I. Introduction

Income tax law governing investments is under pressure because of revolutionary developments in the field of finance. A general explanation of why this is occurring is that tax law places contracts in different "cubbyholes" (for example, debt, equity and options), which often are taxed in quite different ways.\(^1\) Developments in modern finance pressure this system by creating new forms of securities that do not fit into existing cubbyholes and by creating the means to hedge or otherwise alter the payoffs on one form of security so that it is equivalent to another form of security. From this perspective, the problems in the tax area can be said to follow logically from one of the key insights of modern finance, which is that the fundamental building blocks of finance are not the set of conventional securities, but rather are a set of "pure securities," meaning securities that have a positive payoff in one and only one contingent future state.\(^2\) A theory that treats conventional securities as no more than combinations of fundamental units that can be recombined in an enormous number of ways is fundamentally at odds with a legal system that tries to cubbyhole securities into categories that are thought to be different in their essence.

The five articles in this colloquium might seem to portend the end of the income tax as we know it. Professor David Bradford describes how financial innovation creates new opportunities for tax arbitrage, which means opportunities for taxpayers to take costless and riskless

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\(^{1}\) This point is by now banal. Early statements of the basic point, aimed at what was then called deconstruction (currently bifurcation), include Randall K.C. Kau, Carving Up Assets and Liabilities—Integration or Bifurcation of Financial Products, 68 Taxes 1003, 1007 (1990), and Edward D. Kleinbard, Beyond Good and Evil Debt (and Debt Hedges): A Cost of Capital Allowance System, 67 Taxes 943, 947 (1989).

positions that reduce their income tax. The consequence will be that, unless tax law is radically changed, the tax on investment income will become essentially elective for sophisticated taxpayers. Professor Daniel Shaviro argues that this day may arrive sooner than we think, and that tax-saving strategies that are now available with respect to publicly traded securities soon will be available with respect to nonfinancial assets, such as land and closely held businesses.

The articles of Professor Deborah Schenk, Professor David Weisbach, and David Hariton might seem less alarming on the surface for each proposes incremental improvements in income tax law. But their articles point in completely different directions, leaving the reader in doubt about what can or should be done in the short run to save the income tax. Professor Schenk proposes rules to deal with hot new tax-saving strategies involving the use of equity swaps, short sales and kindred transactions to achieve what is in effect a tax-free sale of appreciated stock. Treasury's recent proposal to tax “constructive sales” of securities addresses the same strategies in a more limited way. Professor Weisbach argues that rules such as those proposed by Professor Schenk and Treasury are unadministerable because they depend on the integration of different contracts in a taxpayer's portfolio. Professor Weisbach favors a method of bifurcation, which involves bifurcating securities into familiar elements and taxing them on that basis. Bifurcation has been roundly criticized elsewhere, and his defense of bifurcation boils down to the not very comforting claim that it is better than integration if one must work within existing law. Hariton argues that the entire thrust of current regulatory policy is ill-conceived because large scale regulatory projects inevitably lag far behind developments in the marketplace.

In this essay, I paint a less apocalyptic picture. The visionary articles of Professors Bradford and Shaviro give too little due to the down-to-earth factors of transaction costs, credit risk and legal risk as constraints on financial contracting. Ironically, Professor Bradford's

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9. See, e.g., Kau, note 1; Kleinbard, note 1.
demonstration of the vulnerability of current income tax law to tax arbitrage once these factors are assumed away demonstrates their importance, for it is to these factors that the continued collection of substantial tax on investment income is owed. Professor Shaviro overstates the threat that financial innovation poses to our ability to tax income from nonfinancial assets because he underweights these factors. In the long run, the dire predictions of Professors Bradford and Shaviro may be accurate, for one hallmark of financial innovation is the reduction of transaction costs and the creation of new ways to hedge risk. But the weakening of these constraints does not portend doom for the income tax in the long run, for the development of securities markets also will make it administratively feasible to expand a mark-to-market regime of taxation to a larger class of investment assets, which would forestall tax arbitrage with respect to assets within that class.

But what is to be done in the short run? The remaining three articles in this colloquium can be thought of aspects of a larger project for incremental reform sketched by Professor Jeff Strnad. The goal of this larger project is to suppress discontinuities and inconsistencies in tax law, meaning places in tax law where a minor economic or purely formal difference in two positions significantly alters the tax borne on the positions. The techniques of bifurcation and integration, which Professor Weisbach examines, are useful for analyzing latent discontinuities and inconsistencies in tax law that are revealed by financial innovation. For example, the development of long-term options reveals an inconsistency in the taxation of zero coupon bonds and stock, for such options make it possible to create a synthetic zero by integrating an investment in stock with a long put and a short call in that stock with matched prices and exercise dates. The thrust of Professor Weisbach's arguments regarding the relative merits of bifurcation and integration is that this possibility is better dealt with by changing the tax rules regarding options and stock than by a rule taxing a synthetic zero as a zero. I think this is right, but not for the reason Professor Weisbach emphasizes.

Professor Schenk's article takes up where Professor Weisbach's article leaves off. She proposes rules that use a partial integration method to require recognition of gain on stock held in a portfolio

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when a put is acquired with respect to that stock. She adopts this solution, which she concedes is no better than second-best, because she assumes that the realization rule will not be abolished. Professor Weisbach's message is that the realization rule must be abolished if the problem of "constructive sales" of securities is to be solved in a truly effective manner. Professor Schenk does not disagree with this.

Hariton calls our attention to the important question of how tax law is made and the form it should take. His basic point seems right: A regulatory approach that depends on highly detailed regulations is poorly suited to deal with the rapidly changing environment of modern finance for the inevitable delay in issuing detailed regulations means regulations often are outmoded by the time they are issued. Hariton proposes a plausible alternative regulatory approach: Jettison complex regulations and statutes, reformulate the law around a few general principles, and develop the law using those principles on a case-by-case basis as new securities or transactions appear. Hariton's article is incomplete because he focuses on the role of the tax bar under such a system rather than the role of Treasury, which will be crucial.

II. The Problem of Tax Arbitrage and the Importance of Transaction Costs, Credit Risk and Legal Risk

It is fair to say that Professor Bradford, like Jeff Stmad, who has done some of the most interesting work on financial innovation and tax policy,13 does not address any real tax system. Professor Bradford's goal is to determine how one might design an income tax to eliminate the mathematical possibilities for tax arbitrage in a market that is both complete and perfect, that is, where positions can be taken without transaction costs, credit risk or other impurities. These are the conditions most conducive to arbitrage.

In the way Professor Bradford uses the term, "[a]n opportunity for tax arbitrage profit exists when there is a pair of instruments (or pair of packages of instruments) that are identical in their cash flows but differ in associated flows of taxable income . . . [for then] by entering into exactly offsetting positions in the two instruments, taxpayers may be able to reduce their taxes."14 For example, a corporation might issue a series of 10 zero-interest bonds maturing over the next 10 years and use the proceeds to buy a 10-year bond paying ordinary interest with payments each year equaling the payment it will make to retire a

14 Bradford, Realization, note 3, at 739.
zero-interest bond. Prior to 1982, the interest deduction on the series of zero-interest bonds was front-end loaded because interest accrued on a straight line basis, and so these two positions generated a net tax loss in the early years although they had precisely offsetting cash flows. Today, an opportunity for arbitrage exists in taking the opposite positions—issuing a bond paying ordinary interest to purchase a series of zero-interest bonds with offsetting aggregate cash flows. The interest imputed on the series of zero-interest bonds would be slightly more back-end loaded since the later year zero-interest bonds would be at a higher rate of interest as a consequence of the upward slope in the yield curve.

