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Report to Congressional Requesters

September 2011

FINANCIAL DERIVATIVES

Disparate Tax Treatment and Information Gaps Create Uncertainty and Potential Abuse

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GAO-11-750

Highlights

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Accountability * Integrity * Reliability

Highlights of GAO-11-750, a report to congressional requesters

September 2011

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.

View GAO-11-750. For more information, contact Michael Brostek at (202) 512-9110 or brostekm@gao.gov.

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.

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United States Government Accountability Office
Washington, DC 20548

September 20, 2011

The Honorable Max Baucus
Chairman
The Honorable Orrin G. Hatch
Ranking Member
Committee on Finance
United States Senate

The Honorable Charles E. Grassley
Ranking Member
Committee on the Judiciary
United States Senate

Over the past few years some attention has been focused on certain financial derivatives that have been used to avoid or evade tax obligations. Financial derivatives are financial instruments whose value is based on one or more underlying reference items.[1] Recent legislation has directly addressed one of the most prominent tax avoidance transactions enabled by financial derivatives, and another was addressed through litigation.[2] While a majority of the world's largest companies use financial derivatives to manage and hedge risks, some taxpayers have used financial derivatives to reduce their tax liabilities in ways that have been aggressive and later disallowed, and such use is likely to continue.

In response to your request, 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 its taxpayer guidance, and (3) evaluates IRS actions to identify new financial derivatives products

[1]A glossary of terms is provided at the end of the report.

[2]Cross-border total return equity swaps were used to avoid paying withholding tax on dividend payments to foreign entities, and were addressed by the Hiring Incentives to Restore Employment (HIRE) Act. Pub. L. No. 111-147 § 541, 124 Stat. 71, 115–117 (2010). Variable prepaid forward contracts coupled with a share-lending agreement were used to defer income recognition, and were addressed in *Anschutz Co. v. Commissioner*. 135 T.C. No. 5 (July 22, 2010).

and trends through information sharing with its partners in other federal financial regulatory agencies.

To identify and evaluate how financial derivatives can be used to avoid or evade tax liability, we reviewed academic studies and IRS documents. We also interviewed officials and staff at IRS and the Department of the Treasury (Treasury), and tax experts from the private sector. For this part of the report, we focused on two case studies of financial derivative transactions—variable prepaid forward contracts and cross-border total return equity swaps—as illustrations of the use of financial derivatives to achieve improper or disallowed tax results. We analyzed the taxation of financial derivatives against consistency, a criterion meaning that transactions with equivalent economic outcomes are taxed the same. We identified this criterion through testimonial evidence from tax experts and Treasury officials, and a review of research on the taxation of financial derivatives. It was one of the most frequently cited criteria by these sources, and also the most applicable to our objectives. The criterion of consistency is related to simplicity, administrability, and economic efficiency, several of the criteria for a good tax system that are discussed in our 2005 report on tax reform.[3] A lack of consistency can make the tax system more difficult for taxpayers to comply with, more difficult for IRS to administer, and reduce economic efficiency by influencing the investments taxpayers make by taxing different investments under different tax rules. While consistency may not be the only criteria to consider, we believe it is an important guideline to evaluate whether financial derivatives can be used by taxpayers for abusive purposes.

To evaluate IRS actions to address the tax effects of investments in financial derivatives through its guidance, we reviewed IRS documents and interviewed IRS and Treasury staff and officials about the guidance process, with a specific focus on IRS's and Treasury's processes for developing their Priority Guidance Plan (PGP), which identifies and prioritizes the tax issues that IRS believes are most important to taxpayers and tax administration and should be addressed through guidance. We analyzed financial derivative-related guidance projects included in the PGP from the years 1996 to 2010, determined how long it took for Treasury and IRS to release guidance on those projects, and

[3]GAO, *Understanding the Tax Reform Debate: Background, Criteria, and Questions*, GAO-05-1009SP (Washington, D.C.: Sept. 1, 2005).

compared the time required with the criteria established by IRS and Treasury for the PGP. In addition, we completed case studies of four financial derivative issues that were included in the PGP and were highlighted as significant in interviews with Treasury, IRS, and private sector experts. The four case studies cover credit default swaps, contingent swap payments, variable prepaid forward contracts, and cross-border total return equity swaps.

To evaluate IRS actions to identify new financial derivatives products and trends through information sharing with its partners in other financial regulatory agencies, we examined IRS's information sharing with other federal financial market regulators. To examine information sharing with other agencies, we interviewed relevant officials and staff at IRS and at two financial market regulatory agencies, the Securities and Exchange Commission (SEC) and the Commodity Futures Trading Commission (CFTC). As our criterion, we used IRS's 2009-2013 Strategic Plan, which lists strengthening partnerships across government agencies to gather and share additional information as key to enforcing tax law in a timely manner to ensure taxpayers meet their obligations to pay taxes. In prior work, we have also reported on the importance and value of cross-agency information sharing and coordination, and have established criteria on federal agency coordination and information sharing.[4] We also identified the legislative authorities that govern IRS's disclosure of taxpayer information.

For the purposes of this review, we determined that data on financial derivatives from the Office of the Comptroller of the Currency (OCC) and the subset of IRS PGP data used in our analysis were reliable. See appendix 1 for additional details on our scope and methodology. We conducted this performance audit from May 2010 through September 2011 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

[4]See GAO, *Results-Oriented Government: Practices That Can Help Enhance and Sustain Collaboration among Federal Agencies,* GAO-06-15 (Washington, D.C.: Oct. 21, 2005).

Background

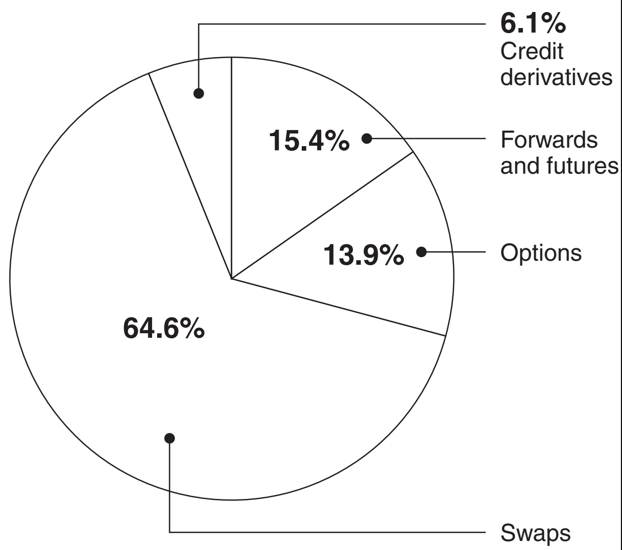
Financial derivatives are globally used financial products that unbundle exposure to an underlying asset and transfer risks—the exposure to financial loss caused by adverse changes in the values of assets or liabilities—from entities less able or willing to manage them to those more willing or able to do so. The values of financial derivatives are based on an underlying reference item or items, such as equities, debt, exchange rates, and interest rates. Since 2001, interest rate contracts have made up the vast majority of all financial derivative contracts, on average 80 percent of all derivatives in terms of notional amount outstanding, and are used to hedge against changes in the cost of capital.[5]

Parties involved in financial derivative transactions do not need to own or invest in the underlying reference items, and often do not. The most common purpose of financial derivatives is to manage the holder's risk, and this is often accomplished by constructing financial derivative contracts that produce more favorable rather than unfavorable tax results. Financial derivatives are sold and traded either on regulated exchanges or in private, over-the-counter markets that allow highly customized transactions specific to the needs of the parties. Financial derivatives are bilateral agreements that shift risk from one party to another but can be used to structure more complicated arrangements involving multiple transactions and parties. Simple financial derivatives act as building blocks for more complex products, and can be broken down into three general categories of products, described in figure 1. Credit derivatives, depending on their structure, fall into one of these three categories, but are often measured as a separate category by government agencies.

[5]Total notional amount represents the value of the reference items underlying financial derivative transactions, and is the amount upon which payments are computed between parties of derivatives contracts. Notional amount does not represent money exchanged, nor does it represent the risk exposure. For example, one party in an interest rate swap pays a 3 percent fixed rate on a notional amount of $100,000, making payments of $3,000 per period. The other party in the interest rate swap would pay a variable rate on the same notional amount in exchange for the fixed-rate payment of $3,000. These two payments are netted and the positive balance is received by one party. The fair market value of all open derivatives contracts reports the value of all trades should they be closed at the time of valuation, and is often used to gauge counterparty credit risk exposure.

Figure 1: Basic Financial Derivative Contracts and Their Market Share by Product Type as of the Fourth Quarter of 2010

Product	Description
Forwards and Futures	Contract between two parties in which the forward buyer agrees to purchase from the forward seller a fixed quantity of the underlying reference item at a fixed price on a fixed date. A futures contract is a forward contract that is standardized and traded on a organized futures exchange, while a forward contract is privately negotiated among the buyer and seller.
Options	Contract that gives the holder of the option the right, but not the obligation, to buy (call option) or sell (put option) a specified amount of the underlying reference item at a predetermined price (strike price) at or before the end of the contract.
Notional Principal Contracts (NPC), or Swaps	According to section 1.446-3(c)(1)(i) of title 26, Code of Federal Regulations, a notional principal contract (NPC) is defined as a financial instrument that provides for the payment of amounts by one party to another at specified intervals calculated by reference to a specified index on a notional amount in exchange for specified consideration or a promise to pay similar amounts. An NPC is a swap under which the parties agree to exchange payments calculated by reference to a notional amount, however not all swaps are considered NPCs.
Credit derivatives	Contract that is designed to explicitly shift credit risk from one party to another. Payments are contingent on the occurrence of a credit event and the value of the contract is derived from the credit performance of one of more corporations, sovereign entities, or debt obligations. Credit derivatives can be structured as forwards, options, or swaps.



Source: GAO analysis of Office of the Comptroller of the Currency (OCC) data.

Note: Office of the Comptroller of the Currency (OCC) reports credit derivatives separate from the other three categories above.

Dealers participate in the financial derivatives market by quoting prices to, buying derivatives from, and selling derivatives to end users and other dealers. They also develop customized derivative products for their clients. Commercial banks, which most often act as dealers, are typically one of the two parties involved in financial derivative transactions. In 2010 the holdings of five large commercial banks represented over 95 percent of the banking industry's notional amounts outstanding.

End users, including commercial banks, securities firms, hedge funds, insurance companies, governments, mutual funds, pension funds, individuals, commercial entities, and other dealers, often use derivatives to protect against adverse change in the values of assets or liabilities, called hedging. Hedgers try to protect themselves from risk by entering into derivatives transactions whose values are expected to change in the opposite direction from the values of their assets or liabilities. According to a 2009 survey conducted by the International Swaps and Derivatives Association, over 94 percent of the largest companies' worldwide use financial derivatives to manage and hedge risks. End users can also use derivatives for speculation by taking on risk in an attempt to profit from changes in the values of derivatives or their reference items. Derivatives are attractive to speculators because they can be more cost-effective than transactions in the underlying reference item, due to reduced transaction costs and the leverage that derivatives provide. Financial derivatives transactions are generally leveraged since parties to these transactions most often initiate the transaction with little money down relative to the expected outcome of the transaction. In any financial transaction, the degree of permissible leverage is determined by the collateral required to secure the transaction. While a high degree of leverage has the potential for large gains, it also carries risks of large losses. As we and others have reported, the risk exposures resulting from derivatives were one of many factors that contributed to the systemic risk that led to the recent financial crisis.[6]

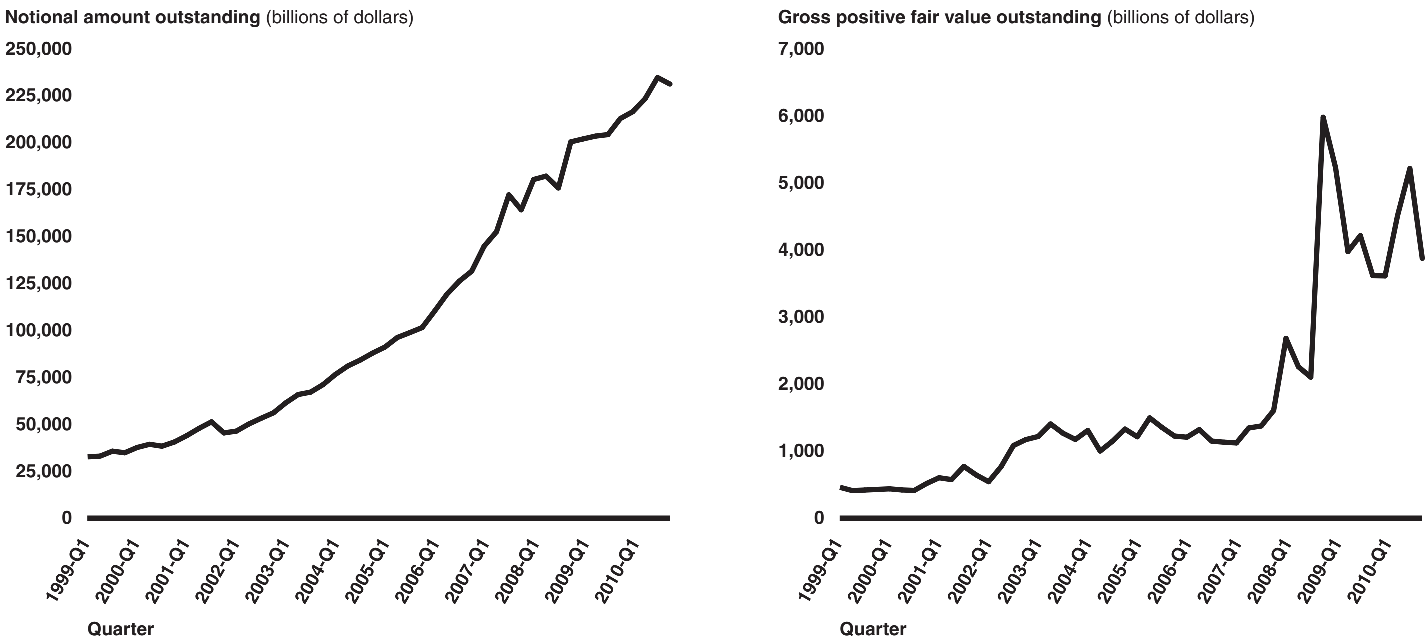
The market for financial derivatives has grown considerably in size over the past two decades. Two common ways to measure the size of financial derivative markets overall are total notional amount and fair market value. Total notional amount represents the value of the reference items underlying financial derivative transactions, and is the amount upon which payments are computed between parties of derivatives contracts. Notional amount does not represent money exchanged, nor does it represent the risk exposure. The second measure, fair market value, can be either the gross positive fair value or the gross negative fair value. The gross positive fair value represents the sum of the fair values of the financial derivative contracts where the commercial bank is owed money by the other party in the contract and represents the maximum losses the

[6]See GAO, *Financial Regulation: A Framework for Crafting and Assessing Proposals to Modernize the Outdated U.S. Financial Regulatory System*, GAO-09-216 (Washington D.C.: Jan. 8, 2009) and Financial Crisis Inquiry Commission, *The Financial Crisis Inquiry Report: The Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States* (Washington, D.C.: January 2011).

bank could incur if all other parties in the contracts default.[7] According to the OCC, between the first quarter of 1999 and the fourth quarter of 2010, the total notional amount outstanding used to calculate payments for derivatives contracts held by insured U.S. commercial banks and trust companies grew over six times, from $32.7 trillion to $231.2 trillion. For those same institutions, gross positive market value grew nearly seven-and-a-half times, from $0.46 trillion to $3.87 trillion (see fig. 2). The difference in these numbers is due to the fact that the notional amount is used to calculate payments from the contracts, which are typically a small percentage of the notional amount. The net present value of these payments determine, in part, gross positive market value. Because commercial banks are one of the parties involved in over 95 percent of financial derivative contracts, these measures are good indicators of the entire U.S. market. The volatility seen in figure 2 during the latter part of 2007 and 2008 is attributed in part to turmoil in financial markets and banking consolidation. In part because different types of financial derivatives are reported differently to IRS by taxpayers and third parties, and in most cases are not clearly identified as financial derivatives, IRS told us that data are not available to estimate overall gains and losses of income earned from financial derivatives.

