-paying common stock is very tax-advantaged. Realization requirement gives taxpayers the opportunity to time their gains and losses, and there is no current income.

Real estate, life insurance have strong tax advantages, but a lot of them are well established. They have been in the Code for a long time. The system does give up capital income revenues by providing these tax advantages. So, the question is, as new products come in, whether it is worth extending this.

Chairman NEAL. Mr. Desmond, your testimony cites the SEC filings both for the issuers of foreign currency ETNs as not requiring current income inclusion and enjoying capital gains treatment, and for the other ETNs with filings advising investors that these products are not debt for tax purposes.

You said that this "presented a unique question whether tax deferral is appropriate." Might you elaborate for us?

Mr. DESMOND. Yes, Mr. Chairman. I think that highlights the issue that I spoke about in my oral testimony, which is which cubbyhole to put these instruments into.

The statements made in the SEC filings with respect to those instruments do walk through the various cubbyholes of the traditional categorizations that financial products fall into, and walk through basically the same analysis that I did in my testimony, and indicate or conclude that they aren't debt instruments because there is no guaranteed return of principle, the value of the underlying indexed asset may go up or down, and if it goes down significantly, your initial investment of \$100, for example, may not be returned to you and it may decline significantly.

Those documents also conclude that there is not an agency relationship, that the issuer is actually issuing its own note and it is not holding the underlying asset on an agency basis for the investor. So, therefore, the treatment that you would have if you actu-

ally held the stock—an agent held the stock for an investor—would also not be appropriate, those documents conclude.

They also go on then to conclude that the treatment as a forward contract is appropriate, and the consequences of that cubbyhole or that category, if you will, are the deferral of the income on those contracts until such time as it is actually realized, either through the end of the contract at the end of its term or upon disposition of the contract before that time.

Chairman NEAL. Mr. Desmond, much has changed since 1993 when Treasury first entertained the thought of guidance on prepaid forward contracts. But as you point out, the investor pool has grown dramatically and includes average investors now. That's part of the consideration and concern of this hearing this morning.

Does this mean that Treasury is more likely to follow through with guidance this time?

Mr. DESMOND. We haven't reached any conclusions, Mr. Chairman, on exactly what the right answer is. I think there is some additional tension being placed on the tax treatment of these instruments because, as you indicated, they have moved more into a retail market.

From our perspective, in terms of the tax issues to address through guidance, one of the key factors we consider is how many taxpayers are affected by the uncertainty of treatment. And 10 or 15 years ago, it was only a small number of taxpayers, relatively, and the urgency of addressing that question was not the same as it might be today when you have thousands or tens of thousands of potential investors.

One other observation on the change in terms of moving this product toward a retail market. Historically, if you had sophisticated investors and institutions investing in prepaid forward contracts, first of all, they often know what they are getting into and they can assume the tax risk and know what they are getting into. Also, many of those holders were institutions, dealers, and electing traders who would be taxed on those currently because they are subject to mark to market rules under existing tax regimes.

When those products move into more of a retail market, the holders are retail investors who likely are not subject to a mark to market regime as sophisticated traders and dealers might be, and therefore you have more of an issue with respect to potential for a deferral.

So, I think there are a number of reasons why that has become an important issue for us, a more important issue as it moves into the retail market.

Chairman NEAL. Thank you.

Professor Raskolnikov, your testimony does an excellent job in describing what our three benchmarks should be in derivatives taxation. As you have said, our piecemeal system often cannot meet these goals. One of the criticisms lodged against the income accrual approach on prepaid forward contracts is that it would be too complex for these average investors to do.

Might you comment on whether this admittedly incremental approach can be administered and complied with?

Mr. RASKOLNIKOV. Thank you, Mr. Chairman, first of all. Second, yes. I think it could. There are more complex regimes. The

constructive ownership rules resulting from the bill introduced by you some time ago is much more complex. So, that is point number one.

Point number two, as I mentioned in my written testimony, when we talk about retail investors, it is important to keep things in perspective. So, it is true that there are many more people who will probably invest and have tax consequences from these kinds of derivatives like ETNs, exchange traded notes, today than 10 years ago when only really wealthy people could do over-the-counter private derivatives with investment banks, like hedge fund swaps, that constructive ownership rules were addressing.

At the same time, in general it is believed that we have over-investment in real estate and under-investment in financial capital, in stocks, and other publicly traded securities. So, a lot of people don't have any savings. Middle class has savings in 401(k)s, IRAs, and tax-deferred accounts. For them, tax consequences don't matter.

So, fairly sophisticated retail investors—I am not saying that these are super-rich, but fairly sophisticated retail investors—are the ones who are going to be likely holders of these derivatives. For them, it is a somewhat complicated regime, but I would not say that it is an inordinately complicated regime. They have accountants. Many of them have tax lawyers. They would probably be able to figure out, especially because financial intermediaries with this kind of regime can provide most or all of the information. That is really key.

The regime is good when it can be implemented. Financial intermediaries can send the equivalent of Form 1099 saying, this is your accrual for the year, and with a copy to the IRS. Then it is going to work. I think that that is likely to be the case here.

Chairman NEAL. Let me yield to Mr. English.

Mr. ENGLISH. Thank you, Mr. Chairman.

Professor, you propose in your testimony what amounts to a substantially higher tax rate on derivatives than on the holder of the underlying assets. Should we in Congress have any concern that this could result in the distortion of investment decisions?

Mr. RASKOLNIKOV. Thank you, Mr. English. Well, yes and no is the answer. It is not so easy. Distortions are always a concern, so you are absolutely right. I agree with you 100 percent.

Speaking about the tax burden on these exchange traded notes or prepaid derivatives being higher than on the underlying asset, it is a tradeoff. It is higher in one sense but it is lower in the other sense. It is higher because there is imputation of interest. That does not happen when you actually invest in the underlying. But it is lower because the trading gains and dividend income is all deferred up to 30 years in the future.

So, this is—you can think about it as balancing two possible tax burdens. One is higher in one context, another one is higher in another.

Mr. ENGLISH. Understood. Mr. Avi-Yonah, given the current state of the economy, what is going on right now in credit markets, my own view is that we should be encouraging and definitely not discouraging U.S. investment. I am concerned that your suggestion

to expand the reach of our withholding taxes might have some potential impact on investment in the U.S.

Barring some major change in the equation, wouldn't your proposal encourage foreign investors to simply shift their investments to countries that wouldn't have these sorts of rules? Isn't that the lesson that we learned from the experience of Germany, which you noted that had a disastrous experience with their 10 percent withholding tax two decades ago? Your thoughts?

Mr. AVI-YONAH. Yes. I mean, this is certainly a valid concern. You could even say that we have now, because of these kinds of concerns, whittled down the scope of the withholding tax so much. I mean, we don't withhold tax on interest, we generally don't withhold tax on royalties and rents, and we under treaties also don't withhold tax on some dividends.

So, what is left is these portfolio dividends, and that is a relatively narrow scope. On this, in order to enforce this, we have a very elaborate set of withholding regulations that everyone who is dealing with foreigners needs to enforce.

So, you could certainly make an argument that there is a problem in having too much law for too little revenue, and that the best thing would be to give up the withholding tax altogether.

I have two concerns with that. One is simply that I don't think it is very likely that Congress will give up on the withholding tax any time soon. There hasn't been any indication.

But the other issue really is that I am worried about some of this lack of withholding tax affecting our ability to tax U.S. people on U.S.-source income. Because there has been, as you may have read in the press recently, stories, for example, about the Lichtenstein banker who turned up with some stolen documentation. The Germans got it, and then they shared it, and then lo and behold, it turns out that some Americans are having bank accounts there, too.

Every time a banker from one of these tax havens gets to talk, it turns out that there are Americans there. There are all kinds of estimates running around about how much of this there is. But where I am concerned is if there was no withholding tax whatsoever on any kind of investment in the U.S., and I am doubtful if the IRS has the capacity in the absence of information or withholding to really enforce our taxes on our residents adequately and prevent them from doing exactly what the Germans did, which is going to Luxembourg and then back into Germany.

So, what can be done about it? Well, I think two issues. One is, I mean, the particular narrow loopholes that I was talking about in terms of closing, I don't think they would affect the overall foreign investment into the U.S. These are relatively small transactions that are particularized to a particular situation, and I don't think they have a broader reach.

What I think might affect the broader issue is if we start looking at the portfolio interest exemption again. I think that needs to be done in coordination with the Europeans in particular. The interesting thing about this is that as a result of the German experience, the E.U. now has a savings directive that applies either to information exchange or withholding tax to all payments to other E.U. residents.



I think they would be perfectly willing to coordinate some kind of withholding tax with us if we are willing to talk with them about it because essentially, that is what they want to do.

Mr. ENGLISH. Would coordination with the E.U. be adequate in itself? Aren't we also talking about some other very large markets where capital can flow to?

Mr. AVI-YONAH. Well, actually, I don't think so because what is nice about this world, in a way, is that obviously you can't leave your money in the tax havens because you don't get a decent rate of return. The other markets that are out there are mostly developing countries, China, India, and so on, and those are too risky for the normal portfolio investors. They don't usually go there.

So, if you look at where the portfolio investors flow, they are overwhelmingly into obviously the member countries. The Japanese already withhold. If we get together with the E.U. and with Japan and we all withhold—even Switzerland, which is a relatively big country, you can't really leave the money there. There is not enough investment opportunities.

In order to earn decent returns at relatively low rates, you have to go into the E.U., the U.S., or Japan. Those are really the only possibilities. I think it is quite plausible to have an agreement with the two of them.

Mr. ENGLISH. I will think about your testimony. That is very challenging.

Thank you so much, Mr. Chairman.

Chairman NEAL. Thank you, Mr. English.

The Chair would now recognize Mr. McDermott.

Mr. MCDERMOTT. Thank you, Mr. Chairman. I want to comment or praise you for bringing the most arcane issue I have seen in my 20 years in Congress.

Chairman NEAL. We won't do it again.

Mr. MCDERMOTT. I don't know how you are going to top this.

Mr. Styracula says if we are going to do this, this is going to be a danger to the economy. So, Mr. Raskolnikov, I would like you to explain to me—I read an article today in the Wall Street Journal which says that the top 400 families, the 400 richest people in this country, pay 18.23 percent income tax. This is down from 30 percent 10 years ago.

So we are piling up wealth more and more in the hands of people who could figure out what this derivative business is all about. Please explain to me why Mr. Styracula would say it threatens our competitiveness if we haven't got all these arcane instruments that basically shelter?

I have an article here from 2006 talking about Goldman Sachs doing some oil trade return notes that don't pay anything until 2036. So, there is no income tax whatsoever on that stuff. So I can explain to the people in my district, put it in terms that I can understand, why derivatives are so important for the competitiveness of the United States that is spending \$3 billion in Iraq, and won't tax, and therefore has got deeper and deeper debt? How are derivatives saving us?

Mr. RASKOLNIKOV. Well, Mr. McDermott, I think that derivatives definitely play a useful function. So, I don't want to say that—

Mr. MCDERMOTT. What is that function?

Mr. RASKOLNIKOV. That function for businesses is risk reduction.

Mr. MCDERMOTT. Risk reduction?

Mr. RASKOLNIKOV. Risk reduction. Hedging. Derivatives allow businesses to keep the risks that they want and get out of the risks that they don't want. So, imagine a jeweler who knows a lot about jewelry but doesn't know a lot about gold prices and silver prices. So the risk that this person wants to take is the risk of how fashions will change and what kind of jewelry to make. But the risk they don't like is they have no idea how the gold prices are going to move.

So, derivatives would allow them, if you wish, to lock in the price of their supplies. It can be gold for jewelers, it can be oil for airlines, and so forth.

Mr. MCDERMOTT. So, the risk is no longer on them. Who is the risk on?

Mr. RASKOLNIKOV. The risk is on someone who wants to take that risk, like a speculator.

Mr. MCDERMOTT. Like a hedge fund?

Mr. RASKOLNIKOV. Maybe it is a hedge fund. Maybe it is a wealthy——

Mr. MCDERMOTT. So, when the hedge fund goes belly up, then we run in and bail out the hedge fund. Is that what we do?

Mr. RASKOLNIKOV. Well, that is a different issue. Bailing out hedge funds is well beyond——

Mr. MCDERMOTT. Well, isn't that what we did? We did that several years ago.

Mr. RASKOLNIKOV. We did do that. That's right, at least with one of them.

Mr. MCDERMOTT. So, we are shifting off of the jeweler, putting it on the hedge fund, and saying, we will catch you when you fall on your rear?

Mr. RASKOLNIKOV. Yes. That last point I am not sure I am happy with. But if the hedge fund is truly interested in taking on a risk, and we are not bailing out hedge funds just because we feel bad about their failures, then derivatives have played a valuable role. If we do bail out hedge funds, then we are just transferring the risk from a jeweler to taxpayers at large. Because it is tax dollars in the end. That doesn't seem like a good idea.

Mr. MCDERMOTT. It doesn't seem like a good idea at all to me.

Mr. RASKOLNIKOV. I agree.

Mr. MCDERMOTT. So, why should we do it? I mean, we defend the taxpayers. This Committee is the one that sets the taxes on the American people and says, you will pay.

Mr. RASKOLNIKOV. Yes.

Mr. MCDERMOTT. Now, why should I want derivatives to be out there when I know I am going to have to say to the American people, we have to bail these guys out because they had this terrible thing happen to them?

Mr. RASKOLNIKOV. Okay. So, the best answer I can give you is this. You want to tax something where you can actually collect revenues. If something you are trying to tax is just going to dis-

appear the moment you levy the tax, then it is not worth levying the tax. That is basically Mr. Styracula's point.

I don't think that they will—now, having said that, I don't think that derivatives will disappear if you start taxing them somewhat more. I don't think that the interest imputation regime that you are considering is a very high tax that will just kill the products. It is just an opinion. People may differ. But that is what I think.

If you did think or if you got convinced that imposing a tax will just kill the product, then you will not have raised any revenue, and that is just not worth spending time on. That is the analysis.

Mr. MCDERMOTT. So, our Committee has to deal with the fear that Mr. Styracula creates for us, that if we do it, we will kill the product?

Mr. RASKOLNIKOV. Well, deal, yes. It is definitely something to consider. It doesn't mean that the answer is, therefore, don't do anything. I hope that is clear from my testimony. It just means, be careful.

Mr. MCDERMOTT. Thank you. Thank you, Mr. Chairman.

Chairman NEAL. Thank you, Mr. McDermott.

