

## FINANCIAL DERIVATIVES

### Disparate Tax Treatment and Information Gaps Create Uncertainty and Potential Abuse

#### Why GAO Did This Study

Recently, concerns have arisen about the use of certain financial derivatives to avoid or evade tax obligations. As requested, this report (1) identifies and evaluates how financial derivatives can be used to avoid or evade tax liability or achieve differing tax results in economically similar situations, (2) evaluates Internal Revenue Service (IRS) actions to address the tax effects of investments in financial derivatives through guidance, and (3) evaluates IRS actions to identify financial derivative products and trends through information from other agencies. GAO reviewed research and IRS documents and interviewed IRS and, Department of the Treasury (Treasury) officials and other experts. GAO analyzed the completion of financial derivative projects on the agencies' Priority Guidance Plans (PGP) from 1996 to 2010.

#### What GAO Recommends

GAO recommends that (1) Treasury determine whether alternatives to the current approach to taxing financial derivatives would promote consistent treatment of economically similar positions and be beneficial, that (2) Treasury and IRS provide more public information on the status of PGP projects, including those related to financial derivatives, and that (3) IRS strengthen information-sharing partnerships with relevant agencies. IRS agreed with the third recommendation and disagreed with the second; Treasury disagreed with the first two recommendations. GAO continues to believe its recommendations would be beneficial.

#### What GAO Found

Taxpayers have used financial derivatives to lower their tax liability in ways that the courts have found improper or that Congress has disallowed. Taxpayers do this by using the ease with which derivatives can be redesigned to take advantage of the current patchwork of relevant tax rules. As new products are developed, IRS and taxpayers attempt to fit them into existing "cubbyholes" of relevant tax rules. This sometimes leads to inconsistent tax treatment for economically similar positions, which violates a basic tax policy criterion. While the tax rules for each cubbyhole represent Congress's and Treasury's explicit policy decisions, some of these decisions were made long before today's complex financial derivative products were created. Some experts have suggested alternate methods to the current approach for taxing financial derivatives. IRS and Treasury, because of their unique position to define policy and administer the tax code, are best positioned to study and recommend a new approach.

When application of tax law is complex or uncertain, as is often the case for financial derivatives, guidance to taxpayers is an important tool for IRS to address tax effects and potential abuse. However, between 1996 and 2010, Treasury and IRS did not complete 14 out of 53 guidance projects related to financial derivatives that they designated as a priority on their annual PGP. While completing guidance is important in providing certainty to taxpayers and IRS and reducing the potential for abuse, challenges like the risk of adverse economic impacts of guidance changes and the transactional complexity of financial derivatives may delay the completion of guidance. Since challenges may prevent IRS from finalizing guidance within a 12-month PGP period, taxpayers need to be aware of ongoing guidance projects' status, some of which may span a number of years.

IRS sometimes identifies new financial derivative products or new uses of them long after they have been introduced and gained considerable use. This slows its ability to address potential abuses. IRS's 2009-2013 Strategic Plan lists strengthening partnerships across government agencies to gather and share information as key to identifying and addressing new products and emerging tax schemes more quickly. Through their oversight roles for financial derivative markets, the Securities and Exchange Commission (SEC) and the Commodity Futures Trading Commission (CFTC) may have information on financial derivatives that is relevant to IRS. Similarly, bank regulators may gain relevant knowledge of derivatives' use. IRS officials said such routine communications in the early 1990s did provide relevant information. Although IRS communicates with SEC and CFTC on derivatives, it does not do so systematically or regularly. Strengthening partnerships would increase opportunities for IRS to gain information on new financial derivative products and uses. Studies of interagency coordination suggest that agencies should look for opportunities to enhance collaboration in order to achieve results that would not be available if they were to work separately, and a number of best practices exist to help agencies meet this goal.