[7] The losses assume no netting of the contracts and that the bank holds no collateral from the other parties in the contract.

Figure 2: Growth in U.S. Derivative Markets: Quarterly Notional Amount Outstanding and Gross Positive Fair Value (1999–2010)



Source: OCC data.

The range and complexity of financial derivative products have grown along with the market. Whereas the first financial derivatives were simple forwards and options contracts on commodities, today financial derivatives can be based on more complex reference items, such as bundles of mortgage-backed securities. These transactions may also combine different simple derivatives with traditional assets like debt or equity, and involve various contractual contingencies, such as credit default or the occurrence of catastrophic events. For example, credit derivatives, which are derivative contracts designed to shift credit risk between parties in the contract, have developed from simple contracts based on a single credit event to more complicated structured products that combine different contracts into a single security.

In its role in administering the tax code, IRS must implement the laws enacted by Congress, through detailed regulations and guidance. The IRS Office of Chief Counsel produces several forms of guidance to accomplish this. The seven most common forms include regulations, revenue rulings, revenue procedures, private letter rulings, notices, announcements, and technical advice memorandums.[8] Regulations, which provide taxpayers with directions on complying with new legislation or existing sections of the tax code, hold more legal weight than IRS's other forms of guidance. Generally, regulations are first published in draft form in a Notice of Proposed Rulemaking, and final regulations are issued after public input is fully considered through written comments and potentially a public hearing. Where new or amended regulations may not be published in the immediate future, notices are often used to provide substantive interpretations of the tax code and other provisions of the law. In addition, IRS issues revenue rulings to provide official interpretations of the tax code, related statutes, tax treaties, and regulations. These interpretations are specific to how the law is applied to a particular set of facts. Revenue procedures provide return filing or other instructions concerning an IRS position. Private letter rulings are written statements issued to a single taxpayer that interpret and apply tax laws to that taxpayer's specific set of facts. They are not officially published and may not be relied on as precedent by other taxpayers or IRS.[9] Announcements, which generally have only immediate or short-term relevance, summarize laws and regulations without making any substantive interpretation; state what regulations will say in the future; or notify taxpayers of the existence of an approaching deadline. Finally, technical advice memorandums are developed in response to technical or procedural questions that develop during an examination or a processing in Appeals.

[8]In this report we use IRS's definition of guidance, which includes regulations, although regulations and guidance are typically considered separate and distinct categories.

[9] Internal Revenue Code (IRC) section 6110 requires public access to rulings, determination letters, technical advice memoranda, and Chief Counsel advice with any taxpayer identification information redacted.

Financial Derivatives Do Not Fit Neatly into the Tax System, Allowing Taxpayers to Use Them in Potentially Abusive or Improper Ways

Unique characteristics of financial derivatives make them particularly difficult for the tax code and IRS to address. The tax code's current approach to the taxation of financial derivatives is characterized by many experts as the "cubbyhole" approach. Under this approach, the tax code establishes broad categories for financial instruments, such as debt, equity, forwards, and options, each with its own rules governing how and when gains and losses are taxed. As new instruments are developed, IRS and taxpayers attempt to fit them into existing tax categories by comparing the new instrument to the most closely analogous instruments for which tax rules exist. However, a new financial instrument could be similar to multiple tax categories, and therefore IRS and taxpayers must choose between alternatives. This could result in inconsistent tax consequences for a transaction that produces the same economic results.

Derivative contracts, particularly those traded over-the-counter, are highly flexible, allowing taxpayers to structure transactions to take advantage of the different tax rules for each tax category. Derivatives can also be coupled with each other and with other types of financial instruments, like more traditional debt or equity instruments, to create hybrid securities. Because hybrid securities often do not clearly fall within a single tax category, it can be challenging for IRS and taxpayers to determine which tax rules are appropriate, and whether the hybrid should be treated as a single instrument or broken up into multiple instruments. While the tax rules for each tax category 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. The cumulative effect of these decisions combined with the fact that many financial derivatives do not fit neatly in any one tax category can result in mistakes or opportunities for abuse by taxpayers.

A Patchwork of Rules from Different Parts of the Tax Code Govern the Taxation of Financial Derivatives

Tax rules governing financial derivatives can be broken down into rules governing the timing, character, and source of gains and losses, as described in table 1. These rules vary depending on a number of factors, including the type of financial derivative product, the underlying reference item, the transaction's cash flows, the type of taxpayer, the taxpayer's purpose for using the transaction, and applicable anti-abuse rules. Over time, as financial derivative products have been developed that do not fit neatly into existing tax categories, numerous tax rules have been created to address new financial products, sometimes without anticipating the relationship between those transactions and others. Therefore, tax rules for financial derivatives can vary widely from one transaction to another.

Table 1: Timing, Character, and Source Applied to Financial Derivatives

Timing	When is the gain or loss taxed? Examples include deferral of income recognition until settlement date or expiration of the contract, marking-to-market at the end of the taxpayer's year, or amortizing over the life of the contract. When gains and losses are recognized can affect the tax rate, as well as the present value of the gains and losses actually taxed.
Character	What is the type of gain or loss? Income or losses can be either ordinary income or loss or short- or long-term capital gains or losses, which affects the tax rate and the ability to defer gains and deduct losses.
Source	Where is the source of the gain or loss located? Source, either foreign or domestic, affects whether the income is taxed by the U. S., whether foreign tax credits are available, or whether withholding taxes apply.

Source: GAO analysis of IRS publications and tax research.

While the source of gains and losses resulting from financial derivatives is generally that of the residence of the recipient, the tax rules for timing and character are more complicated. As stated above, some of these tax rules depend on the type of financial derivative product. For example, nonequity options not held to hedge a transaction are taxed under section 1256 of the Internal Revenue Code (IRC), which requires that the timing of gains and losses are marked-to-market at the end of the tax year, and that the character of gains and losses is treated as 60 percent long-term capital and 40 percent short-term capital.[10] Equity options held by dealers are also taxed under section 1256. However, for equity options not held by dealers, the timing rules are that gains and losses are not realized until the contract matures. Depending on the option's term, the character is either 100 percent short-term capital gain or loss or 100 percent long-term capital gain or loss.

Some tax rules for character also depend on the underlying reference item, regardless of the transaction type. An example of this is a foreign currency contract (known as a section 988 transaction), which may be ordinary or capital depending on a variety of factors outlined in IRC section 988. The gains or losses on a section 988 transaction are

[10]In other circumstances, if a taxpayer holds an investment for more than 1 year, any capital gain or loss is a long-term capital gain or loss. If a taxpayer holds the investment 1 year or less, any capital gain or loss is a short-term capital gain or loss. Tax rates on long-term capital gains are generally lower than short-term capital gain rates and vary depending on the taxpayer's income.

ordinary to the extent they are due to changes in exchange rates. However, the taxpayer may elect capital treatment in certain instances if the contract is a capital asset in the hands of the taxpayer and not part of an offsetting position, also known as a straddle.

Other timing and character rules are based on the purpose of the transaction, such as transactions used for hedging, which are generally treated as ordinary and timed according to the hedged item.[11] Regardless of the type of transaction or reference item, if the transaction qualifies as a hedge, these rules apply.

There are also timing and character rules that are based on the type of taxpayer. For example, the rules under IRC section 475 apply to dealers in securities and, if they elect, commodities dealers and traders in securities or commodities, who must generally mark-to-market securities or commodities under IRS section 475 and recognize gains and losses annually.[12] The character of these gains and losses is ordinary. Since a securities dealer is typically one of the two parties involved in a financial derivative transaction, this often results in different tax treatment for both sides of the transaction. The dealer would generally mark-to-market annually the gains and losses from a financial derivative contract and treat the income or losses as ordinary, while the other party to the transaction would be taxed depending on the factors described in this section.

Finally, the rules for the timing and character of financial derivatives can also vary for different types of payments within a single financial derivative transaction. For example, periodic payments in a NPC are treated differently than nonperiodic payments. Periodic payments are taxed as ordinary income and recognized annually on an accrual basis like interest payments. Nonperiodic payments must be amortized and

[11]26 U.S.C. § 1221(a)(7), (b)(2); 26 C.F.R. §§ 1.446-4, 1.1221-2.

[12]Under a mark-to-market approach, a dealer or electing trader would be treated as though it had sold its securities at the end of each taxable year for fair market value and then repurchased the securities as of the beginning of the following taxable year at the same price. The dealer or electing trader would thus be taxed annually on unrealized appreciation in the securities, and its basis in the securities would be increased to avoid double taxation of that appreciation upon maturity or an actual disposition. If the value of the securities declined, the dealer or electing trader generally would be entitled to claim the unrealized loss.

recognized as ordinary income over the life of the contract. However, early termination payments in a NPC are recognized for timing purposes when they occur, and they give rise to capital gain or loss if the underlying item is capital. In contrast, nonperiodic, contingent payments do not have defined treatment; the tax rules only require taxpayers to account for the payments in a manner consistent with other tax positions. Proposed regulations issued in 2004 stated that taxpayers could use a noncontingent swap method to determine the timing and character of these payments or elect mark-to-market treatment.[13]

There are a number of anti-abuse rules that can supersede the tax rules described above, which further complicate the tax treatment of a transaction. Many sections of the tax code exist for the sole purpose of applying additional rules for certain transactions, including IRC sections 1091 (wash sales), 1092 (straddles), 1233 (short sales), 1258 (conversion transactions), 1259 (constructive sales), and 1260 (constructive ownership transactions). For example, under IRC section 1092, for two or more transactions that are offsetting positions, known as a straddle, a realized loss on one position is currently deductible only to the extent that the loss exceeds unrecognized gains in any remaining offsetting positions. A second example involves constructive sales, or transactions that are treated as sales for tax purposes even though ownership in the property may not have legally transferred. Constructive sales include when a taxpayer enters into a short sale of the same or substantially identical property, an offsetting notional principal contract with respect to the same or substantially identical property, or a futures or forward contract to deliver the same or substantially identical property. Under IRC section 1259, taxpayers are considered as having sold a position at fair market value on the date of the constructive sale.

The tax rules for character, timing, and source described above can be challenging for both taxpayers and IRS to apply. Where these rules overlap or contradict one another, they can create gray areas that allow the same economic outcome to be taxed differently. Even anti-abuse rules, some of which IRS and tax experts believe are largely effective,

[13]Under proposed regulations, the noncontingent swap method requires taxpayers to project the expected amount of contingent payments, to take into account annually the appropriate portions of the projected contingent amounts, to reproject the contingent amounts annually, and to reflect the differences between projected amounts and reprojected amounts through adjustments. 69 Fed. Reg. 8886 (Feb. 26, 2004).

can contribute to the uncertainty because determining when to apply them can be difficult.

Financial Derivative Transactions with Economically Similar Positions Can Have Inconsistent Tax Treatments

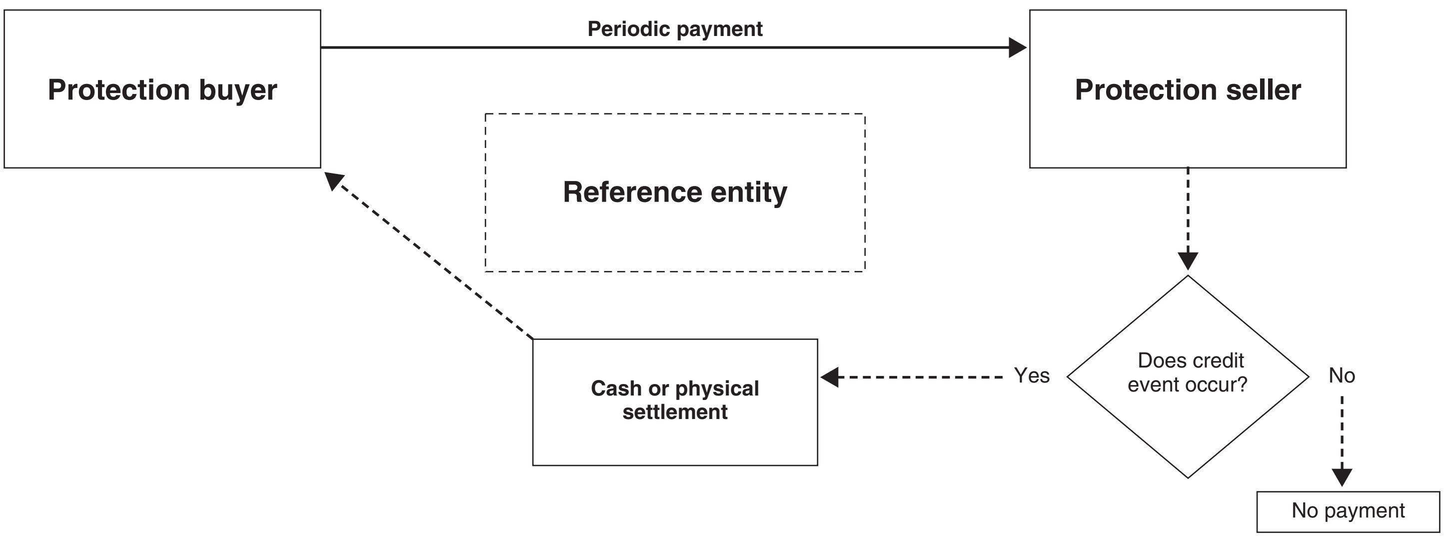
One basic principle of taxation commonly used to evaluate the tax treatment of financial derivatives is consistency, meaning that transactions with equivalent economic outcomes are taxed the same. The tax rules for financial derivatives with equivalent economic outcomes are not always consistent, in part because of their piecemeal development over time as well as the difficulty of developing tax rules for products that are constantly changing. For some types of financial derivatives, similar transactions can fall under different tax rules, particularly if the transactions do not fit well into the tax categories of the existing tax code.