Professor Bradford is appropriately cagey about the harm in the existence of such opportunities for tax arbitrage. What he says on the point is brief and worth quoting in its entirety: ”The opportunity for arbitrage profit of any kind is inconsistent with equilibrium. So the potential for tax arbitrage must be eliminated by some combination of adjustments in asset prices, changes in effective marginal tax rates . . . and increases in transaction costs.”

The basic point seems to be that the existence of opportunities for tax arbitrage is bad because it disturbs markets and undermines the tax base. Professor Bradford is careful in describing the harms of tax arbitrage because, under his assumptions, the existence of an opportunity for tax arbitrage is like a black hole in space; the income tax would collapse into the black hole unless some factor he excludes from the analysis comes into play. Thus, in the quoted passage, transaction costs must come back into the picture. He also raises the dubious possibility that the positive tax attributes of a financial instrument will drive up the instrument’s price. This is dubious for it treats a financial instrument as if it were a real asset that exists in limited supply.

The significance of the factors of transaction costs and credit-risk that Professor Bradford assumes away can be seen using his own example. Both before and after 1982, a corporation—I call it Knersch
Inc.—could zero out its taxes by entering into offsetting positions in zero-interest and ordinary bonds. While the benefit in today's yield curve play is slight, because the cash flows are a wash, in theory, Knetsch Inc. could still zero out its taxes by increasing the notional amount of debt to astronomical amounts without affecting its net worth. The "supply" of capital in theory should not constrain Knetsch Inc. since it would increase supply and demand for capital at the same time. While Knetsch Inc. would be raising and investing capital in different sectors of the market—it would be raising capital in the market for long-term corporate debt paying current interest and investing capital in the market for zero-interest bonds—one would expect that to have little effect on prices since arbitrageurs would rush in to take advantage of any momentary price differences and so eliminate them.

Firms were not quick to take advantage of such tax-saving opportunities. For example, despite the significant tax benefits available to an issuer of discounted bonds prior to 1982, highly rated firms issued such securities only for a brief period from March 1981 to April 1982, when discounted bonds accounted for 14% of domestic debt issues. One explanation for the slowness to use discounted bonds is that the tax benefits had to be magnified by the high interest rates of that period to interest corporate managers in the instrument, which had been negatively perceived in the marketplace because of the credit risk.

There is no evidence today that firms issue straight debt to reinvest in zeros to make the yield curve play. The self-evident explanation is transaction costs and credit risk. Today Knetsch Inc. could buy zero-interest bonds in bulk at little cost, but it would incur a nontrivial cost in issuing its bonds, particularly if it attempted to design mechanisms to enhance their security and so lower its interest rate costs. There are also significant technical impediments to "pure arbitrage" because securities cannot be disaggregated into sufficiently fine units.

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19 See Knetsch v. United States, 364 U.S. 361 (1960), where the Court held a similar transaction involving the combination of a loan and a purchase of an annuity from a life insurance company with offsetting cash flows to be a sham.


22 See Charles W. Haley & Lawrence D. Schall, The Theory of Financial Decisions 221-22, 224-25 (2d ed. 1979) (distinguishing perfect markets "with zero transaction and information costs, zero costs of financial intermediation . . . [and] infinite divisibility of financial assets," from semiperfect markets "that are perfect except that it is 'prohibitively' costly for a financial intermediary or investor to disaggregate a payoff vector (security) into its parts," and complete markets "in which there exist as many linearly independent securities . . . as there are time periods and states of the world," and observing that the "value-additivity principle," under which "the market value of any security is equal to the sum of
Legal risk, another factor Professor Bradford fails to take into account, also may deter tax arbitrage in the real world. The development of securities markets have made possible transactions in which arbitrageurs enter into positions involving huge notional dollar amounts to reap tiny percentage gains. But even under market conditions that would seem conducive to arbitrage, there is little systematic evidence of tax arbitrage. A possible explanation is the element of legal risk. Tax arbitrage works only if the government is willing to go along, and there is a risk that it will not, no matter how good the legal authority for a position, if an outcome seems perverse. Thus, if **Knetsch Inc.** were to do the yield curve play in order to zero out its taxes, it would expect its return to draw a costly audit and perhaps even eventual defeat.

Professor Bradford properly could say that this line of argument misses the point of his article, which is a mathematical inquiry into the essential properties of an income tax at some future date when the evolution of financial markets has progressed to the point where transaction costs and credits risks have been reduced to near zero, securities are infinitely divisible, and perhaps even when the government could be counted upon to abide by its own rules. Professor Bradford has an important and original point to make about how an income tax might be designed to eliminate opportunities for tax arbitrage even under such conditions for he has found a new method for accomplishing this end.

Consider the most realistic set of conditions—the income tax has multiple rates (even if Congress adopted some form of flat tax, presumably some foreigners and public entities, such as municipalities, would remain tax-exempt), and investments are subject to risk. It is well known that a rule requiring that all investments be marked to market would go far towards achieving neutrality. Professor Bradford endorses this method, as well as another method proposed by Alan Auerbach involving a form of retrospective taxation. What is the values of its time-state components” will hold in perfect market or in semiperfect complete market but not in imperfect complete market or in semiperfect incomplete market).

23 A counter-example may be box spreads, which involve huge notional principal amounts for relatively small returns and have been reported to be used by corporations to “refreshen” expiring net operating losses. See Paul O’Keeffe, Box Spreads, Derivatives Wk., Mar. 29, 1993, at 9.

24 Slight imperfections persist under the mark-to-market method. Professor Strnad has shown that perfect neutrality exists only if investments are marked to market and taxed continuously rather than periodically. Strnad, Periodicity, note 13.

25 See Alan J. Auerbach, Retrospective Capital Gains Taxation, 81 Am. Econ. Rev. 167 (1991). The method taxes an investment when it is sold by imputing income over the life of the investment on the assumption that the investment grew in value to its end value at the investment’s current expected yield. There is no concept of basis. Two investments with the same end value that were held for the same period of time will bear the same tax on
new is Professor Bradford’s point that the opportunity for tax arbitrage might be eliminated by using the expected return method, which imputes income at the current expected yield on the adjusted basis of an asset, so long as the problem of strategic trading is dealt with by requiring both parties to commit to, at the time a contract is entered into, a date on which they both will realize any gains or losses on the contract that result when actual return deviates from the expected return.

This is a useful insight for there may be some investments with low trading costs where use of the mark-to-market method is not feasible or attractive, such as contracts traded over the counter that might trade cheaply but with difficult to monitor prices. Parties to such contracts could be required to commit to either Auerbachian retrospective taxation or to a Bradfordian constrained realization date (which could be independent of the disposition date) while contracts that are publicly traded would be subject to mark-to-market. An interesting issue that someone might explore in the future is the interplay of these various rules. For example, might there be a troubling asymmetry if a corporation raised capital by issuing debt in the over the counter market and invested it in debt purchased on publicly traded exchanges if the two classes of debt were subject to different tax regimes although either regime would be neutral if it applied universally?

