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MARK-TO-MARKET TAXATION AS THE WAY TO SAVE THE INCOME TAX—A FORMER ADMINISTRATOR'S VIEW

Clarissa Potter*

The tax world is preoccupied with the abuse of financial products. Every day Wall Street (and increasingly, main street) comes up with a new way to exploit the flaws in the tax law to drain money from the U.S. Treasury.¹ The evolution of tax "engineered" financial products is a source of much anxiety for policymakers and academics.

The biggest problem in responding to tax-engineered financial products is that our current tax system does not measure income or loss from capital accurately. We rely on realization to determine the measurement and timing of income. Realization is the idea that an asset's appreciation should not be taxed until the asset is sold or disposed of, regardless of when the appreciation occurs. The realization requirement is faulted for lacking economic substance and generating arbitrary results. It is said to be a major source of unfairness, inefficiency, and complexity in our tax system.

Some believe that taxing unrealized income is an intractable problem for the current tax system, an "Achilles heel,"² so to speak. This is one of the arguments in favor of replacing the income tax with a different system. Since a consumption tax does not impose tax on income from capital, it necessitates no realization concept.³ So one solution to tax-engineered financial products is radical reform: replace the income tax with a flat tax or retail sales tax.⁴

But others believe that more moderate reform is in order. In the 1997 Laurence Woodworth Memorial Lecture, Professor Halperin

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¹ See Anita Raghavan & Jacob Schlesinger, *Cat and Mouse: Wall Street Concocts New Tax-Saving Ploy; Then It's Feds' Turn*, WALL ST. J., Nov. 6, 1997, at A1, for one description of how tax-engineered financial products develop and how government responds.

² See William D. Andrews, *The Achilles' Heel of the Comprehensive Income Tax*, in NEW DIRECTIONS IN FEDERAL TAX POLICY FOR THE 1980S 278, 280 (Charles E. Walker & Mark A. Bloomfield eds., 1983).

³ See *id.* at 283.

⁴ See Joseph Bankman, *The New Market in Corporate Tax Shelters*, TAX NOTES, June 21, 1999, at 1775, 1785 (describing this as a "nihilist" view).

highlighted the challenge presented by tax-engineered financial products. "The growth of modern financial products has dramatically increased...the difficulty of maintaining the semblance of income taxation. As the sophistication and spread of the use of financial products increases, as it most certainly will, the situation can only get worse."⁵ His prescription was not to abandon the taxation of income from capital, however, but to make it simpler, fairer, and more efficient.

In particular, Professor Halperin advocates a partial mark-to-market regime for measuring income that should be subject to tax. A mark-to-market method requires the taxpayer to ascertain the values of his assets (and liabilities) at the beginning and end of the relevant period, and treat the difference as income or loss. This method allows for the measurement of income and loss over time more in line with the way they accrue economically. But a pure mark-to-market regime for measuring all economic gain or loss, regardless of its source, would present overwhelming administrative problems. By contrast, the more pragmatic approach advocated by Professor Halperin would retain a limited realization requirement when the administrative benefits of realization are large, and use a mark-to-market method for measuring gains and losses when valuation and liquidity problems of such an approach are manageable.⁶

First and foremost, implementation of a partial mark-to-market system would require definition of the base—the assets and liabilities for which taxpayers would use mark-to-market to calculate income. Publicly traded stocks and securities, and derivatives⁷ based on publicly traded stocks and securities, are prime candidates.⁸ Defining the base to

⁵ Daniel Halperin, *Saving the Income Tax: An Agenda for Research*, TAX NOTES, Nov. 24, 1997, at 967, 971.

⁶ See David A. Weisbach, *A Partial Mark-to-Market Tax System*, 53 TAX L. REV. 95, 103-5 (1999).

⁷ A derivative is a contractual arrangement that provides payments based on or derived from changes in the value of other property, payments on the other property, or market-based rates. For example, the payments under an interest rate swap derive from rates of interest or yields on U.S. Treasury securities or other debt instruments. Under the tax law, derivatives of stock and securities are often referred to as "positions" in property. See, e.g., I.R.C. §1092(d)(2) (defining position in personal property under the straddle rules, which disallow a deduction for realized losses to the extent of unrealized gains in offsetting positions in personal property); I.R.C. §1259(b)(3) (defining position for purposes of the constructive sale rules, which require a taxpayer to realize a gain if the taxpayer engages in the economic equivalent of a sale of an appreciated asset by entering into certain offsetting financial transactions).

⁸ See Halperin, *supra* note 5, at 971.

include at least these instruments, it is argued, would improve the measurement of taxpayers' income from financial products and would help resolve the government's battle to limit the use of tax-engineered products. Since this conflict generates a stream of increasingly complex rules, taxing income from financial positions under a mark-to-market regime could also result in significant rule simplification.⁹

But, Professor Halperin acknowledges, there would be many practical problems to work out before this kind of reform could become a reality.¹⁰ So he challenged his audience to work together to develop a proposal that could be adopted.¹¹

As a former tax administrator, I am somewhat skeptical about whether a partial mark-to-market approach could be enacted in the near future. There are a number of reasons for my pessimism. First, the base to which mark-to-market should apply may be more difficult to define than many realize. Second, valuing the financial positions included in even a narrowly-drawn base may prove an overwhelming problem for taxpayers and the Internal Revenue Service. Finally, regardless of how much such a system would improve fairness and efficiency and reduce complexity, it may not be able to garner political support if it is applied to individuals.

This piece is not intended to be an exhaustive treatment of the subject. Rather, it provides the impressions of someone who has been immersed in the current tax policymaking environment. To that end, this piece will review the problems with the realization rules and how adopting a partial mark-to-market system might address them. I will then discuss the problems with defining the base and valuing the positions included in that base under even the most simple conception of a partial mark-to-market system. Finally, I will offer my observations about why I think a partial mark-to-market system would be politically unsalable despite the best arguments of tax experts. But, lest anyone think I am too pessimistic, I believe that the current political concern with the use of tax-engineered financial instruments in corporate tax shelters creates an opportunity to enact a more limited, but still useful version of mark-to-market.

⁹ See *id.*

¹⁰ Professor Halperin also proposed as intrinsic elements of his plan that certain assets be indexed for inflation and that the corporate tax be eliminated for publicly traded corporations. See *id.* at 968.

¹¹ See *id.*

I. REALIZATION VERSUS MARK-TO-MARKET ACCOUNTING

The classic definition of income is the sum of an individual's consumption plus his change in wealth during the relevant measurement period.¹² Under an ideal income tax, a taxpayer would be required to measure the change in his wealth over the taxable year and include in income, or claim as a deduction, the amount of the change plus any cash the taxpayer received.

A taxpayer's gains and losses under the federal income tax, however, have little to do with changes in the taxpayer's wealth for the taxable year. Rather, the timing of income and deduction under our system is largely governed by the realization principle, which defers the taxation of gain or loss until it is "realized" by the taxpayer. Realization depends on the occurrence of an event or transaction appropriate for levying tax.¹³ The paradigm realization event is a sale.

Realization cannot be generalized into a coherent principal of income. It is thought by many to be, at best, a rule of administrative convenience.¹⁴ There are two administrative problems that realization is thought to address. First, assets (and liabilities) can be difficult to value. Therefore, taxing income from capital as it accrues economically (based on measuring the change in values of assets and liabilities) would impose significant administrative costs. Second, taxpayers who are taxed on changes in value might not have sufficient cash with which to pay the tax. Realization should remedy these problems by "providing the taxpayer with both a clear measure of gain or loss and the means of paying tax."¹⁵

But concerns about valuation and liquidity do not fully explain the contours of the realization requirement. Realization generally applies

¹² This is often referred to as the Haig-Simons definition of income. See HENRY C. SIMONS, *PERSONAL INCOME TAXATION* 50 (1938); Robert M. Haig, *The Concepts of Income—Economic and Legal Aspects*, in *THE FEDERAL INCOME TAX 1* (Robert M. Haig ed., 1921), reprinted in *READINGS IN THE ECONOMICS OF TAXATION* (Richard A. Musgrave & Carl S. Shoup eds., 1959).