While the pretax economic outcome of a taxpayer using a financial derivative and actually holding the financial asset underlying the derivative may be the same, due to the inconsistent tax treatment of derivatives, the after-tax outcome can be starkly different. The flexibility in financial derivative contracts allows them to be used to mimic different economic positions. By combining the basic building blocks of financial derivatives highlighted in table 1, together with traditional instruments like debt and equity, taxpayers can virtually create any synthetic position that allows the same economic returns as the reference item without actually owning the reference item. Financial derivatives therefore allow users, in many circumstances, to structure transactions to alter the timing, character, and source of gains and losses to produce more tax-favorable results. For example, through financial derivatives taxpayers can defer gains or accelerate losses, change ordinary income into capital gains or vice versa for losses, or alter the source of the gains to avoid paying withholding taxes.[14] While permitting taxpayers to elect a more favorable tax treatment is not uncommon, when they have done so using financial derivatives, the result has at times been disallowed by Congress. In other cases, IRS and Treasury have successfully challenged during audit or in litigation taxpayers' treatment of financial derivatives.

[14]Besides the lower tax rate applied to long-term capital gains, there is an additional economic benefit of deferring taxes paid associated with the time value of money. Each year a taxpayer defers paying tax on income, that income can be invested in a risk-free asset and increase in value. Assuming tax rates do not change, the tax owed on the original income does not increase. The taxpayer in effect pays less tax in real dollars each year he or she is allowed to defer income recognition. IRC requires accrual of this increase in value for debt instruments, but not equity.

In certain instances, financial derivative transactions can be used to produce equivalent economic outcomes that have different tax results because one financial derivative can fall under numerous tax rules. One prominent example of this is the credit default swap (CDS), which first appeared on the market in the early 1990s. As is shown in figure 3, in a CDS, the buyer pays a periodic fee to the seller in return for compensation if a specified credit event occurs to a reference item. The reference item may be bonds or loans from a corporate entity, sovereign debt, an asset, or an index of these. The credit event may be default, bankruptcy, debt restructuring, or any number of events related to the significant loss in value of the underlying reference item.

Figure 3: Credit Default Swap



Sources: GAO and IRS publications.

Although CDSs became prominent in the market in the 1990s, their tax treatment has remained uncertain. In the absence of guidance, taxpayers do not take a uniform treatment of CDSs, instead selecting the tax position that is most favorable. Taxpayers commonly elect NPC treatment for CDS transactions. As discussed previously, different payments from a NPC have different character treatments, and CDS users can take advantage of these differences to lower their tax liability when one party in the transaction is neutral to the tax results. For example, in a situation when a taxpayer holds a CDS that has appreciated in value and the other party is a dealer, rather than hold the contract until maturity and pay ordinary rates on the income, the taxpayer can terminate the contract early. By doing so the taxpayer receives a termination payment of the same economic value but pays lower long-term capital gains rates. Experts that we interviewed stated that the inconsistent treatment of CDSs increases compliance risk for taxpayers. In the final guidance, Treasury and IRS may determine that the tax treatment of CDSs does not align with how a taxpayer elected to treat a CDS now, and there is a risk that a different treatment could be imposed on transactions entered into prior to the new guidance.

Financial derivatives also allow taxpayers to take advantage of the inconsistencies between asset classes, such as differences in deductions between payments on debt and equity. Taxpayers have done this with one type of financial derivative, by coupling a forward contract with the issuance of debt, which is one type of a mandatory convertible security. Mandatory convertibles are a broad class of securities linked to equity that automatically convert to common stock on a specific date, and allow the issuer to raise capital that is treated as debt in financial statements. However, interest payments on the issuance can be deducted, which would not be possible with dividend payments on a more traditional equity security. In the transaction, a corporation issues units of the security that consist of two components: a forward contract to purchase the corporation’s equity, and debt in the form of the corporation’s note. The purchaser of the unit pledges the note back to the corporation as collateral to pay the settlement price of the forward contract. If the note and the forward are treated as a single hybrid instrument for tax purposes, the single instrument resembles an equity position, and payments on such a position would not be deductible. Currently the note and the forward can be separated for tax purposes under certain circumstances, in which case the corporation can deduct all payments on the note as interest payments on debt, despite the presence of the forward contract.[15]

Financial derivatives also have allowed taxpayers to mimic the ownership of assets such as equities, while achieving a lower tax liability than direct ownership of those assets. One example of this was the disparate treatment of dividend payments on U.S. equity and dividend-equivalent

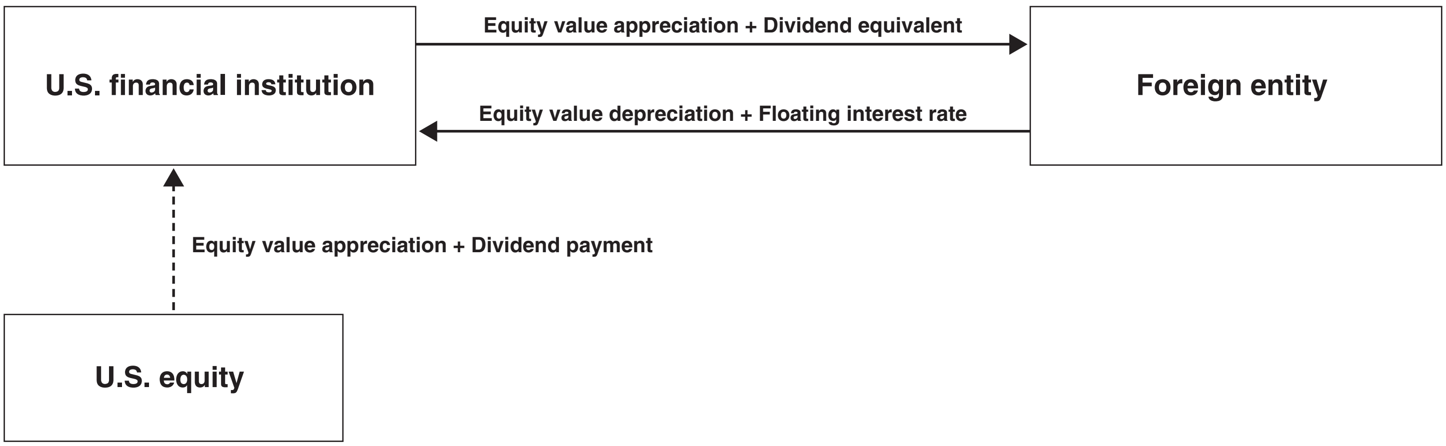
[15]See IRS Revenue Ruling 2003-97. For these tax results to hold, the transaction must have specific legal characteristics, as described in the ruling.

payments from a total return equity swap (equity TRS), held by foreign entities. Foreign entities must pay 30 percent withholding taxes on any dividends received from U.S. sources because the dividend is considered U.S.-source income.[16] However, until recently payments from a swap based on that U.S. asset would not be subject to withholding taxes, as swaps are sourced to the residency of the recipient of swap payments, the foreign entity in the case of the equity TRSs that attempt to avoid withholding taxes. In order to avoid withholding taxes on dividends, a foreign entity would enter an equity TRS, replacing the dividends with dividend-equivalent payments that arise from the swap. In this transaction, a U.S. financial institution pays the foreign entity a cash-flow equivalent to the dividends of a given stock plus any appreciation in the stock price, while the foreign entity pays a floating interest rate used to enter into the agreement plus any stock depreciation. The contract results in the foreign entity mimicking stock ownership without paying withholding tax by taking advantage of differences in source rules for dividend payments and dividend-equivalent payments. The use of equity TRS by foreign entities to avoid withholding had become standard practice since the 1990s, until the Hiring Incentives to Restore Employment (HIRE) Act statutorily required withholding on dividend-equivalent payments (see fig. 4).[17] For tax years before the enactment of the HIRE Act, IRS is challenging equity TRS transactions through the examination process, arguing that they were used to improperly avoid withholding taxes. In addition, IRS issued an Industry Director Directive on January 14, 2010, to assist IRS agents to identify and develop cases with questionable equity TRS transactions.

[16] 26 U.S.C. §§ 871(a)(1)(A), 881(a)(1). The 30 percent withholding tax, which is typically withheld at the source, is not imposed in all circumstances, such as when the income is from certain portfolio debt investments or when a tax treaty sets a different rate.

[17] Pub. L. No. 111-147, § 541, 124 Stat. 71, 115–117 (2010), *codified at* 26 U.S.C. § 871(m).

Figure 4: Cross-Border Total Return Equity Swap



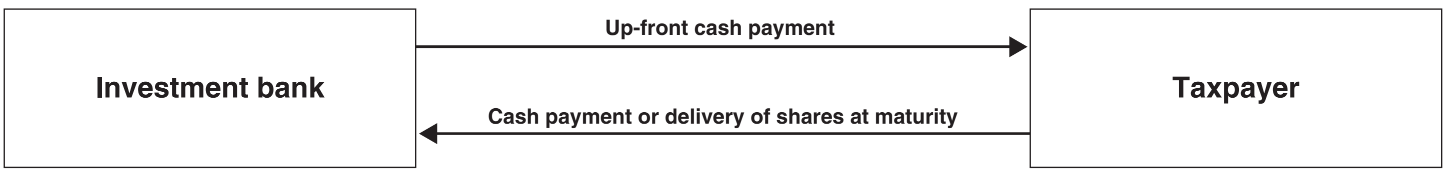
Source: GAO analysis of IRS publications.

Another example where taxpayers have used the inconsistent tax treatment between financial derivatives and direct ownership of the underlying asset was the case of a variable prepaid forward contract (VPFC) held in combination with a share-lending agreement. Taxpayers attempted to use this transaction to defer income by mimicking a sale of equity without recognizing the gains for tax purposes. When taxpayers sell an appreciated security, they must pay short-term or long-term capital gains taxes upon sale. However, over the past decade, taxpayers have used VPFCs to monetize gains in a security's value without paying taxes at the time of the sale. In situations where VPFCs have been used for this purpose, taxpayers agree to sell a variable number of shares to the other party in the transaction, usually an investment bank, at an agreed-upon date, typically 3 to 5 years in the future. VPFCs are customized to the investor and an option to cash-settle is usually included in the contract. The number of shares delivered (or the cash value thereof) is based on a formula involving the stock price on the contract's expiration date.[18] The

[18]The variable nature of the contract mitigates the downside risk at the expense of a cap on gains for both parties. As a simplified example: if a share is originally worth $100, and the VPFC relates to 10,000 shares of stock, the seller of the VPFC may agree to deliver 10,000 shares if the share price is less than $100, the number of shares worth $1,000,000, if the share prices is between $100 and $125, or 10,000 shares, less the number of shares worth $250,000, if the price rises above $125.

dealer typically pays the taxpayer between 75 percent and 85 percent of the market value of the shares up front that is not required to be repaid. By manipulating differences in timing rules, the VPFC thus closely mimics the sale of stock, but the income is not recognized for tax purposes until the contract matures. Because of the variability in the number of deliverable shares, the transaction avoids anti-abuse rules that do not permit deferred recognition of prepaid sales (see fig. 5).[19]

Figure 5: Variable Prepaid Forward Contract

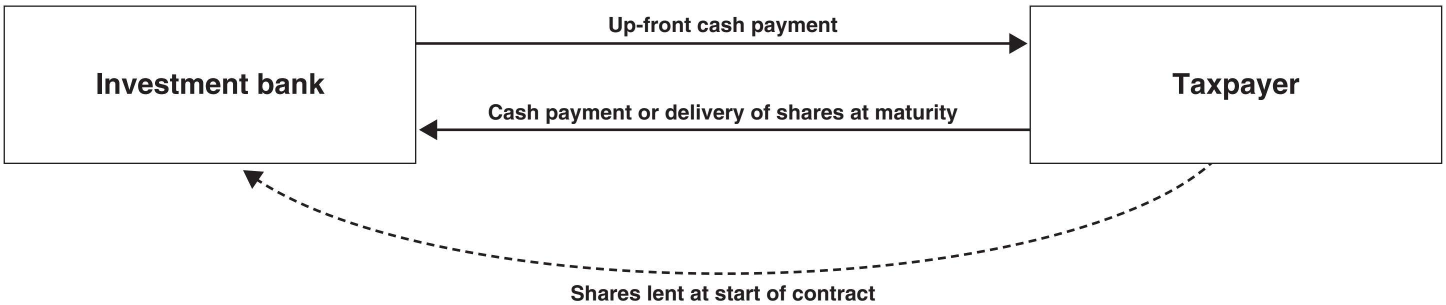


Source: GAO analysis of IRS publications.

While holding a VPFC, taxpayers still retain control of the underlying asset. To earn a greater return on the VPFC as discussed above, taxpayers sometimes couple the VPFC with a share-lending agreement. This type of agreement stipulates that taxpayers lend shares to the investment bank to sell, invest, or use in other ways the shares in its course of business. In this manner, the taxpayers have transferred substantially all of the attributes of owning the shares, but have argued that the shares have not been sold for tax purposes (see fig. 6).

[19]See IRC section 1259 rules on constructive sales.

Figure 6: Variable Prepaid Forward Contract and Share-Lending Agreement



Source: GAO analysis of IRS publications.

The current tax treatment is not the only possible method of taxing financial derivatives, and experts have suggested a number of alternatives that they believe would adopt a more consistent view of financial derivatives and potentially reduce abuse. For example, one common idea is to require mark-to-market treatment on all financial derivatives for all taxpayers, meaning that all gains and losses from financial derivatives would be recognized at the end of each tax year, and to treat all such income as ordinary income. While this approach would result in higher tax burdens for some, proponents cite benefits, which include reduced compliance costs and potential for abuse. This report does not evaluate this approach or any other alternative approaches, which would require significant changes to the tax code. We have previously developed criteria for establishing a good tax system, which include equity; economic efficiency; and simplicity, transparency, and administrability.[20] Consistency, the criterion used in this report, is related to simplicity, administrability, and economic efficiency. While the examples above describe issues that arise from inconsistent tax rules, any alternative approach would involve tradeoffs among these criteria. In considering the effects of alternative tax rules on economic efficiency, IRS and several experts told us that one potential effect of any alternative with less favorable tax outcomes could be that certain financial sector activity might leave the United States. Because of their unique position to define policy and administer the tax code, Treasury and IRS are in the best

[20]See GAO-05-1009SP.

position to recommend an alternative approach to the taxation of financial derivatives.

