

# The Role of Mark-to-Market Accounting in a Realization-Based Tax System

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## I. INTRODUCTION

### A. Overview

Tax analysts often observe that our realization-based tax system is the root of many tax evils, from administrative complexity to the understatement of income.<sup>1</sup> In the view of these analysts, tax policy and tax administration would be substantially enhanced were our tax laws to impose tax on a taxpayer's net accretion to wealth each year, regardless of whether that accretion was "realized" in the technical tax sense.<sup>2</sup> Phrased in the

<sup>1</sup> Professor William Andrews has characterized the realization doctrine as the "Achilles' Heel" of the income tax. Andrews, "The Achilles' Heel of the Comprehensive Income Tax," printed in *NEW DIRECTIONS IN FEDERAL INCOME TAX POLICY FOR THE 1980's* at 278 (Bloomfield & Walker, eds., 1983). The realization doctrine possesses two primary defects: (i) it presents opportunities for deferral of tax on gain; and (ii) it allows for the recognition of artificial losses. The doctrine presents opportunities for deferral of tax in that taxpayers are allowed to delay the payment of taxes on gains until those gains are realized. This deferral of tax reduces the effective rate of tax that is imposed on the gain, which causes the tax system to operate in an inherently non-neutral and arguably unfair manner. See Shuldiner, "A General Approach to the Taxation of Financial Instruments," 71 *Tex. L. Rev.* 243, 246 (1992) (stating that both equity and efficiency norms are violated by the reduction of effective tax rates caused by deferral). Assets which produce deferred income are taxed at a lower rate than assets which produce income which is currently recognized. For general recognition of the value of deferring tax, see, e.g., Andrews, "A Consumption-Type or Cash Flow Personal Income Tax," 87 *Harv. L. Rev.* 1113, 1123-24 (1974); Johnson, "Soft Money Investing Under the Income Tax," 1989 *U. Ill. L. Rev.* 1019, 1021; Cunningham & Schenk, "How to Tax the House that Jack Built," 43 *Tax L. Rev.* 447, 451-56 (1988) (deferral of imputed income). Under another view of deferral, developed by economist E. Cary Brown, deferral of gain under the realization doctrine may, under certain circumstances, be equivalent to exempting from tax the additional earnings which subsequently accrue on this deferred gain. For an illustration of this point, see Hanna, "The Vir-

tual Reality of Eliminating Tax Deferral," 12 *The Amer. J. of Tax. Pol.* 449, 459 (1995).

The second problem with the doctrine is that it provides taxpayers with opportunities to recognize artificial losses, i.e., losses that exceed the economic losses actually incurred. This may be achieved by choosing to realize losses on depreciated property, while simultaneously delaying realization of gains on property which has appreciated. This is a form of tax arbitrage which may very well create negative rates of tax on a person's income. Several provisions of the Code, such as the capital loss limitations, restrictions on deducting investment interest expense, wash sale rules, straddle rules, and rules on related party sales have been enacted in an explicit attempt to prevent people from engaging in tax arbitrage through the realization doctrine. For recognition that these provisions are necessitated by the realization doctrine, see Graetz & Schenk, *FEDERAL INCOME TAXATION* at 390-392, 576 (3d ed. 1995); Scarborough, "Risk, Diversification and the Design of Loss Limitations under a Realization-Based Income Tax," 48 *Tax L. Rev.* 677, 680, note 12 (1993) (capital loss limitations); Shuldiner, 71 *Tex. L. Rev.* at 273-276; Evans, "The Realization Doctrine After Cottage Savings," 70 *TAXES* 897, 898 (Dec., 1992).

<sup>2</sup> Such a tax on accretion (a mark-to-market approach) is generally viewed as the most theoretically desirable of all the various systems of taxing income, since only mark-to-market will consistently measure and levy tax on a person's "economic income" or Haig-Simons income. Brown & Bulow, "The Definition of Taxable Business Income," in *COMPREHENSIVE INCOME TAXATION* at 241, 242-243 (Pechman ed. 1977); Halperin, "Interest in Disguise: Taxing the Time Value of Money," 95 *Yale L.J.* 506, 508-09 (1986);

Fellows, "A Comprehensive Attack on Tax Deferral," 88 *Mich. L. Rev.* 722, 723 (1990). In the literature dealing with the taxation of financial products, in particular, commentators almost invariably acknowledge mark-to-market's theoretical superiority, while at the same time noting the inevitable problems that result when the tax system fails to require the use of mark-to-market in practice. See, e.g., Warren, "Financial Contract Innovation and Income Tax Policy," 107 *Harv. L. Rev.* 460 (1993) (considering a number of proposals to tax financial instruments, the most theoretically optimal of which is mark-to-market); New York State Bar Association, Tax Section, Committee on Financial Instruments, Report on Tax Accounting for Notional Principal Contracts (Sept. 28, 1989) reprinted in 36 *Highlights and Documents* 785, 786 (Oct. 20, 1989); Shuldiner, "Consistency and the Taxation of Financial Products," 70 *TAXES* 781 (Dec., 1992) (stating that "once one forsakes mark-to-market taxation, it becomes extremely difficult to evaluate alternative principles of taxation"); Schenk, "Taxation of Equity Derivatives: A Partial Integration Proposal," 50 *Tax L. Rev.* 571, 573 (1995) (noting that the global approach that has the most appeal for taxing income is universal mark-to-market accounting); Cunningham & Schenk, "Taxation Without Realization: A 'Revolutionary' Approach to Ownership," 47 *Tax L. Rev.* 725, 733-34 (1992); Evans, "Clear Reflection of Income: Using Financial Product Principles in Other Areas of the Tax Law," 73 *TAXES* 659, 664 (Dec., 1995); Scarborough, "Different Rules for Different Players and Products: The Patchwork Taxation of Derivatives," 72 *TAXES* 1031, 1049 (Dec., 1994) (stating that no reform short of mandatory mark-to-market accounting would eliminate all inconsistencies in the taxation of deriva-

more pragmatic alternative, many tax legislative proposals are judged by whether they move our measurement of annual income closer to this (admittedly unattainable) ideal.<sup>3</sup>

This ideal state—sometimes confusingly referred to as an “accrual” model of taxation<sup>4</sup>—is most commonly described by practitioners as a “mark-to-market” accounting system. In the more limited sense in which the concept in fact has been adopted by the Internal Revenue Code (the “Code”), marking to market today connotes a system in which a taxpayer’s core business assets—inventories and other stock in trade, for example—are treated as if sold on the last day of the taxpayer’s taxable year for their market value (and immediately repurchased at that same price).<sup>5</sup> To date, mark-to-market accounting as actually applied by the Code does not extend to marking to market value a taxpayer’s goodwill, fixed assets used in its trade or business, or liabilities.

This article considers the consequences that follow when tax theorists get half their wish—mark-to-market regimes for some (but not all) taxpayers, in respect of some (but not all) of the factors relevant to the production of such taxpayers’ income. This topic has become more urgent with the passage of the Taxpayer Relief Act of 1997 (the “1997 Act”),<sup>6</sup> which extends mark-to-market tax accounting to several new classes of taxpayers. Following the passage of this Act, mark-to-market can

now apply (at a minimum) to securities dealers (in turn broadly defined to include many non-traditional securities businesses, such as originating and selling loans), securities traders, commodities dealers, commodities traders, some segments of the life insurance business, and investors in regulated futures contracts and other specified financial instruments.<sup>7</sup>

This article attempts to examine the practical policy issues raised by mark-to-market tax accounting in the world we actually occupy. In contrast to much of the academic analysis in this area, we therefore do not contemplate tax regimes in which holders and issuers of instruments are taxed symmetrically,<sup>8</sup> or liabilities are marked to market,<sup>9</sup> although we respect the value of such work in developing tax theory and policy.<sup>10</sup> From the other direction, we have not attempted to produce a comprehensive operator’s manual to Code Sec. 475—a job that, in any event, has already been performed admirably by others.<sup>11</sup>

## B. Summary of Major Points Made in this Article

The differences between mark-to-market accounting and traditional methods of measuring annual income inevitably lead to important conflicts. Those conflicts in turn can be resolved only by developing a coherent view of the purposes served by mark-to-market accounting,

(Footnote Continued)

tives). For a contrasting view, see Strnad, “Taxing New Financial Products: A Conceptual Framework,” 46 *Stan. L. Rev.* 569, 574, 604 (1994) (noting that “global pattern taxation,” i.e., the most optimal approach which achieves consistent and universal results, can be achieved not only by mark-to-market (accretion tax) but by other alternatives including but not limited to a cash flow consumption tax); Kleinbard, “Beyond Good and Evil Debt (and Debt Hedges): A Cost of Capital Allowance System,” 67 *TAXES* 943, 955-56 (Dec., 1989) (rejecting a mark-to-market approach for debt because such a system fails to address problems in valuing liabilities, creates countercyclical effects in the economy, and fails to address the tension in the law between debt and equity); Zolt, “The Uneasy Case for Uniform Taxation,” 16 *Va. Tax Rev.* 39, 42 (1996) (suggesting that optimal taxation, which departs from a uniform mark-to-market system, might be more economically efficient).

<sup>3</sup> Robert Haig and Henry Simons each realized that it was impossible, as a practical matter, to implement a comprehensive tax system which taxed persons on unrealized gains. Haig, “The Concept of Income—Economic and Legal Aspects,” *THE FEDERAL INCOME TAX* (1921) reprinted in *READINGS IN THE ECONOMICS OF TAXATION* at 68-69 (1959); Simons, *PERSONAL INCOME TAXATION* at 103 (1938). Professor David Shakow, in his seminal article on the subject, dealt at length with practical problems in implementing mark-to-market in an administrable fashion, including the necessity to exclude some activities from mark-to-market accounting.

Shakow, “Taxation Without Realization: A Proposal for Accrual Taxation,” 134 *Penn. L. Rev.* 1111, 1118-20 (1986). For a more recent proposal to apply mark-to-market accounting to publicly traded stock, as part of a corporate integration regime where the corporate tax would be eliminated or drastically reduced, see Dodge, “A Combined Mark-to-Market and Pass-Through Corporate-Shareholder Integration Proposal,” 50 *Tax L. Rev.* 265, 309-311 (1994).

<sup>4</sup> For the use of the term “accrual” in this context, see, e.g., Shakow, note 3, *supra*.

<sup>5</sup> In order to coordinate a mark-to-market system with existing rules for the inclusion of income and loss from the sale of inventoriable goods, the mark-to-market process usually is phrased as a technical matter as (i) valuing inventories at market, and (ii) treating non-inventoriable goods as if sold on the last day of the taxpayer’s taxable year for fair market value. See, e.g., Code Secs. 475(a)(1), (a)(2).

Unless otherwise noted, all statutory references herein are to the Internal Revenue Code of 1986 (the “Code”) or to the Treasury regulations promulgated thereunder.

<sup>6</sup> Taxpayer Relief Act of 1997, P.L. 105-34, 105th Cong., 1st Sess.

<sup>7</sup> Code Sec. 475 (for dealers and traders in securities and commodities); Code Secs. 817 and 817A (for certain life insurance contracts); Code Sec. 1256 (for regulated futures contracts and other specified financial instruments).

<sup>8</sup> Bradford, “Fixing Realization Accounting: Symmetry, Consistency and Correctness in the Taxation of Financial Instruments,” 50 *Tax L. Rev.* 731 (1995).

<sup>9</sup> Bradford, *UNTANGLING THE INCOME TAX* at 38-46 (1986) (adjusting interest expense for inflation).

<sup>10</sup> See Gergen, “Apocalypse Not?” 50 *Tax L. Rev.* 833, 834-40 (1995). Professor Gergen critiques these theoretical approaches, which frequently predict dire consequences for the income tax resulting from inaccuracies in income measurement, on the grounds that such approaches fail to take into account real world factors such as transaction costs, legal risks, and credit risk. For another approach to the intractable problems of income mismeasurement, especially in the context of financial products, see Kleinbard, “Equity Derivative Products: Financial Innovation’s Newest Challenge to the Tax System,” 69 *Tex. L. Rev.* 1319 (1991) (recommending, *inter alia*, broad delegation of authority by Congress to the Treasury Department to address all tax aspects of financial products); cf., Gergen, *supra*, at 856-59 (proposing an expanded role for the Treasury Department in this area through increased use of rulings).

<sup>11</sup> See, e.g., Caginalp et al., “Section 475 After the 1997 Act and Final(?) Regs—The Makeover Continues,” 76 *Tax Notes* 1071, 1092 (Aug. 25, 1997); Levy et al., “Mark-to-Market Final Regs. Contain Significant Changes and Gaps Requiring Further Guidance,” 11 *J. Bank Tax’n* 14 (Fall 1997); Rosenthal & Rainey, “Final Mark-to-Market Regulations Offer More Guidance and More Choices,” 86 *J. Tax’n* 158 (Mar., 1997); Scarborough, “How To Sort Out Tax Rules for Related Party Hedging” 2 *Derivatives* 279 (July/Aug., 1997); Shepard, “Who’s Marking What to Market?” 76 *Tax Notes* 12 (July 7, 1997).

and then by measuring the respective claims of the conflicting models against that benchmark.

A major thesis of this article is that realization-based tax accounting models, which attempt (in their most sophisticated forms) to approximate mark-to-market results through the use of capitalization systems and other anti-deferral regimes, are useful (and more palatable) surrogates for mark-to-market in most cases, but fall down when applied to businesses where one cannot identify with any reasonable precision the future income (or loss) item to which the current period items of loss (or income) relate.

The compelling examples of such businesses are securities and commodities dealers, because those taxpayers operate as hedged businesses.<sup>12</sup> (Indeed, as discussed in Part II of this article, the use of mark-to-market in the tax system originated in response to pleas from dealers in the 1920s to be *allowed* to use mark-to-market in their hedged businesses.) Taxing income from a hedged business under a realization model inevitably produces whipsaws and distortions resulting from differences in the timing of income recognition for hedges themselves and the underlying property being hedged.<sup>13</sup> Deferral principles cannot deal with this problem, because those rules do not apply to aggregate hedges and similar risk reduction techniques that modern dealers frequently utilize in their business operations.

Thus, the presence of *hedged* activities is the most compelling reason to apply mark-to-market in today's tax laws. The usual justification of mark-to-market accounting based on the presence of liquid and easily-valued assets is inadequate. It fails to explain, for exam-

ple, the mandatory application of Code Sec. 475 to securities dealers but not to mutual funds—both of which usually hold liquid and easily-valued securities.<sup>14</sup>

A principal corollary that follows from this theme is that, when mark-to-market accounting is limited to its proper scope, taxpayers and the government have a common interest in implementing the method. Taxpayers that operate hedged businesses discover that they need mark-to-market accounting to tame the otherwise uncontrollable fluctuations in taxable income that flow from the application of unfettered realization principles to positions that economically hedge one another, but which may be realized, in the tax sense, in different periods. The government in turn desires mark-to-market accounting to prevent such taxpayers from selectively using realization principles whenever feasible to accelerate losses—particularly given the Code's early acknowledgment that deferral mechanisms (such as the wash sale rules of Code Sec. 1091) are inappropriate when applied to hedged businesses.<sup>15</sup>

The second major theme of this article is that mark-to-market accounting, while narrow in scope, must run deep in application: applying mark-to-market in a piecemeal and fragmented manner will frequently distort income measurement and produce a situation that is worse than the results under a realization-based model.<sup>16</sup> This is a classic example of the "second best problem," which constantly occurs when tax policy is implemented in an incremental and ad hoc manner.<sup>17</sup>

This article then draws several other conclusions that logically flow from the two principal themes stated above. One such conclusion is that the definition of

<sup>12</sup> Throughout this article, we use the term "hedge" colloquially, unless otherwise indicated by reference to the more technical use of that term under tax law.

<sup>13</sup> See Sections II.A and III.B.1, *infra*, for detailed discussion of this point. The rules governing hedges in Reg. § 1.446-4 do not function in an effective manner when applied to global hedges and other aggregate risk reduction techniques employed by large-scale securities dealers. Although the hedging rules apply to aggregate risk reduction techniques, they require, for example, that taxpayers match the timing of tax recognition events for hedges with the timing of such events for the underlying property being hedged. Reg. § 1.446-4(d)(1). It is impracticable to comply with such a requirement using a realization-based method of accounting in a dynamic environment involving billions of dollars of securities spread out over numerous profit centers in different parts of the world. The only administrable manner that such matching can be achieved is by mark-to-market accounting, for both the hedges and the underlying properties as well.

<sup>14</sup> As active traders, mutual funds presumably can elect mark-to-market treatment under new Code Sec. 475(f).

<sup>15</sup> See note 38, *infra*, and accompanying text for detailed discussion of this point.

<sup>16</sup> See Gergen, "The Effects of Price Volatility and Strategic Trading Under Realization, Expected Return and Retrospective Taxation," 49 *Tax L. Rev.*

209, 216 (1994) for the proposition that piecemeal application of mark-to-market can create discontinuities between the taxation of financial products, in turn producing turbulence in financial markets and dead-weight loss. For an interesting and persuasive discussion of specific second best problems involved in marking to market only hybrid securities (with a conclusion that mark-to-market accounting should not be applied to hybrid securities in such a piecemeal fashion), see Weisbach, "Tax Responses to Financial Contract Innovation," 50 *Tax L. Rev.* 491, 509-11 (1995).

<sup>17</sup> The General Theory of the Second Best deals with the fact that we live in a imperfect, "second best" world, and as a result, the effects of any particular proposal or program on the allocation of resources cannot be judged by evaluating the proposal in isolation. It may very well turn out that a proposal which, by itself, would appear to increase the efficiency of the allocation of resources ("allocative efficiency"), may, because of its interaction with other imperfect phenomena, produce inefficient results. Lipsey & Lancaster, "The General Theory of the Second Best," 24 *Rev. Econ. Stud.* 11 (1956).

Applied to our particular situation, this second best analysis suggests that requiring mark-to-market for some, but not all assets, may not achieve an overall improvement in allocative efficiency (or in other desirable outcomes) because the realization-based treatment of other assets

may interact with mark-to-market treatment to produce even more distorted results than what occurred before mark-to-market was adopted. It is now commonplace in tax scholarship to acknowledge this problem and the difficulties it presents in analyzing tax proposals.

For thoughtful consideration of second best problems in evaluating a capital gains preference, see Cunningham & Schenk, "The Case for a Capital Gains Preference," 48 *Tax L. Rev.* 319 (1993). For general recognition of second best problems in formulating tax policy, see Shavito, "Selective Limitations on Tax Benefits," 56 *U. Chi. L. Rev.* 1189, 1218-20 (1989); Mundstock, "Taxation of Business Intangible Capital," 135 *U. Pa. L. Rev.* 1179, 1183, note 14 (1987); Scarborough, "Different Rules for Different Players and Products: The Patchwork Taxation of Derivatives," 72 *TAXES* 1031, 1047-49 (Dec., 1994) (discussing specific second best problems that would result from applying mark-to-market and "expected value" taxation proposals to financial derivatives but not to other financial instruments). For analysis of the type of approach necessary to take second best problems into account when formulating legal rules, see Markovits, "A Basic Structure for Microeconomic Policy Analysis in our Worse-Than-Second-Best World: A Proposal and Related Critique of the Chicago Approach to the Study of Law and Economics," 1975 *Wis. L. Rev.* 950, 968-69.

dealer in Code Sec. 475 is overbroad and should be narrowed to apply to dealers as the term has been commonly understood, *i.e.*, those who both buy and sell property to customers in the ordinary course of business and who typically hedge their activities in an extensive manner. In this regard, the application of Code Sec. 475 should be mandatory to commodities dealers, not elective as it is under present law.

The importance of applying mark-to-market comprehensively leads us to observe that the failure of the system to mark the liabilities of a taxpayer to market is a critical shortcoming of the present rules. Subjecting the assets of a taxpayer to mark-to-market, while not subjecting its liabilities, is a one-sided approach that is extremely vulnerable to distortions in income measurement—the very distortions that mark-to-market is meant to prevent. Fortuitously, this failure has had no material impact on the application of mark-to-market accounting to securities dealers (properly defined), because those taxpayers almost invariably finance their operations with short-term liabilities, which are not subject to significant fluctuations in value. This result would not, however, apply to the lending activities of commercial banks and other taxpayers with long-term liabilities, and hence mark-to-market cannot be successfully applied in those situations, absent some satisfactory resolution of the liabilities problem.<sup>18</sup>

A classic example of the dangers of piecemeal application of mark-to-market is the lower-of-cost-or-market method, which applies market valuation to items that have depreciated and cost valuation to items that have appreciated. As we discuss in the article, Congressional reaction to this overly generous method was one historical catalyst to the enactment of Code Sec. 475, and may have contributed to the overly broad definition of dealer in that statute. In any event, the lower-of-cost-or-market method should be repealed for all taxpayers. The method is a testimony to the dangers of the tax system adopting conservative financial accounting principles that are not consistent with sound tax policy.

The article also recommends that Code Sec. 1256 be repealed, on the grounds that it represents a non-uniform application of mark-to-market in an ad hoc manner.<sup>19</sup> On its face, Code Sec. 1256 falls outside of our construct of mark-to-market accounting as a special case of interperiod income matching when future items of income or loss cannot be identified with precision. At a more mundane level, we think it is indefensible that full-time traders who make their daily living on the floors of exchanges treat 60% of their day-to-day business profits as long-term capital gains. Short-term investors also inappropriately receive the benefits of long-term capital gains, under the arbitrary “60/40” rule in present Code Sec. 1256. This preference skews short-term investment decisions—encouraging investment in Standard & Poor’s 500 futures contracts, for example, at the expense of investment in equity index mutual funds. The solution is to repeal Code Sec. 1256, and to rely, in its place,

on the pure mark-to-market rules of Code Sec. 475 for taxpayers within its scope, and on the straddle rules that apply to other taxpayers under present law.

The article also deals with a number of narrower technical issues, and makes the following points.

- (i) The exclusion of residual interests in REMICs (a form of toxic tax waste) under Code Sec. 475 is justified, on the grounds that allowing taxpayers to mark residual interests to market would undermine an important policy objective of the REMIC rules, which is the taxation of phantom income.<sup>20</sup>
- (ii) We defend what others have criticized as the existence of de facto “bad debt reserves” under Code Sec. 475, on the grounds that proper valuation of securities is achieved under Code Sec. 475.<sup>21</sup> For securities dealers (properly defined) with physical inventories, credit adjustments generally should not be necessary, because the market value of those securities is discounted for the ongoing risk of default. In contrast, marking to market a swap dealer’s over-the-counter derivatives book has the effect of accelerating multi-period income into the year that a derivative contract is entered into, thus necessitating the use of adjustments properly to measure the dealer’s income.
- (iii) The intercompany rules of the consolidated return regulations invoke mark-to-market in an inappropriate fashion by applying a permanent mark-to-market taint to property that is transferred from a dealer to a non-dealer member of the same group, and by applying mark-to-market in an unnecessarily complex manner to dealers on their intercompany obligations with non-dealer members.<sup>22</sup>
- (iv) Proposed regulations coordinate the interaction of market discount on bonds with mark-to-market accounting by requiring that the rules for market discount be applied before bonds are marked to market. We argue that this system is unnecessary and unduly complex, and suggest instead that the separate treatment of market discount should recede in favor of a mark-to-market regime applicable to the entire bond.<sup>23</sup>
- (v) The difficulty in dealing with securities “traders” is that the term encompasses two fundamentally different types of investment strategies: trading based on directional views of asset prices on one hand, and relative-value trading that utilizes elaborate hedging methods on the other. For the latter group of traders (such as hedge funds), mark-to-market accounting is appropriate, since the presence of hedging creates the risk of distorted results under a realization system. In contrast, directional traders should not be subjected to mark-to-market ac-

<sup>18</sup> See Section III.B.2, *infra*, for detailed discussion of this point.

<sup>19</sup> See Section IV.D, *infra*, for detailed discussion of this point.

<sup>20</sup> See Section III.C.4, *infra*, for detailed discussion of this point.

<sup>21</sup> See Section III.E.1, *infra*, for detailed discussion of this point.

<sup>22</sup> See Section III.D.2, *infra*, for detailed discussion of this point.

<sup>23</sup> See Section III.E.2, *infra*, for detailed discussion of this point.

counting unless all publicly traded securities are marked to market, because this is essentially the type of activity engaged in by most investors.<sup>24</sup> Thus, the present system of allowing traders to elect mark-to-market is rational, in that it prevents potential distortions for hedge funds, while preserving realization-based tax accounting for generally unhedged traders. Finally, we believe that hedge funds and other traders adopting mark-to-market should probably be treated as recognizing short-term capital gain (as opposed to ordinary income) under Code Sec. 475 in order to avoid the potential whipsaw that might occur from incurring capital losses on other investment activities that are not subject to mark-to-market.<sup>25</sup>

The remainder of this article is organized as follows. Section C below concludes Part I by suggesting that alternative accounting methods, primarily capitalization rules, can approximate the same results as achieved by a mark-to-market system. Section C concludes, however, that these mark-to-market surrogates cannot be effectively employed by modern day securities and commodities dealers, thus dictating that such dealers adopt explicit mark-to-market conventions such as those found under Code Sec. 475. Part II reviews the history and current implementation of mark-to-market tax accounting, with a view to identifying the particular factors that were thought in each case to justify a departure from a realization-based model. Parts III and IV then analyze some of the major points of conflict between mark-to-market and realization tax models today, and attempts to develop principled resolutions of those conflicts.

