

**TAX TREATMENT OF
SHORT-TERM TRADING**

SCHEDULED FOR A HEARING

BEFORE THE

SENATE COMMITTEE ON FINANCE

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In the CONTENTS for JCS-8-90, the bill number in item II.2. should be S. 2160. Also, on p. 8, in the second line of the text under item 2, the bill number likewise should be S. 2160.

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INTRODUCTION

The Senate Committee on Finance has scheduled a public hearing on March 21, 1990, on proposals relating to the Federal tax treatment of short-term trading on long-term investments, including S. 1654 (introduced by Senators Dole and Kassebaum). S. 1654 would impose a tax on the short-term gain realized by pension funds having over \$1 million in assets.

This pamphlet,¹ prepared by the staff of the Joint Committee on Taxation, provides an overview of present and prior law provisions related to taxation of short-term trading (Part I), a description of proposals (Part II), and a discussion of issues relating to the tax treatment of short-term trading (Part III). The Appendix provides information relating to certain foreign countries' taxation of short-term trading.

¹ This pamphlet may be cited as follows: Joint Committee on Taxation, *Tax Treatment of Short-Term Trading* (JCS-8-90), March 19, 1990.

I. PRESENT AND PRIOR LAW

In general, present law does not impose any Federal income tax surcharge or excise tax on the income derived from the sale or exchange of an asset held for a short period of time. Net gains on the sale or exchange of an asset are taxed as ordinary income, regardless of the length of time the asset is held. There are rules under present law, however, that limit the ability of certain entities to derive a portion of their income from short-term investments. In addition, the Securities and Exchange Commission imposes fees with respect to certain securities transactions.

Under prior law, excise taxes were imposed on certain issuances and transfers of securities. In addition, there was a tax preference accorded to long-term capital gains prior to the Tax Reform Act of 1986.

A. Present Law

1. Taxation of short-term trades of RICs and REITs

In general, a regulated investment company (RIC) and a real estate investment trust (REIT) are entities that invest in specified passive investments and meet other requirements. A RIC or REIT generally is subject to a corporate-level tax but receives a deduction for dividends paid to shareholders.

To qualify as a RIC, a company must derive less than 30 percent of its gross income from the sale or other disposition of stock or securities held for less than 3 months. To qualify as a REIT, an entity must derive less than 30 percent of its gross income from the sale or other disposition of (1) stock or securities held for less than one year, (2) property sold in a prohibited transaction, or (3) certain real property held for less than 4 years.

2. Unrelated business income tax (UBIT) and the taxation of portfolio income

The Internal Revenue Code provides tax-exempt status for a variety of entities, such as charitable organizations, social welfare organizations, labor unions, trade associations, and qualified pension funds. Tax-exempt organizations, however, generally are subject to tax on their unrelated trade or business income. The unrelated business income tax (UBIT) is imposed on gross income derived by a tax-exempt organization from any unrelated trade or business regularly carried on by it, less allowable deductions directly connected with the carrying on of such trade or business, both subject to certain modifications.² An unrelated trade or business is any

² The UBIT generally is levied at the corporate tax rates; in the case of charitable trusts, it is imposed at the individual tax rates.

trade or business the conduct of which is not substantially related (aside from the organization's need for revenues) to the organization's performance of its exempt functions.

The UBIT generally does not apply to certain types of "passive" investment income (unless derived from debt-financed property³), such as dividends, interest, royalties, rents,⁴ and gains from disposition of property other than inventory or property held primarily for sale to customers in the ordinary course of a business (sec. 512(b)). Also excluded from the UBIT are gains on the lapse or termination of options to buy or sell securities, written by a tax-exempt organization in connection with its investment activities (sec. 512(b)(5)).⁵

Thus, if a tax-exempt organization owns stock in a corporation, dividend payments received by the organization generally are not subject to the UBIT (unless the organization's purchase of the stock was debt financed), regardless of whether the corporate activities giving rise to the dividend income are related to the organization's exempt functions. In addition, any gain realized from the sale or other disposition of such stock by the tax-exempt organization generally is not subject to the UBIT.

3. Rules relating to pension plan investments

In general

The labor law provisions of the Employee Retirement Income Security Act of 1974 (ERISA) contain rules governing the conduct of fiduciaries of employee benefit plans. ERISA has general rules relating to the standard of conduct of plan fiduciaries and also contains specific rules prohibiting certain transactions between a plan and parties in interest with respect to the plan, such as a plan fiduciary. Plan participants, as well as the Department of Labor, may bring suit to enforce the fiduciary rules. Plan fiduciaries are personally liable under ERISA for any losses to a plan resulting from a breach of fiduciary duty. A court may also impose whatever equitable or remedial relief it deems appropriate for a violation of the fiduciary standards.

The Internal Revenue Code does not contain extensive fiduciary rules. However, in order for a plan to be qualified under the Code, a plan is required to provide that the assets of the plan be used for the exclusive benefit of employees and their beneficiaries. In addition, the Code contains rules prohibiting transactions between a plan and disqualified persons with respect to a plan that are similar to the prohibited transaction rules under ERISA.

³ The term "debt-financed property" means property (the use of which is not substantially related to the performance of the organization's exempt function) held to produce income with respect to which there is an acquisition indebtedness during the taxable year, or during the 12 months prior to disposition if the property is disposed of during the taxable year.

⁴ Interest, royalties, and rents (but not dividends) paid to a tax-exempt organization by an 80-percent-owned entity are subject to the UBIT in proportion to the income of the controlled entity that would have been subject to the UBIT if derived directly by the controlling tax-exempt organization (sec. 512(b)(13)).

⁵ However, income from securities purchased on margin generally is considered to be debt-financed property income subject to the UBIT. See *Elliot Knitwear Profit Sharing Plan v. Comm'r*, 71 T.C. 765 (1979), *aff'd*, 614 F.2d 347 (3d Cir. 1980).

Exclusive purpose rule; prudence standard

The general fiduciary standard under ERISA requires that a plan fiduciary discharge his or her duties with respect to a plan (1) solely in the interest of the plan participants and beneficiaries, (2) for the exclusive purpose of providing benefits to participants and their beneficiaries and defraying reasonable administrative expenses of the plan, (3) with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims, and (4) in accordance with the documents and instruments governing the plan to the extent such documents and instruments are consistent with ERISA.

The prudence requirement is the basic rule governing the standard of conduct of plan fiduciaries, and it is against this rule that actions of plan fiduciaries are generally tested. A plan fiduciary does not violate the prudence standard merely because one investment bears greater risk of loss than others; rather, the prudence standard requires an evaluation of the investments of all assets in the aggregate. The prudence standard charges fiduciaries with a high degree of knowledge. This standard measures the decisions of plan fiduciaries against the decisions that would be made by experienced investment advisors. For this reason, some plan fiduciaries hire professional asset managers to invest plan assets.

Other than the prohibited transaction and self-dealing rules, neither the Code nor ERISA contains specific limitations on the types of investments a pension plan may make.

There has been some concern that ERISA's fiduciary rules require pension fund managers to automatically sell stock held by their funds in response to any above-market prices offered for the stock, rather than consider the long-term investment potential of the stock. In response to such concerns, the Treasury Department and the Department of Labor issued a joint statement on January 31, 1989, reiterating the duties of pension plan fiduciaries.

This statement provides that investment decisions, including tender offer decisions, must be based on what is in the economic interest of the pension plan, recognizing that the plan is designed to provide retirement income. Such decisions are to be based on the facts and circumstances of the particular plan.

The statement provides that, in evaluating a tender offer, it would be appropriate to weigh a tender offer against the underlying intrinsic value of the target company, and the likelihood of that value being realized by current management or by a possible subsequent tender offer. It would also be proper to weigh the long-term value of the company against the value presented by the tender offer and the ability to invest the proceeds elsewhere. In making these determinations, the long-term business plan of the target company's management would be relevant.

