Testimony of Steven M. Rosenthal
Before the U.S. Senate Permanent Subcommittee on Investigations of the Committee on Homeland Security and Governmental Affairs

Abuse of Structured Financial Products: Misusing Basket Options to Avoid Taxes and Leverage Limits
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My name is Steven M. Rosenthal. I am a Senior Fellow at the Urban-Brookings Tax Policy Center, where I research, speak, and write on Federal income tax issues.[1] I have practiced tax law in Washington, D.C. for over 25 years, most recently as a partner at a major law firm. In private practice, I regularly advised hedge funds and other investors on the tax treatment of derivatives. In the 1990s, I was a Legislation Counsel with the Joint Committee on Taxation, where I helped draft tax rules for financial institutions, financial products, capital gains, and related areas. I am the former Chair of the Taxation Section of the District of Columbia Bar Association.

I would like to thank Chairman Levin and Ranking Member McCain and the Subcommittee for inviting me to testify.

Today, I will describe how two hedge funds (the Hedge Funds), with the help of two investment banks (the Banks), purported to convert short-term trading profits into long-term capital gains with derivatives—which lowered the tax rate on their gains from 35% to 15% (the difference in rates for short-term and long-term gains for most of the years in question). I believe the funds stretched two key elements of the tax law to achieve their goal. The Hedge Funds (1) mischaracterized their investment arrangements as derivatives and (2) improperly deferred gains from their arrangements until final settlement. I believe the IRS should challenge both of these assertions—and need only defeat one. I also recommend legislation to address the misuse of derivatives more comprehensively.

I. The Stakes: Short-term or Long-term Capital Gains

The tax preference for long-term capital gains was established long ago. In 1921, Congress first lowered the rate for gain from the sale of property held for more than two years: from 58%, the top individual tax rate for the year, to 12.5%.

Congress cited the "lock-in" effect of high rates to justify the capital gains preference:

> "The sale of farms, mineral properties, and other capital assets is now seriously retarded by the fact that gains and profits earned over a series of years are under the present law taxed as a lump sum (and the amount of surtax greatly enhanced thereby) in the year in which the profit is realized. Many such sales, with their possible profit taking and

[1] I am testifying at the request of the Subcommittee, by letter dated July 9, 2014, from Chairman Carl Levin and Ranking Member John McCain. The views I present here are my own and not those of the Urban Institute, the Brookings Institution, or any other institution or person.

consequent increase of the revenue, have been blocked by this feature of the present law."[2]

Today, our tax rules reduce the tax rate for gain from the (i) sale or exchange, (ii) of a capital asset, (iii) held for more than one year. But to determine whether gain from a sale or exchange qualifies as long-term capital gain, the tax law looks to the substance of the transaction, not the label a taxpayer puts on the transaction.

II. The Investment Transactions

The Hedge Funds are Delaware partnerships and were organized to "purchase, sell (including short sales), invest, trade and deal in securities and other financial transactions related thereto."[3] The funds pass their gains and losses through to their partners.[4]

Investment funds typically separate their investment assets from their operations. So, the Hedge Funds hold investments (including derivatives), but own no equipment or offices--and they do not employ any workers. Rather, they rely on their general partner, Renaissance Technologies LLC (Renaissance).[5] A general partner is "an agent of the partnership for the purpose of its business, purposes or activities."[6] Thus, Renaissance's efforts on behalf of the Hedge Funds are, legally, attributable to the Hedge Funds.[7] And Renaissance employed more than 250 professionals, 90 of whom hold math and science PhDs, mainly to develop and pursue the strategies for these Hedge Funds.

Starting years ago, Renaissance developed investment strategies for the Hedge Funds, which they describe as an algorithm. The strategies pursued statistical arbitrage—which exploits small, and fleeting, pricing anomalies of publicly-traded assets. The strategies were low-risk: they were both diversified and market neutral (with both long and short positions). But they required frequent trading—more than 100 thousand trades a day, and more than 30 million trades a year. Renaissance also sold stocks quickly: it sold 87% within three months, and more than 99% within a year.

In most respects, the Hedge Funds' trading was conventional, albeit frequent and extensive. The Hedge Funds identified assets that were mispriced and arbitraged those pricing anomalies.

