Should Congress change tax law to match new accounting standards?

The Fallout from FAS 133

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LAST JUNE, THE PRIVATE FINANCIAL ACCOUNTing Standards Board (FASB) implemented a new accounting standard that could significantly affect U.S. tax law. The new standard, FAS 133, changes how accountants handle derivatives, which are agreements that derive value from some underlying price or variable, a notional amount or a payment provision. FAS 133 requires accountants who compile balance sheets to show changes in a derivative's value as an asset or loss, even if the derivative remains in an open position. This is a sharp departure from past accounting practices that allowed many types of derivatives, such as forward contracts and swaps, to be left off of balance sheets.

This change may not seem important to people who are not accountants, but it could significantly affect the business world. Some industry experts fear that including the value of these derivatives on balance sheets could exacerbate income volatility and give the appearance that companies are operating irresponsibly or taking unnecessary risks. What is more, the change could accelerate the push for more pervasive fair value accounting requirements. Indeed, a recent FASB "Preliminary Views" report advocated measuring all financial instruments at fair value.

If financial reporting does move to fair value accounting, this change would radically conflict with U.S. tax law. Accountants, when preparing tax returns, generally ignore derivative values and focus on income received and gains realized on the sale of property. However, when these same accountants prepare FASB-compliant financial statements, they must include derivatives in their reporting. Given this difference between the two accounting systems, lawmakers may now wonder if they should change tax law to require reporting of all derivatives and other fair value financial assessments.

Some financial observers would favor this change because it would establish a consistent set of accounting procedures. As columnist Lee Sheppard recently wrote, "Congress should sweep away the various definitions and accounting methods for derivatives that have been installed piecemeal [in tax law] over the last two decades, and replace them with a tax law analogue of FAS 133." But other observers argue that basing tax calculations on fair value accounting would radically depart from the current structure and thus be practically and politically unfeasible.

Despite these difficulties, showing a derivative's value could simplify tax law and unify accounting practices. It would also close a number of tax loopholes that creative accountants use to shelter clients' assets.

DIFFERENCES BETWEEN TAX ACCOUNTING AND FINANCIAL REPORTING

MANY COUNTRIES REQUIRE CONFORMITY BETWEEN TAX and financial accounting, but the U.S. allows a number of differences. For example, accountants show capital depreciation over much shorter time periods on tax returns than on financial reports. Also, accountants who fill out tax returns usually do not deduct the cost of stock options granted to employees until the options are exercised. Despite this, financial accounting requires such options be included in the disclosure of pro forma net income and earnings per share, even though a deduction for stock-based compensation has not been taken.

The differences between tax and financial reporting reflect the different purposes of the two systems. Government established the regulations for tax reporting to produce accurate descriptions of cash flows that can then be taxed. On the other hand, FASB created rules for financial reporting to produce correct depictions of firms' econom-

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ic health so that investors, creditors, and company directors can better make business decisions. Despite the different purposes, the two systems differ significantly in only a few relatively specific sets of calculations. But these disparities open the way for creative accounting that may, in extreme instances, amount to tax fraud. They also prove costly for companies that now must conduct two distinct sets of accounting calculations, one for financial reporting and the other for tax reporting. Given these problems, many commentators advocate conformity between tax accounting standards and financial reporting standards.

WHY FASB ADOPTED STANDARD 133

FASB FAVORS ACCOUNTING STANDARDS THAT HANDLE VARious financial instruments in consistent ways, as much as possible. The board enacted FAS 133 to establish one set of guidelines for handling different types of derivatives. The U.S. Internal Revenue Code, conversely, has a separate tax system for almost every type of derivative and, indeed, for almost every type of financial instrument.