¹³ See Daniel N. Shaviro, *An Efficiency Analysis of Realization and Recognition Rules Under the Federal Income Tax*, 48 *TAX L. REV.* 1, 11 (1992).

¹⁴ See *id.* at 11. See David M. Schizer, *Realization as Subsidy*, 73 *N.Y.U. L. REV.* 1549, 1551 (1998) for a brief survey of academics' views on the purpose and function of the realization requirement. Professor Schizer, contrary to the vast majority of scholars, argues that realization may not be just a rule of convenience, but may also be an effective subsidy for savings. *Id.* at 1552.

¹⁵ Shaviro, *supra* note 13, at 13.

even if an asset is easy to value without a sale and even if the asset is highly liquid. Conversely, transactions are often treated as sales or dispositions (and thereby as triggering realization) even if the transactions provide no information on the money value of the assets involved and no liquidity in the form of cash or liquid assets.¹⁶ One must conclude that other forces have come into play in shaping the way the realization principle is used to measure income.

Because realization is unrelated to economic gain or loss, using it to invoke the measurement of gain or loss for tax purposes is inherently arbitrary. It necessitates drawing arbitrary lines between economically similar transactions, treating one taxpayer as having sold assets while treating a similarly situated taxpayer as continuing to hold. Realization generally depends on actions taken by the taxpayer, so it is largely within the taxpayer's control. In addition, the formalism with which courts and tax administrators have approached the realization requirement makes the cost of triggering realization relatively low, at least for certain types of assets. These factors often combine to allow a taxpayer to trigger realization without changing the economic characteristics of her assets and liabilities. So, theoretically at least, taxpayers can realize losses virtually at will. Conversely, these factors allow a taxpayer to make substantial changes in the economic characteristics of her assets and liabilities without engaging in a sale or disposition. Thus, theoretically, taxpayers can also avoid realizing gains entirely.¹⁷

The arbitrariness of the distinction between events that trigger realization and those that do not, combined with the control taxpayers have over whether they are treated as holding or selling, systematically reduces the tax rate on income from wealth. Professor Shuldiner has described three mechanisms by which this occurs.¹⁸ Imagine that a taxpayer anticipates earning income from an asset due simply to the passage of time. First, the realization requirement allows the taxpayer to defer tax on that anticipated gain.¹⁹ Second, if the value of the asset

¹⁶ *See id.*

¹⁷ An individual who dies holding appreciated property does not pay tax on the gain, and his heirs generally receive a step-up in basis to fair market value under I.R.C. §1014(a)(1). This allows some gains to escape income tax entirely.

¹⁸ *See* Reed Shuldiner, *A General Approach to the Taxation of Financial Instruments*, 71 TEX. L. REV. 243 (1992).

¹⁹ *See id.* at 250-53. Professor Shuldiner refers to this as anticipated deferral. *See id.* As an example, he describes an arrangement under which "Diva" pays "David" \$100 today, and David promises to pay Diva \$121 in two years. *See id.* He shows that even if the facts are

declines because, for example, interest rates rise, the taxpayer can obtain a tax benefit by realizing the loss immediately. But if the value of the asset increases because, for example, interest rates decline, she can avoid realizing the gain and thereby defer tax. This is called the "timing option."²⁰ Third, the taxpayer can turn the potential benefit from the timing option into a certainty by placing herself on both sides of a transaction. One side of this "straddle" will always produce losses that can be realized for tax purposes, while the other side will produce gains that can be deferred.²¹ To do this in the prior example, the taxpayer would acquire the appreciating asset and would sell, or "short," the asset as well.²²

These effects of realization have unfortunate policy implications. Unfairness is a major byproduct: taxpayers who have similar amounts of income may be taxed at different effective rates depending on whether their income can be deferred and whether they can take advantage of the timing option or the straddle technique.²³ For example, if two individuals earn identical amounts of economic income in a year and are subject to the same nominal rate of tax, but one earns income in the form of wages while the other earns income in the form of capital appreciation, the second individual can enjoy a lower effective tax rate

altered so that the amount David pays is either \$100 or \$142, depending on a coin toss, Diva still has income from the passage of time. *Id.*

²⁰ *Id.* at 255-57. See Jeff Strnad, *Periodicity and Accretion Taxation: Norms and Implementation*, 99 YALE L. J. 1817, 1879 (1990) (describing the timing option as the "ability to take losses early and defer any later matching gains") citing George M. Constantinides, *Capital Market and Equilibrium with Personal Tax*, 51 ECONOMETRICA 611 (1983).

Professor Schizer explains the timing option without reference to matching gains. He analogizes the income tax to an arrangement between the taxpayer and the federal government. If an asset increases in value, the government receives a portion of the increase in taxes. If the asset decreases in value, the government reduces the taxpayer's pre-tax loss through tax deductions. The timing option allows taxpayers to share gains and losses on favorable terms by forcing the government to share losses on a contemporaneous basis, but deferring the obligation to share gains indefinitely. See Schizer, *supra* note 14, at 1557.

²¹ See Shuldiner, *supra* note 18, at 257. Although a number of provisions, such as the capital loss limitation rules of I.R.C. §1211 and the restrictions placed deductions for expenses and losses associated with straddles by I.R.C. §263(g) and §1092, are intended to control the use of the timing option and straddle techniques, these rules are of limited effectiveness.

²² When an investor holds a "long" position in an asset, she benefits if the asset increases in value and suffers losses if the asset declines in value. Ownership of the hypothetical asset in the discussion is a "long" position. When an investor holds a "short" position in an asset, she benefits if the asset declines in value and suffers a loss if the asset increases in value. Perfectly matched long and short positions in an asset offset each other economically and result in no net economic income or loss to the investor over time.

²³ See Shuldiner, *supra* note 18, at 261.

by utilizing deferral and the timing option. In addition, realization may undermine the progressivity of the tax system. The reduction in effective tax rates achieved by realization redounds to the benefit of upper-income taxpayers because ownership of capital assets is concentrated in the upper reaches of the income distribution²⁴ (and perhaps for other reasons as well).

Second, because realization reduces the effective tax rate on income from some assets and not others, it may result in inefficient allocation of resources among investments from an *ex ante* perspective.²⁵ In addition, realization can deter taxpayers from changing their investments to maximize yields because doing so can terminate the valuable deferral and trigger the tax.²⁶

Third, even though the realization requirement can be defended on the grounds of promoting administrative convenience by avoiding valuation and liquidity issues, the principle as manifested through the tax law creates its own set of thorny administrative problems.

²⁴ See *id.* at 262. Professor Shuldiner points out that if the tax benefit of deferral is fully capitalized into the price of assets that provide deferral opportunities, then no issue of fairness remains. He also points out that the expected value of unanticipated deferral (utilized through the timing option) is zero, and so the expected tax rate on gains or loss is the statutory rate. "On an *ex post* basis, however, the holder of an instrument with unanticipated deferral is taxed at an effective rate less than the statutory rate." *Id.* at 263. That a difference in rates *ex post* might be considered unfair, even if there is no difference in rates *ex ante*, is hardly a point worth debating.

²⁵ First, realization directs capital away from investments that produce streams of income that are currently taxable and toward investments that produce income in the form of appreciation. All things being equal, the after-tax yield on the latter will be higher as a result of realization. Moreover, because the timing option becomes more valuable as the variance of the return on a transaction increases, realization may encourage investment in risky assets. Finally, the significant transaction costs investors incur in utilizing the straddle technique may also be a source of inefficiency. But, because straddles are balanced positions with no net investment or risk, they should not result in a misallocation of resources. See *id.* at 258-61. See also Edward A. Zelinsky, *For Realization: Income Taxation, Sectoral Accretionism, and the Virtue of Attainable Virtues*, 19 CARDOZO L. REV. 861, 914 (1997).

²⁶ This is called the "lock-in" effect. As a simplified example, consider an individual subject to a 40% marginal income tax rate who has \$200 of appreciation in asset A on which the taxpayer expects to earn 10% per year, compounded annually. Imagine the taxpayer also has the opportunity to realize that appreciation and reinvest it in asset B that will appreciate at a 13% annual return. Assume that at the end of five years each investment will terminate and the taxpayer will have a realization event. The taxpayer will not reinvest the \$200 in the higher-yielding asset (at least not in a way that will result in realization for tax purposes), because the after-tax amount he will receive if he keeps his money where it is (\$193.26) is higher than the after-tax amount he would receive if he reinvested his gains (\$180.60). See Schizer, *supra* note 14, at 1610-11.

