COMMODITY TAX STRADDLES

HEARING

BEFORE THE

SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT

AND THE

SUBCOMMITTEE ON ENERGY AND AGRICULTURAL TAXATION

OF THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

NINETY-SEVENTH CONGRESS

FIRST SESSION

ON

S. 626

A BILL TO AMEND THE INTERNAL REVENUE CODE WITH RESPECT TO OFFSETTING POSITIONS IN PERSONAL PROPERTY, AND FOR OTHER PURPOSES

JUNE 12, 1981

Printed for the use of the Committee on Finance

U.S. GOVERNMENT PRINTING OFFICE

81-237 O WASHINGTON: 1981 HG 97-35

S.361-55

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COMMODITY TAX STRADDLES

FRIDAY, JUNE 12, 1981

U.S. SENATE, SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT AND SUBCOMMITTEE ON ENERGY AND AGRICULTURAL TAXATION,

Washington, D.C.

The subcommittees met, pursuant to notice, at 10:08 a.m., in room 2221, Dirksen Senate Office Building, Hon. Bob Packwood (chairman) presiding.

Present: Senators Dole, Packwood, Wallop, Symms, Byrd, and Moynihan.

[The press release announcing this hearing, the bill S. 626, and an explanation of same follow:]

Press Release No. 81-137

PRESS RELEASE

FOR IMMEDIATE RELEASE
May 28, 1981

COMMITTEE ON FINANCE
UNITED STATES SENATE
Subcommittee on Taxation and Debt Management
Subcommittee on Energy and Agricultural Taxation
2227 Dirksen Senate Office Bldg.

FINANCE SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT AND SUBCOMMITTEE ON ENERGY AND AGRICULTURAL TAXATION SET HEARING ON COMMODITY TAX STRADDLES

Senator Packwood, Chairman of the Subcommittee on Taxation and Debt Management of the Senate Committee on Finance, and Senator Wallop, Chairman of the Subcommittee on Energy and Agricultural Taxation, announced today that the Subcommittees will hold a joint hearing on June 12, 1981 on commodity tax straddles.

The hearing will begin at 9:30 a.m. on June 12, 1981, in Room 2221 of the Dirksen Senate Office Building.

The chairmen stated that the subcommittees would particularly welcome testimony on the general topic of taxation of commodity straddle transactions and specific testimony relating to S. 626, introduced by Senator Moynihan, which would defer the recognition of loss incurred in certain straddles, require capitalization of certain costs incurred in such transactions, and amend certain rules relating to classification of capital assets and capital asset transactions by dealers in securities.

Requests to Testify.--Witnesses who desire to testify at the hearing must submit a written request to Robert E. Lighthizer, Chief Counsel, Committee on Finance, Room 2227 Dirksen Senate Office Building, Washington, D.C. 20510, to be received no later than the close of business on June 5, 1981. Witnesses will be notified as soon as practicable thereafter whether it has been possible to schedule them to present oral testimony. If for some reason a witness is unable to appear at the time scheduled, he may file a written statement for the record in lieu of the personal appearance. In such case a witness should notify the committee of his inability to appear as soon as possible.

Consolidated testimony.--Senators Packwood and Wallop urge all witnesses who have a common position or who have the same general interest to consolidate their testimony and designate a single spokesman to present their common viewpoint orally to the subcommittees. This procedure will enable the subcommittees to receive a wider expression of views than it might otherwise obtain. Senators Packwood and Wallop urge very strongly that all witnesses exert a maximum effort to consolidate and coordinate their statements.

Legislative Reorganization Act.--The chairmen stated that the Legislative Reorganization Act of 1946, as amended, requires all witnesses appearing before the Committees of Congress "to file in advance written statements of their proposed testimony, and to limit their oral presentations to brief summaries of their argument."

(1) All witnesses must submit written statements of their testimony.

(2) 100 copies of the written statement must be filed not later than noon on the last business day before the witness is scheduled to appear. The written statements must be typed on letter-size paper (not legal size).

(3) All witnesses must include with their written statement a summary of the principal points included in the statement.

(4) Witnesses should not read their written statements to the Subcommittee, but ought instead to confine their oral presentations to a summary of the points included in the statement.

(5) Not more than five minutes will be allowed for the oral summary.

Written statements.--Witnesses who are not scheduled to make an oral presentation, and others who desire to present their views to the subcommittees, are urged to prepare a written statement for submission and inclusion in the printed record on the hearings. These written statements should be typewritten, not more than 25 double-spaced pages in length, and mailed with five (5) copies to Robert E. Lighthizer, Chief Counsel, Committee on Finance, Room 2227, Dirksen Senate Office Building, Washington, D.C. 20510, not later than Monday, June 22, 1981.

P.R. No. 81-137

II

97TH CONGRESS
1ST SESSION

S. 626

To amend the Internal Revenue Code with respect to offsetting positions in personal property, and for other purposes.

IN THE SENATE OF THE UNITED STATES

MARCH 5 (legislative day, FEBRUARY 16), 1981

Mr. MOYNIHAN introduced the following bill; which was read twice and referred to the Committee on Finance

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A BILL

To amend the Internal Revenue Code with respect to offsetting positions in personal property, and for other purposes.

1 *Be it enacted by the Senate and House of Representa-*
2 *tives of the United States of America in Congress assembled,*
3 **SECTION 1. SHORT TITLE, ETC.**
4 (a) SHORT TITLE.—This Act may be cited as the
5 "Commodity Straddles Tax Act of 1981".
6 (b) AMENDMENT TO 1954 CODE.—Except as otherwise
7 expressly provided, whenever in this Act an amendment or
8 repeal is expressed in terms of an amendment to, or repeal of,
9 a section or other provision, the reference shall be considered

1 to be made to a section or other provision of the Internal
2 Revenue Code of 1954.

3 **SEC. 2. NONDEDUCTIBILITY OF CERTAIN LOSSES IN CONNEC-**
4 **TION WITH OFFSETTING POSITIONS IN PERSON-**
5 **AL PROPERTY.**

6 (a) IN GENERAL.—Part VII of subchapter O of chapter
7 1 (relating to wash sales of stock or securities) is amended by
8 adding at the end thereof the following new section:

9 **"SEC. 1092. OFFSETTING POSITIONS IN PERSONAL PROPERTY.**

10 "(a) IN GENERAL.—In the case of any offsetting posi-
11 tion in personal property—
12 "(1) that portion of any loss—
13 "(A) which is incurred in connection with the
14 sale or exchange of any position held as part of
15 such offsetting position, and
16 "(B) which exceeds any gain recognized in
17 connection with the sale or exchange of any other
18 position held as part of such offsetting position,
19 shall be treated as incurred as of the close of the bal-
20 anced period; and
21 "(2) the holding period (as determined under sec-
22 tion 1223) of any position held as part of any offsetting
23 position shall not include any portion of the balanced
24 period with respect to the position.

1 "(b) OFFSETTING POSITIONS.—For purposes of this
2 section—
3 "(1) IN GENERAL.—A taxpayer holds an offset-
4 ting position in personal property if the taxpayer holds
5 1 or more positions with respect to personal property
6 which substantially diminishes the taxpayer's risk of
7 loss with respect to 1 or more other positions held
8 with respect to personal property (whether or not of
9 the same kind).
10 "(2) CERTAIN POSITIONS TREATED AS OFF-
11 SETTING.—
12 "(A) IN GENERAL.—Except as provided in
13 subparagraphs (B) and (C), 2 or more positions
14 shall, for purposes of paragraph (1), be treated as
15 offsetting if such positions include substantially
16 equivalent long and short positions and—
17 "(i) such positions are in the same com-
18 modity (whether or not in the same physical
19 form),
20 "(ii) the aggregate margin requirement
21 for such positions (determined on the ex-
22 change where traded or otherwise) is less
23 than that of the sum of the margin require-
24 ments for each such position held separately,

1 "(iii) such positions are in debt instru-
2 ments, or
3 "(iv) such positions are determined,
4 under regulations prescribed by the Secre-
5 tary, to be offsetting.
6 "(B) STANDARD DEVIATION.—No position
7 shall be treated as offsetting under subparagraph
8 (A)(iv) unless the standard deviation of the change
9 in price of 1 or more positions held as part of the
10 offsetting position has been at least 5 times the
11 standard deviation of the change in price of the
12 offsetting position taken as a whole during any 2-
13 year period occurring during the immediately pre-
14 ceding 5-year period.
15 "(C) SATISFACTION OF SECRETARY.—No
16 position shall be treated as offsetting under sub-
17 paragraph (A) (iii) or (iv) if the taxpayer estab-
18 lishes to the satisfaction of the Secretary that
19 such position is not offsetting.
20 "(c) OTHER DEFINITIONS AND SPECIAL RULES.—For
21 purposes of this section—
22 "(1) BALANCED PERIOD.—The term 'balanced
23 period' includes, with respect to any position—
24 "(A) any period during which such position
25 is part of any offsetting position, and

1 "(B) the 30-day period after the day on
2 which such position (or any successor position)
3 ceases to be offsetting.
4 "(2) PERSONAL PROPERTY.—The term 'personal
5 property' means—
6 "(A) commodities,
7 "(B) evidences of indebtedness, and
8 "(C) any other type of personal property
9 (other than stock in a corporation).
10 "(3) POSITION.—The term 'position' means an in-
11 terest (including a futures contract or option) in person-
12 al property. Any personal property acquired by the
13 taxpayer pursuant to a futures contract, option, or
14 other interest shall be treated in the same manner as a
15 position in such personal property.
16 "(4) LONG POSITION.—The term 'long position'
17 means a position which increases in value when the
18 personal property to which it relates increases in
19 value. Such term includes the holding of personal prop-
20 erty, or of a futures contract or option to buy personal
21 property at a fixed price, which so increases in value.
22 "(5) SHORT POSITION.—The term 'short position'
23 means a position that decreases in value when the per-
24 sonal property to which it relates increases in value.
25 Such term includes the selling of personal property

1 short, or the holding of a futures contract or option to
2 sell personal property at a fixed price which so de-
3 creases in value.

4 "(6) DEBT INSTRUMENT.—The term 'debt instru-
5 ment' means any interest bearing obligation.

6 "(7) ATTRIBUTION.—In determining whether any
7 positions are offsetting, the principles of section 318
8 shall apply, except that—

9 "(A) in determining constructive ownership
10 in the case of the members of an individual's
11 family, only such individual, such individual's
12 spouse, and a child of such individual who has not
13 attained the age of 18 shall be taken into account,

14 "(B) constructive ownership from a corpora-
15 tion to a person, or from a person to a corpora-
16 tion, partnership, trust, or estate, shall be deter-
17 mined only if—

18 "(i) there is at least an 80-percent in-
19 terest (determined after the application of the
20 family attribution rules) held by, or in, such
21 person, or

22 "(ii) in the case of a trust, the trust is a
23 trust to which subpart E of part I of sub-
24 chapter J applies; and

1 "(C) in the case of a passthrough entity, con-
2 structive ownership shall be determined under
3 paragraph (8).
4 "(8) TREATMENT OF PASSTHROUGH ENTI-
5 TIES.—
6 "(A) IN GENERAL.—In determining whether
7 any positions are offsetting, a person having an
8 ownership interest in any passthrough entity shall
9 be treated as owning a pro rata share of the per-
10 sonal property, or of any position in personal
11 property, of such entity equal to the person's pro
12 rata share of the ownership interest.
13 "(B) PASSTHROUGH ENTITY DEFINED.—For
14 purposes of subparagraph (A), the term 'pass-
15 through entity' means—
16 "(i) a regulated investment company,
17 "(ii) a real estate investment trust,
18 "(iii) an electing small business corpora-
19 tion,
20 "(iv) a partnership,
21 "(v) an estate or trust, or
22 "(vi) a common trust fund.".
23 (b) TECHNICAL AND CONFORMING AMENDMENTS.—

1 (1) The table of sections for such part VII is
2 amended by adding at the end thereof the following
3 new item:

"Sec. 1092. Offsetting positions in personal property.".

4 (2)(A) The heading for such part VII is amended
5 to read as follows:

6 "PART VIII—WASH SALES; OFFSETTING
7 POSITIONS".

8 (B) The table of parts for subchapter O of chapter
9 1 is amended by striking out the item relating to part
10 VII and inserting in lieu thereof the following:

"Part VII. Wash sales; offsetting positions.".

11 (c) EFFECTIVE DATE.—The amendments made by this
12 section shall apply to offsetting positions established after
13 May 5, 1981, in taxable years ending after that date.

14 SEC. 3. CAPITALIZATION OF CERTAIN CARRYING CHARGES.

15 (A) IN GENERAL.—Part IX of subchapter B of chapter
16 1 (relating to items not deductible) is amended by adding at
17 the end thereof the following new section:

18 "SEC. 280E. CERTAIN EXPENDITURES RELATING TO PROPER-
19 TY IN AN OFFSETTING POSITION.

20 "(a) IN GENERAL.—Any amount—
21 "(1) which would be allowable as a deduction but
22 for the provisions of this section,

1 "(2) which is allocable to personal property (other
2 than an option or a futures contract) which is part of
3 an offsetting position (within the meaning of section
4 1092(b)), and
5 "(3) which is allocable to the balanced period
6 (within the meaning of section 1092(c)(1)) with respect
7 to such personal property,
8 shall be charged to capital account.
9 "(b) CERTAIN AMOUNTS INCLUDED.—For purposes of
10 subsection (a)—
11 "(1) interest on indebtedness incurred or contin-
12 ued to purchase or carry personal property, and
13 "(2) any storage or insurance costs with respect
14 to personal property,
15 shall be treated as allocable to such personal property.".
16 (b) CONFORMING AMENDMENT.—The table of sections
17 for such part IX is amended by adding at the end thereof the
18 following new item:

"Sec. 280E. Certain expenditures relating to property in an offsetting position.".

19 (c) EFFECTIVE DATE.—The amendments made by this
20 section shall apply to expenditures made after May 5, 1981,
21 in taxable years ending after that date.

1 SEC. 4. CERTAIN GOVERNMENT OBLIGATIONS TREATED AS
2 CAPITAL ASSETS.
3 (a) IN GENERAL.—Section 1221 (defining capital asset)
4 is amended—
5 (1) by inserting "or" at the end of paragraph (4);
6 (2) by striking out paragraph (5); and
7 (3) by redesignating paragraph (6) as paragraph
8 (5).
9 (b) CONFORMING AMENDMENTS.—
10 (1) Subparagraph (B) of section 341(c)(2) (relating
11 to determining total assets of a collapsible corporation)
12 is amended by striking out "(and governmental obliga-
13 tions described in section 1221(5))".
14 (2) Subparagraph (D) of section 1231(b)(1) (defin-
15 ing property used in trade or business) is amended by
16 striking out "paragraph (6)" and inserting in lieu
17 thereof "paragraph (5)".
18 (c) EFFECTIVE DATE.—The amendments made by this
19 section shall apply to obligations issued after May 5, 1981.
20 SEC. 5. DEALERS IN SECURITIES.
21 (a) THIRTY-DAY REQUIREMENT.—Subsection (a) of
22 section 1236 (relating to dealers in securities) is amended by
23 striking out "30th" each place it appears.
24 (b) CLEAR IDENTIFICATION REQUIREMENT.—Section
25 1236 is amended by adding at the end thereof the following
26 new subsection:

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1 "(d) CLEAR IDENTIFICATION IN CASE OF OFFSETTING
2 POSITIONS.—For purposes of subsection (a), no security
3 which is part of an offsetting position (as defined in section
4 1092(b)) shall be treated as clearly identified in the dealer's
5 records as a security held for investment unless all securities
6 which are part of the offsetting position have been identified
7 in accordance with such subsection.".
8 (c) EFFECTIVE DATE.—The amendment made by this
9 section shall apply to securities acquired after May 5, 1981,
10 in taxable years ending after that date.
11 **SEC. 6. SALE OR EXCHANGE.**
12 (a) IN GENERAL.—Section 7701(a) (relating to defini-
13 tions) is amended by adding at the end thereof the following
14 new paragraph:
15 "(38) SALE OR EXCHANGE.—The term 'sale or
16 exchange' when used with reference to any capital
17 asset means any disposition of such asset.".
18 (b) EFFECTIVE DATE.—The amendment made by this
19 section shall apply to any disposition after May 5, 1981.

BACKGROUND ON COMMODITY TAX STRADDLES AND EXPLANATION OF S. 626

SCHEDULED FOR A JOINT HEARING

BY THE

SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT

AND THE

SUBCOMMITTEE ON ENERGY AND AGRICULTURAL TAXATION

OF THE

COMMITTEE ON FINANCE

ON JUNE 12, 1981

INTRODUCTION

This pamphlet provides background information for a joint public hearing scheduled on Friday, June 12, 1981, by the Subcommittee on Taxation and Debt Management and the Subcommittee on Energy and Agricultural Taxation of the Senate Committee on Finance on S. 626 and other legislative proposals relating to tax straddles.

Because most tax straddles are structured at least partially in commodity futures contracts, the pamphlet describes the futures industry, futures trading, and tax-motivated transactions in futures. In addition, the pamphlet outlines the present law governing the taxation of futures transactions and explains the provisions of S. 626. Finally, the pamphlet describes two principal alternative proposals: (1) offsetting commodity gains and losses and (2) a marking-to-market system.

I. PREFACE

Interest in the use of commodity futures transactions for tax-motivated purposes has grown rapidly in recent years. The Internal Revenue Service has disallowed certain deductions relating to such transactions and taxpayers have challenged the IRS position. The lead cases[1] involving tax straddles in commodity futures, the most publicized of these transactions, are being litigated currently in the United States Tax Court.

Varied legislative changes have been suggested in the tax treatment of futures transactions and have been discussed by legislators, government officials and industry representatives. A bill introduced in this Session of Congress, S. 626 (Senator Moynihan), includes provisions intended to limit the use of a variety of transactions, including tax straddles in commodity futures and other property, to shelter income from taxation. Alternatives include (1) offsetting commodity gains and losses and (2) a marking-to-market system with various characterizations and rates proposed for income reported on that system.

[1] *Smith v. Commissioner*, Docket No. 12709–77, and *Jacobson v. Commissioner*, Docket No. 185–78.

II. BACKGROUND ON THE COMMODITY FUTURES INDUSTRY

A. Development of the Commodities Industry

Present day commodity futures exchanges can trace their origins to medieval European markets usually held at the principal regional center of production for a particular commodity. Initially, only physical ("cash") commodities were traded. However, as commerce grew in size and complexity, markets expanded to year-round operations and trade in contracts for future delivery developed. Trading practices became standardized and over the centuries, some trade practices were adopted as law.

In the United States, regional cash markets for agricultural commodities developed in the Eighteenth Century. Trade in cash commodities was marked by wide seasonal variations in supply and demand resulting in large fluctuations in prices. At harvest time, farmers glutted the markets with their produce, which far exceeded merchants' immediate needs. Inadequate transportation and storage facilities compounded farmers' economic difficulties. Prices were low; some commodities were kept off the markets; others spoiled and remained unsold. Within months, however, demand would increase and prices would soar as the supply of produce sought by merchants, processors and individuals dwindled and fell short of demand.

In order to increase their control over supply and demand, producers and users of agricultural commodities began to enter forward contracts with each other. Forward contracts are individualized agreements directly negotiated between a particular buyer and a particular seller, and always requiring actual delivery. These contracts called for delivery of a fixed quantity of a commodity at a specific place at a particular time for a fixed price. Forward contracts provided that actual delivery of the commodity would occur in the future, but title to the commodity was transferred when the parties executed the contract.

Although some individual speculation in forward contracts occurred, such speculation was too irregular and insufficient to reduce the risk of price fluctuations. Forward contracts permitted a shifting of the risk of future price fluctuations from the seller to the buyer, but because they required actual delivery of the commodity, they were not very attractive to speculators who might otherwise have been willing to assume the risks of price changes. Futures contracts and futures exchange developed as a means of encouraging speculators to enter the commodities markets and assume the risk of price fluctuations. Knowledgeable, well-capitalized price speculators typically make markets more efficient because their trading responds quickly to information about changes in supply and demand. Also, the active trading of speculators usually makes markets more liquid; that is, it reduces the gap between the prices at which the public is able to buy and sell the commodity.

In this century, futures trading has become increasingly regulated, both by the industry itself and by the Federal Government. Initially futures trading in agricultural commodities was regulated by the Agriculture Department under the Commodity Exchange Act. Later additional commodities were made subject to regulation. The Commodity Futures Trading Commission Act of 1974 created an independent federal agency, the Commodity Futures Trading Commission, and granted its exclusive jurisdiction over futures trading.

B. Commodity Futures Contracts

A commodity futures contract is a standardized agreement either to buy or to sell a fixed quantity of a commodity to be delivered at a particular location in a specified month in the future. Currently, exchanges list contracts for agricultural commodities, heating oil, precious metals, financial paper and currencies. Called "futures," these contracts require payment at the time of delivery.

In the United States, all trading in futures must be transacted through an exchange by exchange members. Futures traders are not allowed to sell futures contracts which they have executed to third-parties off the exchange.

A clearing association at each exchange guarantees performance on commodity futures contracts, i.e., the clearing association interposes itself as a buyer to every seller and seller to every buyer. The association is substituted as the opposite party in every trade and becomes the payment and collection agency for its members. Thus, responsibility on a contract runs between the clearinghouse and the clearing member, for example, the brokerage firm, which executed the contract for its customer.

All futures contracts are subject to the rules and regulations of the exchange where they are traded. For each contract, an exchange establishes a standard contract size. For example, a soybean futures contract consists of 5,000 bushels. Each contract specifies delivery of a particular grade of the contract commodity. Exchange rules may allow a seller to substitute delivery of the standard grade with other specified grades of the commodity, at stated premiums or discounts from the delivery price.

Exchanges list contracts for delivery only in certain designated months, some over three years into the future. In June 1981, the Chicago Board of Trade, for example, listed wheat contracts for July, September and December 1981 and March, May and July 1982. The New York Commodity Exchange (COMEX) listed gold contracts for delivery in June, July, August, October and December of 1981; February, April, June, August, October and December of 1982; and February and April of 1983. Closing futures prices are listed daily in the financial pages of many newpapers.

C. Futures Trading

1. Types of traders

Hedging

Commodities futures trading involves two types of trading: hedging and speculation. A hedger is a business person who produces, sells, or processes the actual "cash" commodity and engages in futures trading for price protection of inventories. For example, a wheat farmer who expects to harvest a crop several months in the future may enter a futures contract to sell wheat to protect against a price decline between the current date and the date when the actual wheat will be available. Also, a flour manufacturer may enter a futures contract to buy wheat to protect against a price increase between the current date and the time when the manufacturer will need the actual wheat. Similarly, financial institutions, which realize ordinary income or loss on the disposition of their securities, may use financial futures to hedge such securities.

Speculation

A speculator does not trade futures for price protection, as the hedger does. Instead, the speculator risks his capital in the hope of profiting from price movements.

Speculators buy if they think prices are too low; they sell, if they consider prices too high. Speculators generally do not take delivery of the physical commodity but instead "liquidate" (i.e., close out or cancel) their futures by making offsetting purchases or sales of an equivalent quantity of futures contracts in the same commodity for the same delivery month. Speculators generally hold their contracts for short periods; some are day-traders, often called scalpers, who get out of the market the same day they get in.

A speculator cannot simultaneously hold an equal number of contracts to buy and to sell the same commodity for the same delivery month on a single exchange. Under exchange rules, such contracts cancel each other out. A speculator who wishes to get out of ("liquidate") a purchase contract prior to the contract's delivery month can "cancel" the contract, and terminate any obligation under it, by executing an equivalent sales contract for the same month on the same exchange.

Obviously, any one person may trade futures contracts, sometimes as a hedger and other times as a speculator, depending on the purpose and the type of transactions which are executed.

2. Trading strategy

Futures v. cash prices

Speculators employ a variety of trading strategies. Traders expecting prices to increase may take a "long" position, that is, enter into contracts to buy a commodity. If a trader expects prices to fall,

he may go "short," that is, enter into contractss to sell. Speculators who are "long" or "short" in the futures markets expect to profit from the difference between the subsequent price of the physical (or cash) commodity and the price at which they purchased the futures contract.

Spreads

Many professional traders employ a trading strategy, frequently referred to interchangeably as spread or straddle trading, which is usually considered more conservative than outright long or short positions. Spreads involve the simultaneous holding of a long position (contract to buy) in one futures contract and a short position (contract to sell) in a related futures contract. The two positions are called the "legs" of the spread. Spread traders hope to profit from changes in the difference between the prices of the two positions. They try to trade spreads when they think prices for the different months are "out of line." This trading strategy is similar to and sometimes referred to as arbitrage.

For example, there is normally a relatively stable relationship between the price of June gold and the price of September gold. This relationship is based on the costs of storing gold (including financing costs) from June to September. Should there be an influx of buy orders for June gold, there would be upward pressure on the price of June gold contracts. Spread traders could then sell June contracts and buy September contracts, which would tend to restore the normal relationship between the two contracts. Because of the large number of spread traders, many markets trade spreads as a single unit; that is, they allow traders to buy and sell the two legs of the spread simultaneously.

3. Mechanics of trading

An individual can trade futures contracts by opening a commodity account with a brokerage firm which holds a membership in one or more commodity exchanges through its officers or partners or with a firm which is registered with the Commodity Futures Trading Commission as futures commission merchant (FCM) placing orders through an exchange member. The firm arranges execution of the individual's order to buy or sell and charges a commission for these transactions. In addition, the firm requires that the individual sign a margin agreement and maintain at least a minimum amount of cash in a margin account.

4. Comparison: futures v. corporate stock

In general

Although aspects of futures trading appear similar to practices and terminology used in securities trading, there are substantial differences between futures and securities trading. Some of these differences are very significant. Unlike corporate stock which a purchaser may hold indefinitely, futures contracts have a limited life span. Holders of futures either must liquidate them prior to their final delivery date, or must make or accept delivery of the commodity pursuant to the contracts.

Payment

When corporate stock is purchased, the buyer must pay the seller the full amount of the purchase price. However, commodity traders do not make any payment for their futures contracts until the contracts' delivery dates. When they enter the contracts, traders merely make a deposit, similar to earnest money, to guarantee performance in the future.

Margin

Margin requirements in futures trading differ greatly from margin requirements in securities trading. The margin established for securities purchases constitutes partial payment for the securities. The remainder of the securities' purchase price is loaned by the broker to the customer, who pays the broker interest for the borrowed portion of the purchase price. Minimum margin requirements may range well over 50 percent of the price of securities. Securities for publicly traded stock margin requirements are subject to Federal regulation.

In futures trading, however, a margin deposit is not a partial payment on the contracts. The margin deposit required for futures trading technically is "earnest money," a cash deposit made as a financial guarantee to the broker that the individual will fulfill his or her future obligations. Margin required for commodity futures accounts generally amounts to 5 to 10 percent of the face amount of a contract. Margin on individual accounts is set by the broker, who as an exchange member, must meet in turn margin requirements established by the exchange. Margin requirements for futures are not regulated by the Government. Thus, broker-set margins reflect exchange requirements.

Margins for futures are higher for positions involving greater risk and lower for positions with less risk. Hedgers have significantly lower margin requirements than speculators because hedgers hold the underlying physical commodity. Speculators' margin requirements depend on the risk of their net position. Spread or straddle positions, usually less risky than outright long or short positions, often have margin requirements of only one percent of the face amount of the two positions.

Exchanges require two types of margin deposits: initial and maintenance. Initial margin is the deposit amount required when the futures positions are established. Maintenance margin is the minimum amount of margin which must be maintained in the margin account at all times to support a position. Maintenance margin is usually set at 75 percent of initial margin. Margin requirements are recomputed daily based on the contract's settlement price, the official price set daily by the exchange. If a trader's overall position declines in value, the amount of the decline will be withdrawn from the margin deposit and paid over to the exchange clearing association. If the trader's margin drops below the maintenance level, the trader will have to deposit additional margin, called variation margin, before the next business day to bring the trader's margin back up to the initial level, or his undermargined positions will be liquidated.

Marking-to-market

If a trader's position has increased in value during the day, the net increase in the position is computed and transferred to the trader's

account before the beginning of trading the next day. The trader has the right to withdraw the full amount of such gains immediately every trading day. However, if a trader's position decreases in value, the trader will have to meet a margin call, that is, deposit additional funds before the next business day. Money paid on position losses is paid into the exchange clearing association which transfers such amounts to those accounts which gained during the trading day. This daily determination of contract settlement prices and margin adjustments to reflect gains and losses is called "marking-to-market."

Marking-to-market requires daily cash adjustments through the exchange clearing association to reconcile exchange members' net gains and losses on their positions. At the close of trading each day, every member must mark all customer accounts to the settlement prices (current market value) for the day. Gains and losses are immediately deposited into or withdrawn from the customer accounts. And, customers in turn are entitled to withdraw their gains, or are required to deposit any margin required because of losses in their accounts at the close of every day under this marking-to-market system.

Leverage

Because the margin deposits required for commodity accounts are so small, leverage—the relation between the amount of money required to control property and the value of the property—is significant. Moreover, unlike an investor who purchases stock on margin, a commodity futures trader does not buy or sell the commodity when he enters the contract. In acquiring a futures contract, a commodity trader only pomises to buy or sell the commodity at a future time. If the trader is a speculator, the trader probably does not plan to hold the contract to maturity, but instead intends to liquidate it by executing an offsetting contract. Thus, the speculator would never be required to pay the full face amount of the contract (or to accept or deliver the commodity itself). When a trader liquidates his position, he receives back the amount in his margin account, as of the date of liquidation, less any commission. If the value of his contracts has increased since they were executed, the trader's margin account will have increased by the amount of the gain (unless the trader previously withdrew the gain). Losses on the contracts will be reflected by the total decrease in the original deposit in the margin account as well as any additional amounts paid in by the trader to meet margin calls. With a very small deposit, as low as five or even one percent of the value of the commodity covered by the contracts, a futures trader can speculate for the profits to be earned (or loss to be incurred) on the full 100 percent of the value of the commodity in the contracts.

Commissions

In securities transactions, brokers immediately charge customers a commission for any security purchased. Brokers also impose an additional commission for any subsequent sales. In futures transactions, however, commissions are charged only after the entire transaction is completed. Ordinarily, no commission is charged when a contract is purchased; the commission is assessed subsequently on a "round-trip" basis when the contract is liquidated.

Options

Certain tax-shelter transactions (described in D., below), including some straddles, can be executed with options. Options differ markedly from both stock or securities and from futures contracts. An option is the right to buy or sell stock (or other property) at a stated price for a fixed period of time. A "call" is the right to buy stock (or other property) at a stated price, and a "put" is the right to sell stock (or other property) at a stated price.

There are two parties to an option transaction, the "writer" of the option, and the "holder" or "buyer" of the option. The writer of a call obligates himself, for a fee (often called the "premium"), to sell stock for a stated price (often called the "striking price") for a stated period of time. For example, he might write a call to sell 100 shares of IBM for $50 per share, for a period of 3 months. The holder of the call pays the premium and obtains the right to buy the IBM stock, at the $50 per share price, for three months. A "put" is just the reverse of the call. The writer of the put promises to buy the IBM stock at $50 per share for a period of three months, and the holder has the right to sell to him at that price if he wishes to do so.

The holder of a call believes the market price of the stocks may rise during the option period (in which case he will exercise his call and acquire the stock at a bargain price). The holder of a "put" feels the market price of a stock may decline, in which case his put will enable him to sell stock at more than its then current market value.

Basically, the obligations of an option writer may terminate in one of three ways: by exercise, lapse, or through a closing transaction. An exercise occurs where the holder of an option utilizes his right to make the writer of the option buy or sell stock at the agreed upon price. A lapse occurs where the holder does not exercise his option during the option period (usually because the holder has incorrectly predicted the trend of the market, so that the option is worthless) and the option period expires. A closing transaction occurs where the writer of the option terminates his obligation under that option by reacquiring it, or by making a payment to an options exchange equivalent to the value of an offsetting option. For example, if X writes a call obligating himself to sell 100 shares of IBM at $50 per share, and the market price of IBM moves upward to $60, X could neutralize his own position with respect to IBM stock by acquiring (through the medium of an options exchange) a call from Y allowing X to purchase 100 shares of IBM from Y for $50 per share. (Of course, X would have to pay a greater premium to Y for this call than X himself had received because of the upward movement in the price of the underlying IBM stock.)

Until 1973, put and call options in stock were traded exclusively "over-the-counter" through put and call brokers. The over-the-counter options are contracts between a specific buyer and specific writer. This means that while the buyer can exercise his option any time he wishes, the writer cannot relieve himself of his obligation except by repurchasing the specific option he has written. (The writer can, however, hedge by buying a similar option if he is willing to pay the relevant commissions and premiums.)

Trading on listed options now is conducted on several exchanges. Unlike over-the-counter options, listed options consist of two con-

tracts—one between the buyer and the options exchange and the other between the writer and the options exchange. A writer of a listed option can relieve himself of his obligation by buying a listed option identical to the one he has written. This is called a "closing transaction." The options exchange then cancels the two identical options.

In addition to options in stocks, exchanges plan to offer options in debt instruments. The Securities and Exchange Commission has authorized the Chicago Board Options Exchange to begin trade soon in options on Ginnie Mae certificates. Applications for additional debt options, including options on Treasury bills, are pending before the SEC.

Futures exchanges have applied to the Commodity Futures Trading Commission for permission to expand their listings to include options on futures contracts on debt instruments. Many of the applications pending before the CFTC pertain to options on futures on the same debt instruments for which applications to trade options have been filed with the SEC.

5. Execution of futures trades

Commodity futures transactions are traded in pits or rings on the floors of the exchanges by floor brokers and floor traders. These individuals, who must be members of the exchange, execute trades for themselves, for member firms and for others. Orders are phoned to managers near the pits who record the orders on slips which runners deliver to floor traders for execution. The trader executes the order by offering the contract by open outcry and hand signals. If another trader accepts the contract, the order is signed as executed by the floor trader and returned by a runner to the firm floor manager. The traders for each side of the contract confirm execution of the order to the clearinghouse. At the end of each trading day, member firms confirm all transactions reported during the day to the clearinghouse, which matches all the trades. The clearinghouse becomes the opposite party to each trade.

6. Price-setting

When long or short positions are traded separately in the pits, the price of each contract is set in the pits by competitive bidding at the time the two traders executing the trade reach agreement. However, when spreads (straddles) are traded as a unit, the floor traders competitively bid and offer the amount of the spread, which in a trading convention, is stated in terms of the contract delivery months, e.g., May-August, and the difference in prices, e.g., 10. The separate prices for each leg of the contract are set later by the two traders outside the pit. Under exchange rules, the price of one leg of a spread must be an *actual price* traded during the day in that contract month. The second leg must be a *possible price*, that is a price which falls between the day's price limits, i.e., the maximum movement up and down which a commodity price is allowed on a single day. Thus, if a contract, which begins a day at 80, and which has limits up and down of 10 in either direction, is actually traded between 75 and 81, the spread traders can assign an actual price between 75 and 81 to one leg, and a "possible" price as low as 70 or as high as 90 to the other leg, provided the spread differential of 10 is maintained.

D. Tax Shelters

The tax potential of certain transactions in commodity futures to defer income and to convert ordinary income and short-term capital gains into long-term capital gains has been recognized by the investment industry for decades. However, only in the last ten to fifteen years has the use of such tax shelters in commodity futures extended beyond commodity and investment professionals to significant numbers of taxpayers, individual and corporate, throughout the economy. The tax advantages of spread transactions in futures are touted in commodity manuals, tax services and financial journals. Brokerage firms have promoted tax spreads or straddles to their clients. Domestic and offshore syndicates advertise tax straddle shelters for which purchasers pay an amount equal to a percentage of their desired tax loss.

1. Tax straddles

Use of tax straddles

Simple commodity tax straddles generally are used to defer tax on short-term capital gains from one tax year to the next tax year and, in many cases, to convert short-term capital gain realized in the first year into preferentially taxed long-term capital gain in a later year. However, in some cases (described below) straddles are used to defer tax on ordinary income and convert that income into short- or long-term capital gain. A simple straddle is constructed by taking equal long and short positions in the same property in the same market. The two positions, called "legs," are expected to move in opposite directions but with approximately equal absolute changes. Thus, for example, if one leg of a straddle in futures contracts increases $500 in value, the other leg can be expected to decrease in value by about the same amount. By maintaining balanced positions, the risks of the transaction are minimized.

A taxpayer using a simple futures straddle as a tax shelter will establish a position in contracts with contract prices of about, say, $10,000 each. The two contracts, one to buy, the other to sell, are identical in every respect, except for their delivery months. Because the taxpayer's position is a straddle, his margin deposit will be very low—as little as one percent of the value of the position ($200). The taxpayer will wait for the market to move, so that one leg of the straddle shows a loss, e.g., $500, and the other leg shows an almost identical gain. The taxpayer will liquidate the loss by entering into the opposite futures contract for the same month. (A contract to sell December wheat, for example, is liquidated by executing a contract to buy December wheat.) In order to maintain a balanced, minimal-risk position, the taxpayer will replace the liquidated leg with a contract which is identical, except for its delivery month. (The replacement contract will have a contract price of about $9,500, if the original long leg was liquidated at a loss, or a contract price about $10,500, if the original short leg was liquidated at a loss.)

The taxpayer will claim the decrease in value in the liquidated leg as a $500 short-term capital loss and deduct it from his income, thereby eliminating a $500 short-term gain for the tax year. At the same time, the taxpayer will continue to hold the other leg, which will have an unrealized gain approximately equal to his "realized loss," that is, about $500. However, the taxpayer will not have paid out any money because no money is due on a futures contract until its delivery date. In addition, because the taxpayer maintained a balanced position, he ordinarily will not be required to put up any additional margin.

The taxpayer will hold the two legs into the following year. In the second year, the taxpayer will close out the two positions. Assuming the holdover contract has increased another $500 in value, the taxpayer will recognize a total gain of about $1,000 on the original leg and about a $500 loss on the replacement leg. If the gain is on the long (buy) position and that position was held for over six months, the taxpayer will report a $1,000 long-term capital gain on the long position and a $500 short-term capital loss on the short position. If he has no other capital transactions for the year, he will report the $500 difference between these legs as long-term capital gain. (His margin, less commissions, will be returned.) Thus, he will have succeeded in deferring his short-term capital gain for one year and converting it to a long-term capital gain. If the gain is in the short (sell) position, the gain will be short-term capital gain. In this case, the taxpayer gets a one-year deferral, but no conversion.

Certain commodity futures trading practices have facilitated tax straddle transactions. Exchange rules at the New York Commodity Exchange (COMEX), for example, provided for "after-hours" trading in spreads under extraordinary circumstances. During such trading sessions, only spreads were traded. In the late 1970s, however, COMEX after-hour sessions in silver futures occurred almost daily. Special sessions at the end of the calendar year lasted hours and drew press attention and comment. In 1980, after investigations suggested that abuses and violations of the Commodity Exchange Act rules, as well as significant tax-oriented trading, occurred during after-hours trading, the Commodity Futures Trading Commission suspended the sessions. In April 1981, the Commission announced its intention to disapprove the COMEX rule providing for these sessions.

Revenue Ruling 77–185

In 1977, the Internal Revenue Service issued Revenue Ruling 77–185,[1] which disallowed deductions for losses and expenses in a simple two-contract silver straddle transaction. The ruling stated that the loss claimed by the taxpayer in connection with the disposition of one leg of the straddle was not *bona fide* because the disposition represented no real economic change and was not a closed and completed transaction. Moreover, the deductions for the loss and expenses were denied because, the ruling held, the transaction was not entered into for profit, but for tax-advoidance purposes.

Although the ruling discusses a two-contract (two-leg) silver straddle, many commodity experts have interpreted the ruling as applying to more complex "butterfly" straddles which involve four (or more)

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[1] Rev. Rul. 77–185, 1977–1 C.B. 48.

legs. Butterfly straddles, like simple straddles, are structured to create tax benefits regardless of the direction in which the market moves. (See item 7, "Butterfly straddles," below.) Thus, Butterfly straddles avoid risks entailed in single-spread straddles. The ruling has aroused controversy. Two lead cases [2] involving IRS deficiency determinations under the theory in Revenue Ruling 77-185, are currently being litigated in the United States Tax Court.

Despite resistance to the IRS position, the ruling has caused some investment advisers to counsel greater caution with respect to tax straddle activity. Some have encouraged clients to vary their trading pattern from the facts outlined in the ruling; others arrange multiple, difficult-to-audit futures trades for their clients in order to give greater evidence of a profit-making motive. Because the IRS ruling dealt with a silver straddle, some tax straddlers switched to other commodities, particularly gold and Treasury bills. Some investment counselors now discourage tax straddles altogether.

Silver was a popular tax-shelter commodity because there generally has been a stable relationship between the price of silver contracts in different months. As noted above, this relationship is based on the costs of holding silver from one month to the other. Thus, the risks of spread trading were considered smaller than in other commodities. However, daily trading in silver was highly volatile, resulting in significant upward and downward price movement. This pattern was conducive to planning significant losses for tax purposes because the typical spread position provided a sizable gain on one leg and an almost precisely equal loss on the other leg. The silver market was considered a contango premium market, that is, a market in which distant futures sold at a premium over spot prices (the current price for the cash commodity) and nearby futures. Moreover, because the supply of silver was considered relatively stable, the price increases over time were largely a function of interest and storage for the silver until the commodity's delivery date, and not generally a function of sudden changes in supply.

The 1977 IRS ruling caused some tax straddlers to abandon silver. The extraordinary silver market crisis in March 1980, which some observers attributed to an attempt to corner the market, while others attributed to interference with market operations by short traders, led most remaining tax straddlers to abandon silver. Subsequently, tax straddle traders turned to other, more predictable commodities with premium market features similar to those which had previously characterized silver. Other precious metals and financial paper became the primary shelter commodities. However, tax straddles also can be executed in agricultural commodities, particularly those commodities which can be stored for long periods.

2. Straddles in Treasury bill futures

Tax straddles in Treasury bill futures offer an additional feature unavailable in other futures straddles. These shelters can be used to convert *ordinary* income, that is, salary, wages, interest, and dividends, into long-term capital gain. This opportunity occurs because,

[2] *Smith* v. *Commissioner*, Docket No. 12709-77, and *Jacobsen* v. *Commissioner*, Docket No. 185-78.

under statutory rule, gain or loss on the sale of Treasury bills is considered ordinary income or loss, while, under IRS interpretation, gain or loss on the sale of T-bill futures contracts is considered capital gain or loss. Straddles in Treasury bill futures generally are structured in the same way as other futures straddles: contracts to buy Treasury bills are offset by an equivalent number of contracts to sell Treasury bills. The execution of these "T-bill" shelters involves one difference: in the case of a loss on a long leg, when the delivery month for the loss leg of the straddle arrives, the taxpayer takes delivery of the bills and then disposes of the bills themselves creating an ordinary loss; in the case of a loss on a short leg, the taxpayer purchases the bills at the market price and delivers the bills themselves at the contract's lower price creating an ordinary loss. Ordinary losses are fully deductible against any type of ordinary income.

The remainder of the straddle transaction is executed in the usual fashion. The taxpayer immediately replaces the liquidated leg. In the following year, the entire straddle is closed out and, if the gain occurs on the long position (contract to buy), the gain is reported as long-term capital gain. These taxpayers may decide to re-straddle in the second year and roll-over their gains and other income indefinitely into the future.

3. Straddles in corporate tax planning

Tax straddles can be used for tax planning by corporations. Transactions can be structured so that income can be deferred to later years, or corporate losses or tax credits utilized by disposing of a straddle's gain leg in the initial year. Tax journals have publicized a number of planning techniques involving the use of straddle shelters.

While some corporations use currency futures to protect against foreign currency fluctuations, some corporations use such futures to construct tax straddles to defer or convert income. Legitimate hedging positions can be transformed into tax shelters by treating some offsetting contracts as straddles. Loss contracts can be liquidated and replaced so that losses offset income in one year. All the while, the company's hedging operations in currency futures remain in place, protecting the company's position in world currency markets.

Businesses with debt holdings or offerings also can easily execute transactions in futures contracts in debt instruments, such as Treasury bills or Ginnie Mae certificates, to create tax benefits. Paper losses can be created to defer income. (See explanation of the unrealized gain maintained in the straddle, in D.I. Tax Straddles, above.) However, gain positions might be realized in order to use up expiring capital loss carryforwards in one year and to "renew" the loss in the next year. Similarly, corporations can set up these "reverse" straddles to take advantage of expiring foreign tax credits.

While these shelter transactions in futures are subject to challenge under Revenue Ruling 77-185, their detection might be difficult. If a corporation has non-tax business purposes for engaging in futures transactions, it might be hard for auditors to distinguish tax-motivated transactions from regular business dealings in futures. Even if tax-shelter transactions are identifiable, it might be difficult for the Internal Revenue Service to prove that the transactions were tax-motivated and had no business purpose.

4. "Cash and carry" transactions

"Cash and carry" tax shelters involve the purchase of a physical commodity, for example, silver, and the acquisition of a futures contract to deliver (sell) an equivalent amount of the same commodity twelve months in the future. The taxpayer finances the purchase with borrowed funds, and deducts the interest expense, storage, and insurance costs in the first year. These deductions offset ordinary investment income, e.g., interest and dividends.

Because the price differential between the current price of the physical commodity and the futures price is usually largely a function of interest and other carrying charges, the futures contract will have a value approximately equal to the total payment for the physical commodity plus interest and carrying costs. The taxpayer will hold the silver and the offsetting futures contract into the next year.

When the 12-month holding period has passed, the taxpayer will deliver the silver on the futures contract and realize a gain on the silver. If the price of silver has increased, the taxpayer can sell the silver, producing long-term capital gain, while closing out the short futures position, creating a short-term capital loss. In either event, the gain will be about equal to the interest and carrying charges but will be treated as long-term capital gain. Thus, investment income taxable at rates as high as 70 percent, would be deferred for a year and converted into capital gains taxable at maximum rates no higher than 28 percent. (The Administration has proposed reducing the maximum rate on investment income from 70 to 50 percent, which would result in the reduction of the maximum long-term capital gains rate from 28 to 20 percent.)

5. Broker-dealer shelters

Securities dealers have special tax-shelter opportunities which straddles makes even more profitable. A securities dealer who identifies some assets as held for investment within 30 days of their acquisition as required under Code section 1236, receives capital gains (or loss) treatment on such assets. Other assets held for sale or as inventory produce ordinary income or loss. If a securities dealer selects and marks certain assets as investments, and treats other, balancing items as inventory, advantageous tax straddles can be structured which are claimed on the broker-dealer's tax return as producing capital gains or losses in his investment account and ordinary income and loss from his inventory. Dealers in debt instruments can straddle ordinary income Treasury bills against debt which produces capital gain or loss. Treasury bill futures transactions add even more planning opportunities.

Some taxpayers consider securities dealers' unique tax-planning opportunities so significant that they establish themselves as broker-dealers solely to exploit these opportunities. Large broker-dealer partnerships pass these tax benefits through to hundreds of partners. Many of these broker-dealer partnerships sell shares in their operations for fees which are based on a percentage, usually ten percent, of the tax loss sought by the investor. Some operations are established off-shore in order to avoid domestic regulatory officials and to prevent the Internal Revenue Service from obtaining their records for audit purposes.

6. Ordinary income dispositions

Some taxpayers and tax shelter promoters have attempted to exploit court decisions holding that ordinary income or loss results from certain dispositions of property whose sale or exchange would produce capital gain or loss. These decisions rely on the definition of capital gains and losses in section 1222 which requires that there be a sale or exchange of a capital asset.

As a result of these interpretations, losses from the termination, cancellation, lapse, abandonment and other dispositions of property, which are not sales or exchanges of the property, are reported as fully deductible ordinary losses instead of as capital losses, whose deductibility is restricted. However, if such property increases in value, it is sold or exchanged so that capital gains, long-term if holding period requirements are met, are reported.

Some of the more common of these tax-oriented ordinary loss and capital gain transactions involve cancellations of forward contracts for currency or securities.

7. Butterfly straddles

A butterfly straddle[8] is a commodity futures spread entailing at least four positions. A butterfly straddle generally is composed of two simple, mirror-image spreads with the same intermediate delivery date.

The butterfly straddle can consist of a long position in a futures contract with a near delivery date, a long position in a futures contract with a distant delivery date, and two short positions in a futures contract with an interim delivery date. A butterfly straddle also may be structured with one near and one distant short position and two interim long positions.

Because the two spreads in the butterfly are established as mirror images of each other, the butterfly provides protection against a change in the price of the commodity whether the market moves up or down and also against any change in the price of the spread. It also makes it more likely that at least one long position will produce a gain and will be held for more than six months, so that short-term gain will be converted into long-term gain.

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[8] The name "butterfly" apparently was given to this operation because, if diagramed a certain way, the transaction resembles a butterfly.

EXAMPLE: Gold Butterfly Straddle

The following example outlines the steps in executing a butterfly straddle in gold futures contracts (100 troy oz.). The following prices are rounded from closing prices listed for contracts traded on the New York Commodity Exchange (COMEX) in the middle of April, 1981.

Gold Futures—100 Troy oz.

Contract:	*Cost per oz.*
February 1982	$550.00
April 1982	560.00
June 1982	570.00
August 1982	585.00
October 1982	600.00
December 1982	610.00
February 1983	625.00

Step 1: April 1981

Establish straddle:

Buy Feb. 1982—Sell June 1982, Sell June 1982—Buy Oct. 1982

Taxpayer deposits one percent of contracts' face value ($229,000) as margin: *$2,290.*

Step II: September 1981

Assume price of gold increased 10 percent:	*September 1981*
February 1982	$605
June 1982	627
October 1982	660

The straddle has potential losses in its two June short positions and approximately equal gains in its two long, February and October, positions:

February 1982	+5,500
October 1982	+6,000
June 1982	−5,700
June 1982	−5,700
Economic gain	+100

Because the taxpayer wants tax losses, he closes out the loss legs (June) with two new straddles:

Sell April—Buy June, Buy June—Sell August

As a result of executing these two straddles, the taxpayer's position now is:

Buy February—Sell April, Sell August—Buy October

The taxpayer thus has the two long, February and October contracts still in place with profits of $11,500, all the while maintaining the spread positions. The profit of $11,500 belongs to the taxpayer as a matter of right. The taxpayer may have already withdrawn the profits as they were credited daily to his account. The taxpayer has a tax loss of $11,400 for 1981. Generally this will be a capital loss deductible against capital gains and up to $3,000 of ordinary income.

Step III. March 1982

Assume additional 10-percent increase:	*March 1982*
February 1982	$665.5
April 1982	677.6
August 1982	707.85
October 1982	726

The taxpayer liquidates all positions by executing offsetting spreads which cancel his positions:

Sell February—Buy April, Buy August—Sell October

The two long positions have gain $24,150:	
February	+11,550
October	+12,600

The April position lost $6,160 since it was entered at $161 per oz, in September 1981:	
April	−6,160

The August position lost $6,435 since it was entered in September 1981 at $643.5 per oz.:	
August	−6,435

Taxpayers recognizes net gain of $11,555 for 1982. (Of course, gain credited to the taxpayer's account in 1981 may have been withdrawn by him in that year.)

Summary

If gain is recognized on a long position held over 6 months, as in this example, it is taxed as long-term capital gain even though the losses in the prior year were deducted against short-term capital gains.

Taxpayer's actual economic change on the butterfly is determined by reducing total gains by total losses:	
All gains	+11,550
	+12,600
All losses	−6,160
	−6,435
	−11,400
Net economic change	+155

Alleged tax savings for 1981: $7,980 (assuming 70-percent bracket).

The taxpayer can enter into a new straddle to generate losses to deduct against the $11,555 of gain for 1982. Alternatively, he can pay tax of $3,235.40 on the long-term gain (assuming a 70-percent tax bracket). In this case, the tax benefit is $4,744.60 ($7,980−$3,235.40) plus the advantage of a one-year deferral.

III. EXPLANATION OF S. 626

(Senator Moynihan)

A. Tax Treatment of Straddles

Present law

Under present law, gain or loss from the sale or other disposition of property is generally recognized by a taxpayer at the time of the disposition of the property (unless non-recognition is specifically provided for by a provision of the Internal Revenue Code).[1]

Wash sales

The Internal Revenue Code includes a wash-sale rule providing for non-recognition of certain losses which do not constitute true economic losses. This provision disallows any loss from the disposition of stock or securities where substantially identical stock or securities (or an option or contract to acquire such stock or securities) is acquired by the taxpayer during the period beginning 30 days before the date of sale and ending 30 days after such date.[2] This provision prevents a taxpayer from selling stock which has declined in value in order to establish a loss for tax purposes, and immediately reacquiring similar stock, because the sale and reacquisition together do not significantly alter the taxpayer's position with respect to that stock. No similar Code provision applies with respect to the disposition of property other than shares of stock or securities.[3]

Capital gains and losses

Generally, under present law, gain or loss from the sale or exchange of a capital asset[4] receives special treatment. In the case of individuals, only 40 percent of the excess of the net long-term capital gain over net short-term capital loss for any taxable year is included in the taxpayer's adjusted gross income.[5] In addition, capital losses of individuals are deductible in full against capital gains, and against up to $3,000 of ordinary income each year.[6] Only 50 percent of the net

[1] Code sec. 1001. However, losses are allowable only if incurred in a trade or business, incurred in a transaction entered into for profit, or resulting from casualty or theft.

[2] Code sec. 1091.

[3] For this purpose, commodity futures are not treated as stock or securities. Rev. Rul. 71-568, 1971-2 C.B. 312.

[4] Code sec. 1221. Capital assets generally include all property held by the taxpayer other than inventory, depreciable property or real property used in a trade or business, certain taxpayer-created property, certain receivables and certain short-term government obligations.

For this purpose, commodity futures contracts may not qualify as inventory. However, they are not allowed capital gains treatment if used as an integral part of the taxpayer's business, such as farming or food processing. *Corn Products Refining Co.* v. *Com'r.*, 350 U.S. 46 (1955).

[5] Code sec. 1202.

[6] Code sec. 1211(b).

long-term capital losses in excess of net short-term capital gain may be deducted from ordinary income.[7] Capital losses in excess of this limitation may be carried over to future years indefinitely, but may not be carried back to prior years.[8]

In the case of a corporation, the net capital gain is taxed at an alternative rate of 28 percent.[9] Capital losses are allowed only against capital gains.[10] Any excess loss may be carried back three years and forward five years.[11]

Generally, in order for gains or losses on the sale or exchange of capital assets to be considered long-term capital gain or losses, the assets must be held for one year or more.[12] In the case of futures transactions in any commodity subject to the rules of a board of trade or commodity exchange, the required holding period is six months.[13]

Short sales

In the case of a "short sale" (i.e., where the taxpayer sells borrowed property and later closes the sale by repaying the lender with identical property), any gain or loss on the closing transaction is considered gain or loss from the sale or exchange of a capital asset if the property used to close the short sale is a capital asset in the hands of the taxpayer.[14] but the gain ordinarily is treated as short-term gain.[15] A contract to sell is treated as the short sale for purposes of these rules.[16]

The Code contains several rules which were enacted to eliminate specific devices in which short sales could be used to transform short-term gains into long-term gains. Under these rules, if a taxpayer holds property for less than the long-term holding period and sells short substantially identical property, any gain upon the closing of the short sale shall be considered short-term gain, and the holding period of the substantially identical property will generally be considered to begin on the date of the closing of the short sale.[17] These rules prevent the conversion of short-term capital gain into long-term capital gain where the taxpayer is free of any significant risk. Also, if a taxpayer has held property for more than one year, and sells substantially identical property short, any loss on the closing of the short sale shall be considered long-term capital loss.[18] This rule prevents the con-

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[7] Code sec. 1211(b)(1)(C).

[8] Code sec. 1212(b).

[9] Code sec. 1201.

[10] Code sec. 1211(a).

[11] Code sec. 1212(a).

[12] Generally, options held for investment are governed by the same provisions of the Internal Revenue Code as are other capital assets. However, section 1233(c) exempts certain options to sell property from the short sales rules if the option was acquired on the same day as the property and the option, if exercised, is exercised through the sale of the property. Section 1234 provides that gain or loss from the sale or exchange of an option has the same character as gain or loss from the sale or exchange of the property underlying the option, if the property were in the hands of the taxpayer. Gain or loss from closing transactions in options is treated as short-term capital gain or loss.

[13] Code sec. 1222.

[14] Code sec. 1233(a).

[15] Code sec. 1233(b)(1). However, if on the date of a short sale, the taxpayer has held substantially identical property for over a year, a loss on the closing of the short sale will be treated as a long-term capital loss. Sec. 1233(d).

[16] Thus, in any commodity futures contract transaction, the person with the obligation to sell may not qualify for long-term capital gains.

[17] Code sec. 1233(b).

[18] Code sec. 1233(d).

version of long-term capital loss into short-term capital loss. For purposes of these rules, property includes stock, securities, and commodity futures,[19] but commodity futures are not considered substantially identical if they call for delivery in different calendar months.[20] In addition, these rules do not apply in the case of hedging transactions in commodity futures.[21]

Straddles

Generally, the Internal Revenue Code does not contain any special rules dealing with straddles in commodities or futures contracts in commodities.[22] In the case of the typical straddle in commodities (i.e. the holding of a contract to buy a commodity in one month and the holding of a contract to sell the same commodity in a different month), neither the wash sale rule applicable to stocks or securities (sec. 1091), nor the special short sales rules preventing conversion of short-term gain to long-term gain, or long-term losses to short-term losses (secs. 1233(b) and (d)) apply.

However, the Internal Revenue Service has ruled[23] that the loss from certain silver futures contracts was not deductible because the taxpayer "had no reasonable expectation of deriving an economic profit from the transactions."[24] This ruling has been the subject of much controversy, and the IRS is litigating the deductibility of certain losses claimed in straddle transactions in the courts.

Explanation of provision

The bill would provide that if a taxpayer holds offsetting positions, the portion of loss incurred in connection with the sale or exchange[25] of any such positions, which exceeds gain recognized from the sale or exchange of any other of these positions, may not be recognized until 30 days after the day on which the positions cease to be offsetting. The period during which the offsetting positions are held plus the 30 days after the positions cease to be offsetting is called the balanced period. (The 30-day period is similar to the period contained in the wash sale rule in present law.)

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[19] Code sec. 1233(e)(2)(A).

[20] Code sec. 1233(e)(2)(B).

[21] Code sec. 1233(g).

[22] Section 465 of the Code does contain rules limiting losses from an activity to amounts which certain taxpayers have "at-risk" in that activity. These rules are generally applicable to all activities, other than real estate, in taxable year beginning after 1978. It is unclear if these rules might apply to straddles.

[23] Revenue Ruling 77-185, 1977-1 C.B. 48.

[24] In the transaction described in the Revenue Ruling, the taxpayers on August 1, 1975, simultaneously sold silver futures contracts for July delivery and purchased an identical number of silver futures contracts for March delivery. Three days later, the March contracts were sold for a loss and an identical number of May contracts were purchased. On February 18 of the following year, the taxpayer simultaneously sold the May contracts and purchased July contracts to cover the short position. The taxpayer reported a loss from the sale of the March silver contracts in 1975 which reduced its short term gain from the sale of real estate and reported a net long-term gain in the next year from the sale of the futures contracts.

[25] Section 6 of S. 626, discussed below, would define the terms "sale or exchange" with reference to a capital asset to mean any disposition of a capital asset.

In addition, the running of the holding periods for the offsetting positions would be suspended for the balanced period. However, in determining a taxpayer's holding period for a position, any period during which the position was held prior to the balanced period could be tacked to any period during which the position was held after the close of the balanced period.

The bill would provide that a taxpayer holds an offsetting position in personal property, if the taxpayer holds one or more positions in personal property which substantially diminishes the taxpayer's risk of loss with respect to one or more other positions in personal property, whether or not the positions involve property of the same kind.

Under the bill, certain positions would be required to be treated as offsetting, unless certain statutory exceptions apply. Two or more positions which include substantially equivalent long and short positions, would be treated as offsetting if any of four conditions are met. These conditions are that (1) the positions are in the same commodity, whether or not in the same physical form; (2) the aggregate margin required by an exchange or otherwise for the positions is less than the sum of the margins required for each of the positions if held separately; (3) the positions are in debt instruments; or (4) regulations determine that the positions are offsetting.

Positions which would be treated as offsetting under any of these four conditions would be excepted from such treatment if the taxpayer establishes to the satisfaction of the Secretary that a position is not offsetting, or, if the position meets an objective standard deviation test established by the bill. The standard deviation test in the bill would exclude positions from offsetting treatment, unless the standard deviation of the change in price of part of the same or similar alleged balanced position was at least five times the standard deviation of the change in the price of the alleged balanced position (or a similar balanced position) over any two-year portion of the immediately preceding five-year period.

The bill would apply to interests in personal property which are interests, including futures contracts or options, in commodities, evidences of indebtedness and any other type of personal property. Stock in a corporation would not be covered by the provision.

Under the bill, a long position would be defined as a position which increases in value when the personal property to which it relates increases in value. A long position would include the holding of personal property, or of a futures contract or option to buy personal property at a fixed price, which similarly increases in value. A short position would be defined as a position which decreases in value when the personal property to which it relates increases in value. A short position would include the selling of personal property, or the holding of a futures contract or option to sell personal property which similarly decreases in value at a fixed price.

Under the bill, positions held by related persons would be treated as held by the taxpayer for purposes of determining whether any positions are offsetting. Generally, the attribution rules in section 318 used in determining constructive ownership of stock also would be used to determine attribution under the bill. However, in determining whether positions are offsetting, an individual's family would be limited to the individual, his or her spouse, and children under the age of eighteen.

In addition, constructive ownership would be considered to exist between a person and corporation, or from a person to a partnership, grantor trust, or estate, only if the person holds at least an 80-percent interest in the corporation, partnership, grantor trust, or estate. A special attribution rule would apply to any of the following pass-through entities: a regulated investment company, a real estate investment trust, an electing small business corporation, a partnership, an estate or trust, and a common trust fund. The bill would treat a person having an ownership interest in any of these passthrough entities as owning a pro rata share of the personal property, or of any position in personal property, of the entity which is equal to the person's pro rata share in the overall ownership of the entity.

Effective date

This provision would apply to offsetting positions established after May 5, 1981, in taxable years after that date.

B. Capitalization of Certain Interest and Carrying Charges

Present law

Under present law, carrying charges, such as storage and insurance, and interest on indebtedness incurred or continued to purchase or carry a commodity held for investment are deductible as an expense paid or incurred for the management, conservation, or maintenance of property held for the production of income (Code sec. 212), notwithstanding that the sale of a commodity may result in long-term capital gain.

However, a limitation is imposed under Code sec. 163(d) on interest on investment indebtedness. Generally, the deduction for such interest is limited to $10,000 per year plus the individual taxpayer's net investment income. Any remaining amount can be carried over to future years.

Explanation of provision

The bill would require taxpayers to capitalize certain otherwise deductible expenditures for personal property, other than options or futures contracts, which is part of an offsetting position (as defined in the bill and discussed above in section A) to the extent the expenditures are allocable to the balanced period. The expenditures to be charged to capital account would be interest on indebtedness incurred or continued to purchase or carry the personal property and any storage or insurance costs for the property.

Effective date

This provision would apply to expenditures made after May 5, 1981, in taxable years ending after that date.

C. Treatment of Short-Term Government Obligations as Capital Assets

Present law

Under present law, most assets held for investment are treated as capital assets. Net long-term gain from the sale or exchange of these assets results in favorable tax treatment and any deductions for net losses from sales or exchanges of capital losses are limited. (See discussion of capital gains under the present law discussion of straddles.) Gain or loss from the disposition of assets which are neither capital assets nor business assets is treated as ordinary and is not eligible for lower tax rates nor subject to the capital loss limitations.

Certain governmental obligations (Treasury bills) issued on a discount basis payable without interest at a fixed maturity not exceeding one year from the date of issue are not treated as capital assets (Code sec. 1221(5)). This provision was originally added to the Internal Revenue Code in 1941, to relieve taxpayers of the requirement of separating the interest element from the short-term capital gain or loss element when an obligation is sold before maturity.[1] Thus, all gains or losses from transactions in such obligations are treated as ordinary income or ordinary loss at the time the obligation is paid at maturity, sold, or otherwise disposed of. (Code sec. 454(b).)

The IRS has held that a futures contract to purchase Treasury bills is a capital asset if held for investment.[2] Thus, for example, a taxpayer holding offsetting positions in Treasury bill futures may take delivery of the Treasury bills on the loss leg of the straddle and sell the bills themselves in order to convert the short-term capital loss on the futures contract into a fully-deductible ordinary loss on the bills.

Explanation of provision

The bill provides that obligations of the United States, of its possessions, of a State or political subdivision of a State, or of the District of Columbia, issued on a discount basis and payable without interest in less than one year, would be treated as capital assets in determining gain or loss. Thus, these obligations would be treated by the holder in the same manner as similar debt obligations. Any discount at issue would be treated as interest under generally applicable tax rules.[3]

Effective date

This provision would apply with respect to obligations issued after May 5, 1981.

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[1] S. Rept. 673 (77th Cong.), Part I, p. 30.
[2] Rev. Rul. 78-414, 1978-2 C.B. 213.
[3] See e.g., *U.S.* v. *Midland Ross Corporation*, 381 U.S. 54 (1965).

D. Identification of Dealer Transactions in Securities

Present law

Under present law, gains and losses from property held primarily for sale to customers in the ordinary course of business are taxed as ordinary gains or losses. Gains and losses from property held for investment are taxed as capital gains and losses.

Gains and losses of a person from the sale of property of a type held by the person primarily for sale are generally ordinary. However, the Code contains a rule (sec. 1236) to allow a securities dealer to identify and segregate certain of its assets as held for investment. Gains and losses from the sale of these assets may be treated as capital gains or losses.

Under the rules, in order to receive capital gains treatment, the security must be "clearly identified" on the dealer's records as held for investment within 30 days following the date of acquisition and may not thereafter be held primarily for sale to customers. If a security is at any time clearly identified as held for investment, ordinary loss treatment is denied.

The term "security" means any share of corporate stock, any note, bond, debenture, or other evidence of indebtedness, or any evidence of an interest in, or right to subscribe to any of the above.

Because a dealer can wait 30 days to identify securities held for investment, the dealer may wait the 30 days to determine which securities rise in value. The dealer might choose to identify these appreciated securities as held for investment in the expectation that this appreciation will hold or continue and be eligible for preferential treatment as long-term capital gains. Also, the dealer might want to treat any securities which have declined in value as held primarily for sale to customers in order to treat losses from these securities as fully deductible ordinary losses.

Explanation of provision

The bill would require a dealer in securities to identify a security as held for investment not later than the day after the date of the security's acquisition instead of before the expiration of the 30th day after its acquisition, as required under present law. No security which is part of an offsetting position would be treated as clearly identified in the dealer's records as a security held for investment unless all securities belonging to the offsetting position are properly identified in a timely manner.

Effective date

This provision would apply to securities acquired after May 5, 1981, in taxable years ending after that date.

E. Sale or Exchange

Present law

The definition of capital gains and losses in section 1222 requires that there be a "sale or exchange" of a capital asset. Court decisions have interpreted this requirement to mean that when a disposition is not a sale or exchange, for example, a lapse, cancellation, or abandonment, the disposition produces ordinary income or loss. This interpretation has been applied even to dispositions which are economically equivalent to a sale or exchange. If a taxpayer can chose the manner of disposing of a capital asset, he may sell or exchange it, if it has appreciated in value, to realize capital gains, but he may chose to dispose of it in some fashion other than a sale or exchange, if its value has decreased in order to realize a fully deductible ordinary loss.

Explanation of provision

The requirement that there be a sale or exchange in order to obtain capital gain or loss on the disposition of a capital asset would be eliminated.

Effective date

This provision would apply to any disposition after May 5, 1981.

F. Revenue Effect

The bill is expected to increase budget receipts by $1.3 billion in fiscal year 1982. Estimates for future fiscal years will depend upon judicial decisions.

IV. Other Proposals

In addition to the rule in S. 626, which would postpone the recognition of losses on partial dispositions of offsetting positions, several other proposals have been made for dealing with the taxation of straddle (offsetting positions) trading and similar transactions. The principal alternatives are (1) a rule restricting deductions for losses in commodity transactions to gains in commodity transactions and (2) an annual mark-to-market accounting system for determining income from regulated futures contracts.

A. Offsetting Commodity Gains and Losses

This proposal would create a special rule for taxpayers whose business is commodity futures trading. Such taxpayers' commodities transactions would be excepted from a general offsetting position rule, for example, the loss postponement rule in S. 626. Instead, they could deduct their commodity losses from their commodity gains. Commodity losses could not be deducted against income or gains from other, noncommodity activities or sources.

This proposal would prevent taxpayers with income or gains from real estate, stock trading, and other non-commodity sources from using commodity straddles to create losses to reduce or eliminate their noncommodity income. However, taxpayers with commodity income or gains could continue to use straddles to defer such ordinary income and short-term gains and to convert them to long-term capital gains.

B. Marking-to-Market

This proposal would provide a special rule for reporting income from regulated futures contracts, that is, futures contracts traded on United States exchanges employing a daily cash settlement, or mark-to-market system for determining traders' margin requirements. (See discussion of marking-to-market in II. C. Futures trading, above.) Futures subject to the mark-to-market rule would be excepted from a more general rule postponing losses on incomplete dispositions of straddles.

A mark-to-market system would require persons subject to the rule to mark all of their positions to market at year end. Their net gain or loss would be approximately equal to the aggregate variation margin which was credited to their accounts, or which they had to pay into their accounts, during the year.

The proper characterization of gains and losses from a mark-to-market system is the subject of debate: proposals range from treating all gains and losses as ordinary income and loss to treating them all as long-term capital gains and losses. Alternatively, income reported on a mark-to-market basis could be taxed at a specified alternative rate. The mark-to-market rule could be limited to active futures traders

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with a significant number of transactions, or it might be applied to all regulated futures contracts, regardless of the amount of trading conducted by a contract holder.

Ordinary losses in a mark-to-market system could be carried over to prior and subsequent years under the present law rules governing net operating losses. If losses on a mark-to-market system are treated as capital losses, they could be carried forward under present law to subsequent years. However, an additional amendment would be required to permit a capital loss carryback of capital losses on regulated futures contracts to prior years.

Generally, mark-to-market proposals would include special rules for futures contracts which are used as hedges for actual commodities in the normal course of a trade or business and which result in ordinary income or loss. Such contracts would be excepted from the mark-to-market rule, provided they are designated as hedges when acquired.

Senator PACKWOOD [chairman, presiding]. The committee will come to order.

I am going to place a statement of Malcolm Wallop in the record at this time. Senator Wallop will be back about 11 o'clock and will preside for the remainder of the hearing.

[The prepared statements of Senators Wallop and Symms follow:]

STATEMENT OF SENATOR MALCOLM WALLOP

Today the Subcommittee on Taxation and Debt Management joins with the Subcommittee on Energy and Agricultural Taxation in reviewing the use of commodity tax straddles to evade the payment of income tax. The Congress has a responsibility to see that commodity tax straddles do not serve the interests of those who merely wish to avoid paying their fair share of income tax. It is my firm belief that our citizens willingly pay their income taxes because they accept the joint responsibility of financing the legitimate activities of our federal government. The tax system is based on voluntary compliance. Voluntary compliance cannot be maintained if our people believe that tax loopholes exist that enable a certain class of citizens to live and work tax-free. Clearly we have a responsibility to put an end to tax loopholes so that equal taxes are assessed on equal income. Everyone should pay their fair share of taxes.

It is also important for the committee to recognize that there are many participants in the commodity exchanges who represent a broad cross section of our country's agricultural economy. The commodity futures markets are important trading centers for farmer's cooperatives, food processors, exporters and grain storage operators. It is essential that we do not enact changes in the tax law that adversely affect legitimate transactions in the commodities markets. I anticipate that today's list of distinguished witnesses will help the committee develop a balance between these two objectives.

STATEMENT OF HON. STEVEN D. SYMMS

First, I would like to thank you Mr. Chapoton for testifying today. I know that you and your department are extremely busy working on the President's tax bill and I appreciate your taking the time to present the Administration's views on this issue today.

While the motivation of the two pieces of legislation pending in the House and Senate, aimed at eliminating commodity tax straddles, is understandable and a sincere effort to keep a volunteer tax system intact, I believe that these bills, as currently drafted, would irreparably damage our nation's agriculture, livestock and financial markets.

I am personally concerned about this apparently intricate tax avoidance issue and feel it needs to be addressed. However, at the same time I fear that the proposed solutions may cause more problems than they solve.

In changing the method of inventory valuation, the proposed legislation would unintentionally create tax uncertainty (i.e., net income uncertainty) of enormous proportions for all producers, consumers, and dealers in commodities. This increased uncertainty would ruin the liquidity and efficiency of our nation's agriculture, livestock and financial markets. Indeed, a comprehensive study made recently by Coopers and Lybrand, which I understand was submitted to you yesterday, demonstrates that the impact of the proposed legislation on the United States Treasury would be disastrous. Focusing only on the market in United States Treasury obligations, Coopers and Lybrand concluded that without a comprehensive exemption of all inventory transactions the interest expense of financing the Federal debt would be increased by a minimum of $2.46 billion a year, and possibly very much more. Thus, if the legislation were passed as proposed, the Federal budget would have to be increased by some $7.5 billion or possibly more over the next three fiscal years.