Mr. Cantor is recognized.

Mr. CANTOR. Thank you, Mr. Chairman. I did want to follow up on some of the questions from my friend from the State of Washington, although it certainly whether or not be on the lines of Iraq. I don't know how we could ever involve the question of Iraq when we are sitting here talking about capital-guaranteed products.

Nonetheless, I do want to follow up. I want to find out, Mr. Styracula, about the nature of sort of the retail investors out there. You talked about the size of our market, \$114 billion versus three times that in Europe. Dr. Avi-Yonah talked a little bit about the sovereign wealth funds and the nature or the source, the timing, and the character of the income.

So, can you just in more layman terms try and talk about what the nature of that marketplace is? Who is involved and where is it going?

Mr. STYRCULA. Thank you, Mr. Cantor. I appreciate the opportunity to do so.

If we go back to the market break in 2000, where all of the indexes—during the dot com implosion of approximately March 2000, where indexes were losing up to 40 percent of their value, what wound up happening is for a considerable period of time, for 2 or 3 years thereafter, indexes were up only single digits.

Many of the major firms, such as JPMorgan, Merrill Lynch, and Morgan Stanley, started developing what we call structured products or investments for higher net worth investors to actually repair their portfolio with higher income, two times upside on indexes up to a cap, some relatively sophisticated financial instruments. Those investors did exceptionally well from the market break of 2000 until 2003.

So, that led to the growth of an industry in which we said, well, these are very useful products, some of the more simple ones, not the super-sophisticated ones, and these are products that have utility in dialing out volatility and market risk—or taking on market risk, as the esteemed professor had mentioned—if they want to do

so. Also, for the first time, average investors were able to get access to markets they otherwise couldn't get into—commodities, currencies, and what we call the BRIC countries, Brazil, India, China, and Russia.

So these products have—the reason that the market is growing is because average investors are having a positive experience with them. They are perfect hedges in market volatility; when markets shift and we are in an interest rate-decreasing environment, structured products provide an opportunity to increase, based on some equity strategies that may be a bit too arcane to get into here, but structured products have proven to be very useful and well-accepted investments for average American investors.

Mr. CANTOR. Mr. Chairman, if I could ask, do you know the breakdown of the average sophisticated investor, if you will, versus the institutional investor versus, again, those using these products to hedge risks or to speculate versus the more commonplace investor profile that we think of when people deal with their 401(k)s or other types of savings or investment vehicles?

Mr. STYRCULA. Absolutely. Breaking down the \$114 billion figure that we have received from external data providers, the belief is that \$67 billion of that is in the hands of individual investors, and probably the majority—we don't have the breakdown, but the majority of that is in the upper high net worth or accredited investor status. So, we are really looking at about a 30 to \$40 billion market for the retail investor right now.

There are as many as 40 structured products issuers in the U.S., including some insurance companies that have gotten into the business, some mutual fund companies, as well as the traditional private bank and broker dealer communities as well.

So, we are starting to see, for example, one of the most prominent structured products of the last year involved being able to access commodities markets. For regulatory reasons, up until approximately the year 2000, many investors couldn't have access to these markets. Now there are forms of capital-guaranteed access to the markets; as well, exchange traded notes are providing an exceptional useful function in accessing difficult markets. It is true that the market is in its infancy, but we see phenomenal growth potential in it.

Mr. CANTOR. Mr. Chairman, if I could ask Dr. Avi-Yonah very quickly on the tax theory behind where we are currently, these vehicles versus the other funds out there where you are having to pay taxes every year.

I mean, is it ultimately the fact that if you are a mutual fund investor, let's say that you have a claim to an underlying asset, that somehow you are then taxed on that interest; and the fact that in these vehicles here, that you have really—as you say, the tax treatment is a little bit different than the other regulatory treatment, that there is a debt instrument there that ultimately is not realized? Is that really what we are talking about?

Mr. AVI-YONAH. Well, in the case of those particular instruments, the theory of the bifurcation is that you really have a unit that can be broken up, and the investor has the right to break it up and sell the note part separately. Therefore, because of that, the

IRS is willing to set aside the forward contract and the note and treat the note as separate from the forward contract.

But they are marketed as a single unit, and they are treated as equity for other purposes. So, my view is that there is no particular reason to bifurcate them in this case. We don't usually bifurcate financial instruments.

Mr. CANTOR. Thank you, and thank you all very much for being here.

Chairman NEAL. Thank you, Mr. Cantor.

The Chair will now recognize Mr. Herger.

Mr. HERGER. Thank you very much. I want to thank you, Mr. Chairman, for allowing me to sit in on this Subcommittee, and Mr. English. This is certainly a very important issue, one that is certainly very complex, and I appreciate your holding this hearing today.

Mr. Desmond, you mentioned that the IRS notice requesting comment on prepaid derivative contracts listed a variety of areas of concerns about which the Service hoped to learn more. Could you perhaps go through some of those issues and highlight for us what the policy concerns are and which additional information would be helpful to decisionmaking?

Mr. DESMOND. Yes, Mr. Herger. I think the notice does walk through a number of issues that we have asked for public comments on. I think a number of them have been alluded to in the testimony here this morning.

I think one that was talked about was the concern that we would have with not interrupting the ordinary business use of derivative instruments. As was talked about by some of the other witnesses, there are business reasons why taxpayers enter into derivative instruments unrelated to taxes, or at least only tangentially related to taxes. We don't want to be publishing any rules that would interfere with those business uses of derivative instruments.

Another sort of fundamental question is whether or not in this context it is in fact appropriate to require some type of current accrual of income for tax purposes. I think we have talked about the various cubbyholes that instruments can fit into. In many historical contexts, we don't require accrual for tax purposes until there is actually realization. So, if you hold stock and it appreciates in value, even though you will be recognizing income as the value goes up, you are not taxed on that appreciation until a much later date when you sell the stock.

So, there is a fundamental question about, in the context of these instruments, whether accrual should be required. Assuming you conclude that accrual should be required, there are a number of different avenues to get there, a number of different models already in the Tax Code that could be built upon in a regime that would facilitate current accrual.

We have talked about the mark to market method that is used in other contexts. There are some other instruments and special rules that we have published in other contexts that require current accruals even though there is no actual cash flow on the instrument. So, that question, again, if you decide that you should have current accrual, how you should do that. So, those are issues that we are looking at.

There are also a number of issues that come up in the international context. If you have either investments being made by U.S. taxpayers abroad in these instruments or investments by foreign taxpayers, a number of special withholding tax issues come up and other issues that are unique to the cross-border context that we have also asked for comments on.

Mr. HERGER. I thank you very much.

Just on the capital gains, Dr. Avi-Yonah, could you tell me what you feel perhaps the proper rate on capital gains should be? Is it the current law of 15 percent, or should it be raised or lowered?

Mr. AVI-YONAH. Well, first, I have never been persuaded that there is any really good reason to tax capital gain at the lower rate. We of course had equivalence under the 1986 Act. The basic reason is that most of the arguments in favor of a lower rate on that capital gains assume that we are going to treat all of these instruments under a realization requirement.

If we adopt Professor Raskolnikov's suggestion of doing a mark to market requirement, then you don't have the lock-in problem and the various other problems, or the inflation problems, and all the other problems that have traditionally been given as a reason to tax at least capital gains on these kind of very liquid instruments where you don't have a valuation issue and you don't have a liquidity issue. Taxpayers are able to realize and pay the tax whenever they want to.

Mr. HERGER. So, then you feel the tax rate should be—should it remain at 15 percent, or should it be raised?

Mr. AVI-YONAH. Well, I think that is basically—rate is a question for Congress. But what I think is that there should—

Mr. HERGER. What is your opinion?

Mr. AVI-YONAH. My opinion is that there should be the same rate on capital gains as there is for ordinary income. Whatever the rate is—

Mr. HERGER. So, you feel it should be raised, then?

Mr. AVI-YONAH. Under the current rate structure, it would be raised, yes.

Mr. HERGER. Mr. Raskolnikov, what is your feeling? Is the rate where it should be? Should it be raised? I know the Administration and the Treasury feels it should be permanently made at the 15 percent—maintained where it is. What is your thoughts?

Mr. RASKOLNIKOV. I like the 1986 Act. Lower rates on ordinary income, higher rates on capital gains. Single rate.

Mr. HERGER. So, you would like to see them raised?

Mr. RASKOLNIKOV. Yes. Broader base and lower rates is the way to go.

Mr. HERGER. Thank you, Mr. Chairman.

Chairman NEAL. We have time for another round of questioning. So, Mr. Desmond, let me ask you about credit default swaps, which seem to be in the news a lot recently. It seems that Treasury has entertained the thought of guidance here, and I think most of us believe that would be very helpful.

We have heard that, in its absence, parties to these unregulated swaps have been free to take whatever position is most convenient as to the character and tax treatment. Can you explain if Treasury

is working on guidance, and when we might expect to see some result?

Mr. DESMOND. Yes. Thank you, Mr. Chairman. Credit default swaps are an instrument. We have been talking mostly or I have been talking about derivative instruments with an underlying asset, an index asset, of being an equity of some kind. That is what we are talking about in the context of most exchange traded notes.

There are also derivative instruments that can give someone exposure with respect to a credit risk, and that is what credit default swaps generally are, although there are all different categories of them.

It is an issue that we have been looking at. Back in 2004, we issued a notice requesting comments on the appropriate tax treatment of credit default swaps, focusing in particular on a number of international issues that come up with respect to foreign taxpayers.

There are, I think, a number of reasons why investors enter into credit default swaps that have nothing to do with taxes. There are business reasons why you want to seek credit protection. You may have a loan outstanding to a particular individual and you may want to protect yourself against the credit risk with respect to that borrower, and credit default swaps—or excuse me—yes, credit default swaps do offer some protection in that context.

So, it is an issue that we have thought about. It is an issue that we have solicited comments on. But it is really not one that is driven necessarily by taxes. There are a lot of reasons for entering into these, a whole number of different types of credit default swaps that may have different tax treatment depending on what particular type of credit default swap you are looking at, and a number of different options for their characterization depending on the facts.

Chairman NEAL. So, given that explanation, you really don't have a timetable?

Mr. DESMOND. I don't think we really do have a timetable. Again, it has been since 2004 that we have been looking at this. It does come up in discussions of these other issues, like notional principal contracts, that are on the table when we talk about derivatives generally.

So, it is something we talk about, again. Again, we see lots of non-tax reasons for entering into these instruments. It is not something that we have seen as we have with the exchange traded notes, sort of a renewed reason for looking at it. I think the issues that are out there with respect to credit default swaps are the same issues that have been out there for some time.

Many of the issues that are coming up recently are not necessarily tax issues. They are questions about the value of these instruments and other things that might raise non-tax issues that I think are putting them into the—sort of bringing the discussion of them up again. But those are really—many of those are not tax issues.

Chairman NEAL. Is it possible, then, based upon the answer that you have given that a tax preparer or tax attorney or accountant could argue the issue flat around for their client?

Mr. DESMOND. Certainly there are a number of different types of credit default swaps, and the tax treatment with respect to those different varieties, there can be—you know, absent very clear guidance on a specific transaction, there are certainly arguments as to the particular tax treatment of it.

Chairman NEAL. Mr. English.

Mr. ENGLISH. Thank you, Mr. Chairman.

Mr. Avi-Yonah, I understand that the U.S. tax treatment of an equity swap with a non-U.S. person is not clear, and that the existing guidance regarding U.S. withholding rates is incomplete. My understanding further is that in the absence of clear rules in this area, banks use a variety of factors to attempt to identify good equity swaps as distinguished from bad ones.

In this regard, would it be helpful if there was a clear set of rules to determine when an equity swap should be respected and when they should be recharacterized to subject payments to withholding and/or information reporting such as, for example, a share lending arrangement or a nominee ownership arrangement? If so, is this something best addressed by the IRS, or should Congress intervene legislatively?

Mr. AVI-YONAH. So, I think that the fundamental issue is the source rule because our current source rule is that all payments on notional principal contracts basically are taxed based on the residence of the recipient, which in the case of a foreign would mean that they are not U.S. source income and not subject to withholding tax.

You mentioned our treatment of securities lending transaction. In that context, we have decided to source the payments by reference to the underlying. So, a dividend substitute payment that is paid from a U.S. borrower of a security to a foreign lender of a security is treated for withholding tax purposes and other tax purposes as equivalent to a dividend because it is a dividend equivalent.

I personally think that the same treatment should be extended to dividend equivalence in other contexts, such as swaps, equity swaps. If you do that, then I don't think it matters so much.

I mean, under the current law, basically the question is, where do you draw the line, and how much can you go in the direction of hedging your investment and tracking precisely the dividends and still be under the notional principal contract source rule?

But my view is that the source rule needs to be changed. As I mentioned before, I can't think of any other example where such a major source rule was adopted by regulation without any congressional input, as far as I can tell. Most of our source rule, by far the vast majority of our source rules, are in the Code. I think that this is something for Congress to take a look at.

Mr. ENGLISH. So, this is something that you would recommend we consider a legislative solution?

Mr. AVI-YONAH. Yes, I do.

Mr. ENGLISH. Very good.

Mr. Raskolnikov, you went through a variety of pros and cons of a mark to market regime and concluded, as I understood it, that on balance, it is a workable system for derivatives. In particular, you have dismissed the concerns about investor liquidity to pay



for the taxes since many derivative investors are comparatively wealthy.

But is that really the case for mutual fund or ETN investors, and would you make any allowance for them?

Mr. RASKOLNIKOV. Thank you, Mr. English. So, mutual funds are outside of my proposals because mutual funds are not derivatives.

Mr. ENGLISH. Well, then, let's focus on—

Mr. RASKOLNIKOV. ETNs. So, thank you for asking the question. It actually gives me an opportunity to say something about what Mr. Styracula said and just clarify one thing. He said—

Mr. ENGLISH. I would like to stay focused, though, because I have very limited time.

Mr. RASKOLNIKOV. Oh, sorry.

Mr. ENGLISH. If you could directly answer the question.

Mr. RASKOLNIKOV. Sorry. So, the question—but that goes exactly to your question. So, apparently \$30 billion is invested in retail prepaid forwards. Thirty billion dollars is a large number, but we don't know how many people are there.

I suspect—I suspect—that most of these people are fairly well off; or if they are not well off, they are investing in 401(k)s and IRAs and they won't care about the mark to market regime. So, will these relatively well-off people have liquidity? I suggest that it is quite likely that they will to pay the tax, yes.

