

TAX LAW REVIEW

VOLUME FORTY EIGHT

NUMBER THREE

COMMENTARY
DEFERRING TAX LOSSES WITH AN EXPANDED § 1211

CALVIN H. JOHNSON

NEW YORK UNIVERSITY SCHOOL OF LAW

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Commentary

Deferring Tax Losses With an Expanded § 1211

CALVIN H. JOHNSON*

I. INTRODUCTION

Loss limitations, such as those in § 1211, seem to be necessary within a realization-based tax system so long as the taxpayer has the ability to select which assets to sell within the tax year and which to hold until another tax year. Absent limitations, rational investors would invest in volatile investments, both real and synthetic, and would report a perpetual series of tax losses, while breaking even economically or gaining ground. Even where the investor had no hidden gains as it turns out, an asymmetry in which losses may be recognized immediately and gains deferred indefinitely gives too much incentive to volatile investments.

Robert Scarborough argues that the § 1211 loss limitations need to be expanded beyond "losses from the sale or exchange of a capital asset," which are covered under current law, to cover losses on bets more generally.¹ Under Scarborough's system, betting losses would be usable against betting gains, but not against interest or compensation income. Scarborough shows that bets can be made with a taxpayer's liabilities as well as with assets, and that bets can arise in transactions that are not sales or exchanges.

Scarborough's arguments are a contribution to the literature. If anything, his fault is in stopping too soon. Scarborough, for instance, would not "impute" interest where no payments occur.² The force of his logic, however, seems to require that a zero interest be disaggregated into a payment of anticipated interest, offset by the outcome of a bet. Scarborough also apparently would not apply his system to all

* Professor of Law, University of Texas. This paper is based on a prior panel presentation to the Committee on Sales, Exchanges and Basis, Tax Section of the American Bar Association.

¹ Robert H. Scarborough, Risk, Diversification and the Design of Loss Limitations Under a Realization-Based Income Tax, 48 Tax L. Rev. 677, 701 (1993).

² Id. at 709.

cases where material losses can be realized selectively, but would define the frontiers of his system by looking at a noisy set of factors.³

A proper tax structure should neither encourage volatility nor make risky transactions rational that would be irrational in absence of a tax. To remove volatility incentives from the tax system, an investor must expect, when he makes an investment, that the time-adjusted tax rate applied to any losses will be no higher than the time-adjusted tax rate applied to any gains. If gains can be deferred, losses must be deferred as well.

II. THE CASE FOR LOSS LIMITATIONS

For practitioners, the capital loss limitations are a curse. The limitations generally provide that capital losses may be used only against recognized capital gain,⁴ and if the taxpayer has no such gains, recognition of the losses is deferred, possibly indefinitely, until offsetting capital gains are recognized.⁵ Over the years, tax planners have spent a fair amount of energy trying to characterize losses as unrestricted ordinary losses or as losses not arising on a sale or exchange. Capital loss limitations discourage losses, and while losses are not beneficial, viewed in isolation, losses inevitably arise in risky transactions and risky transactions are sometimes benign or beneficial.⁶ Capital losses are economic losses that already have reduced the taxpayer's wealth. Capital loss restrictions operate only when the losses have been realized, recognized and have satisfied all other limitations in the Code. Still, the loss limitations, or some equally unpopular substitute, seem to be required to counteract selective realization by the taxpayer.

A. *Hidden Gains*

The loss limitations rules function, first, to prevent a taxpayer from deducting realized losses while keeping economic gains hidden from tax. Assume, for example, that an investor *I* buys two volatile investments, *A* and *B*, for \$100,000 each. Assume either that the § 1211 restrictions have been repealed or that investments *A* and *B* are not

³ *Id.* at 710-11.

⁴ Individuals may deduct up to \$3,000 a year of capital losses against ordinary income. IRC § 1211(b). For substantial losses, \$3,000 is not a material amount and it is ignored here. Corporations may offset capital losses only against realized capital gains. IRC § 1211(a).

⁵ Individuals can carry capital losses forward indefinitely until death. Corporations, however, must use the capital losses within a total of nine tax years (the year of the loss, the prior three years and the subsequent five years); after a five-year carryforward, corporate capital losses expire. IRC § 1212(a)(1).

⁶ Scarborough, note 1, at 685. See J.E. Stiglitz, *The Effects of Income, Wealth, and Capital Gains Taxation on Risk-Taking*, 83 Q.J. Econ. 263 (1969).

capital assets.⁷ *A* and *B* are purchased shortly before the end of the tax year, but they are volatile enough to change dramatically in value by year end. By year end, investment *A* has appreciated to \$170,000 while investment *B* has dropped in value to \$50,000. Overall, *I* has improved his position from \$200,000 to \$220,000.

I sells investment *B* by year end, realizing the \$50,000 loss, but holds investment *A* until death. The tax rate on the gain from *A* is zero, because of deferral and then exemption.⁸ If capital losses were deducted against salary and other ordinary income taxed at a 41% tax rate, *I* would show only the \$50,000 tax loss from the two investments (worth \$20,500 in a 41% bracket) when, in fact, he has improved his economic net worth by \$20,000.