Taxpayers, recognizing that the distinction between transactions that trigger realization and those that do not is essentially arbitrary, rationally seek to structure transactions to fall on the desired side of the line. Thus, taxpayers who wish to dispose of appreciated assets seek to do so without triggering realization, and strategies exist to achieve that goal. Conversely, taxpayers who wish to realize losses without disposing of depreciated assets also have techniques to which they can resort. The government responds by proposing more and more specific and complex rules to control realization events, preventing realization in some cases and triggering it in others. In addition, the rules attempt to reduce the benefits of realization by adopting rules aimed at limiting taxpayers' ability to use liquid, easy-to-value financial positions to accelerate losses and defer gains.²⁷ This is a vicious cycle of taxpayers exploiting the weaknesses of realization and lawmakers responding with ad hoc efforts aimed at abuse. It has led to a briar patch of rules that are formalistic, difficult to understand, difficult for taxpayers to comply with, and virtually impossible for the IRS to enforce.

As one might expect, this problem has not lacked for scholarly attention.²⁸ Many have detailed the flaws in our realization-based system and suggested ways to reduce or eliminate our reliance on realization and jettison many of the complex rules that have grown up around it. Although some have attempted to develop pure accretion systems that would tax all economic appreciation or depreciation as it occurs,²⁹ the trend seems to be toward a more pragmatic approach: developing a better "mixed" system that includes some continued role for realization.³⁰

²⁷ See Halperin, *supra* note 5, at 969-70. See Alvin C. Warren, Jr., *Commentary: Financial Contract Innovation and Income Tax Policy*, 107 HARV. L. REV. 460 (1993), for a discussion of various uses of financial products. See William M. Paul, *Constructive Sale Under New Section 1259*, TAX NOTES, Sept. 15, 1997, at 1467, for a discussion of the Congressional response to a specific income-deferring strategy.

²⁸ For overviews of scholarly work in this area, see Zelinsky, *supra* note 25, at 866-79; Schizer, *supra* note 14, at 1593-1600.

²⁹ See, e.g., David Shakow, *Taxation without Realization: A Proposal for Accrual Taxation*, 134 U. PA. L. REV. 1111 (1986); Fred B. Brown, "Complete" Accrual Taxation, 33 SAN DIEGO L. REV. 1559 (1996).

³⁰ See, e.g., Weisbach, *supra* note 6, at 96 (reviewing proposals for mixed systems); Warren, *supra* note 27, at 473-82 (surveying different suggested approaches); Shuldiner, *supra* note 18, at 283-90; Deborah H. Schenk, *Taxation of Equity Derivatives, a Partial Integration Proposal*, 50 TAX L. REV. 571 (1995); Jeff Strnad, *The Taxation of Bonds: the Tax Trading Dimension*, 81 VA. L. REV. 47, 115 (1995).

The mixed system that has been proposed by Professor Halperin would require all taxpayers to use mark-to-market accounting for a broad class of assets (and liabilities).³¹ Taxpayers would account for any increase or decrease in market value of these positions each year and pay tax (or receive a credit or refund) on the net change. The problem with this regime, however, is specifying whether any particular position should be included. By necessity, adopting a partial mark-to-market system would require line-drawing. Positions subject to mark-to-market would have to be distinguished from those that remain under realization.³²

Going back to the justification for the realization rule, one would want to avoid applying a mark-to-market approach to positions that are hard to value or are illiquid (which probably turn out to be overlapping groups). Similarly, one would get the most benefit from the mixed system if the mark-to-market method applied to those positions most easily used to manipulate realized gains or losses. Professor Weisbach suggests an abstract test for whether a position should be included in the mark-to-market regime: compare the costs of applying mark-to-market to the position (for instance, problems with valuation and liquidity) to the benefits of withdrawing the position from the scope of the realization

³¹ Other mixed systems are conceivable. Current tax law provides a limited version of mixed systems. It requires some taxpayers to use mark-to-market accounting for certain of their assets and liabilities. See I.R.C. §475 (requiring dealers in securities to mark-to-market their positions in securities and hedges in those securities). It also requires or allows all taxpayers to mark-to-market narrowly defined categories of financial instruments. See I.R.C. §1256 (requiring mark-to-market accounting for regulated futures contracts, foreign currency contracts, non-equity options and dealer equity options); I.R.C. §1296 (allowing certain owners of "marketable" stock in a passive foreign investment company to use mark-to-market accounting).

³² Professor Zelinsky argues that drawing a line between assets that are subject to a mark-to-market regime and those that are not would create the same kind of allocative inefficiency that realization does. This is because mark-to-market would raise the effective tax rate of income from assets included in the base relative to assets still taxed under realization. See Zelinsky, *supra* note 25, at 915-18. Professor Weisbach suggests that to reduce the inefficiencies of taxing some assets and liabilities under one regime and the rest under another, the nominal tax rate for items included in the mark-to-market base should approximate the effective tax rate on items still subject to realization. In other words, the rate of tax that would apply to mark-to-market income and loss would be lower than the rate that would apply to realized gains and losses. See Weisbach, *supra* note 6, at 100-1. It is unclear how this could be accomplished.

For purposes of my discussion, I assume there are significant limits to our ability to achieve rate equality. Thus, there would continue to be a compelling need to draw discernable and enforceable lines between the realization regime and the mark-to-market regime.

principle (such as a more accurate measurement of a taxpayer's income and reduced rule complexity).³³ But translating this standard into rules that the IRS and taxpayers can apply is a difficult problem.

One way to solve this problem is to classify assets and liabilities according to characteristics that tend to make them easy to value and liquid. There seems to be a consensus that public trading is a characteristic of a stock or security that would militate in favor of including an asset in a partial mark-to-market regime. These assets are, it is said, easy to value and highly liquid. In addition, the fairness, efficiency and complexity costs of taxing them under realization are high.³⁴ Professor Weisbach goes as far as to suggest application of the realization requirement to these positions is merely a historical accident.³⁵

Limiting the base of the mark-to-market regime to publicly traded stock and securities, however, would probably not provide significant relief from the problems engendered by realization, as Professor Weisbach points out. To avoid mark-to-market (and retain the benefits of realization), taxpayers could simply shift from direct positions in stock and securities to derivative positions; fairness, efficiency, and complexity problems would persist.³⁶ For example, instead of investing in stock directly, an individual might enter into an equity swap under which she would be entitled to payments equal to all the stock's appreciation and would be required to make payments to the extent of the stock's decline in value. If the equity swap was structured properly, the investor could retain a significant portion of the gain deferral, timing option, and straddle benefits that she had for a direct investment. Thus, even if there is no public market for a certain derivative, such as an over-the-counter option, forward, swap, or notional principal contract, or a contingent payment debt instrument, the derivative should be included in the mark-to-market base if it is a reasonable substitute for publicly traded property. To minimize inefficiencies in adopting a partial mark-to-market regime, Professor Weisbach concludes, derivative instruments should be taxed as their closest substitutes are.³⁷

³³ See Weisbach, *supra* note 6, at 103.

³⁴ See *id.*

³⁵ See *id.* at 96.

³⁶ Cf. *id.* at 103-6.

³⁷ See *id.* at 105.

Moreover, a partial mark-to-market system probably should not be limited to publicly traded stock, securities, and their derivatives.³⁸ Professor Weisbach believes that implementation of a partial mark-to-market system would require comparing the benefits of mark-to-market accounting to its costs for numerous different transactions.³⁹ This analysis is likely to be difficult, time consuming, and fraught with uncertainty.

But even limited to positions in publicly traded property (including derivatives), it is thought that a mark-to-market regime could reduce inefficiency attributable to deferral, the timing option, and the straddle technique.⁴⁰ Moreover, it would allow significant pruning of a number of complex provisions from the tax law.⁴¹

So perhaps we should examine the “easy” case of marking publicly traded stocks, securities, and their derivatives before we take on the harder chore of deciding whether other assets should be included in the base.