Recently, I wrote to Assistant Secretary Roger Mehle with regard to this matter and I would like to read the copy of the letter I addressed to him. For your information, I have not yet received a reply but that is understandable since the letter was just recently sent. (Read attached letter)

As I stated earlier, I am concerned about the growth for the search of some tax avoidance scheme. However, I do not believe that the approach taken should restrict normal market functions. I believe a more broad-based approach towards all tax avoidance schemes is perhaps a better approach such as 1) lowering the rates considerably so that the attraction of any scheme would be significantly reduced, or perhaps 2) study the method suggested by Senator Long such as a minimum tax.

After yesterday's executive session with attorneys from your office, the IRS, the Joint Tax Committee, the Finance Committee staff and our own personal staff, I am not sure if the attorneys that were representing the Administration understood the mechanics of the tax straddle nor the impact that their views would have on the markets. Consequently, it seems to me to be extremely dangerous to make a policy decision on an issue when the policymakers are not properly conversant on the issue.

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington D.C., June 6, 1981.

Mr. ROGER W. MEHLE,
Assistant Secretary for the Office of Domestic Finance,
Washington, D.C. 20220

DEAR ASSISTANT SECRETARY MEHLE: As you probably know, the Congress has become increasingly concerned with the potential for tax abuse associated with the "Silver Butterfly" and other commodity tax straddle techniques. The House Ways and Means Committee held extensive hearings on the issue on April 30, 1981, when it considered H.R. 1293. On June 12, the Senate Committee on Finance will conduct hearings on this issue as well, when it considers S. 626.

I am personally concerned about this apparently intricate tax avoidance issue and feel it needs to be addressed. At the same time, I fear that the proposed solutions, such as those embodied in S. 626 and H.R. 1293, may cause more problems than they solve.

One such problem raised in the Ways and Means Committee hearings seems to have escaped throughtful analysis. This is the problem of significant increases in debt costs should the tax treatment of Treasury bills be changed. I am concerned that a change in existing tax treatment could cause significant disruptions in the government debt and financial futures markets. If Treasury bill income were to be considered capital gain, it seems probable that the primary and secondary government securities markets could become less liquid, more volatile, and the financial futures markets less effective for hedging. In addition, when losses were incurred they would no longer be fully deducted. These factors all point to increased risk, which as you know means increased cost. I am concerned that the added costs of funding the National Debt that would likely result under the proposed changes now before the House Ways and Means Committee and on June 12 before the Senate Finance Committee could far outweight any benefit from increased tax revenues.

I would appreciate your analysis of this potentially serious problem in managing the National Debt. I will look forward to receiving your analysis on this critical question.

Thank you for your assistance and attention to this important matter.

Sincerely,

STEVE SYMMS,
U.S. Senator.

Senator PACKWOOD. I might say to those who have been waiting out there, nothing nefarious has gone on behind the closed doors. It was simply the staff trying to explain to us what a straddle is and how it works.

We didn't want the press to realize how limited our knowledge was.

We have many witnesses today, and I am going to ask you to observe our time limits and hopefully, Mr. Secretary, you also, to observe our time limits today.

Your statements will be put in the record in their entirety. But it would be much more helpful to us if you abbreviate your oral statements and we will have ample time to ask questions.

We are going to have to hold the witnesses to 5 minutes each. There is one witness who will be here today who is not here to testify on straddles. He is here at our invitation to testify on technology and taxation. He could not come on the day we wanted him. His testimony will be inserted in the middle of the hearing. It is unrelated to this subject. I don't think, Mr. Chapoton, you have to have any comments on his testimony.

Are you ready?

Mr. CHAPOTON. Yes, sir.

Senator PACKWOOD. Mr. Secretary.

STATEMENT OF HON. JOHN E. CHAPOTON, ASSISTANT SECRETARY OF THE TREASURY FOR TAX POLICY

Mr. CHAPOTON. Thank you, Mr. Chairman.

We have a rather lengthy statement that we have submitted for the record. We will try to keep this rather brief.

I am accompanied this morning by Bill McKee, who is the Tax Legislative Counsel at the Treasury Department and David Shakow, Deputy Tax Legislative Counsel, both of whom have spent a good number of hours examining these transactions.

As we indicate more fully in our prepared testimony, the use of various kinds of straddles for tax avoidance purposes has become a very serious problem for the tax system as a whole.

These transactions are quite complicated, and I think it would be helpful if I gave a very brief and basic explanation of how the commodities markets operate and how a commodities straddle works.

First, it is important to understand how the commodity futures markets generally operate.

A commodities future is a bilateral contract. It is an agreement between two parties, one to buy and the other to sell, a fixed amount of a commodity, at a set price, at a fixed time in the future.

The buyer has concluded that the price of the commodity may go up, and he will profit on the contract if the price does indeed go up.

The seller believes that the price may go down, and wants to lock in today's price. If the price does go down, the futures contract is a success for him. Of course, if the price goes up, the seller will end up a loser on the futures' contract, since he will have agreed to sell at today's lower price for which he contracted.

Similarly, if the price goes down, the buyer will end up with a loser on the futures contract, since he will have agreed to pay today's higher price.

Since each contract will create one winner and one loser, depending upon which way the price moves, the exchanges need a mechanism to be sure that the losers pay up on their contracts, that they don't skip town when the day of reckoning comes.

That mechanism is called marking to market. At the end of each day, the losers on that day are required to come up with the amount of money they lost on that day, in cash.

This money must be paid by the start of business on the next day. Those persons who fail to pay in the cash will have their positions liquidated.

The additional payment that is made is called a variation margin, but it serves a very different role than the margin in a securities account.

In a securities account the margin reflects the amount that can be borrowed to make the securities purchase. When a customer gets a margin call, he is being asked to pay back the part of the loan that was previously made to him.

In the futures market, customers don't have to borrow money to purchase contracts, as I explained. A futures contract is just a contract, and does not involve either party making a payment to the other when it is entered into.

Margin calls are simply part of the system that requires that the parties to the contract stay current on the gains and losses in their contracts.

Of course, as part of the system, not only are losers required to pay amounts in to reflect their losses, but winners are permitted to withdraw that money to reflect their gains.

These payments are made today, on a daily basis, by the participants in the futures market.

As I have indicated, each commodity futures contract specifies a month for delivery. At any one time, contracts for various months will be traded on the commodity exchange.

We take a market like silver, with a supply of the silver that is not dependent upon how a particular year's crop is doing. The relationship among the prices for the various month's contracts is easy to understand.

Basically, the market assumes that the price of silver will go up in a regular fashion. Without going into much complexity, the market is assuming that the price of silver will go up to reflect inflation.

This is not to say that there aren't some people in the market who believe that the price of silver will go up for other reasons, and others who believe that the price will go down.

What it does mean is that once the pressure from the bears and the bulls plays itself out to set a particular level for the underlying price of silver, that market price for silver will be translated into a series of prices into the future, to reflect the expected level of inflation over the succeeding months.

This brings us to the straddle transaction. The basic straddle is a pair of futures contracts, one to buy and the other to sell, generally involving the same commodity.

These transactions can be entered into wholly for nontax reasons, for example, when an investor believes that the relationship between the two particular months' prices is out of line.

In that case, we would expect the investor to liquidate the straddle when the prices come back into line, if they do, and to recognize gain or loss on the straddle transaction.

Note, however, that the economic gain or loss results from a change in the relationship between the prices for the two contracts, not from the fluctuation in the prices of either of the two positions alone.

When the straddle is entered into for tax purposes, a different pattern is followed.

As I explained before, when prices go up, those persons who have agreed to buy the commodity will make money, and those who have agreed to sell will lose. When prices go down the opposite will occur. If a taxpayer holds a straddle position, it will behave like a child's seesaw. One side will go up while the other goes down. At the end of the year, the taxpayer sees which side has the loss, and terminates that position.

For example, if prices have gone up the taxpayer will terminate the sell position on which he has lost money. Of course, in order to avoid any significant risk, he will simultaneously with that termination, establish another sell position for a different month, so he still will have a seesaw in place.

However, for tax purposes, he will show only a loss in the current year. The gain will show up in the following year, unless the taxpayer does another straddle to defer the gain further in the succeeding year.

What I have described will explain how the straddle can be used to defer income from one year to another, without going into details. The details are set forth in our written statement. I can say there are a number of techniques by which the taxpayer may be able to insure that the loss side of the transaction is an ordinary loss that can be used to offset ordinary income—wages, interest, business profits—while the gain side is a long-term capital, taxed at 40 percent of normal rates.

Such a straddle will not only defer income from year to year, but will convert ordinary income into long-term capital gain.

Our proposal tries to insure that the tax consequences of straddle transaction come closer to the economic realities. Both sides of a straddle constitute a single investment and should be taxed as such.

Taxpayers should not have the loss part of this investment taxed in this year, and the gain part taxed in another year.

For that reason, we recommend that taxpayers not be allowed to take losses when the loss transaction is actually part of a balanced position that has not yet been liquidated.

Moreover, the character of both parts of the straddle should be the same. The gain should not be long term, while the loss is short-term loss, if in fact it is all a single investment.

For that reason, we recommend that the holding period of both parts of the straddle be suspended while the straddle is in place.

However, we recognize that taxpayers with substantial numbers of future transactions will not be able to account easily for all

those transactions under a balanced position approach. They and we have difficulty in determining which of the short positions are offset by which long positions.

For those taxpayers, we propose that the mark-to-market procedures that is used in the futures market today be applied to determine tax consequences. In other words, taxpayers who pay more variation margin for the year than they are allowed to withdraw under the mark-to-market procedure would have a loss for the year. Those who receive more than they pay would have a gain. This proposal is not difficult to apply in practice since it simply follows the procedure that persons in the market are already using to settle their accounts.

It eliminates any need to determine when a taxpayer is in a balanced position.

Our proposals are set out in greater detail in the written testimony we are submitting for the record.

The proposals that are in the prepared testimony that I have not described in my oral presentation relate to the conversion of ordinary income into capital gain. They are crucial to a solution of the straddle problem. However, because they require significant elaboration and explanation, I will not describe them any further this morning, unless there are specific questions about them. These proposals are essentially the same as the proposals we made in our prepared testimony before Ways and Means, and they have not been the subject of as much comment as the basic straddle proposal.

I should note also, that as in our previous testimony, before Ways and Means, we are advocating an exemption for persons whose futures' transactions hedge risks in their business dealings in physical commodities. These are the farmers and the grain elevator operators who use future contracts as part of their normal business practices. Those taxpayers would simply identify their hedging transactions, to have them excluded from the rules of our proposal.

Finally, Mr. Chairman, let me make the point that it has been argued that any proposal in this area should not apply to professional commodity traders.

Instead, persons have suggested that traders and other persons be eligible for tax-favored treatment of their commodities' gains.

Treasury has not incorporated such an exception in its proposals for dealing with the problems in this area. Our emphasis continues to be on the correct method for tax purposes, for dealing with gains and losses from commodities transactions.

Our proposals depend not on the taxpayers' intent, but rather reflect the economics of transactions in the futures market.

Futhermore, we could see no reason to afford this particular class of taxpayers the opportunity to defer income at their election, and to convert that income into long-term capital gain.

The driving thrust in these markets has been and will continue to be the opportunity to make an economic profit. Taxing persons who are professional traders does not deprive them of a chance to make an economic profit.

Thus, we expect these markets will continue to function in an efficient manner.

That concludes our oral statement, Mr. Chairman. We would be happy to answer any questions.

Senator PACKWOOD. Thank you, Mr. Secretary.

Senator Dole.

Senator DOLE. I have one question, Mr. Secretary, and maybe you have already had a chance to address it.

We have been told that the proposed change in the method of valuing inventory should not apply to any transaction entered into in the ordinary course of business for the purpose of reducing the potential gain or loss on inventory produced, consumed, bought, held for sale, or sold in the ordinary course of business.

Now, does Treasury have a position on such a provision?

Mr. CHAPOTON. Our position is that if the hedging transaction to hedge fluctuation of inventory prices is designated as such, then the rule would not apply. Mark to market and balanced positions rules would not apply.

Senator DOLE. All right. Well, there has been some language suggested based on a study that I guess will be discussed later on this morning.

Perhaps I could read you the precise language suggested. It is very brief.

> Neither the offsetting position rule nor the mark to market rule shall apply to any transaction entered into for the purpose of reducing potential gain or loss on inventory produced, consumed, bought, held for sale or sold in the ordinary course of business.

Now you may want to study that in more detail. That in essence is something that may belong in any legislation we propose to pass.

Mr. CHAPOTON. I think we would agree, provided the hedge transaction in the futures contract is designated as a hedge on inventory.

Senator DOLE. Well, we will discuss this specific language later. There is some interest in Treasury in that exemption.

Mr. CHAPOTON. Yes, sir.

Senator DOLE. You would support it if it is properly drawn?

Mr. CHAPOTON. Yes, sir.

Senator DOLE. Thank you,

Senator PACKWOOD. Senator Symms.

Senator SYMMS. Thank you, Mr. Chairman.

Mr. Chapoton, Mr. Secretary, I appreciate your testifying today. I know that you are extremely busy down in the Department working on the President's tax bill. We appreciate you taking time to talk about this issue today.

I would have to say that I agree that I understand where your motivation is coming from on these two pieces of legislation in the House and Senate that are aimed at trying to eliminate commodity tax straddles.

Understandably, I can see, as a Treasury point of view, that you, I hope, are trying to make a sincere effort to keep the volunteer tax system, volunteer taxpaying in effect.

But, my own opinion is that these two bills, as currently drafted, would do a lot of damage to the Nation's agriculture, livestock and also, something that I think we on the Finance Committee should consider, the financial markets and what the cost would be of Treasury bills in refinancing the national debt.

Not that I am not concerned about the intricate tax avoidance issue, I am. I think we need tc address it. But, I think at the same time, I am really concerned that these proposed solutions will cause more problems than they might solve.

The method of changing inventory which you just addressed with Senator Dole, it appears to me and would you agree with me that this would provide for tax uncertainty and net income uncertainty.

Do you think that would happen?

Mr. CHAPOTON. No, Senator. The point that Senator Dole mentions, and our response to that I think it would not cause uncertainty. You could continue to hedge inventory. You would designate the transaction as such and the market should work.

Senator SYMMS. You mean if we do anything that would affect uncertainty with respect to what the taxes are, we are increasing the cost. I think that would really ruin the liquidity and the efficiency that we have developed up to this point in our agriculture, livestock and also, financial markets.

That is what one of my real concerns is.

I asked you earlier this morning, but I ask you here for the record. There was a comprehensive study which I have not read yet, by Coopers and Librand, which I understand was submitted to you yesterday, the same time that I received a copy of it.

Their proposition is that it would be disastrous to the Treasury as far as the Treasury obligations. They concluded that the comprehensive exemption of all inventory transactions and the interest expense of financing the Federal debt would be increased by a minimum of $2.46 billion year, and possibly more if the legislation were passed as proposed.

The Federal budget would have to be increased by some $7.5 billion, over the next 3 fiscal years.

Do you agree with that?

Mr. CHAPOTON. No.

Senator SYMMS. Have you had a chance to study that yet?

Mr. CHAPOTON. We have not had a chance to study that report. I understand it did arrive in Treasury yesterday. I have not seen it and studied it personally.

However, from reviewing it this morning with my people who have really not had a chance to study it either, we think that we have covered the basic problem raised by Coopers and Librand adequately by the inventory designation, the rule I just mentioned.

We think we answer their concern directly, though it wasn't an answer to that report.

We have, Senator, been in close touch and worked with our debt management people in the Office of Public Finance in the Treasury Department.

We, too, were concerned about the very point that you are raising. We do not think that our proposal will, with this provision that I have described, the hedging transaction designated as such, on inventory, that it will have an adverse effect.

Senator SYMMS. Mr. Chairman, I ask unanimous consent to insert in the record, a letter that I will address later on the next go round, that I addressed to Mr. Roger Mehle, yesterday in relation to this.

I will get into that later. But, I wanted to ask one more question in the time that I have.

Don't you think that a better approach to this whole problem of tax avoidance and deferral schemes would be to lower the rate considerably of our income tax code?

Wouldn't that make more sense than to try to come in here and put Vaseline on a cancer here and there and not really address the real problem?

Mr. CHAPOTON. Senator, we think, No. 1, we certainly, as you well know, agree with you that we need to lower overall income tax rates. We are spending a great deal of time on that.

But, in addition, when a problem such as this does come to our attention, we do not feel we can ignore it, no matter what the rates may be.

Senator SYMMS. I might just mention one other thing, if I could, Mr. Chairman.

Yesterday, Senator Long mentioned that in a case like this maybe we could have a minimum tax on a taxpayer that had a certain amount of income.

Do you think that would have a better approach?

I really think every approach that has come up to now would be very disastrous to all these markets.

Mr. CHAPOTON. We respectfully do not agree that it will be disastrous. We have studied that closely. We have studied it at Senator Long's request and the minimum tax, but not as directly related to this problem.

It is not, we do not think that would be an answer to this concern.

Senator SYMMS. I think my time has expired. Thank you.

Senator PACKWOOD. Senator Moynihan.

Senator MOYNIHAN. Thank you, Mr. Chairman.

Mr. Secretary, just to be explicit now, we take it that the administration of President Reagan is committed to legislation to deal with this issue of the kind you just described, and you consider this a very serious issue.

I believe you estimated that a first year savings in revenues would be $1.3 billion.

Mr. CHAPOTON. That is fiscal 1982 estimate; correct.

Senator MOYNIHAN. We heard your colleague there say to us that he feels this is a large problem today and will become much larger as the techniques of spread use become more common.

Mr. CHAPOTON. If nothing is done, it certainly will become larger, yes sir.

Senator MOYNIHAN. I take it that the proposal that you have made is not in essence different from the legislation that I introduced, with the exception that those persons with more than 50 transactions a year, who typically would be traders, would settle up, as you might say, in a mark to market basis at the end of the year?

Mr. CHAPOTON. That's correct.

Senator MOYNIHAN. Now, sir, this has the ease of its practice as you say which the markets themselves carry out now. They do that every day.

But, for the person who just enters with the object of deferring or converting income, and no economic purpose of any kind, it just makes it not possible. No respectable firm would arrange such matters. No respectable attorney would advise such matters.

To that extent, it will police itself.

Mr. CHAPOTON. I agree.

Senator MOYNIHAN. Could I ask you this, however. Our commodity markets are essential. I think they are absolutely indispensable economic institutions. I think your inventory provisions are very wise.

That means that persons who use these commodities or produce these commodities are not affected in any way. They could continue to do what they now do.

Mr. CHAPOTON. Correct.

Senator MOYNIHAN. They will use the commodity markets for the purpose that they now use them which are indispensable to people who grow corn or wheat or hogs or mine silver or copper or whatever.

But with respect to the purposes of people entering just for tax avoidance, it is the judgment of many persons in the market that the mark to market just won't work, that a great deal of commodity business will shift overseas inasmuch as only contracts traded on U.S. exchanges would have the provision.

What is your judgment?

Mr. CHAPOTON. We have, of course, heard that argument too, Senator. We do not think that will happen. We think we have—that the markets in this country have a lot going for them other than—a lot going for them other than the tax benefits currently offered.

We think, indeed, that the markets will probably be made more efficient. There will be additional taxes paid by traders on the market under our proposal.

But, there are distortions caused by the tax aspects of the market now. We think, in the long run this will be an improvement in their efficiency.

Senator MOYNIHAN. These markets were thriving well before these tax purposes appeared; isn't that the case?

Mr. CHAPOTON. Absolutely. The markets, of course, predated the tax straddle.

Senator MOYNIHAN. Thank you, Mr. Secretary.

Thank you, Mr. Chairman.

Senator PACKWOOD. Senator Byrd.

Senator BYRD. Thank you, Mr. Chairman.

What would be the effective date of your proposal?

Mr. CHAPOTON. Senator, it was earlier this year. I don't have a specific date. I tell you, we are continuing, have continued on the Ways and Means Committee appearance and since then have continued to work on the legislation, have continued to meet with groups.

I must say an effective date and a transitional rule is something we need to look at, the possible need for a transition rule, particularly for traders, is something we need to look at further.

But, we would have an effective date, basically, earlier this year.

Senator Moynihan used the words "tax avoidance." Is this tax avoidance or tax deferral?

Mr. CHAPOTON. To the extent—it is both. To the extent it is simply deferring capital gains from one year to the next or long-term capital gain for one year to the next, it is simply deferral.

But, it is clear that the opportunity exists for conversion of short-term capital gain into long-term capital gain which is tax avoidance, and indeed, the conversion of ordinary income into long-term capital gain which is also avoidance and deferral.

Senator BYRD. I have been told that Merrill Lynch no longer will handle transactions of this type; is that correct?

Mr. CHAPOTON. I have been told that too, Senator.

Senator BYRD. Thank you. I have no further questions.

Senator MOYNIHAN. Mr. Chairman, could I just say that you are quite correct, my friend and colleague, I said "tax avoidance." But being also clear that tax avoidance is every taxpayers' right. There is nothing wrong with it. At a certain point deferral becomes avoidance, because you have an effective tax free loan. But, there is nothing irregular about this. It is a question of whether it is good public policy.

Senator PACKWOOD. Any further questions?

Senator BYRD. No. Thank you, Mr. Chairman.

Senator PACKWOOD. Senator Dole.

Senator DOLE. I have no questions. I want to thank Mr. Chapoton for his good work on the tax bill. That is not an issue here. It is sort of like David versus Goliath on that stacked Ways and Means Committee. You have done an excellent job. [Laughter.]

We might help you out by speeding up passage on this side, if that would help.

Mr. CHAPOTON. We would appreciate that very much, Mr. Chairman.

Senator PACKWOOD. Senator Symms.

Senator SYMMS. Thank you, Mr. Chairman.

Now, I wanted to get this clear, Mr. Chapoton, maybe you said it in your statement and I didn't understand it. Did you say that it is Treasury's position that you want to have a Treasury bill that is traded as a financial instrument become considered a capital gains.

Mr. CHAPOTON. That is correct. Yes, sir.

Senator SYMMS. Now if that is your position, would that be the same on Government securities? All Government securities would become capital gains and viewed as a commodity?

Mr. CHAPOTON. Well, it would become capital asset, correct.

Senator SYMMS. A capital asset.

Mr. CHAPOTON. Yes.

Senator SYMMS. Well, if that is the case, don't you think those markets could become less liquid then?

Mr. CHAPOTON. No.

Senator SYMMS. You see, you know, I think Senator Moynihan's point, to get to what I am trying to get at, I agree with his point that if you disrupt the ability for liquidity for a soybean producer, wheat producer, silver producer, whoever it is, probably the end result is 15- or 20-cents-a-bushel cheaper prices for farmers.

It is hard to prove, I agree, but it could be that it would turn out that way. That will cost the Treasury a lot of money, too, and less

revenue, if the farmers don't have as good efficient market to market their crops in or the producers.

On the other hand, we are faced with the problem of financing a $1 trillion national debt. You are faced with it as part of the Treasury Department.

If you disrupt the ability for liquidity in those Government securities and cause more volatility in them, then you happen to catch this thing when the market is no longer smooth and steady, but it is up and down and more volatile and less liquid, and a much thinner market because we have driven out some speculators for whatever reason that they are in there, whether it is for tax deferral or for the speculation for anticipation of cheaper or higher prices or whatever motivates that individual to get in the market, what happens if we find out it is going to cost $2 billion or $3 billion more to finance the national debt?

This almost becomes self-defeating.

Mr. CHAPOTON. We certainly would not want a proposal that has that, we would not support a proposal that has that effect. We do not think it will have that effect.

Senator SYMMS. That is one of the questions I raise in the letter that I submitted in the record. It is probably down at Treasury today. I sent it early this week.

Mr. CHAPOTON. We will respond to that.

Senator SYMMS. I hope you will examine that very carefully. I am very concerned about what might happen in the name of trying to have a taxing system that doesn't allow for one class of taxpayers not to pay taxes and another class to pay taxes, that we end up discombobulating an already shaky system of financing this massive debt of the Federal Government.

Mr. CHAPOTON. Well, Senator, we will respond to that and we have been concerned, as I have mentioned earlier, have been concerned about that possibility from the start.

That is why we have been in constant contact with our public finance people, Assistant Secretary Mehle and his people, from the outset of the development of our proposal.

We will take a look at your letter and that report you are submitting.

Senator SYMMS. Thank you.

Senator PACKWOOD. Senator Moynihan, any other questions?

Senator MOYNIHAN. Well, Mr. Chapoton, may I just ask—yes, I do have a question.

Do you happen to know who retained the accounting firm to tell you that it would cost you another $3 billion to borrow in future and that, therefore, you shouldn't do anything with the present arrangement?

Mr. CHAPOTON. No, sir. As I say, I have not personally reviewed——

Senator MOYNIHAN. Would it surprise you if it turned out to be the people who trade in Treasury notes?

Mr. CHAPOTON. It would not surprise me.

Senator MOYNIHAN. It would not surprise you. Nor would it surprise me. I think, before the day is out, we might want to get that down. All right?

That is all I have.

Senator PACKWOOD. Thank you very much, Mr. Secretary.
Mr. CHAPOTON. Thank you very much, Mr. Chairman.
[The prepared statement of Hon. John E. Chapoton follows:]

STATEMENT OF HON. JOHN E. CHAPOTON, ASSISTANT SECRETARY FOR TAX POLICY

Messrs. Chairmen and Members of the Committees, I am pleased to appear before you today to offer the views of the Treasury Department on the growing use of transactions involving commodities, commodities futures, and financial futures for tax avoidance purposes. Although the Treasury Department is prepared to offer recommendations for legislation to curb the emerging pattern of abuse from these transactions, I must stress that our principal focus has been, and continues to be, on the economic program of the President and on the tax proposals which are a part of that program. Our comments on the use of commodities and futures transactions for tax avoidance purposes, and the recommendations that we make, must be understood as secondary in importance to the overwhelming need for swift and decisive action on the President's program.

The use of commodities and commodities futures in various tax avoidance schemes raises very serious problems in the administration of the tax laws.[1] As the Internal Revenue Service has focused more attention on these transactions, the magnitude and depth of the problems have become readily apparent. For example, when one of the eight Service groups that deal with commodities related transactions was asked recently to produce some examples of major transactions in commodities currently under audit, this sample of returns alone disclosed, in the aggregate, one quarter of a billion dollars in losses being questioned. Not only is the amount of the losses which are claimed staggering, but also, the number of taxpayers utilizing such tax avoidance schemes is rising at an alarming rate.

I. BACKGROUND ON THE OPERATION OF THE FUTURES MARKET?

In order to appreciate the difficulties raised by commodities and other futures transactions, it is helpful to understand the operation of the futures markets in general. These markets, and the instruments which are traded on these markets, are totally unlike the stock and securities markets with which most of us are familiar. As will be described in more detail later, all commodities futures positions are "marked to market" on a daily basis, and actual cash will be either paid or received in respect of an increase or decrease in the market value of a position in the commodities futures market.

A commodities futures contract is a standardized, interchangeable, executory contract either to purchase or to sell a specified quantity of a particular commodity at a specified time in the future at a fixed price. This contract is not an option—it is a binding, bilateral agreement for a transaction to occur in the future. The person who will receive delivery of the specified quantity and grade of the commodity in a particular month (the "delivery month") upon full payment of the contract price is referred to as being in a "long" position. The person who will make delivery of the commodity in the delivery month is referred to as being in a "short" position. A "straddle" is a position in which a person simultaneously holds both a long and a short position, ordinarily in the same commodity, but in different delivery months (e.g., June 81 silver and August 81 silver).

Futures contracts may be settled by delivery or by taking an opposite or offsetting position in the futures market. Very few futures are held to maturity and virtually all are offset by the holder entering into an opposite position prior to the maturity date. For example, the holder of a long position in December silver may elect, at any time prior to the receipt of delivery, to enter into a contract to sell December silver, thereby offsetting his December long position.

A clearinghouse for each exchange guarantees performance on all futures contracts. Every day, once the accuracy of all of the transactions on the exchange is verified, the clearinghouse of the exchange becomes the buyer for everyone who has

[1] In my testimony today, I have assumed that taxpayers can successfully maintain that they are entitled to certain tax benefits as a result of engaging in these transactions. In fact, the Internal Revenue Service has taken a contrary position on many of these issues and litigation is presently being maintained in the courts. This litigation is proceeding on the basis of several theories any one of which, if successful, would deny the taxpayers the favorable tax consequences which they claim. The length of time needed to achieve a judicial resolution of these issues to a degree sufficient to prevent taxpayers from claiming the tax benefits of these transactions on their returns may be quite long. Accordingly, we believe that a legislative solution to these questions is necessary to curtail these abuses. We are confident that the Internal Revenue Service will ultimately prevail in the litigation, however.

sold a contract and the seller for everyone who has bought a contract. This enables the individual trader to liquidate particular contracts with ease because the purchase of an offsetting position is automatically matched against the previously held contract, and both are cancelled.

A person who enters into a futures contract, for example, a long contract for October 82 silver, is not required to pay the full contract price until the delivery date in October 1982. The person is, however, required to deposit original margin funds with the broker, in an amount at least equal to the minimum set by the exchange for that position. This initial margin is a form of "earnest money." In addition to the original margin, the person may be required to put up additional margin, in cash, which is known as "variation margin." The amount of variation margin for any one contract on a given day is a function of the amount and direction of the daily price move. At the end of each day, a committee (the "Committee on Quotations") for each exchange on which futures trading occurs sets the "settlement price" for each contract for that day. A settlement price is determined for every contract on the exchange, even though there may not have been any trades in the contract that day. The settlement price is then used by all clearing member firms on the exchange to determine the amount of variation margin that they are required to pay to, or that is credited to their account with, the clearinghouse in respect of their open customer positions. Each commission house thus receives cash from the clearinghouse which it, in turn, uses to pay out, in cash, the profits earned that day by its customers. Similarly, the commission house must pay from its own funds, or customer funds obtained by a margin call, any losses sustained that day by customers. Generally, any additional variation margin is required to be paid, in cash, before the opening of trading the next day. If the member firm is entitled to receive variation margin, the excess is generally available on the day following calculation of the settlement price. Thus, if a person buys one Treasury bill futures contract for delivery of December 81 Treasury bills (the standard contract provides for delivery of a $1 million face amount of 90 day bills) at 87.30 and the settlement price reaches 87.50, the person will be entitled to receive $500 in cash (the variation margin required for this contract is $25 per point).

This process of "marking to market" has no analog in the stock or securities market. In the stock market, a person can purchase securities on margin (i.e., part of the purchase price is provided in the form of a loan collateralized by the securities). A person cannot, however, withdraw the appreciation in his securities position for his unfettered use—any withdrawal of cash can only be in the form of a loan. This must be distinguished from the cash disbursements made under mark to market. These cash payments are not loans—the cash is subject to the complete and unfettered right of the person to spend it as he wishes. Thus, in no real sense is the gain unrealized or is there a lack of a closed and completed transaction. On a daily basis, the realized trading gains are made available, in cash, to the taxpayer and realized losses are made up, also in cash. The daily settlement works to close each futures position at the end of each day.

II. USE OF COMMODITIES AND FUTURES CONTRACTS FOR TAX AVOIDANCE PURPOSES

Taxpayers are currently engaged in an astonishing variety of transactions, the principal purpose of which is tax avoidance, involving commodities (e.g., silver, soybeans, Treasury bills) and futures contracts for commodities. Although a strict categorization of these transactions is difficult, we have grouped them into five basic classes for purposes of analysis:

Straddle transactions involving balanced positions in particular commodities. A taxpayer will enter into a futures contract obligating him to purchase a given quantity of a commodity in some future month and also enter into a futures contract obligating him to sell the same quantity of the commodity (or a closely related commodity) in some other future month. These transactions present the opportunity both to defer the payment of tax and to convert short term capital gain to long term capital gain.

Cash and carry transactions. The taxpayer simultaneously acquires the actual commodity and contracts to sell the same quantity of the commodity in a future month. This is most effective with commodities in which the price difference between the months (the "spread") is primarily a function of the cost of carrying the commodity. In addition to deferral, this transaction permits the conversion of ordinary income to long term capital gain.

Transactions involving Treasury bills and Treasury bill futures contracts. These transactions allow for both deferral and conversion of ordinary income to long term capital gain by capitalizing on the difference, for tax purposes, between a Treasury bill (not a capital asset) and a futures contract for a Treasury bill (a capital asset).

Utilizing a provision of the Internal Revenue Code permitting dealers in securities to identify and segregate certain assets as held for "investment" and thus eligible for treatment as a capital asset. These transactions also involve both conversion and deferral.

Straddle transactions which permit the recognition of an ordinary loss and an offsetting capital gain through manipulation of the "sale or exchange" requirement. This transaction is used to convert ordinary income into long term capital gain.

The most widely publicized of these techniques is the commodities straddle. As described above, the taxpayer contracts to enter into both a "long" and a "short" position in a commodity. Because the long and short positions are in different delivery months, the contracts do not automatically cancel each other with the clearinghouse. The offseting contracts generally cover the identical commodity (e.g., short June silver—silver to be delivered in June—and long Ausust silver) but may often involve the same commodity in a physically altered form (e.g., soybeans and soybean meal) or two or more commodities whose price movements are known to be highly correlated. In a straddle transaction, the taxpayer's economic risk is not measured by the price change in the underlying commodity; a given price change will produce a gain in one position and a loss in the other. Rather, the risk in a straddle is a function of a change in the price relationship between the different delivery months. If the spread between the months remains stable, a movement (up or down) in the price of the underlying commodity will produce an unrealized gain in one position and an unrealized loss of approximately the same magnitude in the offsetting position. The effect is not unlike the movement of a child's seesaw.

In straddle transactions, the magnitude of the tax loss claimed in the first year substantially exceeds the overall economic loss inherent in the straddle position. Moreover, there is no impediment to achieving an indefinite deferral of the gain through the use of a series of such transactions in each year. The benefit derived from a simple straddle transaction is the ability to defer, or roll over, an amount of gain from one tax year to the next. The value of such a deferral can be viewed as a tax free loan from the government in an amount equal to the tax that would otherwise be due.

In addition to mere deferral, however, tax straddles can be used to convert short term capital gain into long term capital gain. In order to accomplish this objective the straddle position containing the unrealized gain must be the long position and the long must be held for at least 6 months. A short position (i.e., a contract requiring the holder to make delivery) will always produce short term capital gain or loss. If an appreciated long position is held for six months and thereafter sold at a gain, the gain will be long term.

The ideal commodity in which to place a tax straddle is one with significant volatility in the price of the underlying commodity, but a relatively stable price spread between delivery months. A taxpayer entering into a straddle in such a commodity waits for the expected price movement in the underlying commodity (either up or down), sells the loss leg (maintaining the position having the offsetting unrealized gain), and claims the full amount of the loss for tax purposes. In order to maintain the same minimal risk position, the taxpayer will immediately purchase a position identical to the one just sold (long or short, as the case may be) in the same commodity but in a different delivery month.

Although the use of precious metals futures contracts is widely publicized as a medium for tax straddles, the opportunity for deferral and conversion is present in trading in other nonagricultural, and agricultural, commodities. The requirements for a good straddle vehicle are met by any commodity with a sufficiently volatile price, spreads between months that closely reflect carrying costs, and sufficient market liquidity so that contracts can easily be entered into and offset.

As an example of a typical straddle, a taxpayer may be both long June 1981 and short August 1981 silver. When the taxpayer experiences a loss in his June 1981 silver position which meets his requirements for a tax loss, he will liquidate that position and will purchase another long position, possibly in February 1982 silver. He will remain in a straddle position (protected against price movements in the underlying commodity) and can dispose of both legs in the following tax year, yet he may claim a tax loss on his 1980 return attributable to the sale of the June 1981 position. The wash sale rules, which generally apply to the sale at a loss and repurchase within 30 days of substantially identical stock and securities, do not apply to transactions in commodities futures.

The risk of loss in a straddle transaction may br further minimized through the use of the so-called "butterfly" straddle. A butterfly straddle actually involves the purchase of two offsetting straddle positions; four contracts in all. In addition to the long June 81—short August 81 silver straddle described above, the taxpayer utilizing a butterfly straddle may purchase another straddle in which he is short August

81 and long October 81 silver. (The taxpayer's overall position is as follows: 1 long contract for June 1981 silver, 2 short contracts for August 1981 silver, 1 long contract for October 1982 silver). For a taxpayer in this position, any loss attributable to a change in the spread between months experienced with respect to one straddle position will be almost entirely offset by a gain attributable to the same change in the spread in the second straddle position. The spreads will move in the opposite direction from each other, but in approximately the same amount, thus reducing the economic risk attributable to a lack of stability in the spread between delivery months.

The Internal Revenue Service, in 1977, ruled that a loss in a silver straddle in not a deductible loss for federal income tax purposes. Rev. Rul. 77-185, 1977-1 C.B. 48. The ruling was not limited to butterfly straddles. The Service has applied a similar analysis in the case of losses claimed with respect to straddles involving other commodities. Rev. Rul. 78-414, 1978-2 C.B. 213 (straddle transactions in futures contracts covering Treasury bills).

The second basic category of transactions which we have identified as used for tax avoidance purposes are those referred to as cash and carry transactions. A cash and carry transaction affords the taxpayer the opporturnity both to defer the payment of income taxes and also to convert ordinary income (taxable at a maximim 70 percent rate) into long term capital gain (taxable at a maximum 28 percent rate). In the cash and carry transaction, the taxpayer acquires the actual commodity (e.g., silver) and simultaneously enters into a contract for the delivery of the same quantity of the commodity (a "short") more than one year hence. This transaction usually involves commodities in which the spread between the price of the actual commodity and the price for the futures contract is generally a function of the costs of carrying the commodity to the delivery month: storage charges, insurance, and an interest factor. Thus, the spread acts to compensate the holder for the market's evaluation of the cost of carrying the commodity. Generally, this spread will not increase above the full carrying costs. To the extent that it does at any given point in time, arbitrageurs enter the market to profit from the disparity, causing the market to return to the equilibrium relationship between the spread and the actual carrying charges. The taxpayer holding the actual commodity may claim current deductions for the cost of storage, insurance, and interest paid on the indebtedness incurred to carry the commodity even though the spread compensates him for these costs. After a year, if the price of the underlying commodity has risen above the contract price for the short postition, the actual commodity can be sold and the gain reported as a long term capital gain if the commodity is a capital asset in the hands of the taxpayer, (there will also be a short term capital loss when the futures contract is offset.) If the spot price is not in excess of the contract price of the short position, the taxpayer can deliver the physical commodity against his obligation under the short position. In either case, the gain from the sale or exchange of the commodity will be reported as a long term capital gain and the amount of the net gain will be substantially equal to the sum of the interest, storage, and insurance charges claimed as current deductions by the taxpayer. Thus, the taxpayer will have been able to defer an amount of ordinary income equal to the deductions claimed and to convert that ordinary income to long term capital gain.

The taxpayer in the cash and carry transaction is able to assure himself of being compensated for the carrying costs at the time the spread is entered into. Although the taxpayer may bear the risk that these costs will increase dramatically in the interim, the taxpayer may also be able to "lock in" the cost of borrowing, generally the major carrying cost, at the same time that he locks in the spread (which contains a component that compensates for the interest cost). This substantially reduces the risk that the carrying changes actually paid will exceed the spread between the spot price and the futures price when the position is established.

The third principal category of transactions in this area involves transactions designed to capitalize on the differential treatment, for tax purposes, of Treasury bills and Treasury bill futures contracts or other governmental debt obligations. Under current law, Treasury bills and other governmental obligations issued at a discount, with a fixed maturity not exceeding one year, are expressly excluded from the definition of a "capital asset" by section 1221(5). Gains and losses on the sale or exchange of a Treasury bill constitute ordinary income or loss and there is no need to segregate the portion of the original issue discount accrued during the time the obligation is held from the gain or loss realized upon the sale or other disposition of the obligation. Further, no part of the discount at which the obligation was originally issued accrues as income until the date on which it is paid at maturity, sold, or otherwise disposed of.

Although a Treasury bill is, by statute, excluded from the definition of capital asset, the Internal Revenue Service has ruled that, generally, a commodities futures

contract for the delivery of a Treasury bill constitutes a capital asset. Rev. Rul. 78-414, 1978-2 C.B. 213. Accordingly, gain or loss recognized on the sale or exchange of such a futures contract constitutes a capital gain or loss.

The different tax treatment of Treasury bills and Treasury bill futures contracts (and other government obligations) has been used by taxpayers in transactions which both defer amounts of ordinary income and convert that income to short term or long term capital gain. One trading strategy involves the person entering into a Treasury bill futures straddle in much the same way that the taxpayer entered into the silver straddle described earlier. Assume, for example, that the taxpayer buys one contract for delivery of a Treasury bill in September 1981 (a "long") and sells one contract for delivery of a Treasury bill in December 1981 (a "short"), and that interest rates rise in the interim. The rise in the interest rates will result in the September 1981 long position producing an unrealized loss and the December 1981 short position producing an unrealized gain of approximately the same amount. The taxpayer will maintain this straddle position until the settlement date on the September contract, accept delivery of the Treasury bill, and immediately sell that Treasury bill on the market claiming an ordinary loss on the sale of the Treasury bill. The December short position would be closed out at the same time, producing a short term capital gain. The taxpayer can then use some other straddle, such as a silver straddle, to defer the recognition of this short term capital gain to a later taxable year and ultimately to convert it to a long term capital gain.

The fourth category of transactions which we have identified involve the use of a special provision of the Internal Revenue Code permitting dealers in securities to identify and segregate certain of their assets as held for investment. Under current law, gains and losses from property held primarily for sale to customers in the ordinary course of business are reported as ordinary income or loss. Gains and losses from property held for investment, however, are capital gains and losses. Under section 1236, however, persons who are dealers in securities are able to identify and segregate certain of their assets as held for investment, even though these assets are similar, or identical, to assets which are held as inventory, provided that they do so within 30 days of the date of acquisition.

We have disovered that partnerships are being organized, and interests in such partnerships sold to investors, which are intended to operate as so-called "broker dealers" and "market makers" with regard to a wide range of securities. It is claimed that these investments provide ordinary losses equal to some multiple of the taxpayer's cash investment (e.g., 3:1) with income recognition, often in some later year, at long term capital gain rates. These broker-dealer partnerships generate their ordinary losses and capital gains, in part, by establishing straddle positions in securities, and waiting up to 30 days for a price movement to produce a loss on one position and an offsetting gain in the other. The partnership then identifies the loss position as inventory and the gain position as investment and closes out the straddle position, reporting an ordinary loss on the "inventory" assest and a capital gain on the "investment" asset. Although futures contracts on commodities and financial instruments, which are uniquely suited to the balanced position role, are not "securities" for purposes of section 1236, it appears that taxpayers may claim similar tax treatment for these gains or losses by analogy. It is not essential to the success of these schemes that the "investment" asset be held for more than one year. All that is needed is to produce an ordinary loss and an offsetting short term capital gain. As was demonstrated earlier, there are any number of straddle transactions that can be used to defer the short term capital gain and convert it to a long term gain in a later year.

The final category of transactions which we have identified as presenting opportunities for tax avoidance are certain straddle transactions which may directly convert ordinary income into long term capital gain as well as producing deferral of the income to a later year. Under the Code, a taxpayer generally recognizes gain or loss upon the "sale or other disposition" of property. In order for the gain or loss to constitute a capital gain or loss, the asset must be a capital asset in the taxpayer's hands and the disposition must qualify as a "sale or exchange" of the asset. To the extent that a disposition does not constitute a sale or exchange, the gain or loss is ordinary.

Taxpayers are now entering into certain contracts, generally forward contracts (a forward contract is similar to a futures contract, except that it is separately negotiated rather than standardized, and not traded on an exchange), as part of a balanced position. For example, the taxpayer may enter into a forward contract to purchase German marks in September 1982. On the same date, the taxpayer may enter into a forward contract with another person to sell the same or similar quantity of marks in December 1982. This is similar to the basic straddle transaction discussed earlier with its accompanying seesaw effect. With a fluctuation in the

price of marks, there will be an unrealized gain with respect to one of the contracts and an unrealized loss with respect to the other contract. The taxpayer will cancel (in a disposition not amounting to a "sale or exchange") the contract showing the loss upon payment of an amount of money equal to the loss to the other party to the contract. At the same time, the taxpayer will assign or sell to another party the contract producing the unrealized appreciation. In this type of forward contract straddle, the taxpayer will report an ordinary loss on the contract that was cancelled equal to the amount paid to cancel the contract and a capital gain on the contract that was assigned, which will be long term if the contract has been held for more than one year and constitutes a capital asset in the hands of the taxpayer. Thus, the transaction is used to convert an amount of ordinary income into long term capital gain. Although the above example illustrates this transaction using currency forward contracts, any form of forward contract where there is sufficient volatility in the price of the underlying commodity can serve as a ready vehicle.

III. PROPOSALS FOR LEGISLATIVE CHANGES

The Treasury believes that legislative action is necessary to stem the growing use of commodities and commodities related transactions for tax avoidance purposes. As we stated earlier, the Internal Revenue Service is actively litigating the tax issues involved in these transactions. Such litigation is likely to take many years to achieve a definitive resolution that would prevent taxpayers from claiming the benefit of these transations on their returns. Decisive and clear cut action is needed to stop these tax avoidance schemes. We estimate that adoption of the proposals set forth below will increase budget receipts by $1.3 billion in fiscal year 1982.

1. Straddle transactions

The Treasury proposal for the basic straddle transaction would establish a general rule for commodities and commodities related transactions, similar in approach to the "balanced position" rules of S. 626. It would also establish a special rule for persons with a significant volume of transactions for whom the pairing of balanced positions is difficult and for certain inventory transactions.

Under the general rule, a taxpayer could not recognize a loss from a balanced position in excess of the gain recognized as part of the same transaction, unless the taxpayer remained out of that position for 30 days. Any loss in excess of recognized gain would be treated as sustained for tax purposes at the close of the 30 day period unless the taxpayer disposes of all of the straddle positions before the running of the 30 day period. In that case, the loss would be treated as sustained on the day the person disposes of the last position.

A balanced position would be one in which the taxpayer's risk of loss is substantially reduced by reason of holding two or more positions in property. We propose that the Internal Revenue Code set forth a series of presumptions that would conclusively identify balanced positions. These positions are as follows:

(a) Positions in the same commodity, whether established in the actual commodity or a futures contract for the commodity.

(b) Positions with respect to the same commodity, but in a substantially altered form (e.g., silver and silver coins; soybeans and soybean meal).

(c) Positions in commodities with respect to which the margin, required by any exchange on which the commodity is traded (or otherwise), for entering into the balanced position, is less than the aggregate margin required for each of the positions held separately.

(d) All positions in debt instruments and futures contracts for debt instruments.

(e) All such positions as the Secretary may, by regulation, prescribe.

The conclusive presumptions that would be set forth in (d) and (e) would not apply in those cases where the taxpayer can establish, to the satisfaction of the Secretary, that the positions are not offsetting.

Whenever a taxpayer is in a balanced position, the holding period for any property that is part of the balanced position would be suspended for the period that the position is considered balanced. Accordingly, a balanced position could no longer be used as a vehicle for converting short term capital gain into long term capital gain.

We also propose that a special rule apply in the case of persons who have a significant volume of commodities transactions. Most often, this rule would apply to persons who are traders in commodities. The volume of their transactions makes a balanced position rule, requiring the identification of particular positions, cumbersome to apply. There is also the risk that such a rule could be avoided by these market participants.

In lieu of the balanced position rule, we propose that these persons be subject to a mandatory "mark to market" rule for their positions in futures contracts traded on an organized futures exchange. Under the normal operating rules of the futures

exchanges, futures positions are marked to market daily. Actual cash settlements are made on a daily basis to reflect the gains and losses in the futures position. The daily cash payments are not loans and do not bear interest. Thus, the rule we propose does no more than make the tax laws reflective of the underlying market transactions.

The persons who would be subject to this special rule would be a class of traders in commodities. For these purposes, we would define a "trader in commodities" as any person who entered into more than 50 transactions in futures contracts traded on an organized exchange in at least 3 of the 4 quarters of the taxable year. A "transaction" would be defined as a single trade, regardless of the number of contracts that are part of that trade. This mark to market rule would apply only to positions in futures contracts on an established commodities exchange where there is marking to market and would apply to all persons who satisfy the volume test even if they engage in no straddle transactions. For positions in property that are not traded on such an exchange, the general rule, which requires the identification of balanced positions, would apply. All exchange traded futures contracts for persons subject to this special rule would be marked to market. There would be no need to identify balanced positions for exchange traded futures transactions.

Persons subject to this rule would be required to mark all of their positions to market at year end. As a practical matter, their net gain or loss will be approximately equal to the aggregate amount of variation margin to which they are entitled, or with respect to which they must pay in, during the year. A special valuation rule might have to be provided to discourage distortions in the settlement price of particular contracts at year end.

Under our proposal, gains and losses would be ordinary and losses could be carried over to prior and subsequent years under the current net operating loss rules. As part of our proposal, a transitional rule might have to be provided to deal with gains and losses accrued prior to the effective date.

Treasury does not intend for its proposal to interfere with the normal hedging activities that are carried on as part of an active business, e.g., the farmer locking in a price for his crop or the grain merchant hedging his inventory. Accordingly, we have incorporated a special exception for persons who use the futures markets to hedge quantities of the physical or financial commodities that they use in their trade or business. Those persons could designate certain of their futures contracts as hedges at the time such positions are established. (A similar rule would also apply for persons who use short sales of the actual commodity as hedges.) Designated hedges would not be subject to the general balanced position rule and the futures contracts that are a part of these positions would not be marked to market. The futures contracts to which we are referring are already treated as ordinary income assets under a decision of the Supreme Court. Thus, they offer no opportunity to convert ordinary income into capital gain. Nevertheless, the opportunity to use such transactions to defer ordinary income from year to year may still remain. We expect that this opportunity will be limited, however, because the hedging exception would be limited to designated positions that are actually being used as part of the normal activities of the business and not for tax avoidance purposes. Moreover, taxpayers must account for these hedges in a consistent manner from year to year. Appropriate safeguards would be necessary to insure that this exception cannot be exploited to create new tax shelters.

2. Cash and carry transactions

The Treasury proposal for cash and carry transactions adopts the approach of S. 626, with one modification. Carrying costs (such as storage and insurance, and interest on indebtedness incurred or continued to purchase or carry the property during the period of time that it is held as part of the balanced position) would be required to be added to the basis of the commodity. Thus, these costs would offset the gain on the sale of the commodity, preventing taxpayers from rolling over or deferring income to a later year and, in many cases, converting ordinary income to long term capital gain.

The Treasury proposal on this point differs from S. 626 only in its treatment of carrying costs for cash and carry transactions involving ordinary income assets (*e.g.*, property held for sale to customers in the ordinary course of the taxpayer's trade or business). Our proposal would permit taxpayers to continue to deduct currently the carrying costs related to these ordinary income assets even where the asset is hedged and thus part of a balanced position. Because the sale or exchange of both the futures position constituting the hedge and the asset result in ordinary gain or loss, there is no opportunity for conversion.

3. Treasury bills and treasury bill futures contracts

The Treasury proposal on this point is identical to S. 626. It would repeal the exclusion for short term, discount obligations from the definition of a capital asset. Thus, Treasury bills would be capital assets and gain or loss from sale or other disposition of Treasury bills would constitute capital gain or loss, provided that the security was a capital asset in the hands of the taxpayer. The holder of a Treasury bill would be required to take into account, as interest income, that part of the market discount accruing during the period of time the instrument was held.

For the vast majority of holders, this change will be of little consequence. Dealers in Treasury bills would continue to recognize all of the gain or loss as ordinary income or loss. Other persons who purchase bills would include as interest on such bills a ratable portion of the purchase discount on the bills. Thus, a person who buys a bill with ten weeks to maturity at 96, and holds it for five weeks, would include $2, half the market discount, as interest income. This rule is proposed in order to avoid any negative impact on the Treasury's debt management activities. No change is suggested in the rules of current law which require inclusion of this amount in income only upon the payment at maturity, sale, or other disposition of the obligation.

Treasury does not believe that this change in the income tax treatment for Treasury bills will be damaging to the market for U.S. government obligations or have an adverse impact on the Treasury's debt management activities. In fact, the change in the treatment of Treasury bills may eliminate one distortion in the market which is now observed. In the month of December, deliveries of Treasury bills against futures contracts are abnormally high and have, on occasion, caused a squeeze in the deliverable supply of instruments. In December 1980, for example, deliveries of Treasury bills on the Chicago Mercantile Exchange's Treasury bill futures contract amounted to approximately 55.6 percent of the deliverable supply. This should be contrasted with deliveries in September 1980, where the relevant percentage was 14.7 percent.[1]

4. Identification and segregation of assets by securities dealers

Under the proposal, the 30 day period within which securities must be identified, for purposes of the special treatment provided in section 1236, would be shortened. For the gain from the sale or exchange of a security to qualify as capital gain under S. 626, such security would have to be identified as held for investment by the close of the day following its date of acquisition. Our analysis indicates that this change in the time required for the identification of investment assets is appropriate. The requirement that the security not be held for sale to customers at any time following the close of the identification period would be retained, as well as the rule regarding the treatment of securities sold at a loss.

In addition, we propose that section 1236 be amended to provide explicitly that any security constituting part of a balanced position will receive the unfavorable treatment mandated by section 1236 (i.e., capital loss and ordinary income), unless all securities that are a part of the balanced position are identified as investment securities on the dealer's records under the rules of section 1236. We believe that this change would simply clarify the treatment under current law of such balanced positions.

5. Sale of exchange requirement

In order to eliminate the ability of taxpayers to convert ordinary income into capital gain or loss through manipulation of the sale or exchange requirement, we propose that the sale or exhange requirement of current law be eliminated. Thus, any disposition of a capital asset would yield a capital gain or loss. Our proposal on this point is identical to the provision contained in S. 626.

Although this change may appear far reaching, we believe that it reaches the appropriate tax result without undue consequences. The character of the gain or loss ought to depend on the character of the underlying assets, not the method of disposition. This change might have consequences for the abandonment of assets and for casualty losses. Casualty losses generally produce an ordinary loss under current law and we would not propose changing this characterization. In the case of abandonment losses, however, to the extent that such losses may be recharacterized as ordinary under current law if a sale of exchange is avoided, we believe that the proposed change would achieve the proper tax result. The bulk of abandonments typically involve property used in a trade or business where a sale or exchange of such property also produces an ordinary loss. For property not covered by this

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[1] Source: Commodity Futures Trading Commission: Report to the Congress in response to section 21 of the Commodity Exchange Act, Pub. L. 96-276, 96th Cong., 2nd Sess. section 7, 94 stat. 542 (June 1980) table II-8.

provision of current law, we see no reason to permit taxpayers to elect the character of the gain or loss on disposition, depending on the mode of disposition.

IV. CONCLUSION

While our proposals will certainly have some effect on the quantity of transactions in the futures markets, we believe that, in the final analysis, they will improve, rather than detract from, the efficiency of these markets. It is incorrect to argue that the value of a market to the economy is measured by the quantity of transactions taking place there. In fact, a market is most valuable when the price of its goods—be they futures or any other goods—reflects best their inherent economic value. When values are distorted by tax considerations, the market is less efficient, not more, and some persons who would enter an efficient market may remain outside of an inefficient one. We believe that our proposals improve the efficiency of futures markets by insuring that measured gains or losses from transactions reflect economic gains or losses. We believe that they also improve efficiency by insuring that traders enter into financial arbitrage when they believe that price differences between assets are too great, but not when they believe that tax arbitrage offers them the possibility of profit without reference to financial considerations. Although we have reached these conclusions only after a process of careful analysis, we are prepared to consider any evidence that some or all of these markets will suffer significant harm from these proposals.

We believe that our proposals adequately deal with the problems that have arisen, and are likely to arise, with the use of the existing commodities contracts. We must point out that there are proposals to permit trading in a broad range of options (including options on Treasury bills), a futures contract based on the Standard & Poors stock average, and even options on futures. We will be reviewing carefully the extent to which current law, and the new rules we have proposed, operate to prevent the use of any new financial instruments for tax avoidance purposes.

As I stated previously, the problem of the use of commodities related transactions for tax avoidance purposes raises very serious problems in the administration of the tax laws. The use of these transactions to defer the payment of tax and to convert ordinary income to long term capital gain must be eliminated. We urge this Committee to act to eliminate this abuse.

Senator PACKWOOD. Next, we will take the panel from the exchanges, Mr. Wilmouth, Mr. Berendt and Dr. Yeutter.

Then, when we finish that panel, we will hear Mr. Landau.

Senator SYMMS. Mr. Chairman, I might just make a comment that would follow what Senator Moynihan said. I am really more concerned about the issue, than I am about who hired the accounting firm.

I think, oftentimes, sometimes in Washington we miss the point on, oftentimes it is the people who are involved in a particular industry—I note, that Mr. Reagan has a very hard time getting anybody that has any qualifications confirmed any more, because of all the laws that the Congress has passed in the last year.

So, someone who really knows something about the subject, they are automatically withdrawn from an appointment to the administration.

If they happen to know about the oil business, they don't want him in the Department of Energy.

If they know about trading commodities, they have a hard time getting on the CFTC, because of our ethics in Government rules.

I hope we don't allow ourselves to discount what may be or may not be a very credible report, just because of who might have engaged them to bring it about.

If it is going to cost us $2 to $3 billion more a year, to finance the national debt, I think we should know that and then maybe we ought to approach this problem from a broader base of having a minimum tax on them or reduce the rates that people pay again.

I think that would avoid most of the problem, anyway.

Senator PACKWOOD. Mr. Wilmouth, are you going to go first?

Mr. WILMOUTH. Yes, I will.

Senator PACKWOOD. Go right ahead.

PANEL OF: ROBERT K. WILMOUTH, PRESIDENT, THE CHICAGO BOARD OF TRADE, CHICAGO, ILL.; LEE H. BERENDT, PRESIDENT, COMMODITY EXCHANGE, INC., NEW YORK, N.Y.; AND DR. CLAYTON YEUTTER, PRESIDENT, CHICAGO MERCANTILE EXCHANGE, WASHINGTON, D.C.

Mr. WILMOUTH. In the past few years, there has been a proliferation of tax shelter devices involving commodity spreads. Their sole purpose is to facilitate avoidance on income from activities having absolutely nothing to do with commodity trading.

As to the enactment of legislation directed specifically at commodity transactions entered into for the sole purpose of sheltering unrelated income, I can state our position quite simply. That is, that we have no problem.

But, we do have a problem with legislative language so constructed that it could virtually destroy the ability of commodity futures markets to continue to perform their economic functions; namely, those of risk transfer and price discovery.

This would clearly be the result, if legislation were adopted, which taxed commodity futures on regulated U.S. commodity exchanges on a so-called mark-to-market basis, as explained just a few moments ago, by the Assistant Secretary.

What is wrong with this approach? Many things, but let me note just a few.

This concept, mark to market, should be recognized for what it is; a fundamental departure from the concept of income realization in the U.S. tax law. No one is taxed under accepted tax principles until income is realized in a closed transaction.

All taxpayers can retain appreciated assets without being taxed on that appreciation.

Moreover, the result is not changed by the receipt of cash on account of that appreciation.

A homeowner can borrow against his increased equity.

A stock investor can draw from his margin account when his stock appreciates.

Under this mark-to-market proposal the commodity industry alone would be subjected to taxation on this phantom imputed income—paper gains, on December 31, that can, and in volatile commodity markets often do, disappear in early January.

The concept could also result in the creation of instruments to be traded in nonregulated off exchange facilities, either here or abroad, to avoid mark-to-market tax rules for futures.

The concept will result in chaos for the speculator who will have various aspects of his business taxed in different ways.

For example, the relationship of the futures contract to the underlying cash contract will be distorted since the tax consequences would differ for each.

Thus, the price relationships, which are so important would be on the basis of tax laws rather than on the basis of supply and demand.

This concept would cause the taxpayer to lose control of his destiny. He couldn't do any tax planning. Every trade would have a tax impact.

The concept would cause settlement price wars on December 31, and in the latter days of the year, when trading would be a battle between the longs and the shorts, with taxable income being totally dependent upon the closing price that day.

It would, therefore, diminish the viability of the market as a hedging vehicle.

The concept will impact more than the futures market since the world of commodities includes many other instruments—spot positions, forward contracts, options. All are essential to an economically efficient U.S. economy.

The concept will cause traders to flee the commodities market and place their capital elsewhere since the incidence of taxation is market related and not related to any decision made by the trader.

This will cause major economic problems for the country.

We feel, in conclusion, that there is a simple way in which legislation to prevent continuation of a tax abuse can avoid disruption of commercially necessary trading activity, and that is by the inclusion of a qualifying gains provision which would continue existing rules, but permit them to be applicable only to the extent that they apply to related commodity gains, or to spread transactions which are an integral part of the trade or business of commercial hedges.

This would effectively achieve what the Treasury Department has officially stated it seeks to achieve—the elimination of acknowledged abuse of commodity spreads, in such a way that will not, and let me quote, "impede legitimate economic activity in this area."

Moreover, by such an approach, the examples of tax spread abuse, the so-called horror stories cited by the Treasury, and I am sure reviewed by this group, would be eliminated.

Thank you very much, Mr. Chairman.

Senator PACKWOOD. Thank you, sir.

Mr. Berendt.

Mr. BERENDT. Thank you, Mr. Chairman.

Commodity Exchange, Inc., or COMEX, as you may know, is the largest metal futures market in the world, and has become the world-wide market place for hedging, by miners, producers, and refiners of gold, silver and copper.

We welcome this opportunity to appear before you and present our views on various proposals to modify the tax treatment of transactions in the futures market.

The stated purpose of the various proposals has been to prohibit persons who have absolutely no interest in or connection with our Nation's futures markets from using those markets solely for tax avoidance.

We support that purpose and encourage a speedy determination of the most effective method of achieving that goal.

There is absolutely no valid reason for suggesting that a person with profits from real estate or oil or gas transactions or, more poignantly, a person with a substantial amount of earned income should be able to convert those profits or income into long-term

capital gains, merely because that person is fortunate enough to know a commodities broker who is familiar with straddle techniques.

However, in attempting to prevent those transactions, it is essential that the legitimate uses of straddles be understood in order to avoid termination of those uses and the resulting destruction of our markets.

There are many legitimate uses of straddles which are discussed in our written testimony, and I urge you to read that testimony to fully understand how straddles are used by commercial participants in our markets.

Why would the abolition of the current tax treatment of straddles for market participants destroy our markets?

The answer is really quite simple. It must be recognized that speculators are a critical ingredient in the functioning of our markets, since the markets are intended to afford hedging opportunities for producers, miners, refiners, and others similarly situated, there must be a pool of capital willing to be on the other side of a hedger's transaction, in order to enable the hedger to shift his risk.

It is only the much-maligned and misunderstood speculator who will utilize his capital to permit that risk transference.

It is also the speculator who supplies our market with a liquidity necessary to permit easy entry to and exit from our markets by hedgers while, at the same time, allowing minimum price adjustment.

Volume equals liquidity which equals a market where economically realistic prices are constantly discovered.

However, those speculators recognize the dramatic risk that they will experience in our futures markets. They are unwilling to assume those risks without a reasonable opportunity to earn a reasonable profit.

Short-term capital gains do not afford speculators a reasonable profit inducement.

The only method by which speculators in the futures markets can obtain long-term capital gains treatment, is through the use of straddles.

Absent that ability, not only would straddle transactions disappear from our market, but outright transactions by speculators would similarly disappear.

This would require the commercial users of our markets to seek other markets for their hedging activity.

With the current proliferation of foreign futures and similar markets in London, Hong Kong, Amsterdam, Geneva, and other centers, it would not take long for the United States to lose its preeminence as the world center for futures trading.

Proposals have surfaced which would tax the speculators' commodity gains at less than short-term rates, but at greater than long-term rates.

Since futures speculators are now obtaining long-term treatment, this would result in a tax increase.

These proposals, we believe, would discourage the important economic function served by the commodity speculators, by increasing his tax burden.

The Treasury Department has developed an alternative proposal which has become known as the mark-to-market approach.

The defects of this proposal are dramatic. The proposal first would result in different tax treatment for futures contracts and for other types of contracts such as forward contracts which are a regular part of the business of the commercial users in our market. Since commercial enterprises can frequently use futures contracts and forward contracts interchangeably, there would be no reason to use the futures contracts and accept treatment less favorable than other similar instruments.

In addition, selecting an arbitrary date, such as December 31, for evaluating all market positions would present persons with the opportunity, in lightly traded maturities, to distort the market, possibly on December 31, to reduce their tax obligation for the entire year.

Various floor brokers have told me that if that proposal were introduced, they would probably do their best to remain off the floor on December 31, and avoid the problems that will result.

In an attempt to resolve the problem that I mentioned earlier about the improper use of our markets by persons who have no bona fide interest in our markets, our industry has developed a proposal which we believe will resolve the problem and would encourage you to look at it, and review it, in the time that you have before you have to go to developing the bill.

Thank you, Mr. Chairman.

Senator PACKWOOD. Thank you, sir.

Dr. Yeutter.

Dr. YEUTTER. Yes, Mr. Chairman.

This subcommittee has already been exposed to some of the so-called horror stories in the tax straddle area. I just want the record to show initially and immediately, that we do not defend any of those.

We in no way wish to defend the tax avoidance and tax deferral schemes to which Senator Moynihan referred. That should be apparent to all who are here today.

We are not in the tax avoidance business, we are in risk management business. I hope the subcommittee and the committee will appreciate and understand that as we work on a solution to the problem.

Second, I want to add, Mr. Chairman, that this is an issue that ought to be resolved in 1981. It is not an issue that can be resolved judicially. We, that is, our members, are spending a lot of time in court on these issues. The Internal Revenue Service is spending a lot of time in audits and in courts. That is not the way to solve the problem.

The way to solve the problem is to do so legislatively. The real question involved here is how. No one disagrees that there is a problem. No one disagrees that it is a problem that merits solution, and solution immediately. The question is whether we can devise a solution that is not worse than the problem, a cure that is not worse than the disease. That is our concern.

There is no doubt that the mark-to-market proposal, for example, will lead to the demise of the tax straddle device. Our concern is that it may also lead to the demise of the industry. That would

have immense consequences to our economy, as well as to ourselves. That certainly would be most, most unfortunate.

Well, let's look at the proposed solutions. The first one that surfaced was the so-called "balanced" or "offsetting" position concept to which Mr. Chapoton referred this morning. I really believe that everybody who has looked at that concept thus far considers it to be an absolutely impossible one to administer and enforce.

We could increase the size of the Internal Revenue Service by 10 times and it would still not be an efficient or viable solution.

The alternative suggested by Mr. Chapoton is to move to the mark-to-the-market approach, which has simplicity to it and some superficial appeal. I fear, however, that the Treasury is being much too cavalier in its evaluation of this particular concept.

I was interested in Mr. Chapoton's comment that he did not see disastrous consequences to the industry if this concept were to become law. I cannot speak with that high level of confidence. I wish I could. I fear that the Treasury Department is responding here from a level of knowledge that is much too limited, notwithstanding the high level of talent that is present in that Department.

I have not seen many Treasury Department representatives in Chicago, learning about this industry, in recent weeks and months. I do not believe they can learn about the impact of this kind of legislation and the effect it may have on our industry by sitting behind their desks in Washington, D. C.

I am terribly concerned about the impact of the mark-to-market concept. I will simply illustrate that in a couple of ways.

Senator Dole, you have a lot of wheat farmers in Kansas, as does Senator Packwood in Oregon. I wonder how FARMARCO would react to the mark-to-market concept, with a tremendous proportion of futures market liquidity in December each year being represented by tax trades.

If mark-to-market trading distorts futures markets during the months of November and December, FARMARCO will not be able to effectively hedge that wheat, and neither will any of the other growers in this country.

Your potato growers in Idaho, Mr. Symms; your potato growers in Long Island, Senator Moynihan; and the soybean growers of Virginia, Senator Byrd, will experience the same difficulty.

We cannot have an effective futures market that is distorted by tax consequences late in the year or early in the following year, as I am sure the mark-to-market concept would do.

The other point, of course, that was mentioned by Mr. Wilmouth, is the relationship to markets outside the futures area. What does one do if that grain elevator operator in Kansas has a position in the cash market in which he shows losses, and one in the futures market which shows gains? Again, the tax situation will distort his response.

I am concerned too with the negative comments about carving out an area in the "basket" approach that would favor commodity traders. There just has to be a way to give those traders a means of income averaging. Under the mark-to-market concept, how would you like to be a trader with $100,000 of income one year, and $100,000 of loss the next year, paying perhaps 70 percent in taxes

the first year, and taking a $3,000 loss deduction the next year? That is not a very satisfactory proposition.

All in all, then, Mr. Chairman, I would simply say that I hope the subcommittees will look at the alternatives here very, very carefully, in terms of their potential impact on the industry, as you attempt to solve a problem which clearly merits attention.

Senator PACKWOOD. Thank you.

I had a chance to read all of your statements earlier. They were very good and helpful.

I appreciate your abbreviating your statements and staying within our time limits. It is very helpful to us.

Senator Dole.

Senator DOLE. I read the statements. We hope we can work with the witnesses in figuring out some way to do this, and I must say, without losing sight of the problem before us.

We are engaged right now, in this committee and others, in cutting medicaid benefits, food stamp benefits, and every benefit you can think of.

We were examining returns, yesterday, which show people with millions in income paying no tax. Some were traders. So, we have a problem. It may be good for the traders to say "take care of all those dentists and doctors and others who are avoiding tax; but don't bother us."

I am not certain it is quite that simple. So, we are going to be taking a hard look at how we can be fair and across-the-board.

It may not be painless, but I don't think anything we have done around here so far this year has been painless.

If you have a solution that is painless—but one thing we can't tolerate is people making millions a year and paying no tax, when we were arguing on the House floor a few days ago, whether we should make poor people put up money for food stamps.

It is a real problem.

Senator PACKWOOD. Bob, I would agree with your conclusion, but for this. Year after year, we pass economic incentives for people to do one thing or another, whether it be tax free municipal bonds or in the old days, drilling for oil. We give incentives to do it. They do it. They minimize their taxes by taking advantage of the law which we pass. Then they come back and we browbeat them for taking advantage of the law that we passed.

Senator DOLE. No, it is not illegal. It is perfectly legal. I guess those who haven't done it are the ones who ought to be criticized. [Laughter.]

There aren't many of us left. Most people know about them. [Laughter.]

Senator PACKWOOD. Senator Symms.

Senator SYMMS. Bob, in your testimony you mentioned a solution. I think you all agree with it, but I just want you to go through that again. You say there is a simple way in which legislation can prevent the continuation of a tax abuse, can avoid disruption of the commercially necessary trading activities. This is by the inclusion of a qualifying gains provision.

Could you explain that again to us in simple language?

Mr. WILMOUTH. Certainly. Let me try.

Essentially, what we are saying is that people who are involved in this marketplace are contributing a significant amount of capital, a very large amount of capital. The risks that are entailed in this business are extremely great, and the price fluctuations are very volatile.

So, it is an extremely risky business. We estimate that about 80 percent of the people who are involved in speculating in commodities markets lose some money.

These people, who are speculators and who are contributing to the marketplace, give it its liquidity. That enables us to have the best export program going.

That enables the farmer to be able to protect himself.

That enables the elevator operator to protect himself, speaking in the grains area only.

Those people who are in the commodities market and who make money in the commodities market may do so on a short-term basis. It is possible for a commodity trader or speculator, professional trader, or for somebody on the outside, to make a short-term profit, overnight literally, or within a matter of a week or a month or some time like that, a signficant profit.

We are saying because of the tremendous amount of risks that are involved, if he makes profits in the commodity markets, and only profits from the commodity markets, he should be entitled to income average.

He should be entitled to a tax parity that is available to him in other high-risk—in fact, less high risk—capital-intensive industries.

So, if you make money in the commodities market, you should be allowed to income average that to protect it, to spread it out over a period of time.

I would say that the tax abuses that you have looked at, all of those you have examined, most of those, at least—in fact, all of those we have seen, relate to income that is brought in from the outside—even ordinary income or gains from securities sales or something like that—is brought into the commodities market and protected there.

We agree that that abuse should not be tolerated.

There are, yes, I think, Senator Dole, there are individual traders who perhaps are rolling forward, so as to speak, and not paying taxes.

In some cases, that is probably necessary, because although they made money in one year, when it comes time to pay their taxes they may have lost all of that and then some. They may then roll that previous gain forward for another year.

But it is our very strong feeling that, because of the economic risks involved, and by taking a look at the amount of open interest on our exchanges, that is not a very prevalent situation.

That is rare and if there is some way to stop it, we would certainly want to stop that too. But we don't believe it is a real world problem.

Senator SYMMS. I guess if either one of you two want to comment on that.