When losses are deductible, *I* can afford to lose money as a matter of pretax economics. In the next year, *I*, therefore, moves two \$100,000 amounts from sound, nonfluctuating investments into a new set of volatile investments, *C* and *D*. Investment *C* appreciates to only \$130,000 and investment *D* drops to \$50,000, so that overall the investments go from \$200,000 to \$180,000 and *I* loses \$20,000 before tax. By selling the loss property *D* while holding the gain property *C*, however, *I* would report a \$50,000 tax loss. A deduction of the \$50,000 loss against 41% bracket salary income would add \$20,500 value to the transaction and would make the money-losing transaction profitable after tax. The tax system then causes bad investments because investors shift their investments from nonfluctuating profit-making investments to investment sets like *C* and *D* that lose money.

Although this example involved the investment of substantial capital for at least a short period of time, the strategy depends on volatility and not length of investment. Thus, interest costs incurred to borrow the capital need not be substantial. The required volatility can exist, moreover, with puts and calls or private contracts and other kinds of synthetic capital. All that is needed is sufficient volatility in the transaction for a loss to accrue this year, while the gain is deferred to another tax year. If an investor is in a position to lose \$20,000 of real money (provided the investment can generate a tax loss of \$50,000), there should be many investors willing to take positions on the other side to supply the loss. There also seems to be no intrinsic limit as to

⁷ The most promising assets for this strategy under current law include assets described by § 582(c) (debt held by bank, savings and loan or small business investment company is ordinary asset), § 1221(1) (property held for sale to customers in ordinary course of a trade of business, including real estate taxpayer has improved), § 1231(a)(2) (net losses from sale of real property used in a trade or business) and § 1232 (options to buy or sell ordinary assets).

⁸ IRC § 1014.

the frequency with which the strategy is used and the amounts involved.⁹

The taxpayer realizes a \$50,000 tax loss in the examples, but the loss is not economic, viewing the taxpayer's position as a whole because unrealized gain offsets the realized loss. Losses offset by unreported gains might be called "hedged losses." These "hedged losses" motivate the § 1211 restrictions. Section 1211 matches the hedged loss against realized capital gain by deferring the losses until the gains are realized.

The problem of hedged losses is much like that posed by straddles. Section 1092 defers losses on one leg of a "straddle" if the taxpayer has unrealized gain from the other leg.¹⁰ Section 1092 is targeted, however, to positions that the taxpayer knew were offsetting when undertaken,¹¹ whereas, selective realization of losses is a problem whenever realized losses turn out to be offset by unrealized gains, even when there was no assurance when the investments were made as to how the risks would affect each other. Unrealized gain offsets the reported loss even if the gain property has few resemblances or ties to the loss property.

B. Asymmetrical Expected Tax Rates

Where a taxpayer does not have unrealized gains to offset the losses, the reported losses represent real losses even considering the taxpayer's complete position. Explaining § 1211 solely in terms of matching implies that losses should be allowed to the extent they exceed unrealized gains.¹²

The realize-losses, defer-gains strategy distorts investment, however, even when there are no hidden gains, because prior knowledge

⁹ At the extreme, without loss limitations, investments will resemble the old joke: A guy walks into the bar and tells the bartender, "I flipped a coin 100 times and came up with tails 47 times in a row." "Forty-seven times in a row?" the bartender says, not believing a word of it. "What are the odds against that one? Is that some of kind of a record?" "It wasn't so hard," the guy answers, "I just stopped counting heads."

¹⁰ Any disallowed loss is carried forward and treated as sustained in the following year. IRC § 1092(a)(1)(B).

¹¹ IRC § 1092(c) (defining a "straddle" as offsetting positions and defining "offsetting positions" in terms of "a substantial diminution of the taxpayer's risks"). Section 1092(c)(3) presumes, for instance, that puts and calls in the same commodity or in debt of the same maturity are offsetting positions. Also presumed to be a straddle are "positions [that] are sold or marketed as offsetting positions (whether or not such positions are called a straddle, spread, butterfly, or any similar name)." IRC § 1092(c)(3)(A)(iv).

¹² See, e.g., IRC § 1092(a)(1) (deferring loss deductions on straddles, but allowing immediate deduction to the extent the loss exceeds the offsetting gain position of the straddle, other than on "identified straddles"); ALI Federal Income Tax Project, *Integration of the Individual and Corporate Income Taxes*, Reporter's Study 132 (1993); see also Scarborough, note 1, 680-81.

that the strategy can be used gives an investor a strong incentive to favor volatility. Investments *C* and *D*, for example, were irrational before tax (two \$100,000 investments had an outcome of \$180,000 with a loss of \$20,000), but rational after tax because the tax loss added value to the transaction. Suppose, however, \$130,000 and \$50,000 were not outcomes of separate investments, but rather equally possible outcomes of a single \$100,000 investment *E*, which is irrational before tax. With a 50% chance of gaining \$30,000 and 50% chance of losing \$50,000, *E* has a negative expected value.¹³ But if the \$50,000 loss can be deducted immediately in a 41% tax bracket, the after-tax loss will be only \$29,500 and if the gain can be deferred indefinitely, the full \$30,000 of wealth will remain after tax. *E* is equally likely to produce a \$30,000 gain or a \$29,500 loss and that is a bet with a positive expected outcome.

The incentive problem created by the realize-losses, defer-gains strategy is the asymmetry in the real or time-value adjusted rate of tax on gains and losses. Losses taken immediately save tax at the nominal statutory tax rate, whereas, deferred gains bear tax at less than the nominal rate because of deferral.