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[2] H.R. Rep. No. 67-350, at 10-11 (1921)
[3] The Hedge Funds are Badger Holdings LP and Mosel Equities LP, with identical objectives in their limited partnership agreements.
[4] Their partners are other partnerships, known as feeder funds, which are tailored to meet the tax and non-tax objectives of different categories of investors, including tax-exempt entities, foreign investors and others.
[5] Each Hedge Fund gave Renaissance "complete and exclusive responsibility for managing and administering the affairs of the partnership."
[6] Del. Code Ann. Tit. 6, sec. 15-301(1).
[7] *Sun Capital Partners III LP v. New England Teamsters & Trucking Industry Pension Fund et al.*, 724 F.3rd 129, 147 (1st Cir. 2013) (the efforts of a general partner, and its affiliates, to manage a portfolio company are attributable to the partnership).

But the Hedge Funds did not buy, hold, and sell the stocks directly. Instead, the Banks purported to buy, hold, and sell the stocks.[8] The Hedge Funds and the Banks used two interrelated contracts to structure the investment arrangement: First, a Bank agreed to pay a Hedge Fund the net profits from the trading of a basket of stocks in a designated account at the Bank (the "Basket Contract").[9] Second, the Bank granted The Hedge Fund's general partner, Renaissance, the exclusive authority to buy and sell stocks for the designated account (the "Investment Management Agreement"). That permitted Renaissance to select the stocks to buy and sell, when to buy and sell, and how to route the orders.

To enter a Basket Contract, a Hedge Fund might deposit, say, $10 million, in the account at a Bank. The Bank also might contribute, say, $90 million, which permitted up to $100 million to trade (a leverage ratio of 10). The Basket Contract typically had a term of three years—but a Hedge Fund could "exercise" (i.e., cash out) the Basket Contract at any time. In fact, the Hedge Fund typically exercised the Basket Contracts after more than a year to qualify their gains as long-term. The Bank also could "knock-out" (i.e., terminate) a Basket Contract if the value of the account fell to or below $90 million. But the risk of a knock-out was remote, in part because the Banks had early trigger points to require the Investment Manager to sell positions, or reduce leverage, before losses fell to $90 million.[10] In fact, neither Bank terminated any of the more than 60 Basket Contracts of the Hedge Funds.

Upon a Hedge Fund's exercise of a Basket Contract, the Bank paid the Hedge Fund the greater of (1) zero or (2) the return of the Hedge Fund's $10 million deposit (less amortized fees for the Bank), increased by (i) the basket profits—which were the gains, interest, and dividends that had been earned in the account and reduced by (ii) the basket losses—which were the losses, interest expense, commissions and other trading costs that had been incurred and further reduced by (iii) an interest charge on the $90 million advance.[11] As mentioned earlier, in remote circumstances, a Bank could knock-out a Basket Contract early but, otherwise, the Hedge Fund would invariably exercise the Basket Contract, as the Hedge Fund could receive some value and would pay nothing to exercise.

As mentioned above, Renaissance, the general partner of the Hedge Funds, directed the trading in the designated accounts—not the Banks and not a third party. Under some Investment Management Agreements, Renaissance could trade without prior approval by the Bank. According to other agreements, the Bank could reject any trade prior to actual execution. But Renaissance sent the trades directly to the exchange, and did not did not notify a Bank of its

[8] The Banks were Barclays Bank PLC and Deutsche Bank AG.

[9] The Banks labeled the contracts "Barrier Options" or "Basket Options," but I believe "Basket Contracts" better describes the contracts. An option is a right, but not the obligation, to buy or sell designated property at a fixed price. And the right may or may not be exercised. Here, the Hedge Funds were virtually certain to exercise the Basket Contracts (at a price of zero)—so, in my view, they were not options.

[10] The Banks also imposed trading parameters that further limited the possibility the Bank could lose money (e.g., the Banks limited the concentration of investment in a single company or industry).

[11] The Banks profited through fees and financing charges. Otherwise, the Banks were indifferent—any loss (or gain) on the Basket Contracts was offset by the gain (or loss) on the stock in the account.

trades in advance. Thus, there was no opportunity for a Bank to reject a trade, nor did a Bank ever reject or reverse a trade.[12]

In substance, the Basket Contracts and the Investment Management Agreements replicated a typical brokerage arrangement. That is, the Hedge Funds, through their general partner, Renaissance, directed the buying and selling of stocks for the accounts at the Banks, and the Hedge Funds profited from the trading.