Dr. YEUTTER. Yes, if I may supplement just for a minute, in a general way.

It seems to me, Mr. Chairman and members of the subcommittee, what we must do here is design a solution that will not force risk takers out of the futures market. That is the difficult challenge that all of us face and the challenge that was reflected in Mr. Wilmouth's comments. If there are no risk takers in these markets, there will be no hedgers. Those potato farmers, wheat farmers or soybean farmers, urban businessmen, contractors, or people dealing in Treasury instruments, will not be able to hedge, particularly in the distant months.

That is a more important issue now agriculturally than it is in the nonagricultural areas, because the agricultural contracts—exports, for example—traditionally extend many months into the future. Much of the liquidity there comes from spread trading.

Senator SYMMS. How much of the trades on all three of these exchanges of legitimate trades, traders on the floor are making, are actully hedges?

What percentage would you guess?

Mr. WILMOUTH. I think it is very difficult to say. I will say this, in our grain markets, which are our oldest markets—we are a 134-year-old grain exchange—over 50 percent are hedges.

But, don't forget, we need the speculators in there.

Let me give you——

Senator SYMMS. I was told it was over 80 percent, at one time. They were legitimate hedges, people trying to protect themselves from risk.

Mr. WILMOUTH. I am talking about commercial participants. But if you include the speculators who may have a hedge on in a cash-and-carry situation, it does rise significantly above that.

Let me give you, if I can, in just one moment, one of the problems that we foresee.

Let's say that one of the major grain companies in this country decides to contract for the sale of a million metric tons of wheat to some foreign country, for delivery 15 months from now.

They come in to the marketplace, at the Chicago Board of Trade, and protect that price that they have guaranteed in effect to the foreign country.

If we don't have speculators who are there willing to take that price risk from them, and speculators won't if they have enormous taxation burdens, then our export program, which accounts for 22 percent of our balance of payments last year, is going to go out the window.

That's one of the big concerns we have. We need the speculators there to take the risks for the commercial people such as the large grain companies, et cetera.

Senator SYMMS. Thank you.

Senator PACKWOOD. Senator Moynihan.

Senator MOYNIHAN. Thank you, Mr. Chairman.

Mr. Chairman, I think we should be more than grateful to the three representatives of our three principal exchanges for coming to us and saying they agree with the problem as we define it, which is that there is an invasion of these markets for purposes they were never intended to serve and needn't serve and cannot be of any general public interest because it is pure distortion of the tax code.

You see we have a problem. We agree on the nature of the problem and we agree we have to find an answer which produces a sufficient 51 percent agreement among all the parties or something if we can.

May I cite to you gentlemen, what you know, but for those who might be listening, who might think we have some animus against these markets, it was just 2 years ago, or 2½, 3 years ago, in our tax bill of 1978, Revenue Act of 1978, the issue arose whether some kinds of commodity transactions should be included in the 12 months capital gains requirement.

There was strong sentiment that they should, and this committee said they shouldn't. With respect, if I could make a point, since I am the villain here a little bit today, it was my proposal that entitles you to a 6-month holding period on all commodity futures contracts on your market, sir, yours and yours.

Now, that is of some advantage to you. Would you not agree?

Dr. YEUTTER. Absolutely.

Senator MOYNIHAN. You would rather have it then 18 months, wouldn't you?

And the stock exchanges took that with sufficient good humor. But, you know, we have not been uninterested in your operations, because we know how absolutely crucial they are.

In trying to find a solution, I think Mr. Wilmouth, what you talked about was an arrangement, one that was referred to as like to like, that you can only deduct a loss if you are going to offset a gain in the commodity market, you have to have a loss in the commodity market.

You just can't bring in money from outside for purposes of deferring or conversion.

I think that has a certain attraction. It means that people who are in those markets, taking economic risks in those markets will not find their situation changed in any way.

I think that is your object, isn't it? If the people who have always been in there could just stay in there and not have any bill passed here at all, that would be fine for you?

Mr. WILMOUTH. Yes.

Senator MOYNIHAN. Well, that would be fine by me too, if we could figure out a way.

Dr. YEUTTER. Yes. If I might comment on that, Senator Moynihan.

Senator MOYNIHAN. Certainly.

Dr. YEUTTER. The major criticism we have had from Members of Congress on this is the fact that our proposal would still permit this continuous rollover situation that Senator Dole had mentioned.

As we indicated earlier, we simply have not been able to design a sound way of precluding that result.

We certainly have no objection to preventing continuous rollover if there is a way to draft language that would do so.

Senator MOYNIHAN. Thank you.

Senator PACKWOOD. Senator Byrd.

Senator BYRD. Thank you, Mr. Chairman.

It seems to me that Congress will need to act to prevent the abuse of straddles and butterflies, what have you.

I think also it is important as you gentlemen point out, that in doing that, we do not destroy or greatly diminish the effectiveness of the commodity markets which are important.

Have you gentlemen attempted to work out an arrangement or agreement with the Treasury where both objectives can be accomplished?

Dr. YEUTTER. We have been spending a lot of time at it, Senator, not only with the Treasury, but particularly with members and staff on the Ways and Means Committee because they began this exercise a bit before you did on the Senate side. At the moment, we still have not resolved the differences.

With respect to our proposal, the basket approach that Mr. Wilmouth discussed, the Treasury objection is that we still have a continuous rollover potential.

With respect to the Treasury proposal, which is now the mark to market concept, we simply say we have very grave conceptual reservations about its impact on our industry and on the U.S. economy. So, at the moment, we are at an impasse. I hope we can resolve it. I believe we are all aiming at the same objective. We simply haven't reached that objective yet.

Senator BYRD. In the past, when we attempted to correct abuses, it has become somewhat impossible, and then have to be recorrected.

Dr. YEUTTER. Yes. I am deeply concerned about that, Senator Byrd. If I might comment please.

Because of the questions Senator Symms raised with respect to debt management, that has to be a major concern to all of us as Americans.

The Treasury Department indicated this morning that they felt their proposal would not adversely affect management of the national debt. I am not so sure that is correct.

It seems to me that we must be very, very careful that the solution that is designed here, does not lose a whole lot more revenue for the Federal Treasury than it generates.

Mr. BERENDT. If I may comment, Senator, just on that point. You are correct, there are situations that if the wrong decision is made, you have to come back in an attempt to correct the problems that result.

It took a long time for the markets in this country to develop into what they are today and to maintain the positions in the international commerce that they have.

They have developed over a period of years, because they have a tremendous amount of participation, a tremendous pool of speculative capital that is available so that commercial users can effectively hedge their risk.

What we are saying is that the Treasury's position, as was mentioned earlier, is that they disagree that people will flee our markets, as we are contending, that they will leave and go somewhere else, that they will find other methods of investment.

Our concern is that if they are wrong and we are right, the damage that will be done to our markets may almost be irreparable.

To come back at a later date, and to try and revise the legislation, to recapture the business that has been lost to these markets,

and to get the liquidity we have developed in these markets back, is something which we are concerned we will never be able to do.

What we are saying through our proposal is, while it may not be, the be all and the end all, the perfect cure, we believe it gives something so that we can preserve the marketplace and maintain our position as we have it today.

Senator BYRD. I think it is important. But, I also think it is very important that the abuses that have taken place be prevented in the future.

All of you agree with that?

Dr. YEUTTER. Yes; we agree.

Mr. WILMOUTH. Yes, sir.

Mr. BERENDT. Yes, sir.

Senator BYRD. You folks are the experts on this. I should not admit it, but I don't think I ever heard of a straddle or a butterfly until recently. Perhaps we on this committee should have been aware of it in the past.

But, I must say, frankly, I wasn't.

Dr. YEUTTER. It is a very complicated industry, Mr. Byrd, as you know. One of our concerns in dealing with this problem, Mr. Chairman, and members of the committee, is that there is simply not a high level of knowledge anywhere in the country, either in Washington, D.C. or elsewhere on this subject. That makes it extremely difficult to know what action should be taken. I am concerned that people who have a relatively low level of knowledge are among those who are attempting to design solutions to a problem they really do not understand.

Senator BYRD. Thank you.

Senator SYMMS. Mr. Chairman, I just want to ask one more question. I know the chairman wants to move this on. It relates to the question I asked Mr. Chapoton. I want to direct this to you, Bob. I think you trade these Treasury bills at the Board of Trade.

Dr. YEUTTER. We do.

Senator SYMMS. You touched on that, but I can't see how you could avoid causing more illiquidity in the market if you change that to a capital gain instrument.

If you could explain that a little bit more. Maybe I don't understand it. But I don't understand how the Treasury can sit there and say they are not going to cause it to be illiquid if they make the markets more illiquid, it looks to me like it is going to cost us money as taxpayers to fund the national debt.

Dr. YEUTTER. Senator Symms, there is no question about that. That was the reason for my earlier comment. It seems to me that this is one element of the tax straddle issue that has had relatively little attention. We have been paying so much attention to the broader question of tax avoidance, that we really haven't focused in on Treasury bills or Treasury instruments specifically. All of us agree that there is a situation prevalent there that needs to be changed. Again, it is a question of how it should be changed, because we are now dealing with hundreds of billions of dollars of Treasury debt. The impact here could be very, very significant. If we follow the wrong course in the treatment of Treasury bills, the cost to the Government could be many times any income that might be generated by this legislation.

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Senator SYMMS. Let me ask one other question. I think, Lee, you touched on it in your testimony about the fact we might drive these markets to London or other places. We wouldn't necessarily have to go that far, if Canada, for example, wanted to take up where the United States leaves off, couldn't they become the major grain marketing country very easily just by looking down here and seeing what the potential interference that the U.S. Government could do to their market, they could just pick it up over there and take it and we wouldn't get it back.

Mr. BERENDT. Absolutely. I think the fact that so many centers are looking to develop futures markets very similar to the ones that operate in this country is evidence enough of what you say is a valid threat.

Dr. YEUTTER. In fact, Senator Symms, it is not simply a matter of going to foreign locations. It is a matter of shifting domestically as well, because participants can simply shift from a futures market to a cash-forward market, which is relatively unregulated.

I question whether there is any public policy benefit in having that occur.

Senator SYMMS. Thank you very much, Mr. Chairman. Thank you all very much for being here this morning.

Senator PACKWOOD. Gentlemen, thank you very much for coming.

Mr. WILMOUTH. Thank you.

Mr. BERENDT. Thank you.

Dr. YEUTTER. Thank you.

Senator PACKWOOD. Thank you all.

[The prepared statements of the preceding panel follow:]

SUMMARY STATEMENT OF ROBERT K. WILMOUTH, PRESIDENT, CHICAGO BOARD OF TRADE

I am Robert K. Wilmouth, President of the Chicago Board of Trade, the oldest and largest commodity futures exchange in the country. Our members represent a cross-section of America's economy—particularly its agricultural economy. Participating in our trade pits at any given time are representatives of farmers' cooperatives, food processors, exporters, grain storage firms, financial institutions, brokers representing the public, and professional risk takers known as speculative traders.

Speaking on behalf of all of these groups—and the constituencies which they serve—I wish to express our very serious concern about one specific legislative proposal under consideration. Our overall concern is discussed in a separate detailed statement which we request be entered into the record along with this summary statement. We hope the Committee and its staff will thoughtfully consider both statements.

In the past few years, there has been a proliferation—and unabashed promotion—of tax shelter devices involving commodity spreads. Their sole purpose is to facilitate tax avoidance on income from activities having absolutely nothing to do with commodity trading.

As for the enactment of legislation directed specifically at commodity transactions entered into for the sole purpose of sheltering unrelated income, I can state our position quite simply: No problem!

What we do have a problem with is legislative language so constructed that it could virtually destroy the ability of commodity futures markets to continue to perform their economic functions: the functions of risk transfer and price discovery. This would clearly be the result if legislation was adopted which taxed commodity futures on regulated U.S. Commodity Exchanges on a so-called "mark to market basis", whereby taxes are paid on net realized gains and losses plus or minus the net unrealized gains and loses in positions open at taxable year end.

What's wrong with this approach? Many things, but let me note just a few:

(1) This concept is a radical departure from the underlying therory of the Tax Code, which is to tax only realized gains and losses.

(2) This concept imposes a tax on transactions which are still open, the results of which are still uncertain, in fact are totally unknown and subject to over-night change.

(3) This concept will result in the creation of "instruments" to be traded in non-regulated off exchange facilities to avoid mark to market tax rules for futures.

(4) This concept will result in chaos for the speculator who will have various aspects of his business taxed in different ways. For example, the relationship of the futures contract to the underlying cash contract would be distorted since the tax consequences would differ for each. Thus, the price relationship would be on the basis of tax laws rather than that of supply and demand.

(5) This concept causes the taxpayer to lose control of his destiny as he cannot do any tax planning, and every trade would have a tax impact.

(6) This concept will cause settlement price wars on December 31 and in the latter days of the year when trading will be a battle between the longs and the shorts, since taxable income will be totally dependent on the closing price that day. It would diminish the viability of the market as a hedging vehicle.

(7) This concept will impact more than the futures markets since the world of commodities includes many other instruments—spot positions, forward contracts, options—all essential to an economically efficient U.S. economy.

(8) This concept will cause traders to flee the commodities market and place their capital elsewhere, since the incidence of taxation is market related and not related to decisions made by the trader. This will cause major economic problems for the country:

(a) As futures markets grow more illiquid, the price discovery and risk transfer mechanism they provide will be diminished in utility, resulting in higher prices to consumers, lower prices to the farmer, and a reduction in exports and consequent impact on balance of payments.

(b) Less liquidity in futures markets will inhibit bond dealers and others from swapping out of and into new treasury debt financings, thus impairing the ability of the Treasury to fund U.S. debt.

(c) Banks will be reluctant to lend money on positions which cannot be hedged because of an illiquid futures market. Credit users will have severe bank leveraging problems, resulting from tax liability on futures positions.

(9) The cash and carry portion of the Treasury proposal will result in a reduction in the amount of commodities carried for future consumption by the market. The effects of this reduced carryover inventory are:

(a) The likelihood of reduced prices paid to producers and increased prices paid by consumers.

(b) Material increase in the vulnerability of the U.S. Agricultural system to external shocks.

(c) Under today's tax system speculators in the commodities markets enjoy a tax advantage as a reward for their willingness—at the risk of future price fluctuation—to assume storage costs of currently produced commodities for future consumption. If the taxation of this activity is punitive, this assumption of storage costs will disappear and other providers of storage will not replace entirely this capacity. We will then have higher costs for the storage capacity that is available, a material reduction in overall capacity, and results as stated in (a) and (b) above.

Tax treatment that discriminated against persons who, day in and day out, provide the bulk of the risk capital required for risk transfer would have a predictable and unavoidable result: it would drive risk capital out of the market and into alternative investments that might not be as economically or socially beneficial but which provide relief from inequitable taxation.

It is essential that Congress recognize the far-ranging effects of such occurrences. And, indeed, they would be far-ranging. Far-ranging and serious. Impacting on farmers who may or may not use futures markets directly but who rely on their existence and viability. Impacting on country grain elevators that could not afford to store grain—and banks that could not afford to lend on stored grain—in the absence of effective hedging. Impacting on merchants and food processors and manufacturers who hedge in connection with inventories and merchandising. Impacting on exporters who couldn't sell for export in the cash market if they were unable to buy for export in the futures market. And impacting, in the final analysis, where higher marketing costs always impact in final analysis: on consumers.

Our detailed submission discusses spread or straddle transactions—and traders known as spreaders—in considerable detail. Suffice it for here to emphasize that spreads provide a major portion of market liquidity and—in the distant delivery months in which many market users must trade—they provide virtually all of the liquidity. Any diminution of bona fide spread trading at a time when futures

exchanges are being called on to sharply expand their risk-transfer capabilities would directly and critically affect the various groups I have just mentioned.

In conclusion, there is a simple way in which legislation to prevent continuation of a tax abuse can avoid disruption of commercially-necessary trading activities. That is by the inclusion of a "qualifying gains" provision which would continue existing rules but permit them to be applicable only to the extent that they apply to related commodities gains or to spread transactions which are an integral part of the trade or business of commercial hedgers. This would effectively achieve the Treasury Department's stated intent of eliminating the use of certain commodity spreads to create tax losses as an offset to unrelated income and yet will not—and I quote—"impede legitimate economic activity" in this area. Moreover, by such an approach, the examples of "tax spread" abuse cited by the Treasury in its December, 1980, report and recommendations should be eliminated.

If this appears to suggest that professional commodity traders be somehow treated more favorably than other investors, such is definitely not the case. The fact is that those who provide capital for risk transfer in the commodities market are—under existing law—subject to other tax rules which operate in a particularly disadvantageous way given the nature of the commodity business and the way their income is treated for tax purposes.

It should be kept in mind, for one thing, that unlike other investment activities to which risk is incidental, commodity futures markets exist for the specific purpose of risk assumption. That is, the assumption of pre-existing price risks. The inherently high risks involved subject commodity traders to inordinately wide and sudden swings in their incomes. They might make $100,000 in December and lose it in January. Another characteristic of commodity trading—also with obvious tax implications--is that while other investors can and do defer gains simply by not selling, commodity traders do not have that option. Every futures contract has a fixed expiration date.

This tax disadvantage is compounded by other factors. Unlike salary or business income generally, the gains of a commodity exchange member are treated as "capital." Which means that they are not eligible for the 50 percent maximum tax, but are subject to the highest tax rate, currently 70 percent. It also means that losses can't be carried back—as ordinary losses can—to obtain a refund of previously paid taxes. That means that if a trader makes $100,000 in December, but loses $100,000 in January, he is taxed on $100,000 although he really has a net of zero.

Only by being able to offset commodity-related gains by losses from spreads at the time these losses are actually incurred is the commodity trader able to achieve any measure of parity with other investors.

The Chicago Board of Trade seeks only to preserve this measure of parity—so as to avoid an exodus of the risk capital upon which commodity markets are absolutely dependent. And so as to avoid unintended and undesired economic consequences.

Moreover—and finally—the inclusion of the "qualifying gains" provision which we suggest would require no new precedents. Tax laws now include references to "related business income." In fact, the distinction between persons who engage in a line of activity for profit and persons seeking tax-motivated losses is a familiar anti-shelter technique—similar to the minimum tax on intangible drilling costs, the limitations on deductibility of investment interest, the "at risk" rules, and the "limitation on artificial losses" provision adopted in 1975.

Such a provision should end a tax abuse, produce significant revenue gains, and preserve the viability and effectiveness of a marketing system that is—deservedly so—the envy of the world.

Detailed Statement of Robert K. Wilmouth, President, Chicago Board of Trade

Introduction

I am Robert K. Wilmouth, President of the Chicago Board of Trade, the world's oldest and largest futures exhange.

The Chicago Board of Trade appreciates this opportunity to present its views regarding proposed legislation which, if enacted in this present form, would drastically reduce the viability and economic usefulness of the nation's futures markets. Moreover, for reasons which testimony will explain, the adverse impact would by no means be limited to the markets themselves. Farmers, who may or may not utilize futures markets directly but who continuously rely on their existence and their efficacy, would clearly be done grievous harm. So, too, would ten of thousands of rural businesses: country grain elevators that would no longer be able to bid as aggressively for farmers' crops or provide storage for such crops in the absence of

the risk transfer capability provided by futures markets; agricultural banks that routinely finance the storage of grain and other commodities only when these commodities are properly hedged on a futures market; processors for whom inventory acquisition and forward pricing would frequently be impossible in the absence of liquid, competitive futures markets; exporters who depend on futures market pricing to compete effectively with the state-controlled exporting cartels of other nations; and, ultimately, consumers who are the principal beneficiaries of a marketing system that is the envy of the world.

As the Congress is well aware, legislation affecting the taxation of capital has a direct and often immediate influence on the use of capital. Indeed, much of the existing tax legislation has been enacted after thoughtful consideration by Congress for the specific purpose of affecting capital utilization. For example, investment tax credits and accelerated depreciation to encourage investment in capital assets and enhance industrial and agricultural efficiency. Other examples abound: long-term capital gains to stimulate the flow of capital into equity markets; deductions and credits permitted to attract capital into housing construction, energy development and conservation, and employment opportunities for the disadvantaged; and a host of other economic activities deemed to contribute to the public good.

While the economic benefits which can—and do—accrue from favorable tax treatment are widely acknowledged, it is ironic and unfortunate that objections raised to unfavorable tax changes tend too often to be dismissed as little more than anguished cries of those who stand to be fiscally wounded. Too often, somewhat myopically, there is a tendency to focus on tax revenues that might or might not be raised without adequate consideration of the certain and greater economic damage that would be done. Or of who, in the final analysis, would be most damaged.

"Adequate risk capital is as essential to a (futures) market whose primary function is risk transfer as adequate equity capital is to a (stock) market whose primary function is equity accumulation. Or as venture capital is to oil an gas exploration. Or as development capital is to the housing industry."

Presently proposed tax legislation, by causing the flow of capital to be diverted into other areas of investment, would seriously impair the ability of futures markets to continue to provide risk transfer opportunities and meaningful price information to those businesses which require and benefit from such opportunities and information. The financial consequences would be calamitous and far-reaching. Moreover, projections of large sums of additional tax revenue may, in large measure, be illusory, because the inevitable result of economic damage to any industry is less rather than more tax revenue.

FUTURES MARKETS: GROWING TO MEET A NEED

The rapid and relatively recent growth of futures trading—with its concurrent requirements for adequate sums of risk capital—is best understood by understanding the reasons for growth.

"From 1970 to 1980, trading volume on the Chicago Board of Trade—the Nation's oldest and largest futures exchange—increased nearly sixfold: From 7.9 million contracts traded to 45.3 million contracts traded. The growth of other futures exchanges was comparable. In total, about 90 million contracts were traded in 1980."

The reasons for growth are numerious: educational efforts which have improved the understanding of futures markets and these uses; the introduction of additional futures contracts, particularly in the area of financial instruments; and an improved "delivery system" via an expanded brokerage capability. But one reason clearly stands out above all others: futures trading has increased substantially because the need for futures trading has increased substantially . . . primarily due to increased production and increased price volatility.

Case in point: during the 1969-1970 crop year, the U.S. produced 4.7 billion bushels, of corn, exported 612 million bushels, and the price of corn fluctuated between $1.16 and $1.59—a range of 43 cents. In sharp contrast, during the 1979-1980 crop year, the U.S. produced 7.9 billion bushels of corn, exported 2.4 billion bushels, and the price of corn fluctuated between $2.57 and $3.63—a range of $1.06. This increased price volatility—today versus ten years ago—is typical of virtually every agricultural commodity. And, indeed, most non-agricultural commodities as well. For example, in the three decades prior to 1970, the price of money (as indicated by the prime interest rate) had never fluctuated more than 1.5 percentage points in any single year. In 1980 alone, it fluctuated from a low of 11.25 percent to a high of 21.5 percent.

Without belaboring the point, the primary causes of greater price volatility for agricultural commodities are worth noting. In 1970 and the prior decade, prices of most such commodities were established directly or indirectly by the government,

through production controls, non-recourse price support loans, and the management of massive surpluses owned by Commodity Credit Corporation. Subsequent to 1970, these programs were phased out, surpluses were sharply reduced, and major export markets developed. Consequently, prices began to reflect not the static and arbitrary whims of Washington but the everchanging realities of worldwide supply and demand.

The inevitable companion of increased production and increased price volatility is increased risk: for farmers who can no longer be certain at planting time what price their crops will bring at harvest time; for grain elevators that stand to lose hundreds of thousands and even millions of dollars if the market price of a stored crop drops sharply during the period of storage; for processors if inventories acquired at a high price were suddenly to decrease in value; for exporters if they enter into commitments to ship grain at some future time and specified price without knowing what they may eventually have to pay for the grain to be shipped.

Increased volatility in interest rates has likewise translated into increased risks: for borrowers—ranging from small businesses to large corporations—who face sharply higher costs when interest rates rise; and for lenders and investors—banks, insurance companies and employee pension funds, to mention but a few—who face lower returns when interest rates fall (as well as losses in portfolio values when interest rates increase).

As greater price volatility and uncertainty led to steadily greater financial risks, effective means of risk management became, increasingly and literally, a business "survival skill." And the most effective available means of price risk management was—and is—hedging. That is, the purchase or sale on the futures market of a specific commodity or financial instrument for delivery at a specific future time at a specific price. In so doing, the hedger is able to reduce the risk of adverse price changes.

The growing requirement for risk management and the ability of hedging to meet this requirement is reflected in the impressive statistics of futures trading volume. In short, the volume of futures trading has increased because there has been a necessity for it to. Fortunately, our markets have been able to respond to this necessity. And, indeed, we believe we have responded well. A buyer anywhere in the country can generally find willing sellers within a matter of minutes—usually at a price within a fraction of a cent of the previous transaction and even if the purchase is for delivery as much as two years in the future. Similarly, someone wanting to sell a commodity for future delivery has immediate access to competitive buyers. Quite obviously, the effectiveness of futures markets depends on the liquidity of futures markets—on having an adequate number of competing buyers and sellers at all times: When prices are low as well as when prices are high. When prices are moving downward as well as when prices are moving upward. When prices are volatile as well as when prices are stable. When buy and sell orders arrive in a trickle as well as when they arrive in a flood.

THE ROLE OF RISK CAPITAL

To some extent—but to only a limited extent—sellers wanting to hedge against declining prices can and do sell to buyers wanting to hedge against rising prices. And vice versa. Only rarely, however, is there an even "match-up" of hedgers who want to sell and other hedgers who simultaneously want to buy. The real world simply doesn't work that neatly. At and following grain harvest, for example, hedgers such as farmers and country grain elevators are predominantly sellers. At other times, such as when there may be a surge in export demand, hedgers may become predominantly buyers. Moreover, the actions of hedgers are influenced by their price expectations. A manufacturer of breakfast cereal, for instance, is most likely to hedge (as a buyer) at times when he expects corn or wheat prices to rise. And, conversely, he is less likely to hedge if he expects prices of those raw materials to decline. Similarly, a corporation planning a bond sale is most likely to hedge when it fears rising interest rates. On the other hand, the management of a pension fund expecting to have capital to invest would be most inclined to hedge if it expected interest rates to decline.

Consequently, no futures market could possibly remain continuously viable and liquid if its only participants were hedgers. Prices that zoomed sharply upward when a preponderance of hedgers wanted to buy and plummeted sharply downward when a preponderance of hedgers wanted to sell would bear scant resemblance to the realities of supply and demand. Such a market would be of little use to those attempting to manage risks and even less use as a mechanism for competitive price discovery.

Futures markets can perform their economic functions only when there is adequate and continuous availability of risk capital. That is, capital provided by specu-

lative traders who—in the hope of realizing a profit—are willing and able to assume those price risks that hedgers shun.

Because price forecasting is, at best, uncertain and subject to vagaries that preclude prediction, speculative traders understandably differ in their expectations. Some analyze current and prospective market conditions and conclude that prices are likely to rise. Others analyze the same or different conditions and determine that prices are likely to decline. Such differing expectations are, quite literally, what "make a market"—a market in which there are at all times some persons willing to buy and others willing to sell. This, simply put, is why hedgers seeking to sell are almost always able to find an immediate buyer (at or near the current price) and other hedgers seeking to buy are almost always able to find an immediate seller (at or near the current price).

The market couldn't work any other way. Indeed, it couldn't survive any other way.

SPECULATIVE TRADERS: WHO ARE THEY

Speculative traders can be classified in two ways: by whether they are public traders or on-the-floor professional traders. Most so-called "public" traders are individuals in other lines of work who generally speculate in commodity futures on a limited and occasional basis. For the most part, such persons are seeking to improve the returns from their overall investment portfolios by employing some portion of their assets to assume large risks in pursuit of potentially large profits. But most of the risk capital for futures trading—particularly at certain times and in connection with certain contracts—is provided by professional speculative traders. It is the capital supplied by these persons, on a day-in and day-out basis, upon which futures markets are principally dependent for their liquidity.

Speculators can be classified, secondly, by how they trade. Some are "position" traders. They make a judgment as to which direction they expect prices to move over a period of weeks or months and take a position in the market accordingly . . . buying if they anticipate higher prices and selling if they anticipate lower prices. In most cases, they hold these positions until such time as their price objectives are realized or until the market has proven their expectations wrong. The large majority of public speculation falls in the category of position trading, as does much of the professional speculation.

Other speculative traders are known as "scalpers." These traders usually buy and sell continuously and quickly in the hope of realizing profits from a large number of small price movements. Unlike "market makers" in securities markets, they have no legal obligation to either buy or sell (and thereby provide constant liquidity) but that is clearly their function. Such traders are, almost without exception, on-the-floor traders. Public traders, who must rely on a chain of phone communications to and from their broker, lack the instant trade execution and constant market presence that scalping requires.

Scalpers are an important source of speculative capital and market liquidity, especially during active markets when there are a large number of buy and sell orders to be filled for commercial participants (i.e., hedgers).

A third category of speculative trader is spreaders. Their trading techniques, motivations and risks will be explained in somewhat greater detail since it is largely a failure to understand spread trading that has prompted proposed tax legislation.

SPREADERS: A SPECIAL KIND OF TRADER

Speculative traders known as spreaders are among the most important sources of risk capital and market liquidity on a day-to-day basis. In the absence of sufficient "spreading," (or "straddles") some commercial users of futures markets—such as exporters of grain and long-term storers of agricultural commodities—would be severely handicapped in their efforts to hedge cash market purchases and sales. In fact, they would at times find it impossible to hedge effectively.

Unlike position traders and scalpers whose primary concern is with the up or down direction of price movements, the spreader attempts to profit solely from changes in price relationships. Or, more specifically, from a change in price differences. Such as the difference between the price of a futures contract for delivery of soybeans in January and the price of a futures contract for delivery of soybeans in May. Or between the price of corn and the price of wheat (called an inter-market spread).

The concept of spreading is relatively simple. A spreader expecting the difference (the "spread") between January soybeans and May soybeans to change over time would purchase one futures contract and sell the other (the purchase and sale being

dictated by the present price differential and the way in which it is expected to change).

Example.—The January soybean futures contract is currently $8.30 a bushel and the May soybean contract is 30 cents a bushel higher at $8.60. A spreader expecting the 30 cent difference to widen would sell January soybeans and purchase May soybeans. If, over time, January soybeans increased in price to, say, $9.00 and May soybeans to $9.35, the increase in the spread from 30 cents to 35 cents would yield the spreader a profit of 5 cents a bushel. For each 5,000 bushel (standard) contract, that would be a profit of $250. Had the spreader expected the initial 30 cent difference to narrow rather than widen, he would have bought the January contract and sold the May contract.

While the concept of spreading is relatively simple, the methodology and the skills required are far from simple. To be successful in this complex and highly competitive area of commodity trading, an individual must possess a thorough understanding of price relationships and a keen and constant sensitivity to anything and everything which can change these relationships.

There is a commonly-held but completely erroneous view—since spreaders are unaffected by any absolute price level movements which leave the spread unchanged—that spreading is a "riskless" transaction. Nothing could be further from the fact. As in any economic endeavor that offers a potential for profit, there are commensurate risks. Spreading is no exception.

In a "normal" market for grains, the price difference, between, say, a contract for January delivery and May delivery the same year is influenced by the "carrying charges." That is, the costs associated with owning and storing the commodity from January until May. The principal costs involved are interest on the invested capital, storage expense (of so much per bushel per day), and insurance on the stored commodity. Thus the spread between January and May, to continue the illustration, can be up to but seldom in excess of the cost of storing the actual commodity for that period (otherwise, traders would simply take delivery of the grain in January and hold it in storage until May).

Although the spread cannot exceed the carrying costs, the spreader is continuously subject to the risk that—for a variety of possible reasons—the carrying costs themselves may change. In either direction For example, if the availability of storage space were to become tight, the daily fees for storage might be increased. Or, ir the supply of storage space were to exceed the demand for it, the owners might well cut their storage fees to compete for business. Changes in interest rates also have a predictable and obvious effect on carrying costs: Increasing carrying costs when interest rates rise and decreasing carrying costs when interest rates decline.

Additionally, changes in supply and demand circumstances can cause the spread (between futures prices for two contract months) to be anywhere from nominally to substantially less than the actual carrying costs. Indeed, as sometimes happens, a strong demand for immediate delivery may actually cause the price of the nearby futures contract to exceed the price of the distant delivery month.

"In our earlier example, a particularly strong demand for immediate delivery of soybeans could cause the price of the January futures contract to increase from $8.30 to, say, $8.70 while the May futures contract remained at $8.60. The trader who expected the spread (May over January) to widen from 30 cents would have a loss of 40 cents a bushel: $2,000 per contract."

The situation described above—i.e., a negative carrying charge—is known as an "inverse market." To the extent that such a market occurs, the spreader who did not foresee it can incur huge losses.

The notion that spreads are somehow riskless is refuted by evidence as well as logic. A detailed statistical analysis by Professor Douglas Breeden of Stanford examined, in 1979, whether spread transactions in gold futures and silver futures present real economic risk. (These commodity futures were selected because the IRS, in a 1977 revenue ruling, had dealt with a silver futures transaction and because it was felt that spreads in other commodities would be at least as risky and probably more so. This was later verified in 1980 by another study of Professor Breeden's involving thirteen commodities.) Professor Breeden documented that spreads in gold and silver futures have historically involved considerable economic risk. In fact, when the leverage typically employed by futures traders is taken into account, the least risky spreads in gold futures and silver futures involved greater risk than owning a typical common stock.

Spreaders provide a substantial percentage of total market liquidity. But in certain distant contract months, they provide practically all of the market liquidity.

The reason is apparent: most position trading is in the nearby contract months, as very few such traders are willing to assume the high level of risk associated with

trading in contract months about which very little is known of the supply and demand. Spreaders, on the other hand, are willing and able to buy and sell in distant contract months because their risks are reduced by having opposite positions in nearby contract months.

In the absence of spread trading in distant months, commercial users of the market needing to hedge in these months would likely find "no takers." Or certainly not enough to fill large orders.

The ramifications of illiquidity in distant contract months would be immense and far-reaching. For instance, assume that a major grain exporter were to receive an order for several million bushels of corn—a portion to be shipped in three months, another portion in nine months and the balance in fifteen months. Hedging those purchases to be shipped in the first delivery would likely present no problem since position traders generally provide adequate liquidity in the nearby contract months. But in the absence of spreaders, there would be substantially less liquidity in contracts nine months into the future and virtually no liquidity at all in contracts fifteen months into the future. If unable to hedge, the chances are the exporter might be unwilling to accept the order and the associated risk. And the sales would go to the farmers of some other nation (probably a nation where prices and export contracts are government-managed).

As a footnote to the discussion of various speculative trading strategies, it should be pointed out that very few professional, on-the-floor member traders fit exclusively into any one category. Rather, a speculator with "positions" may simultaneously have spreads. Or he may have positions at one time and spreads at another. Similarly, individuals who are primarily spreaders may, at times, have outright market positions or participate in the market as scalpers. This is clearly one of the strengths of a viable market: The fact that risk capital is mobile; it can move rapidly to wherever it is currently needed.

It also bears noting that while most spreads involve a simultaneous purchase and sale of different futures contracts, this is by no means always the case. A trader who has a position in a particular commodity may create a spread by "adding a leg." That is, by taking an opposite position in a different delivery month or a different commodity.

Such a trader may, at the time the leg is added, have either a profit or a loss in his initial position. If he has a profit, the spread serves the purpose of attempting to lock in his gain while allowing him to further profit from a favorable change in the spread differential. If he has a loss in the initial position, the spread is likely to be motivated by a conviction that the market price is still likely to move in the anticipated direction; but until market conditions improve the spread reduces the risk of additional losses.

TAX TREATMENT OF GAINS AND LOSSES FROM COMMODITY TRADING

Proposed straddle legislation should not be considered in isolation, but in the context of the overall tax situation of commodity speculators. Some current provisions in the Internal Revenue Code subject commodity speculators to substantial tax disadvantages in comparison with persons who earn their living through other investments, such as stock. The characteristics of spread have the effect of leavening harsh tax results that would otherwise arise under present law.

First, commodity speculation is distinguished by extreme volatility of profits and losses. General tax rules apply harshly in such a volatile context. This volatility is a function of risk. While there is virtually no investment activity that does not involve some degree of risk, it must be recognized that futures trading is conducted for the specific purpose of risk transfer. Through the commodities market, a preexisting risk—the risk that a commodity may change adversely in price—can be shifted from those who are unable or unwilling to bear the risk to those who are willing and able to assume it. There is more than just a subtle distinction between a market in which risk is incidental to investment and a market where risk is the principal function.

Commodity prices fluctuate dramatically in response to events which are beyond the control and even the foresight of investors. For example, the sudden and sharp rise in soybean prices in 1973 (and the attendant gains and losses) was triggered by an event so remote and improbable that most people were unaware of it: the disappearance of anchovies from the coastal waters of Peru (and the resultant shortage of protein sources). Some months later and equally precipitous *decline* in soybean prices (with more gains and losses) was caused primarily by the imposition of an export embargo which the then current Administration had stated flatly was not under consideration.

Because of this extreme exposure of futures prices to such unpredictable events, and because of the leverage involved, the commodity speculator has far less opportu-

nity than does the typical investor to stabilize net income or losses from year to year. A commodity trader can earn large profits in one month only to see them totally wiped out in the following month. A six-figure income for one year may be offset by a six-figure loss the next.

As a result, commodity traders are peculiarly disadvantaged by the limitation on deductibility on capital losses. Under current law, capital losses can be used each year to offset only capital gains plus $3,000 of ordinary income. Individuals cannot carryback capital losses to offset income from prior years. There is a strong administrative argument against a capital loss carryback; tax return preparation for individuals would be complicated enormously if prior years' returns of inviduals were subject to amendment to account for the capital losses that can frequently be incurred by average taxpayers. However, the economic effect of capital loss carryback restrictions can be devastating in the case of a commodity trader who is forced to pay taxes on his net gains but to forego any current tax benefits from net losses.

A second distinction between commodity traders and other investors is the more limited ability of commodity traders to defer realization of gain on commmodity futures. Unlike shares of common stock or a parcel of real estate, a commodity futures contract cannot simply be held for whatever period of time happens to suit the investor's tax situation. All futures contracts have fixed expiration date that is seldom more than 2 years from the date of purchase. In fact, the average futures contract is held for less then 7 days. Such is the nature of a marketplace requiring a high and continuous level of liquidity.

A spread offers the commodity trader some measure of the tax planning available to other investors. Consider a trader who has a spread consisting of 10 contracts (50,000 bushels) of January soybeans sold short at $8.30 and 10 contracts of May soybeans bought long at $8.60. He is expecting the 30¢ spread to widen. Assume that weeks or months later the January soybean price has climbed by 40¢ to $8.70 and the May soybean price has climbed by 45¢ to $9.05. The trader now has a loss of $20,000.00 (40¢ × 50,000 bushels) in the January contract and gain of $22,500.00 (45¢ × 50,000 bushels) in the May contract.

By disposing of the loss contract in one year and the gain contract in the following year, the commodity trader can "average out" the wide and sudden annual income swings which are especially characteristic of his business. The strategy is similar to that employed by most stock investors who typically match losses and gains. Likewise, if he holds the long May contract for at least 6 months, the commodity trader may be able to obtain the benefits of favorable long-term capital gains treatment routinely available to investors trading in assets having fewer inherent constraints on the timing of gain realization.

The tax treatment of spreads not only serves to mitigate the unduly severe impact the tax laws would otherwise have on traders; it also reflects the economic realities of the marketplace. The legs of a spread frequently are separate transactions—in economic intent as well as in fact. As already pointed out, the two legs of a spread are often initiated separately and lifted separately solely on the basis of profit considerations.

Furthermore, contrary to the apparent assumptions underlying the pending straddle bills, the spreads of traders typically involve substantial economic risks and rewards. Indeed, the use of spreads is the essence of the business of many commodity traders. A trader who speculates correctly on the price relationship between commodity delivery months can reap a substantial economic gain. A trader who speculates incorrectly can incur a substantial economic loss. If a trader is deprived of any means of deferring gains until years in which the gains can be used to offset losses and of qualifying for long-term gains treatment, the commodity trader's risk capital would be eroded very rapidly through a levy of up to 70 percent on net gains with vitrually no current deduction for net losses.

In summary, present tax rules with respect to spreads offer commodity traders some measure of tax parity with other investors—and commodity markets some measure of parity in competing with other investment endeavors for necessary risk capital. It is essential that this parity be preserved. It is essential to the viability of our markets and essential in order to avoid far-ranging economic consequences which are neither intended nor desired.

Unfortunately, in recent years, the tax treatment afforded commodity trading for good and necessary reasons has become subject to some misuse as a number of firms and merchants of tax shelters have unabashedly promoted commodity spread as a way for high-bracket persons to reduce or defer the taxation of income from unrelated business activities. That is, from gains having nothing at all to do with commodity trading.

Participation in our markets for this purpose has never been advocated or endorsed by the Chicago Board of Trade or, to the best of our knowledge, by any other

exchange. Moreover, we concur with these who view such transactions as an inappropriate market use and we support legislation which would preclude so-called "tax spreads" from being used to offset profits from unrelated businesses.

To whatever extent such practices are being employed, it is possiblie that significant additional tax revenue might be realized. An amendment of this nature would involve no new precedents. Indeed, tax laws now include distinctions having to do with "related business income."

As presently drafted, however, proposed tax legislation would go far—and dangerously—beyond the correction of an acknowledged abuse. If enacted without amendment to limit its application exclusively to the area of abuse, it would clearly have disastrous consequences: disastrous for market liquidity, for markets users, and for the national economy.

At the very least, thoughtful consideration mandates asking and answering such questions as:

How, and why, would proposed tax rules affect the access of futures markets to adequate risk capital?

Simply put, risk capital would be driven from the market. Or, more precisely, other more attractive investment opportunities (those enjoying more favorable tax treatment) would pull risk capital away from futures trading. As previously mentioned, investment capital in this country is highly mobile and, in a growing economy, the competition for it is intense. Even the exposure to taxation as potentially confiscatory as that which would result from proposed rules—i.e., having to pay up to 70 percent of net annual gains in taxes with virtually no offsetting deductions in years of net losses—would rapidly make other investment alternatives much more inviting. Particularly those types of investment offering ready access to long-term capital gains treatment, rapid depreciation write-offs, investment credits and the like. In summary, tax treatment of the nature proposed would leave the professional trader with no prudent choice but to take his capital and invest it elsewhere.

To what extent would an exodus of risk capital reduce market liquidity?

While no precise projection of reduced liquidity is possible, it would certainly be substantial.

As pointed out, spreaders are major providers of market liquidity and, in the distant contract months, they provide virtually all of the liquidity for commercial firms seeking to protect themselves against adverse price changes by buying or selling futures contracts.

Reduced liquidity would by no means be limited to spread transactions or to distant delivery months. As exodus of risk capital from futures markets would also reduce the amount of capital devoted to position trading and scalping, which provide much of the liquidity in nearbly contract months.

What would be the effects of reduced market liquidity?

There would unquestionably be effects in three areas:

First, illiquidity resulting from insufficient risk capital would abruptly extinguish the growth of futures trading and of the price risk transfer opportunities that futures markets are providing to an ever-increasing number of commercial users. Indeed, without adequate liquidity, there is no way in which the markets could continue to serve, effectively, even their present users.

Second, many commercial firms would find hedging difficult and others—those needing to buy or sell in distant contract months—would find it all but impossible. There is abundant evidence, from both the past and the present—of the unwillingness of hedgers to participate in illiquid markets. An individual or firm that buys a futures contract wants assurance that there will be an activeness and competitive market when the time comes to sell the futures contract.

Third, market illiquidity would severely impede the process of competitive price discovery which (along with risk transfer) is a primary economic function of futures markets. It is frequently overlooked that speculators do more than just contribute to market competitiveness and liquidity. They are also the principle communicators of supply and demand information. Unlike hedgers, who are primarily concerned with achieving price protection, speculative traders depend for their livelihood on their ability to quickly and accurately assess worldwide supply and demand conditions, and to buy or sell accordingly. Price at any given time is thus a consensus arrived at by thousands of individual analysts who are willing to put their capital where their convictions are. Futures prices arrived at in this way reflect the best possible determination of current value based on existing supply and demand knowledge.

In an absence of liquid and competitive markets and the conduit they provide for the collection and dissemination of information, the result would be what economists call price "distortion."

Still another consequence: Increased price volatility and wider bid-ask differences would occur as traders, seeking to protect themselves in the environment of an illiquid market, reduced the prices they were willing to pay and increased the prices at which they were willing to sell.

Who would be most harmed by illiquid and therefore inefficient futures markets?

Any inefficiency or distortion in the marketing system inevitably does the most harm to those groups and individuals at the extremes of the system: That is, producers at the one end of the system and consumers at the other end.

In the case of agricultural commodities, farmers would clearly suffer the greatest harm and in the greatest number of ways. They would find it increasingly difficult to hedge the prices of their own products, such as grains and livestock. And, to the extent that illiquid markets resulted in price distortion, they could receive lower prices for their products. In addition, when country grain elevators and other buyers such as cash grain brokers, processors, and exporters are unable to hedge effectively against adverse price changes, or are able to hedge only at lower prices, the result is predictable: they offer farmers less for their crops.

Consumers would be harmed for the simple reason that risk is a cost. If processors and other middlemen are no longer able to transfer this cost through hedging, they do the the only other thing they can do: They include the cost of risk in the prices of their products. And consumers end up paying it.

Among commercial market users, who would be hurt by illiquid markets?

Anyone and everyone that uses futures markets to hedge:

Farmers who rely on hedging as a means of establishing the price of a crop before, during, and after harvest. Banks are inclined to provide better financing terms to a farmer who hedges.

Country grain elevators that cannot afford the risks of buying grain from farmers and storing it until needed in the absence of the price protection hedging affords. Additionally, the only way many elevators can borrow money to finance storage is if the grain is currently and fully hedged.

Processors such as corn refiners and soybean crushers for whom hedging is an integral part of both their buying and marketing strategies. In the absence of effective hedging opportunities, they would have to have wider margins to cover the price risks of commodity ownership.

Manufacturers who use such metals as copper and silver and who, like food processors, rely on futures markets to minimize price risks.

Banks that rely on hedging by borrowers to protect the market value of commodities pledged as collateral. Also the rapidly growning number of banks that hedge directly as a means of asset and liability management.

Exporters who could not make competitive long-term sales and price commitment in the absence of effective hedging opportunities.

Savings and loan associations, mortgage brokers and others who provide mortgage funds for home construction and ownership. Hedging is increasingly being employed as a way to reduce the risks inherent in volatile interest rates.

Employee pension funds that find they can often realize higher returns and minimize interest rate risks through hedging.

And the list goes on.

A SOLUTION TO THE PROBLEM OF TAX ABUSE

The Chicago Board of Trade supports the enactment of legislation which would address, specifically, the use of futures markets solely for tax purposes: namely the proliferation in recent years of schemes employing commodity spreads to defer or reduce taxation on profits and incomes derived from unrelated business activities. Changes made in the tax law should not, however, be allowed to disrupt either the normal commercial utilization of spread transactions or the availability of risk capital that is essential to the function of a futures market.

This can be achieved by the passage of a bill which essentially follows—with two important exceptions—the recommendations of the prior Administration with respect to restrictions that would be placed on the use of spreads to accelerate losses or to convert short-term gains into long-term gains.

The first necessary exception: the restrictions should not apply to the extent a taxpayer has related income which falls into the category of "qualifying gains." That is, gains derived from purchases and sales of commodity futures contracts.

Secondly, the restrictions should not apply to commercial hedgers who enter into straddles as an integral part of their trade or business (such as in inventory acquisition, storage or export transactions).

The "qualifying gains" approach would prevent the use of certain spreads as gimmicks by persons seeking to create tax losses as an offset to unrelated income while preserving what is universally recognized as an essential trading technique. Persons using futures markets to derive economic profit—whether as hedges or as speculators providing risk capital—would not be subject to the tax restrictions. On the other hand, such a bill would curtail the sheltering activities of those who enter the market not for the purpose of producing an conomic profit but for the purpose of generating paper losses. This distinction—between persons who engage in a line of activity for profit and persons seeking tax-motivated losses—is a familiar anti-shelter technique that has been used in such provisions as the minimum tax on intangible drilling costs, the limitations on deductibility of investment interest, the "at risk" rules, and the "limitation on artificial losses" (LAL) provision adopted by the Ways and Means Committee in 1975.

The "qualifying gains" exception would also mitigate formidable "tracing" problems for the IRS. That is, the all but impossible task of scrutinzing each transaction of every professional commodity trader to ascertain which, if any, of hundreds of thousands of purchases and sales during the year might possibly have had some relationship to a spread that contributed to deferral of income or long-term capital gains treatment. Such a situation would be an audit and litigation nightmare (with incalculable costs to all concerned) since traders in commodities markets may have hundreds of trades in a single day and one day's trades may involve countless permutations and combinations of offsetting and partially offsetting positions. One can only imagine and cringe at the possible compounding of the nightmare if intermarket as well as intramarket transactions also had to be examined.

Clearly the strongest argument for the "qualifying gains" approach is that it would achieve, specifically, what the Treasury Department has officially stated it seeks to achieve: the elimination of an acknowledged abuse of commodity spreads in such a way that it will not "impede legitimate economic activity" in this area. Significantly, the examples of abuse cited by the Treasury in its December, 1980, report and recommendations concerning "tax spreads" should be eliminated by the legislative approach endorsed by the Chicago Board of Trade. That is, by legislation which focused solely on tax spreads utilized to offset unrelated business income.

Insofar as most other provisions of the proposals are concerned, we support their enactment essentially as suggested. For example, whether the current law is amended to consider Treasury bills and other government obligations as capital assets (rather than ordinary assets) is less important than that the actual obligations and the futures contracts for these obligations be treated on a consistent basis.

In the case of "look back" time during which a securities dealer must identify those securities to be held for investment, we support a reduction from the present 30 days to provide for more prompt identification. A period of settlement date plus 2 days would seem reasonable.

There is, however, one provision of the Treasury proposal which should be excluded from legislation. Specifically, that provision having to do with the current tax treatment of what are known as "cash and carry" transactions. Under the Treasury's proposal, a firm (or it could be a farmer) that held personal property such as grain as one part of a spread (straddle) would be prohibited from deducting the carrying costs of such storage. Expenses such as the storage fee, insurance and interest on borrowed capital used to finance storage would have to be capitalized and added to the basis of the property.

This would be blatantly and indefensibly discriminatory since, to the best of our knowledge, there is no other business which is prevented from deducting the bona fide expenses of financing its inventories. Moreover, it would—without any justification whatsoever—discriminate against one particular type of inventory financing: The financing of inventory which is hedged. Deductibility of expenses would be denied, for example, to a farmer who hedged the storage of his own grain. Or to a country elevator which, as a condition for obtaining bank financing may be required to hedge. Or to an investor, who, as an occasional facet of his business, may carry and finance grain which such businesses as country elevators, merchants and exporters would otherwise have to carry and finance.

Conclusion.—The legislative approach suggested by the Chicago Board of Trade would fully achieve the mulitple goals of ending a tax abuse, producing significant revenue gains, and preserving the viability and effectiveness of a marketing system that is . . . deservedly so . . . the envy of the world.

STATEMENT OF LEE H. BERENDT, PRESIDENT, COMMODITY EXCHANGE, INC.

Messrs. Chairman and members of the subcommittees, my name is Lee H. Berendt. I am president of Commodity Exchange, Inc., generally known as Comex. Comex is the largest metals futures market in the world and the third largest futures market in the United States. Metal futures traded include gold, silver, copper, and zinc. In addition, trading is conducted in 90-day Treasury bills, two-year Treasury notes, and GNMA certificates. At present, Comex has 772 members, and its volume is about 14 percent of the total United States futures market volume. I welcome this opportunity to appear before you to present our views on the proposal of Senator Moynihan (S. 626), and the various alternative proposals, which would alter the tax treatment of commodity straddles.

I feel a special burden today. The particular transactions which led to the Internal Revenue Service's 1977 revenue ruling and to litigation now in the Tax Court were executed on Comex. Moreover, press reports on the straddle controversy always seem to be written exclusively in terms of transactions in silver futures. By the close of today's hearing, however, I trust the other witnesses and I will have convinced you that the trading which takes place on Comex and other futures exchanges, including straddle transactions, serves the valid needs of legitimate business operations.

The commodity futures markets, for many years a little known and less understood, but nevertheless vital, segment of our American economy, have gone virtually unnoticed. In recent months, however, with the public and media focus on tax and budget issues, attention has become focused on those markets in seeking out methods of generating additional tax revenues.

However, in seeking to fulfull the reasonable goal of fairly generating legitimate tax revenues, oppressive legislation has been proposed which might temporarily generate additional tax revenues but which, for the reasons discussed in this statement, would also destroy the fabric of our delicate and finely-tuned futures markets. On its face, this proposed legislation, focuses on commodity straddles, a seemingly exotic and mysterious trading device. However, it will also dramatically curtail all other futures trading by speculators because of the absolute inability of speculators to obtain long-term capital gains in the futures markets. This would virtually dry up liquidity in our futures markets and render those markets incapable of performing their statutorily mandated and socially desirable functions of enabling hedging and facilitating price discovery. When one examines the scope of items traded on these futures markets, it becomes very clear that they must be allowed to function smoothly and efficiently.

When trading first began on the futures markets, it was conducted primarily in grains and cotton. Over the years, the scope has broadened significantly. At present, there are futures markets in existence for commodities as diverse as livestock, lumber, precious and base metals, foreign currencies, and even orange juice. The commodities traded on the futures markets are extremely important to many industries which comprise the American economy.

The markets for these items exist because there is sufficient liquidity in them. There is no guarantee that a market will thrive once it is established. At one point in time, for example, futures were traded for wool, rye and eggs. Those markets vanished due to a lack of liquidity. Today's markets would certainly meet the same fate if the proposed legislation dealing with straddle transactions were to become law in its present form.

The events with which the Congress and the public should be concerned involve the employment of commodity straddles for the sole purpose of tax avoidance by persons who do not otherwise utilize the futures markets. It has been estimated that about one-half of the 92 million futures transactions executed in 1980 involved straddles, a minute fraction of which were entered into by non-commodity traders solely for tax avoidance. These dealings, although they comprise a de minimis portion of all futures transactions, are nevertheless abusive and should be eliminated. they are engineered solely to avoid the payment of taxes by persons with no real interest in our nation's futures markets and make no positive contribution to the national economy. However, the need to terminate these abusive practices is not sufficient justification for the destruction of our futures markets. That destruction would almost certainly be the result of the proposed legislation. Furthermore, the proposal has obscured the distinctions between legitimate straddle transactions and the use of straddling to create improper and unsound tax advantages. This has resulted in the wholesale condemnation of the use of straddles which would assuredly have serious repercussions if implemented.

The legislation which has been proposed to combat the tax avoidance accomplished by the illegitimate straddle scheme will render it economically unsound for speculators to engage in any and all futures transactions, whether outright trades

or straddles. As discussed below, the straddle serves to create markets for distant months which would otherwise not exist for a lack of liquidity. Liquidity allows the hedger to immediately find a willing trading partner for a transaction as far as two years in the future. Unless speculators have sufficient incentive to participate in such trading, the futures market will evaporate.

Why would the abolition of the current tax treatment of straddles for market participants remove the economic activity of speculators from our markets? The answer is really quite simple. It must be recognized that speculators are a critical ingredient in the functioning of our futures markets. Since the markets are intended to afford hedging opportunities for producers, miners, refiners, and others similarly situated, there must be a pool of capital willing to be invested on the other side of a hedger's transaction in order to enable the hedger to shift his risk.

It is only the much maligned and misunderstood speculator who will utilize his capital to permit that risk transference. It is also the speculator who supplies our market with the liquidity necessary to permit easy entry to and exit from our markets by hedgers while at the same time allowing minimum price adjustments. Price discovery must be accurate since according to one economic analysis, "* * * just a 1 percent error in agricultural futures prices would result in a misallocation of as much as $1.5 billion per year." Volume equals liquidity which equals a market where economically realistic prices are constantly discovered.

However, those speculators recognize the dramatic risks they will experience in our futures markets. They are unwilling to assume those risks without a reasonable opportunity to earn a reasonable profit. Short-term capital gains do not afford speculators a reasonable profit inducement. The only method by which speculators in the futures markets can obtain long-term capital gains treatment is through the use of straddles. Absent that ability, not only would straddle transactions disappear from our markets, but outright transactions by speculators would similarly disappear. This would require the commercial users of our markets to seek other markets for their hedging activities.

In the simplest of economies, two individuals can meet and agree to transact business. One party may agree to provide certain goods which the other agrees to purchase. The two individuals can then decide upon all the terms of their agreement, or contract. Such terms may include but are not limited to price, quantity, quality and date of performance.

However, the majority of today's business transactions do not transpire in that fashion as the realities of the marketplace preclude such simplicity. Today, when use is made of the commodity futures market, one party to the contract will not even know the identity of the other party to the contract, let alone communicate with him.

Without a market for futures, individuals who desire to buy or sell goods at a certain price and time would have to search for a willing party with whom to contract. The transaction costs associated with this process would be so extreme as to be prohibitive. Since all costs of production and manufacture inevitably are absorbed by the consuming public, this would result in dramatic price increases for all consumer goods that are, or include, commodities traded on our futures markets.

The elimination of these transaction costs is one of the functions performed with virtual perfection by the futures market. The efficiency of these markets obviates the need to locate an actual trading partner in the physical marketplace. Individuals, commonly referred to as hedgers, can enter into futures transactions to obtain insurance for a certain revenue level or to place a limit on raw material costs. In this manner they may conduct their business affairs while minimizing or eliminating the business risks that they would otherwise face, thus resulting in stabilized and lower prices for the consumer when he purchases a loaf of bread or a jar of coffee. A perfect example of the hedger is the farmer who would not plant his crops without some assurance as to the price he will receive for his production. Such risk management is made possible solely through the futures markets and particularly through the participation of speculators.

Speculators, simply defined, are individuals who are willing to risk their capital for the opportunity to earn a profit. They do not grow crops, mine ore, or raise livestock; but they perform a function of equal importance. Without the participation of speculators, the activities of producers would not be so easily undertaken. The speculator is the faceless individual on the other side of the hedging transaction who agrees to assume the hedger's risk. In an effort to survive in the futures markets, the speculator must learn how to manage the risks inherent in futures trading. The tax costs associated with any profits are clearly a part of that risk management. Since commodity speculators are accustomed to long-term capital gains treatment for their profits, a tax at any greater rate would result in a diminution of the conomic activity of commodity speculators. The increases in taxes

and the diminution of economic activity are results that are totally inconsistent with the stated goals of the Reagan administration.

One of the chief arguments upon which straddle opponents rely is the theory that the straddle transaction is a riskless endeavor. Nothing could be further from the truth. What the staddle neatly accomplishes is the conversion of the risk associated with a change in commodity price over time into the risk that the monthly difference, or spread, in price for the same commodity will shift for or against him.

Unlike the hedger who enters into a futures contract because he fears a change in commodity prices, the straddler is not concerned with price direction. He has eliminated this particular risk by executing the straddle. But the straddler is preoccupied with the price spread between months which, in the metals and financial futures markets on Comex, is a function of the carrying costs associated with a given commodity. The carrying costs consist of insurance, storage, and most significantly, finance charges.

It would be ludicrous to suggest that no risk exists in expenses which are a function of the prime interest rate. This indicator is no longer the passive measuring device it was in previous times. A five point jump in the prime rate in a very brief period of time is not unknown and can result in a financial debacle for one who has borrowed to cover a major position in gold, silver or any other commodity. The existence and magnitude of this risk has also been established statistically by an analysis prepared by Professor Douglas Breeden of Stanford. These findings demonstrate that the least risky spreads in gold and silver futures involve greater risk than that associated with owning a typical common stock. Individuals will take this risk because they perceive the potential for a meaningful reward. The proposed legislation would eliminate this potential and would remove from the markets those persons now willing to assume the hedger's risk.

The transference of risk is accomplished at the same time that the futures markets perform their price discovery function. The participation of a multitude of hedgers, speculators, and arbitrageurs determines the value of a given commodity at a given point in time. The interaction of all these market participants results in a volume of trading which permits the maintenance of small differentials between bid and asked quotations on the floor of our markets and makes for ease of entry and exit into the market. This also results in a level of certainty about fair price discovery which would not otherwise exist. The efficient operation of the market with respect to risk transfer and price discovery depends upon one attribute of the market—liquidity. The broad participation of speculators in the futures market creates a degree of efficiency which would disappear under the restrictive conditions which would exist under the proposed legislation.

It should thus be apparent that the activity of speculators is required for the markets to function smoothly. As has been noted, there is a direct relationship between the level of trading volume and market efficiency. Increased volume results in minimized price fluctuation and smaller transaction costs for market participants. Because straddling potential serves to attract capital to the futures market, thereby enhancing liquidity, it should be the posture of Congress to support and encourage these legitimate ativities, rather than effect their termination. The use of tax policy to bring about desired economic benefits is not a new or unusual concept. In other areas, tax benefits are conferred upon individuals willing to engage in the inherently risky ventures of oil drilling and real estate development. These acitivities are perceived as beneficial to the overall national economy and a similar view should be adopted regarding commodity futures trading.

It cannot be denied that this activity has been abused by certain individuals. These abuses should be halted as quickly as possible. But care should be taken to ensure that the costs of these corrective measures do not exceed the benefits. The collapse of the futures markets is simply too great a price to pay to eliminate tax avoidance, particularly when alternate legislation has been proposed which would eliminte the abusive transactions without driving the futures speculator out of our market place.

While various legislative proposals to deal with commodities straddles have been formulated, that which receives perhaps the lion's share of attention is the proposal offered by the Treasury Department which has come to be known as the "mark to market" approach. The plan, which is based upon the market's practice of daily payments of variation margins, stipulates that taxes be levied at ordinary income tax rates on the sum of realized gains and losses for the year, plus or minus the net unrealized gains or losses in any positions which remain open at the close of the taxable year. While a cursory perusal of this plan, along with its contemplated benefits, may lead to the conclusion that it is sound and beneficial, a more detailed analysis reveals that it is based upon a gross distortion of the variation margin concept and is plagued by a large number of significant drawbacks.

It is an estabished practice of the commodity futures market that at the close of day's trading, there is a cash settlement which occurs on all futures contracts. Decline in value of a position results in a variation magin call while an appreciation in value of a position results in a payment or credit to the appreciated position. The debits and credits are entered in the accounts on the morning after the price change. The purpose of these variation margin payments is to insure the financial integrity of outstanding futures contracts and the marektplace. Although this practice is following on all United States futures markets, it is no followed for similar instruments, such as forward contracts that are not traded on regulated exchanges. These other instruments are traded world-wide. This absence of symmetric treatment gives rise to one of the problems with the Treasury proposal which will be discussed below. Before identifying the numerous shortcomings of the "mark to market" approach, it would be useful to examine the rationale for the daily payment of the variation margin.

When a trader undertakes to occupy a position in the futures market he is required to deposit margin funds with the broker known as earnest money. Subsequent days' gains and losses are paid in cash by or to the trader. This is the daily variation margin. The misconception upon which the "mark to market" approach is founded is that each day's trading may be viewed individually, as a closed transaction. Therefore, the Treasury proposal contemplates no problems, either theoretically or practically, with imposing a tax upon the net gains or losses in open position at year-end. But such a procedure is fraught with numerous problems and ignores the reasoning which underlies the payment of the variation margin.

The primary reason a daily variation margin is paid is to preserve the integrity of commodity futures markets. If individuals were able to engage in a large volume of futures transactions without being subject to a daily settlement, the potential for financial failures would increase dramatically. When a trader's position deteriorates in a given trading session, he is forced to put up—in cash—the total losses he sustains. If he can't meet this demand, he must liquidate his position. Were this demand not to be made upon him, he would be free to engage in more transactions, regardless of the extent of his losses. When the day of reckoning finally arrives, the trader would have to pay the aggregate amount of his losses. Were he unable to do this, a default would occur with the potential for a "domino effect" resulting in the defaults of others.

Perhaps the most serious drawbacks of the "mark to market" approach is that it imposes a tax upon an unrealized gain which could conceivable exist on only the last trading day of the taxable year. A taxpayer in a favorable position at year-end would become liable for taxes assessed upon his gain. In the first trading sessions of the following year, his position could be reversed. Where this to happen, he would be forced to make daily cash payments equal to the losses he sustained. This would drain him of the cash gains he was deemed to have earned in the previous year while still requiring him to expend cash to pay the taxes assessed thereon. It would not be unusual for a trader to be forced to liquidate some positions to simply pay taxes. This would reduce the liquidity of the market in addition to requiring the trader to pay tax on a gain he no longer holds.

The "mark to market" proposal thus represents a marked departure from prevailing tax theory in that taxes are levied upon open transations where the ultimate gain or loss has not yet been determined. This is true because the payment of a daily cash margin is not reflected of a completed event. The trader is still at risk and taxing him on what may prove to be temporary gains is very dangerous. This is the reasoning which gave rise to the principle of realization of gains and losses, which lies at the very foundation of our tax system. This realization concept enables the taxation on other events which do not represent closed transactions to be postponed. For example, taxes are never imposed on loan proceeds or deposits received because no income has been realized. Similarly, in the case of straddle transactions, no tax should be imposed until the transaction is finally closed.

Another difficulty spawned by the proposed straddle legislation concerns the irrational distinction between futures contracts and other similar commercial instruments executed off the exchanges. Since other instruments such as forward contracts do not require the daily margin payment associated with futures contracts, the "mark to market" approach would have no adverse impact upon trading in those areas. The inevitable result would be that hedgers would seek methods of hedging other than that available on the domestic exchanges. With the current proliferation of foreign exchanges around the world in such places as London, Amsterdam, Switzerland and Hong Kong, these alternate markets would grow while our American futures markets would lose their position as the world's pre-eminent futures markets. The potential for growth of these other markets is enhanced

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further by the fact that they are virtually self-regulating and remain unhampered by the impediments that the pending legislation would create.

This expansion of activity on foreign markets would create an outflow of capital from the organized futures markets, thus reducing the liquidity on those markets with the attendant impairment of the performance of the risk transfer and price discovery functions. Surely, these results cannot be consistent with the new administration's stated goal of confirming America's role as a world leader.

An additional negative side-effect of "mark to market" should also be considered at this point. In an effort to streamline and perfect the operations of the futures markets, certain changes may be contemplated. Ultimately, it may be feasible to eliminate the requirement of the daily margin payment while still guaranteeing the market's integrity through the use of some form of reserve fund or insurance device. This would avoid the pyramiding problem which has been discussed in other Congressional hearings relating to the silver market. However, the enactment of the Treasury's proposal would preclude this possibility because the tax system would be dependent upon the payment of these margins. It would be disadvantageous for the futures markets to labor under such inflexibility.

It is a fact of economic life that producers, miners, farmers, and other commercial users of our markets must have the ability to freely engage in hedging transactions. In response to the domestic liquidity problems stemming from the "mark to market" plan, these hedgers would actively seek out other markets upon which to trade. The effects of this movement abroad on our national economy would only be detrimental. There is nothing to be gained domestically by exporting our futures business. As a result of the certain liquidity problems, consumers would bear the ultimate burden. The marketplace which has come to be the envy of the world would crumble and disappear. A reduction in the overall level of production and a decrease in total tax revenue would certainly follow.

The considerations discussed above have not been developed in an attempt to persuade the Congress to ignore straddle abuses. Rather they have been highlighted so that corrective legislation is not hastily enacted without consideration of viable alternatives. It is the position of the futures industry that these abuses should be outlawed, but not at the expense of crippling the economy. These problems can be corrected while simultaneously preserving the efficient functioning of the futures markets. This could be accomplished under the futures industry proposal.

The proposal suggested by the futures industry is one which addresses the most significant problems created by the alternative legislative plans, namely overbreadth. If the other proposals were enacted into law, they would discourage market participation by both the active trader as well as the individuals engaging in abusive straddle schemes. The industry proposal however would discourage persons who have no bona fide interest in our futures markets from distorting the market purpose while simultaneously fostering active market participation and vital economic activity by the futures trader. This would remove the destructive tax straddler from the realm of futures trading without a sacrifice in liquidity and with a probable improvement in price discovery.

The industry proposal, which has become known as the "basket" concept, addresses the problems raised in the other proposals regarding the accelerated recognition of losses and the conversion of short-term capital gain into long-term capital gain. This proposal does so while allowing legitimate commodities trading to continue. At the heart of the industry's proposal is the concept of "qualified gains."

The qualified gains approach would prevent the abusive offsetting of unrelated income (e.g., real estate transaction profits) against commodities losses by grouping together like transactions so that those who are engaging in futures and commodities trading for a profit would not be adversely and unfairly affected. Income which consists of the qualified gains going into the "basket" would not be subject to the restrictions imposed upon other unrelated income. Furthermore, commercial hedgers who engage in straddles in pursuit of their trade or business would also be exempt from the restrictions placed on straddle transactions. Thus, the proposal would remove the incentive for certain individuals to execute improper tax shelter straddles while allowing a sufficient volume of needed futures transactions to transpire with the attendant economic benefits.

The qualified gains "basket" would be composed of net gains from transactions in commodities and evidences of indebtedness (together with any gains from straddles). Straddle losses could be used to offset these related gains, but could not be used to shelter such unrelated income as that arising from real estate ventures, oil and gas investments and even earned income. In essence, the merits of the industry proposal lie in its sharpness of focus. It concentrates on the abuses which exist and excises them while leaving the healthy remainder of the market to grow and flourish.

The industry proposal recognizes and takes into account various aspects of the futures markets which the other proposals seemingly ignore or fail to understand. Fundamentally, our proposal recognizes that only a minute portion of all straddles are tax avoidance schemes and that most are legitimately profit-motivated. Secondly, that industry proposal accepts the indisputable notion that spread transactions are essential if the futures markets are to perform the important functions with which they have been charged.

While effectively achieving those goals to which the other proposals aspire, the industry's approach results in none of the ill side-effects associated with the former. For example, the cash flow problems certain to arise under the "mark to market" approach would never crop up under the industry proposal. It is free from this impediment because it does not employ the novel and rather bizarre device of taxing gains before they are realized. In other words, our proposal raises none of the theoretical and practical dilemmas associated with the departure from the realization principles upon which our tax system is based.

Another obstacle which need not be confronted under the "basket" approach is the insurmountable tracing tasks which Senator Moynihan's proposal, and similar legislation introduced by Congressman Broadhead (H.R. 1293), contemplate. Since all speculative spreads would be treated identically under these other proposals, the active trader whose annual transactions number in the thousands would be forced to trace through all of his transactions to ascertain the tax ramifications. Similarly, the IRS in attempting to audit the day-to-day trader would face the same monumental task.

The industry's proposal greatly reduces the amount of tracing effort which would need to be expended under these proposals. Because our proposal groups all related gains and losses together, tracing is necessary only under those conditions where a taxpayer seeks to use spread losses against gains which are not qualified gains. Unlike the individual who seeks only to abuse the straddle technique, the active market trader is unlikely to occupy this position. Therefore, the tracing problem is minimuzed or eliminated.

One problem that would not occur under the industry proposal but which might present serious problems under the Treasury proposal is market activity on December 31. It is not inconceivable that some traders would attempt to manipulate the prices in illiquid distant maturities on that date in order to obtain very significant tax benefits. The marketplace would readjust on January 2, but that would not change the tax impact of market activity on December 31. Many floor traders have stated their unwillingness to appear on the floor on December 31 if Treasury's proposal is adopted.

There are other benefits, perhaps less tangible, which may accrue under the industry's proposal. For example, it would provide for greater internal consistency within the taxation scheme than the other proposals. Under the "mark to market" approach, there exists directly conflicting treatment of straddle gains with that accorded similar gains in securities transactions. Securities gains are not taxed until the underlying shares are sold and the proceeds are received by the trader. Under "mark to market", straddle "gains" are taxed even though the underlying position is not liquidated and the trader remains entirely at risk. This confusion and inconsistency will hamper attempts to smoothly administer the taxation system.

This inconsistency gives rise to additional difficulty in that the investor is deprived of the ability to engage in effective tax planning. Whereas taxes are usually imposed upon gains resulting from a taxpayer's investment decisions, the incidence of taxation under the Treasury proposal is market-related (and in fact the result of only one day's trading activity) and not within the taxpayers's control. The inability to control these tax expenses will incourage the taxpayer to leave the futures market and investment elsewhere. None of these problems would arise under the approach proposed by the futures industry.

The industry recognizes the problems which have arisen in the futures market and its responsibility to cooperate in solving them. It is in that spirit of cooperation and mutual benefit that the industry proposals have been made. While the futures markets may suffer no direct financial losses from improper tax straddling, it does have to bear its share of the national loss caused by unnecessary tax avoidance. Futhermore, the reputation of the industry is tarnished by the publicity which abusive tax straddles have received. The commodities futures industry desires the complete elimination of these loopholes and supports the efforts to do so. But a word of caution may be appropriate.