The seriousness of the distortion from asymmetrical rates can be attributed to the quite modest time-value adjusted, effective rate of tax imposed on the gain leg of a bet on long-term investments. The average effective tax rate on gain from stock has been estimated at between 2.3% and 11%.¹⁴ It has been estimated that some 75% to 80% of appreciation in the economy escapes tax by reason of § 1014.¹⁵ The combination of deferral and § 1014 drops the effective rate on average into the 2% to 11% range. Deducting losses immediately against income in a 41% bracket, while taxing gains at an effective tax rate of 2% to 11%, means that there is a spread of 23% to 39% between the real tax rate that generates the tax savings for losses and the real tax rate applied to the gain. The combination of high rates for

¹³ $(\$30,000 + -\$50,000)/2 = -\$10,000$.

¹⁴ Alan J. Auerbach, *Capital Gains Taxation and Tax Reform*, 42 *Nat'l Tax J.* 391, 394 (1989) (effective tax rate of 11%); Martin J. Bailey, *Capital Gains and Income Taxation, in The Taxation of Income from Capital* 11, 22, 26 (Arnold C. Harberger & Martin J. Bailey eds., 1969) (effective tax rates of 8% to 9%); Jane G. Gravelle & Lawrence B. Lindsey, *Capital Gains*, 38 *Tax Notes* 397, 400 (Jan. 25, 1988) (5.6%); Calvin Johnson, *Undertaxation of Holding Gains*, 53 *Tax Notes* 807, 812 (Mar. 11, 1992) (2.3%).

¹⁵ Laurence J. Kotlikoff, *Intergenerational Transfers and Savings*, 2 *J. Econ. Persp.* 41, 43 (1988) (75% of gains excluded by death); Laurence J. Kotlikoff & Lawrence H. Summers, *The Role of Intergenerational Transfers in Aggregate Capital Accumulations*, 89 *J. Pol. Econ.* 706 (1981) (80% of wealth passes to next generation). See also Johnson, note 14, at 812 (investors disproportionately pass on high gain property and consume low gain property, so that if 80% of all wealth is passed to the next generation, considerably more than 80% of tax on built-in gain must be passed on).

losses and low rates for gains creates a negative tax that *adds* value to the expected pretax economics.¹⁶

Spreads of that magnitude create a material and unjustified incentive for volatility. One might argue for incentives for savings and real investment, but it is difficult to think of any justification for incentives structured to increase volatility or risk, especially at the edge of the rocket-scientist arrangements, where the realize-losses, defer-gains strategy can be used so easily. All other things being equal, risk is a real economic cost that should be discouraged rather than subsidized.

The incentive for volatility results not from deferral also of gains alone, but rather from an asymmetry in which gains are deferred but losses are not. Deferring losses until deferred gains were taxed would yield a lower than statutory tax rate, but no incentive for more volatile investments. Assume, for instance, a stable investment *F* that will grow at a guaranteed 5% rate for seven years. Thus, a \$100 investment will be worth \$140.71 pretax in seven years. Assume another investment *G* that has a 50% chance of growing to \$281.42 in seven years and a 50% chance of becoming worthless. To risk-neutral investors, both investments have the same expected pretax terminal value.¹⁷

Assume a 60% tax rate imposed on sale in seven years. The 60% tax reduces the final position on *F* from \$140.71 to \$116.28,¹⁸ which is identical to the after-tax return if a 56% tax had been imposed annually.¹⁹ The deferral alone partially reduced the real time-adjusted tax rate.

Still, the lower 56% rate would not encourage risky investment *G* over guaranteed investment *F*. If both the gain and the loss on risky investment *G* were recognized only in year seven, it also would have its expected position reduced by tax from \$140.71 to \$116.28, that is, by the same 56% tax.²⁰

If, by contrast, the loss is deductible earlier than the end of seven years and the tax savings is allowed to grow in value, the more volatile

¹⁶ The asymmetry of effective tax rates for gains and losses could be partially eliminated by increasing the tax on holding gains, for instance, by charging interest on delayed tax when the property ultimately is sold. See, e.g., Alan J. Auerbach, *Retrospective Capital Gains Taxation*, 81 *Am. Econ. Rev.* 167 (1991). Repeal of § 1014 would prevent 75% to 80% of gains from disappearing from the tax base. Any *increase* in tax on gains is likely to *increase* the rate of savings: Most savings appear to be targeted savings in which high after-tax returns reduce the rate of savings. An increase in tax on gains also would ease the shift toward investments that have low realized income and high unrealized holding gains.

¹⁷ $(\$281.42 + 0)/2 = \140.71 .

¹⁸ $\$140.71 - (\$40.71 \times 60\%) = \$116.28$.

¹⁹ The after-tax position of \$116 is like an after-tax growth at 2.2% because $102.2^7 = 116$. A tax that reduces the after-tax annualized return from 5% to 2.2% is a reduction of the annualized return by 56% because $(5\% - 2.2\%)/5\% = 56\%$.

²⁰ $[(\$281.42 - (60\% \times \$181.42)) + [0 + (60\% \times \$100)]]/2 = \$116.28$.

investment *G* would be not just equal to investment *F* but better after tax. Assume, for instance, that *G* is sold on an efficient market that makes the price reflect contingencies as soon as they are known and thus, the value of *G* drops to zero quickly (a smart market would reduce the sales price of an investment to zero as soon as contingencies are clear that make it worthless). If the \$60 tax savings occurs soon after the investment starts and is allowed to grow for seven years at 2.2% (the expected after-tax rate), the \$60 grows to \$69.87. The 50% chance of losing has an expected value of \$34.46 (50% x \$68.92) and the overall position has an expected worth of \$120.74 (\$86.28 + \$34.46). Nonvolatile investment *F* had a value of only \$116.28 after-tax. The immediate loss and deferred gain favored volatile investment *G* over *F*.