II. THE SCOPE OF THE MARK-TO-MARKET BASE

When I put on my tax administrator’s hat, it seems to me the first question is what do we mean by the term “publicly traded stocks and securities”? To define publicly traded stocks and securities as financial instruments that are easy to value and highly liquid is tautological. If the income tax adopted a partial mark-to-market regime, we would need a clearer picture of the test for public trading and the mechanism for determining whether a particular stock or security met that test. In other

³⁸ In his article, Professor Weisbach also says that most debt, whether asset or liability, traded or not, generally should be included in the mark-to-market base. See *id.* at 108-14. This recommendation is partially based on the inaccuracy of current rules requiring accrual of original issue discount. See Joseph Bankman & William A. Klein, *Accurate Taxation of Long-Term Debt: Taking Into Account the Term Structure of Interest*, 44 TAX L. REV. 335 (1989); Theodore S. Sims, *Long-Term Debt, the Term Structure of Interest and the Case for Accrual Taxation*, 47 TAX L. REV. 313 (1992). It is also based on the tax savings that can be obtained by holders of debt instruments who engage in strategic trading to accelerate losses and defer gains. See generally Strnad, *supra* note 30 [The Taxation of Bonds: the Tax Trading Dimension]; Mark Gergen, *The Effects of Price Volatility and Strategic Trading under Realization, Expected Return, and Retrospective Taxation*, 49 TAX. L. REV. 209 (1994). But Professor Weisbach’s recommendation raises the specter of trying to distinguish between debt and other liabilities, such as leases, and trying to disaggregate debt from non-financial transactions, such as deferred payments or prepayments for goods or services.

³⁹ See Weisbach, *supra* note 6, at 105.

⁴⁰ See *id.* at 131-3; Halperin, *supra* note 5, at 972.

⁴¹ See Weisbach, *supra* note 6, at 122-31.

words, is it possible to translate the concept of "public trading" into a satisfactory statutory or regulatory definition?

We probably mean two things when we say a financial instrument is "publicly traded." First, we mean that the instrument is sold by willing sellers to willing, unrelated buyers with enough regularity to provide a reliable approximation of the price at which any holder could contemporaneously sell the instrument. Second, we mean that there is a mechanism for broadly disseminating information about that price.

Articulated this way, however, public trading continues to be a mere abstraction. To define the term in the abstract is a long way from providing a concrete set of rules that would allow taxpayers and the government to discern the real-world scope of a mark-to-market regime. There are no objective measures for whether a financial instrument meets my two tests. Rather, determining that an instrument should be treated as publicly traded would be prudential.

How should that definitional exercise be carried out? What is the proper emphasis between the two elements of public trading, and how specific or general should a definition of public trading be? Should the definition of public trading provide bright-line rules, or require the taxpayer or the government to exercise judgment?

Some examples of this exercise can be found in current tax law. The public trading concept is used in many provisions under the tax code, and it is described in a number of different ways. It is not my purpose to discuss them all, or even a significant portion of them, but a small sample will illuminate what is at stake. Current law shows that there is not a single, universally accepted definition of public trading for tax purposes. Examining the way some provisions of current law make the abstract idea of public trading more concrete shows some of the choices that would have to be made in adopting a partial mark-to-market method for publicly traded stocks and securities.

The straddle rules under IRC §1092 defer deductions for losses when a taxpayer holds offsetting positions in "actively traded" personal property. Regulations treat property as actively traded under this provision if there is an established financial market for the property.⁴² The regulations provide a list of established financial markets, which includes national securities exchanges like the New York Stock Exchange

⁴² See Treas. Reg. §1.1092(d)-1(a) (1993).

and the American Stock Exchange, the National Association of Securities Dealers' interdealer quotation system, commodities exchanges like the Chicago Board of Trade and over-the-counter, "interdealer" markets.⁴³ The regulations are relatively formalistic, relying on objective indicators of price availability without requiring a separate determination of whether there is enough trading in the security to produce accurate prices.⁴⁴

The rules that prevent taxpayers from deferring tax on earnings from "passive foreign investment companies" allow taxpayers who hold interests in these companies to elect to mark their interest to market if the interests are "marketable."⁴⁵ These rules have a much narrower conception of what it means for a stock to be publicly traded than do the straddle rules. A stock is "marketable" only if it is "regularly" traded on a national exchange or market system in the United States, or on a market that is determined by the Treasury Department to provide prices that represent fair market value.⁴⁶ Here, it appears, the overriding concern is whether the price provided by the market is reliable so that taxpayers cannot understate the value of their stock to take advantage of the deferral that the passive foreign investment company rules were enacted to prevent in the first place.

Public trading is also relevant to the tax treatment of partnerships. A publicly traded partnership is generally taxed as a corporation rather than as a flow-through entity.⁴⁷ The regulations define public trading broadly. The definition covers partnership interests traded on national securities exchanges, including exchanges that have a low number of transactions, many foreign securities exchanges, and interdealer

⁴³ Treas. Reg. §1.1092(d)-1(b)(1) (1993).

⁴⁴ This may somewhat over-simplify the regulations. Established financial markets also include "interdealer markets" and "debt markets," both of which are defined to insure an element of price reliability. Treas. Regs. §§1.1092(d)-1(b)(1)(vi) and (vii) (1993). An "interdealer market" is a system that provides a "reasonable basis" for determining fair market value, such as "recent" price quotations or prices of "recent" transactions. Treas. Reg. §1.1092(d)-1(b)(2)(i) (1993). A debt market exists, subject to certain limitations, if "price quotations...are readily available from brokers, dealers or traders." Treas. Reg. §1.1092(d)-1(b)(2)(ii) (1993).

⁴⁵ I.R.C. §1296. Taxpayers may use this election to avoid rules that treat a portion of sale proceeds and certain distributions as earnings attributable to prior taxable years. These amounts would otherwise be taxed at the highest marginal rates applicable in the prior years, and would be subject to an interest charge for deferral. See I.R.C. §1291.

⁴⁶ See I.R.C. §1296(e)(1)(A). See also JOINT COMMITTEE ON TAXATION, GENERAL EXPLANATION OF TAX LEGISLATION ENACTED IN 1997 311 (Comm. Print 1997).

⁴⁷ See I.R.C. §7704(a).

892 VALPARAISO UNIVERSITY LAW REVIEW [Vol. 33

quotation systems that provide firm buy or sell quotations.⁴⁸ It also includes interests "readily tradable" on secondary markets or their equivalent.⁴⁹ But the regulations place a significant limit on the scope of the public trading definition: a partnership's interests are publicly traded only if the partnership itself facilitates the trading.⁵⁰

Each approach to defining a public trading concept gives different weight to the characteristics embodied in the term. The provision defining marketable stock of passive foreign investment companies is oriented toward insuring that an instrument is not marked-to-market unless the taxpayer (and the IRS) can determine market prices with a high level of confidence. In other words, if accuracy of value is important, a public trading definition like that provided by the straddle regulations may be too broad. In contrast, the regulations that define public trading in the partnership context are oriented toward treating any price disseminating process, such as computer bulletin boards or listings on the Internet, as indicative of public trading. By that token, the public trading definition used under the straddle rules may be too narrow.

The regulations illustrate another important consideration—whether the definition of public trading must provide bright lines, or whether it can simply enumerate general characteristics and allow taxpayers and the IRS to use discretion on a case-by-case basis. The "active trading" definition under the straddle rules calls for the exercise of some discretion by the IRS and taxpayers. The rules for passive foreign investment companies take a much narrower and more formalistic approach by limiting the scope of public trading under the statute to, essentially, trading that occurs on a national securities exchange or market system. The regulations under section 7704 take a different tack.

⁴⁸ See Treas. Reg. §1.7704-1(b) (1995).

⁴⁹ See Treas. Reg. §1.7704-1(c) (1995). A secondary market exists if holders of the partnership's interests have a "readily available, regular and ongoing opportunity to sell or exchange" interests through a means that publicly disseminates information about offers. Treas. Reg. §1.7704-1(c)(2)(iii) (1995).

