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Tax reform of financial products?

The idea may be theoretically interesting, but it is too complex and practically unworkable

By Robert N. Gordon

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The House Ways and Means Committee has released a draft proposal for sweeping reform of tax laws dealing with financial products.

Most of the proposals might be too complex or unfair to become law.

Financial derivatives no longer would generate capital gains or losses. Instead, all gains and losses on derivatives would be treated as ordinary income and loss.

In addition, these instruments would be marked to market Dec. 31 so that all unrealized gains and losses at year-end would be recognized for tax purposes.

This would apply whether or not the derivative or the referenced asset were publicly traded. It would apply not only to actual derivatives but also to investments with embedded options.

As an example, one specific proposal would direct taxpayers to value the call option embedded in a convertible bond each year and then pay tax on any appreciation in this theoretical option. How one might go about coming up with that value is beyond me.

Derivatives are defined to include options, future contracts, forwards and swaps. The definition also would tax short sales as derivatives.

The actual language defines a derivative as any “evidence of an interest in” a referenced asset such as a stock or stock index. It is thought that the proposals weren't meant to include ownership of the actual stock.

However, at a recent American Bar Association meeting, the banter got exciting as prominent attorneys and government speakers ruminated on what “evidence of an interest in” might encompass.

Clearly, American depository receipts would be marked to market.

One lawyer said that he was concerned that if shares were lent out of a margin account, the investor would end up owning a derivative rather than a stock.

Providing no comfort, Karl Walli, senior counsel in the Treasury Department's Office of Tax Legislative Counsel, answered, “Economically, a securities-lending transaction has always been a derivative.”

Matthew Stevens, a partner at Ernst & Young, pointed out that investors don't hold actual shares but have a brokerage statement that is “evidence of an interest in” shares that reside at a depository.

He doesn't think that was what was intended, nor does he think a law to that effect would be passed.

Taxpayers would be instructed to act as if the shares were sold when an investor entered a derivative.

For example, let's say you buy a stock at $10 and watch it rise to $25. You decide to sell a call option with a strike price of $30, but in doing that, you create a taxable event of the shares as if you had sold them at $25.

This doesn't seem equitable and would “kill” covered-call writing.

If these derivatives rules were passed, futures and broad-based index options no longer would be taxed as 60% long term and 40% short term, though they still would be marked to market at year-end.

I think that the real target of these derivatives proposals are exchange-traded notes.

The Investment Company Institute has been gunning for ETNs for years, and marking them to market at year-end would remove what ICI considers ETNs' unfair tax advantage over mutual funds.

I don't agree with Daniel Crowley, a former lobbyist for the ICI, who said that without the tax advantage, “there would be no reason for [ETNs] to exist.”

The notes eliminate tracking error and are very useful when accessing difficult asset classes that don't fit neatly into exchange-traded funds or open-end funds, such as master limited partnerships.

I worry most about the suggestion to force investors to use an average cost basis in computing gain or loss when exiting a position. Investors currently can use specific lot identification when they dispose of only a portion of their securities holdings.

This idea was first floated by the Clinton administration in 1996 and again in 1997. It was estimated that the change would bring in $1 billion a year and not require lengthy debate or legislation to be implemented.

Because of this, I'm concerned that it may be adopted in the search for revenue. When it was offered in the 1990s, members of the securities and mutual fund industries testified about the negative consequences; they and others could lend their voices again.

The committee's proposals include adding a related-party rule to the wash sale rule, and changing the taxation of distressed debt.

Stay tuned.

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