Diversification

ERISA requires that plan fiduciaries diversify the investments of the plan so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so. Generally, a pen-

sion plan is not permitted to invest more than 10 percent of its assets in qualifying employer real property and qualifying employer securities.

Fiduciary standards for retirement plans maintained by State and local governments

The ERISA fiduciary standards do not apply to retirement plans maintained by State and local governments; accordingly, there are no generally applicable Federal standards for the investment of assets of such plans. No uniform fiduciary standards have been adopted by the States, although many States have adopted some variant of the ERISA prudence standard.

4. Securities and Exchange Commission (SEC) transaction fees

Under present law, securities market transactions on organized exchanges are assessed a fee of 1/300 of one percent of dollar volume. Merger and proxy filings are assessed a fee of 1/50 of one percent per transaction. Securities offerings are assessed a registration fee of 1/50 of one percent of the value of the offering.

5. Commodity Futures Trading Commission (CFTC) transaction fees

Under present law, there are no fees imposed on futures and options transactions regulated by the CFTC.

B. Prior Law

1. Prior law excise tax on issuance and transfer of securities

Between 1914 and 1965, excise taxes generally were imposed on the issuance and transfer of stocks and certificates of indebtedness issued by a corporation.⁶ Immediately prior to their repeal, excise taxes were imposed at a rate of 0.1 percent of the actual value on the original issue of stock and 0.04 percent of the actual value on subsequent transfers of stock. In addition, excise taxes were imposed at a rate of 0.11 percent of the face value on the original issue of such certificates of indebtedness and 0.05 percent of the face value on the subsequent transfer of such certificates of indebtedness.

Certain exemptions were applicable to the imposition of these excise taxes. For example, obligations of the Federal Government, and State and local governments were exempt, as were certain shares of domestic building and loan associations and cooperative banks. In addition, transfers to or by a broker, transfers by reason of death or bankruptcy, and certain odd-lot sales were among the exempt transactions.

These excise taxes, which were administered through the sale of documentary stamps, were viewed as complicating the large variety of security transactions to which they applied. They were repealed as part of the Excise Tax Reduction Act of 1965 (P.L. 89-44).

⁶ These taxes were not imposed during the period between September 8, 1916, and December 1, 1917.

2. Prior law preference for long-term capital gains

Prior to the Tax Reform Act of 1986, gains on capital assets held for 6 months⁷ or more received a partial exclusion from income. Gains on capital assets held for 6 months or less were taxed as ordinary income. This distinction created a relative penalty on income earned from short-term trades.

⁷ Since 1976, the holding period required to qualify for long-term capital gain or loss treatment has changed a number of times; it has been 6 months, 9 months, and 1 year.

II. DESCRIPTION OF PROPOSALS

1. S. 1654 (Senators Dole and Kassebaum)

The Excessive Churning and Speculation Act of 1989 (S. 1654) was introduced on September 21, 1989, by Senators Dole and Kassebaum. The bill would impose an excise tax on the short-term capital gains of certain pension funds. In particular, the bill would impose a 10-percent tax on gains from the sale of assets held for 30 days or less, and a 5-percent tax on gains from the sale of assets held for 30 days but not longer than 180 days.

The tax would not apply to gains from the sale of assets in a transaction which is entered into primarily to reduce risk of price changes of assets held by the pension plan, or to reduce risk of interest rate fluctuations with respect to borrowings of the plan. However, the transaction must be identified as a transaction exempt from the tax before the close of the day on which the transaction is entered into.

The tax would apply to sales of assets by qualified pension plans (sec. 401(a)), annuity plans (sec. 403(a)), and simplified employee pension plans (sec. 408(k)). The tax would not apply to plans with assets of less than \$1 million.

The provisions would apply to assets acquired after the date of enactment of the bill.

2. S. 2160 (Senators Sanford, Sasser, and Ford)

The Long-Term Investment, Competitiveness, and Corporate Takeover Reform Act of 1990 (S. 2190) was introduced by Senators Sanford, Sasser, and Ford on February 22, 1990. Among other things, the bill would make it a prohibited transaction for a pension plan to sell or dispose of stock, securities, options, futures, or forward contracts which are held for less than 3 months unless less than 30 percent of such plan's gross income for the fiscal year is derived from such sales or dispositions. This rule is similar to the present-law rule applicable to RICs and REITs.

The bill also would amend the fiduciary rules of ERISA to provide that plan fiduciaries are required to take into account the long-term as well as the short-term interest of participants and beneficiaries of the plan in voting on a tender offer, merger, combination, or sale of substantially all the assets of a publicly owned business the securities of which are held by the plan.

In addition, the bill would amend ERISA to generally prohibit the use of excess assets following plan termination to finance the acquisition of employer securities.

3. Income tax surcharge on short-term trading income

As an alternative, the premise of S. 1654 could be broadened to impose an additional income tax at the rate of 5 percent on the net

income from all short-term trades (as defined below). In addition to pension funds, the net income from short-term trades of all tax-exempt organizations, and all U.S. individual and corporate taxpayers would be subject to tax. The net income of all foreign persons earned from short-term trades of personal property located in the United States and of financial securities of U.S. entities, including partnership interests, options, futures contracts, and similar instruments also would be subject to tax when traded in the United States. A special 5-percent tax would apply to the net short-term gains of pass-through entities.

Any transaction involving an asset held for less than one year would be deemed a short-term transaction. Transactions covered would be all those for which domestic taxpayers are currently liable for capital gains inclusion. Taxpayers could be allowed to offset short-term gains with short-term losses. Alternatively, as in S. 1654, the tax could apply only to gain realizations with no offset for losses.

4. Securities transfer excise tax (STET)

A tax could be imposed at the rate of 0.5 percent of the value of the securities on the seller at the time of sale, exchange, or transfer of the security.⁸ The tax would apply to all sales which take place in the United States and to sales abroad by U.S. citizens, residents, or tax-exempt organizations.

For administrative reasons, the tax would apply regardless of the period the seller held the securities. However, because the tax would be levied only once regardless of the length of the holding period, it would be much more significant for short-term than long-term holding periods.

The STET would apply to all equity securities and all public and private debt instruments which represent a long-term interest. The tax would apply to sales of options, futures contracts, and limited partnership interests. In addition, the tax would apply to sales of non-publicly traded securities.

For pass-through entities, such as mutual funds and limited partnerships, the tax would apply to both the trades made by the entity and trades of interests in the entity. The initial issue of any security would not be subject to the tax, but subsequent transfers would be subject to the tax. Consequently, origination of a mortgage or commercial loan would not be subject to tax, but subsequent transfers of the debt instruments would be subject to tax.

5. SEC transaction fees

Under the President's fiscal year 1991 budget proposal (submitted to the Congress on January 29, 1990), the fee on securities market transactions would be increased to 1/220 of one percent of the dollar volume traded. This fee would be extended to most over-the-counter securities transactions (e.g., those transactions on the National Association of Securities Dealers Automatic Quotation

⁸ A STET was mentioned as a revenue raising option in 1987. See Joint Committee on Taxation, *Description of Possible Options to Increase Revenues Prepared for the Committee on Ways and Means* (JCS-17-87), June 25, 1987.

A similar securities transactions tax is imposed in several other countries. (See the Appendix, Part A.)

(NASDAQ) system). The fee on merger and proxy filings would be increased to 1/40 of one percent of the value of the transaction. The registration fee on securities offerings would be increased to 1/40 of one percent of the value of the offering.

The proposed fee increases and fee impositions would be effective July 1, 1990.

6. CFTC transaction fee

Under the President's fiscal year 1991 budget proposal, a fee of 11 cents per transaction for CFTC-regulated futures and options trades would be imposed, beginning October 1, 1990.