III. IS THE INCOME TAX Viable IN THE SHORT- AND MIDDLE-RUN?

Professor Shaviro foretells of a “crisis in the taxation of financial assets,” and “a new era of tax-sheltering” with respect to nonfinancial assets, since the appearance of new forms of derivatives will enable taxpayers “to make the tax characterization of particular positions essentially elective, to exploit differences in tax rates and to engage in tax arbitrage.” Professor Shaviro’s vision of the future will seem truly apocalyptic to some. His prediction is that the inability to tax investment income will lead to the adoption of a consumption tax, which many believe to be a good thing.

Professor Shaviro poses the big question: Will financial innovation make it unacceptably difficult to tax investment income? I want to

27 Shaviro, note 4, at 643, 644.
28 Id. at 653.
29 Id. at 645.
suggest contra Professor Shaviro that the answer is "probably not" in the short run and the long run and "maybe not" in the middle run. The major threat financial innovation poses today is to the corporate tax base, and that threat has begun to be addressed.\(^3\) It may well be that the dangers of financial innovation have been overstated even with respect to what is becoming the canonical case of tax inconsistency—the ability to use stock, a long put and a short call to replicate a zero-interest bond. This transaction can be done in this simplest form only if long-term options are available cheaply on the underlying stock. Markets in long-term options have not evolved to this point yet. Publicly traded options with a period longer than two or three years are difficult to find, even with respect to commodities where the demand for such options should be greatest. To replicate options for periods even as short as a year, it is often necessary to use dynamic positions in shorter term (three-, six-, or nine-month) options that are traded in sufficient quantity. The difficulty and risk in such techniques increases with the term of the replicated option. The published work that I am aware of does not push such techniques beyond three years.\(^3\)

Positions in publicly traded stock can be hedged through means other than publicly traded options. Long-term options might be bought over the counter, although presumably at a more than trivial cost (which partly would reflect the difficulty the writer of the option faces in constructing a hedge). An owner of stock also might enter into an over-the-counter swap. There is much anecdotal evidence of the wealthy using swaps or techniques with equivalent results (such as going short against the box) effectively to dispose of stock while avoiding tax,\(^3\) including the story Hariton tells in this issue.\(^4\) His story also suggests that such deals are costly to do; he describes a lengthy meeting involving four lawyers and an undisclosed number of bankers to put together one deal. He does not tell us how much work

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\(^{31}\) Much of this threat comes from the explosion in the use of MIPs and other instruments that convert equity into debt. See David P. Hariton, Distinguishing Between Equity and Debt in the New Financial Environment, 49 Tax L. Rev. 499 (1994), for a discussion of these instruments.


\(^{34}\) Hariton, Hedged Positions, note 35.
was done outside that meeting, or what profit the bank hoped to make from the deal, both of which would increase the cost.

An additional problem lurks in the background of Hariton's story. The bank is intensely concerned with ensuring the creditworthiness of the owner of the stock. Presumably, it will insist on terms that secure the stock or other collateral. The same problem exists if the taxpayer buys a put and sells a call to convert stock into a fixed-income asset. The counterparty to the call will demand security from the writer. If the call is sold on an exchange, this security would come from margin requirements that are reset daily by marking the position to market. From Treasury's perspective, these security needs may well be the Achilles heel of the equity swap for the posting of stock as security on a contract or other steps taken to protect the counterparty might serve as a signal for the application of a constructive sale rule.

These problems with maintaining hedges become even worse with respect to nonfinancial assets, which I take really to mean nonfungible assets, the subject of Professor Shaviro's article. While a long-term hedge of a position in stock probably has to be done through a nonpublicly traded contract, contracting is simplified considerably by the fact that the underlying stock itself is publicly traded. That an asset is publicly traded, or that it has a value that can be derived from publicly traded securities, is important because that indirectly reduces the problems of monitoring the performance of the contract (that is, determining if a condition for payoff has been fulfilled or the value of a payoff, if that value is contingent) and reduces the risk of moral hazard (that is, the risk that an interested party will influence the outcome to profit herself).

For example, in Hariton's equity swap, that the stock is publicly traded means that the payoff on the swap can be determined cheaply from the stock's price. The parties also could rely (in effect, free ride) on market and legal mechanisms to deter manipulation of the stock price and so the contract payoff. Compare the difficulties that arise in writing a forward contract with respect to land or a closely held business. On settlement day, the parties will be faced either with the expense and worry of valuing the asset to determine the settlement price or the counterparty will have to take the asset and pay the exercise

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35 One consequence is demands that individuals entering swaps have substantial other assets. See Daniel Shefter, Tax Proposals on "Short Against the Box" and Other Hedging Transactions, 70 Tax Notes 581, 584 n.10 (Jan. 29, 1996) (reporting that "swap counterparties require taxpayers to possess substantial assets (e.g., $5 to 10 million) other than their hedged securities to enter into an equity swap").

36 See Arrow, note 2, at 142 (concluding that "the factor known as the 'moral hazard' is perhaps the most important" limit on "both insurance in particular and risk-shifting through the market in general").
price. The counterparty on the forward contract also would be concerned that the asset holder might allow the asset to waste or otherwise use the asset in an opportunistic manner since the holder does not fully bear the loss from his misuse.\textsuperscript{37}

Public trading in nonfungible assets (and liabilities) does occur through pooling. Real estate, mortgages and credit card receivables have been securitized,\textsuperscript{38} and securitization of insurance risks seems inevitable given the current tribulations of the reinsurance market.\textsuperscript{39} Pooling works because it overcomes the problems that otherwise exist in betting on the value of nonfungible assets. Misvaluation of an asset or misbehavior by a party who can affect the value of an asset is less a problem for pooled assets because a loss on an individual asset will have a trivial impact on the value of interests in the pool, and the aggregate amount of such losses for the entire pool can be predicted with some certainty statistically. Pooling has not been thought to lend itself to the sort of tax-saving strategies that concern Professor Shaviro, except in one respect. There is a concern that classes of interests in a pool might be structured to produce artificial income and loss. Current law "solves" this problem through rather strict rules that limit the interests that can be created out of such a pool.\textsuperscript{40}

\textsuperscript{37} See Merton H. Miller, Financial Innovation: The Last Twenty Years and the Next, 21 J. Fin. & Quantitative Analysis 459, 465, 467 (1986) (emphasizing availability of cash settlement and reduction of moral hazard from trading by interposing intermediary as two salient features of futures markets that made futures successful innovations.

\textsuperscript{38} Modern mortgage pools were first created in the 1970's, and the first pools with multiple classes of interest were created in 1981. Consumer loans were first securitized in 1985 and credit cards receivables were first securitized in 1987. These dates are from John D. Finnerty, An Overview of Corporate Securities Innovation, J. App. Corp. Fin., Winter 1992, at 23, 29-31. The mortgage figure includes collateral mortgage obligations, real estate mortgage investment conduits, and mortgage pass-through certificates.