Mr. ENGLISH. I wish I had a little more confidence in your suspicions.

Mr. Desmond, are there any studies that would illuminate on this point?

Mr. DESMOND. Not that I'm aware of, Mr. English. I think the numbers that have been thrown out are industry data. They are not data that the Treasury Department has looked at. So, nothing that we have done. Nothing that I am otherwise aware of.

Mr. ENGLISH. Then I will go back to the professor.

If Congress were to opt against the mark to market regime for derivatives that you have advocated, do you think the time value of money-based alternative, which is outlined in the Chairman's bill, would be workable? Why or why not?

Mr. RASKOLNIKOV. I think it may be workable, yes. Why? It is a fairly simple system, much simpler than other legislation that has already been passed, like constructive ownership rules.

Financial intermediaries who are selling these products to the masses, so to speak, well-off masses, for sure, will be able to provide taxpayers with information about the accruals that need to be included in income, and they will be able to provide this information to the IRS. That is the hallmark of a workable system.

Mr. ENGLISH. Thank you, Mr. Chairman.

Chairman NEAL. Thank you, Mr. English.

I want to thank the witnesses for their testimony today. We perhaps will have some followup questions that will be asked of you, and we hope you will respond promptly. This was most helpful. So, at this point, I would like to thank you, and again take the opportunity to call the second panel.

Let me thank the panelists, and we will begin with Mr. Sauter.

**STATEMENT OF GEORGE U. "GUS" SAUTER, CHIEF INVESTMENT OFFICER, THE VANGUARD GROUP; MANAGING DIRECTOR, QUANTITATIVE ENERGY GROUP**

Mr. SAUTER. Chairman Neal, Ranking Member English, and Members of the Subcommittee, good morning. My name is Gus Sauter, and I am the Chief Investment Officer of the Vanguard Group.

Vanguard is one of the world's largest investment management firms, with nearly \$1.3 trillion in U.S. assets under management in more than 150 mutual funds. I directly oversee the management of approximately 75 percent of these fund assets, including both indexed and actively managed equity and bond and balance funds, as well as money market funds.

I am glad to have the opportunity this morning to share our views on exchange traded notes or ETNs. My perspective on these products is that of the Chief Investment Officer of Vanguard, with professional responsibility for investing in financial products and capital markets for the benefits of millions of investors.

Our basic message is that now is the time to address these products that some in the press are calling derivatives for the masses. Indeed, all one needs to begin investing in these derivatives is \$50 and a brokerage account.

Unparalleled, and I am told unintended, tax benefits have in part fueled the explosive recent growth of ETNs. There were no ETNs at all in May of 2006. The first ETN was offered in June of 2006. Since then, six issuers have brought some 30 different ETNs to market. At the end of 2007, just 2 months ago, there were \$4 billion in ETNs. Today, just 2 months later, there are \$6 billion worth of assets.

New ETNs are now being announced on a regular basis. In our view, this explosive growth may have been many magnitudes greater than it currently is if ETNs' current tax treatment had been thought to be relatively certain to continue.

ETNs are presented as a way to convert investment returns into long-term capital gains and to defer tax payment until the derivative is sold or redeemed, possibly many years in the future. No comparable financial product is taxed so favorably. Regulated futures, for example, are marked to market annually, that is, treated as sold at the end of each year, and taxes may be owed without an actual sale, though they are also exchange traded forward contracts like ETNs.

This highly favorable tax treatment is the result of a gap or loophole and not an express policy decision. ETNs are simply bringing to a head a question that has been left unresolved for many years, how prepaid forward contracts should be taxed.

The time has come to answer this question directly. As a manufacturer, seller, distributor, and consumer of investment products, Vanguard is keenly interested in knowing how ETNs are and will be taxed. Their treatment should be the result of deliberate policy choices rather than legislative or administrative gaps.

Under current conditions, retail investors can be expected to continue to buy these offerings, making it increasingly complicated to reset expectations and adopt a sound comprehensive tax policy in the future.

In addition, current tax policy has the potential to create significant collateral damage to many participants in the capital markets. Consider, for an instance, the case of municipal bonds. Consider an ETN that is created to provide the performance of the broad U.S. taxable bond market, the Lehman aggregate bond market.

That ETN would provide the investor the return of the U.S. bond market without taxation on a current basis. Taxes would be deferred until the investment is sold. At that point, they would be taxed as capital gains.

You can imagine that this is a very appealing investment for a taxable investor, and that these types of investments would compete against municipal bonds, which also have a tax-favored status. As a result, municipal bonds would have to have substantially higher interest rates than they currently pay, dramatically increasing the cost of financing municipal projects.

At the same time, there are other industries that are greatly impacted by this. Variable annuity providers, for instance, again allow investors to aggregate or participate in markets while not being taxed currently and paying tax at the end of the investment timeframe. At that point, the investment is taken out and paid current income taxes. You can imagine that an ETN would be much more favorably viewed than a variable annuity.

Then finally, the retirement savings industry would be dramatically impacted. Today there are incentives, from a tax standpoint, to invest in 401(k) plans. If ETNs were available, those incentives would be gone.

That is why we are here today, to support H.R. 4912, introduced by Chairman Neal. It takes a significant step in what we regard as the right direction to address ETNs and other prepaid forward contracts. Clarity is essential to enable financial services firms and investors to plan for the future. We look forward to working with you to improve the situation going forward.

I thank you for the opportunity to share our views, and I will be pleased to answer any questions.

[The prepared statement of George U. "Gus" Sauter follows:]

TESTIMONY OF GEORGE U. "GUS" SAUTER  
CHIEF INVESTMENT OFFICER AND MANAGING DIRECTOR  
VANGUARD

Before The Subcommittee on Select Revenue Measures

Committee on Ways and Means  
United States House of Representatives  
March 5, 2008

Chairman Neal, Ranking Member English, and Members of the Subcommittee:

Good morning. My name is Gus Sauter, and I am the Chief Investment Officer and a Managing Director of Vanguard, an investment firm based in Malvern, Pennsylvania. Vanguard is one of the world's largest investment management firms, with nearly \$1.3 trillion in U.S. assets under management in more than 150 mutual funds. I directly oversee the management of approximately 70% of these fund assets, including both indexed and actively managed equity, bond, and balanced funds, as well as money market funds.<sup>1</sup>

I am glad to have this opportunity to share our views on "exchange-traded notes" or "ETNs." My perspective on these products is that of the Chief Investment Officer of Vanguard with professional responsibility for investing in financial products and capital markets for the benefit of millions of Americans. Our basic message is that now is the time to address these products that some in the press are calling "derivatives for the masses." Indeed, all one needs to begin investing in these derivatives is \$50 and a brokerage account.

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<sup>1</sup> The remainder of the assets invested in Vanguard mutual funds are managed by third party advisers we select and oversee on behalf of our funds.

Unparalleled and, I am told, *unintended* tax benefits have in part fueled the explosive recent growth of ETNs.<sup>2</sup> There were no ETNs at all in May 2006. Since then, 6 issuers have brought some 30 different ETNs to market, collecting more than \$6 billion. Assets have increased more than 400% over the past 12 months or so and more than 50% over the past few months despite market setbacks. New ETNs are now being announced on a regular basis. In our view, this explosive growth may have been many magnitudes greater if ETNs' current tax treatment had been thought relatively certain to continue.

ETNs are presented as a way to convert investment returns into long-term capital gains and to defer payment of tax until the derivative is sold or redeemed, possibly many years in the future. No comparable financial product is taxed so favorably. Regulated futures contracts, for example, are marked to market annually (that is, treated as sold at the end of each year, and taxes may be owed, without an actual sale), though they are also exchange-traded forward contracts like ETNs.<sup>3</sup>

I am told that this highly favorable treatment is the result of a gap or loophole and not an express policy decision, that ETNs are simply bringing to a head a question that has been left unresolved for many years: how prepaid forward contracts should be taxed.

The time has come to answer this question directly. As a manufacturer, seller, distributor, and consumer of investment products, Vanguard is keenly interested in how ETNs are, and will be, taxed. Their treatment should be the result of deliberate policy choices rather than legislative or administrative gaps. Under current conditions, retail investors can be expected to continue to buy these offerings, making it increasingly complicated to reset expectations and adopt a sound and comprehensive tax policy.

That is why we are here today -- to support H.R. 4912, introduced by Chairman Neal. It takes a significant step in what we regard as the right direction to address ETNs and other

<sup>2</sup> No doubt part of ETN growth can be explained by factors that perhaps deserve attention in another forum. For example, ETNs are lightly regulated and can be designed to deliver nearly any investment exposure someone wants to sell.

<sup>3</sup> But ETNs are *prepaid* and futures are not.

prepaid forward contracts. Clarity is essential to enable firms and investors to plan for the future. We look forward to working with you to improve the situation going forward.

I thank you for the opportunity to share our views. I will be pleased to answer any questions that you might have.

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Chairman NEAL. Thank you, Mr. Sauter. Congresswoman Schwartz wanted to acknowledge your presence here today. She is tied up at a Budget Committee markup.

Mr. SAUTER. Thank you.

Chairman NEAL. Mr. Paul.

**STATEMENT OF WILLIAM M. PAUL, COVINGTON & BURLING  
LLP, ON BEHALF OF INVESTMENT COMPANY INSTITUTE (ICI)**

Mr. PAUL. Thank you. Mr. Chairman, Ranking Member English, and Members of the Committee, my name is William M. Paul. I am a partner with the law firm of Covington & Burling LLP. I appear before you today on behalf of the Investment Company Institute, the National Association of U.S. Investment Companies, which include mutual funds, closed-end funds, exchange traded funds, and investment trusts.

In my written statement, I include some challenges on that innovative financial products pose to the tax system. Because of time limitations, I will direct my remarks before you this morning to ETNs.

ETNs pose two challenges to the tax system. One is the treatment of the time value of money return on the prepayment by the investor. The other is the fact that the return on the ETN reflects the results of a series of notional investments and reinvestments in commodities or securities that would result in current recognition of gain or loss if an investor engaged in them directly or through a partnership or mutual fund. As noted in the technical explanation of H.R. 4912, these two problems are exacerbated by the 30-year maturities of many ETNs.

The time value of money concern focuses on the prepaid forward structure of ETNs, the "wrapper," if you will, without regard to the nature of the underlying assets and whether the composition of those assets changes over time. The holder makes an upfront payment some 30 years before the issuer is obligated to perform. Even though the total amount the holder will receive is contingent, a portion of the holder's return is attributable to the time value of the prepayment.

In contrast, the constructive ownership concern views the prepaid forward contract as a means of acquiring the full economics of ownership without the tax consequences of ownership. This concern focuses on what is going on inside the contract or inside the wrapper. Approaches motivated by this concern, notably section 1260, try to ensure that the taxpayer does not achieve a better tax result from ownership through a derivative than he would receive through a direct investment.

The ICI supports H.R. 4912 as an important first step in addressing ETNs. However, we believe that improvements are needed in order to provide a comprehensive response to ETNs. The technical explanation of the bill identifies both the time value of money concern and the constructive ownership concern. The bill itself addresses only the former. The bill would require holders to accrue interest income on their investment in the contract under a modified version of the OID rules. The bill does not attempt to implement constructive ownership policies based on notional gains realized inside the contract.

In our view, it is more important for the tax system to respond to the constructive ownership concerns raised by ETNs than to the time value of money concerns. The arguments for taxing the time value of money return to prepaid forward contracts are economi-

cally sound, but the tax policy considerations involved are subject to legitimate debate.

In contrast, we believe that the constructive ownership policy is well established in our tax system and much more compelling. As articulated in the legislative history of section 1260, that policy mandates that a taxpayer who replicates economic ownership of a referenced asset through a derivative should not receive better tax treatment than one who owns directly. This policy is fundamental to protecting the tax base tied to returns on capital investment.

In many ways, ETNs can be viewed as the next generation of constructive ownership transactions that section 1260 is intended to address. When section 1260 was enacted in 1999, derivatives were being used to provide economic ownership of hedge funds and mutual funds without the tax consequences of direct ownership. With ETNs, the result was that ordinary income and short-term gains were deferred and converted to long-term gains.

ETNs use improved technology in the form of dynamic indexes to fall outside the scope of section 1260. The dynamic index functions as a synthetic mutual fund or partnership, so much so that ETNs even impose a notional investor fee each year that mimics a mutual fund management fee. Notwithstanding the advances in technology, the results obtained by investing in ETNs are precisely the results that section 1260 was intended to stop.

While amending section 1260 to cover ETNs is possible, the consequences that follow under that provision would effectively kill most ETNs. Accordingly, we would support the alternative approach of expanding the concept of notional amounts credited under the contract in H.R. 4912 to include notional gains realized inside of the contract.

For example, the commodity ETNs reflect the return from trading strategies in futures contracts. As those notional futures contracts are closed out or settled, the resulting gains are credited under the contract and could appropriately be included in income of the holders.

Such an approach would require the issuer to provide the requisite information to holders in a way that is closely analogous to the requirements for the qualified electing fund, or QEF, election under the rules that apply to passive foreign investment companies, or PFICs. The rules addressing investments in a PFIC can be viewed as a precursor to section 1260.

In the relatively simple days when that legislation was enacted, U.S. taxpayers were deferring and converting investment income by investing in offshore funds that do not make current distribution of income or gains. Congress responded in 1986 with rules to prevent such deferral and conversion.

The various approaches adopted to prevent taxpayers from deferring and converting investment income by investing in PFICs could provide a model for addressing the deferral and conversion afforded by ETNs.

First, if the issuer provides the necessary information, the holder could elect to include in income the notional income and gains credited for the year. This would be the QEF analogue. Second, because ETNs are publicly traded, the holder could elect mark to market treatment, just as the holder of publicly traded PFICs can. Third,



if the holder fails to elect either of these alternatives, the deferred tax and interest regime of section 1291 or the existing section 1260 regime could apply.

Thank you very much. I would be happy to take your questions.  
[The prepared statement of William M. Paul follows:]

**Prepared Statement of William M. Paul,  
Covington & Burling LLP, on behalf of Investment Company Institute (ICI)**

My name is William M. Paul. I am a partner with the law firm of Covington & Burling LLP. I appear before you today on behalf of the Investment Company Institute ("ICI"), the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange traded funds, and unit investment trusts. Members of ICI manage total assets of \$12.33 trillion and serve almost 90 million shareholders.

