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TAX ISSUES RAISED BY FINANCIAL PRODUCTS: SHORTS AGAINST THE BOX, COLLARS AND EQUITY DERIVATIVES

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Mr. Kleinbard received his J.D. degree from Yale Law School, where he was an articles editor of the Law Journal. He received his M.A. and B.A. degrees in history and medieval and renaissance studies respectively from Brown University. Mr. Kleinbard is a member of the Bar in New York and is admitted to practice before the United States District Court, Southern District of New York and the United States Court of Claims.

Mr. Kleinbard is a member of the American College of Tax Counsel and of the American Association of Financial Engineers, where he serves on the Board of Advisors. He is also a member of the American Bar Association, the Association of the Bar of the City of New York and the New York Bar Association, where he formerly was a member of the Executive Committee of the Tax Section and co-chairman of the New Financial Products Subcommittee.

In 1995, Mr. Kleinbard was named one of New York's finest lawyers by *New York Magazine*, and one of America's 45 leading lawyers under the age of 45 by the *American Lawyer*. In 1996, he was named one of the top tax advisers on the East Coast by the *International Tax Review*.

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In her pre-public service days, Clarissa was a tax associate with the New York office of Sullivan & Cromwell. Her specialties included the taxation of financial products and institutions, taxation of damage awards, tax incentives for education, and recently, the tax treatment of farmer cooperatives.

Professor Susan J. STABILE: My name is Susan Stabile. I am an Associate Professor here at the St. John's School of Law. Welcome to the first of what I am sure you will find to be four tremendous panels addressing various aspects of tax law.

We start off today with a focus on financial products or derivatives. What are derivatives or financial products? I recently read a comment suggesting that derivatives are like obscenities: We generally know them when we see them even if we do not often think of the dictionary definition of the term.

In simplest terms, a derivative is a security whose value rises and falls depending on what happens to some other security, commodity or group or index of securities or commodities to which the derivative is linked. Broadly speaking, derivatives can be divided into equity derivatives and debt derivatives, although the form of these products can vary tremendously, as you will see from our speakers today. The focus of our panel today will be primarily on entity derivatives.

Parties enter into derivatives for various reasons. One of the most common uses of financial products is asset management. That is, someone who owns an equity security enters into it a derivative to hedge exposure to the risk of a downturn in that security.

Another common use of equity derivatives is to create a synthetic position, to effectively create the ability to gain from a particular security without actually having the security in your portfolio. The focus today of our speakers will be on the first of those uses, on the use of derivatives as part of an asset management scheme. However, time permitting, they may also get to the use of derivatives as an alternative to buying an equity security.

Let me now turn this over to Clarissa Potter, our first speaker

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Mr. Shashy received his B.S. in Political Science with highest honors from the University of Florida in 1970, and received his J.D. degree with highest honors from the University of Florida School of Law in 1973. In 1975, Mr. Shashy received his LL.M. in Taxation from New York University School of Law where he served as Managing Editor of the *Tax Law Review*. From 1975-1976, he taught full-time in the Graduate Tax Program at New York University School of Law. From 1976-1984, he served as an adjunct professor in the Tax Program while practicing law in New York City.

who will give us an overview of the tax issues that have to be looked at when dealing with financial products.

Ms. Clarissa C. POTTER: Good morning. It is really wonderful to be here on this beautiful day in this wonderful facility. Let me give you just a little background about what I do, and then I am going to start this off by identifying the overall tax concerns we have when we look at derivatives. Then, the rest of the panel will speak in more detail about particular transactions and particular issues.

As Acting Tax Legislative Counsel, I have the primary responsibility for all domestic tax policy issues. Whenever legislation is proposed or enacted, whenever regulations are proposed or drafted or issued, they go through me. I have to keep foremost in my mind basic tax policy concerns. I think that in the financial products area, these policy concerns are often very starkly illuminated. But to set the stage it is worth briefly reviewing the factors that I consider when I think about a financial product, or a particular approach to financial products.

Obviously, the first thing I think about when I consider tax policy relating to financial products is fairness, meaning treating similarly situated taxpayers similarly, treating differently situated taxpayers differently, and trying to create a symmetry between the parties that enter into financial products.

Each of these things turns out to be very difficult in the area of financial products because of the malleability of the products; taxpayers can vary minor aspects of their transactions or their contracts, and end up with very different results. It is also very hard because of the development of the treatment of financial products over the years. The incremental evolution of the law itself makes it difficult to pick out whose treatment should be symmetrical or whose should be analogous.

Ed Kleinbard invented the concept of cubbies, or cubbyholes, as they apply to financial products. The idea is that we have certain known types of financial transactions, debt and equity, for example, and we know how those instruments are treated under the tax code. When we find something new, we have to try really hard to either squeeze it into the debt cubbyhole or into the equity cubbyhole. However, over time we have developed quite a large number of these cubbyholes describing different kinds of instruments and transactions. Fairness, therefore, becomes

problematic in the context of financial products because it is hard to decide which existing transaction the current transaction is most like.

Economic efficiency is another major consideration. We try very hard, though we are seldom successful, to ensure that our rules are not a motivating incentive or disincentive for taxpayer behavior action. Ideally, tax rules would not be the reason taxpayers engage in particular transactions.

In addition, when we develop an approach to the tax treatment of financial transactions, we try very hard to get as close to the economics of the transactions as possible. This also is a difficult task because often the economics are quite complicated and difficult to discern, perhaps not in the abstract, but in practice.

Ability to pay tax is also something that is traditionally a concern. Is it appropriate to tax someone at a certain point? Do they have the ability to pay the taxes at that point? That is often an issue in realization-based taxation. For example, inherent in realization-based taxation is the idea that when you own an asset you should not be taxed on the gain from that asset until you have realized the gain. Until that point, you do not have the cash in hand to pay the taxes. The concern over a taxpayer's ability to pay, based on a realization approach, has faded over time. Consequently, you will find that in many of the newer rules that apply to financial transactions, we have moved away from this idea that we do not impose tax until the taxpayer actually has cash in hand.

Finally, another important consideration for me as a tax administrator is ease of administration. In a lot of discussions, certainly in theoretical and academic discussions, this is a consideration that gets very short shrift. When we talk about how a particular transaction is structured and how it should be taxed, the question always arises: What do we know about that transaction in reality, and how can we find out that information? More and more, a popular approach to dealing with the problems presented by financial transactions, derivatives in particular, is something called mark-to-market. This means that periodically the taxpayer's position in the contract is valued and compared to a prior value (i.e., the value at the time when the taxpayer entered into the transaction or at the end of the taxpayer's prior taxable year). You compare the two values so that if the contract

has appreciated in value, you tax the appreciation. The basic idea of mark-to-market is that it might be appropriate periodically, once a year say, to check that change in value and tax the taxpayer based on that change. So, if the financial instrument appreciated by \$20, you tax the \$20.

It sounds very simple. From an administrative perspective, however, except in very limited cases, such as stock that is traded on the New York Stock Exchange, it is a difficult rule to administer. It is difficult for a variety of reasons. Principally, it is difficult for taxpayers and the IRS to determine the value of a contract even if the contract is publicly traded, and certainly it is difficult when you get beyond the simple case. I think the administration of a particular rule is applied to a financial transaction often comes to the forefront in terms of policy concerns about the rules you apply to the transactions.