### C. Actual and Surrogate Mark-to-Market Accounting

Every tax advisor (and most every taxpayer) understands, at least intuitively, the economic distortions

caused by the realization principles of the Code, whether those distortions are reflected in a decision to sell depreciated investment securities at year-end and hold appreciated positions until January, or in the tax return of a dance studio whose gross receipts are received in periods prior to incurring the related expenses.<sup>26</sup> The Code's three fundamental responses to such interperiod distortions have been (i) to do nothing, when the distortions run invariably in the government's favor;<sup>27</sup> (ii) to develop interperiod matching systems, usually when the distortions produce uncertain results or would otherwise accelerate deductions; and (iii) to develop asymmetrical pro-fisc rules in those cases where the taxpayer otherwise would have excessive freedom to apply realization principles selectively.<sup>28</sup>

In most cases, mark-to-market accounting as it is employed today—Code Sec. 1256 being the principal exception—falls into the second of these categories, as an interperiod income-matching strategy adopted by the Code to tax related components of an integrated activity in one time period, rather than in the different periods in which those components would be accorded tax significance under traditional realization principles. Mark-to-market accounting, however, is just one of several mechanisms employed by the Code to accomplish this result.<sup>29</sup>

By far the more common interperiod matching device employed by the Code is the mechanism of deferral. One good example of a deferral approach is the uniform capitalization rules of Code Sec. 263A, where interperiod matching results are simulated by capitalizing all costs associated with producing property and recovering those costs only when the property is sold. A key factor here is the capitalization of interest expense in a manner intentionally designed<sup>30</sup> to achieve the same results as if a return on equity (i.e., unrealized profit) had been imputed and currently taxed—exactly what a mark-to-market system accomplishes.<sup>31</sup> In effect, this is an example of “stealth” mark-to-market accounting commonly referred to as “expected value” taxation in the academic literature.<sup>32</sup> Similarly, Reg. § 1.446-4 effectively adopts

<sup>24</sup> With respect to publicly-traded securities, it would be difficult to justify marking to market the portfolio of a professional “directional” trader and not the portfolio of an investor. For a description of the distinction between traders and investors generally, see Part II, *infra*.

<sup>25</sup> See Section IV.C, *infra*, for detailed discussion of this point.

<sup>26</sup> *Schlude v. Com.*, 63-1 USTC ¶9284, 372 U.S. 128 (1963).

<sup>27</sup> Hence the absence of comprehensive timing rules for “prepaid” services income. But cf. Rev. Proc. 71-21, 1971-2 C.B. 549 (allowing one year deferral of prepaid income in certain situations). The hedge timing rules of Reg. § 1.446-4 stand out as a heroic exception to this general rule. For a contrasting view which argues, for example, that taxing prepaid income when received is not a distortion, see Johnson, “The Illegitimate ‘Earned’ Requirement in Tax and Non-Tax Accounting,” 50 *Tax L. Rev.* 373 (1995).

<sup>28</sup> Hence the existence of the asymmetrical wash sale rules of Code Sec. 1091,

which apply only to losses and not to gains.

<sup>29</sup> See, e.g., Shaviro, “Risk-Based Rules and the Taxation of Capital Income,” 50 *Tax L. Rev.* 643, 721 (1995) (summarizing the methods listed in the text as “indirect” ways to tax economic accrual, as opposed to the direct approach of mark-to-market accounting); Warren, note 2, *supra*, at 474 (listing five different approaches used in the taxation of financial products, only one of which is mark-to-market).

<sup>30</sup> Evans, “The Evolution of Federal Income Tax Accounting—A Growing Trend Towards Mark-to-Market?” 67 *TAXES* 824, 826, n. 24 (Dec., 1989) (quoting Treasury Department officials who were heavily involved in formulating these rules and who confirmed that a simulated mark-to-market result was intended).

<sup>31</sup> If all of a taxpayer's costs are capitalized and if unrealized profit is also added to income and capitalized as well, then a mark-to-market result has been attained. (Admittedly, this equivalence to mark-to-market would only be achieved for the

assets of the taxpayer, since the taxpayer's liabilities would remain subject to the realization doctrine.) The cost capitalization rules under Code Sec. 263A attempt to achieve this result by requiring capitalization of all costs, and by using the “avoided cost” method of capitalizing interest under Code Sec. 263A(f)(2)(A)(ii). This method stacks all debt first against a taxpayer's activities involving the production of property, thus typically resulting in 100% of those activities being viewed as financed with debt, which in turn attracts interest which is capitalized. Reg. § 1.263A-9. Of course, to the extent that the interest rate on the debt is less than the rate of profit on the production activities, the method will fall short and fail to achieve the same results as mark-to-market. For discussion of this shortcoming and other defects with these capitalization rules, see Evans, note 30, *supra*, at 830-33.

<sup>32</sup> Shuldiner, “A General Approach to the Taxation of Financial Instruments,” note 1, *supra*, at 246, 284-87; Warren, note 2, *supra*, at 478-79 (including expected

an analogous deferral approach for hedging transactions within its scope, by requiring taxpayers to adopt timing conventions for hedge gains and losses that correspond to the timing of income/loss realization in respect of the item being hedged.<sup>33</sup> Other deferral mechanisms are less sophisticated, but the overall theme is the same.

Another surrogate mark-to-market regime is "retrospective" taxation, in which gains are taxed when realized, but that tax is subject to an implicit interest charge to compensate the fisc for the multi-year deferral of realization of those gains.<sup>34</sup> An example of retrospective taxation in the Code today is the basic tax regime imposed on U.S. holders of stock in a "passive foreign investment company" (PFIC).<sup>35</sup> That regime imposes an incremental tax on gains from the disposition of such stock, calculated as if the taxpayer had earned its net gain *ratably* over the life of the investment.

This straight-line accrual rule probably is necessary as an administrative matter, but is a key weakness of retrospective taxation in practice. For example, if a taxpayer invested \$1 in a PFIC in 1987, and sells that investment for \$101 in 1997, the resulting \$100 gain will be treated as if earned at the rate of \$10 per year. If in fact the investment languished for 9 years, and achieved all of its appreciation in the tenth year, the PFIC regime's simplifying assumption will produce a very high effective rate of tax, which in theory can exceed 100%.<sup>36</sup>

Deferral schemes raise the effective tax rate applied to a transaction by the after-tax financing cost of the deferred expenses from the period they are incurred to the period they are recognized for tax purposes. Mark-to-market accounting, by contrast, *accelerates* future income (or loss) into the current period, with a resulting tax liability that is smaller than the result obtained by

deferral mechanisms to a degree that reflects the time value of money. When deferral mechanisms are implemented correctly, they have the *same* economic effect as mark-to-market—that is, the two approaches produce identical *present values* of tax liabilities.<sup>37</sup>

The Code generally applies deferral mechanisms to defer current period expenses to a future period in which the income attributable to those expenses is realized. Deferral regimes accordingly require a matching of current period income or loss recognition with the future transactions to which they relate. Such regimes thus only operate successfully where there is a one-to-one correspondence between discrete transactions. As this article demonstrates, however, when applied to large-scale securities or commodities dealers in particular, this matching is simply impossible to perform. A securities dealer today can have hundreds of billions of dollars of positions, and enter into thousands of trades every day, undertaken by different trading and hedging centers. Similarly, a dealer's hedges frequently relate to the aggregation of many different underlying positions, rather than to one identified position. In such circumstances, a cardinal virtue of a mark-to-market accounting regime is that it obviates the need to identify the particular *future* item of income or loss to which a current item relates.

The Code today recognizes the impossibility of linking a dealer's current and future trades on a one-to-one basis, and therefore exempts securities dealers, for example, from the wash sale and straddle rules.<sup>38</sup> (At the same time, very large-scale traders are fully subject to the straddle rules, thereby imposing on them an enormously (and unfavorably) distorted deferral regime.) Mark-to-market accounting thus is an advantage to dealers, hedged traders and to the fisc, because (for the reasons

(Footnote Continued)

value taxation as an example of a "formulaic" taxation of contingent returns); Scarborough, note 2, *supra*, at 1032 (proposing expected value taxation as one of three regimes to achieve more appropriate tax treatment of derivatives); Cunningham & Schenk, note 2, *supra*, at 733-37 (proposing a modified expected value system); Gergen, note 16, *supra*, at 217 (proposing an expected value system for assets which trade at prohibitive transaction costs, since such a system is vulnerable to strategic trading where assets may be traded at more moderate costs). For a general proposal to adopt an expected value system involving the imputation of interest in cases where assets were not susceptible to valuation, see Dodge, *THE LOGIC OF TAX 316* (1989). For a proposal to apply expected value taxation to the construction of property, involving an imputed return to equity, see Cunningham & Schenk, note 1, *supra*. Finally, for an alternative system, where imputed returns to equity as well as interest on debt would be deductible, thus achieving a form of corporate integration, see Kleinbard, note 2, *supra*, at 957-61.

<sup>33</sup> The timing rules for hedging transactions provide a general rule that a taxpayer's method of accounting for hedging transactions must clearly reflect income and, accordingly, must "reasonably match" the timing of income, deduction, gain or loss from a hedging transaction

with the timing of those items from the position being hedged. Reg. § 1.446-4(b).

The limited experience of taxpayers with Reg. § 1.446-4 already has raised difficult interpretational questions, including (i) problems in identifying the position being hedged versus the hedge itself, (ii) the timing asymmetry that occurs under the regulation because the regulation addresses only *hedge* timing (so that recognizing income on the item being hedged does not trigger loss in respect of the hedge, in the absence of an actual disposition of the hedge), and (iii) uncertainties as to the timing conventions that should be adopted in particular cases.

<sup>34</sup> For discussion of such a system, see Fellows, note 2, *supra*; Meade, *THE INSTITUTE FOR FISCAL STUDIES, THE STRUCTURE AND REFORM OF DIRECT TAXATION* at 132-35 (1978); Dodge, note 32, *supra* at 316-17. For criticism of such a system as creating the potential for tax-oriented trading strategies, see Auerbach, "Retrospective Capital Gains Taxation," 81 *Amer. Econ. Rev.* 167, 168 (1991). Professor Auerbach would remedy this problem of strategic trading by taxing all investments as if they earned a certain rate of return, and not allowing losses to be recognized if that rate of return was not achieved.

<sup>35</sup> See Code Sec. 1291(c).

<sup>36</sup> For other criticisms of the retrospective method, see Strnad, "Periodicity and Accretion Taxation: Norms and Implementation," 99 *Yale L.J.* 1817, 1864-65, 1893-99 (1990) (discussing the problems of such a system, which Professor Strnad terms an "exponential approximation," including the fact that asset values move in "jerky" ways); Evans, "The Taxation of Multi-Period Projects: An Analysis of Competing Models," 69 *Tex. L. Rev.* 1109, 1150-55 (1991) (discussing arbitrage behavior that may result from the use of such methods, which are inherently inaccurate).

<sup>37</sup> See, e.g., Gergen, note 16, *supra*, at 217, where he states, on the basis of an empirical study, that a retrospective return method may approximate results achieved under a mark-to-market regime for certain types of assets (assets trading at moderate transaction costs whose prices are not extremely volatile). For a comparable approach, see Halperin, note 2, *supra*, at 521-24, discussing equivalent results that are obtained by subjecting a transaction to different tax treatments, including the use of surrogate approaches such as substitute taxation (taxing another person in lieu of taxing the primary person accruing the economic income).

<sup>38</sup> Code Secs. 1091(a), 1092(e) and 1256(e).



developed above) surrogates for mark-to-market accounting expose both sides to complete uncertainty of application in practice.

This article seeks to demonstrate that mark-to-market accounting is on firmest policy ground when that acceleration is employed to achieve matching of related items of income and loss, just as in the deferral case. As noted earlier, properly-implemented mark-to-market accounting and properly-implemented deferral mechanisms produce economically equivalent tax liabilities.<sup>39</sup> The fundamental challenge, therefore, is to identify those cases where mark-to-market accounting is superior to a deferral system, presumably on administrative grounds—particularly in light of our collective habitual (if not strictly logical) tendencies to characterize mark-to-market accounting as a troubling exception to realization principles, while regarding methods that defer deductions as just good tax accounting.

## II. HISTORY OF MARK-TO-MARKET ACCOUNTING FOR TAX PURPOSES

Mark-to-market accounting has been used by taxpayers and the government to address similar problems arising in different circumstances. This Part II describes those problems and the use of mark-to-market accounting in the attempts to resolve them. Because the concerns driving mark-to-market accounting for dealers have been very different from the those driving mark-to-market accounting for traders and investors, the discussion that follows considers separately the development and use of this accounting method for each class of taxpayers.

This mode of organization presupposes that one can adequately distinguish, for example, a securities dealer from a securities trader. In fact, since its inception the tax law has required just such a distinction to be made, and, while the issue is regularly litigated, the basic legal standards are well established. Under case law, whether

a taxpayer is a dealer with respect to particular securities it owns generally depends upon the use of such securities by the taxpayer; the taxpayer's general status as a dealer in securities (e.g., by being registered as a broker/dealer) is not dispositive with respect to any particular securities. In other words, a registered dealer in securities can be deemed a dealer with respect to some securities it holds and an investor or trader with respect to others.<sup>40</sup>

The traditional touchstone for determining if a taxpayer is a dealer with respect to physical securities (i.e., stocks and bonds) is whether it holds such securities "primarily for sale to customers in the ordinary course of [its] trade or business." [Emphasis added.]<sup>41</sup> The analogy drawn in applying this test is that of a merchant or middleman that purchases its "stock in trade, in this case securities, with the expectation of re-selling at a profit, not because of a rise in value during the interval of time between purchase and resale [but rather from the mark-up in the selling price] . . . [t]his excess or mark-up represents remuneration for their labors as a middleman bringing together buyer and seller . . ."<sup>42</sup>

Traders and investors, by contrast, do not perform merchandising or market-making functions, because they lack customers.<sup>43</sup> For example, floor traders are members of securities or commodities exchanges that actually trade on the floor of such exchanges for their own account. When they do so, such traders are under no obligation to make or maintain markets for what they are trading; as such, they are treated as traders for tax purposes, regardless of the volume of their trading activity.<sup>44</sup> On the other hand, floor specialists also trade on the floor of a securities exchange for their own accounts, but because of their explicit obligation to provide liquidity in certain securities, they are treated as dealers for tax purposes.<sup>45</sup> Thus, despite what may be practical difficulties in determining whether a taxpayer is a dealer or trader in securities, conceptually that distinction has been made for tax purposes since the early days of the Code.

<sup>39</sup> Others believe that the administrative impracticality of mark-to-market, combined with the imperfect nature of other surrogate approaches, portends real crisis in the income tax system. For a discussion of these views and a response that the crisis is not as severe as portrayed, see Gergen, note 10, *supra*, at 833 (arguing that the presence of transaction costs and both credit and legal risks act in a prophylactic manner to reduce the extent of tax-oriented transactions which exploit inaccuracies in the tax system).

<sup>40</sup> *George R. Kemon, et al.*, CCH Dec. 18,271, 16 T.C. 1026 (1951) (taxpayer's firm was registered securities dealer, but court distinguished between securities it held for sale to customers, which were treated as ordinary assets, and those it held for investment or speculation, which were treated as capital assets).

<sup>41</sup> *Kemon*, 16 T.C. at 1032 (citing Code Sec. 117(a)(1) of the 1939 Code—the predecessor to Code Sec. 1221(1), which retains the quoted language).

Recent cases continue to apply the "customer" requirement. *E.g.*, *Stephen Marrin, et ux.*, CCH Dec. 51,826(M), 73 T.C.M. 1748 (1997); *Humes Houston Hart*, CCH Dec. 51,812(M), 73 T.C.M. 1684 (1997); *Lewis Fuhrer*, CCH Dec. 48,987(M), 65 T.C.M. 2420 (1993).

See Raby & Raby, "Ordinary Deductions, but Capital Losses for Securities Traders," 74 *Tax Notes* 611 (Feb. 3, 1997) (discussing recent cases and trader/dealer distinction).

<sup>42</sup> *Kemon*, 16 T.C. at 1032-33. Treasury regulations that previously permitted securities dealers to value their securities inventory at lower-of-cost-or-market incorporated this notion of merchandising securities as the hallmark of a securities dealer. Reg. § 1.471-5 (adopted in 1958) ("[A] dealer in securities is a merchant of securities . . . regularly engaged in the purchase of securities and their resale to customers; that is one who as a merchant buys securities and sells them to customers . . .").

<sup>43</sup> *Kemon*, 16 T.C. at 1026. As such, a trader is not compensated by a spread or mark-up in its securities bought and sold, nor does it receive commissions. See *Seeley v. Helvering*, 35-1 USTC ¶ 9362, 77 F.2d 323 (CA-2 1935).

<sup>44</sup> *Faroll v. Jarecki*, 56-1 USTC ¶ 9367, 231 F.2d 281 (CA-7), cert. denied, 352 U.S. 830 (1956). See also *Frank J. Laureys, Jr.*, CCH Dec. 45,446, 92 T.C. 101 (1989), acq. and nonacq. 1990-1 C.B. 1 (applying same test to options market makers); cases cited in note 41, *supra*.

For a comprehensive description of the tax treatment of the different participants in financial and commodities markets, see Kramer, FINANCIAL PRODUCTS: TAXATION, REGULATION, AND DESIGN § 8.1-8.3 (Revised ed., 1991).

<sup>45</sup> *Helvering v. Fried*, 36-2 USTC ¶ 9538, 299 U.S. 175 (1936); *Stokes v. Rothensies*, 45-2 USTC ¶ 9360, 61 F.Supp. 444 (ED Pa. 1945), *aff'd per curiam*, 46-1 USTC ¶ 9251, 154 F.2d 1022 (CA-3 1946); Rev. Rul. 71-30, 1971-1 C.B. 226; Rev. Rul. 60-321, 1960-2 C.B. 166.



## A. Mark-to-Market for Dealers

**1. The Early Commodities Dealer Rulings.** Mark-to-market tax accounting has been a feature of the income tax system since its earliest years. Moreover, while related to inventory valuation, mark-to-market accounting has always been understood as more than just an inventory valuation method.

The earliest Income Tax Acts did not address inventories at all, but the Revenue Act of 1918 added Code Sec. 203 to the tax law—the almost word-for-word lineal antecedent of current Code Sec. 471(a).<sup>46</sup> The earliest administrative practice apparently was to permit inventories to be valued only at cost, but when the first formal rules were adopted, inventories could be valued either at cost or at the lower-of-cost-or-market value.<sup>47</sup>

The use of an inventory valuation other than cost might have been thought to violate realization principles, but the Treasury regulation appears to have been only mildly controversial.<sup>48</sup> It did, however, raise at this early date the possibility that some but not all of a taxpayer's business results would be measured on an (asymmetrical) nonrealization model—a point whose implications, when understood a few years later, led to mark-to-market accounting.

Two of the very earliest administrative rulings addressing inventories related to the securities industry. The first simply confirmed that securities dealers, like other taxpayers, indeed could value their inventories at the lower-of-cost-or-market value, if they so elected.<sup>49</sup> The other ruling—which lies at the heart of much of the real impetus for mark-to-market accounting—concluded that a securities dealer's open short sales could not be valued at year-end under the dealer's inventory accounting methods, because an open short position was a contractual liability, not an asset. That ruling stated that:

The statute nowhere authorizes the inventorying of liabilities, and this is true even though the liability is one to return specific property in kind on demand. Such a liability is exceptional in character. However, the word "inventory" in its commonly accepted commercial usage, refers to the inventorying of assets only.<sup>50</sup>

Thus, from the income tax system's earliest days, securities dealers found themselves with different annual income-measurement concepts applying to different parts of what the dealers must have viewed as an integrated business: "longs," as inventory, could be valued

at the lower-of-cost-or-market, while "shorts" could only be valued at cost (*i.e.*, reflected only through traditional realization events). Of course, securities dealers at the time had no reason to complain,<sup>51</sup> but one core problem that led to mark-to-market accounting systems—Treasury's unwillingness to create consistent timing rules for the "long" and "short" sides of an integrated business—was already in place.

At around the same time as these securities rulings, cotton and wheat dealers sought administrative permission to adopt a more comprehensive mark-to-market tax accounting system for their operations. Although the regulatory basis for doing so is not clear, these commodities dealers apparently valued their physical ("spot") inventories at market, in part because they maintained that the complex nature of their business made it impossible to ascribe a "cost" to individual purchases, and in part because marking to market was the long-time industry practice.<sup>52</sup> The commodities dealers carefully hedged all their "long" positions with "short" futures and forward contracts; these hedges were necessary not only as a risk control matter but also to obtain bank financing for their highly leveraged businesses.<sup>53</sup>

The Service required the dealers to report their hedge contracts on a realization basis, thereby exposing the dealers to enormous and unpredictable fluctuations in their taxable income, because mark-to-market inventory gains would be offset economically, but not in a taxable income sense, by unrealized hedge losses. The dealers, who clearly viewed this problem as threatening their survival, first petitioned to include the unrealized gains and losses from their open futures contracts as adjustments to their mark-to-market inventory values.<sup>54</sup> This request was rejected, on the grounds that the futures contracts were separate from the dealer's purchases of "spot" commodities, and therefore could not figure into inventory valuations of those spot positions.<sup>55</sup>

The dealers then proposed simply to value their open contractual hedges at market—that is, to adopt a mark-to-market accounting method for their futures contracts used as hedges. The Committee on Appeals and Review set out the dealers' brief in its entirety in the Committee's memorandum resolving the issue. It is worth quoting from that brief, because it sets the stage for much of the discussion that follows:

In the keeping of books in the cotton business, it has been the custom, existing over a period of approximately 50 years, for the cotton merchant to take

<sup>46</sup> The early history of inventory methods is summarized in Schneider, *FEDERAL INCOME TAXATION OF INVENTORIES* § 7.01[2] (1997).

<sup>47</sup> Advisory Tax Board Recommendation 48, 1 C.B. 47 (1919) (describing prior practice and then-current regulations).

<sup>48</sup> *Cf.* Appeals and Review Memorandum 100, III-3 C.B. 66 (1920) (describing opinion of Attorney General on validity of these inventory methods).

<sup>49</sup> Office Decision 8, 1 C.B. 56 (1919). One wonders today whether the impetus for the ruling was the natural incredulity of the dealers that they had been handed so munificent a gift—one that would endure until 1993.

<sup>50</sup> Solicitor's Memorandum S-1179, 1 C.B. 60, 62 (1919). See also Mimeograph Letter (Mim.) 2703, 4 C.B. 52 (1921).

<sup>51</sup> So long as inventories were on lower-of-cost-or-market, a dealer that was both long and short on securities of similar tenor would in some cases obtain a tax windfall, and in no case suffer a tax detriment.

<sup>52</sup> "At the close of the year, either fiscal or calendar, the cotton merchant takes an inventory of the cotton on hand. This cotton consists of bales purchased from the first day of the season to the last and represents a wide difference in price paid. The universal practice has been to inventory at market, because that tells the real value of

his commodity; further, because the identity of the bale and the matter of cost cannot be determined, hence it is impossible to take it other than at the market price." Appeals and Review Memorandum 135, 4 C.B. 67, 69 (1921). See also Solicitor's Memorandum 5693, V-2 C.B. 20 (1926) (amending and clarifying A.R.M. 135 in this regard).

<sup>53</sup> Appeals and Review Memorandum 100, III-3 C.B. 66 (1920); A.R.M. 135.

<sup>54</sup> A.R.M. 100. Decades later this method was approved by one court. *Monfort of Colorado, Inc. v. Com.*, 77-2 USTC ¶ 9572, 561 F.2d 190 (CA-10 1977).

<sup>55</sup> A.R.M. 100.

into consideration at market his forward sales, purchases, and hedges, and if they show a profit, that is added to the season's business. If, on the other hand, they show a loss, it is deducted from the season's business. His real profit, or loss, is thereby determined for the year. This system of bookkeeping is the only accurate and correct system that has been devised that truly reflects the net profit or loss of any given year's business, either fiscal or calendar. It is the system in vogue, approved by auditors who certify to the correctness of his financial statements which are the basis of his credit, and is the system accepted by his bankers for all his financial transactions and the only system which would not be false and misleading.

There was no difficulty in the transaction of the cotton business or the determination of the gains, or losses, for the fiscal or calendar year of the respective cotton merchants until the passage of the income-tax law. It appears, however, that in the practical application of the tax and the provisions for its enforcement, that the cotton and grain business were not considered in the making of regulations that would tend to protect those businesses from the imposition of taxes on unearned profits.

\* \* \* \*

Conformable to the law as set forth in the above provisions, which are applicable to the question up for consideration, the cotton men ask that they be permitted to show in their balance sheet as reflecting their real losses or gains, such losses or gains as may be, in their open hedges, unfilled forward sales, or forward purchases, because unless they are included in such balance sheet their real profit is not truly reflected.

In the matter of hedges, . . . so far as transactions through the exchange are had, these transactions are made in the following manner: [Futures exchange variation margin system described.] So, in real practice, so far as hedges are concerned, the cotton merchant has in hand, if he has a profit in the transaction, his profit from day to day. On the other hand, if he loses in the transaction he actually pays the loss incurred from day to day.

The same is true relative to his forward sales, or forward purchases; that is, the amount of his loss is absolutely determined from day to day and the amount of his profit is determined from day to day, so that his loss or profit in those transactions is a loss or profit which is definitely ascertainable and determinable with mathematical precision and accuracy at the close of his fiscal or calendar year, or any day during the year.

It occurs to us that the question before the Committee for determination is simply a matter of accounting or bookkeeping, and the making of regulations as to the manner in which the cotton merchants are to keep their books so as to conform to the rule of the Department and to show their real profits or real losses in their fiscal or calendar year.<sup>56</sup>

The Committee on Appeals and Review agreed with the dealers' arguments, and therefore permitted the dealers to mark their open contractual hedges (but not their speculative positions) to market at year-end. The Committee also implicitly endorsed the dealers' use of market (rather than cost or lower-of-cost-or-market) accounting for their "spot" inventory.<sup>57</sup> The Committee's resolution of this issue (as well as the Committee's rejection of the related proposal to fold unrealized gains and losses from hedging contracts into the dealers' inventory costs) remain the view of the Service today.<sup>58</sup>

Mark-to-market tax accounting thus was born, not as an anti-abuse measure introduced by Treasury or Congress, but rather in response to a taxpayer initiative. The themes advanced by the cotton dealers—in particular, their emphasis on mark-to-market accounting for open contractual positions as a cure for the timing mismatches that otherwise would result from reporting the income of a hedged trading business on a nonrealization basis for inventory and a realization basis for everything else—remains one essential touchstone in identifying the proper scope of mark-to-market accounting today.

**2. Rise of Derivative Markets.** Little changed in the application of mark-to-market accounting principles to dealers in more than 6 decades from the resolution of the cotton dealers' issues to the mid-1980s. Securities dealers were permitted to use mark-to-market (in addition to cost or lower-of-cost-or-market) accounting for their inventories,<sup>59</sup> but in the absence of any compelling reason to do so, virtually all securities dealers continued to rely on lower-of-cost-or-market, which yielded results that were skewed in the dealers' favor.