III. ISSUES RELATING TO THE TAX TREATMENT OF SHORT-TERM TRADING

A. Background Data on Short-Term Trading

In general

The volume of securities trading has increased substantially over time. In the entire calendar year 1960, less than 800 million shares of stock were traded on the New York Stock Exchange. Recently, an average week had trades in excess of 800 million shares. Increased trading volume is not limited to the New York Stock Exchange. Volume also has grown substantially on the American Stock Exchange and in the over-the-counter markets. Moreover, financial innovations and reduced transactions costs have permitted the expansion of options and futures contracts. An organized market in stock futures generally did not exist 30 years ago. Today, the dollar value of stock futures contracts traded can exceed the dollar value of trades on the stock market. Foreign markets have experienced substantial growth in trading volume as well.

An apparent growth in short-term trading has accompanied the growth in volume of total trades. Many of the financial instruments introduced during the last two decades for trading on organized markets are short-term contracts. For example, options on a stock index or a commodity futures contract generally have expiration dates within two years of their purchase. Growth of markets in these new instruments accounts for a substantial portion of the growth in total volume of trades and volume of trades in which the investor holds the asset for less than two years.

Aside from growth in instruments which mature within a relatively short period, some observers point to evidence of turnover rates in the equity markets as evidence of shorter holding periods among investors in corporate equity. A turnover rate is the ratio of the market value of trades during a specified period (usually one year) to the average market value of all of the assets over the same period. Table 1 lists the turnover rate for issues listed on the New York Stock Exchange for selected years, 1920-1988.

Table 1.—Trading Activity on the New York Stock Exchange,
Selected Years, 1920–1988

| Year | Reported share volume (millions) | Dollar value of trading (billions) | Turnover percentage | Reported number of trades (thousands) | Average dollar size of trade |
|-----------|----------------------------------|------------------------------------|---------------------|---------------------------------------|------------------------------|
| 1920..... | 227.6 | n.a. | 91 | n.a. | n.a. |
| 1930..... | 810.6 | n.a. | 67 | n.a. | n.a. |
| 1940..... | 207.6 | n.a. | 14 | n.a. | n.a. |
| 1950..... | 524.8 | n.a. | 23 | n.a. | n.a. |
| 1960..... | 766.7 | n.a. | 12 | n.a. | n.a. |
| 1962..... | 962.2 | n.a. | 13 | n.a. | 204 |
| 1964..... | 1,236.6 | n.a. | 14 | n.a. | 218 |
| 1966..... | 1,899.5 | 98.6 | 18 | n.a. | 240 |
| 1968..... | 2,931.6 | 145.0 | 24 | 9,704 | 302 |
| 1970..... | 2,937.4 | 102.5 | 19 | 7,566 | 388 |
| 1972..... | 4,138.2 | 158.6 | 23 | 9,339 | 443 |
| 1974..... | 3,517.7 | 96.8 | 16 | 8,031 | 438 |
| 1976..... | 5,360.1 | 165.7 | 23 | 9,587 | 559 |
| 1978..... | 7,205.1 | 205.6 | 27 | 10,050 | 717 |
| 1980..... | 11,352.3 | 382.4 | 36 | 13,015 | 872 |
| 1981..... | 11,853.7 | 396.1 | 33 | 11,696 | 1,013 |
| 1982..... | 16,458.0 | 495.1 | 42 | 12,609 | 1,305 |
| 1983..... | 21,589.6 | 775.3 | 51 | 15,051 | 1,434 |
| 1984..... | 23,071.0 | 773.4 | 49 | 12,954 | 1,781 |
| 1985..... | 27,510.0 | 980.8 | 54 | 14,649 | 1,878 |
| 1986..... | 35,680.0 | 1,388.8 | 64 | 18,972 | 1,881 |
| 1987..... | 47,801.3 | 1,888.7 | 73 | 22,635 | 2,112 |
| 1988..... | 40,849.5 | 1,365.9 | 55 | 17,739 | 2,303 |

n.a.—not available.

Source: New York Stock Exchange *Fact Book*, 1989.

Although in 1988 the turnover rate declined from its peak in 1987, it is higher than it was 20 years ago.

Some use a turnover rate as one measure of the average holding period of assets. For example, at a turnover rate of 20 percent, on average every asset on the exchange is sold once every 5 years. At a turnover rate of 60 percent, on average every asset on the exchange is sold once every 20 months. Under this measure, high turnover rates indicate short-term trading. However, this conclusion is not necessarily accurate. Some argue that the strong bull market of the 1980s induced many individuals to sell assets which they had held for a long period, and consume or reinvest the proceeds. Such sales and reinvestment would increase measured turnover rates, but need not indicate short holding periods. For example, if 80 percent of the shareholders of XYZ Company purchased

their shares 10 years ago and the remaining 20 percent of shareholders purchased their shares within the last year, the turnover rate of XYZ Company shares would be 20 percent. If in the next year all shareholders sold their shares, the measured turnover rate for that year would be 100 percent. However, the average holding period of those shareholders who sold was 9 years.

Another factor that could affect measured turnover rates without reflecting shorter holding periods is the accounting methodology of measured turnover and the growth of options markets. Some observers note that institutional investors have made increasing use of options to hedge their portfolios against adverse price movements in the market. For example, institutions write and sell covered call options⁹ against stock already in their portfolios. Proceeds from the option sale are treated as a sale for accounting purposes. If the price rises sufficiently to warrant exercise of the call option, the strike price times the number of shares also is accounted for as a sale. If the institution takes the proceeds from this sale and reinvests them, the transaction appears as a purchase. This is the case even if the proceeds are reinvested in the same stock which was called. Thus, in one sense, although the institution has engaged in three transactions, its holdings of the underlying asset have remained unchanged and its holding period also may be said to have been unchanged. But, in terms of turnover as generally measured, the institution has ended one holding period and started another one.

However, others argue that the same sequence of transactions might occur if the institution were attempting to arbitrage short-term price differences between the options and equity markets. They argue that exploitation of such short-term differences should properly be labeled short-term trades. On the other hand, the market may price different securities so that the number of such arbitrage opportunities is limited.

Pension funds, university endowments, and mutual funds

The importance of pension funds as participants in the securities markets has increased in the last 30 years. In 1960, pension funds held 4 percent of traded equity securities. In 1980, pension funds held 19 percent of traded equity securities. In 1987, pension funds held 24 percent of traded equity securities.¹⁰ For comparison, in 1980, while private pensions owned 13.4 percent of the equities listed on the New York Stock Exchange, other institutional investors held 22 percent of the equities listed on the New York Stock Exchange.¹¹

⁹ The buyer of a call option has the right to buy the underlying asset (e.g., shares of stock) for a specified price (the "strike price") prior to a specified date (the "expiration date"). The seller of the call option must deliver the shares to the owner of the call option if the owner of the option decides to exercise the option. The call option is said to be "covered" if the seller owns a sufficient quantity of shares sufficient to "cover" the exercise of the option. Conversely, the buyer of a put option has the right to sell the underlying asset (shares) to the seller of the put option at a specified strike price prior to the option's expiration date.

¹⁰ Arnold J. Hofman, "Pension Funds and the Economy, 1950-87," in U.S. Department of Labor, *Trends in Pensions*, 1989.

¹¹ Other institutions include insurance companies, investment companies, State and local pension funds, nonprofit institutions, common trust funds, mutual savings funds, and foreign institutions. See U.S. Department of Labor, *Trends in Pensions*, 1989, Table A-20.

Table 2 reports average turnover rates for the equity portions of portfolios of pension funds, college and university endowments, and mutual funds for selected years. Turnover rates have risen over the past two decades.