The topic of derivatives and their taxation is broad, diverse and exceedingly complex. I will not attempt to cover the topic in anything approaching a comprehensive way. Rather, I would like to make some general observations and then turn to a discussion of exchange traded notes.

**I. Derivatives**

A derivative is a financial instrument the value of which is determined by reference to one or more financial assets, such as stocks, bonds or commodities. Traditional derivatives include options, forwards and futures contracts. Nontraditional derivatives, that is, derivatives that have been developed more recently, include interest-rate swaps, equity swaps, credit default swaps prepaid forward contracts, and myriad variations on these instruments. The tax rules governing traditional derivatives are fairly well established. Tax rules governing interest-rate swaps, equity swaps and most total return swaps were adopted by Treasury in the early 1990s and have worked relatively well. Issues still exist, however, with respect to equity swaps and total return swaps. No guidance has been issued as yet on credit default swaps or on the treatment of holders of prepaid forward contracts.

One of the factors contributing to the development of new derivatives is the desire of participants in the capital and financial markets to gain more targeted exposure to specific risks. For example, if an institution wants exposure solely to the credit risk of a corporate issuer, holding bonds of that issuer is not sufficient because it entails both interest-rate risk and credit risk. Credit default swaps were developed to enable market participants to isolate pure credit risk from interest-rate risk. Other factors driving innovation in financial products are a desire to avoid regulatory and other restrictions and to reduce inefficiencies associated with existing alternatives. Advances in computer and communications technology have significantly enhanced the ability of Wall Street to develop new financial products in recent years.

The dramatic increase in the use of nontraditional derivatives has been greatly facilitated by the development of standardized agreements to govern transactions in the over-the-counter market. Using standardized agreements makes the market much more efficient because participants do not need to separately negotiate the terms of each transaction. ISDA has been the key player in developing these standardized contracts, which exist for many types of nontraditional derivatives, including credit default swaps.

**II. Challenges to the Tax System**

Most of our tax rules were developed in simpler times when the economic environment was not nearly as diverse, complex and sophisticated as it is today. If a corporation issued a security for cash, it was generally either stock or debt. Now corporations issue a variety of instruments for cash and the tax question is no longer merely the historic debt-equity question. Instead the question is how should the tax system categorize the instrument and how should it be taxed?

Our annual accounting system for computing income does not deal well with contingencies that are not resolved by the end of the taxable year. In earlier, simpler times this inadequacy was tolerable as the number and scope of transactions raising problems were contained. In the modern era, with its plethora of contingent payment contracts in the trillions of dollars, the pressure on our traditional realization principles is intense. Congress and Treasury have responded in various ways to prevent the deferral that would result under traditional realization principles. Examples include the contingent payment debt rules, which require current accrual at a market rate of interest even though the amount the holder will ultimately receive

is unknown; the mark-to-market rules of section 1256, which apply to most exchange traded derivatives and require the parties to the contract to recognize gain or loss based on the fair market value of the contract on the last day of the year; and section 475, which requires securities dealers to mark their positions to market without regard to whether they are traded on an exchange.

Developing appropriate regimes for taxing new financial products is a daunting process in many respects. The products are often complex and difficult to understand economically, and they can be used by market participants in various ways, some of which may be more threatening from a tax perspective than others. The fundamental issue that needs to be “gotten right” in developing an appropriate tax response is the economics of the instruments. If the tax treatment is out of whack with the economics, the product will be over-utilized or under-utilized. Moreover, even a relatively small mistake in taxing the economics can lead to extensive over-use (and associated revenue loss). If the tax law makes a mistake in the depreciation of restaurants by using a useful life that is 1 year too short, the number of excess restaurants built in the U.S. may increase at the margin. But the “bricks and mortar” reality of building restaurants creates significant frictions on the ability to exploit the resulting undertaxation. In the financial products world, this is not the case. The availability of leverage (either direct or indirect) and the ability to add zeros to the end of numbers with the stroke of a pen—or more aptly, the stroke of a computer key—make it easy for slight errors to have very significant ramifications.

This is not to say that the development or use of new financial products is primarily tax driven. To the contrary, they are primarily driven by business, investment and economic considerations. Taxes are, however, often an important factor.

One way in which tax is often a factor is in choosing the specific financial product or products that a taxpayer will use to achieve its business or investment objectives. It is widely understood that the same cash flows can be generated by different combinations of financial products that are taxed in different ways.<sup>1</sup> Understandably, taxpayers will tend to use the financial product or combination of products that result in the most favorable—or least onerous—tax treatment.

Yet another challenge is the flexibility of financial products. In developing appropriate rules, Treasury and IRS are very cautious in “drawing lines” that define whether a product is subject to a particular regime or not. If they draw a bright line, financial products can morph so that they fall either just inside that line or just outside that line, with significant differences in tax treatment as a consequence. One recent example of this phenomenon is so-called “call-spread converts.”

The need to “get it right” in determining the correct treatment for a new financial product means that Treasury and IRS are often slow to respond. In the last 20 years or so, Treasury has struggled mightily and with mixed success to issue much needed guidance in this area. The contingent debt regulations were issued in proposed form and modified and withdrawn several times over a 10-year period before the ultimate approach was finally adopted. Treasury has been thinking about the taxation of prepaid forward contracts since at least 1993<sup>2</sup> and had a guidance project on its business plan for several years, but has never issued guidance. After an 11-year hiatus following the issuance of the notional principal contract regulations in 1993, Treasury finally addressed swaps with contingent nonperiodic payments in 2004 by issuing proposed regulations that have proved to be highly controversial. Treasury has been studying credit default swaps now for several years. Treasury’s ability to respond to new financial products is also often hampered by questions regarding the scope of Treasury’s authority.

These observations are not intended as a criticism of Treasury. Their caution is understandable. However, the market does not stand still while Treasury reflects. If there is market demand for a product, the market for the product will grow and the tax treatment will be determined by what is known as “market practice.” Even though there is not a hard and fast “Wall Street rule,” it is undeniably the case that it becomes more difficult over time for Treasury, the IRS or even Congress to put the genie back in the bottle.

### III. Approaches to Taxing New Financial Products

In evaluating how a new financial product should be taxed, practitioners and Treasury tend to follow the same approach. The first step is typically to identify

<sup>1</sup>For example, the cash flows of a zero coupon bond can be created by buying a stock and entering into a forward contract to sell the stock. Similarly, the cash flows from buying a zero-coupon bond and a call option on a stock are the same as the cash flows from buying the stock and a put option to sell the stock.

<sup>2</sup>See preamble to T.D. 8491, 58 Fed. Reg. 53125, 53126 (Oct. 14, 1993).

other products for which tax rules exist and that are similar to the new product in question. Thus, for example, discussions about how credit default swaps should be taxed tend to focus on comparing them to options and notional principle contracts, both of which are closely comparable but not exactly the same. In the case of credit default swaps, comparisons are also made to financial guarantees and insurance.

In conducting this evaluation, the “norm” is to view the product as a single instrument. A convertible bond is often cited as an illustration of this approach. Although a convertible bond is economically equivalent to straight debt and an option to acquire the issuer’s stock, it is treated as a single instrument for tax purposes.

While a new product is typically analyzed as a single instrument, this is not always the case. On occasion, products are “bifurcated” into two or more instruments to determine the appropriate tax treatment. A good example is the treatment of swaps with significant nonperiodic payments, which the regulations bifurcate into a loan and an “on market” swap.<sup>3</sup> There are also examples of the tax law integrating two separate but related instruments and taxing them on a combined basis. The straddle rules are an example of partial integration.

The current controversy regarding variable prepaid forward monetization transactions can be viewed as a dispute over whether two separate but related transactions should be integrated in determining the appropriate tax treatment. (This controversy is often confused with the separate, but also current, controversy regarding the treatment of holders of prepaid forward contracts generally and of exchange traded notes more specifically, which I will turn to in a moment.) The variable prepaid forward contract monetization transaction controversy relates to whether a taxpayer holding appreciated stock should recognize gain when he enters into a forward contract requiring him to deliver a variable number of shares on a specified future date and receives in return an upfront payment equal to 80 to 85% of the current market value of the stock. In Revenue Ruling 2003–7,<sup>4</sup> the IRS ruled that if properly structured, this transaction does not result in gain recognition at the time the taxpayer enters the contract and receives the upfront payment. More recently, the Service has learned of variations of the transaction that include a separate but related share lending agreement pursuant to which the taxpayer lends the stock to the same counterparty and authorizes the counterparty to sell the stock subject to an obligation to return identical stock at a later time. The Service has issued a technical advice memorandum, an advice memorandum, and a coordinated issue paper, all taking the position that the share lending agreement is effectively part of the variable delivery forward transaction and that the two in combination result in a current sale.<sup>5</sup> The securities industry strongly disagrees with this view and a case presenting the issue has been docketed in the Tax Court.

#### IV. Exchange-Traded Notes

I would now like to turn to a discussion of a new financial product known as an exchange traded note (“ETN”). After providing a summary description of ETNs, I will describe the challenges that ETNs present for the tax system. I will then turn to the consideration of possible legislative responses, focusing primarily on the approach reflected in H.R. 4912.

##### A. Description of ETNs

###### 1. Common Features of ETNs

While there are some variations, ETNs typically have the following features:

- a. They are long-term notes (often 30 years) issued by a bank (the “Issuer”).
- b. There are typically no interest or other payments on the notes prior to maturity.
- c. The notes are issued in denominations of \$50 and do not guarantee return of principal.
- d. The amount due at maturity is determined by reference to a specified index that (i) takes into account the performance of a specified investment or trading strategy, and (ii) is reduced by an “investor fee” that accrues at a stated rate (ranging from 40 to 125 basis points).
- e. ETNs may be redeemed prior to maturity in lots of 50,000 notes or more. The redemption price is the index value of the notes at that time (in some instances reduced by a redemption fee). This redemption feature is designed to ensure that the market price of an ETN corresponds to the value of the index it tracks.

<sup>3</sup>See Treas. Reg. § 1.446–3(g)(4).

<sup>4</sup>2003–1 C.B. 363.

<sup>5</sup>See TAM 200604033; Advice Memorandum 2007–004; LMSB Coordinated Issue Paper 04–1207–077.

f. Holders of ETNs are subject to the Issuer's credit risk, *i.e.*, the risk that the Issuer will not be able to pay the notes at maturity or that the market price of the notes may be adversely affected by a decline in the Issuer's creditworthiness. The redemption feature described above may mitigate this risk.

g. The tax disclosures for ETNs generally indicate that they should be treated as prepaid forward contracts for tax purposes, and the terms of the ETNs require holders and the Issuer to treat the notes that way. The disclosures generally state that holders should not recognize gain or loss prior to the sale, redemption or maturity of the notes and should receive long-term capital gain treatment if they hold an ETN for more than 1 year.

## 2. Different Types of ETNs

There are currently at least 34 ETNs. I understand that at least 8 more have either just launched or are about to launch, with many more in the pipeline. The 34 ETNs that I have had the opportunity to review can be broken down into six categories based on the nature of the index they reference (the "reference index"): (i) commodities, (ii) foreign currencies, (iii) equities, (iv) option strategies, (v) master limited partnerships, and (vi) closed-end funds. ETNs in each of these categories are described below.<sup>6</sup>

### a. Commodity ETNs

There are currently 20 commodity ETNs, the returns on which are tied to various "total return" commodity indexes. Examples include the S&P GSCI Total Return Index, the Dow Jones-AIG Industrial Metals Total Return Sub-Index, and the Rogers International Commodity Index. Each of these indexes tracks the return a taxpayer would receive if he or she entered into a series of commodities futures contracts and also invested in Treasury bills or some other interest-bearing obligations. For example, the S&P GSCI Total Return Index ETN reflects the return a taxpayer would receive by holding Treasury bills and entering into a basket of 24 futures contracts on physical commodities. The relative weightings of the commodities in the index are adjusted over time. The index value is determined by "rolling over" the referenced futures contracts, *i.e.*, as a futures contract approaches its settlement date, it is replaced by a new futures contract on the same commodity.

### b. Foreign Currency ETNs

There are six foreign currency ETNs. Three of these ETNs track the exchange rate between the U.S. dollar and, respectively, the Euro, the British Pound and the Japanese Yen. The terms of these ETNs appear to be identical except for the referenced foreign currency. An investor in these ETNs is entitled to receive at maturity an amount equal to the stated principal amount multiplied by the increase (or decrease) in the specified index, minus the accrued investor fee. The specified index has two components. The "currency component" is equal to the increase or decrease in the specified exchange rate (*e.g.*, Euro/USD) since the notes were originally issued. The "accumulation component" is an interest return tied to an overnight deposit rate in the referenced foreign currency. In Rev. Rul. 2008-1, the IRS ruled that these ETNs are to be taxed as foreign currency-denominated debt instruments.

In recent weeks three additional foreign currency ETNs have been introduced. Two of these ETNs track baskets of currencies and pay a cash yield to holders. The third ETN tracks an index tied to the "carry trade," which refers to the strategy of borrowing in currencies with low interest rates and lending in currencies with higher interest rates. Currently, the index reflects "borrowings" in five specified currencies and corresponding "loans" in five other specified currencies.

### c. Equity ETNs

There are currently five equity ETNs, each of which tracks an index reflecting a segment of the public equities markets. These include the Spectrum Large Cap U.S. Sector Momentum Index, the Morningstar Wide Moat Focus Total Return Index, the Opta S&P Listed Private Equity Index, and an index that tracks the "Dogs of the Dow."<sup>7</sup> By way of example, the "Dogs of the Dow" ETN reflects the return an investor would receive if he or she invested an equal amount in each of the ten stocks included in the Dow Jones Industrial Average that have the highest dividend yield. The index is adjusted each December to add or subtract stocks and to rebalance the weighting of any stocks that remain within the ten "dogs."

<sup>6</sup>The information provided about existing ETNs reflects my best understanding based on information I have had the opportunity to review and may be incomplete.