⁵⁰ See Treas. Reg. §1.7704-1(d) (1995). The partnership is not publicly traded, even if its interests are traded on a secondary market or its equivalent, unless "[t]he partnership participates in the establishment of the market or the inclusion of its interests" in the market, or the partnership "recognizes any transfers made on the market" by redeeming the interests of the transferor partners or admitting the transferee to the partnership or recognizing the transferee as a partner. *Id.* Moreover, a partnership is not treated as readily tradable on a secondary market or its equivalent if there is only a small amount of trading in its interests. See Treas. Reg. §1.7704-1(j) (1995).

While they eschew a formalistic definition of public trading, they require a partnership to take action before it can be considered publicly traded. This places a significant limit on the application of the provision to the interests of any particular partnership and gives power over classification, at least in part, to those who manage or control the partnership (rather than to all interest holders). These rules suggest, at least in this context, that a broad, imprecise definition of public trading may produce an unacceptable level of uncertainty.

As the prior discussion illustrates, there is no clear consensus under current tax law of how public trading should be defined when it comes to stocks and securities. So, while saying that a mark-to-market regime should apply to publicly traded financial instruments may help conceptually to circumscribe the mark-to-market base, it does not solve the problem of how to write rules that would achieve this result. Moreover, devising a rule for derivatives would prove even more difficult. As the earlier portion of this paper discussed, a mark-to-market system that applied to publicly traded stocks and securities should also apply to their close substitutes. This statement is, at least in part, based on the proposition that if a derivative is a close substitute for a publicly traded financial instrument it should be sufficiently liquid and easy to value to merit inclusion in the mark-to-market regime.⁵¹ But on its face, articulating rules to test whether a non-publicly traded financial instrument is a close substitute for a publicly traded instrument seems more difficult than defining what constitutes public trading.

The test for whether a derivative meets an abstract “close substitute” or ease of valuation and liquidity metric could not rest on a mere observation that the derivative is somehow based on the value of, or the payments on, a publicly traded financial instrument. Consider the dividend swap: a party agrees to pay all the dividends on a specified number of shares of a publicly traded stock for a specified period. In exchange, he will receive periodic payments equal to a particular interest rate index times a notional principal amount (set equal to the initial value of the shares of stock).⁵² On one hand, the swap likely does not by itself represent a close substitute for any publicly traded financial instrument—it represents only a small temporal piece of ownership of the underlying stock. It may be difficult for the taxpayer to derive a value

⁵¹ See Weisbach, *supra* note 6, at 105.

⁵² See *Report of the Tax Section of the New York State Bar Association on Notional Principal Contract Character and Timing Issues*, reprinted in TAX NOTES, June 8, 1998, at 1303, 1309 (describing and dividend swap and other esoteric notional principal contracts).

for the swap from the value of that stock. On the other hand, a dividend swap combined with another contract, such as the right or obligation to purchase the underlying stock for a fixed price in the future, could represent a very close substitute for ownership of the stock itself. This suggests that one might want to provide rules that require taxpayers to mark-to-market derivative positions that combined constitute close substitutes for publicly traded stocks and securities; but this would invite significant additional complexity.

At any rate, it is difficult to imagine a relatively simple test that could rely on objective characteristics (comparable to exchange-listing for stocks) as markers for liquidity and easy valuation in the case of many derivative financial instruments. If these contracts were to be included in the mark-to-market base one can imagine that they would be included either by general standards of uncertain application or by clearer, more easily applied rules that would lead to arbitrary results and potential abuse.

But what does it matter whether a particular financial instrument is included or excluded from the mark-to-market base in a mixed system, provided that a reasonably broad group of positions is included? To put it another way, why should uncertainty about whether a particular position qualifies as "publicly traded" be of particular concern under a partial mark-to-market regime? Uncertainty about what is included in the base would allow taxpayers (or the government) to decide whether an asset should be subject to mark-to-market after unanticipated changes in value are known. For example, when the value of an instrument declined while in the taxpayer's hands, the taxpayer would want the instrument to be included in the mark-to-market base if he had the option. If the asset appreciated, the converse would be true. If taxpayers were permitted to "correct" a mistaken inclusion of an instrument in (or exclusion of an instrument from) the mark-to-market base, then uncertainty about whether an instrument should be treated as publicly traded would provide that option.

The taxpayer's ability to make ex post determinations based on knowledge of unanticipated price changes could be restricted. For example, taxpayers could be required to indicate at the time of acquisition whether an instrument should be included in or excluded

from the mark-to-market base and could be held to that determination.⁵³ Controlling taxpayer selectivity alone, however, would not necessarily eliminate the costs of uncertainty. For example, in a partial mark-to-market system taxpayers would be likely to take the tax treatment of instruments into account in making investment decisions. If instruments were treated differently than anticipated, claims of unfairness and additional inefficiency might result. A rule that required taxpayers to designate an instrument as publicly traded would not prevent the government from using information about changes in value to selectively challenge taxpayers' designations.⁵⁴ Thus, even limited uncertainty about the borders of the public trading definition might undercut the efficiency improvements of a partial mark-to-market regime by giving taxpayers an incentive or disincentive to invest in financial instruments that are at the margin.

Regardless, adopting a partial mark-to-market regime would require a new set of complex definitional rules. By complex, I mean rules that are hard to understand or comply with, or rules that are so detailed that most individuals would not be able to master them. One only needs to examine the current definitions of "actively traded," "marketable," or "publicly traded" under current regulations to see how complex such rules can become.⁵⁵ Does this necessity offset the benefits of adopting partial mark-to-market? This is a question that is difficult to answer. But we must keep in mind the competing costs inherent in delineating the base of the mark-to-market regime, even for the easiest case.

III. VALUING POSITIONS INCLUDED IN THE MARK-TO-MARKET REGIME

Many assets are hard to value in the absence of a sale—that is the heart of the problem with a mark-to-market regime. In theory, however,

⁵³ This is the strategy adopted by the mark-to-market rules that apply to securities dealers. See I.R.C. §§475(b)(2), (c)(2)(F)(iii), and (d)(2).

⁵⁴ We could, for purposes of argument, assume that government agents would never use hindsight in determining whether an asset should be included in the mark-to-market base. But the temptation would be hard to resist. Moreover, even if they did not make retrospective determinations about whether an instrument should be subject to mark-to-market based on the performance of the investment, it would probably appear to taxpayers that they did. After all, it is generally not an IRS agent's job to point out to the taxpayer that he paid too much tax.

⁵⁵ See Treas. Reg. §1.1092(d)-1(a) (1993); Treas. Reg. §1.7704-1(c) (1995); Temp. Treas. Reg. §15A.453-1(e)(4) (as amended in 1994) (describing a readily tradable debt instrument for purposes of determining whether payment has been made under an installment sale).

publicly traded stocks and securities should not be difficult to value, and so this argument does not mandate a realization requirement for them. As we have seen, however, a partial mark-to-market regime that would apply to publicly traded stocks and securities but would not apply to their derivatives might make little improvement in the fairness, efficiency, or simplicity of the overall tax system. While some may find reason to think that these derivatives would not present overwhelming valuation problems, I believe that even a narrowly targeted mark-to-market regime is likely to spark significant disputes over valuation if they are included in the base.

The fair market values of many derivatives cannot be observed from market prices because they are not listed on exchanges or traded on markets, and no buy or sell prices on outstanding contracts are quoted by market makers. Rather, the values have to be estimated through the use of financial models. This makes the values they are assigned suspect. The point of adopting a mark-to-market regime is to provide a better measure of income, and inaccurate valuations would undermine that goal by imposing tax arbitrarily. The more inaccurate valuations are, the more a mark-to-market system for financial instruments will tend to approach realization.

This tendency can be viewed from two different perspectives. First, taxpayers may have difficulties proving that they have properly valued their derivatives. Thus, despite a taxpayer's honest efforts to correctly value her financial positions, the IRS could reject the values and use hindsight to impose new values. The IRS could accelerate the taxpayer's gains by challenging her on the valuation of her winners and letting her losers run.