Table 2.—Mean Equity Portfolio Turnover, Selected Years, 1964–1986

[In percent]

| Year | Pension plans ¹ | | College and university endowment funds ² | Mutual fund ² |
|-----------|----------------------------|-----------------------|---|--------------------------|
| | Unweighted ³ | Weighted ⁴ | | |
| 1964..... | 9.3 | n.a. | n.a. | n.a. |
| 1966..... | 12.5 | n.a. | n.a. | n.a. |
| 1968..... | 19.9 | n.a. | n.a. | n.a. |
| 1970..... | 25.8 | n.a. | n.a. | n.a. |
| 1972..... | 31.4 | n.a. | n.a. | 48.7 |
| 1974..... | 20.6 | n.a. | 16.5 | 38.7 |
| 1976..... | 26.2 | n.a. | 16.1 | 39.5 |
| 1978..... | 29.0 | 34.4 | 14.3 | 46.0 |
| 1980..... | 49.6 | 39.5 | 21.7 | 47.1 |
| 1981..... | 46.8 | 51.9 | 28.0 | 56.8 |
| 1982..... | 63.2 | 56.4 | 28.0 | 75.1 |
| 1983..... | 70.8 | 60.2 | 50.6 | 75.9 |
| 1984..... | n.a. | 57.1 | 51.8 | n.a. |
| 1985..... | n.a. | 63.2 | n.a. | n.a. |
| 1986..... | n.a. | 61.3 | n.a. | n.a. |

¹ Source: U.S. Department of Labor, *Trends in Pensions*, 1989.

² Source: Stephen A. Berkowitz and Dennis E. Logue, "The Portfolio Turnover Explosion Explored," *The Journal of Portfolio Management*, Spring 1987.

³ Average of stock turnover rates for all pension plans from SEI data.

⁴ Dollar weighted average of stock turnover rates for all pension plans as reported on Form 5500.

n.a.—not available.

The turnover rates of pension funds and other institutional investors reported in Table 2 are comparable to the turnover rates on the New York Stock Exchange reported in Table 1. Consistent with this observation is data which show that pension fund share sales as a percentage of total share sales remained roughly constant at 20 percent between 1977 and 1986, reaching a high of 22 percent in 1981 and 1982 and a low of 16 percent in 1986.

Individuals

There is little data available which would permit analysts to compute turnover rates for individuals, because individuals are not required to report their portfolios. There is some information available, however, on the holding period of realized gains.

Table 3 reports, by holding period, the number of transactions and the dollar value of those transactions undertaken by U.S. individual taxpayers in 1985. The data show that approximately 60 percent of all individual realizations were of assets held 1 year or longer and more than 20 percent of transactions involved assets held 5 years or longer. If measured by dollar values, approximately 55 percent of all individual realizations were of assets held 1 year or longer and approximately 25 percent involved assets held 5 years or longer. When transactions are separated into gain and loss transactions, approximately 39 percent (12 percent if measured by value of gain) of gain transactions involved assets held less than 1 year, while 47 percent (35 percent if measured by value of loss) of loss transactions involved assets held less than 1 year.

Table 3.—Realization of Gains and Losses by Individuals by Holding Periods

[All asset types, 1985]

| Holding period | Sales price ¹ | | Capital gain | | Capital loss | |
|--|-----------------------------|---------------------|----------------------------|---------------------|-----------------------------|---------------------|
| | Transactions (thousands) | Value (millions) | Transactions (thousand) | Value (millions) | Transactions (thousands) | Value (millions) |
| All transactions ² | 29,471 | \$402,136 | 19,454 | \$101,891 | 10,581 | \$22,124 |
| Less than 1 year: | | | | | | |
| Less than 1 month | 4,150 | 81,599 | 2,555 | 3,018 | 1,684 | 2,269 |
| 1 to 2 months | 1,361 | 17,395 | 850 | 1,019 | 594 | 783 |
| 2 to 3 months | 968 | 12,855 | 580 | 1,008 | 454 | 709 |
| 3 to 4 months | 851 | 11,214 | 465 | 721 | 407 | 509 |
| 4 to 5 months | 705 | 7,818 | 401 | 555 | 367 | 555 |
| 5 to 6 months | 618 | 8,464 | 367 | 558 | 274 | 367 |
| 6 to 7 months | 829 | 9,883 | 576 | 1,427 | 260 | 508 |
| 7 to 8 months | 486 | 6,269 | 308 | 891 | 190 | 497 |
| 8 to 9 months | 593 | 6,324 | 403 | 669 | 189 | 440 |
| 9 to 10 months | 528 | 5,640 | 372 | 641 | 181 | 438 |
| 10 to 11 months | 434 | 4,215 | 290 | 679 | 142 | 253 |
| 11 to 12 months | 650 | 7,182 | 380 | 876 | 236 | 377 |
| Total, less than 1 year | 12,173 | 178,858 | 7,547 | 12,062 | 4,978 | 7,705 |

1 year or more:

| | | | | | | |
|------------------------------------|---------------|----------------|---------------|---------------|--------------|---------------|
| 1 to 2 years | 4,916 | 52,343 | 3,031 | 9,187 | 1,961 | 3,915 |
| 2 to 3 years | 3,329 | 33,395 | 2,040 | 7,728 | 1,322 | 2,502 |
| 3 to 5 years | 3,043 | 38,401 | 2,206 | 13,411 | 873 | 2,773 |
| 5 to 10 years | 3,256 | 46,054 | 2,364 | 21,073 | 910 | 3,727 |
| 10 or more years..... | 2,753 | 53,084 | 2,268 | 38,430 | 537 | 1,500 |
| Total, 1 year or more | 17,298 | 223,278 | 11,907 | 89,829 | 5,603 | 14,419 |

¹ Sales price column may include fewer transactions than the sum of the capital gain and capital loss columns because some taxpayers did not report the gross sales price of the transaction, only the net gain or loss.

² Data with missing holding periods omitted.

Source: Internal Revenue Service, Sale of Capital Assets File.

Table 4 reports, by holding period, the dollar value of transactions of capital gain realizations on corporate stock undertaken by individuals in 1973 and 1985. The dollar value of gain realized on holdings of less than 6 months, and on holdings of less than one year was a greater percentage of total realizations in 1985 than 1973. This difference could arise from differences in stock market performance in those years. 1985 was a strong year for the stock market, while in 1973 the stock market finished the year with a substantial decline in value over the last 3 months. Moreover, during the bull market of the 1980s many individuals bought stock. The figures in the table only report sales. Such short-term sales could be small relative to purchases of stocks which are added to individual portfolios and held for long periods. Table 4 reports that, even in a year like 1985, two-thirds of the dollar value of capital gains realized on corporate equity represented holdings which had been held 3 years or longer. Comparison of Table 4 to Table 3 reveals that measured by value of gain, approximately the same percentage of gains realized on corporate stock involved assets held less than 1 year as was the case for all assets. Of course, gains on corporate stock account for more than 50 percent of all gains.