<sup>7</sup>The formal name of this index is the "Dow Jones High Yield Select 10 Total Return Index."

d. Option Strategy ETN

There is one option strategy ETN that reflects the performance of the CBOE S&P 500 BuyWrite Index. This index is designed to measure the total return a taxpayer would receive from owning all of the stocks in the S&P 500 Index and writing a succession of 1-month call options on the S&P 500 Index that are either “at the money” or slightly “out of the money.”<sup>8</sup>

e. Master Limited Partnership ETN

One ETN tracks the return an investor would receive from investing in a number of energy-oriented master limited partnerships (“MLPs”). This ETN tracks the BearLinx Alerian MLP Select Index. Unlike most ETNs, this ETN makes periodic payments, which are tied to the amounts investors would receive as distributions if they invested in the underlying MLPs directly.

f. Closed-End Fund ETN

There is one ETN that tracks an index of 75 closed-end funds. This ETN tracks the Claymore CEF Index, which consists of closed-end funds that are selected based on distribution yield and “discount” to net asset value (*i.e.*, the excess of net asset value over the price at which the fund’s shares trade in the market). This ETN also makes distributions that correspond to the distributions a direct investor in the underlying funds would receive.

**B. Problems That ETNs Present for the Tax System**

As the Technical Explanation of H.R. 4912 recognizes, ETNs pose two challenges to the system: (i) the treatment of the “time value of money” return on the prepayment and (ii) the fact that the index “represents a series of notional investments and reinvestments” in commodities or securities that would result in the current recognition of gain or loss if an investor engaged in them directly or through a partnership or mutual fund. As further noted in the Technical Explanation:

These two fundamental problems in turn are exacerbated by the very long-term maturities of many ETNs, often 30 years. If the tax analysis proposed by issuers of ETNs and similar instruments were to prevail, investors in such instruments would thus be able to defer tax from the current returns with which they are credited, and from the sales and purchases with which they are credited, for up to 30 years.

The ICI very much agrees with this statement regarding the challenges posed to the tax system by ETNs. Before turning to a discussion of H.R. 4912, I would like to make a few observations about both the “time value of money” and “constructive ownership” aspects of ETNs.

The “time value of money” concern focuses on the prepaid forward structure of ETNs—the “wrapper” if you will—without regard to the nature of the underlying assets and whether the composition of those assets changes over time. The holder makes an upfront payment some 30 years before the issuer is obligated to perform under the contract and is compensated for doing so by the fact that his return under the contract is tied to prices in the cash market (*i.e.*, the current market price) instead of the forward price. (Alternatively, the holder is compensated by an explicit interest factor as part of the ETN index formula.) Even though the total amount the holder will ultimately receive is contingent, a portion of the holder’s ultimate return is attributable to the time value of the prepayment. Generally speaking, the holder’s ultimate return will be greater as a result of the prepayment by an amount equal to the future value of the prepayment at maturity, with such future value computed using an appropriate interest rate.

In contrast, the constructive ownership concern views the prepaid forward contract merely as a means to accomplishing the full economics of ownership without the tax consequences of ownership. This concern focuses on what is going on inside the contract—inside the wrapper. Approaches motivated by this concern, notably section 1260, try to ensure that the taxpayer does not achieve better tax results from ownership through a derivative than he or she would receive through a direct investment. Under this view, the appropriate treatment from a time-value-of-money perspective is tied to how time value associated with a direct investment in the underlying would be treated. For example, if the underlying is simply 100 shares of some nondividend-paying stock, a constructive ownership approach would not attempt to tax any time value of money return. It would simply attempt to tax the

<sup>8</sup>An at-the-money call option has an exercise price equal to the current value of the underlying stock. An out-of-the-money call option has an exercise price above the current value of the underlying stock.

prepaid forward consistently with (or at least no better than) taxation of direct ownership of the underlying stock.

I think of these alternative approaches to ETNs as analogous to the approach to partnership taxation under subchapter K. In certain respects, subchapter K views the partnership as an entity (an “entity approach”) and in others it looks through the partnership to the underlying assets and activities of the partnership (the “aggregate approach”). In much the same way, a time-value-of-money approach looks at the wrapper and a constructive ownership approach looks at what is going on inside the wrapper.

### **C. H.R. 4912**

On December 19, 2007, Congressman Neal introduced H.R. 4912 (the “Bill”) addressing the tax treatment of ETNs and other prepaid forward contracts. The Bill would require holders of “prepaid derivative contracts” to include an amount equal to the “interest accrual amount” in taxable income each year. Such amount would be treated as interest income. The Bill would not affect the tax treatment of the issuer of a prepaid derivative contract.

The interest accrual amount for any taxable year is generally equal to the product of the holder’s adjusted basis in the contract at the beginning of the year multiplied by the monthly short-term applicable Federal rate (“AFR”) for the first month of such taxable year. However, if “notional amounts are credited” under the contract at a higher rate, then the income accrual amount is computed by multiplying the holder’s adjusted basis in the contract by such higher rate. If a holder acquires or disposes of a contract during the taxable year, the interest accrual amount for the year is prorated based on the relative portion of the year that the holder held the contract. The holder’s basis in the contract would be increased by the interest accrual amounts included in the holder’s gross income.

Distributions with respect to a contract would not be includable in income. Distributions would first reduce the holder’s basis in the contract and distributions in excess of basis would be treated as gain from a sale of the contract. Any loss on the disposition of a contract would be an ordinary loss to the extent of basis increases attributable to the interest accrual amounts included in the holder’s income.

Special rules apply in the case of contracts that are publicly traded. First, the interest accrual amount for a taxable year is capped at the mark-to-market gain for the year. Second, if this cap is triggered for a taxable year, the excess interest accrual amount not taken into income is carried forward to the next taxable year and increases the interest accrual amount for such year. Third, although the holder’s basis in the contract for gain and loss purposes will be increased by the interest accrual amount includable in income for the year (after application of the mark-to-market cap), the holder’s adjusted basis for purposes of computing the interest accrual amount in the following year is increased by the full income inclusion amount determined without regard to the mark-to-market cap. A contract is treated as publicly traded if (i) it is traded on a qualified board or exchange, or (ii) the issuer (or a person acting on the issuer’s behalf) regularly provides firm bid and ask quotes to the public with respect to the contract.

The Bill would not apply to any contract held for less than 1 year that is disposed of before the due date for filing the tax return for the tax year in which the contract was acquired. The Bill also would not apply to any contract that is marked to market with respect to the taxpayer.

The Bill defines a “prepaid derivative contract” as any “prepaid contract” with a term greater than 1 year that is a derivative instrument with respect to (i) one or more securities, (ii) one or more commodities, or (iii) any financial index. Excluded from the definition are instruments that are treated for tax purposes as: (i) stock, (ii) debt, (iii) a partnership interest, (iv) part of a constructive ownership transaction to which section 1260 applies, (v) a hedging transaction within the meaning of section 1256(e)(2), (vi) a notional principal contract, or (vii) an option. The Treasury Department is given authority to apply the Bill’s provisions to options that are “economically similar” to a prepaid derivative contract. The term “prepaid contract” is defined to mean any contract under which there is no substantial likelihood that the taxpayer will be required to pay any additional amount under the contract.

The Bill would apply to contracts acquired after the date of enactment.

### **DISCUSSION**

The ICI supports the Bill as an important first step in addressing ETNs.<sup>9</sup> We have a number of technical suggestions and comments, which we will provide to the

<sup>9</sup> While this discussion focuses on ETNs, the ICI is not opposed to the Bill’s application to prepaid forward contracts that are not publicly traded.

staff. For the remainder of this testimony, I would like to focus on our “big picture” comments.

As noted above, the Technical Explanation of the Bill identifies both the “time value of money” concern and the “constructive ownership” concern. However, the Bill itself addresses only the former concern. The Bill would require holders to accrue interest income on their investment in the contract under a modified version of the OID rules. The Bill generally does not attempt to implement “constructive ownership” policies based on notional gains recognized inside the contract.

We believe that a comprehensive approach to ETNs is needed. We are concerned that an approach that accrues interest at the short-term AFR (currently 3.2%) may be insufficient to achieve appropriate taxation of ETNs consistent with applicable tax policies. We are just at the beginning of creativity in the ETN world, and without a comprehensive and robust response, we suspect that Congress will need to revisit this area in the near term to respond to continued developments. We believe that the Bill could be enhanced by expanding on the concept of “notional amounts credited under the contract” (“NACUC”). The Technical Explanation makes clear that the Bill limits NACUC to explicit interest or dividend yields inside the contract. The concept of notional amounts credited under the contract could be expanded to include notional gains realized inside the contract. For example, the commodity ETNs reflect the return from trading strategies in futures contracts. As those notional futures contracts are closed out or settled, the resulting gains are, in some sense, credited under the contract and could appropriately be included in income of the holders.

In our view, it is more important for the tax system to respond to the constructive ownership concerns raised by ETNs than to the time-value-of-money concerns. The arguments for taxing the time-value-of-money return to prepaid forward contracts are economically sound, but our tax system has to date generally refrained from imputing an interest-like return when the return on the instrument is totally contingent.<sup>10</sup> In contrast, we believe that the constructive ownership policy is well established in our tax system and much more compelling.

As articulated in the legislative history of section 1260, that policy mandates that a taxpayer who replicates economic ownership of a referenced asset through a derivative should not receive better tax treatment than one who owns directly. This policy is fundamental to protecting the tax base tied to returns on capital investment.

In many ways, ETNs can be viewed as the next generation of constructive ownership transactions that section 1260 is designed to address. When section 1260 was enacted in 1999, derivatives were being used to provide economic ownership of hedge funds and mutual funds without the tax consequences of direct ownership. A taxpayer and an investment bank would enter into a forward contract or other “total return” derivative with, say, a 3-year term. After 3 years, the taxpayer would receive an amount measured by the value of the hedge fund plus distributions he would have received had he held the interest in the hedge fund directly over the 3 years. As with ETNs, the result was that ordinary income and short-term gains were deferred and converted to long-term gains. ETNs use improved technology—in the form of dynamic indexes—to fall outside the scope of section 1260. The dynamic index functions as a synthetic mutual fund or partnership, so much so that ETNs even impose a notional “investor fee” (e.g., 125 basis points) per year that mimics a mutual fund management fee or the fee an investor would pay a financial advisor to manage a portfolio of directly owned securities. Section 1260 does not apply because instead of referencing the return on a partnership or mutual fund, ETNs reference the return on a dynamic index. Notwithstanding the advances in technology, the results obtained by investing in ETNs are precisely the results that section 1260 was intended to stop.

The rules addressing investments in passive foreign investment companies (“PFICs”) can be viewed as a precursor to section 1260. In the relatively simple days when that legislation was enacted, U.S. taxpayers were deferring and converting investment income by investing in off-shore funds that do not make current distributions of income or gains. Congress responded in 1986 with rules to prevent such deferral and conversion.<sup>11</sup> In their current form, the PFIC rules provide three alternative regimes. The “default” regime is very much like the section 1260 regime. Long-term gain treatment is denied and the taxpayer is generally required to treat any gain as arising ratably over his holding period and pay interest on the implicit deferral of tax. Recognizing the harshness of this regime, Congress provided the “qualifying electing fund” (“QEF”) regime, which affords the taxpayer the option of including in income currently his share of the PFIC’s income and long-term capital

<sup>10</sup> But see Treas. Reg. 1.446-3(g)(4), *supra*.

<sup>11</sup> See Code §§ 1291–1298.

gain. In order for this election to be available, the PFIC must agree to provide the taxpayer with the requisite information each year. More recently, Congress has added a mark-to-market election with respect to PFIC stock that is publicly traded. If this election is made, all mark-to-market gain is treated as ordinary income and mark-to-market losses are treated as ordinary to the extent of prior mark-to-market gains.

While amending section 1260 to cover ETNs is possible, the consequences that follow under that provision would effectively kill most ETNs. Accordingly, we would support an alternative approach along the lines of expanding the concept of notional amounts credited under the contract under H.R. 4912, as described above.

Note that such an approach would require the issuer to provide the requisite information to holders in a way that is closely analogous to the requirements for the QEF election under the PFIC rules. Indeed, the three approaches contained in the PFIC rules could provide a model for addressing the deferral and conversion afforded by ETNs. If the issuer provides the necessary information, the holder would include in income the notional income and gains credited for the year (the QEF analogue). Alternatively, because ETNs are publicly traded, the holder could elect mark-to-market treatment. If the holder fails to elect either of these regimes, the default rule could be the section 1260 regime.

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Chairman NEAL. Thank you, Mr. Paul.

I welcome back an individual who has spent a career sitting at that dais, Mr. Samuels.

**STATEMENT OF LESLIE B. SAMUELS, PARTNER, CLEARY GOTT-  
LIEB STEEN & HAMILTON LLP, ON BEHALF OF SECURITIES  
INDUSTRY AND FINANCIAL MARKETS ASSOCIATION (SIFMA)**

Mr. SAMUELS. Chairman Neal, Ranking Member English, and Members of the Subcommittee, thank you for inviting me to testify. I am a lawyer now in private practice with the firm of Cleary Gottlieb Steen & Hamilton. I am testifying today on behalf of the Securities Industry and Financial Markets Association, SIFMA.

I am here today to discuss the tax treatment of prepaid derivative contracts. On behalf of SIFMA, I would like to thank Chairman Neal for having this hearing to facilitate a dialogue on the appropriate tax treatment of prepaid derivatives and comparable financial instruments.

We welcome the opportunity to provide our views on the development of a comprehensive set of rules for taxation of prepaid derivatives that are consistent, administrable, fair, and certain. The Treasury Department and the IRS have commenced a similar review of this complex area, and we are actively working with them.

For the reasons discussed below, SIFMA has serious concerns with H.R. 4912. In particular, we are concerned that the bill would impose an overly complex tax regime that would single out prepaid derivative contracts for unfavorable treatment by requiring that investors include amounts in income that they have no right to receive and may never receive. In some cases, investors will be taxed on phantom income even when the value of the prepaid derivative is falling.

During the last 15 years, the capital markets have seen a growth in the volume and variety of prepaid derivatives. These instruments have grown in popularity because they give investors convenient and cost-efficient access to sophisticated financial strategies and enable them to take financial positions with respect to a vast selection of referenced financial assets and cash flows.



Many prepaid derivatives provide risks and returns that are different from a hypothetical direct investment in the underlying assets. These prepaid derivatives provide returns that do not mimic direct ownership of the referenced assets.

Prepaid derivatives are utilized by a broad base of investors, including individuals, retirement plans, tax exempts, mutual funds who are buyers, and other institutional investors.

Recent media attention has focused on a relatively new type of prepaid derivative, an exchange traded note or ETN. ETNs, which represent a small subset of the market, are actively traded on an exchange. The idea behind the ETNs is to give retail investors access to sophisticated financial strategies and liquidity on a cost- and tax-efficient basis.