This cozy arrangement fell apart in the mid-1980s; by the end of that decade, large securities dealers, like cotton dealers decades earlier, found themselves clamoring for a mark-to-market regime for at least part of their business.<sup>60</sup> The reason, of course, was the surge in the use of over-the-counter derivatives products, particularly swaps and other notional principal contracts.

Dealers in swaps and similar over-the-counter derivatives do not hold their derivatives positions primarily for resale; instead, they provide the same economic service (providing liquidity to the marketplace) by standing ready to enter into either side of a new contract with customers. As such, a dealer's swap book, while giving rise to ordinary income or loss, probably is not inventory in the classical sense.<sup>61</sup> If that hypothesis is

<sup>56</sup> A.R.M. 135, 4 C.B. at 69-71.

<sup>57</sup> A taxpayer's ability to use mark-to-market for *unhedged* commodities inventories was confirmed by Solicitor's Memorandum 5693, V-2 C.B. 20 (1926).

<sup>58</sup> Rev. Rul. 74-223, 1974-1 C.B. 23 (restating A.R.M. 135); Rev. Rul. 74-227, 1974-1 C.B. 119 (restating A.R.M. 100).

<sup>59</sup> Reg. § 1.471-5 (adopted under T.D. 6336, 1958-2 C.B. 176).

<sup>60</sup> See, e.g., Letter from C. Beerbower on behalf of nine interest rate cap dealers to K. Dolan, Associate Chief Counsel (Technical and International), Internal Revenue Service (Mar. 4, 1988), reprinted in 88 *Tax Notes Today* 69-29 (Mar. 28, 1988).

<sup>61</sup> Fundamentally, inventories are necessary for tax purposes "in every case in which the production, purchase, or sale of *merchandise* is an income-producing factor." [Emphasis added.] Reg. § 1.471-1. Furthermore, under those regulations, "inventory should include all finished or partly finished goods and, in the case of raw materials and supplies, only those

correct, then swap dealers probably cannot avail themselves of any inventory accounting method for swaps, and instead arguably could be compelled—in the absence of some statutory or regulatory permission to do otherwise—to rely on traditional realization principles in accounting for swaps gains and losses.

A dealer's swap book, like the cotton dealer's books decades earlier, is always hedged, at least with respect to first-order economic risks. These hedges in turn frequently include futures contracts and exchange-traded options. In the 1980s, most dealers reported their income from those contracts on a realization basis, just like their swaps,<sup>62</sup> but nonetheless found themselves with enormous and uncontrollable fluctuations in taxable income, because their swaps typically were multi-year contracts, while their exchange-traded hedge contracts had terms of only a few months. Although the cause of the problem (short-dated hedges versus long-dated customer positions) was different from the original cotton dealer's dilemma (mark-to-market inventory method versus realization-based hedge method) the re-

sult was the same—and so too was the proposed solution.

Taxpayers—typically large-scale over-the-counter derivatives dealers—stepped forward to urge the Treasury to adopt an elective mark-to-market regime for their derivatives books (including hedges).<sup>63</sup> The arguments advanced were essentially identical to those set out in the cotton dealers' briefs<sup>64</sup>—mark-to-market is the only system that accurately measures the income of a business with offsetting long and short positions (and thus prevents timing mismatches), mark-to-market is required for financial accounting purposes and for reporting a regulated dealer's results to the Securities and Exchange Commission, and the individual positions can be valued with satisfactory precision.<sup>65</sup>

The over-the-counter derivatives dealers gained extra force for their argument from the fact that they were willing to make some sacrifices to be able to mark their positions to market. In particular, to the extent that a

(Footnote Continued)

which have been acquired for sale or which will physically become a part of *merchandise* intended for sale, . . . if title thereto will pass to the purchaser of the product to be sold therein." [Emphasis added.]

Although the definition of inventory is broad (and, as Reg. § 1.471-5 demonstrates, countenances intangible property such as securities), it is difficult to characterize the business of an over-the-counter derivatives dealer as buying and selling merchandise from and to customers. While its business is a customer business, an over-the-counter derivatives dealer typically "sells" a derivatives contract to a customer, not by assigning an existing contract sitting on the dealer's shelf of merchandise, but rather by entering into a new contract with the counterparty. As a dealer's derivatives business grows, so too does its "book" of open contractual positions. A derivatives dealer thus does not primarily hold merchandise for sale, but rather holds itself out as having the willingness and capacity to enter into specified financial contracts with customers.

It is true, of course, that dealers do on some occasions assign an existing derivatives contract to a third party. More frequently, however, a dealer or a customer terminates a derivatives contract by direct negotiation with the counterparty (and payment of a termination fee), or by entering into an offsetting contract. Moreover, the assignments that are made by a dealer typically are executed among dealers and not with customers (and form a relatively small part of their business). An analogy can be drawn between an over-the-counter derivatives dealer's contract positions with its customers and accounts payable and receivable, and receivables do not constitute inventory. *Westfield & Fall River Lumber Co.*, CCH Dec. 1460, 4 B.T.A. 135 (1926).

In order to include over-the-counter derivatives dealers, Code Sec. 475 (which places a securities dealer's inventory on mark-to-market accounting) provides that

a "dealer" is also a taxpayer who "regularly offers to enter into, assume, offset, assign or otherwise terminate positions in securities with customers in the ordinary course of a trade or business." Code Sec. 475(c)(1)(B). Similarly, Code Sec. 475(a)(2) specifically includes non-inventory securities (i.e., over-the-counter derivatives) held by a dealer. Cf. Reg. § 1.954-2(a)(4)(iv) (defining for subpart F purposes a "regular dealer" as a merchant (in the traditional sense) or a person that "makes a market in derivative financial products . . . by regularly and actively offering to enter into positions in such products to the public in the ordinary course of business"). The same regulation adopts the new term "dealer property" precisely to include derivatives and other non-inventory property within its scope. Reg. § 1.954-2(a)(4)(iii) (definition of "inventory"); Reg. § 1.954-2(a)(4)(v) (definition of "dealer property").

<sup>62</sup> Code Sec. 1256 does not apply to hedging transactions. Code Sec. 1256(e).

<sup>63</sup> Some taxpayers, particularly commercial banks active in swaps, simply adopted a mark-to-market accounting method for their swap books, either on the theory that swaps were sufficiently inventory-like that they should be able to be valued under an inventory method, or on the theory that, as A.R.M. 135 itself implicitly concluded, mark-to-market accounting in these circumstances is so plainly the correct answer that no court would ever sustain a challenge to its use.

We readily agree that this self-help led to a result that clearly reflected income, and that realization did not do so—at least in an economic sense. We therefore conclude that, whatever the technical authority for this approach, taxpayers should not be faulted today for pioneering the methodology that the tax law now requires.

<sup>64</sup> See, e.g., C. Beerbower's letter, note 60, *supra*; Letter from Salomon Brothers Inc. to K. Walli, Internal Revenue Service (Dec. 6, 1991), reprinted in 91 *Tax Notes Today* 255-37 (Dec. 17, 1991).

<sup>65</sup> The valuation of over-the-counter derivatives is not as simple as looking up the price of a publicly-traded security on a quote screen or newspaper. Advances in finance theory, which provided the sophisticated financial models, paired with exponential increases in computer power, have enabled dealers to price such derivatives using prevailing market inputs and their own mathematical models. But cf., "Bank of England Examines Options," *Financial Products* 6 (Oct. 23, 1997) (news brief describing results of Bank of England survey of options valuations by market participants, revealing wide variation in valuations, particularly for exotic options).

These proprietary valuation systems developed by derivatives dealers have raised the concern that on audit, the Service would have to rely upon the dealers' own valuations of their positions. Derivatives dealers have strong incentives to be objective in their valuations because they are used for pricing, risk management, financial and regulatory reporting, and compensation purposes.

Notwithstanding these facts, and indicative of the complexity of these valuation models, the Service has engaged the Los Alamos National Laboratory to develop valuation software for its agents to use on audit. This project has been extensively criticized. See, e.g., Letter from D. Aaron, Wall Street Tax Association, to the Internal Revenue Service, reprinted in 97 *Tax Notes Today* 69-63 (Apr. 10, 1997); Letter from L. Uhlick, Institute of International Bankers, to the Internal Revenue Service, reprinted in 97 *Tax Notes Today* 186-43 (Sept. 25, 1997); Letter from J. Considine, New York Clearing House Association, to the Department of Treasury and the Internal Revenue Service, reprinted in 97 *Tax Notes Today* 206-19 (Oct. 24, 1997); Letter from H. Gann, Miller & Chevalier, to the Internal Revenue Service, reprinted in 97 *Tax Notes Today* 162-27 (Aug. 21, 1997).

dealer ran a "matched book,"<sup>66</sup> marking its positions to market would require that the dealer's spread—representing income that would be otherwise realized over the life of the matched swaps—be recognized in the year the contracts are entered into.<sup>67</sup>

These arguments persuaded Treasury to respond, although not with the same alacrity with which matters were handled in 1921. Eventually, however, Treasury proposed Reg. § 1.446-4, which permitted dealers to place their over-the-counter derivatives businesses onto a mark-to-market system.

Reg. § 1.446-4, as originally proposed in 1991,<sup>68</sup> caused a storm of protest among dealers in over-the-counter derivatives, because Treasury insisted on extricating a concession as the price of allowing derivatives dealers to mark their positions to market. Specifically, proposed Reg. § 1.446-4(a)(1) required that:

The dealer or trader and all persons related to the dealer or trader within the meaning of Sections 267(b) and 707(b)(1) account for the securities and commodities that they hold in their capacity as dealers or traders (or as hedges of such securities or commodities) on their income tax returns either on the basis of cost or on the basis of market value, but not at the lower-of-cost-or-market value.<sup>69</sup>

Although securities firms and banks were willing to make some sacrifices, they were not prepared to give up lower-of-cost-or-market accounting for their physical inventories to be able to mark their derivatives positions to market.<sup>70</sup>

As it turned out, the enactment of Code Sec. 475 made moot the disagreements between over-the-counter derivatives dealers and the Treasury.<sup>71</sup> As discussed in more detail below, Code Sec. 475 eliminated lower-of-cost-or-market accounting for a dealer's securities inventory by placing such securities on mark-to-market, and it

also extended mark-to-market accounting to "interest rate, currency, or equity notional principal contract[s]."<sup>72</sup>

In response to criticism of the original proposed regulations, Treasury repropoed Reg. § 1.446-4 in entirely new form in 1993.<sup>73</sup> As repropoed, the regulation served a different (and larger) agenda, by requiring that the timing of inclusion of gains and losses from "hedging transactions" be matched. Repropoed Reg. § 1.446-4 was promulgated together with Prop. Reg. § 1.1221-2; together, the two regulations represented Treasury's response to the problems of taxing business hedges after *Arkansas Best Corp. v. Commissioner*.<sup>74</sup> While extremely important, Reg. § 1.446-4 does not adopt a mandatory mark-to-market regime (although the regulation contemplates its use in certain cases),<sup>75</sup> but rather articulates general principles of income and loss matching, and leaves it largely to taxpayers to implement those principles in particular hedging strategies.

3. Code Sec. 475. To this point, this article has argued that much of the original impetus for mark-to-market accounting systems came not from Congress or the Treasury, but rather from dealers with large *hedged* positions in property, where the "longs" and "shorts" comprising those hedged positions were subject to different timing rules under traditional inventory and realization principles. The addition of Code Sec. 475 to the Code in 1993, however, introduces a second theme: the use of mark-to-market accounting as an anti-abuse measure to curb perceived excessive taxpayer electivity in timing gains and losses under a realization-based system.

Any realization regime inherently offers a taxpayer considerable freedom in choosing when gains and losses from assets held by the taxpayer will be includible in taxable income. Indeed, this electivity (the so-called "timing option") is often described as the principal weakness of realization systems.<sup>76</sup> As applied to inves-

<sup>66</sup> In a "matched book," a dealer hedges its position, for example, in a 5-year swap with one counterparty with a mirror swap with another counterparty. In contrast, swaps in a "hedged book" are hedged with short-term derivative instruments. In a large swap book, there will generally be offsetting swap positions, so that only the net risk exposure on the entire book needs to be hedged.

<sup>67</sup> See, e.g., Letter from Securities Industry Association to F. Goldberg, Commissioner, Internal Revenue Service (Sept. 20, 1991), reprinted in 91 *Tax Notes Today* 209-58 (Oct. 9, 1991); Salomon Brothers' letter, note 64, *supra*. This acceleration of income recognition is described in greater detail in Section III.E.1., *infra*.

<sup>68</sup> Notice of Proposed Rulemaking FI-16-89, 1991-2 C.B. 951.

<sup>69</sup> 1991-2 C.B. at 962 (emphasis added).

<sup>70</sup> Some commentators referred to this conditioned use of mark-to-market accounting for derivatives held by dealers as "blackmail." American Bar Association—Section of Taxation's "Comments Regarding Proposed Treasury Regulations 1.443, 1.446-4, 1.512(b)(1)(a)-1 and 1.1092(d)-1" (June 10, 1992), reprinted in 92 *Tax Notes Today* 139-25 (July 8, 1992); Pratt, "Beltway Blackmail," *Investment Dealers'*

*Digest* 22 (Sept. 23, 1991). Pratt, however, points out that:

"There is little controversy over whether or not LCM [lower-of-cost-or-market] is a lopsided, pro-taxpayer accounting technique. Most of the industry's arguments in favor of LCM boil down to 'Why single us out?'—rather than 'This is a fair, accurate measurement of our income.'"

Pratt also notes that the "blackmail" arose from the Service's exaggerated perception that swaps were hedged with cash positions in securities, and *vice versa*, which generally was not the case. *Id.* at 24.

<sup>71</sup> See, e.g., Securities Industry Association's letter, note 67, *supra*; Letter from International Swap Dealers Association to K. Walli, Internal Revenue Service (Sept. 27, 1991), reprinted in 91 *Tax Notes Today* 210-50 (Oct. 10, 1991); Letter from American Bankers Association to F. Goldberg, Commissioner, Internal Revenue Service (Sept. 23, 1991), reprinted in 91 *Tax Notes Today* 203-34 (Oct. 1, 1991); Salomon Brothers' letter, note 64, *supra*.

The tax bar also weighed in on the side of the dealers. See New York State Bar Association—Tax Section Committee on Financial Instruments' "Report on Proposed Regulations on Methods of Ac-

counting for Notional Principal Contracts," reprinted in 24 *Highlights & Documents* 633 (Jan. 16, 1992); American Bar Association report, note 69, *supra*.

<sup>72</sup> Code Sec. 475 was enacted under Section 13223 of the Revenue Reconciliation Act of 1993, P.L. 103-66, 103d Cong., 1st Sess. (Aug. 10, 1993).

<sup>73</sup> Code Sec. 475(c)(2)(D).

<sup>74</sup> Notice of Proposed Rulemaking and Notice for Public Hearing FI-54-93, 1993-2 C.B. 615.

<sup>75</sup> 88-1 USTC ¶ 9210, 485 U.S. 212 (1988).

<sup>76</sup> Cf. Reg. § 1.446-4(e)(2) (providing that marking to market hedges of items that are marked to market "clearly reflects income"). This regulation, however, is not retroactive, and hence does not answer the question of whether dealers were authorized to mark their swap books to market prior to the enactment of the 1993 Act. See note 63, *supra*.

<sup>77</sup> See, e.g., Shuldiner, note 1, *supra*, at 250; Strnad, note 36, *supra*, at 1882-84 (discussing the costs of the timing option to the tax system); Strnad, "The Taxation of Bonds: The Tax Trading Dimensions," 81 *Va. L. Rev.* 47, 53 (1995) (suggesting that it may be necessary to move to a mark-to-market system in accounting for bonds, because of problems created by the

tors, tax analysts often describe the Code's limitations on the deductibility of capital losses (as well as the straddle rules of Code Sec. 1092, described below) as rough-and-ready limits on excessive electivity, although most commentators agree that those rules accomplish this objective imperfectly, at best.<sup>77</sup>

Dealers, by contrast, are *not* constrained by capital loss limitations or the straddle rules.<sup>78</sup> In such circumstances, the only constraints on taxpayer electivity in a realization regime are, at most, transaction costs—and a lower-of-cost-or-market accounting system for inventory eliminates even those frictions.<sup>79</sup> What is most surprising about Code Sec. 475, then, is not that it became law, but rather that it did so as late as 1993.

Perhaps it was the obviousness of both the issue and the solution that explains the brevity of Code Sec. 475's legislative history, which adds to the statute's ongoing interpretative problems. Code Sec. 475 originated in President Bush's 1992 tax bill,<sup>80</sup> which emerged in essentially the same form as Section 3001 of the Revenue Bill of 1992.<sup>81</sup> The Conference Report on the Revenue Bill of 1992 only states matter-of-factly that the then prevailing law allowing lower-of-cost-or-market valuation of inventory securities resulted in an asymmetric recognition of unrealized losses on such securities, whereas both unrealized losses and gains would be recognized under mark-to-market.<sup>82</sup> The Conference Report also states that inventory securities are valued at market for financial accounting purposes. The Revenue Bill of 1992 was passed by Congress but ultimately vetoed by President Bush.

The legislative history to Code Sec. 475, as enacted by the Revenue Reconciliation Act of 1993,<sup>83</sup> is similarly sparse in its description of the reasons for change. The House Report, for example, states that inventories of securities generally are easily valued at year-end, and in fact are valued on a mark-to-market basis for financial accounting purposes.<sup>84</sup> The Report then goes on to state that simply eliminating lower-of-cost-or-market accounting for securities inventories would not go far enough, because securities dealers are not subject to wash sale limitations on selling securities at a (deductible) loss and then immediately repurchasing them.

Congress, then, saw securities dealers' positions as satisfying two criteria that made mark-to-market look both fair and necessary: those positions are easily valued, and they are highly liquid (thus allowing dealers to employ "self help" lower-of-cost-or-market results through year-end sales of loss positions). This premise is true in respect of some dealer positions, but is demonstrably false (or at least exaggerated) in respect of others, such as over-the-counter derivatives—as the government itself knew, from its years of deliberation on the swap dealers' request for an elective mark-to-market swap accounting system.

These objections were not advanced with any great passion by the securities dealers, because they recognized the inevitability of mark-to-market accounting for their core physical inventory positions, and because the derivatives accounting problems of the prior decade had taught them that the only truly unworkable system would be one in which part, but not all, of their core business activities would be on mark-to-market. Once the inevitability of legislation had been accepted, the securities dealers advocated a *broad* application of mark-to-market to their core dealer activities (subject only to clarifying that nondealer investment positions would remain outside of mark-to-market), and concentrated their energies instead on (i) transition relief, (ii) a congressional commitment to resolve the problem surrounding the taxation of hedging transactions in the aftermath of *Arkansas Best Corp. v. Commissioner*,<sup>85</sup> and—most important—(iii) creating a presumption that their mark-to-market activities give rise to ordinary income and loss.<sup>86</sup>

This last point deserves some elaboration, because it actually relates to the purpose of mark-to-market accounting. Code Sec. 475(d)(3) basically provides that a securities dealer's securities positions (other than those identified as investments) give rise to ordinary income or loss, unless the security is held "other than in connection with its activities as a dealer in securities." The "in connection with" standard is deliberately broad in scope, and encompasses everything that a dealer does that is in furtherance of its securities dealing trade or business. The test does not require, for example, that a

(Footnote Continued)

timing option). For an important study of the effects of this "timing" option on returns from investing, see Gergen, note 16, *supra*, at 210.

<sup>77</sup> See note 1, *supra*. As an example, Professor Gergen, note 16, *supra*, at 213-14 (and sources cited therein), has suggested that the capital loss limitation is significantly flawed, basing his conclusion on three factors: (i) studies that show a significant increase in year-end trading, which is believed to be partly tax motivated; (ii) studies that show that price volatility positively affects asset prices, which is presumably caused by the tax advantages obtained by selling depreciated assets while retaining appreciated assets (the timing option); and (iii) the availability of various ways to produce capital gains which may be offset by capital losses.

<sup>78</sup> Code Secs. 1091(a), 1092(e) and 1256(e).

<sup>79</sup> One interesting question underlying the history of Code Sec. 475 is why the Treasury chose not to address the bulk of the problem decades earlier, by simply eliminating lower-of-cost-or-market as a permissible inventory valuation method under Reg. § 1.471-5. Concerns about implicit Congressional reenactment seem particularly misplaced where Congress left inventory methods generally entirely up to the discretion of Treasury. Code Sec. 471(a).

<sup>80</sup> Section 372 of the Long-Term Growth Act of 1992, H.R. 4150, 102d Cong., 1st Sess. (1992).

<sup>81</sup> H.R. 11, 102d Cong., 2d Sess. (1992).

<sup>82</sup> H.R. Rep. No. 102-1034, 102d Cong., 2d Sess., 770 (Oct. 5, 1992).

<sup>83</sup> P.L. 103-66, 103d Cong., 1st Sess. (Aug. 10, 1993).

<sup>84</sup> H.R. Rep. No. 103-111, 103d Cong., 1st Sess., 660 (May 25, 1993).

<sup>85</sup> 88-1 USTC ¶ 9210, 485 U.S. 212 (1988). As described immediately above, shortly after the 1993 Act became law, Reg. §§ 1.1221-2 and 1.446-4 resolved the hedging transactions dilemma without the need for further congressional action.

See House Budget Committee Report, H.R. Rep. No. 103-111, 103d Cong., 1st Sess., 666 (May 25, 1993); House-Senate Conference Committee Report, H.R. Rep. No. 103-213, 103d Cong., 1st Sess., 616 (Aug. 4, 1993).

See also, Kleinbard & Greenberg, "Business Hedges After *Arkansas Best*," 43 *Tax L. Rev.* 393 (1988) (discussing problems for hedging caused by the decision).

<sup>86</sup> Code Sec. 475(d)(3).

dealer demonstrate that every security it holds is sold to or bought from a customer.

This broad character rule—that all of a securities dealer's business activities give rise to ordinary income or loss—is intimately connected to the application of mark-to-market accounting. As described earlier, the Code's limitations on the deductibility of capital losses can best be viewed as a modest, but nonetheless essential, limit on taxpayers' ability to realize investment losses while deferring the realization of investment gains. When this limit is applied, however, to a mark-to-market taxpayer whose activities (e.g., inventory sales and inventory hedges) generally give rise to ordinary income or loss, the possibility of capital losses arising on some fragment of the taxpayer's business exposes the taxpayer to a different sort of whipsaw, but one that could be equally devastating to a hedged business strategy.

Congress saw mark-to-market accounting as a system that both reflected economic measures of income and could not be gamed by taxpayers. In a world in which net capital loss cannot offset ordinary income, character mismatches, like timing mismatches, expose a taxpayer to the rules of noneconomic taxable income and audit gaming—in this case, by revenue agents. By eliminating the practical pressures of the audit process, Code Sec. 475(d)(3) essentially ensures that the statute will apply evenhandedly, viewed from all perspectives.

**4. Commodities Dealers Revisited.** In drafting Code Sec. 475, Congress was careful to exclude commodities and commodity-linked over-the-counter derivatives from the statute's scope. No sooner was the ink dry on the new legislation, however, when many commodities dealers—particularly those that specialized in over-the-counter commodities derivatives—realized that life without mark-to-market was more painful than life with it, for the same reasons that swap dealers had discovered a few years earlier. Dealers in physical commodities, of course, have been able to use mark-to-market accounting since 1921, but commodities *derivatives* dealers, like commodities swap dealers, arguably do not have inventories to which the long-standing rule applied.

The result was eerily reminiscent of the earliest years of the income tax, but reflected much more poorly on the current state of tax administration. Several commodities derivatives dealers, with the support of their local District Offices, applied to the Service to change their accounting methods to a mark-to-market system. In light of the strong support of both Treasury and Congress for mark-to-market, as evidenced by Reg. § 1.446-4 and the passage of Code Sec. 475, the commodities derivatives dealers no doubt expected to receive permission to adopt a mark-to-market accounting system by return mail, but in fact years passed without the National Office being able to come to terms with the requests.

In the end, the commodities derivatives dealers took their case to Congress. The 1997 Act now permits commodities dealers to elect into a mark-to-market regime, by applying the operative rules of Code Sec. 475 to commodities, commodities derivatives, and certain other interests or financial instruments therein, in the same manner that those rules apply to securities.<sup>87</sup>

The most extraordinary aspect of new Code Sec. 475(e) is that it is elective. The statute's legislative history lists the same factors supporting mark-to-market for commodities dealers as Congress listed in 1993 in respect of securities dealers, and even notes that "many" commodities dealers today employ lower-of-cost-or-market accounting for their inventories.<sup>88</sup> Had the President's proposal to eliminate lower-of-cost-or-market accounting in all cases been adopted,<sup>89</sup> the elective nature of Code Sec. 475(e) might not have been quite so puzzling, because many commodities derivatives dealers, once required to hold inventories at cost (or at market), might have opted for a mark-to-market system to eliminate timing whipsaws. As it is, Code Sec. 475(e) perhaps serves as a forceful reminder that not every component of tax legislation is shaped by tax policy agendas.

## B. Life Insurers

Life insurance companies are taxed under a regime that arguably is even more abstruse than, and certainly is completely different from, the rules applicable to securities dealers. Nonetheless, the Code relies on mark-to-market accounting for life insurers to solve precisely the same sort of taxpayer-driven timing whipsaw concerns that first led to the adoption of mark-to-market accounting for commodities and securities dealers.

Life insurance premiums give rise to liabilities on the part of life insurers—in particular, the obligation to pay death benefits. Unlike the taxation of classic liabilities, however, the Code treats life insurance premiums entirely as gross income.<sup>90</sup> Since, by definition, the offsetting liability (the payment of which gives rise to a deduction) does not mature into a current claim until some indeterminate date in the future, the fundamental premise of life insurance taxation (that premiums constitute income) would, if uncorrected, expose life insurers to a substantial acceleration of net income.

The solution adopted by the Code, of course, is to permit life insurers to deduct annual additions to their reserves to meet future insurance claims. The determination of a life insurer's reserves, then, plays a critical role in accurately measuring an insurer's annual net income. Phrased differently, the annual addition to reserves serves in practice to divide an insurer's gross receipts into two streams—amounts received in respect of liabilities assumed by the insurer (for which the premium gross income and corresponding reserve deduction net to zero, just as a deposit with a bank does not give rise to

<sup>87</sup> Code Sec. 475(e), as added by § 1001(b) of the 1997 Act.