Challenges Slow the Development of Guidance on Financial Derivatives Increasing Uncertainty and Potential for Abuse

In their role of implementing tax laws enacted by Congress, Treasury and IRS play the crucial role of translating tax laws into detailed regulations, rules, and procedures. When application of the law is complex or uncertain, as is often the case for financial derivatives, guidance is an important tool for addressing tax compliance and emerging abusive tax schemes. Particularly when financial derivative products are new, how financial derivative products should be taxed under the current tax regime can be unclear. However, Treasury and IRS face a number of challenges in developing guidance for financial derivatives that may delay completion of guidance. Although taxpayers are accustomed to exercising judgment when taking a tax position for their transactions, the lack of clarity for many derivatives can lead to heightened compliance risk and abuse.

Taxpayers we interviewed said that Treasury and IRS have not issued guidance on a number of financial derivative tax issues that have a significant impact on their decision making. For example, before the passage of the HIRE Act in 2010, the last guidance IRS issued on transactions that avoid withholding taxes on dividends similar to cross-border equity TRSs were final regulations in 1997.[21] During the past two decades, the use of equity TRSs to avoid withholding taxes grew as many taxpayers interpreted the lack of tax guidance as IRS's approval of the tax treatment of the transaction.

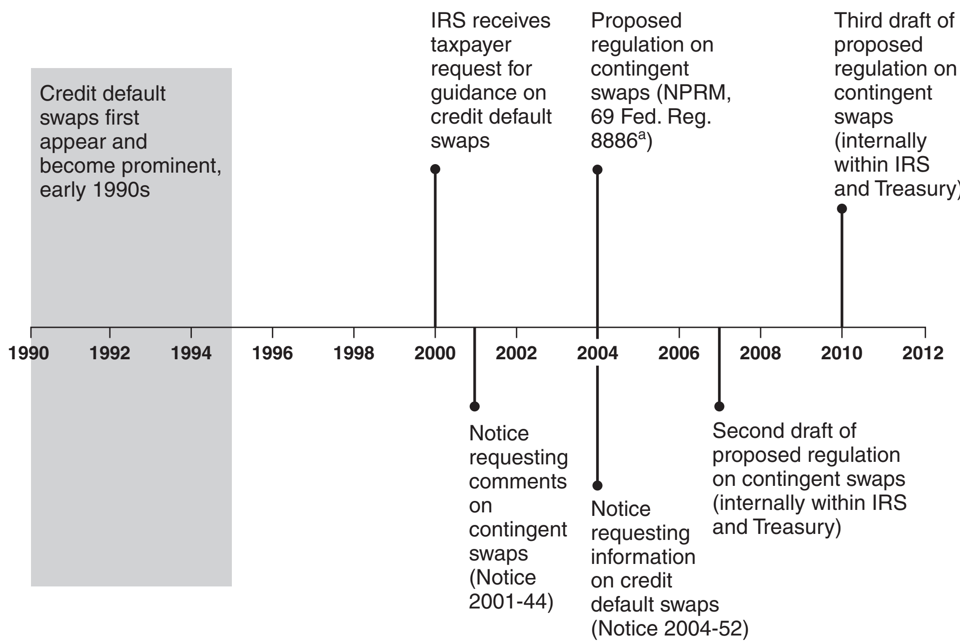
Similarly, IRS has not issued final regulations on contingent swaps since the proposed regulations in 2004, and finalized guidance on the appropriate tax treatment of CDSs has not been issued since a notice requesting comment on their tax treatment in 2004 (see fig. 7 for a timeline). This leaves taxpayers with little clarity on how to treat gains or losses from a swap payment dependent on a contingency. Contingent swaps are swaps that contain contingent nonperiodic payments determined by the occurrence of a specified event, such as the price

[21] 62 Fed. Reg.53, 498 (Oct. 14, 1997).

movement of an underlying asset.[22] CDSs are a special type of a contingent swap, where the triggering event is a credit event, such as the default of debt issued by a third party. According to IRS, the only requirement for taxpayers is that they clearly reflect income in their method of accounting for these transactions. IRS first issued a notice soliciting comments on the tax treatment of contingent swap payments in 2001, which eventually led to a first round of proposed regulations in 2004. These proposed regulations offer two accounting methods: (1) mark-to-market treatment, or (2) annually projecting the expected value of the contingent payment and paying the appropriate tax as if it were a nonperiodic, noncontingent payment, known as the noncontingent swap method. After issuing the proposed regulations in 2004, IRS has gone through several internal iterations of draft regulations without issuing final regulations on contingent swaps.

[22]According to proposed regulations, a contingent nonperiodic payment is "any nonperiodic payment other than a noncontingent nonperiodic payment," which in turn is "a nonperiodic payment that either is fixed on or before the end of the taxable year in which a contract commences or is equal to the sum amounts that would be periodic payments if they are paid when they become fixed." 69 Fed. Reg. 8886, 8893 (Feb. 26, 2004).

Figure 7: IRS Actions on Contingent Swaps and CDS



Source: IRS.

[a]Notice of Proposed Rulemaking (NPRM).

Note: In 1996, Treasury and IRS issued their first finalized regulations on contingent payments for any financial instrument, which addressed contingent payment debt instruments. 61 Fed. Reg. 30,133 (June 14, 1996). Although the regulations helped frame IRS and Treasury's thinking on contingent swaps, these regulations are not included in the timeline because they did not specifically address contingent swaps. For additional details see appendix II.

IRS first learned of CDSs in a request for a private letter ruling from a taxpayer in 2000. However, IRS did not issue any guidance on CDSs until 2004, when it requested information from taxpayers on four alternative treatments. In the absence of finalized guidance, the 2004 notice allows taxpayers to place CDSs in one of four distinct tax categories for financial instruments.[23] Experts and practitioners told us that the tax treatment for

[23]Notice 2004-52 describes CDS as similar to a NPC, an option, an insurance contract, and a financial guarantee.

CDSs is unclear, the alternatives do not necessarily arrive at the same tax liability, and taxpayers do not uniformly use one of the alternatives. The lack of guidance has resulted in taxpayers choosing different tax treatments, and according to some taxpayers we interviewed, deferring income recognition even when they are reasonably certain of gains. Taxpayers and experts that we interviewed also stated that the inconsistent treatment of CDSs increases the tax compliance risk they face because Treasury and IRS may determine that the final tax treatment of CDSs will not align with how some taxpayers are treating CDSs now and that determination may be applied to transactions entered into in prior years.

The absence of guidance on contingent swaps and CDSs affects IRS's ability to assess tax liability and address potential abuse. When exam teams in IRS identify a potentially abusive financial derivative used by a taxpayer, they have a number of resources to understand the tax effects and determine the appropriate tax liability. IRS has specialists in financial instruments that regularly assist revenue agents, as well as IRS attorneys who provide specialized legal advice. When an IRS exam division determines that a potential abuse has a large enough scale to warrant the necessary resources to address broadly, there are multiple avenues to raise the issue beyond the particular exam. One of these avenues is the issuance of guidelines by an IRS exam division to field examiners, such as an Industry Directive, as was the case with cross-border equity TRSs.[24] Another mechanism is a request for nonprecedential guidance from IRS's Chief Counsel in the form of a legal memorandum to IRS staff. Issues can also be developed into a series of cases for litigation. For issues that are broad enough, Chief Counsel can eventually issue published guidance, which differs from the previous options in that it typically has a broader legal application. The other alternatives are not generally legally binding on IRS or taxpayers, except with regard to the taxpayer involved. As another example, for VPFCs with share-lending

[24]See LMSB-4-1209-044 *Industry Directive on Total Return Swaps Used to Avoid Dividend Withholding Tax*, issued January 14, 2010.

agreements, IRS has issued guidance from exam divisions and Chief Counsel, and has also developed a number of cases for litigation.[25]

IRS and Treasury issue guidance in the form of regulations, revenue rulings, revenue procedures, notices, and announcements as well as other types of guidance. IRS Chief Counsel and Treasury's Office of Tax Policy have established a prioritization schedule for developing and issuing guidance, known as the Priority Guidance Plan (PGP).[26] The PGP is issued each year and identifies the guidance projects that are the current IRS and Treasury guidance priorities to be completed over a 12-month period that runs from July 1st to June 30th of that PGP year. The PGP is available to the public on IRS's website, and is updated periodically to include additional guidance project priorities and identifies which guidance projects have been completed up to that point. However, periodic updates to the PGP do not identify guidance projects that have been removed from the plan without having any guidance issued. Not all guidance projects being worked on are on the PGP, and a number of pieces of guidance affecting derivatives were not PGP projects. For example, Notice 2002-35, which addressed tax shelters using NPCs, was not on the PGP before it was published. The PGP serves as both a public statement of the guidance taxpayers can expect to receive over a 12-month period and an internal prioritization of resources within IRS and Treasury. Given the pace at which derivative markets evolve, timely guidance that addresses tax issues is important to reduce uncertainty and opportunities for abusive tax strategies. However, Treasury and IRS face a number of challenges that are discussed below that may delay the completion of guidance.

[25]In 2006, the Pre-Filing and Technical Guidance office within the Large and Mid-Size Business (LMSB) division issued an Emerging Issue Paper. In 2008, LMSB issued Coordinated Issue Paper LMSB-04-1207-077. Starting in 2004, IRS has entered into litigation against at least three separate taxpayers, in relation to these issues.

[26]The PGP is also known as the Guidance Priority List or the Business Plan.

Between 1996 and 2010 IRS and Treasury Did Not Complete One-Fourth of the Priority Guidance Projects That Involved Financial Derivatives

We analyzed 53 projects that involve financial derivatives that IRS and Treasury have placed on the PGP since 1996, and found that one-fourth of the projects were not completed (see table 2).[27] Almost all of the guidance projects that were completed were published within 2 years of first appearing on the PGP.[28]

Table 2: Completion Rate of Financial Derivative Guidance Projects, 1996-2010

	Count	Percentage
Complete	39	74
Incomplete	14	26
Total	**53**	**100**

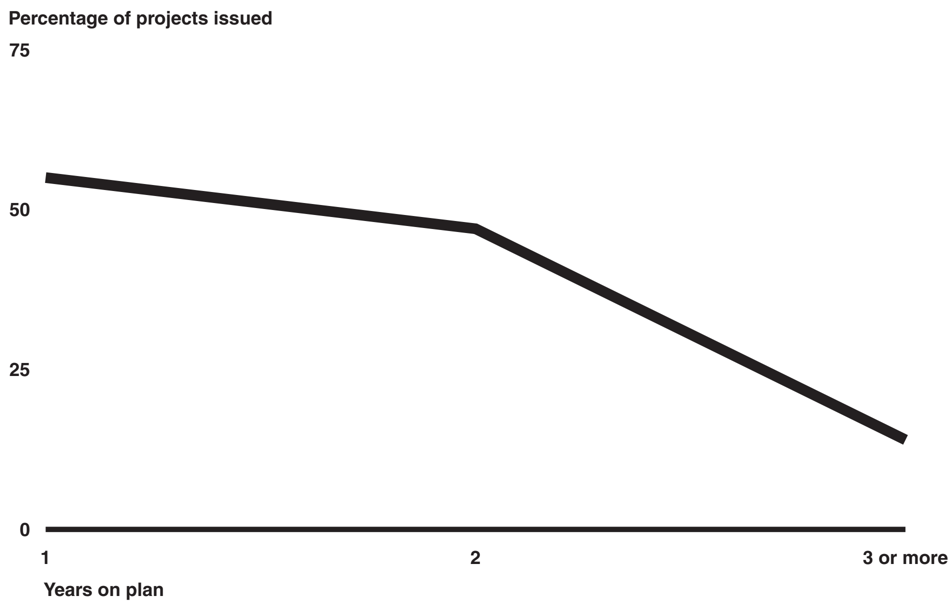
Source: GAO analysis of IRS data.

Of the 53 projects on the PGP, IRS and Treasury completed just over half (29) within their first year on the plan, and removed 5 that were not completed. Of the 19 projects that remained on the plan for 2 years or longer, just under half of those (9) were completed and 3 were not completed and removed. Only 1 of the 7 projects that were on the PGP for 3 or more years was completed as of the end of the 2010 PGP year (June 30, 2010). Some of the PGP projects that were removed or not completed from 1996-2010 dealt with tax issues related to the case studies described above on contingent swaps and equity TRSs. Figure 8 presents the completion rates for projects related to financial derivatives on the plan for 1 or more years.

[27]IRS Chief Counsel's database which tracks guidance projects, Counsel Automated Systems Environment-Management Information System (CASE-MIS), only has data available going back to 1996.

[28]See appendix II for list of the 53 priority guidance projects.

Figure 8: Completion Rates of Financial Derivative Guidance Projects, 1996-2010



Source: GAO analysis of IRS data.

We found, that on the basis of our analysis, projects not issued within 3 years were more likely to be regulations, and related to more complex issues. Four projects that were on the plan for 4 years or longer without being completed were regulations addressing particularly controversial and complicated issues, including (1) capitalization of interest and charges in straddles under IRC section 263(g), (2) constructive sales rules under IRC section 1259, (3) contingent payments in notional principal contracts, and (4) elective mark-to-market accounting for certain qualifying taxpayers under IRC section 475. While it is important for IRS and Treasury to finalize guidance on these projects to provide clarity to IRS and taxpayers, there are a number of challenges involved, including the patchwork structure of the relevant tax rules and other issues discussed below. These challenges can make it difficult to issue guidance on the tax treatment of financial derivatives within the 12-month time frame established in the PGP.

Challenges Specific to Financial Derivatives Slow the Guidance Process

While some reasons for the delay in the issuance of guidance on financial derivatives are common to all guidance projects, financial derivatives have characteristics that present challenges to IRS and Treasury.

Overcoming these challenges requires time and resources, which can cause significant delays in issuing guidance that addresses the concerns facing taxpayers and IRS.

The transactional complexity of many derivative products and the complex tax rules governing them make it difficult to determine appropriate tax treatment

The growing sophistication of financial derivatives and the complex tax rules governing them have made it difficult for Treasury and IRS to resolve issues not addressed in legislation or existing guidance. On the one hand, financial derivative products can involve multiple transactions and entities, or terms can be altered to reach different tax results. These factors impede IRS's ability to identify a product's economic outcome, business purpose, and the applicable tax rules. The complexity of VPFCs is one example where IRS concluded and the courts agreed that some claimed tax results of the transactions were improper, depending on the entities involved and what other contracts the VPFCs were coupled with. On the other hand, multiple tax rules can apply to the same financial derivative product depending on certain factors such as the type of taxpayer, the underlying asset, and the context in which the product is being used. Treasury and IRS often spend years working through these complexities, and at times have been unable to reach a consensus.