Since the incentive for volatility is caused by asymmetrical deferral of gains, but not losses, rather than by the deferral inherent in the realization system alone, the § 1211 remedy, deferring losses until there are gains, addresses the cause of the difficulty.

One might also fix the asymmetry, at least in theory, by reducing the tax rate applied to losses. Section 1211 could be replaced, for instance, with an immediate tax savings at a rate that approximates the expected tax rate on holding gains, adjusted to reflect expected deferral in paying the tax. Assume, for instance, that an investor acquires an investment for which the effective tax rate applied to gains is expected to be 6.5%, that is, the midpoint in the range of estimates of the overall effective tax rate on long-term investments.²¹ The investor might be given an immediate deduction for losses, but only at the 6.5% rate expected with respect to gains.

An immediate tax deduction for losses at a modest tax rate so as to achieve symmetry with the tax on gains is more of a theoretical idea than a practical suggestion. Investors and investments have widely diverging expected tax rates for gains, depending, for example, on such things as the investor's life expectancy and his need to liquidate the investment. A single tax rate applied to every investment will give some investors asymmetrical rates favoring volatility and some asymmetrical rates penalizing volatility. The investor might well know whether a 6.5% rate for losses is generous or not for any given investment. The investor will decide to favor or avoid risky investments depending on the investor's estimate of expected tax rates, but it seems impossible for the government to adjust the tax rate on losses to fit the wide variations in investor expectations.

²¹ See note 15.

The § 1211 limitation has been said to result in overtaxation of risky investments and to cause investors to avoid fluctuating investments.²² To test this suggestion, however, it is necessary to examine not only loss limitations, but also the time-adjusted tax rate for losses as compared to the real, time-adjusted tax burden on gains. The tax system would neither encourage nor discourage riskiness and volatility if the expected effective tax rate for losses were the same as the expected tax rate for gains.

The current capital loss limitations seem, if anything, too generous under this standard. Section 1211 occasionally may result in complete loss disallowance, but it comes nowhere near to ignoring 75% to 80% of losses, as § 1014 does for gains. Section 1211 also generally does not defer losses for the 15 to 20 years that is common for long-term investments.²³ If the tax system were neutral between volatile and steady investments for long-term investing, the tax rate available for losses would have to be in the range of the 2% to 11% effective rates available for gains. Loss limitations, viewed in isolation, may discourage risk, but the phenomenon seems likely to be swamped by the advantages of deferring gain. Under current law, volatile investments seem to be undertaxed relative to stable ones and that induces a shift to greater risk.

C. Loss Limitations for Ordinary Assets

As Scarborough points out, the fact that gain from an asset is taxed at ordinary rates does not justify an exemption from the § 1211 limitations.²⁴ The 1986 Act eliminated the difference between ordinary in-

²² See, e.g., Stiglitz, note 6, at 265.

²³ There are two additional reasons to think that § 1211 does not reduce the effective tax rate for losses below the effective tax rate for gains. First, taxpayers control realization not only to defer tax gains and accelerate tax losses, but also to realize their gains and losses in the best possible tax bracket. Gains should be realized when outside income is low and losses should be realized to offset high outside income. The flattening of the tax rates since 1981 reduces, but does not eliminate, this effect. (For example, rates for individuals in 1981 ranged from 14% to 70%, IRC § 1 (before amendment in 1986), in 1986 (prior to the 1986 Tax Reform Act) they ranged from 11% to 50%, IRC § 1 (before amendment in 1986), and, now, range from 15% to 39.6%. IRC § 1.) Furthermore, the gains and losses themselves affect the bracket, so that the advantage of rate choices will be flattened or reversed by the gain or loss itself.

Second, losses are usable under the loss limitations against the earliest gains realized, rather than against the gains deferred for an average period of time. They are offset against any realized gains, even though the investor holds most gains until death. To ensure a symmetry of tax rates for gains and losses, losses should be deductible at the rate determined from the average or overall time-adjusted tax rate on gains, not at the effective tax rate applied to the first realized gains.

²⁴ Scarborough, note 1, at 682.

come tax rates and capital gains tax rates for a time,²⁵ but did not obviate the need for the loss limitations, as long as the taxpayer has discretion to realize those gains and losses. If the taxpayer never realizes the gain leg of his investments, for instance, it does not matter whether the nominal tax on that gain is a preferential 28% rate or a draconian 90% rate.

Section 1211 currently applies only to losses on the sale or exchange of capital assets, which means that it does not govern a number of investments in which one would expect to see a very wide spread between the time-value adjusted tax on gain and the immediate tax rate applied to losses. Under § 1231, for instance, net loss from the sale of building and equipment used in a business is a fully deductible ordinary loss. Buildings, especially, are held long-term, so that the loss limitations should apply to bring the tax for gains and losses into symmetry. In *Cottage Savings Association v. Commissioner*,²⁶ to cite another example, the Supreme Court held that a bank realized a loss when it swapped one package of debt securities for another. Under § 582(c), debt held by a bank or savings and loan association is an ordinary asset, exempt from the capital loss limitations. Long-term debt, however, fluctuates dramatically in value as interest rates fluctuate. A bank is free to sell portfolio debt to realize a loss or to hold the debt to defer the gain. Long-term debt securities generate very substantial disparities in the tax rate applied to gains and to losses. The banks in *Cottage Savings* knowingly took advantage of asymmetrical effective tax rates to produce negative taxes that increased the value of risky debt securities.²⁷