<sup>88</sup> House Ways and Means Committee Report on the Revenue Reconciliation Bill of 1997, H.R. 2014, 105th Cong., 1st Sess. 195, as reprinted in Special 4, No. 27 *Standard Federal Tax Reports* (CCH)

(June 18, 1997). The legislative history is silent as to the accounting method employed by such lower-of-cost-or-market dealers in physical commodities for their contractual hedges.

<sup>89</sup> Staff of the Joint Committee on Taxation, "Description of Revenue Provisions

Contained in the President's Fiscal Year 1998 Budget Proposal" (Feb. 10, 1997), reprinted at 44 *Highlights and Documents* 1863, 1897 (Feb. 11, 1997).

<sup>90</sup> Code Sec. 803(a)(1).



income to the bank), and amounts received in respect of the insurer's economic role of intermediation (which represents true gross income).

In the 1960s, life insurance companies began marketing variable annuities to customers.<sup>91</sup> Variable annuities essentially enable a policyholder to determine overall investment philosophy in return for assuming all investment risk.<sup>92</sup> In traditional annuities, by contrast, the insurance company in effect guarantees a rate of return paid to the policyholder. To accommodate this change in investment strategy, life insurance companies set up special, segregated accounts for variable annuities, to record amounts held in respect of these contracts separately from the insurer's other assets held for traditional insurance policies. The theory underlying the segregation was that the insurer's "general" investment account was managed under an entirely different set of risk factors than were the insurer's various variable accounts, and that "new money" invested by the insured in a variable account should earn a return that would not be affected by the return on the insurer's existing pool of investment assets.<sup>93</sup>

Similarly, beginning in the 1970s, separate accounts were formed for variable life insurance, which differs from traditional insurance in that policyholders bear the investment risk on the policies, as opposed to traditional insurance where the insurance company guarantees certain minimum returns.<sup>94</sup> Finally, separate accounts were also established for pension plan assets managed by insurance companies, for which the insurance company likewise did not guarantee any particular rate of return on the assets invested on behalf of the beneficiary.

Variable life products (whether annuities or whole life) simply did not fit with traditional insurance reserve calculation methodologies, which effectively applied a single rate of interest to the insurer's entire pool of reserves held to satisfy insurance claims for annuities and life policies.<sup>95</sup> Since the entire purpose of variable policies was to treat an insured's investment as "new money" whose net investment results effectively belonged to the insured, the Code's use of an insurer-wide blended result and an assumed rate of return measured

by interest rates would almost guarantee a mismatch between the insured's ultimate benefits and the insurer's increases to its reserves.<sup>96</sup>

The tax law responded to this timing whipsaw in 1984 by adopting Code Sec. 817. That provision, and the recently-enacted analogous rules of Code Sec. 817A (dealing with "modified guaranteed contracts"), resolve timing whipsaw issues by adopting a mark-to-market accounting regime for additions to an insurer's reserves (and the related investment assets) for variable insurance products, where those products are treated for state law purposes as a segregated account whose earnings inure to the benefit of the insured.<sup>97</sup> The insureds in turn pay tax on these amounts as part of their investment return on the product when these amounts are distributed, under the rules generally applicable to the taxation of insurance products.

The net result of Code Sec. 817's mark-to-market system for variable insurance product reserves (and assets) is to exempt appreciation in a segregated account from corporate level taxation. This result, which may seem counterintuitive at first, in fact follows from the role of life insurance reserves as the mechanism for distinguishing an insurer's liability to its insureds from the insurer's own earnings. Variable life segregated accounts typically are valued at fair market value for regulatory and financial accounting purposes and economically are viewed as owned by the policyholder or beneficiary. (Any reader who owns a variable annuity will appreciate the truth of this statement, since all statements received from the insurance company on the annuity account provide the account's current fair market value, based on a mark-to-market methodology.) Since gain (or loss) inside the account accrues to the benefit of the owner, it is appropriate that the insurance company, which lacks an economic stake in the appreciation, not pay tax on these amounts.

Code Secs. 817 and 817A thus use mark-to-market accounting to resolve a possible timing whipsaw (in this case, the possible overinclusion of premium income net of additions to reserves that would result from the Code's general reserve calculation methodologies) that

<sup>91</sup> Anderson, ANDERSON ON LIFE INSURANCE § 1.12, 7.3 (1991). The first authorized variable annuity was offered by the Teachers Insurance and Annuity Association of America (TIAA), when it received permission from the New York legislature to form the College Retirement Equities Fund (CREF) in 1952. The value of the CREF annuities was largely determined by the value of the stocks held by CREF.

<sup>92</sup> See generally Black & Skipper, LIFE INSURANCE, Ch. 7 at 13 (12th ed. 1994) (for description of variable annuities and traditional annuities).

<sup>93</sup> *Id.*

<sup>94</sup> *Id.*, Ch. 6 at 127.

<sup>95</sup> *Id.*, Ch. 6 at 128.

<sup>96</sup> Life insurance reserves generally are calculated under Code Sec. 807(d). As a practical matter, in most cases Code Sec. 807(d)(2) requires that reserves be calculated by using state insurance law methodologies (including mortality tables) and

the Code's applicable federal rate as the discount rate.

<sup>97</sup> This result is achieved through two different mechanisms by Code Secs. 817 and 817A. Code Sec. 817A, enacted by the Small Business Job Protection Act of 1996 (P.L. 104-188, 104th Cong., 2d Sess.), provides that assets held by a segregated account within its scope are marked to market, and gain or loss is taken into account for the current taxable year. Code Sec. 817A(b)(1). The effect of this on the insurance company's taxable income is immediately offset, however, through an increase in the amount of the company's reserves (deductible, for tax purposes) which reflects the increased fair market value of the assets. In particular, Code Sec. 817A(a) provides that, in the case of a contract under its purview, Code Sec. 807(e)(1)(A)(19) shall not apply. The referenced clause provides that the net surrender value of any contract (which forms part of the reserve) shall be calculated

without any regard to any market value adjustment of the contract. Thus, Code Sec. 817A(a) indirectly provides that increases in market value also increase life insurance company reserves, which results in an offsetting deduction against the income created when the assets are marked-to-market.

The same result is achieved in a different manner under Code Sec. 817, which provides for a tax-free, mark-to-market adjustment of basis to the extent that the amount of the adjustment is included in reserves established for the account. Code Sec. 817(b). Increases in reserves generally result in increases in deductions, which would be inappropriate here since the mark-to-market adjustment was not initially taxed; Code Sec. 817(a) corrects this by eliminating the additional deduction. Thus, the net result under Code Sec. 817 is that assets are marked to market, but resulting gain or loss is not taxed to the insurance company.



insurers otherwise would face.<sup>98</sup> Although the reasons for that whipsaw are different from those for the whipsaws faced by dealers, both the fundamental nature of the problem and the solution adopted are directly analogous.

### C. Mark-to-Market for Traders and Investors

The tax law also permits or requires mark-to-market accounting for traders and investors in limited circumstances. The history of the use of mark-to-market in these cases is largely the mirror image of the development of mark-to-market for dealers, in the sense that its application for traders and investors was driven originally by anti-abuse concerns, and only more recently by taxpayers seeking relief from timing whipsaws.

1. **Code Sec. 1256.** It is difficult today to recall just how serious a threat tax straddles once were to the collection of tax revenues, to the integrity of the tax system, and to the Service's ability to administer the Code.<sup>99</sup> The mark-to-market provisions of Code Sec. 1256 can best be understood, however, by reminding ourselves of the sense of urgency motivating Congress and Treasury alike in 1981 to eliminate the use of tax straddles by individual holders and investors to shelter both ordinary income and unrelated capital gains.<sup>100</sup>

Straddle schemes utilizing various futures contracts effectively allowed individuals of even moderate income levels to defer and convert their ordinary income and short-term capital gains into long-term capital gains.<sup>101</sup> Under such schemes, a taxpayer who realized short-term capital gain in Year 1 would, during that year, sell a futures contract for the delivery of a certain amount of a

commodity (such as silver) in a certain month (e.g., April) of Year 2, and simultaneously buy a futures contract for the same quantity of that commodity for delivery in another month (e.g., February) of Year 2.<sup>102</sup> These two positions combined would largely (but not perfectly) shield the taxpayer from exposure to fluctuations in the price of the underlying commodity. The two contracts taken together would expose the taxpayer to some "basis risk" between the long and short positions, because the delivery dates under each of the contracts were different, but that risk was small relative to the risk represented by the volatility in the spot price of the underlying commodity.<sup>103</sup>

During Year 1, when the price of the underlying commodity moved in either direction in an amount sufficient to create a loss in one of the contract positions that offset the taxpayer's unrelated short-term capital gain, that loss position was closed out. If, for example, the price of the commodity rose, then the taxpayer would close out its short futures position by purchasing an offsetting future for delivery of the same quantity of the underlying commodity on the same date, thereby creating a short-term capital loss. If the price of the commodity fell, then the taxpayer would sell its long futures position at a short-term capital loss. In either case, once the loss-producing futures position was closed out, the taxpayer immediately entered into a replacement contract so that the taxpayer locked in the gain on its other position. In Year 2 the taxpayer would liquidate both of its futures positions, and potentially realize a long-term capital gain, which could be deferred even longer by entering into another straddle.<sup>104</sup>

<sup>98</sup> The phenomenon is a timing difference rather than a permanent difference, because any net difference in payouts under a life contract and the reserves attributable to that contract effectively are reflected as deductions or income in the year the payout takes place. Mechanically, that result is achieved by taking the payout as a deduction and including in income the reduction in reserves attributable to the payments made under the contract.

<sup>99</sup> "The use of commodities and commodities futures in various tax avoidance schemes raises very serious problems in the administration of the tax law." Statement of J. Chapoton, Assistant Secretary for Tax Policy, Department of the Treasury, at the Hearing on Commodity Tax Straddles before the Committee on Ways and Means, House of Representatives, 97th Cong., 1st Sess., (Apr. 30, 1981), H.R. Rep. 97-15, 60 (the "1981 House Hearings").

"Based on my 3 1/2 years experience as Commissioner of Internal Revenue, the schemes which these bills address are doing more to undermine the fairness of the tax system than any others." Statement of J. Kurtz, at the Hearing before the Subcommittee on Taxation and Debt Management and the Subcommittee on Energy and Agricultural Taxation of the Committee on Finance, United States Senate, on S. 626, 97th Cong., 1st Sess., 197 (June 12, 1981) (the "1981 Senate Hearings").

<sup>100</sup> The history of the anti-straddle legislation is summarized in Thompson, "An Examination of the Effect of Recent Legislation on Commodity Tax Straddles," 2 *Va. Tax Rev.* 165 (1983); Strauss, "An Analysis of the Tax Straddle Provisions of the Economic Recovery Tax Act of 1981," 60 *TAXES* 163 (March, 1982).

<sup>101</sup> The difference in marginal rates for individuals prevailing at the time these straddles were actively marketed made such conversion very lucrative. In 1980, for example, the highest marginal rate on ordinary income was 70%, while the maximum rate on long-term capital gain was 28%.

<sup>102</sup> Generally any nonseasonal, nonperishable commodity for which futures contracts existed could be used for these straddles. Precious metals, particularly silver, were the most popular choice for straddle positions.

<sup>103</sup> Normally the difference in prices between the two offsetting contracts would reflect the incremental cost of carrying the commodity for the additional time period under the longer-term contract. Changes in short-term interest rates, for example, would affect this price difference, but because the longer-dated contract usually settled one or two months after the shorter-term contract, this difference was not substantial.

If even this basis risk was unacceptable, the taxpayer could enter into a "butterfly straddle," whereby another pair of long-

short contract positions, that mirrored the original straddle in terms of directional exposure on the delivery date spread, could be added that would offset any changes in the spread on the first straddle. Using the example given in the text, above, by selling April contracts and buying June contracts, the taxpayer could effectively eliminate any basis risk (but would incur more fees and also give up the opportunity to gain from such basis risk).

<sup>104</sup> Short-term capital gain could be converted into long-term capital gain only if the taxpayer's long position in the straddle appreciated, and such long position was held for longer than six months. Under then Code Sec. 1223(8), futures contracts held more than six months qualified for long-term capital gain or loss treatment. Under Code Sec. 1233(b), however, any gain from closing out a short position in a commodities futures contract was treated as short-term capital gain. Thus if the taxpayer's short position had appreciated, and if it wanted to convert (in addition to deferring) its income, the taxpayer would have needed to enter into another straddle in hopes that the long position thereunder would appreciate.

Another popular straddle utilized Treasury bill futures, which achieved the effect of converting a taxpayer's ordinary income into capital gain. This result was possible because Treasury bills and other short-term government obligations issued at a discount were at the time explicitly

The Service attempted to clamp down on the widespread use of tax straddles by publishing Revenue Ruling 77-185.<sup>105</sup> The facts of that ruling involved a silver straddle that operated in the manner described above, and through which the taxpayer attempted to defer and convert short-term capital gain into long-term capital gain. The Service denied a deduction for the taxpayer's short-term capital loss under the straddle on the theory that (i) the liquidation of the loss position followed immediately by the replacement of essentially the same position "resulted in no real change of position in a true economic sense, and [did] not represent a closed and completed transaction,"<sup>106</sup> and (ii) the transaction was not one entered into for profit, as required under Code Sec. 165(c)(2) for a loss to be deductible by an individual taxpayer.<sup>107</sup>

The Service did not have a particularly strong technical case for its "common law" wash-sale argument, in light of the fact that the Code provided clear statutory wash sale rules that did not reach straddle transactions.<sup>108</sup> Similarly, the short sale rule of Code Sec. 1233, which would have characterized the eventual straddle gain as short-term capital gain (and thus prevent conversion) did not apply to commodity futures requiring delivery in different calendar months.<sup>109</sup> The inadequacies of these Code provisions in respect of commodities straddles made expansion of the scope of these rules an obvious potential solution to the straddle problem.<sup>110</sup>

In the 1980-1981 period, two different approaches emerged to address these problems. One approach was introduced in Congress in different forms (but centered

on the same theme) by Congressmen Brodhead and Rosenthal in the House of Representatives<sup>111</sup> and Senator Moynihan in the Senate.<sup>112</sup> These bills basically would have extended the "wash sale" rules of Code Sec. 1091 (which eventually were enacted as the straddle rules of Code Sec. 1092) by expanding the range of transactions to which such rules would apply. This expansion was achieved by invoking the then new concept of "offsetting positions with respect to personal property." Thus both bills would have provided that if a taxpayer held such offsetting positions, the portion of any loss which exceeded recognized gain (which would be all of such loss if no gain were yet recognized) from such positions would not be recognized until thirty days after the positions ceased to be offsetting.

The other approach was to put regulated futures contracts (the most common and visible vehicles for tax straddles) on a mandatory mark-to-market system for all investors. This idea originally was championed by the tireless efforts of Donald Schapiro, both individually and through the New York State Bar Association,<sup>113</sup> and later was adopted by Treasury.<sup>114</sup> This mark-to-market approach was ultimately adopted as Code Sec. 1256.<sup>115</sup>

"Code Sec. 1256 contracts" (referred to as "regulated futures contracts" in 1981) are marked to market annually, and 60% of the gains or losses are treated as long-term capital gain or loss, and 40% as short-term capital gain or loss. This "60/40" treatment under Code Sec. 1256 results in a blended marginal tax rate, which at the time of enactment was a maximum of 32%, and today is roughly 28%.<sup>116</sup>

(Footnote Continued)

excluded from the definition of capital assets under then Code Sec. 1221(5). In contrast, futures in Treasury bills, as commodities contracts, were treated as capital assets. Rev. Rul. 78-414, 1978-2 C.B. 213. Like other commodities futures straddles, a taxpayer would take long and short positions on Treasury bill future contracts for delivery in different months (e.g., long on an October contract and short on a December contract). With a change in interest rates, one of the contracts would lose value, while the other one would appreciate by an approximately offsetting amount. The loss position was closed out by physical delivery—creating an ordinary loss—whereas the gain position was closed out by entering into an exactly offsetting contract—creating a short-term capital gain, which in turn could be converted into long-term capital gain by entering into another straddle.

<sup>105</sup> 1977-1 C.B. 49.

<sup>106</sup> *Id.* at 50. The Service relied upon *Gordon MacRae*, CCH Dec. 24,128, 34 T.C. 20 (1960) and *Frederick R. Horne*, CCH Dec. 14,610, 5 T.C. 250 (1945), to support this argument.

<sup>107</sup> Whether commodities straddles offered any reasonable expectation of pre-tax profit to satisfy the requirement of Code Sec. 165(c)(2) was not easy to determine. Some commentators thought that such straddles did offer a reasonable prospect for pre-tax profit. See, e.g., Goldfein & Hochberg, "An Analysis of IRS' Ruling that Straddle Transactions Lack Requisite

Profit Motive," 47 *J. Tax'n* 142 (1977), cited in Strauss, note 100, *supra*, n. 33. Experts commissioned by the Service opined that the chances for making a pre-tax profit on such tax-driven straddles were very slim. See "Silver Butterfly: Best Tax Dodge in America," *Washington Post* (Mar. 15, 1981), cited in Strauss, note 100, *supra*, n. 34.

<sup>108</sup> Rev. Rul. 71-568, 1971-2 C.B. 312.

<sup>109</sup> Code Sec. 1233(e)(2)(B). Code Sec. 1233 did, however, limit the effectiveness of the straddle (in terms of conversion) by treating any gain on the short position of the straddle as short-term capital gain. See note 104, *supra*.

<sup>110</sup> The Service did have a chance to litigate its position on commodities straddles in *Harry Lee Smith*, CCH Dec. 38,835, 78 T.C. 350 (1982), in which the Tax Court rejected the Service's arguments that (i) the straddle losses were not genuine, (ii) the transactions should be stepped together and losses recognized only upon conclusion of the straddle scheme, and (iii) the transactions lacked economic substance. The court did, however, uphold the Service's argument that straddle losses were not deductible under Code Sec. 165(c)(2) because they did not result from transactions entered into for profit.

<sup>111</sup> H.R. 1293, 97th Cong., 1st Sess. (Jan. 21, 1981).

<sup>112</sup> S. 626, 97th Cong., 1st Sess. (Mar. 5, 1981).

<sup>113</sup> Schapiro, "Commodities, Forwards, Puts and Calls—Things Equal to the Same Things Are Sometimes Not Equal to Each Other," 34 *Tax Lawyer* 581, 602 (1981); Statement of D. Schapiro at the 1981 House Hearings, note 99, *supra*, at 199; Statement of D. Schapiro (on behalf of the New York State Bar Association) at the 1981 Senate Hearings, note 99, *supra*, at 128; New York State Bar Association Tax Section Committee on Financial Institutions and Financial Futures—Report on Pending Legislation Dealing with Commodity Tax Straddles and Related Matters, 1981 Senate Hearings, note 99, *supra*, at 130.

<sup>114</sup> Statement of J. Chapoton, Assistant Secretary for Tax Policy, Department of the Treasury, at the 1981 House Hearings, note 99, *supra*, at 60; Statement of J. Chapoton at the 1981 Senate Hearings, 58; Thompson, note 99, *supra*, at 177.

<sup>115</sup> The 1981 Act, P.L. 97-34, 97th Cong., 1st Sess. § 503 (Aug. 13, 1981).

<sup>116</sup> Today, the maximum "60/40" rate would be 27.84% (i.e., 60% of the maximum long-term capital gains rate of 20%, and 40% of the maximum short-term capital gains rate of 39.6%).

IRS Notice 97-59, 1997-45 I.R.B., issued to resolve certain issues arising from the new capital gains rates and holding period requirements under the 1997 Act, provides that "[g]ain or loss from a Section 1256 contract, to the extent that it is treated as long-term capital gain or loss under Section 1256(a)(3), is now treated as

As originally adopted in 1981, Code Sec. 1256 applied only to "regulated futures contracts." There are essentially two basic elements to the definition of this term: (i) such contracts are traded on a regulated exchange, and (ii) are subject to a system of mark-to-market on such exchange whereby the taxpayer's account with such exchange is credited and debited according to the change in the market value of the contract.

This latter feature of regulated futures contracts—"variation margin"—has been proffered as a reason to permit or require mark-to-market accounting since the Service's early rulings allowing the use of mark-to-market for cotton futures held by cotton dealers.<sup>117</sup> While the existence of a system of variation margin provided a pretext for departing from realization principles in the case of cotton dealers in 1921, Code Sec. 1256 as originally adopted appears to have relied heavily on the variation margin argument to defeat anticipated constitutional challenges.<sup>118</sup> The concern about violating traditional realization principles presumably was greater in the Code Sec. 1256 case because mark-to-market was imposed as an anti-abuse measure, whereas in the cotton dealer case it was demanded by the taxpayers themselves to prevent whipsaws against them.

Even with its long-established (if relatively little known) precedents, mark-to-market under Code Sec. 1256 has nonetheless been controversial from the start—surviving, for example, in *Murphy v. United States*,<sup>119</sup> a serious challenge to its constitutionality on the grounds that Code Sec. 1256 taxed a taxpayer's unrealized income. Despite the apparent lack of concern over the constitutionality of mark-to-market accounting today, the case raised a fundamental question over its legality that has yet to be resolved directly.

In *Murphy*, the taxpayer was an individual investor in futures contracts, who realized gain on his contract positions when they were marked to market under Code Sec. 1256. There is no indication in the facts of the case that the taxpayer pursued a spread or straddle strategy with such futures contracts, or speculated on the directional movements in the prices of the underlying commodities. The taxpayer paid the tax thereon under protest, and ultimately filed suit in district court seeking

a refund for the tax on the basis that Code Sec. 1256 was unconstitutional because it taxed unrealized gain.<sup>120</sup> The district court granted the government's motion for summary judgment.<sup>121</sup>

The Ninth Circuit was similarly decisive in its disposition of the appeal. The *Murphy* Court affirmed the constitutionality of Code Sec. 1256 by approving the theory that the variation margin system to which futures contracts were subject allowed the taxpayer to constructively receive the gain arising from such contracts when marked to market. The court found that:

Although *Murphy* did not sell his futures contracts, his gains could be treated as realized because he was entitled to withdraw those gains daily. There were no restrictions, and his failure to receive cash was entirely due to his own volition [citation omitted]. *Murphy's* failure to withdraw his gains immediately was little different from a failure to withdraw interest which has been credited to a bank account. Absent substantial limitations, the interest is taxable, whether withdrawn or not [citation omitted]. So, too, with *Murphy's* commodity gains. Of course, today's gain could be eliminated by tomorrow's loss, but that would not change the fact that today's gain was available today. *That the investment remains at risk is inconsequential; so do loaned or deposited funds.* [Emphasis added.]<sup>122</sup>

*Murphy's* analogy between variation margin and amounts loaned or deposited in a savings account is not very convincing, because there is a fundamental difference between the risks involved in the two situations. In the case of a loan or demand deposit, the risk to which the investor is exposed is the creditworthiness of the debtor or bank; once the interest is earned and paid, the investor is no longer exposed to any risk with respect to that amount. In the case of a futures contract, a positive balance in the variation margin one day can be wiped out (and even turn into a liability, i.e., a margin call) the next day by a fluctuation in the price of the underlying commodity, and if that should occur, the investor has no rights or remedies to claim the previous positive balance. Alternatively, if the investor withdraws a positive balance, that balance is subject to the contingency of a margin call, which might require such amount to be

(Footnote Continued)

attributable to property held for more than 18 months [and thus subject to tax at 20%]."

The "60/40" character rule is generally described to have been a political compromise.

<sup>117</sup> See Section II.A.1, *supra*.

<sup>118</sup> Because credits and debits were made daily to a trader's account with the exchange, and any balance therein could be withdrawn (to the extent it exceeded margin requirements), the balance was said to be "realized" under the constructive receipt doctrine, even if the trader never actually withdrew such balance, and even if such balance could be wiped out by marking to market the next day.

<sup>119</sup> 93-1 USTC ¶ 50,270, 992 F.2d 929 (CA-9 1993).

<sup>120</sup> The genesis of the realization requirement is generally attributed to the

Supreme Court's decision in *Eisner v. Macomber*, 1 USTC ¶ 32, 252 U.S. 189 (1920), wherein the Court ruled that a stock dividend (i.e., a pro-rata dividend on stock of a company paid with additional stock of that company) did not constitute taxable income to a shareholder. Commentators disagree, however, as to whether the realization requirement is a constitutional requirement or simply a matter of administrative convenience. Compare Surrey, "The Supreme Court and the Federal Income Tax: Some Implications of the Recent Decisions," 35 *Ill. L. Rev. Nw. U.* 779 (1941) (arguing that realization is an administrative requirement), with Ordower, "Revisiting Realization: Accretion Taxation, the Constitution, Macomber, and Mark to Market," 13 *Va. Tax Rev.* 1 (1993) (arguing that realization is a constitutional requirement).

The *Murphy* Court did not address the status of the realization requirement, since it ruled that Code Sec. 1256 did not violate such requirement in the first place. *Murphy*, 992 F.2d at 931 ("Because of the unique accounting method governing futures contracts [i.e., mark-to-market with variation margin], the gains inherent in them are properly treated as constructively received. . . . We need not, and do not, decide the broader issue of whether Congress could tax the gains inherent in capital assets prior to realization or constructive receipt.").

<sup>121</sup> The district court decision was neither officially reported nor published by tax news services.

<sup>122</sup> *Murphy*, 992 F.2d at 931.

redeposited into the margin account. Moreover, *Murphy* does not address the post-1981 extension of Code Sec. 1256 to instruments that do not provide for variation margin.