The tax treatment of gains and losses that are contingent on a particular event is an example of an issue that Treasury, IRS, and private sector experts have identified as particularly difficult to resolve. Treasury and IRS legal counsel have devoted considerable resources—as of April 2011 IRS alone had logged nearly 7,800 staff hours over a 9-year period—to determine the appropriate treatment of contingent swap payments, but have been unable to reach a consensus. Despite being on the PGP every year since 2004, when proposed regulations were issued, Treasury and IRS have been unable to establish the appropriate treatment of contingent nonperiodic payments in final regulations in large part due to the complexity of the timing and character issues, as well as other issues discussed earlier. CDSs have also been the subject of considerable analysis by Treasury, IRS, and experts on the appropriate tax treatment. Since issuing a notice in 2004, IRS has not issued any guidance on how CDSs should be treated for tax purposes. During this time, the structure of CDS products has diversified from products that were referenced to a single entity to products based on a pool of obligations, such as an index and others that are rolled into more complex products. IRS and Treasury have not established the appropriate treatment of a basic CDS product, a necessary first step in determining the tax treatment of more complex CDS products.

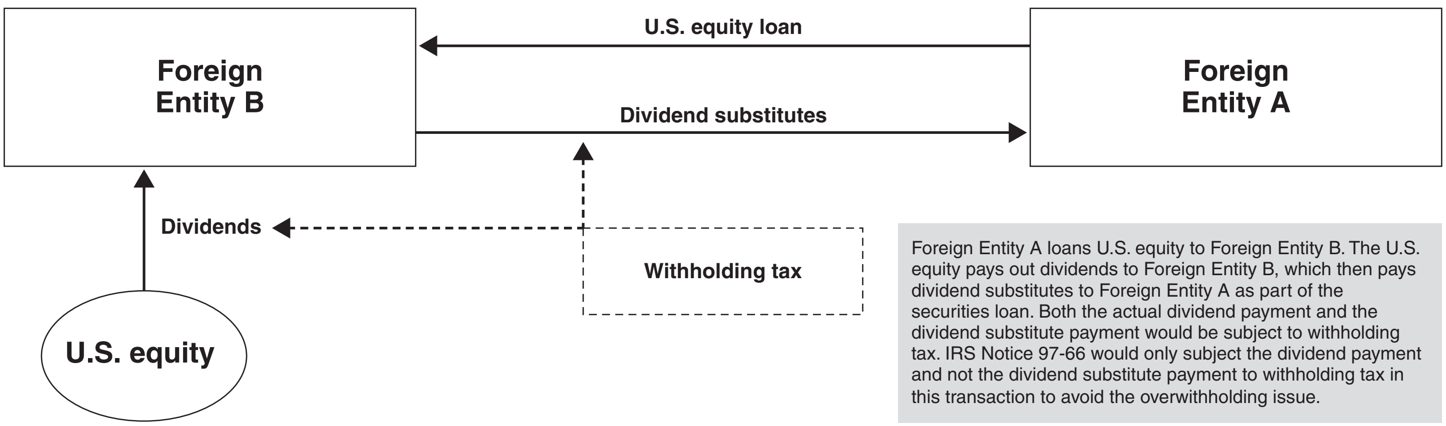
Some financial derivatives have been developed to take advantage of new guidance in ways unintended by IRS

The timeliness of Treasury and IRS guidance is also affected by concerns that issuing new guidance could provide new opportunities for tax abuse. This is especially true for financial derivatives, as they can easily be altered to achieve a desired tax effect. IRS told us that whether it issues further guidance depends on a careful consideration of the possible unintended effects that guidance might have, and that Treasury and IRS must carefully evaluate potential guidance changes to help ensure that while addressing problems in one area they do not raise issues in another. One example of guidance that Treasury and IRS issued that had unintended consequences was IRS Notice 97-66, which dealt with withholding taxes on dividend-substitute payments. Certain payments made by a domestic entity to a foreign entity may be subject to a 30 percent withholding tax, depending on source rules for that type of payment. Dividend payments made from owning equity and dividend substitute payments made from a securities loan are subject to withholding tax. Prior to the passage of legislation in 2010, some taxpayers and representatives took the position that dividend-equivalent payments made from an equity TRS were not subject to withholding tax.[29] IRS had begun challenging the equity TRS transaction based on judicial doctrines before the 2010 legislation was enacted.

When Treasury finalized the regulations for dividend-substitute payments in 1997, tax practitioners were concerned that the regulations could result in the cascading of withholding taxes in cases where the same shares of equity were lent between two foreign parties. As seen in figure 9, in this transaction, the actual dividend and the dividend-substitute payment would be subject to withholding tax, resulting in withholding tax exceeding the 30 percent withholding rate.

[29]Dividend substitute payments on U.S. equity made when a foreign owner loans the equity securities to a U.S. entity are sourced similar to a transferred security according to 1997 regulations, meaning they are also subject to the 30 percent withholding tax when payments are made to foreign entities. (Treas. Reg. 1.861-3(a) (6), adopted by T.D. 8735, 11-6-97) However, according to 1991 regulations, the source of dividend-equivalent payments made from a total return equity swap is determined by the residence of the taxpayer, so a U.S. entity making payments to a foreign entity does not need to withhold taxes. (Treas. Reg. 1.863-7(b), adopted by T.D. 8330, 1-11-91).

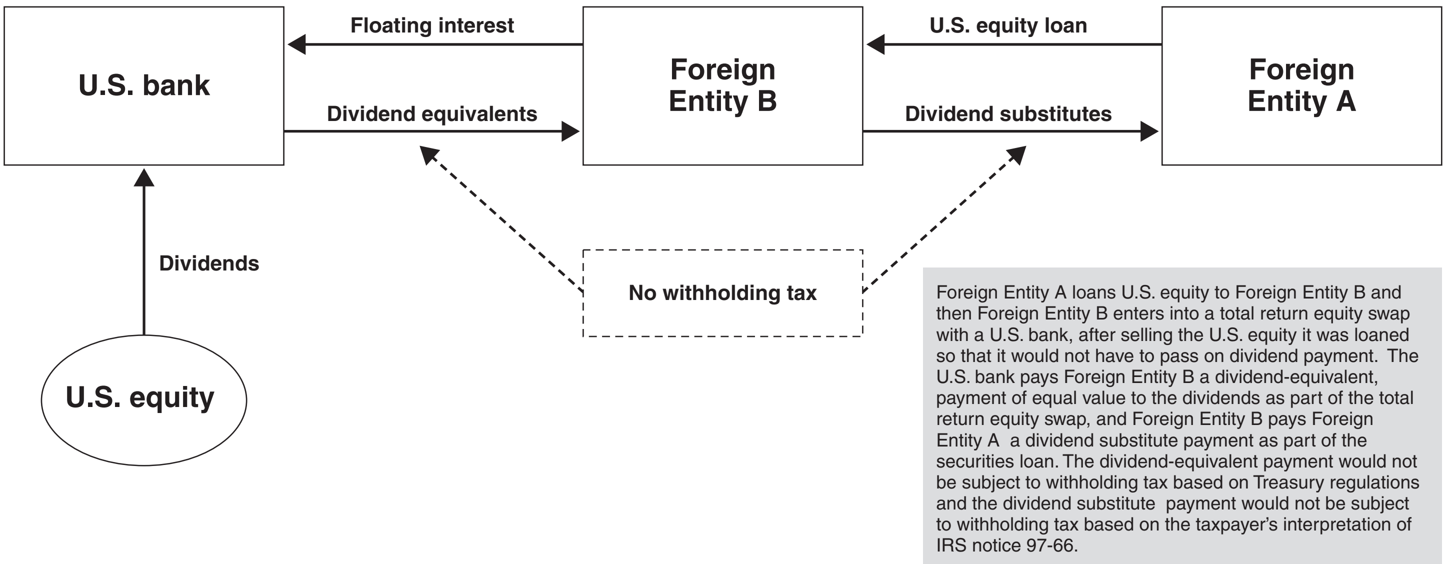
Figure 9: Cascading Withholding Taxes through Equity Securities Loan



Source: GAO analysis.

In response, IRS issued Notice 97-66, intended to avoid cascading withholding on instances described in the example above. However, some financial institutions took the position that a literal reading of the IRS notice meant that a dividend-substitute payment made between two foreign parties located in jurisdictions subject to the same withholding rate was not subject to any withholding tax. As seen in figure 10, in this transaction, the dividend-equivalent payment would not be subject to withholding tax because of 1991 Treasury regulations and the dividend-substitute payment would not be subject to withholding tax based on the taxpayer's interpretation of IRS Notice 97-66. As stated above, Congress eventually disallowed the avoidance of dividend withholding through this transaction with the passage of the HIRE Act.

Figure 10: Combining a Total Return Equity Swap and an Equity Securities Loan



Source: GAO analysis.

This example and others have made Treasury and IRS aware of the importance of weighing the need for guidance with the potential that new guidance may also provide new opportunities for taxpayers to aggressively reduce their tax liability by altering the structure of a transaction. The ability of financial market participants to react quickly to guidance means that Treasury and IRS have to consider the unintended effects that may occur when issuing guidance. As indicated in the example above regarding Notice 97-66, the time it takes Treasury and IRS to identify and mitigate any tax avoidance strategies that arise from issuing guidance can take a number of years.[30] While timeliness is an important factor for issuing guidance, taking steps to ensure the effectiveness and the desired results of the guidance are also important factors for IRS and Treasury to consider.

[30]After the passage of HIRE Act, enacted March 18, 2010, IRS replaced Notice 97-66 with Notice 2010-46.

The rapid growth of the financial derivatives market increased the potential economic impact of guidance

The considerable growth in financial derivatives markets has increased the potential economic effects of guidance issued by Treasury and IRS. IRS officials have said that in preparing guidance they do not consider the number of taxpayers taking a certain tax position on a financial derivative product, but rather they base their decisions on tax rules established in the IRC, Treasury regulations, and judicial doctrine. However, in light of the size of a product's market, officials told us that it is important to consider the economic effects of their guidance decisions. Economic consequences of concern identified by officials and experts include losing financial business overseas to countries with more business-friendly tax regimes.

An example of one of the economic risks facing IRS and Treasury surfaced during the process of issuing guidance on how withholding taxes should apply to cross-border derivative payments. When Treasury and IRS considered requiring withholding on cross-border equity TRSs in 1998, Congress, IRS, and Treasury faced numerous concerns from taxpayers that this would limit foreign investment in the U.S.[31] Withholding has also been a concern for cross-border CDSs. In terms of notional amount outstanding, the U.S. share of the global CDS market has, on average, been about one-third of the total market since the end of 2004. IRS staff and private sector experts have said that subjecting CDSs to withholding tax presents a risk that investors will move their business overseas. IRS officials said that this has been a major impediment in the resolution of whether withholding tax should apply to CDSs, particularly in light of the rapid growth of the credit derivatives market.

Staff turnover, legal authority, and enforcement responsibilities have delayed the progress of financial derivative guidance projects

As Treasury and IRS work through the many complexities of issuing guidance for financial derivatives, they also must deal with institutional factors such as staff turnover, legal authority, and the different roles of Treasury and IRS that can delay the issuance of guidance. Staff turnover at IRS and Treasury can bring current market knowledge from the private sector; however, this turnover can also sometimes affect the timeliness of guidance. New staff typically have to familiarize themselves with the issues raised in ongoing guidance projects, may have a different perspective on the issues raised in the projects, or may believe the project should have a different priority.

[31]See the proposed rules regarding trading safe harbors. 63 Fed. Reg. 32,164 (June 12, 1998).

Determining whether Treasury and IRS have the necessary authority to take certain positions can also delay the development of guidance projects. Treasury and IRS have at times been reluctant to explore and ultimately issue guidance to resolve tax issues when there is concern about whether IRS has the legal authority to require a certain tax treatment for financial products. For example, although many experts consider mark-to-market treatment the most appropriate resolution for contingent swap payments, IRS had concerns about whether it could require taxpayers to follow mark-to-market treatment for contingent swap payments.

IRS's enforcement responsibilities can also affect the time it takes to complete guidance projects. Treasury and IRS may want to issue guidance on a certain issue, but if IRS is currently conducting litigation or auditing on that issue it may be difficult to consider alternative guidance positions when IRS has already taken a position in an audit or in court. For example, one of the reasons that Treasury and IRS did not attempt to address gaps in existing guidance on VPFCs with new guidance was because IRS was litigating the issue and did not want to publish guidance that might affect IRS's case.

Delayed Guidance Increases Compliance Risk and Costs, among Other Negative Consequences

Delays in the issuance of guidance on financial derivatives have substantial negative consequences for both taxpayers and IRS, which are summarized in table 3. However, IRS and Treasury may also benefit by not issuing timely guidance. The ambiguity that results from a lack of clear guidance could make taxpayers less willing to take risky tax positions because of the concern that IRS may determine the position is abusive in the future.

Table 3: Negative Consequences of Delayed Guidance on Financial Derivatives

Consequences for taxpayers	Consequences for IRS
• Uncertainty • Imperfect market competition • Reduced confidence in tax system	• Increased time and resources in audits and litigation • Opportunities for tax abuse • Negative reputation

Source: GAO analysis of interviews with Treasury, IRS, and tax experts.

Exchange-Traded Notes

The case of exchange-traded notes (ETN) is an example of the increased compliance risk associated with uncertainty. ETNs are contractual obligations, traded on an exchange, which generally provide investors the right to receive a return that is based on changes in the value of an index. ETNs are sold, or issued, by financial institutions to investors in the form of debt instruments. The investor makes a prepayment to the issuer of the ETNs for a payment at maturity based on the performance of the index. In this sense, an ETN is a prepaid forward contract traded on an exchange. Economically, an ETN produces a similar investment and risk profile as an exchange-traded fund (ETF) that all may track the same index, with the exception that the ETN investor is exposed to the risk of the issuer. For tax purposes, however, ETFs differ from ETNs. In order to track an index, ETFs must yearly rebalance the shares they hold and investors must generally pay capital gains taxes on shares sold. In addition, the shares held by ETFs may pay dividends, for which the holder must pay taxes even if the dividends are reinvested into the underlying shares. Investors in an ETN, on the other hand, generally treat all gains and losses generated by the ETN as a prepaid forward contract. This means ETNs are treated as open transactions and any gains or losses would not be recognized until the ETN is traded or redeemed. In 2007, IRS issued guidance requiring ETNs on foreign currency to accrue interest income that is taxed at ordinary rates, but the general tax treatment of returns on ETNs has not been established by IRS and Treasury.[33] The market has grown considerably since 2006, when ETNs first appeared. Developing guidance on ETNs has been listed as a priority by IRS and Treasury since 2009. As of August 2011, 170 ETNs had assets of almost $16 billion. One of the major attractions to ETNs is their beneficial tax treatment, and the delay in issuance of guidance could put an increasingly large number of taxpayers at risk of noncompliance.