But the Hedge Funds also achieved a substantial non-tax and tax advantage. As a non-tax matter, the Hedge Funds could borrow more than a regular brokerage customer, who often is subject to regulatory limitations.[13] As a result, the Hedge Funds increased their leverage and limited recourse to the Hedge Fund's other assets. Under the Basket Contracts, the Hedge Funds averaged a leverage ratio of 12 or 13. For a typical brokerage customer account subject to Federal Reserve regulation, the maximum leverage ratio is 2.

For tax purposes, the Hedge Funds reported the profits from their rapid trading as long-term gain (from terminating a derivative they held for more than a year), rather than short-term gain from the sale of stocks held for a shorter period. At the time of most of these transactions, gain realized on the sale or disposition of capital assets held for more than a year was taxed at a top individual rate of 15%, compared to a regular top rate of 35% (now 20% and 39.6%[14]).

III. Basic Tax Issues for the Basket Contracts

In general, stock, derivatives, and other investments are capital assets. And, as noted above, gain from the sale of a capital asset that is held for more than a year is taxed at reduced rates.[15]

The Hedge Funds pursued a short-term trading strategy. Normally, their gains would be short-term. But the Hedge Funds wrapped the Basket Contracts around their investment strategies and claimed long-term gain upon exercise (after more than a year).

The Hedge Funds must overcome two hurdles to treat their gains from the Basket Contracts as long-term: first, the Basket Contracts must represent derivatives and not, in substance, the ownership of the basket of stocks in the designated accounts (which are bought and sold throughout the year). Second, if the Basket Contracts represent derivatives, and not the

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[12] The Banks compiled a list of stocks which the Hedge Funds could not purchase because the Banks could not hold the stocks for regulatory reasons. From time to time, the Banks might add another stock to the list—which, in theory, could cause the sale of that stock.

[13] For example, the Federal Reserve, with Reg. T, requires an investor to post an initial margin of 50% and to maintain a margin of 25% thereafter.

[14] There is also now a 3.8% tax on net investment income, whether short-term or long-term, for higher-income taxpayers. Code sec. 1411.

[15] A derivative also is subject to sec. 1234A, which provides that "[g]ain or loss attributable to the . . . termination of a right or obligation . . . with respect to property which is (or on acquisition would be) a capital asset . . . shall be treated as gain or loss from the sale of a capital asset." An investor's gains from the termination of a derivative with respect to stock are capital.

stock in the designated accounts, the Basket Contracts must not be fundamentally changed during the year (which would require gains to be recognized early).

For tax purposes, I believe Hedge Funds would lose both challenges—not win both. That is, I believe the Basket Contracts represent ownership of the basket of stocks in the designated account. And, were the Basket Contracts derivatives (and not ownership of the stocks), the Basket Contracts were fundamentally changed during the year.

A. Do the Basket Contracts Represent Derivatives—or the Ownership of the Stocks in the Referenced Accounts?

A derivative is a financial contract that derives its value by reference to other assets or indices—in the case of the Basket Contracts, the baskets of stock and other positions in the designated accounts at the banks. And derivatives vary: they include forward contracts, futures, options, notional principal contracts, and many other arrangements.

Businesses and investors use derivatives to manage price or interest-rate risk. For example, an airline might enter a forward contract to lock-in the price of jet fuel for the future—the forward would fix a price for a specified grade of jet fuel to be delivered later. Or an investor could buy a put option to hedge against a fall in the price of her stock—the put would entitle the investor to sell her stock at a pre-set price (which might, ultimately, be higher than the market price of the stock at the exercise date).

In recent years, as technology advanced, the use of derivatives expanded. Now investors and others use derivatives for a wide range of purposes, sometimes to replicate returns that are economically similar to holding an asset or a portfolio of assets.

The Hedge Funds reported their gains on the Basket Contracts as gains from derivatives—not accumulated gains from the ownership of an ever-changing basket of stocks in the designated accounts. But the tax law characterizes an arrangement based on its substance, not its form. So, does the Basket Contract represent a derivative that references the value of a basket of stocks—or the actual ownership of the basket of stocks, with the accumulated gains? I believe the ownership of the basket of stocks, for three reasons.