This committee has broad jurisdiction and is one of the most powerful in Congress. In exercising its authority, however, this committee must be careful not to legislate too broadly. The adverse effects on the economy and national welfare of improperly designed legislation may far exceed the $1.3 billion which the Treasury

has suggested it loses annually from straddle transactions. If the corrective measures which are adopted adversely affect legitimate futures transactions, the same money which now supports the proper functioning of those markets will migrate to other ventures which properly reward financial risk taking. If more than the loophole is closed, legitimate futures trading will cease and those individuals engaging in abusive transactions in this market will pursue their tax avoidance elsewhere. Should speculative capital leave the futures markets, the decreased liquidity will ultimately cost the national economy far more—in terms of reduced economic activity and higher prices—than whatever tax revenues may be received by the Treasury.

I again thank the committee for this opportunity to testify.

Testimony of Dr. Clayton Yeutter[1]

Mr. Chairman, thank you for this opportunity to present the views of the Chicago Mercantile Exchange on proposed legislation dealing with the taxation of income derived from commodity straddles.

We are here today to discuss an extremely complex matter caspsulized by the terms "silver butterfly spread" or "silver butterfly straddle." I will venture that the meaning of these terms is understood by few. For most people they either have something to do with last year's collapse of the silver market or they refer to the allegedly massive tax abuse schemes which have recently been publicized. For nearly everyone the connotation these words carry is not a pleasent one.

Today I would like to focus on the word "spread" (or "straddle" which is used synonymously). I will separate it from the loaded headlines and describe as best I can the routine and legitimate transactions it represents in the world of commodity futures trading. An appreciation of the frequency and motives with which traders in our markets "put on spreads" contrasted with the rarity of the creation of the "silver butterfly straddle" is necessary if the committee is to knowledgeably legislate in this area. In other words it is important—in fact, crucial—to separate the "good guys" from the "bad guys."

In recent years taxpayers who have never before participated in futures markets have sought to postpone taxes on real estate gains or other similar activities unrelated to the commodities markets. They have done this through use of the so-called "tax straddle." I will not in my presentation defend the public policy implication of these endeavors. As the chief executive of a large commodity futures exchange, I have no desire to see our markets used as conduits for such schemes. We are in the risk management business, not the tax avoidance business.

In order to define spreads and spread traders, I will first briefly describe the larger role of futures markets in our economy. Then after discussing the spread traders' function in the markets I will comment briefly on existing tax law as it applies to commodity spreaders. Finally I will spend a few moments commenting on some of the proposals before this committee.

I. Purposes of Futures Markets—Risk Transfer and Price Discovery

Futures markets provide farmers, businessmen, and financial institutions with opportunities to shift some of their price risk to individuals or firms willing to accept that risk. One who wishes to transfer the risk is called a "hedger," and one who accepts the risk is called a "speculator." Both are essential to the risk transfer process.

Risk transfer and risk management have never in our nation's history been more important. Farmers, business firms, and financial institutions are today operating in a global market which is far more volatile than it was a few years ago. Our economy is experiencing double digit inflation, double digit interest rates, unpredictable fluctuations in the price of imported crude and petroleum products, and political upheavals among some of our major trading partners. All of this creates a level of business uncertainty exceeding anything we have ever experienced in our free enterprise system.

This unprecedented volatility has stimulated American business and financial institutions to search for new mechanisms to reduce risk and provide stability for their operations. Futures markets have evolved as an extremely effective and flexible device to meet this need. This explains the dramatic growth of our industry, which today trades several times the volume of five years ago. "Risk management" is becoming a byword of the 1980s, and futures markets have become synonymous

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[1] President and Chief Executive Officer, Chicago Mercantile Exchange; former Deputy Special Trade Representative and former Assistant Secretary of Agriculture.

with that term. These markets work because they provide those who would transfer risk (hedgers) with a ready reserve of risk transferees (speculators).

Speculators also provide independent evaluations of prices for the future, thereby providing producers and consumers with an estimate of supply and demand conditions that would otherwise be unavailable. The more participation, the greater the accuracy of the weighted opinion. Through this process, futures markets provide reference points for the consummation of business at competitively determined prices. The rapid and wide dissemination of futures prices also fosters competition in the establishment of cash prices in many local markets. This is the "price discovery" function of futures markets, an important addendum to the traditional risk transfer function. In addition, futures prices help to establish market values in a wide range of auxiliary services such as storage, transportation, processing and, in recent years, in the cost of money.

The primary purposes of futures markets—risk transfer and price discovery—will be thwarted if tax laws have the effect of discouraging the entry of risk capital to the futures industry.

II. MARKET LIQUIDITY—VITAL FOR RISK TRANSFER

Market liquidity—the quantity of bids and offers flowing to a given market—determines that market's success. Obviously, the greater the volume of bids and offers competing with each other, the narrower the price range between them. The narrower the range, the more viable and efficient the market. For a hedger, liquidity contributes to the ease with which he can enter and exit the market at a price level providing the risk protection he seeks.

For the speculator, liquidity is also critical. The greater the trading volume, the smaller the impact a large buy or sell order will have on price. A speculator wishes to buy or sell in the futures market without significantly affecting the price level, lest he injure his own position in the process. Illiquid markets are shunned by both commercial hedgers and professional speculators.

Speculation (i.e., speculative liquidity) is a vital, beneficial force in futures markets.

III. SPREAD TRADING—VITAL FOR LIQUIDITY

Daily trading volume in some contract markets consists of 50 percent spread trading—half the contract's liquidity. In the more distant months, spread trading may constitute as much as 90 or 95 percent of the liquidity. Obviously spreading is a fundamental market function.

It is one of three basic trading techniques.[1] While all can be used by either hedgers or speculators, spread trading is overwhelmingly a speculative technique, and by far the most productive contributor to market liquidity.

In a simple spread, the spreader trades the differential between two contract months in the same commodity.[2] He buys a contract to accept delivery of a commodity in one month and sells a contract to make delivery of the same commodity in a different month.[3] Thus, his profit potential is not based on whether the price of the commodity goes up or down (as he is both long and short) but rather on the narrowing or widening of the price differential between the two contract months comprising his spread position. When the spreader beleives prices between months are "out of line" he tries to make a profit upon realignment.

Spread trading's most important addition to liquidity, and its most important benefit to the commercial hedger, is that it provides essentially all of the market

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[1] The three are position trading, scalping (market-making) and spreading. They are discussed in detail in the appendix, provided for the record, authored by Leo Melamed, Esq., Special Counsel to the Board, Chicago Mercantile Exchange, and a commodity trader by profession.

[2] There are many types of more complicated spreads. These include inter-commodity spreads such as long corn, short cattle; spreads between a commodity and the product derived from the commodity, such as spreads between hogs and pork bellies; and intermarket spreads, such as between our gold contract and the contract in Hong Kong. Many more complicated variations are possible.

[3] Each trader entering into a futures contract has an unconditional duty to make or accept delivery when the contract matures. Once the traders, through the exchange members representing them, have entered into the contract, the contract is in effect split in two, with the exchange or its clearinghouse assuming the rights and obligations of the opposite side of each of the two trades. Thus, the contracts are ultimately between a trader and the exchange or its clearinghouse. The trade who will accept delivery is said to have purchased the contract, i.e., to have gone long; the other is said to have sold the content, i.e., gone short. Importantly, futures contracts are rarely held to maturity. Instead, traders eliminate their respective rights and obligations by liquidating their positions: a long position is liquidated by an offsetting sale; a short position is liquidated by an offsetting purchase.

liquidity for the more distant contract months. Few speculators are willing to take "naked" positions 12 or 18 months in the future because of the enormous risk inherent in doing so. Yet many businesses wish to engage in transactions that far in advance, and can only do so if they can hedge their positions. Without spread traders to buy or sell hedgers' contracts such transactions could never take place. What are the economic implications of this? Export trading provides the classic example. How many long term sales of U.S. soybeans or wheat could be consummated in the absence of a futures market with its spreading potential? The answer is virtually none. Thus, the importance of spread trading to the American agricultural economy should be self evident. One can readily provide comparable examples in the industrial and financial sectors.

SPREAD TRADING—EXISTING TAX TREATMENT

"Tax straddles" are in exception in the spread trading world, not the rule. The vast majority of all spread transactions have a profit motive; the participant seeks to gain from the widening or narrowing of his spread.

I'm certain the intent of Congress is to deal with the exceptions, not to impose unnecessary or improper tax burdens on legitimate, profit motivated spread transactions. As you begin to consider this issue, it would be relevant to consider also existing tax law as it applies to traders.

For reasons that are difficult to perceive, the present tax code contains disparities which work to discriminate against commodity traders (including spreaders) in a variety of ways. This applies particularly when one compares tax provisions relating to members of a commodity exchange such as ours with members of a stock or options exchange. The latter can be considered broker-dealers under the provisions of the Internal Revenue Code, and can thereby characterize their transactions in buying and selling securities or stock options as being that or an ordinary business. Their gains are, therefore, considered to be ordinary income, and their losses ordinary loses. Such is not in the case of a spread trading member of our exchange. The member of a stock or options exchange will also be able to take advantage of the Net Operating Loss sections of the Internal Revenue Code in his years of negative income. Our member, on the other hand, is likely to be taxed at the maximum unearned income level in good years, and then be limited to a $3,000 loss deduction in bad years. The stock or options exchange member is able to utilize the more favorable earned income maximum tax rates.

The commodities trader is also denied long-term capital gains treatment on short sales (no matter how long the position has been held).

With this formidable array of tax disadvantages already present, one must question the public policy motivation of adding to the list. Spread traders, and other participants in our industry have rolled with the punches of U.S. tax law for a long time. For many, another punch would simply cause them to duck—they would move their investment capital elsewhere. They would choose to leave an arena where they could be taxed at maximum rates one year and denied most "normal" tax loss deductions the next.

So as the Committee contemplates the array of proposals before it I urge you not to throw another punch at the commodity trader. As the committee seeks to right the abuses perpetrated by the "bad guys" it is important that you not drive the "good guys" from the markets.

You are well aware of the proposals before the committee; therefore, I will not review them in detail. What I will do is briefly highlight some of the features of the various proposals which are of greatest concern:

Cash and carry

A number of bills and proposals would preclude the deduction of carrying costs on hedged inventory. Instead they would require that such costs (e.g., storage, insurance, and interest payments on wheat) be capitalized. This is an issue unrelated to tax straddles and its inclusion here simply confuses an already difficult debate. Farmers and other businessmen have been deducting carrying costs on their inventories for decades, presumably without complaint. In these volatile times it seems incongruous to recommend tax provisions that would discourage the holding of inventories, a function which adds stability to our economy. The economic impact of such provisions would be adverse to producers and consumers alike.

Tracing transactions

Spreaders may establish and lift positions a dozen times per day, 200 days per year. For these traders to reconstruct opposite or "offsetting" positions would be extremely difficult and costly, if not impossible.

Even with a penalty system, as envisioned in some proposals, the Internal Revenue Service would face a monumental task in monitoring such transactions. There has to be a better way!

Hedging exemptions

Hedging operations should clearly be exempted from any rules which are developed in this area. It should be noted also that dealers in currency and metals markets frequently construct complex hedges using other than regulated futures markets. A hedging exemption should contemplate multi-part hedging combining futures and other market transactions.

Timing of taxable events

While the mark to market approach suggested in some legislative proposals is appealing because of its apparent simplicity, it also contains significant flaws which could lead to problems not now envisioned.

Foremost among these would be the impact of having tax consequences determined while positions are still open, a major departure from the concepts of present tax law. Because a trader would be forced to pay taxes on positions open at year end (positions still at risk) he will inevitably enter into some period of tax motivated trading at year end. Because he would have lost much of his ability to affect timing of incidences of taxation he might similarly be forced to enter periods of "cash motivated"trading before tax payment due dates. While it is difficult to gauge the possible effects of such aggregate trader behavior it seems certain that significant market distortions would occur. Distorted markets would be of little value to either the hedger or the commodity pricer.

A mixing of mark to market with other tax treatments for traders dealing in regulated futures markets and in spot markets, options markets and forward contracts could also lead to unforeseen problems. Not the least of these would be the aforementioned tracing problem impacting both the taxpayer and the IRS.

CONCLUSION

In summary, it is important for this committee to realize that in dealing with the subject of tax straddles, it is also dealing with an industry of major economic relevance. Futures trading is probably the most effective risk management device available to businesses and financial institutions today. It is used by thousands of individuals and firms, including all those who are actively engaged in agricultural exporting. Total annual turnover on our Exchange alone is now measured in trillions of dollars.

If futures markets are to perform their essential function, the transfer of risk, they must have speculative capital available. If the is to be a risk transferor, there must be a risk transferee. Spread traders provide a major proportion of the speculative capital on all futures markets particularly in distant trading months. Without spreaders, no futures market would be viable. Therefore, it is important that our tax laws not discourage the movement of speculative capital into spread trading. At a minimum, the tax laws should be neutral in this area; some would argue that they should encourage the flow of speculative capital to these markets making them more liquid and thereby more efficient in carrying out their hedging function.

At present, tax laws already place commodity traders at a disadvantage. They receive less favorable treatment than many of their counterparts who provide speculative capital to other industries. To carry that disadvantage even further is impossible for us to rationalize or defend.

As you go about the business of correcting tax straddle abuses we encourage you to take extreme care to pinpoint the corrective actions.

We in the futures industry will continue to work with the committee and its staff on lanuguage that will respond to the prevailing abuses without adversely affecting the vital role of spread trading in risk management.

Again, Mr. Chairman, I thank the committee for the opportunity to appear before you today.

Senator PACKWOOD. I want to ask Dr. Landau to testify now, because he came at our invitation and could not appear on the day we were having the hearings on research and development.

Then, we will move on to the panel of Mr. Oppenheim, Mr. Schapiro, and Mr. Ginsburg.

STATEMENT OF DR. RALPH LANDAU, CHAIRMAN OF THE BOARD, HALCON INTERNATIONAL, INC., NEW YORK, N.Y.

Senator PACKWOOD. Dr. Landau, thank you for accommodating your schedule. I know you have been out of the country and you could not come on the day we had the hearings. We appreciate your coming this morning.

Dr. LANDAU. Thank you very much, Senator.

I am appearing today to acquaint this distinguished committee for the publication next week, of a new and very important book that relates to the current national debate on tax policy.

The title of the book is "Taxation, Technology and the U.S. Economy," which will be published under the auspices of the Polytechnic Institute of New York, as a special issue of the International Journal, *Technology in Society*.

My statement today is drawn primarily from the contents of the papers and treatise, plus a few synthesizing remarks by my coeditor and myself.

I managed to extract one copy from the publisher, in loose-leaf form for the purposes of this hearing which I will be glad to give to the committee.

Next week we will have bound copies. Technology is the forgotten subject in today's headlines regarding tax policy and economic policy, but it is the single most important contributor to the growth of the American economy since the last century, accounting for one-third to one-half of all economic growth.

This new treatise contains 18 papers by prominent authors from the economics profession such as Lawrence Klein, who is the Nobel Prize Winner in 1980, Dale Jorgenson, Michael Boskin, and Burton Klein.

From the business technical world such as Arthur Bueche of General Electric, Robert Dee of SmithKline, Thomas Vanderslice of General Telephone, J. P. Grace of W. R. Grace.

Public officials such as Senator Bentsen, Dr. Charls Walker, George Carlson and Gary Clyde Hufbauer.

Entrepreneurs, such as Edwin Zschau on electronics and myself for chemicals, and venture capitalist Reed Dennis.

It was edited by Dr. Bruce Hannay, of Bell Telephone Laboratories and myself.

New economic data in the treatise indicate that the decline in U.S. productivity and economic growth since the early 1970's, has been due to a dramatic decline in the rate of technical change and that future development of new technology for all industries, should be the primary focus of efforts to stimulate future U.S. economic growth.

To offset the drag on the development of new technology for the U.S. economy, immediate steps must be taken to reduce the effective rate of taxation on capital.

It is the expected after tax rate of return which governs decisions to invest and to commercialize an innovation. Increases in investment rates, particularly more modern and efficient technological plants, would lead to better productivity growth, and therefore lower inflation rates.

This is the fundamental approach which should be taken to our current economic problems—the real way to combat inflation.

Technological innovation, the key to productivity and economic growth in the 1980's, is performed by small and large companies as well as by individuals.

History shows that the small company or individual is responsible for a disproportionate share of the breakthrough innovations such as computers, fibers, medicines, jet airplanes, xerography and so on which made possible much of the big growth of the past. These innovations also provide virtually all of the new jobs.

Large companies can undertake the really big innovations in energy, metals and materials, communications, aerospace and so on. Their role is equally indispensable to the economic growth of the Nation.

But each type of innovator needs different tax incentives.

For individuals, they include reductions in the capital gains taxes, reductions in the top tax rate for dividend and interest income, now at 70 percent, improvement in the capital loss provisions, and reinstatement of favorable stock option rules.

For corporations, technology fostering incentives include accelerated depreciation, improved investment tax credits, easing of the at risk rules, and deductibility of dividend payments.

For research and development there is widespread recognition that some form of tax credit, both for additional research and development by companies, and for research and development at universities paid for by industry, is highly desirable to grow the "seed corn" of the future.

Today's R. & D. portfolio may be tomorrow's capital budget.

The contributing authors of the new treatise, strongly recommend extensive business oriented and proinvestment personal tax cuts, like those set forth above, all at once, not piecemeal.

They contend the net cost to the economy, if all of the above tax incentives were adopted, would be quite small in dynamic terms, much smaller than Kemp-Roth or equivalent personal across-the-board cuts.

But their effect would be highly targeted to savings, investment, risk taking and innovation. Hence, to productivity and noninflationary growth.

The authors reach no consensus regarding the Kemp-Roth type of tax cuts, because they probably less directly affect the question of technology.

Thank you very much for the privilege of being able to address you.

Senator PACKWOOD. Doctor, I do have a question. In looking at your last two or three pages where you talk about taxation, you say the authors are much less agreed among themselves on the use of a Kemp-Roth tax cut, as opposed to some very targeted cuts aimed toward capital gains, dividends, reinvestment dividend exclusion and what not.

Dr. LANDAU. Yes.

Senator PACKWOOD. You touch upon the very sore point the Congress is dealing with.

One, when we try to estimate how much revenue we are going to lose or not lose anyway, and you are talking about 2 or 3 or 4 years down the road, we can be off $50 or $100 billion in our estimates.

I know the argument about the reflows, and if we cut everybody's taxes, indeed, it will pay for itself, eventually.

Dr. LANDAU. Yes.

Senator PACKWOOD. What you are saying is that—I want to emphasize it once more, assuming we could accurately predict what revenue losses might come from certain tax cuts, you would prefer that those tax cuts be targeted rather than across the board?

Dr. LANDAU. It is not I, who is speaking for myself. Dr. Hannay and I are attempting to present to you, the results of 18 authors who have been working for a year in their preparation of a treatise, without any particular reference to this bill or any other bill.

But, their conclusions are what I have given you.

Senator PACKWOOD. Senator Wallop.

Senator WALLOP. Thank you very much, Mr. Chairman.

Doctor, do you believe that further reductions in capital gains generally has an important role to play in stimulating new investment in innovative firms which develop new technology?

Dr. LANDAU. Some of the authors in this volume advocate the complete abolition of the capital gains tax. They point out that a number of countries, including some of our principal foreign competitors, such as West Germany and Japan do not tax capital gains at all.

One must therefore draw the inference that to a degree there is a great deal to be said for further reduction in the capital gains tax.

Senator WALLOP. It might well have a fair effect on the R. & D. firms then. They would be the likely growth areas.

Dr. LANDAU. It would.

Senator PACKWOOD. Thank you.

Senator WALLOP. Thank you.

Dr. LANDAU. Thank you.

Senator PACKWOOD. Doctor, thank you. If you can leave that free book, we won't have to buy one next week. [Laughter.]

Dr. LANDAU. It is your copy. It is a very rare copy.

Senator PACKWOOD. Thank you for coming again, and for accommodating your schedule to us.

[The prepared statement of Dr. Ralph Landau follows:]

STATEMENT BY DR. RALPH LANDAU,[1] CHAIRMAN, THE HALCON SD GROUP, INC.

EXECUTIVE SUMMARY

The first treatise ever prepared on the subject of "Taxation Technology, and the U.S. Economy" will be published on June 19, under the auspices of the Polytechnic Institute of New York, as a special issue of the international journal, Technology in Society.

Technology is the forgotten subject in today's headlines regarding tax policy and economic policy, but it is the single most important contributor to the growth of the American economy since the last century—accounting for one-third to one-half of all economic growth.

The new treatise on "Taxation, Technology and the U.S. Economy" contains 18 papers by prominent authors from the economics profession (such as Lawrence Klein, Nobel Prize Winner in 1980, Dale Jorgenson, Michael Boskin, and Burton Klein), the business-technical world (Arthur Bueche of General Electric, Thomas

[1] Dr. Landau holds an Sc. D. in chemical engineering from M.I.T. He is co-founder and long-time chief executive officer of the Halcon SD Group, Inc., an entrepreneurial company, and a prominent figure in his industry. He is also a director of a Dow Jones company and a trustee of two leading universities.

Vanderslice of General Telephone, and J. Peter Grace of W. R. Grace), public officials (Senator Bentsen, Dr. Charls Walker, George Carlson, Gary Clyde Hufbauer), entrepreneurs (Edwin Zschau, electronics, and Ralph Landau, chemicals), and venture capitalists (Reid Dennis). It was edited by Bruce Hannay of Bell Telephone Labs and myself.

New economic data in the treatise indicate that the decline in U.S. productivity and economic growth since the early 1970's has been due to a dramatic decline in the rate of technical change, and that future development of new technology for all industries should be the primary focus of efforts to stimulate future U.S. economic growth.

To offset the drag on the development of new technology for the U.S. economy, immediate steps must be taken to reduce the effective rate of taxation on capital. It is the expected after-tax rate of return which governs decisions to invest and to commercialize an innovation. IncreaseJrates, particularly in more modern and efficient technological plants, would lead to better productivity growth and therefore lower inflation rates; this is the fundamental approach which should be taken to our current economic problems—the real way to combat inflation.

Technological innovation, the key to productivity and economic growth in the 1980's, is performed by small and large companies, as well as by individuals.

History shows that the small company or individual is responsible for a disproportionate share of the breakthrough innovations—such as computers, fibers, new medicines, agricultural chemicals, jet airplanes, xerography, etc.—which made possible the big growth of the past. These innovations also provide virtually all of the new jobs.

Large companies can undertake the really big innovations: in energy, in metals and materials, in communications, and so forth. Their role is equally indispensable to the economic growth of the Nation.

But each type of innovator needs different tax incentives. For individuals, they include: (1) reductions in the capital gains taxes; (2) reductions in the top rate for dividend and interest income (now 70 percent); (3) improvement in the capital loss provisions; and (4) reinstatement of favorable stock option rules.

For corporations, technology-fostering incentives include: (1) accelerated depreciation; (2) improved investment tax credits; (3) easing of the at-risk rules; and (4) deductibility of dividend payments.

For research and development, there is widespread recognition that some form of tax credit, both for additional research and development by companies and for research and development at universities paid for by industry, is highly desirable to grow the "seed corn" of the future.

The contributing authors of the new treatise strongly recommend extensive business-oriented and pro-investment personal tax cuts, like those set forth above, all at once—not piecemeal. They contend the net cost to the economy if all the above tax incentives were adopted would be quite small in dynamic terms—much smaller than Kemp-Roth or equivalent personal across-the-board cuts—but their effect would be highly targeted to savings, investment, risk taking, and innovation, and hence to productivity and non-inflationary growth.

The authors reach no consensus concerning the Kemp-Roth type of tax cuts.

STATEMENT OF DR. RALPH LANDAU, CHAIRMAN, THE HALCON SD GROUP, INC.

My name is Ralph Landau.[1] I am appearing today to acquaint this distinguished Committee with the publication next week of a new and very importat book that relates directly to the current national debate on tax policy: "Taxation, Technology and the U.S. Economy," which will be published under the auspices of the Polytechnic Institute of New York as a special issue of the international journal Technology in Society. My statement today is drawn primarily from the contents of the eighteen papers in the treatise, plus some synthesizing remarks by my co-ditor and myself.

THE CURRENT STATE OF THE ECONOMY

Today's economic headlines are dominated by issues such as: balancing the federal budget by budget cuts; Federal Reserve monetary control; inflationary effects of deficit spending; reducing the level of Government spending; general across-the-board tax cuts; and high levels of interest rates.

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[1] Dr. Landau holds an Sc. D. in Chemical Engineering from M.I.T. He is co-founder and long-time Chief Executive Officer of the Halcon SD Group, Inc., an entrepreneurial chemical company, and is a prominent figure in his industry. He is also a director of a Dow-Jones company and a trustee of two leading universities.

The 1980 election results made clear that the American people were and apparently still are dissatisfied; indeed, our fellow citizens share the widespread conviction of economists and other specialists that there is "something rotten in the state of the economy."

What is wrong? Consider the unhappy facts: Inflation has been at unprecedented heights; we have seen little or no growth in productivity; American companies have lost market shares to overseas competitors; we are burdened with higher and higher taxation; high unemployment persists.

The contrast with our principal foreign competitors—Japan and West Germany—during the period 1962 to 1978 can be summarized as follows:

	United States	Japan	West Germany
Average investment as a percent of GNP	17.5	32.0	24.6
Government spending (excluding transfer payments) as a percent of GNP	21.4	8.8	16.9
Productivity growth, average annual percent increase	2.7	8.2	5.4
Real economic growth per annum—overall average annual increase in real GNP, percent	3.5	8.3	3.7

By these commonly-accepted yardsticks of economic health, the U.S. ranks the worst. This is further evidenced by a dramatic difference in savings rates between the three countries; in 1978, the U.S. net savings rate was 5.8 percent, compared to 16.9 percent for Japan and 12.5 percent for West Germany; this relative difference generally persisted throughout the 1962–78 period.

Taxes on capital formation, coupled with bigger government spending which hobbles the private sector's performance, are surely a major part of the problems. Since the U.S. inflation and interest rates are also higher, these differences underscore the conclusion that the combined effect of our less favorable environment—in particular, the discouraging short-term investment horizon—is to hamper investment, research and development, and innovation.

THE FAILURE IN TECHNOLOGY DEVELOPMENT

A disturbing aspect of the current debate on economic and tax policy is the infrequent mention of (and perhaps an even greater lack of appreciation for) the most important failure of all—in technology.

Ever since the industrial revolution, it is America's technological progress which has fueled our growth from a log cabin economy to the greatest industrial power in the world. It should be remembered that:

At a growth rate of only 2 percent per year in real income per person, standards of living can almost double between generations. (In fact, this feat was accomplished from 1870 through 1950 by an average productivity increase of 1.8 percent per year. It should also be kept in mind that the population was increasing greatly over the same period.)

Since the middle of the last century, the United Kingdom, which was then the wealthiest nation on earth, has grown about 1 percent less per year than the U.S., and is now a relatively poor member of the Common Market; its productivity increase was only 1.2 percent last year.

From one-third to one-half of all the growth of the American economy in this period has come from technological change; the rest was about evenly divided between capital and human investment. However, over shorter time periods, the contribution of technological change has been much greater.

Between 1945 and the early 1970's, the U.S. real growth rate was slightly above its historic average; but since then, real growth (measured as the annual rate of growth in real GNP per employed worker) has been substantially zero—a worse performance than Japan, Germany, France, and many other nations, except for only the U.K.

Are we going the way of the U.K.? After all, that 1 percent difference between the U.S. and U.K. growth rates equates approximately to the contribution of technology.

What is wrong?

If technological progress has been the major factor in the growth of America's economy for 100 years, has it faltered since the early 1970's? The latest data leads clearly to the conclusion that it has.

One might look for other explanations for our poor economic performance, such as the tremendous increase in energy costs since 1973. However, other countries also suffered from "oil shock"—often, even more so than the U.S. So this is not the cause of our relative decline.

It has been found in recent and very careful studies that from 1973 to 1976, the fall in the rate of economic growth was due to a dramatic decline in the rate of technical change; the obvious conclusion is that future development of new technology for all industries should be the primary focus of efforts to stimulate future U.S. economic growth. These studies further indicate that to offset the drag on the development of new technology for the U.S. economy, immediate steps must be taken to reduce the effective rate of taxation on capital. The resulting increase in investment rates would lead to better productivity growth and therefore lower inflation rates. Indeed, this must be the fundamental approach to our current problems—it is the real way to combat inflation, reducing it gradually in time through basic technological improvements in the economy. Close study of the decade of the 1970's, by contrast, shows that effective tax rates appeared to increase—and hence to decrease after-tax return—and thus reduced the incentive to invest and innovate. These economic findings confirm the experience of many active participants in the economic process.

These are vital points. Yet, little is being said or done explicitly about the all-important factor of technology.

THE TREATISE ON "TAXATION, TECHNOLOGY, AND THE U.S. ECONOMY"

Dr. Bruce Hannay, Vice President for Research of the Bell Laboratories, and I set out to consult the experts on this subject last year, following up on our extensive studies on these subjects over five years for the National Academy of Engineering, where Dr. Hannay is Foreign Secretary and I was a Council member. We have produced the first comprehensive treatise dedicated to the subject of the intimate relationships between technology, taxation, and the U.S. economy.

Why did we do this? Because of the great national interest in innovation, especially technolcgical innovation (which, as shown earlier, lies at the heart of the growth factor in the economy)—an interest which swelled in 1979 and 1980. Various prominent private studies were undertaken at about the same time, as was the Presidential Policy Review of President Carter (the latter especially receiving wide national attention), but the two-year focus on this issue wound up limply at the end of 1980 without any tax policy actions—although the Senate Finance Committee Bill of late summer 1980 was an exception to this neglect. Yet, as mentioned above, tax policies are of special importance, for they can significantly affect incentives to save and invest, and motivate industry to innovate. It is now virtually unchallenged that in the advance economies of today, the bulk of technological advance comes from decisions made in response to potential economic incentives—or disincentives.

Let us analyze this further by a more detailed explanation of the treatise.

The special issue of Technology in Society published for the Polytechnic Institute of New York by Pergamon Press, which Bruce Hannay and I co-edited, deals directly with this central issue affecting the current tax debate. The treatise on "Taxation, Technology, and the U.S. Economy" contains 18 papers by prominent experts from several areas. The contributors are:

Economists.—Professor Lawrence Klein, University of Pennsylvania; Nobel Prize Winner in 1980; Dr. Roger Brinner, Vice President, Data Resources, Inc.; Professor Michael Boskin, Stanford University; Professor Dale Jorgenson, Harvard University; Professor Burton Klein, California Institute of Technology; Professor Joseph Cordes, George Washington University; Dr. Alvin Jay Harman, International Institute for Applied Systems Analysis and the Rand Corporation.

Business-Technical Participants in Technological Innovation.—Drs. Boyd J. McKelvain and Dr. Arthur M. Bueche (Senior Vice President), General Electric Company; Robert F. Dee, Chairman, Smigh Kline Corp.; J. Peter Grace, Chairman, W. R. Grace & Co.; Dr. Thomas A. Vanderslice, President, General Telephone & Electronics Corp.

Public Officials.—Senator Lloyd Bentsen, Democrat, Texas; George N. Carlson, International Economist, Office of International Tax Affairs, U.S. Treasury; Dr. Gary Clyde Hufbauer, former Deputy Assistant Secretary for Trade & Investment Policy, U.S. Treasury and Director, International Tax Staff; now Deputy Director, International Law Institute, Georgetown University; Dr. Kenneth McLennan, Vice President, Committee for Economic Development; Charles E. Walker, former Deputy Secretary of the Treasury under President Nixon.

Entrepreneurs.—De. Ralph Landau, Chairmn, Halcon/SD Group, Chemicals; Dr. Edwin V. W. Zschau, Chairman and President, System Industries, Electronics.

Venture Capitalists.—Reid W. Dennis, past President, National Venture Capital Association, and President, Institutional Venture Partners.

While there are still others who could have enriched our volume, these authors are distinguished and expert representatives of their fields—they are indeed "heavyweights."

In the remainder of my remarks, I would like to briefly summarize for the Committee some of the major issues raised,and conclusions reached, in the treatise.

THE EFFECTS OF TECHNOLOGY ON THE ECONOMY

The diffusion of technology into the economy, and its subsequenty growth and productivity enhancement, occur in one of two ways:

By "deepening"—i.e., by capital expansion using existing technology. This can still improve productivity. It is a quantitative change, and involves little or no technological risk;

By innovation—i.e., qualitative change—when something technologically new is tried for the first time. This is usually done to improve the economic efficiency of a process, or to make a superior product which may improve the quality of life, or the competitive position of a firm. It entails using resources more efficiently, rather than simply using more and more resources. Innovation therefore involves a significant technological and economic risk.

But innovation itself is of two kinds: Improvements—smaller, more gradual, less risky; and Breakthroughs—more revolutionary, much riskier.

Both kinds of technological innovation consist of two phases: Research and development (R. & D.)—which is less costly (usually less than 50 percent of the total cost of an innovation, often as little as 10 percent), and less risky; and The first commercialization or embodiment—usually representing more than 50 percent (up to 90 percent) of the total cost and the more risky phase, since it frequently involves capital expenditures under a different set of tax and incentive systems than R. & D.

From the standpoint of productivity improvement, what counts is the incorporation of innovation in capital goods. A rapid rate of improvement needs high capital investment, because it is the vehicle for the diffusion of technology into the economy.

Thus, we see that the capital formation associated with the riskier phases (such as, in the most striking example, the first commercialization of breakthrough innovations), is the key component of the innovative process. But all innovation is inherently risky. Hence, tax policy affects decisions to innovate in a major way, because it is the after-tax return on investment which governs decisions to invest and therefore to commercialize. The riskier the innovation is perceived to be, the greater the after-tax return that is demanded by the investor.

However, R. & D. is the vital precursor to innovation, even though it is a cost, while only commercialization can convert it into an economic benefit. Thus, today's R. & D. portfolio may become tomorrow's capital budget. R. & D. therefore may also be sensitive to tax policy. In essence, R. & D. is not likely to be undertaken unless an ultimate prospect of profitable return can be visualized, however dimly.

Some examples of technological innovation and its effects may be helpful in demonstrating its importance throughout American history: Agriculture is the most successful technological industry of all, continuing over a long time span and with an extremely favorable balance of trade. At the time of the Civil War, a farmer could feed only himself and two ot three others. By World War II, he had increased his output four to six times. The 1980 farmer feeds 65 people at home and abroad. That is productivity increase brought about by technology. The following chart shows this clearly:

[Manhours per bushels]

Year	Wheat	Corn for grain	Cotton
1800	373	344	601
1840	233	276	438
1880	152	180	303
1900	108	147	284
1915–19	98	132	299
1925–29	74	115	268
1935–39	67	108	209
1945–49	34	53	146
1955–59	17	20	74
1965–69	11	7	30
1970	9	7	26

The result of this trend is that, whereas after the Revolution virtually all of America was devoted to agriculture, now less than four percent are so occupied, while fully 72 percent of employment is in the service sector.

The computer is seen as the quintessential American technological innovation of the post-World War II era. The first one (ENIAC), built in the 1940's for several million dollars, could be purchased in 1978 for less than $100 in a micro-computer which calculates 20 times faster, is 10,000 times more reliable, requires 3600 times less power and 300,000 times less space. Twenty-five years ago, it cost $1.25 to do 100,000 multiplications by computer; today, it costs less than one cent.

In 1965, the first communication satellite was launched and could carry 240 telephone calls simultaneously. By the late 1970's, improved satellites could handle 6,250 simultaneous calls. The next generation of satellites will handle 12,000-14,000 calls!

THE BREAKTHROUGH INNOVATION

The breakthrough innovation is the kind that: changes the direction of a whole industry; creates new industries; creates new jobs; or changes the rate of growth of the economy significantly.

It is basically unpredictable, and certainly unforeseen as to scope, dimension, and economic effects. Some of these have been mentioned previously. Let us list here some more examples of breakthrough innovations since the Second World War which have done all these things, and which, of course, were largely or entirely unforeshadowed in advance:

Pharmaceuticals.—Antibiotics; Hypertension drugs; Anti-ulcer drugs; Birth control pills; Vaccines.

Chemicals.—Herbicides Synthetic fibers; Plastic films for packaging.

Electronic devices.—Transistors; Integrated Circuits; Lasers; Solar Cells; Videotapes and Discs; Magnetic Recordings.

Computers.—Mainframe large computers; Minicomputers; Microprocessors; Hand calculators.

Communications.—Optical Fibers; Satellite systems; Television; Stereo sound.

Transportation.—Jet airplanes; Space vehicles; Lead-free gasoline.

Reproduction.—Xerograpy; Instant photography.

Materials.—Plastics; Alloys, ceramics, etc.

Household appliances.—Air conditioners; Electric clothes washers and dishwashers.

While this list is incomplete, it is still spectacular.

Could we continue to achieve breakthrough innovations, if the climate were right? Yes, say the technologist! Today marks the leading edge of a revoluntionary change in technology that began only a little more than a quarter of a century ago—a technology drawn from an entirely new scientific base that bears little resemblance to the science that engineers and scientists learned even three decades ago. Today, one deals with phenomena that were inconceivable and impossible in the world of Newtonian mechanics. New industries are arising out of wave mechanics, quantum electronics and the new physics of solids; their products are revolutionizing older technologies both in efficiency and in function. And coming just over the horizon is biology!

THE LIMITATIONS OF ECONOMETRIC MODELS IN PREDICTING QUALITATIVE TECHNOLOGICAL CHANGE

A study or the well known econometric models such as Wharton, Data Resources, Chase Econometrics, etc., shows that they are unable to predict the arrival or effect of breakthrought innovations. This inability to predict is understandable because the models are based on extrapolating the past into the future, i.e., they are static in concept, as indeed they must be except for smooth trends from the past. But qualitative or breakthrough technical change introducts discontinuities—unforeseen events—which no econometric equation can handle. Hence, one notes the caution with which the authors of such models attempt to predict the future.

The same limitations exist on the effect of economic incentives on individuals and corporations. These equations can extrapolate past performance, but cannot readily predict changes in behavior when ground rules or perceptions change, without reasoning from past behavior. An example of this was found in 1978 when the static models predicted a $2 billion revenue loss to the Treasury from the reduction in the Capital Gains Tax, but the actual results, based on the dynamic effects of people taking individual actions based on the lower tax, wiped out the "predicted loss."

For these reasons, many of the authors in the treatise on "Taxation, Technology, and the U.S. Economy" speak of a dynamic economy, one which is not readily

predictable on a macroeconomic scale, but which depends on the constant interaction and change of many dynamic components—in other words, the multitude of feedbacks throughout the system which influence further actions and decisions. A discontinuity caused by a breakthrough innovation is the most dynamic of changes; it is a "loophole"—indeed, a very happy loophole—in the static equilibrium law or supply and demand, because it has been seen to actually expand the whole market to unforeseen heights.

THE INDIVIDUAL, THE SMALL COMPANY, AND THE LARGE CORPORATION

The contribution to innovation of individuals, small companies and large corporations is often misunderstood. It is a fallacy to believe that innovation comes primarily from any one of these three primary economic groupings. They all innovate, each in its own way.

The large companies have the cash flow to implement the really large projects. In 1981, corporate cash flow is expected to be $186.5 billion, but corporations have a physical investment need of $282.5 billion. This is virtually equal to all the long-term capital provided (mostly for very different types of investment) by banks, savings institutions, insurance companies, pension/retirement funds, and individuals to mortgages, bond markets, and new equity issues—largely the annual pool of personal savings and income from the non-profit sector. The corporate role in the economy is obviously central, because the corporations can take significant risks, and they provide the major international trade and balance of payments effects. The total trade balance of technologically intensive industries is positive; that of the nontechnological industries is negative.

Individuals and small companies are, however, equally important. Traditionally, they are the original sources of a disproportionate number of breakthrough innovations, and are the providers of the bulk of the new jobs in the U.S. Venture capital plays a very important role in the financing of these activities.

Both are also important for the defense effort. In many respects, the U.S. is not in an arms race, but a technology race.

FOSTERING INNOVATION AND TECHNOLOGICAL CHANGE

The perception of the contributors to the treatise, and indeed of knowledgeable people in many walks of life, is that the pace of innovation has faltered in the last decade, especially in the area of breakthrough innovations. Yet innovation cannot be forced—it can only be fostered.

It is clear from the above, however, that capital formation, and the climate for its stimulation, are the central prerequisites for technological change and innovation; foremost among the "climate conditioners" is tax policy. The treatise therefore places primary emphasis on policies to stimulate capital formation, and stresses that, taking the dynamic effects upon the economy into account, there will be little loss to the government in static terms and very large potential gains in dynamic terms.

Another important purpose (and effect) of tax policy, although admittedly of less impact in the short run, can be to enhance research and development. In this connection, the treatise emphasizes that tax policy considerations are important for both large and small companies, as well as individuals.

What are the key findings? A summary can be found in the "Introduction and Overview" which we have written for "Taxation, Technology and the U.S. Economy." We say with respect to tax policy that:

"In essence, then, our intuition is that there is a wide-spread consensus on the need for far-reaching business and investment tax measures to stimulate R & D and capital formation. This view extends to tax reduction on capital gains and present high marginal rates on investment income. There is no real agreement on the extent of general personal income tax rate cuts, probably because the impact on technology and innovation is less direct. If our interpretation of what the authors are saying is correct, however, policy makers have a right to assume that extensive business and pro-investment personal cuts—even of the broadest kinds envisioned by the authors—will really cost the economy very little in static terms, but that it may gain a great deal in dynamic terms as the economy grows and productivity increases. Hence, the largest tax cuts currently under national consideration really come down to the general across-the-board individual tax rate reductions and their dynamic effects on saving, on work, and on numerous other psychological and political factors which are largely outside the scope of this special issue. What the authors are saying, in our opinion, to the policy makers is nevertheless clear: You are justified in making—indeed obliged to make in view of the national urgency—extensive business-oriented and pro-investment personal tax cuts. It is better to

include a very broad mix, all at once, rather than piecemeal, as a real business stimulus to investors; the bigger general across-the-board personal tax cuts must involve additional considerations, some of which are discussed herein."

Minor tinkering with tax rates is totally insufficient to stimulate innovation in the 1980's. A sustained increase in the rate of innovation requires a much more fundamental revision of the incentives to innovate, starting with capital investment and greater risk taking.

The key tax policies that are mentioned in the papers in the treatise on "Taxation, Technology, and the U.S. Economy" are, for individuals:

(1) reductions in the capital gains taxes

(2) reductions in the top tax rate for dividend and interest income (now 70 percent)

(3) improvement in the capital loss provisions, and

(4) reinstatement of favorable stock options.

For corporations, the key tax policies are:

(1) accelerated depreciation

(2) improved investment tax credits

(3) easing of the at-risk rules, and

(4) deductibility of dividend payments

For research and development, there is widespread recognition that some form of tax credit, both for additional research and development by companies and for research and development at universities paid for by industry, is highly desirable to grow the "seed corn of the future."

The treatise also includes innovative tax-policy proposals, some based on performance of the firm.

There is much less agreement among the authors regarding the wisdom or urgency of general across-the-board tax reductions, but it is noted that the magnitude of the presently-proposed reductions of this kind (Kemp-Roth or variations thereof) is much greater than the sum of all the foregoing business-oriented and pro-investment personal cuts, particularly when seen in dynamic terms; this only underlines the significance of the recommendations quoted above.

I appreciate this opportunity to contribute to the important work of this Committee.

Thank you very much.

Senator PACKWOOD. We will now move on to Mr. Oppenheim, Mr. Schapiro, and Mr. Ginsburg.

Good morning, gentlemen.

Mr. Oppenheim, do you want to go first?

PANEL OF: STEVEN D. OPPENHEIM, CPA, MEMBER OF THE COMMODITIES AS TAX SHELTERS TASK FORCE, FEDERAL TAX DIVISION AND PARTNER OF OPPENHEIM, APPEL, DIXON & CO., NEW YORK, N.Y., REPRESENTING THE AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS; DONALD SCHAPIRO, TAX SECTION, NEW YORK STATE BAR ASSOCIATION, NEW YORK, N.Y.; AND MARTIN D. GINSBURG, PROFESSOR OF LAW, GEORGETOWN UNIVERSITY LAW CENTER, WASHINGTON, D.C.

Mr. OPPENHEIM. I wish to thank you for the opportunity you allow me to testify.

The AICPA firmly supports legislation which will effectively correct tax abuses. We understand and believe that there are abuses in the commodities area.

We believe that the proposed legislation addresses a real problem. However, some of the suggestions are either unworkable, because of their complexity, do not cure the problem or, in fact, create more of a problem than the existing rules.

We do not think that the use of the "balanced or offsetting" concept is the correct approach, since it is administratively unworkable and is based on the notion that risk reduction is something that should be discouraged.

It is not risk reduction that is the villain which Congress wishes to catch. It is the lack of profit motive.

Our changes have been suggested with that in mind. Risk reduction is not wrong. Risk reduction is appropriate business and investment policy.

We recommend that, for taxpayers other than dealers or commercial hedgers, a mark to market mechanism be applied to regulated futures contracts at year end, with the net amount of gain or loss being treated as long-term capital gain or loss.

We recognize that this constitutes a substantial change in tax theory and moves away from the concept of income realization on completed transactions.

Therefore, if enacted, it should be limited to regulated futures contracts only. Here it would be consistent with the economic practices of the industry, where gains and losses are settled on a daily basis.

In the case of cash and carry, it appears to us that the investment interest expense limitations have removed a great deal of the problem in this area and no change is necessary.

Furthermore, the way the proposed legislation is written, cash and carry would apply to interest bearing obligations as well as noninterest bearing commodities.

Thus, the taxpayer would be in the position of having the interest expense treated as capital loss, but the interest income received treated as taxable ordinary income.

This seems as unfair to us as the riskless conversion of ordinary income to long-term capital gains.

Whatever changes are enacted into legislation, we recommend that exemptions be made for bona fide dealers or hedgers who are engaged in such transactions in the ordinary course of their business.

It is our position that the dealer rule should be clarified and strengthened.

The concept of making a Treasury bill a capital asset is certainly reasonable on its face. However, it is not reasonable in practice.

The calculations of capital gain and loss and of interest income would be extremely burdensome. The changes are unnecessary, since a simpler solution to achieve the same result is at hand.

Instead of making a Treasury bill a capital asset, all options and futures contracts on Treasury bills should be made noncapital assets, thus reducing the ability to convert gains and losses from ordinary to capital by making or taking delivery of the underlying asset.

The spread problem, that is the ability to take a loss in one year and gain in another, would be dealt with by the use of the mark to market, except that any gain or loss should be ordinary.

In conclusion, we think the purpose of the legislation is good. We feel that the changes that we have suggested will make the legislation understandable, enforceable, and in keeping with the Government's policy of reducing interference without sacrificing revenue or encouraging tax dodges.

In earlier testimony, a point was made that abuses encourage other people to be abusive. That may be true. It is certainly true

that complex legislation, which is neither understandable nor enforceable invites abuse.

Let me repeat the three positive recommendations we are making orally—there are others in the written text: the use of mark to market with long-term capital gain treatment, the treatment of Treasury bill futures and options as noncapital assets and leaving Treasury bills as noncapital assets, and strengthening and clarifying the definition of what constitutes a dealer.

We believe that enactment of legislation embodying these recommendations would stop most if not all of the abuses we are concerned about, but without the disruption of proper and normal business activity that would result from the enactment of the proposed legislation as it now stands.

We, of course, will assist any and all Members of Congress, the Treasury Department, and the Internal Revenue Service, in whatever way possible, to accomplish the desired result of understandable, effective tax legislation.

Senator WALLOP [acting chairman, presiding]. Thank you very much, Mr. Oppenheim. I think what we will do is hear from the entire panel and then direct questions to you.

Mr. SCHAPIRO. Mr. Chairman, gentlemen, my name is Donald Schapiro. I am appearing here in behalf of the New York State Bar Association Tax Section.

I would ask that my statement and the accompanying report, dated May 27, which was prepared by our committee on financial institutions and financial futures be included in the record of these proceedings.

The full statement of the Bar Association Tax Section is contained in the report. I will just summarize here what seems to me to be the most pertinent points to the discussion.

Senator WALLOP. Your statement will be included in the record.

Mr. SCHAPIRO. Thank you, Mr. Chairman.

First of all, we recommend that legislation be enacted under which traders and speculators entering into futures contracts, in U.S. markets, regulated by the CFTC, that is regulated futures contracts, be taxed on a mark to market basis, but with a tax rate sufficiently favorable to attract capital necessary to make these markets liquid.

We believe that long-term capital gain and loss treatment without regard to holding periods, would be an appropriate method of taxing these contracts where they are not used as commercial hedges.

I might point out that our proposal differs from that of the Treasury Department in two ways. First of all, the Treasury Department, where it uses mark to market, would tax gains and losses at ordinary income rates. We do not think that is sufficiently favorable to attract the necessary liquidity.

Second, the Treasury Department uses mark to market for some, less than all of the contracts traded by a taxpayer and we think that the Treasury position would open itself to relatively easy circumvention, would be administratively terribly difficult, and is unnecessary.

Our second proposal is that executory contracts, other than regulated futures contracts, that is puts, calls, forward contracts, and

futures transactions on foreign exchanges should not be taxed on a mark to market basis, because they don't involve daily transfers of cash. They are not a sum zero system.

We are of the view, however, and we would favor legislation which would set forth when these contracts will defer losses on offsetting investment items, and when they will suspend holding period for long-term capital gain.

That is essentially the problem we have now in short sales of stocks and securities. We have a sensible law for that. We think that as the trading in investment type items increases—commodity investments, gold, silver, agricultural products, whatever they may be, that there should be equivalent rules cutting holding periods.

We recommend, third, that rules be adopted which would prevent conversion of ordinary income to capital gain, through deductions for interest and other carrying costs on cash and carry transactions where capital assets are held by a taxpayer without significant risk of loss of capital, that is, where the assets are hedged.

In this respect, our views differ from those of Mr. Oppenheim, sitting on my left. We don't believe that the investment interest rule is a sufficient protection here.

As far as averaging goes, we agree totally with the industry representatives that it is manifestly unfair not to have an averaging system for gains and losses and commodities.

We recommend that that averaging system be accomplished by allowing capital loss carrybacks the way the averaging system is handled for a variety of other kinds of items. The averaging problem is a problem for everyone.

Finally, we do recognize the importance of attracting risk capital to the futures markets in the United States.

We do recommend that they be treated favorably.

We would like, however, to identify two methods which would produce a favorable result with which we do not agree and we think would represent bad tax policy.

First, in our view, it is not sound tax policy to permit deferral to subsequent years of gains in commodities transactions closed during a year, or for the contracts marked to market.

Thus, we are opposed to a continuation of the tax straddles, even if limited to offsetting commodity related income.

We therefore disagree with the industry position on that matter.

Second, we do not believe it is sound tax policy to permit conversion of ordinary income to capital gain through cash and carry transactions.

I thank you very much for this opportunity to appear.

Senator WALLOP. Thank you very much, Mr. Schapiro.

Dr. Ginsburg.

Mr. GINSBURG. Good morning, Mr. Chairman.

My name is Martin D. Ginsburg. I am a professor of law, at Georgetown University Law Center where I teach various subjects in the field of Federal taxation.

Previously, before moving to the District of Columbia last year, my wife having gotten a good job here, I was the Beckman Professor of Law at Columbia University Law School and, for some 20 years before that, practiced law in New York City primarily in the Federal tax field.

I appear today on behalf of no group or client. I think no client would have me. I am merely here as an interested academic.

That commodity futures contracts and related animals are exploited in volume for undue tax advantage doesn't really seem to be a highly debatable proposition.

The field is more mysterious, perhaps, than other tax shelters in that the terms are so strange and confusing. It is sometimes hard to know what a commodity or commodity future or a commodity futures contract or a forward contract is. I am not at all sure that everybody knows what a butterfly is, and assuming they are not lepidopterists, why they ought to care.

None of that seems, however, terribly significant here. The straddle is not an awfully complicated notion. What is happening out there is that, to no sound purpose you can perceive, lead is being turned into gold, in large amounts.

In one commodity transaction or in a series of transactions, this year's ordinary income becomes next year's long-term capital gain, at worst, and maybe many years down the line long-term capital gain, and maybe never any gain at all.

The use of commodity transactions as the modern philosopher's stone is nothing new in tax planning. Conversion of short-term gain to long-term gain, for example, has been a popular indoor sport for a great many years. What has changed is the number of players, the volume of transactions, and the not unfounded belief that the special nature of Treasury bills invites conversion from ordinary income to capital gain.

This kind of a thing having gone on, in one fashion or another, time out of mind, one would think the Commissioner must have had something to say about it.

Indeed, he did, but not until fairly recently and not, I am afraid, in any cosmically effective way. The Commissioner has been vocal in his belief that a commodity transaction created to minimize the tax consequences of unrelated short-term capital gain or ordinary income, if there is no realistic potential of significant economic profit and the transaction results in no economic loss, produces nothing that is deductible against anything.

I think there is a great deal to be said for the Commissioner's position, but in every case it requires knowledge of facts and resolution of questions of fact on which unreasonable men and women may and no doubt will differ.

A wise person once pointed out that if determination of a pervasive tax issue requires repeated resolution of a question of fact, it is altogether likely the tax system is asking the wrong question.

It seems to me that the legislation that is before this committee is an attempt to ask the right questions. Ought we change the tax rules relative to Treasury bill transactions without regard to motive, tainted or pure? Should a taxpayer be prevented from using the futures market as a means of rolling over to a later year a gain otherwise currently taxable? Or as a means of transmuting short-term gain into long-term gain?

The legislation answers those questions, "yes," we ought to be preventing this in a way that does not require a million audit disputes a year and an impossibility of working it out.

The mark to market concept, and most of the balance of what Mr. Schapiro spoke to immediately before, are things with which I am strongly in agreement. We had the pleasure of testifying together on the House side although, in that case, in the opposite order.

Mr. Chairman, it is great fun for an academic to attend hearings on tax shelter transactions. This morning no one defends the abusive tax avoidance use of commodities.

But, you know, at hearings no one ever defends the abusive tax avoidance use of anything. Everyone at tax shelter hearings turns out to be highly public spirited. Without fail, this is evidenced by an intense desire to prevent the destruction of the Republic from the assured and horrendous side effects of whatever tax change is going to be made.

But, in the end, we really have to make some of these tax changes or the Republic will be in a great deal more difficulty, simply because the tax system falls into disrepute.

Senator WALLOP. Thank you very much, Mr. Ginsburg.

Senator Moynihan.

Senator MOYNIHAN. Thank you, Mr. Chairman. If I could just respond to Professor Ginsburg's last point.

I have been in quite a few hearings in these matters now. You are right. Without exception, abuses of the Tax Code are condemned, and without exception changes in the Tax Code are deplored.

It is a straddle, I think. [Laughter.]

This may seem a bit self-serving, but may I ask the panel, is it not a real possibility that if we don't do something here, these exchanges are going to become discredited. The kinds of income tax returns we examined yesterday are going—are not going to stay unnoticed that long.

Every so often in the life of an industry or a business, it needs to be told it is going to have a problem by people who are—who have its interest at heart; if you don't do this, you are going to be seen as a giant swindle.

Isn't that possible? I have said, meaning no disrespect to H & R Block, that if we don't do something pretty soon, H & R Block is going to be arranging straddles for you. [Laughter.]

We have had some suggestions from attorneys that never would—tax attorneys who never would involve themselves in this, but it was almost a malpractice by a tax attorney not to say to taxpayer, "You know, you don't have to pay taxes this year. We can roll them over."

Isn't that kind of problem coming upon us?

Mr. Ginsburg.

Mr. Schapiro.

Mr. SCHAPIRO. As a practicing lawyer, I would say, Senator, it is a very serious problem. In November of a year, I will get called up by people who will say, for 15 percent or 20 percent, we can convert ordinary income into capital gain or defer it forever.

Now, this isn't to say that as a practicing lawyer I would recommend it to clients, I don't. But it is a serious problem in terms of an effective tax system.

I agree with you totally. I think that anything which permits any class of taxpayers, absent the strongest possible legislative need such as tax-exempt interest from municipalities, not to pay taxes, at their election, is a very serious problem in the community understanding of it.

It is very hard indeed, as a tax lawyer, to impress upon people the need to report accurately and not to take positions where things like this are going on.

I think everyone would agree with that. But, certainly I believe Professor Ginsburg would agree with me. I think Mr. Oppenheim would agree with me.

Mr. OPPENHEIM. Senator, I agree in theory. The practice I think is somewhat different. I think the abuse is real. I think the ability to do so at a perceived economic cost that is very low on regulated exchanges is overpublicized. I know of a great many cases where people have entered into what we have discussed as riskless spreads, only to find out that that was not the case, and that there was enormous amount of risk.

You have seen markets move in very strange and very quick ways and the poor taxpayer who believed it was riskless found out later it was not.

I think that is a very real problem. Legislation may be necessary to prevent the taxpayer from being his own worst enemy.

These are real trades and he finds out too late that they are.

Senator WALLOP. I will have to say, if you will permit me, Pat——

Senator MOYNIHAN. Surely.

Senator WALLOP. Well, you have the floor and I will permit you an extra minute on that basis, but it is absolutely not the business of Government to protect the taxpayer or any other segment of Government from his own worst self.

That is a matter of big brotherism that I find just totally and abhorently offensive. If a guy wants to go out there and thinks he is going to con the Government out of $100,000 of taxes and it ends out costing him $200,000, I say hooray. [Laughter.]

He learned something and maybe he won't be so anxious to get at the Government again. We don't need to protect people from themselves. We may need to protect the Government from people, but not the people from themselves.

Mr. OPPENHEIM. Senator, I agree with that, but the perception that has permeated the room and has been expressed in much of the proceeding is that these are riskless.

There are some trades that are, in fact, riskless. Those I think are eminently attackable under present law as not real.

Senator WALLOP. On that basis, I quite agree with you. But those things that are riskless are relatively rare, too. The risk changes as soon as they are discovered.

Go ahead.

Senator MOYNIHAN. Still, one has the impression that the greater number of these transactions arranged are successful. What would be wrong in that?

Mr. OPPENHEIM. Senator, I disagree.

One, I think that in order to have a long-term capital gain, in a commodity transaction, one must stipulate a rising market. That

is, the value of the commodity increases, and there is the capital gain. The long-term capital gain is on the long side, not the short side.

Senator MOYNIHAN. But on tax deferral, isn't that a relatively easy thing to do?

Mr. OPPENHEIM. Oh, excuse me, but in tax deferral there is a cost. Ultimately, if you defer your gain at a cost of 10 percent a year, and that is not necessarily the right number, after 10 years of deferral you have gained nothing.

Senator MOYNIHAN. Ten years of a tax free loan from the Government?

Mr. OPPENHEIM. Yes; you have that, but you then have the element of risk in the transaction where you may end up losing substantially more than the cost.

In real transactions the risk of loss can be very, very surprising and very large.

Senator MOYNIHAN. I am sure of that. But, are we also witnessing an ever-widening practice? It was estimated by the Treasury that 15 percent of transactions of commodity exchanges are now for this purpose.

I take it that Professors Schapiro and Ginsburg—I didn't hear you, Mr. Oppenheim—but you think a mark to market arrangement would work and would not disrupt the exchanges?

Mr. GINSBURG. Yes.

Mr. SCHAPIRO. I do also, provided that there is an effective favorable tax rate like long-term capital gain.

I think a mark to market rule, with ordinary income, such as being proposed by the Treasury is likely to have disruptive effects, because it should have. People are taking risks. You are asking people to invest money and take risks for a less favorable return than they can get in other capital investments.

I think we just ought to assume people will do what is sensible, if you would like people to take risks in the futures market. I think our Bar Association Tax Section believes they should.

We think that liquid markets are terribly important to the economy. They serve a very useful purpose. We think they should be encouraged. We think it should be done with long-term capital gain rate. Everyone will pay taxes.

Our Bar Association says favor the commodities exchanges, but have everyone pay taxes once a year. We just ought to have a rule whatever the rate is. Actually, there is no revenue involved in long-term capital gain, because the losses are equal to the gains. It is a sum zero system.

You could put the entire thing on a long-term capital gain and loss basis and there is not one penny of difference in revenue, as compared with whether it is an ordinary income tax gain and loss system.

Senator MOYNIHAN. Mr. Chairman, could I ask just one second, to ask Mr. Schapiro, what would you think an appropriate rate would be?

Mr. SCHAPIRO. Well, our Bar Association has recommended a straight long-term rate. We understand that some people in the Treasury Department and otherwise feel that is too favorable a

rate as compared with people engaged in other activities. This is not a revenue matter. It is a horizontal equity matter.

Our report points out why we think the disadvantages of mark to market from a tax viewpoint justify the 28 percent, 20 percent, whatever it is, if the top rate is reduced to 50 percent.

Senator MOYNIHAN. It is likely to be 20 percent.

Mr. SCHAPIRO. Fine. We would say yes on that. Because we think there are a lot of disadvantages in the mark to market rule.

For example, there is no step up in basis on death. You can't make gifts of the thing. You can't skip the tax on a corporate liquidation. There are many places where the mark to market rule is tough.

The industry representatives have said it is. We agree. But we think if you give it a long-term capital gain rate, that is fair and appropriate. If you feel that you would like to give it a higher tax rate, it has been suggested, for example, that some part of these gains will be taxed without regard to holding period at long term, and some at short term.

One suggestion that I have seen is that 20 percent of the gain be treated as long-term gain and 80 percent be treated as short-term gain.

Well, as I said to the people discussing it, gentlemen, that is a matter of price. Everyone I think from the industry side would say, you know, 99-percent long, 1-percent short, OK.

Everyone at the Treasury would say 99-percent short, 1-percent long, OK.

I am through as a lawyer now. I say, gentlemen, you just set your own price and the system will work. I think those losses, and there will be losses equal to gains, ought to be offset against other income. I think we ought to have a system in which people are attracted to speculate in the commodity markets. They do a great thing for our economy.

Senator WALLOP. Senator Symms.

Senator SYMMS. I wanted to ask Mr. Oppenheim a question. You mentioned that this is not risk free. We have heard a lot of talk from Treasury about how safe it is to play a silver straddle and defer your income.

But, if you happen to try to get into this when the price of silver on the spot month, which is the nearby month, and it hit $48 an ounce. Three months later, and it was way ahead of the far out month, so the next day there was a $6 or $8 correction, I believe in silver on the spot price.

Now, if you were trying to put a straddle on for a client, and you got involved in a situation where the price in the 3-month period went from $48 an ounce down to $10.80, and at that time the nearby months were ahead of the far out months, and when it hit $10.80, it reversed the position.

What happens to all those tax straddles?

Mr. OPPENHEIM. Senator, first, I don't put clients into tax straddles.

Senator SYMMS. Well, I didn't mean that you did, but say that somebody does it. Say a CPA or somebody tries to help his client get a tax straddle. What happens to that person?

Mr. OPPENHEIM. First of all a CPA will say that you have short-term capital gains, and that you ought to think about ways of planning for the tax.

Assuming that the client finds his way into the commodities arena and does a trade, similar to the one you have outlined, he stands to lose a great deal of very real money.

Because, when you have done a spread transaction, you have based your prices on a relationship between the nearby and the far out month.

As soon as that relationship changes, you have either made or lost money, real money. And, in fact, as the relationship changes to your detriment, as you have heard earlier, you must continue to put up money to maintain that position.

Then, if the market does move the limit, as it often does, you may be unable to get out of those positions, but continue to have to put up money. When markets move down the limit or up the limit, you may not be able to execute a transaction. You will hear that from others.

Therefore, you will stay there increasing your loss with no way to get out.

Senator WALLOP. That loss is daily and rather real.

Mr. OPPENHEIM. Oh, yes. There are stories about people losing millions, professionals, because they cannot get out. It happened during the silver run up and down. You just could not get out.

As I said earlier, you may not like the tax consequences of the trades, but those trades are very real.

Senator SYMMS. Do you disagree with what the—you said you like the mark to market rule?

Mr. OPPENHEIM. I like the mark to market approach, as you will see in detail in our written statement. At long-term capital gains rates, with 1-year-end adjustment, as we have suggested in our written statement, in lieu of a basis adjustment; yes I do, or yes, we do.

Senator SYMMS. What about the comment that Dr. Yeutter made about the question I asked, I don't know if you were in the room then and heard it, about the financing of the national debt and the debt servicing.

Do you agree with his conclusion on that?

Mr. OPPENHEIM. I have no ability to either agree or disagree. Practical experience tells me that there are so many changes that occur, that they may be unpredictable.

I am more concerned in terms of the national debt with the proposed change in the status of Treasury bills. I think that——

Senator SYMMS. That is what I am talking about.

Mr. OPPENHEIM. Oh, I firmly believe there will be a change. I believe that liquidity will suffer from the proposed change to make a Treasury bill a capital asset.

Senator SYMMS. So you don't favor that then.

Mr. OPPENHEIM. No, sir.

Senator SYMMS. Well, am I correct in saying on this mark to market point of view, we would end up on December 31, with the tax considerations what was regulating the market rather than other factors, if you go to mark to market?

Mr. OPPENHEIM. Yes, but in the case of Treasury bills, we have recommended Treasury bill futures be treated as ordinary. So, thus, any gain or loss on the mark to market basis would parallel the existing Treasury bills.

Senator SYMMS. Let's go back to the soybeans then. If you go mark to market on soybeans, what happens on December 31 or in the later part of December?

Do you have people in there involved in the markets that are thinking about taxes instead of the supply and demand of soybeans?

Mr. OPPENHEIM. In my opinion, that would be very difficult. At that time, since your positions will be tax neutral, that is, you will be taxed on your ending positions whatever they are, you are then saying in my opinion, the only way I could affect the tax treatment of my positions would be to manipulate the market.

Senator SYMMS. Do you want to comment?

Mr. SCHAPIRO. Yes, Senator. I don't quite see why that would be true. The commodity markets are an absolutely neutral system. The tugs and hauls ought to be exactly equal on every day. Anyone who was going to benefit from a price increase will have an opposite number who is losing from the price increase.

This is an absolutely sum zero system. I can't conceive why there would be any tax manipulation. To put it differently, I can't conceive how it would be possible, and if it were possible, the CFTC ought to change the rules.

If we accept the basic economic concept of movement of money back and forth, every win has a loss and every loss has a win. I don't see why anything should happen on December 31.

Senator SYMMS. Mr. Wilmouth said and let me quote what he said. It bothered me somewhat. It bothers me to hear you—I would just like to try to understand here.

> The concept will cause settlement price wars on December 31, and later days of the year when trading will be a battle between the longs and the shorts since taxable income will be totally dependent upon the closing price that day and it would diminish the viability of the market hedging vehicle.

As a farmer, if I thought that people were going to settle the price of soybeans or wheat based on the taxing code, not on what the price of soybeans were, I would sure want to stay out of that market and figure out some other way. I would go contract with the private dealers or something and stay out of the—I can see why they would be concerned with this.

Right now, we are the center of the world on the soybean market.

Mr. SCHAPIRO. Senator Symms, I agree. I would be concerned too, if I thought it was so. But every day is a war between the longs and the shorts. This is what the whole discovery of price is. This happens all the time. That is what the markets are all about.

I can't quite see what distortion anyone is talking about on a particular day during the year, December 31 or not.

Now, it may be so, but I haven't heard any explanation of it from anybody, nor does it seem to me as a reasonable person that there would be one.

Now, I may be wrong, but certainly it would have to be explained in some way that I haven't yet heard.

Senator SYMMS. He says the concept will result in chaos for the speculator who will have various aspects of his business taxed in different ways.

For example, the relationship of the futures contract to the underlying cash contract would be distorted since the tax consequence would differ for each.

Thus, the price relationship would be on the basis of tax laws rather than on supply and demand.

That is what they are talking about.

Mr. SCHAPIRO. Well, I think everyone agrees that for the commercial hedger, the farmer, the grain operator, these rules wouldn't work. We would continue the same rules we now have. I am just not sure I understand why this would happen.

I could understand that the present tax system is favorable. Of course, it is. It is desirable. We have a great market, under a favorable tax system.

The question before this committee and the Congress is whether there ought to be an alternative favorable, or almost as favorable, system put in which will also agree with basic tax concepts that people should pay tax once a year on their income.

That is what we are talking about. We ought to accomplish everything that people want to do, and to keep the markets, to avoid anything going wrong with them. But we should do it in a way in which people pay tax once a year. That is all.

Senator WALLOP. Senator Dole.

Senator DOLE. I have no questions.

Senator WALLOP. The first panel testified that the marked to market approach would violate long-standing tax rules requiring the realization of gain before a tax was imposed.

I just ask generally, as a panel, what is your judgment on that? Would it violate long-standing concepts?

Mr. GINSBURG. No, I don't think so. My friend Mr. Schapiro has a wonderful poker game illustration, if I can get him to give it.

Mr. SCHAPIRO. No. I don't think it would do anything like that. Cash moves back and forth. This is the only market that I know of in which cash moves back and forth every day. Really what we are taxing is the cash moving back and forth.

When your house goes up in value, you just can't get cash from anybody without interest, cash without interest.

If you margin stocks, you have to pay interest on the borrowing. You are liable to return it.

Here you get your cash. You can close your position out. That is the end of it.

On the question of whether there are losses and gains, I talk to my good friend, Marty, and I say, it is like a poker game. I mean, do you win at the end of every hand, at the end of every session. Or if you win or lose money at the end of a whole weekend, at what point do you measure it?

I would say that any time you can quit, you have had your gains or losses.

Senator WALLOP. What happens if that isn't in the year that you are talking about. You are saying anytime that they quit. But, if somebody starts on December 31, isn't that the principle of what is going on here anyway?

Mr. SCHAPIRO. No. The rule is that once you get the cash, you are able to withdraw it and it is an appropriate time to tax when people have cash which they can keep.

Our suggestion is that you tax the cash received when the contract is performed or on December 31.

Senator WALLOP. December 31 is not necessarily when a gain has been realized.

Mr. SCHAPIRO. Our view would be that it is appropriate to tax the gain at that time, because you have the cash at hand and you can say, I want to keep the cash. I want to end my transaction.

We think that is appropriate, and that it is unlike other things. It is not like taxing a house and not like taxing appreciation in stock.

On December 31, when everything is all over, if I am long, and Marty is short, we have exchanged cash. We can stop. That is the end of it. One of us has the cash and can keep it.

If we would like to remain in on January 1 and January 2, that is fine. At that point, once again we are making a decision to stay in or go out.

We recognize of course, it is a little different than normal realization concepts, but for example, there are many other cases like this. Securities dealers, for accounting purposes have to record their securities on a mark to market basis at year end. That's standard accounting, sometimes for taxes, sometimes not.

Gold and silver which is produced is valued at market by mining companies at yearend. It is not at all unusual for highly liquid things.

Senator WALLOP. I guess what causes me concern is that quotation that Senator Symms just read, as to what it might do to the commodity markets, the longs and shorts on the last day of the year, and the total distortion of the ordinary forces that are at work on it.

If you are going to cash in everything on December 31, longs and shorts, what happens to the poor guys for whom the commodity markets theoretically were designed in the first place, namely, the producers and the millers.

For instance, in the case of wheat, the producers, and in the case of cattle, the butchers.

Mr. SCHAPIRO. They are left exactly as they were. The only thing we are doing is——

Senator WALLOP. Except forces which have nothing to do with the value of their commodity are at work on it there.

Mr. SCHAPIRO. No. All the producers are left in exactly the same position. They are not marked to market. They are taxed as commercial hedgers. There are no changes made to the tax rules for them.

Senator WALLOP. No changes made in the tax rules, but there may be a hell of a change in the price and who cares about tax rules if somebody has got your goodies.

Mr. SCHAPIRO. But why——

Senator WALLOP. That is what you are in it for, if you are a hedger. It is different to be a speculator and a hedger; that is what I am trying to get at.

What happens to the hedger, theoretically, for whom these markets were put up? The hedger is in existence because of the speculator. There is no question about that. But if the speculator has all kinds of forces at work on him, on a last day of the year, which have nothing to do with the commodity at hand, the supply or futures forecast or anything else, what happens then to the people for whom these markets were originally set up?

Mr. OPPENHEIM. Senator, what happens now?

Senator WALLOP. What happens right now is that there isn't a tax settlement date on December 31.

Senator SYMMS. Lots of trading right now.

Mr. GINSBURG. What there is now, let's go back to the folks that Mr. Schapiro had. One of them has a loss situation, and one of them has a gain.

If you come down to yearend and can make use of a loss, you will close out that transaction in order to get the loss. Since you don't want the gain, you won't close out that part, the gain end of it, if you are on the gain side.

The markets have been operating and people have been operating this way for a long time, except that currently the system is a great deal more artificial, I think, than it would be in a realistic mark to market world.

If I may just comment on one other thing, the question of being able to take the gains and isn't that an appropriate time for taxing you?

Last year this committee was very active in putting through the Installment Sales Revision Act of 1980. It is a lovely thing and postpones gains all over the place. But the one time that you don't defer is when the seller holds a demand note given by the buyer.

The 1980 legislation reconfirmed the position, in the law since 1969, that if you have a demand note we are going to tax you now, because you can take the money out, you can demand it.

It doesn't seem to me mark to market is cosmically different from that rule.

Senator WALLOP. Does any other member of the panel have another comment?