Table 4.—Gross Gains on Corporate Stock Realizations by Individuals, by Holding Period (1973 and 1985)

| Holding period | 1973 gains ¹ | | 1985 gains ² | |
|---|-------------------------|----------------------|-------------------------|----------------------|
| | Gains (millions) | Percent-age of total | Gains (millions) | Percent-age of total |
| Total gains..... | \$26,100 | 100.0 | \$56,120 | 100.0 |
| <i>Less than 6 months:</i> | | | | |
| Less than 1 month... | 164 | 0.6 | 1,717 | 3.1 |
| 1 to 2 months..... | 115 | 0.4 | 793 | 1.4 |
| 2 to 3 months..... | 107 | 0.4 | 663 | 1.2 |
| 3 to 4 months..... | 76 | 0.3 | 546 | 1.0 |
| 4 to 5 months..... | 68 | 0.3 | 444 | 0.8 |
| 5 to 6 months..... | 45 | 0.2 | 396 | 0.7 |
| Total gains held less than 6 months..... | 573 | 2.2 | 4,559 | 8.1 |
| <i>6 to 12 months:</i> | | | | |
| 6 to 7 months ³ | 153 | 0.6 | 1,072 | 1.9 |
| 7 to 8 months..... | 133 | 0.5 | 557 | 1.0 |
| 8 to 9 months..... | 99 | 0.4 | 475 | 0.8 |
| 9 to 10 months..... | 96 | 0.4 | 499 | 0.9 |
| 10 to 11 months..... | 53 | 0.2 | 496 | 0.9 |
| 11 to 12 months..... | 61 | 0.2 | 408 | 0.7 |
| Total gains held less than 1 year | 1,169 | 4.5 | 8,066 | 14.4 |
| <i>1 or more years:</i> | | | | |
| 1 to 2 years ⁴ | n.a | n.a | 6,050 | 10.8 |
| 2 to 3 years ⁴ | n.a | n.a | 4,284 | 7.6 |
| 3 to 5 years ⁴ | n.a | n.a | 6,118 | 10.9 |
| 5 to 10 years ⁴ | n.a | n.a | 9,986 | 17.8 |
| 10 years or more ⁴ ... | n.a | n.a | 21,617 | 38.5 |
| Total gains held 1 year or more.. | 24,931 | 95.5 | 48,054 | 85.6 |

¹ Source: Steven Kaplan, "The Holding Period Distinction of the Capital Gains Tax," National Bureau of Economic Research Working Paper Number 762, September 1981.

² Source: Internal Revenue Service, Sale of Capital Assets file.

³ In both 1973 and 1985 capital gains were long term if the asset was held 6 months or longer.

⁴ Data from 1973 unavailable for holding periods greater than one year.

B. Policy Issues Relating to Short-Term Trading and Tax Policy Towards Short-Term Trading

Many observers have raised questions about the effects of short-term trading on the economy. As would be expected, one's beliefs regarding the effect of short-term trading on the economy help determine one's perception of the appropriate role of tax policy towards short-term trading. In general, observers have identified three broad areas on which short-term trading might affect the overall economy: the length of business and investor planning horizons; market volume, volatility, and liquidity; and the efficient allocation of the economy's resources.

1. Short-term trading and long-term investing

Some observers claim that many investors overemphasize short-term profits. Some argue that this is particularly true in the case of institutional investors such as tax-exempt organizations and pension funds.¹² This occurs because the money managers of these organizations frequently are judged on the basis of quarterly or monthly performance rather than performance over a longer period. This short-term focus of market participants exhibits itself in frequent short-term trading of securities. These observers contend that because of this emphasis on short-term trading, the stock market forces corporate managers to pursue short-term profits and often ignore investments with potentially large long-term profits. They note that long-term investments frequently may decrease short-term earnings and that the stock market penalizes decreased short-term earnings by limiting access to the capital markets for needed funds or by inducing a takeover and change in management. They also argue that short-term profits may come at the expense of funding research and development or that the research and development budget is redirected from seeking long-term breakthroughs to safer short-term projects. In these cases, a short-term focus will have long-term repercussions on the profitability of the firm.

Critics of this view dispute that the stock market has a short-term focus. They note that all shareholders want the value of their stock to be as high as possible, and this is true regardless of whether they have held their shares 1 month or 10 years. They argue that the desire for a high share value does not automatically instill a demand for short-term profits. They note that some evidence exists showing that institutional investors may favor stock in corporations which undertake high research and development expenditures, and the stock market appears to reward announcements of increases in research and development budgets.¹³ They also cite the high values placed on certain technology stocks as evidence that the stock market is willing to pay for returns which accrue in the future.

Some critics also dispute the claim that institutional investors, in particular, have a short-term focus. They observe that financial ob-

¹² See Pat Choate and J.K. Linger, *The High-Flex Society* (New York: Knopf), 1986.

¹³ See Gregg A. Jarrell, Ken Lehn, and Wagner Marr, "Institutional Ownership, Tender Offers, and Long-Term Investment," Office of the Chief Economist, Securities and Exchange Commission, April 19, 1985.

ligations of many of the institutions often are in long-term liabilities, for example, pension fund liabilities. They contend that such future obligations should instill a desire to plan for the long term. Some evidence exists that pension funds with higher turnover rates perform less well than those with lower turnover rates.¹⁴ This would provide further incentive to avoid excessive short-term trading. The critics also note that pension funds and other tax-exempt institutions have been major sources of funds for venture capital, which suggests that institutional investors do take a long-term view.

Some analysts contend that if American corporate managers have shortened their planning horizons, it is because of a high cost of capital. For example, a corporate manager may be looking at the choice between two alternative investments: one would return \$1,000 for each of the next 10 years; and the other would return \$2,500 for each of the next 3 years.¹⁵ At an interest rate of 10 percent, the present value of the first alternative is \$6,144.57, while the present value of the second alternative is \$6,217.13. The profit-maximizing manager would choose the alternative which offered \$2,500 for 3 years in lieu of the longer-run investment. However, if the interest rate were 8 percent, the present value of the first alternative would be \$6,710.08 and the present value of the second alternative would be \$6,442.74. The profit-maximizing manager would choose the alternative which pays \$1,000 per year over 10 years and eschew the shorter-term alternative.

Some who believe that short-term trading has fostered a short-term planning horizon among American corporate managers advocate the imposition of a tax on short-term trading. They argue that such a tax will reduce the return to short-term trading. For example, a STET which assessed a tax of \$1 per purchase over a one-year period would impose a \$52 total tax liability on an investor who bought an asset each week only to sell it the subsequent week. The same tax would impose only a \$1 total tax liability on an investor who bought an asset and held it throughout the year. If the two investing strategies were equally profitable in the absence of the tax, the long-term strategy would now be \$51 better than the short-term strategy. Others argue that the return to short-term trading might be reduced more directly by imposition of an excise tax on short-term gains, such as would be imposed on pension funds by S. 1654.

Others note that a STET would increase the transactions costs of undertaking trades. They note that some evidence suggests that the primary cause of increased portfolio turnover rates is a substantial reduction in transactions costs over the past two decades.¹⁶ Consequently, they argue that short-term trading can be effectively dampened by increasing transactions costs through imposition of a STET.

¹⁴ See Richard Ippolito and John A. Turner, "Turnover, Fees and Pension Plan Performance," *Financial Analysts Journal*, November-December 1987.

¹⁵ The example assumes that, for the 3-year project, at the end of 3 years the proceeds only may be invested at the market interest rate.

¹⁶ See Stephen A. Berkowitz and Dennis E. Logue, "The Portfolio Turnover Explosion Explained," *The Journal of Portfolio Management*, Spring 1987.

Opponents of taxes on short-term trading argue that such taxes are taxes on capital. Thus, they contend that as taxes on capital they will raise the cost of capital to American business. For example, one study suggests that a STET imposed at a rate of 0.5 percent would lead to a 9.3 reduction in the value of corporate equity.¹⁷ It is cheaper for business to raise new equity capital when stock market values are high than when they are low. As the example above demonstrates, a higher cost of capital (the discount rate in the present value calculation) can lead corporate managers to choose investments which have shorter economic lifetimes. Consequently, opponents of income taxes on short-term gains and STETs argue that by increasing the cost of capital, such taxes are more likely to shorten corporate managers' planning horizons than to lengthen them.

