

Is Mark-to-Market Taxation on the Horizon?

Robert N. Gordon*

In June 2016 the Senate proposed the “Modernization of Derivatives Tax Act of 2016”. The act would mark to market all derivatives at year end AND treat all gains or losses as ordinary income. The definition of derivatives is quite broad. (click here for legislation)

Not for the first time, Congress is considering a switch from realization-based capital gains taxation to an annual mark-to-market model. The Camp proposal now under discussion would change the rules for derivatives—and in so doing could bring other financial instruments into the mark-to-market net. Similar proposals have faded in the past, but as President Obama has included the concept in his 2014 Budget, investors and tax professionals alike are advised to pay attention this time around.

Introduction

Late in 2011 there was an unusual joint hearing of the House Ways and Means Committee and the Senate Committee on Finance on the taxation of financial products.¹ The bulk of the time was focused on the idea of marking assets to market at the end of each year, in order to curb perceived inequities and abuses, especially those arising from the complex taxation of derivatives.

In January of this year, Representative Dave Camp, House Ways and Means Committee Chairman, released a draft proposal for sweeping reform of tax laws dealing with financial products.² This was followed up by a hearing in March.

At that hearing, those testifying were surprisingly upbeat about the prospects and benefits of marking to market all derivatives at year end. The Camp proposal encompasses any derivative or “evidence of an interest”:

- Any share of stock in a corporation;
- Any partnership or beneficial ownership interest in a partnership or trust;

* Robert N. Gordon is the president of Twenty-First Securities Corporation, which he co-founded in 1983, and since 1991 has also served as an adjunct professor at New York University’s Graduate School of Business. He is also a member of the *Journal’s* Board of Advisors and Contributors. He may be contacted by email at bob@twenty-first.com.

¹ See “Taxwriters, Panelists Agree on Need to Reform Taxation of Financial Products,” available at 2011 TNT 235-1 (Dec. 7, 2011); see also Staff of Jt. Comm. on Tax’n, “Present Law and Issues Related to the Taxation of Financial Instruments and Products” (JCX-56-11, Dec. 2, 2011) (report prepared for hearing).

² Ways and Means Discussion Draft (Jan. 23, 2013), available at http://waysandmeans.house.gov/uploadedfiles/leg_text_fin.pdf.

- Any note, bond, debenture, or other evidence of indebtedness;
- Subject to limited exceptions, any real property;
- Any commodity which is actively traded (within the meaning of Internal Revenue Code Section 1092(d)(1));³ or
- Any currency.

Now, the President's Budget for Fiscal Year 2014 includes a proposal very much like the Camp proposal to mark-to-market all derivatives at year end.⁴ The President's proposal seems slightly less all-encompassing than the Camp proposal.

Why Annual Marking to Market Hasn't Happened Yet

After looking through the academic research and literature on the subject, I found that every 20 or 30 years Congress toys with the idea of changing the realization-based capital gains taxation model.⁵ A few of these forays ended after pretty much everyone came to the conclusion that asking people to pay tax on phantom profits just isn't fair, and might even be unconstitutional.

Others got past the fairness issue but got bogged down on the problems that taxpayers would face in trying to find the money to pay the tax on the unrealized appreciation.

If the analysis gets past these hurdles, the practical realities of administering the tax come into play:

- How do you value assets that are not publicly traded?
- Are capital losses marked-to-market, too?
- Can taxpayers start deducting capital losses—and, if not, can the losses at least be carried back?
- How much money does the Treasury lose by allowing the deductibility of losses?

Daunting as all of the above questions are, the really big headache is the first one: How does one value a fine-art collection, say, or real estate? One answer that

³ See Treas. Reg. § 1.1092(d)-1(a) (noting that “[a]ctively traded personal property includes any personal property for which there is an established financial market”).

⁴ See The President's Budget for Fiscal Year 2014, available at <http://www.whitehouse.gov/omb/budget/>.