D. Hedges as Ordinary Assets

The availability of the realize-losses, defer-gains strategy also makes it unfortunate that the Tax Court and the Service treat hedging transaction losses as ordinary losses. In *Arkansas Best Corporation v. Commissioner*,²⁸ the Supreme Court cut back on the *Corn Products*²⁹

²⁵ The Tax Reform Act of 1986 imposed a maximum tax rate of 28% on both ordinary income and capital gain, although it also had a phase-out bubble that could impose a 5% surtax only on ordinary income. IRC § 1(a)-(d), (g), (i) (as amended by Pub. L. No. 99-514, §§ 101, 301, 100 Stat. 2085, 2096, 2216). The 1993 Act kept the 28% maximum tax on capital gains, but increased ordinary rates up to 41% (considering two phase-out surtax bubbles). IRC §§ 1(a), 68, 151(d)(3) (as amended by the 1993 Act, Pub. L. No. 103-66, § 13201, 107 Stat. 416, 457).

²⁶ 111 S.Ct. 1503 (1991).

²⁷ The taxpayer in *Cottage Savings* exchanged a pool of mortgages for another pool of nearly identical mortgages pursuant to a program sponsored by the Federal Home Loan Bank Board, whose "acknowledged purpose . . . was to generate tax losses . . . that would not substantially affect the economic position of the transacting S&L's." Id. at 1506.

²⁸ 485 U.S. 212 (1988).

doctrine in a way thought to make many hedging transactions subject to the capital loss limitations for the first time.

In *Federal National Mortgage Association v. Commissioner*,³⁰ however, the Tax Court held that losses on business hedges were ordinary assets exempt from the loss limitations. The Federal National Mortgage Association or "Fannie Mae" was created by Congress, originally as a government entity, in order to provide a secondary market for housing mortgages and its primary assets are mortgages bought in portfolios or pools from the originating banks. A rise in interest rates destroys Fannie Mae's profits (just as it destroyed the profits of the savings and loan industry) because the portfolios are mostly long-term, fixed-rate mortgages, which drop in value when interest rises, and Fannie Mae finances most of the portfolio with debt, which becomes more expensive when interest rises. Fannie Mae tried to protect itself with respect to specific commitments to buy long-term indebtedness by purchasing puts and short sale positions on risk-free long-term government debt. A general rise in interest rates would have made the puts and short sale positions more valuable, which would offset partially the losses Fannie Mae would suffer on increased debt costs (and decreased portfolio value). Interest rates did not rise, however, and in 1985 and again in 1986, Fannie Mae lost the purchase price of the expired puts and suffered a loss under its obligations to perform under the futures and short sale contracts. The Tax Court held the hedges were an integrated part of Fannie Mae's mortgage business and held that the hedge losses were ordinary losses.

The ordinary asset "remedy" was a mistake if it was meant to allow Fannie Mae to deduct the loss leg of the hedge immediately, in circumstances in which Fannie Mae reported the gain leg of its transaction over the life of the mortgage portfolios. If the costs of the hedges were so integrated to Fannie Mae's mortgage business, the costs should have been capitalized to match the income from that business. Fannie Mae proved to the satisfaction of the court, a connection between its put and short sale hedging activity and specific commitments to acquire mortgage pools. The hedging losses thus should have been treated as costs of those commitments and written off over the approximately 30-year life of those mortgages.³¹ The capital loss limita-

²⁹ *Corn Prods. Ref. Co. v. Commissioner*, 350 U.S. 46 (1955).

³⁰ 100 T.C. 541 (1993) discussed in Scarborough, note 1, at 704-05 nn.65-66.

³¹ See Rev. Rul. 81-160, 1981-1 C.B. 312 (commitment fees and standby charges paid by borrower were in nature of price paid for option and they are amortized over life of the loan); Rev. Rul. 57-400, 1957-2 C.B. 520 (bank must capitalize fee paid to make loan over the life of the loan).

The Service, under a great deal of lobbying pressure, has acquiesced in *Fannie Mae*, by issuing regulations treating "business hedges," as narrowly defined, as ordinary assets.

tion the Service sought to apply was probably less drastic a remedy than matching would call for because Fannie Mae probably will be able to use its § 1211 capital losses, using its investment resources to generate capital gain, long before it recognized the interest income that the business hedges protected.

Treating Fannie Mae's losses as capital losses, however, also would have been a bad result. Fannie Mae might never have any capital gain, at least absent some tax planning. A portfolio of debt securities held by a bank or savings and loan association is comprised of ordinary assets³² and Fannie Mae had conceded in prior controversies that its mortgage and other debt holdings were ordinary assets.³³ Income on the sale of its primary assets would be ordinary, unshelterable gains.³⁴ Absent future capital gains, § 1211 operates as a death warrant for costs. The costs are not just deferred, but disallowed permanently.

Determining when capital losses can be used is a hard problem. Defining too broadly the items capital losses can shelter means that material risk incentives will remain. For example, defining shelterable gains to include all of the taxpayer's income permits an investor to use the realize-losses, defer-gains strategy as far as it needs to, that is, to shelter all of its taxable income. Defining shelterable gains too narrowly, by contrast, will cause the taxpayer to have no future gains to shelter, and the remedy, intended to match costs to associated future gains, instead will disallow costs permanently.