The scope of Code Sec. 1256 itself was expanded considerably in 1984 in order to fill some gaps left by the 1981 Act, and in order to tax economically similar transactions in a consistent manner.<sup>123</sup> Mark-to-market under Code Sec. 1256 was expanded to cover "nonequity options"—which in fact can be options on equity indices (but not on individual stocks)—in the hands of traders and investors, and equity options in the hands of options dealers. The issue of how options should be treated was already raised in 1981, because the economics of a futures contract on an underlying asset can be replicated by a combination of options on such asset. At first, Congress accepted the arguments of the affected industries that such instruments were not utilized in tax straddles; by 1983, however, it was clear that options were being so used.<sup>124</sup> Congress therefore swept such options, with certain exceptions, under the scope of Code Sec. 1256 in 1984.<sup>125</sup>

It is odd that none of the industry groups affected by the expansion of Code Sec. 1256 challenged the constitutionality of imposing mark-to-market tax accounting on their financial products, because listed options are not subject to the same non-tax mark-to-market system that is required for regulated futures contracts (*i.e.*, involving variation margin).<sup>126</sup> It was, after all, the very existence of variation margin for regulated futures contracts that formed the basis for upholding the constitutionality of Code Sec. 1256 as it applied to such contracts.

On balance, however, the options industry decided not to challenge the expansion of Code Sec. 1256, because it wanted its products to be subject to Code Sec. 1256 so that traders and investors therein could obtain

favorable "60/40" capital treatment.<sup>127</sup> The willingness of the options industry to embrace mark-to-market for the sake of obtaining "60/40" treatment thereunder marked the transformation of Code Sec. 1256 from an anti-abuse measure to essentially a quid pro quo for certain taxpayers.

Code Sec. 1256 raises several technical concerns that arise because its mark-to-market rules conflict with the timing rules applicable to other investments, and lead in the straddle arena to the infamous mixed straddle problem. A "mixed straddle" is a straddle where at least one, but not all, of the positions is a Code Sec. 1256 contract.<sup>128</sup> Because of the disparity between the tax treatment of Code Sec. 1256 contracts and other types of transactions, a "mixed straddle" presented another possibility for a taxpayer to convert unrelated short-term capital gain (albeit only 60% thereof) into long-term capital gain (by obtaining Code Sec. 1256 "60/40" capital treatment). For example, if a taxpayer had \$1000 of short-term capital gain, it could enter into a mixed straddle where only one of the offsetting positions was a Code Sec. 1256 contract. If the non-Code Sec. 1256 contract position depreciated in value by \$1000, the taxpayer could dispose of that position and realize a capital loss, which would offset its \$1000 short-term capital gain. At the same time, however, the taxpayer would realize a gain of approximately \$1000 on its Code Sec. 1256 contract, which would be treated as "60/40" capital gain, thereby achieving the conversion.

In order to prevent such conversion through mixed straddles, Treasury regulations provide that the short-term capital loss realized from one or more non-Code Sec. 1256 positions in a mixed straddle is also given "60/40" capital treatment.<sup>129</sup> This provision is commonly referred to as the "killer rule" because it is asymmetric and cuts only against the taxpayer.<sup>130</sup> To avoid

<sup>123</sup> The scope of Code Sec. 1256 was first expanded in 1982 to include foreign currency contracts. Technical Corrections Act of 1982, P.L. 97-448, 97th Cong., 2d Sess., § 105(c)(5)(A).

Under Code Sec. 1256 as originally enacted in 1981, a foreign currency futures contract would have been treated as a regulated futures contract, but a foreign currency forward contract with a commercial bank would not have been so treated, because the latter was not subject to variation margin or traded on a designated exchange. Foreign currency futures and forwards are essentially the same contracts economically, and are used interchangeably by traders. As noted in the House Ways and Means Committee Report, the volume of forward currency trading in the interbank market greatly exceeded foreign currency futures trading. H. Rep. 97-794, 97th Cong., 2d Sess., 23 (Sept. 8, 1982). Thus in order to tax the two types of contracts consistently, foreign currency forward contracts were added to the definition of "regulated futures contract" under then Code Sec. 1256(b).

<sup>124</sup> Wetzler, "The Tax Treatment of Securities Transactions Under the Tax Reform Act of 1984," 25 *Tax Notes* 453, 455 (Oct. 29, 1984).

<sup>125</sup> Deficit Reduction Act of 1984, P.L. 98-369, 98th Cong., 2d Sess., § 102(a)(2) (adding nonequity options and dealer equity options to the definition of "Code Sec. 1256 contract").

<sup>126</sup> The seller of a listed (*i.e.*, exchange-traded) option is subject to variation margin in its account with the exchange, but not the buyer of an option. See, *e.g.*, Chicago Board of Trade's *Commodity Trading Manual* at 177 (1994). Unlike futures contracts, which can be either an asset or a liability to either the buyer or seller of such contracts, depending upon the price of the underlying asset, an option is always an asset to the buyer and a liability to the seller. As such, only the option seller is subject to variation margin on a listed option.

By contrast, the fact that futures contracts require the imposition of variation margin on both buyer and seller was an argument made in 1981 in favor of imposing mark-to-market accounting. See Statement of D. Schapiro at the 1981 House Hearings, note 99, *supra*, at 199 ("The sum of the daily gains is exactly equal to the sum of the daily losses on the U.S. exchanges, and cash moves backwards and forwards. Taxing this cash as giving rise to gain or loss does not seem to me

like taxing unrealized appreciation in a house.").

<sup>127</sup> "The CBOE [Chicago Board Options Exchange] viewed the 60/40 treatment as sufficiently enticing both to investors and to dealers to overcome the acceleration of tax liability that results from marking to market. Moreover, the CBOE was willing to have its customers placed under a mark-to-market system for tax purposes despite its not using a system of variation margin . . ." Wetzler, note 124, *supra*, at 456.

<sup>128</sup> Code Sec. 1256(d)(4)(A).

<sup>129</sup> Temp. Reg. § 1.1092(b)-2T(b)(2).

<sup>130</sup> The "killer rule" does not provide that short-term capital gain from the non-Code Sec. 1256 position in a mixed straddle is treated as "60/40" capital gain. As a result, in the absence of some other mitigating rule, a mixed straddle in which the non-Code Sec. 1256 position is profitable and the Code Sec. 1256 position unprofitable can convert unrelated long-term capital gain into short-term capital gain.

The "killer rule" was essentially mandated by the legislative history of 1981 Act itself. The Senate Finance Committee Report states that:

"If a taxpayer fails [to make a mixed straddle election] . . . , [a]ll positions in the straddle, both futures contracts and other

the "killer rule," a taxpayer with a mixed straddle must make one of two elections,<sup>131</sup> or establish a mixed straddle account.<sup>132</sup> Under any of these elections, the mark-to-market treatment under Code Sec. 1256 is either avoided or mitigated for mixed straddles. There is some irony at work here, since straddles employing futures contracts were what stirred Congress to enact Code Sec. 1256 in the first place.<sup>133</sup>

In retrospect, and in light of all its complexity, it is not obvious why Congress thought it desirable to introduce both the straddle rules of Code Sec. 1092 and the mark-to-market rules of Code Sec. 1256 into the Code in 1981. The reason seems to be rooted in the desperate nature of the anti-straddle struggle, and a concern that the straddle rules would be unenforceable when applied to an active futures trader's hundreds or thousands of trades each year.<sup>134</sup> In fact, Congress's fears in this regard were misplaced, because the straddle rules loom larger and larger in the tax planning of investors and traders, as complex hedged investments become more common and as taxpayers become more familiar with the full force of the straddle rules.

Ironically, Code Sec. 1256 today is a rule favorable to most taxpayers. For example, purchasing a call option on the Standard & Poor's 500 equity index will subject the holder to a maximum blended "60/40" rate of 27.84%, even if the option is held for only a few days. The maximum rate on gain from a direct investment in a Standard & Poor's 500 equity index fund, by contrast, is 39.6%, unless the fund interest is held for more than one year.<sup>135</sup> While the "60/40" treatment may have originally served as a palliative for the imposition of mark-to-

market on futures contracts, it has now become a sought-after tax benefit in itself.

**2. Mixed Straddle Accounts.** Large-scale traders and investors (such as hedge funds) that engage in complex "hedge" or "arbitrage" trading strategies are subject to even greater tax timing whipsaws than are dealers.<sup>136</sup> First, of course, such traders have the same issues of hedging long-term positions with short-term contracts that bedeviled derivatives dealers for years prior to the enactment of Code Sec. 475. Second, unlike dealers, traders and investors are fully subject to the rigors of the loss deferral principles of the straddle rules, which (when applied to hedged trading strategies) operate to defer realized losses, but not realized gains. Finally, as described above, the "killer rule" can subject a taxpayer to a whipsaw from the application of the "60/40" character treatment under Code Sec. 1256. The mixed straddle elections under Code Sec. 1256(d) and Code Sec. 1092(b) provide relief from the last of these whipsaws, but require specifically identifying offsetting positions that make up a straddle. Such elections thus are simply too cumbersome—if not impossible—to make for all but the simplest trading strategies. For such taxpayers, Congress added another election under Code Sec. 1092(b)(2) in 1984 whereby they could establish a segregated mixed straddle account.<sup>137</sup>

To a tax theorist, the mixed straddle account is another manifestation of the inherent problem of requiring mark-to-market accounting on a piecemeal, unsystematic basis. Because of the internal netting mechanism of mixed straddle accounts,<sup>138</sup> a taxpayer theoretically can convert some of its short-term capital gain inside its

(Footnote Continued)

property, are subject to the loss deferral rule in Section 1092. . . . The application of Section 1092 to such unidentified, mixed straddles will result in the deferral of all losses with respect to which there is offsetting unrealized gain, so that . . . losses on property outside the mark-to-market system are deductible to the extent of gains on futures contracts in the mark-to-market system (provided there are no unrealized gains in other offsetting positions)." [Emphasis added.]

S. Rep. 97-144, 97th Cong., 1st Sess., 158-59.

<sup>131</sup> Under Code Sec. 1256(d) or Code Sec. 1092(b)(2)(A)(i)(I), as implemented by Temp. Reg. § 1.1092(b)-3T.

<sup>132</sup> Code Sec. 1092(b)(2)(A)(i)(II); Temp. Reg. § 1092(b)-4T. The mixed straddle account is described in Section II.B.2, *infra*.

<sup>133</sup> If a taxpayer makes a Code Sec. 1256(d) election for an identified mixed straddle, mark-to-market treatment under Code Sec. 1256 will not apply to any Code Sec. 1256 contract that forms part of such straddle. Code Sec. 1256(d)(1). The difficulty with the Code Sec. 1256(d) election is that each position forming the mixed straddle must be identified by the close of the day that the first Code Sec. 1256 contract that forms a part thereof is entered into. Code Sec. 1256(d)(4)(B). Thus any mixed straddle on which positions are added after the day that the first Code Sec. 1256 contract component of the straddle

is entered into, does not qualify for the Code Sec. 1256(d) election.

Under the Code Sec. 1092(b)(2)(A)(i)(I) election, the effects of mark-to-market are mitigated, because, although Code Sec. 1256 contracts are still marked to market, gains and losses on the positions identified as comprising a mixed straddle are netted. For example, if a taxpayer realizes a loss on the disposition of its non-Code Sec. 1256 position of a mixed straddle for which a Code Sec. 1092(b)(2)(A)(i)(I) election has been made, the taxpayer offsets that loss to the extent of corresponding unrealized gain on its Code Sec. 1256 contract. At the end of the tax year, the Code Sec. 1256 contract is marked to market, but any resulting gain is reduced by the amount of loss on the non-Code Sec. 1256 position that was offset earlier in the year by unrealized gain on the Code Sec. 1256 contract. Temp. Reg. § 1.1092(b)-3T.

<sup>134</sup> Strauss, note 100, *supra*, at 170.

<sup>135</sup> Listed options on broad stock indices such as the Standard & Poor's 500 are considered "nonequity options" under Code Sec. 1256(g)(6)(B), and are therefore Code Sec. 1256 contracts that receive "60/40" capital treatment.

<sup>136</sup> Because their gains and losses are capital, traders and investors do not qualify for the hedging transaction exception of Code Secs. 1092(e) and 1256(e), or the hedging rules of Reg. § 1.446-4.

<sup>137</sup> Deficit Reduction Act of 1984, note 125, *supra*, 103(a) (amending Code Sec.

1092(b) to grant Treasury broad regulatory authority to prescribe rules concerning treatment of mixed straddles). In fact, Section 103(b) of the Deficit Reduction Act required Treasury to issue such regulations within six months of the date of enactment. The rules governing the treatment of mixed straddle accounts were issued under Temp. Reg. § 1.1092(b)-4T.

<sup>138</sup> Generally, gains and losses on Code Sec. 1256 contracts and non-Code Sec. 1256 contracts are netted separately (and based on a daily mark-to-market). The net gain or loss on Code Sec. 1256 contracts is then netted with non-Code Sec. 1256 contracts, if there is any offset. If there is no offset (because both types of contracts show a net gain or loss), then net gain or loss on the Code Sec. 1256 contracts is accorded "60/40" capital treatment, whereas the net gain or loss on non-Code Sec. 1256 contracts is treated as short-term capital. Finally, at the end of the tax year, the daily net amounts are netted once more to arrive at a total long-term and short-term capital gain or loss amounts. Temp. Reg. § 1.1092(b)-4T(c).

In order to limit the potential for conversion of short-term capital gains into long-term gain, a limit of 50% of the annual net gain from a mixed straddle account can be long-term capital gain; the amount of gain above 50% is recharacterized as short-term gain. Similarly, short-term capital loss is limited to 40% of the total net loss, and losses in excess thereof

mixed straddle account into long-term gain—precisely the result that the “killer rule” was designed to prevent.<sup>139</sup> (A mixed straddle account, however, does not offer even a theoretical opportunity to convert short-term gain on assets outside the account into long-term gain.)

In practice, however, high-volume traders with hedged positions, such as hedge funds, typically utilize mixed straddle accounts not to obtain any tax rate advantage, but as a defensive measure. By establishing a mixed straddle account, a taxpayer can preclude the Service on audit from matching up positions from among the hundreds or thousands entered into by the taxpayer and deeming them to have been unidentified mixed straddles subject to the dreaded killer rule. Moreover, the mixed straddle account effectively allows such traders and investors to expand mark-to-market treatment to investments beyond Code Sec. 1256 contracts, because the mixed straddle account rules technically require only one Code Sec. 1256 contract to be included in the account.<sup>140</sup>

In fact, many hedge funds utilize mixed straddle accounts today, not for the potentially favorable conversion of short-term capital gains into “60/40” gains, but rather to place their investments on mark-to-market, and thereby avoid the otherwise inevitable (and uncontrollable) application of the loss deferral principles of the straddle rules to their (definitionally) hedged trading strategies. Indeed, in some cases a hedge fund, realizing the asymmetrical and devastating consequences of applying the straddle rules to its hedged trading strategies, will deliberately introduce some Code Sec. 1256 contracts as hedges for the purpose of enabling a trading strategy to be put onto mark-to-market. The hedge fund does so because it otherwise faces an environment in which a hedged trader or investor is often hurt, and never helped, by the vagaries of our realization system, as modified by the straddle rules. The mixed straddle account thus operates under such circumstances as the

proverbial tail (mark-to-market treatment) that wags the dog (realization treatment), or the exception that swallows the rule.

**3. The 1997 Act’s Extension of Code Sec. 475 to Securities and Commodities Traders.** Perhaps recognizing the fundamental distortions of applying realization principles and the asymmetrical straddle rules to hedged securities traders (whose magnitude and volume of activity can rival that of the major dealers), Congress, in the 1997 Act, permitted both traders in securities and traders and dealers in commodities to *elect* to mark their positions to market.<sup>141</sup> Once the election is made, all positions held by such dealer or trader and used in its business are marked to market, except those positions that represent investments and are identified as such.<sup>142</sup> Moreover, gains and losses on such positions that are marked to market are treated as *ordinary* income or loss.<sup>143</sup> Under Code Sec. 475(c)(2), which defines “security” for purposes of Code Sec. 475, Code Sec. 1256 contracts (to the extent not used as a hedge and not described under Code Sec. 475(c)(2)(F)), are excluded from the scope of Code Sec. 475 mark-to-market, and thus continue to be accorded “60/40” capital treatment.

Mixed straddle accounts are *not* affected by the amendments to Code Sec. 475, and remain an alternative method of tax accounting for traders that utilize Code Sec. 1256 contracts. In many cases, of course, a sophisticated trader will be able to season an arbitrage strategy with a sprinkling of Code Sec. 1256 contracts, thereby effectively obtaining 2 elections: the ordinary income/loss regime of new Code Sec. 475(f), or what is in practice a short-term capital gain/loss regime under the mixed straddle account rules.<sup>144</sup> The decision will depend in part, on the character of the taxpayer’s other activities. The decision also may be affected by the fact that the Code Sec. 475(f) election is permanent, while the mixed straddle account election is made annually.<sup>145</sup> Most fundamentally, however, the decision as to which regime to elect may be driven by the fact that Code Sec.

(Footnote Continued)

are recharacterized as long-term capital loss. Code Sec. 1092(b)(2)(B)(i); Temp. Reg. § 1.1092(b)-4T(c)(4).

<sup>139</sup> As a practical matter, the claim that mixed straddle accounts can be used to obtain a tax rate advantage is overstated. Treasury regulations require marking all positions in a mixed straddle account (including non-Code Sec. 1256 contract positions) to market on a daily basis. Temp. Reg. § 1.1092(b)-4T(c)(1). This limits the ability of a taxpayer to use Code Sec. 1256 contracts to shelter a short-term gain within a mixed straddle account. Marking to market daily reduces the likelihood of taxpayer-favorable conversion because the fluctuations in values on a daily basis should be lower than on a less frequent basis.

Finally, the Service has the broad authority to add or remove a taxpayer’s position in a mixed straddle account, or to move such position between different mixed straddle accounts, provided that it deems the taxpayer’s original designation not to have met a “reasonable person”

standard. Temp. Reg. § 1.1092(b)-4T(b)(4)(i), (ii).

<sup>140</sup> The definition of “mixed straddle account” under Temp. Reg. § 1.1092(b)-4T(b)(1) does not expressly require a Code Sec. 1256 contract to be included in such account. Code Sec. 1256(d)(4) defines “mixed straddle” as including at least one Code Sec. 1256 contract, but that definition applies only for purposes of the Code Sec. 1256(d) mixed straddle election. Given the rules for netting non-Code Sec. 1256 contract positions with Code Sec. 1256 contract positions, a mixed straddle account must necessarily contain at least one Code Sec. 1256 contract, as the term clearly implies.

<sup>141</sup> The election for dealers in commodities is provided under new Code Sec. 475(e), and the election for traders in commodities or securities is provided under new Code Sec. 475(f).

<sup>142</sup> Code Sec. 475(e)(1) (extending by reference the rules applicable to securities dealers to commodities dealers); Code Sec. 475(f)(1)(B) (for traders in securities); Code Sec. 475(f)(2) (extending by refer-

ence the rules applicable to securities traders to traders in commodities).

<sup>143</sup> For commodities dealers, the reference in new Code Sec. 475(e)(1) to rules applicable to securities dealers makes it clear that ordinary treatment applies to positions that are marked to market. For traders in securities or commodities, however, no similar explicit reference provides for ordinary treatment, but the Conference Report on the 1997 Act provides that “[g]ain or loss recognized by the electing taxpayer under the provision is ordinary gain or loss.” Statement of Managers on H.R. 2014, 105th Cong., 1st Sess., 1745, as reprinted in 46 *Highlights & Documents* 1667 (Aug. 1, 1997); Caginalp et al., *supra*, note 11, at 1092.

<sup>144</sup> The text assumes that, if a trader has relatively few Code Sec. 1256 contracts in its mixed straddle account, its net gain from its arbitrage strategy is likely to be attributable to its non-Code Sec. 1256 positions, and thus be wholly or largely short-term.

<sup>145</sup> Compare Code Sec. 475(f)(3) with Temp. Reg. § 1.1092(b)-4T(f)(1).



475(f) applies to *all* activities within the scope of the taxpayer's trade or business, while the mixed straddle account rules apply on a strategy-by-strategy basis.<sup>146</sup> For a taxpayer that hedges all of its activities, the distinction has little significance, but for a taxpayer that is an active trader of unhedged positions as well as of hedged positions, the mixed straddle account does not require the trader to forego capital character for its unhedged trading activities as the price of mark-to-market accounting for its hedged strategies.

### III. CURRENT CONFLICTS IN APPLYING MARK-TO-MARKET ACCOUNTING TO DEALERS

#### A. Overview

**1. Income Matching for Specific Cases.** One lesson that follows from the history of mark-to-market accounting summarized in Part II is that the Code today requires mark-to-market accounting, not on the basis that it is an inherently superior measure of income and therefore should be adopted wherever political opposition is surmountable, but rather as a response to specific failings of our normative tax accounting rules in particular applications. As Part II demonstrated, in the case of securities dealers, commodities dealers and insurance companies, those pressures originally came from taxpayers themselves. These dealers and insurers relied extensively on hedging (or asset/liability matching) to conduct their businesses, but found that, for tax purposes, they were the victims of random timing whipsaws when gains and losses on their offsetting positions were realized in different periods. The *reasons* for those timing whipsaws differed from case to case—mark-to-market accounting for physical inventories, in one case; differing maturities for over-the-counter derivatives and the positions used to hedge those derivatives, in the second; and different measuring rules for premium income and the reserves associated with that income, in the third—but the phenomenon itself and the motivation for reform remained essentially constant.

As discussed in Part I, mark-to-market accounting is most firmly grounded when it serves as an alternative to traditional deferral principles in those unusual cases where interperiod matching rules are required, but where deferral principles break down. As the rest of this Part

III demonstrates, the Code gets in trouble when it forgets this narrow role, and instead unrealistically treats mark-to-market accounting for dealers as the opening wedge of a drive to apply mark-to-market accounting for the economy as a whole, or as a way of putting one class of taxpayers beyond the temptations of lower-of-cost-or-market inventory methods.

This Part III therefore expands on the themes identified in Part II by identifying specific points of conflict between mark-to-market accounting, on the one hand, and realization principles, on the other, as applied to dealers. This discussion addresses, in particular, conflicts raised by Code Sec. 475, but is not intended as a comprehensive review of the operation of Code Sec. 475, which has ably been addressed by a number of other articles.<sup>147</sup> In each case, the article draws on the historical setting developed earlier to help identify the problem that mark-to-market was intended to address, and thereby to illuminate how those current conflicts should be resolved.

#### B. The Scope of Code Sec. 475—Who Should Be Marked to Market?

**1. The Overbreadth of Code Sec. 475.** The first and most fundamental conflict between mark-to-market accounting and realization principles, of course, is simply deciding which taxpayers should fall within the mark-to-market scheme, particularly where (as in the case of securities dealers) that system is mandatory. The historical perspective developed in Part II helps to answer this question—and the sorry history of Code Sec. 475 since 1993 serves as an almost-slapstick reminder of the consequences of losing sight of mark-to-market accounting's proper role.

Code Sec. 475(c)(1) applies to taxpayers that regularly buy or sell securities from customers. As extensively developed in the many articles dissecting the operation of Code Sec. 475, the effect of this definition is to sweep into mark-to-market accounting entire classes of taxpayers that do not suffer from the timing whipsaws that spurred the development of mark-to-market accounting in the first place.<sup>148</sup> The resulting furor has required the adoption of a wide range of regulatory relief measures.<sup>149</sup> The very titles of some of these relief measures—the “negligible sales” exception, or the “customer paper” exception—hint at the ludicrousness of the original statutory definition of “securities dealer.”<sup>150</sup> The

<sup>146</sup> Compare Code Sec. 475(f)(1) (election applies to “any security held in connection with such trade or business”) with Temp. Reg. § 1.1902(b)-4T(b)(1) (a mixed straddle account includes only a “designated class of activities”). It is true that Code Sec. 475(f)(3) contemplates separate elections for each trade or business of a taxpayer, but we do not believe that each investment strategy constitutes a separate trade or business.

<sup>147</sup> See note 11, *supra*.

<sup>148</sup> See, e.g., Caginalp et al., note 11, *supra*, at 1073-1074; Levy et al., note 11, *supra*, at 14-16; Rosenthal & Rainey, note 11, *supra*, at 158; Scarborough, note 11,

*supra*, at 301; Sheppard, note 11, *supra*, at 13.

<sup>149</sup> Temporary regulations to Code Sec. 475 were issued on Dec. 29, 1993 (T.D. 8505, 1994-1 C.B. 152), and final regulations were issued on Dec. 12, 1996 (T.D. 8700, I.R.B. 1997-7, 5). Proposed regulations were also issued on Jan. 4, 1995 (60 Fed. Reg. 397) and on June 20, 1996 (61 Fed. Reg. 31474). See also Rev. Proc. 97-43, I.R.B. 1997-39, 12 (discussing procedure for obtaining consent to change accounting method to comply with elections out of certain exemptions from dealer status).

<sup>150</sup> These exceptions exclude certain taxpayers from the sweeping statutory definition of “securities dealer.”

Under the “negligible sales” exception, a taxpayer who regularly purchases securities from customers in the ordinary course of a trade or business, but makes no more than negligible sales of the purchased securities, is not treated as a dealer in securities unless the taxpayer elects to be so treated or the taxpayer accounts for any security as inventory for purposes of Code Sec. 471. Reg. § 1.475(c)-1(i). A taxpayer is deemed to engage in no more than negligible sales of debt instruments if, during the taxable year, either the taxpayer sells fewer than 60 debt instruments (in whole or in



breadth of the statute also exposes the fisc to unintended results, as demonstrated, for example, by the current trend among industrial firms *not* to elect the "customer paper"<sup>151</sup> exception. Instead, these firms treat themselves as securities dealers in respect of the financing they provide their customers, in order to use mark-to-market valuations to reduce the face amount of their receivables otherwise currently includible in income, by reflecting in the year the receivables are originated valuations that reflect both time value of money discounts and customer credit risks.

In Part II, we discussed the traditional tax definition of a securities dealer as a "merchant" in securities, profiting by earning a middleman's spread from buying and selling from customers. A securities dealer (in this classic sense) as an economic matter is compensated for providing liquidity to the marketplace: the dealer buys, not what it thinks will appreciate, but what the customer wishes to sell, and the dealer sells, not property that it fears will depreciate, but rather whatever the customer wishes to buy.<sup>152</sup> True dealers generally hedge their inventories from first-order price risk, both because of the absolute size of the inventories relative to their capital, and because those inventories reflect the collective requirements of the dealer's customers, not the dealer's own market views. For this service the dealer charges a price, which is reflected in over-the-counter markets (where the dealer holds inventories and is a principal to its customers) in the bid-ask spread.