2. Short-term trading, market volume, market liquidity, and volatility

Some economists believe that one of the basic services a stock market provides is liquidity, and liquidity depends upon volume of trades in the market. They note that the absence of a liquid market can appreciably increase the risk to the investor of undertaking a long-term investment and the cost of capital to business. An investor making a long-term investment is more likely to make the investment if a liquid market exists on which the investment can be sold should the need arise. In a liquid market, a buyer can readily be found and price changes are relatively small from transaction to transaction. The lack of a liquid market exposes the investor to greater financial risk as the investor might have to substantially discount his asking price in order to attract a buyer. Conversely, a business seeking to raise capital might have to increase its promised return if potential investors fear there is little possibility of subsequent sale of their holdings. Stock markets may provide liquidity by designating parties to "make a market" in given securities. These parties are responsible for ensuring that prices change in an orderly manner as supply reacts to demand. Some firms sometimes will provide liquidity for their own securities by promising to redeem shares at specified prices (e.g., oil and gas limited partnerships).

In this view, the growth of futures and options markets has increased opportunities for liquidity available to investors as well as provided new ways to spread risk. In this view, the short-term trader provides a useful service by increasing the market's liquidity. The increased liquidity and ability to spread risk should foster a positive environment for long-term investing and reduce the cost of capital to business. The increase in trading volume of the last two decades is viewed as a benefit to the economy under this view.

Others claim that too much liquidity can exist in a stock market. They argue that excessive liquidity encourages destabilizing speculation, which increases market volatility. Increased market volatility increases the riskiness of investment and thereby raises the cost of capital to business. They observe that the increases in market

¹⁷ See Donald W. Kiefer, "A Stock Transfer Tax: Preliminary Economic Analysis," Congressional Research Service Report No. 87-278 S, March 31, 1987.

turnover and volatility have accompanied increases in volume. In particular, they point to the trading volumes and volatility in the months before and after the stock market crash of 1987. Critics of this view note that no theoretical connection between volume and volatility exists and the volatility prior to the 1987 crash was not notably high by historic standards. They observe that volatility always tends to rise in crashes and fall in booms.¹⁸

Some who believe that too much instability currently exists in the financial markets advocate tax policies such as a STET or an income tax on short-term gains to reduce market volume. By making shorter term trades less economical, such taxes should reduce trading volume. Critics of such policies argue that reductions in volume need not translate into reductions in volatility. They claim that such proposals likely will drive those who trade on small price movements from the market and leave in the market those who trade on large movements, thereby potentially increasing volatility. They note that market participants who trade on small price margins help ensure that price changes occur in an orderly manner. They also claim the loss of liquidity itself could produce larger price changes when large blocks of stock are sold. Proponents of such measures point to the foreign experience with security transfer taxes and observe that the Japanese and British markets do not appear to lack for liquidity.

3. Short-term trading and the efficient allocation of the economy's resources

Many economists believe it is important for markets to be "efficient." By efficiency, they mean that the prices of securities determined by the market are "correct" given all available information. Prices are correct or efficient if they incorporate all available information about the earnings prospects of the firms whose assets are traded as well as other information which might be relevant, for example, estimates of future inflation in the economy. Market efficiency is important because in market economies prices send signals about the relative value of goods and services. When consumers want more bread than currently is supplied, they bid up the price of bread. Similarly, if investors desire more investment in computer companies they drive up the prices of the stock of computer manufacturers. This makes it relatively inexpensive for existing manufacturers to raise new equity capital and also creates the opportunity for an entrepreneur to establish a new computer company and raise equity capital. In summary, some economists view the efficiency of financial markets as necessary to assure the efficient allocation of the economy's investment funds.

In the theory of efficient markets, the speculator and arbitrageur play positive roles. If a stock's price diverges from its underlying true or fundamental value, a profit opportunity exists.¹⁹ If, for ex-

¹⁸ See Merton H. Miller and Charles W. Upton, "Strategies for Capital Market Structure and Regulation," Report Prepared for the Center for Business and Policy Studies, Stockholm, Sweden, September 1989.

¹⁹ In the theory of efficient markets, there is no "true" value of any good or service in a market economy. Prices simply reflect the value at which willing buyers and willing sellers contract for goods and services. In the case of marketable securities, current prices may reflect a weighted average of investors' expectations of future performance of the issuing firm.

ample, a stock's market price were less than its fundamental value, the speculator who recognizes this deviation will purchase shares. This increase in demand will drive the market towards the fundamental value. The speculator will continue to purchase shares until the market price equals the fundamental value. In the absence of speculation, the market price could provide investors with an incorrect signal, perhaps leading to a misallocation of investment resources. To the extent that the speculator's knowledge of the fundamental value resulted from information about the company that was privately possessed, by purchasing the stock and driving up its price, the information about the company's earnings prospects is revealed to other investors. A substantial body of evidence exists in the economics and finance literature which argues that the financial markets are efficient.²⁰

Critics of the efficient markets view point to the crash of 1987 as inconsistent with an efficient capital market. More generally, they argue that evidence exists that stock prices are more volatile than is justified by changes in the underlying fundamental values of the assets.²¹ In the view of such critics, such excess volatility may arise from excessive short-term speculation and financial arbitrage. Defenders of the efficient capital markets theory note that subsequent studies have questioned the statistical validity of the excess volatility view. They also argue that the so-called short-term portfolio insurance strategies which some blame for the crash of 1987 were generally only a United States phenomenon, and yet other markets fell significantly as well. They further assert that much of the crash could be explained by market fundamentals.²²

Proponents of the efficient markets view state that any tax which either drives a wedge between market values and fundamental values, or which seeks to drive arbitrageurs and speculators from the market ultimately will harm the allocation of capital in the economy. They claim such taxes will slow the market's signaling function. They further note that a tax on the income from short-term trading will encourage investors to remain locked in to their investments. This creates capital market inefficiencies by discouraging investors from redeploying their funds to potentially more profitable investments. Proponents of such taxes question both the efficiency of the market and the degree of harm which would befall an efficient market if a modest income tax surcharge on short-term gains or a STET were imposed. They note that a modest STET would raise total transactions costs to approximately the level that prevailed prior to the deregulation of brokerage commissions in 1974. They observe that many of the studies providing evidence for the efficient markets theory draw on data from prior to 1974 and therefore a return to higher transactions costs could not be too harmful. Critics of such taxes note that gains in efficien-

²⁰ See Eugene Fama, "Efficient Capital Markets: A Review of the Theory and Empirical Work," *Journal of Finance*, vol. 25, May 1970.

²¹ See Robert Shiller, "Do Stock Prices Move Too Much to be Justified by Subsequent Changes in Dividends?", *American Economic Review*, June 1981.

²² See, Miller and Upton, "Strategies for Capital Market Structure and Regulation." Some have cited tax legislation reported out of the House Ways and Means Committee as responsible for a sizeable portion of the 1987 crash. See Mark Mitchell and Jeffrey Netter, "Triggering the 1987 Stock Market Crash: Anti-Takeover Provisions in the Proposed House Ways and Means Tax Bill," *Journal of Financial Economics*, September 1989.

cy have come about from the expansion of the options and futures markets and that these efficiency gains are threatened by any policy designed to reduce use of or access to these markets.

Some analysts have asserted that even if the financial markets are efficient at determining prices, there is another efficiency loss about which policy makers should be concerned. They argue that too much human capital is devoted to trading paper assets rather than to creating new wealth in the economy.²³ They observe that while the level of employment in the securities industry has increased over the past two decades, trading volumes have increased even more dramatically. They argue that little of the work is involved in directing new real investment, but rather that tremendous resources are devoted to a zero-sum game where what trader A gains is offset by a loss to trader B. Because this activity consumes substantial resources, these analysts conclude that the private benefits which accrue to the individuals far exceed any benefits to society as a whole. Another way to express this view is to say that from society's perspective there is too much investment in producing information of the type needed to make profitable trades, and that the extra information has insufficient value for society to justify its cost of acquisition. In this view, tax policy which reduces the private returns to trading would reduce the amount of human resources devoted to gathering this extra information, and permit the resources to be redeployed to society's benefit.