These are the overriding concerns: Fairness, efficiency, ability to pay, and the ease of administration. Apart from these broad policy concerns, there are other tax concerns that are implicated by financial transactions and derivatives in particular. These can be classified in four or five categories. All of these categories actually overlap, but I will address them as if they are separate concepts.

First is the proper measurement of income. Second is the timing of the income, which is very closely related to the proper measurement of the income. Third is the timing of deductions, which is ancillary to or a corollary of timing of income. Fourth, there is the character of the income, whether it is ordinary or capital, whether it represents interest or a dividend. Related to this, when you talk about an asset, is the holding period of the asset. Finally, in the international context, a very important concept is source.

Let me just very quickly elaborate on these ideas, and then we can see how these ideas come into play when we discuss the particular transactions we are going to talk about. The rest of the panelists will describe the proper measurement of income, but one of the big problems that we face in the financial derivatives context is the lump-sum payment made by one of the parties. The payment can be conceptualized in two ways: It could be income or it could be a loan.

Under general tax principles, the principal amount of the loan

is not income to the taxpayer because that amount must be paid back to the lender. In the classic case of the loan with fixed interest and fixed principal, this is very clear. I borrow \$100 and I am going to have to pay interest on it. In five years I am going to have to pay \$100 back.

When you move away from that classic case and into the world of contingent borrowings, the concept becomes more difficult. Say I borrow \$100 and I am going to buy an asset with it. I say to the lender, "You know, I am going to pay you interest but I am not going to pay you market rate of interest. I am going to pay you a lower rate but you get part of the appreciation of my property if it appreciates. I am not going to give you \$100 back. I may give you \$110. I may give you \$90."

In that case, it is more difficult to discern whether the \$100 that comes in on the loan should be treated entirely as principal on the loan, or whether there may be something else going on. Rather, the transaction may include a loan and some other kind of contract, and perhaps the \$100 payment may be partially attributable to this other contract. How do you decide what other kind of contract is imbedded in this transaction, how do you decide how much of the \$100 to attribute to that contract, and how should the amount attributed be taxed?

Timing. Again, you get that \$100 lump-sum amount and assume it is not a loan. Should you take it all into income up front? Should it be spread out over the period of the contract? Should part of it be deferred under what we will refer to later as the "open transaction doctrine"? In other words, assume I know that some or all of the \$100 is income, but I do not know how much, so I will have to wait and see.

When there is no cash flow—when I do not receive a lump sum but I have entered into some kind of transaction—does that create an event that would cause me to recognize gain or income for some other reason? We will talk about that in a minute in the case of constructive sales transactions.

Finally, I talked briefly before about mark-to-market, which is this idea that I would value my assets periodically to figure out how much income I should take into account.

All of these different approaches appear somewhere along the spectrum between the mark-to-market system, which does not require any kind of a realization event or any particular cash

flow to result in income recognition, and the other extreme, which would be the repayment of a loan, when there is cash but no income. You find points all along that spectrum where financial products fall into place: It is often problematic, especially in the context of a new financial product, to figure out where they should fall.

I mentioned deductions before. Should a deduction associated with the financial transaction be accrued over time? Even if I know generally the amount of a deduction that I will associate with a financial transaction, should I spread it out over time in a way that is unrelated to the cash flows but is perhaps related to the economics of the transaction? Should I use matching concepts to try to link that deduction to a particular item of income and offset those two? We have got provisions like the hedge timing rules which try to match deductions and income,¹ and netting rules for notional principal contracts that try to actually match cash flows, such that if you have cash flows that offset, you take that into account.² Then we have a number of rules that defer deductions to prevent taxpayers from currently reducing their income and then deferring tax. For example, we have the so-called straddle rules which provide that in situations where you have a position that generates income and a position that generates deductions that are closely linked, you have got to wait for the income to take the deduction.³ You cannot just take the deduction first. Similarly, the wash-sale rules try to accomplish the same thing.⁴

Character of income or deduction is another very important consideration in financial transactions. It is often difficult to determine the character of income and deductions from derivatives. In the recent past, since the passage of the Tax Reform Act of 1986, many thought about character less as a question of the rate of tax that applied to income and more of a question of timing. Typically, with capital gains or capital losses, the taxpayer has more control over timing. This is in contrast to ordinary income and ordinary deductions, where there tends to be less control over timing.

¹ Treas. Reg. 1.446-(a)(2)(i)(1998) (hedge).

² Treas. Reg. 1.446-3(g)(1) (1998) (swap).

³ I.R.C. § 1092 (1998) (straddles).

⁴ Treas. Reg. 1.1092b-1T (1998); I.R.C. § 1091(e) (1998) (wash sale rules).

Last year, however, because of the dramatic reduction in the rates that apply to long-term capital gains,⁵ we rediscovered other considerations in addition to the timing of income. So, it becomes much more important to think about whether a particular item of income or deduction is capital or ordinary.

The other issue I mentioned as particularly relevant to character and capital gains is the question of holding period. The holding period is something that derivative contracts are often used to manipulate. For example, if a taxpayer no longer wants to hold an asset, but would recognize short-term capital gain if the asset were sold, the taxpayer can use a derivative to dispose of the economics of the asset without having a realization even for tax purposes. The goal is to put off recognizing the gain so that it can be converted from being short-term capital gain to being a long-term capital gain and thereby obtain the benefits of long-term capital gain rates.

That covers the many issues I generally take into account when I think about the taxation of derivatives. I briefly mentioned source, which is of particular interest in the cross-border context. In general, U.S. taxpayers, as you know, are subject to tax on all of their worldwide income regardless of its source. However, taxpayers can reduce their U.S. tax liability by being able to obtain the benefit of a credit for foreign taxes on foreign-source income. It is often very advantageous for U.S. taxpayers to change the source of their income from U.S. source to foreign source. Derivatives can be used under a variety of strategies to accomplish that.

Mr. Edward KLEINBARD: First, before we let you off the hook here, you said one thing that I thought was quite surprising in your list of goals that the Treasury has in looking at financial instruments, and that was symmetry between the issuer and an investor, so that what happens on the issuer side is mirrored on the investor side. Symmetry obviously is one of those qualities that human beings have a quick and sort of superficial attachment to, sort of an easy aesthetic. But why on earth should symmetry be a goal of the tax policy of the United States? We have, for example, lots of issuers who are not U.S. issuers who

⁵ I.R.C. § 1(h)(1)(C-E) (1998) (providing lower tax rates for capital gains than for ordinary income).

can issue to U.S. investors. We have investors that are tax exempt; in fact, they dominate most of the capital markets. We have investors that are taxable. We have individuals. We have corporations. We have corporations with losses, corporations that are paying taxes. Why is symmetry important?

MS. POTTER: I think that historically symmetry was thought to be more important than it probably is now. Let me give a quick example. In the case of a loan from a lender to a borrower, the borrower is going to pay interest on the loan. Tax rules will tell the borrower how much interest it can deduct each year. Correspondingly, tax rules should tell the lender how much interest it should include each year. If you have got the economics of the transaction correct, theoretically you should tell the borrower to deduct the same amount of interest at any particular time as the lender is including.