For example, assume a taxpayer has two assets, derivative A and derivative B, each of which has a starting value of \$50. She values each at \$100 at the end of the year. In the second year the taxpayer unwinds derivative A and receives a net payment of \$190. She values derivative B at \$10 at the end of the year. The government might attempt to use the unwind payment as evidence that the value assigned to derivative A in the first year was too low. If successful, the government would accelerate gains on derivative A into the first year. It is conceivable that the taxpayer could respond by asserting that she also mis-valued derivative B in the first year. In practice, however, a taxpayer may not be able to disavow earlier valuations, especially if the taxpayer has a great many financial positions and the government challenges the valuation of only a portion.

The more likely scenario, however, is that the government will have difficulty policing the values taxpayers place on their derivatives. Taxpayers have much more information about the value of their financial positions than the government. If taxpayers could systematically undervalue assets or overstate liabilities, they could defer income under a mark-to-market regime. Even a randomly inaccurate valuation model would allow taxpayers to realize losses on overvalued securities and derivatives (by selling or unwinding) and to defer income from the undervalued ones.⁵⁶

Valuation problems could significantly erode the promised fairness and efficiency of a partial mark-to-market regime. Although a mark-to-market regime with imprecise valuation might still reduce the unfairness and inefficiency of the tax system, it would do so at significant administrative cost. Thus, the taxpayer's abilities to sustain their valuations and the government's ability to police the values that taxpayers assign are important considerations in assessing the advisability of adopting a partial mark-to-market system.

How difficult would it be to value financial derivatives? That is an empirical question that is difficult to answer. Some suggest that two factors—the availability of computer programs that can run derivative valuation models and the regulatory and financial accounting standards requiring taxpayers to value their securities and derivatives at fair market value⁵⁷—should decrease concerns about the accuracy of valuation under a mark-to-market regime.

But evidence to the contrary can be found in the IRS's experience with valuing securities under the mark-to-market regime that applies to securities dealers.⁵⁸ Despite the fact that securities dealers have been required to use mark-to-market accounting for tax purposes for more than five years, no good mechanism has evolved to allow taxpayers to

⁵⁶ This assumes, of course, that a more accurate price would be produced by arm's-length negotiations with third parties over unwind or sales price, and that the taxpayer would be aware that the value indicated by the taxpayer's pricing model is different than the negotiated unwind or sales price.

⁵⁷ See Weisbach, *supra* note 6, at 107-8. Cf. David S. Miller, *Taxpayers' Ability to Avoid Tax Ownership: Current Law and Future Prospects*, 51 TAX LAW 279, 343 (1998).

⁵⁸ I.R.C. §475 requires dealers in securities to mark all of their positions in securities to market, including securities that are not publicly traded.

feel confident about their tax returns or to insure they are not using valuation strategies to reduce taxes.⁵⁹

In 1995, the IRS initiated a plan to create a system that would allow it to audit the values securities dealers place on their derivative positions. Recognizing the complexities of valuing derivatives, the IRS hired Los Alamos Laboratories to develop a system that could provide IRS auditors with values for interest rate swaps.⁶⁰ The IRS and Los Alamos Laboratories worked together on this project for several years, but even though Los Alamos had significant resources to devote to the project,⁶¹ and interest rate swaps are one of the least complex and best understood derivatives, the project ultimately failed.⁶²

It is not possible to be certain why the IRS abandoned the Los Alamos project. It may have been a budgetary issue, which is worrisome in itself. But another possible reason is the hostility that the community of securities dealers had toward the project. The securities industry claimed the Los Alamos model would not produce reasonable values for interest rate derivatives. The model, they argued, could not adequately take into account liquidity, credit, volatility, and certain other kind of risks that securities dealers are exposed to in interest rate swaps.⁶³ Ultimately, however, it appears that objections were based on concerns about how the tax system would harmonize competing valuation models

⁵⁹ Indeed, there are strong hints that taxpayers are using valuation strategies to reduce taxes under I.R.C. §475. It is common wisdom that dealers mark receivables and other debt instruments down from face value to reflect changes in interest rates and obligor credit quality, but never mark the instruments above face value. Cf. Oggie Caginalp et al., *The Mark-to-market Rules of Section 475—an Update*, TAX NOTES, Nov. 24, 1997, at 961, 966 (expressing doubt about whether a demand obligation that bears an above-market interest rate (such as a credit card receivable) would ever be valued above its stated principal amount under a mark-to-market regime, even if its true fair market value might be higher). While some might argue that this strategy should not make a meaningful difference in tax collections, its similarity to the bond trading strategies described by Professor Strnad (which can significantly reduce the taxes) would cast doubt on this assertion. See Strnad, *supra* note 30, at 75-79 [The Taxation of Bonds: the Tax Trading Dimension].

⁶⁰ See John Turro, *IRS Contracting to Produce Derivatives-Valuation Software*, TAX NOTES TODAY 48-46, Mar. 10, 1995, available in LEXIS, Fedtax Library, TNT file.

⁶¹ For a recent discussion of the capabilities of former Los Alamos Laboratory scientists, see Thomas Petzinger Jr., *Sometimes it Takes a Nuclear Scientist to Decode a Market*, WALL ST. J., Mar. 12, 1999, at B1.

⁶² See Darren Allen, *IRS Seeks Viable Valuation Methods; Official Predicts Uncertainty for Dealers*, 120 DAILY TAX REP., June 23, 1998, at G1-2.

⁶³ See *id.*

and whether a program that would spot-check taxpayers' valuations could be fair.⁶⁴

The securities industry has consistently argued that the IRS should rely on the valuations securities dealers use for non-tax book purposes.⁶⁵ The tension between a desire for high book income and the desire for low taxable income would, the industry says, protect the integrity of their valuations of derivatives. The industry would not understate book value to reduce taxes, so the argument goes, because the non-tax costs of doing so would outweigh the benefits. For example, because book values are used for financial statement purposes and for purposes of determining the capital that a dealer is required to keep in highly liquid assets (and therefore cannot use for risky enterprises), securities dealers experience significant pressure to place high values on their portfolios. In addition, they argue, each trader is compensated based on the value of the portfolio he or she trades.⁶⁶ Therefore, significant pressure exists within the firm to value securities correctly relative to other securities.

The IRS has yet to adopt this approach explicitly.⁶⁷ It has never officially articulated its reasons, but one can imagine it is motivated by a

⁶⁴ The program was intended to "batch process" dealer positions (for instance, process large numbers of positions automatically). But it probably was never meant to make overall adjustments to a taxpayer's return. Instead, it was originally intended to allow auditors to question the valuation of specific positions. Although the IRS possibly could have used the system to evaluate the process by which the taxpayer was valuing its derivative positions, instead of the values of the positions themselves, it is unclear whether the IRS intended to use the Los Alamos model this way or whether the IRS had the expertise to do so. For an argument in favor of the more general approach, see Phillip Mann, *American Bar Association Tax Section Members Comment on Valuation Software*, TAX NOTES TODAY 186-42, Sept. 25, 1997, available in LEXIS, Fedtax Library, TNT file (suggesting that Los Alamos model be used to develop evidence of reasonableness of taxpayer's method of valuing derivatives, rather than actually to value positions held by taxpayers).

⁶⁵ *Id.*; Letter from Hal I. Gann, Miller & Chevalier, to the Internal Revenue Service (July 25, 1997) reprinted in TAX NOTES TODAY 162-27, Aug. 21, 1997, available in LEXIS, Fedtax Library, TNT file; Letter from Debra M. Aaron, Wall Street Tax Association, to Belinda S. McCafferty, Internal Revenue Service (Apr. 17, 1997) reprinted in TAX NOTES TODAY 89-33, May 8, 1997, available in LEXIS, Fedtax Library, TNT file; Letter from Debra M. Aaron, Wall Street Tax Association, to Suzanne Boule, Internal Revenue Service (Mar. 11, 1997) reprinted in TAX NOTES TODAY 59-52, Mar. 27, 1997, available in LEXIS, Fedtax Library, TNT file; Letter from Henry Ruempler, American Bankers Association, to the Internal Revenue Service (Feb. 28, 1994) reprinted in TAX NOTES TODAY 46-58, Mar. 9, 1994, available in LEXIS, Fedtax Library, TNT file.