Senator SYMMS. I want to pursue your question. Maybe it was going over my head here. You are talking about this termination or at the end of the year and having the finalization. What about the guy that goes in there and he has gotten ahead on a contract, a trader, say. At the yearend, you mean it is cash, he can sell it that day if he chooses to.

Mr. SCHAPIRO. He doesn't have to sell it. He has the cash whether or not he sells it. The cash is credited to his account and he can withdraw it whether or not he sells it.

Senator SYMMS. In other words, you want to put him on an accrual basis?

Mr. SCHAPIRO. I want to put him on a cash basis. [Laughter.]

Senator SYMMS. Well, he may not have the cash the next day. If the price goes down, he has lost it.

Mr. SCHAPIRO. He has lost it the next day.

Senator SYMMS. You want to tax him on the dead horse then?

Mr. SCHAPIRO. Well, no, I want to tax him on his gains and I want to give him a loss carryback just like everybody else in life does.

If I am engaged in the widget business, and I make money in widgets this year, and I lose money in widgets next year, I get a loss carryback.

If I am a lawyer and I make money this year and I lose money next year, I get a loss carryback.

Senator SYMMS. That never happens to lawyers. [Laughter.]

If I understood correctly what the situation is, if the trader today makes $100,000 this year, pays taxes on it, next year he loses $100,000, he doesn't get paid back by the Government. You are saying you would like for him to be able to do that.

Mr. SCHAPIRO. Absolutely. The law should be changed to do that. The people who are in the commodities industry are totally right, that the present law is terribly unfair in that regard.

It is also incidentally, unfair in allowing short-term gain only for short positions. There is no earthly reason why someone who is at the risk of the market, in a short position, for more than 6 months, under today's law, should not be entitled to long-term gain. The law doesn't provide it. It is a mistake. We think the law should be changed.

The people who were speaking about the defects of present law are entirely right. Their remedy of allowing people to roll things over forever we don't think is right. We think it should be cured in a different way.

Senator SYMMS. I think I understand better what your position is now. I appreciate that. But there is so much risk involved in the volatility of these markets, if we do anything to remove the traders, you have to assume that the risk is going to be greater then, because the price is going to fluctuate more as those markets get thinner.

Mr. SCHAPIRO. Absolutely. I would assume, incidentally, if you enacted a bill allowing long-term capital gains for the commodity speculators and traders that you would flood the market. I am guessing now, but in comparison to alternative investments I can see, at least in my mind's eye, the newspaper advertising. You know, stocks have to be held for a year to get long-term gains. Options have to be held for a year. Come to the commodities market.

There is a very favorable tax rate. The reason it doesn't cost the Government any money is because there are losses equal to every gain. For everyone who wins, there is a loser.

The loser only gets a long-term capital loss, which is a very, very undesirable kind of loss.

Senator SYMMS. Thank you, Mr. Chairman.

Senator MOYNIHAN. Mr. Chairman, could I just press one more question to this panel?

Is there a possibility of a distortion in attracting too much money to these markets?

Mr. SCHAPIRO. Senator, I really don't know. But I say, it would seem to me within the confines of what is predictable and the studies that can be made and the ability of the economic system to

provide information and to set a tax rate, it ought to be possible to do that.

I just don't know, but it seems to me you could find it out.

Senator MOYNIHAN. Your point being, you are arguing about price.

Mr. SCHAPIRO. Exactly, sir.

Senator MOYNIHAN. Your principle, and I think it ought to be heard, is that persons should pay taxes once a year. Any person with a position in the commodities market, at the end of the year, if he has gained on that, he has the cash available to do so.

If he chooses to keep his position not liquidated, well, that's his choice; right?

Mr. SCHAPIRO. Exactly.

Senator MOYNIHAN. He is in a position to pay taxes. He has the cash.

Mr. SCHAPIRO. Exactly.

Senator MOYNIHAN. Once a year to do so. You would like to see a change whereby losses could be carried forward and back in ways that are normal.

Mr. SCHAPIRO Yes.

Senator MOYNIHAN. I gather the panel all agrees with that?

Mr. OPPENHEIM. Yes.

Mr. GINSBURG. Yes.

Senator MOYNIHAN. That would substantially improve the position of traders who might indeed have big losses and big gains in alternate years and can't use them now as other businessmen can do.

Mr. OPPENHEIM. That is correct.

Senator MOYNIHAN. I think this is very illuminating. I thank the panel very much.

Senator WALLOP. There may be questions the committee or staff may have to submit to you. It would be very helpful if you would respond to those.

Thank you very much.

Mr. SCHAPIRO. Mr. Chairman, with all respect to the Moynihan bill, we think in that form it really would be virtually impossible to operate under. We are suggesting a system we think will operate very simply and it will be easy to audit.

We believe very strongly the Treasury proposal is not sound. We have explained why in our report. We don't think it will work. We think it will lead to more tax avoidance.

Basically, the Treasury says more than 50 trades in three out of four quarters, you get ordinary income or loss.

Less than 50 trades out of three of four quarters, you get capital gain or loss.

Supposing I run my portfolio just until the end of the year, so that was 2 more trades, I go over the line and I get ordinary income and loss treatment.

Well, it is not very hard for me to see that if I am a winner, I will stay on the side of the capital line. If I am a loser, I will go over and get ordinary loss. Then I begin to think about how about myself and my brother, he takes one side of every trade, I take another. At the end of the year one of us is going to win and one of us is going to lose, exactly the same amount. The winner stays

short of the mark and achieves capital gain. The loser goes over the edge and is treated as an ordinary loss.

Treasury says they really can't police a taxpayer with a lot of trades. Well, you could have 10,000 trades in two out of the four quarters and still not be mark to market.

We don't think it is a good idea.

Senator MOYNIHAN. Could I just ask, Mr. Schapiro, you know that the bill we put in originally was put in for discussion purposes. We have discussed at that general meeting we had a while ago a second proposal which we called Proposal A.

I gather you find that in the range of the kind of a thing you would like to see done?

Mr. SCHAPIRO. Yes; that's correct.

Senator MOYNIHAN. There is a round 1 proposal. I thank you very much, gentlemen.

Senator SYMMS. Thank you very much.

[The prepared statements of the preceding panel follow.]

STATEMENT OF STEVEN D. OPPENHEIM ON BEHALF OF THE COMMODITIES TAX SHELTER TASK FORCE OF THE AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, FEDERAL TAX DIVISION

I wish to thank the Committee for allowing me the opportunity to testify on behalf of the Commodities Task Force of the AICPA Federal Tax Division. Our report will be considered by the Executive Committee of the Tax Division at its next meeting and if there are any changes to our recommendations or conclusions, we well inform you promptly.

The AICPA firmly supports legislation which will effectively correct tax abuses. We understand and believe that there are abuses in the commodities area. We believe that the proposed legislation addresses a real problem. However, some of the suggestions are either unworkable because of their complexity, do not cure the problem, or, in fact, create more of a problem then the existing rules. In that regard, let me be specific about certain provisions.

We do not think that the use of the "balanced or offsetting" concept is the correct approach since it is administratively unworkable and is based on the notion that risk reduction is a bad thing.

It is not risk reduction that is the villian that Congress wishes to catch, it is the lack of profit motive. Our changes have been suggested with that in mind. Risk reduction is not wrong. Risk reduction is appropriate business and investment policy. One should always encourage individuals in business to maximize revenues and minimize losses.

A statistical measurement of risk as a test can lead to some very erroneous conclusions. Physical commodities trade as a function of both scarcity and carrying cost. The major carrying cost is interest. Thus, for example, if the weather is good and a good crop of soybeans is expected and there is no political unrest in the world to prevent copper from being mined, it is possible that copper and soy beans will have parallel movement. Statistical anaylysis could lead the IRS to conclude that soy beans and copper are similar enough that a long position in one should be considered as balanced by a short position in the other. This does not take into account that when the underlying factors become disparate there will be substantial differences and the economic consequences could be disastrous if the two positions were treated as offsetting.

Because the approach of the proposed legislation is inappropriate and far too broad in its scope, we expect that it would be administratively unworkable. The items of balance are almost without limit to one's imagination. The Internal Revenue Service, even though it intends to enforce these rules fairly, has had a history of being unable to extricate itself from the morass of detail, and thus, in the past, has issued some very quetionable and perhaps erroneous rulings and conclusions as to the nature of risk in these types of transactions.

We recommend that, for taxpayers other than dealers or commercial hedgers, a mark to market mechanism be applied to regulated futures contracts at year end, with the net amount of gain or loss being treated as long term capital gain or loss. We recognize that this constitutes a substantial change in tax theory and moves away from the concept of income realization on completed transactions. Therefore,

if enacted, it should be limited to regulated futures contracts only. Here it would be consistent with the economic practice of the industry, where gains and losses are settled on a daily basis.

There has been other testimony in other hearings as to the effectivenss of this proposal. We would like to make a suggestion which we believe would make it more workable. Once the mark to market has taken place, you are faced with the problem of the gain having been realized and there needing to be a basis adjustment or some other form of adjustment in the subsequent period to allow for the already taxed income. Rather than using a difficult procedure, such as marking each of the appreciated contracts to market (i.e., the gain contracts up only to the extent of the net gain in the futures market), we recommend that the entire amount of the long term capital gain generated by the mark to market be reversed in the subsequent year as a long term capital loss. Thus, no basis adustment is necessary, no complicated recordkeeping is required, and dipsosal of the underlying contracts will then result in gain or loss as if the mark to market had not taken place. However, the income will have been taxed in the earlier period to the extent that the economic gain was deemed realized at year end. It seems to us that this has the advantage of recognizing the gain or loss on regulated futures contracts on a daily basis, just as the industry does. Yet it keeps in place the mechanics of historical cost income realization, and the ease of recordkeeping will enable us, as accountants, to prepare tax returns without great difficulty to ourselves or our clients and the Internal Revenue Service will have a relatively easy audit procedure rather than a complicated set of records to review.

In the case of forward contracts, we feel no such procedure is warranted since there are a number of substantial differences between forward contracts (non-exchange trade contracts for future delivery) and futures:

1. A forward contract requires a more than one year holding period for long term capital gain rather than the six month period used for exchange traded futures contracts.

2. In practice, a forward contract is not marked to the market daily, but is a credit risk assumed between the buyer and the seller. The buyer of a forward contract has to be sure that the seller will deliver. Conversely, the seller has to be sure the buyer will pay at the time of delivery. Each will act accordingly. In commercial practice, it is evaluation of the credit risk that determines one's willingness to deal in private forward transactions and we think the possiblity of tax abuse, given the commercial risks, is relatively low.

If Congress wishes to pass legislation applying a balanced or offsetting position type of test, a better approach would be to utilize the test of substantially identical, which has a long history of understanding and application. That test could be broadened to include, for all non-dealers in the underlying commodities, making the physical commodity, that is deliverable against the futures contract, substantially identical to the futures contract. In that regard, for the non-converter (that is other than one who changes the form of a commodity in the ordinary course of its delivery or business) the same result could apply to mere changes in form. The best example of those might be soy beans, soy bean oil, and crush, or copper ingots against copper wire.

Further, if Congress decides to use the balanced or offsetting concept we think that, as a matter of policy, existing sections should be amended rather than new sections created. The creation of new sections might cause inconsistency among the various sections. The proposed legislation does exactly that; create new sections layered upon old sections. We think that a better result than creating new section 1092 would be to amend both sections 1091 and 1233 to deal with the problem.

In the case of cash and carry, it appears to us that the investment interest expense limitations have removed a great deal of the problem in this area and no change is necessary. Furthermore, the way the proposed legislation is written, cash and carry would apply to interest bearing obligations, as well as non-interest bearing commodities. Thus, under the present wording, the taxpayer would be in the position of having the interest expense treated as capital loss, but the interest income received as taxable ordinary income. This seems as unfair to us as the riskless conversion of ordinary income to long term capital gains. If there is a provision for capitalization of interest expense, it should be reduced (that is not capitalized), to the extent that the taxpayer receives interest income.

Whatever changes are enacted into legislation, we recommend that exemptions be made for bonafide dealers or hedgers engaged in such transactions in the ordinary course of their business. These taxpayers already have a complete set of rules and all income or loss is ordinary in nature. There has been no demonstration of abuses in these areas other than what constitutes a dealer in the underlying commodity. Let us remember that there is no such thing as a dealer in futures contracts.

It is our position that the dealer rules should be clarified and strengthened and one should not throw the proverbial baby out with the bath water by complicating an already difficult and complex area. A dealer should be defined as one who in the ordinary course of business on a continuous basis maintains a two sided market (is ready to buy or sell to or from customers).

The concept of making a treasury bill a capital asset is certainly reasonable on its face. However, it is not reasonable in practice. The calculations of capital gain and loss and of interest income would be extremely burdensome. The changes are unnecessary since a simpler solution to achieve the same result is at hand. Instead of making a treasury bill a capital asset, all options and futures contracts on treasury bills should be made noncapital assets, thus reducing the ability of one to convert gains and losses from ordinary to capital by making or taking delivery of the underlying asset. The spread problem, that is, the ability to take a loss in one year and a gain in another, would be dealt with by the use of mark to market, except that any gain or loss should be ordinary.

Where the taxpayer owns the physical and is short the future contract, the mark to market concept would apply only to the futures position and not to the physical asset. The taxpayer would not be able to know what the effect of this situation would be at the time he initiated it, and thus the opportunity for effective conversion or deferral would be virtually eliminated. Of course these rules should not apply to dealers since any gain or loss on T bills or related hedging transactions will be ordinary in any event.

In the case of a 30-day look back rule, one must remember that the securities industry already has a most elaborate mechanism for preventing the willy nilly conversion of gains to capital and losses to ordinary. In fact, the rule is stricter than in any other industry which has both inventory and investment possiblities. We do not think the 30-day period is too long in view of the volume and scope of transactions taking place. Again, we believe that this is a problem that can best be dealt with by clarifying and strengthening the definition of who is a dealer and what is inventory, rather than by changing the basic rule. If, however, the rule must be changed, we recommend that the period be shortened to not less than a two week period, thus allowing some time after the settlement date for taxpayers to determine the status of what they have acquired.

Any change in the investment account classification under section 1236 would have a substantial economic effect on dealers in securities, beyond the tax consequences. The Federal Reserve rules in margin specifically refer to this section in determining what is adequate or inadequate margin. Therefore, any change in this area should be made with consideration of the possible adverse impact on a dealer's financing of his inventory.

Eliminating the sale or exchange requirement to generate capital gain or loss seems to have a number of problems. This would be a substantial change in existing law and have a sweeping effect well beyond that of curing tax shelter abuse. The proposed legislation would deal only with dispositions of capital assets. What about the obligation or "short" side of a transaction? Would the nature of the gain or loss be long term or short term? There is a substantial difference of opinion between the judiciary and Treasury regarding whether disposing of the short side of a forward contract results in long term or short term capital gain or loss.

In any event, we believe form should not rule over substance. There are significant differences between selling a contractural obligation, pairing off a contractural obligation, (that is, entering into an offsetting transaction with the same person) and making a payment to be relieved of a contractural obligation. Each will result in a substantially different debtor/creditor relationship, and thus the form does have substance.

We recommend that this particular proposal be subject to further consideration and not be enacted at this time, since the unanswered questions far exceed the abuse that is deemed to take place. It is possible that the abuse can be attacked under current law since the test for deductible payment is not met, and there is merely an increase in liabilities.

In conclusion, I wish to thank you for allowing me to testify. We think the purpose of the legislation is good. We feel the changes that we have suggested will make the legislation understandable, enforceable and in keeping with the government's policy of reducing interference without sacrificing revenues or encouraging tax "dodges". In earlier testimony, a point was made that abuses encourage other people to be abusive. That may be true. It is certainly true that complex legislation which is neither understandable nor enforceable, invites abuse. We of course will assist any and all members of Congress, the Treasury Department and the Internal Revenue Service in whatever way possible to accomplish the desired result of understandable, effective tax legislation.

STATEMENT OF DONALD SCHAPIRO

My name is Donald Schapiro. I am appearing on behalf of the New York State Bar Association Tax Section, and respectfully request that the accompanying Report on Pending Legislation Dealing with Commodity Tax Straddles and Related Matters, dated May 27, 1981, prepared by the Committee on Financial Institutions and Financial Futures of the Tax Section, be included in the record as a part of my statement.

A summary of the State Bar Tax Section recommendations is set forth at the start of the Report.

The Report discusses a Bill introduced by Senator Moynihan (S. 626), a Bill introduced by Representatives Benjamin S. Rosenthal and William Brodhead (H.R. 1293 and 1338) and the proposal of the Treasury Department presented by the Assistant Secretary for Tax Policy, John E. Chapoton, in testimony before the House Ways and Means Committee on April 30, 1981. Since the date of the Ways and Means Committee hearing, there have been a number of other proposals for legislation to deal with commodities tax straddles and related matters.

The full position of the State Bar Tax Section is contained in the Report. A summary of its position regarding factors common to all of the various proposals is set forth below:

1. We recommend that legislation be enacted under which traders and speculators entering into futures contracts on markets regulated by the Commodity Futures Trading Commission in the United States ("regulated futures contracts" or "RFCs") would be taxed on a mark-to-market basis with a tax rate sufficiently favorable to attract the capital necessary to make these futures markets liquid. We believe that long-term capital gain and loss treatment, without regard to holding period, would be an appropriate method of taxing RFCs which are not used as commercial hedges.

2. If Congress should choose to treat a fixed part of the gain from RFCs as short-term capital gain, with the balance being treated as long-term gain, without regard to holding period, we recommend that parallel treatment be allowed for losses. There should be no restriction on using RFC losses to offset capital gain from other activities.

3. We are of the view that executory contracts other than RFCs (e.g. puts, calls, forward contracts and futures transactions on foreign exchanges) should not be taxed on a mark-to-market basis because they do not involve daily transfers of cash. We are of the view, however, that these executory contracts in some circumstances should cause (a) deferral of losses on offsetting investment type items (including other executory contracts) and (b) suspension (including termination) of holding periods in offsetting investment type items in relationship to their qualification for long-term capital gain.

4. We urge that Congress (a) specify with particularity which types of executory contracts will be endowed with the ability to defer loss and suspend holding period, (b) specify with particularity which type of investment items will be subject to loss deferral and holding period suspension rules, (c) specify in general when executory contracts are offsetting to investment type items (including other executory contracts) and (d) integrate any new holding period suspension rules with the existing short sale rules of Code Section 1233.

5. We recommend that any set of new rules be made easy for the Revenue Service to audit and simple for the average commodity trader or speculator to observe when dealing only in RFCs. We also recommend that the more complex rules described in paragraphs 3 and 4, above, be drafted with clarity sufficient to permit their policy and interrelationship with other interlocking Code provisions to be understood by the Treasury Department, tax practitioners and the courts.

6. We recommend that rules be adopted which would prevent conversion of ordinary income to capital gain through deductions for interest and other carrying costs on "cash-and-carry" transactions where capital assets are held by a taxpayer without significant risk of loss of capital because the assets are hedged through RFCs or otherwise.

7. We recommend that gain and loss in different years from commodities related transactions be subject to averaging through carryovers and carrybacks of capital losses.

8. We recognize the importance of attracting risk capital to the futures markets in the United States, and accordingly recommend that the tax treatment of RFCs be sufficiently favorable to attract the capital needed for market liquidity. While other appropriate methods of providing favorable tax results may be available, we recommend, as noted above, that this result be achieved by treating all gains and losses on non-commercial hedging RFCs as long-term capital gain or loss without regard to holding period. We also wish to identify two possible methods for producing favorable tax results for traders and speculators in RFCs which should not be adopted

because they do not represent sound tax policy. First, it is not sound tax policy to permit deferral to a subsequent year of gains from commodities transactions closed during a year, or from RFCs marked-to-market during a year. Further, we do not believe it is sound tax policy to permit conversion of ordinary income to capital gain through cash-and-carry transactions in investment type items which are protected against market risk through hedging.

On behalf of the New York Bar Association Tax Section I express my appreciation for this opportunity to appear before your Subcommittee.

May 27, 1981

NEW YORK STATE BAR ASSOCIATION TAX SECTION
COMMITTEE ON FINANCIAL INSTITUTIONS
AND FINANCIAL FUTURES

REPORT ON PENDING LEGISLATION DEALING WITH COMMODITY TAX STRADDLES AND RELATED MATTERS*

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* This report was written by Donald Schapiro, Chairman of the Committee on Financial Institutions and Financial Futures, with the assistance of David J. Boschwitz, Secretary of the Committee. Helpful comments were received from Eric J. Anderson, Lawrence A. Garber, Alan S. Lederman, James B. Lewis, Michael L. Schler and Stephen S. Selig.

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INTRODUCTION

The purpose of this Report is to comment and offer recommendations on three legislative proposals concerning the tax treatment of commodities transactions: (1) a bill introduced by Representatives Benjamin S. Rosenthal (D-NY) and William Brodhead (D-Mich)[1/] (2) a bill introduced by Senator Moynihan (D-NY)[2/] and (3) the proposal of the Treasury Department, presented by Assistant Secretary for Tax Policy, John E. Chapoton in testimony before the House Ways and Means Committee on April 30, 1981. These legislative proposals are intended to prevent taxpayers from using commodity and commodity-related transactions to (a) convert ordinary income to capital gain, (b) convert short-term capital gain to long-term capital gain, and (c) defer recognition of income from the year in which it is realized

1/ Introduced as H.R. 1293 and H.R. 1338, "To Prohibit Tax-Motivated Commodity Straddles". A copy of the Rosenthal/Brodhead Bill is attached to this Report.

2/ Introduced on March 5, 1981 as S. 626, the "Commodity Straddle Tax Act of 1981". A copy of the Moynihan Bill is attached to this Report.

until a subsequent year. The tax avoidance strategies against which these bills are aimed, as well as the history and mechanics of the futures markets, are described in Assistant Secretary Chapoton's statement and in a pamphlet providing background for the hearing prepared by the Joint Committee Staff (April 28, 1981).[3/]

SUMMARY OF RECOMMENDATIONS

The Committee on Financial Institutions and Financial Futures (the "Committee") agrees with the goals of these proposals, but feels that the recommendations summarized below would better achieve these objectives.

(a) Taxpayers, other than persons engaged in "cash and carry" transactions and certain hedgers, should recognize gain or loss on futures transactions on U.S. commodities exchanges on a mark to market basis at year-end and immediately before futures contracts are closed-out by taking or making delivery or by entering into offsetting transactions.

(b) For taxpayers who are not hedging inventory or other ordinary income assets, gain or loss recognized under this mark to market rule should be treated as long-term gain or loss regardless of how long positions are held. For taxpayers who are hedging inventory or other ordinary income assets, such gain or loss should be treated as ordinary income or loss.

3/ The Treasury Testimony and the Joint Committee Staff Pamphlet are reproduced in B.N.A. Daily Tax Report No. 83 (April 30, 1981), J-1 to J-12.

(c) The short sale rules of Section 1233 and the wash sale rules of Section 1091 should be amended to prevent taxpayers from using transactions in futures contracts, forward contracts and other executory contracts, whether or not traded on U.S. commodities exchanges, to shift gain or loss (whether ordinary or capital) between years or to shift between long-term and short-term capital gain or loss. For these purposes, attribution rules should be provided to attribute ownership between spouses and from pass-through entities (such as partnerships, trusts and Subchapter S corporations) to individual owners.

(d) Taxpayers should be required to capitalize interest paid or accrued on indebtedness secured by any non-inventory physical commodity, the holding period of which is suspended under the short sale rules as amended under paragraph (c) above.

(e) Realized gains attributable to market discount on certain U.S. obligations purchased with borrowed funds secured by the obligations should be treated as ordinary income rather than capital gain.

(f) Individuals should be permitted a capital loss carryback or, as a minimum, should be permitted to carry back any net capital loss arising from transactions on U.S. commodities exchanges subject to the mark to market rule against any capital gain arising from such transactions in prior years.

(g) Forward currency contracts and other executory contracts not traded on U.S. commodities exchanges should give rise to the same type of gain or loss, whether ordinary or capital, irrespective of the manner in which they are closed-out or performed.

(h) The rules permitting ordinary income and loss for commercial hedging transactions should be broadened and made more flexible, particularly as they relate to interest rate futures contracts (a) traded by banks to hedge against risk of loss on securities portfolios, which give

rise to ordinary income or loss when held by a bank, and (b) traded by business taxpayers to hedge against changes in interest rates.

(i) Taxpayers who would be entitled to ordinary income or loss treatment on futures contracts under the commercial hedging rules of existing law as they may be expanded under paragraph (h) above, should be required to identify hedge transactions at the time they are entered into under rules similar to those adopted under Code Section 1236, as it may be amended.

I. The Rosenthal/Brodhead & Moynihan Bills

The Rosenthal/Brodhead[4/] and Moynihan Bills[5/] would provide rules regarding the tax treatment of certain "offsetting positions" in "personal property", including straddles and other balanced transactions, would change the tax characterization of Treasury bills and other short-term governmental discount obligations, would require capitalization of carrying expenses incurred in

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4/ The Rosenthal/Brodhead Bill (except for the amendment to section 1236) would apply to property acquired after January 27, 1981, in taxable years ending after that date. The amendment to section 1236 would apply to property acquired after the date of enactment of the Bill, in taxable years ending after that date.

5/ The loss deferral and holding period suspension rules of the Moynihan Bill would apply to offsetting positions established after May 5, 1981, in taxable years ending after that date. The capitalization of carrying expense rule would apply to expenditures made after May 5, 1981, in taxable years ending after that date. The deletion of section 1221(5) would apply to obligations issued after May 5, 1981. The amendment of section 1236 would apply to securities acquired after May 5, 1981, in taxable years ending after that date. The elimination of the sale or exchange requirement would apply to post-May 5, 1981 dispositions.

carrying transactions in "personal property"[6/] and would also shorten the 30-day period for identifying securities acquisitions as held for investment. Additionally, the Moynihan proposal would eliminate the requirement that a capital asset must be disposed of by "sale or exchange" in order to qualify for capital gain or loss treatment.

Integral to the loss deferral, holding period suspension and capitalization of carrying expense rules of both Bills is the concept of "offsetting positions" in "personal property".[7/] Both Bills define a "position" as "an interest (including a futures contract or option)". Under the Rosenthal/Brodhead Bill, "personal property" includes all types of personal property; the Moynihan Bill contains the same definition, but excludes corporate stock.

Both Bills contain a general rule which defines "offsetting positions" as any combination of positions which substantially diminishes the risk of loss of any one of the positions.

6/ Carrying transactions (or cash and carry transactions) involve the purchase of a physical commodity offset by a short futures or forward contract or by a put option.

7/ The Rosenthal/Brodhead Bill uses the term, "straddles" to describe such offsetting positions.

The Rosenthal/Brodhead Bill provides a rebuttable presumption under which positions would be deemed to be offsetting if (i) the positions are customarily treated as offsetting positions; (ii) the combined nature of the positions entitles the taxpayer to reduced margin requirements; or (iii) the positions are deemed to be offsetting under factors prescribed in regulations to be issued by the Internal Revenue Service. To defeat this presumption, a taxpayer must establish to the satisfaction of the Internal Revenue Service that the positions were not offsetting.

Under the Moynihan Bill, positions would be treated as offsetting "if such positions include substantially equivalent long and short positions"[8/] and (i) the positions are in the same commodity (regardless of physical form); (ii) the combined nature of the positions entitles the taxpayer to reduced margin requirements; (iii) the positions are in "debt instruments" (interest bearing obligations); or (iv) the positions are determined to be offsetting under regulations to be promulgated

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8/ A "long position" is "a position which increases in value when the personal property to which it relates increases in value." A "short position" is one which increases in value when the related personal property decreases in value.

by the Internal Revenue Service.[9/] However, the Moynihan Bill contains a safe harbor under which positions are treated as not offsetting unless the standard deviation of the change in price of any one of the positions is at least five times the standard deviation of the change in price of the combined positions during any two year period occurring during the five year period preceding the taxpayer's establishment of the positions.

Both Bills provide attribution rules for purposes of determining whether positions held by related taxpayers are "offsetting positions". The Rosenthal/Brodhead Bill refers to the rules contained in sections 267, 707(b) and 414; the Moynihan Bill refers to section 318. Both Bills limit family attribution to a person, his spouse, and minor children; the Moynihan Bill limits entity attribution to situations in which a person has "at least an 80 percent interest" in the entity. Both Bills also provide a special attribution rule for any person who has an ownership interest in any pass-through entity regardless of the size of the person's ownership interest (e.g., partnerships, estates, trusts and regulated investment companies).

9/ A taxpayer would be allowed to escape these latter two rules if he established to the satisfaction of the Internal Revenue Service that positions were not offsetting.

The loss deferral rule of both Bills is designed to prevent taxpayers who enter into "offsetting positions" from recognizing losses in years earlier than the years in which offsetting gains are recognized. Under this rule, as contained in the Rosenthal/Brodhead Bill, a taxpayer would not recognize a loss incurred on closing out one side of an offsetting position (in excess of gains realized on positions which offset the loss position) until he either closes out the offsetting position or leaves the offsetting position unprotected for 30 days.[10/] Under the Moynihan Bill, the deferral period would not expire, in any event, until 30 days after the taxpayer has closed out the loss position. A taxpayer who does not close out the offsetting gain position would be required to leave it unprotected during this 30-day period.

The holding period suspension rule of both Bills is designed to prevent taxpayers from using straddles and other balanced transactions to convert short-term capital gain into long-term capital gain. Under this rule, a taxpayer's holding period in any position which forms part of an offsetting position would be suspended during the

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10/ Both Bills refer to the period during which losses are deferred and holding period is suspended as the "balanced period".

time he would not recognize a loss under the loss deferral rule.

Both Bills contain a rule which is designed to prevent taxpayers from claiming current deductions for expenses incurred in commodity carrying transactions (i.e., interest, storage and insurance expenses incurred in transactions in which a taxpayer owns a physical commodity protected as to price change by a short futures or forward contract or by a put option) while reporting the offsetting commodities gain as capital gain. Under both Bills, a taxpayer who holds "personal property" offset by another "position" would be disallowed deductions for carrying expenses (including interest) and would be required to add these expenses to the cost basis of the "personal property". These expenses would thus reduce any capital gain (or increase any capital loss) recognized on disposition of the "personal property".

A further rule of both Bills is aimed at preventing taxpayers from using offsetting positions in T-bills to convert ordinary income into capital gain by realizing ordinary loss upon sale of the T-bill (or T-bill options held by the taxpayer) and capital gain on the disposition of offsetting futures contracts (or options written by the taxpayer). This rule would accomplish this result by eliminating the current exclusion

(contained in section 1221(5)) from capital asset status of Treasury bills and other short-term governmental discount obligations. Under this amendment and current Code and judicial rules, T-bills would be treated as capital assets, accruing original discount (as opposed to market discount) as interest. However, a holder of a T-bill would report no income until sale, exchange or other disposition of the obligation. At that time, the holder would be deemed to have received interest attributable to the original issue discount (as opposed to market discount) which accrued during his holding period.[11/] If the holder disposes of the obligation by sale or exchange, any excess of the sales proceeds over the sum of the cost of the obligation plus accrued original issue discount would be treated as short-term capital gain; any deficit of the sales proceeds over this sum would be short-term capital loss.[12/]

11/ I.R.C. § 454(b) (original discount on such obligations "shall not be considered to accrue" until the date of disposition of the obligations).

12/ Although this latter result (*i.e.*, interest income and short-term capital loss) *might* seem harsh, it is supported by both the legislative history which accompanied the introduction of section 1221(5) (1941 Act § 115(b)), S. Rep. No. 673, 77th Cong., 1st Sess. 30-31, and the Service's ruling position at the time, I.T. 3486, 1941-2 C.B. 76, declared obsolete by Rev. Rul. 69-43, 1969-1 C.B. 310, and T.D. 4276, VIII-2 C.B. 83 (1929), declared obsolete by Rev. Rul 67-406, 1967-2 C.B. 420.

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Both Bills contain a rule which is designed to prevent securities dealers from using the 30-day identification period of section 1236 to designate loss positions as held for inventory (ordinary loss) and gain positions as held for investment (capital gain). Both Bills would require securities dealers to identify securities as held for investment within one day after acquiring the securities. Additionally, the Moynihan Bill would require securities dealers to identify all securities involved in an offsetting position as held for investment in order to qualify any of the securities for capital treatment.

The Moynihan Bill, but not the Rosenthal/Brodhead Bill, contains an additional rule which would eliminate the "sale or exchange" requirement for capital gain or loss treatment. This rule is intended to prevent taxpayers from claiming ordinary losses on certain dispositions of capital assets (e.g., closing out a forward contract by private settlement). Under this rule, gain or loss realized on the disposition of a capital asset would be treated as capital gain or loss, regardless of whether the disposition were by sale, exchange or some other kind of disposition.

II. The Treasury Proposal

The Treasury proposal contains both a "general" and a "special" rule to eliminate tax-abusive straddle transactions. The general rule, a "balanced position" rule similar to the "offsetting position" rules of the proposed Bills, is intended to cover "the basic straddle transaction". The special rule is a mark to market rule which is intended to apply to persons whose significant volume of commodities transactions would render difficult the task of pairing balanced positions.

The Treasury proposal defines "balanced positions" in the same manner as the Moynihan Bill defines "offsetting positions".[13/] Under the Treasury proposal, a taxpayer who enters into "balanced positions" would be required to defer losses and suspend holding periods under rules identical to the loss deferral and holding period suspension rules of the Rosenthal/Brodhead Bill.[14/]

The Treasury proposal, unlike the Rosenthal/Brodhead and Moynihan Bills, contains a rule under which persons who engage in a significant volume of commodities

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13/ See discussion at pp. 5-7, *supra*. Mr. Chapoton's testimony did not indicate whether attribution rules would be applied to determine whether positions are "balanced".

14/ See discussion at pp. 8-9, *supra*.

transactions (usually traders) would be required to mark open futures transactions to market at tax year-end and treat the resulting gain or loss as ordinary gain or loss. Assistant Secretary Chapoton stated in his testimony, "The volume of their transactions makes a balanced position rule, requiring identification of particular positions, cumbersome to apply. There is also a risk that such a rule could be avoided by these market participants."

This mark to market, ordinary income and loss rule would apply to any person who enters into more than fifty transactions in futures contracts traded on organized exchanges in at least three of the four quarters of the taxable year. The Treasury proposal refers to persons who satisfy this numerical test as "traders in commodities". This Report will refer to such persons as "futures traders".

The Treasury proposal also contains a special rule for futures traders who use the futures markets to hedge physical commodities. These persons would be permitted to identify certain futures positions as hedges and avoid marking these futures positions to market. The testimony states that "an exception such as this would apply only to the extent that designated positions are not being used for tax avoidance purposes."

In addition to the rules which are designed to deal with tax straddles, the Treasury proposal, like the proposed Bills, would require capitalization of carrying expenses (including interest) incurred in cash and carry transactions[15/] and would change the tax status of T-bills and other short-term governmental discount obligations to capital asset status.[16/] In order to alleviate the problem of computing original issue discount on T-bills purchased after their auction, the Treasury proposal would determine the amount of original discount on a T-bill purchased after its auction with less than 13 weeks remaining to maturity at the time of its purchase by reference to the original discount on 13-week bills maturing on the same date as the purchased bill. A bill with more than 13 weeks, but less than 26 weeks, remaining at the time of purchase would be treated as having the same original discount as a 26-week bill maturing on the same date as the purchased bill. Thus, a single one-year T-bill which changes hands between the 26th and 13th week preceding maturity, and again after the 13th week preceding maturity, would be treated as having the original discount of similar maturity 26-week bills when acquired by the first subsequent holder, and would be treated as having the original

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15/ See discussion at p. 9, *supra*.

16/ See discussion at pp. 9-10, *supra*.

discount of 13-week bills maturing on the maturity date of the actual bill, when acquired by the second subsequent holder.

The Treasury proposal also follows the proposed rules of the Moynihan Bill which would shorten the identification period of section 1236 from thirty days to one day[17/] and would eliminate the "sale or exchange" requirement for capital gain or loss treatment.[18/]

III. Committee Comments

Both the concepts of "offsetting positions", as defined in the Bills, and that of "balanced positions", as defined in the Treasury proposal, would introduce a new statutory concept. This concept would be loosely defined because of the difficulty of deciding, in a myriad of different factual circumstances, when there is, and when there is not, a "substantial diminution of the taxpayer's risk of loss from holding any position by reason of his holding" one or more other positions. The question would be presented concerning the extent to which risk must be diminished to qualify as a "substantial diminution" as well as whether risk could be considered "substantially" diminished if a substantial risk remained.

17/ See discussion at p. 11, *supra*.

18/ See discussion at p. 11, *supra*.

These ambiguities might make it difficult to enforce any new statute, and could also create uncertainties in the operation of the commodities markets. Thus, it is possible that if the "offsetting" or "balanced" position approach were adopted, the promoters of tax shelters might attempt to design and market "strategies" and transactions which they would contend did not "substantially diminish" a taxpayer's risk of loss. Furthermore, such promoters might attempt to "bury" such transactions in a welter of other transactions, making it difficult to select and match up so-called "offsetting" or "balanced" positions. On the other hand, from the point of view of legitimate commodity futures traders, the introduction of such an uncertain test might create sufficient doubt regarding the tax results of transactions to discourage traders from remaining in the marketplace to provide risk-shifting and liquidity.

Several additional difficulties inherent in the proposed Bills and the Treasury proposal become evident when they are viewed in conjunction with the existing tax treatment of commodities transactions. Under present law, transactions in futures contracts traded on organized U.S. commodities exchanges (referred to as "Regulated Futures Contracts", or "RFCs"), may be divided into three classes:

(a) The first class of RFC transactions consists of inventory hedges, that is, RFCs which are used to shift risks of price changes in physical inventories. RFCs used to hedge inventories are treated as giving rise to ordinary income and loss. Sometimes these inventory-hedge RFCs are marked to market as part of the taxpayer's inventory method.

(b) The second class of RFCs are business hedges that do not involve inventories. These hedges include RFCs entered into to shift risks of adverse fluctuations in foreign exchange or interest rates. The tax law treatment of these non-inventory business hedges is not entirely clear, but some of these transactions are treated as giving rise to ordinary income and ordinary loss.

(c) The third class of RFC transactions consists of speculative (i.e., non-hedging) RFC transactions. Speculative RFCs give rise to capital gain or loss, with a six months long-term holding period for long positions. Short positions in speculative RFCs under existing law always give

rise to short-term capital gain and loss if closed by offset.[19]

For purposes of this Report, RFCs which give rise to ordinary income and loss will be termed, "commercial hedges". The unmodified term, "RFCs", will be used to indicate RFCs which give rise to capital gain and loss under existing law.

As an initial matter, it should be noted that neither the proposed Bills nor the Treasury proposal attempt to rationalize the tax treatment accorded commercial hedging transactions by re-examining the proper scope of the concept of commercial hedges. As explained more fully below, this Committee feels that a re-examination of the rules in this area would be appropriate at this time.

Furthermore, the rules of the proposed Bills relating to RFCs[20] and those of the Treasury proposal relating to RFCs traded by persons who are not futures traders provide no changes in the current tax treatment

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19/ A taxpayer who enters into a short RFC has made a short sale of an RFC. When he closes the short sale by entering into a long RFC, he is at once purchasing an RFC equivalent to the RFC previously sold short and delivering it to close out his short position. His instantaneous holding period in the RFC results in gain or loss from the closing transaction being treated as short-term capital gain or loss if the RFC is a capital asset in his hands.

20/ That is, non-commercial hedging RFCs as defined above.

of RFCs other than the loss deferral and holding period suspension rules. Apparently, therefore, all gain or loss on short RFCs would continue to be treated as short-term capital gain or loss irrespective of holding period, and no capital loss carryback would be available for individuals.

Representatives of the futures industry have pointed to these characteristics of present law, that is, automatic short term capital gain on short positions without a capital loss carryback as being inequitable. In the judgment of this Committee, these provisions of existing law are, indeed, inequitable and should be changed.

Furthermore, the proposed Bills and the Treasury proposal fail to eliminate many of the tax planning choices available under existing law. For example, since gain or loss would not be recognized on taking delivery under a long RFC, taxpayers would be able to (a) convert long-term loss on an RFC held for more than six months into short-term loss by taking delivery of the underlying commodity and selling it before 12 months has elapsed from the time he entered into the RFC, and (b) postpone recognition of gain or loss on a long RFC to a following year by taking delivery of the commodity and not disposing of it until a later year. Furthermore, a person who has

held an appreciated physical commodity for more than twelve months could sell a balancing short RFC and, if market prices continue to rise, take a short-term loss on the RFC by closing it out, while reporting the offsetting gain on the underlying commodity as long term capital gain.[21/]

The tax avoidance potential of straddles would be met under the general rule of the Treasury proposal by a process of identifying and pairing "balanced positions". As noted above, the Treasury testimony states that such pairing could be "cumbersome to apply" and, in connection with the application of a balanced position rule to transactions of futures traders, the Treasury proposal states that "the risk [exists] that such rule could be avoided by these market participants." Additionally, it seems reasonable to predict that persons

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21/ This illustration assumes the RFC is in a commodity other than stock or securities to which the short sale rules of Section 1233 (b) & (d) would not be applicable if the taxpayer closed the RFC by making delivery of the underlying commodity.

The consequences illustrated by the example - *i.e.*, short-term loss and long-term gain -- may be viewed as fortuitous, since, if prices had decreased after the short position was entered into, the taxpayer would have generated short-term gain and a lesser amount of long-term gain (or possibily long-term loss). Nevertheless, the mark to market rule proposed in the following part of this Report would eliminate the possibility of this fortuitous result.

who have a significant volume of futures transactions, albeit not enough to qualify as futures traders (e.g., 1,000 transactions in each of the last two calendar quarters and less than 50 transactions in the first two calendar quarters) might also be able to find ways to avoid the balanced position rules.

As noted above, under the Treasury's special rule, transactions in RFCs entered into by futures traders would be marked to market at year-end and taxed at ordinary income and loss rates. It appears to this Committee that treating RFC transactions as capital or ordinary transactions depending on the volume of a taxpayer's transactions, would effectively result in allowing many taxpayers to elect either capital or ordinary treatment by choosing whether to enter into a few year-end transactions. Therefore, this approach would allow such taxpayers to continue tax avoidance strategies and could present administrative difficulties. For example:

1. The Treasury proposal does not state whether RFCs held by a futures trader (a person with more than 50 RFC transactions in three out of four quarters of the taxable year) would be marked to market, with ordinary income and loss, immediately before closing out the RFCs by taking or making delivery. If RFCs are not so marked to market,

appreciated long RFCs could be terminated by taking delivery, with the possibility of realizing capital gain (possibly in a later year) on a subsequent sale of the underlying commodity, while depreciated long RFCs would generate current ordinary losses under the mark to market rule upon entering into offsetting transactions. On the other hand, a rule requiring such RFCs to be marked to market upon taking or making delivery, would be difficult to apply because it would be impossible to tell whether a particular taxpayer was a futures trader until, at the earliest, sometime during the third quarter of his taxable year, and, possibly not until the very last day of his taxable year.

2. An individual could conduct his RFC trading in a manner which would enable him to qualify or not qualify as a futures trader by virtue of a few trades at year-end. If the taxpayer had a net gain in RFCs, he could choose to not qualify as a futures trader, and thus report all transactions as capital gain. On the other hand, if he had a net loss, he could choose to qualify as a futures trader by executing a few extra trades and consequently report his losses as ordinary losses under the mark to market rule.

3. The Treasury proposal in its current form does not provide attribution rules for its special rule. Absent attribution rules, related parties could adopt a tax strategy of entering into equal and opposite RFC transactions, while keeping their annual volume of transactions near the level required for qualification as a futures trader. The member of the pair with net gains could receive capital gain treatment by choosing to not qualify as a futures trader; the other member of the pair, with offsetting losses, could receive ordinary loss treatment by executing the necessary number of year-end transactions to qualify as a futures trader. The related parties might be a husband and wife, or two partnerships with the same members, or an individual and his wholly-owned corporation, or two sister corporations, or two siblings, or two business partners, or even two friends.

4. The special rule would seem to be inconsistent with allowing a futures trader to maintain an identified capital gain investment account under principles similar to those of Code Section 1236. Could the failure to permit taxpayers to speculate for capital gain be justified? If an

investment account were allowed, how would it be possible to establish a sensible rule for prompt identification of investment transactions in such a volatile market?

5. Absent attribution rules, would a futures trader's spouse who is not a futures trader be allowed to have an RFC investment account? How would the Revenue Service effectively police the movement of transactions between the couple?

These questions, we suspect, illustrate only a few of the many issues which would be raised by allowing, in effect, elective treatment of RFC losses as ordinary losses. Perhaps many of the problems referred to above would be addressed by generalized rules against "tax avoidance" in the statute or the regulations, but generalized prohibitions on tax avoidance have not proved successful in the past. This form of statutory provision is not, in the judgment of the Committee, a proper method to meet such problems.

We also note that the Treasury proposal states that "there would be no need to identify balanced positions for exchange traded [RFC] transactions" in the case of futures traders. However, the problem of pairing balanced positions would remain with regard to RFC positions of

futures traders which are "balanced" by transactions in physical commodities, options, forward contracts and futures contracts on exchanges outside the United States. For example, suppose a futures trader has held for less than twelve months silver bullion, or a long forward silver bullion contract, or a Swiss franc deposit, which has appreciated in value. Absent a "balanced" or "offsetting" position rule, this futures trader would be able to sell an offsetting short RFC, and, if the price of silver or francs continues to rise, report an ordinary loss on his depreciated short RFC while reporting the offsetting gain on his long position as long-term capital gain (in the same, or possibly a later, year) after holding the position for more than one year. Although a subsequent drop in market prices could result in ordinary gain and long-term loss, the futures trader would nevertheless have succeeded in protecting himself from the subsequent drop in prices.[22/]

22/ The example discussed in footnote 21, supra, illustrates a similar transaction in which a continued rise in prices would provide the taxpayer with tax benefits while a drop in prices would create disadvantageous tax consequences. Although the possibility of achieving such tax benefits could be viewed as being too fortuitous to constitute "tax abuse", it would be preferable neither to sustain nor to foster fortuitous tax windfalls.

This example and others which experienced arbitrageurs no doubt could construct suggest to the Committee that the proposed mark to market, ordinary income or loss rule would not obviate the need for a balanced position rule with respect to futures traders.

It is the view of this Committee that the Treasury proposal, in differentiating the tax treatment of RFCs as ordinary or capital on the basis of something as elective as the number of a person's transactions, would not prevent taxpayers from manufacturing offsetting ordinary loss and capital gain. As one knowledgeable and articulate expert in the area of futures trading has expressed the maxim known as Laraye's Law: "Give the tax shelter market any investment producing ordinary loss, against which a hedge can be constructed, and the shelter promoters will beat the fisc every time."

For the reasons stated more fully below, the Committee recommends that all non-commercial hedging RFCs be taxed in the same fashion, at long-term capital gain and loss rates, and that all RFCs be marked to market prior to being closed out by offset or delivery as well as at the end of the tax year. The Committee recommendations are discussed in more detail in the subsequent section of this report.

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Neither the proposed Bills nor the Treasury proposal suggest amendments to the short sale rules of Section 1233. As explained below, the Committee believes that the short sale rules should be updated and expanded to cover investment-type items other than stock and securities. For example, as noted above, the "balanced" and "offsetting" position rules, while suspending holding period, would not convert short-term loss to long-term loss where a taxpayer enters into a short position, not meeting the requirements of 1233, which offsets an unrealized long-term gain in a physical commodity held by the taxpayer and the market continues to rise. Moreover, where the existing short sale rules might overlap with the new "balanced" or "offsetting" position rules, there could be inconsistent holding periods, since under the short sale rules, holding period is totally eliminated, while under the proposed rules, holding period is merely interrupted.

IV. Committee Recommendations

A. Tax Straddles

It is suggested that the objectives sought to be achieved by the Bills and the Treasury proposal could be better accomplished by a different statutory approach.

The alternative approach suggested below would minimize the areas of ambiguity and interfere less with the orderly functioning of commodity futures exchanges, which provide business with important and liquid markets for shifting otherwise uninsurable price change risks.

To avoid introducing the novel and somewhat ambiguous concept of "offsetting" or "balanced" positions into futures trading on United States exchanges, it is suggested that futures transactions on organized U.S. commodities exchanges, which are regulated by the Commodity Futures Trading Commission and which involve daily variation margin, be taxed under a set of special rules to be explained below. In the case of transactions not conducted on regular futures exchanges in the United States, such as transactions in forward foreign exchange contracts, other forward contracts, options, and futures transactions on exchanges outside the United States, it is suggested that the rules necessary to eliminate tax avoidance be developed by amending Internal Revenue Code Section 1233 (dealing with short sales) and Section 1091 (dealing with wash sales). As noted above, this Report will refer to regulated futures contracts on United States commodities exchanges, which involve daily cash variation margin,

as "regulated futures contracts" (or RFCs), and will refer to all other executory contracts to be made the subject of changes in the tax law as "non-RFC contracts." Non-RFC contracts would thus include forward foreign exchange contracts and futures contracts on exchanges outside the United States.

1. Rule Suggested for RFCs

(a) Mark to Market Proposal

Since daily variation margin is required for transactions in RFCs, gain and loss on open RFCs is reflected in cash on a daily basis. In these circumstances, it is suggested that taxpayers, other than persons engaged in cash-and-carry transactions, be required to mark open RFCs to market (viz., recognize the gain or loss reflected in debits or credits for variation margin) at the end of each taxable year and immediately before closing out RFCs by taking or making delivery or by entering into offsetting transactions. The existence of variation margin payable in cash would assure that all gains and losses which were recognized under the proposed mark to market rule had in fact been reflected by the taxpayer in cash receipts or payments.

The Committee proposes two limited exceptions to this mark to market rule. First, although commercial hedgers would generally be subject to the rule (with gains and losses taxed at ordinary income rates), certain commercial hedgers, like grain dealers, who hedge inventories of physical commodities and who elect to utilize existing acceptable inventory methods in accounting for price changes in RFCs would be excepted from this rule. However, all commercial hedging transactions in RFCs would be subject to record-keeping and identification rules, as explained below. Second, cash-and-carry transactions, identified as such, would not be marked to market because the cash item to which the futures contract relates is not marked to market.

The mark to market rule would be applied on closing out RFCs by taking or making delivery or by entering into offsetting transactions. This would prevent taxpayers from deferring gains and losses by taking delivery and from converting long-term loss into short-term loss by making or taking delivery.

(b) Character of Gain or Loss under Mark to Market Rule

Commercial hedgers who use RFCs to hedge price changes of inventory or other ordinary income items they hold or intend to acquire would be required to treat hedging gains and losses as ordinary income or loss because items offset by such hedges receive ordinary income or loss treatment upon disposition. As explained above, all commercial hedging transactions in RFCs would be subject to record-keeping and identification requirements in order to prevent hedgers from designating loss transactions as hedges and gain transactions as investments after the losses or gains have accrued.

All persons other than commercial hedgers would receive capital gain or loss treatment on RFC transactions. This recommendation, therefore, does not follow the Treasury proposal of distinguishing futures traders from other speculators in RFCs.

This Committee further recommends that all capital gains and losses recognized by non-commercial hedgers under the mark to market proposal be treated as long-term gain or loss, regardless of holding period. The long-term gain or loss rule for non-commercial hedgers would not be expected to result in any revenue

loss because RFCs are traded under a sum-zero system in which each day's gains on all RFCs exactly equal each day's losses.[23/] Indeed, this aspect of RFC trading underlies the mark to market accounting system employed on U.S. futures exchanges.

When the recommendations contained in this Report were circulated in proposed form among experienced lawyers in the Government and in private practice, some of the persons reviewing the materials raised the question whether it was right as a matter of equity and tax policy to adopt a rule under which persons trading in RFCs could derive long-term capital gain without any holding period requirement. These reviewers pointed out that under the rule proposed by the Committee, gain on transactions opened and closed within a single day would be taxed at a maximum rate of 28% under the existing rate schedule, and at a rate of 20% (50% top rate on 40% of long-term gain

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23/ As a matter of theory, it is possible that over a year's time, commercial hedgers as a group trading in RFCs would suffer a net loss on RFCs deductible from ordinary income and, correspondingly, speculators in RFCs, as a group, would have a net gain taxable as capital gain. There is no reason, however, to expect that such a result would be any more likely than the opposite result under which, over a year's time, speculators as a group would suffer losses deductible as long-term capital loss, while commercial hedgers would have an aggregate profit taxable at ordinary income rates.

subject to tax) if the top tax rate were reduced from 70% to 50%. This result, they stated, seemed unduly favorable to RFC traders as compared with traders in stocks, securities, options, foreign currencies, physical commodities, and forward contracts.

The first response to such criticisms is that the lower tax on long-term capital gains, be it 28% or 20%, is provided by statute for persons who risk capital and meet the specified statutory requirements. The issue to be considered in connection with RFCs is whether the requirements for this lower tax rate should be extended to traders in RFCs without regard to holding period, if this change is to be made as part of a set of new rules utilizing the mark to market method of taxing RFCs.

The Committee, in making its recommendations, considered at length the issues of tax equity and tax policy raised by its proposal to eliminate holding period requirements for long-term capital gain and loss on RFCs. For the reasons stated below, the Committee believes that its proposed rules are sound and fair, and recommends they be adopted.

Reverting to square one for purposes of establishing a tax rule for RFCs, the Committee considered, first, whether RFCs, other than those involved in commercial hedging, should ever be taxed at ordinary income

rates. We concluded that a rule involving ordinary income and loss was unsound because it would endanger revenues by opening up the possibility of creating ordinary losses which would offset dividends, interest, salaries and other ordinary income.[24/] It also seemed to us that persons who risk capital in the futures markets are performing an important economic function for society, and that they could be expected to divert capital from organized futures markets into other areas of investment and speculation if the possibility of more favored long-term capital gain treatment were to be barred to them. We thus decided that ordinary income treatment of RFCs is not appropriate.

If we adopt the view that non-commercial hedging RFCs should, in general, be taxed at capital gain and loss rates, the issue than becomes whether elimination of the holding period requirement for long-term gain is sound tax policy as a part of the mark to market set of rules for taxing RFCs. Since daily gains and losses on

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24/ The phrase, "to customers" was inserted into the language of section 1221(1) (then section 117(b)) in 1934 in order to prevent a stock speculator trading on his own account from claiming ordinary losses. See S. Rep. No. 558, 73rd Cong., 2d Sess. 22. The phrase, "to customers" was chosen because exchange-traded stock transactions do not involve merchandising activities.

the organized futures exchanges in the United States exactly offset one another, there is no significant issue of revenue loss, so long as both gains and losses are taxed in the same manner. The question narrows, then, to one of fairness as between traders in RFCs and investors and traders in other items such as stocks, securities, options, and forward contracts, who must hold their assets for twelve months to secure favored long-term capital gain treatment.

The Committee is of the view that the tax disadvantages imposed on traders in RFCs by reason of the mark to market rule, and the elimination of short-term loss, constitute material tax detriments which act to counter-balance the favorable tax result of allowing long-term capital gain for RFCs without a holding period.

The examples below illustrate the application of the long-term gain and loss rule on a mark to market basis for RFCs, and point out the disadvantages to holders of RFCs, as compared with traders in such items as stock, securities, options, and futures contracts.

> 1. If a taxpayer has realized long-term and short-term capital gains within a tax year which is still open, a loss on RFCs will always "attack" and offset the long-term gain, whereas a loss on other investment items, if taken by the taxpayer at a time of his choosing before the holding period has been met, will offset short-term capital gain. Thus, the trader

in RFCs has no flexibility to create short-term loss by disposing of a loss position at an early date.

2. A taxpayer holding an appreciated investment in the form of shares of stock can elect to hold the investment past year-end and not pay tax on any unrealized gain until the shares are disposed of. If the investor holds the shares for more than a year, he can make a short sale "against the box", realize the cash, and still postpone gain until the closing of the short sale. The holder of an RFC would have no such election, since the RFC would be automatically marked to market at year-end, or upon entering into a closing transaction.

3. A taxpayer holding an appreciated investment in stock or options can transfer the item to his children, to a charity, or to his corporation, without recognizing any gain. Tax, if any, would be paid by the donee or transferee, possibly at a much lower rate than the transferor would have incurred. Any gift tax paid by the donor would be added to the tax cost basis of the appreciated investment. The holder of an RFC has no such tax planning possibilities. RFCs cannot be legally disposed of except through transactions on an exchange, or on death. In any event, under the rules proposed by the Committee, gain or loss would be recognized on the mark to market basis at the time of any disposition of an RFC.

4. The holder of appreciated investment securities is entitled to a step-up in basis on death, thus eliminating capital gain tax on all appreciation occurring during his lifetime. RFCs, in contrast, are marked to market at the end of each tax year, and would be marked to market at the end of the taxpayer's taxable year occurring by reason of his death. Thus, no gain on an RFC would escape tax on death.

5. Appreciated investment securities can, in many cases, be distributed by corporations to shareholders, by partnerships to partners and, by trusts to beneficiaries, without giving rise to any tax to the transferor. Sometimes, the transferee of the investment obtains a step-up in income

tax cost basis, as in the case of taxable corporate liquidations. RFCs would not enjoy this favorable treatment. They would be marked to market, and taxed at the time of any disposition, whether or not the RFC was closed out on an exchange.

These illustrations are not exhaustive. They are merely intended to point out that the proposed mark to market rule for RFCs imposes substantial tax disadvantages on holders of RFCs as compared with investors in other items which are not marked to market. Accordingly, while elimination of the holding period requirement for RFCs with respect to long-term capital gain is a blessing, it is by no means an unmixed blessing, given the elimination of short-term loss and the mark to market rule. On this basis, the Committee feels its proposals do not unduly favor investors in RFCs as compared with investors in other investments. Taking all these factors into account, the Committee believes its proposal is sound, and recommends its adoption by Congress as a part of the entire set of new rules recommended in this Report.

(c) Transition Rule

it is possible that the Congress would wish to consider providing a transition rule for taxpayers who have large unrealized net gain positions in RFCs at the end of their tax years immediately preceding the first year to which the mark to market rule would apply. This

net gain might represent the accumulated amount of many years of straddling gains forward. If the mark to market rule is viewed as being akin to a mandatory change of accounting method, it could be appropriate to spread the unrealized gain over the five or ten year period following adoption of the new rules. The adoption of such a rule would not bar the Revenue Service, in appropriate cases, from seeking to disallow or postpone losses from straddles in years before the change to the mark to market method, thus reducing or eliminating the amount of net unrealized gain to be spread forward.

2. Rules Suggested for Non-RFC Contracts and Physical Commodities

For transactions involving non-RFC contracts, that is, forward contracts, options and futures contracts on exchanges outside the United States, it is suggested that the tax avoidance potential contained in tax straddles be met by amendments to the short sale rules of Code Section 1233 and the wash sale rules of Code Section 1091 in lieu of introducing a new concept of "offsetting" or "balanced" positions. For these purposes, attribution rules should be provided to attribute ownership between spouses and from pass-through entities, such as partnerships, trusts, estates and Subchapter S corporations, to individual owners.

As far as non-RFC contracts are concerned, the short sale rules contained in Code Section 1233 can be expanded to create prophylactic holding period rules comparable to those which are now applied to short sales of stock and securities. After all, short sales of stock "against the box" are a form of balanced position, and the existing rules of Code Section 1233 are adequate to prevent tax avoidance in this area. The amendments to Code Section 1233, as applied to non-RFC contracts, would be designed to prevent conversion of short-term gain to long-term gain, and to prevent conversion of long-term loss to short-term loss. These rules would be applied in a manner similar to the rules now in effect for stock and securities.

It is suggested that amendments to Code Section 1233 to cover non-RFC contracts and other physical commodities be accomplished as follows:

(a) Code Section 1233(e)(2)(A) would be amended to expand the definition of property (not inventory) subject to the short sale rules to cover non-RFC contracts and, to the extent desired, foreign currencies, precious metals and/or any other investment type item deemed to be the subject of possible tax avoidance by shifting short-term gain to long-term gain, or long-term loss to short-term loss. Gain and

loss on futures contracts traded on U.S. exchanges (RFCs) would be eliminated from the short sale rules totally since such gain and loss would be recognized under the mark to market rule discussed above, although (as discussed below) the existence of RFC transactions in combination with non-RFC transactions could postpone losses or convert short term loss to long term loss.

(b) The last sentence of Section 1233(b) would be amended to expand, to the extent desired, the definition of a short sale to include entering into any executory contract to sell, including an RFC.

(c) The provisions of Section 1233(e)(2)(B) would be changed to provide that items of "property", as defined under Section 1233(e)(2)(A), will be deemed "substantially identical" if they have a substantial similarity in price movement.

The concept of "substantial identity" of non-RFC contracts for short sale purposes presents much the same type of ambiguity as arises in the concept of "offsetting positions" employed in the Rosenthal/Brodhead and Moynihan bills and the concept of "balanced positions" employed in the Treasury

proposal, but there is some existing precedent under the short sale rules to provide guidance in resolving the ambiguities. Furthermore, except in instances where a taxpayer trades in both the RFC and non-RFC markets, ambiguities in the concept of "substantial identity" under the suggested rules would not have any impact on futures trading on U.S. commodities exchanges because contracts on such exchanges (RFCs) would be taxed under the mark to market rule.

(d) Section 1233(d) should be amended to provide that losses realized on non-RFC items which are "substantially identical" to RFC items held by the taxpayer will be treated as long-term loss. This rule is necessary to prevent the possibility of converting short-term capital gain into long-term capital gain by entering into balanced transactions in RFCs and non-RFCs which could otherwise generate a short-term loss on the non-RFC leg (to offset the unrelated short-term gain) and long-term gain on the RFC leg.

The suggested expansion of Code Section 1233 would not present a significant danger of dislocation to our economy because futures transactions on U.S. exchanges

would be largely unaffected. The suggested changes to Section 1233 merely reclassify gains from long-term to short-term and reclassify losses from short-term to long-term. Present law would continue to apply to stock and securities, subject to whatever rules were adopted regarding the issue whether forward contracts and RFCs in stock and securities would be deemed short sales for purposes of determining the holding periods of property.

In addition to changing the holding period rules under Code Section 1233, the tax statute should also be amended to prevent shifting of gains from one year to another in the case of RFC and non-RFC contracts which generate losses which are protected by equivalent offsetting positions. The evil to be remedied can be identified by concentrating on a taxpayer's year-end open positions in non-RFC contracts and determining the amount of any unrealized appreciation in these items ("unrealized profit items"). The extent of unrealized year-end appreciation in unrealized profit items represents the maximum amount of loss which the taxpayer could have incurred during the year which remains "protected" at year-end.

It is suggested that Code Section 1091 be amended to provide for postponement of losses taken during a year on items of property (whether RFCs, non-RFC contracts or

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physical commodities) which are "substantially identical" (defined in the same way as the Section 1233 amendment suggested above) to unrealized profit items, but opposite, as to long or short position, to the unrealized profit item. Such deferred losses would be paired with the unrealized profit item, and the loss would be postponed until the time at which the paired unrealized profit item was closed out. Only those losses realized and accrued after the date of acquisition of an unrealized profit item would be subject to pairing and postponement, and the taxpayer could reduce the amount of a particular loss subject to postponement by showing that some part of the loss was attributable to events and transactions occurring before the taxpayer's acquisition of the unrealized profit item. The aggregate amount of loss which would be postponed could not exceed the aggregate unrealized year-end appreciation in unrealized profit items open at year-end.

In order to insure enforcement of the loss deferral rule, taxpayers, would be required to report year-end open gain positions in non-RFC items. However, every taxpayer would be permitted to eliminate from consideration for pairing and deferral, losses taken during the year which were part of transactions which the taxpayer,

himself, identified at the time of their inception as "straddle transactions". Taxpayer-identified straddle transactions could give rise to no loss until the entire transaction was closed out so that losses taken on taxpayer-identified straddles would be matched by gain on the other leg. Similarly, unrealized gain on taxpayer-identified straddle transactions at year-end would not attract loss to be postponed because there would be an open unrealized loss at year-end on the other leg of the straddle.

In summary, the wash sale rules suggested to combat year-to-year shifting of income by tax straddles involving non-RFC contracts would, in effect, apply a paired transaction concept (no loss until gain) for those transactions which the taxpayer identifies as straddles at the time he enters into them and, as well, for losses in transactions, including losses in RFC transactions, which are not designated as straddles by the taxpayer, but are economically similar to the taxpayer's year-end open gain positions in non-RFC contract items. Losses could be disallowed only to the extent of aggregate unrealized gains on open transactions and as noted, loss postponement would be applied only to items which were not previously identified by the taxpayer as part of a "straddle transaction".

Where a taxpayer is dealing exclusively in RFCs, there would be no necessity for him to identify straddle transactions. However, where a taxpayer is trading in both RFCs and non-RFCs, an open unrealized gain position in a non-RFC transaction would subject losses on "substantially identical" RFC transactions to postponement unless the taxpayer identified the RFC transaction as part of a straddle involving some other position. This rule, although complicating the treatment of RFCs, is necessary to deal with the possibility of deferring income recognition by entering into balanced transactions in RFCs and non-RFCs, which could otherwise generate losses (to offset unrelated income) on open RFCs under the mark to market rule while keeping the non-RFC gain leg open until a later year.

B. Treasury Bonds, Notes and Bills

The rule in the Bills and the Treasury proposal which would convert Treasury Bills to capital assets would appear to be sound if the record-keeping requirements caused by such a change are not too difficult.

A number of low coupon Treasury and Government guaranteed bonds and notes are currently being traded. Sometimes taxpayers purchase such notes at a market discount with borrowings, secured by the obligations, which

provide substantial interest deductions. After holding the obligations for a little more than a year, they then sell the obligations, or collect them at maturity. Under current law, any market discount in excess of original issue discount is reportable as capital gain. It is suggested that the law be amended so that gains attributable to market discount on Treasury Bonds and Notes and U.S. Government guaranteed obligations be treated as ordinary income if the obligations are used to secure borrowings.

C. Capitalizing Interest

The Bills and the Treasury proposal would require taxpayers to capitalize interest paid to carry property where the taxpayer's risk of loss is substantially diminished by some offsetting position. These transactions are commonly referred to as "cash and carry transactions." The purpose of this proposed change in law made by the Bills is to prevent the creation of ordinary deductions through interest expenses which are offset by capital gain.

It is suggested that the same result be reached under the statutory structure recommended above by enacting a rule which would call for capitalizing interest on debt

secured by non-inventory property (excluding stock or securities) the holding period of which is suspended under the short sale rules amended as suggested above. Capitalization of interest is not suggested where the property being carried is stock or securities because these items usually carry some current return. Furthermore, the investment interest limitations of current law eliminate much of the potential abuse for individuals. Finally, the existing tax rules for stock and securities appear not to present undue opportunities for tax avoidance except for the transactions in U.S. Government securities discussed above.

D. Capital Loss Carryback for Individuals

In connection with the trading of commodities and other items, individuals sometimes report capital gain in one year and capital loss in a following year. In the case of individuals, capital losses which are incurred before capital gains can be carried forward. Present law does not allow a capital loss carryback for individuals. It is suggested that a capital loss carryback be allowed to individuals as it now is allowed to corporations. Individuals are presently permitted net operating loss carrybacks, and it seems appropriate to provide the same treatment for capital loss carrybacks.

A capital loss carryback seems particularly appropriate for futures contracts which are marked to market (RFCs) as suggested above, because the mark to market rule may require taxpayers to accelerate gain recognition at year-end. If the Congress desired, the capital loss carryback for individuals could be restricted to the amount of long-term loss arising from RFCs during a year, and the carryback of that loss could be limited to the amount of long-term gain from RFCs in a carryback year in which the taxpayer reported net capital gain from all capital transactions. This limited capital loss carryback rule could be restricted to tax years to which the mark to market rule applied, thus minimizing any revenue loss.

E. Requirement of Sale or Exchange

Present law requires a taxpayer to dispose of a capital asset by "sale or exchange" in order to receive capital gain or loss treatment. In these circumstances, it has been suggested by courts and commentators that losses on forward currency contracts and other forward contracts can be converted from capital losses to ordinary losses by closing out the contracts by private settlement. The Moynihan Bill and the Treasury proposal would eliminate the "sale or exchange" requirement for capital gain or loss treatment. This Committee agrees that taxpayers should

not be permitted to claim ordinary losses by disposing of capital assets such as forward contracts or notes in this manner.[25/]

It is not here suggested that forward currency contracts should be treated as giving rise to capital gain or loss as opposed to ordinary gain or loss, regardless of the purposes for which the contracts are held, and this matter is under current study by the Treasury Department. The point here made is that whatever treatment is to be accorded sales or terminations of non-RFC contracts, the character of gain or loss ought not to be affected by whether the contract is sold or terminated.

If the short sale rules of Section 1233 are amended to bring forward contracts under these rules, a policy decision must be made as to whether gains and losses on disposition or closing of short positions in forward contracts held for more than one year will produce long-term gain or loss. If remaining exposed to price risk for more than one year on a short position is held to result in long-term gain or loss, the manner of closing the short contract should be irrelevant in characterizing gain or loss as short-term or long-term. Following this

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25/ The Committee is expressing no view on whether the "sale or exchange" requirement should be retained with respect to the disposition of capital assets other than those which are discussed in this Report.

principle, Section 1233 should be amended to provide that "naked" short positions held for more than one year will produce long-term gain or loss (regardless of the manner in which the positions are closed or disposed of). If this rule is adopted, Section 1233 should be further amended to provide that a short position which suspends the holding period of a long position should itself be subject to a suspended holding period.

F. Expansion of Ordinary Income Treatment for Commercial Hedging Transactions in RFCs and Forward Contracts

With the increase in trading of interest rate futures and foreign currency futures, it would be desirable for the Congress to re-examine the area in which gains and losses on futures trading should be treated as qualifying for ordinary rather than capital treatment as a commercial hedge. For example, banks report gains and losses on securities sales as ordinary income items under Code Section 582. Banks which engage in futures transactions to hedge existing securities portfolios or forward purchases should be permitted to treat gains and losses on futures transactions as ordinary income and loss, since the futures transactions are a substitute either for interest received or foregone, or gain or loss which would be treated as ordinary rather than capital. The same rule should apply to corporations

which use interest rate futures to hedge borrowing costs. The issue of foreign currency exchange fluctuations, and the use of forward and futures contracts to cushion the effect of fluctuations in foreign currencies should also be examined with a view to determining when and how futures and forward transactions should be treated as ordinary items rather than items giving rise to capital gain or loss.[26/]

RFCs which are intended as commercial hedges against inventory, other ordinary income assets or interest rates, should be made subject to a rule, similar to that contained in Code Section 1236, which requires an early and positive taxpayer identification of commercial hedging RFCs. In this manner, a taxpayer would be permitted to identify for ordinary income and loss treatment, RFCs intended as commercial hedges against changes in the price level of ordinary income assets or interest rates. RFCs not so identified would be subject to long-term capital gain and loss treatment.

The period of time allowed for identification should be as short as possible in light of existing computer technology. Taxpayers who employ more primitive bookkeeping methods could be allowed a longer identification period.

26/ As stated at p. 49, *supra*, the Treasury Department is currently considering issues involving the application of hedging principles to transactions in forward currency contracts. The Committee is not expressing a view on the proper resolution of such issues.

G. Effective Dates and Transition Rules

If any new set of rules is adopted, consideration must, of course, be given to questions regarding effective dates and transition rules.

HR 1338, TO PROHIBIT TAX-MOTIVATED COMMODITY STRADDLES, INTRODUCED BY REPS. BENJAMIN S. ROSENTHAL (D-NY) AND WILLIAM BRODHEAD (D-MICH) ON JAN. 27, 1981
(TEXT)

(Note: For report on bill, see Report No. 17, G-6.)

To amend the Internal Revenue Code of 1954 with respect to straddles, and for other purposes.

IN THE HOUSE OF REPRESENTATIVES

____________, 19__

Mr. Rosenthal (for himself, Mr. Brodhead, Mr. Edwards of California, Mr. St Germain, Mr. Rodino, Mr. Harkin, Mr. Peyser, Mr. Conyers, Mr. Won Pat, Mr. Pepper, Mr. Forsythe, Mr. Hughes and Ms. Mikulski) introduced the following bill which was referred to the Committee on ________________ ________________.

A BILL

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. POSTPONEMENT OF RECOGNITION OF LOSSES, ETC.

"(a) General Rule. --Part VII of subchapter O of chapter 1 of the Internal Revenue Code of 1954 (relating to wash sales of stock or securities) is amended by adding at the end thereof the following new section:

"SEC. 1092. STRADDLES

"(a) General Rule. --In the case of a straddle--

"(1) that portion of any loss with respect to such straddle which exceeds the recognized gain with respect to such straddle shall be treated as sustained not earlier than the close of the balanced period, and

"(2) the running of the holding period for each position which is part of such straddle shall be suspended for the balanced period.

"(b) Straddle Defined. --For purposes of this section--

"(1) In general. --The term 'straddle' means offsetting positions with respect to personal property.