Now, that is an extreme simplification. There are lots of reasons why that may not be true, why you may not end up with that result. First, we hardly ever get the economics right. It is very, very difficult to get the economics right even in a very simple loan.

Secondly, taxpayers, the lender and the borrower, may be in completely different situations created by the tax system. This is the most common case: The lender is a pension fund or some other tax-exempt person. It is not concerned with what kind of interest income it is receiving and how it is taxed. That means nothing to it. The borrower, however, who is entitled to interest deductions, will care a great deal about how quickly it gets to deduct its interest. The borrower would prefer to be able to deduct all of the interest in the first year even if the loan has a five-year term. If you have a tax-exempt lender on the other side, the lender would be perfectly happy to include all its interest in the first year. So, besides the fact that we do not get the economics right, the taxpayers are often in very different situations.

I think those are the two primary reasons why there is a movement away from symmetry. In general, you start with symmetry because symmetry has historically been viewed as an antidote to tax rules that do not accurately reflect the economics of a transaction. But because of the recognition of the dramatic differences in the rules that apply to taxpayers, symmetry is no

longer seen as serving this function and so is not such an important policy consideration. Nonetheless, I think many people believe still in symmetry. Ed, I am sure that you have gone to people and argued in favor of symmetry when you did not like some rule that was proposed.

MR. KLEINBARD: No.

MS. POTTER: You never do that, Ed.

MR. KLEINBARD: I would never do that. I am intellectually consistent at all times.

MS. POTTER: Yes, that is right and next time Ed comes in and says, "This is completely unfair to the other side of the transaction," I will remember that.

MR. KLEINBARD: I think of symmetry as the excuse for not getting the rules right. "Well, we did not get the economics right but we should not worry because it is symmetrical." So, what we give one side we will take back from the other and, of course, for the reasons you stated, it never works. Symmetry strikes me as a false kind of comfort for poor tax rules.

MS. POTTER: Generally, I would agree with that. I think the problem tends to be that, historically, people have believed in symmetry as an independent norm. You find even now that most statutory provisions are enacted based on the concept of symmetry, and that policy makers in general are very loath to move away from symmetry. In fact, a number of legislative provisions were proposed in the last couple of years relating to drawing the line between debt and equity. A corporate issuer issues an instrument. Is it debt? Is it equity? The Treasury proposed a number of rules to deny interest deductions when the instrument was just a little too close to equity. The complaint most often heard when people came in to discuss these proposals was, "This is a heads you win, tails we lose" approach for the Government, which seems, at a very gut level, a bad approach. It is an intuitive reaction, and yet when you really look at the policy basis for symmetry, I think you come up with some real questions about it. So much for that.

MR. SHASHY: I cannot resist. Clarissa, may I ask you one question?

MS. POTTER: Absolutely. I knew this was how this was going to turn out. The other panelists told me they were going to talk about this other stuff. They really came here to ask me ques-

tions.

MR. SHASHY: Yes, it is the classic bait and switch. You talked about four principles: Fairness, efficiency, ability to pay and administrability. These are all valid principals from a policy-making standpoint. Let's talk for a second about administrability. The flip side of that is the taxpayer's ability to comply with rules. We have heard a lot and thought a lot about the growing complexity in the tax law. I think it is safe to say, as you did, that the emphasis has been on getting the right answer as opposed to administrability. Not that administrability has not been considered. We are talking about emphasis here.

The question is whether you think that the focus on getting it right has been a trend over the last ten years, particularly in the area of taxation of financial products. Do you see any movement in the other direction as a trend? More consideration of administrability and the ease of taxpayer compliance?

MS. POTTER: I think there is always a tremendous tension that presents itself on that question and I think for any particular project or for any particular issue, the weight given to either economic accuracy or administrability fluctuates a great deal. There is a pretty profound understanding of this at the Treasury Department and at the IRS.

I gave the example of mark-to-market as a new approach that seems economically accurate, simple and seemed administrable. It turns out that it is not—surprise, surprise. I think mark-to-market is something that has received a lot of attention, a lot of work and a lot of interest in the last four or five years. It has brought to the forefront this problem of administrability and ease of compliance.

Since there seems to be a tension between economic accuracy and administrability in the treatment of derivatives under the tax law, the question is the cost of simplicity. This is actually probably more of a political question than a policy question. It is possible to write rules, I believe, that are fairly simple to administer and fairly simple to comply with, but that violate fairly profoundly some of these other values like efficiency and perhaps even fairness.

People can make the determination that simplicity is worth it from a societal perspective. What kind of resources are we going to expend on people like me trying to figure out how derivatives

should be taxed, and on people like Ed telling their clients how we would tax their transactions and accordingly what kind of derivatives they should create? That is a different question than the efficiency of the particular tax rule.

The problem is that, as a political matter, people have been unwilling to accept the kind of rough justice you get when you write those kinds of rules. The result is that you end up, if you are not careful, with very simple, administrable rules that are only for the benefit of taxpayers. Anyone who finds those rules onerous or not suitable for their particular transaction, at least from their perspective, can obtain a different set of rules which more closely track the economics of their transaction. That ends up being even worse than a relatively complicated system— at least from the perspective of collecting the right amount of tax from the right people. From a fairness perspective, it becomes even worse than a relatively complex, more difficult to administer approach that applies to everybody generally.

MR. KLEINBARD: In private practice, I think that the universal experience is that taxpayers are willing to put a lot of energy into understanding very difficult rules that produce favorable results for them and find that rules that produce unfavorable results are too damned complicated. That is funny how that works.

MR. SHASHY: Clarissa has laid the foundation to describe the effects for a number of different financial products, derivative products, in light of the principles she has described.

Imagine, again, our hypothetical taxpayer owns— has a position in equity investments, stock for example, and that the position has gone up in value. The taxpayer could be an individual. It could be a corporation. It could be you.

Let's imagine the taxpayer has this investment and wants to hedge against risk with respect to the position, perhaps monetize the investment. The taxpayer is hesitant to do those things in the traditional way, which would be a sale of the asset, because of tax consequences triggering gain.

There have been a number of products, some of them contractual and some of them market transactions, that have developed over the years whereby taxpayers have essentially been able to successfully shed the risk with respect to a position. Sometimes they even have been able to monetize the position without trig-

gering tax gains.

Some of those products are of mere historical importance. They have seen better days from a tax standpoint because legislation has caught up with them or regulations have caught up with them. However, one of the things that I think you will sense as we talk about these various products is the evolutionary process that goes on in the market place, as taxpayers find new and ever more interesting ways to manage their assets tax-efficiently.

I want to talk to you about two things primarily: Equity swaps and short sales. My comments about the tax consequences of these two items should be considered largely historical. Mary Harmon will talk about section 1259 and tell you about how that provision, which was enacted in 1997, changed the tax results of the two products I am about to describe for you.

An equity swap is a financial derivative that is contractual in nature. It is a contractual arrangement whereby the owner of a position in stock would for a defined period of time, which is the term of the equity swap contract, part with risk from the position and essentially transmute that position into a synthetic economic position with respect to another investment. Assume that the taxpayer, who owns stock that has appreciated, goes to a bank or other financial intermediary and enters into a swap contract. Under the terms of the swap contract, the taxpayer agrees to pass along to the counterparty, to the bank, the economics if you will, with respect to the stock position that the taxpayer continues to hold as a nominal matter. That means that over the term of the contract, the taxpayer will pass dividends along to the counterparty. It would also pay the counterparty the appreciation, if you will, with respect to the stock position that occurs during the term of the contract.