For taxpayers, one of the main tax-related consequences is the increased compliance risk associated with uncertainty. (For an example see the sidebar on Exchange-Traded Notes.) For example, if no clear guidance exists on how to treat a transaction for tax purposes, taxpayers must come up with their own position, which may be different than IRS's approach and present increased compliance risk. Tax positions may also differ among taxpayers, which causes a consistency problem for both taxpayers and IRS. In developing tax positions where no clear guidance exists, taxpayers often look to other sources of information provided by IRS and Treasury that lack the legal status of finalized guidance. Tax experts said that they prefer written guidance to informal statements made by agency officials at conferences, which do not necessarily represent IRS's official position on a transaction. In addition, taxpayers rely on nonprecedential advice that IRS issues to either individual taxpayers or to IRS exam teams.[32] If IRS disagrees with a taxpayer's position, the taxpayer is at risk of either penalties or litigation costs if the taxpayer decides to challenge the agency. If guidance is later issued that affects positions taken by taxpayers retroactively, this could put taxpayers' current positions at risk of being noncompliant, although officials said it may be unlikely that Treasury and IRS would do this, as long as the taxpayer's method was reasonable and consistently applied.

Another consequence that the absence of guidance results in is imperfect market competition. According to market participants, because most derivatives are not tax driven, contracts may be executed even if the tax results are unclear. Taxpayers may look for other parties in a transaction who are willing to take on the additional tax risk, resulting in what one expert called a "race to the bottom" as parties vie for business by taking on riskier tax positions. In addition, all of these issues can reduce taxpayers' confidence in the fairness of the tax system.

[32]Nonprecedential advice includes Private Letter Rulings (PLR), Technical Advice Memorandums (TAM), and Chief Counsel Advice (CCA). PLRs and TAMs are issued to taxpayers and exam teams and are only binding on the IRS and the taxpayer in the specific circumstances addressed. CCA is issued to exam teams and is not legally binding.

[33]See IRS Revenue Ruling 2008-1 and IRS Notice 2008-2.

Variable Prepaid Forward Contracts

The case of variable prepaid forward contracts (VPFC) is an example of the negative consequences to both taxpayers and IRS of delayed guidance. In 2003, IRS issued Revenue Ruling 2003-7, which addressed what IRS thought was the most prevalent form of VPFCs. The ruling allowed taxpayers to use VPFCs to defer income for tax purposes, avoiding capital gains rules under IRC section 1001 and constructive sale rules under IRC section 1259. However, it was not until after the issuance of the revenue ruling that the agency became aware of the coupling of VPFCs with a share-lending agreement, described in the text above and which taxpayers had been using since at least 2000 to monetize their assets while claiming that there was no sale for tax purposes. IRS did not publish further guidance to address the newly identified transaction. Further, exam teams had to wait approximately 2 years before a technical advice memorandum (TAM) was issued, which gave them the legal support to challenge this practice. Although TAMs are public, taxpayers can not rely on them as legal precedent. Because of the shortcomings of IRS's initial guidance and IRS's inability to quickly issue new guidance, taxpayers were led to believe their transactions would not be challenged. For the same reasons, IRS exam teams were limited in their ability to take action against what they considered and IRS ultimately judged to be an improper tax result.

For IRS, one negative consequence of delays in guidance on financial derivatives is increases in time and resources spent on examinations and litigation. Without clarity on a tax issue, audit teams must often spend more resources examining the tax results of derivative transactions, which may include requesting advice from IRS Chief Counsel, often a time-consuming process. IRS staff told us that having clear, timely guidance can significantly reduce the amount of time and uncertainty revenue agents and IRS counsel encounter resolving tax issues during an exam. If taxpayers and revenue agents have divergent views on tax positions, a technical advice memorandum or other legal memorandum may be requested, which can increase the amount of time in exam. If IRS is unable to issue guidance on a transaction, they may pursue a litigation strategy, which itself can take years and require a great deal of resources from both IRS and the taxpayer.

Another negative consequence for IRS is that in the absence of guidance taxpayers may attempt to take positions that may be abusive. (For an example see the sidebar on Variable Prepaid Forward Contracts.) For both cross-border equity TRSs and VPFCs, delays in guidance from IRS led to the transactions becoming more widespread throughout the market. The burden may be increased on exam teams to address a greater number of completed transactions. Delays in issuing guidance can also put IRS's reputation at risk. Tax experts and practitioners that we spoke with expressed frustration at the delay in the issuance of guidance on financial derivatives and in the lack of information on the status of guidance projects, which negatively affected their perspectives of IRS.

Taxpayers are Unaware of the Status of Guidance Projects for Financial Derivatives

IRS and Treasury guidance priorities may change due to a number of factors, including changes in legislation, policy, market circumstances, and management agendas. Taxpayers need to know about these changes when they affect their tax planning and business decisions. As discussed earlier, one-fourth of derivative guidance projects were not completed between 1996 and 2010, and tax experts and practitioners that we spoke with were not aware of the status and prioritization of many of these guidance projects. Tax experts and practitioners stated that information about the status of projects was not publicly available, and they often only knew about a project's status through informal statements made by IRS and Treasury officials at conferences and other meetings. IRS will purposely keep some guidance projects off the public list when the issue is legally sensitive and could negatively affect IRS's efforts in an audit or litigation if the guidance projects were publicly announced.

The current system for communicating the PGP does not allow IRS to effectively communicate the status of guidance projects to taxpayers. For most years since 1996, IRS has issued periodic updates on its website to the PGPs after initial plans were released, listing projects that were added or completed during the year. All PGPs, whether initial or updated, are potentially subject to change. However, because projects can be added to the PGP at any time without an accompanying change in the publicly available plans, changes in guidance prioritization are not always clearly communicated to taxpayers. In addition, PGPs do not include target completion dates, something IRS uses internally, which would give taxpayers a clearer timeframe for expecting guidance. Therefore, taxpayers lack clarity as to when they can expect guidance on issues that IRS and Treasury have publicly stated are priorities. While there may be challenges and risks in communicating more detailed information and updated status, particularly when there may be unanticipated setbacks in the development of guidance, other federal agencies routinely do so.

Providing status information for PGP projects would require IRS to maintain reliable internal monitoring data on guidance projects. IRS Chief Counsel uses a data management system, Counsel Automated Systems Environment – Management Information System (CASE-MIS), to track progress of guidance projects and monitor interim milestones in project lifecycles. CASE-MIS has been available since 1996, and was modified in 2008. The effectiveness of this system has been critiqued multiple times over the past 10 years by the Treasury Inspector General for Tax Administration, and in response IRS has made improvements to the monitoring of projects in the database.[34] In our own review of data used by IRS to monitor guidance projects, we found a number of data reliability issues that may impede the agency's ability to effectively monitor guidance projects in order to report status to taxpayers. Most notable, the current status and target date of projects are not consistently recorded correctly for all projects. In addition, discerning when a project moved onto the PGP, its date of publication, and when or why it was removed without publication is difficult. This information is essential for IRS and

[34]See Treasury Inspector General for Tax Administration (*TIGTA) 2010-10-106: Chief Counsel Can Take Actions to Improve the Timeliness of Private Letter Rulings and Potentially Reduce the Number Issued*; *TIGTA 2008-10-075: The Published Guidance Program Needs Additional Controls to Minimize Risks and Increase Public Awareness*; and *TIGTA 2003-10-081: Improvements to the Office of Chief Counsel's Published Guidance Process Would Enhance Guidance Provided to Taxpayers and the Internal Revenue Service*.

Treasury to effectively manage the guidance process and to communicate project status to taxpayers. Although status information can be collected manually, the electronic management system is intended to improve efficiency and reporting capability by avoiding time-consuming manual data collection and processing. Since 2008, IRS has been taking steps to improve the effectiveness and reliability of CASE-MIS, including the issuance of staff memorandums and closer attention to reliable data entry, with the purpose of increasing efficiency, productivity, and decision making.[35]

Opportunities Exist for IRS to Leverage Information from SEC and CFTC on Financial Derivatives

IRS Does Not Systematically or Regularly Communicate with SEC or CFTC on Financial Derivatives

Currently, IRS does not systematically or regularly communicate with SEC or CFTC on financial derivatives. IRS's 2009-2013 Strategic Plan lists strengthening partnerships across government agencies to gather and share additional information as key to enforcing the law in a timely manner to ensure taxpayers meet their obligations to pay taxes. SEC's and CFTC's oversight role for financial derivative markets make them key agencies for IRS to partner with on financial derivatives. Both regulatory agencies told us that opportunities may exist to share additional information on financial derivatives with IRS. However, IRS's ability to share taxpayer information with other federal agencies is limited under IRC section 6103, which governs the confidentiality of taxpayer data. IRS officials say that the lack of reciprocal information sharing is an impediment to effective collaboration with SEC and CFTC.

IRS has occasionally received information from SEC on financial derivatives that were suspected of being used for abusive tax purposes. Such information, however, is received only on an ad hoc basis, either

[35]See, for example, Chief Counsel Notices *CC-2011-009: File Maintenance and Management Information System Requirements,* issued on March 11, 2011.

through requests initiated by IRS or referrals from SEC. SEC officials told us that when potential tax abuses have been identified and shared with IRS, the SEC examiner involved in the case typically had some tax expertise or had worked with IRS in the past. For example, in 2008, SEC examiners discovered a strategy employed by hedge funds to structure short-term capital gains into long-term capital gains through the use of options. This information was referred to IRS because SEC staff believed that IRS may conclude that the structuring of transactions in this manner may result in an incorrect treatment of capital gains. IRS said that this information was essential to the eventual development and issuance of related guidance.[36] However, agency officials told us that SEC and CFTC examiners often do not have tax expertise. As a result, potential tax abuses may not be identified and shared with IRS.

Information from SEC and CFTC Could Help IRS Identify New Products, Emerging Trends, and Relevant Issues

The proliferation of financial derivatives present a challenge for IRS in identifying potential abuses and ensuring timely guidance addresses the full range of financial derivative products. In recent years, new uses of financial derivative products have been introduced, and abusive uses have spread faster as technology developments have made it easier to create new products.

In the past, IRS met regularly with a group of federal agency officials, including those from SEC and CFTC, academics, and other market experts, to discuss financial products, including financial derivatives, and market trends. The group was established by an academic institution and met for about 10 years beginning in 1990, and participants joined the group by invitation. IRS and others who were part of the group told us that academic sponsorship encouraged both federal agency and private sector experts to join the group and candidly share information on new financial derivative products and uses. According to Treasury officials, regularly participating in these meetings with officials from SEC and CFTC and the private sector helped them to (1) identify new financial derivatives, (2) improve their understanding of these new products, (3) become aware of regulatory schemes that may have tax implications, and (4) make contacts with other knowledgeable agency officials and experts in financial derivative products. IRS told us that understanding all sides of a financial derivative transaction, both tax and regulatory, helps

[36] IRS Chief Couns. Mem. AM2010-005 (Oct. 15, 2010).

to clarify the purpose of the transaction and reveal potential tax abuse. Since the group disbanded after the academic sponsorship dissolved, there has been no regular, coordinated communication process for sharing information on financial derivatives between IRS and SEC and CFTC. According to IRS officials, such a process could help IRS ensure they are fully using all available information to identify and address compliance issues and abuses related to financial derivatives.

In addressing problems in financial markets that emerge quickly, we have found that collaboration between federal agencies is especially important for federal agencies to maximize performance and identify and resolve problems faster.[37] IRS officials told us that they typically uncover new financial derivative abuses during an audit, meaning by the time IRS identifies the financial derivative product, and issues guidance, the market for a financial derivative product can be relatively large and developed. SEC may identify new products and emerging trends in financial derivatives trading before IRS because new products on exchanges must be approved by SEC before they can be traded, and others may be disclosed in financial statements. According to IRS officials, improved collaboration could help IRS more quickly identify and analyze emerging financial trends and new products in the financial derivatives market before taxpayers even file their tax returns.

According to IRS officials, having a more regular way to obtain information about certain sales reported to SEC in disclosures of insider trading could have sped IRS's identification of the use of VPFCs with share-lending agreements. When taxpayers deferred income recognition by not considering a VPFC and share-lending agreement as constituting a sale on their tax return, some taxpayers reported the transaction as a sale for SEC purposes. IRS officials obtained this information, but had they been regularly and systematically communicating with other agency officials on financial derivatives, problems with these transactions may have been identified earlier. IRS officials believe that because certain information on financial derivatives may be reported for both regulatory and tax purposes, reviewing certain types of transactions collaboratively with SEC and CFTC could help IRS better identify abuse. For example, IRS told us that certain information on financial derivatives from SEC

[37] See GAO-06-15.

Form 4s, which relate to insider trading, and 10Ks have been useful for identifying new financial derivative products and potential tax issues.

Federal banking regulators, such as OCC, also have information on financial derivatives. Although the federal banking regulators do not oversee derivatives markets, their oversight of banking institutions includes evaluations of risks to bank safety and soundness from derivatives activities. For example, as we reported in 2009, their oversight captures most CDS activity because banks act as dealers in the majority of transactions and because they generally oversee CDS dealer banks as part of their ongoing examination programs.[38] Furthermore, as OCC-regulated banks may only engage in activities deemed permissible for a national bank, the agency periodically receives requests from banks to approve new financial activities, including derivatives transactions. Information collected during these reviews may provide IRS with information on financial derivatives.

As we were completing our audit work, IRS officials told us that they had recently begun developing plans to have regular meetings with SEC to discuss new products and emerging issues related to financial derivatives. In previous work, we have established best practices on interagency coordination to help maximize results and sustain collaboration.[39] These best practices 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. Federal agencies can enhance and sustain collaborative partnerships and produce more value for taxpayers by applying the following eight best practices:

1. Define and articulate a common outcome.
2. Establish mutually reinforcing or joint strategies.
3. Identify and address needs by leveraging resources.
4. Agree on roles and responsibilities.
5. Establish compatible policies, procedures, and other means to operate across agency boundaries.
6. Develop mechanisms to monitor, evaluate, and report on results.
7. Reinforce agency accountability for collaborative efforts through agency plans and reports.

[38] See GAO-09-397T.

[39] See GAO-06-15.

8. Reinforce individual accountability for collaborative efforts through performance management systems.

These best practices would support a collaborative working relationship between the IRS and SEC and CFTC. While we generally believe that the application of as many of these practices as possible increases the likelihood of effective collaboration, we also recognize that there is a wide range of situations and circumstances in which agencies work together. Following even a few of these practices may be sufficient for effective collaboration.

