Commentary: Fixing Realization Accounting: Symmetry, Consistency and Correctness in the Taxation of Financial Instruments

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Recommended Citation

Commentary

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David Bradford’s article explores the nature of tax arbitrage exemplified by the use of financial instruments.¹ To identify rules that would eliminate arbitrage opportunities, Professor Bradford seeks to specify what properties such a rule must possess. He focuses on the distinction between arbitrage opportunities presented by time and those presented by risk, and concludes that a successful rule must eliminate both.² Consistency is necessary to eliminate timing arbitrage and a preset rate is necessary to eliminate risk arbitrage.

In reaching this determination, Professor Bradford observes that the difficulties for rulemaking posed by timing arbitrage are more challenging than perhaps has been fully appreciated.³ To the extent that this is true (and that critiques of the tax system have concentrated more on risk arbitrage), it may be linked to the distinction in the current system between fixed and contingent returns. Although this relationship does not mirror the time vs. risk contrast directly (for example, Professor Bradford’s case of long-term bonds, which may be fixed but not riskless), there is some similarity. In the context of the realization system, “less risky” investments, those with fixed returns, have lent themselves more readily to some form of accrual taxation—the classic example being the treatment of original issue discount (OID) bonds.⁴ Although such a rule does not eliminate timing arbitrage, it comes closer to economic income than realization’s wait-and-see method, and, with the “assistance” of transaction costs, it may reduce arbitrage effectively. In contrast, “more risky” investments, those with contingent returns, typically have faced a realization-based wait-and-see rule, reflecting a judgment that issues of administrability and legitimacy can make it difficult to tax such gains and losses before they have been determined.⁵ From the perspective of the existing realization system, it is the contingent returns (that is, the “more risky”

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² Id. at 738.
³ Id. at 743-57.
⁴ See IRC §§ 1272-1275.
⁵ Of course, prerealization taxation has been implemented with limited application, for example, the mark-to-market regime of § 1256.
investments), whose current taxation is perhaps farthest from economic income, that appear to pose a barrier to more “arbitrage-proof” rules.

Regardless of why the literature may have focused on risk, the goal is to ascertain the origins of both risk and timing arbitrage and identify the keys to eliminating them. Of the four proffered methods for preventing arbitrage, two provide Professor Bradford with the desired result of eliminating arbitrage potential in a transaction involving both risk and time: the mark-to-market rule and the Auerbach retrospective allocation rule. Because Professor Bradford considers a universal mark-to-market regime unlikely, he focuses on the Auerbach method, the only one of the four that is both “successful” and incorporates a realization mechanism. Professor Bradford then considers whether other methods (beyond the four) are available. He proposes a broad rule using a gain recognition date (GRD) and a gain tax rate (GTR), along with imputation of interest to basis and interest charges on deferred tax payments, to satisfy the conditions of consistency and preset rates. The broader proposed rule is not in addition to the Auerbach method; rather, the latter is described as a particular version of the proposed rule where the GRD and the GTR are zero, leaving only imputation of interest to an imputed basis.

In understanding the results of Professor Bradford’s analysis, it may be helpful to observe that the arbitrage issue (both risk and timing) ultimately returns to the question of the effective tax rate for gain and loss. If a taxpayer faces different effective tax rates for gain and loss, arbitrage is possible. In the case of risk-free transactions in a single tax rate world, symmetry eliminates timing arbitrage by preventing a taxpayer from holding both sides of a single transaction, which, in the absence of symmetry, might have different timing rules for inclusions and deductions. Such an asymmetric scenario (for example, immediate deductions and deferred income) would effectively subject the taxpayer to two different tax rates in an economically net zero transaction, thereby presenting a timing arbitrage opportunity. In a multi-tax rate world, where the market cannot successfully eliminate arbitrage opportunities between economically equivalent instruments facing different tax rules, consistency (which includes the lesser stan-

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7 Bradford, note 1, at 769.
8 Id. at 770-72.
9 Id. at 776.
10 Timing or arbitrage between two different transactions that are economically equivalent but are subject to different tax rules is eliminated by the market in a single tax rate world.
standard of symmetry) is necessary to eliminate the timing arbitrage. Absent a requirement of consistency, a taxpayer could take a gain position on an instrument subject to one tax regime and a loss position on one subject to another so that, although the taxpayer faced a particular tax rate in both cases, the timing (immediate deduction, deferred income) would create different effective tax rates.

Finally, with the inclusion of risk in the picture, both consistency and a preset rate become necessary. As noted above, consistency serves to prevent different effective tax rates on the gain and loss sides of two economically equivalent transactions. Requiring a preset rate achieves a related goal, eliminating the possibility of different effective rates for gain and loss due to a strategy of cherrypicking with a single type of transaction (risk arbitrage). Thus, in one sense, elimination of the two kinds of arbitrage can be seen as simply requiring a mechanism that ensures that gain and loss are taxed at the same effective rates. For the purpose of evaluating and designing rules, however, it is necessary to think more precisely, as Professor Bradford has done, about the operation of the two kinds of arbitrage and the separate ways in which they arise.