The counterparty, for its part, will agree to pay the taxpayer the returns that are based on or derived from another financial instrument. In the case of a swap based on the S&P 500 Index, the counterparty would agree to pay the taxpayer appreciation that occurs with respect to the S&P 500 Index.

If the S&P goes down in value, then the taxpayer would owe the counterparty, the bank, the difference between the stock value and the S&P 500 value. If the equity position in the stock goes down in value, the counterparty would pay the taxpayer.

Those are basically the economics. It is a contractual trade, if you will, or exchange of the economics from two different positions. At the end of the term of the swap contract, the economic calculations are done. One party will have profited and the other will have lost. Whoever is in a profit position will get a net payment. Whoever is in a loss position will make a net payment.

Historically the taxation of that transaction has been relatively simple. The profit is taxable, and the loss is deductible at the point in time when the payment is received or the payment is made. That is a basic equity swap described fairly briefly. There obviously are much more complex swaps that can be done.

Let's talk next about a short sale. Short sales come in two flavors for purposes of this discussion. First, let's talk about a basic short sale, what I will call a naked short sale. In the case of a naked short sale, the taxpayer that does not own a given item of property nonetheless wants to sell the property. So, in a short sale you basically sell something that you do not own. I grew up thinking that if you sold something you did not own, you go to jail. I grew up to find out that Wall Street does it every day. It is an interesting transaction.

Why would you sell something that you do not own? Well, you would sell something at today's price that you did not own if you thought the price or the value of that asset was going to go down over the time, so that after having sold it at today's price, you could go into the market later, buy it at a lower price and make a profit. Is that a good idea? Well, if you guess correctly, and the value of the asset goes down, it is a great idea and you will make money. If you guess incorrectly, you will lose a lot of money. Since there is no upside limit, there is no ceiling on the values to which stocks can soar; your risk in a naked short sale is unlimited. So, it is a very risky proposition.

The way in which a short sale is effectuated is you call your broker and you say to your broker, "I would like to sell short, 100 shares of XYZ stock." The broker implements that transaction for you by finding a buyer who wants to buy 100 shares of XYZ stock at today's price. Once the buyer ponies up the money, the broker advances stock or delivers stock to the buyer. Since the taxpayer on whose behalf the short sale has been made did not own the stock, the broker is essentially advancing the stock on behalf of the taxpayer to the seller. The broker will make an en-

try in the taxpayer's margin account indicating an obligation on the part of the taxpayer to deliver to the broker an equivalent amount of stock at some point in the future.

When the short sale takes place, that is the point in time when the short sale is opened. When the taxpayer delivers the equivalent amount of stock to the broker, that is the point in time when the short sale is closed. Those terms have significance from the tax standpoint.

During the pendency of the short sale, after it is opened and before it is closed, an additional calculation must be made if the underlying stock that has been sold and has been essentially advanced by the broker is dividend-paying stock. In that case, the taxpayer will make payments to the broker to compensate for the fact that the broker has had to borrow stock from some other source and advance it to implement the short sale, and that the broker is paying a dividend equivalent amount to whomever loaned the stock to the broker.

In the taxpayer's account, the cash proceeds from the sale are entered as a credit so the taxpayer has that credit in its account. He cannot take the money out because there are securities regulations and broker policy. In fact, it is a margin transaction and the margin rules require the taxpayer to post in the margin account additional collateral security for the open short position to ensure that it will ultimately be closed.

Historically the tax system has viewed short sale transactions as open transactions. That law began to develop over 60 years ago. It is reflected in the regulations under section 1233. From an income tax standpoint, a short sale is not consummated until the taxpayer delivers the stock to the broker to close the short sale.

Why is that? The reason from a tax standpoint is that until the taxpayer delivers stock to close the short sale, you do not know what the taxpayer's basis is for the property the taxpayer will have disposed of, and the tax law therefore holds the transaction until the closing occurs. Note what has happened. The taxpayer has been paid proceeds from the short sale and typically in the tax system, when you receive proceeds of cash, that is deemed an appropriate time to tax the taxpayer. In this case, however, because of the uncertainty of what the ultimate tax gain or loss will be, because you do not know yet what the tax-

payer's basis is for what will be delivered to close the short sale, the tax system holds the transaction open.

Now, let's talk about a short sale against the box. A short sale against the box is a little different. In a short sale against the box the taxpayer enters into a short sale with respect to the stock that the taxpayer currently owns, that the taxpayer has in its account. Let's imagine stock that was bought more than 18 months ago and that it has appreciated in value since the taxpayer purchased the stock. The taxpayer would like to shed risk, or hedge against a risk of a future decline in value of that position. However, the taxpayer would like not to sell the stock in a traditional way, thus triggering gain from a federal income tax standpoint.

The taxpayer calls the broker, just as in the naked short sale, and asks the broker to sell short from the taxpayer's account the number of shares of stock that the taxpayer has in the account. The broker delivers stock to the buyer that again is borrowed by the broker; the broker does not deliver stock from the taxpayer's account. Until very recently, the same open transaction rule applied from the taxpayer's standpoint. The taxpayer's account was credited with cash from the short sale, and the transaction remained open as a matter of tax law. This was because the taxpayer might close the short sale ultimately by delivering the stock from the taxpayer's account, which has appreciated greatly, or the taxpayer might go into the market and buy another block of stock equivalent to the number of shares sold short and deliver those shares. The tax consequences for the taxpayer would differ because those two blocks would have a different basis. So, the transaction was held open until the taxpayer closed the transaction. Historically, that is the way the short sale against the box was treated in the tax law.

Again, if there are dividends on the underlying stock, the taxpayer makes a dividend equivalent payment to the broker. In this instance, because of the fact that the taxpayer actually has the securities in the taxpayer's account that were sold short, there is no requirement that the taxpayer post additional margin in the account. While the taxpayer cannot withdraw the proceeds of the short sale from the taxpayer's account, the taxpayer can borrow against those proceeds. I think up to 95 percent of those proceeds can be borrowed by the taxpayer.

Now, while the proceeds are sitting in the taxpayer's account, if the taxpayer has enough clout with the brokerage firm, it effectively will be paid interest effectively in the form of a rebate on those funds. Most small retail customers typically do not get that rebate. Those are the basics with respect to equity swaps and short sales. I think at this point, Mary, it would be timely for you to talk a little about constructive sales.

MS. POTTER: Actually, let me just ask a question that may draw useful analogy here. Assume I did the short sale against the box and my broker held cash for me from the sale, and I decided to borrow that cash from the broker and invest it in the S&P 500. It is true that I would then have approximately the same transaction as the swap transaction you described originally.

MR. SHASHY: That is right.

MS. POTTER: That shows that the equity swap transaction gives you almost the identical economics that you get from these two transactions, the short sale against the box plus the borrowing and the additional investment. That turns out to be true in the case of an awful lot of financial transactions where you can replicate a transaction that you can do in one step by taking three or four steps: The additional steps might give you different tax results.