Business hedges, exempted from the capital loss limitations, are positions taken to offset fluctuations in interest rates, price changes or currency values that would destroy the value of taxpayer's inventory and other ordinary assets and only if the taxpayer identifies the other leg of its position. Reg. § 1.1221-2(b). The IRS simultaneously issued proposals that would require business hedges to be reported under some kind of accounting method that "reasonably" matches the timing of the losses with related gains under clear reflection of income standards (but this rule does not apply to a farmer or a cash method taxpayer with less than \$5 million gross receipts). Reg. § 1.446-4. Of course, even small farmers and cash method taxpayers have to capitalize capital expenditures and are subject to § 1211, and the "clear reflection of income standards," as applied by the courts, have not been an unyielding rock. In yielding, the Service is not doing a very good job of insuring that losses cannot be selectively realized before gains.

³² IRC § 582(c).

³³ *Federal Nat'l Mortgage Ass'n*, 100 T.C. at 545. The court did not specify the legal ground of the agreement that the mortgages were ordinary assets.

³⁴ Fannie Mae should have been able to create some capital gains, by investing in some capital assets, had it lost its case. As argued in text accompanying note 53, the best solution for hard problems often is to let the taxpayer use a private or planning remedy in the most efficient way possible.

received.⁴³ Since 1984, "interest-free" loans have been re-analyzed as if there were a receipt of interest, combined with a counter payment with its own tax character.⁴⁴ Extending inevitable interest from investments in debt to investments in general is a small step.

B. Critique of Scarborough: What Scope?

Scarborough would not apply his betting loss limitations to all bets. He would not "impute" interest received on an investment where none existed and he would not apply the system where he does not consider the abuse to be serious, as determined by a vague set of factors.⁴⁵ This Section first argues that his system is sound enough to cross over the boundaries he would erect. Second, the Section argues that Scarborough's effort to create additional shelterable income by identifying *excessive* business returns is doomed to failure. Finally, the Section criticizes Scarborough's facts and circumstances boundary and attempts to articulate how far, at least in theory, his reforms should reach.

1. Imputed Interest

Scarborough "does not propose to impute income when none exists under current law."⁴⁶ To use his example, if an investor realizes a \$2 return from an investment when the expected return is \$5, Scarborough would not view the investor as realizing \$5 of income, offset by a \$3 betting loss.

The failure to impute interest, offset by a restricted betting loss, makes it hard to see a coherent rationale in Scarborough's schedules. It is plausible to argue that interest should be unshelterable because it is inevitable. The opportunity to earn interest forces discounting of future cash to a net present value. Disaggregating investment returns into a risk-free interest rate plus or minus a bet is, as Scarborough puts it, "fundamental to modern finance theory."⁴⁷ The logic of § 7872 is that there is no such thing as an interest-free or low-interest loan, at least when the loan amount is substantial. A low- or no-inter-

⁴³ IRC § 1272 (originally enacted as IRC § 1232A by the Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, § 231, 96 Stat. 324, 496). IRC § 1274, enacted by the Tax Reform Act of 1984, Pub. L. No. 98-369, § 41, 98 Stat. 494, 538, extended the current accrual of interest to liabilities received on substantial sales of property.

⁴⁴ IRC § 7872 (enacted by the Tax Reform Act of 1984, Pub. L. No. 98-369, § 172, 98 Stat. 494, 699).

⁴⁵ Scarborough, note 1, at 710-11.

⁴⁶ *Id.* at 709. In the same paragraph, however, Scarborough allows that his system might be changed to impute interest.

⁴⁷ *Id.* at 683 n.18 and sources cited therein.

est loan is instead a payment of market-rate interest, offset by some counter payment that has its own tax character. I would have thought the logic of § 7872, imputing market-rate interest, was inescapable here. Refusing to impute interest means that Scarborough's system would prohibit betting loss from sheltering unrelated interest income, but would allow betting loss to shelter interest that is internal to the investment. The distinction between shelterable internal interest and unshelterable external interest would be hard to police and makes no sense in any event.

2. *Excessive Business Income*

Scarborough's refusal to impute interest might be viewed as a concession to administrability, except that he is willing to go to considerable lengths to find "excessive" business income to place on the betting schedule for betting losses to shelter. Businesses commonly hedge against adverse currency or price changes to preserve their regular business profits with puts, futures or short sales. If the adverse change does not occur, the business ends up with the ordinary business income it sought, combined with losses in the form of the costs of expired puts or of fulfilling futures or short sales that have moved in the wrong direction. Scarborough would not allow the business to use those costs to shelter the business profits achieved at normal interest rates, but if the profits the business makes on its capital are higher than the unshelterable discount rate, he would allow the excessive portion to be offset by betting losses, including the costs of puts, futures contracts and short sales.⁴⁸

Calculation of excessive business profits seems doomed to failure. Scarborough would treat a business profit as excessive, by looking to its percentage of the current fair market value of the business capital and not to its percentage of historical cost.⁴⁹ Determining the value of business capital would require a calculation of the value of not only specific assets, for which some kind of market exists, but also the unallocated residual value, that is, the goodwill of the business as a whole. Nontax GAAP accounting steadfastly has refused to calculate the goodwill of a business as a whole prior to sale, on the grounds that it is not feasible.⁵⁰ I suspect that tax accounting, without help from the accounting profession, would have to follow suit.