To start, the label of a contract does not matter, as the IRS explained in holding that a purchaser of a deep-in-the-money "option" effectively owned the referenced stock.[16] That was because the "option" was so likely to be exercised the taxpayer effectively assumed the benefits and burdens of owning the stock. The IRS added its ruling was "based on the application of the doctrine of 'substance over form,' [and] it will be applied whenever the substance of the transaction is the purchase of stock, not an option."

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[16] Rev. Rul. 82-150, 1982-2 C.B. 110, 111. In my view, the Basket Contracts are not options for tax purposes, as the Hedge Funds would almost certainly exercise these "options." For tax purposes, there must be a "substantial likelihood" that a taxpayer will not exercise a contract for the taxpayer to treat the contract as an option, regardless of the label of the contract. See Rev. Rul. 85-87, 1985-1 C.B. 268. Although a Basket Contract is not an option, it might, in theory, be another form of derivative (for example, a cash-settled forward contract). The tax rules are similar.

Second, to identify the true owner of stock, we must look through "wrappers." For example, a court looked through a "wrap-around annuity" to find that a taxpayer who directed the investment of funds for an account at an insurance company beneficially owned the investments, not the insurance company.[17]

Third, to identify the true owner of stocks, we must examine the benefits and burdens of the ownership of the stocks. With the basket of stocks referenced by the Basket Contracts, the Hedge Funds received all of the opportunities of gain from trading the stocks and incurred the burden of losses--until the Bank stopped the trading. The Hedge Funds also earned the interest, dividends, and other income from the stocks, bonds, and cash in the account—and paid the financing, commissions, and other expenses from the trading. Finally, and unusually, the Hedge Funds, through Renaissance, selected the stocks to buy and sell for the designated accounts, when to buy and sell them, and how to buy and sell them (that is, the size of the lots to trade and the routing of the orders). As a result, the Basket Contracts, combined with the Investment Management Agreements, simply rewarded the Hedge Funds for their own trading efforts; the Hedge Funds did not derive their return from the performance of specified assets or indices, which is the hallmark of a derivative.

The Hedge Funds might assert their arrangement transferred some indicia of ownership of the stocks to the Banks but, these indicia were, in my view, economically trivial. The Hedge Funds apparently allowed the Banks to vote the stock in the accounts—but the right to vote publicly-traded stock, held for a short period, generally is worth very little. And the Hedge Funds permitted the Banks to loan the stock in the accounts, but customers with brokerage accounts also typically permit their brokers to loan their stock—and these customers own the stocks, or the right to the return of the stocks, in the account.

The Hedge Funds might also argue the economic substance of their investment arrangement differed from a regular brokerage account since the arrangement allowed the Hedge Funds to leverage their investments more than a regular brokerage account would permit. But the extra leverage, by itself, does not answer whether the arrangement is a derivative or ownership. In my view, the arrangement simply was a favorable way, from a leverage standpoint, to own stock.

B. If the Basket Contracts Represent Derivatives, were the Basket Contracts Fundamentally Changed before Settlement?

The timing of gains is important under our tax system. Taxpayers must recognize income when they have "undeniable accessions to wealth, clearly realized, and over which the taxpayers have complete dominion."[18] Gain may arise either as "cash derived from the sale of an asset" or

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[17] *See* Christoffersen v. U.S. 749 F.2d 513 (8th Cir. 1985) ("We cannot too often reiterate that 'taxation is not so much concerned with the refinements of title as it is with actual command over the property taxed—the actual benefit for which the tax is paid." *quoting* Griffiths v. Comm., 308 U.S. 355, 357-58 (1939)).

[18] Commissioner v. Glenshaw Glass Co. 348 U.S. 426 (1955).

as “a result of exchange of property.”[19] Thus, taxpayers must realize gain “from the exchange of property for other property differing materially either in kind or in extent.[20]

In the leading authority on the modification of a non-debt contract, the IRS explained:

> “A change in contractual terms effected through an option provided in the original contract is treated as an exchange under section 1001 if there is a sufficiently fundamental or material change that the substance of the original contract is altered through the exercise of the option. Under such circumstances, the old contract is treated as if it were actually exchanged for a new one.”[21]

Thus, the IRS ruled that an employer that exercised an option to change the insured under a key person insurance policy must realize gain on the contract because the change in the insured changed the “fundamental substance” of the contract (“[T]he essence of a life insurance contract is the life that is insured under the contract”). The IRS added that “the result would be the same if the employer insured a person holding a particular position and, thus, no formal substitution is made when a new person occupies that position.”