"(2) Offsetting positions. --A taxpayer holds offsetting positions with respect to personal property if there is a substantial diminution of the taxpayer's risk of loss from holding any position with respect to personal property by reason of his holding 1 or more other positions with respect to personal property (whether or not of the same kind).

"(3) Presumption. --

"(A) In general. --For purposes of paragraph (2), 2 or more positions be presumed to be offsetting if--

"(i) the positions are customarily treated as offsetting positions (whether or not such positions are called a straddle, butterfly, or any similar name),

"(ii) the aggregate margin requirement for such positions is lower than the sum of the margin requirements for each such position (if held separately), or

"(iii) there are such other factors as the Secretary may by regulations prescribe as indicating that such positions are offsetting.

"(B) Presumption may be rebutted. --Any presumption established pursuant to subparagraph (A) may be rebutted if the taxpayer establishes to the satisfaction of the Secretary that the positions were not offsetting.

"(c) Balanced Period. --

"(1) In general. --For purposes of this section, the term 'balanced period' means any period during which the taxpayer holds the straddle plus the 30-day period after the day on which the positions which make up the straddle cease to be offsetting.

"(2) Shortening of 30-day period where taxpayer disposes of all positions. --If, before the close of the 30-day period specified in paragraph (1), the taxpayer disposes of all of the positions which make up a straddle, the balanced period shall be treated as ending on the day on which the taxpayer makes the last such disposition.

"(d) Definitions and Special Rules. --For purposes of this section--

"(1) Personal property. --The term 'personal property' means--

"(A) commodities,

"(B) evidences of indebtedness,

"(C) currency, and

"(D) any other type of personal property.

"(2) Position. --

"(A) In general. The term 'position' means an interest (including a futures contract or option).

"(B) Successor position -- If the taxpayer (within the period beginning 30 days before and ending 30 days after the date of the disposition of a position) acquires a successor position, such successor position--

"(i) shall be treated as the same position as the position to which it succeeds, and

"(ii) shall be treated as held on each day which intervenes between the disposition of the interest which it succeeds and the day on which such successor interest is acquired.

For purposes of the preceding sentence, personal property acquired by the taxpayer pursuant to a futures contract, option, or other interest shall be treated as a successor position to such interest.

"(3) Positions held by related persons, etc. --

"(A) In general. --In determining whether 2 or more positions are offsetting, the taxpayer shall be treated as holding any position held by a related person.

"(B) Related person. --For purposes of subparagraph (A), a person is a related person to the taxpayer if--

"(i) the relationship between such person and the taxpayer would result in a disallowance of losses under section 267 or 707(b), or

"(ii) such person and the taxpayer are under common control (within the meaning of subsection (b) or (c) of section 414).

"For purposes of clause (i), an individual's family shall consist only of such individual, such individual's spouse, and a child of such individual who has not attained the age of 18.

"(C) Certain flow-through entities. --If part or all of the gain or loss with respect to a position held by a partnership, trust, or other entity would properly be taken into account for purposes of this chapter by a taxpayer with respect to whom the entity is not a related person, then, except to the extent otherwise provided in regulations--

"(i) such position shall be treated as held by the taxpayer, and

"(ii) the offsetting positions held by the taxpayer shall be treated as held by the entity.

"(e) Cross Reference. --

"For provision requiring capitalization of certain interest and carrying charges where there is a straddle, see section 263(g)."

(b) Clerical Amendments. --

(1) The table of sections for such part VII is amended by adding at the end thereof the following new item:

"Sec. 1092. Straddles."

(2) The heading for such part VII is amended to read as follows:

"PART VII--WASH SALES; STRADDLES."

(3) The table of parts for subchapter O of chapter 1 of such Code is amended by striking out the item relating to part VII and inserting in lieu thereof:

"Part VII. Wash sales; straddles."

SEC. 2. CAPITALIZATION OF CERTAIN INTEREST AND CARRYING CHARGES IN THE CASE OF STRADDLES

Section 263 of the Internal Revenue Code of 1954 (relating to capital expenditures) is amended by adding at the end thereof the following new subsection:

"(g) Certain Interest and Carrying Costs in the Case of Straddles.--

"(1) General rule.--No deduction shall be allowed for interest and carrying charges properly allocable to personal property which is part of a straddle (as defined in section 1092(b)). Any amount not allowed as a deduction by reason of the preceding sentence shall be chargeable to the capital account with respect to the personal property to which such amount relates.

"(2) Interest and carrying charges defined.--For purposes of paragraph (1), the term 'interest and carrying charges' means--

"(A) interest on indebtedness incurred or continued to purchase or carry the personal property, and

"(B) amounts paid or incurred to insure, store, or transport the personal property."

SEC. 3. CERTAIN GOVERNMENTAL OBLIGATIONS ISSUED AT DISCOUNT TREATED AS CAPITAL ASSETS.

(a) General Rule.--Section 1221 of the Internal Revenue Code of 1954 (defining capital asset) is amended by striking out paragraph (5) and by redesignating paragraph (6) as paragraph (5).

(b) Technical Amendment.--Subparagraph (D) of section 1231 (b) (1) of such Code is amended by striking out "paragraph (6)" and inserting in lieu thereof "paragraph (5)".

SEC. 4. PROMPT IDENTIFICATION OF DEALER TRANSACTIONS IN SECURITIES.

Subsection (a) of section 1236 of the Internal Revenue Code of 1954 (relating to gains and losses of dealers in securities) is amended by striking out "30th" each place it appears therein.

SEC. 5. EFFECTIVE DATES.

(a) In General.--Except as provided in subsection (b), the amendments made by this Act shall apply to property acquired by the taxpayer after January 27, 1981, in taxable years ending after such date.

(b) Section 4.--The amendment made by section 4 shall apply to property acquired by the taxpayer after the date of the enactment of this Act in taxable years ending after such date.

(End of Text)

S 626, "COMMODITY STRADDLES TAX ACT OF 1981," INTRODUCED BY SEN. DANIEL MOYNIHAN (D-NY) ON MARCH 5, 1981 (TEXT)

S. 626

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE, ETC.

(a) SHORT TITLE.—This Act may be cited as the "Commodity Straddles Tax Act of 1981".

(b) AMENDMENTS TO 1954 CODE.—Except as otherwise expressly provided, whenever in this Act an amendment or repeal is expressed in terms of an amendment to, or repeal of, a section or other provision, the reference shall be considered to be made to a section of other provision of the Internal Revenue Code of 1954.

SEC. 2. NONDEDUCTIBILITY OF CERTAIN LOSSES IN CONNECTION WITH OFFSETTING POSITIONS IN PERSONAL PROPERTY.

(a) IN GENERAL.—Part VII of subchapter O of chapter 1 (relating to wash sales of stock or securities) is amended by adding at the end thereof the following new section:

"SEC. 1092. OFFSETTING POSITIONS IN PERSONAL PROPERTY.

"(a) IN GENERAL.—In the case of any offsetting position in personal property—

"(1) that portion of any loss—

"(A) which is incurred in connection with the sale or exchange of any position held as part of such offsetting position, and

"(B) which exceeds any gain recognized in connection with the sale or exchange of any other position held as part of such offsetting position,

shall be treated as incurred as of the close of the balanced period: and

"(2) the holding period (as determined under section 1223) of any position held as part of any offsetting position shall not include any portion of the balanced period with respect to the position.

"(b) OFFSETTING POSITIONS.—For purposes of this section—

"(1) IN GENERAL.—A taxpayer holds an offsetting position in personal property if the taxpayer holds 1 or more positions with respect to personal property which substantially diminishes the taxpayer's risk of loss with respect to 1 or more other positions held with respect to personal property (whether or not of the same kind).

"(2) CERTAIN POSITIONS TREATED AS OFFSETTING.—

"(A) IN GENERAL.—Except as provided in subparagraphs (B) and (C), 2 or more positions shall, for purposes of paragraph (1), be treated as offsetting if such positions include substantially equivalent long and short positions and—

"(i) such positions are in the same commodity (whether or not in the same physical form),

"(ii) the aggregate margin requirement for such positions (determined on the exchange where traded or otherwise) is less than that of the sum of the margin requirements for each such position held separately,

"(iii) such positions are in debt instruments, or

"(iv) such positions are determined, under regulations prescribed by the Secretary, to be offsetting.

"(B) STANDARD DEVIATION.—No position shall be treated as offsetting under subparagraph (A)(iv) unless the standard deviation of the change in price of 1 or more positions held as part of the offsetting position has been at least 5 times the standard deviation of the change in price of the offsetting position taken as a whole during any 2-year period occurring during the immediately preceding 5-year period

"(C) SATISFACTION OF SECRETARY.—No position shall be treated as offsetting under subparagraph (A)(iii) or (iv) if the taxpayer establishes to the satisfaction of the Secretary that such position is not offsetting.

"(c) OTHER DEFINITIONS AND SPECIAL RULES.—For purposes this section—

"(1) BALANCED PERIOD.—The term 'balanced period' includes, with respect to any position—

"(A) any period during which such position is part of any offsetting position, and

"(B) the 30-day period after the day on which such position (or any successor position) ceases to be offsetting.

"(2) PERSONAL PROPERTY.—The term 'personal property' means—

"(A) commodities,

"(B) evidences of indebtedness, and

"(C) any other type of personal property (other than stock in a corporation).

"(3) POSITION.—The term 'position' means an interest (including a futures contact or option) in personal property. Any personal property acquired by the taxpayer pursuant to a futures contract, option, or other interest shall be treated in the same manner as a position in such personal property.

"(4) LONG POSITION.—The term 'long position' means a position which increases in value when the personal property to which it relates increases in value. Such term includes the holding of personal property, or of a futures contract or option to buy personal property at a fixed price, which so increases in value.

"(5) SHORT POSITION.—The term 'short position' means a position that decreases in value when the personal property to which it relates increases in value. Such term includes the selling of personal property short, or the holding of a futures contract or option to sell personal property at a fixed price which so decreases in value.

"(6) DEBT INSTRUMENT.—The term 'debt instrument' means any interest bearing obligation.

"(7) ATTRIBUTION.—In determining whether any positions are offsetting, the principles of section 318 shall apply, except that—

"(A) in determining constructive ownership in the case of the members of an individual's family, only such individual, such individual's spouse, and a child of such individual who has not attained the age of 18 shall be taken into account.

"(B) constructive ownership from a corporation to a person, or from a person to a corporation, partnership, trust, or estate, shall be determined only if—

"(i) there is at least an 80-percent interest (determined after the application of the family attribution rules) held by, or in, such person, or

"(ii) in the case of a trust, the trust is a trust to which subpart E of part I of subchapter J applies; and

"(C) in the case of a passthrough entity, constructive ownership shall be determined under paragraph (8).

"(8) TREATMENT OF PASSTHROUGH ENTITIES.—

"(A) IN GENERAL.—In determining whether any positions are offsetting, a person having an ownership interest in any passthrough entity shall be treated as owning a pro rata share of the personal property, or of any position in personal property of such entity equal to the person's pro rata share of the ownership interest

"(B) PASSTHROUGH ENTITY DEFINED.—For purposes of subparagraph (A), the term 'passthrough entity' means—

"(i) a regulated investment company,

"(ii) a real estate investment trust,

"(iii) an electing small business corporation,

"(iv) a partnership,

"(v) an estate or trust, or

"(vi) a common trust fund."

(b) TECHNICAL AND CONFORMING AMENDMENTS.—

(1) The table of sections for such part VII is amended by adding at the end thereof the following new item:

"Sec. 1092. Offsetting positions in personal property".

(2)(A) The heading for such part VII is amended to read as follows:

"PART VII—WASH SALES; OFFSETTING POSITIONS"

(B) The table of parts for subchapter O of chapter 1 is amended by striking out the item relating to part VII and inserting in lieu thereof the following:

"PART VII. WASH SALES; OFFSETTING POSITIONS."

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to offsetting positions established after May 5, 1981, in taxable years ending after that date.

SEC. 3. CAPITALIZATION OF CERTAIN CARRYING CHARGES

(a) IN GENERAL.—Part IX of subchapter B of chapter 1 (relating to items not deductible) is amended by adding at the end thereof the following new section

"SEC. 280E. CERTAIN EXPENDITURES RELATING TO PROPERTY IN AN OFFSETTING POSITION

"(a) IN GENERAL.—Any amount—

"(1) which would be allowable as a deduction but for the provisions of this section,

"(2) which is allocable to personal property (other than an option or a futures contract) which is part of an offsetting position within the meaning of section (1092 (b)), and

"(3) which is allocable to the balanced period (within the meaning of section 1092 (c)(1)) with respect to such personal property,

shall be charged to capital account

"(b) CERTAIN AMOUNTS INCLUDED.—For purposes of subsection (a)—

"(1) Interest on indebtedness incurred or continued to purchase or carry personal property, and

"(2) any storage or insurance costs with respect to personal property,

shall be treated as allocable to such personal property.".

(b) CONFORMING AMENDMENT.—The table of sections for such part IX is amended by adding at the end thereof the following new item:

"Sec. 280E. Certain expenditures relating to property in an offsetting position."

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to expenditures made after May 5, 1981, in taxable years ending after that date

SEC. 4. CERTAIN GOVERNMENT OBLIGATIONS TREATED AS CAPITAL ASSETS

(a) IN GENERAL.—Section 1221 (defining capital asset) is amended—

(1) by inserting "or" at the end of paragraph (4),

(2) by striking out paragraph (5); and

(3) by redesignating paragraph (6) as paragraph (5).

(b) CONFORMING AMENDMENTS.—

(1) Subparagraph (B) of section 341(c)(2) (relating to determining total assets of a collapsible corporation) is amended by strik-

ing out "(and governmental obligations described in section 1221(5))".

(2) Subparagraph (D) of section 1231(b)(1) (defining property used in trade or business) is amended by striking out "paragraph (6)" and inserting in lieu thereof "paragraph (5)".

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to obligations issued after May 5, 1981.

SEC. 5. DEALERS IN SECURITIES.

(a) 30-DAY REQUIREMENT.—Subsection (a) of section 1236 (relating to dealers in securities) is amended by striking out "30th" each place it appears.

(b) CLEAR IDENTIFICATION REQUIREMENT.—Section 1236 is amended by adding at the end thereof the following new subsection:

"(d) CLEAR IDENTIFICATION IN CASE OF OFFSETTING POSITIONS.—For purposes of subsection (a), no security which is part of an offsetting position (as defined in section 1092(b)) shall be treated as clearly identified in the dealer's records as a security held for investment unless all securities which are part of the offsetting position have been identified in accordance with such subsection.".

(c) EFFECTIVE DATE.—The amendment made by this section shall apply to securities acquired after May 5, 1981, in taxable years ending after that date.

SECTION 6. SALE OR EXCHANGE.

(a) IN GENERAL.—Section 7701(a) (relating to definitions) is amended by adding at the end thereof the following new paragraph:

(38) SALE OR EXCHANGE.—The term 'sale or exchange' when used with reference to any capital asset means any disposition of such asset.".

(b) EFFECTIVE DATE.—The amendment made by this section shall apply to any disposition after May 5, 1981.

(End of Text)

STATEMENT OF MARTIN D. GINSBURG

Mr. Chairman and Members of the Committee: my name is Martin D. Ginsburg. I am a Professor of Law at the Georgetown University Law Center teaching various subjects in the field of federal taxation. Previously, before moving to the District of Columbia last year, I was the Beekman Professor of Law at Columbia University School of Law and, for some twenty years prior to joining that faculty, practiced law in New York City primarily in the federal tax field.

That commodity futures contracts and related animals currently are exploited in volume for undue tax advantage does not seem a highly debatable proposition. This family of arrangements fits well in the phylum of tax shelter devices, exhibiting in each transaction some or all of the tax shelter's common characteristics, deferral of income, leveraging of investment through indebtedness or risk, and conversion from high tax income category to lower tax and even, in some cases, no tax at all.

The tax avoiding weaponry in this shelter's arsenal is extensive and, to most of us, quite mysterious. Terms with a definition uncertain or arcane or both seem to abound. What exactly is, or is not, a "Commodity," a "Commodity Future," a "Commodity Future Contract" long or short, a "Forward Contract" long or short that is not subject to the rules of a board of trade or commodity exchange, a "Put" or "Call" or "Strip" or "Strap" or "Straddle" or "Spread"? What is a "Butterfly" and why ought we care? Some of this, without doubt, is important in applying the holding period and short sale and option (if not the wash sale) provisions of present law. But a fine comprehension of the Alchemist's dictionary is not, happily, prerequisite to understanding what is going on out there.

Simply stated, what is going on out there is lead is being turned into gold. Sometimes the conversion is direct and complete. In other cases, low grade lead first is turned into higher grade lead which then is transmuted into gold. In this world, low grade lead is ordinary income, higher grade lead is short-term capital gain, and gold is long-term capital gain. For the patient and aggressive, there is even a platinum transmutation in which a large part of the long-term capital gain turns into nothing taxable at all.

Let us consider Mr. Rich, a 70 percent bracket taxpayer with an appetite for tax avoidance. Specifically, it is 1981 and Mr. Rich decides not to pay tax on his top $100,000 or so of ordinary income. Here is one way he might go about it.

Mr. Rich goes "long" treasury bill futures and Mr. Rich goes "short" treasury bill futures. A treasury bill future is a contract to buy ("long") or sell ("short") a fixed amount of treasury bills—the basic trading unit is $1 million face value of treasury bills—at a future date for a fixed price. Mr. Rich is careful that the delivery month under his long contracts is different from the delivery month under his short contracts.

Interest rates change and the value of Mr. Rich's long position rises. Mr. Rich sells the long Treasury bills future contracts at a gain. The sale is made more than six months after Mr. Rich acquired the contracts. The gain is long-term capital gain. In the real world, to protect himself against futher interest rate fluctuations Mr. Rich would rehedge his position—substantially reduce or eliminate risk of true economic loss—by purchasing new long contracts that specify yet another delivery month.

For every action there is, more or less, an equal and opposite reaction. The original long position having risen in value, the short position has declined in value. Mr. Rich looks forward to suffering a loss on it. The correct term is "looks forward" and not "suffering" because, in this Orwellian world, a properly taken loss is a good thing. Mr. Rich will take his loss by purchasing treasury bills and delivering the bills against his contract obligation. The bills will cost him more than he will be paid under the contract. That is his tax loss. The loss is fully deductible ordinary loss, and that is the good thing.

In a perfectly imperfect world, Mr. Rich will invest for long-term capital gain of approximately $100,000 and ordinary loss in about the same amount. Of course, he cannot control the market. Interest rates may go up rather than down. The gain leg may turn out to be the short position. Mr. Rich can still transmute a long leg loss into ordinary loss—he will take delivery of the depreciated Treasury bills and promptly sell them—but his short side gain will be short-term capital gain. Lead still, but higher quality lead than the ordinary income he has now offset. No fear. Poor in transactional costs but affluent in expectations, Mr. Rich will commence a new adventure, perhaps purchasing and selling silver futures contracts, with the intention at worst of rolling over the short-term gain to next year, at best of converting this year's short-term gain into long-term gain next year.

The use of commodities, commodity futures, and commodity options as the modern philosopher's stone is not new in tax planning. Conversion of short-term gain to long-term gain, for example, has been a popular indoor sport for a great

many years. What has changed, I think, is the number of players, the volume of transactions, and the not unfounded belief that the special nature of treasury bills invites conversion from ordinary income to capital gain. Although Treasury bill futures are capital assets, the Treasury bills themselves are ordinary assets, and the play of one against the other is the road to tax riches. For reasons technically more complex but no less enjoyable, so is the interplay of put and call options written and held on Treasury bills.

This sort of thing having gone on, in one fashion for another, time out of mind, surely the Commissioner must have had something to say about it. Indeed he did, but not until fairly recently and not, I am afraid, in a cosmically effective way. The Commissioner is vocal in the belief that a commodity transaction created to minimize the tax consequences of unrelated short-term capital gain (or ordinary income), which offers no realistic potential of significant economic profit and results in no real economic loss, produces nothing that is deductible either against capital gain or against ordinary income. (Rev. Rul. 77-185, 1977-1 C.B. 48, amplified by Rev. Rul. 78-414, 1978-2 C.B. 213.) There is, I think much to be said for the Commissioner's position but, in each case, it requires knowledge of facts and resolution of questions of fact on which unreasonable men and women may and no doubt will differ. A wise person once pointed out that if determination of a pervasive tax issue requires repeated resolution of a question of fact, it is quite likely the tax system is asking the wrong question.

In essence, the legislation now before this Committee is an attempt to ask the right questions. Ought we change the income tax rules relative to Treasury bill transactions? Without regard to motive tainted or pure, should a taxpayer be prevented from using the futures market as a means of rolling over to a later year gain otherwise taxable in the current year? Or from using commodity straddles and similar transactions as a transmutation device to convert short-term capital gain into long-term capital gain? Or from deducting interest and carrying charges on a commodity in hand if a relative future position builds capital gain? Should protective rules, if enacted with respect to commodity transactions, also apply to transactions involving stocks and securities?

The bill now before this Committee answers "yes" to each of these questions and proposes as well to shorten by 29 days the 30 day identification period set forth in section 1236(A) (relating to gains and losses of dealers in securities). I am much enamored of that proposal but, in the absence of greater knowledge of impacts, less comfortable with the notion of applying new commodity transaction rules to transactions in corporate stock.

As to the main things the bill addresses, I think the four questions asked are right questions. The bill's decision to respond affirmatively to three of them seems to me sound indeed. The bill's affirmative response to the fourth question, capitalization of interest and carrying charges in the case of a straddle, also seems to me reasonable.

While I think the determination ot curb Treasury bill, rollover, and other trasmutation abuses salutary, I have some question about the means to these ends the bill employs.

The bill would eliminate the rollover potential by applying something of a wash sale concept when the taxpayer holds offsetting commodity positions that substantially diminish risk of economic loss. A different approach would requiure that the taxpayer (other than a taxpayer legitimately hedging a business inventory) mark to market all regulated futures contracts in hand at year-end. This procedure might be followed to force recognition in full, or more narrowly to offset otherwise allowable losses generated in closed commodity transactions during the year. Under the "mark to market" approach, which was recommended by a number of us who testified before the House Ways and Means Committee April 30, 1981 on H.R. 1293, it is irrelevant whether particular commodity positions are or are not offsetting. As the bill comprehends, what is relevant and should be taken into account are commodity positions held by certain persons closely related to the taxpayer or by entities whose gains and losses flow through to the taxpayer. I believe "mark to market" preferable to "identity offsetting positions" for the most practical of reasons. A taxpayer's; or a related group of taxpayers', commodity transactions can involve positions far more balanced than at first they appear to be. A taxpayer's commodity trading activity may be voluminous and the paper trail extensive and impenetrable, perhaps intentionally so. The audit burden in an "identify offsetting positions" world could, I suspect, prove heavier than the system reasonably should bear.

The bill addresses the transmutation potential of present law by suspending holding period while the taxpayer enjoys offsetting positions and for 30 days thereafter. An alternative approach to the rollover problem, under which a finding of

offsetting or balanced commodity positons is not required, does not readily comport with this suspension of holding period notion. But the transmutation problem, ameliorated through the mark to market concept, may be resolved another way. Since the concern is that the taxpayer will use commodity transactions to generate long-term capital gain and short-term capital loss, the latter to be offset against short-term gains from other transactions, one solution lies in requiring that all commodity transaction gains and losses (including those generated in marking to market), or at the least all transactions involving regulated commodity futures, first be netted one against the other, as if the taxpayer had no other capital gains and losses in the taxable year.

If a commodity transaction "basket" of this sort were created, the net gain or net loss which the basket yields then could be factored into the normal capital gain and loss computation equation, But, while that is a conventional notion (present § 1231 employs something of the sort), it is not an inevitable one. An alternative and arguable fairer approach in a year-end "mark to market" world would disregard holding period, apply a tailored § 1202 deduction (less than the 60 percent deduction attracted by noncommodity long-term capital gains) to net commodity gains.[1] and allow a carryback and carry forward of net commodity losses.

To harmonize the tax treatment of Treasury bills, Treasury bill futures, and options with respect to each, an amendment is proposed to treat Treasury bills as capital assets. This will require application of the original issue discount rules to Treasury bills, and suggests that an ordinary income producing rule might sensibly be applied as well to market discount on Treasury obligations. While application of "discount" rules raises the unwelcome specter of tax complexity, the concern ought not prove significant since under amended law, as under present law, the holder of a discount obligation issued by the government should not be required ratably to accrue the discount in income over the life of the obligation.

I should like to close this morning with two final points. They are of a practical nature.

If Congress should adopt a mark to market approach to the tax treatment of commodity transactions, and should opt for the variation under which unrealized gains are fully recognized at year-end, some taxpayers will be faced with a previously unanticipated, potentially awesome first year tax liability. These are taxpayers who over time have built up a very large unrealized appreciation in aggregate commodity positions. While it seems fair to say the legislative objective inherent in marking to market is to eliminate this sort of thing in the future, it probably is not the legislative objective to eliminate—in a capital punishment sense—taxpayers who have done this sort of thing in the past. The Committee might well consider an amelioration under which excess threshold gain would be spread forward and treated as recognized, for example, over a ten year period beginning with the year of enactment.

Finally, I have a hobbyhorse to ride. If Congress should adopt mark to market, separate basket treatment of commodity transactions, and a carryback for net commodity losses, the time will be ripe for making an important, ameliorative change in the tax treatment of net capital losses incurred by non-corporate taxpayers. Under present law a corporation is permitted to carry back a net capital loss three years, but an individual taxpayer is afforded no capital loss carryback. That denial comports with no sound tax policy and senselessly discourages the taking of investment risk by individuals who, having profited from the closing out of one successfull investment, are otherwise well-positioned to undertake new and perhaps more speculative investments. In the legislative course that led to last year's enactment of the highly regarded Installment Sales Revision Act this problem attracted some attention, in part because the new law's treatment of sales for contingent payment expands the number of cases in which the seller may have capital gain in earlier years and a capital loss in a later year. The Installment Sales Revision Act made no change in the capital loss carryback provision, however, because it was rightly concluded that the carryback problem of individual taxpayers has pertinence well beyond the installment sale context and deserves separate Congressional consideration. If the Committee determines to place the loss carryback in focus in legislating on commodity transactions, it would I believe be an appropriate opportunity for the Committee also to consider affording non-corporate taxpayers and

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[1] A corporate taxpayer, of course, does not receive the Sec. 1202 deduction and, instead, under present law it is taxed on net long-term gains at a reduced rate of, currently, 28 percent. Under the approach here recommended, a corporate taxpayer's net commodity gains would be taxed at a statutorily specified rate. For example, if the maximum individual income tax rate were to remain at 70 percent and the special sec. 1202 deduction applicable to the individual taxpayer's net commodity gains were, say, 20 percent, assuming a maximum corporate tax rate of 46 percent the special rate applicable to net commodity gains might be set at 40 percent.

elective three year carryback of net capital losses in excess of some statutorily specified floor amount.[1]

Senator SYMMS [acting chairman, presiding]. Next we will have N. Jerold Cohen and Jerome Kurtz.

PANEL OF N. JEROLD COHEN, SUTHERLAND, ASBILL & BRENNAN, ATLANTA, GA., AND JEROME KURTZ, PAUL, WEISS, RIFKIND, WHARTON & GARRISON, WASHINGTON, D.C.

Senator SYMMS. Mr. Kurtz please go right ahead. Welcome to the committee.

Mr. KURTZ. Good morning. Senator Symms, I am appearing today in my individual capacity. I have a short statement I would like to submit for the record and then make a few points orally if I may.

I would like to comment on this problem giving somewhat greater weight than I think has been given in the testimony we have heard to date, about the effect of this type of tax arrangement on the voluntary compliance system.

We have a voluntary compliance system that yields about $500 billion a year in income taxes. It is a marvel to the rest of the world, but it is a system that can't be taken for granted.

It is really too much to expect the average taxpayer to comply fully and voluntarily with his tax obligations when he becomes aware of the fact that there are other taxpayers with huge amounts of economic income who pay little or no tax.

During the years that I was Commissioner of Internal Revenue, I saw serious problems in what is known now as the underground economy, serious problems among tax protestors.

Various surveys that were conducted confirm what is commonsense, that people will look for their own way of avoiding taxes if they believe that others, particularly those better off economically, are avoiding theirs legally.

So, I think there is a great deal at stake in trying to solve this problem.

Tax straddles, as they have been discussed this morning are a gimmick. I heard the question discussed as to whether there was risk in these transactions. Of course there is risk in the transactions, at least in many of them, but that is not the issue. The issue is how much risk compared to how much loss is being taken.

I have seen situations where the amount of income that is deferred may be in the millions. The fact that there may be a risk of losing $10,000 or $20,000 is really irrelevant to whether the taxpayer should be permitted to take a loss of the magnitude that is taken.

The tax straddle itself involves taking the loss on one side of a transaction and protecting the gain on the other side.

Clearly that loss bears no relation to what the gain or loss may be on the straddle position, that is, on the spread.

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[1] Some floor amount, perhaps in the $10,000 neighborhood, is appropriate for various reasons. First, individual taxpayers are permitted to offset a modest amount of net capital loss against ordinary income in the loss year and in successive carry forward years, hence the problem of unusable capital loss realistically focuses on the sizable capital loss only. Second, the carryback floor will reduce to insignificance the Internal Revenue Service's administrative burden in processing carryback refund claims. Third, Congress can peg the floor amount at a level that will eliminate any significant potential revenue cost while preserving the incentive to investment risk taking that the capital loss carryback will engender.

When one invests in a straddle, one has gain or loss on the changes in the spread between the two positions.

But, what is being claimed on the tax return is not the gain or loss on the spread position, but the gross gain on the one side of the transaction, which as I say, bears no relation to what is happening to the straddle itself.

There is no provision in any proposal that has been put forward which would in any way disallow the losses on spreads or on straddles.

The question is the timing of the losses that are claimed on one leg, versus the gain on the other leg. When the transaction as a whole is closed out, the loss would be allowed under any proposal.

We are concerned with a gimmick. As Professor Ginsburg said, however, no one defends gimmicks. The argument being made is that others should not be entitled to the gimmick but that it produces worthwhile results in the particular case under examination.

I am not sure that the average taxpayer feels any differently about the tax system, whether he sees doctors and dentists avoiding taxes on their real income or whether he sees those engaged in the commodity business avoiding taxes on their real income.

The equity question, it seems to me, is very much the same. The argument essentially that is being made is that those engaged in this business are performing a worthwhile economic or social function, and therefore, are entitled to tax relief, or at least taxation at a much lower rate.

I would suggest that if this committee meets to decide how to hand out tax exemptions on the basis of contributions to society, there will be a very long line and many ahead of commodity dealers in that line. I thank you.

Mr. COHEN. My name is Jerry Cohen. I am a private practitioner and formerly served as Chief Counsel for the Internal Revenue Service.

I have a statement I would like to have made a part of the record, and I would like just to spend a few minutes talking about how I perceive this problem and to testify in favor of Senator Moynihan's bill.

Although I am testifying as a private practitioner, I am testifying from my perspective during the time that I spent with the Internal Revenue Service.

I think that this problem is one of the most serious problems we have in taxation today, not just because of the billions of dollars that are involved in the problem itself, but because of the damage it does to our entire tax system.

It is clear to me that rank and file taxpayers are looking around and seeing these very wealthy taxpayers avoiding large amounts of taxes and saying: "Where is my straddle? Where is my tax shelter?"

What they are being led to are tax shelters that are really criminal under the tax laws. I think that is a direct result from schemes such as these straddle schemes.

Senator Byrd mentioned: Is this a matter of tax avoidance or is it deferral?

Well, there are millions of taxpayers out there who would love to defer their taxes. What we have here is a deferral and a redeferral and a redeferral and a redeferral, ad nausium.

It is interesting to testify after the industry panel and listen to them describing where they would like to come out.

They created these tax avoidance schemes. They profited by the substantial commissions on the schemes. They used the schemes to avoid their own taxes, both on these commissions and on other commissions, and now they are pleading to be allowed to remain out of the group of citizens in the United States who bear the tax burden.

There are a lot of Americans who are contributing capital to our economy and who are assuming huge risks and who are paying taxes.

I think that it is very damaging to the system if there is a response which says that a particular group can continue to stay out of the tax system. I think that is tremendously damaging to the tax system itself.

These cases are being litigated now. They are crowding the dockets of the Tax Court which handles about 95 percent of the tax litigation in the country. It now has the largest docket of cases in its history—over 40,000 cases. It can't manage that. The Service does not have the resources to manage this through litigation either.

I think that the only solution to the problem is legislation. I think it is needed urgently. I like the proposal that is before this committee. I like the mark to market approach. I just want a solution to the problem. Thank you.

Senator MOYNIHAN. Mr. Chairman, I think that we have heard two powerful statements, from men that have earned the respect and regard of this committee and their public service in the Government, in the executive branch over the years.

Mr. Commissioner, in your statement you said based on my 3½ years experience as Commissioner of Internal Revenue the schemes which these bills address are doing more to undermine the fairness of the tax system than any others.

You would describe this as something of a crisis.

Mr. KURTZ. Yes. I think it is an extremely serious problem. The use of straddles, which Professor Ginsburg pointed out when he testified, is not new. But the volume is relatively new and expanding really at an alarming rate.

It is also being—we see it being used in the returns I saw and probably you have now seen, by people with the highest incomes in the United States. They are absolutely shocking.

As I said, I think that this system, our whole tax system rests on taxpayers' sense of fairness. When we lose that we have lost the goose that is laying the golden egg.

Senator MOYNIHAN. Mr. Cohen, you would agree?

Mr. COHEN. Yes, exactly.

Senator MOYNIHAN. We are not trying to do anybody an injustice. We don't mind people making money. But we have seen tax returns for persons with millions of dollars of income and no tax. It is wrong. The perception of this system is equitable is what makes it work. Although if half the country were lawyers, the other half

taxpayers, you still wouldn't keep up with the ingenuity if people didn't trust the system.

Mr. COHEN. That is correct.

Senator MOYNIHAN. People do trust our system, though Jimmy Carter didn't. He said it was a disgrace to humanity. I thought that was a rather large statement. Humanity had a lot to account for besides the U. S. Internal Revenue Code. [Laughter.]

To the contrary, one of the things we should be proud of and we could take some pride in is the degree to which taxes are paid voluntarily and adequately.

Commissioner, didn't you find our tax system working when people paid their taxes?

Mr. KURTZ. Yes, it largely works very well. The problem with it is that it has worked so well, for so long, that there is a tendency to take it for granted. That is a serious mistake.

I think we are beginning to see some erosion in confidence. Once that confidence is eroded, it will not easily be restored. That is why I view this kind of device as a problem.

Senator MOYNIHAN. People should live in a country where one is not forced necessarily to pay taxes in order to understand the blessings of a country where paying taxes is thought necessary.

Just get yourself into a world where the life of the business economy moves around avoiding taxes and you will know how blessed we have been and how urgent then is a situation which arises which threatens that confidence. This committee has some responsibility to act.

Mr. KURTZ. I agree completely, Senator Moynihan.

Senator DOLE. Well, I don't think there is any question about whether this committee is going to act. I think it is a question of just what we will do.

You both indicated you support the Treasury's position which is pretty much the same as your proposal, I understand.

Senator MOYNIHAN. We have about three proposals around. [Laughter.]

I think Mr. Schapiro would not have supported the Treasury. You would. I could be happy with either. We are in the range of agreement on these things, Mr. Chairman.

Mr. KURTZ. Let me say I would support the Treasury proposal. Whether the Treasury proposal is perfect in its present form, I am not certain. I am sure issues have been raised as a result of this hearing and the Treasury will look at its proposal again, and perhaps some adjustments are needed.

Senator MOYNIHAN. You certainly support the idea of taxpayers paying taxes once a year?

Mr. KURTZ. Oh, yes. I feel very strongly about that.

Senator DOLE. You also both indicated that we should take prompt action. That gets into some discussion whether or not that might be a matter that should be included in the package we know is going to finally pass the Congress that would be the President's program.

Is that what you were indicating?

Mr. KURTZ. Yes. I certainly would hope that the matter is addressed very soon. Let me say that as Jerry Cohen pointed out, in

addition to being a major problem of equity or lack of equity, it is a major administrative problem for the Service.

The Service has put in fairly elaborate systems to identify these returns and examine them and litigate them, but it consumes enormous resources. That is, the Service does not believe a lot of these schemes really work, but the problems of finding them and examining them and litigating them consumes enormous resources and obviously cannot be completely successful.

Where you are dealing with 100 million tax returns, you cannot find every one that ought to be found.

So, there is a continuing problem, a continuing proliferation of the schemes and a use of very scarce resource in the Service which under the proposed budget are becoming even scarcer.

Senator DOLE. Are there any other schemes we ought to be looking at that you may have mentioned as you left the Service?

Mr. KURTZ. Yes, there are a number of problems that ought to be addressed.

If I might take a moment for a thought that I included in my statement, but didn't discuss, because it is not directly the subject of the hearing, but it is the subject of the broader problem of tax abuses.

I think if we look at the history of tax abuses, tax shelters and tax gimmicks of one kind or another, we see a history of the Treasury coming to the committees and saying there is a problem. The committees reacting by legislation, and then another set of problems arising, the committee reacts again.

The committee has, over the years, reacted with rules—at risk rules, first in certain industries, then more generally and now straddles.

But all of these gimmicks are evidence of a more fundamental problem with the tax system. The very fundamental problem with the tax system is that there is no penalty on a taxpayer for entering into a transaction which gives him the opportunity to take a very aggressive and probably improper reporting position.

There is no down side risks. All tax practitioners have been in the position of a taxpayer coming in and saying:

> Oh, I bumped into so and so at a cocktail party. He has an investment in a gold mine that has been recommended to me. Here it is. What do you think about it?

A thoughtful practitioner will say, "I don't think there is a chance in 100 that that deduction will stand up." And the client will say, "What happens if I claim it and I am wrong and it is disallowed?"

You are really forced to say to the taxpayer, well you have to pay the tax you would have paid anyhow, and interest at a substantial bargain.

The taxpayer then says, "Why shouldn't I do it?"

As long as one cannot say to the taxpayer that there is a significant down side risk, taxpayers will not be discouraged from engaging in really outrageous schemes.

As long as taxpayers are willing to engage in them the boundless imagination of promoters in this area will develop them. It will be a constant game.

In the end, there must be a down side risk provided that will cause taxpayers to ask their lawyer, what are the chances of my

prevailing in the case, not simply, will I go to jail, which is really the extent of the questioning that goes on today.

Senator DOLE. Thank you.

Senator MOYNIHAN. Thank you very much.

[The prepared statements of the preceding panel follow:]

STATEMENT OF N. JEROLD COHEN, SUTHERLAND, ASBILL & BRENNAN, ATLANTA, GA.

SUMMARY OF COMMENTS

The witness will suggest that commodity tax straddles pose a serious problem for tax administration. The Internal Revenue Service litigation program will not solve this problem and a legislative solution is required to curtail these abuses.

Mr. Chairman and members of the committee, my name is Jerry Cohen and I am a partner in the firm of Sutherland, Asbill & Brennan and formerly served as Chief Counsel for the Internal Revenue Service. It is a pleasure to be here today as a private tax practitioner to testify in support of S. 626, legislation introduced by Senator Moynihan, dealing with what I consider to be one of today's major tax administration problems—commodity tax straddles.

The Internal Revenue Service is spending a substantial portion of its very limited resources attempting to stem an ever increasing tide of highly questionable tax shelter schemes. Most of these shabby schemes contain at least three essential ingredients: In the first place they lack any real economic objectives. In the second place, they are usually based upon highly questionable interpretations of the tax laws. And finally, they offer a no-cost opportunity of gambling on avoiding a tax audit or substantially deferring the date of payment of tax liability.

These highly publicized schemes are damaging to the tax system in a way which is far out of proportion to the amount of taxes being evaded or avoided. It is the prevalence of these schemes which has caused the rank and file taxpayer to begin looking for ways to "shelter" his income. Unfortunately, the shelters being used by the rank and file taxpayers often constitute criminal violations of the tax laws. Thus it is my firm conviction that shabby shelter schemes, such as the commodity straddles which are the subject of this legislation, are directly responsibile for the increased fraudulent reporting of exemptions on W-4's and other similar problems being faced by the Internal Revenue Service today.

Tax straddles are openingly promoted and widely marketed as methods of avoiding or deferring the payment of income taxes. Often these transactions are sold as a method of transforming ordinary income into capital gain and then continually deferring the payment of the tax on that capital gain. While serving as Chief Counsel for the Internal Revenue Service, I saw repeated instances of returns of very high income individuals with little or no tax reported because of losses or deductions attributable to tax straddle transactions.

I feel certain that the taxpayers whose returns I saw will ultimately pay the tax liability which they hoped to avoid. The Service has already identified a number of these returns and the losses taken on the returns are being disallowed. The first of the tax straddle cases are being litigated and others are docketed and scheduled for litigation. However, the audit and litigation programs will not solve or even contain this problem.

Remember that the taxpayers who are entering into these transactions are often willing to settle for deferral of their tax liability if they cannot avoid that liability by escaping audit. Until there is precise legislation in the area such taxpayers will be willing to take the position that the Internal Revenue Service rulings and court cases do not really apply to them in order to continue participating in the audit lottery or continuing deferring their tax payment. The Internal Revenue Service simply does not have the resources necessary to audit all of these taxpayers and litigate all of the necessary cases.

Even if the resoruces were available, the courts do not have the facilities to promptly dispose of the cases. The Tax Court, which receives over 95 percent of the tax cases filed in the United States, has the largest docket of cases in its history. In the fiscal year ending September 30, 1980, the Tax Court received over 20,000 cases. In the fiscal year ending September 30, 1976, the Tax Court received only 11,000 cases and yet it was overwhelmed by its case load that year. The Tax Court's docket is now swollen to some 40,000 cases, creating a tremendous litigation logjam. Consequently, the only solution to the problem is the legislation solution.

It seems to me that it is extremely important that Congress pass, as soon as possible, legislation similar to S. 626. Many will be heard to say that this legislation

is not broad enough. The commodities industry is too adept at these transactions to be totally deterred by the legislation. This should not slow up the legislation effort, however. It is much more important to enact legislation as soon as possible than it is to attempt to prepare legislation which will cover every imaginable scheme. The important fact is that this legislation will carve a large swath through the schemes that are currently multiplying.

Others will say that the legislation is to broad: that the net will catch many transactions which are not tax avoidance schemes at all. I do not believe that this is a legitimate cause of concern. In the first place the legislation does not bar the taking of a loss on any transaction unless there is an offestting profit. The legislation merely defers the loss while a balanced position is being maintained. In the second place, the legislation does have an ameliorating provision. If the taxpayer is not engaged in a tax avoidance scheme the Internal Revenue Service may permit the deduction of the loss.

Thus, I fully support this legislation, I think that it is of extreme importance to our tax system, and I urge its adoption.

STATEMENT OF JEROME KURTZ

Mr. Chairman and members of the subcommittees, I am pleased to appear today to discuss proposed legislation dealing with the taxation of commodity straddles. These transactions present some of the most serious abuses in our income tax system. I am appearing in my individual capacity, not representing any client or organization.

The success of our tax system depends on voluntary compliance. The willingness of taxpayers to comply voluntarily with our tax laws depends, in large measure, on their perception of the fairness of the tax system. It is too much to expect that the willingness of middle income taxpayers to comply voluntarily with our tax laws won't be seriously diminished when very high income individuals file returns showing no taxable income as a result of transactions having little effect on their economc well-being. Our tax system, which has been described as the envy of the world, will not remain so unless these abuses are eliminated.

Based on my 3½ years experience as Commissioner of Internal Revenue, the schemes which these bills address are doing more to undermine the fairness of the tax system than any others.

The Service has ruled adversely on the allowability of the losses claimed in some of these transactions and is devoting substantial resources to examining returns claiming these losses. But intense enforcement activity alone cannot eliminate the problems. The fact that the Government may eventually prevail in litigation will still not prevent many taxpayers from engaging in such transactions and taking aggressive reporting positions on their returns.

Congress must act.

You will hear arguments that the losses claimed in these straddle transactions should be allowed because they arise out of real transactions involving real risks, or that straddles provide needed liquidity to the commodities markets, or that dealers should be exempted from any restrictive legislation because they are engaged in business and have gains from commodities transaction.

These arguments obscure the real issues.

The issue is not whether there is any risk in a straddle transaction but rather how the amount at risk compares to the loss being claimed. This is a familiar issue and one Congress has faced and resolved in other areas. In many of the early tax shelter schemes, a taxpayer would commit, say $10,000 of his funds to a project and borrow $30 or 40,000 on a non-recourse basis, that is, without any obligation to repay the loan. He would then claim losses equal to the total investment including the non-recourse financing. Congress reacted to this obvious abuse by limiting the taxpayer's deduction to the amount he had at risk—the amount he could actually lose. In the commodity area the problem is similar. The taxpayer's real exposure to loss is significantly mitigated by an offsetting market position, rather than by non-recourse financing, but the abuse is the same—claiming losses many times the actual loss or the exposure to loss.

As to the question of providing needed liquidity to the commodities markets, the issue is how much and at what cost. It is difficult to believe that much, if anything, is gained in the functioning of markets when large numbers of people participate in balanced positions. The markets work by matching offsetting risk takers. Completely covered positions do not supply risk takers. But even if this volume of transactions does add something to the functioning of the markets, the addition cannot be a justification for undermining our income tax system. These markets functioned before the proliferation of tax straddles and will continue to function without them.

If Congress were to decide to give out tax exemptions on the basis of taxpayers contributions to society, there undoubtedly would be many worthy recipients it would rank ahead of tax-straddlers.

The same may be said of commodity dealers. I cannot imagine any reason why those whose income is from dealing in commodities should be permitted to exempt themselves from income tax by engaging in transactions whose principal purpose is to shelter their real economic gains.

Acting promptly on these bills is essential to the well being of our tax system. But ending the tax abuses in the futures markets will not solve the broader problem of abusive tax shelters. The ingenuity of lawyers, accountants and promoters is boundless and new gimmicks will be developed and marketed. The Internal Revenue Service will continually be trying to catch up with the latest scheme unless a more fundamental change is made to our new tax law—a change that would affect the willingness of taxpayers to take highly doubtful positions on tax returns. The major attraction of many tax shelter schemes is the taxpayers' belief that participation in the scheme will afford him the opportunity to file a tax return showing less taxable income than he believes he really has with little or no penalty for being caught. He believes that, at worst, his deduction will be disallowed and he will eventually have to pay the tax he would have paid in the first place without the shelter plus interest at a bargain rate. So even the loss of his tax case and his investment is still probably a fair price to have paid for the deferral of tax at low interest rates. That is the extent of the risk. But the benefit is that he may not be audited at all, in which case he has reduced or substantially deferred his taxes improperly. A tax shelter may be thought of as a free or almost free ticket to the audit lottery.

An abusive tax shelter, at its worst, may be defined as a scheme designed to give a taxpayer a reporting position for claiming a deduction in the hope that his return will not be examined or that tax can be deferred without penalty. No amount of examination activity will stop taxpayers from playing the audit lottery as long as the ticket to play is free—as long as there is nothing to lose.

The more I've thought about the problem, the more convinced I've become that the basic problem lies in our penalty structure.

As it now stands we have penalties only for fraud or negligence. Courts seem generally unwilling to apply these penalties to taxpayers in tax shelter transactions involving professional opinions even where the opinion is highly qualified. Moreover, the negligence penalty is only 5 percent—hardly a deterrent and not enough to result in any real risk of loss.

I believe that if our self assessing system is to continue to work it should provide a significant financial penalty for substantial deficiencies. Such a penalty might apply to all substantial deficiencies or be limited to those resulting from tax motivated investments.

Work would have to be done to determine the appropriate type and level of deficiency to which such penalty would attach and the amount of penalty so as to leave out routine errors on returns and generally the returns of average taxpayers.

A strengthened penalty structure would deal directly with the root of the abusive tax shelter problem. The taxpayer would have the burden of evaluating the real risk that the claimed tax benefit might be disallowed with the attendant penalty. I am convinced that the opinions of professionals would become much more precise in appraising the tax shelters and that taxpayers would be more inclined to read these opinions. The opinions would be given more carefully because of the risk of claims by taxpayers who relied on them and were penalized when the opinions proved to be wrong.

A more rational penalty structure would be one that discouraged taxpayers from playing the audit lottery by requiring both taxpayers and their advisers to address the probable allowability of tax benefits, rather than simply whether the position taken will attract a negligence or fraud penalty. Achieving this goal would do much to assure that high income taxpayers meet their fair share of the tax burden and consequently would do much to increase the confidence of the average taxpayer in the fairness of the system.

Senator DOLE. Mr. Portnoy, Mr. Mennel, Mr. Maduff, and Mr. Delaney.

PANEL OF: ROBERT PORTNOY, GENERAL COUNSEL, PUBLIC SECURITIES ASSOCIATION, NEW YORK; DONALD M. MENNEL, CHAIRMAN, COMMITTEE ON AGRICULTURE, MILLER'S NATIONAL FEDERATION; MICHAEL L. MADUFF, MADUFF & SONS, INC., CHICAGO, ILL.; AND EDWARD N. DELANEY, BOGAN & FREELAND, WASHINGTON, D.C.

Mr. PORTNOY. Mr. Chairman and members of the committee, my name is Robert Portnoy. I am general counsel of the Public Securities Association.

I am accompanied by John C. Bates of the law firm of Squires, Sanders & Dempsey.

PSA represents about 300 investment banking firms and commercial banks which participate in the market of the U.S. Government and municipal securities.

And 33 of the 34 primary dealers in Government securities, as recognized by the Federal Reserve, are members of PSA.

As you know, there have been bills introduced in both the House and Senate aimed at curtailing the use of commodity tax straddles.

There have also been a number of less formal conceptual proposals circulated for discussion.

My comments will address the most significant provisions of these proposals as they may affect the Government securities market.

These proposals share the common objective of restricting risk-free commodity tax straddles designed to defer ordinary income or convert it into long-term capital gain.

However, we are concerned that they may be overly broad, thereby impairing the market making activities of Government securities dealers and adversely affecting market liquidity.

We are particularly concerned because the legislative proposals to date have approached the straddle problem by broadly defining balanced or offsetting positions in personal property to include all debt securities.

PSA wishes to submit five recommendations for your consideration which we believe will serve to properly target any legislation in this area.

Let me outline them for you.

We recommend that a specific exemption from any offsetting position, mark to market or cash and carry rules for all transactions involving ordinary income inventory of merchants, including dealers in securities.

We recommend that bona fide risk minimizing, hedging techniques be recognized as an important tool used to both minimize risk and to maintain liquidity in the Government securities markets.

We recommend that ordinary income treatment be provided for both Treasury bills and Treasury bill futures contracts.

We recommend that all transactions involving the ordinary income inventory of dealers in securities be specifically exempted from any required capitalization of interest and carrying charges.

Last, we recommend that at least a 1-week period be given to securities dealers who identify and segregate assets under the so-called 30-day lookback provision of the tax code.

Securities dealers are merchants in securities and are regularly engaged in the purchase of securities for resale for customers. These transactions are profit oriented and the dealer realizes ordinary income or loss for Federal tax purposes.

In performing their market making and distribution functions securities dealers maintain inventories of Government securities just as a grain merchant maintains inventories of his product.

The legislative proposals now being considered, however, would require that all taxpayers, including securities dealers and other merchants defer any losses on such inventory if positions held were deemed to be offsetting.

These restrictions could produce great uncertainty and substantially reduce the liquidity and efficiency of the Government securities markets.

A specific exemption from any offsetting position, mark to market or cash and carry rules is necessary so that all transactions involving the ordinary income inventory of merchants, including dealers in securities will be fully insulated from the application of any antistraddle legislation which Congress may adopt.

Without this exemption, the antistraddle limitations could be applied to taxpayers where the intent is clearly not to defer or reduce taxes, but instead to provide greater liquidity or hedge risks in the regular course of business.

This exemption is required by all types of merchants, including farmers, grain merchants and securities dealers.

As already mentioned, the accounting firm of Coopers & Lybrand has recently completed a study which measures the potential impact of the commodity tax straddle legislation on both the operations of dealers in Government securities and on the Government securities market.

This study includes projections as to the potential increased borrowing costs for the Treasury should the offsetting position and balance period restrictions be applied to the ordinary income inventory of dealers in securities.

The study estimates that these costs could eventually approach $3 billion.

I draw the study to the committee's attention, and if it has not already been introduced, would like to submit the study for the record.

Senator DOLE. It will be made a part of the record.

Mr. PORTNOY. Thank you.

PSA submits that significant problems for the securities industry would result if, as proposed, the treatment of Treasury bills is conformed to the present capital asset treatment for Treasury bill futures contracts.

PSA believes this undesirable result could be avoided if ordinary income treatment were provided for both Treasury bills and Treasury bill futures contracts.

Thank you.

Mr. MENNEL. I am Donald M. Mennel, chairman of the board of the Mennel Milling Co., a soft wheat flour milling firm.

I have been a member of the Chicago Board of Trade for 21 years, personally, and our company for 57 years.

I am appearing before you today as chairman of the Committee on Agriculture of the Millers' National Federation.

We are the national trade association of the wheat and rye flour milling industry. The Federation represents over 75 percent of the commercial domestic flour milling capacity in the Nation.

Its members own and operate mills in 36 States and Puerto Rico.

The Committee on Agriculture is the Federation's chief policy and legislative committee.

First, let me briefly describe how a flour miller fits into the marketing system and how he utilizes futures market.

The miller is a processor, an essential middle man's middle man. He buys the wheat from the farmer, country elevator or grain terminal, either directly or through some type of merchant.

The grain seller is seeking a price as high as possible. "Sell on the bulge," is the common saying. The miller sells his wheat in the form of flour, often on long-term, firm-priced contracts. "Buy on the dip," the baker says.

These two events, the sale of flour and the purchase of wheat rarely, if ever, occur at the same time.

Hence, flour millers seek to protect themselves against price fluctuations which might provide unacceptable risk.

Flour millers are the classic example of hedgers. Millers utilize commodity markets extensively. They hedge cash wheat purchases by the sale of wheat futures.

They hedge flour bookings through the purchase of wheat futures.

As flour millers, we are asked very often to purchase cash wheat for delivery far in the future.

For example, the first quarter of this calendar year, we as a company were asked by several good suppliers to buy Soft Red Winter wheat for delivery in January 1982, at a firm price.

Without speculators in the futures market willing to purchase the March 1982 wheat futures, we could not have hedged successfully and could not have come up with a reasonable price.

As it was, we were able to buy the wheat and sell the far off future with very little risk to us.

Similarly, we have flour buyers looking at the current price level, much below last year at this time, who are asking us daily for quotes at firm prices for shipments far into the future.

In some cases, this means as far as July or August 1982.

Again, without speculators in the market to take the opposite sides of our hedges, it would be impossible to quote, let alone contract for such delivery.

More often than not, the speculator who is willing to accept the transfer of risk from the miller is the spreader. The spreader and hedger comprise most of the open interest in distant month futures.

The ability to transfer risk to such spreaders makes it possible for the miller to assure himself of a reasonable return, keeping milling margins low and offer a competitively priced product to the public.

Quite simply, the presence of speculators in the market benefits all of us, consumers and producers.

The necessity to hedge makes it essential that millers be afforded the utmost flexibility in placing a hedge.

This requires that the liquidity of the futures market be preserved to the maximum extent possible.

Toward that end, the Federation was involved in 1976 and 1977, with the CFTC, in development of the definition of a bona fide hedge and in the related issue of the right to cross-commodity hedge.

Three aspects of S. 626 concern us. Let me assure you at the outset that, to the best of my knowledge, based upon a recent survey of our industry, not a single flour miller has ever attempted to use the tax-deferring straddle.

It is our customary accounting procedure to bring all open trades to market at the end of each period.

Our initial concern, therefore, is that in section 1092, the definition of offsetting position includes millers' traditional hedging patterns which I have described.

The balanced period concerns us. We really don't know how we could do it. Under the proposed definition we are far from certain how a processor could roll a hedge forward.

Section 208 certainly leaves things very fuzzy for us as far as capitalization of interest and storage charges go. If we had to do this it would increase our cost enormously.

These are the major questions. There are some minor ones. We do appreciate very much that we were able to come here and present our position and we hope the committee will move with due deliberation in the passing of any bill on this subject.

Thank you.

Mr. MADUFF. Mr. Chairman, members of the committee, my name is Michael Maduff. I am a commodity trader. I am a member of practically every commodity exchange in the United States.

For the past 15 years, I have been the chief executive officer of Maduff & Sons, commodity brokerage firm in Chicago.

I grew up in the commodity business. My father was in business before me.

I have been involved in practically every aspect of commodity trading. I have been a floor trader. I am a broker. I operate a farm. I am a merchandiser of pork bellies. I am a gold arbitragure. I am even a mortgage banker, using the futures markets as a hedge.

I am here today strictly in my own behalf. I speak for no one but myself. I am not a representative of any exchange to which I am a member or of any trade association.

I concur with a lot of the negative comments that have been made about the mark to market scheme. I think it is a very bad scheme. I think it is a radical departure from our system of taxation. I think that even the proponents of that scheme, such as Mr. Schapiro, recognize that it is onerous to the industry and that is why they insist it involve a very low rate of taxation.

I must say that if the committee or the Congress were to pass a bill which incorporated mark to market at a very favorable tax rate, I would be delighted to conduct my business under such a bill, under such a law, but that would not make it right.

I think that the problem can be dealt with. I think that it can be dealt with effectively with a bill such as Senator Moynihan has presented.

The major thing however, is that we have to identify and define what constitutes a balanced transaction. I believe it can be identified. I believe it can be defined. I believe it can be done in a manner that is easy to do, that can be understood by every taxpayer, by every broker, by every trader, and by every Internal Revenue Service agent.

I really don't think the problem is as complicated as the lawyers and accountants would have us all think.

Thank you.

Senator DOLE. You told us everything but how to do that.

Mr. MADUFF. From Mr. Chapoton who started this morning off right through, he has described how the tax straddle works. It works with two simultaneous transactions, and I would emphasize the word most strongly, "simultaneous." The instant you remove the simultaneous nature of those two transactions you insert into the system of straddles a tremendous economic cost which makes it totally unworkable and nobody will follow it.

It is very possible for us, as a matter of fact, sir, we currently keep track of simultaneous transactions on our computers, because simultaneous transactions are given a special commission rate.

We can identify every single simultaneous transaction that is done as a broker.

We can be required to do so. It is easy for the IRS to audit. It is easy for the taxpayer to know what is going on.

When you have a simultaneous transaction, that transaction ought to be given the kind of treatment that Senator Moynihan's bill envisions.

But when you have nonsimultaneous transactions, transactions on different exchanges at different times, in different commodities, those transactions have of their nature such a tremendous economic risk and such a tremendous economic cost that they will not be used as a tax straddle, as a tax deferral or tax avoidance device.

Furthermore, for the system to work now, Senator, you must execute your two simultaneous transactions in a very distant commodity month, something at least into next year, 2 months into next year.

While there is a great deal of liquidity in our market, if you eliminate the simultaneous trade, the simultaneous spread trade, you will find what we call a substantial bid offer spread. There is a difference between the price at which you will buy and the price at which you will sell.

Those distant contract months are thin. If I wish to say buy March silver and sell May silver, other than as a simultaneous transaction, I am going to get hit with a tremendous spread and it is going to cost me a great deal of money, far more than the tax savings would ever be worth.

Mr. DELANEY. My name is Edward N. Delaney, I am an attorney at law, practicing in Washington, D.C. I appear today on behalf of COMARK.

COMARK is a California organization which is a dealer and market maker in commodities, commodity options and in U.S. Government securities.

I think you have already heard extensively today about the importance of these markets and the industry.

I think you also heard substantial testimony about the adverse impact and the consequences on the markets if you enact legislation rashly or that is really not well thought out.

It hurts me to say this, since I worked with Senator Moynihan on a number of other very important matters, but S. 626 should not be enacted into law. It is just much too complicated. It presents a series of problems or raises a series of problems as I think you will find, which have very serious consequences to not only the Government but people participating in basic industries of the country.

I might also point out that the position of the Internal Revenue Service with respect to straddles and commodity straddles particularly, has been questioned by one of its former agents, a person who allegedly was the agent responsible for setting up a number of these issues and developing the audit guidelines.

He has published an article. I have attached a copy of it to my testimony. I hope you will read it.

We present some 11 substantive and technical changes we recommend be a part of any legislation that this committee recommends.

Let me say I am pleased to hear consideration of the fact that this is not necessarily an abuse.

Unfortunately, many of these issues get tagged as abuses, and that sets a mind frame on solutions that are recommended.

Straddles are a proper use of existing law. If the Congress doesn't like the results of the law, fine. Let's change it. But let's not change it from the point of view of it being an abuse.

There are many taxpayers investing in real estate and other investments who have very substantial sums of income, and do not pay taxes.

If that is an abuse, then maybe you should legislate there.

All I want to do is to suggest to you that you consider this from the point of view, if you do not like the results that exist under current law, let's change those in a way that does not harm the industry or the country as a whole.

One of the more important of the substantive changes that we urge for your consideration is a redefinition of a balanced or offsetting position. You will find that on page 6 of my testimony. It is an attempt to design a reasonable provision and one that is administrable.

I believe we have taken a substantial step forward over existing proposals.

It may well be appropriate to limit the type of income against which losses arising out of commodity transactions can be used as an offset. That's fine. We want to focus on it specifically.

We have made suggestions relative to the definition of "qualified gains" against which such losses could be offset and suggestions for a carry forward and a carry back to help average out fluctuating gains and losses.

On the question of Treasury bills being defined as capital assets, we submit that will cause not only the problems noted in the Coopers & Lybrand study, but terrible administrative difficulties.

That conclusion is supported by the legislative history of the provision of current law that does not treat such items as capital assets.

The problems in this area result from the Internal Revenue Service issuing a ruling treating futures contract as a capital asset.

We urge that you repeal that ruling, drop the provision, set it aside so that the futures contracts and the bills will both be treated as ordinary income producing items.

We strongly urge that there be exemptions for hedgers. Also, we believe you have created an inconsistency in the 30-day extended balanced period. It is inconsistent with existing wash sale provisions. We recommend a change in that.

We have a series of other proposals that you should consider.

Senator SYMMS. Thank you all very much.

Senator Moynihan.

Senator MOYNIHAN. Thank you, Mr. Chairman.

I would certainly like to thank Mr. Delaney for putting in his testimony the statement I made when I introduced that. I still regard the measure as a discussion draft and invite anyone who wishes to comment on it. Hopefully we will get a consensus.

I simply make the point that if I hadn't introduced this bill, I don't think we would have this hearing, would we?

I have no further comments. I wish to thank Mr. Maduff for a very eloquent and personal affirmation of his determination to live dangerously. It does show a certain assent to a condition of greater security.

You start out in the pork belly pit and then you make your way into gold and finally you end up a mortgage banker. My understanding is that mortgage bankers live very serene lives.

I would like to say, if I may, to Mr. Mennel, that all the legislation being contemplated specifically exempts persons who are hedging against inventory.

Mr. MENNEL. We appreciate that very much.

Senator MOYNIHAN. If it did, that would solve the miller's problem, would it not?

This legislation wouldn't affect him.

Mr. MENNEL. Correct. Unless it reduced the liquidity of the market a great deal.

Senator MOYNIHAN. Yes.

That we don't want to do. Thank you all.

Thank you, Mr. Chairman.

Senator SYMMS. Mike, I think you made an excellent point. You say that to your knowledge, without precedent in our economic system, where transactions have never been taxed until they are completed. If this concept is carried to a logical extreme, every home owner would have to revalue his home at the end of the year and pay taxes on the appreciation.

I hate to have that suggested here. If the IRS is around they may suggest that next year.

I think that is a significant point. It does make the mark to market very difficult.

Mr. MADUFF. Senator, if I may share one thing with you. This morning coming over here in a cab, I was talking with the cab driver. In 1946, this gentleman purchased as his home a 35 acre farm 38 miles north of here. He paid $45 an acre for that farmland, 38 miles from here.

Today, he has placed that farm land in a trust for his grandchildren because it is probably worth $1 million.

Of course, there has been no tax on it. There will be tax on it in his lifetime. I imagine there will be a step up in basis and it will pass to his grandchildren through this trust.

So, it is a radical departure for us to say this one industry we will tax on a balance sheet basis, while the rest of the economy is taxed on an income statement basis.

If we were to expand it I think our whole economic system would fall apart.

Senator SYMMS. Well I guess if he gets that placed in a trust before he dies, he won't get it taxed.

Mr. MADUFF. He already has it there.

Senator SYMMS. You are correct in that. If—under our present death tax laws, he would probably get nailed pretty hard on that.

The other question I wanted to ask you on the simultaneous trade. You are saying you could—you would accept some kind of a change in this on simultaneous trades. I did understand you correctly?

Mr. MADUFF. Absolutely, sir.

Senator SYMMS. Is it possible to make a simultaneous trade unless you do it at the close of business of the day?

Mr. MADUFF. No, simultaneous trades are made at—throughout the day.

Senator SYMMS. By placing an order on a spread on how far apart they are so they come off together?

Mr. MADUFF. Exactly. It is handled on a single piece of paper. The broker is instructed to make the trade at a specific differential between the two contract months.

I think what you are referring to is a provision at the COMEX where there is a spread session or has been a spread session after the close of trading specifically for those transactions.

But, those transactions take place on all exchanges throughout the business day. They are easily identifiable.

Senator SYMMS. Is that a different position than what your presidents of your respective exchanges testified to?

Mr. MADUFF. Yes, sir. I stand alone.

Senator SYMMS. How many of your colleagues that are on the floor would agree with you?

Mr. MADUFF. To be quite honest, Senator, I haven't taken a survey. I think, I truly think if my colleagues were to take the time and recognize that there is a need for us to pay taxes once a year, instead of once a year at the very most, we would—they would probably agree with me.

This is the type of transaction, this straddle transaction, this simultaneous spread transaction, this is the transaction that is causing us all the trouble.

I don't like being in this position of disrepute. It has brought our industry into disrepute and I think there is no need for it.

We can identify that transaction and get at the culprit and go on about our business.

Senator SYMMS. If all simultaneous trades, you would say would be considered for tax purposes?

Mr. MADUFF. All simultaneous trades I believe would be considered for tax purposes to be a single trade and consequently, if you use the simultaneous trade, you couldn't recognize a loss on one side of it without simultaneously recognizing the profit on the other.

Whether it is a matter of deferring the loss until the profit is closed out or using the loss as an adjustment in the basis of the profit leg of the spread, that is of no major consequence.

Senator SYMMS. So what you are saying is if the guy is in there on the floor and he is buying beans and he is buying beans and he keeps buying more and the price keeps going up, and then all of a sudden he starts getting scared, a few days later, but he is still basically a bull, he starts selling some on another month because he is not quite so sure for a few days, then that would be different?

Mr. MADUFF. Yes.

Senator SYMMS. He would be a legitimate hedger, but he is just scared, for whatever reason, decides to change his position, so he starts selling March against May or whatever it happened to be.

Mr. MADUFF. Yes, that would be legitimate Senator, but I want to point out one thing. The trader on the floor who is buying margin and then turns around and sells May, for him to do that efficiently, even there, he has to do it in a nearby month, something in 1981, which will serve him no purpose for taxes.

If he does it in a 1982 contract, as we sit here today, he is going to take a bath in terms of the economic difference because when he goes to sell that May 1982 contract, he is going to sell it at a much lower price, simply because of the lack of liquidity in that distant contract.

Senator SYMMS. Yes, I see what you mean. What I mean is, you are—you want to differentiate between simultaneous trades and other trades.

I mean there are other reasons. What I am getting at is that somebody may be a bull in silver and think the price is going up, so he is long. Then, he gets panicked because Congress talks about selling the stockpile or somebody else is or whatever is the case.

So, he starts selling another month. You say if he loses or gains that is legitimate hedging. He is just hedging his position, he gets his nerve back up to lift the shorts and be long again.

Mr. MADUFF. Precisely.

Senator SYMMS. If he makes a simultaneous trade, what you are recommending is the simultaneous trade be considered one transaction?

Mr. MADUFF. Yes, sir. That's truly a balanced position. Simultaneous trade. That is the problem I think this committee is trying to address right now.

Senator SYMMS. Any other questions?

Senator MOYNIHAN. Is it not so there is a difference between the position of a homeowner at the end of the day when his house may have appreciated and then the owner of a futures contract, because

the futures contract would be paid cash at the end and can take that gain right then and there. Cash is available to him.

Mr. MADUFF. Senator, there is certainly a distinction, but I think that it is sometimes misunderstood. My father has always said that when we collect on that variation margin at the end of the day, and we still have the position open, we are only temporary custodians of that money, because the market can and frequently does take it away from us tomorrow morning.

I think this is one of the major flaws of the mark to market approach. Another element that the mark to market approach totally just ignores is the fact that I still have as an investment that original margin deposit. I have never gotten that back. That is there.

Mr. Schapiro would say, well at the end of the hand, or end of the day you finished the game and you can pick up your money and walk away. But you can't pick up your money and walk away in the middle of the hand, while the money is sitting on the table.

That's what we are talking about. We are talking about an open transaction. It is not that easy to simply say, well you can sell it out. You can't. You are in there. You are locked into it. You have a firm, unlimited commitment to ante up if that market goes against you tomorrow morning.

Senator SYMMS. Thank you.

[The statements of the preceding panel follow:]

OUTLINE OF TESTIMONY OF ROBERT A. PORTNOY, PUBLIC SECURITIES ASSOCIATION

I. INTRODUCTION

A. Description of PSA.

B. Summary of PSA position.

While PSA sympathizes with the objective of restricting risk-free commodity tax straddles designed to defer ordinary income or convert it to long-term capital gain, we are concerned that remedial legislation may be overly broad, thereby impairing the market-making activities of government securities dealers and adversely affecting market liquidity.

II. COMMENTS AND RECOMMENDATIONS

A. The Government Securities Market.

(1) One of the most vital qualities of government securities for investors is their liquidity.

(2) The over-the-counter market maintained by government securities dealers provides this liquidity which, in turn, has enabled the Treasury and federal agencies to finance significant amounts of debt in recent years.

(3) Government securities dealers perform both market-making and new issue distribution functions.

(4) With the increased size and volatility of the government securities market, government securities dealers have increasingly turned to financial futures as a means of hedging their risk.

B. An Exemption for Ordinary Income Inventory is Essential.

A specific exemption from any "offsetting position," "mark-to-market" or "cash and carry" rules is necessary so that all transactions involving the "ordinary income" inventory of merchants, including dealers in securities, will be fully insulated from possible application of any anti-straddle legislation which Congress may adopt. PSA is particularly concerned that the government securities dealers' vital market-making and distribution functions would be substantially impaired without such specific exemption.

C. Bona Fide Hedging Techniques Should be Recognized.

Hedging is an important tool used to both minimize risk and to maintain liquidity in the government securities markets. Instead of acknowledging the importance of these legitimate hedging techniques to the efficient functioning of the government securities markets, the legislative proposals have equated risk minimization with

risk-elimination assuming that such transactions were intended solely as a means of tax avoidance.

D. Treatment of Treasury Bill and Futures.

PSA submits that significant problems for the securities industry would result if, as proposed, the treatement of Treasury bills is conformed to the present capital asset treatment of Treasury bill futures contracts.

E. Capitalization of Interest and Carrying Charges.

PSA believes that transactions involving the ordinary income inventory of securities dealers should be exempt from any cash or carry restrictions which may be adopted.

F. Identification and Segregation of Assets Held for Investment by Securities Dealers.

PSA believes that standard industry settlement and administrative procedures require that at least one week period be given to dealers in order to identify and segregate assets.

Statement of Robert A. Portnoy, General Counsel of Public Securities Association

Mr. Chairman and members of the Committee, the Public Securities Association is pleased to present its views on legislative proposals to limit commodity tax straddles. PSA represents about 300 investment banking firms and commercial banks which underwrite, trade and sell securities issued by the U.S. government and federal agencies and state and local governments. PSA members provide primary market distribution of government securities and secondary market liquidity for investors in these securities.

Thirty-three of the 34 "primary" dealers in government securities, as recognized by the Federal Reserve, are members of PSA. These dealers and dealer banks are the mainstays of the market through which the Treasury finances the federal debt and the Federal Reserve implements monetary policy.

While PSA sympathizes with the objective of restricting risk-free commodity tax straddles designed to defer ordinary income or convert it to long-term capital gain, we are concerned that remedial legislation may be overly broad, thereby impairing the market-making activities of government securities dealers and adversely affecting market liquidity. We are concerned because the legislative proposals to date have approached the straddle problem by broadly defining "balanced" or "offsetting" positions in personal property to include transactions in evidences of indebtedness, including U.S. Treasury securities. By decreasing market liquidity, making hedging more difficult, and denying the ability to fully deduct losses, these overly broad legislative proposals could significantly increase the cost of borrowing to finance the National Debt. It has been estimated that on an annualized basis, each one-quarter percent increase in the effective rate of a six-month Treasury bill means an increase of $240 million in the cost of funding the National Debt. Therefore, we strongly suggest that the Committee carefully target any legislation to eliminate real abuses without affecting bonafide transactions which are not motivated by tax avoidance.