For instance, tax law requires the taxing of stock dividends when they are received, but there is no taxing of increases in share values until the shares are sold. Options, when not traded on exchanges like the Chicago Mercantile Exchange or the Chicago Board Options Exchange, are taxed under traditional property principles that often view them as down payments. Exchange-traded options and exchange-traded futures contracts are valued ("marked-to-market" under Section 1256 of the Internal Revenue Code) at the end of the taxpayer's tax year and any change in value is recognized as a capital gain or capital loss. Unlike stock, which produces a lower capital gain rate if held for more than one year, capital gains or losses on Section 1256 contracts are automatically 60 percent long-term capital gain and 40 percent short-term capital gain (or loss in either case), regardless of the holding period.

Because the tax code uses such a complex and confusing system to handle different financial instruments, it opens the way for irregular and questionable tax accounting methods. Over time, creative lawyers and financial engineers have exploited the tax system by developing new and ever more sophisticated instruments and strategies that produce savings for those who can afford such planning. To the extent that such efforts are successful, these tactics ultimately end up shifting tax burdens in a way that differs from government's original intent for the tax system. A more consistent tax accounting system would limit the opportunity for these tactics.

FAS 133 and Structured Notes One example of a particularly problematic category of instruments is that of "structured notes." These securities include such common debt issues as Participating Hybrid Option Note Exchangeable Securities (PHONES), Debt Exchangeable for Common Stock (DECS), equity linked notes (ELKS), and an alphabet soup of other acronyms including PERQS, CHIPS, and YEELDS. Investment banks market such instruments to corporations that hold stock in other firms for various purposes (merger, acquisition, control). The holding companies often want a more immediate return on their stock than the long-range plan may allow. Investment banks provide a means of obtaining capital for such stock holdings in a move known as monetization that corporations prefer when they receive little or no dividends from the stock. Most high-tech stocks fall into this category.

PHONES illustrate the kind of creative engineering that has become a part of the financial landscape. Marketed by Merrill Lynch, Comcast became the first company to issue these instruments in mid-1999 when it monetized its AT&T stock. The Comcast notes were to mature in 30 years and had a number of embedded derivative features, including:

- If, at maturity, AT&T shares were worth more than 150 percent of AT&T's share value at the issue date (allowing for certain adjustments like stock splits, etc.), the maturity of the security was to be extended for another 30 years.
- The periodic interest payments were determined by formula to be 1.75 percent of par, plus the amount of the cash dividend paid on AT&T shares.
- A holder could exchange his PHONES after one year from the date of issue for cash equal to 95 percent of the value of AT&T shares. This percentage rose to 100 percent if Comcast elected to defer quarterly interest payments on the notes.
- On maturity, the holder would receive the greater of the issue price (as adjusted) or the value of an AT&T share.

In addition to receiving cash, Comcast also obtained interest deductions on its debt.

Because PHONES are, from a tax perspective, contingent payment debt instruments, tax accountants determine the interest payments and deductions from the comparable yield. The actual interest payments Comcast made amounted to 1.75 percent of the principal amount each year, but the comparable yield was determined to be 9.3 percent. The latter percentage determined Comcast's deductions. Thus, Comcast managed to orchestrate three bene-

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fits with the PHONES: It received higher deductions than the payments it actually made to the holders of the debt; it monetized its AT&T stock holdings without an adverse tax consequence; and it was able to arrange financing on a tax-advantaged basis.

Comcast's use of PHONES highlights a problem with current tax law. Some experts believe the 9.3 percent interest deduction should not be allowed because accountants will correlate the final payment on the PHONES with the position Comcast holds in the AT&T stock. These experts argue that the correlation triggers application of the complex "straddle" rules that preclude deductions where one position offsets another. If the Clinton Administration gains passage of its proposed 2001 budget, it will end this debate by requiring application of the straddle rules that would eliminate PHONES' tax benefit.

Beyond the question of the size of the deduction, the tax system treats PHONES debt as a single debt instrument even though the debt includes derivative features. However, if a company issues the PHONES as two independent instruments — a debt and derivative — the tax system could apply tax rules to each of them separately or, depending on certain factors, could integrate them into a single "synthetic" instrument. As long as the derivative features are not clearly and closely related to the host contract, the financial accounting system treats the embedded derivatives as "stand alone" derivatives. Thus, the tax system may respond in different ways to PHONES depending on whether the deal is structured as a single transaction or as a combination of more than one trade.

