[JOINT COMMITTEE PRINT]

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

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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.

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[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 contracts—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)

[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[3] 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.

[3] 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 I: 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

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[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 passthrough 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 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.

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