THE GOVERNMENT SECURITIES MARKET

One of the most vital qualities of government securities for investors is their liquidity—the ability to transform them into cash quickly and at low cost. The over-the-counter market maintained by government securities dealers provides the basis for this liquidity which, in turn, has enabled the Treasury and federal agencies to finance significant amounts of debt in recent years.

In performing this market-making function, dealers in government securities arrange transactions with both their customers and other dealers, purchase debt directly from the Treasury for resale to investors and buy and sell securities for their own account. In the normal course of these activities, they typcially maintain a large inventory of government securities and substantial positions in both the cash and financial futures market.

The size and daily volume of transactions in this market are enormous. In recent years, the amount of debt issued by the federal government has grown substantially. In 1981 it is expected that the Treasury's net new borrowings in marketable bills and coupon securities will total over $70 billion. This will be added to the more than $612 billion of priviately-held Treasury debt outstanding at the end of 1980.

As I indicated, a vital element of this vast market is the liquidity provided by securities dealers. In the first 3½ months of this year, the daily average volume of transactions in Treasury securities by the 34 dealers that report to the Federal

Reserve exceeded $23 billion. This figure compares with daily average transactions by reporting dealers in 1974 of $3.6 billion, an increase of more than 600 percent.

As this market has grown in size and volume of transactions, it has become more volatile, particularly in the 18-month period since October 1979. During 1980, interest rates on newly-issued three-month Treasury bills fluctuated from a low of 6.4 percent to a high of more than 16.7 percent. Dollar price swings of six points in one day in the once-staid Treasury bond market have not been uncommon during this period.

Because of the risk inherent in this market environment, securities dealers have increasingly turned to financial futures as a means of hedging their risk. Without financial futures it is doubtful whether government securities dealers would be able to perform their new-issue distribution and market-making functions without risking substantial losses, which could well prove unacceptable to them.

In general, we would like to caution the Committee against taking an approach which equates risk-minimizing transactions which are essential tools for government securities dealers and other businessmen in today's market environment with transactions which are substantially "risk-free." We also urge the Committee to adopt a legislative approach which would not affect adversely the efficient functioning of the market for government securities.

Hedging has existed for many, many years but the establishment of viable futures markets in the late seventies has caused the use of hedging to grow considerably. The volatility of interest rates has further stimulated the development of hedging techniques. Currently, participants in the government securities market, as a matter of sound financial management, will frequently take significant positions in a wide variety of instruments, in a broad range of maturities, which reduce the market risk in the positions in which they are primarily interested. Therefore, PSA believes that any legislation should clearly distinguish legitimate risk-minimizing hedging techniques from the risk-free straddle intended solely as a tax avoidance transaction.

AN EXEMPTION FOR ORDINARY INCOME INVENTORY IS ESSENTIAL

Securities dealers are merchants in securities and are regularly engaged in the purchase of securities for resale to customers. These transactions are profit oriented, and the dealer realizes ordinary income (or loss) for federal tax purposes. In performing their market-making and new issue distribution functions, securities dealers maintain inventories of government securities, just as a grain merchant maintains inventories of his product.

The legislative proposals now being considered, however, would require that all taxpayers, including securities dealers and other merchants defer any losses on such inventory if positions held were deemed to be offsetting. It is likely that such a restriction would produce great uncertainty and substantiallly reduce the liquidity and efficiency of the government securities markets.

A specific exemption from any "offsetting position," "mark-to-market" or "cash and carry" rules is necessary so that all transactions involving the "ordinary income" inventory of merchants, including dealers in securities, will be fully insulated from the application of any antistraddle legislation which Congress may adopt. Without a specific exemption, it may be asserted that offsetting positions exist, and related limitations should apply, in cases where the intent clearly is not to defer or reduce taxes but, instead, to provide greater liquidity or hedge risks in the regular course of business. This exemption is required by all types of merchants, including farmers, grain merchants and securities dealers.

The broader the notion of offsetting positions in "personal property" included in any legislation, the greater the need for a specific exemption for all transactions related to ordinary income inventory. PSA is particularly concerned that the government securities dealers' vital market-making and distribution functions would be substantially impaired without such specific exemption.

BONA FIDE HEDGING TECHNIQUES SHOULD BE RECOGNIZED

Once dealers' inventory functions have been insulated, we believe that Congress should define "offsetting positions" in some way that does not require comparing standard deviation of price changes, margin requirements and possible reduction in risks associated with two securities or other properties.

The tests suggested in the legislative proposals are likely to prove quite unworkable in practice. In addition, they would present substantial problems in terms of both compliance and administration.

The definition of offsetting positions fails to recognize or in any way account for the legitimate use of hedging transactions. Hedging is an important tool used to

both minimize risk and to maintain liquidity in the government securities markets. Instead of acknowledging the importance of these legitimate hedging techniques to the efficient functioning of the government securities markets, the legislative proposals have equated risk minimization with risk-elimination assuming that such transactions were intended solely as a means of tax avoidance.

Therefore, we believe that the definition of offsetting positions should be more narrowly drafted in order to target the legislation to eliminate real abuses without affecting bona fide hedging transactions.

TREATMENT OF TREASURY BILLS AND FUTURES

PSA sympathizes with the concern expressed in the straddle bills about combining the use of Treasury bills and Treasury bill futures to defer ordinary income and convert it into capital gain. PSA submits, however, that significant problems for the securities industry would result if, as proposed, the treatment of the underlying asset is conformed to the present capital asset treatment for Treasury bill futures provided under a 1978 I.R.S. ruling. In addition, subjecting a loss on Treasury bill transactions to the $3,000 limitation on deductibility of capital losses could provide a disincentive to the purchase of the bills.

In 1941 Congress decided that to avoid computational and recordkeeping problems, Treasury bills should not be classified as capital assets. When the 1954 Code was enacted, this position was maintained. Congress was concerned in 1941 that, since original discount on a Treasury bill accrued over the life of the bill, each successive holder of a particular bill would have to know the exact amount of original discount in order to determine what portion of proceeds from sale of the bill was accrued discount, or interest, and what portion resulted in capital gain or loss. If the difficulties in applying the original issue discount rules to Treasury bills were significant in 1941, they are far greater today in view of the increased size of the market and volume of transactions. Furthermore, even if the recordkeeping requirements for original issue discount could be implemented today, the cost of doing so would likely be very high.

The proposed treatment of Treasury bills as capital assets could fundamentally alter the way in which Treasury bills are now traded. Today, 13 week, 26 week and 52 week Treasury bills—regardless of when issued—are all traded with reference to the period remaining to maturity. This provides important liquidity to the bill market because, when bills in these categories have the same periods to maturity, they trade as essentially fungible obligations. If Treasury bills are treated as capital assets, however, under the proposals the original issue discount provisions would apply to each. As a result of the differences in original issue discount for the various bills, there will be corresponding differences in the amount of ordinary income or capital gain or loss which particular Treasury bills will produce when sold. This, in turn, means that bills which today are traded as essentially fungible obligations could no longer be traded in that manner. The result clearly would be a reduction in the liquidity of the Treasury bill market.

The decrease in the liquidity of the Treasury bill market, as well as a decrease in the ability to hedge risks in the futures market and the inability to fully deduct losses incurred may all contribute to increased risk premium in the form of greater discounts or higher interest rates on Treasury bill securities.

The revenue implications of this increased risk premium may be quite substantial. For example, in 1980 Treasury issued $21.8 billion in 6 month bills at an average interest rate of 11.38 percent. If this rate increased one-fourth percent it would imply an increase of $240 million in debt service. In addition, in 1980 Treasury issued $48.5 billion in one year Treasury bills, a one-half percent increase in interest rate on these instruments would have cost the Treasury $243 billion last year. The possible increased costs represented by these figures are very significant, yet no anlaysis has yet been presented to address this issue. PSA believes that this undesirable result could be avoided if ordinary income treatment were provided for both Treasury bills and Treasury bill futures contracts.

CAPITALIZATION OF INTEREST AND CARRYING CHARGES

PSA is also concerned that the legislative proposals dealing with capitalization of interest and carrying charges are overly broad and may thus seriously affect the ability of market participant to legitimately finance positions they take in the market. Under the proposed legislation, carrying costs and interest on indebtedness incurred on continued to purchase or carry any government security for any period during which the security is considered part of a "balanced" position would have to be capitalized and added to the basis of the security.,

Dealer firms making markets in government securities typically purchase a substantial part of their inventories with borrowed funds. More than 95 percent of the value of their holdings may be financed with borrowed money; the dealer's own capital furnishes the remainder. Thus, the cost and availability of funds is an important consideration in a dealer's willingness to hold securities.

PSA is opposed to any change in the rules for treatment of interest and carrying charges for government securities because of the potential adverse effects on dealers' market-making functions and market liquidity. We, therefore, believe that all transactions involving the ordinary income inventory of dealers in securities should be specifically exempted from any required capitalization of interest and carrying charges.

IDENTIFICATION AND SEGREGATION OF ASSETS HELD FOR INVESTMENT BY SECURITIES DEALERS

Under current law, a dealer in securities may determine whether particular securities will be held for investment or for sale to customers within 30 days following acquisition of the securities. In order to qualify for this provision, the dealer must undertake proper physical and accounting segregation of the secruities.

Legislative proposals to restrict tax straddles would eliminate this special provision for securities dealers. We recognize that elminiation of the provision has been proposed because of concern over the use of this provision by certain limted partnerships purporting to operate as secruities dealers but in fact organized to engage in tax motivate straddles. However, we believe that standard industry settlement and administrative procedures require that at least a one week period be given to dealers in order to identify and segregate assets.

In closing, PSA would welcome the opportunity to work with the Committee in developing a legislative proposal that would accomplish the objective of restricting risk-free commodity tax straddles while not impairing the market-making activities of government securities dealers or adversely affecting market liquidity.

TESTIMONY OF DONALD M. MENNEL, PRESIDENT OF MENNEL MILLING CO., FOSTORIA, OHIO

SUMMARY

1. Flour millers are the classic example of hedgers. Millers hedge their cash wheat purchases by the sale of wheat futures and also hedge their flour bookings (sales) by the purchase of wheat futures.

2. Without speculators (in particular, spreaders) in the market it would be difficult for millers to place hedges involving distant month contracts.

3. The ability to transfer risk (hedge) results in reasonable returns, low milling margins and products available to the public at competitive prices.

4. The inclusion of traditional hedging patterns in the definition of "offsetting positions in personal property" (straddles) in Section 1092 of S. 626 is unjustified. Commercial grain processors are not tax dodgers.

5. The definition of "balanced period" in Section 1092 of S. 626 would seriously limit the ability of flour millers to hedge.

6. Provision of S. 626 requiring capitalization of interest and carrying charges on physical commodities held as part of an offsetting position (hedges included, under the bill) would unfairly penalize flour millers and greatly increase their costs.

I am Donald M. Mennel, Chairman of the Board of the Mennel Milling Company, a soft wheat flour milling firm. I have been a member of the Chicago Board of Trade for 21 years, our company for 57 years.

I am appearing before you today as chairman of the Committee on Agriculture of Millers' National Federation. MNF is the national trade association of the wheat and rye flour milling industry. The Federation represents over 75 percent of the commercial domestic flour milling capacity in the nation. Its members own and operate mills in 36 states and Puerto Rico. The Committee on Agriculture is the Federation's chief policy and legislative committee.

This morning I would like to present several concerns of the U.S. flour milling industry over S. 626, the "Commodity Straddles Tax Act of 1981." These concerns of millers apply to similar measures introduced in the House of Representatives.

But first, let me briefly describe where a flour miller fits into the marketing system and how he utilizes futures markets. The miller is a processor, an essential middleman. He buys his wheat from the farmer, country elevator or grain terminal—either directly or through some type of merchant. The grain seller is seeking a price as high as possible. "Sell on the Buldge," is the common saying. The miller

sells his wheat in the form of flour, often on longterm, firm priced contracts. "Buy on the Dip," the baker says. These two events, the sale of flour and the purchase of wheat, rarely, if ever, occur at the same time. Hence, flour millers seek to protect themselves against price fluctuation which might provide unacceptable risk.

Flour millers are the classic example of hedgers. Millers utilize commodity futures markets extensively. They hedge cash wheat purchases by the sale of wheat futures. They hedge flour bookings through the purchase of wheat futures.

As flour millers we are asked very often to purchase cash wheat for delivery far in the future. For example, last January, we as a company were asked by several very good suppliers to buy soft red winter wheat for delivery in January, 1982 at a firm price. Without speculators in the futures market willing to purchase the March, 1982 wheat futures, we could not have hedged successfully and could not have come up with a reasonable price. As it was, we were able to buy the wheat and sell the far off future with very little risk to us. Similarly, we have flour buyers looking at the current price level—much below last year at this time—who are asking us daily for quotes at firm prices for shipment far into the future. In some cases this means to July or August, 1982. Again, without speculators in the market to take the opposite sides of our hedges, it would be impossible to quote, let alone contract for such delivery.

More often than not the speculator who is willing to accept the transfer of risk from the miller is a spreader. The spreader and hedger comprise most of the open interest in distant month contracts. The ability to transfer risk to such spreaders makes it possible for the miller to assure himself of a reasonable return, keeping milling margins low and offer a competitively priced product to the public. Quite simply, the presence of speculators in the market benefits all of us as consumers.

The necessity to hedge makes it essential that millers be afforded the utmost flexibility in placing a hedge. This requires that the liquidity of the futures markets be preserved to the maximum extent possible. Toward that end, the Federation was involved in 1976-77 with the Commodity Futures Trading Commission in development of the definition of a bona fide hedge and in the related issue of the right to cross-commodity hedge,

There are three aspects of S. 626 which cause flour millers concern. Let me assure you at the outset that, to the best of my knowledge—based on a recent survey of our industry-not a single flour milling company has ever attempted to use the tax deferring straddle. It is our customary accounting procedure to bring all open trades to market at each period end. Our initial concern, therefore, is that in Sec. 1092 the definition of "offsetting positions in personal property" (or straddle) includes the miller's traditional hedging patterns which I have described. We believe that the inclusion of commercial hedging in that definition, whether unintentional, or simply ill-advised, is unjustified.

A second concern also is found in Section 1092 of the Senate bill. The definition of "balanced period" causes millers great concern, since, under the proposed definition, we are far from certain how a processor could "roll a hedge forward." For example, we do not believe the Congress would wish to mandate that flour millers and other processors not be able to protect themselves from losses when lifting one side of a hedge late in a tax year and not be able to recognize that loss in that tax year.

Third, proposed Section 208E leaves it less than clear that the provisions for capitalization, storage and interest charges do not apply to hedgers. How could a processor, under this bill, deduct carrying costs and interest on cash commodity held as part of an off setting position? Such a prohibition would result in patently discriminatory tax treatment of commercial hedgers.

Statement of the American Feed Manufacturers Association

The American Feed Manufacturers Association (AFMA) is the national trade association representing livestock and poultry feed manufacturers. The members of AFMA are large and small companies and cooperatives who manufacture complete feeds and feed concentrates for livestock and poultry. Feed manufacturing uses substantial [1] quantities of grains and oilseeds.

As extensive users of commodities, feed manufacturers use commodity futures markets to hedge inventories and requirements for feed ingredients and to hedge commitments to supply feed. Such hedging is a basic, fundamental, meritorious use of the futures markets which limits the risk of commodity price fluctuation to the benefits of farmers, feed manufacturers, and consumers. These uses in no way

[1] This week the Washington Post estimated that livestock and poultry feed use 55 percent of nation's total corn crop. The Washington Post, June 8, 1981, p. A6.

constitute tax avoidance and AFMA unequivocally opposes tax abuse or the avoidance of legitimate tax obligations.

AFMA is concerned about three aspects of S. 626. While it may be unintended, hedging is clearly and literally encompassed within the definition of "offsetting positions in personal property" and would thus become subject to special and burdensome tax rules. Second, the legislation would require that interest and storage charges on physical inventory held as part of an "offsetting position" be capitalized rather than treated as current expenses. Read literally, this means that the interest and carrying charges on a feed manufacturers's hedged inventories could not be treated as current expenses. Third, legitimate spreads and straddles provide liquidity to the futures markets which make those markets workable for hedgers. To the extent that the proposed legislation extends beyond the limitation of clearly defined abusive practices, the legislation could have a chilling effect on legitimate spreads and straddles which in turn could impair the liquidity of futures markets and thereby impair the workability of the markets of hedgers.

HEDGING

S. 626 would restrict the recognition of losses on futures contracts purchased as a hedge to offset grain requirements or inventories. A feed manufacturer with a contract to deliver a certain amount of feed may hedge that contract with futures, lifting the futures contract as he purchases cash grain to fulfill the contractual obligation. Or a feed manfacturer may purchase an inventory of cash grain and sell futures contracts to lock in his margin. When the hedge is lifted, the feed manfacturer may still have some of the hedged inventory on hand or may be purchasing new inventory for current business. Under this various circumstances, the literal provisions of S. 626 appear to prohibit the feed manufacturer from immediately recognizing a loss on the hedge as a cost of doing business.

While AFMA understands that the sponsors of this legislation do not intend that it should extend to hedges, AFMA wishes to emphasize the importance of hedging for the benefit of farmers, processors, and consumers and urge that hedging be clearly outside the scope of the legislation, not the subject of a narrow exemption capable of later restrictive interpretation by the Internal Revenue Service. Feed manufacturers should not be required to provide documentation to support each hedging transaction as if it were a deduction for a three-martini lunch.

CAPITALIZATION OF CARRYING CHARGES

The provisions of S. 626 requiring the capitalization of carrying charges, if read literally, would prohibit a feed manufacturer from treating the interest and storage charges on hedged inventory as expenses, but rather require those charges be capitalized. The explanation of this provision provided in the March 5, 1981 Congressional Record suggests that it is directed to a rather specialized situation involving "cash and carry" transactions, whereby it is possible to treat a gain on certain sales of physical silver as long term capital gain, offset by a current deduction for interest, storage and insurance. The Internal Revenue Service explanation states: " * * * The short sales rules of Section 1233 may not technically apply (the spot silver and the July, 1981 futures are not 'substantially identical'), so that the gain on the sale of the physical silver is reported as a long term capital gain. (Emphasis supplied). Cong. Rec. March 5, 1981, S. 1843."

In the IRS example taxpayer purchased and held $100,000 worth of silver together with an offsetting silver futures contract for 12 months to obtain a tax advantage worth a maximum of $4,872 [($11,600 times 70 percent = (11,600 times 28 percent)]. This is a very considerable commitment of capital for a relatively modest gain. The fact that "short sale rates of Section 1233 may not technically apply" may call for reconsideration of those rules, but does not call for the sweeping language of the proposed Section 280E.

The IRS example involves an interest deduction of $12,000. An individual taxpayer is already limited to deducting no more then $5,000 (10,000 on a joint return) plus net investment income as interest on investments. [IRC § 163(d)]. A trust's investment interest deduction is limited to net investment income. It is unclear why the example provided is not or cannot be adequately controlled by the existing restrictions of Sections 163(d) and 1233.

Feed manufacturers incur substantial charges for interest and storage relating to commodity inventories. Those inventories will very often be hedged by futures contracts. Income in respect to inventories is taxed as ordinary income, *Corn Products Refining Co.* v. *Commissioner of Internal Revenue,* 350 U.S. 46 (1955). The carrying charges on these inventories should not be capitalized.

MARKET LIQUIDITY

Legitimate spread and straddle transactions are important to commodity futures market liquidity. Market liquidity is necessary if commodity futures are to be a useful hedging tool. A thin market with little trading is not an attractive market for hedgers or speculators. An example would be the Chicago Mercantile Exchange's creation of a market in turkey futures which became inactive after only a few weeks of trading because of lack of sufficient trading and liquidity.

Speculators who take spread positions into far forward months offset and complement the trading of commodity producers and users who wish to hedge over longer periods of time. The market which are maintained by these hedgers and speculators are useful to the participants and provide signals regarding likely shortages or surpluses. These signals help farmers to expand or curtain production before shortage or surplus occurs. The legislation which the Congress develops to deal with tax avoidance and abuse should be carefully articulated to create no burden on the legitimate spreads, straddles, and hedges which are necessary to create meaningful futures markets with adequate liquidity. Overbroad or imprecise legislative language would have a chilling effect on legitimate futures trading and would impair the interests of feed manufacturers, but even more important, be contrary to the public interest in meaningful and useful futures markets.

SUMMARY

In conclusion, AFMA urges these Subcommittees to carefully articulate the practices of tax avoidance and abuse which will be regulated and to ascertain that no unintended regulatory burden will impair the use of commodity futures for hedging or the underlying liquidity created by legitimate futures spreads and straddles.

REMARKS OF MICHAEL L. MADUFF, PRESIDENT, MADUFF & SONS, INC., CHICAGO, ILL.

Mr. Chairman and Members of the committee, I appreciate the opportunity to appear before your Committee today to share some thoughts with you about the pending legislation to correct abuses in the use of commodity straddles.

By way of introduction, my name is Michael Maduff, I am a member of practically every commodity exchange in the United States and, for the past fifteen years, I have been chief executive officer of the brokerage firm of Maduff & Sons, Inc. I grew up in the commodity business and have been active in all aspects of it—floor trader, broker, farm operator, merchandiser of pork bellies, gold arbitrageur, even as a mortgage banker using futures contracts as a hedge. I am here today on my own behalf only and not as a representative of any exchange or association dealing in commodities.

Currently the most popular proposal before this Committee is a mark-to-market scheme in which traders would be taxed as if all open transactions had been in fact closed out at the closing price on the last day of the fiscal year. I would charactrize this as a balance sheet, as opposed to an income statement, approach. To my knowledge, it is without precedence in our economic system where transactions have never been taxed until they were completed. Were this concept carried to a logical extreme, every homeowner in America would have to revalue his home at the end of each year and pay taxes on the appreciation. Even placing a cash flow limitation on the concept, it would include all those who have, for one reason or another, sought to refinance their homes, as well as all of the persons and business organizations dealing in property of any kind on a financed basis.

From a practical standpoint, the proposal imposes a grave injustice on commodity traders. Althogh it purports to tax their cash flow from exchange variation margins, no allowance is made for the original margin which the trader must leave on deposit with the exchange or his broker. Additionally, a trader, in fact, remains fully liable for losses due to adverse price movements after the fiscal year-end. The proposed carry forward-carry back provisions would still not protect a trader from this economic liability. A paper profit on December 31st could be turned into a loss in January and would, nontheless, be taxed on April 15th with a refund not available until a year later. Please note that we are talking here about a single transaction and not losses from new transactions, wiping out profits from separate transactions in a prior fiscal year.

Some of the mark-to-market proposals made have included favorable tax treatment, in addition to the carry forward-carry back provisions. Clearly, if a mark-to-market provision were enacted with a very favorable tax rate on such "profits", as a taxpayer and a trader, I would not complain. But, just because such a bill would be palatable, doesn't make it right.

This is not to say that there is no solution to the problem of abusive tax deferral or income conversion through the use of commodity tax straddles. If we are willing to view the world not in theoretical terms but on the basis of the real wrkings of the commodity markets and practical considerations of real taxpayers, it is possible to define a commodity straddle in terms that could be understood and readily audited by any broker, any taxpayer, any IRS agent. And, it is possible to make that definition tight enough to make commodity tax straddles so uneconomic that they will, in fact, be a thing of the past.

Thank you very much.

STATEMENT OF EDWARD N. DELANEY ON BEHALF OF COMARK

SUMMARY

(I) The commodities markets and the commodities industry serve very important functions in the financial and productive structure of the economy of the United States. The commodities markets and industry are finely tuned, and highly sensitive to the impact of legislation and regulation. Legislation or regulation not fully thought out, and carefully tailored to accomplish only that which is essential could irreparably damage the comodities markets and industry.

(II) S. 626 is exceedingly complex, confusing and lacking in clarity. Senator Moynihan said, in effect, in his introductory statement that it was not a bill that should be enacted into law. We agree. The Committee on Finance should not favorably report S. 626.

(III) Serious questions have been raised with respect to the position of the Internal Revenue Service regarding commodity straddles. These issues should be addressed by the Treasury Department before ~~any~~ legislation affecting the commodities markets and industry is enacted.

(IV) We suggest eleven substantive and technical recommendations that we submit should be a part of any legislation that the Congress might adopt with respect to the taxation of commodity straddles.

Mr. Chairman and Members of the Subcommittees, my name is Edward N. Delaney, and I am an Attorney At Law with offices at 1000—16th Street, N.W., Washington, D.C.

I appreciate the opportunity of appearing today on behalf of Comark, a California organization that is a dealer and market maker in various commodities and commodity options. Comark is regulated by the Commodity Futures Trading Commission, a federal agency charged with the supervision of the commodities industry. Comark Commodities, a subsidiary of Comark, acts as a comodity futures broker, while another subsidiary, Comark Asset Management acts a commodity trading advisor. Both are registered with the Commodity Futures Trading Commission. Comark is also a dealer and market maker in the United States government securities. Through another subsidiary, Comark Securities, Comark acts as a municipal securities dealer. Comark Securities is registered with the Securities and Exchange commission as a broker-dealer. It is a member of the National Association of Securities Dealers, the Securities Investor protection Corporation, and is subject to regulation by the Municipal Securities Rulemaking Board.

In the Senate Finance Committee press release announcing these hearings (Press Release No. 81-137) it was stated that: "The chairmen stated that the subcommittees would particularly welcome testimony on the general topic of taxation of commodity straddle transactions and specific testimony relating to S. 626 * * *."

I will comply with this request, as well as suggesting some comments with respect to specific aspects of any legislation that is to be considered.

(I) The commodities markets, and the commodities industry—as you have heard and will hear from others much more qualified than I to speak to the issue—serve very important functions in the financial and productive structure of the economy of the United States. These functions range from protecting the prices received by the farmers of this nation for their crops to providing essential liquidity and interest rate protection in the financial markets.

The commodities markets, and the industry, are finely tuned, and highly sensitive to the impact of legislation and regulation. Legislation or regulation not fully thought out, and carefully tailored to accomplish only that which is essential, could irreparably damage the commodity markets, and the industry. We believe that such a result would couse untold harm to the financial structure of this nation, with resulting harm to many citizens engaged in basic industries of this country.

I submit that we are not being alarmist in our comments, but rather are acknowledging an immutable fact of the financial life of this nation.

We respectfully urge that the Subcommittees, the Finance Committee, the Senate and the Congress, not be stampeded into the enactment of rash legislation that could seriously damage an important segment of the complex financial infrastructure of this nation. Rather we urge that issues that some see in this area receive thorough and thoughtful consideration, away from a rush to treat what some believe to be abuses.

(II) A cursory examination of S. 626 gives rise to the inescapable conclusion that the bill is exceedingly complex, and draconian in some aspects of its application. A more careful and thoughtful review of the bill engenders even greater concern. Ambiguity builds on ambiguity. Lawyers specializing in the tax field find the provisions to be particularly complex, confusing, and lacking in clarity.

It is submitted that if S. 626 were to be enacted into law it would have a substantial number of unintended effects of major proportions. Some have estimated that a greater loss in revenue to the Treasury will result from the provisions of S. 626 changing the status of Treasury Bills to that of capital assets than will be recaptured under the most optimistic estimates of revenue from the other provisions of the bill.

Furthermore, it is clear that Senator Moynihan, who introduced S. 626, did not consider it to be a bill that should be enacted into law. As the Senator said in his introductory statement: "The bill has a May 5, 1981 effective date. I have chosen that date because I still regard the measure as a discussion draft; I invite anyone who wishes to comment on it. I suspect it will be late April or early May before I have a bill that I can say with confidence is the best bill that can be written."

I urge that S. 626 not be approved by these Subcommittees.

(III) I deem it important to bring to the attention of the members of your Subcommittees some serious questions that have been raised abut the position of the Internal Revenue Service regarding commodity straddles.

The April 1981 issue of Commodities, the Magazine of Futures Trading, includes an article written by Douglas McLean. Mr. Chairmen, I request that the copy of that article which is appended to my written statement be entered in the record of these hearings.

The note accompanying the article points out that Mr. McLean was a revenue agent with the Internal Revenue Service, and that during his last three years with the Service he was a commodities specialist. Furthermore, it is stated that he authored the original Internal Revenue Service Commodity Options and Futures Audit guidelines. The title of McLean's article is "IRS attack on tax straddles fraught with error, ignorance."

Mr. McLean's comments, I submit, raise important questions that should be resolved before the Congress enacts legislation in this area. While Mr. McLean's article was published more than two months ago, I am not aware that the Treasury Department or the Internal Revenue Service has addressed the issues he has raised.

Mr. Chairman, I submit that you should request the Treasury Department to comment upon the questions raised by Mr. McLean. Until acceptable answers are submitted for public review, I submit that your Subcommittees should not report out legislation dealing with the tax aspects of commodity transactions.

(IV) For the consideration of the Subcommittees, and other interested persons, I submit several substantive and technical suggestions. I believe the proposals I make are reasonable, simple in comparison to existing legislative proposals being considered, and directed to the issues that are apparently of greatest concern.

1. The definition of "offsetting positions" in the proposed legislation is much too broad, complex, and difficult, if not impossible, to administer. The following alternative definition is, I submit, reasonable, as well as being reasonably clear and administrable.

"For purposes of this section, a taxpayer holds an offsetting position in personal property if the taxpayer holds substantially equivalent long and short positions in the same commodity (whether or not in the same contractual or physical form) or in debt instruments of the same issuer. For purposes of the preceding sentence, a long position in a debt instrument will be deemed to be substantially equivalent to a short position in a debt instrument of the same issuer if, at the time the last such position is established, (i) in the case where either debt instrument had an original term to maturity of one year or less, the respective dates of maturity of the two debt instruments do not differ by more than thirty (30) days; and (ii) in any case other than that described in (i) above, the respective dates of maturity of the two debt instruments do not differ by more than the remaining term to maturity of the debt instrument maturing first or twelve (12) months, whichever is less."

It may be that the term "same issuer" used in defining a "substantially equivalent" debt instrument should include a person who guarantees an issue, as well as a person who is the actual issuer, i.e., the United States would be deemed to be the

issuer of any issue that it guarantees. Furthermore, it may be that a thirty day difference or a twelve month difference in maturity dates would not be adequate. The thrust of the proposal is its concept—not the numbers of days or months.

2. While it may be appropriate to limit the income that may be offset by losses resulting from commodity straddles, such losses should properly be an offset against gains from similar transactions. Such gains are referred to as "qualified gains."

I submit that losses realized upon the closing of one side of a commodity, security or foreign currency straddle should offset realized gains from other commodities (physical, futures or options), securities (including evidences of indebtedness) and foreign currency transactions. Any excess loss should be carried back and forward to offset similar realized gains in other tax years.

3. Enacting a provision defining Treasury Bills to be capital assets will generate, we submit, insurmountable administrative problems. The legislative history of the present provision of the Internal Revenue Code determining that a Treasury Bill is not a capital asset fully supports our position.

I urge that, as an alternative, section 1234(b) of the Internal Revenue Code be amended to include futures contracts. The effect of such an amendment would be that gains or losses resulting from transactions in Treasury Bill futures contracts would be treated as ordinary income or loss.

4. I submit that it is essential that any legislation considered for enactment contain an exemption for hedging transactions. Such transactions do not present the problems that concern some legislators, while at the same time being essential, as you have heard here today, to the operations of many businesses.

5. If the 30 day extension of the "balanced period" of the legislation under consideration is to be enacted, it is essential that it be modified so as to conform with the "wash sales" rules of the Internal Revenue Code. Under the wash sales rules a loss deduction is allowed as of the date that the loss is incurred so long as substantially identical property is not acquired within 30 days before or 30 days after the loss transaction. The proposed straddles legislation would allow the loss at the end of the extended 30 day period if a substantially identical position is not acquired within the 30 day period. This conflict with the other wash sales provisions will cause unnecessary administrative problems and complexities.

If the proposal is adopted, it should be conformed to the existing wash sales provisions.

6. Any proposed elimination of the concepts of a "sale or exchange" for purposes of realizing capital gain or loss would be a major change in a long recognized requirement of the tax law. It is respectfully submitted that such a change should not be made without substantial additional study because of its potential impact on the tax law generally.

7. The standard deviation test set forth in proposed section 1092(b)(2)(B) of S. 626 is, I submit, impossible of administration. It should not be included in any legislation proposed for enactment.

While I am certain that the provision was well intended, its serious failings substantiate the view that the rush to enact this legislation, without careful thought and thorough analysis and study, will result in enactment of legislation with major flaws that may well irreparably harm an important segment of the nation's economy. We again urge the utmost of caution.

8. We submit that "dealers" and "traders" should be exempt from the provisions of any legislation that is ultimately enacted. The provisions of existing law reflect a fair and equitable tax treatment of dealers and traders.

The definition of a trader contained in the testimony of the Treasury Department before the House of Representatives' Committee on Ways and Means is a sound definition. The definition of a dealer might well be founded on the dealer definition set forth in the Federal Securities laws. Further study of this aspect is warranted.

9. We believe that the capitalization of interest and carrying charges in those circumstances referred to as "cash and carry" transactions may well have totally unintended results. The question of capitalization of certain costs in other factual situations is one currently receiving a good deal of attention in the judicial and adminitrative arenas. I urge that this issue receive further thoughtful consideration before precipitous legislative action is undertaken.

10. We submit that any legislation enacted with respect to commodity straddles must take account of the possible inequitable bunching of income that might well result. Equity calls for a spreading or averaging provision that will be fair to affected taxpayers, as well as reasonably simple in operation and administration. Again, this is an area that warrants further consideration before the enactment of any legislation.

11. It is submitted that there are many sound reasons of tax policy and administration for making any legislative proposals impacting commodity straddles effective

with respect to transactions where the opening transaction occurs on or after January 1, 1982. If that date is not deemed to be feasible, the effective date of any such legislation should be no earlier than the date on which the proposed bill is signed into law, and then should apply only to transactions where the opening transaction is acquired on or after the effective date. Any earlier effective date or an effective date provision that applies to any transaction occurring after the effective date regardless of when the opening transaction occurred will result, we submit, in a serious dislocation of the commodities markets, the outcome of which is unpredictable other than to say it will do substantial harm to the commodities markets and the market place.

(V) Again, I urge the Subcommittee not to take rash action with respect to legislation that could well have a substantial adverse impact on the commodities markets or the industry. Mr. McLean's article, in and of itself, generates sufficient concerns that have not been spoken to by the Treasury Department.

We will be pleased to work with the staff of your Committee, with the staff of the Joint Committee on Internal Revenue Taxation, with the Treasury Department, and any other interested persons, to help develop legislative proposals that will resolve any real problems found to exist without destroying a vital segment of the complex and sensitive financial infrastructure of the nation.

I thank you for the opportunity of appearing before you today. I will be pleased to attempt to answer any questions that any of the members may have. Thank you.

My Position—IRS Attack on Tax Straddles Fraught With Error, Ignorance

(By Douglas McLean)

The Internal Revenue Service's (IRS) attack on tax straddles in audits, in court and in Congress is based on indiscriminate application, erroneous analyses and factual ignorance. The judicial and legislative myths that can perpetuate from those errors will affect the entire commodity trading community, not just tax straddlers.

The attack errors began with Revenue Ruling (RR) 77-185 and the events leading to its issuance. RR 77-185 denies a silver futures tax straddle loss deduction, describing it as "artificial" loss from transactions "which result in no real economic loss."

The grounds cited for loss deduction denial are "no real change of position in a true economic sense" and the lack of "a closed and completed transaction." All related out-of-pocket expenses also are denied deduction citing prior court cases. RR 78-414 applies all the conclusions reached in RR 77-185 to a Treasury bill futures tax straddle. By logical extension, all commodity futures tax straddle transactions should be denied loss deductions by IRS personnel.

Two technical advices were issued by the IRS national office prior to RR 77-185. Both advices concerned the same taxpayers and tax straddle facts. The first advice allowed the claimed loss deduction. An IRS agent rebutted that first advice. The rebuttal primarily was based on a silver market price analysis, which now is known to contain hypothesis error, pricing error and an unverifiable conclusion.

A second advice resulted, and the claimed loss deduction was denied. Subsequently, RR 77-185 was issued, effectively making the second advice conclusions applicable to all. The underlying vehicle attracting all of the attention is the basic tax straddle:

1. An equal amount of bought and sold futures, held by one taxpayer, with significant unrealized market loss accruing to either the bought or the sold futures.
2. Simultaneous liquidation of those loss-value futures (or some portion of them) and the repurchase or resale of the same futures with different contract delivery dates.
3. Subsequent retention of the remaining bought and sold futures until the long-term capital gains tax holding period is reached, or a new tax year is reached, or both.

LOSS REQUIREMENTS

Step 2 above creates claimed tax loss. That loss must conform to all requirements in Internal Revenue Code section 165 and related U.S. Treasury regulations before deduction is allowable. Requirements which bear most on tax straddle loss deductibility include:

Individual taxpayers may deduct losses incurred in any transaction entered into for profit.

Only bona fide loss is deductible.

A loss must be evidenced by closed and completed transactions.

Erroneous IRS analyses bear most on the question of whether tax straddles can be "entered into for profit." The IRS uses the phrase "balanced position" to describe what it perceives as transactions structured to nullify profit from any price fluctuations. It relies on the above-mentioned rebuttal price analysis in contending that silver tax straddles are inherently riskless transactions.

A hotly debated question is whether a "butterfly" tax straddle (two basic straddles joined together by a common bought or sold contract delivery date) has inherently less risk than a single basic tax straddle. This question has meaning because the two technical advices concerned butterfly tax straddles, whereas RR 77-185 applied those advices to all silver tax straddles, basic or butterfly.

The IRS national office as yet remains convinced that all silver butterfly tax straddles are inherently riskless transactions. Academic experts have prepared statistical studies that purport to prove this risklessness. However, to date these studies have suffered from deficiencies and unrealistic, simplified assumptions such as: using weekly market prices rather than daily or intra-day prices; limiting the transaction results studied to those within a time frame that is less than the earliest delivery date contained in study straddle constructs; limiting the data years studied; and ignoring the additional risk potential in butterfly straddles liquidated one straddle at a time.

Perusal of futures prices from August 1975 until March 1976 provides positive evidence of significant tax straddle transaction risk using the "facts" in RR 77-185. Of course, the "facts" in that ruling are fictitious, as they are in every revenue ruling. Whatever the real trades are, they at least will be consequential as those fictitious "facts."

The IRS riskless "balanced position" concept alluded to in RR 77-185 is empirically incorrect. The error encompasses basic and butterfly tax straddles. Any U.S. futures tax straddle can be "entered into for profit."

NEED GOOD FAITH

There are several, little-known, bona fide tax straddle problems. One problem concerns whether all tax straddle parties have to act in good faith before a tax straddle loss can be bona fide. Another problem is created by spread pricing rules in general use at U.S. futures exchanges.

Bona fide means authentic, genuine and in good faith. Bona fide often seems to be confused with lawfulness. The two concepts do not necessarily relate to each other.

Tax straddles usually involve several transaction parties. Typically, a client/taxpayer, a brokerage firm and a floor trader. One or more of those parties could act in bad faith during a tax straddle sequence.

For instance, a brokerage firm could trade with other clients within the firm and not send trades to the exchange floor. That trading could be reported to each client as normal exchange trading. In this hypothetical situation the client/taxpayer is acting in good faith and the brokerage firm is not.

Assume further that the IRS learns of those in-house cross trades. The IRS would deem the in-house cross trades as not bona fide for any client/taxpayer tax loss purpose. That IRS viewpoint is a latent risk each taxpayer assumes when using other parties in tax straddle executions.

STRADDLE TRADES

There are two basic ways to trade tax straddles. Arbitrarily named, they are:

Spreads. These are tax straddles established and liquidated using simultaneously bought and sold futures contracts with different delivery dates as one unified trading unit. A typical spread order would be "buy May, sell November, basis 1,200."

Arbitrages. These are tax straddles established and liquidated using concurrently bought and sold futures contracts with different delivery dates as separately traded units. A typical arbitrage order would be "buy May at market" and "sell November at market" in two orders at the same time and on the same futures market.

Special rules are necessary for spread orders because individual contract dates only rarely trade with exactly the same price differences at which spreads are ordered. The usual rule is that prices assigned to each contract in a spread order must be within a range of prices each individual contract traded at within that particular trading day or by the time of the spread execution.

Tax straddles could be established and liquidated using only "basis." Straddle gains and losses can be computed without individual contract prices. This is because individual contract prices have only secondary economic meaning in spreads.

"Basis" determines the spread's gain or loss. Therefore, individual contract price assignments in spread trading essentially are cosmetic for economic gain or loss

computation purposes. Of course, assigned prices do have significance in computing claimed loss amounts at step 2 in a basic tax straddle.

The previous paragraph contains the gist of a perplexing problem related to spreads. The following hypothetical example illustrates that problem:

Assume that the May futures bought above at $7.50 in a spread are sold one week later at $7.30. By itself, this transaction appears to create a 20¢ loss.

However, the May contract price range reported on the buying date is $7.40 to $7.50, and on the liquidation date it is $7.30 to $7.40. The May contracts, thus, were assigned the highest price traded on the day they were bought and assigned the lowest price traded on the day they were liquidated. Because any price in the ranges on the respective market days could be assigned to the May contracts to achieve their economic goal, any amount up to 20 cents could be claimed as the "correct" loss amount.

Notice that market price fluctuations did not create the seemingly exact 20 cents loss. Two man-made price assignments created that amount. To summarize, exchange spread pricing rules create a tax bona fides problems: Claimed loss amounts cannot be determined uniquely, and transaction results are insensitive to market price fluctuations.

An arbitrage order presents an immediate difficulty to the intitiated in increased execution risk when compared to an equivalently executed spread order. Though spread order buying and selling always will be a simultaneous event by definition, arbitrage order buying and selling always will be concurrent events separated by time or space.

That means an arbitrage order to buy futures probably would be executed on a market uptick and to sell futures on a market downtick, moments or pits apart in even the best circumstances. Each arbitrage order would begin in a probable two-tick loss position relative to an equivalently executed spread order. Remember, it takes a minimum of three arbitrage orders to complete one tax straddle, thereby increasing that probable economic risk by at least three times.

However, there is a compelling tax bona fide tradeoff in using arbitrage orders because each individual contract is executed at exactly current market price. Therefore, arbitrages result in uniquely determinable loss amounts, and transaction results are sensitive to market price fluctuations.

CREATES UNCERTAINTY

The "closed and completed transaction" requirement creates problems for both the IRS and tax straddlers.

That requirement, the basic regulatory ground cited in RR 77-185 for tax straddler loss denial, creates an uncertainty problem. Courts easily could rule in present tax straddle litigation cases, using any of the previously mentioned grounds or other grounds beyond the scope of this article. That means the ruling's regulatory underpinning could remain untested for years to come.

Tax straddle traders face a problem created by past IRS success in applying integrated transactions theories to transactions that can be unified and which seem too tax advantageous. Spreads are more susceptible to that kind of IRS approach than arbitrages because of the unified transaction nature inherent in spreads. In theory and practice, arbitrages always contain unique transactions due to the timing differences mentioned earlier.

Another economic purpose problem: Any bought and sold futures position (say, bought May, sold September) is uniquely different from any other bought and sold futures position (say, sold September, bought December) in risk potential. That is due to a variety of U.S. marketplace structure and pricing factors, as well as position delivery date.

INCORRECT CONCLUSIONS

At least one of the previously mentioned statistical studies concludes that there is position risk proportional to time between position delivery dates. Therefore, the conclusion set out in RR 77-185 that "the August 4 sale resulted in no real change of position in a true economic sense" also is empirically incorrect.

At this writing there are several recent public announcements that bear on the tax straddle future. The original technical advice cases are on the April tax court calendar in New York City, and a trial seems reasonably certain.

In his outgoing budget message, President Carter recommended banning tax straddles, based on estimated lost tax revenue totalling about $1 billion annually. That estimate cannot be supported by any known facts and is, at best, a politically useful myth.

An administrative nightmare is looming for every commodity trader if the recent Vanik-Rosenthal legislative proposals are indicative of IRS thoughts on how to ban tax straddles. Any "personal property" with fair market value under taxpayer control could be used by the IRS to offset individual commodity losess. Not just tax straddle losses, but all commodity losses for individuals effectively could be banned by a Vanik-Rosenthal type law and heavy-handed IRS interpretation.

Presently, pursuing tax straddles can seem like traversing an uncharted minefield. Good guidance can direct a tax straddle transaction through the tax problems, though currently at considerable cost in talent and money.

If the IRS could exercise some candor in addressing its tax straddle issue errors, heavy-handed determinations or outright bans could be avoided.

Senator SYMMS. We now call up the last panel which will be Mr. Robert S. McIntyre and Mr. Jay Angoff.

PANEL OF: ROBERT S. McINTYRE, DIRECTOR, FEDERAL TAX POLICY, CITIZENS FOR TAX JUSTICE, WASHINGTON, D.C., AND JAY ANGOFF, ESQ., STAFF ATTORNEY, PUBLIC CITIZEN'S CONGRESS WATCH, WASHINGTON, D.C.

Mr. MCINTYRE. Mr. Chairman, and members of the committee, I am Robert S. McIntyre. I am here representing Citizens for Tax Justice, which is a coalition of public interest and labor organizations working to improve the fairness of the tax laws.

Our member organizations themselves represent tens of millions of middle- and lower-income working people. Having sat through these hearings, as well as the hearings on the tax cut legislation, it occurs to me that—were my members represented by some of the lobbyists you have heard from—they would be advocating all sorts of special tax breaks for workers. Accelerated depreciation write-offs for "human capital," tax credits for working more hours in 1 year than in the prior year, capital gains treatment of wages, and so forth all might be on the list. But, for better or worse, my members have chosen to take a less parochial approach. Our position is that we would like to make the tax system collect the revenues the Government needs in as fair a manner as possible. We take that position because we think many of the things the Government does are good. National defense, helping out people who are on hard times, building the roads, many things the Government does.

And, to do those things, we need a tax system. We can't have a system that doesn't tax anybody. We think the tax system should instead tax everybody fairly.

That brings me to what is apparently the main remaining issue before the committee on commodities straddles. That is, how should the tax system treat professional traders in commodities?

The position we take, and I think it is the one which is the most reasonable and the most economically correct, from a tax policy point of view and from the point of view of preserving these commodities markets, is that we should tax the brokers like other taxpayers.

Now, technically the way to do that that works the best is the "mark-to-market" system. What we are talking about is taking into account gains or losses, that are in fact realized on a cash basis, at the end of the year, whether it is a win or a loss situation.

The tax rates that ought to be applied to the brokers I think ought to be the same rates that are applied to other people who

work for a living, which means the progressive tax rates in the system currently.

So, therefore, we have a difference of opinion with Mr. Schapiro only in what the tax rates ought to be and what the loss offset ought to be, because we are going to allow people that lose in the market to take ordinary losses.

So, we are encouraging risk to the extent you know that, if you do lose, you are going to get a large tax offset; if you win, you are going to pay your share to the Government, on an annual basis.

Now, one final side point I would like to point out, because I am not sure the committee has appreciated this yet, and I think it is very important. It is discussed in a footnote in our testimony.

In 1979, we saw a very large increase in capital gains realizations. Some have suggested that that is an effect of the 1978 reduction in capital gains taxes.

To say that the capital gains tax cut had no effect on realizations in the year immediately following it, I think would be silly. I am sure that it did increase realizations at least in the short run.

But there is another factor I think you ought to keep in mind when you are looking at these extraordinary increases in realizations, especially at very high income levels, and that is that at the same time this was happening, we saw an extraordinary expansion in the use of Treasury bills and financial futures to transform ordinary income into capital gains.

Now I am trying to get some hard numbers on that for the committee over the next week or so, so we can more properly evaluate the 1978 cuts.

But, there is no question that the expanded volume of T-bill futures and the corresponding increase in actual delivery of T-bills, which instead of being the usual 2 or 3 percent delivery, as is typical in these markets, has been up to as high as 50 percent in some of the months near the end of the year, suggests that a very substantial portion of increase in capital gains realization has been due to a tax shelter which has nothing to do with the goals of what we all want for the economy.

Thank you.

Senator SYMMS. Thank you.

Jay Angoff.

Mr. ANGOFF. Mr. Chairman, my name is Jay Angoff. I am a lawyer with Congress Watch which is a public interest advocacy group founded by Ralph Nader.

I think that this committee is performing a great public service in holding these hearings on the commodity tax straddle, because while the average American taxpayer, year after year pays taxes at the rate set out in the Internal Revenue Code, for upper income individuals, the rates set out in the code is often a myth.

It will remain a myth regardless of whether the top rate on unearned income is 70 percent or 50 percent, as long as tax avoidance devices like the commodity tax straddle are permitted to exist.

Now it is important to recognize what tax straddles don't do. They don't contribute to capital investment. They don't encourage R. & D. They don't increase productivity. They don't create jobs.

As Merrill Lynch has said, in an internal tape recording on promoting tax straddles, the tax straddle really only has one purpose, to try to help the client keep more of his money.

With respect to the degree of risk involved in a straddle, Prof. Roger Gray, of Stanford has calculated that the odds are 40 to 1 against even getting your money back as a result of the tax straddle. He calls it inherently inconceivable that tax straddles could have been traded for their profit potential.

It is important to note that until recently the COMEX had special tax straddle trading sessions that took place after the close of regular trading after 2:15.

On the last business day of 1976, for example, the special session didn't end until 7:30 with trading reaching a record 127,000 contracts. Only 300 of which or one-fortieth of which of 1 percent were regular, single month trades.

During these special sessions, according to the CFTC, on any given day, when the market has had a very wide price range, the trader is in a position to calculate almost to the penny what the net result of his actions will be prior to entering the market.

In general, S. 626, I think would prohibit the abuses of tax straddles. We do, however, think the attribution rules in S. 626 should be tightened and that the general rules of section 318, with respect to constructive ownership of stock be applied to tax straddles, so that the holdings of the taxpayer, his spouse, his children, grandchildren, and parents will be considered in determining whether the taxpayer holds offsetting positions.

I would also urge the committee to get the views of the CFTC on the question of whether exempting commodities traders from tax straddles legislation serves any legitimate policy goal before enacting any provisions that would exempt or give a preferential rate of tax to any particular industry.

We also agree with the Treasury Department on the general approach of mark to the market. If, under mark to the market, the taxpayer realizes gains and losses every day, if the taxpayer is gaining, he can withdraw it, if he has a loss he can make an additional deposit with his broker.

We agree with the Treasury also that gains and losses whether to gain and loss or loss it should be ordinary income and not capital gain or loss.

Finally, Mr. Chairman, we urge you to take decisive action to outlaw tax straddles, because of their potential effect on our voluntary tax system.

Voluntary compliance by average people with our tax laws has always been exceptionally high. It is really one of the wonders of our tax system.

But there is a real possibility that ordinary people would become less willing to voluntarily pay 15 or 20 or 25 or 30 percent of their hard earned income in taxes, when they see the widespread use of commodity tax straddles and other tax avoidance devices by those making many times more than they are.

As long as straddles, as well as other tax shelters exist, and the more people know about them, the greater the threat to our voluntary tax system becomes.

Thank you very much.

Senator SYMMS. Thank you.
Senator Moynihan.
Senator MOYNIHAN. Mr. Chairman, I don't have any questions. I think I will quit when I am ahead. We can close with Mr. McIntyre and Mr. Angoff who are very positively disposed toward these matters.
I do think it is important and they speak to a genuine question which is the confidence of the American people in the equity of their tax system.
If it becomes pronounced fact that there are some people who just don't pay taxes or don't pay nearly as much as they might, and others, because they have access to some forms of manipulation of the tax code, you are going to get troubles.
Mr. ANGOFF. Senator, that is the perspective in which I am interested in this legislation. I am an average taxpayer. My parents are average taxpayers. All my relatives are. They have never been able to use any device like this. The more they see devices like this being used by other people, I know, the more annoyed they get at paying their 35 percent income tax.
Senator MOYNIHAN. This is a thing we have to do. I would like to say, Mr. Chairman, it is not every day that Congress Watch shows up in this hearing room to congratulate the Committee on Finance.
Senator SYMMS. I think we might have broken a record.
Mr. ANGOFF. Not only the Committee on Finance, but also the Reagan Treasury Department.
Senator SYMMS. That may cause me to go down and reexamine the Reagan Treasury Department. [Laughter.] I just want to say I appreciate your concern.
I do think it ought to be mentioned when you say what straddles will do or won't do, many of us believe the tax rates in the United States are too high, and there is too much capital being confiscated by Government that is not left to work in the private sector.
I have a good friend out in Idaho who always used to say that loopholes were just breathing space for the free enterprise system. Without them the whole country would go down the drain.
He happens to be a developer, in a small town of Caldwell, Idaho, that always said that. He said it jokingly, but when you say that tax straddles don't contribute to capital investment, if the taxpayer is able to defer his income for a year and invest the money in a Home Savings and Loan Bank, does that help or hurt housing?
Or if he pays the taxes to the Government and they waste the money on some foreign aid program somewhere, what does that do?
What about R & D? What if that taxpayer takes the money that he diverts from paying this year and invests the money in a highly sophisticated electronics program for—to try to develop a new chip or something, computer chip?
Mr. ANGOFF. Senator, as to your first point, our position has always been the tax rates are too high. If we get rid of some of these loopholes and some of these shelters like commodity tax straddles, we can reduce the rates, we can reduce the rates for everyone.
Senator SYMMS. Would you support former Secretary of Treasury Simon's position—that we should get rid of most of the tax deduc-

tions and lower the rates to about 15 to 20 percent and charge everybody on gross income?

Mr. ANGOFF. That certainly has a lot of—I have a lot of sympathy on that position, yes.

Senator MOYNIHAN. Careful. He said progressive.

Mr. ANGOFF. With the right kind of exemptions.

Senator MOYNIHAN. You can get in trouble back at the office. [Laughter.]

Senator SYMMS. I think that Bill Buckley, the distinguished editor of and brother of Senator Moynihan's former opponent used to write what we should do is give every taxpayer a $1,500 exemption. That would probably have to be increased today maybe to $2,000, so that the working family and the low incomes would be protected.

The first $2,000 of every American would be tax free and then after that charge everyone a flat income.

That would certainly raise havoc with the CPA and the attorney tax lawyer field. But it would put all those very brilliant minds to work being cost accountants and we could do things much more efficiently.

I personally would favor that. I think it is what we should do in this country and it would not be a problem.

Mr. Maduff out here wants to trade. He can go in there and take the risk and trade. There is no advantage for anyone to figure out some complicated scheme to get out of taxes because they all know the rates are not excessive.

Mr. ANGOFF. Well, Senator Symms, you may not like to hear this, but we do have some common ground then.

Senator SYMMS. Well, I think on that note, the meeting is adjourned.

Mr. ANGOFF. Thank you, Senator Symms.

Mr. MCINTYRE. Thank you.

[The prepared statements of the preceding panel follow:]

STATEMENT OF ROBERT S. MCINTYRE, DIRECTOR, FEDERAL TAX POLICY, CITIZENS FOR TAX JUSTICE

Mr. Chairman, members of the Committee. I am Robert S. McIntyre, Director of Federal Tax Policy for Citizens for Tax Justice, a coalition of public interest and labor groups dedicated to improving the fairness and efficiency of the tax laws at the federal, state, and local levels. We appreciate the opportunity to express our views on the need to reform the tax treatment of commodity straddles.

INTRODUCTION

Designed to defer tax liability indefinitely or to convert ordinary income into lightly taxed capital gains, commodity tax straddles have set a new—and almost unbelievable—standard for tax shelter abuse. Cases have been found in which a single individual has attempted to shelter over $10 million in income in a single year through the use of straddles. Straddle partnerships generating "losses" in the hundreds of millions of dollars have been identified. And unlike most other tax loopholes, which generally are at least intended to serve some social goal, commodity tax straddles are economically useless. Their primary effects appear to be to shift the tax burden away from the wealthy onto average taxpayers and to divert countless hours of valuable expert labor into wasteful tax avoidance planning.[1]

[1] The enormous recent expansion in the use of straddles as tax shelters is illustrated by the geometric increase in the volume of trading in financial futures over the past few years—up 200 percent in 1978, another 140 percent in 1979, and still another 125 percent in 1980—coupled with an unheard of number of actual deliveries of Treasury bills to satisfy contracts. Although in normal futures transactions contracts are almost never performed on, the straddle technique

If the commodity straddle were a legal tax avoidance device, it would be an elegant and foolproof way to avoid forever the payment of income taxes. This fact, in and of itself, is sufficient to make clear that the scheme cannot be legal. It seems virtually certain that the courts will not sanction a tax avoidance device which has the potential to destroy the individual income tax. Such a result would be clearly inconsistent with the intent of Congress in enacting the tax laws.

Nevertheless, the wheels of the judicial system turn slowly and the ability of promoters to find false distinctions to rationalize additional variations seems endless. Therefore, there appears to be rather general agreement that serious legislative actions needs to be taken against these abusive tax shelters.

Earlier this year, two bills—Senator Moynihan's S. 626 and H.R. 1293—were introduced to crack down on straddle abuses. The hearings held by the Ways and Means Committee on H.R. 1293 generated sufficient responses from affected and interested parties to narrow the issues before Congress considerably. Apparently, there is little dispute over the desirability of denying the benefits of "butterfly spreads" and the like to future non-professional investors. Cracking down on straddles in Treasury bills and curbing the ability of securities dealers to wait 30 days before classifying their positions as business or investment also appear to be relatively non-controversial steps. The primary issues remaining before Congress appear to be the following:

(1) Should professional commodity traders be exempted from the straddle reforms—and thereby exempted from income taxes—or, alternatively, should they be allowed to treat their income as long-term gains, taxed at very low rates?

(2) Should past, non-professional straddlers be grandfathered?

(3) Should so-called "cash and carry" straddles be covered by the reforms?

(4) Should a related scheme designed to convert ordinary income into short-term gain, eligible for offset by long-term capital losses, be addressed (by changes in the "sale or exchange" rule)?

(5) How should the basic reform be drafted?

We would like to address the rest of our testimony to these issues. In particular, we direct the Committee's attention to part (5) of our statement, in which we endorse Senator Moynihan's revised approach, which we believe would be of tremendous use in curbing straddle abuses and reforming the tax treatment of future contracts in general.

(1) Should professional traders be exempted from the reforms?

Absent a compelling case, it is difficult to understand why the members of a particular profession, however meritorious their activities, ought to be exempted from bearing their fair share—or potentially any share—of the tax burden. Since we do not find that the commodities industry has made such a case, we urge the Committee not to approve either tax exemption—as could occur under the "qualified gains" proposal put forward by the professional traders—or special capital gains treatment of professional trader income.

On behalf of their petition for special treatment or exemption from taxes, the commodities professionals make essentially two arguments. The first is nothing but smoke. They maintain that professional straddling is a useful, often profitable form of speculation which helps to enhance the liquidity of markets by increasing trading volume. There is no need for the Committee to explore the merits of this contention, since it has absolutely nothing to do with the tax issue under consideration. We are not talking here about outlawing straddling—only about disallowing its unwarranted favorable tax consequences. If straddling is indeed a legitimate form of trading that is important to the marketplace, it can be continued. The only change which the proposed legislation would make is to remove an illegitimate consequence of straddling—the ability to shelter income from taxation.

The second industry argument for an exemption for dealers has more substance. They maintain that to try to subject dealers to taxation is a hopeless task, that the countless permutations and combinations of offsetting positions which dealers can easily arrange would create such formidable tracing problems for the IRS that attempts to unravel them would prove fruitless.

Such boasting should not be taken lightly—obviously Congress does not want to enact an unenforceable statute. Fortunately, however, there appears to be a relatively easy and straighforward way around this problem. In fact, this alternative

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involving T-bills—which is used to convert ordinary income into capital gains—does require delivery. One witness before the Ways and Means Committee suggested that almost half of the contracts coming due in November and December have recently been settled by actual delivery. At the same time, we have seen a sharp corresponding increase in capital gains realizations at high income levels—up almost 130 percent in the over $200,000 AGI class (after adjusting for inflation) from 1978 to 1979. The link between the increased T-bill straddles and the jump in capital gains realizations seems apparent.

approach has such administrative advantages that we suggest it be made the general rule for taxing all commodity futures transactions. As is described in part (5) below, our approach involves taking advantage of the industry practice of issuing daily evaluations of commodity gains and losses and settling accounts on the same basis. Technically, this is called "marking to the market," and, as will be seen in part (5) below, its existence offers an opportunity for breathtaking simplicity in the treatment of all futures transactions.

(2) Should existing straddlers be grandfathered?

The industry proposal to exempt "qualified gains and losses" from the straddle reforms would appear to have the perhaps unintended result of grandfathering previous tax shelter straddles which are still outstanding. This is because technically the industry rule would allow commodity "losses" to continue to offset commodity "gains."

For example, suppose that in 1977 an executive used a Treasury bill straddle to defer the tax on, say, $1 million in salary to 1978. Then, in 1978 the corresponding gain from the Treasury bill straddle was again deferred to 1979, with another straddle. And so on. Now, if the legislation approved by Congress allows continued use of straddle "losses" to offset "qualified gains," this executive will be allowed indefinite deferral on the $1 million.

Such grandfathering might avoid some nasty lawsuits by taxpayers against their brokers, but at a rather steep price. It would entail congressional sanction for taxpayers who have flaunted the law and thumbed their collective nose at their fellows. Therefore, even if, in its wisdom, the Committee decides to exempt brokers from taxation, we urge that past non-dealer tax evaders not also be pardoned.

(3) Should "cash and carry" straddles be covered by the reforms?

The term "cash and carry" conjures an image of a cut-rate furniture store, which holds its costs down by refusing to issue credit or make deliveries. In the predictably perverse language of commodities, however, "cash and carry" involves both borrowing and delivery.

Under a "cash and carry" arrangement, a reluctant taxpayer will borrow money and use the funds to buy a quantity of an actual commodity. At the same time, the taxpayer will enter into a futures contract to sell the same quantity of the commodity at a point in the subsequent tax year. The future selling price will reflect the original cost plus the costs associated with holding the physical commodity—mainly the interest on the debt, plus storage and insurance.

The purpose of this seemingly meaningless transaction is to convert ordinary income in one tax year into long-term capital gain in the next. This result is achieved by taking ordinary deductions for the carrying costs of the physical commodity as they are incurred, and then selling the commodity in the succeeding tax year for a capital gain. The futures contract is necessary to protect against unforeseen fluctuations in the price of the commodity. If the price of the commodity declines, the actual commodity. If the price of the commodity declines, the actual commodity will be delivered to close out the futures contract at the appropriate time. If the price of the commodity increases, the loss on the futures contract will be balanced by an increase in the gain on the actual commodity. (These effects are illustrated in Chart I.)

CHART I

AN EXAMPLE OF A "CASH AND CARRY" DEAL IN SILVER

In this example, the taxpayer would like to convert approximately $8,700 in ordinary income into a long-term capital gain. Case A shows the essential structure of a "cash and carry" deal designed to achieve this result, and how it would work in a stable silver market. Cases B and C illustrate how the purchase of a futures contract assures the desired result even in a volatile silver market.

A. The basic "cash and carry" transaction, and how it works in a stable market.

May 1, 1981:	BORROW	$55,750.
	BUY	5,000 oz. of silver at 11.15/oz. (Total cost = $55,750)
	SELL	One 5,000 oz. contract for June 1982 silver at 13.05/oz. (Total price = $65,250)

The costs of holding the silver for the 13 months from May 1, 1982 are expected to be $9,000 in interest on the $55,750 (at 14.9%), $444 in storage charges, and $56 for insurance. This explains the $9,500 difference between the current price of silver and the June 1982 futures price. The cost of holding the silver for 12 months is $8,769.

			GAIN (LOSS)
May 2, 1982	SELL	5,000 oz. of silver at $12.90/oz.	$ 8,769
	BUY	One June 1982 silver contract at $13.05/oz. (Closing out futures position)	---
		Net capital gain	$ 8,769

Thus, the taxpayer will have taken ordinary deductions totalling $8,769, matched by a capital gain of $8,769. In this case, the futures contract was unnecessary.

B. Now, suppose the price of silver on May 2, 1982 had increased to $20/oz. This doesn't really matter to the taxpayer, because of the futures contract.

May 2, 1982	SELL	5,000 oz. of silver at $20/oz.	$ 44,750
	BUY	One 5,000 oz. contract for June 1982 silver at $20.27/oz. (Closing out futures position)	(36,103)
		Net capital gain	$ 8,647

The enormous change in the price of silver has changed the size of the capital gain by only $122.

C. Now, suppose the price of silver on May 2, 1982 has decreased to $10/oz. Again, the taxpayer doesn't really care.

May 2, 1982	SELL	5,000 oz. of silver at $10/oz.	$ (5,750)
	BUY	One 5,000 oz. contract for June 1982 silver at $10.14/oz.	14,557
		Net capital gain	$ 8,807

In spite of the price change, the capital gain is only $38 different from that in the stable market.

The legislation before the Committee would attempt to curb this shelter by requiring that the carrying costs be capitalized and added to the basis of the commodity, rather than deducted, whenever the commodity is part of a balanced position. This seems straightforward enough, and will work fine whenever the commodity is used as security for the loan. In order to put more teeth in the rule, however, we suggest that the Committee report make clear that Congress intends the rule to apply to all indebtedness incurred during a period surrounding the time the commodity is acquired—other than purchase money loans clearly connnected with other purchases.[1]

The industry objections to restricting "cash and carry" transactions are again mostly smoke with little fire. First, industry representatives argue that the "cash and carry" shelter should be continued because of the general deductibility of interest, even on consumer durables.[2] In fact, however, Congress has previously required the capitalization of interest expenses in cases where abuses have been found. The most notable example is construction period interest on real estate.[3]

Second, the industry argues that the "cash and carry" shelter is a justifiable tax expenditure because it will encourage commercial inventory hedging, a practice said to be sound and often necessary. If such hedging is in fact sound and necessary, however, it does not require a tax subsidy. If it is not, it should not be granted one.

We urge that the "cash and carry" rule be retained in the bill. (The approach we suggest in part (5) below would appear to reduce but not eliminate, the need for special "cash and carry" rule.)

(4) Should a related scheme designed to convert ordinary income into short-term gain, eligible for offset by long-term capital losses, be addressed?

An additional reform in this area, recommended by the Carter Treasury and included in S. 626, but omitted from H.R. 1293, would deal with an abuse designed to convert ordinary income into short-term capital gain, which can then be offset by a long-term capital loss. The abuse stems from a peculiarity in current law which provides for ordinary loss treatment when an asset is disposed of in situations not considered a "sale or exchange."

For example, suppose a taxpayer has $200,000 in salary income and $200,000 in long-term capital loss. Under normal tax rules, the taxpayer cannot offset the ordinary income with the capital loss.[4] If, however, the taxpayer can convert the ordinary income into short-term capital gain, the offset is allowed.

Naturally, a technique which attempts to achieve this result has been invented. Under this scheme, the taxpayer will enter into a balanced position in a commodity. When there has been sufficient price fluctuation to achieve the equal "gain" and "loss" required, the taxpayer will sell the gain leg—for a short-term capital gain—and cancel the loss leg by paying the other party to the contract the necessary amount. The taxpayer will take the position that the cancellation of the contract is not a "sale or exchange" and is therefore an ordinary loss. This loss will be used to offset the taxpayer's ordinary loss. This loss will be used to offset the taxpayer's ordinary income; the short-term capital gain will be offset by the taxpayer's long-term capital loss. The result: zero taxable income.

Under S. 626, the "sale or exchange" requirement would be eliminated. The commodities industry points out in opposition that such a change would be too broad and could have unforseen and unintended effects. We suggest therefore that the rule in S. 626 be narrowed to apply only to the balanced position situation. (In many cases, this abuse may be curbed by the approach we suggest in the following section).

(5) How should the reforms be drafted?

The bills introduced earlier this year on commodity straddles—S. 626 and H.R. 1293—would have attempted to curb the tax shelter potential of straddles by treating the legs of a balanced commodities position as one transaction, thereby denying taxpayers the opportunity to manipulate the various parts to obtain tax advantages. In addition, they would have suspended the running of the capital gains holding period during the pendency of a balanced position. This approach is conceptually straightforward, but, in our view, unduly complicated to administer, perhaps impos-

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[1] Thus, we would not follow the court interpretation on "interest on indebtedness incurred or continued to purchase or carry" the investment under section 265 of the code.

[2] This year a number of members of Congress have suggested limiting the deductibility of consumer interest.

[3] IRC section 189.

[4] Since only 40 percent of long-term capital gains is subject to tax, a full offset of long-term losses against ordinary income would be grossly unfair. In addition, since taxpayers can easily manage their portfolios to realize losses while deferring gains, allowing more than a very limited offset of capital losses against ordinary income would lead to intolerable distortions in income measurement.

sibly so in the case of professional commodities dealers. At the Ways and Means hearings on straddles on April 30, we therefore suggested an alternative approach, which involves a complete restructing of the taxation of gains and losses in commodity futures. This approach—called "marked-to-market"—was also endorsed by a number of the expert witnesses who testified before the Ways and Means Committee, and has been incorporated by Senator Moynihan in his revised proposal.

In order to appreciate the simplicity and fairness of the "marking-to-market" approach, the Committee needs to understand how profits and losses are actually recognized in futures trading. An excellent explanation is included in the Joint Committee on Taxation staff pamphlet, at page 8. We will run thourgh a simple illustration here.

Suppose that on May 4, 1981, you buy a futures contract entitling you to purchase 37,500 pounds of coffee in July of 1982 at $1.20 per pound—a total price of $45,000. Your broker might ask you to put up, say, 10 percent of the contract price, or $4,500, "on margin" as earnest money. Now suppose that on May 5 rumors of an upcoming shortage of coffee beans drive the July 1982 futures price up to $1.26/lb. Your contract is now worth 5 percent more, or $47,250. This additional $2,250 will be deposited in your account, and can be immediately withdrawn. In other words, your gain is immediately realized.

Suppose that you do in fact withdraw the gain—a sensible decision since you can spend it or invest it. But on May 7 word reaches the market that the expected coffee bean shortage was a hoax—that actually there will be a slight surplus. The price of July 1982 coffee now drops to $1.14/lb., 5 percent below your contract price. Your broker will now demand that you deposit an additional $2,250 in your account to maintain your margin.[1] (Should you refuse, your account will be liquidated.) In this case, you have an economically realized loss.

In each of these cases, your margin account has been "mark-to-the-market" in commodities lingo. In each case, the gain or loss is immediately realized—that is, you either have the actual cash or must pay actual cash.

Under current tax rules, however, these economically realized gains and losses would not be taken into account for tax purposes until you actually close out your position in the commodity contract. This approach not only fails to comport with economic reality, it makes the commodity straddle tax shelter possible. If the tax system followed the "marking-to-market" rule, then tax shelter straddles would be eliminated. A balanced position in a commodity (or in "sympathetic" commodities, for that matter) would, by definition, not be affected by changes in futures prices, since a loss on one leg would be automatically offset by a gain on the other. This is why brokers require little or no margin deposit on straddles.

Therefore, we urge the Committee to restructure the tax treatment of all commodity futures to take account of the economic reality of "marking-to-market." Under our proposed rule, taxpayers would include in income year the sum of the daily gains and losses on their futures accounts during the year—a figure which brokers could easily provide.

Under this approach, the rather complicated rules in the original commodity straddle bills dealing with the basic commodity straddle problem would generally not have to be applied.[2] The typical straddle would simply no longer work as a tax shelter, since the element of deferral of gains would be eliminated. Our approach would also solve the administrative problem of dealing with complicated transactions by professional traders. In fact, at a minimum, we strongly recommend that the "mark-to-market" rule be applied to the professionals.

"Mark-to-market" does not solve all straddle problems. Changes in the treatment of Treasury bills, a prompt identification rule for brokers, back-up rules for non-exchange trading, and to some extent the "cash and carry" rules and changes in the "sale or exchange" requirement will still be needed. But "mark-to-market" is an elegant and simple cure for most current straddle abuses and is recognized by commodities experts as the approach which is by far the most consistent with both economic reality and sound tax policy.

Finally, since futures gains and losses are in fact computed and credited or debited from trader accounts on a daily basis, it would no longer make sense to perceive profits or losses in futures as ever being long-term capital gains or losses. Under the "mark-to-market" rule we propose, all such gains and losses would be short-term for tax purposes—just as they are in real life.

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[1] For simplicity—this example ignores the difference between "initial margin" and "maintenance margin," see the JCT staff pamphlet at page 8. The distinction is not important for the analysis here.

[2] For straddles which are conducted on exchanges where "mark-to-the-market" is not observed, the rules in the original bills could be retained.

CONCLUSION

Swift action by the Congress to curb commodity tax straddle abuses is a necessity if we are to avoid huge revenue losses and further diminution of public respect for the tax system. We urge the Committee to include straddle reforms as part of the tax cut legislation which is enacted this year.

STATEMENT OF JAY ANGOFF, STAFF ATTORNEY, PUBLIC CITIZEN'S CONGRESS WATCH

Mr. Chairman, members of the committee, my name is Jay Angoff, and I am a staff attorney with Public Citizen's Congress Watch, a public interest advocacy group founded by Ralph Nader. Public Citizen is a nationwide consumer organization with approximately 70,000 contributors annually.