Conclusions

Although financial derivatives enable companies and others to manage risks, some taxpayers have used financial derivatives to take advantage of the current tax system, sometimes in ways that courts have later deemed improper or Congress has disallowed. The tax code establishes broad categories for financial instruments, such as debt, equity, forwards, and options, each with its own tax rules governing how and when gains and losses are taxed. However, as new financial derivative products and uses are developed, they could be similar to multiple tax categories, and therefore IRS and taxpayers must choose different tax treatments. In certain instances, this has allowed economically equivalent outcomes to be taxed inconsistently. Without changes to the approach to how financial derivatives are taxed, the potential for abuse continues. Experts have suggested alternative approaches that they believe would provide more comprehensive and consistent treatment. However, each alternative would present tradeoffs to IRS and taxpayers, including tradeoffs to simplicity, administrability, and economic efficiency. This report does not address or evaluate alternatives for taxing financial derivatives. Because of their unique role in defining policy and administering the tax code, Treasury and IRS are best positioned to study and recommend an alternative approach to the taxation of financial derivatives.

Outside of any comprehensive changes to the current approach to the taxation of financial derivatives, one way that Treasury and IRS address potential abuses and provide clarity to tax issues is through its taxpayer guidance. The lack of finalized guidance has negative consequences for both IRS and taxpayers, including uncertainty that inhibits IRS staff during audits and litigation and leaves taxpayers uncertain about whether they have appropriately determined their tax liabilities. However, challenges that IRS and Treasury face in developing guidance for financial derivatives, including the risk of adverse economic effects of guidance changes and the complexity of financial derivative products, have resulted in some PGP projects taking longer than the 12-month period established in the plan. As such, uncertainty is heightened because taxpayers may not be aware when projects are going to take longer than the 12-month period and IRS does not provide public updates to the PGP as changes occur to project status, priorities, and target dates.

The growth in the complexity and use of financial derivatives presents another challenge for IRS. IRS sometimes identifies new financial derivative products or new uses of existing products long after they have been introduced into the market. Consequently, IRS is not always able to quickly identify and prevent potential abuse. One way to identify new products or new uses of products in a timelier manner could be through increased information sharing with SEC and CFTC given their oversight role of financial derivative markets and products. Our prior work suggests that there may also be opportunities for bank regulators to share any knowledge of derivatives that they gain. This would be consistent with IRS's goal of strengthening partnerships across government to ensure taxpayers meet their obligations to pay taxes.

Recommendations for Executive Action

To better ensure that economically similar outcomes are taxed similarly and minimize opportunities for abuse, the Secretary of the Treasury should undertake a study that compares the current approach to alternative approaches for the taxation of financial derivatives. To determine if changes would be beneficial, such a study should weigh the tradeoffs to IRS and taxpayers that each alternative presents, including simplicity, administrability, and economic efficiency.

To provide more useful and timely information to taxpayers on the status of financial derivative guidance projects, the Secretary of the Treasury and the Commissioner of Internal Revenue should consider additional, more frequently updated reporting to the public on ongoing projects listed in the PGP, including project status, changes in priorities, and target completion dates both within and beyond the 12-month PGP period.

To more quickly identify new financial derivative products and emerging tax issues, IRS should work to improve information-sharing partnerships with SEC and CFTC to better ensure that IRS is fully using all available information to identify and address compliance issues and abuses related to the latest financial derivative product innovations. IRS should also consider exploring whether such partnerships with bank regulatory agencies would be beneficial.

Agency Comments and Our Evaluation

We provided a draft of this report to the Secretary of the Treasury and the Commissioner of Internal Revenue for review and comment. Treasury disagreed with our first recommendation to undertake a study that compares the current approach to alternative approaches for the taxation of financial derivatives. Treasury cited a body of literature written by academics, practitioners, and others that considers the subject. Treasury also mentioned that Congress has resources available, such as the Joint Committee on Taxation, which could advise them about alternative approaches to the taxation of financial derivatives. Treasury said that its resources would be better spent drafting and issuing guidance on these subjects. Treasury also noted that it is available to assist the Ways and Means Committee and the Finance Committee in any undertaking concerning alternative approaches to the taxation of financial derivatives.

In our report, we describe how the current approach to the taxation of financial derivatives results in inconsistent tax consequences for transactions that produce similar economic outcomes. We cite the existing body of literature and alternatives to the current approach of taxing financial derivatives proposed by some tax experts and practitioners that they believe would adopt a more consistent and comprehensive view of financial derivatives and potentially reduce abuse. However, no consensus has emerged on these issues from existing literature or from the resources available to Congress. As the tax policy setting body for the executive branch, the Treasury Department, in consultation with IRS, is uniquely suited to weigh the alternative approaches and, along with Congress, make judgments as to which is best for the economy, tax administration, and the proper application of sound tax principles. While Treasury states it would rather focus on guidance development to address tax compliance and emerging abusive tax schemes, the current piecemeal development of guidance as well as the difficulty of developing tax rules for new products has presented challenges and opportunities for abuse. We believe that as the locus of tax policy expertise in the executive branch, Treasury has a responsibility to make proposals to overcome the deficiencies to the current approach to taxing financial derivatives. Towards that end, we recommended Treasury should undertake a study that compares the current approach to alternative approaches to the taxation of financial derivatives. Regardless of whether Treasury decides it needs a study to make such proposals, achieving a more comprehensive approach is the desired end.

IRS and Treasury disagreed with our second recommendation to provide more timely and useful information to taxpayers on the status of financial derivative guidance projects. IRS said that while it firmly supports transparency in the regulatory process, officials do not believe that the additional reporting recommended would be worth the additional resources such reporting would require. They believe that the annual updates provide an appropriate measure of the status of projects. Treasury also said that it would be difficult to provide precise predictions of when guidance would be issued and that attempting to pinpoint the timing of when guidance might be released would not necessarily be that helpful.

We agree that it is important for IRS and Treasury to balance the usefulness of additional reporting on the status of priority guidance projects with any additional administrative burden. However, Treasury and IRS also need to ensure that taxpayers have sufficient information to make intelligent decisions. In this report, we describe that one-fourth of financial derivative guidance projects on Treasury and IRS's PGP were not completed between 1996 and 2010. A number of the guidance projects that were not completed were on the PGP for 3 or more years, and tax experts and practitioners that we spoke with said they were not aware of the status and prioritization of many of these guidance projects. In recommending more frequent updates to the public on priority guidance projects, we recognize the difficulty in estimating how long the development of a particular piece of guidance may take. Our recommendation did not envision pinpointing the timing of when guidance may be released, but rather being timelier in officially revising estimates when the agencies know that announced time frames are no longer realistic. When it becomes likely that a project on the PGP will not be completed in the plan year because of delays or a change in priorities, the public should be alerted. Tax experts and practitioners we interviewed said that information about the status of projects was not publicly available, and that they often only knew about a project's status through informal statements made by IRS and Treasury officials at conferences and other meetings. Such information on the status of guidance projects should be provided to all interested taxpayers as part of formal periodic updates to the PGP. Some of this information is already available in IRS's internal guidance tracking database and providing it would, therefore, likely add little additional administrative burden for the agencies.

IRS agreed with our third recommendation to improve information-sharing partnerships with the SEC and CFTC. IRS said that they recognize the benefits of systematically gathering and sharing information that would identify new financial products and the potential for abusive tax avoidance transactions.

IRS's and Treasury's letters commenting on our report are presented in appendix III and IV. IRS also provided technical comments, which we incorporated as appropriate.

As we agreed with your office, unless you publicly announce the contents of this report earlier, we plan no further distribution of it until 30 days from the date of this report. At that time, we will send copies of this report to the Chairmen and Ranking Members of other Senate and House committees and subcommittees that have appropriation, authorization, and oversight responsibilities for IRS. We are also sending copies to the Commissioner of Internal Revenue, the Secretary of the Treasury, the Chairman of the IRS Oversight Board, and the Director of the Office of Management and Budget. Copies are also available at no charge on the GAO website at http://www.gao.gov.

If you or your staffs have any questions or wish to discuss the material in this report further, please contact me at (202) 512-9110 or brostekm@gao.gov. Contact points for our offices of Congressional Relations and Public Affairs may be found on the last page of this report. GAO staff members who made major contributions to this report are listed in appendix V.

Michael Brostek
Director, Tax Issues
Strategic Issues

Appendix I: Additional Methodology Details

Criteria to Evaluate How Well the Tax System Addresses Financial Derivatives

To evaluate the tax rules for financial derivatives, our criterion was consistency, meaning that economically similar transactions are taxed similarly. We identified this criterion through interviews with tax experts and a review of research articles on the taxation of financial derivatives. This was the most commonly mentioned criterion by these sources, and also the most applicable to our objectives. We evaluated the tax effects of financial derivatives based on testimonial evidence, academic studies, and our analysis of four financial derivative case studies. These case studies included cross-border total return equity swaps, variable prepaid forward contracts, credit default swaps, and contingent swaps. Through interviews with Department of the Treasury (Treasury) and Internal Revenue Service (IRS) staff, former Treasury staff, and other tax experts, we identified how the transactions were structured, when IRS first recognized these transactions, and all guidance issued by Treasury and IRS on these issues. We also identified the challenges of issuing timely guidance and the consequences for IRS and taxpayers due to delayed or absent guidance. Based on these case studies, we applied the criterion of consistency to highlight how the structure of these transactions was not in line with the criterion.

Criteria and Methodology to Evaluate the Issuance of Published Guidance Related to Financial Derivatives

To evaluate IRS's and Treasury's ability to publish timely guidance on emerging financial derivative tax issues, we analyzed guidance projects from Treasury and IRS's Priority Guidance Plan (PGP). We also performed an in-depth study of four case studies of specific financial derivative transactions that have had delayed guidance. According to Treasury and IRS, the PGP is used each year to identify and prioritize the tax issues that should be addressed through regulations, revenue rulings, revenue procedures, notices, and other published administrative guidance. The PGP focuses resources on guidance items that are most important to taxpayers and tax administration. To measure the timeliness of guidance on financial derivative tax issues, we used the criterion established by Treasury and IRS that guidance projects on the PGP are intended to be published within the 12-month period of the PGP year.

We reviewed the projects included on the PGP from 1996 to 2010, the years for which IRS had electronic records available. We submitted a data request to IRS Chief Counsel from their Counsel Automated Systems Environment-Management Information System (CASE-MIS), which the agency uses to track the development of guidance projects. We searched the database for projects, focusing primarily on the units within Chief Counsel that work closest with financial derivatives. We selected projects whose description mentioned either a type of derivative in particular (future, forward, swap/notional principal contract, or option), a section of the Internal Revenue Code that directly affects financial derivatives, or a use or abuse of financial instruments that typically involves derivatives (such as hedging or straddles). In reviewing the data from CASE-MIS, we encountered some data issues, such as the same guidance project showing up more than once on the same PGP year or guidance projects with start dates after their publication date, among other issues, which led us to conclude that the CASE-MIS data were unreliable for an analysis of all guidance projects, which did not allow a comparison of derivative projects to nonderivative projects. However, we did determine that the use of CASE-MIS data was sufficiently reliable to analyze the subset of projects dealing with financial derivatives alone. This is because the small number of derivative projects allowed us to address and resolve individually each of the data issues we encountered, something not feasible for the much larger dataset of all PGP guidance projects. After identifying the financial derivative guidance projects based on the criteria above we submitted the list to IRS Chief Counsel for their verification. They identified additional projects we had not found in our prior searches, some of which did not meet our criteria for selecting projects or our scope and were not included. In total, we identified 53 guidance projects in the PGP related to financial derivatives.

To analyze the timeliness of the identified projects, we calculated completion rates for projects that were completed within the 1-year criterion, and rates for projects that were completed at any point. These calculations only included projects that were on the plan before the current PGP year. To take account of the fact that guidance projects can be censored (i.e., have not yet been completed within the time frame of the study or were dropped from the PGP before they had a chance to be completed), we estimated completion rates over time using hazard rates. Hazard rates calculate the rate at which projects are complete in a period, given that they were open at the start of that period, and therefore allow us to adequately account for censored projects. In the report, we refer to hazard rates as completion rates. The small sample size does not allow us to draw conclusions on the process for issuing guidance in IRS and Treasury more generally beyond financial derivatives or the time period under study.

To further examine the IRS and Treasury guidance process and evaluate the challenges that IRS and Treasury face when issuing guidance on financial derivatives, we selected four financial derivative case studies that have been on the PGP and have been highlighted in interviews with Treasury, IRS, and tax practitioners as financial derivative transactions that presented tax abuse or tax compliance concerns. The case studies that met this criterion included contingent payment swaps, credit default swaps, variable prepaid forward contracts, and cross-border total return equity swaps. For each of the four case studies, we interviewed IRS and Treasury officials and other tax experts, and analyzed research on the taxation of derivatives, to discuss the identification and progression of these transactions as guidance projects, the challenges IRS and Treasury face issuing guidance on these transactions, and the consequences IRS and taxpayers face from a lack of guidance.

Appendix II: Financial Derivative Priority Guidance Projects

	Description of guidance projects	Guidance published	Years on PGP	First year on PGP	Completed
1	Information reporting requirements for securities futures contracts	Notice 2003-8	1	2002	Yes
2	Tax shelter using options to shift tax basis	Notice 2001-45	1	2001	Yes
3	Tax shelter using foreign currency straddle	Notice 2002-50	1	2002	Yes
4	Tax shelter using foreign currency straddle	Notice 2002-65	1	2002	Yes
5	Tax shelter using foreign currency options	Notice 2003-81	1	2003	Yes
6	Tax shelter using S corporations and warrants	Notice 2004-30	1	2003	Yes
7	Tax shelter using options to toggle grantor trust status	Notice 2007-73	1	2007	Yes
8	Exchange traded notes (prepaid forward contracts)	Notice 2008-2	1	2007	Yes
9	Overwithholding and U.S. tax avoidance from dividend-substitutes payments	Notice 2010-46	1	2009	Yes
10	Clarification of notional principal contract abuses	Notice 2006-16	1	2005	Yes
11	Contingent payments in notional principal contracts	Notice 2001-44	1	2001	Yes
12	Valuation under §475	Announcement 2003-35	1	2002	Yes
13	Exchange-traded equity options without standard terms	Final regulations, 65 Fed. Reg. 3812	1	1999	Yes
14	Character of hedging transactions	NPRM, 66 Fed. Reg. 4738	1	2000	Yes
15	Character of hedging transactions	Final regulations, 67 Fed. Reg. 12863	1	2001	Yes
16	Exchange-traded equity options without standard terms	NPRM, 66 Fed. Reg. 4751	1	2000	Yes
17	Exchange-traded equity options without standard terms	Final regulations, 67 Fed. Reg. 20896	1	2001	Yes
18	Dealer to dealer assignment of notional principal contracts	Final regulations, 63 Fed. Reg. 4394	1	1997	Yes
19	Securities futures contracts under §1256(g)	Revenue Procedure 2002-11	1	2001	Yes
20	Safe harbor in valuing securities and commodities for broker-dealers under section 475	Revenue Procedure 2007-41	1	2006	Yes
21	Classifying exchange as Qualified Board of Exchange for §1256	Revenue Ruling 2007-26	1	2006	Yes
22	The effect of collars on qualified covered calls status.	Revenue Ruling 2002-66	1	2002	Yes
23	Classifying exchange as Qualified Board of Exchange for §1256	Revenue Ruling 2010-3	1	2009	Yes
24	Classifying exchange as Qualified Board of Exchange for §1256	Revenue Ruling 2009-24	1	2009	Yes
25	Exchange traded notes (prepaid forward contracts)	Revenue Ruling 2008-1	1	2007	Yes
26	Contracts that provide total-return exposure on a commodity index	Revenue Ruling 2006-1	1	2005	Yes
27	Notional principal contracts that hedge debt instruments	Revenue Ruling 2002-71	1	2002	Yes
28	Variable prepaid forward contracts	Revenue Ruling 2003-07	1	2002	Yes