MS. HARMON: That is a perfect lead-in to the next topic which is the new constructive sale legislation that was enacted last year, section 1259 of the Internal Revenue Code. I noticed when Clarissa was listing the considerations that the Government takes into account when they are thinking about rules, interpreting rules and coming up with new rules, she talked about the realization concept. Here is just a little dig. She mentioned that the concept has been fading over time. I would suggest that it is fading much more rapidly in the last five years than —

MS. POTTER: Since I have been in the Government.

MS. HARMON:—in the previous 100.

MS. POTTER: One of my mottoes is that realization is about cash and I just do not believe in cash.

MS. HARMON: The constructive sale legislation—the name tells you a little bit about what the Government and what Congress decided to do—imposes sale treatment in cases where no actual sale existed in the legal sense or tax sense prior to the en-

actment of this legislation.

The equity swap and the short sale against the box that Hap described, are transactions where the shareholder had the underlying stock and then entered into these transactions either to hedge some or all of the market risks of that stock, or to diversify that stock investment into a different investment such as the S&P 500, which is the example that we were using.

Section 1259 represents a fundamental movement in the tax law. It is certainly not, in my opinion, an inappropriate policy decision to make, but it should be recognized as a fundamental change from the realization concept that we have lived with for years and years. There had been some movement in this direction previously, for example, the mark-to-market for dealers.⁶ The difference is that dealers typically had to mark-to-market for accounting purposes anyway and are in a better position to do so. Section 1259 is very different.

Section 1259 provides that if you have an underlying position in stock, debt or a partnership interest that has appreciated in value, and you enter into certain types of financial contracts with respect to that stock or substantially identical stock, debt or a partnership interest, then you will be treated as if you had sold the underlying stock, debt or partnership interest.

Financial positions that trigger a constructive sale are (1) the short sale against the box that Hap just described, where you own the stock and do a short sale, and (2) a total return swap, which was the type of swap that Hap showed you, where you take the total return of your underlying shares and trade it into some other return, either the S&P 500 or maybe a debt return. In each case, you eliminate all of your downside risk and you provide all of the upside to the bank or investment bank. The constructive sale rules are also triggered by a short futures or a forward contract, where you set a price today and agree to sell your stock forward at that price in the future. Further, just to make sure that people do not reverse the transaction by entering into the swap first and then buying the asset, this reverse transaction is also covered by the legislation. Also serving as triggers for sale treatment are other transactions that (1) have substantially the same effect as those described above, and (2) are de-

⁶ I.R.C. § 475 (1998).

scribed in regulations, which under the legislative history are to be prospective. I would guess that, at least with respect to collars, the regulations will be prospective, except in cases of abuse. I assume that any regulations in this area will be prospective unless a transaction provides exactly the economics that one would have if you entered into a short against the box.

MS. POTTER: Let me quickly interject a few things that I think are worth noting. First of all, the base concept behind this legislation is that if a taxpayer has 100 shares of IBM and he goes out and sells those shares, even if he invests every penny from the sale, the taxpayer still owes tax on the gain he had in the IBM shares. Then, if instead of actually selling those shares, I go through a number of other steps by entering into these financial transactions,—engaging in a short sale against the box of my IBM shares, then borrowing the proceeds from my broker and investing in the S&P 500, how come I have gain in that context? There we have a problem of fairness between similarly situated taxpayers, and obviously the better informed, the better advised, the wealthier taxpayer can take advantage of this lack of similar treatment to obtain a tax advantage. That is my first point.

The other point worth noting here, and this is just an aside, is that there is another way to think about the problem. The real reason why short sale against the box transactions did not give rise to gain is because we have very odd accounting rules for figuring out what stock you sell and when engage in a sale transaction. We had a rule that said taxpayers can identify any shares they want as the shares they sold; for a short sale against the box, what the taxpayer would say is, “I sold the shares I borrowed. I did not sell the shares I owned.” Now, in the case of businesses that produce merchandise, for example, taxpayers cannot do that. They have to use inventory accounting methods which provide that if you make a sale of your inventory, your accounting method tells you the cost of what you sold. You do not have a choice. To a certain degree, you can look at the section 1259 legislation as imposing an accounting method for determining what securities the taxpayer sold.

MR. KLEINBARD: I really object to that not because what you say is untrue as a policy matter. It is clearly right as a policy matter and was developed by a learned academic article that so

argued.⁷ But in fact, the 1997 legislation wimped out. It did not accomplish the purpose of imposing an accounting inventory type law.

Just imagine that you have a barrel of oil and you put the oil in by the cupful and you sell it by the cupful and you have a rule that says I was putting in cups of oil now and selling them for years. Now I am going to dip into my barrel and ladle out a cup and sell it to a customer and say that is the cup I put in on June 12, 1983. I can recognize that. Of course you cannot recognize it. It is all bundled. It is all just oil in a barrel and yet with stock, we can do that. What Clarissa set up and then wimped out on in 1997 -

MS. POTTER: Me? I did not wimp out on anything.

MS. HARMON: I have to say, I heard her argue in favor of average basis many times. I do not think she wimped out.

MR. KLEINBARD: In fact, we have a sort of rule like that in the short against the box arena. But if you are just long a lot of stock, you own 1,000 shares of stock you bought at different points in time and then you sell 100 of those 1,000 shares, you get to say those 100 I sold, I can recognize them and that is just like that cup of oil from the barrel. Those are the shares I bought on June 12, 1983, not the shares I bought on August 15, 1996. So, we did not in fact accomplish in the 1997 Act the very policy that you just laid out.

MS. POTTER: Well, I actually share the same view on the results of the 1997 Act, but an accounting-inventory type rule for securities was a proposal. The Administration proposed the imposition of a single set of rules to account for sales of stocks and securities. There were differences of opinion about what is the right accounting method, but unfortunately there were a lot of important people out there who were very hostile to this idea for obvious reasons.

MR. KLEINBARD: The President wanted NAFTA. He got NAFTA. He wanted this and he wanted that and we have gotten this.

MS. POTTER: Well, I think it is very hard for Congress to understand how this could be so important. At any rate, the aver-

⁷ Edward D. Kleinbard, *Risky and Riskless Positions in Securities*, 71 TAXES 783 (Dec. 1993).

age cost basis rule for securities was one of our proposals that was not enacted. Nonetheless, I think that accounting method is a way to think about what the constructive sale provision accomplishes. I am afraid that wimping out is not a fair way to put it, since I fought very long and hard for average costs basis for securities.

MS. HARMON: Except that obviously the constructive sale proposal covers transactions that would not be included in an average basis rule —

MS. POTTER: No, that is very definitely true.

MR. KLEINBARD: Right.

MS. POTTER: If the average cost basis proposal had been passed, probably the constructive sale provisions would not have applied to short-sale-against-the-box transactions. It already would have been covered by an accounting method. However, because the average cost basis proposal was not passed, the constructive sale provision applies to short sales against the box as well as a number of other transactions.

MS. HARMON: Other transactions that, as Clarissa pointed out earlier, provide very similar economics to the shareholder and the Government. I think that is the fundamental policy change that was made. The Government decided economics alone would control realization for these particular structures.

I am going to briefly give you the other rules on constructive sale. There is a 30 and 90 day rule⁸ which provides that where the investor enters into a hedge during the year, closes the hedge within the 30 days of the end of the year and stays unhedged for 60 days, the investor can wait until the subsequent year, or later years if it wants to stay unhedged, until it sells and the constructive sale rules will not impose a sale treatment on the initial hedge.