⁶⁶ Cf. Letter from Debra M. Aaron, Wall Street Tax Association, to Suzanne Boule, Internal Revenue Service, *supra* note 65.

⁶⁷ Indeed, at the time the legislation enacting I.R.C. §475 was under consideration, the securities industry recommended that the legislation provide a presumption in favor of

worry that taxpayers' impulse to reduce taxes may overpower countervailing pressures. If book value was adopted as presumptively correct for tax purposes, securities dealers might find ways to reduce the tension between tax considerations and financial and regulatory accounting rules and employee compensation practices. It is not hard to conceive of the industry recruiting its regulators in the effort. There are examples of regulators who accommodate the strategies of their regulated industries to this end, even when to do so would seem counter to the interests that the regulators are charged to protect.⁶⁸

Still, public companies seem to face enormous pressure to keep their financial statement income high.⁶⁹ Businesses are subject to increasing requirements to report the value of their financial instruments under Generally Accepted Accounting Procedures (GAAP), which could lessen concerns about systematic understatement of value.⁷⁰ However, in the

book value. See Letter from Hal I. Gann, Miller & Chevalier, to the Internal Revenue Service, *supra* note 65. This approach was not adopted by the legislation or by the legislative history, even though it may have been assumed at the time that the IRS would implement § 475 with a de facto presumption in favor of a dealer's book value. See *id.*; See also COMMITTEE ON THE BUDGET, CONFERENCE REPORT ON THE OMNIBUS BUDGET RECONCILIATION ACT OF 1993, H.R. DOC. NO. 103-213, at 616 (1993).

⁶⁸ See *Cottage Savings Assoc. v. Comm'r*, 499 U.S. 554 (1991). This case describes a situation in which the Federal Home Loan Bank Board appeared to manipulate its own accounting rules to allow savings and loans to claim tax losses without incurring losses for regulatory accounting purposes, even though doing so also may have been in conflict with the Board's own mission of policing the solvency of the savings and loans. The Federal Reserve Board provides another example. In 1994, banks tried to convince the IRS to allow interest deductions for instruments that would obtain a desirable equity classification under existing Federal Reserve regulatory capital rules. When they failed, they convinced the Federal Reserve Board to change its rules so that they could treat "monthly income preferred securities," which can be debt for tax purposes, as equity capital for non-tax regulatory purposes. Cf. John C. Reid, *MIPS Besieged—Solutions in Search of a Problem*, TAX NOTES, Dec. 1, 1997, at 1057, 1063 ("Query whether this can be interpreted as the Federal Reserve cooperating with the issuers to achieve [equity] status and a tax deduction for interest paid.")

One might argue that these examples are inapposite, because in each case the regulator changed its rules to allow an *arbitrage* between the regulatory accounting rules and the tax rules. If tax rules followed accounting rules, taxpayers would not have benefitted from the changes. Nonetheless, the examples suggest that regulators are willing to take their "constituents'" tax needs into account when formulating their own rules.

⁶⁹ If there were not such great pressure, many of the currently popular corporate tax shelters, which allow taxpayers to keep financial accounting income high while reducing taxable income, would hold less attraction. See Bankman, *supra* note 4, at 1780-81.

⁷⁰ FASB 107 requires businesses that file financial statements under Generally Accepted Accounting Principles ("GAAP") to disclose in footnotes the fair value of the financial instruments they own. In the future these businesses may be required to include the value of the instruments directly on their balance sheets. See DISCLOSURES ABOUT FAIR MARKET

absence of complete continuity between the mark-to-market base for accounting purposes and the base for income tax purposes, taxpayers might retain the ability to manipulate values (and taxable income) without substantially affecting their overall financial statement position. Complete continuity between the two bases would require tax rules to conform strictly to accounting rules, which is an unlikely scenario. Moreover, not all taxpayers produce GAAP financial statements, and so the confidence this consideration brings to valuation of derivatives may be limited.

IV. POLITICAL RESISTANCE TO A MARK-TO-MARKET REGIME

I have only touched on the administrative problems that would arise under the most basic partial mark-to-market proposal. But even if this partial mark-to-market regime improved the efficiency and fairness of the income tax and reduced complexity, there would be one more obstacle to overcome—the antipathy of individuals (and their representatives) to any rule that taxes income before it is realized. That hostility is likely to be expressed as an argument that mark-to-market would be too complex for the average individual.

I can image the protests against my assertion that individuals would find a partial mark-to-market regime complex. The realization requirement necessitates complex rules, many of which, it is asserted, could be eliminated if realization were replaced by mark-to-market for traded stocks and securities (and their derivatives). Why would an ordinary, middle-income taxpayer object to such a proposal? The

VALUE OF FINANCIAL INSTRUMENTS, STATEMENT OF FINANCIAL ACCOUNTING STANDARDS NO. 133 (Financial Accounting Standards Bd. 1998); Weisbach, *supra* note 6, at 107. In addition, FASB 133 will require firms to account for their derivative positions at fair value and to reflect changes in value in earnings. See ACCOUNTING FOR DERIVATIVE INSTRUMENTS AND HEDGING ACTIVITIES, STATEMENT OF FINANCIAL ACCOUNTING STANDARDS NO. 133 (Financial Accounting Standards Bd. 1998).

Businesses probably would be reluctant to report lower earnings under GAAP rules just to save tax, because they use GAAP financial statements to communicate their value to investors. It is conceivable, however, that businesses would “educate” analysts about the reasons for low book valuations of their stocks, securities and derivative positions. There is also some anecdotal evidence that securities analysts might not rely as heavily on some parts of the GAAP financial statements as is commonly thought. In the context of a recent debate about write-offs for research and development expenses in mergers, securities analysts reportedly are giving more weight to cash flow and less weight to non-cash items. See, e.g., Elizabeth MacDonald, *Merging Firms are Renouncing R&D Write-Off*, WALL ST. J., Mar. 22, 1999, at C1, C3. Such a trend might make a FASB requirement to value financial instruments at fair market value less significant.

902 VALPARAISO UNIVERSITY LAW REVIEW [Vol. 33

average individual does not hold arcane derivatives⁷¹—she is much more likely to own exchange-traded stock, securities, or mutual funds. She is not likely to face significant difficulties determining which properties are subject to mark-to-market or valuing those properties—most of this information could be supplied by her investment advisor or securities broker. Moreover, she is likely to benefit from a lower tax burden if the system moves away from realization and toward a more accurate measurement of income.⁷²

By the same token, however, the ordinary individual taxpayer probably does not often encounter the complex realization-based rules that exist under current law.⁷³ Thus, a majority of individual taxpayers are unlikely to find their tax calculation simplified by a partial mark-to-market regime. The existence of two different regimes for taxing assets (not to mention the possibility of marking debt to market) under a partial mark-to-market approach might even be perceived as more complex.

But I am not arguing that the average taxpayer would find the calculation of their tax significantly more difficult under a partial mark-to-market regime. Rather, I believe that the charge would be raised because accepting a mark-to-market regime would require individuals to change their understanding of how much income they have. I agree with Professor Zelinsky's assessment that there is a "deep-rooted (if economically naive) intuition...that unrealized appreciation constitutes 'paper gain' and is thus insufficiently authentic to be taxed."⁷⁴

⁷¹ See Weisbach, *supra* note 6, at 107 (describing various rules that limit individuals' access to non-traded financial instruments).

⁷² Overall efficiency improvements in the system are likely to make this taxpayer better off. Moreover, it does not seem unreasonable to assume that high-income and wealthy individuals benefit disproportionately from deferral, the timing option and straddle techniques provided by the realization requirement and that therefore lower- and middle-income individuals would benefit disproportionately from the shift to a partial mark-to-market regime. Cf. Shuldiner, *supra* note 18, at 261-5.

⁷³ One obvious exception is the limitation of deduction for capital losses located in I.R.C. §1211. Another point of interaction between individuals and the more complex realization rules is the restriction on losses from wash sales. I.R.C. §1091 disallows a taxpayer's loss on the sale of stock or securities if he replaces the stock or securities during a 30-day window on either side of the sale. Evidence that a relatively broad cross-section of taxpayers plan around these rules can be found in a regular end-of-the-year report in *The Wall Street Journal* that describes cut-off dates for making wash sales without running afoul of the disallowance. See, e.g., Vanessa O'Connell, *Tax Report*, WALL ST. J., Oct. 29, 1997, at A1.