⁵ See Alan J. Auerbach, “On the Design and Reform of Capital-Gains Taxation,” 82 *Am. Econ. Rev.* 263 (1992); David Elkins, “The Myth of Realization: Mark-to-Market Taxation of Publicly-Traded Securities,” 10 *Fla. Tax Rev.* 375 (2010); Edward D. Kleinbard, “Designing an Income Tax on Capital,” in *Taxing Capital Income* 165 (eds., Henry J. Aaron et al., 2007); Henry Ordover, “Revisiting Realization: Accretion Taxation, the Constitution, *Macomber*, and Mark to Market,” 13 *Va. Tax Rev.* 1 (1993); Clarissa Potter, “Mark-to-Market Taxation as the Way to Save the Income Tax—A Former Administrator's View,” 33 *Val. U. L. Rev.* 879 (1999); David J. Shakow, “Taxation Without Realization: A Proposal for Accrual Taxation,” 134 *U. Pa. L. Rev.* 1111 (1986).

has been proposed is to apply the mark-to-market concept only to those publicly traded securities that have easily ascertained year-end values. Previous analyses have discussed the problem with creating asset classes of winners and losers, and concluded that doing so would cause massive economic distortions.⁶ To minimize taxes, people would move out of publicly traded securities, hurting the markets. A behavioral change leading investors to favor insurance-wrapped products, over-the-counter derivatives, and private securities would be inevitable.

Why Mark-to-Market Idea Still Tempts Lawmakers

The reason that Congress contemplates the marking to market of assets every so often is the perception that investors have too good a deal under the realization-based system. The ability to cherry-pick what gains or losses to realize and pay tax on is indeed an important tool in tax-efficient investing. It should be noted, however, that under our system the IRS is your partner when you make money; but when you lose, you're on your own—unless you have been lucky enough to have taken some gains that year. The limitation on the deductibility of capital losses is the trade-off for being able to time the realization of gains.⁷ The wash sale rule hinders a true ability to manipulate gains and losses,⁸ and the straddle rules further inhibit any possible problems with cherry-picking gains and losses.⁹

The Camp Proposals

Under both the Camp proposal and the President's proposal, 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, as noted above, these instruments would be marked-to-market at year end, so that all unrealized gains and losses would be recognized for tax purposes.

It should be noted that if these derivatives rules were passed, futures and broad-based index options no longer would be taxed as 60 percent long-term and 40 percent short-term, although they still would be marked-to-market at year-end.¹⁰ In the Camp proposal this would apply whether or not the derivative or the referenced asset was publicly traded. The President's proposal seems to be limited to derivatives referencing only publicly traded property. The proposals would apply not only to actual derivatives, but also to most investments with embedded options. An example in the Camp proposal would direct taxpayers to value the call option embedded in a convertible bond each

⁶ See *id.*

⁷ See IRC § 1211.

⁸ See IRC § 1091.

⁹ See IRC § 1092.

¹⁰ See IRC § 1256.

year and then pay tax on any appreciation in this theoretical option. How one might go about coming up with that value is the challenge.

Exactly What Instruments Are Covered by the Camp Proposal?

In the Camp proposal, derivatives are defined to include options, futures 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.¹¹

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 affirmatively, “Economically, a securities-lending transaction has always been a derivative.” A partner at Ernst & Young pointed out that most investors do not hold actual shares but, rather, have a brokerage statement that is “evidence of an interest in” shares that reside at a depository; thus, maybe all common stocks would need to be marked-to-market under these rules. He doesn’t think that was what was intended, nor does he think a law to that effect would be passed.

Under the Camp proposal, taxpayers would also be instructed to act as if the shares were sold when an investor entered a derivative on shares he or she holds. For example, let’s say you buy a stock at \$10 and watch it rise to \$25. You are temporarily worried about the share price so you buy a put to protect yourself. But now by doing that, you create a taxable event on the shares, just as if you had sold them at \$25. This does not seem equitable and would kill strategies such as covered-call writing or protective put buying.

What’s Next?

The President’s inclusion of these concepts in this year’s budget forces us all to take these proposals seriously. Although most practitioners don’t expect the notion of mark-to-market to be broadly applied anytime soon, there are certain instruments, like ETNs, that may get caught in the fight. The President has a habit of re-proposing suggested revenue raising possibilities in each of his budgets, and we would expect to see these mark-to-market proposals become perennials popping up each year if they are not acted upon.

¹¹ See Lee A. Sheppard, “What’s in the Camp Derivatives Draft?” available at 2013 TNT 23-1 (Feb. 4, 2013).



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