Critics of this view respond that one should not judge the securities industry solely by what those relatively few highly compensated individuals do for society, but rather by what the industry does for society. They argue that the highly compensated trader helps support the infrastructure of the securities industry which provides liquidity and price discovery services to all. They note that tax policies designed to contract the number of short-term trades would have the collateral effect of reducing liquidity and the efficiency of price discovery services to all.

4. Other issues related to taxation of short-term trading

Hedging.—Critics of taxes on short-term trading point out that legitimate hedges constitute a substantial number of short-term trades. They argue that taxes which discourage hedging could penalize risk-taking by reducing the investor's potential for spreading risk. Proponents of taxes on short-term trades counter that exceptions could be provided for legitimate hedges. However, such exceptions could be difficult to administer.

Off-shore trading.—Some critics of taxes on short-term trades have argued that such taxes will create incentives to trade outside the United States. They argue that this will harm the domestic securities industry. Proponents of such taxes counter that the British and Japanese markets have grown despite security transfer taxes. They note that America is geographically positioned to provide a trading market which is critical to the growth of the 24-hour trading day, and that this should help demand for trading to remain

²³ See Lawrence H. Summers and Victoria P. Summers, "When Financial Markets Work Too Well: A Cautious Case for a Securities Transactions Tax," Annenberg Conference on Technology and Financial Markets, February 28, 1989.

strong. Critics of taxes on short-term trading claim that the British and Japanese reduction in their security transfer tax rates was the result of competition with America's trading markets. They also claim that the Swedish transactions tax makes futures markets un-economic in Sweden.²⁴

Progressivity.—Generally, higher-income taxpayers own the majority of financial securities which are held by individuals in the United States. Consequently, some proponents have claimed that any tax on short-term trading will be generally progressive, with the tax falling more heavily on higher-income taxpayers than lower-income taxpayers. Others caution that the case for the progressivity is not certain. They note that with the substantial ownership of corporate equity by pension funds that such taxes may, in fact, fall on the retirement incomes of millions of taxpayers.

C. Issues Relating to the Design of Taxes on Short-Term Trading

1. Breadth of transactions subject to tax

In general.—Determining the appropriate breadth of the tax is difficult. If the tax does not apply broadly to all types of transactions, certain transactions would be favored over other transactions, creating capital market inefficiencies. Similarly, if the tax does not apply broadly to all traders, trades by some individuals would be favored over trades by other individuals. Such a distinction would place some traders at a competitive disadvantage.

Breadth of assets subject to tax.—A neutral tax should apply to debt as well as equity. To do otherwise would distort financial choices in favor of debt. However, if the goal of the tax is to induce managers to plan with a longer time horizon, including debt may be unnecessary because managers are likely to concentrate more on the price of their company's stock than on the price of their company's debt. Inclusion of governmental securities raises the cost of borrowing to Federal, State and local governments. Exempting government debt would give investors an incentive to purchase government securities rather than invest in private enterprises. Excluding short-term debt instruments favors short-term borrowing. However, including short-term borrowing under a uniform tax rate increases short-term borrowing costs relative to long-term borrowing costs.

For example, even if interest rates remained unchanged, it would cost more for a business to issue a six-month note in January and a subsequent six-month note in July, than to issue a single one-year note in January. In the absence of the tax, with a rising term structure of interest rates, the business might prefer to continuously roll over short-term notes because this permits the exploitation of lower short-term interest rates and provides added flexibility since they always have the option of locking in long-term interest rates.

For a STET, particular design issues arise. Including debt could create the administrative problem of determining when debt is a security, for example, whether commercial loans would be subject

²⁴ See Miller and Upton, "Strategies for Capital Market Structure and Regulation," and "Government to Axe Turnover Tax," *Tax Notes*, vol. 46, February 12, 1990, p. 809.

to the tax. Not including debt could exacerbate the administrative problem of determining which securities are debt and which are equity. To be neutral, a STET should apply to publicly and non-publicly traded securities. Inclusion of non-publicly traded assets would make administration of the tax difficult. Not including non-publicly traded securities would create a bias in favor of raising capital outside of the public markets, and thereby subject the process to less regulatory oversight.

Under the income tax surcharge option, using the existing tax base of sales of capital assets could make exceptions difficult to design and create administrative complexity. If, for example, sales of real property were to be exempted, would losses on real property be able to offset gains on the short-term trades of equities? Such exceptions would necessitate the design of an entirely new tax, rather than the imposition of a simple surcharge.

Breadth of individuals subject to tax.—To be neutral, any tax on short-term trading should apply to all traders, including otherwise tax-exempt institutions and foreign persons. Some have observed that to exclude foreign persons would create a competitive advantage for foreign traders in the United States. For example, they have argued that exclusion of trades by foreign persons would make it less expensive for a foreign person to take over a United States business than it would be for a domestic acquirer. Others have countered that under an income-based option, taxing the trades of foreign persons might require overriding outstanding tax treaties. Imposition of a STET would not require overriding tax treaties.

2. Transactions undertaken abroad

In transactions undertaken overseas, the ability to use "street names" could make administration and compliance more difficult. Transactions made by U.S. citizens abroad present significant reporting problems. It may prove difficult to exert jurisdiction over foreign situs transfers. Exempting such transactions would provide an incentive for U.S. citizens to trade abroad. Transactions by U.S.-owned foreign intermediaries could present significant avoidance possibilities. Broadening the base of the tax to include such intermediaries may curtail modifying existing tax treaties.

As an example of the difficulties of dealing with transactions undertaken abroad, the U.K. attempts to subject foreign trades to its STET by imposing the STET at triple the regular rate on shares sold for trading on foreign markets. This affects only new issues and not the stocks of outstanding securities which could trade abroad. However, avoidance of the U.K. STET through the trading of other securities in U.S. markets could prove to be a problem for U.K. tax authorities.

3. Pass-through entities

Under either the STET or income tax surcharge option, consideration must be given to the treatment of pass-through entities (e.g., mutual funds and partnerships). Taxing both the trades made by the entity as well as trades in the interests in the entity would subject such investments to a double tax. On the other hand, taxation at only one level would create avoidance problems. For example, if

the tax only applied to trades involving interests in the entity, it would be possible for investors to create mutual funds which engaged in short-term trades at no penalty. The double tax could be reduced by applying one level of the tax at a reduced rate.

APPENDIX:

FOREIGN COUNTRIES' TAXES AFFECTING SHORT-TERM TRADING

A. Securities Transfer Excise Taxes

Overview

Seven of the ten member nations of the European Economic Community currently impose some form of securities transfer excise tax. Each of the United States' four major trading partners in the Pacific rim imposes a securities transfer excise tax. Canada does not impose a securities transfer excise tax. Below are brief summaries of the securities transfer excise taxes which are imposed in Europe and the Pacific rim.²⁵ Table 5 provides summary information on revenue raised by such taxes in several of the countries.

Countries in the European Economic Community

Belgium.—Belgium imposes a securities transfer excise tax (STET) on the exchange of shares, bonds, and other securities. The basis of the assessment is the transfer price rounded to the nearest BFR 100. The tax rates are as follows: debt securities issued by the national government—0.07 percent, debt securities issued by foreign governments—0.14 percent, other securities/shares—0.35 percent, and futures contracts—0.17 percent.

In addition to the tax on transfers, Belgium has an annual tax on securities quoted on the Belgium stock exchange. The tax rate is 0.42 percent and is payable by the company whose stock is listed on the exchange.

Denmark.—Denmark imposes a STET of 0.5 percent on the transfer of securities. The tax is customarily shared equally between the buyer and the seller. Trades between professional brokers are exempt from the tax. The STET in Denmark takes the form of a stamp duty.