Likewise, the Hedge Funds modified their options every time Renaissance, their agent, changed the Basket Contract by changing the stock in the designated account. Renaissance’s modifications became material during the term of the contract—most likely daily but, at least, every three months, after the turnover of almost 90% of the basket. And the modifications were fundamental to the Basket Contract. The reference assets or indices are the essence of the arrangement (and, more generally, of a derivative contract).

The Hedge Funds might counter their investment shifts occurred automatically, pursuant to a trading algorithm. But the Hedge Funds’ agent, Renaissance, controlled these shifts—not an algorithm operating unchecked. Importantly, Renaissance’s highly-trained employees constantly worked on and modified the algorithm—always exploring and adding new price signals, which set the trading parameters.

Finally, each time the Hedge Fund’s agent, Renaissance, sold an investment at a gain, the Hedge Funds locked-in more trading profits. And the Hedge Funds could cash out their accrued profits any time they chose to do so. As a result, the Hedge Funds acceded to wealth, clearly realized, over which they had complete dominion. The Hedge Funds should recognize their gains currently, not await the settlement of a Basket Contract.

IV. A Uniform Tax Treatment for Derivatives: Mark-to-Market

Congress established a capital gain preference to relieve the lock-in effect of holding property that accreted in value over time. Congress did not lower the rate for gains from short-

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[19] Helvering v. Bruun, 309 U.S. 461 (1940).

[20] Treas. Reg. sec. 1.1001-1(a).

[21] Rev. Rul. 90-109, 1990-2 C.B. 191. In 1996, the IRS “did not alter the ‘fundamental change doctrine articulated in Revenue Ruling 90-109” for non-debt instruments when it adopted regulations for modifications of debt instruments. T.D. 8675, 1996-2 C.B. 61.

term trading—or countenance wrapping a derivative around short-term strategies. So, as a matter of tax law and policy, the IRS should not allow taxpayers to transform their short-term profits into long-term gains through the alchemy of derivatives.

I believe the IRS can, under current law, challenge successfully the most extreme strategies with derivatives or purported derivatives (such as the ones in front of this Subcommittee). But the IRS has limited resources to challenge the wide variety of derivative-related strategies, which often are complicated and abstruse. So, in my view, Congress should address the taxation of derivatives comprehensively—and reflect the income from derivatives more clearly.

To do so, I believe tax accounting ought to follow financial accounting for derivatives, which requires companies to mark-to-market their derivatives at year-end (i.e., to measure the value of their derivatives at market at year-end).[22] The current taxation of derivatives is complicated and inconsistent. There are different rules for different derivatives, for different uses of the same derivative, and for different taxpayers. As a result, two derivatives that are economically the same may be taxed quite differently. For many years, investors have exploited these tax differences to manipulate the character, timing, or source of their income to reduce their tax liability.

To account for derivatives for financial reporting, companies struggled for a long time for a variety of reasons: (i) the effect of derivatives was not transparent in basic financial statements; (ii) the accounting guidance for derivative instruments and hedging activities was incomplete; (iii) the accounting guidance for derivative instruments and hedging activities was inconsistent and (iv) the accounting guidance for derivatives and hedging was difficult to apply. In 1998, to address these problems, the Financial Accounting Standards Board (the board) issued Statement of Financial Accounting Standards No. 133, *Accounting for Derivative Instruments and Hedging Activities*.[23] These rules required companies to measure all assets and liabilities on their balance sheet at "fair value," which is very similar to "fair market value" for tax. When first issued, these rules were widely considered the most complex accounting standards ever promulgated by the board. Now, more than 16 years later, these rules have been widely-implemented, are familiar to the accounting community and are working well.

Last year, Chairman Camp of the House Ways & Means Committee released a discussion draft to reform the tax of derivatives by marking them to market at year end. Earlier this year, the Chairman revised his tax reform proposals—and, again, proposed a mark-to-market to tax derivatives. I believe this step is overdue. It would greatly reduce the amount of time and energy that taxpayers and the IRS devote to the taxation of derivatives, an enterprise that has been demanding increasing effort in recent years.

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[22] I first compared the tax and financial accounting for derivatives in Rosenthal and Price, *Tax and Accounting for Derivatives: Time for Reconciliation*, Tax Notes 895 (1999).

[23] The board codified FAS 133 at Accounting Standards Codification ("ASC") 815.