CTJ Citizens for Tax Justice

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Derivatives Proposal from Top House Tax-Writer Could Improve Tax Code — if the Revenue Is Not Used for Rate Cuts

In recent weeks, Dave Camp of Michigan, the Republican chairman of the House Ways and Means Committee, released tax proposals related to the complex world of derivatives that would have real benefits — if Camp was not proposing to use all the resulting revenue savings to offset cuts in tax rates.[1] Congress instead should consider enacting these proposals and using the revenue to protect and preserve programs like Medicare that are increasingly targeted for self-destructive cuts.

Current tax law treats "derivatives" — futures contracts, options, swaps, and so forth — in a variety of ways, none of them correct. This allows taxpayers to use derivatives to avoid or defer taxes on investment income.

Derivatives — the Basics

A derivative can be thought of as a contract between two parties to make some sort of transaction and that has a value derived from the underlying asset involved in that transaction. For example, two people can enter into a contract that gives party A the right to buy stock from party B at a certain price in the future. If the price of the stock rises above that price, party A wins (he gets to buy the stock at less then its value) and party B loses (he has to sell the stock at less than its value). Conversely, if the stock value turns out to be less than the contract price, party B wins (and party A loses).

Derivatives can be useful financial tools for businesses, particularly for hedging risks. For example, a farm business may want to reduce risk by setting a future price for its crops at a certain level. So the farm agrees to sell the crops at a future date at that certain price. The buying party is betting that the value of the crops will be higher in the future. This "hedging" may or may not turn out to maximize the farm's profits, but the business can eliminate its downside risk.

In recent years, derivatives have become far more complex, particularly as they have become traded by individual and corporate investors who have no connection to or

[1] See the House Ways and Means Committee's Tax Reform web page. http://waysandmeans.house.gov/taxreform/default.aspx

interest in the underlying assets. For example, imagine that neither party in the contract described above actually owns or plans to buy the crops that the contract refers to. The contract really is just a bet by the two parties on which way the crops' value will move.

How Derivatives Are Used for Tax Avoidance

Derivatives can also create huge opportunities for tax avoidance. To take just one example, some high-profile people of enormous wealth, including Ronald S. Lauder, heir to the Estée Lauder fortune, have used a derivative called a "variable prepaid forward contract" to sell stock without paying taxes on the capital gains for a long time. Lauder entered into a contract to lend $72 million worth of stock to an investment bank and promised to sell the stock to the bank at a future date at a discounted price, in return for an immediate payment of cash.[2] The contract also hedged against any loss in the value of the stock. The contract put Lauder in a position that is economically the same as having sold the stock — he received cash for the stock and did not bear the risk of the stock losing value — and yet he does not have to pay tax on the capital gains until several years later, when the sale of the stock technically occurs under the contact.

Billy Joe "Red" McCombs, co-founder of Clear Channel and former owner several sports teams, used the same type of derivative, the "variable prepaid forward contract," to dodge capital gains taxes. He entered into a contract to lend an investment bank his Clear Channel stock for $292 million and officially sell the stock to the bank several years later. The IRS did decide that the contract was actually a sale, and that he owed $44.7 million in back taxes — but then settled for only half that amount.[3] Dole Food Co. Chairman David H. Murdock and former AIG chairman and CEO Maurice "Hank" Greenberg have both entered the same type of contracts for hundreds of millions of dollars.[4]

Key Reform Proposal: Mark-to-Market Taxation

The most significant of Chairman Camp's proposals would subject most derivatives to what is called "mark-to-market" taxation. At the end of each year, gains and losses from derivatives would be included in income, even if the derivatives were not sold. All profits (and losses) would be treated as "ordinary," meaning that they would be treated as regular income and would be ineligible for the special low tax rates on capital gains.

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[2] David Kocieniewski, "A Family's Billions, Artfully Sheltered," *New York Times*, November 26, 2011. http://www.nytimes.com/2011/11/27/business/estee-lauder-heirs-tax-strategies-typify-advantages-for-wealthy.html?_r=0&pagewanted=all

[3] Jesse Drucker, "Buffett-Ducking Billionaires Avoid Reporting Cash Gains to IRS," *Bloomberg*, November 21, 2011. http://www.bloomberg.com/news/2011-11-21/billionaires-duck-buffett-17-tax-target-avoiding-reporting-cash-to-irs.html

[4] Id.

The new rule would exempt those derivatives that are used for actual business hedging.

Assuming the mark-to-market system is implemented properly without loopholes or special exemptions for those with lobbying clout, the result would be that the types of tax dodges described above would no longer provide any benefit. The taxpayers would not bother to enter into those contracts because they would be taxed at the end of the year on the value of the contracts (meaning they are unable to defer taxes on capital gains) and the gains would be taxed at ordinary income tax rates.

There is no revenue estimate for this proposal at this time, but experts believe it could raise substantial revenues from curbing tax avoidance. Unfortunately, Chairman Camp proposes to use the revenue savings from this and other loophole-closing provisions to offset reductions in tax rates, but there is no reason why Congress could not enact this reform as a way to raise revenue.