\textsuperscript{40} Under the so-called Sears Regulations, Reg. § 301.7701-2 to -4, investment trusts may have only one class of interests. REMICs may issue multiple classes of regular interests, which generally must pay interest on a current basis at a fixed rate or qualifying variable rate, IRC § 860G(a)(1)(B)(i), and one class of residual interests, IRC § 860D(a)(3). Residual interests predictably produce "phantom income" because the interest holder is taxed on the excess of interest paid to the trust over the interest paid out to the regular interest holders. I assume that in a typical REMIC the rate of return on the mortgages held remains constant over time or declines, but the aggregate rate of interest paid out to regular interest holders increases as the short-lived tranches, which bear the lowest rate of interest, are paid out. The consequence is that a REMIC predictably generates phantom income in the early years. The REMIC rules ensure that this phantom income bears tax by prohibiting exempt entities from holding residual interests, IRC § 860E(e)(3)(B), limiting ownership by foreign entities, IRC § 860E(e)(5)(A), and making it impossible to offset such income with other losses, IRC § 860E(a). Because of these tax disadvantages, cre-
If I am right that the problems Professor Shaviro describes exist mostly for assets that fall in the shadow of securities markets, then there is little to fear from financial innovation with respect to nonfungible assets in the short run. The short-run threat is limited to those assets that currently are publicly traded, or assets with values that can be derived from the values of publicly traded securities or futures contracts. I think that even this threat may be overstated, but that is plainly an issue that deserves further research. In the long run, techniques probably will be developed that make it possible to hedge or otherwise to play with the payoffs on broader classes of assets, including many forms of wealth that are not themselves publicly traded. Professor Strnad notes that some California land owners are exploring dynamic hedging strategies to eliminate risk on land they hold that they prefer not to sell for tax reasons. But the development of such techniques does not doom the income tax in the long run because dynamic hedging techniques implicitly make it possible to value the underlying asset currently or on a periodic basis, and so they open the door to extension of a mark-to-market system to those assets.

The problem is in the midterm, for inevitably Treasury will lag behind the investment community in understanding new hedging strategies and in designing appropriate solutions. At the current time, for example, Treasury faces many difficult issues involving the taxation of publicly traded securities and commodities because they and some of their derivatives are not taxed on a mark-to-market basis. Such midterm problems might be dealt with, however, by creating mechanisms that enable Treasury to monitor developments in the financial community and empower it to take appropriate countermeasures. In the long run, Congress could go a long way towards solving many current and future problems by empowering Treasury to tax on a mark-to-market basis publicly traded securities or assets with values that can be derived from publicly traded securities.

There are, of course, political barriers to such a change, but it is important to realize that the problem is political and not intrinsic to an income tax. The “crisis in the taxation of financial assets” is not a justification for moving to a consumption tax since the crisis might be resolved adequately by strengthening the income tax through the gradual extension of a mark-to-market system.

41 Jeff Strnad, Comment at Tax Law Review Colloquium on Financial Instruments (May 18, 1995).
Perhaps a consumption tax is preferable from the perspective of financial markets because a strategy of preserving the income tax by expanding a mark-to-market system in the wake of financial innovation will alter the “natural” evolution of financial markets and techniques in undesirable ways. For example, a strategy of taxing publicly traded securities on a mark-to-market basis might deter some natural users from entering securities markets. Furthermore, designers of dynamic hedging strategies that make it possible to hedge risk with regards to nonfungible assets would have an additional reason to be secretive about those strategies if their publication would bring Treasury to the door. Such secrecy can impose significant social costs. But it is also possible that the short-term tax benefits from devising new financial strategies or instruments under an income tax will stimulate innovation in a way that has a long-run positive effect. This happened in the case of zero interest bonds. Corporations began to issue zero interest bonds in significant numbers in 1981 and 1982, in part because of the tax benefits, but once those benefits were eliminated, the market for zero interest bonds grew in part because of demand by institutions that wanted to avoid reinvestment risk on fixed-interest positions.42

IV. Two Analytical Techniques for the Short Run

Professor Weisbach begins his article by assuming away Professor Shaviro’s question whether the effort to tax investment income is worth maintaining. He assumes that in today’s political environment there is no choice but to tinker with the existing income tax. His general thesis can be sketched quickly. Much of the article presents a scheme for classifying new financial contracts, meaning contracts that do not fit into existing tax law cubbyholes. Professor Weisbach divides new financial contracts into two types: hybrids and synthetics. Hybrids combine existing contracts (that is, contracts that fit in an existing legal cubbyhole) into a new form of contract.43 An example is a contingent debt instrument, which Professor Weisbach views as a combination of a zero interest bond and a contract such as a forward or an option with a contingent payoff.44 Synthetics use multiple positions (apparently these positions may or may not fit within existing cubbyholes) to mimic an existing contract.45 An example is mimicking a zero-interest bond by coupling stock with a long put and a short call.

42 Miller, note 37, at 463. As Professor Miller observes, some of the continued market for zeros was attributable to a glitch in Japanese tax law.
43 Id. at 206.
44 Id.
45 Id. at 212.
This is an odd way to describe new financial contracts for it does not allow for the possibility of what would be described as a genuine innovation in financial theory—meaning a security that made securities markets more complete by making it possible to take a position with respect to some risk that could not be taken using existing securities. Indeed, some new securities, such as zero coupon bonds and long-term options, do not fit easily within this typology since they neither combine nor replicate existing securities. Still, this typology is suitable for describing many new securities, and in particular, hybrid debt instruments. And it is a natural typology for a tax lawyer to adopt since it takes existing tax law as its frame of reference.

Professor Weisbach's normative argument is a defense of bifurcation as the preferred approach for taxing new forms of contracts. Bifurcation is a method that determines the tax treatment of a new financial contract by dividing it into elements that fit within existing law cubbyholes. Integration, in the way Professor Weisbach defines the term, involves "taxing a combination of positions as if they were a unit." Under integration, the combination of a position in stock, a long put and a short call might be taxed as a zero interest bond.

Professor Weisbach's analysis of the relative merits of bifurcation and integration as forms of rule is underdeveloped. He identifies one true defect of a rule that requires the integration of contracts in a taxpayer's portfolio, which is the administrative problem of monitoring a taxpayer's portfolio to determine if it holds the requisite contracts. Even this administrative objection to integration needs to be

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47 Id. at 217-21.
48 Id. at 238.
49 One of the other two problems Professor Weisbach identifies with integration falsely assumes that the success of this method depends on being able to integrate positions into a contract that fits within an existing cubbyhole. Thus, he concludes integration is "difficult or impossible" when a position in stock is combined with a collar—where the investor buys a put and sells a call with different exercise prices—that leaves the investor subject to limited risk since the integrated position does not fit into any existing cubbyhole in the tax law. Id. at 241. The obvious question is why not create a new cubbyhole? Indeed, a possible cubbyhole for the position Professor Weisbach describes already may exist, for an investment in stock combined with a collar looks like debt with contingent interest. (Professor Weisbach may not recognize this point because he classifies contingent debt as a hybrid. Id. at 206. and the collar as a variation on a synthetic. Id. at 241. I do not dwell on this criticism because it merely illustrates the artificiality of his classification scheme. As any classification scheme is artificial, this is not much of a criticism of his particular scheme.)