	Description of guidance projects	Guidance published	Years on PGP	First year on PGP	Completed
29	Definition of dealer in securities futures contracts	Revenue Ruling 2004-94 and Revenue Ruling 2004-95	1	2004	Yes
30	Credit default swaps	Notice 2004-52	2	2003	Yes
31	Valuation under §475	NPRM, 70 Fed. Reg. 29663	2	2003	Yes
32	Valuation under §475	Final regulations, 72 Fed. Reg. 32172	2	2005	Yes
33	Exchange-traded equity options without standard terms	NPRM, 63 Fed. Reg. 57636	2	1997	Yes
34	Mark-to-market accounting for commodities dealers and electing traders in securities and commodities under §475	NPRM, 64 Fed. Reg. 4374	2	1998	Yes
35	Capitalization of interest and carrying charges in straddles	NPRM, 66 Fed. Reg. 4746	2	2000	Yes
36	Treatment of interest rate swaps in arbitrage restrictions on tax-exempt bonds	NPRM, 72 Fed. Reg. 54606	2	2006	Yes
37	Accounting for unidentified hedging transactions	Revenue Ruling 2003-127	2	2002	Yes
38	Classifying exchange as Qualified Board of Exchange for §1256	Revenue Ruling 2009-4	2	2007	Yes
39	Contingent payments in notional principal contracts	NPRM, 69 Fed. Reg. 8886	4	1999	Yes
40	Definition of foreign currency contracts under §1256(g)(2)[a]	Notice 2007-71	2	2004	No
41	Prepaid forward contracts under §446	No guidance issued	1	2001	No
42	Application of §1256 to certain derivative contracts[b]	No guidance issued	1	2010	No
43	Dividend-equivalent payments under section 871(M) (following HIRE Act)[b]	No guidance issued	1	2010	No
44	Effect of credit risk on swap valuations under §475	No guidance issued	1	2000	No
45	Straddles with uneven positions	No guidance issued	1	2001	No
46	Treatment of interest rate swaps in arbitrage restrictions on tax-exempt bonds	No guidance issued	2	2004	No
47	Equity derivatives	No guidance issued	2	2000	No
48	Exchange traded notes (prepaid forward contracts)[b]	No guidance issued	3	2008	No
49	Securities lending and other withholding tax	No guidance issued	3	2002	No
50	Constructive sale rules under §1259	No guidance issued	4	1998	No
51	Capitalization of interest and carrying charges in straddles	No guidance issued	5	2002	No
52	Mark-to-market accounting for commodities dealers and electing traders in securities and commodities under §475	No guidance issued	5	2002	No
53	Contingent payments in notional principal contracts[b]	No guidance issued	7	2004	No

Source: GAO analysis of IRS data.

[a]This project was completed in 2007, when it was no longer on the Priority Guidance Plan (PGP). To be designated as completed for our analysis, a project must be completed while on the PGP.

[b]Guidance has not been issued for these projects, although they were still on the PGP as of the end of June 30, 2010.

Appendix III: Comments from the Internal Revenue Service

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

DEPUTY COMMISSIONER

September 2, 2011

Mr. Michael Brostek
Director, Tax Issues
Strategic Issues Team
U.S. Government Accountability Office
441 G Street, N.W.
Washington, DC 20548

Dear Mr. Brostek:

Thank you for providing your draft report, Financial Derivatives: Disparate Tax Treatment and Information Gaps Create Uncertainty and Potential Abuse (GAO-11-750), for our review and comments. We appreciate the time your GAO Team spent reviewing our relevant tax rules and guidance projects to address the taxing of financial instruments.

We agree with your recommendation to improve information sharing partnerships with the Securities and Exchange Commission (SEC) and Commodity Futures Trading Commission (CFTC). As your report indicates, our 2009-2013 Strategic Plan includes planned actions to continue to strengthen our partnership with other government and bank regulatory agencies to more quickly identify new financial derivative products and emerging tax issues. The Large Business and International (LB&I) Division has had several meetings with the SEC regarding investment funds. We recognize the benefits of systematically gathering and sharing information that would identify new financial products and the potential for abusive tax avoidance transactions.

Our specific responses to all of your recommendations are enclosed. If you have any questions, please contact me at (202) 622-6860, or your staff may contact Floyd Williams, Director, Office of Legislative Affairs at (202) 622-3720.

Sincerely,

Steven T. Miller
Deputy Commissioner for
Services and Enforcement

Enclosure

Enclosure

RECOMMENDATION 1:

To better ensure that economically similar outcomes are taxed similarly and minimize opportunities for abuse, the Secretary of the Treasury should undertake a study that compares the current approach to alternative approaches for the taxation of financial derivatives. To determine if changes would be beneficial, such a study should weigh the tradeoffs to IRS and taxpayers that each alternative presents, including simplicity, administrability, and economic efficiency.

MANAGEMENT RESPONSE:

The Secretary of the Treasury will address this recommendation in a separate response to the GAO draft report.

RECOMMENDATION 2:

To provide more useful and timely information to taxpayers on the status of financial derivative guidance projects, the Secretary of the Treasury and the Commissioner of the IRS should consider additional, more frequently updated reporting to the public on ongoing projects listed in the Priority Guidance Plans (PGP), including project status, change in priorities, and both target completion dates within and beyond the 12-month PGP period.

MANAGEMENT RESPONSE:

The IRS firmly supports transparency in the regulatory process, and through the priority guidance plan (PGP) and its regular updates provides notice to the public of the projects on which Treasury and the IRS are focusing their resources. In addition, Treasury and IRS officials routinely speak at meetings and public conferences about guidance projects, and those appearances are widely reported in the tax press. This activity provides the public with continual insight into the guidance plan progress.

The IRS does not believe that the additional reporting recommended would be constructive or necessary. We believe that the annual updates provide an appropriate measure of the status of projects. The additional reporting recommended will not provide taxpayers with information that, on balance, justifies the additional administrative burden on the government, particularly given that the existing process provides a substantial amount of transparency.

RECOMMENDATION 3:

To more quickly identify new financial derivative products and emerging tax issues, the IRS should work to improve information sharing partnerships with SEC and CFTC to better ensure that the IRS is fully using all available information to identify and address

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compliance issues and abuses related to the latest financial derivative product innovations. The IRS should also consider exploring whether such partnerships with bank regulatory agencies would be beneficial.

MANAGEMENT RESPONSE:

We agree with this recommendation. The IRS will consider ways to improve information sharing partnerships with SEC and CFTC regarding financial derivatives, particularly in the area of new products. The IRS will also consider whether partnerships with banking regulatory agencies would be beneficial.

Appendix IV: Comments from the Department of the Treasury

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

September 2, 2011

Mr. Michael Brostek
Director, Tax Issues
Strategic Issues Team
U.S. Government Accountability Office
441 G Street, NW
Washington, DC 20548

Dear Mr. Brostek:

We appreciate the effort that went into GAO's draft report titled "Financial Derivatives: Disparate Tax Treatment and Information Gaps Create Uncertainty and Potential Abuse" and the understanding of complex issues that it conveys. We are pleased to respond to the recommendations contained in the draft report.

The "Recommendations for Executive Action" section of the report sets forth two recommendations for the Secretary of the Treasury. The first recommendation is that "the Secretary of Treasury should undertake a study that compares the current approach to alternative approaches for the taxation of financial derivatives." There is already a substantial body of literature written by academics, practitioners, and others that considers this subject. For example, reports prepared by the American Bar Association, the New York State Bar Association, and industry trade groups routinely discuss the issue of alternative ways to address the taxation of derivatives. Moreover, Congress has also conducted hearings and engaged in other activity related to financial derivative taxation, and has available to it its own resources, including the Joint Committee on Taxation, that could advise about alternative legislative approaches. Rather than generate yet another study that considers how derivatives should be taxed, Treasury believes that its resources would be better spent drafting and issuing guidance on these subjects. The Treasury Department is, of course, always available to assist the Ways and Means Committee and the Finance Committee in any undertaking concerning alternative approaches to the taxation of financial derivatives.

The second recommendation is that "the Secretary of the Treasury and the Commissioner of the IRS should consider additional, more frequently updated reporting to the public on ongoing projects listed in the [priority guidance plan], including project status, changes in priorities, and both target completion dates within and beyond the 12-month period." The Treasury Department firmly believes in and supports transparency in the regulatory process, and through the priority guidance plan (PGP) and its regular updates provides notice to the public of the projects on which Treasury and the IRS are focusing their resources. In addition, Treasury and IRS officials routinely participate in and speak at Bar Association meetings and public conferences about guidance projects, and those appearances are widely reported in the tax press. This activity provides the public and practitioners with continual insight into the guidance plan progress. However, the Treasury Department does not believe that the additional reporting recommended in the report would be constructive or necessarily be worth the additional administrative resources such reporting would require. In light of the fluid nature of the development of guidance it would be very difficult to provide precise predictions of when guidance would be issued. In addition, it is not clear whether attempting to pinpoint the timing when guidance might be released would necessarily be that helpful. It is our experience that legitimate tax planning is not materially affected by the current approach of communicating guidance activity through the PGP, and that the existing process provides a substantial amount of transparency to the public.

We appreciate the opportunity to comment on the draft report, and look forward to working with you in the future.

Sincerely,

Mark J. Mazur
Deputy Assistant Secretary (Tax Analysis)

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Appendix V: GAO Contact and Staff Acknowledgments

GAO Contact

Michael Brostek, (202) 512-9110 or brostekm@gao.gov

Staff Acknowledgments

In addition to the contact named above, the following staff made significant contributions to this report, Jay McTigue, Assistant Director; Kevin Averyt; Timothy Bober; Tara Carter; William Cordrey; Robin Ghertner; Colin Gray; George Guttman; Alex Katz; Natalie Maddox; Matthew McDonald; Edward Nannenhorn; Jose Oyola; Andrew Stephens; Jason Vassilicos; and James White.

Glossary

Bifurcation	The process of dividing a financial instrument into its component parts.
Constructive Ownership Transaction	Under Internal Revenue Code (IRC) section 1260, gains from constructive ownership transactions are taxed as ordinary income and not capital gains to the extent that such gains exceed the net underlying long-term capital gains and impose accompanying interest charges. Section 1260 applies to derivatives that stimulate the return of certain assets, such as a hedge fund or another pass-though entity by offering the holder substantially all of the risk of loss and opportunity for gain from the underlying asset.
Constructive Sale	A transaction where a taxpayer attempts to obtain economic gains from the sale of an appreciated position without legally transferring ownership and triggering taxable income. IRC section 1259 contains rules that affect the treatment of gains from constructive sales.
Contingent Swap	A swap contract in which a payment is contingent or otherwise conditional on some event occurring during the period of the contract.
Conversion transaction	A transaction that generally consists or two or more positions taken with regard to the same or similar investments, where substantially all of the taxpayer's return is attributable to the time-value of the taxpayer's net investment in the transaction. IRC section 1258 contains rules for the treatment of conversion transactions.
Credit Default Swap (CDS)	Bilateral contract that is sold over-the-counter and transfers credit risk from one party to another. The seller, who is offering credit protection, agrees, in return for a periodic fee, to compensate the buyer, who is buying credit protection, if a specified credit event, such as default, occurs.
Fair Value	See gross positive fair value.
Forward	A privately negotiated contract between two parties in which the forward buyer agrees to purchase from the forward seller a fixed quantity of the underlying reference item at a fixed price on a fixed date.

Future	A forward contract that is standardized and traded on an organized futures exchange.
Gross Positive Fair Value	The sum total of the fair values of contracts owed to commercial banks. Represents the maximum losses banks could incur if all other parties in the transactions default and the banks hold no collateral from the other party in the transaction and there is no netting of the contracts.
Hedging	The process whereby an entity will attempt to balance or manage its risk of doing business or investing.
Mark-to-Market	For tax purposes, under mark-to-market rules, any contract held at the end of the tax year will generally be treated as sold at its fair market value on the last day of the tax year, and the taxpayer must recognize any gain or loss that results.
Mandatory Convertible	Security linked to equity that automatically converts to common stock on a prespecified date.
Notional Principal Contract (NPC)	According to section 1.446-3 (c)(1)(i) of title 26, Code of Federal Regulations, a financial instrument that provides for the payment of amounts by one party to another at specified intervals calculated by reference to a specified index upon a notional principal amount, in exchange for specified consideration or a promise to pay similar amounts.
Notional Amount	Total notional amount represents the amount of the reference items underlying financial derivative transactions, and is the amount upon which payments are computed between parties of financial derivatives contracts. Notional amount generally does not represent money exchanged, nor does it represent the risk exposure.
Option	Contracts that gives the holder of the options the right, but not the obligation, to buy (call option) or sell (put option) a specified amount of the underlying reference item at a predetermined price (strike price) at or before the end of the contract.

Over-the-Counter Derivatives	Privately negotiated financial derivative contracts whose market value is determined by the value of the underlying asset, reference rate, or index.
Short Sale	This type of transaction occurs when a taxpayer borrows property (often a stock) and then sells the borrowed property to a third party. If the short seller can buy that property later at a lower price to satisfy his or her obligation under the borrowing, a profit results; if the price rises, however, a loss results. IRC Section 1233 contains rules that can affect the treatment of gains and losses realized on short sales.
Straddle	The value of offsetting positions moves in opposite directions so a loss on one position is cancelled out by the gain on an offsetting position. IRC Section 1092 contains rules that can affect the treatment of straddles.
Total Return Equity Swap	A contract that provides one party in the transaction with the total economic performance from a specified reference equity or group of equities and the other party in the transaction receives a specified fixed or floating cash flow that is not related to the reference equity. A cross-border total return equity swap is a contract that occurs between a domestic and foreign party.
Variable Prepaid Forward Contract (VPFC)	Agreement between two parties to deliver a variable number of shares at maturity (typically 3 to 5 years) in exchange for an up-front cash payment, which generally represents 75 to 85 percent of the current fair market value of the stock. The VPFC usually has a cash settlement option in lieu of shares at maturity.
Wash Sale	A wash sale is when a taxpayer acquires a stock or security within 30 days of selling a substantially similar stock or security; under IRC section 1091, the taxpayer is not generally permitted to claim a loss on such a sale.

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