This Committee is performing a great public service in holding these hearings on the commodity tax straddle, an abusive tax shelter which enables some of the richest people in the nation to cheat the Treasury out of $1.3 billion a year. For while the average American taxpayer year after year pays taxes at the rate set out in the Internal Revenue Code, for corporate investors and executives the rate set out in the code is a myth—and it will remain a myth, regardless of whether the top rate on unearned income is 70 percent or 50 percent or anything else, as long as tax avoidance devices like the commodity tax straddle are permitted to exist.

We hear the word "loopholes" a lot. But provisions which are often referred to as "loopholes"—such as the oil depletion allowance or the expensing of intangibles—were deliberately put there by Congress. Although they may now be counterproductive, inefficient, and unfair, at one time Congress thought they served legitimate policy goals. Tax straddles, on the other hand, are the purest form of loopholes—not only do they serve no legitimate policy goal, but Congress never intended for them to be there in the first place.

Essentially, commodity straddles are balanced positions in the same commodity on both sides of the market. Whether the price of the commodity goes up or down, the taxpayer will obviously lose on one leg of the straddle and gain the same amount on the other.

The taxpayer will recognize his loss on the loss leg of the straddle and take an ordinary loss in the first year. He will recognize the gain on the gain leg of the straddle in the following year, and thus will realize a capital gain in that year. He thus both offsets ordinary income in one year and converts that ordinary income into capital gains in the next year. Alternatively, the taxpayer can simply set up a series of straddles, year after year, and thus can indefinitely postpone paying even the low capital gains tax on the straddled amount.

ABUSES OF TAX STRADDLES

It is important to recognize what straddles do not do. They don't contribute to capital investment; they don't encourage R&D; they don't increase productivity; and they do not create jobs.

Their sole purpose is to enable wealthy investors to avoid taxes. As the Wall Street Journal has noted, the commodity tax straddle is "one of the biggest tax shelters of them all—an almost riskless way to have your financial cake and eat it to."[1]

That the sole purpose of tax straddles is to avoid taxes is beyond doubt. In 1975, for example, Merrill Lynch poduced a tape for its brokers—the subject was apparently considered too sensitive to be written down—which explained how straddles work. The tape explained:

"Gentlemen, this is what the usual commodity tax straddle is all about changing short-term situations with high tax rates into long term with a maximum tax rate of 25 to 25 percent (sic). Said another way, tax straddles enable us to create for a reasonable cost the capital gains and losses we need to materially change the tax liability of high-bracket taxpayers."

Merrill Lynch also cheerfully noted:

"And do not forget this very important point most of the overall costs of doing a tax straddle is assumed by Uncle Sam since commissions and difference loss are reflected in the net capital gains or losses realized."

Finally, in case anyone had missed it, the tape concluded:

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[1] Wall Street Journal, June 6, 1978, at 1.

"Do not forget: a tax straddle really has only one purpose—to try to help your client keep more of his money.[2]

Other tax straddle promotions also make clear that what they're offering is a tax shelter, not an opportunity for profit. Commissions are often a percentage of the tax savings, and sometimes the sellers offer legal representation as part of their package. Some sellers also strongly imply that tax straddles are probably unlawful, but they recommend that people use them anyway because (1) they're hard to catch, and (2) even if a tax straddler is caught it can take years before he actually has to pay.

And the sellers often recommend and construct complicated schemes to hide tax straddles from the IRS, such as running offsetting positions through accounts nominally held by different people.

Tax straddles have been a very large part of the business of some brokerage houses, most notably of Merrill Lynch. According to the Wall Street Journal, "Tax straddles have brought tens of millions of dollars of commissions into the brokerage houses during a very pinched time.[3]

Brokers have done particularly well on the Comex, where tax avoidance flourishes most dramatically and openly. Straddles have at times accounted for 75 percent of the open market transactions there, and they still account for the bulk of them. And no wonder: until recently the Comex had special trading sessions that took place after the close of regular trading at 2:15. On the last business day of 1976, for example, the special session didn't end until 7:30, with trading reaching a record 127,584, contracts, only 306—or one-fortieth of 1 percent—of which were regular single month trades.[4]

During these special sessions, according to the CFTC, on "any given day when the market has had a very wide price range, the trader is in the position to calculate almost to the penny what the net result of his actions will be prior to entering the market.[5]

All this tax straddle trading, of course, distorts the commodities market. As the former director of the CFTC's enforcement division has emphasized, it often "artificially pumps up trading volume, creating an illusion of liquidity and market breadth that can be misleading to act on.[6]

CURRENT LAW ON TAX STRADDLES

Arguably, straddles are already against the law. Specifically, Section 165(c)(2) of the Code states that individuals may deduct losses incurred in any transaction entered into "for profit." It is clear that the straddles are not entered into for profit, but only to create artificial losses and to convert ordinary income into capital gains, i.e., for tax purposes. Professor Roger Gray of Stanford, one the nation's leading commodity theoreticians, emphasizes that the odds are 40 to 1 against even getting your money back as a result of a tax straddle. He calls it "inherently inconceivable" that tax straddles could have been traded for their profit potential.[7]

Moreover, the IRS has ruled that straddles are illegal. In Rev. Rul. 77-185, the IRS disallowed the losses created by a commodity tax straddle because the taxpayer's "dominant purpose" was to create an artificial loss, and the taxpayer had no "reasonable expectation of deriving an economic profit" from the transaction.

But despite this IRS ruling, the attitude of wealthy investors and the investment community was sumed up by a Finance Committee staff member as follows: "There is no reason," he said, "that [an investment firm] should cave into an IRS position that is not law."[8]

In other words, taxpayers do not regard an IRS ruling as the law of the land. They would probably acknowledge that a court decision would have more weight, but they have done their best to avoid court decisions. For example, in 1973 Merrill Lynch constructed a tax straddle and thus created a tax loss for two taxpayers. The IRS disallowed the loss and ordered the taxpayers to pay $57,000, and the taxpayers sued the IRS. The case was to begin November 3, in New York. On the courthouse steps, however, Merrill Lynch paid the plaintiffs more than $100,000—about double the amount in controversy—to drop the suit, but the judge wouldn't let them. The

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[2] See Hearings on Silver Prices and the Adequacy of Federal Actions in the Marketplace, 1979-80, before the Commerce, Consumer and Monetary Affairs Subcommittee of the House Committee on Government Operations, at 906-09, 96th Cong., 2nd Sess. (1980).

[3] Wall Street Journal, June 6, 1978, at 1.

[4] Id. at 24

[5] Wall Street Journal, June 6, 1978, at 24.

[6] Wall Street Journal, Sept. 20, 1977.

[7] Washington Post, Dec. 21, 1980, at G2.

[8] "Poor Little Butterfly: The IRS Has Frowned on Tax Gimmick Straddles," Dec. 22, 1980.

judge explained: "What bothers me is what role is Merrill Lynch going to continue to play in silver straddle cases? Are we going to gear up for trail and have Merrill Lynch come in at the 11th hour and get rid of the case." [9]

The short answer to the judge's question is yes, unless Congress acts to explicitly outlaw tax straddles. Taxpayers do not regard IRS rulings as the law, and they may continue to try to prevent a court from ruling, as Merrill Lynch has done. Moreover, without legislation only a Supreme Court decision would be the law of the land, and such a decision would even under the best of circumstances, take years. As a practical matter, therefore, only Congress can close the tax straddle loophole.

WHAT S. 626 WOULD DO

S. 626 would effectively prohibit both tax avoidance techniques made possible by straddles. First, it would prohibit taxpayers from creating a bogus ordinary loss in the first year to offset income in that year, by prohibiting the taxpayer from recognizing his loss as long as he holds the offsetting leg of the straddle. In other words, he can't recognize the loss until he recognizes the gain, and thus gets no tax advantage.

Second, it would prevent the taxpayer from converting ordinary income into capital gain by suspending the running of the capital gain holding period while the straddle is held.

We do, however, think the attribution rules in S. 626 should be tightened. Section 1092(c)(7) of the bill provides, in effect, that a taxpayer may not circumvent the prohibition on straddles by having his wife or his children under 18 hold the other leg of the straddle. However, this definition is much to narrow. Straddles could still be held by the taxpayer and his children over 18, or his mother and father or any other relative except for his wife and his children under 18. We therefore urge that the general rule of § 318 with respect to constructive ownership of stock be applied to tax straddles, so that the holdings of the taxpayer, his spouse, his children, grandchildren and parents will be considered in determining whether the taxpayer holds offsetting positions.

It is important to emphasize that S. 626 does not outlaw straddles. It simply prohibits the use of straddles to avoid taxes. For example, farmers or cereal processors who "hedge"—i.e., who establish offsetting positions in a futures contract in order to protect either a selling price or costs—and who then close out their positions, will still be able to recognize any otherwise allowable losses they sustained.

The commodities traders and the securities industry may well argue that outlawing straddling for tax purposes threatens the "liquidity" of the futures markets. If speculators who use the market to speculate can't also use the market to shelter their income from taxes, they argue, many speculators will no longer trade and there won't be enough demand for the other side of a hedger's contract. But if this is true, something is wrong with the futures contract market, not with S. 626. Any contracts which are dependent upon tax trading to make it in the competitive marketplace have no real economic purpose, unless, as Congressman Rosenthal has said, "we decide here, as a matter of public policy, to provide a special tax-trading shelter for the wealthy." [10]

Interestingly, although we have all heard cries about how prohibiting straddling for tax avoidance purposes will harm farmers, country grain elevators, merchants, food processors, manufacturers, exporters and even consumers, these cries come not from the farmers and merchants themselves, but rather from the professional traders: those people who either get commissions from creating tax shelters or who use the straddles themselves to avoid taxes.

The professional traders have even go so far as to ask for a special exemption that would allow them to avoid taxes by using commodity straddles even though all other professions would be prohibited from using them. On its face, their suggestion seems ludicrous. I am told that the more one knows about the commodities futures market the more ludicrous it becomes. I respectfully urge the Committee to get the views of the CFTC on the question whether exempting commodities traders from tax straddle legislation serves any legitimate policy goal.

Finally, we agree with the Treasury Department that for individuals with a substantial volume of commodities transactions "marking to the market" would be the best approach. In actual practice in the commodities exchanges gains and losses on futures contracts are realized everyday. If the taxpayer has gain he can with-

[9] Washington Post, Dec. 21, 1980, at G2.

[10] Testimony of Rep. Benjamin Rosenthal before the House Ways and Means Committee, April 30, 1981.

draw it, and if he has a loss he can make an additional deposit with his broker. Under this "mark to the market" approach, the taxpayer would simply add up his daily gains and losses on his futures accounts during the year and report the total. The total, whether a net gain or loss, would be ordinary income. As the Treasury Department has explained,

"Because futures positions are marked to market on a daily basis under the normal operating rules of the exchange, with actual cash settlements on a daily basis, this rule does no more than make the tax laws reflective of the underlying market transactions." [11]

CONCLUSION

In conclusion, Mr. Chairman, we urge you to take decisive action to outlaw the use of straddling for tax purposes—and outlaw them without making a special exception for certain professions—because of the potentially disastrous implications of the proliferation of commodity tax straddles for our voluntary tax system.

Voluntary compliance by average people with our tax laws has always been exceptionally high and is really one of the wonders of our system. But there is a real possibility that ordinary people will become less willing to voluntarily pay 15 to 20 or 25 or 30 percent of their hard-earned income taxes when they see the widespread use of commodity tax straddles and other tax avoidance devices by those making many times more than they are. The longer straddles, as well as other tax shelters exist—and the more people know about them—the greater the threat to our voluntary tax system becomes.

Thank you very much.

Senator SYMMS. Thank you.

Senator MOYNIHAN. Thank you, gentlemen.

[Whereupon, at 1:20 p.m., the hearing adjourned, subject to the call of the Chair.]

[By direction of the chairman the following communications were made a part of the hearing record:]

STATEMENT OF HARVIE BRANSCOMB, JR., CHAIRMAN OF THE SECTION OF TAXATION OF THE AMERICAN BAR ASSOCIATION

Mr. Chairmen, members of the subcommittees, my name is Harvie Branscomb, Jr. I am Chairman of the Section of Taxation of the American Bar Association. In that capacity, I am pleased to express the views of the Section of Taxation with respect to legislative proposals relating to "tax straddles." These views are only those of the Section and should not be construed as representing the position of the Association.

GENERAL COMMENTS

Mr. Chairmen, in our opinion, the Internal Revenue Service is justified in its concern that certain commodity transactions have been improperly utilized as a device for reducing current income taxes. Straddles are being used to defer income to a later year, to convert ordinary income to capital gains, and to convert short term capital gains into long term capital gains in situations where there is little or no potential for profit or risk of economic loss.

In addressing this problem, it is important to bear in mind that the straddles area presents one of the most difficult and highly technical areas of the tax law. It is likely that any legislative response to the straddles problem will be complex in its terminology and its operation, that it will affect transactions that are not tax motivated straddles and which indeed may not even be generally known as straddles, and that at the same time it will not fully preclude the use of commodity futures transactions, futures contracts, puts and calls, and similar devices for tax motivated purposes. Therefore, we think the solution should be narrowly drawn with Congress making a commitment to review this law after it has been in effect to ascertain how well it is working and whether it needs to be revised.

The Internal Revenue Service has already embarked upon an aggresive effort to curtail improper straddles. Revenue Rulings 77-185 and 78-414 take the position that certain straddles do not produce deductible losses. The Internal Revenue Code contains certain provisions with regard to the use of "wash sales" of securities but these do not apply to futures contracts. In addition, Section 183 applies to losses which are not deductible and transactions which are not "engaged in for profit".

[11] Testimony of John Charpcton before the House Ways and Means Committee, Apr. 30, 1981.

However, neither of these Sections nor other provisions of the Code apply with enough predictability and certainty to preclude the growing tax abuse that is being generated by the use of straddles. In our opinion, a legislative solution is needed to solve these problems.

SPECIFIC COMMENTS

Scope of bill.—In our opinion it is important that the present bill be narrowly drawn to apply only to contracts of the type which are bought and sold on regulated securities and futures markets or otherwise publicly traded. This definition would exclude corporate stock, but include commodities, currency contracts and contracts for the future payment of money. If experience shows this limitation is inadequate, consideration should be given to enlarging it when the law is reviewed in the future, as we recommend.

The following are some of the abuses of straddles and our recommendations for dealing with them at this time:

1. *Cash and Carry.*—Taxpayers purchase a commodity, borrow to finance the purchase and then deduct interest, storage and other carrying expense. The taxpayers also acquire a futures contract to sell the commodity, in order to avoid substantial economic risk on the purchase. The commodity is later sold, after increasing in value, and thus generating a capital gain. The bill needs to make it clear that carrying charges in purchasing and holding a commodity when such an offsetting position is present can be deducted as current expenses when the expenses are incurred for the purchase, production or holding of inventory or other ordinary income assets.

2. *Conversion of ordinary deduction into capital gains.*—A typical way of converting ordinary deductions into capital gains is to enter into a straddles transaction in which the loss leg generates an ordinary loss and the gain leg generates capital gain. For example, under current law Treasury bills sold at a loss generate an ordinary loss and yet a hedge with a Treasury bill futures contract produces capital gain. A solution to this problem is the creation of a basket approach where both sides of the hedge will be treated in the same manner. Under this approach, all gains and losses on a straddle position will be of the same character, either ordinary income or short term or long term capital gain.

In addition, the "thirty day look back" rule which now allows securities dealers to identify securities acquired as being either capital assets or inventory assets should be changed to require such identification to be made by the normal commercial delivery date.

3. *Deferral of income.*—Straddles have been used to defer gain from year to year (thus having the effect of permanent deferral). While one solution to this problem is the "market to market" approach, where all gains and losses are realized annually at year end, this would be a substantial departure from the cash method of accounting and still does not solve the problem of futures contracts not sold on regulated exchanges. Although there is considerable merit to this position, we feel that a better solution to the problem would be to expand the "wash sale" rule so that losses are not realized for tax purposes if the taxpayer is not "at risk" or "naked" in a contract for thirty days. This can be accomplished by amending the wash sale rule and the short sale rule be making them apply to futures contracts as well as to securities.

4. *End of permanent deferral.*—Many brokers and dealers have been deferring their commodity income for numerous years, creating an enormous deferred tax liability. We recommend bringing this deferral to an end but realized the large impact payment of this tax burden may have. We suggest that these taxpayers be allowed to elect to take this deferral into income over ten years, in the same manner as authorized for taxpayers who change accounting methods under Section 481.

5. *Hedging transactions.*—A true hedging transaction, entered into as a means of price insurance where the hedge is an intergral part of an active trade or business, should be exempt from the application of this bill. However, this exemption should be narrowly drawn to limit its applicability to those actually using the hedge strictly for economic purposes.

TECHNICAL COMMENTS

In preparation for this appearance, a Tax Section Task Force has reviewed H.R. 1293 and H.R. 1338, identical bills introduced by Congressman Brodhead and Con-

gressman Rosenthal, respectively.[1] We have also reviewed Senator Moynihan's bill, S. 626. We direct our technical comments to those bills.

1. *Definition of personal property.*—In H.R. 1293, the term "personal property" is defined as (A) commodities, (B) evidences of indebtedness, (C) currency, and (D) any other type of personal property. The latter provision would include corporate stock which is expressly excluded under S. 626. This is a significant difference raising major policy questions. S. 626 does not expressly cover currency expect to the extent that the term "Personal property" may be sufficiently broad. Certainly currency future should be treated the same as futures in evidence of indebtedness.

Because of the broad application of these bills to personal property, the Committee should carefully consider whether there are types of property and transactions that are unintentionally swept within the ambit of the proposed legislation.

2. *Definition of offsetting position.*—Under H.R. 1293, any two positions are presumed as offsetting if (i) the positions customarily treated as straddles, (ii) the aggregate margin requirement for such positions is lower than the margin requirement for any one position, or (iii) there are other factors (as determined by the Secretary) indicating that such positions are offsetting.

The definition of "offsetting position" in S. 626 is substantially more precise, requiring substantially equivalent long and short positions in the same commodity (whether or not in the same physical form) or in debt instruments or where the aggregate margin requirements are reduced. However, S. 626 also contains a "catch-all" for regulations to be prescribed by the Secretary. S. 626 does restrict the Secretary by providing a statistical safe harbor for transactions in different commodities based on "standard deviation" of changes in price of such commodities during any two-year period during the preceding five years. Safe harbor provisions generally are desirable, but this particular provision is somewhat difficult to evaluate because it requires a certain amount of statistical expertise which many of us lack. Certainly it is too complex for the ordinary taxpayer to understand or utilize without professional assistance. Presumably the brokerage houses would retain expert statisticians to determine whether various commodities have met the safer harbor test.

While each bill provides that the presumption or existence of offsetting positions may be rebutted, a greater than normal standard of proof is provided by requiring such rebuttal to be established to the satisfaction of the Secretary.

In addition, the question of whether an offsetting position exists is not limited to the presumptive situations and there is no assurance that many other situations would not be treated as offsetting even though no tax abuse is involved. For example, a taxpayer having a substantial portfolio of bonds may substantially diminish his risk of loss by borrowing money on a long term basis with respect to a mortgage on his personal residence. A banking institution which issues long term certificates of deposit may well have an offsetting position which diminishes its risk of loss with respect to its portfolio of government bonds. Thus, a great variety of business transactions could be affected by the proposed statute in addition to the transactions typically used for straddle tax avoidance. Before any statute is passed, a clearer line should be drawn between abusive transactions that are intended to be covered and normal business transactions that are not intended to be affected.

There is no definition as to what constitutes a substantial diminution of risk of loss even in an orthodox straddle position, although S. 626 would appear to be preferable by requiring "substantially equivalent long and short positions." However, S. 626 should be clarified to indicate that positions will not be offsetting unless the long and short positions are substantially equivalent, with perhaps some guidelines as to what constitutes substantial equivalence. While obviously an exact equating of the offsetting positions would be impossible, a clearer line should be drawn. Thus, for example, if a taxpayer has a short position with respect to ten units of a commodity, would a long position with respect to only two units constitute a substantial diminution with respect to all ten units in the short position?

The following examples illustrate the problems:

Situation I.—Assume Taxpayer (X) enters into the following transaction:

TRANSACTION

October 31, 1980—Buy: 200 contracts (5,000 ounces per contract) for May 1981 silver at $16.9020 per ounce. Sell: 400 contracts for February 1981 silver at $16.8060 per ounce.

The price of silver rises and on December 31, 1980, X buys 200 contracts of February 1981 silver at $17.5040 per ounce, thereby closing his excess short position

[1] Because the two House bills are identical, this testimony will, for convenience, refer to H.R. 1293.

in 200 contracts for February 1981 silver and realizing a loss of $698,000. He remains short in 200 contracts with an unrealized additional loss of $698,000 and is long in 200 contracts with an unrealized gain of $602,000.

Under these bills, it is unclear whether X would be permitted to recognize his realized loss of $698,000 because of his long position in 200 contracts for May 1981 silver. Specifically, the Internal Revenue Service may identify the 200 contracts closed on December 31, 1980, as an offsetting position with respect to X's long contracts, thereby preventing him from realizing the loss. This is an incorrect result because the loss was not realized with respect to the disposition of one side of an offsetting position; rather, the loss of $698,000 was in excess of any net unrealized gain from the balanced position represented by his long position and short position in the 200 contracts of silver held on December 31, 1980.

Situation II.—A variation of this same problem is present when the taxpayer purchases different commodities that may be treated as offsetting positions. For example, assume the following transaction:

TRANSACTION

October 31, 1980—Buy: 200 contracts (5,000 ounces per contract) for March 1982 silver at $16.9020 per ounce. Sell: 200 contracts (100 ounces per contract) for January 1982 gold at $540.00 per ounce.

The price of silver and gold rise by .10 and $29.00, respectively. On December 31, 1980, X buys 200 contracts of gold, thereby closing his short position and realizing a loss of $580,000. X has unrealized gain with respect to his long position of only $100,000.

The amount by which X's losses exceed his net unrealized gain (*i.e.*, $480,000) should be permitted as a deduction in 1980, because it is only to the extent of unrealized gain from the long contract that X is in an offsetting position.

Situation III.—A similar situation exists when the taxpayer purchases one position during the year and assumes an offsetting position some time thereafter. For example, assume the following facts:

TRANSACTION

October 31, 1980—Buy: 200 contracts (5,000 ounces per contract) for March 1981 silver at $16.9020 per ounce.

December 30, 1980—Sell: 200 contracts for January 1982 silver at $16.4050 per ounce.

From October 31, 1980 to December 30, 1980, the price of silver drops $0.20 per ounce. At the opening of trading on December 31, 1980, X sells his long position for $16.7020 per ounce, thereby realizing a loss of $200,000.

With respect to that transaction, X realized a real economic loss of $200,000. It is a fortuitous event if he covers this loss from gain recognized upon the liquidation of his short position purchased December 30, 1980. X should be permitted to recognize the loss attributable to that period of time that his long position was not offset by a corresponding short position.

In a carefully constructed straddle, the different sides of the offsetting position should move in equal amounts, so that for any unrealized loss there is a corresponding unrealized gain. In actual practice in transactions entered into for economic profit, however, unrealized losses may exceed unrealized gain. H.R. 1293 and S. 626 would prevent the recognition of the loss in excess of unrealized gain until the close of the balanced period. This would appear to be an unjustifiable result because realized loss in excess of unrealized gain from the other side of the offsetting position represents true economic loss. Stated simply, loss should be deferred to the close of the balanced period only to the extent of unrealized gain. The proper point of time for measuring net unrealized gain to offset realized losses is an open question. Either the date of loss realization or the last day of the taxable period would appear appropriate.

As the term offsetting position is presently defined, these bills would reach all transactions in which the taxpayer holds two positions customarily treated as a straddle, since a straddle by definition has the economic effect of reducing the taxpayer's risk of loss. In that regard, the test for determining whether there is an offsetting position avoids motive analysis by focusing on the objective fact of whether the position provides the taxpayer with a substantial diminution of the risk of loss. This approach represents a radical departure from the Internal Revenue Service's existing position in Rev. Rul. 77-185, 1977-1 C.B. 48, wherein the loss recognized on one side of an offsetting position is disallowed because he suffered no economic loss and there was no closed and completed transaction. However, it would appear appropriate as a matter of policy to exempt a straddle position established

solely for the purpose of deriving economic gain. More specifically, a transaction with respect to one side of an offsetting position should be exempted, if the transaction was consummated for other than tax purposes.

3. *Tax year of loss.*—Each of these bills prohibits the taxpayer from recognizing a loss with respect to an offsetting position until the close of the balanced period. The term "balanced period" means any period during which the taxpayer holds offsetting positions "plus the 30-day period after the day on which such positions cease to be offsetting." As a result, if an individual, A, owns an offsetting position in V contracts and closes out the loss position on December 31, 1980, A will not be entitled to recognize that loss until the tax year 1981, even if A does not reestablish an offsetting position in V contracts.

The result of postponing the recognition of the loss until the end of the balanced period is inconsistent with the wash sales provisions of section 1091 of the Internal Revenue Code. In particular, section 1091 of the Code denies a loss on the sale of stock or securities if, within a period beginning 30 days before the date of the sale and ending 30 days after such date, the taxpayer acquired substantially identical stock or securities. Thus, if an individual, A, sells X stock on December 31, 1980, A may recognize any loss attributable thereto in calendar year 1980, unless he repurchases the stock within 30 days. Accordingly, these bills should be amended to conform to the wash sales provisions, so that a loss with respect to an offsetting position could be recognized, if such offsetting position is not reestablished within a 30-day period. For this purpose, the "substantially identical" requirement of section 1091 should be modified to a requirement of a long or short position having similar economic effect to the position disposed of.

In any event, it would appear unjustifiable to postpone the recognition of loss beyond the point of time when both legs of the straddle have been disposed of, at least if there has been no reinstatement of either position within the wash sale period. For example, if the taxpayer buys one May Sugar Contract and sells one October Sugar Contract in November of 1980, and disposes of both Contracts in December of 1980, at an overall loss, he should be permitted to recognize the overall loss in 1980. While H.R. 1293 so provides, S. 626 does not.

4. *Hedging transactions in active trade or business.*—Under H.R. 7541 introduced in the past legislative session, a taxpayer engaged in a true hedging transaction as an integral part of his business would have been exempted from the provisions of the bill. This treatment is not provided under H.R. 1293 or S. 626.

We believe that true hedging transactions, which are engaged in strictly for economic purposes (rather than tax purposes) should be exempted from the provisions of these bills. Certain remarks by various congressmen indicate that the abuse sought to be eliminated by these bills is not present in the true hedging transactions. See Representative Brodhead's introductory remarks with respect to H.R. 1239 (the true hedger, such as the average farmer, enters the futures market for economic reasons—not for tax reasons); Senator Moynihan's introductory comments with respect to S. 626 (straddles used by investors to make a profit are perfectly legitimate). This exception for true hedging transactions should include all instances in which the taxpayer takes positions in property as a form of price insurance, especially if the hedge is an integral part of an active trade or business. We recognize that there may be some policy considerations for limiting the nature of trades or businesses which would be covered by such exception.

It would appear appropriate to extend any such exception for ordinary business hedging transactions to include hedging transactions in interest rates futures markets. The interest rate futures markets are valuable to savings and loan associations, small banks, and members of the construction industry. For example, a financial manager who anticipates having funds to lend or invest in the money market at some later date may hedge against a drop in the interest rates by going long in interest rate futures.

Example 1.—Corporation X makes a commitment on March 1 to provide $1,000,000 to a mortgage pool on December 1. To hedge against a rising interest rate, X sells ten Ginnie Mae contracts. Interest rates rise.

Cash	*Futures*
March 1: $1,000,000 Commitment based on current Ginnie Mae's cash price of 99-24 (yield 7.989).	Sells 10 December Ginnie Mae contracts at Market 99-00 (yield 8.092).
December 1: Sells $1,000,000 of Ginnie Mae to investors at market 92-24 (yield 8.992).	Liquidates short positions at prevailing market 92-000 (yield 9.105).
Loss: $70,000.	Gain: $70,000. Net climbs: $0.00.

In addition, consideration should be given to expanding this exception to instances in which the taxpayer enters into the hedging transaction as protection against a currency fluctuation.

Example 2.—Assume an American citizen, A, purchases an asset for investment purposes in Switzerland. A executes the contract on March 1 to purchase an asset for $250,000 Swiss francs payable on December 1. Under that scenario, A is subject to the risk that the value of Swiss francs will rise during the nine-month period. To protect himself, A establishes a long position.

Cash	*Futures*
March 1: Short 250,000 Swiss francs at 0.4113=$102.825.	Buys 2 Swiss francs contracts at .4223=$105,575.
December 1: Buys 250,000 Swiss francs at 0.5559=$138,975.	Sells 2 Swiss francs contracts at .5623=$140,575.
Loss: $36,150.	Gain: $35,000.
	Net loss: ($1,150.)

5. *Offsetting position in other than the same commodity.* These bills would create an area of uncertainty and litigation where taxpayers are dealing in more than one commodity. Under these bills, an offsetting position with respect to personal property may exist whether or not the personal property underlying each position is of the same kind. It would appear that there may be instances in which a professional trader may take a number of positions with respect to different types of personal property and intend to achieve economic gain from each position independent of the other positions, rather than handling any two positionsd as a straddle.

Many traders attempt to hedge through contracts in different commodities and such transactions may well be salutary rather than tax abuses. Another aspect of this same problem relates to a partnership that acts as a broker-dealer and market maker and also invests and trades for its own account. Under these bills, it would appear that, for example, an offsetting position in V contracts could be established if the partnership maintained a long position in V contracts for its inventory and a short position in V contracts for its investment account. Assuming the positions are traded independently and not as straddle, a loss recognized with respect to one of the positons should not be disallowed.

Another version of that same problem could arise with respect to a holder of X bonds who holds an option on the same or other bonds.

6. *Attribution rules.* Under each of these bills, a taxpayer is deemed to own the positions of other persons attributed to him pursuant to varying attribution rules.

Under H.R. 1293 attribution is by reference to the provisions of sections 267, 707(b) and 414 (b) and (c), with family being limited to spouse and children under the age of 18. Under these provisions there would be attribution to the taxpayer from a 51 percent owned corporation or a trust created by the taxpayer regardless of the relationship of the beneficiary of such trust to the taxpayer. There would also be attribution between brother-sister corporations ineligible to file consolidated returns.

Under S. 626 attribution is by reference to section 318 with the same family limitation as under H.R. 1293, but with an 80 percent interest requirement for attribution to or from corporations, partnerships, trusts or estates, except for trusts to which subpart E of subchapter J applies. Each bill provides for additional attribution from "flow-through" or "pass-through" entities. The existence of these attribution rules, however, may result in penalizing taxpayers in situations where such penalty is not waranted.

For example, if an individual, A, owns 80 percent (51 percent if H.R. 1293 and H.R. 1338 apply) of Corporation X, and A owns a short position in corn futures and X owns a long position in oat futures, the two positions would apparently be treated as offsetting positions. Accordingly, if the price of oats falls and X liquidates its long position at a loss, X will not be entitled to deduct the loss until the end of the balance period. A may well be in a higher tax bracket than X and any tax avoidance resulting from such a situation is difficult to discover. Becacuse A and X are separate taxable entities with different tax rates and economic situations, it would not appear appropriate to aggregate the futures contracts for determining if an offsetting position existed.

A more extreme inequitable example may be visualized under the attribution rules of H.R. 1293. Assume that T establishes a trust with an independent corporate trustee for the lifetime benefit of an indigent aunt. The trustee invests in government bonds. The trust investment which could never benefit T personally economically or through any tax benefit would be treated as an offsetting position to any short position of T in evidences of indebtedness.

I would further appear that the attribution rules could well be limited to spouses where a joint return can be filed, to grantor trusts (including section 678 trusts), because such trusts are the alter-ego of the grantor (or beneficiary under section 678) and the transactions end up on the same tax return, to pass-through entities and to corporations eligible to file a consolidated return.

In other situations the potential for tax abuse would appear to be remote. The whole point of tax deferral through the use of a straddle is that one leg of the straddle will produce a loss while the other produces a gain, but there is no way of predicting which when the straddle is entered into. Thus, except in the above cases there can be no assurance that the loss will be realized by the taxpayer for whom the loss will create the greater tax benefit.

Even if the taxpayer realizing the loss is an individual and the offsetting position is held by his wholly-owned corporation, the gain will be recognized by the corporation in a different tax bracket and an additional taxable transaction will be required to bring that gain out of corporation solution for the benefit of the shareholder.

In the case of "flow-through" or "passthrough" entities, the bills should be amended to specify in what manner the partner's pro rate share of the partnership's position is to be determined. Obviously, some adjustment to a pro rata attribution should be made for those instances in which a special allocation exists in the partnership agreement adjusting the partner's right to gain or loss from a disposition of the futures contract. Moreover, relief from this provision may be required for limited partners who do not control the investment activities of the partnership and where it would be mere happenstance if the partnership owned property which would be considered offsetting with respect to positions owned by the limited partners.

The provision with respect to "flow-through" or "pass-through" entities would also seem to apply onerous reporting requirements on partnerships. For example, under the provisions of H.R. 1293, a publicly owned limited partnership would have to account at the end of each of its partner's taxable years for the partnership's holdings in future contracts.

7. *Change of status of Treasury bills.*—Each of these bills would also amend the definition of capital assets so as to treat Treasury Bills as a cpaital asset. The purpose of this amendment is to close a potential tax avoidance area converting ordinary income into capital gain through the use of futures contracts with respect to Treasury Bills. this problem results from the treatment of a futures contract as a capatal asset under the provisions of Rev. Rul. 77-414 even though the underlying subject matter of the contract was not a capital asset. It is submitted that the tax avoidance opportunity could equally be eliminated by legislatively overruling Rev. Rul. 77-414 and providing that a contract for the purchase or sale of a non-capital asset shall be treated as a non-capital asset.

The conversion of Treasury Bills to capital assets will be a complicating provision in the tax law which may well have an adverse economic effect on the market for Treasury Bills as well as possibly opening tax avoidance opportunities in other areas. It should be noted that for certain taxpayers, short term capital gains are more desirable than the same amount of ordinary income. For example, a taxpayer having long term capital losses may use those losses, dollar for dollar, to offset short term capital gains but may only use those losses at fifty cents on the dollar against ordinary income subject to a further aggregate deduction limitation of $3,000 per annum.

In the case of estates and trusts, short term capital gains are excluded from the definition of distributable net income under section 643 to the extent that they are allocated to corpus and are not paid, credited or required to be distributed to a beneficiary during the taxable year. Under the proposed amendments, there will be situations periodically, at least, when Treasury Bills can be purchased with a built-in short term capital gain and permit taxpayers to take advantage of such a situation.

On the other hand, estates and trusts may be reluctant to purchase Treasury Bills as against other forms of interest producing obligations since the sale of such Treasury Bills prior to maturity may result in a short term capital loss and a short term capital loss will, in most instances, be less desirable. In any event, the sale of Treasury Bills may result in complications in the preparation of the tax return in allocating between interest and capital gain.

If this amendment is made, there should also be a clarifying amendment to the provisions of section 1232 to make it clear that the original discount is to be treated as interest and not as capital gain. Absent such an amendment, there could be a contention that the entire discount would be short term capital gain.

The foregoing analysis of the proposed legislation incorporates a number of suggestions which, in the opinion of the Section of Taxation, would improve such a statute. If it is the decision of the Committee that their straddle problem is to be dealt with legislatively at this time, and that the legislative solution should follow the loss disallowance approach, the Section would be prepared to provide further assistance in developing a revised statutory provision that would deal with the problems outlined above. Indeed, some of the members of the Section have already been in communication with the staff of the Joint Committee in this regard.

As the deliberations of the Committee proceed, the Section of Taxation will continue its efforts toward the development of a solution to the straddle problem which will, insofar as feasible, curtail the use of straddles for tax reduction and tax deferral purposes where there is no material economic risk involved.

Statement of Walter E. Auch, Chairman, Chicago Board Options Exchange

I. INTRODUCTION

I am pleased to submit this statement on behalf of the Chicago Board Options Exchange (CBOE) on the subject of the taxation of offsetting positions in certain types of personal property. This issue has been addressed in S. 626, a bill introduced by Senator Moynihan, and in subsequently revised proposals prepared by Senator Moynihan and his staff, each of which would amend the Internal Revenue Code by adopting a "Commodity Straddles Tax Act of 1981."

CBOE is a registered national securities exchange subject to the regulatory authority of the Securities and Exchange Commission. It is the world's largest marketplace for the trading of put and call options to sell and to buy shares of corporate stock. CBOE currently lists for trading options on the common stocks of approximately 120 of the Nation's largest corporations. CBOE's 1,231 members include virtually all of the major national securities firms as well as many smaller regional firms located throughout the country and approximately 1,100 brokers and dealers who transact business on the CBOE trading floor in Chicago. Although the early development of CBOE was sponsored by the Chicago Board of Trade, today the two exchanges are completely separate institutions, and CBOE does not trade or propose to trade any commodities or commodity futures.

CBOE's interest in the subject currently under consideration is a limited one, since the proposed Commodity Straddles Tax Act is directed only at the tax consequences of certain offsetting positions in commodities and evidences in indebtedness, and would not apply to trading in corporate stock options to buy or to sell corporate stock.[1] However, CBOE has recently received SEC approval to initiate a new market in options to buy and sell GNMA pass-through securities, which are interests in pools of residential mortgages guaranteed by the federal government. GNMA securities are currently the subject of futures trading on certain boards of trade, and CBOE's proposal would extend options trading to these same underlying financial instruments. Since the Commodity Straddles Tax Act is proposed to apply to offsetting positions in evidences in indebtedness, which would include positions in GNMA securities, we are concerned at the impact of certain of the bill's provisions on our proposed new GNMA options market and potential users of that market.

In the remainder of this statement, we shall describe the difficulties that the Commodities Straddles Tax Act, as it has been proposed, would present for our proposed GNMA options market and its users. We shall also suggest certain exemptions that we believe must be included in the Act in order to enable it to fulfill the intended purpose of preventing identified tax straddle abuses without unnecessarily interfering with entirely legitimate uses of the GNMA options market.

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[1] The definition of "personal property" contained in S. 626 expressly excludes "stock in a corporation." It is our understanding that this language is intended also to exclude options on corporate stock. This result follows from the bill's treatment of an option as a "position" in the underlying property, so that if the underlying property is not "personal property", then an option on that property is not a "position in personal property", hence not subject to the offsetting position rule. We believe that a more direct way to exclude options on corporate stock from the coverage of the bill is simply to draft the exclusion from the definition of "personal property" so it refers to "stock in a corporation or options to buy or to sell stock in a corporation."

II. WITHOUT APPROPRIATE EXEMPTIONS FOR HEDGERS AND MARKETMAKERS, USES OF CBOE'S PROPOSED GNMA OPTIONS MARKET AND THE MARKET ITSELF WOULD BE SEVERELY AND UNNECESSARILY HARMED BY THE COMMODITY STRADDLES TAX ACT

We are concerned that the "offsetting position" provisions of S. 626 and related proposals go beyond what is needed to prevent the kind of tax abuse against which the proposals are directed. Unless these provisions are revised, they will seriously disadvantage CBOE's proposed GNMA options market and users of that market by unduly restricting a significant number of legitimate risk limiting transactions involving GNMA options that are not entered into for tax avoidance purposes and do not serve as tax shelters. The specific harm to the GNMA options market that would result from the adoption of an Act that does not contain an exemption for dealers in securities to the extent of their ordinary income or loss market-making activites, and that does not contain an exemption for commercial hedgers may be summarized as follows:

A. In the absence of an exemption for dealers in securities, the offsetting position rule would make it impossible for CBOE marketmakers in GNMA options to function, thereby depriving the GNMA options market of depth, continuity and liquidity, and perhaps destroying the market altogether.

B. Commerical hedgers and other non market-maker users of the GNMA options market would be prevented by the offsetting position rule from engaging in legitimate risk-reducing GNMA options transactions that do not involve tax avoidance. In the remainder of this part II we shall elaborate on each of these problems, and we shall present our recommended solutions.

A. As planned, CBOE's GNMA options market will utilize the same competing market-maker system that has proved successful in its stock options market over the past eight years. This innovative system, which was developed by CBOE at the time it created its listed options market, depends upon the interaction of a large number of competing market-makers to provide the liquidity that is necessary to the proper functioning of the market. Market-makers in GNMA options will be obligated under exchange rules to bid and offer for their own accounts in all of the various series of GNMA options that are traded. A competing market-maker system is to be distinguished from the unitary specialist system that historically has prevailed on securities exchanges, where a single individual or firm—the specialist—bears the principal market-making responsibility in each listed security. Market-makers must also be distinguished from traders, since, unlike traders, market-makers are required to continually make two-sided markets as a part of their ordinary business activities, and, as a result, their gains and losses are treated as ordinary items for income tax purposes.

GNMA options are proposed to be traded in a number of series that differ from each other in terms of the expiration date of the option and the exercise price to be paid for the purchase (or sale) of a fixed quantity of underlying GNMA securities upon exercise. Examples of different series of GNMA options are the following:

March 1974 GNMA call.—gives the holder the right to purchase a fixed quantity of GNMA securities by paying 74 percent of their principal amount until the option expires in March;

June 1980 GNMA call.—gives the holder the right to purchase a fixed quantity of GNMA securities by paying 80 percent of their principal amount until the option expires in June.

June 1980 GNMA put.—gives the holder the right to sell a fixed quantity of GNMA securities for a price that is 80 percent of their principal amount until the option expires in June.

CBOE intends to provide a market for no fewer than 10 series of GNMA calls and 10 series of GNMA puts at any one time (5 different months and at least two exercise prices for each month). Since additional series will be introduced to reflect price changes in the underlying GNMA market, as many as 40 or more series of GNMA options being traded at one time will not be unusual.

GNMA option marketmakers will be required to make markets in all of the series of GNMA options that are traded. Since the GNMA options market is anticipated primarily to serve the the needs of mortgage bankers and other institutional users whose hedging needs will involve very large dollar amounts, it can be seen that at any given time individual marketmakers, in the course of meeting their market-making obligations, may be required to assume for their own accounts very large aggregate positions as buyers or writers of options. In order to manage the risk of these large positions, most options marketmakers will engage in what is known as "spreading" among the different options series.

A spread is a combination of two or more options positions in which at least one position is that of the holder of an option and at least one position is that of the writer of an option. The purpose of a spread is to reduce the risk associated with the

separate positions that make up the spread. An example of a spread would be the purchase of a June 70 GNMA put and at the same time the sale of a September 70 GNMA put. A person owning the spread would anticipate that in the event of an increase in the price of underlying GNMAs, all or part of any loss incurred in the June 70 GNMA put position would be offset by a profit in the September 70 GNMA put position.

The following presents an illustration of how spreads can be used by market-makers to limit the risk of their marketmaking activities. Assume that in January a mortgage banker undertakes to produce $10,000,000 in GNMA securities, which he hopes to sell at a predetermined yield in July. The mortgage banker may choose to hedge his exposure to price changes in the GNMA market during the period that he is producing and warehousing mortgages by purchasing 100 September 70 GNMA puts, which cover an aggregate of $10,000,000 of GNMAs. If we assume that the current market price of an underlying GNMA is 70 at the time the mortgage banker's order to purchase the 100 puts reaches the CBOE floor, the order may be filled by, say, 5 marketmakers each agreeing to sell 20 September 70 GNMA at a premium of 3 points (i.e., a premium of $3,000 for each put). In this situation, all of these marketmakers may be expected to hedge the risk of their "short" (i.e., seller's) position by spreading—they will buy GNMA puts of different series or, perhaps, they will buy or sell GNMA calls. The objective of spreading is to have an offsetting position to the position resulting from selling the original 20 puts to the mortgage banker.

For example, one of the marketmakers who sold 20 September 70 puts might choose to hedge that position by purchasing 20 September 68 puts. This market-maker may pay a premium of 2¼ points ($2,250) for each of the September 68 puts. If the marketmaker is able to close out both sides of this spread within the next day or so, his projected net gain or loss on the aggregate spread would depend upon whether the market price of GNMAs remains the same, rises or falls, as shown in the following table:

GNMA price	Put premium		Gain (loss) for 20 puts in closing out positions		Net gain (loss) on 20 option spread
	September 1968	September 1970	September 1968	September 1970	
68	3	4¼	$15,000	($25,000)	($10,000)
70	2¼	3	0	0	0
72	1⅝	2¼	(12,500)	15,000	2,500

If instead of closing out the spread within a few days, the marketmaker were to maintain the spread until the options either expired or were exercised, his maximum gain would be $15,000 if the price of GNMAs remained at 70 or above and his maximum loss would be $25,000 if the price of GNMAs fell to 68 or below.

If the market-maker does not spread his short position in 20 September 70 GNMA puts but simply maintains it as an unhedged position, although he might profit to the full extent of the $60,000 premium received if the price of GNMAs remains at 70 or above, he also would be subject to losses far in excess of the maximum spread loss of $25,000, depending on how far below 70 the price of GNMAs might fall. For example, his net loss would be $140,000 if the GNMAs declined to 60.

The foregoing illustrates that options spreading does not eliminate risk, but simply reduces risk, and that the gains and losses that may be incurred as a result of a spread position are not predetermined or in any sense artificial, but instead depend upon factors such as the length of time that the spread position in maintained and changes in the market price of the underlying GNMAs.

Since CBOE's marketmakers are obligated to make continuous two-sided markets, they will at all times be establishing and closing out positions in the various series of GNMA options, some as a result of bidding or offering in response to the demands of the market, some in order to hedge the risk of positions established in making markets, and some to adjust their positions as needed to reflect price changes, exercises and expirations. Obviously, some of these positions will result in profits and others will result in losses. (As illustrated above, the nature of a spread is that the losses of one or more components will be offset, to a degree, by the profits of one or more of the other components.) But this is not to say that spreading makes marketmaking risk-free or that the gains and losses incurred are not real.

Although a GNMA options spread is not a "straddle" in the ordinary sense of the word, in that it does not consist of "mirror-image" opposite positions, and although a spread does not eliminate risk but merely reduces it, many, if not all, GNMA options spread would nevertheless fall within the definition of an "offsetting position" contained in proposed section 1092(b). This is because the elements of a GNMA options spread are "offsetting" in the defined sense that they are intended to diminish the risk of loss from holding any single element of the spread, and in many cases the aggregate margin for the spread is less than the margin for the short side of the spread alone. (In the case of options, unlike futures, long positions may not be margined, but must be paid for in full.) Therefore, since GNMA options market-makers can always be expected to hold a large number of offsetting positions in various series of GNMA options, if these positions are treated as "offsetting" for purposes of proposed section 1092, the market-makers would never be allowed to deduct their losses so long as they continued to be engaged in market-making activities, but would instead be taxed fully on gross "profits," at ordinary income rates.[1] Plainly, no market-maker could long remain in business in this situation. The consequences would either be that there will be no GNMA options market-makers at all, and therefore no GNMA options market, or that what market-makers there are will not be able to use spreading techniques to limit their risk. The latter would result in greater costs, reduced liquidity and, in general, a much less efficient market.

An obvious solution to this problem is to provide an exemption from the offsetting position rule of section 1092 for securities dealers whose activities in otherwise covered property result in items of ordinary income or loss. Such an exemption for securities dealers is consistent with the treatment provided under the wash sale rule contained in section 1091. With such an exemption section 1092 would still apply to prevent all of the kinds of tax avoidance schemes cited by the Treasury Department, but it would not have a seriously adverse effect on CBOE's proposed GNMA options market.

B. Marketmarkers on the CBOE floor are not the only persons who can be expected to take advantage of the risk limiting features of GNMA options for purposes unrelated to tax avoidance. For example, as suggested in the preceding discussion, mortgage bankers have indicated great receptivity to this new market for purposes of hedging the enormous risks to which they are subject to producing and marketing GNMA securities. In the absence of an organized options market, mortgage bankers have traditionally relied upon a cash market in so-called standby or forward contracts, and to a lesser extent upon GNMA futures, to limit the market risk to which they are subject while accumulating mortgages and producing GNMAs. However, recent failures in the GNMA forward market have led to its virtual disappearance, and the home mortgage market has suffered as a consequence. CBOE believes that its proposed GNMA options market will fill an urgent need by providing a reliable and efficient new hedging mechanism for mortgage bankers and other professionals in the residential mortgage market, which should be especially useful in the current period of heightened volatility in interest rates.

Here, too, the basic use that will be made of GNMA options will be to offset positions in underlying GNMA securities or related instruments. For example, a mortgage banker might purchase GNMA puts to protect himself from an increase in interest rates during the four or more months that it takes for GNMA securities to be produced. If interest rates do not decline, the mortgage banker will be able to sell his production in GNMA securities as anticipated, and he will either allow his GNMA puts to expire or will sell them for any remaining value they may have. However, if interest rates rise, causing the mortgage banker to incur a loss on his GNMA production, he will be able to offset all or part of that loss by selling his now profitable GNMA put options in CBOE's secondary trading market.

Mortgage bankers typically will always be in one stage or another of GNMA production, and, like marketmakers in the earlier example, will always have a number of different offsetting positions in options, futures or forwards that hedge the risks of their various banking activities. Such persons would be severely disadvantaged by any provision in the Code that would prevent them from deducting losses, even against related gains, that are routinely incurred in their ordinary business operations. It does not appear that this is an intended consequence of the Tax Straddles Act, and although no such exemption was included in the original bill (S. 626), a more recent proposal does include the outlines of a hedger's exemption. In

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[1] The "mark-to-market" alternative that has been proposed for certain regulated futures contracts could have no application to GNMA options or other securities options; unlike RFC's, unrealized gains in open positions in options are not reflected in variation margin payments available to the holder of the profitable position.

our view, such an exemption is essential if the risk-limiting potential of the GNMA options market is to be realized.

It may have been thought that the provision of the bill that would allow losses 30 days after the close of the balanced period would provide adequate relief to commercial hedgers. However, this provision would not serve the needs of those hedgers who are continually engaged in hedging as a part of their ongoing business activities. Instead, what these hedgers need is an exemption from the general rule that would allow them to deduct losses on offsetting positions by using these losses to adjust the basis of the business property being hedged. Such a provision would still prevent the improper use of straddle losses to shelter unrelated income, which was the focus of the abuses cited by the Treasury. It would, however, enable commercial hedgers (which in the case of GNMA options include mortgage bankers, GNMA dealers and home builders) to utilize the risk limiting features of options and futures as an integral part of their business activities.

Statement of the Securities Industry Association

The Securities Industry Association is pleased to submit its view on S. 626 and the general subject of taxation of income derived from commodity straddles. SIA represents over 500 leading investment banking and brokerage firms headquartered throughout the United States which collectively account for approximately 90 percent of the securities transactions conducted in this country. The activities of SIA members include retail brokerage conducted on behalf of 30 million individual shareholders, institutional brokerage, over-the-counter market making, various exchange floor functions and underwriting and other investment banking activities conducted on behalf of corporations and governmental units at all levels. Because of their role in the capital markets, SIA members are in a position to recognize the impact of tax policy on investment decisions by corporations and investors.

The SIA has carefully reviewed the proposal made by Assistant Secretary John Chapoton before the Committee on Ways and Means of the House of Representatives on April 30, 1981. Although the SIA has numerous technical comments and substantial concerns about the proposal to require that gain or loss on regulated futures contracts be "marked to market" at the end of the taxable year, the SIA defers to the views of those in the commodities industry as to the workability of the approach.

The SIA doubts that ordinary income treatment of gains and losses recognized on regulated futures contracts which are marked to market is appropriate in view of the substantial risk assumed by speculators in these markets. We understand that consideration is being given to taxation of gains and losses on regulated futures contracts at an intermediate rate which is greater than the rate of tax on long term capital gain but less than the rate on short term capital gain. We think that a rate which reflects the risks borne by participants in these markets and other disadvantageous tax attributes of regulated futures contracts should be given careful consideration by the Committee.

S. 626, the bills introduced in the House by Representatives Brodhead and Rosenthal, and the Treasury Department proposal all recognize the approporiateness of an exemption from the legislation for what are termed "genuine hedging transations." The SIA suggests that the statute and the legislative history define "genuine hedging transactions" to include those transactions in which ordinary income or ordinary deductions are generated with respect to each position which is a part of a straddle. Where each offsetting position which is part of a straddle generates ordinary income or ordinary loss, there is no opportunity for conversion of ordinary income into long term capital gains. This is the situation with respect to dealer transactions in securities by dealers in securities. For example, a dealer in securities which hedges its long position in debt securities held in inventory would recognize ordinary income on the sale of the inventory and on closing out the position entered into to establish the hedge. The dealer in securities is in no different position from the merchant of grain which maintains inventories of grain for sale of customers in the ordinary course of business.

One of the major provisions of the House bills, S. 626, and the Treasury proposal is a provision which would require the capitalization of interest and carrying charges allocable to personal property which is part of a straddle. The SIA continues to believe that such legislation is unnecessary because of existing provisions in the Code limiting the deductibility of investment interest. We understand, however, that consideration is being given to an exemption for futures designated as "ordinary income inventory hedges" provided acceptable accounting procedures are followed. Such an exemption could do much to alleviate the concerns expressed by the SIA before the House Committee on Ways and Means. Nonetheless, we would stress

the importance that the statutory language be clear that the interest or carrying charges required to be capitalized be limited to the taxpayer's net interest expense, i.e. the interest expense on debt incurred to carry the balanced position reduced by any interest income derived by the taxpayer on the property which is part of the straddle. Unlike any other inventory asset, debt securities, which are proposed to be treated as "personal property" subject to the straddle rules, generate income while held by the taxpayer. The bills which have been introduced in Congress could be read to require that the interest income on debt securities would be taxable but the matching interest expense incurred to finance the purchase would be capitalized if the dealer attempted to reduce his exposure in the financial futures markets.

At the hearings before the Committee on Ways and Means and in meetings between SIA representatives and the staff of the Joint Committee on Taxation and the Treasury Department, we expressed our concern about the proposal to treat governmental obligations issued at a discount with a maturity of one year or less as capital assets. The SIA understands that a solution to the various technical problems which would be created by application of the original issue discount rules now applicable to governmental obligations under Section 1232 has been developed by the Joint Committee staff. Our representatives are in touch with the responsibile staff and are pleased to offer such assistance as may be helpful in explaining the operation of the market in Treasury bills.

S. 626 would eliminate the 30 day period provided for in Section 1236 pursuant to which securities may be clearly identified for investment by dealers in securities. Gain or loss from securities so identified as for investment produce capital gain or loss upon disposition. Under the proposed legislation, securities, which for these purposes also includes corporate stock, would be treated as clearly identified for investment only if all securities which are part of an offsetting position are marked for investment.

Representatives of the SIA have been in touch with the staff of the Senate Finance Committee and have indicated various administrative problems with a requirement for marking on the date of acquisition of securities. We have indicated, however, the feasibility under existing procedures of a rule requiring clear identification for investment within 7 calendar days after the securities are acquired or the first business day after the seventh day if the seventh day is a holiday.

The SIA will continue to discuss possible approaches to the multitude of technical problems raised by the proposed legislation, and we hope we can play a constructive role in the development of the legislation.

Statement of Richard O. Scribner, Executive Vice President, Legal and Regulatory Affairs on behalf of the American Stock Exchange

Summary of Comments

1. Any "tax straddle" legislation should contain a broad exemption for dealers, marketmakers, hedgers and others with respect to transactions which are connected with their trades or businesses.

2. The provisions in current law providing securities dealers a period of time within which to identify in their records securities which they hold for investment are amply justified and should not be eliminated. Limited partnership abuses in this area should be dealt with by legislation which would affect only those abusive limited partnerships.

I am Richard O. Scribner, Executive Vice President for Legal and Regulatory Affairs of the American Stock Exchange ("Amex"). I submit this statement for the record on behalf of the Amex in connection with public hearings held by the Committee on Finance of the United States Senate on June 12, 1981 on legislative proposals relating to commodity "tax straddles".

The Amex is a registered national securities exchange which maintains an auction market for trading stock and stock options. As such, the Amex plays a special role in the capital formation process. More than half of the trading on the Amex is done by individual investors who provide a crucial source of capital for over 900 small and medium-sized companies whose securities are listed here. As a major stock options market trading one-third of all listed options in the United States, we have a major role in providing a risk transferance mechanism for all investors, both individual and institutional.

While it is not engaged in commodity futures trading, the Amex intends in the future to provide a market for trading options on debt instruments and, perhaps, on other investment products. Furthermore, many Amex members are also actively engaged in transactions in debt instruments, currency, and commodities and in futures contracts and options on such properties. Consequently, we have a special

concern for the continued viability of these markets. We are submitting these comments on tax measures that have the potential to undermine the depth and liquidity of these markets.

I. RISK REDUCTION AS A BASIC CAPITAL MARKET FUNCTION

The capital markets of the United States perform vital and complex functions which are basic to the health and growth of the entire economy. The primary function of these markets is to raise capital to enable businesses and governments to operate. This function cannot be accomplished however, unless the capital markets also provide active and dependable secondary markets where investors can freely transfer or reduce their capital risks.

Investors generally will not make direct capital investments in businesses or governments unless a market exists where they will be readily able to dispose of those investments, whether at a profit or loss, when they see fit. In addition, investors are far more willing to make direct capital investments, and to participate in the secondary markets, where they have opportunities to reduce the risks of their capital investment short of an outright transfer of their investment. Options markets, such as that currently provided by the American Stock Exchange for stock options, exist primarily to provide just such opportunities. A report of the Special Study of the Options Market to the SEC in 1979 concluded that options provide "useful alternative investment strategies," including "a means for shifting the risk of unfavorable short-term stock price movements from owners of stock who have, but do not wish to bear, such risks, to others who are willing to assume such risks in anticipation of possible rewards from favorable price movements.[1] Non-stock options should provide similar benefits for markets in their underlying properties.

II. ANY TAX STRADDLE LEGISLATION SHOULD EXEMPT MARKETMAKERS

It is important to appreciate the vital role played by market makers in the effective operation of the capital markets. Market makers on registered national securities exchanges are required by regulations of the Securities and Exchange Commission and exchange rules to provide orderly and continuous markets for investors. They fulfill their functions and reponsibilities by risking their capital in short-term positions in those securities for which they are responsible. They must continually shift between long and short positions in their securities and, as an economic necessity, hedge their risks in every available way. A market maker in our proposed Treasury Bill options contracts, for example, will frequently be making a market in a number of separate put and call option contracts all covering the same underlying Treasury Bills. He will continually be switching between net long and short positions in each of those contracts in the ordinary course of his business, and realizing profits and losses as a result. Any net long position the market maker may have in one of the contracts at any given time will diminish his risk of loss to some extent with respect to all other net short positions he may then have in any other of the contracts and vice versa. Put option positions may to some limited extent diminish his risk of loss in similar (long or short) call option positions. Any one of these positions may thus constitute an "offsetting" position under S. 626 and other legislation proposed in the House of Representatives with respect to numerous other positions. Any position established in any of his contracts within 30 days of the sale of another position will be a "successor" contract and will thus continue the "balanced period" of the straddle position.

The capital markets cannot exist without market makers, who, by risking their capital, provide the basic ingredients which enable the markets to function. The proposed tax straddle legislation has serious adverse consequences for market makers unless it provides a general exclusion for them. It is unlikely that market makers could continue to function effectively with the inequity and uncertainty which would result from the tax straddle legislation without such an exemption.

III. INVESTMENT ACCOUNTS OF SECURITIES DEALERS

The proposed legislation would reduce from 30 days to 1 day the period of time within which a dealer in securities could identify a security as being held for investment, and thus potentially productive of capital gain on its disposition.

The perceived abuse at which this proposed change is directed revolves around the attempted manipulation of the securities dealers' investment account provisions

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[1] Report of the Special Study of the Options Market to the Securities and Exchange Commission, Committee Print 96-IFC3, December 22, 1978. Quotations are from the covering letter to the Report by Richard L. Teberg, Director, and from page 1 of the Report.

of the Code (Section 1236) by limited partnerships the principal financial interests in which are held by non-securities dealers. The proposed change, instead of simply restricting the use of the dealers' investment account provisions by such partnerships, would adversely affect the investment accounts of all securities dealers, to their detriment and that of the capital markets in general.

The existing Code rules on investment accounts of securities dealers were adopted in the Revenue Act of 1951 in order to avoid constant disputes and litigation between securities dealers and the IRS as the ordinary versus captial nature of gains or losses on securities. The rules provide that any loss sustained by a dealer in securities on any security will be a capital loss if at any time the security was identified in his records as having been held for investment. A securities dealer, therefore, unlike dealers in real estate, art, antiques or virtually any other property, cannot obtain an ordinary loss on a security which he has held for investment at any time, even though at the time of its sale he is actually holding the security in connection with his activities as a dealer.

On the other hand, a dealer in securities cannot realize a capital gain on the sale of any security unless (1) it is identified in his records as held for investment within 30 days of its acquisition, and (2) it is not actually held for sale to customers in the ordinary course of his business at any time after the 30-day period. The identification of a security as being held for investment does not, therefore, result in capital gain treatment, if the security is, in fact, held for sale to customers at any time after the 30-day period. Dealers in all other types of property have no such statutory identification requirement and can always attempt to prove that a particular property was held for investment at the time it was sold, even though it had earlier been held as inventory.[2]

The existing dealer investment account provisions are not in fact a tax loophole for securities dealers, but instead contain significant restrictions over and above the rules applicable to other dealers in property. Any abuses of dealers' investment accounts by tax oriented limited partnerships should be addressed directly. In this regard, the Amex would support a provision, along the lines of the proposal of the Securities Industry Association, whereby limited partnerships in which more than 60 percent of the partnership losses are allocated to limited partners would not be treated as dealers in securities. At the very least, it is essential that bona fide securities dealers be provided a realistic opportunity, taking into account operational considerations, to make an investment designation. To further tighten the already strict rules applicable to bona fide securities dealers is unwarranted.

IV. CONCLUSION

Any "tax straddle" legislation should contain a broad exemption for dealers, market-makers, hedgers and others with respect to transactions which are connected with their trades or businesses. The Amex supports the proposals in this regard in the Securities Industry Association presented at these hearings.

The provisions in current law providing securities dealers a period of time within which to identify in their records securities which they hold for investment are amply justified and should not be eliminated. Limited partnership abuses in this area should be dealt with by legislation which would affect only those abusive limited partnerships.

SUBMITTED STATEMENT OF THE AMERICAN FEDERATION OF LABOR AND CONGRESS OF INDUSTRIAL ORGANIZATIONS

The AFL-CIO supports S. 626, a proposal intended to stop the use of tax straddles for tax avoidance purposes.

With increasing popularity over the last ten to fifteen years, straddles are being used by wealthy individuals and corporations to generate artificial paper losses from transactions that have no real economic risk. By way of illustration, a straddle in commodities can be created by holding a contract to buy a commodity in one month while at the same time, holding a contract to sell the same commodity in a different month. By manipulating these offsetting positions as the market moves, taxpayers can generate mythical losses and expenses for tax purposes without paying out any money because no money is due on a futures contract until its delivery date.

The amount of revenue loss to the Treasury from this tax gimmick is enormous. Estimates are that passage of this measure will add $1.3 billion to budget receipts in fiscal year 1982. At a time when members are searching for ways to use the tax

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[2] They can also attempt to prove that a particular property, once held as inventory, was held for use in the business (for example, for rent) at the time it was sold, and obtain capital gain or ordinary loss treatment under sectionl 1231 of the Code.

structure as a device to promote economic growth, reduce the effects of runaway inflation and generate employment opportunities, the Congress can ill afford to ignore a tax shelter gimmick that serves to drive up the price of commodities, adds to the deficit and serves absolutely no economic purpose. A sorely needed tax reform is surely preferable to slashing basic social programs in the name of budget balancing. It cannot be denied that the use of straddles is a tax loophole available only to the most wealthy individuals and corporations.

In 1977, the Internal Revenue Service ruled, in the case of a straddle in silver futures contracts, that the taxpayer could not deduct an artificial short-term capital loss because no real economic effect was intended to result from the taxpayer's transactions and, in fact, the dominant purpose for engaging in the straddle was tax avoidance. Cases contesting other IRS tax deficiency determinations are now pending in the courts. The Congress must not sit back while the slow and tedious process of such litigation winds its way through the judicial system.

The proposal under consideration would, generally, eliminate futures contract spreads as a tax shelter technique by providing, in effect, that losses derived from a "balanced" position be ignored. If a futures position is offset by another futures position held by the taxpayer within 30 days of the date the first futures position is closed at a loss, the first futures position would be considered to have been balanced and tax "losses" would not be allowed. A "straddle" is defined as offsetting positions with respect to personal property including, for example, commodities, debt obligations, currency or stock.

The widespread growth of this particular tax shelther device distorts commodity markets and drives up prices that are ultimately pushed on to consumers.

The AFL-CIO urges swift action to eliminate straddles as a tax avoidance scheme.

MID-AMERICA COMMODITY EXCHANGE,
Chicago, Ill., June 19, 1981.

Hon. BOB PACKWOOD,
Hon. MALCOLM WALLOP,
Finance Subcommittee on Taxation and Debt Management, Finance Subcommittee on Energy and Agricultural Taxation, Washington, D.C.

GENTLEMEN: Committee Press Release No. 81-317 invited statements for the printed record of the Subcommittees' hearings on commodity "tax straddle" legislation. We take this opportunity to respond.

MidAmerica Commodity Exchange, now more than 100 years old, is a federally regulated Contract Market for corn, wheat, soybeans, oats, live cattle, live hogs, gold and silver. Through the development of smaller trading units—called "Mini Contracts"—MidAmerica has made futures trading possible for a broad segment of producers, merchants, users, and public speculators.

MidAmerica contracts are particularly beneficial to agricultural producers, country elevators, and processors only just beginning to institute a hedging program. The benefit of the small contract size at MidAmerica is that agricultural producers, for example, are provided an alternative to the larger contracts traded on other exchanges, often too cumbersome for meeting smaller hedging needs. The 1200 Members of MidAmerica traded nearly three million contracts in 1980. MidAmerica supports legislation to curb tax abuse which has allowed individuals to shelter, defer, and convert gain and income from unrelated ventures through various tax-oriented commodity transactions, as addressed by Senator Moynihan's bill, S. 626.

Respectfully, our support of S. 626 ends there.

You should know that, to the best of our knowledge, MidAmerica Commodity Exchange does not harbor "tax" trading as that term is understood by the Committee. However, the success of MidAmerica's markets, like those of any U.S. commodity exchange, are particularly dependent on continued market liquidity. We believe that market liquidity at MidAmerica, as in most everything else in the business world, is affected by provisions in current tax law that equalize the overall tax position of professional commodity traders with risk takers in other sectors. Together with the three [1] exchanges which appeared to present testimony on opposition to S. 626, MidAmerica believes enactment of S. 626, would constitute a major, perhaps fatal, blow to American commodity markets. Moreover, to take our opposition one step further, we believe that until a more sophisticated legislative offering than S. 626 is actually available in bill form, it will be impossible for any exchange or witness to comment with the necessary exactitude on the overall impact to the markets of proposed legislation in this area.

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[1] Chicago Board of Trade, Chicago Mercantile Exchange, and Comex Testimony: Subcommittee Hearings (June 12, 1981).

Based on our soundings of the Committee and its staff, we understand that, at this point, fully developed Subcommittee legislation on the subject is still a goal, rather than an actuality. Therefore, we feel we can only express our position on "tax straddle" legislation generally, and await specific bill language to provide more detailed comments.

MidAmerica's position on legislation to cure the abuses of current law affecting commodity positions consist of two simple—and we hope directly conveyed—points:

1. Congressional action addressing publicized tax payer abuses of present law governing commodity transactions is entirely appropriate and supported by MidAmerica;

2. However, tax legislation that would alter, in any way, market liquidity at MidAmerica and other successful commmodity markets, or which penalizes hedging, is not only harmful to MidAmerica and its membership; but to the overall reliance of important sectors of the economy on U.S. futures markets for hedging and price discovery.

We are not only concerned about the provisions of S. 626 in its present form: our alarm also encompasses the proposals contained in Secretary Chapoton's testimony before the Subcommittee on June 12.

Moreover, we are extremely worried about the effect of pressures on the Subcommittees to move legislation affecting the composition, utility, and liquidity of the nation's commodity markets into final form to meet a tight legislative schedule. That consideration of this legislation also falls during a period where, we believe, the Subcommittee and Congress are conerned with larger overall tax and budget issues, and subjected to pressures from constituents and the Administration to enact legislation prior to the August recess, heightens our fears.

Treasury's acknowledgement at the Subcommittee's hearings, that their proposals—not yet seen—would have some effect on U.S. markets exemplifies one aspect of our concern. In the current environment, full appreciation of the importance of the relationship between U.S. tax policy and the efficient marketing and movement of physical commodities on a world wide basis, the pricing of those commodities—and in turn, the relationship of both to liquid futures markets—is being lost.

We are hardly impressed with Treasury's Pollyanna declaration that its proposals will, in the final analysis, "improve rather than detract from the efficiency of these [e.g., futures] markets."[2] Treasury's statement that "when values are distorted by tax considerations, the market is less efficient, not more",[3] is, we submit, misleading, gratuitous, and naive. No MidAmerica market has ever been disturbed by tax considerations, and we challenge Treasury to prove otherwise.

To the contrary, (aided, perhaps, by a close reading of Treasury's own statement) it can be demonstrated that enactment of punitive tax law affecting "straddle" positions can have repercussions beyond that possibly imagined by Treasury, striking at the most vital aspect of a successful futures market; the magic of its existence.

Futures markets involve more than a simple function of matching the proverbial willing buyer with a willing seller. A major equation of the U.S. futures marketplace also involves the need of merchants, exporters, financial institutions, processors, manufacturers, feedlot operators, farmers, brokers, and country elevators for a forum to offset—to hedge—risk. The risk involved lies in the exposure of holding (or contracting to buy or to sell) a commodity: an unhedged position in a volatile market can, literally, wipe out a business in one day.

Today, this risk is hedged through a futures position; however, without spreading positions in distant months, there would be no offsetting positions for hedge orders: without adequate incentives for spreaders—including tax incentives—there will be no spreads. It is understood that failure to hedge increases prices down the processing line until they are eventually paid by the ultimate consumer.

While both Treasury and the Bill's author, Senator Moynihan, have proposed changes in S. 626 to attempt to make it less dangerous to the marketplace, many of the problems we see here are not the sort of problems that can be cured by a "quick fix" through adding a "hedging exemption," or by special rates for "mark to market" positions.[4] Nor can they be cured when the industry feels compelled to continually attempt to interdict one unrealistic legislative proposal after another.

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[2] P. 17 of Treasury's prepared statement, Hearings.

[3] Id.

[4] One remaining problem of which we are aware is that the legislative proposals to date singularly key off past individual taxpayer abuse and ignore the equally important issue of diversion of capital away from futures markets. Does anyone truly believe that with a (proposed) long term capital gains rate of 20 percent, a "special" 40-45 percent "mark to market" tax rate for commodity professionals will attract the necessary capital to keep U.S. futures markets viable institutions?

Our greatest fear is that the time may soon come when imposed legislative deadlines may force the Committee to take a still unsatisfactory proposal and attach it to a general tax bill, in the interest of avoiding criticism for being "soft" on tax avoidance schemes involving the commodity markets, and/or for revenue raising purposes. In such a situation, Congress, the commodity industry, and the general economy: each loses.

We believe that the current legislative environment is such that neither sponsors of the legislation, staff working on legislative proposals, the Department of Treasury, or we dare say, even the commodity industry, are being given full opportunity to study possible alternatives that might not cause the alarm that current proposals are creating in our industry.

In view of the above, MidAmerica, therefore, respectfully suggests the Committee take one of two actions with respect to the pending legislation. Either:

1. Adopt the alternative treatment proposed by the commodity industry for professional traders, or;
2. Redraft S. 626 in a form so that the industry and the public will have the opportunity to more closely study its proposed treatment of transactions by market professionals, (including hedgers) and hold new hearings on this legislation.

We look forward to working with you and your staff on these difficult issues.

Very truly yours,

DAVID H. MORGAN, *President.*

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June 16, 1981

Honorable Robert Dole
Chairman
Senate Committee on Finance
2227 Dirksen Senate Office Building
Washington, D. C. 20510

Re: S. 626

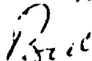
Dear Mr. Chairman:

The National Grain Trade Council, a voluntary association whose policy-making members are organized grain exchanges and national grain marketing associations, request that this letter in opposition to the approval of S. 626 be a part of the record of hearings on the proposal.

This bill, and similar proposals, laudable as its purpose may be to target tax shelter devices involving commodity spreads or straddles, needs to be substantially revised to be certain that the fluidity of futures trading be not impaired and that the tax status of commercial spreaders and hedgers be not adversely affected.

We agree with and endorse the position of the Chicago Board of Trade as presented by its President, Robert K. Wilmouth, at your Committee's hearings on June 12, 1981.

Respectfully,



William F. Brooks
President and General Counsel

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