The third and last problem Professor Weisbach identifies with integration is even more puzzling for it seems to assume that the process of integration could not lead Treasury to change features of the tax law to avoid objectionable outcomes. His example is a case where an investor buys a taxable bond that is funded with the proceeds of a tax-exempt
qualified. Monitoring is less of a problem if it is in a taxpayer’s interest to reveal that it holds contracts that should be integrated under the rule. This is why monitoring is not a significant problem under the hedging regulations, although those regulations use a method of integration. For example, a taxpayer who acquires a futures contract to hedge inventory has an incentive to reveal that the contract is acquired as a hedge to ensure that any loss on the contract will be ordinary in character and so usable to offset ordinary income on the inventory.  

The monitoring problem is one aspect of the larger problem of compliance, which is much more complex than Professor Weisbach lets on. The complexity and indeterminacy of a rule, along with the penalties for noncompliance, are likely to have a greater effect on compliance than whether the rule employs a method of bifurcation or integration. If so, compliance will be worse under a complex or indeterminate bifurcation rule than it would be under a simple and clear integration rule. Few tax professionals will countenance fraud—and it is fraudulent not to disclose contracts in a portfolio that clearly should be integrated—while many will take every defensible advantage of indeterminate rules, and some have low tolerance and respect for overly complex rules. For instance, my hunch is that there is less evasion of the rule on “conversion transactions,” which uses a method of integration to tax as ordinary the income from two more positions that, in the aggregate, produce a riskless return, at least in transactions that plainly fall within the ambit of that rule, than there is disregard of

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bond. After tax, these transactions might be a wash (the interest earned on the tax-exempt bond will equal that paid on the taxable bond minus the tax), but, as Professor Weisbach observes, if one integrates the two positions, it improperly would allow an offset of the otherwise nondeductible interest paid with respect to the tax-exempt bond against the interest earned on the taxable bond. Id. at 240. Integration seems patently wrong in this case only if one assumes, as Professor Weisbach does, that the exemption of the interest paid to the holder of the tax-exempt bond would survive integration of that bond into a taxable investment on the taxpayer’s books. This is very unlikely under existing law. Professor Weisbach presumably assumes that the proceeds of a tax-exempt bond issued by a state or local government go to a taxable entity that pays the interest on the bond. Such a bond will be classified as a private activity bond, IRC § 141(b)(2)(B), which means that the interest paid on the bond will be exempt if the proceeds are used for one of a limited list of public purposes, IRC § 142. If a state or local government reinvests the proceeds of a tax-exempt bond at a higher rate, the exemption will be lost. IRC § 148. Even were this not unlikely, integration might lead to changing existing law to deny the exemption.

50 A rule requiring that a hedge be identified immediately discourages a taxpayer from waiting to see if it will be to its advantage to invoke the rule. Reg. § 1.1221-2(e)(i), (ii) (requiring “same day” disclosure of hedging transactions and “substantially contemporaneous” identification of hedge item). If prior identification is not made of a defined “hedging transaction,” the taxpayer gets the worst of both worlds, for gain will be ordinary while loss will be capital. Reg. § 1.1221-2(f)(2)(iii).

51 IRC § 1258.
the rules in partnership tax on hot assets,\textsuperscript{52} which take a technique similar to bifurcation to an extreme and which are hellishly complex.\textsuperscript{53}

Even when an integration rule is indeterminate or complex—as regulations implementing Treasury's proposals on constructive sales of equity probably would be—there are ways to reduce noncompliance. The partnership disguised sale rules give rise to a monitoring problem similar to that under a bifurcation rule, for they require that multiple transactions be associated over time (paradigmatically, a contribution of appreciated property to a partnership shortly followed by a distribution of other property to the contributing partner in liquidation of her interest are treated together as a sale).\textsuperscript{54} And the rules are very indeterminate.\textsuperscript{55} The regulations impose fairly clear reporting requirements that generally sweep more broadly than the disguised sale rules themselves.\textsuperscript{56} The effect is to require disclosure in most cases where the rules might apply and, presumably, to encourage tax lawyers to give cautious advice in circumstances where disclosure is required. A similar strategy could be used in regulations implementing a constructive sale principle by requiring a taxpayer to disclose when it enters into a short position on an appreciated security it holds in its portfolio, or when the taxpayer writes an option, purchases a forward contract or enters into a swap with respect to such a security.

I do not want to dwell on this criticism of Professor Weisbach's fine article, for his discussion of the techniques of bifurcation and integration is helpful. These techniques are a useful bridge between finance theory and tax law for they are good ways to test for potentially troublesome discontinuities in tax law. I take the concept of discontinuity from Professor Strnad.\textsuperscript{57} The concept of continuity can be grasped by picturing financial contracts as located within a space based on their fundamental economic characteristics. For the moment, put aside the question of what those characteristics might be, or, to put the point in spatial terms, what dimensions define the space of financial contracts. Also, put aside the question of why one should care about continuity. Tax law is acceptably continuous when one can

\textsuperscript{52}IRC § 751.

\textsuperscript{53}An asset distribution from a partnership that changes the partners' proportionate interests in ordinary income assets is disaggregated into a distribution and sale to try to prevent shifting ordinary income among partners.

\textsuperscript{54}IRC § 707(a)(2)(B).


\textsuperscript{56}Reg. § 1.707-3(c)(2) (requiring disclosure of distribution within two years of contribution unless former falls under several limited exceptions).

\textsuperscript{57}See Strnad, Framework, note 11, at 598 ("Continuity adds the requirement that the difference in tax treatment for any two positions must approach zero as the two positions converge.").
move through space, passing from one position (a position may consist of one or more contracts) to another position with slightly different characteristics without any abrupt changes in the tax they bear. For example, the current law on debt instruments may be acceptably continuous because while the tax varies depending upon whether an instrument pays variable or contingent interest, these differences tend to be negligible for debt instruments that lie in the gray areas between these cubbyholes. Conversely, there is a grave discontinuity in the treatment of debt and equity because a small change in the economic characteristics of an instrument can have a large tax impact.

Professor Bradford's case of pure tax arbitrage illustrates the related concept of inconsistency, though it is a special case. Inconsistency exists when the tax on a position differs depending on its formal character. Whether a cash flow is positive or negative may be thought of as one dimension of a position. An opportunity for pure tax arbitrage exists when positions have polar cash flows and the tax they bear is not similarly polar.

While it is easy to grasp the concept of continuity intuitively, it is difficult to give the concept practical content. Let me quickly sketch how I think Professor Strnad gives the concept content and then I will suggest a different and more simplistic approach that employs the techniques of bifurcation and integration. Professor Strnad works within an analytical model that assumes a complete securities market in which a unique "pure security" provides a payoff (positive or negative) in every relevant contingent state. The coordinates of a position in financial space are the underlying pure securities of which that position is composed. Changes in positions are denoted by the removal or addition of a pure security. Under a perfectly continuous tax system, the removal or addition of a pure security in a position would alter the tax borne on that position by the tax borne on the pure security in isolation.