France.—France assesses a STET on the transfer of securities, bonds, and commodity contracts. The tax rate on the transfer of securities and bonds is 0.3 percent for transactions less than FF 1,000,000 and 0.015 percent for amounts in excess of this amount. The tax rate on the transfer of commodity contracts varies from 0.2 to 0.26 percent.

In general, transactions between professional brokers trading in their own accounts are exempt from the tax. In addition, most

²⁵ See Gregg A. Esenwein, Congressional Research Service Memorandum, May 10, 1989, and My Saw Shin, "Taxation of Stock Transfers in Various Foreign Countries," Law Library of Congress, July 1989.

transactions carried out on provincial stock exchanges are also exempt from the STET.

West Germany.—West Germany has two distinct taxes on capital transactions. The first is called a “company tax” and is assessed when a company first issues stock. It is also imposed when there are other increases or additional contributions to a company’s capital. In these instances, the tax rate is 1 percent. In the case of stock which is issued as a result of mergers, the tax rate is 0.5 percent.

The second type of capital transfer tax is assessed on stock exchange transactions. The tax rate ranges from 0.1 to 0.25 percent, with the lower rate applicable to the transfer of government securities. The tax is imposed on all domestic transactions and on transactions that take place abroad if one of the parties is a West German national. The tax rate is halved if the exchange occurs abroad and only one of the parties engaged is a West German national.

Italy.—Italy imposes a STET on the exchange of stocks, bonds, and various other securities. The rate of tax depends on the type of transaction and the nationality of those involved in the exchange. The tax rate is halved in the case of transfers of Italian government securities or securities backed by the Italian government.

Netherlands.—The Netherlands imposes a STET on the purchases and sales of securities by resident stockbrokers. The tax rate is 0.12 percent. In addition, the Netherlands also assesses a capital tax of 1 percent on new issues of share capital. The tax is paid by the corporate entity issuing the shares. The Netherlands has proposed abolishing its stock transfer tax effective July 1, 1990.²⁶

United Kingdom.—The United Kingdom (U.K.) imposes a STET in the form of a stamp duty. The tax rate is 0.5 percent on the exchange of stock or other marketable securities.²⁷ The 0.5 percent tax rate is also assessed on other increases or contributions to a corporation’s capital, shares issued as a result of mergers, and corporate repurchases of outstanding shares.

The rate of tax is tripled for securities that are sold for trading on foreign markets. For instance, the U.K. imposes a tax of 1.5 percent on the exchange of American Deposit Receipts, or ADRs. ADRs are securities that are traded on U.S. stock exchanges but represent shares in U.K. and other non-U.S. firms. The tax on ADRs was adopted as a means of reducing the movement of capital transactions from London to U.S. stock exchanges.

Pacific Rim Nations

Hong Kong.—Hong Kong imposes a STET of 0.6 percent on the transfer of stocks, bonds and other securities. The tax is split evenly at 0.3 percent between the buyer and seller of the securities. The tax is in the form of a stamp duty.

Japan.—Japan imposes a STET on the transfer of stocks, bonds, and other securities. Japan lowered its tax rates in 1989. Tax rates range from 0.01 to 0.30 percent,²⁸ depending on the type of instru-

²⁶ See “Another Turnover Tax May Be Decapitated,” *Tax Notes*, vol. 46, February 12, 1990, p. 808.

²⁷ The tax rate was reduced from 2 to 1 percent in 1984 and from 1 to 0.5 percent in 1986.

²⁸ Prior to 1989 tax rates ranged from .01 to 0.55 percent.

ment being exchanged and the parties engaged in the transaction. In general, transfers conducted by professional securities firms are subject to a lower rate of tax.

For example, if handled by a securities firm, the sale of stock is subject to a tax of 0.12 percent; exchanges of stock by other entities are taxed at a rate of 0.30 percent. Lower rates apply to sales of corporate debt, with rates of 0.06 and 0.16 percent. Sales of national bonds conducted by a securities trading firm are subject to a tax of 0.01 percent, while any other sales of national bonds are subject to a tax of 0.03 percent.

Japan has proposed a transfer tax on exchanges of financial futures, a new capital market which opened in June 1989. The tax will take effect on October 1, 1990. The tax rates for this particular capital transfer tax will be 0.0001 percent (one ten thousandth of one percent) of the value of the transaction. However, for the first two years, the tax rate will be at one-tenth the regular rate in the case of Euroyen deposit rate futures and no tax will be imposed on Eurodollar deposit rate futures or yen-dollar exchange rate futures contracts.

Republic of Korea (South Korea).—South Korea levies a STET of 0.5 percent on the transfer of stocks, bonds and other securities. No tax is assessed if both parties to the transfer are nonresidents.

Taiwan.—A STET of from 0.15 to 0.3 percent is assessed on the value of stocks, bonds, and other securities at the time of transfer. Government securities are exempt from this transfer tax.

Table 5.—Security Transfer Taxes and Tax Revenue in Selected Foreign Countries in 1985

| Country | Revenue (billions) ¹ | Tax revenue as a percentage of | | |
|---------------------|---------------------------------|--------------------------------|------|------------------------|
| | | Total revenue | GNP | Market value of equity |
| France | \$0.6 | 0.26 | 0.12 | 1.19 |
| Germany | 0.3 | 0.14 | 0.04 | 0.28 |
| Italy | 1.6 | 1.10 | 0.38 | 6.10 |
| Japan | 2.3 | 1.42 | 0.17 | 0.34 |
| Netherlands..... | 0.4 | 0.63 | 0.32 | 1.17 |
| United Kingdom..... | 1.4 | 0.80 | 0.30 | 0.01 |

¹ Revenue in dollars calculated at average exchange rate for 1985.

Source: Lawrence H. Summers and Victoria P. Summers, "When Financial Markets Work Too Well: A Cautious Case for a Securities Transactions Tax," Annenburg Conference on Technology and Financial Markets, February 28, 1989.

B. Taxes on Income from Short-Term Trades by Individuals

Overview.—A number of countries do not tax the income from capital gains regardless of the period for which the asset was held. Some countries which do tax the income from capital gains do not distinguish holding period. For example, Canada, which provides a partial exclusion for income from capital gain, does not vary the

exclusion by holding period. Some countries (*e.g.*, the United Kingdom) adjust the measure of gain for inflation (indexing). Adjustments for inflation vary by holding period. Below are brief descriptions of some foreign countries' tax distinctions for gains based on holding period.²⁹

Belgium.—Capital gains resulting from the sale of commercial or industrial assets are generally taxed as part of income with no distinction for holding period. Gains on other assets generally are exempt from tax. The only holding period distinction arises on capital gains on land located in Belgium which has been held by individuals for less than eight years.

France.—Gains realized by businesses or individuals on real property held two years or less and on personal property held one year or less are treated as ordinary income. Long-term gains on such property receive a preferential tax rate. Holding period distinctions do not apply to securities.

Germany.—Gains realized by businesses are included in ordinary income. For individuals, gains are distinguished by short-term and long-term with short-term gains in excess of DM 1,000 (approximately \$588 at current exchange rates) are included in ordinary income. Long-term gains are exempt. Gains from real property held for less than two years and personal property (including securities) held for less than 6 months are considered short-term.

Japan.—On sales of securities, no distinction is made for holding period. Gains on sales of real estate are separated into short-term (held less than 10 years) and long-term (held 10 years or more), with higher tax rates applying to short-term gains. On other assets, gains realized on assets held less than 5 years are taxed as ordinary income, while only one half of the gain on an asset held 5 years or longer is included in ordinary income.

²⁹ See Organization for Economic Co-operation and Development, *Taxation of Net Wealth, Capital Transfers and Capital Gains of Individuals* (Paris: OECD), 1988.