⁴⁸ Id. at 711, 714-16.

⁴⁹ Id. at 713.

⁵⁰ Cf., e.g., William P. Hackney, *Accounting Principles in Corporation Law*, 30 *Law & Contemp. Probs.* 791, 813-23 (1965) (arguing that corporate law cannot feasibly use fair market value of assets to control dividend distributions, in part, because value requires valuation of the entire business).

Looking to returns as a percentage of goodwill value, moreover, largely will destroy the purpose of the endeavor. High return rates and high value investments are alternative explanations of the same phenomenon, and they have an inverse relationship to each other. One can describe a prosperous business either as having a high return on low investment or a normal return on a very valuable investment. If the return is volatile, one can describe the business either as making a lot of bets with its money or as having a capital and stock value that is fluctuating rapidly to give the normal discount rate. Yet, Scarborough would make one description—high interest rate—generate lots of shelterable income and he would make the other description—high capital value—generate only unshelterable income. The effort to distinguish the two is doomed.

Finally, businesses make excess profits for reasons other than winning on a bet. Businesses generate a great deal of compensation income by reason of the efforts and entrepreneurial skills of their founders. Arguably, compensation income has nothing to do with a bet; it is all skill. Businesses commonly earn rents, moreover, because they have a monopoly or protected position or because the market has not had time to react to their supra-fair market value returns. For investments purchased on large, efficient markets in which prices react quickly to available news, it is plausible that all returns available after the price has adjusted to news must be viewed as discount rate plus or minus random results of a bet. Plausibly, returns on fungible investments purchased in big markets have no compensation element. But for a real business with tangible, nonfungible assets and a custom-skilled work force, capital cannot move so quickly and prices do not adjust, so that premium returns can be due to rent, position or skill as well as to luck.⁵¹ In Scarborough's system, only luck would be shelterable. Again, the effort to distinguish shelterable from nonshelterable income seems doomed.

If Scarborough is concerned about hedges to protect normal business profits, moreover, then limitations like § 1211 are too crude to do a good job of matching. As noted, for instance, in *Federal National Mortgage Association v. Commissioner*, Fannie Mae paid for puts, short sales and futures contracts to protect its profits from specific pools of long-term debts it was committed to purchase. Proper matching would treat the costs of the hedges as acquisition costs of the specified pools purchased and would allow the costs to be amortized only

⁵¹ See, e.g., Lester C. Thurow, *Dangerous Currents: The State of Economics* 144-50 (1983) (emphasizing speed of price adjustments for financial instruments versus sluggishness of prices and persistent return variations on tangible business assets).

over the very long life of the debt.⁵² A § 1211 remedy would allow the costs to be written off over the first betting gains that Fannie Mae received from any source and that would occur, presumably, in too short a time to satisfy good matching. Capitalization and matching theory handles the deferral that is needed within the business better than a § 1211 remedy would. Investment costs treated as capital expenditures deferred by § 263 or by general accounting principles, would not be reached by a loss limitation system.

Scarborough's system would become more manageable if business operating income were not placed on the bet schedule. The system then would manage losses from discrete and identifiable investment or borrowing decisions, made on markets where prices adjust quickly and there is no compensation or rent. Once the system became more manageable, there would be less need to curtail its jurisdiction.

3. *The Facts and Circumstances Boundary*

Scarborough would not apply his loss limitations to bets on all assets and liabilities. He argues that there is no formula or bright-line rule to set the proper boundaries for his system, but only a set of factors. He would consider, for instance, the risk or liquidity of the asset or liability and the taxpayer's control over realization. Using these factors, he argues that there is a strong case for making nondividend-paying stock subject to his separate schedules, a moderate case for making long-term debt subject to the schedules and only a weak case for making short-term debt and short-term options subject to his rules.⁵³

It is difficult to know how much risk or control is too much, unless one has a theory about what is just right and some idea how to measure it. One cannot exercise judgment without knowing the baseline. Without a theory, the facts and circumstances are just noise and static, providing no answers and no way to settle disputes. Thus, a better theory of what needs to be measured must be articulated before trying to create or apply a factors test.

a. *The Underlying Theory*

There are two difficulties with unrestricted losses: equity and incentives. Taxpayers can shelter real consumable cash from tax with losses that are not real losses, viewing the taxpayer's wealth in aggregate.

⁵² See note 31 and accompanying text.

⁵³ Scarborough, note 1, at 711.

Under that theory, it is equitable to defer the taxpayer's losses whenever the taxpayer has unrealized gains on some assets.

Second, unrestricted losses permit taxpayers to achieve asymmetrical real tax rates by deferring gains but not losses. This asymmetry creates an incentive for volatile investments that bear negative tax. The seriousness of the negative tax should be judged according to the expectations an investor faces when he makes an investment choice. If tax savings from losses *can* come early, but tax costs on gains *can* come late, the losses should be deferred. If the net present value of the earliest possible tax savings is higher than with the net present value of the latest tax on gains, losses should be deferred.

b. Lean Pro-IRS

A loss limitation system probably has to be applied somewhat in favor of the Service and against the taxpayer. There is a tendency for penalties to heal automatically while loopholes only get worse. Taxpayers have a drive to exploit loopholes and achieve after-tax returns. Small holes become gaping holes in the dike, and there is no automatic remedy nor tendency for loopholes to close. Where limitations pinch too tight, by contrast, there is commonly a private cure that is reasonable and efficient. Taxpayers, for example, avoid permanently losing tax recognition of losses under § 1211 by diversifying their investments in capital assets so as to have capital gain. (This private planning remedy even has salutary nontax effects—the risks in undiversified portfolios are real social costs that diversification avoids.) Smart planners adapt to tax systems that inhibit risk in the cheapest possible ways, so that risk inhibitions tend to be self-healing. For many matters, the designers of a tax system should leave the correction of penalties on hard issues to private tax planners because they are so good at what they do.⁵⁴