An approach that is grounded on the concept of a complete securities market that is composed of pure securities may be useful for financial engineering, but I am not sure that such an approach is necessary or even appropriate for Treasury to use in formulating tax law. Financial engineers need a method that enables them to create new securities. Tax policymakers are not directly concerned with innovation; they can be satisfied if the law governs the existing set of securities tolerably well and there is not a socially harmful level of

58 Reg. § 1.1275-5.
59 Reg. § 1.1275-4.
60 See Strnad, Framework, note 11, at 598.
uncertainty regarding the tax treatment of novel securities. The implication is that tax policymakers might be satisfied if they can create and preserve continuity in taxation of the existing set of securities.

The techniques of bifurcation and integration are useful tools for assessing discontinuities and inconsistencies in tax law in cases where the security under study can either be decomposed into other securities or combined with other securities to replicate another security. If a security can be decomposed into other securities, or if by combining a security with other securities another security can be replicated, and if tax law is not continuous and consistent across these positions, an opportunity for tax arbitrage exists. At this stage of the analysis, there is no reason to differentiate between the two techniques—they are simply different directions on the same path of analysis (if security $C$ decomposes into securities $A$ and $B$, evaluation of the arbitrage possibility involves integration if the focal point of analysis is $A$ and $B$, and bifurcation if the focal point of analysis is $C$).

There is no reason to think that Professor Weisbach would disagree with this statement, for the distinctions he draws between bifurcation and integration are concerned with a later stage in the analysis, when one asks what form of rule is most administrable. His thesis can be restated: On identifying a possibility for tax arbitrage because of an inconsistency in the taxation of security $C$ and the equivalent combination of security $A$ and security $B$, it generally will be better to change the law on $A$, $B$ and/or $C$ to eliminate that discontinuity rather than to adopt a rule taxing a combination of $A$ and $B$ as $C$.

If there were complete freedom to change the tax law, it seems fairly clear that it would be better to address tax arbitrage possibilities through the first course rather than the second. Not only does the first course run into a monitoring problem, it also increases the complexity of tax law by overlaying one body of rules on others. Arguably, the first course is better suited to addressing the distortionary impact of discontinuities and inconsistencies in tax law. Consider the canonical case again: the replication of a zero with an investment in stock combined with a long put and a short call. The different tax rules that apply to these two positions create an opportunity for tax

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61 The only justification for putting the extreme demands on the tax law that Professor Strnad would as an ideal—he wants the tax law to be universal and consistent, as well as continuous, meaning that a rule should exist for every possible security and that each unique "pure security" should bear a unique tax, see Strnad, Framework, note 11, at 573—would be a concern that gaps and latent discontinuities in tax law may affect financial innovation in an undesirable way. That claim depends on a number of questionable assumptions regarding the sensitivity of players in financial markets to tax uncertainty and latent tax discontinuities, as well as the debatable assumption that it is best that tax law have no influence on financial innovation.
arbitrage (there is an opportunity for riskless after-tax profit if the proceeds from issuing a zero are invested in a synthetic zero). A rule that taxes a synthetic zero as a zero, if compliance was perfect, would eliminate that opportunity. But the inconsistency in the taxation of the two positions remains, which may distort the relative value of these securities—for example, tax-paying investors will tend to overvalue nondividend paying stock and options as compared to a zero because of the deferral of tax on the expected yield. One could address both the opportunity for tax arbitrage and the distortion by changing the tax rules that apply to equity and options to impute income on the expected yield on investments in stock and options.

Professor Weisbach does not make the last argument, perhaps because he assumes that the rulemaker, presumably Treasury, has limited power to change the law. But the limited power of Treasury to change the law is, in fact, the best argument for preferring rules that use an integration method over rules that use a bifurcation method. There are two reasons. One is that it is easier to enact a rule that targets a particular transaction or use of a security, particularly if that transaction can be characterized as novel and abusive, then it is to change the law regarding the taxation of an existing security. For example, if the “synthetic zero” truly is a problem, Treasury is more likely to be able to enact a rule taxing synthetic zeros as zeros (which it should have the authority to do under § 1258) than it is likely to persuade Congress to change the law to impute income on the expected yield on investments in stock and options.

The other reason applies in the case of a novel security that can be decomposed into existing securities. If the rules on the component securities are imperfect but unchangeable, the Treasury might do better crafting a new rule for the security. Consider a zero interest debt instrument that is convertible into stock upon maturity. This instrument contains two of the three elements of the synthetic zero, a long position in stock and a long put (the short call is omitted). Bifurcation of that instrument might lead to a horrible result (if the instrument is taxed as an investment in stock coupled with a put with a strike price equal to the face amount of the debt instrument, the expected yield would avoid tax until sale of the stock and there would be an artificial loss should the put lapse unexercised) or merely a bad result (if the instrument is taxed as an investment in a zero-interest bond coupled with an investment in an option to buy stock, the expected yield on the portion of the investment allocated to the option would escape tax). Taxing the instrument as a contingent debt instrument taxes the expected yield on the entire amount of the investment.
V. A Case Study: Equity Hedges

Professor Schenk’s thoughtful proposals on how to deal with equity hedges\(^6^2\) can be used to illustrate the limitations and perhaps the wisdom of a policy that focuses on suppressing sharp tax discontinuities through integration rules. Treasury’s recent proposal to require recognition of gain upon a “constructive sale”\(^6^3\) of a security is consistent with the policy I advocate. Professor Schenk’s proposal goes further than that, and therein, I suggest, lie its problems.

An equity hedge begins with a taxpayer who owns appreciated stock that she would like to sell so that she could reinvest the proceeds. A corporation with substantial assets or an individual with the wealth of Croesus might enter into a swap; the merely rich probably would go short against the box, in effect selling borrowed shares of the same stock and investing the proceeds.\(^6^4\) Were the taxpayer a corporation and the block of stock sizeable enough, it might monetize the stock by issuing debt that could be converted into shares of the stock.\(^6^5\)

Professor Schenk’s and Treasury’s proposals both would recognize gain in the case of the long-term swap or when the taxpayer goes short against the box. Her proposal differs from Treasury’s for she would recognize gain to the extent a transaction eliminates the risk of loss on a position while the Treasury proposal would find a constructive sale only if the transaction “substantially eliminates risk of loss and opportunity for gain.”\(^6^6\) Thus, she would recognize gain if the taxpayer acquired a put on appreciated stock with a strike price above the stock’s basis\(^6^7\) while the Treasury’s proposal would not since the taxpayer retains the right to any increase in the stock’s price. Indeed, Professor Schenk would recognize gain if the taxpayer acquired a put for a period as short as twenty-four hours\(^6^8\) and would do so even if the exercise price of the put was well below the then market value of the stock (but above the taxpayer’s basis in the stock) so there was little chance of the put being exercised.\(^6^9\)

I find Professor Schenk’s argument for the broader rule to be unpersuasive. Much of her argument is premised on what she believes to

\(^{62}\) Schenk, note 5.

\(^{63}\) Treasury Bill, note 8, § 9512; see also Treasury Dep’t, General Explanation of the Administration’s Revenue Proposals, 96 TNT 56-9, Mar. 20, 1996, available in LEXIS, Fedtax Library, TNT File.

\(^{64}\) See note 35.

\(^{65}\) See Brad M. Barber, Exchangeable Debt, Fin. Mgmt., Summer 1993, at 48 (discussing tax and nontax motivations for issuing exchangeable debt).

