

DID TAX AVOIDANCE PLAY A ROLE IN THE FALL OF LONG-TERM CAPITAL?

HON. RICHARD E. NEAL

OF MASSACHUSETTS

IN THE HOUSE OF REPRESENTATIVES

Friday, October 2, 1998

Mr. NEAL of Massachusetts. Mr. Speaker, in the past week, we all read about the gathering of Wall Street's financial giants and their agreement to bail out Long Term Capital Management L.P., which "The Wall Street Journal" has referred to as a "high flying hedge fund that was on the verge of collapse."

After a meeting orchestrated by the Federal Reserve, a group of investment firms and commercial banks agreed to a \$3.5 billion bailout of Long-Term Capital. Without this bailout, Long-Term Capital's \$80 billion balance sheet and additional exposure in the form of off-balance-sheet agreements would have been liquidated. A forced liquidation could have had an adverse impact on worldwide markets.

The financial service industry bears the overwhelming portion of blame. Lenders extended enormous amounts of credit without adequate supervision or knowledge of the activities of the fund.

However, Congress also shares a part of the blame for this debacle. Derivatives have legitimate uses, but they can be used to create excessive levels of leverage by avoiding margin requirements. They have the potential of tax avoidance. Congress was aware of this. The Commodity Futures Trading Commission (CFTC) raised questions earlier this year about the adequacy of supervision of hedge funds. Congress not only chose to ignore the warning of the CFTC, but it pushed legislation that would prohibit the CFTC from proposing new derivatives regulation.

This tax avoidance potential of derivatives did not cause the fall of Long-Term Capital, but it may have added fuel to the fire in the failure. In the fall of 1997, management of Long-Term Capital wanted to increase its stake in the fund. Rather than invest directly, the founder and partners entered into a complex transaction with Union Bank of Switzerland (UBS) that gave them \$750 million of equity in the fund through the use of derivatives. According to Derivatives Strategy Special online Report, the management of Long-Term Capital deliberately chose this complex transaction in order to convert foreign interest income from their offshore hedge fund into long-term capital gains and defer it for seven years. Their motivation for this transaction was pure and simple—tax evasion.

Congresswoman KENNELLY was the only one who had the foresight to recognize that the tax avoidance potential of derivatives should have a legislative response. On February 5, 1998, Congresswoman KENNELLY introduced H.R. 3170, legislation which would prevent the use of derivatives to convert ordinary income into long-term capital gain eligible for the 20% capital gain rate. That legislation was aimed at investments in hedge funds through derivatives. The deal that the management of Long-Term Capital entered into with UBS is an example of a transaction that the Kennelly legislation would have shut down.

I commend Congresswoman KENNELLY on her efforts to prohibit transactions that use derivatives for tax avoidance. If this legislation

had been enacted, the motivation for the transaction between the managers of Long-Term Capital and UBS would have not existed.

The rise and fall of Long-Term Capital will be studied by Congress in the upcoming months. I plan on following Congresswoman's KENNELLY lead and to work towards the passage of legislation which addresses the tax avoidance potential of derivatives.

The Kennelly bill affects transactions such as the transaction between the founder and partners of Long-Term Capital and UBS that are not available to the ordinary investor because of their cost. In an economic sense these transactions are equivalent to ownership, but their costs are substantially greater than the costs of a simple purchase.

Congresswoman KENNELLY believes that there is no tax policy justification for giving an investor in a derivative more favorable tax treatment than an investor in an identical underlying product. The Kennelly bill redefines the concept of when there is ownership for tax purposes in order to take into account the economic substance of these new transactions.

I look forward to working on the Kennelly bill and ultimately working towards passage of legislation that addresses the potential tax avoidance of derivatives. Attached is a technical description of the Kennelly legislation.

CONSTRUCTIVE OWNERSHIP TREATMENT

The Kennelly bill would apply to taxpayers who hold constructive ownership positions with respect to any financial property. The legislation would treat gain from constructive ownership positions as long-term gain only to the extent the investor would have received long-term gain treatment if he/she held the underlying asset directly.

The bill would define constructive ownership as any of the following transactions (and any other transaction having substantially the same effect as a transaction described below):

- 1) entering into an offsetting notional principal contract with respect to the same or substantially identical property;
- 2) entering into a futures or forward contract to acquire the same or substantially identical property;
- 3) granting a put and holding a call with respect to the same or substantially identical property and such options have substantially equal strike prices;
- 4) entering into 1 or more than other transactions (or acquiring 1 or more positions) that have substantially the same effect as a transaction described in any of the preceding subparagraphs.

The bill would only apply to financial positions in stock, debt instruments, partnerships and investment trusts held through derivatives. This legislation is not intended to apply to interests held through mutual funds.

A deferred interest charge would apply to constructive ownership transactions in order to recapture the benefits of deferral. The deferred interest charge would be equal to the underpayment of tax rate in Section 6601.

The legislation would be effective for gains recognized after date of enactment.

IN CELEBRATION OF THE 40TH ANNIVERSARY OF THE U.S. CIVILIAN SPACE PROGRAM

HON. GEORGE E. BROWN, JR.

OF CALIFORNIA

IN THE HOUSE OF REPRESENTATIVES

Friday, October 2, 1998

Mr. BROWN of California. Mr. Speaker, today marks the 40th anniversary of the establishment of the U.S. civilian space program. I would like to congratulate Administrator Goldin and all of the NASA team of NASA's 40th anniversary. It is a significant milestone, and all of the present and former NASA and contractor employees should feel proud of what our nation's civil space program has accomplished. I believe that space exploration is a noble calling, and one that is worthy of our continued support.

When I celebrate a birthday or anniversary, I like to reflect both on what has come to pass in my life and what might still lie ahead. I think that it is appropriate that we do the same at this juncture in NASA's life as an institution.

It is difficult to know what to say and what to leave out in a statement such as this. I have been interested in our nation's civil space program since its inception, and I have rejoiced at its successes and grieved at its setbacks over the years. I also have tried to play a small part in helping to nurture our space program's growth during my tenure in Congress.

As we try to assess how best to approach America's future in space, I would like to offer some thoughts on ways in which our civil space program has succeeded, as well as ways in which it has fallen short. I hope that those observations may provide useful guideposts for NASA's future.

Where has our civil space program succeeded? I believe that there can be no disputing that the nation's history of excellence in space and Earth science is one of the most gratifying outcomes of the space program's establishment 40 years ago. To say that we have been unlocking the secrets of the universe may be a cliché—but it also is a simple statement of fact. Robotic probes have visited every other planet in our solar system except Pluto. Equally important, we are gaining insights into our own planet and into how human activities affect its systems.

Yet, as the news about the immense burst of gamma-rays and X-rays from deep in space that bathed Earth in radiation last month and disrupted spacecraft operations demonstrates, we also are learning how little we really know about the universe. Nevertheless, we are making advances. From the earliest satellites to the Hubble Space Telescope, the Mars Pathfinder, and beyond, NASA's scientific activities have enriched our stores of knowledge and captured our imaginations. I find it incomprehensible that anyone could seriously assert that NASA has made these space activities "boring."

Another area where I think our space program has succeeded is in the use of space technology to deliver benefits to society. Communications satellites, weather and remote sensing satellites, technologies for health care and industrial competitiveness, and so forth—all of these have improved the quality of our lives. Yet I strongly believe that we can do more to harvest the potential of space to help