The function of the tax system, moreover, is to raise revenue and some distortions may be inevitable in the process of raising revenue. To delegitimize a revenue-raising provision, one must show not only that it distorts behavior, but also that there is a feasible alternative way to raise the revenue with less distortion. Loss allowances, by contrast, which also lose revenue, have no leeway or allowance to be distortive because they cannot be justified by the need to raise revenue. Distortions must be reserved for raising revenue.

⁵⁴ If Fannie Mae, for example, had a problem of unusable losses, it was one that could have been avoided, at not very serious cost, by diverting some of its investments into capital gain. See note 34.

In structuring loss allowances, accordingly, a negative tax that would encourage volatility must be avoided. Losing revenue and encouraging volatility does double damage. To eliminate volatility incentives, an investor must expect when he makes the investment that the time-adjusted tax rate applied to losses will be no higher than the time-adjusted tax rate applied to gains.

c. Materiality

A strong sense of materiality is necessary in applying the income tax. Trivial issues can divert Service auditors away from more serious disputes. Some costs are too small to be worth accounting for.⁵⁵ Materiality should be defined with precision, however, both to avoid bogus materiality arguments and to produce a workable bright-line rule. A vague set of materiality rules is self-contradicting: More time and effort is spent arguing over what to argue about than would be spent simply deferring the costs. Current law has a fine bright-line "materiality" standard on loss limitations: Capital losses of \$3,000 may be deducted per year.⁵⁶ Because accounting has become relatively cheaper because of computer technology, the dollar level of materiality could even be moved down.

d. Distill the Problem

Scarborough also seems to exempt some discrete investments from his bet schedule because the investments generate a lot of periodic income, for instance, interest. It is a mistake to compare periodic income with selective realization in this way, because the framework allows a taxpayer to avoid the loss limitations by surrounding the selective realization strategy with enough nondiscretionary current income. Instead, the system should distill the losses and gains from a more complicated investment transaction and put the distilled bets on a separate schedule. Current law does this, for instance, by identifying restricted losses and shelterable gains solely as those from a sale or exchange.⁵⁷ The wisdom of current law could be used to expand the

⁵⁵ See IRC § 132(a)(4), (e)(1) (exempting de minimis fringe benefits from tax and defining "de minimis" as benefits so small as to make accounting for them unreasonable or administratively impracticable). Deferring costs is, however, not necessarily very expensive as a matter of accounting. Good matching by deferring costs for extended periods, is no more expensive accounting than keeping track of the costs for expensing.

⁵⁶ IRC § 1211(b)(1) (allowing individuals to deduct \$3,000 of capital losses against otherwise unshelterable ordinary income).

⁵⁷ Reg. § 1.1211-1(a), (b) (allowing corporations and individuals to deduct losses "sustained. . . from sales or exchanges" from capital gains from "sales or exchanges").

definition of sale or exchange, step by step, to describe losses that should be disallowed.

e. Reiterative Rollover

Scarborough also suggests that there is no need for loss limitations on short-term puts and calls.⁵⁸ Loss limitations need to be retained or extended to some cases, however, solely because of the annual accounting period. If a taxpayer can realize a loss by year end, while holding some property with offsetting gain, then the taxpayer can recognize a loss this year and roll taxable income over into the next year, even if the gain leg of a hedge is recognized very soon into the new year. Differences in realization of only a few days make a whole year's worth of difference in tax. A rollover of only a few days' duration can be the basis of continual annual rollovers that defer all of a taxpayer's income indefinitely. Before concluding that a mismatch between a gain and a loss is only short term, it should be clear that the taxpayer can never do it again.

f. Incremental Steps

It also may be that neither the theory or work for a real revision of the capital loss limitations has been finished and that Scarborough's perceptions can be used to expand § 1211 on an incremental basis. Scarborough argues persuasively that the premium paid to repurchase a corporation's issued debt and the losses from a junk bond are the kind of losses that need to be restricted.⁵⁹ It would be a very simple matter to define the redemption or worthlessness of an obligation as a sale or exchange for the purposes of § 1211. Loss limitations also should be applied to the loss reported by the taxpayer in *Cottage Savings*⁶⁰ and an expansion of the straddle provisions of § 1091 may be needed for broader coverage of very high volatility synthetic investments. Such modest and salutary steps may be the best that can be expected.

⁵⁸ Literally, his position would seem to repeal § 1092, deferring losses on tax shelters known as identified straddles. Straddles were fairly abusive under prior law. Section 1092 defers losses only on straddles, a transaction with a defined connection between the gain leg and the loss leg that leaves the investor ab initio with substantially less risk. See IRC § 1092(c)-(f) (defining covered straddles). As a matter of economics, it does not matter whether the gain leg resembles or is tied to the loss property, so long as the gain offsets the loss and maintains the taxpayer's fair market value net worth.

⁵⁹ Scarborough, note 1, at 713.

⁶⁰ *Cottage Savings Association v. Commissioner*, 111 S.Ct. 1503 (1991).