\(^{66}\) Schenk, note 5, at 587-88; Treasury Bill, note 8, § 9512.

\(^{67}\) See Schenk, note 5, at 585-86.

\(^{68}\) See id. at 589.

\(^{69}\) See id.
be the appropriate limits to the realization principle; it ought to apply only if gains are difficult to value. From this premise, she concludes that the principle of realization ought not apply to an equity hedge, including the acquisition of a put, because the hedge establishes a floor on the value of the underlying position (even a short-lived put does this). The argument is unpersuasive because it is odd to resolve an issue of social policy with a norm derived from the tax system (or, in this case, the limits on the principle of realization). As Professor Schenk concedes, not everyone believes that the realization rule is a bad thing that should be honored only when administrative problems necessitate it. In any event, arguments that Congress should tax all measurable gains cannot justify the specific proposal, for were Congress persuaded by these arguments, then surely it would adopt a rule taxing all publicly traded securities on a market-to-market basis, eliminating much of the need for the rule proposed by Professor Schenk.

On what basis then should Professor Schenk’s proposal be compared with Treasury’s proposal? One approach is to compare their costs and benefits. These include transaction costs as well as welfare gains and losses from altering how risks are allocated through financial contracts. Transaction costs include the cost of tax planning and enforcement and the cost of writing, monitoring and enforcing financial contracts. Welfare gains and losses result when the rules affect the capital structure of firms or portfolio choices of individuals, which may affect resource allocation indirectly and may have positive or negative value in its own right. The most famous example of negative welfare effects that result from tax distortions of financial markets involves the tax bias for debt over equity, which is said to harm national welfare by inducing firms not to use the corporate form and by inducing corporations to be overleveraged and to avoid making dividend distributions.

We lack the information and the analytical skill to engage in a sophisticated comparison of the costs and benefits of alternative incremental changes in tax law. Nevertheless, I think we can be reasonably confident that the social benefits of a change outweigh the social costs.

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70 See id. at 629-30.

71 See id. at 641. If publicly traded securities were taxed on a mark-to-market basis, then to preserve continuity, a similar, but broader, rule would be needed that would tax a non-publicly traded contract to the extent its value could be derived from publicly traded securities. This would entail taxing a contract that could be converted into a publicly traded security or into cash at the option of the holder.

if the change suppresses a sharp discontinuity or an inconsistency in
tax law.

Thus, I find Professor Schenk's assessment of the costs and benefits
of a limited "constructive" sale rule to be convincing. One expects
that there is a net social benefit in deterring transactions such as going
short against the box or entering into a long-term equity swap because
another type of contract (a sale) achieves the same economic conse-
quences at significantly lower transaction costs. Indeed, such transac-
tions are understood by the parties to be equivalent to sales that are
done in a more complex and costly manner for purely tax reasons. 73

Even the Treasury's modest "constructive sale" proposal has offset-
ting costs. Professor Schenk discusses one such cost: Taxpayers will
pursue even more costly ways to achieve the same end. Another po-
tential cost results from the possibility that a new instrument that ex-
plants a discontinuity or an inconsistency in tax law may have a
positive effect on social welfare because by doing so, the instrument
ameliorates the distortionary effect of tax law. For example, if it is
ture that elimination of the distortionary tax bias between debt and
equity would enhance social welfare, it is possible that a new instru-
ment that enables corporations to obtain debt treatment for what is in
effect equity enhances social welfare by reducing that distortion. 74
One might think of such innovations as self-help tax reform. I do not
think that such costs should weigh heavily against Treasury's proposal,
but I cannot develop that argument here.

Professor Schenk's proposal is troubling because it sweeps much
further than Treasury's proposal. Once Professor Schenk is done
broadening the rule to deal with various evasions, the rule could apply
whenever a taxpayer enters into or alters a financial contract where
the value of that contract is negatively correlated with the value of an
equity position held by the same taxpayer on which there might be
unrealized gain. This sweeps in many hedges, for often a firm that has
purchased stock to hedge a position later will take other positions with
values that are inversely correlated with the value of the stock. For
example, if a coal-burning utility bought stock in a coal company with
which it had a long-term contract to facilitate monitoring of the coal
company's performance or to hedge price risk on the contract, every
future position the company might take to protect it from downward
movements in the price of coal might trigger the rule since that posi-
tion also would protect the utility from a downward movement in the
price of the stock. Professor Schenk suggests that the rule might be

73 See Schenk, note 5, at 636 n.235.
74 An example is MIPS (Monthly Income Preferred Shares). See Lyn Perlmuth, Mips
expanded to cover all securities and even some nonfinancial assets, which would extend the rule even further.

Presumably Professor Schenk would deal with this problem by crafting specific exceptions to the general rule. This solution probably requires long and complex regulations, which will be difficult to interpret and even more difficult to explain to clients. Such opaque regulations impose transaction costs even in cases that plainly fall within the scope of the exceptions, because a cautious manager would be inclined to consult with tax counsel to confirm that fact. This solution also requires a fair amount of knowledge about how firms hedge, and inevitably new transactions or strategies will appear that raise hard interpretive questions. The exceptions also may create loopholes that taxpayers can exploit with some security in the cases meant to be taxed because the black letter of the regulation is on their side. The regulations under § 704(b) illustrate several of these phenomena; they raise transactions costs for all partnerships no matter how mundane their allocations of income and loss while leaving loopholes for the sophisticated to exploit.

I would not even guess whether these costs outweigh the benefits of the broader rule, assuming suitable exceptions could be crafted. One way of explaining my disagreement with Professor Schenk is that she is more willing than I to incur uncertain costs to rationalize the tax system. This is a defensible point of view for the long-run benefits of pressing quickly to rationalize the tax law may well outweigh the short-run costs. I take a more short-run perspective, partly because I am cynical about the prospects for truly rationalizing tax law, but also because my study of the interaction of tax law and financial innovation suggests that changes and even prospective changes in the tax law can have dramatic short-run effects in the financial world. A policy of suppressing only sharp tax discontinuities and inconsistencies defers to whatever forces drive finance by striking only in those areas where one can be fairly confident that tax law is having positively harmful effects.

VI. A Method for the Short Run

When I first read David Hariton’s article, I thought it was a cynical jest. He proposes abandoning the use of “technical analysis,” by which he means the interpretation of highly detailed regulations, as

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75 Schenk, note 5, at 622-26.
76 This is not entirely accurate for, as I said, her argument is not entirely based on a comparison of the costs and benefits of the rule. What she finds decisive is a normative principle derived from tax law that gain on a position should be taxed when the position can be valued and readily converted into cash.
the primary method to determine the tax treatment of new financial contracts for a method of "logic, parallelism and judgment," by which he means deciding specific cases by reasoning from a few general principles or canonical cases. For example, Hariton might have dealt with straddles by using the general principle of substance over form rather than through the complex statute and regulations of § 1092.