The fundamental flaw in Code Sec. 475 is that the drafters lost sight of the original problem—timing whipsaws for true dealers (which inevitably rely extensively on hedging)—in their zeal to address a secondary problem—the astonishingly generous lower-of-cost-or-market inventory accounting system. The solution that we believe would have resulted in a stronger statute would have been to repeal lower-of-cost-or-market generally for all taxpayers, and to apply the more extensive mark-to-

market regime only to "true" dealers—that is, taxpayers that buy and sell securities from customers. Instead, Congress in 1993 (and again in 1997) avoided the larger issue of lower-of-cost-or-market, and adopted an overbroad definition of securities dealing, in order to force as many taxpayers as possible off lower-of-cost-or-market and onto mark-to-market accounting.

What, then, should be the criteria for determining the scope of Code Sec. 475's mandatory mark-to-market regime? In this regard, it should first be noted that the reasons proffered by Code Sec. 475's legislative history for placing dealers on mark-to-market—ease of valuation and liquidity<sup>153</sup>—are overrated and do not justify the imposition of the method. As the government knew from its past experience with derivative dealers, many contracts owned by these dealers were neither easily valued nor liquid, in any reasonable sense of the word. If ease of valuation and liquidity were the criteria justifying the use of mark-to-market, then taxpayers owning publicly-traded securities (at least mutual funds and other corporate taxpayers) would have been placed on this method years ago, because publicly-traded securities quintessentially satisfy these criteria.

We would, instead, submit that a more compelling rationale for the use of mark-to-market is that taxpayers running a business that by necessity consists of *hedged* positions need a mark-to-market system to avoid distortions and whipsaws created by timing differences between their long and short positions, or between their long-dated and short-dated positions.<sup>154</sup> The need for some sort of interperiod income matching methodology for such taxpayers has been demonstrated through the history of mark-to-market accounting for dealers. Moreover, for the reasons developed in Part I, traditional deferral-based interperiod income matching schemes break down when applied to hedged dealer business, because a one-to-one correspondence between an item of current period income (or loss) and a future item of

(Footnote Continued)

part), or the total of the debt instruments (or parts thereof) that the taxpayer sells is less than 5% of the debt instruments that it acquired (from customers or otherwise). Reg. § 1.475(c)-1(c)(2). The example most frequently proffered of a taxpayer for which the negligible sales rule was intended is a community bank, which makes loans (and hence is treated as purchasing securities), but which infrequently sells them.

The "customer paper" exception excludes from the dealer definition taxpayers who would not be dealers in securities but for their purchase and sale of debt instruments that are "customer paper" of the taxpayer or a member of the same consolidated group at the time of purchase or sale. Reg. § 1.475(c)-1(b)(1). A debt instrument is "customer paper" as to a person at a point in time if: (i) the person's principal activity is selling non-financial goods or providing nonfinancial services; (ii) the debt instrument was issued by a purchase of the goods or services at the time of the purchase of those goods or services in order to finance the purchase; and (iii) at all times since the debt instrument was is-

sued, it has been held either by the person selling those goods or services or by a member of the same consolidated group. Reg. § 1.475(c)-1(b)(2). An industrial firm that sells goods on credit is an example of a taxpayer that can elect the customer paper exception.

<sup>151</sup> A taxpayer may elect to disregard the "customer paper" exception under Reg. § 1.475(c)-1(b)(4). Once made, the election can be revoked only with the Service's express consent. Reg. § 1.475(c)-1(b)(4)(ii).

<sup>152</sup> *George R. Kemon*, note 40, *supra*, at 1032; *J.C. Bradford v. U.S.*, 71-2 USTC ¶ 9542, 444 F.2d 1133, 1135 (Cl.Ct.); *Stephen Marrin, et ux.* note 41, *supra*, at 1752. See Raby & Raby, note 41, *supra* (discussing recent cases and trader/dealer distinction). See also discussion note 42, *supra* (quoting definition of a dealer in securities under Reg. § 1.471-5).

<sup>153</sup> See notes 80-84, *supra*, and accompanying text for detailed discussion.

<sup>154</sup> Professor Gergen, note 16, *supra*, at 217, has suggested an alternative rationale for mark-to-market accounting, based on his important study of the influence of

different tax systems on the effective rate of tax assessed on historical returns in the marketplace. Professor Gergen would impose mark-to-market accounting on securities that may be traded with low transaction costs, on the grounds that ownership of such securities renders the tax system especially vulnerable to strategic trading utilizing the timing option. While we regard this proposal as cogent and, in many respects, theoretically persuasive, as Professor Gergen notes his proposal would result in imposing mark-to-market accounting on most publicly-traded securities and on over-the-counter products that may be traded with low costs. We think it unlikely that mark-to-market accounting will, in the foreseeable future, be imposed on individual investors, or for that matter mutual funds, owning stocks traded on the various exchanges. As a result, we prefer the hedging rationale for mark-to-market offered in the text above, on the grounds that it more closely corresponds to present law and what we believe to be the likely near-term future of the tax system.

loss (or income) cannot be established. Mark-to-market accounting thus emerges as the *only* feasible system for addressing the timing issues inherent in such hedged businesses, as the securities dealers learned to their chagrin through the over-the-counter derivatives experience of the mid-1980s.

Our proposed alternative—mandatory mark-to-market for all true dealers, including securities and commodities dealers (*i.e.*, dealers that make genuine 2-way markets), and the elimination of lower-of-cost-or-market accounting for all taxpayers—obviates the need to write exceptions for banks that simply lend money, or for industrial firms that simply finance customer purchases (or, conversely, eliminates the possibility of using mark-to-market accounting to reduce year of sale income attributable to such financing). Our alternative might be criticized, however, as leaving intact the taxpayer self-help available in cost-based realization systems, in which economic losses might be realized at year-end and gains deferred.

Our answer to this criticism is that an ersatz definition of the term “securities dealer,” adopted in the hopes of limiting taxpayer timing electivity, applies almost randomly, and certainly to only a fraction of relevant cases. Taxpayer timing electivity is already addressed by the straddle rules, capital loss limitations, the hedge timing rules of Reg. § 1.446-4, and other safeguards. Given the reality that Congress is not likely to adopt an economy-wide mark-to-market system of federal income taxation, it asks too much of a rule aimed at securities dealers to cure the economy-wide timing electivity issues with which the Code has wrestled for generations.<sup>155</sup>

**2. The Importance of Liabilities.** An important defect with the present mark-to-market system is that only a taxpayer's assets are marked to market, while liabilities of the taxpayer are accounted for under traditional realization standards. This reality limits the usefulness of the method and prevents its application to other taxpayers whose capital structures differ from those of securities dealers.<sup>156</sup>

The problem can be illustrated by a simple example. Assume that a taxpayer purchases a fixed rate investment instrument for \$100, while financing the purchase of this instrument by borrowing \$100 from a creditor. There is a subsequent decrease in interest rates, which

results in the taxpayer having an economic gain of \$10 on the asset, and an economic loss of \$10 on the liability. Under the present mark-to-market system, the \$10 of gain on the asset would be currently taken into account at year-end, while the \$10 loss on the liability would only be recognized in subsequent periods, either through deduction of interest expense (at now premium rates), or in a deduction if the liability were redeemed at a premium price. Of course, the opposite fact pattern may occur, where the taxpayer benefits from this distortion if interest rates increase, resulting in a taxable loss on the assets, and unrealized gain on the liability.<sup>157</sup>

In short, the failure to mark to market liabilities is a systematic shortcoming of our present system, and creates the potential for significant distortion of income.<sup>158</sup> We do not anticipate that this shortcoming will be addressed in the near future, but it is worth considering whether these distortions are occurring to a significant extent in the case of securities dealers using mark-to-market under present law.

Fortuitously, such distortions do not occur today, for the simple reason that true securities dealers and commodities dealers, to an overwhelming extent, finance their businesses with short-term liabilities, *i.e.*, debt that is typically overnight (or no more than a few days) in duration to match the high turnover of their inventories. In the case of securities dealers, for example, government securities inventories overwhelmingly are funded through overnight sales-repurchase (“repo”) transactions, which for this purpose are analogous to overnight secured borrowings. Short-term liabilities are less vulnerable to price swings that are due to changes in interest rates, and thus result in only minimal distortions under a system that marks only assets to market.

Mark-to-market accounting cannot successfully be applied to other taxpayers with long-term liabilities, absent changes in the method to include liabilities. For example, we believe that mark-to-market accounting cannot successfully be applied to the lending activities of a commercial bank, because of the significant long-term liabilities present in the bank's capital structure, which are used to fund its loans. Phrased differently, those matching liabilities function as natural hedges for the interest rate risks inherent in the bank's loan portfolio. To mark one leg of a hedged transaction to market,

<sup>155</sup> See Schenk, note 2, *supra* (discussing possible alternatives to an economy-wide mark-to-market system).

<sup>156</sup> Ironically, similar difficulties in dealing with liabilities have plagued proposals to index the Code for inflation, for reasons quite similar to those described below. Shuldiner, “Indexing the Tax Code,” 48 *Tax L. Rev.* 537, 540, 641-48 (1993).

<sup>157</sup> One of the controversies concerning the Financial Accounting Standards Board's (FASB) proposals to require mark-to-market financial accounting for derivatives relates to this problem of inconsistent application. Banks and other institutions could be whipsawed by the FASB's proposals if they attempted to protect themselves against increases in interest rates on their future borrowings by currently engaging in derivative transac-

tions which would create “short” positions in interest rate-sensitive instruments. Under such a strategy, for example, if interest rates subsequently increased, banks would be required to pay a higher rate of interest on their new borrowings, thus incurring an economic loss. However, the increase in interest rates would also decrease the value of the interest rate sensitive instruments, which would result in a gain to the banks since they were short in those instruments. (In effect, by engaging in these transactions, banks and other institutions would be hedging themselves against such interest rate risks.) Unfortunately, under the FASB's proposals, if interest rates were to fall, banks would be required to report financial accounting losses on their short positions, while the offsetting economic gains (consisting of

lower future borrowing costs) would not be reported as accounting gains since such items are merely an “expectation” and presumably too speculative to be recognized under generally accepted accounting principles. Lowenstein, “Corporate America Bullies FASB, Part II,” *Wall Street Journal* at C1 (Sept. 11, 1997). Once again, piecemeal application of mark-to-market accounting produces distortive results, here in the context of financial reporting where incentives are to report book profits, not losses.

<sup>158</sup> For recognition of this problem, and a resulting conclusion that mark-to-market accounting may not represent a desirable regime, see Kleinbard, note 2, *supra*, at 956.

while leaving the other leg valued at cost, is a fundamental error that is inherently distortive.<sup>159</sup>

Code Sec. 475 loses sight of this potential distortion, and sweeps large classes of assets that in fact are funded by long-term liabilities—for example, bank loans—into its scope.<sup>160</sup> Bank loans are relatively easy to value—certainly easier than exotic over-the-counter option-based derivatives—but that relative ease of valuation does *not* mean that those assets necessarily should be subjected to a mark-to-market regime, when the natural hedges of those assets (the liabilities used to fund the loans) are themselves subject to interest rate risk and are *not* within any mark-to-market system currently permitted by the Code.

The mark-to-market accounting rules for variable insurance products described earlier<sup>161</sup> is an instructive application of this thesis, and not (as it might at first appear) an exception thereto. A life insurer's insurance obligations are, of course, long-term, but the insurer's annual additions to reserves effectively mark those obligations to market—in a simplified and appropriate manner for the insurer's general account, and in a precise manner for the insurer's segregated variable accounts. The Code adopts this unique mark-to-market approach to the liability side of an insurer's balance sheet (along with the mark-to-market of the assets held in the insurer's segregated variable accounts) in order to accelerate the deduction into the same period into which the relevant income (the gross amount of premiums) is included. In this one case, then, and in contrast to the one-sided mark-to-market of a portfolio of bank loans (but not the related liabilities incurred to fund the loans), mark-to-market principles are applied in a consistent manner to both assets and liabilities (albeit in the sense of contractual obligations, not indebtedness for money borrowed).

The ambiguous and potentially expansive definition of “dealer” and “securities” in Code Sec. 475 creates a real risk of inappropriate application of Code Sec. 475 to other taxpayers whose liability structures are not amenable to mark-to-market as it exists under the Code.<sup>162</sup> Mark-to-market accounting is desirable only if it is applied in a uniform and broad manner; piecemeal application of mark-to-market may actually result in a system

which is more distortive than its realization-based predecessors.

**3. Should Mark-to-Market Be Elective for Commodities Dealers?** As previously described, the 1997 Act amended Code Sec. 475 to permit commodities dealers to elect to apply mark-to-market accounting to their dealer businesses.<sup>163</sup> The expansion itself makes perfect sense, of course, but leaves unanswered the question of whether that extension should have been on a mandatory basis. We believe that the answer must be yes.

The legislative history to the 1997 Act does not explain this extraordinary decision to offer commodities dealers electivity (and continued lower-of-cost-or-market inventory methods), while requiring securities dealers to adopt mark-to-market accounting. In light, however, of (i) the inherent policy problems raised by lower-of-cost-or-market (which at least some commodities dealers appear to employ); (ii) the fairness of the results reached under mark-to-market, and (iii) the appropriateness of applying those rules to commodities dealers under our tests developed above (hedged businesses subject to timing whipsaws and heavy reliance on short-term funding), there is every reason to require commodities dealers to mark-to-market.

Commodities dealers are vulnerable to timing distortions created by hedging in a manner that is similar to securities dealers. In the absence of *mandatory* mark-to-market for commodities dealers, however, the only candidates for elective mark-to-market will be those dealers that cannot rely on lower-of-cost-or-market to remedy their timing distortions in a one-sided manner. Those taxpayers presumably will include over-the-counter derivatives dealers (which are likely to conclude that their derivatives books are not inventory)<sup>164</sup> and taxpayers unfortunate enough to have elected an inventory accounting method other than lower-of-cost-or-market at the inception of their businesses.

The issues raised by electivity seem to us particularly forceful when one combines electivity concerns with the point developed earlier, that the Code's existing surrogate forms of mark-to-market accounting—the various deferral mechanisms that link current income or expense to its future corresponding amounts—generally do not apply to dealers,<sup>165</sup> and, in light of the absolute

<sup>159</sup> See Weisbach, note 16, *supra*, at 510, for discussion of the distortions created when mark-to-market and realization-based accounting methods are applied to separate legs of offsetting positions, such as a hedge. Professor Weisbach's conclusion, with which we concur, is that consistent use of a realization-based approach is preferable to piecemeal application of mark-to-market in such a situation.

<sup>160</sup> Regularly making loans to customers in the ordinary course of a trade or business is considered a purchase of a security for Code Sec. 475(c)(2) purposes, so that banks may be considered dealers in securities. Reg. § 1.475(c)-1(c)(1)(i). Rev. Rul. 93-76 specifically does not exclude banks from being dealers in securities, noting that its activities may bring it within the definition of a dealer in securities in Code Sec. 475(c)(1). Rev. Rul. 93-76, 1993-2

C.B. 235. Indeed, the legislative history of Code Sec. 475 provides the following example of a dealer in securities:

“For example, assume that, in the ordinary course of a trade or business, a bank originates loans that are sold if the loans satisfy certain conditions. In addition, assume that (1) the bank determines whether a loan satisfies the conditions within 30 days after the loan is made, and (2) if a loan satisfies the condition for sale, the bank records the loan in a separate account on the date that the determination is made. For purposes of the bill, the bank is a dealer in securities with respect to the loans that it holds for sale.”

H. Rep. No. 103-11, 103d Cong., 1st Sess. 226 (1993) (Conference Report). See Levy et al., note 11, *supra*, at 15-16.

<sup>161</sup> See Section II.B, *supra*, for detailed discussion of this point.

<sup>162</sup> Bank lending, for example, fits within the Code Sec. 475 definition of securities dealers. See note 160, *supra*, for a discussion on banks as securities dealers.

<sup>163</sup> Code Sec. 475(f)(2).

<sup>164</sup> See note 61, *supra*.

<sup>165</sup> Code Secs. 1092(e) and 1256(e) exempt dealers from the straddle rules. Code Sec. 1091(a) excludes securities dealer activities from the wash sale rules, as does Reg. § 1.446-4(a)(2)(i) for such dealer activity (including activities of electing commodities dealers) from the hedge transaction rules (by providing that the regulation does not apply to any position to which Code Sec. 475(a) applies). In addition, the interest capitalization rules of Code Sec. 263A(a)(1)(B) do not apply to property which is inventory in the hands of the taxpayer.

size and value of a typical dealer's trades, are very difficult to apply to dealers with any degree of reliability. Given that many commodities dealer positions are by definition liquid assets, the ease of self-help in such circumstances to accelerate unrealized losses, and the ineffectiveness of the Code's surrogate mark-to-market mechanisms, commodities dealers should be required to adopt the real thing.<sup>166</sup>

### C. What Positions Should Be Marked to Market Under Code Sec. 475?

**1. General Rule.** If the principal purpose of Code Sec. 475, as applied to true dealers, is to eliminate timing whipsaws (as well as to curb the taxpayer electivity inherent in realization-based systems), it must follow inexorably that Code Sec. 475 should be drafted to bring within its scope *all* of the positions directly connected with that dealer business. In general, Code Sec. 475 does just that, and moreover treats the resulting gain or loss as ordinary, to prevent character whipsaws as well.<sup>167</sup> Nonetheless, Code Sec. 475 does contain a number of exceptions to its application. This Section III.C explores those exceptions to see what underlying conflicts those exceptions reflect, and to determine whether those underlying conflicts in fact have been resolved.

**2. The Interaction of Two Mark-to-Market Regimes—Code Secs. 475 and 1256.** Code Sec. 475 excludes from its coverage commodities futures and other contracts accounted for under the mark-to-market rules of Code Sec. 1256(a).<sup>168</sup> Although at first blush this may appear as a mere drafting issue involving priorities among two competing mark-to-market models, its implications are quite important. Essentially, under current law, dealers in equity options on the floor of the options exchanges and "floor traders" on the commodities and options exchanges are allowed capital gains treatment for ordinary business profits realized through day-to-day operations, to the extent they engage in those operations through Code Sec. 1256 contracts.<sup>169</sup> This is an astoundingly generous result.

As we discuss later in the article, Code Sec. 1256 seems outmoded and inappropriately generous, even for investors.<sup>170</sup> But its application to full-time dealers and floor traders who are engaged in day-to-day operations on the floors of exchanges is one of the more puzzling anomalies in the tax laws. How can one justify allowing such a full-time entrepreneur to report 60% of its ordinary profits from Code Sec. 1256 contracts as long-term capital gains,<sup>171</sup> while this same type of profit (assuming it is realized outside of Code Sec. 1256) is taxed as ordinary income to securities dealers (and dealers in all other property, for that matter),<sup>172</sup> and short-term capital gains to other traders?<sup>173</sup>

Later in this article we discuss the application of Code Sec. 1256 more generally to traders and investors, and recommend changes in the statute from that perspective. But confining the discussion here to dealers, we believe Code Sec. 475 should be amended, so that it applies to Code Sec. 1256 contracts owned by persons otherwise subject to Code Sec. 475's provisions. Code Sec. 475 should trump Code Sec. 1256 in instances where both statutes apply, on the grounds that the mark-to-market mechanics of Code Sec. 475 are far more sensible than the ad hoc, politically inspired provisions of Code Sec. 1256.

**3. Investment Positions and Code Sec. 1092.** Code Sec. 475 effectively carves investment assets out of its scope, thereby preserving the Code's traditional concept of Code Sec. 1236 investment accounts for securities dealers.<sup>174</sup> By ceding ground to Code Sec. 1236, the mark-to-market rules simply acknowledge that the same financial asset can take on different characteristics for a taxpayer (e.g., as stock in trade or as an investment) depending on the context in which it is held, and that it would be anomalous to conclude that the Code should require some taxpayers to forfeit the benefits of the Code's investment incentives (particularly long-term capital gains tax rates) in respect of classic investment activities as the price of pursuing their chosen business profession.<sup>175</sup>

<sup>166</sup> As an aside, in the past, we understand that some commodities dealers (for example, integrated oil and gas companies) have expressed concern that a mandatory mark-to-market regime would require them to mark to market, for example, their petroleum reserves in the ground, under the theory that those reserves could be viewed as commodities. We would agree that subjecting reserves to mark-to-market accounting would be inappropriate—those reserves pertain to the business of exploiting and extracting natural resources, not the business of dealing in commodities. The solution to this problem lies, however, in accurately defining what constitutes a dealer business, not in taxpayer electivity.

<sup>167</sup> Code Secs. 475(a), (b) (applying the provisions of the section to securities held by a securities dealer in such capacity); Code Sec. 475(d)(3)(A) (treating gain or loss under the section generally as ordinary gain or loss).

<sup>168</sup> Code Sec. 475(c)(2).

<sup>169</sup> Code Sec. 1256(a)(3).

In general, an "equity option" is an option to buy or sell stock, or an option whose value is determined, directly or indirectly, by reference to any stock or stock index. Code Sec. 1256(g)(6)(A). An "options dealer" is generally a person registered with an appropriate national securities exchange as a market maker or specialist in listed options. Code Sec. 1256(g)(8)(A). "Dealer equity options" are, with respect to an options dealer, equity options purchased or granted by the options dealer in the normal course of its activity of dealing in options, and listed on the qualified board or exchange in which the options dealer is registered. Code Sec. 1256(g)(4). For a discussion on floor traders as dealers, see generally *Frank J. Laureys, Jr.*, note 44, *supra*; *Kramer*, note 44, *supra*, at § 8.2(a).

<sup>170</sup> See Section IV.D, *infra*.

<sup>171</sup> Code Sec. 1256(a)(3)(B).

<sup>172</sup> Code Sec. 475(d)(3)(A).

<sup>173</sup> Code Sec. 1256(a)(3)(A).

<sup>174</sup> Code Sec. 475(b)(1)(A) carves securities held for investment out of the scope of

the section. Code Sec. 475(b)(1)(B) does the same for debt which is not held for sale. Reg. § 1.475(b)-1(a) excludes securities from the scope of the mark-to-market requirement if they are held for investment or not held for sale, and appropriate identification is made. Investment assets held by a dealer thus fall outside the mark-to-market rules of Code Sec. 475, and will give rise to capital gain or loss, if the identification rules of Code Sec. 475 and 1236 are complied with. The Service takes the view that the identification rules of Code Sec. 1236 are conceptually different from those of Code Sec. 475. See Rev. Rul. 97-39, I.R.B. 1997-39, 4.

<sup>175</sup> An underlying premise of this distinction is that investment activities can be adequately identified, which explains the same-day identification rules of Code Secs. 1236(a)(1) and 475(b)(2). See Reg. § 1.1236-1(d), 1.475(b)-2(b). Under Reg. § 1.475(b)(4), taxpayers effectively cannot elect investment results for notional principal contracts. This appears to have been motivated by the view that notional prin-

Investment positions, whether held by an investor or by a dealer in its Code Sec. 1236 account, are subject to the asymmetrical surrogate mark-to-market principles of the wash sale and straddle rules, which operate to defer realized losses, but not realized gains.<sup>176</sup> In particular, the straddle rules of Code Sec. 1092 require a taxpayer to defer realized loss in respect of a position in personal property to the extent that the taxpayer has at year-end unrealized gains in respect of offsetting positions (or certain successor positions) in such property.<sup>177</sup>

By its terms, Code Sec. 1092's loss deferral rules would appear to have no relevance to dealers covered by Code Sec. 475. Code Sec. 1092(e) provides that the straddle rules do not apply to hedging transactions (within the meaning of Code Sec. 1256(e)), and, more dramatically, Code Sec. 475 itself requires a dealer to mark all of its dealer positions to market, thereby guaranteeing that there can be no unrealized gain in respect of dealer positions at year-end, and therefore nothing to which Code Sec. 1092's loss deferral rules could apply.

Interestingly, however, Code Sec. 475(d)(1) provides that Code Sec. 1092's loss deferral rules *do* apply to any loss realized under Code Sec. 475(a). Since by definition a dealer will have no unrecognized gain in respect of its dealer activity, we believe that the only case to which Code Sec. 475(d)(1) can be addressed is the case of a dealer that realizes a *net* loss in respect of its dealer activities and has at year-end an unrealized gain in a Code Sec. 1236 account.<sup>178</sup>

We believe that this result is wrong. If in fact a position that purports to be in an investment account relates to a dealer's business, the right remedy is for the Service to exercise its authority to bring that position fully into Code Sec. 475's mark-to-market system (subject to that section's misidentification character penalty provisions).<sup>179</sup> Relying on Code Sec. 1092 in such circumstances would produce inappropriate results where the dealer's Code Sec. 475 activities give rise to a net loss.

Conversely, if there is no factual nexus between a position in an investment account and a dealer's business activities, Code Sec. 1092 should have no application. Code Sec. 1092 itself would be virtually impossible to apply in such circumstances—to what “position” would the dealer's net loss be said to relate? More fundamentally, Code Sec. 1236's Chinese wall between dealer and investment activities should not be breached simply by virtue of the coincidence of a net loss on one side and unrealized gain on the other. (*Non-coincidental* gaming,

of course, is addressed by the Service's Code Sec. 475 authority described in the preceding paragraph.) This conflict should be resolved by reversing the conclusions reached in Code Sec. 475(d)(1) in respect of the priority of Code Sec. 1092. Code Sec. 1092 should not apply to losses recognized under the mark-to-market rules of Code Sec. 475.

**4. Code Sec. 475 and REMIC Residuals.** Another conflict involving Code Sec. 475 would occur if the mark-to-market provisions of Code Sec. 475 were applied to residual interests in a real estate mortgage investment conduit (REMIC). In this situation, Code Sec. 475 should defer to the special regime established for the taxation of REMICs. To mark REMIC residual interests to market would undermine the carefully established provisions that are necessary for REMIC taxation to work in a coherent manner. Therefore, it is appropriate, as under the present regulations, that a dealer owning residual interests in a REMIC not be subject to Code Sec. 475 with respect to those interests.