Given the broad diversity of financial instruments and the ways they can be combined and separated, a system based on fair market value provides a consistent approach to valuing them. But implementing this approach may be easier said than done. Valuing instruments with embedded derivatives will require a significant level of financial

GLOSSARY OF TERMS

Derivatives A derivative is a contractual arrangement that derives value based on some underlying price, a notional amount or a payment provision. The value could also be based on an underlying variable like an interest rate, an index value, a foreign exchange rate, or another readily determinable figure. The notional amount is a number of currency units, shares, bushels, pounds, or other units specified in the contract. FAS 133 mandates that a derivative requires no initial net investment or, at most, an initial investment that is much smaller than most contracts involving similar potential gains and losses. FAS 133 also notes that a derivative must require or permit net settlement, which is a provision that allows the parties to discharge any future obligation by settling the value of the derivative in cash or in something that is readily converted to cash.

Forwards A forward contract is an agreement to exchange a specified amount of a designated good, commodity, or security at a specified forthcoming value date (or settlement date), but at a price fixed today (on the trade date). Forwards are generally not taxed until the transaction is closed, and are therefore treated as open contracts until the closing event.

Futures A futures contract is an exchange-traded instrument that serves the same economic function as a forward contract. Futures contracts are standardized in terms of value dates, sizes of contracts, and characteristics of the underlying instruments. On a daily basis, futures contracts are marked to market, and cash settled, with the exchange clearing house serving as the intermediary guaranteeing that gains and losses are settled each day. Futures are taxed under the mark-to-market rules of Section 1256 of the Internal Revenue Code.

Options An option is the right, but not the obligation, to purchase (or sell) some underlying instrument for a specified price on a specified day in the future, or for a specified period terminating on a specified date in the future. An option to purchase is a call; an option to sell is a put. Options can be traded on exchanges or they can be arranged between parties acting outside of any exchange or regulated market. Exchange-traded options are taxed under the same mark-to-market rules that apply to futures. Several other Internal Revenue Code provisions describe the tax consequences of selling, exercising, or failing to exercise non-exchange-traded options.

Structured Notes A structured note is a debt instrument whose interest payments or principal value is linked to the value of some underlying asset, reference rate, or index. Structured notes may also be called hybrid debt instruments, consisting of a host contract and a derivative instrument. The tax law provides special original issue discount rules that apply to these instruments, which it generally calls contingent payment debt instruments.

Swaps A swap contract is an agreement between two parties to exchange two respective cash flows, generally based on some notional amount (say, $1 million), but involving different underlyings. These two payments will frequently be netted, with the only actual payment at any given interval being made by the party that owes the larger amount. Plain vanilla interest rate swaps involve one party paying a fixed amount (based on a fixed rate of interest) and the other party paying a variable amount (based on a floating rate of interest). Most tax consequences concerning swaps are determined under regulations issued by the Treasury Department. The Treasury regulations are fairly specific as to the timing for inclusion of swap payments in income, but there is a great deal of confusion and controversy as to the character (ordinary vs. capital) of certain payments, particularly the final payments under a contract.

engineering skill, and those with greater facility with valuation methodologies will be better able to conduct the required tax calculations.

Another factor to consider is that government wants the tax system to collect taxes as efficiently and quickly as possible. However, the IRS is concerned that some companies will use the current system to defer tax liabilities indefinitely. A tax system based on fair value would limit companies' ability to use this delaying tactic.

FAS 133 and embedded derivatives The tax code also has problems handling instruments that combine features of several types of financial transactions. One such "hybrid instrument" is convertible debt where the guarantor has the option to convert the debt into shares of the issuing corporation. In this and many other cases, the derivates are not free standing; they are built into other instruments.