It is important to note that staying unhedged for 60 days does not mean simply avoiding a short against the box transaction or an equity swap. It means unhedged in the context of section 246(c),⁹ which is a looser standard; it means “diminishing the risk of loss.” So, during this period that the taxpayer must remain unhedged, the taxpayer cannot enter into put options or

⁸ I.R.C. §§ 1259(c)(3); 246(c)(4) (1998).

⁹ I.R.C. §§ 246(c)(4) (1998).

collar transactions, which we will talk about in a minute.

There are other types of hedges. (I am using the word hedge rather loosely. I know sometimes that drives Clarissa crazy, but I would like to say that a taxpayer is hedging against the risk of loss.) The taxpayer may be totally eliminating the risk of loss, which is what the Government did not like, or the taxpayer may be just mitigating the market risk. The taxpayer may want to keep some of the upside or downside in the underlying stock. When Treasury initially proposed constructive sale legislation, it was written in those terms: In order to trigger sale treatment, a taxpayer must substantially eliminate the upside and the downside in the underlying asset.

The legislative language became more specific on the Hill, but the legislative history—and I believe both the legislative history in both the House and Senate—repeats Treasury's initial rule that a constructive sale is found only if a transaction eliminates substantially all of the upside and of the downside in the underlying asset.

So, what financial products can you enter into if you have an appreciated position and you do not want to be caught under the constructive sale regulations? You clearly can purchase an at-the-money put option and thus eliminate 100 percent of your downside risk without triggering a sale. You can write call options. You can enter into certain collars which are put-call option combinations that I will describe.

You may be able to offset your risk with a product based on an index like the S&P 500. If you have a portfolio of stocks, you could swap out that return on that portfolio and into the S&P 500. You might just lose your dividends received deduction,¹⁰ but you are not going to be within the constructive sale rule. It would certainly be only a partial hedge, not a complete and total hedge.

Or you might enter into a forward contract that has a variable delivery amount because the definition of forward contracts that trigger a constructive sale require a specific price and a specific amount of the underlying asset to be delivered. These forward contracts may be caught even if cash settled.

Let's talk about collars and what you can do. In a collar

¹⁰ I.R.C. § 243 (1998).

transaction, the shareholder of XYZ corporation will buy a put option from the bank and sell a call option to the bank. The shareholder is trying to reduce the downside risk, and in order to reduce the cost of buying that put option, it will sell a call option, giving some of the upside of the underlying position to the bank.

People were doing "costless" or "premium neutral" collars. They would try to price the transaction so that the put and call option premia would exactly offset each other, thus there would be no cost to entering into the transaction. We do not know exactly at what level a collar will work under the constructive sale legislation, although I assume we have regulations ready to go out the door that will tell us.

MS. POTTER: Well, actually I think that Mary brings up an important point about this legislation and a lot of other legislation that has to do with financial transactions. Congress tends to grant the Treasury Department and the Internal Revenue Service a great deal of authority to interpret the law and to provide additional rules to make the law work.

In this case, Congress recognized that it was just going to be too difficult, and it probably was not politically feasible, for them to say well, if you have a call option that allows somebody else to buy the stock for a particular price and a put option that allows you to sell it to somebody else for a particular price, how close can those prices be? If they are both right at the current market price, if the stock goes up, you do not get any benefit from the stock going up. If the stock goes down, you do not suffer any detriment. Obviously, that arrangement would be covered by this legislation, but what if there is \$5 difference? Or if there is a 10 percent difference? What difference between the two contracts does there have to be before you still have significant opportunity to gain on the stock you hold and significant risk of loss?

Congress concluded that this was a very difficult line for them to draw. As it turns out, it is a very difficult line for the Treasury and the IRS to draw, too. In addition, there are a lot of other questions that are going to be difficult to answer.

Given this special rule that Mary mentioned very briefly, the 30/90 day rule that allows an unwind of these hedge transactions without imposing the detriment of these rules, that is, without causing a gain recognition, the question is: How much need is

there for more specific rules? If many taxpayers can avoid the rules altogether by availing themselves of the unwind exception in the statute?

So, in addition to trying to write rules that support good tax policy and support the legislation and what Congress intended, we also have to be very careful about how our resources are spent there is a lot of different competing guidance that needs to be provided right now.

MS. HARMON: The collars are really different because I know that Congress was looking at them and was saying that the more volatile the stock, the more likely that you are either going to hit the put side or the call side of the collar. That is right, but you do not hit it on day one. Also, which side are you going to hit and when are you going to hit it? So, I would argue that unless it is really a very tight collar or unless you find someone who is such a good prophet regarding where stock prices would be at the time that the collar would pay off, constructive sale treatment should not be triggered. The collar value should be at least consistent with the rest of that legislation and not cause sale treatment until the taxpayer has actually eliminated its upside and downside potential.

I am going to just throw out another proposal because this is along my theme of the constructive sale rule being a fundamental change in the tax law. A change where the Government made a policy call that the economics to the taxpayer were the important determinative factor in whether to trigger gain or not, as opposed to having the trigger be whether the taxpayer continues to have the vote on the stock, continues to control the corporation, or continues to have other shareholder or equity-holder rights in the underlying equity.

There is a new proposal—it is just a member proposal right now on the Hill—called the constructive ownership proposal, and this proposal provides that in the situation where a taxpayer does not own an underlying asset, does not go out and buy the underlying asset but, instead, enters into a financial transaction to receive the economics of that asset, the Government wants to consider the taxpayer as owning the underlying asset. The Government's reasons for doing so is that if you buy a partnership interest, you are going to have flow-through of gains and income as it is earned in the partnership on your tax return. You will

also have the character of that gain and income flow through to your tax return.

If you enter into a swap or a collar on that partnership interest instead of buying the partnership interest, the rules for partnership flow-through do not apply to you. Because the Government saw deferrals and recharacterization possibilities in these structures, or at least because Congresswoman Kennelly saw these things, she has introduced the constructive ownership proposal which, generally, would treat the taxpayer as owning the underlying stock.

The proposal is pretty brief at this point and there are many, many questions raised by it. My guess would be that before it really goes forward, there would be a lot more thought put into it. I do not know if anything is happening or not.

MS. POTTER: I am not sure. Well, it is definitely something that people are concerned about. It is also of very great interest to Wall Street. I could tell you that right before—this was not a provision that came from Treasury, although Treasury is supportive of doing something about the issue—but right before the provision actually was introduced by Mrs. Kennelly, I probably got 10 to 15 calls a day asking me whether I was working on something.

MS. HARMON: You made some statement to the PLI in California, and I was not there. You have got to be careful what you say.

MR. KLEINBARD: I thought in the time we have left, I would do two things. First for the benefit of people who do not work in the area, I want to take two minutes to try to put some of the really useful points that Clarissa, Hap and Mary have made into a little bit of context so that the comments can be seen in a larger context. Second, if we have time, I want to talk a little bit about the evolution of capital markets transactions that try to accomplish in the capital markets, where there are public offerings of securities, the same kinds of results that Hap and Mary have described in a private contractual market.