The basic point here is that REMIC residual interests (the equity in a REMIC) are a form of toxic tax waste, resulting from the fact that the owners of the residual interest (i) may not anticipate receiving any additional cash flow from their interest, and (ii) may anticipate recognizing taxable income (and incurring a subsequent tax liability) from their interest, even though they will receive no cash to allow them to pay such tax (“phantom income”).<sup>180</sup> The REMIC rules go to great measures to insure that the phantom income will produce tax payments from its owners, requiring, for example, that tax be paid on this phantom income even if the income is recognized by a tax-exempt organization,<sup>181</sup> or even if the income would otherwise be offset by net operating losses of the taxpayer.<sup>182</sup> The REMIC rules thus are unique, in that they insure appropriate tax results by mandating symmetrical treatment of the parties, and close off any avenue of escape from this symmetrical result.

If a dealer were allowed to include a residual interest in its marked-to-market securities, then the negative value of that residual would produce the effect of a deduction for the dealer, reducing the dealer's income and resulting tax liability. This initial deduction would offset the future tax payment on the phantom income, and thus undermine the carefully constructed (and otherwise watertight) REMIC system. Excluding negative REMIC residual interests from Code Sec. 475 is therefore a legitimate action which is necessary for the REMIC system of taxation to work as it was intended.<sup>183</sup>

(Footnote Continued)

cial contracts inherently are not investment assets, but rather invariably constitute dealer property or hedges of dealer activity.

<sup>176</sup> See Code Secs. 1091 and 1092.

<sup>177</sup> Code Sec. 1092(a)(1).

<sup>178</sup> Cf. Temp. Reg. § 1.1092(b)-5T(d) (treating inventory “write-downs” as losses potentially subject to Code Sec. 1092).

<sup>179</sup> Under Code Sec. 475(b)(2), securities misidentified as exempt from marking to market must be marked to market. See generally Caginalp et al., note 11, *supra*, at

1095; Levy et al., note 11, *supra*, at 20; Rosenthal & Rainey, note 11, *supra*, at 164.

<sup>180</sup> See Kramer, note 44, *supra*, § 36.4(c), 41.2(k); Peaslee & Nirenberg, *THE FEDERAL INCOME TAXATION OF MORTGAGE-BACKED SECURITIES* 287-92 (Rev. ed. 1994).

<sup>181</sup> Code Sec. 860E(b).

<sup>182</sup> Code Sec. 860E(a)(1); Reg. § 1.860E-1(a)(1).

<sup>183</sup> The 1993 temporary regulations under Code Sec. 475 only excluded negative value residual interests from applica-

tion of mark-to-market accounting, which is consistent with the explanation provided above in the text. See Peaslee & Nirenberg, note 180, *supra*, at 328 (discussing former Temp. Reg. § 1.475(c)-2T). In contrast, the 1995 proposed regulations, which were finalized in 1997, expanded the exemption from Code Sec. 475 to cover all residual interests in REMICs, regardless of whether those interests have a positive or negative fair market value. Reg. § 1.475(c)-2(a)(3). Although the preamble to the regulations does not fully explain this shift in position, in all likeli-

## D. Mark-to-Market and Counterparty Symmetry

Mark-to-market accounting raises fundamental and unavoidable conflicts between the taxation of a financial instrument in the hands of a taxpayer that employs mark-to-market, and the taxation of that instrument in the hands of a counterparty that does not. This Section III.D explores several of these conflicts.

1. **Symmetry in General.** The taxation of financial products would be easier if all parties were similarly-situated taxpayers, but that is not the circumstance under which we operate.<sup>184</sup> Investors and issuers alike may be tax-exempt institutions, or foreign, or endowed with net operating losses or other tax attributes. In such a world, symmetry of tax positions between the parties to a financial transaction (so that my tax windfall is your tax pain, and therefore is reflected in price) cannot exist, and therefore seems to us to be the wrong paradigm to guide tax policy.<sup>185</sup>

Mark-to-market accounting presents another example of asymmetry in tax profiles between counterparties to financial transactions. A securities dealer accounts for a financial position under mark-to-market accounting, while the dealer's customer will typically use traditional realization principles (if it is a taxpayer at all). For the dealer, the process of marking to market invariably self-corrects for any noneconomic accrual (or nonaccrual) of income or loss in respect of a transaction, while the customer must rely on the traditional tax rules applicable to the transaction, at least until disposition or termination.

For example, imagine that a swap dealer enters into an equity swap on the common stock of a publicly-held company with an end user, under which swap the appreciation or depreciation in the underlying stock will be paid or received by the dealer, as the case may be, at the end of three years. The dealer hedges its swap by buying the underlying stock. Most observers today believe that the end user does not record income or loss in respect of the price appreciation/depreciation component of the swap until that contingency is resolved at the end of three years. The dealer, however, is indifferent to the resolution of this issue, because the dealer will mark to market each year both its open swap position and its offsetting "physical" hedge.

It may be argued that the tax treatment of the end user in this example is not optimal, but that debate is only obscured by focusing on the dealer's lack of a stake in the resolution. There simply exist too many tax-indifferent counterparties (foreign swap dealers, or tax-exempt institutions, for example) to rely on the dictates of tax symmetry between taxpayers to solve the problem of

tax inconsistencies across different investment opportunities of a single taxpayer.<sup>186</sup>

Our earlier discussion of why REMIC residuals are excluded from mark-to-market accounting under Code Sec. 475 is consistent with this analysis. The taxation of REMICs is *not* an exercise in illogic, but rather a coherent and self-contained system that is designed to have no escape routes.<sup>187</sup> REMIC residuals are excluded from Code Sec. 475 precisely to avoid introducing an escape route where none currently exists. In other cases, however, where policymakers believe that illogic is at work in the taxation of a financial instrument, the answer is to address that inconsistency, not to introduce noneconomic tax competitive issues across differently-situated financial intermediaries through redefining the scope of Code Sec. 475.

2. **Mark-to-Market and Consolidated Returns.** The present consolidated return regulations take the position that if a dealer, subject to Code Sec. 475, transfers a security to an affiliated non-dealer in an intercompany transaction, the non-dealer continues to be subject to mark-to-market treatment with respect to that security for as long as it is held.<sup>188</sup> We believe that this represents an unwarranted expansion of mark-to-market accounting, again in a piecemeal and inconsistent manner, to taxpayers otherwise using realization methods. The various policy reasons leading to the exemption of the non-dealer from a mark-to-market system should apply with equal force when the non-dealer acquires securities from a dealer subject to mark-to-market accounting. No abuse occurs here—the dealer has been required to take all income into account under Code Sec. 475, and thus no deferral or shifting of income occurs in any manner.

Indeed, the existence of a self-help remedy lends support to our conclusion that this unfair rule should be modified. Under the self-help approach, the dealer can sell the security to a third party, and the non-dealer can purchase that security in the marketplace, without the mark-to-market taint it would acquire from an intercompany transaction. Because the present regulations can easily be avoided, they currently constitute nothing more than a trap for the unwary, or an obstacle for the way that can be avoided through incurring additional transaction costs. Neither of these reasons justifies their existence.

A different variation of this problem occurs when one member, a dealer, that is a party to an intercompany contractual obligation (such as a swap), accounts for that obligation under a mark-to-market system. Since application of Code Sec. 475 by such a dealer to its side of the obligation results in the *recognition* of gain, this recognition event will trigger the requirement that the dealer's affiliate mark to market its side of the obligation

(Footnote Continued)

hood the government justified this change by noting that most residual interests do have negative values, and that Treasury's methodology for determining whether an interest has a negative value may be defective, thus making it difficult for the government to be confident that it knows a negative residual from a positive one. Given these factors, excluding all REMIC

residual interests from Code Sec. 475 may be justified as a low-cost simplification of the law that is much easier to administer than the theoretically correct rule.

<sup>184</sup> See generally Bradford, note 8, *supra*, at 743-47.

<sup>185</sup> See generally Shuldiner, note 2, *supra*, at 782; Kleinbard, note 2, *supra*, at 960.

<sup>186</sup> For a criticism of symmetry, based on the presence of tax-exempt or tax-insensitive institutions, and a suggestion that symmetry should not be pursued as a significant tax policy goal, see Kleinbard, note 10, *supra*, at 1362.

<sup>187</sup> See Section III.C.4, *supra*.

<sup>188</sup> Reg. § 1.1502-13(c)(7)(ii) (Ex. 11).



as well, even if the affiliated counterparty is not a dealer and therefore would otherwise be allowed to account for the obligation under a realization-based method.<sup>189</sup>

An example illustrates the problem.<sup>190</sup> Assume a non-dealer operating corporation engaged in business activities is exposed to risks resulting from changes in interest rates or commodity prices. This corporation, a member of a consolidated group, hedges this risk with another member, which is a dealer in securities. The dealer member then hedges its position with the non-dealer member by entering into an offsetting position with an unrelated third party.

The hedge between the two corporate members is an intercompany "obligation," and under the consolidated return rules, the application of mark-to-market accounting under Code Sec. 475 by the dealer to this obligation will, in essence, require the non-dealer member to mark to market its side of the transaction as well.<sup>191</sup> The dealer also marks to market its hedge with the unrelated third party (since it is subject to Code Sec. 475), and thus the dealer's income has been properly measured. The problem is that the non-dealer member is not allowed to mark to market its position with third parties that initially led it to enter into the hedge with the dealer. As a result, a potential for timing and character mismatches occurs, because the non-dealer member is required to mark to market its hedge, while not being allowed to mark to market its hedged positions with third parties.

This example illustrates that mark-to-market accounting only works properly when used in a comprehensive manner. Under the consolidated return regulations, mark-to-market accounting is applied in a piecemeal and fragmented fashion, leading to a distortion in income measurement caused, essentially, by the application of two disparate accounting methods by one taxpayer.

The regulations offer two complex and ad hoc solutions to this problem. The first solution (which most

securities dealers adopt) is the "separate-entity" election,<sup>192</sup> under which all members of a consolidated group are treated as though they were separate entities, instead of being divisions of a single corporation.<sup>193</sup> Under the regulations, assuming that the dealer is marking to market its side of the transaction, the special rules governing intercompany obligations do not apply, and the non-dealer affiliate is not required to mark to market its side of the hedge.<sup>194</sup> With respect to the dealer's side, both its intercompany hedge as well as its outside third party position will be marked to market, thus achieving a satisfactory result in that regard as well.<sup>195</sup>

The second solution is an election permitted under the Code Sec. 475 regulations<sup>196</sup> that allows a securities dealer to avoid marking to market this particular hedge. This, in turn, results in the non-dealer affiliate being allowed to retain the use of the realization method with respect to its side of the hedge as well.<sup>197</sup> Essentially, both parties are allowed to use a realization system with respect to the same transaction. Thus, ironically, the use of mark-to-market accounting is abandoned here, since it would have produced a distorted measure of income in comparison to the measure achieved by a realization system.

This second solution (abandoning mark-to-market for dealer affiliates) can work only for the simplest of dealers, since most large-scale dealer firms will not be able to link their intercompany transactions with a specific third-party transaction. At best, then, this solution is an artifact of the overbreadth of Code Sec. 475 that we have previously described; at worst it is a trap for unwary dealers, which generally are better served by making the separate entity election.

The difficulty with these solutions is that their utilization (indeed, merely understanding the problem to begin with) demands an extraordinary knowledge of a number of highly technical tax rules. Absent such an understanding, these solutions can be easily missed and therefore lost,<sup>198</sup> leading to a mismeasurement of in-

<sup>189</sup> Under the consolidated return regulations, the realization of any income, gain, deduction, or loss from an assignment or extinguishment of an intercompany obligation by one member will cause the obligation to be treated as satisfied for its fair market value, i.e., essentially marked to market by both sides. Reg. § 1.1502-13(g)(3). If the obligation still remains in existence after this deemed satisfaction, then the obligation is viewed as reissued for its fair market value.

<sup>190</sup> For an excellent presentation of this problem, see Scarborough, note 11, *supra*. We are also indebted to Mr. Scarborough for his helpful discussions with us regarding this problem.

<sup>191</sup> Under Code Sec. 1.1502-13(g)(3) of the consolidated return regulations governing intercompany obligations, the fact that a dealer member marks to market its side of the hedge forces the non-dealer member also to mark to market its position, even though the non-dealer member is otherwise taxed under a realization-based system.

<sup>192</sup> Reg. § 1.1221-2(d)(2).

<sup>193</sup> Treatment as divisions of a single corporation is the underlying principle of the consolidated return regulations, and is exemplified by the "single-entity" approach which is the default rule adopted by the regulations. Reg. § 1.1221-2(d)(1).

<sup>194</sup> Instead, the non-dealer affiliate may account for its transaction with its dealer affiliate as a hedge of its outside position. Thus, any gain or loss from the non-dealer member's side of the intercompany transaction will be matched both as to timing and as to character with its third-party transaction that created the business risk being hedged. Reg. § 1.1221-2 and 1.446-4.

<sup>195</sup> See Scarborough, note 11, *supra*, at 299.

<sup>196</sup> Reg. § 1.475(b)-1(d).

<sup>197</sup> The regulations apparently achieve this result through a convoluted application of three different rules. First, the election under Reg. § 1.475(b)-1(d) allows the dealer to avoid marking to market the security representing its outside position with the third party, since this security hedges a position of another member of the taxpayer's consolidated group. (To

qualify under this rule, the dealer must timely identify this security as a hedging transaction as required under Reg. § 1.1221-2(b)). Second, having avoided mark-to-market treatment of this outside position, the dealer is then able to avoid marking to market its intercompany transaction under Code Sec. 475(b)(1)(C), on the grounds that the intercompany transaction is itself a hedge with respect to the outside position, and the outside position is not marked to market. Third, the non-dealer affiliate is allowed to use the realization method with respect to its side of the intercompany transaction, since the dealer is not using mark-to-market accounting for the transaction, which in turn avoids triggering the rules of Reg. § 1.1502-13.

<sup>198</sup> Regulations under Code Sec. 475 require, for example, that specific securities be identified by a dealer as being exempt from mark-to-market accounting. Reg. § 1.475(b)-1(d). If such a taxpayer discovers the inconsistent treatment of hedged positions too late, it will not be able to comply with the identification procedures, and therefore will not be able to avoid mark-to-market accounting for the hedge.



come. The government may be properly criticized here for creating a trap that can be avoided only through the assistance of tax specialists to guide taxpayers through a Byzantine maze of complexity.

We think a more satisfactory solution to the problem would have been the adoption of a general default rule that a dealer does not mark to market obligations with other non-dealer members.<sup>199</sup> This would have avoided the problems resulting from the dealer's mark-to-market treatment creating the necessity of a symmetrical recognition event for the non-dealer affiliate, and would have resulted in a much simpler system.

### E. Selected False Conflicts Between Code Sec. 475 and Realization Principles

The previous sections of this Part III have explored points of conflict between Code Sec. 475's mark-to-market regime and other Code provisions. This Section III.E effectively reverses that inquiry, by examining some issues that the Service believes present important conflicts between mark-to-market and realization principles, but where no such conflict in fact exists. If Code Sec. 475 is to function effectively, it is as important *not* to develop rules elevating red herrings to substantive importance as it is to resolve actual substantive conflicts in a manner consistent with the statute's purpose.

**1. Bad Debt Reserves.** Recent attention in the tax press<sup>200</sup> has been addressed to the question of whether Code Sec. 475 implicitly permits taxpayers to circumvent the Code's prohibition against reserves for bad debts. At a practical level, the issue has arisen most forcefully as a result of the unreasonably broad definition of dealer, which results in any taxpayer that provides goods or services on credit being characterized as a dealer in those loans subject to Code Sec. 475, unless the taxpayer elects to be excluded under the customer paper exception. Such a taxpayer can avoid making this election, mark its loans to market, and thus effectively value those loans at less than face value, thereby attaining what has been characterized as the equivalent of a reserve for bad debts. If our proposals were accepted, and Code Sec. 475 were to apply only to genuine dealers, then this issue would not arise.

The Code's pre-1986 allowance of bad debt reserves was in fact flawed. For example, assume that a bank loans \$1 million to each of 20 customers, for a total loan portfolio of \$20 million. If the bank's experience is that

5% of its loans prove uncollectible, under the Code before its amendment by the Tax Reform Act of 1986 (the "1986 Act"), the bank would have been allowed to establish immediately a \$1 million reserve against this loan balance.<sup>201</sup> This treatment was wrong and inappropriately favored the bank. The bank would not have spent \$20 million to obtain assets with a value of \$19 million.<sup>202</sup> Instead, the most reasonable initial value to attribute to the loans is \$20 million, which is what the bank just paid to acquire the assets. The "missing" \$1 million in fact is reflected in the risk premium included in the interest rate charged by the bank over the life of its loans to compensate the bank for particular loans that go bad. This risk premium provides the bank with an overall return on its \$20 million investment commensurate with the returns available on other competing investments. Because the income to which the bad debt losses relate would be realized over the life of the loans, the immediate establishment of a \$1 million bad debt reserve in this situation understated current income, which led to the method's repeal in 1986.

Pre-1986 Act bad debt reserve methodologies thus were fundamentally flawed, because they accelerated deductions that related to future credit losses into the current period, while leaving the risk premium income that compensated the lender for the credit losses to be recognized in future years.<sup>203</sup> As applied to true dealers, however, the fundamental question raised by this brief history is whether mark-to-market accounting practices, as actually applied in the field, operate to match or distort a taxpayer's current and future income and related credit losses. The resolution of this question turns out to be surprisingly subtle, because it depends on the details of how dealers in fact mark their positions to market.

In the case of "physical" securities held in inventory (e.g., over-the-counter stocks and bonds), dealers generally mark positions they own to the price that they could realize by selling those securities to other dealers. Under this methodology,<sup>204</sup> net "long" positions in physical securities are marked to the *bid* side of the market (i.e., the price that dealers would pay to buy those securities), and net "short" positions in physical securities (which arguably are not inventories, but which are valued under the same principles) are marked to the *ask* side of the market (i.e., the price that other dealers would *charge* the taxpayer to purchase securities to cover the short position). These bid and ask prices reflect all relevant data

<sup>199</sup> If this rule were adopted, the dealer should be allowed to treat its intercompany transaction and any offsetting third-party transaction as hedges (to the extent identifiable as such)—to avoid distortions occurring if the third-party transaction were marked to market while the intercompany transaction was not.

<sup>200</sup> See, e.g., Sheppard, note 11, *supra*.

<sup>201</sup> Former Code Secs. 108(e)(7)(B) and 166(c) (before repeal in 1986).

<sup>202</sup> As noted by the tax press, in some situations the fair market value of the loan may be less than the loan's face amount even at the loan's original inception. E.g., Sheppard, note 11, *supra*, at 14. This will most commonly occur in situations in-

volving customer receivables which may be non-interest bearing, or which may bear an inappropriately low rate of interest given the credit risk. In our view, however, that is a fact that argues *for* a de facto bad debt reserve as opposed to supporting the opposite position. There is no reason that businesses providing goods and services to customers should be systematically overtaxed if business practices dictate that interest not be charged on customer receivables, or charged at a low, subsidized rate. For more discussion of this point, see Evans, note 30, *supra*, at 841-42.

<sup>203</sup> On the other hand, it can be argued that post-1986 Act law goes too far the

other way, in that the specific charge-off lags behind the actual deterioration in value of a lender's loan portfolio. Letter from J. Chapoton to J.R. Mentz, Assistant Treasury Secretary, 31 *Tax Notes* 826 (May 26, 1986); Committee on Tax Accounting Problems, Section of Taxation, American Bar Association, "Comments on Section 906 of H.R. 3838, Repeal of the Reserve Method of Accounting for Bad Debts," 86 *Tax Notes Today* 63-189 (Mar. 31, 1986) (comments are views of individual members of the Committee).

<sup>204</sup> Code Sec. 475 does not stipulate how to mark to market, but rather simply instructs taxpayers to mark to "fair market value." Code Secs. 475(a)(1), (a)(2).

concerning the security in question (except possibly volume discount issues), including credit risk, and it therefore would be inappropriate to make further credit adjustments to those values.

In contrast, over-the-counter derivatives generally by consensus are marked to market under a very different process. A dealer's derivatives positions typically are not held for sale to customers, but rather in the ordinary course remain on the dealer's books for the life of the contract. No doubt motivated by this factual difference between inventories of physical securities and over-the-counter derivatives, dealers typically mark their over-the-counter derivatives to *mid-market*—that is, the mean of the bid and ask prices.<sup>205</sup>

For example, assume that the mid-market rate for a 5-year interest rate swap is 7% versus the London Interbank Offer Rate ("LIBOR"), and that the bid-ask spread is 20 basis points. (In reality, spreads usually are much narrower, but the authors do not wish the reader to misperceive the issue as trivial.) If a swap dealer promises to pay LIBOR and receive fixed interest on a \$1 million notional principal amount swap, the dealer thus will receive 7.1% of the notional principal amount per annum. If the dealer then enters into an offsetting swap with another customer, the dealer will receive LIBOR and pay 6.9% per annum.

At the end of the day in this example, the dealer would have created for itself the economic equivalent of an annuity of \$2,000 per year for 5 years (\$1 million x 0.002) (assuming, of course, that no credit defaults took place). If the dealer marked its "long" swap to the bid side of the market (i.e., at 6.9%) and its "short" swap to the ask (i.e., at 7.1%)—as the dealer would for physical securities that it held for resale or cover, respectively—the dealer would show no net income from the two swaps at the end of the day.<sup>206</sup> In practice, however, the swap dealer marks the two swaps to mid-market (i.e., at 7.0%), thereby reflecting as an *immediate* profit<sup>207</sup> the present value of that \$2,000 per year annuity.<sup>208</sup> The dealer does so because the presumption is that both swaps will remain on the dealer's books over their terms, and therefore that the dealer has completed at the time the swaps are entered all steps required to earn that

income. (In addition, marking to the bid and ask side of the markets would have the effect of recording less immediate income as a derivatives book was being built up—a result that was thought to be undesirable for a host of self-evident non-tax reasons.)

Marking to mid-market thus *accelerates* income compared to realization principles, and therefore raises the precise mirror image of the problems posed by immediate deductions of credit reserves before 1986. Phrased differently, marking to mid-market accelerates into the current period many years of future gross income, but does not reflect the expenses or losses necessary to earn that gross income. Dealers therefore adjust their mid-market marks for over-the-counter derivatives to achieve a proper matching of income and expense, by establishing adjustments for credit risks, future administration costs, liquidity risks, and so on.

A moment's reflection reveals that the Service should be delighted that over-the-counter derivatives dealers' non-tax agendas have led them to accelerate income in this fashion, as a literal application of Code Sec. 475(a) might have led to the conclusion that dealers should mark their "long" swaps to the bid and "short" swaps to the ask side of the market, thereby deferring the day in which the fisc would participate in a dealer's success. Instead, the Service has issued no guidance on this universal market practice, which silence has left dealers with a generalized anxiety that any adjustments made from pure mid-market marks might be viewed as impermissible reserves.<sup>209</sup>

Dealers have responded by carefully documenting their adjustments as case-by-case exercises in valuation, but all that energy is misplaced as a policy matter. Upfront credit and other reserves are inappropriate in a realization world, as our bank loan demonstrates.<sup>210</sup> Reserves also have no place when dealers mark to the bid and ask side of the market (except to the limited extent that those adjustments in fact relate to defining the relevant market, such as the cost of selling blocks of illiquid securities). When a dealer marks to mid-market, by contrast, the dealer is accelerating gross income, and the Service should be forthright enough about that fact to permit straightforward adjustments from that mid-

<sup>205</sup> By convention, the mid-market rate is the rate available to very creditworthy counterparties, and therefore reflects very little credit risk premium.

<sup>206</sup> The dealer would discount the obligation to pay 6.9% at 6.9%, resulting in a zero net present value to the dealer, since an obligation of the dealer is being discounted by a rate equal to the obligation's nominal rate. Similarly, the dealer would discount the right to receive 7.1% at 7.1%, also resulting in a zero net present value to the dealer. Thus, if a dealer were to mark its long swap to the bid rate and its short swap to the ask rate, it would not report any income upon entering into a swap.

<sup>207</sup> The dealer discounts the obligation to pay 6.9% at 7.0%, resulting in a positive net present value to the dealer, since an obligation of the dealer is being discounted by a rate higher than the obligation's nominal rate. Similarly, the dealer discounts the right to receive 7.1% at

7.0%, also resulting in a positive net present value to the dealer, since an asset of the dealer is being discounted by a rate lower than the asset's nominal rate. Marking to mid-market thus results in positive net present values which are taxable income to the dealer. However, this methodology, without additional adjustments to reflect credit risk, has the effect of overstating the dealer's income, because assets and liabilities are discounted in a manner that does not take into account such potential future adjustments to cash flow.

<sup>208</sup> See Letter from Salomon Brothers Inc., note 64, *supra*.

Dealers in practice mark each swap to mid-market, regardless of whether the swap is perfectly hedged by an offsetting swap. Thus, if the dealer in the above example entered into only one of the two swaps in the text, it nonetheless would record an immediate profit equal to the

present value of \$1,000 per year for five years.

<sup>209</sup> See Sheppard, note 11, *supra*, at 14.

<sup>210</sup> This statement holds true when the rate of interest charged on a loan is equal to the prevailing market rate at the time (including an appropriate risk premium), as in the case of bank loans. Upfront reserves would be appropriate, however, where the stated interest rate was less than the prevailing rate at the time of the transaction. For example, merchants providing goods and services to customers on credit and not charging any interest whatsoever on such loans are overtaxed unless they are allowed the use of an upfront reserve for bad debts. In our view, this latter issue should, however, be addressed comprehensively, not through the ad hoc solution of industrial firms affirmatively electing dealer status to obtain the economic equivalent of a bad debt reserve on customer receivables.

market mark whose purpose is to bring into the same current period good faith estimates of the future expenses associated with that accelerated income.

One concern that might follow from the above discussion of a dealer's adjustments to mid-market valuations is that a dealer might *overestimate* those adjustments, thereby reducing its current period income. One answer is that in every case the dealer would be reporting more income from its derivatives business than a literal reading of Code Sec. 475(a)(2) might require. A less glib response, however, would be that this is but one example of the protections that the Service would have obtained had the Service adopted the dealer community's suggestion for a presumption that dealer's mark-to-market valuations for non-tax purposes would be accepted for Code Sec. 475 purposes as well.