⁷⁴ See Zelinski, *supra* note 25, at 893.

This intuition is hard for tax professionals to understand and accept. We have internalized the Haig-Simons definition of income, so we tend to think others are being disingenuous when they say that they think it is unfair or complex to tax “phantom income” (to use the popular pejorative). But my own experience leads me to believe that individuals’ attachment to the concept of realization is strong, sincere, and not motivated simply by greed.

I am convinced that individuals’ understanding of how much income they have and their understanding of how much tax they pay would make it difficult, if not impossible, to adopt a mark-to-market regime that applied directly to financial instruments that they hold.⁷⁵ My experience tells me that arguments about the efficiency benefits of a mark-to-market system are unlikely to be persuasive because they would be largely meaningless to most individuals. Moreover, many individuals may believe they would have to pay more tax, observing that they have to calculate the change in value of their stocks and securities every year and pay tax on the income and realizing that they would not have had to pay the same tax at the same time under realization. That many would have to pay the tax anyway,⁷⁶ and that the present values of the tax payments under a mark-to-market system and under realization could be made equal for many taxpayers⁷⁷ is likely to carry little rhetorical weight. Sadly, I see no real likelihood that a mark-to-market regime that, applied to a broad class of individual taxpayers, even one that applied only to publicly traded stocks and securities and their derivative products, will be a vehicle for making substantial improvements in our income tax system.

⁷⁵ Professor Shaviro has discussed the effect of “cognitive biases” on tax reform. Among other things, Professor Shaviro points out, it is quite clear that people want “to pay as little tax as possible while receiving as much value from government services as possible.” Daniel Shaviro, *Beyond Public Choice and Public Interest: A Study of the Legislative Process as Illustrated by Tax Legislation in the 1980s*, 139 U. PA. L. REV. 1, 57-64 (1990). However, individuals have difficulty evaluating what they receive in government services, so they generally evaluate their welfare based on how much tax they pay. *See id.* Moreover, they tend to be bad judges of how much tax they pay, both in a relative and an absolute sense. *See id.*

⁷⁶ Those who hold interests in mutual funds often do not get the full benefits of realization because of the funds engage in trading. On the other hand, some taxpayers can defer realization until death, in which case they likely would pay more tax under a mark-to-market regime.

⁷⁷ Professor Weisbach recommends that mark-to-market gains and losses be subject to a nominal rate that is equal to the effective rate of tax on income from assets under realization. In other words, mark-to-market income would be taxed at a lower rate than gains under realization. *See Weisbach, supra* note 6, at 100.

But does this mean that a partial mark-to-market proposal has to be taken off the table completely? I think not. Although policy makers do not have much of an appetite for abstract improvements in the tax system, they are able to stomach changes that target "abusive" behavior. Even when Congressmen vehemently decry tax increases, they find themselves voting for provisions that increase someone's taxes; it does not seem to matter much as long as the provisions are dressed in anti-abuse rhetoric. Recent years have seen a number of times when members of the Senate Finance Committee and House Committee on Ways and Means have joined forces with the Department of Treasury to introduce pieces of legislation aimed at specific, putatively abusive, behavior.⁷⁸ Somehow, these provisions do not seem to qualify as tax increases, as if tax increases and anti-abuse measures were mutually exclusive terms.

Could this phenomenon be harnessed to actually improve the tax system by adopting some form of partial mark-to-market? I believe it is only a matter of finding the right approach. There is no question that anxiety runs high about the use of financial products to obtain untoward tax results. If a mark-to-market regime believably targeted these abuses, it would have a shot.

Perhaps we could find a way to limit the application of a mark-to-market regime to corporations, certain partnerships and wealthy or high-income individuals. Or perhaps the regime could apply only to taxpayers who engage in certain kinds of transactions. Another

⁷⁸ See, e.g., *Archer Pulls Plug on Exploitation of Section 357(c) Ambiguities*, TAX NOTES TODAY 202-2, Oct. 20, 1998, available in LEXIS, Fedtax Library, TNT file (describing anti-abuse legislation introduced by House Committee on Ways and Means Chairman Archer (R-Texas) that was precipitated by a Clinton administration proposal); *Chief Taxwriters Would Kill Tax-Free Distribution of REIT Liquidations To C Corps*, TAX NOTES TODAY 100-1, May 26, 1998, available in LEXIS, Fedtax Library, TNT file (describing joint introduction by chairmen of the House Committee on Ways and Means and Senate Finance Committee of legislation to eliminate a perceived abuse of a tax provision); *Tax Chairs Offer Stapled REIT Bill*, TAX NOTES TODAY 59-1, Mar. 27, 1998, available in LEXIS, Fedtax Library, TNT file (describing similar action by committee chairmen); *ABA Tax Section Meeting: Treasury's Kohl Wants More Help From the Practitioner Community*, TAX NOTES TODAY 99-11, May 22, 1995, available in LEXIS, Fedtax Library, TNT file (noting "current willingness of the taxwriting committees, their staffs, and the staff of the Joint Committee on Taxation to consider quick legislative fixes to inappropriate or unintended applications of the code"). Professor Shaviro observed this preference even in the Tax Reform Act of 1986, a piece of legislation touted for its tax policy achievements. The legislation, he says, had a tendency, "magnified at each stage of the legislative process, to address perceptions of abuse through selective limitations at the expense of ... base broadening." See Shaviro, *supra* note 73, at 51.

approach would be to give taxpayers more opportunities to elect a mark-to-market method of accounting for publicly traded stocks and securities and their derivatives and give them incentives to make the election. We may already be taking steps in that direction.⁷⁹

In any event, there may be creative ways to take individuals out of the mark-to-market picture⁸⁰ and focus instead on the types of taxpayers and transactions that generate the lion's share of the problems with realization: large corporations and high income or net-worth individuals. While such an approach may not be entirely satisfying from a policy perspective, neither is partial mark-to-market. The question is whether an even more limited partial mark-to-market system would make an incremental improvement in the taxation of financial instruments. I believe that it would, although I am sure that a real-world application of such a regime would have some surprising results.⁸¹ Nonetheless, if we are going to propose something as practical as saving the income tax, why not come up with a plan that can be enacted?

⁷⁹ In 1997, the tax law was modified to allow securities and commodities traders to elect mark-to-market accounting for securities and commodities. Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 1001(b) *reprinted in* 1997 U.S.C.C.A.N. 788, 906-07 (codified as I.R.C. § 475(f)). One reason a taxpayer might elect to use this method is to avoid the rules that limit losses on certain financial transactions, such as the wash sale rules of I.R.C. § 1091 and the straddle rules of I.R.C. § 1092, which are onerous for active securities and commodities traders. *Cf.* Letter from Leon M. Metzger, Paloma Partners Company LLC, to Donald C. Lubick, Department of the Treasury (Feb. 11, 1999) *reprinted in* TAX NOTES TODAY 37-33, Feb. 25, 1999, *available in* LEXIS, Fedtax Library, TNT file.

Another example of this possible trend is the "constructive ownership" proposal contained in the Administration's most recent budget submission. Taxpayers could avoid certain undesirable tax results under this provision by electing to mark certain financial instruments and derivatives to market. *See* DEPARTMENT OF THE TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION'S REVENUE PROPOSALS 123 (Feb. 1999) *reprinted in* 123 DAILY TAX REPORT, Feb. 2, 1999, Text Supp. No. L-32.

⁸⁰ Individuals may not need to be completely shielded from the mark-to-market method. For example, many mutual fund shareholders might be indifferent to whether their mutual fund was required to use mark-to-market accounting.

⁸¹ As an example, few anticipated how useful the mark-to-market accounting method would be to securities dealers in allowing them to become intermediaries for tax shelters. This limited mark-to-market regime "allows securities dealers to serve as tax owners without suffering liability, and permits their customers unintended benefits of our realization-based system." Miller, *supra* note 57, at 342.

