Senate Committee on Finance
U.S. Senator Orrin Hatch (R-UT), Ranking Member
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HATCH STATEMENT AT JOINT COMMITTEE HEARING ON TAX REFORM & TAX TREATMENT OF FINANCIAL PRODUCTS

WASHINGTON – U.S. Senator Orrin Hatch (R-Utah), Ranking Member of the Senate Finance Committee, today delivered the following remarks during a Joint Senate Finance-House Ways and Means Committee hearing on tax reform and the tax treatment of financial products:

Thank you, Chairmen Baucus and Camp for this hearing. And thank you Mr. Barthold and the staff of the Joint Committee on Taxation for producing this important report on the tax treatment of financial products.

Twenty-five years ago, the Tax Reform Act of 1986 was signed into law by President Ronald Reagan. At the time of the 1986 Act, which was the last major tax reform we have had in the United States, the tax treatment of financial instruments and derivatives was a relatively new and highly undeveloped area of our nation's tax law. In fact, derivatives were unknown to most of the American public, although early evidence of these types of instruments can be traced back to ancient Greece.

As I have said before, when Congress undertakes comprehensive tax reform —and it must — that reform should be based on the same three principles that led to the enactment of the Tax Reform Act of 1986: fairness, simplicity and economic growth. I am very much looking forward to hearing what our witnesses have to say today, particularly as these three principles relate to the tax treatment of financial instruments and derivatives.

Allow me to share a few of my initial thoughts. Financial instruments generally refer to stocks, bonds, hybrid instruments, and derivatives. Derivatives include options, forward contracts, future contracts, and swaps. They are called derivatives because their value is derived from some other asset, liability, or other measure. The use of derivatives has skyrocketed in the last 20 to 25 years. According to the Bank for International Settlements, in June 2011, the total notional amount of outstanding over-the-counter derivatives was $707 trillion. Of this amount, $554 trillion was due to interest rate contracts and $65 trillion to foreign exchange contracts. These figures are mind boggling — to give some perspective, the size of the U.S. economy is about $15 trillion.

In the last several years, there has been a lot of discussion of credit default swaps, which is a type of derivative. These swaps became front page news during the recent financial crisis involving Lehman Brothers and American International Group (AIG). According to the Bank for International Settlements, the volume of credit default swaps peaked at $58 trillion in 2007, and declined to about $30 trillion at the end of 2010. Surprisingly, given the size and number of credit default swaps, for a number of years, it was not clear how these swaps were treated for tax purposes. It was just three months ago that the U.S. Treasury Department issued proposed regulations addressing the tax treatment of credit default swaps.

Generally, the tax treatment of financial products involves three major issues: timing, character and source. The timing issue relates to when an item of income or expense is taken into account for tax purposes. The character issue relates to whether the income is ordinary income or capital gain. And the source issue relates to whether the income is U.S. source or foreign source. Although these three issues involve principles that are fundamental to the U.S. income tax system in general, they are particularly applicable to the taxation of financial products.

Again, I would like to thank our witnesses for attending this hearing and look forward to their comments on this timely and complex issue.

And again, Chairmen Baucus and Camp, thank you for holding this important hearing on tax reform.

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