Bloomberg

Goldman Critic Sides With Buffett to Shut Futures Tax 'Loophole'

By Silla Brush - Sep 20, 2011

A U.S. senator known on Wall Street for taking on Goldman Sachs Group Inc. (GS) has a new target -- a tax benefit for derivatives traders that has also been derided by Warren Buffett, the billionaire investor and tax-code critic.

The special congressional committee set up to cut $1.5 trillion from the federal deficit should consider taxing futures and other derivatives at ordinary income rates, Senator Carl Levin, a Michigan Democrat and chairman of the Permanent Subcommittee on Investigations, wrote in a letter to the panel. The Office of Management and Budget has estimated that a similar administration proposal could raise about $2.8 billion in revenue.

Futures, non-equity options and other types of derivatives transactions are currently taxed at a top rate of 23 percent; ordinary income is taxed up to 35 percent.

The tax system "encourages bets on derivatives over direct capital investments that are key to economic growth," Levin said in a Sept. 15 letter. "Closing this tax loophole would put a stop to that market distortion."

Levin's reputation for expertise in financial matters was enhanced by his committee's investigation of the 2008 credit collapse, which was released in April and criticized Goldman Sachs for its role.

Since 1981, some types of derivatives traded on exchanges owned by CME Group Inc. (CME), the world's largest futures exchange, and CBOE Holdings Inc. (CBOE) have been taxed at a blended rate. The split allows 40 percent of a gain or loss to be taxed at short- term rates and 60 percent at long-term rates.

Eliminating Shelters

Congress passed the system in an effort to eliminate tax shelters popular in the late 1970s that were used to lower rates. The futures industry opposed changing the system at the time, leading Congress to adopt the blend as a compromise.

The system has been criticized this year, including by Buffett, 81, the chief executive officer of Berkshire Hathaway Inc. and self-made billionaire, who called it part of a series of "extraordinary tax breaks" that benefit the mega-rich. "Others own stock index futures for 10 minutes and have 60 percent of their gain taxed at 15 percent, as if they'd been long-term investors," Buffett wrote in an Aug. 15 op-ed in the New York Times.

In his fiscal 2012 budget, President Barack Obama proposed requiring ordinary tax treatment of income for day trading for certain dealers in equity options and commodities. Dealers in other types of property treat income as ordinary, the administration said in the budget proposal. "There is no reason to treat dealers in different types of property differently," the proposal said.

Increasing Revenue

The provisions in the president's budget would raise $144 million in 2012 and $2.75 billion between 2012 and 2021. The increase relies on an assumption that the value of derivatives will rise over the decade, Yoram Keinan, shareholder at Greenberg Traurig LLP law firm, said in an interview.

Derivatives exchanges have opposed changing the tax system when it has been proposed in the past. When Obama pitched a related change in the 2010 fiscal budget, CBOE said the proposal would "adversely affect the entire marketplace, including the investing public." Changing the tax system would lead dealers and other market makers to pass on costs to clients, the group said.

In a statement yesterday, CME Group spokesman Chris Grams said "the exchange continues to oppose any change to the existing tax rule, which was instituted in 1981 for futures transactions as part of a conscious Congressional policy."

Heavy Lobbying

Proposals to change the tax system have failed to advance in Congress, in part because of heavy industry lobbying, said Viva Hammer, a partner at KPMG LLP and formerly a member of Treasury's office of tax policy responsible for tax law on financial products.

"Clearly the lobbyists protecting that bailiwick, that benefit, are extremely effective, and they will not let that go unless they rip apart the entire internal revenue code, I can promise you that," Hammer said in a telephone interview.

"People have been calling for years and years saying that this whole 40-60 thing is ridiculous," Keinan said. "But no one took action."

Last week, the Internal Revenue Service proposed regulations to help define which types of

derivatives fall under the blended tax rate. Trades subject to the blended system are known as "1256 contracts," named for the section of the tax code.

Dodd-Frank Act

The IRS proposal follows the Dodd-Frank Act, the financial overhaul enacted in July 2010, which aims to increase regulation of derivatives, which helped fuel the 2008 credit crisis. The U.S. Commodity Futures Trading Commission and Securities and Exchange Commission are leading U.S. efforts to complete regulations required under the law that will govern trades conducted by firms including Goldman Sachs, JPMorgan Chase & Co. (JPM) and Cargill Inc.

The law aims to have most of the $601 trillion over-the- counter market -- transactions directly between buyers and sellers -- guaranteed by clearinghouses and traded on exchanges or other platforms. Interest-rate swaps, currency swaps, equity swaps and other types of swaps are excluded from the list of 1256 contracts.

In the proposal, the IRS clarified that credit-default swaps, which traders use to wager on the credit quality of a company or a country, will not be taxed at the blended rate.

The deadline for public comments is Dec. 14.

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