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HOUSE TAX BILL CONVERSION PROVISION: FUTURES OUT, OPTIONS IN, RISKS UP

The House-passed tax bill would tax capital gains on commodities and stocks as if they were ordinary income if the positions were hedged by means of futures contracts. The Ways and Means Committee print claims that a hedged position — in which the holder of the stock or commodity has a firm agreement to sell the asset to a buyer at a certain price at a specific future date — is "indistinguishable from loans in terms of the returns anticipated and the risks borne by the taxpayer". The asset-holder is supposedly in a position like that of a lender whose income is due to the "time value of money" rather than market risk, earning interest rather than profits from speculation. The contention is absurd. The rationale is based on brainless semantics, not economics.

It is ludicrous tax policy to regard the returns of one party to a transaction as ordinary interest income and the losses of the other party to the same transaction as capital losses, yet that is what the House bill does.

The problem, as the House sees it, is this. Suppose X bought $100 of gold bullion, cotton, or World Wide Widget Corporation stock and agreed to sell it (or some similar property) to Y at some future date for $115. Under current law, X would report a $15 capital gain on the sale of the asset. However, because the sale was definite from the day of purchase, the House would consider the transaction to be not risky enough to deserve capital gains treatment — being too much like interest. The House would call the transaction a "conversion transaction" and treat a portion of the $15 profit as if it were ordinary income ("but not as interest", according to the cryptic Ways and Means Committee print). The portion that would be treated as ordinary income would be the $100 asset acquisition price multiplied by 120% of some interest rate selected by the Treasury.

As the proposal states: "For example, assume that X purchases stock for $100 on January 1, 1994, and on that same day agrees to sell it to Y on January 1, 1996 for $115. Assume that the applicable rate is 5%. On January 1, 1996, X delivers the stock to Y in exchange for $115 in satisfaction of their agreement. Assume that under current law X would have recognized a capital gain of $15. Under the provision, $12.36 of that amount would be recharacterized as ordinary income (i.e., 120% of 5% compounded for two years, applied to an investment of $100)."

Petty criticisms of the example aside (e.g., anyone familiar with financial markets knows that they are not open on New Year's Day; If the futures trade were made the day after the purchase, would the 24 hours of risk let the taxpayer avoid the penalty? If the income is to be taxed as ordinary income because it resembles interest, why is it to be viewed "not as interest"? If it is to be viewed "not as interest", why is the amount denied capital gains treatment set with reference to an interest rate?), does the proposal make sense? It does not.

Consider the more sensible treatment of stock options which would be retained under the proposal. Asset sales resulting from the sale of options to buy, as opposed to firm commitments to buy, would not

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be considered "conversion transactions". One could buy stock for $100 and sell a call option giving the option buyer, in exchange for a modest fee or premium, the right to buy the stock at $115 prior to some future date, but there would be no "conversion" treatment even if the option were exercised and the stock were ultimately sold for $115. There would be a capital gain of $15 (plus the premium from the sale of the option). Why a capital gain and not ordinary income? Because, according to the Committee print, the holder of the stock was not guaranteed a sale, and was subject to the risk that the stock might not be called, and might even fall in value.

This prissy distinction about the risk to a particular holder of the asset at a particular point in time is not good tax policy and completely misses the economics of the situation. The distinction between interest and capital gains has nothing to do with risk, and is not merely semantics. Interest is a flow of current income reflecting current economic output. People borrow to invest in assets that earn a return greater than the cost of the loan. For example, they may borrow to buy a machine that earns a profit. The profit reflects the addition to GNP that the machine provided. If the profit is large enough to cover the debt service and the wear and tear on the machine, with a little left over, the investor will proceed with the transaction. The interest received by the lender in effect gives the lender credit for much of the net increase in the GNP produced by the machine.

A capital gain is the result of a change in the valuation of an asset. The gain is a pure price change, not additional GNP or national income. For example, a share of stock may rise in price today because of an increase in the company's expected future production and profit. The future profit will be part of GNP when and if it occurs (and will be taxed then, too). The current jump in the share price is merely the present value of the company's expected future after-tax income. The capital gain itself is not income. Counting it as income would double count the future profit, and overstate GNP. Taxing the gain would double tax the future profit.

In a hedged position, the two parties to the futures contract are engaged in activities that help the market value an asset. The seller of the contract is betting that the price of the commodity or stock is not going to exceed the contract price by the date set. The buyer of the contract is betting that it will. Neither is necessarily the ultimate user of the commodity. Any profit, interest, or dividend resulting from the use of the commodity or the operations of the company whose stock underlay the futures trade is part of GNP, and will be taxed as such by the income tax. The futures market valuation process is not part of GNP and clearly represents a capital gains situation for both parties to the futures process. It is bad economics to regard it as anything else.

In brief, the rise in the value of a hedged asset is a capital gain, period. It is not a loan; there is no borrower; there is no investment of borrowed money in an output-producing, income-generating piece of property; there is no interest paid to share the returns with the provider of the funding.

Clearly, the potential for gains for the seller of the futures contract is matched by the potential for losses for the buyer. It is ludicrous tax policy to regard the returns of one party to a transaction as ordinary interest income and the losses of the other party to the same transaction as capital losses, yet that is what the House bill does. Will the House next declare that wages paid by a business are to be amortized as capital outlays over the life of the worker while the wages received by the worker are to be treated as ordinary income and taxed when received? That too would raise revenue but be utter nonsense.

The result of the House bill provision would be to pressure some individuals to use options rather than futures. Potential futures buyers, who bear the risk that the House views as meriting a differential, would have to bid more for the contracts as a result of the higher tax on the seller, and would share the penalty. Risk would be harder to spread, the attractiveness of owning assets would be reduced, and the amount of productive capital created by the economy would be less than in the absence of this tax bias.

The House claims to be eliminating an artificial distinction between ordinary income (interest-like earnings) and capital gains. In fact, there is nothing artificial about such a distinction. They are different.

In fact, however, the case against the House provision does not depend solely on the distinction between interest and capital gains. Ideally, neither the interest on a bond nor the capital gains that trouble the House in the hedging situation should be taxable items. Income is taxed when earned. If used for consumption, there is little additional federal tax. If saved or invested, it is taxed again on the returns (e.g., interest, dividends, undistributed profits). Capital gains are hit even harder. Both the returns and the current valuation change reflecting the returns are taxed. Consequently, interest is doubly taxed, while capital gains are subject to triple taxation or worse. A neutral tax would allow a deduction for saving and tax all the returns (akin to an IRA), or allow no deduction and not tax the returns (as with tax exempt bonds).

The current treatment of gains on hedged asset holdings is multiple taxation. Insofar as the gains receive somewhat diminished tax rates due to the limited capital gains differential, it is a small degree of relief from multiple taxation. That relief ought not to be ended.

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