Some members of the mutual fund industry have expressed concern that the availability of ETNs to retail investors reduces the relative attractiveness of mutual funds and puts them at a competitive disadvantage. SIFMA believes that ICI's assertions that ETNs are substantially similar to mutual funds and that they benefit from far superior tax treatment are oversimplified and not helpful to moving forward the debate.

There are important differences in the economic terms of ETNs and mutual funds. These differences explain why ETNs and mutual funds are treated differently for tax purposes. Most notably, mutual fund investors have the current right to receive cash. Holders of ETNs do not.

The difference between the tax treatment of ETNs and mutual funds is based on a fundamental rule of tax law that an investor who has the full right to take cash income but elects not to is subject to taxation on the cash as if it were received. This is why investors in mutual funds are taxed currently on distributions even when they choose to reinvest the cash. Similarly, when holders of ETNs have the right to receive cash, they are taxed on that cash.

Another important difference between mutual funds and the prepaid derivatives is that investors in mutual funds effectively own the underlying securities held by the funds. In contrast, a prepaid derivative is an unsecured contract between the investor and the issuing company. Investors in these derivatives are fully exposed to the credit risk of the issuer until maturity of the contract. By contrast, investors in mutual funds are not subject to this type of credit risk.

Although many prepaid derivatives are issued in the nominal form of corporate notes, they are not debt instruments in the tax sense of the word. Unlike traditional debt, these notes do not entitle an investor to an unconditional return of the principal at maturity plus some amount of interest. Investors in prepaid derivatives may receive no returns, and can have a significant risk of losing some or all of the original investment.

Under tax principles of income realization, investors should generally not be taxed on phantom income and unrealized gains which can evaporate at any time along with the investor's original investment.

H.R. 4912 would fundamentally change the way all prepaid derivative contracts are treated. The bill will require accrual of income despite the fact that the investor does not receive any

amounts currently and is not assured of repayment of the original investment. In short, H.R. 4912 moves the line on when phantom income should be accrued from debt to include prepaid derivatives that are not debt-like.

In considering whether the phantom income line should be moved, it is important to keep in mind other investments where phantom income is not required. For example, an investor in non-dividend-paying common stock is not taxed until the stock is sold.

One of the reasons that the tax rules for derivatives give rise to so many different views about what is the right answer is that there are many piecemeal rules addressing a range of financial instruments in the marketplace.

We appreciate that this hearing has been called to start the legislative review of the current tax rules as they apply to complex financial products. Since the Treasury has also called for comments on the taxation of prepaid derivatives, we respectfully suggest that the legislative review be coordinated with Treasury's consideration of these same issues.

We look forward to participating in this important dialogue. Thank you.

[The prepared statement of Leslie B. Samuels follows:]

TESTIMONY OF  
LESLIE B. SAMUELS  
SECURITIES INDUSTRY AND FINANCIAL MARKETS ASSOCIATION  
BEFORE THE SUBCOMMITTEE ON SELECT REVENUE MEASURES OF  
THE COMMITTEE ON WAYS AND MEANS  
U.S. HOUSE OF REPRESENTATIVES  
MARCH 5, 2008

Chairman Neal, Ranking Member English, and Members of the Subcommittee, thank you for inviting me to testify. I am a lawyer in private practice with the firm of Cleary Gottlieb Steen & Hamilton LLP, and I am testifying today on behalf of the Securities Industry and Financial Markets Association ("SIFMA").<sup>1</sup> I am here today to discuss the tax treatment of prepaid derivative contracts.

On behalf of SIFMA, I would like to thank Chairman Neal for holding this hearing to facilitate a dialogue on the appropriate tax treatment of prepaid derivative contracts and comparable financial instruments. We welcome the opportunity to provide our views on the development of a comprehensive set of rules for taxation of prepaid derivative contracts that are consistent, administrable, fair and certain. The Treasury Department and Internal Revenue Service have commenced a similar review of this very complex area as announced in Notice 2008-2, and we are actively working with them on this review.

For the reasons discussed below, SIFMA has serious concerns with H.R. 4912. In particular, we are concerned that H.R. 4912 would impose an overly complex tax regime that

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<sup>1</sup> The Securities Industry and Financial Markets Association brings together the shared interests of more than 650 securities firms, banks and asset managers. SIFMA's mission is to promote policies and practices that work to expand and perfect markets, foster the development of new products and services and create efficiencies for member firms, while preserving and enhancing the public's trust and confidence in the markets and the industry. SIFMA works to represent its members' interests locally and globally. It has offices in New York, Washington D.C., and London and its associated firm, the Asia Securities Industry and Financial Markets Association, is based in Hong Kong.

would single out prepaid derivative contracts for unfavorable treatment by requiring that investors include amounts in income that they have no right to receive and may never receive. In some cases, investors will be taxed on phantom income even when the value of the prepaid derivative contract is falling. SIFMA is also concerned that H.R. 4912 adopts a “one-size-fits-all” approach that would impose an unfavorable tax regime on many prepaid financial instruments that, under current law, are tax neutral or even tax disadvantaged compared to a hypothetical investment in the referenced property directly or through another financial instrument.

**1. The Prepaid Derivative Contract Market is Not New.** The recent publicity regarding exchange-traded notes may have created an impression that prepaid derivative contracts are a new financial market development. On the contrary, complex derivative contracts with returns linked to the performance of equities and other risky assets have been in existence for more than 15 years. American Express issued the first publicly-traded variable prepaid forward contracts (so-called DECS) in October 1993. An investor in those DECS would make money or lose money depending on whether the underlying stock rose or dipped in value and was paid a fixed-rate coupon that was treated as ordinary income. Investors bought DECS rather than buying the stock of the underlying company because they wanted current income and the stock paid no dividends.

In subsequent years, the capital markets have seen an explosive growth in the number, volume, and variety of prepaid derivative contracts. These instruments have grown in popularity because they give investors convenient and cost-efficient access to sophisticated financial strategies and enable them to take financial positions with respect to a vast selection of referenced financial assets and cash flows. Like DECS, many prepaid derivative contracts provide risks and returns that are different from a direct investment in the referenced asset. Prepaid derivative instruments are a common and important financing and investment tool.

**2. The Emergence of Exchange-Traded Notes.** Recent media attention has focused on a relatively new type of prepaid derivative contract commonly referred to as an exchange-traded note, or ETN. ETNs, which represent a small subset of the prepaid derivative market, are actively traded on an exchange. The idea behind ETNs is to give “Main Street” retail investors access to sophisticated investment strategies and liquidity on a cost and tax efficient basis.

Some members of the mutual fund industry have expressed concern that the availability of exchange-traded notes to retail investors reduces the relative attractiveness of mutual funds and puts them at a competitive disadvantage. In November 2007, the Investment Company Institute (“ICI”) encouraged the Committee on Ways and Means to change the current tax treatment of retail ETNs because, the ICI argued, such ETNs are similar to mutual funds but enable investors to benefit from tax deferral in a manner that is far superior to investors in mutual funds. SIFMA believes that these arguments (that ETNs are substantially similar to mutual funds and that they benefit from far superior tax treatment) are oversimplified and not helpful to moving forward the debate on the tax treatment of prepaid derivatives.

**3. Comparison Between ETNs and Mutual Funds.**

*a. ETN Investors Have No Right to Receive Cash Distributions Currently.*

There are important differences in the economic terms of ETNs and mutual funds. These differences explain and justify the respects in which they are treated differently for tax purposes. Most notably, investors in mutual funds have a current right to receive cash; holders of ETNs do not.

The difference between the tax treatment of ETNs and mutual funds is based on a fundamental rule of tax law that an investor who has the full right to take cash income, but elects not to, is subject to taxation on that cash as if it were received. Taxpayers cannot avoid tax on cash they could put in their pockets simply by using it for other purposes. This is why investors in

mutual funds are taxed currently on distributions from the mutual fund even if they choose to reinvest the cash. In short, investors in mutual funds are taxed on distributions because they have the choice of keeping the cash or reinvesting it.

Holders of ETNs are subject to the same treatment. When they have the right to receive cash (because the ETN provides for current payments), they are taxed on that cash, generally at rates less favorable than the rates that apply to mutual fund investors. Similarly, a holder of an ETN that has appreciated in value is treated the same as the holder of shares in a mutual fund. In either case, unrecognized gain that does not correspond to any entitlement to receive cash distributions currently is taxed only when the shares or ETNs are sold. An investor in an ETN remains fully at risk during the term of the contract and must wait to maturity to determine whether there will be gain or loss on its original investment. This treatment is the same as the treatment of an investor in a mutual fund.

In considering the taxation of prepaid derivatives, it is also important to recognize that many prepaid derivative contracts require periodic cash payments. For example, when interest rates were very low, investors bought these instruments in order to get an above-market coupon. Issuers have generally required investors to treat such coupons as ordinary income, even if the coupons economically are tied to tax-favored income like qualified dividend income. An investor in the underlying stock or a mutual fund holding the stock would pay tax on that income at the lower qualified dividend income rate. Under current law, U.S. taxable investors in these coupon-paying instruments are actually *tax-disadvantaged* compared to buying the underlying stock or the mutual fund.

*b. ETNs Do Not Represent Ownership of Any Assets.* Another important difference between mutual funds and prepaid derivative contracts is that investors in mutual funds effectively own the underlying securities held by the mutual funds. Upon a liquidation of a mutual

fund, investors will receive their pro rata share of securities held by the fund. In contrast, a prepaid derivative is an unsecured contract between the investor and the issuing company that provides for a payment at maturity determined by an objective formula that generally references the performance of securities, commodities or financial indices and, in certain cases, payment of periodic amounts. (Under the terms of a derivative contract, the investor has no special right in respect of referenced assets; in fact, the issuing company has no obligation to own the referenced assets.) Because a prepaid derivative contract is merely an unsecured promise to pay, investors in prepaid derivative contracts are exposed to the risk that the issuer will not pay them if its own financial condition declines. We understand that the recent wave of write-downs by many financial institutions is affecting both pricing and willingness of some investors to invest in prepaid derivative contracts. By contrast, investors in mutual funds are not subject to this type of credit risk.

**4. Many Investors Purchase Prepaid Derivatives for Non-Tax Reasons.** The decision to invest in prepaid derivative contracts (including ETNs) rather than directly in the underlying asset is based on a number of criteria and not only tax considerations. Many investors choose prepaid derivative contracts because they meet a variety of important financial needs unrelated to tax considerations.

For example, many prepaid derivatives provide returns that **do not** mimic direct ownership of underlying assets, but instead replicate the performance of sophisticated investment strategies that incorporate buying and selling options, entering into short sales, and employing leverage. Prepaid derivative transactions make these complex strategies available to a broad base of investors, including individuals, tax-exempt entities, retirement plans, mutual funds, and other institutional investors. Because of the legal form and economic characteristics of these prepaid derivative transactions, they are permitted investments for those investors who cannot legally enter

directly into options or other derivative transactions on a stand-alone basis or who can do so but are required under applicable investment guidelines to treat them less favorably.

In addition, ETNs and other prepaid derivative contracts provide “one-stop shopping” for investors, allowing an investor to make a single investment in order to obtain exposure to asset classes they could not otherwise access. For example, most individuals do not invest in commodity futures due to their complicated nature and cash flows. Mutual funds effectively cannot invest in commodities or commodity futures, except in very limited amounts. This may explain why the single largest ETN by far is based on an objective formula linked to commodity futures. Other reasons to invest in prepaid derivatives include a more favorable fee structure implied in the pricing of prepaid derivative contracts and liquidity.

**5. Current Tax Law Analysis of Prepaid Derivatives.** For all the variety of prepaid derivative instruments, their hallmark feature is that investors place all (or a substantial portion) of their investment in the contract at risk of loss, until the maturity of the instrument. Although many prepaid derivative contracts are issued in the nominal form of corporate notes, they are not debt instruments in the U.S. federal income tax sense of the word. Unlike traditional corporate debt, these “notes” do not entitle an investor to an unconditional return of the principal at maturity plus some amount of interest. Instead, the payment at maturity of the instrument is determined by the performance of some financial asset or strategy. Investors in prepaid derivatives not only may receive no return but also can have a significant risk of losing some or all of the original investment. This “risk of loss” feature is prominently disclosed in the offering documents.

Tax law draws a fundamental distinction between investments that constitute debt and those that do not. Investors in debt instruments are generally guaranteed an unconditional repayment of their original investment and seek pre-determined returns based on the time value of money. By comparison, for non-debt instruments, such as stock, options, forward contracts, and swaps,



investors generally assume a risk of loss of their original investment in the hope of receiving an unpredictable (but potentially greater) return.

Tax law reflects this fundamental difference between debt and non-debt instruments by requiring that investors in debt instruments (and certain swaps that have an easily identifiable debt component) recognize income on a current basis under a set of complicated accrual rules. Investors in non-debt transactions on the other hand, do not generally take any conditional returns into income until such returns become fixed. For example, if an investor buys stock of two companies, one of which distributes its earnings annually and one of which reinvests all of its earnings, the investor is subject to tax on the corporate earnings of the first company but not the second. Investors in corporate stock pay tax only on dividends distributed by the corporation and do not pay tax on any increase in value of the stock until the stock is sold, regardless of how long they choose to hold the shares, and regardless of the fact that the increase in value may be attributable to reinvested earnings. Investors that sell options are not taxed on the option premium received until the option lapses or is exercised, and buyers of options are not required to impute any interest income notwithstanding that the pricing of options takes into account the time value of money.

There are currently no statutory provisions that specifically address the tax treatment of prepaid derivative contracts. The Internal Revenue Service has given guidance on only a limited class of these derivatives. In the absence of explicit rules, leading academics and tax practitioners have undertaken an extensive analysis of these transactions under current law. This analysis has applied long-standing general tax principles to arrive at what is now a broad market consensus on how prepaid derivative contracts should be treated for tax purposes under current law.

As a general matter, the tax analysis of prepaid derivatives should be driven by the fact that a holder is exposed to the risk of loss of all or substantially all of his or her investment in a

contract. The holder does not have a claim for the return of a sum certain principal amount. Investors are seeking risk-based (as opposed to time value of money) returns from these instruments. This risk of loss exists throughout the term of the instrument.

Under the time-honored tax principles of income realization and recognition, investors should generally not be taxed on phantom returns and unrealized gains, which can evaporate at any time along with the investor's original investment. Under current law, because investors in prepaid derivative contracts genuinely put their capital at risk, under long-standing general tax principles, the returns on these instruments should not be taxed as returns on debt.