It seems to me that in the area of financial products, you can divide up to 97 percent of all the questions that arise into two broad kind of themes. The first is the issue of whether the instrument has fixed economic returns or contingent economic returns? Certain returns or uncertain returns?

If an instrument has fixed returns, then you go and you get David Garlock's book¹¹ out of the library and you read about the original discount issue rules. It is all very complicated but it is most of the time, quite straightforward. It is when you have instruments that have uncertain returns that all of the controversy tends to come up. There are three, and arguably perhaps now four, basic themes relevant to what to do with financial instruments that have uncertain returns.

The traditional answer is to do nothing; wait and see. Buy an instrument and see what happens and pay your tax once you know for sure. A profoundly exotic example of that is a share of stock. You buy a share of stock. It goes up. You sell it. Then you have gain. Do not do anything until you sell it. So, wait and see is sort of the base case for what to do with uncertain cash flow.

The second approach is what I think of as the expectations theory, and I think Professor Reed Shuldiner has been the chief intellectual architect of this being an instrument of tax policy. The expectations theory says you may not know for sure what you are going to get when you buy an instrument with contingent flows, but you are buying it to get a positive return. Therefore, we can tax you on the basis of some assumed positive return from the instrument. At some point, somewhere down the line, we will have to catch up, we will have to reconcile the expectations with reality.

You see the expectation theory most comprehensively, and perhaps wrongly, developed in the contingent payment debt regulations, where it is used not only to construct the rule for timing—because these are principally timing issues—but also to mangle the character of gains that you realize.

So, wait and see is one timing rule and expectations theory is another. The contingent payment debt regulations of 1275-4¹² is the chief example of the actual application of the expectations theory to solve the timing question, and then, as I said (this is my modest view), to mangle the character of that gain as well.

The third approach is mark-to-market, which Clarissa talked about. I think Clarissa's remarks on mark-to-market were par-

¹¹ DAVID C. GARLOCK, *FEDERAL INCOME TAXATION OF DEBT INSTRUMENTS* (3d ed. 1997).

¹² Treas. Reg. 1.1275-4(b) (1998).

ticularly interesting because there is a tendency in academic circles to see mark-to-market as a panacea. If only the Government were bright enough to realize that mark-to-market is the answer, we could all get on and do something more interesting like law and anthropology or something like that.

In fact, mark-to-market turns out to be very difficult. There are a handful of people in this room who have actually tried to apply mark-to-market due to their business in the dealer community and in some aspects of the banking community and so on. It turns out that there are all sorts of good reasons, intellectual reasons, not simply that it is hard to value a particular instrument. There are also policy reasons why mark-to-market has a much more limited utility than one might at first expect. That is an area—the limitations on mark-to-market in the real world—that has not been adequately explored, it seems to me. In the real world where (in contrast to the academic world) pigs in general do not have wings, it turns out that mark-to-market is not always easily applied.

The fourth possible kind of rule to deal with the problems of fixed versus contingent flows—and I am not frankly quite sure whether this is a genuine category or just a subset of one of the others—might be viewed as the mimicry rules. What I am thinking of is the point that Mary has just gone through, the constructive sale rule on the one hand, and the constructive ownership rules on the other.

Let's take the constructive ownership side. We have a contingent contract that produces contingent flows. How will we figure out the timing of income from those flows? How will we figure out the character of gain or loss from those flows. Let's do it by analogizing the contract to the very underlying instrument it mimics. For example, this instrument mimics an investment in a partnership hedge fund. Well then, we will look to what it mimics to determine the tax consequences. So, there are four possible answers to timing, and to a lesser extent, to character issues, associated with uncertain cash flows.

The second issue that comes up and the second big theme that I just want to address—and I think this is a place where Clarissa should feel very proud of what she has accomplished and what Treasury has accomplished in the last five years—is when do you look at an instrument as separate, by itself, to figure out what

its tax consequences are? What cubbyhole do you stick it in? When do you look at it in context to determine its income, determine its timing, determine its character,—particularly its character?

So, I see the first issue—the first cluster of issues as primarily timing and to a lesser extent character. The second set of questions, the *contextual* use of an instrument, as raising character first and then to a lesser extent, timing.

There is a perfect example of this second theme in the regulations¹³ that the Treasury came up with on hedging of the ordinary gain or loss transactions or hedging liabilities. In those regulations, an instrument that would ordinarily give rise to capital gain or loss magically gives rise to ordinary income or losses if it is used in a particular context to hedge an ordinary income asset or to hedge an ordinary income liability.

So, the assets—the hedge, the vehicle itself—change their character depending on the context. Emphasis upon the context in which an instrument is used, rather than a single rule for an instrument at all times has been the great accomplishment of the Treasury in the last few years. It breaks down the cubbyholes and says that the tax analysis of the instrument changes depending on the context in which it is used. It is a very different way of looking at an instrument.

The section 1221 hedging rule¹⁴ is one example that worked very well. The straddle rules¹⁵ are an example of the same kind of principle done in a way that works very badly. They work very badly because they are, in fact, the prime example of the heads, Treasury wins, tails, taxpayer loses result, and they are deliberately designed that way. It was not, “Oops, gee, look at that. We ended up screwing taxpayers.” It was deliberately designed to accomplish that result in 1981.

MS. HARMON: Although they were looking at probably worse transactions —

MR. KLEINBARD: Yes, absolutely.

MS. HARMON: —than the rules now apply to.

MR. KLEINBARD: No, you know the entire self-assessment system was at stake. I absolutely agree with that. I think it is a

¹³ Treas. Reg. 1.1221-2 (1994).

¹⁴ *Id.*

¹⁵ I.R.C. § 1092 (1983).

wonderful accomplishment that now Treasury is actually considering a proposed legislation to make those rules fairer, to make them work in the context in both directions, not simply to defer loss and not defer gain.

Finally, the best examples or the most powerful examples of contextual analysis are the rules that Treasury has developed to contemplate integrating different instruments. For example, assume that the taxpayer issues a Malaysian Ringgit indexed bond. Let me say first that anytime you see a U.S. corporation issuing a financial instrument in public capital markets, a debt instrument, that is extremely weird looking, what is going on almost invariably is that the issuer has no interest in that particular bizarre financial bet that is embedded in that contract. Rather, what they have is an investment banker who wants to buy that bet from them at an attractive price and so they issue Malaysian Ringgit indexed bonds and then they swap out all the Malaysian Ringgit risk and swap themselves into a single dollar instrument. In the old days, you would say, well what is the taxation of Malaysian Ringgit index bonds or what is the taxation of the swap? Do those two rules ever speak to each other? Of course not. You end up with bizarre results of one kind or another.

Now we look at them and say hey, you swapped into a U.S. dollar obligation. Let's forget all the stuff about the separate cubbyholes of the instrument. Let's not even talk about the context. Let's just treat them as they are. They are stapled economically. Let's staple them for tax purposes and treat this as a dollar borrowing by the issuer.

So, what we have seen in the last few years through the initiatives of the leadership in Treasury is a real breaking down of the separate cubbyholes in which financial instruments are placed, and the much more sophisticated notion of looking instead at the context in which they arise.

MS. POTTER: I think Ed, something that you just pointed out which is a really interesting observation especially in the current environment, are the places where we have tended to be successful at least by your judgment, have involved —

MR. KLEINBARD: Often wrong but never in doubt.

