

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

people in America and around the world to live better lives. We dare not walk away from that responsibility.

Another development that has been gratifying to me has been the emergency—allbeit somewhat unevenly—of a healthy and growing commercial space sector. Can anyone dispute the importance of commercial satellite communications to the world's economy, both directly and indirectly? I expect to see similar developments in commercial remote sensing, launch services, and in areas we do not even contemplate at present.

Yet, a world with a large, global commercial space sector offers challenges to policymakers. I would gently note that those who argue for unleashing the private sector to commercialize space on a global scale should not then attempt to demonize companies for pursuing their interests globally. Loose allegations of unpatriotic behavior against American companies are not helpful as we attempt to sort out the complex issues associated with commerce in a multipolar world.

Next, I must say that I consider one of NASA's finest achievements to have been its continued adherence to the principle that "activities in space should be devoted to peaceful purposes for the benefit of all mankind." NASA has made international cooperation an integral part of its mission, and I think it has paid dividends to our nation over the past four decades. As I testified to the House space subcommittee fifteen years ago on NASA's 25th anniversary:

"We have tended to cut back on these activities when budgets are tight, or when we get nervous about technology transfer to other nations. My view is that international cooperation serves many functions and is important to support; political, scientific, and economic benefits can be derived from international cooperation."

I continue to stand by those sentiments.

Before I close, I must confess that I have been disappointed by what we have not accomplished in our space program since its inception. Among my frustrations is our sorry record in the development of low-cost space transportation. For too long, we have seen advances in transportation come in fits and starts, instead of being an integral part of the space agency's R&D portfolio. That approach has seriously impeded the progress of our nation in space exploration and utilization. I believe that we are making some improvements in our approach to developing new transportation systems; however, we must not go overboard in the other direction and make our programs dependent on the delivery of revolutionary advances by a date certain. Innovation does not work that way—especially under constrained budgets.

Speaking of budgets, those who know me know that I long have been troubled by the nation's inconsistent support of our civil space program. Both Congress and the White House have at various times over the last forty years, wreaked havoc on NASA's ability to make and carry out long-range plans. While some have argued that there is no long-term vision or plan for NASA, I would submit that over the years there have been no lack of plans, studies, and recommendations both from the space agency and from distinguished panels of outside experts—my files are filled with them! Rather, the nation—and I most definitely include Congress in this criticism—has been

unable or unwilling to establish institutional mechanisms for providing a stable budgetary and programmatic framework in which long-term (i.e., over multiple Administrations and Congresses)—and possibly multinational—R&D initiatives can be carried out successfully. Until we address that situation, I am not optimistic that we will be able to achieve many of the ambitious goals that NASA is contemplating for the 21st century.

One of those goals, of course, is human exploration beyond low Earth orbit. I believe that this is one of the areas in which we have fallen most short, to my intense disappointment. I still consider it extremely short-sighted for the Nixon Administration to have canceled the nation's program of lunar exploration just as it was transitioning from an amazing technological and managerial achievement to a sustained program of scientific and human exploration.

Then, when President Reagan approved the development of a Space Station in 1984, I never would have believed that almost fifteen years later we still would not have launched even the first elements of the Station into orbit. Still, there are no easy villains in the Space Station saga—as much as some would like to find them. The simple truth is that NASA, successive Congresses, and successive Administrations all have had their fingerprints on this program, and any blame for the slow progress of this program needs to be shared. At the same time, all of us will have to now work together for this program to be completed successfully.

However, I would like to look forward to the future of human space exploration and not just dwell on past missteps. There are no lack of worthy goals for human exploration. Those goals need to be a fundamental part of our vision for NASA's future.

While there is more that I could say, I will conclude my statement on that note. I have offered these observations with the intention of stimulating some discussion on how best to proceed as our space program enters the 21st century. We must learn from our past if we are to avoid becoming captive to our past.

HONORING THE INTERNATIONAL ALLIANCE OF THEATRICAL STAGE EMPLOYEES LOCAL UNION 51 OF HOUSTON, TEXAS

HON. KEN BENTSEN

OF TEXAS

IN THE HOUSE OF REPRESENTATIVES

Friday, October 2, 1998

Mr. BENTSEN. Mr. Speaker, I rise to congratulate The International Alliance of Theatrical State Employees Local Union 51 as they celebrate their 100th Anniversary on February 23, 1999. Local 51, which is an integral part of Houston's highly successful arts community, will celebrate with a Gala Program in the Brown Theater of the Wortham Theater Center in Houston, Texas.

The International Alliance of Theatrical Stage Employees, Moving Pictures Technicians, Artists and Allied Crafts of the United States and Canada (I.A.), which began in 1893, represents people behind the scenes in the manifold media of show business and exhibitions. Today, there are over 800 local unions throughout the United States and Can-

ada. The local chapter of the Galveston-Houston Theatrical Stage Employees Protective Union was chartered on May 1, 1899. Houston's own Local 51 broke away from that larger group and is today the only stage crafts union in Harris County. In the early part of this century, members of Local 51 set up the traveling vaudeville shows and performances by touring companies that came to the Bayou City first by train, later by truck. Local 51 even supplied the personnel for the backstage work at the downtown movie houses. By the time Houston's major arts organizations presented their first performances, the Local was already in place to provide professional, behind-the-scenes service.

Every stage craft is practiced by these dedicated men and women, making each a valuable link in the production of any show. From the moment a production or meeting is conceived until the last truck pulls away, I.A. technicians are on the job. Today, Local 51 boasts a work roster of over 400 technicians and can fill a producer's or promoter's crew needs with only one telephone call. The local provides a network of qualified technicians for projects of any magnitude.

The members of Local 51 are known and respected worldwide for the quality of the work they provide. They have traveled from China to Singapore to Cairo and throughout the United States with the road tours of hits such as "Phantom of the Opera", "Jesus Christ Superstar", "State Fair", "Carousel", and with David Copperfield. The talents of Local 51 are not limited to the stage. The local has provided convention and exhibit support for several local audio visual companies and in every major hotel and meeting facility in Houston.

Mr. Speaker, I congratulate Local Union 51 as they celebrate this special time in their history, and extend to all members my personal appreciation for their contributions to the arts in Houston.

ASSESSING TAX CUTS

HON. LEE H. HAMILTON

OF INDIANA

IN THE HOUSE OF REPRESENTATIVES

Friday, October 2, 1998

Mr. HAMILTON. Mr. Speaker, I would like to insert my Washington Report for Friday, October 2, 1998 into the CONGRESSIONAL RECORD.

ASSESSING TAX CUTS

With the new congressional session approaching and a projected \$1.6 trillion surplus in the U.S. Treasury over the next ten years, it is not surprising to see Washington politicians crafting and talking about tax cuts which will appeal to constituents. People will naturally be eyeing the several proposals to determine how they affect their own pocketbook. That is an entirely appropriate perspective, but people ought also to be looking at another question: What impact will the tax proposals have on the distribution of income and wealth in the country?

Broad income trends: Tax proposals need to be assessed in light of two broad trends in our country—the widening income gap between the haves and the have nots, and the difficulty middle-class families have had in improving their status despite the current economic boom.

There is not much doubt but that the gap between the nation's poorest and richest workers has widened. Adjusted for inflation,