In a nutshell, investors in debt know that they will have income; the only question is *when*. Investors in prepaid derivative transactions, on the other hand, do not know *whether* they will have any income or whether they will recoup their investment. Waiting until an investor gets paid to impose the tax in this instance is not "deferral"; it is common sense. Applying tax rules developed for debt instruments where investors are entitled to a return of principal does not fit the risk profile of prepaid derivative contracts.

**6. Our Concerns About H.R. 4912.** H.R. 4912 would introduce a fundamental change in the way all prepaid derivative contracts are treated. H.R. 4912 would treat such contracts in the same way as debt by requiring a holder to accrue interest income on the amount invested and pay tax currently on such income. H.R. 4912 would require accrual of income despite the fact the holder does not receive any amounts currently and is not assured of repayment of its original investment or a return on the investment. H.R. 4912 would require a phantom income recognition for many investors in prepaid derivative contracts. As a result, these investors who will be taxed on phantom income would have to either liquidate their investment in the contracts (where such investments are liquid) or come up with cash to pay the tax by selling other investments or foregoing other investment opportunities.

We are also concerned about the complexity and administrability of H.R. 4912's rules. Under the complex calculations required by H.R. 4912, phantom income on ETNs will be calculated in a series of steps. Then investors will need to keep track of their revised adjusted basis and possibly a hypothetical adjusted basis in the ETNs. It could even be possible for an investor not to know at year-end whether or not the investor has any phantom income for that year. We are particularly concerned that retail investors will find these rules to be complex and difficult to understand. By contrast, mutual fund investors are simply taxed on the cash they receive, or are entitled to receive.

This phantom income accrual requirement of H.R. 4912 would be fundamentally different from the OID rules, which require a holder of a zero coupon bond to accrue annual interest income even in the absence of cash paid, because the holder of such a zero coupon bond is unconditionally entitled to receive at maturity its investment and a time value of money return. In short, H.R. 4912 moves the line on when phantom income should be accrued from debt to cover prepaid derivative contracts whose financial characteristics, by definition, are not debt-like. In considering whether the line should be moved, it is important to keep in mind other investments where accrual of phantom income is not required. For example, an investor in common stock where the issuer retains its earnings is not taxed until the common stock is sold. In these common fact patterns, and many others, a risk-free return is not imputed to the investor.

7. **Principles for Taxing Financial Instruments.** As a matter of tax policy, any new legislation on the taxation of financial instruments should follow four principles. First, any new rules should be clear and as unambiguous as possible. Second, the legislation should be consistent, which means that it should generally treat in a similar way different types of financial instruments that have similar economic and financial features. Third, the rules should be administrable and understandable by investors. Fourth, new legislation should strike an appropriate balance between

consistency with the taxation of the assets referenced in derivative contracts and recognition that financial derivatives are complex instruments that do not represent mere laundry tickets to the underlying assets. A new set of tax rules that are based on these four criteria would be a substantial improvement of the existing tax system and would be welcomed by taxpayers.

We have significant concerns that the current version of H.R. 4912 is overly broad and does not reflect the tax policy principles described above. As a result, it may create new uncertainties and new disparities at the same time it alleviates others. In this very complex area, H.R. 4912 could produce unfair and unintended results in many situations. For example, H.R. 4912 would impute phantom income at the applicable federal rate ("AFR") on a prepaid derivative whose formula refers to the S&P 500 index, even though the dividend returns on the S&P 500 index are expected to be less than the AFR. Another example is that if an ETN loses value, there would be no adjustment for prior years' phantom income inclusions until the year of the maturity or sale.

One of the reasons that the tax rules for derivatives give rise to so many different views about what is the right answer is that there are too many piecemeal rules addressing a range of financial instruments in a marketplace that is dynamic and innovative. We appreciate that this hearing has been called to start the legislative review of the current tax rules as they apply to complex financial products and determine whether changes may be necessary, taking into account the great importance that these instruments have to financial markets and tax policy objectives. The Treasury Department and Internal Revenue Service have also called for comments on the taxation of prepaid derivatives. In light of the complexity of the issues that will need to be resolved in order to arrive at fair and administrable tax rules, we respectfully suggest that the legislative review be coordinated with the Treasury's consideration of these same issues in order to permit Congress to make the most informed decisions that will reflect sound tax policy objectives. We look forward to participating in this important dialogue.

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Chairman NEAL. Thank you, Mr. Samuels.  
Mr. Shulman.

**STATEMENT OF MICHAEL B. SHULMAN,  
PARTNER, SHEARMAN & STERLING LLP**

Mr. SHULMAN. Chairman Neal, Ranking Member English, and Members of the Subcommittee, thank you for inviting me to testify. I am a lawyer in private practice with Shearman & Sterling in Washington, D.C. My practice focuses on the taxation of financial instruments, including prepaid forward contracts.

In this regard, I have advised a number of clients on tax issues associated with exchange traded notes. However, I am appearing here today on my own behalf and not on behalf of any client or organization. The views I express here are solely my own.

I would like to speak to you today about several important tax policy issues raised in connection with prepaid forward contracts, including those associated with H.R. 4912. With certain limited exceptions, taxpayers recognize gain or loss from investment activities only when a realization event occurs.

The current treatment of prepaid forward contracts is consistent with this realization-based approach. That is, an investor that acquires a prepaid forward contract is not taxable on its investment until it sells the contract or receives cash with respect to the contract.

To be sure, there are certain exceptions from the tax system's realization-based approach. For example, a holder of a debt instrument may be required to accrue interest on the instrument prior to the receipt of cash. But this is because the holder of a typical debt instrument is entitled to a return of, as well as a return on, its investment. As the Joint Committee report correctly points out, there is simply a dividing line between debt and non-debt instruments.

It is understandable that prepaid forward contracts, and exchange traded notes in particular, would provoke a lively tax policy debate regarding these important issues. But I would ask the Committee to consider whether it is wise to abandon the realization-based approach the tax system has traditionally employed.

I recognize that the tax consequences associated with owning a prepaid forward contract are different and in many cases more favorable than those associated with ownership of the underlying asset or assets. In particular, under current law, the holder of a prepaid forward contract does not recognize dividends and interest on a current basis and is unaffected by the shifting of assets underlying the contract.

It is important to recognize, however, that ownership of a prepaid forward contract differs in several important respects from direct ownership of the underlying assets, including that the investor bears the credit risk of the counterparty under the prepaid forward contract; the investor does not exercise any voting rights that may be associated with the underlying assets; it has no dominion and control over any cash flow generated by the underlying assets; and it has no control over the acquisition or disposition of the underlying assets.

There have been assertions that the current tax treatment of prepaid forward contracts is inappropriate because such contracts are economically equivalent to a non-prepaid forward contract to buy the underlying assets and a deposit of funds to secure the for-

ward price, in which case the holder would be required to accrue interest income on a deposit.

To the extent that legislative changes are advanced under the principle that prepaid forward contracts are economically similar or even identical to other investment strategies, I would respectfully suggest that innumerable examples exist of financially equivalent transactions that have different tax treatment.

The Joint Committee report does an excellent job of framing the tax policy debate over prepaid forward contracts. Here we do not have a situation where the tax results to holders of prepaid forward contracts necessitate a change in law. Instead, Congress is presented with two competing tax policy concerns. On the one hand is the fundamental principle that investors are not taxed with respect to investment until they receive cash. On the other hand, there is the fact that holders of a prepaid forward contract may derive more beneficial tax treatment than the owner of investments with similar economic profiles.

Historically, Congress has abandoned the realization-based approach to taxation only when it needed to do so in order to prevent a tax result that was viewed as untoward. I respectfully suggest that prepaid forward contracts do not present such a situation.

Turning to H.R. 4912, I would assert that the proposed bill would reverse settled law by requiring the imputation of interest on prepaid forward contracts even though the amount required to be included in income by investors would bear little or even no relationship to the investor's economic income.

Thus, if the bill is intended to address the disparate tax treatment under current law between prepaid forward contracts and direct ownership of the underlying assets, it fails to do so and instead provides a regime that in most cases would be substantially more adverse than the treatment that would apply to direct ownership of the underlying assets.

Moreover, the tax regime proposed by the bill is novel and more punitive relative to prior legislation, including provisions targeted to more debt-like transactions. For example, Congress's enactment of provisions addressing market discount bonds in 1984 and conversion transactions in 1993 avoided requiring the imputation of interest even though both provisions were targeted to transactions that provide investors with debt-like returns, unlike prepaid forward contracts.

No interest imputation was required in such cases, presumably because of the administrative complexity of an interest imputation system. As I mentioned earlier, prepaid forward contracts do not provide holders with debt-like returns and thus present a less likely candidate for an interest imputation system than those prior regimes that rejected such a system.

Finally, the tax issues associated with prepaid forward contracts are not unique and instead exist across a broad range of financial instruments. I would suggest that any legislative approach to the treatment of prepaid forward contracts should be undertaken in connection with the broader consideration of the tax treatment of all financial products.

Thank you for your attention, and I look forward to taking any questions you may have.

[The prepared statement of Michael B. Shulman follows:]

**Prepared Statement of Michael B. Shulman,  
Partner, Shearman & Sterling LLP**

Chairman Neal, Ranking Member English, and Members of the Committee, thank you for inviting me to testify. I am a lawyer with the firm of Shearman & Sterling LLP. My practice focuses on the taxation of financial instruments, including the tax treatment of prepaid forward contracts. However, I am appearing here today on my own behalf, and not on behalf of any client or organization. The views I express here are solely my own.

I would like to speak to you today about several important tax policy issues raised in connection with prepaid forward contracts, including those associated with H.R. 4912.

With certain limited exceptions, taxpayers recognize gain or loss from investment activities only when a realization event occurs. For example, a taxpayer who invests in corporate stock generally recognizes no gain or loss with respect to its investment for tax purposes (other than dividend income) until its disposition of such stock, regardless of price fluctuations.

The current treatment of prepaid forward contracts is consistent with this realization-based approach. That is, an investor that acquires a prepaid forward contract is not taxable on its investment until it sells the contract or receives cash with respect to the contract.

To be sure, there are certain exceptions from the tax system's realization-based approach. For example, a holder of a debt instrument may be required to accrue interest on the instrument prior to the receipt of cash, but this is because the holder of a typical debt instrument is entitled to a return of (as well as a return on) its investment. Another example is the constructive sale rules, which require the recognition of gain where a taxpayer has effectively "locked in" gain with respect to an appreciated financial position. The policy rationale for the existing exceptions to the realization-based approach have no application to prepaid forward contracts. Specifically, in contrast to a debt instrument, a holder of a prepaid forward contract has no right to a return on (or even a return of) its investment. And, unlike the constructive sale context, the holder of a prepaid forward contract has not "locked in" any amount of gain.

It is understandable that prepaid forward contracts (and exchange traded notes in particular) would provoke a lively tax policy debate regarding these important issues. But I would ask the Committee to consider whether it is wise to abandon the realization-based approach the tax system has traditionally employed.

I recognize that the tax consequences associated with owning a prepaid forward contract are different (and in many cases, more favorable) than those associated with ownership of the underlying asset or assets. In particular, under current law, the holder of a prepaid forward contract does not recognize dividends and interest on a current basis that it would recognize if it were the tax owner of the underlying assets and is unaffected by the shifting of assets underlying the contract. It is important to recognize, however, that ownership of a prepaid forward contract differs in several important respects from direct ownership of the underlying assets. First, the investor bears the credit risk of the counterparty under the prepaid forward contract, and thus might not receive the economic results of the underlying assets if the counterparty defaults on its obligations. Second, the investor does not exercise any voting rights that may be associated with the underlying assets. Third, the investor has no dominion and control over any cash flow generated by the underlying assets. And fourth, the investor has no control over the acquisition or disposition of the underlying assets.

There have been assertions that the current tax treatment of prepaid forward contracts is inappropriate because such contracts are economically equivalent to a non-prepaid forward contract to buy the underlying assets and the deposit of funds to secure the forward price (in which case the holder would accrue interest income on the deposit). To the extent that legislative changes are advanced under the principle that prepaid forward contracts are economically similar or even identical to other investment strategies, I would respectfully suggest that innumerable examples exist of financially equivalent transactions that have different tax treatment. If one were to attempt to change the tax system to provide identical tax treatment for financially equivalent transactions, such a change (even if possible) would result in a tax system entirely different from the one we have today.

Turning to H.R. 4912, I would assert that the proposed bill would reverse settled law by requiring the imputation of interest on prepaid forward contracts, even though the amount required to be included in income by investors would bear little

or no relation to the investor's economic income. Thus, if the Bill is intended to address the disparate tax treatment under current law between prepaid forward contracts and direct ownership of the underlying assets, it fails to do so and instead provides a regime that in most cases would be substantially more adverse than the treatment that would apply to direct ownership of the underlying assets.

Moreover, the tax regime proposed by the Bill is novel and more punitive relative to prior legislation, including provisions targeted to more debt-like transactions. For example, Congress' enactment of provisions addressing market discount bonds in 1984 and conversion transactions in 1993 avoided requiring the imputation of interest, even though both provisions were targeted to transactions that provided investors with debt-like returns. No interest imputation was required in such cases presumably because of the administrative complexity of an interest imputation system. As I mentioned earlier, prepaid forward contracts do not provide holders with a debt-like return, and thus present a less likely candidate for an interest imputation system than those prior regimes that rejected such a system.

Finally, the tax issues associated with prepaid forward contracts are not unique, and instead exist across a broad range of financial instruments. I would suggest that any legislative approach to the treatment of prepaid forward contracts should be undertaken in connection with a broader consideration of the tax treatment of all financial products.

Thank you for your attention and I look forward to taking any questions you may have.

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Chairman NEAL. Thank you, Mr. Shulman.

Mr. Sauter, we have heard a lot about the credit risk inherent in ETNs. Why don't you comment on the credit risk of issuer banks, and is this something the average retail investor is worried about? I think that is consistent, and you might have an opportunity to clarify the differences in your testimony and Mr. Samuels' testimony about the differences between a mutual fund and an ETN.

Mr. SAUTER. Yes. Thank you. I think most individual investors really think of ETNs as a cousin to ETFs, ETFs being a type of mutual fund with certain exemptive relief. But they don't really fully understand the implications of an ETN. They don't really understand that they have credit exposure at the end of the day. They have just heard that ETFs are tax-efficient and ETNs are even more tax-efficient.

With respect to an investment in a prepaid forward contract, if you really break it down and see what is going on behind the scenes, there is an issuer who is taking exposure to a referenced asset, and the investor who wants the return of that referenced asset. One would hope that the issuer is investing in that referenced asset and not just taking risk on.