Nevertheless, the centrality to both arbitrage mechanisms of different effective tax rates on gain and loss offers another way to see Professor Bradford's proposal: as providing a single effective rate within a transaction (the risk problem) through the GTR and the GRD, and providing a single effective rate across transactions (the intertemporal problem) through imputation of interest to basis and interest charges on deferred tax payments. Moreover, this restatement of the issue highlights part of the difference between risk and timing arbitrage that may cause the latter to be a greater challenge to rule drafting. To the extent risk raises concerns regarding different effective rates for a given instrument (cherrypicking), and timing raises concerns regarding different effective rates between economically equivalent instruments (for example, Professor Bradford's comparison of single unit bonds v. OID bonds under old tax rules), the latter may be inherently a more complicated question to resolve—hence his observations on the difficulty of eliminating timing arbitrage.

Professor Bradford's article, although primarily analytical, seeks more than an idealized answer to the arbitrage problem. It aims at improving the current system, a task that is ultimately one of administration and policy. The question is how to use the improved understanding of tax arbitrage to make changes. The government needs to consider ways in which to connect fundamental observations to realistic tax policy. A first step could be to pursue a question raised at the outset of Professor Bradford's article: What is the actual role of trans-
action costs in limiting tax arbitrage? Are transaction costs declining? Should one anticipate that the developing financial technology essentially will eliminate such costs? Some exploration of this general question already has been undertaken, and the answers may say something about how to evaluate the costs and benefits of moving to an alternative system. To make such an assessment, the government also must identify the costs of moving to Professor Bradford's proposed rule, including the administrative and informational concerns that might arise.

One immediate change required would be the removal of special rules for capital gain and loss. Certainly, the capital gains preference is incompatible with the elimination of arbitrage. Also, other special rules must be evaluated for their arbitrage potential, including the treatment of tax-exempt participants and the step-up of basis on death. Depending on the scope of the proposed rule, arbitrage opportunities might develop between those transactions that were subject to the proposed rule and those that were not. Given that the proposal likely would be implemented on a limited basis initially, perhaps restricted to financial instruments, this concern may be particularly important. The exact nature of the potential problem depends in large part on where the dividing line is drawn and how it is described. If the definition of financial instruments is fairly expansive (thus including within its scope the majority of transactions likely to be paired strategically with each other), and the Service is granted significant discretion, as an anti-abuse measure, to classify a transaction as subject to the proposal, then, in theory, much arbitrage potential may be eliminated. However, the demonstrated ability of sophisticated planners to develop techniques to achieve their goals, combined with the difficulty of the Service's task of policing the boundary, calls for a measure of skepticism and caution about eliminating arbitrage if the proposal is pursued with limited scope.

Other direct implementation questions also arise. To the extent the GTR is beyond the taxpayer's control (because it is set by the government or determined by formula), would there be pressure on setting the acquisition date? That is, would taxpayers have a strong incentive to manipulate the date identified as the acquisition date, after they obtained more information on the value of their positions? This might not be a problem, even if taxpayers had such an incentive, if it

12 IRC § 1(h).
13 See, e.g., §§ 401(a), 501(a) (exempting pension plans from tax), §§ 501(a),(c) (exempting charitable organizations from tax).
14 IRC § 1014.
were generally difficult to manipulate the acquisition date. If, however, such manipulation were feasible or demanded significant government resources to uncover, some safeguard might be necessary.

One possibility is the use of a same day identification rule, similar to the rules used for hedges. Unfortunately, the premise underlying such a rule may be false in this case. Typically, same day identification rules presume that the acquisition date is clear; the identification requirement simply forces the taxpayer to elect hedging treatment on that day, rather than later, when more information on the contract value is available. If, however, the acquisition date is the source of debate, the premise fails and the rule is not a serious barrier to manipulation.

Another possibility is the development of a joint buyer/seller identification rule, with the expectation that the two parties would have opposite incentives with regard to setting the acquisition date. Unfortunately, if one party has more to gain from adjusting the date than the other has to lose, an adjustment could be made and the net benefit shared. Ultimately, it may be more appropriate to view an acquisition date problem as a case of fraud, rather than as an example of legal, strategic planning.

The use of the GTR also raises questions. Would effective application of this proposal make it necessary to record the appropriate GTR for each instrument because it would vary? Would each asset require its own schedule in the event of different GTRs, so that offsetting of gains and losses did not occur prior to application of the GTR? For example, if taxpayer acquires asset A in Year 1, asset B in Year 2, asset C in Year 3, and sells all three assets in Year 5, the GTR for each asset might be different from each other (either because the baseline for calculating it, for example, taxpayer's prior year marginal rate, changed, or because it was set by the government and, as frequently happens, Congress changed the rates) and different from any other tax rate generally applicable to the taxpayer that year. Similar questions apply to the selection of the interest rate for imputation to basis. If the true period interest rate could be identified, how and when would one be determined? If it were a rate selected by the government (and thus would be likely to vary over time), what arbitrage opportunities might exist?

Unfortunately, the vagaries of policy implementation, the constraints of administration, and the almost certain likelihood of constant changes to the tax system make it difficult to move easily from theory to execution. This problem may be exacerbated when the proposal under consideration seeks to eliminate arbitrage, which, by its

15 Reg. § 1.1221-2.
very nature, thrives on changes and inconsistencies in the tax system. Hopefully, an increasing understanding of timing and risk arbitrage will facilitate the development of rules that can be implemented practically with as close an approximation of the desired goal as possible.