**2. Market Discount.** Under currently proposed regulations a dealer that purchases bonds with market discount is required to account separately for amortized market discount as interest income every year when the bond is marked to market in the dealer's hands.<sup>211</sup> (Similar principles apply in the case of a bond purchased at a premium.)<sup>212</sup> If a bond's fair market value is \$950 at the beginning of the year, and its value at the end of the year is \$965, then a dealer generally would recognize \$15 of ordinary income under Code Sec. 475 as the bond was marked to market. If the bond had been purchased at a discount, however, and \$10 of market discount would have accrued for the year in question, then the rules require the market discount provisions to apply before the bond is marked to market.<sup>213</sup> As a result, \$10 of market discount is recognized as interest income, with the remaining \$5 of gain recognized as ordinary income under mark-to-market. The total net amount of taxable income (in this case \$15) is not altered by this rule. Instead, the effect of the regulations is to transmute regular ordinary income into interest income based on the market discount for the year in question.

In our view, these regulations are ill-advised and represent a triumph of technical literalism over sound administrative practice. Mark-to-market accounting should be implemented as a unitary and comprehensive method of accounting, not a piecemeal routine applied

to leftovers. There are several reasons supporting this conclusion.

First, from a purely pragmatic perspective, in our experience many securities dealers cannot comply with these requirements due to their complexity. The difficulties of separately tracking market discount within a mark-to-market system in a scenario involving billions of dollars of securities are beyond the capabilities of many systems currently in place. This reason should suffice, in and of itself. As an aside, we believe that even if systems were engineered to take these rules into account, the costs of this compliance would vastly exceed its benefits. This is a prime example of an opportunity for the Service to simplify the tax laws in ways that are, for all practical purposes, revenue neutral.

Second, the historical rationale underlying the market discount rules was to prevent income that was economically equivalent to interest from being disguised as capital gain.<sup>214</sup> Indeed, given the large preference provided to capital gains, this is a very legitimate concern and serves as a strong justification of the market discount rules. This concern is completely absent, however, in the context of a dealer (or a trader, for that matter) under Code Sec. 475, since all of the income would be taxed as ordinary income under mark-to-market. Thus, the historical and very legitimate reasons for applying the market discount rules are not present in the case of mark-to-market under Code Sec. 475.

Third, the distinction between ordinary income and interest income (which is at stake in these regulations) is only of minor importance for most taxpayers. For corporate taxpayers, the distinction is generally trivial,<sup>215</sup> and whatever distinction exists is offset to a significant extent by the fact that an equal but opposite skewing would result in the case of a bond held at a premium (or a short position in a market discount bond).

In sum, there are powerful reasons of economy and internal consistency to employ mark-to-market accounting in a comprehensive fashion, and only weak reasons for retaining the proposed regulations' hybrid approach. We do not believe that the Service and Treasury disagree with this assertion in the abstract; instead, their representatives have expressed concern that Congress has not directed them to ignore the market discount rules.

<sup>211</sup> Prop. Reg. § 1.475(a)-1(c)(2). As background to the market discount rules, a taxpayer that purchases a 5-year, \$1000 face value bond for \$950 would normally defer recognition of market discount until the bond matured in five years, at which point the \$50 of market discount would be taxed as interest income. Code Sec. 1276. If the taxpayer were to sell the bond before its maturity, then a portion of the gain, equal to a maximum of \$10 for every year the bond was held (\$50 total discount divided by five years), would be characterized as interest income, with the remainder of the gain treated as capital gain. *Id.* Thus, if the taxpayer were to sell the bond for exactly \$965 in one year, recognizing gain of \$15, the gain would be bifurcated into components—\$10 would be taxed as interest income, and \$5 would be capital gain. Assume now that this taxpayer is a dealer in securities subject to

Code Sec. 475 with respect to the bond. If the bond were worth \$965 in one year after purchase, the taxpayer would recognize a total of \$15 of income, even though the bond was still in the taxpayer's possession. Under the proposed regulations, \$10 of that \$15 gain would be taxed as interest income and \$5 would be taxed as ordinary income to the dealer. Prop. Reg. § 1.475(a)-1(e).

<sup>212</sup> See Prop. Reg. § 1.475(a)-1(c)(3).

<sup>213</sup> See Prop. Reg. § 1.475(a)-1(e).

<sup>214</sup> See Staff of the Joint Committee on Taxation, "General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984," 98th Cong., 2d Sess., 93 (1984).

<sup>215</sup> Generally, market discount is treated as interest income when recognized. Code Secs. 1276(a)(1), (a)(3). As such, the source of market discount income under realization principles should be deter-

mined by the residence or place of incorporation of the issuer of the market discount bond. Code Secs. 861(a)(1), 862(a)(1).

No rules today describe the source of mark-to-market gains, but we believe that most dealers look to the closest analogy, and source such gains in the same manner that gains from the actual sale of the underlying securities would be sourced. The source of gain from the sale of *inventory* (which is the category that includes most market discount bonds held by a dealer) is determined by reference to the place of sale, which in the case of a bond ordinarily is the place where the bond has its principal trading market and where the bond is "cleared." Code Sec. 865(b). Mark-to-market gain from a bond of a foreign issuer thus ordinarily is treated as foreign source gain—just as accrued market discount would be.

Our response is that we are gratified that Congress did not direct the Service to override market discount principles in implementing the new mark-to-market rules of Code Sec. 475, because we think it would reflect badly on Congress were it to wallow in this sort of administrative minutiae. A fair reading of the legislative history of Code Sec. 475 is that Congress thought that mark-to-market was both necessary and sufficient as a tax regime for dealers. At worst, Congress created a conflict between two Code sections: there is no reason to assume, however, that Congress preferred the less logical resolution of this conflict. We therefore urge that the Service resolve this conflict by relying on the point made throughout this article, that mark-to-market accounting is most principled when it is narrow in scope but deep in application, and accordingly conclude that no reason has been identified that is strong enough to overcome the presumption in favor of applying mark-to-market in these circumstances.

#### IV. CURRENT CONFLICTS IN APPLYING MARK-TO-MARKET ACCOUNTING TO TRADERS AND INVESTORS

##### A. Overview

Unlike dealers, securities and commodities *traders* originally were swept into mark-to-market accounting for at least part of their activities out of anti-abuse concerns, crystallized by the straddle crisis of the late 1970s.<sup>216</sup> More recently, the elective expansion of Code Sec. 475 to securities and commodities traders reflects the fact that the existing tax rules applicable to large-scale traders and investors, particularly the straddle rules of Code Sec. 1092, expose those taxpayers to precisely the same sort of timing whipsaws that dealers previously faced.<sup>217</sup>

Today, investors are required to use a realization-based system, and are subject to the straddle rules,<sup>218</sup> wash sale rules,<sup>219</sup> and other anti-abuse provisions.<sup>220</sup> Traders, in contrast, may elect a mark-to-market system and thereby emancipate themselves from these anti-abuse rules (at the price of gain acceleration),<sup>221</sup> or, alternatively, use the same realization system applicable to investors. Perhaps even more important is the tremendous difference in character recognition. The realization-based system results in capital gains and losses to both investors and traders, while mark-to-market some-

times results in ordinary income to electing traders that adopt it—except when it leads to capital gain.<sup>222</sup>

It may be that the disparity in accounting methods currently available to traders is unprecedented in the history of our tax law. Even under the law prior to 1993, while dealers could elect mark-to-market, their gains and losses were all ordinary, irrespective of whether mark-to-market or a realization-based system was used. For traders, the character of the gain itself depends upon the particular method chosen, which is an extraordinary difference indeed.

The first question, then, is which system is theoretically correct for a trader—mark-to-market accounting or realization-based models backed-up with anti-abuse regimes? As a corollary, if a mark-to-market regime is desired, should it be elected on an account-by-account basis (as mixed straddle accounts are today), or for all of a trader's trading activities? The second principal question is whether any net gain or loss resulting from a mark-to-market regime should be taxed as ordinary or capital.

The difficulty in analyzing this area lies in the fact that the term "trader" encompasses two drastically different types of business activities:

- (i) hedge funds and other complex operations engaging in huge volumes of transactions that rely on offsetting hedged or arbitrage positions,<sup>223</sup> and
- (ii) "directional traders" or "frequent investors," i.e., persons engaged in more traditional securities activities who achieve the status of traders simply because they buy and sell on a relatively frequent basis.

Section IV.B therefore considers the issue of whether mark-to-market accounting should be mandatory or elective for traders in general. Section IV.C then reviews the special issues relevant to hedge funds and similar institutional traders.

##### B. Mandatory or Elective Mark-to-Market for Traders?

Should mark-to-market be required for all traders in securities and commodities? Although we have supported the mandatory application of mark-to-market to dealers (including commodities dealers), mark-to-market should *not* be required for traders; there are differ-

<sup>216</sup> See Section II.C.1, *supra*, for detailed discussion.

<sup>217</sup> See Section II.C.2, *supra*, for detailed discussion.

<sup>218</sup> Code Secs. 1092 and 263(g).

<sup>219</sup> Code Sec. 1091.

<sup>220</sup> *E.g.*, Code Secs. 1233 (short sale rules) and 469 (passive activity rules).

<sup>221</sup> Code Secs. 475(e), (f).

<sup>222</sup> Compare Code Sec. 475(d)(3) (ordinary character for traders electing Code Sec. 475 treatment) with Temp. Reg. § 1.1092(b)-4T (capital character for mixed straddle accounts).

<sup>223</sup> Hedge funds have grown tremendously in recent years—in terms of both

the number of such funds and the assets they manage. In the past year, investors have invested \$40 billion in hedge funds, bringing their total assets under management to over \$140 billion. There are now over 3000 hedge funds operating—up from about 420 in 1990. Tergesen, "As Hedge Funds Grow, Their Walls Don't Look So High," *New York Times* at 11 (Nov. 2, 1997).

As the industry grows, some funds are having increasing difficulty finding investment opportunities consistent with their professed strategies. Jereski, "Hedge Fund to Shrink Capital of \$6 Billion by Nearly Half," *Wall Street Journal* at C1 (Sept. 22,

1997) (reporting Long-Term Capital Management's decision to return \$3 billion in capital to investors). Many hedge funds now pursue a wide variety of opportunistic investment strategies—hedged and unhedged. See Tergesen, *supra*. The Soros group of funds, for example, pursues a range of strategies from holding blue-chip stocks to speculating in currencies, and its volatile results often make headlines. Jereski & Sesit, "Soros Takes a \$2 Billion Trading Hit," *Wall Street Journal* at C1 (Oct. 31, 1997).

ences between the two groups that justify disparate treatment as a matter of tax policy.

First, as previously discussed, it seems more appropriate for traders to recognize gains and losses as capital in nature, and not ordinary, given the nature of a trader's business orientation. In addition, traders are subject to a host of anti-abuse rules (such as the wash sales rules) from which dealers are exempt.<sup>224</sup> As a consequence, realization-based systems are viable from a tax policy perspective for traders who are not engaged in widespread hedging operations.

Finally, the definitional distinction under the tax laws between a trader and investor is hazy and uncertain. Assuming that investors will be allowed to remain on realization systems, there is no strong policy rationale for forcing an investor onto mark-to-market if he or she unwittingly strays into trader territory by virtue of the volume and frequency of his or her activities. No magical change in economic status occurs as one evolves from investor to trader that would justify the government imposing mark-to-market on a previously realization-based taxpayer. In contrast, the factual difference between a trader and dealer is much more substantive, and therefore would justify a drastic change in accounting methods.

Indeed, if one believes in a preference for long-term capital gains, then it is important that directional traders—those who actually make bets on the direction of future prices—not be forced onto a mark-to-market regime, since such traders may very well have long-term positions, and it would be quite difficult to maintain a distinction between short-term and long-term capital

gains under a mark-to-market system.<sup>225</sup> Moreover, mark-to-market removes the “hidden” capital gains preference that exists because of deferral. In essence, deferral under the realization doctrine provides an implicit capital gains preference, apart and separate from any preference which is explicitly provided in the form of reduced nominal rates of tax.<sup>226</sup> This second, hidden type of capital gains preference is, of course, frequently vilified in the academic literature as unfair and non-neutral.<sup>227</sup> If, however, one believes in a capital gains preference,<sup>228</sup> then the tax benefits of deferral through realization arguably are consistent with that belief, on the theory that it encourages long-term savings and long-term capital formation.<sup>229</sup> Ironically, a limited version of such a system is now in place in Code Sec. 1(h), which provides sliding tax rates corresponding with longer holding periods for property.<sup>230</sup> Thus, one may argue that the hidden capital gains preference is consistent with congressional intent and popular political sentiment regarding the taxation of capital gains.

### C. Special Issues Raised by Hedge Funds

Hedge funds and similar institutional traders employing arbitrage strategies generally should find mark-to-market accounting irresistibly attractive. Adopting mark-to-market accounting allows traders that employ hedged or arbitrage strategies to avoid the distortions resulting from timing differences in the recognition of gain and loss between (i) the hedges themselves; and (ii) the positions being hedged. Of course, this was the same problem that originally drove dealers to use the method.

<sup>224</sup> As described earlier in the text, reconciling lower-of-cost-or-market inventory accounting necessitates placing dealers on mark-to-market accounting, since dealers can achieve the same practical results as lower-of-cost-or-market through engaging in wash sales of loss securities. This point, which argues for placing dealers on a mandatory mark-to-market system, does not apply to traders, since traders are not allowed to use lower-of-cost-or-market, and since they are subject to the wash sale and straddle rules. Thus, a principal reason for placing dealers on mark-to-market accounting does not exist for traders.

<sup>225</sup> As an example, what if a person purchased an asset in February of the current year, the asset was marked to market in December of that year, and in October of the following year the asset was sold? Presumably, one would want all of the gain to be taxed as long-term capital gain, but that result is not easy to attain, given the fact that a return for the current year has to be filed before the holding period of the asset is determined (in October of the following year). One could adopt a “look-back” rule under which the final tax liability would be adjusted to take into account the ultimate holding period, which might result in refunds to the taxpayer if the holding period turned out to be long-term. Cf. Code Sec. 460(b)(2). But such a system is complex and difficult to administer. The defense industry has been using a similar “look-back” rule since the Tax Reform Act of 1986 to account for long-term con-

tracts, and there have been constant complaints about its complexity and numerous proposals to simplify its mechanics. See, e.g., Letter from D. Fuqua, Aerospace Industries Association, to K. Gideon, Department of Treasury, 91 *Tax Notes Today* 41-31 (Feb. 21, 1991); Statement of the Associated General Contractors of America to the House Ways and Means Committee, 90 *Tax Notes Today* 232-29 (Nov. 14, 1990). If a look-back approach is difficult to implement for people who build rockets and satellites, it might prove difficult for others to administer as well.

<sup>226</sup> See McDaniel, Ault, McMahon, Jr., & Simmons, *FEDERAL INCOME TAXATION: CASES AND MATERIALS* 222-23 (3d ed., 1994). Also see Johnson, “The Undertaxation of Holding Gains,” 55 *Tax Notes* 807 (May 11, 1992), for graphic illustrations of the inverse relationship between holding periods and effective tax rates.

<sup>227</sup> Unfair because it disproportionately benefits people with high incomes, and non-neutral because it subjects capital to different rates of tax, depending on the particular type of investment and how long it is owned. E.g., see Evans, note 1, *supra*, at 897. See also Dodge, “Restoring Preferential Capital Gains Treatment Under a Flat Rate Income Tax: Panacea or Placebo?,” 44 *Tax Notes* 1133, 1141 (Sept. 4, 1989) (criticizing capital gains rate preference on similar grounds); Shuldiner, note 1, *supra*, at 261-65 (discussing equity issues presented by defer-

ral). For the position that capital gains should be taxed, like any other income, on the grounds that capital gains typically represent wealth that is consumed as opposed to reinvested, see Johnson, “The Consumption of Capital Gains,” 55 *Tax Notes* 957 (May 18, 1992).

<sup>228</sup> We do not, in this article, defend a capital gains preference or advocate such a preference on tax policy grounds. Our point is simply that the existing system provides such a preference to investors holding securities, both explicitly in the form of preferential rates and implicitly in the form of deferral through the realization doctrine. Given this regime and its availability to investors, we do not believe that any persuasive tax-policy arguments exist to justify placing traders on a mandatory mark-to-market system, thereby depriving them of both the explicit and implicit benefits available to others under the Code.

<sup>229</sup> For an extensive analysis of arguments supporting as well as opposing a capital gains preference, see Cunningham & Schenk, note 17, *supra*; for a summary of these principal arguments, see Graetz & Schenk, note 1, *supra*, at 571-76.

<sup>230</sup> The rates of tax assessed on capital gains vary, depending on whether the property is held for (i) more than 12 months, but not more than 18 months; (ii) more than 18 months but not more than five years; or (iii) more than five years (for assets acquired after December 31, 2000). Code Sec. 1(h).

Hedge funds, however, have an even more dramatic reason than do dealers to desire mark-to-market accounting—traders (but not dealers) are subject to the application of the asymmetrical straddle rules that defer the recognition of realized losses, but not gains. The straddle rules ensure that hedged traders can be expected to adopt a mark-to-market system without any further compulsion.

Many hedge funds and similar traders today in fact can satisfy their desire for mark-to-market accounting treatment through either of two competing regimes: Code Sec. 475, as amended by the 1997 Act, and the mixed straddle account rules of Temp. Reg. § 1.1092(b)-4T. While it is true that a mixed straddle account must contain at least some Code Sec. 1256 contracts,<sup>231</sup> in many cases hedge or arbitrage strategies can be engineered to accommodate this requirement. More generally, however, amended Code Sec. 475 and the mixed straddle account rules are constructed on fundamentally different underlying principles as to the proper scope of mark-to-market accounting for traders. We believe that one or the other (or some combination) may be correct, but that it is very unlikely that both are.

There are three principal differences between mixed straddle accounts and amended Code Sec. 475:

- (i) mixed straddle accounts involve an annual election,<sup>232</sup> while Code Sec. 475, if elected, essentially applies on a permanent basis;<sup>233</sup>
- (ii) mixed straddle accounts do not have to apply to the taxpayer's entire operation,<sup>234</sup> while Code Sec. 475 is a comprehensive regime that admits no exceptions for activities within the scope of its trading operations;<sup>235</sup> and
- (iii) mixed straddle accounts result in capital gains or losses,<sup>236</sup> while Code Sec. 475 produces gains or losses of an ordinary nature.<sup>237</sup>

While this question is not an easy one, we believe that Code Sec. 475 represents the more desirable system, given our thesis that comprehensive application of mark-to-market is desirable for hedged businesses. Mark-to-market should be treated as an accounting method that is relatively permanent in nature, and, as discussed in more detail in the paragraphs below, it should apply in a comprehensive manner to all of a taxpayer's trading operations. On the other hand, we believe that capital gain (or loss) characterization is the better tax policy choice for a trader, and thus we regard Code Sec. 475's ordinary gain or loss treatment as inappropriate.

Our preferred mark-to-market regime for hedge funds and similar traders thus would be an amalgamation of the existing rules for mixed straddle accounts and Code Sec. 475: a system that embraces a permanent and comprehensive application of mark-to-market accounting and that also adopts capital gain or loss characterization. The implementation of this idea would require a further amendment to Code Sec. 475 and the repeal of the mixed straddle account regulations. The second of these presumably would follow naturally from the repeal of Code Sec. 1256 itself, which we suggest below.

Our conclusion that Code Sec. 475's business-wide approach is to be preferred over the mixed straddle account's strategy-by-strategy election might be criticized as unfair, because it would require traders to use mark-to-market accounting for unhedged trading strategies (where the case for mark-to-market is weak) in order to avoid timing distortions in their hedged positions.<sup>238</sup> Such a hybrid system theoretically could be administered by imposing contemporaneous identification requirements on traders, analogous to those in place for dealers who wish to identify securities as investments outside the scope of Code Sec. 475.<sup>239</sup>

On the other hand, allowing the use of such a hybrid system might place intolerable audit burdens on the Service, which would have to ensure that taxpayers were properly complying with the identification rules and not using this hybrid system to whipsaw the government. The potential for abuse here is very serious, with taxpayers potentially ignoring the rules and using after-the-fact identification to place securities which had depreciated in a mark-to-market system, while preserving the benefits of a realization system for their more successful investments. Although we believe it is a difficult question, on the whole we are inclined to support an all-or-nothing approach, largely for these administrative (rather than logical) reasons.

Finally, hedge funds and other traders electing Code Sec. 475 probably should be required to report their mark-to-market gains as short-term capital gains, as opposed to ordinary income. Treating mark-to-market gains and losses as short-term capital gains may help reduce the possibility of accidental or deliberate whipsaw, in the event that investment assets held by the trader and identified (properly or not) as being outside the scope of Code Sec. 475 produce capital losses. In contrast, treating mark-to-market gains and losses as ordinary results in the possibility of ordinary income (or loss) from trading activities and capital gain (or loss)

<sup>231</sup> Code Sec. 1256(d)(4)(A).

<sup>232</sup> Temp. Reg. § 1.1092(b)-4T(a).

<sup>233</sup> Code Secs. 475(e), (f). Of course, a taxpayer may always petition the Service for consent to change its method of accounting, including a change from marking to market under Code Sec. 475 to another system. However, the Service's consent to such a change is by no means assured; indeed, one would suspect that the Service will view requests to switch out of Code Sec. 475 with a jaundiced eye.

<sup>234</sup> Temp. Reg. § 1.1092(b)-4T (including in a mixed straddle account positions

held as a capital asset in a designated class of activities).

<sup>235</sup> Of course, the rules allow a taxpayer to avoid application of Code Sec. 475 with respect to investments that have no connection to its trading operations. Code Sec. 475(f)(1)(B).

<sup>236</sup> Temp. Reg. § 1.1092(b)-4T(C).

<sup>237</sup> Reg. § 1.475(d)-1(a).

<sup>238</sup> This situation is reminiscent of taxpayers complaining about the loss of lower-of-cost-or-market for all their securities as a condition of using mark-to-market for their derivatives. See notes 68-70, *supra*, and accompanying text for the his-

tory of this controversy. However, the situation described above in the text seems more sympathetic, because retaining the use of mixed straddle accounts for part of one's operations does not produce the distortions that are created by the use of lower-of-cost-or-market.

<sup>239</sup> Reg. § 1.475(b)-(2). Traders would have to identify, on the date of acquisition, securities subject to tax under a realization-based method and those subject to mark-to-market accounting, and such identification would dictate the subsequent treatment of these securities.



from identified investment activities—a result that can lead to obvious tax unfairness in either direction.

### D. Code Sec. 1256

Given the evolution of the tax law over the last 15 years and our increasingly sophisticated understanding of financial products, Code Sec. 1256 is really quite an odd provision. The most striking feature of Code Sec. 1256 is that it imposes mark-to-market accounting on taxpayers (including traders and investors) who are not necessarily engaged in hedged positions. Given the thesis of this article that the most compelling rationale for mark-to-market is to prevent distortions otherwise produced by the taxation of hedged positions under a realization system, Code Sec. 1256's indiscriminate use of mark-to-market is an anomaly that should be retained only if a convincing case can be made that it serves some greater tax purpose.

Code Sec. 1256 may be defended as eliminating any selectivity problem, by requiring all parties to use the same method of accounting for certain contracts, thus avoiding difficulties with adverse selection that permeate any elective method. Moreover, the method provides an accurate measure of income, and prevents taxpayers from any of the gaming that occurs under a realization-based system.

Code Sec. 1256 seems unnecessary, however, to address the problems that originally led to its enactment. The serious gaming problems that occurred in this area in the past (*i.e.*, straddle transactions) have been eliminated by the straddle rules of Code Sec. 1092 and related provisions, thus making Code Sec. 1256 unnecessary as an anti-abuse measure.<sup>240</sup> Moreover, once the possibilities for arbitrage are eliminated by the straddle rules, the short-term nature of most Code Sec. 1256 contracts provides limited possibilities for deferral of tax. Certainly, by comparison with the deferral opportunities provided by equity investments, deferral under Code Sec. 1256 contracts (which typically have short-term maturities) is trivial. If mark-to-market is to be embraced as a way of ending deferral, then it should be applied first to publicly-traded equities; regulated futures contracts would come in a distant second or third in order of importance.

In addition, Code Sec. 1256's character rules seem unjustified, and may very well distort market behavior. It is quite odd to give a few classes of investments the benefits of long-term capital gain status for 60% of all

gains, regardless of the holding period. Why should a person be able to purchase a regulated futures contract, hold it for two weeks, and pay tax on any gain at an effective rate of roughly 28%, when the very same economic bet, if made through another investment vehicle, must be held for more than twelve months to receive comparable treatment? Although this favorable treatment may have been originally necessary as a political inducement in order to pass the 1981 legislation, that is not an argument for continuing this provision as we enter a new century. After the 1997 Act's lowering of rates on long-term capital gains, Code Sec. 1256 ironically now serves as a quasi-tax shelter, providing an automatic long-term holding period in an unwarranted and inappropriate manner.

Another argument against Code Sec. 1256 is that it is complex. It applies to a number of investments outside of regulated futures contracts, and creates administrative burdens and difficulties. A realization-based system, backed up by the straddle rules, is an easier tax system to administer.

In addition, the so called "constructive receipt" argument, which has been advanced in defense of Code Sec. 1256, is overstated.<sup>241</sup> This argument, in our view, is not sufficiently strong to justify imposing mark-to-market accounting on the wide variety of arrangements currently subject to Code Sec. 1256, many of which do not possess the exchange-provided liquidity that characterizes true commodities futures.

Thus, in conclusion, Code Sec. 1256 is badly in need of repair. At the very least, treating gain under these contracts as long-term capital gain (in part) is an inappropriate windfall that raises concerns of fairness as well as allocative efficiency. At a deeper level, it is not clear that Code Sec. 1256 is justified, given the current state of play in existence for other, competing types of investments and the complexity created by the provision. The abuses that Code Sec. 1256 targeted are effectively dealt with by the straddle rules, and the income deferral opportunities in this area are not particularly substantial, given the short-term nature of the contracts at issue. Finally, the liquidity arguments justifying Code Sec. 1256 are largely specious and fail to distinguish adequately Code Sec. 1256 contracts from other types of investments. Code Sec. 1256 is comparable to computer technology developed in 1981—revolutionary in its time, but now obsolete and in need of replacement.

<sup>240</sup> See notes 99-112, *supra*, and accompanying text.

<sup>241</sup> See notes 118-122, *supra*, and accompanying text.