So, the investor in the prepaid forward contract has essentially loaned money to the issuer in order to make that investment in the underlying referenced asset. I think that is what supports the accrued interest principal.

If you look at a futures contract, an exchange traded forward contract, in that case again you are looking to get the return of the referenced asset. The one difference here versus an ETN or other prepaid forward contract is you are not putting the money upfront. In this case, the investor holds on to cash, but there is a daily mark to market so that there is cash movement that reflects the return on the investment on a daily basis.

So, the investor has far less risk in a futures contract than they do in an ETN or prepaid forward contract. They have given their money to the issuer, in the case of the prepaid forward contract,



and they are at risk at the end of the prepaid forward contract whether or not the issuer actually has the ability to repay their principal plus the return on the referenced asset.

There is, of course, settled tax policy as to how futures contracts should be taxed. In their case, they are taxed quite onerously, in fact. They are marked to market on an annual basis and taxed 60 percent long-term, 40 percent short-term capital gains.

At the same time, in order to get the full rate of return, the investor has to take the cash that they would have invested, or that they would have advanced in the case of a prepaid forward contract—they take that cash and they put it in an interest-bearing asset, and they pay current tax on the interest they are earning. That is how they get the same total rate of return before tax as the prepaid forward contracts. So, they are paying tax on an accrual basis annually, and they are also paying mark to market at the end of the year.

In a mutual fund, you have a different situation. There, the investor actually owns a pool of assets. They know that they don't have credit risk whether or not those assets will be available at the end of the day. They have a good deal of assurance that at the end of their ownership time period that they will receive payment for their investment.

Of course, mutual funds are taxed currently. When income is received currently, they pay the tax or they pass it on to the investor who pays tax, whether it is in the form of interest, whether it is in the form of dividends, whether it is in the form of capital gains.

Contrasting that to the prepaid forward contract, it doesn't pay any return currently. At the end of the investment, everything is taxed at a capital gains rate. So, you have converted the character of the income into capital gains tax rates and you have deferred it significantly in time.

I would argue that from an investor's standpoint, they don't understand the risk they have, the counterparty risk they have in the prepaid forward contract. I would say that in the case of an exchange traded futures contract, forward contract, that there is far less risk to the investor that they are going to get their true investment return, but yet there is onerous taxation. In the case of a mutual fund, there is far less risk if any risk that they will get the rate of return of the referenced asset. Again, there is much higher taxation.

Chairman NEAL. Mr. Samuels, I want to give you an opportunity to respond.

Mr. SAMUELS. I would like to make a couple of observations about the prepaid derivative market. First, it is a complicated situation to talk about. I think Mr. McDermott had it right at the beginning. It is quite arcane.

In talking about prepaid derivatives, there is a whole range of prepaid derivatives. We are talking about so-called ETNs. That is one kind. It is a subset. But there is a whole range of over-the-counter derivatives. That is just two parties getting together and entering into a prepaid. Those have returns that are paid—some of them have returns that are paid currently. Actually, I think some ETNs may have returns that are paying currently.

When you have returns that are being paid currently on a prepaid derivative, if you compare it to a mutual fund, the prepaid derivative holder could actually be in a worse position because you don't pass through qualified dividends. You don't pass through capital gains.

So, it is a very complicated topic to deal with. I don't think there are any easy answers. I admire and support the Committee's review of the topic because it is something that has been talked about for a long time and needs further review. I think this is a very good time to be talking about it.

With respect to ETNs and credit risk, our information from some of our members is that in light of the recent large write-downs in the market that some of the financial institutions have had to take, that that has affected their ability with respect to entering into prepaid forwards and the pricing of prepaid forwards so that the credit quality is important to those participants in the market.

The other thing I would say about the ETN market is that it is, as we have all said, a relatively new instrument. But an example in terms of the investor base, and this is what makes it complicated, is that our information, for example, on the largest issuer—which is Barclays Bank has issued about 5 or \$6 billion of ETNs; they are the largest issuer—in the 18 months that their ETNs have been outstanding, the market turnover has been \$22 billion. That is the number that they have supplied us.

So, they had issued \$5 billion over 18 months, and it is ramping up. The turnover is \$22 billion. So, that shows that people aren't holding these and putting them under their beds, you know. There is a significant turnover, and that is because the investor base that is buying these are not just individuals, but they are institutions, including mutual funds, buying ETNs.

Chairman NEAL. I want to give Mr. English a chance to ask a question. We are going to be on the floor for about a half hour, so I would like to—if we could go forward on this. Mr. English.

Mr. ENGLISH. Thank you.

Mr. Samuels, it is good to see you back. The Neal bill would require investors in ETNs and prepaid derivative contracts to accrue income every year and pay tax on that income every year even if they don't actually receive the income. Are there other products that, under current law, benefit from deferral?

Mr. SAMUELS. Mr. English, the tax law has a dividing line generally speaking between debt and debt-like instruments on which there may be accrual, like original issue discount, and the non-debt-like instruments, financial instruments, like stock and options, which do not require accrual. The question is—and it was referred to before—what cubbyholes should prepaid forwards be put in?

But there is a dividing line and a long history of not imputing risk-free rates of return on stock or options, for example.

Mr. ENGLISH. Thank you.

Mr. Paul, you are testifying today on behalf of ICI, which I know is, as I am, a strong supporter of Representative Ryan's GROWTH Act. That would provide tax relief for millions of Americans investing in mutual funds for long-term goals such as retirement by de-

ferring taxation on automatically reinvested capital gains until fund shares are sold.

I believe this is good tax policy, and I believe mutual funds provide a diversified, well-regulated investment vehicle for allowing individuals to meet their financial goals.

As we consider the tax deferral of other instruments and the appropriate taxation of prepaid derivative contracts, which include exchange traded notes, I would wonder, Mr. Paul, basically why do you believe the deferral treatment of these derivatives should be different?

Mr. PAUL. Thank you, Mr. English. The ICI very much appreciates your support of the GROWTH Act. Let me make clear the ICI continues to very strongly support that legislation.

In supporting the GROWTH Act, the ICI is asking Congress to evaluate the policy arguments for allowing a mutual fund investor to reinvest capital gain dividends without current tax. There are a number of similar rollover provisions in the Code that reflect similar policy judgments.

For example, you can roll over the gain from the sale of small business stock if you reinvest it in other small business stock. You can roll over the gain from publicly traded securities if you reinvest them in a small business investment company. We used to have a provision that allowed you to roll over the gain on the sale of your principal residence. We now just have an exclusion.

In the case of mutual funds, the policy argument is tied to encouraging long-term savings in a diversified and highly regulated investment vehicle, namely a mutual fund, which is subject to all the investor protection safeguards of the 1940 Act.

Congress, as we know, has not enacted the GROWTH Act, so we are in a world in which mutual fund investors pay tax on reinvested capital gain dividends. In that world, we are asking Congress to consider the policy and revenue implications of allowing the deferral and conversion permitted by ETNs.

That deferral and conversion is not the result of a deliberate policy choice by Congress. I think this hearing is very commendable because I think this is something that needs attention, and if Congress decides that this conversion and deferral is appropriate, then so be it. But we don't think that is the right answer.

Unless Congress acts, investors will have a strong tax incentive to invest in an unregulated ETN with issuer credit risk over a highly regulated mutual fund. This seems to us to turn tax policy on its head.

Mr. ENGLISH. On that point, Mr. Paul, I noticed last week ICI submitted a paper to the Senate Republican Task Force on Competitiveness, and in that paper you discussed the tremendous growth of UCITS, which are the European version of ETNs. ICI in that paper recommends on page 12 and 13 that Congress allow mutual funds to offer similar products with a tax rollup feature, meaning that investors would not be taxed until they redeem their shares.

As I understand it, you are recommending that mutual funds be allowed to offer an ETN-style mutual fund with unlimited deferral, the same concept as the GROWTH Act. Today you are testifying

that such products should be taxed under the Neal bill or under your proposed solution.

If Congress enacted your recommendation, would you propose that these new products would benefit from tax deferral, as described in last week's paper, or under the regime that you propose in today's testimony?

Mr. PAUL. I am sorry. I am not sure I followed the last part of that question. Could you——

Mr. ENGLISH. If I could just——

Mr. PAUL. If the proposal were adopted, then what was the question?

Mr. ENGLISH. Do you propose that these new products——

Mr. PAUL. I'm sorry. The new products being——

Mr. ENGLISH [continuing]. Benefit from tax deferral, as described in last week's paper, or under the regime you proposed for today's testimony?

Mr. PAUL. When you say these new products, do you mean the newly proposed UCIT-style mutual fund or ETNs?

Mr. ENGLISH. That is correct. That utilizes the tax rollup feature.

Mr. PAUL. Well, I think, sir, the way I think about that proposal you just described is it is an expanded version of the GROWTH Act proposal. It wouldn't be limited to long-term gains. But the policy issue again is the same. Does Congress want to adopt a policy of encouraging long-term savings and diversified vehicles that are subject to the protections of the 1940 Act? I think that is part of what is going on in that proposal.

That obviously has not been enacted, and given revenue limitations, it seems to me it is not likely to be enacted any time soon. So we continue to be operating in a world in which mutual fund investors do pay current tax. In that world, the juxtaposition of an ETN against a mutual fund, with no taxation on the ETN, again I think creates a perverse result from a tax policy perspective, that you are creating a tax incentive for somebody to invest in an unregulated product with credit risk as opposed to a diversified regulated product with no credit risk.

Mr. ENGLISH. I agree with you that tax policy should take into account competitive differences imposed by the Tax Code. But I am also looking for an exposition of tax theory here that should guide us more broadly, which I guess brings me back to the point I made, Mr. Chairman, in my initial testimony, that maybe this is an issue that is best approached with more than simply a tax solution.

But I thank you, Mr. Paul, and I appreciate the nuances of your testimony.

Chairman NEAL. Thank you, Mr. English.

Mr. Samuels, considering that Treasury has said today specifically that these other ETNs "present unique questions as to whether the deferral of tax is appropriate," will you be advising your SIFMA or your issuer clients that retail investors should be aware that the previous tax advice could be reversed?

Mr. SAMUELS. Chairman Neal, first let me say that——

Chairman NEAL. You will be here for a long time. You know you aren't leaving easily today.

[Laughter.]

Mr. SAMUELS. I know that. First let me say this, that SIFMA is working with Treasury actively in responding to their request for comments, and will continue to do that.

I believe that the disclosure in the ETNs' prospectuses say that the law can be changed, and that while there is a consensus of what the law is now, it certainly could be changed in a variety of ways. I think that that is an issue that investors need to take into account when they make their decision to buy an ETN.

Chairman NEAL. Thank you. We might have time for Mr. Reynolds, if you would like, to get in a question.

Mr. REYNOLDS. Thank you, Chairman. I just listened to both the hearing and comments by you, Chairman, and the Ranking Member. As we look at the complexity of this issue, one, I think it is important that we also see what Treasury comes back and lays out to us on this.

But what I haven't heard from anybody, as I understand both industries looking very closely at that, is if anyone has taken a look at what the bottom line is on what is best for the investor while we watch industries have viewpoints of some solutions here, particularly while we are at a tenderness of our economy on making moves much, I guess, as Mr. English has outlined on the aspect of which derivatives, if all or some or a few.

So, anybody have a comment as they look at what is best for the investor on this?

Mr. SHULMAN. Well, I certainly have comments on that. I guess from my perspective, the tax system has always avoided imposing taxes on phantom income except in situations where it was really important to do so, such as in the case of debt instruments. This is not a debt instrument.

Here the income will be phantom income in the sense that investors do not receive cash. Under the Chairman's bill, the investors would be subject to tax without receiving any cash. As importantly, investors may never receive the amount that they would be taxed on. So, they could be taxed on imputed interest yet never ultimately realize an economic gain from the instrument.

So, certainly from an investor perspective, I think the current system is certainly more favorable and I think more in line with the historic realization-based approach we have always had.

Mr. SAUTER. If I might, I would like to say if we strip away the tax consequences for a minute and ask what is best for the investor representing the mutual fund industry, obviously I believe that mutual funds offer the best benefit to investors. The reason I believe that is because they are highly regulated and they do have a pool of assets that assures the return that you are expecting to get.

If you look at an ETN, the investor is ultimately taking on credit risk for which they are not compensated. The economic similarity between an ETN would be investing in a mutual fund that provides the same exposure to the referenced asset plus writing a CDS contract. Writing a CDS contract would be taking exposure to the credit quality of the issuer of the ETN.

It turns out that writing a CDS contract, taking credit exposure to, let's say, Barclays Bank, would cost you about 1 percent—or you would receive 1 percent per year. So, if you were to invest in a mu-

tual fund and also get the credit exposure, you would be getting the referenced asset plus 1 percent a year.

The investor is not getting that, but that is the risk they are taking with an ETN. So, I would say before taxes, I think the mutual fund is a better product than an ETN for the investor, the difference being after tax, the ETN has tremendously favorable tax treatment. We believe that there should be parity.

Chairman NEAL. I am trying very hard. We have about 2 minutes left. Mr. Herger, would you like to squeeze in a question?

Mr. HERGER. Very quickly, yes.

Chairman NEAL. Obviously, a general one.

Mr. HERGER. Mr. Samuels, the rationale for the lower taxes for capital gains and dividends is to encourage investment in those assets. In the case of an ETN, however, the investor clearly is not buying these assets, and the insurer may but is not required to invest in them to hedge its exposure.

As such, should the traditional arguments in favor of justifying a lower tax rate on capital gains apply to the derivative product like an ETN?

Chairman NEAL. Very short answer, Mr. Samuels.

Mr. SAMUELS. I would say yes. I believe that the investor is taking risk with respect to a capital instrument, and that therefore they should be entitled to capital gains.

I would also say, just to quickly recap, we are saying different industries. We are all part of the same financial services industry. We are trying to provide products to investors to encourage them to invest and to save. I think we can have some differences, but I think that—just I think it is important for people to keep that in mind.

Mr. HERGER. Thank you, Mr. Chairman.

Chairman NEAL. Thank you. I want to thank the witnesses for the testimony today. Again, it was very helpful, and we will have some perhaps written followup questions. We hope you will respond.

But thank you. This does help to clarify issues for Members of the Committee in what I assume is going to be a continued and ongoing debate.

This hearing stands adjourned.

[Whereupon, at 12:00 p.m., the hearing was adjourned.]