FAS 133 labels these instruments "embedded derivatives" and develops a system to handle them. The new standard requires financial accountants to separate an embedded derivative from its host contract, unless the embedded instrument is "clearly and closely related" to the host. Barring this exception, accountants record the derivative on the balance sheet at its fair value while the debt host is handled in the same manner as current practice.

Current tax law considers an embedded derivative to be a contingent payment debt instrument, known to the financial world as a structured note. The tax system, unlike FAS 133, does not separate the derivative from the host. Instead, tax law treats a contingent payment debt as a single instrument. Under the contingent payment debt rules, tax accountants determine the annual interest by using the comparable yield, which is the yield the issuer would pay on a fixed rate debt instrument with terms and conditions similar to those of the structured note. Thus, if a corporation issued a fixed rate note on the same day with the same term, the same payment schedule, and subordinated at the same level, the rate on that note would be the comparable yield for the structured note.

SHOULD FINANCIAL ACCOUNTING INFLUENCE TAX LAW?

GIVEN THE DIFFERENT PURPOSES OF TAX LAW AND FINANcial accounting, can there be a happy union of the two? The tax system generally seeks to determine how the taxpayer's economic position has changed — and how much he can be taxed — as a result of transactions during the current tax period. Financial reporting, on the other hand, informs shareholders of changes in the value of the corporation's assets, liabilities, and shareholder equity, and describes the business's earnings and profits. Despite these differences, both systems provide information about changes in values, but each system does so at different moments for different periods. Given this common base, the divergences between the two systems are surprising and troubling.

Over 20 years ago, Supreme Court Justice Harry A. Blackmun wrote in *U.S. v. Frank Lyon Co.* that "the characterization of a transaction for financial accounting purposes on the one hand, and for tax purposes on the other, need not necessarily be the same." Despite Blackmun's opinion, Washington policymakers must decide whether the tax system should come closer to a fair value approach. Fair value accounting contains significant practical difficulties in determining values when so many factors can affect an asset's (or liability's) value. It is hard to imagine either Congress or the public accepting taxes based on factors related to such concerns as credit quality, liquidity, operational risk, or reputation risk. Nevertheless, the ad hoc nature of the current tax system has introduced a heterogeneous mishmash of complexities that are equally difficult to understand and perhaps harder to justify than the factors that go into financial valuations.

From a congressional perspective, implementing a broad mark-to-market tax system could be a form of political suicide. How many taxpayers would want to pay a tax because the value of their Intel stock rose by 20 percent? However, if Congress enacts this change together with a large cut in the tax rate, the change might be more palatable. Voters may be more willing to pay a tax on a change in value if the tax rate were 12 percent instead of 28 percent or 34 percent.

The more fundamental question is whether Congress and the IRS can give up some of the history that has put so many conflicting and confusing layers in the tax law. That may depend on the public's ability to accept a system that abandons an almost religious belief in sale or other disposition as a precursor to recognition. The tax system evolved in response to specific transactions, waiting for financial innovation to provide new questions and to suggest new solutions. The cat and mouse game between the IRS and taxpayers continues, and Congress and tax regulators fill in the holes one at a time. Given the rate of innovation, it seems unlikely that regulatory refinements will ever keep up.

Of course, even if lawmakers could perfect domestic transactions under the U.S. system, they will not have solved everything. Variations between different countries' tax systems will always provide opportunities for tax arbitrage, as evidenced by the movement of many hedge funds and other investment companies offshore. A more comprehensive tax system might end up encouraging this migration. Congress must ultimately decide whether such threats should deter efforts to simplify the tax code and make it more consistent. If Congress does decide to improve the tax system, FAS 133 could provide some important principles that lawmakers can use to begin their debate. R

Editor's Note: *In late November, the D.C. Bar Association offered a special program on derivatives. One of the panelists was John Buckley, Democratic chief counsel for the House Ways and Means Committee. Noting that the tax system is slowly adopting mark-to-market approaches, he said he favored extending the effort to include derivatives. Buckley added that fasb's adoption of Standard 133 was "an interesting and important step" toward a simpler recordkeeping and tax system.*