This proposal seemed a cynical jest because the benefit Hariton claims for it, a reduction in the cost of doing tax analysis, likely would be overwhelmed by the cost of greater legal uncertainty in a system where answers had to be derived from sparse and often conflicting authorities. Hariton pays little attention to the costs of legal uncertainty, perhaps because he thinks they would not be borne by parties to innovative contracts, for their lawyers would resolve uncertain issues in favor of their clients. Hariton dismisses the fear that tax advisors would take advantage of what probably would be a less constraining system of law, but his reasons are unconvincing. He suggests this problem might be addressed through anti-abuse regulations, like the recent § 701 regulation, missing a key distinction between the nature of that regulation and the system he proposes. That regulation supplements rather than supplants a highly technical body of rules. Hariton's other argument is that there is no option but to trust the tax bar since they administer the tax law in any event. The obvious rejoinder is that it is easier to punish malefactors in the bar when the boundaries they should not transgress are clearly identified by regulation or statute.

Nevertheless, I came to appreciate that Hariton was on to something important. My views crystalized on reading a recent article by Cass Sunstein that is support for Hariton's criticism of the modern tendency to address new financial instruments through highly technical bodies of rules. As Professor Sunstein notes, a "system of rules" entails "approaches to law that try to make most or nearly all legal judgments under the governing provision in advance of actual cases." A logical corollary of this point is that a system of rules works badly when the world is in flux. The financial world is in an extraordinary state of flux, and so it may well be that the unhappy state of affairs in tax offices on Wall Street that Hariton describes—a close reading of highly technical rules often produces no answer to a question or what seems to be an idiotic answer—is endemic to any system of rules. In other words, more and better rules will not solve

77 Hariton, Hedged Positions, note 7, at 824.
78 Reg. § 1.701-2.
80 See id. at 961.
the problem because drafters do not have the foresight to develop sufficiently better rules.

While Hariton’s diagnosis of the ills of a rule-based approach to taxing new financial contracts may be correct, he surely is wrong on two fundamental points. First, he errs in focusing on the role of the tax bar and ignoring the role of Treasury in what might be described as a casuistic system of legal analysis. If decisionmakers are to be vested with a great degree of discretion (and that seems inevitable in a system where decisions are made case by case and on the basis of sparse authority), the natural person in whom to vest primary decisional authority is someone who is charged to consider all of the interests at stake and who is expert in the relevant areas of law or policy. Treasury is the natural institution in which to find or place such people.

Reducing the reliance on regulations, as Hariton proposes, requires dealing with more issues by ruling. Incentives and mechanisms would be necessary to ensure that the appropriate cases get presented to Treasury in a timely fashion for a ruling. While delays in issuing rulings probably make it infeasible to require that issuers obtain a tax ruling in advance of the first issue of a new instrument, it might be feasible to require issuers to notify Treasury of publicly traded instruments with novel features when they are issued. Careful thought would have to be given to when rulings might be applied retrospectively and whether rulings might be made conditional on an instrument not later exhibiting undesirable properties. It also might be necessary to loosen the standards for imposing penalties. For example, penalties might be imposed for taking a position on an issue for which there is no clear authority either pro or con if that issue is not presented to Treasury. To do this would require significant changes in current law and practice. Currently, Treasury relies mostly on regulations. Rulings are used episodically to address specific problems, and usually with a fair amount of lag time. Typically, rule changes announced through either regulation or ruling have only a prospective effect. Pending such announcements, taxpayers can take aggressive positions on issues on which there is not yet clear authority without

81 Professor Sunstein uses the term “casuistry” nonopprobriously to describe a method of legal analysis similar to that advocated by Hariton. See id. at 958.

fear of real sanction. In a few cases, Treasury has moved quickly by informally announcing a position to be taken in a later ruling.83

My other point of disagreement with Hariton goes to how tax law ought to be relevant to the decisions Treasury makes regarding new instruments. Hariton seems to assume that tax law is a coherent web of principles and decisions from which a person with sufficient knowledge of the law and integrity (Ronald Dworkin’s Hercules would serve well in this role84) could determine a “correct” answer to most questions. Tax law is not like this. Attempts to square tax law with deep principles—the leading candidate is the principle that taxable income should equal economic income, or consumption plus a change in wealth—founder because so much of tax law is driven by administrative and political concerns.

For example, I doubt that Hariton would agree that the principle that taxable income ought to equate with economic income should govern the transactions he discusses in his article. They involve variants on a hedge of an equity position in stock on which there is substantial unrealized appreciation.85 Were this the governing principle, the logical conclusion would be that, if there is doubt about the tax consequences of these transactions, the gain should be taxed. Perhaps Hariton thinks these cases should be governed by the principle of substance over form, but then the outcome would turn on which of several possible forms of that principle were adopted. For example, if one recognized a transaction if it had any potential economic substance, most forms of equity hedges would be respected because the taxpayer might close out the hedge and return to his original posi-

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83 An epynomous illustration is the quick response to a transaction in which a corporation exchanged Quarterly Income Capital Securities ("QUICs") for outstanding preferred stock. The instrument included a 150-point penalty for past-due interest with the thought that this would negate the option of issuer to defer interest payment for five years so that original issue discount rules would not come into play. The deal was publicized in Tom Pratt, Lehman Adds New Wrinkle in Latest "QUICs"?Preferred Swap; Late Payment Penalty Eliminates OID Accruals, Inv. Dealer's Dig., July 31, 1995, at 13. Cynthia Beerbower, the deputy assistant secretary for tax policy, said in an interview that the "penalty" was insufficient to avoid treating this as a true option to defer payment. See Tom Pratt, Treasury Official Takes Shot at Lehman's "QUICs" Twist; Says Penalty in Williams Deal Shouldn't Eliminate OID, Inv. Dealer's Dig., Aug. 21, 1995, at 12. A revenue ruling followed in October, 1995. Rev. Rul. 95-70, 1995-2 C.B. 124. It was silent on the effective date, so presumably it applied retroactively. See IRC § 7805.

84 See Ronald Dworkin, Law's Empire 239 (1986).

85 The five transactions are (1) entering into a swap of the return on the stock for the return on an index fund or on debt, (2) borrowing an equivalent block of stock and selling it short, (3) entering into a forward contract to sell the stock, (4) buying a put and selling a call on the stock and (5) issuing a contingent debt instrument with a payoff equal to the value of the stock.
tion, while if one recast a transaction into its simplest form if it was
done in a more ornate way for tax reasons most forms of equity
hedges would be taxed as sales.87

Treasury should proceed instead by analogizing new instruments to
existing instruments using the methods of bifurcation and integration
with the twin goals of suppressing sharp discontinuities in tax law
while striving to tax true economic income. Under such an approach,
Treasury would rule that the cases Hariton describes are sales because
they are economically equivalent to sales. What Hariton teaches is
that this might be done better by establishing the broad principle in
rulings that address the easiest cases (this could be done either
through regulation or ruling), leaving the boundaries of the principle
to be defined on a case by case basis. But one should not be deluded
into thinking that significant progress can be made through such incre-
mental actions. Real progress will be made only when the worst statu-
tory discontinuities are eliminated. The approach I suggest is only the
best of several tolerably bad options.

86 See McDonald's Restaurants of Ill., Inc. v. Commissioner, 688 F.2d 520 (7th Cir.
1982) (explaining several versions of step transaction doctrine including weakest versions,
which would respect a step unless there was binding commitment to take next step).
87 See Saul Levmore, Recharacterizations and the Nature of Theory in Corporate Tax