MS. POTTER: Have tended to involve transactions that give rise solely to ordinary income or deduction. So, when we talk

about the hedging transactions, those are transactions that are conducted by businesses in connection with transactions from which they would only get ordinary income, ordinary deduction.

We tend to be much less successful, as shown by the straddle rules and also by Ed's criticism of our contingent debt rules, when you have got contracts and transactions that can give rise either only to capital gains and losses or to both capital gains and losses and ordinary gains and losses.

The reason for this is that it is just incredibly difficult to accommodate both, especially in transactions where you can move capital loss into the ordinary deduction basket or ordinary income into the capital gain basket. We continue to have a tremendous struggle on that front which, unfortunately, has been recently made significantly worse. I am afraid that the prospect of getting the kind of good results, in context as Ed put it, I think quite appropriately, for things that give rise to both capital income and deduction, and ordinary income and deduction is—I am not sure that the prospect of that is real favorable, unfortunately.

MR. KLEINBARD: In the 3 or 4 minutes I have left, I will return to the prepared text having delivered this little homily. To the extent anybody in fact, which would surprise me, was interested in the prepared part of the remarks, they are based on a paper that appeared in Louis Freeman's twelve volume annual PLI extravaganza, in a little piece called, *Everything I Know About New Financial Products I Learned From DECS*.¹⁶

What we are going to talk about here is, I just think it is interesting to see how similar economic ideas can be translated into different marketplaces. Mary talked about the costless collar as a way of reducing risk in respect of appreciated position that a taxpayer owns and then if need be, monetizing that to a borrowing.

One of the problems with costless collars or with shorts against the box, back when you could do them, is that they are limited in size by the existing market place, the existing liquidity in the market place for the stocks in question. This is because

¹⁶ Edward D. Kleinbard & Erika W. Nijenhuis, *Everything I Know About New Financial Products I Learned From DECS*, in *Tax Strategies for Corporate Acquisitions, Dispositions, Spin-Offs, Joint Ventures, Financings, Reorganizations and Restructurings 1997*, at 461 (PLI Tax L. & Est. Planning Handbook Series No. 412, 1997).

the other side to the transaction is typically a dealer, and dealers are not in fact interested in making the equal and opposite bet to the bet that you want to make. Dealers are interested in making a dealer spread and they do that by hedging the risk that they are taking by writing a contract with you. So, they need to have some way of hedging.

For that and for some other reasons, people ask the question, can we do costless collars not by writing a contract with the dealer who then has to go out and hedge and, in fact, entering the cost of hedging into the price that the dealer offers you, but rather by going directly to the capital markets, the public markets for stocks and bonds. That is what the original exchangeable DECS product was all about. That is exactly the same idea translated into the capital markets, and the basic context in which the idea originally developed was that there were lots of corporations out there with strategic investments that they had made. They owned 18 percent of some other public company and then they decided that was a really stupid strategic investment or that it was the prior CEO's strategic investment, and so they wanted to get rid of it, but they wanted to get rid of it in some way that would maximize their return and not make them look too stupid if they sold too quickly.

So what they basically came up with was a public costless collar transaction. The first one was called DECS. I do not even think that the investment banker who did that remembers what DECS stands for, but I think it is debt exchangeable for common stock, and the basic idea was a contract sold in the public markets, called a note for SEC purposes. You know at the top it says note, and promises to give to the investor for every \$50— we are going to assume that share of stock today is worth \$50 —to give to the investor at the end of 3 years, one share of stock if the stock price was at \$50 or below, to give them \$50 worth of stock between \$50 and \$60 in value, and give them 5/6ths of a share of stock for value above \$60 a share.

If you think about that for a moment, what that means from the point of view of the seller of this security is that it has written in effect a costless collar in one sense. It has bought a put to the public—put to the investors at \$50, and it has written a call at \$60, on 5/6ths of a share so that the issuer— maybe this dia-

gram helps here.¹⁷ I only have two accomplishments in my life. One was that I coined the term cubbyhole for financial instruments and the other was describing this curve as a kinky forward contract and it has been the only way I have gotten people interested in working in tax law at my firm – by telling them that they can work on kinky forward contracts.

The payoff return is in fact exactly the same as the return that you would see if you would map out your—if you take this, this is the investor return. If you do the flip side, the issuer who owns the underlying stock and has written the contract to sell the underlying stock, his return would be in effect to mirror this, he would have—he would be flat \$50 for the first piece. He would then make all the profits from \$50 to \$60 and 1/6th of the profit above \$60 in this example.

At the end of 3 years the investor gets between 5/6ths of a share and 1 share depending on where you are on the curve, or the issuer gives cash instead and just keeps the stock. He changes his mind and then the third CEO comes along and says that was a good strategic investment after all.

The instrument essentially, as I said, replicates a collar and a borrowing, but the instrument itself is different and its tax characteristics have to be described. It pays interest every period. It pays off at maturity a value—a share of stock or cash for the value between zero and infinity. So, I will end with these questions and stop here. It raises the very question that we have been talking about all along. It raises the question first, what—and unfortunately I kind of slanted the answer in how I phrased this here.

MS. POTTER: What a surprise.

MR. KLEINBARD: It raises the question: What is the nature of this instrument in the first place? What cubbyhole does not it belong to because we have not completely abolished all cubbyholes? Is this instrument a contingent bond in which case one set of rules apply or is it something new and different? The conclusion we came to—and yelled at everybody until they decided it was easier to agree than to keep persisting—is that it is something new and different. In fact it is a publicly offered collateral-

¹⁷ See Edward D. Kleinbard, Exchangeable DECS - Payout Schedule, appended herein as Appendix I, at 34.

ized forward contract, so that for the first time, they saw a public market in collateralized forward contracts. Collateral makes a lot of sense here since the issuer does not know who is going to buy these contracts at maturity and, therefore, we created a new cubbyhole which is —you know, when you do not like the results of existing cubbyholes —

MS. HARMON: That Clarissa agreed with or no?

MR. KLEINBARD: Absolutely. The second question is whether issuing the contract creates a constructive sale and that is a question that Mary just talked about. It is the same question here as in the private contracts.

The third question is well, if this in fact is not a contingent debt instrument, what do you do with all that interest that is paid every period? The answer is that it still is interest. Then people say, “Oh, but you said it is two instruments and it is really only one instrument.” This becomes very metaphysical. This is sort of like the scholasticism of the 13th century or something, and the answer is no. You can have one overall contract in respect of which they could deposit some cash on which interest is paid.

Hap gave you that example earlier. That is where the short sale is. You do a short sale. As he says, you can make and lose a lot of money but you have got cash in our short sale. Your broker pays you interest on that. The fact that you are getting interest on the cash in the short sale does not mean it is not a short sale. It means it is a short sale on which you happen to be getting some interest on your cash that is kept at your broker.

Finally, we have the dreaded straddle issue. So the DECS instrument, and then there are a series of fun permutations of this in more recent years that the article that I referred to goes through, the DECS instrument tees up in the public markets with exactly the same issues as we talked about in the beginning with respect to the private market.

APPENDIX I

EXCHANGEABLE DECS - PAYOUT SCHEDULE

EDWARD D. KLEINBARD

