Treasury Position On Section 1231 Gains And The Earned Income Tax Credit

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HAZARDS OF HEDGE-TO-ARRIVE CONTRACTS
— by Neil E. Harl

In the same manner as others bearing price risks, farmers buy and sell commodity futures to hedge against fluctuating prices. Likewise, farm taxpayers sometimes engage in speculative transactions.

A principal matter of concern from an income tax perspective is the line between hedging and speculation. Hedging transactions are defined in terms of reducing the risk of price (or interest rate) fluctuations in the ordinary course of the taxpayer’s business. Both sets of issues are discussed in this article.

What are “hedge-to-arrive” contracts?

Hedge-to-arrive or HTA contracts emerged about a decade ago in the Eastern Cornbelt and have since spread unevenly over much of the grain-producing regions of the country. The contracts operate in a manner similar to a hedge except — (1) the buyer (often the local elevator) has usually borne the margin deposits rather than the seller (as under a hedge) and (2) the seller can benefit from a narrowing of the basis in the commodity. Although the buyer shoulders the margin calls, those costs are ultimately passed to the seller. In recent months, the mounting margin calls and the costs incurred in rolling the contracts to a later futures month have risen to such a level as to raise a question whether the seller has sufficient assets to pay the obligation. In some instances, lenders supplying credit to elevators and other buyers obligated under HTA contracts have been requesting additional collateral to back lines of credit to the buyers. Losses of as much as a half million dollars on HTA contracts have been charged back to sellers.

HTA contracts were conceived and flourished in times of relative stability in commodity prices. Few anticipated the extreme price patterns seen during the first four months of 1996.

Regulatory framework governing hedge-to-arrive contracts

The Commodity Futures Trading Commission (CFTC) has been given statutory authority over “accounts, agreements ... and transactions involving contracts of sale of a commodity for future delivery, traded or executed on a contract market....” Federal law specifies that these “futures” contracts are illegal “off-exchange” contracts unless offered and sold on CFTC-designated boards of trade. Bona fide hedging transactions are specifically exempted from the legislation. Cash forward contracts are excluded from the definition of futures contracts and thus are not subject to CFTC regulation. These are “any sale of any cash commodity for deferred shipment or delivery.” The exclusion for cash forward contracts is predicated upon the fact that both parties to the contract contemplate future delivery of the actual commodity and intend that delivery of the actual commodity occur. The exclusion is not available to cover contracts of sale for commodities sold for speculative purposes and which are not based upon the expectation that delivery of the actual commodity by the seller would occur in the future.

Origin of cash forward contract rule. The exclusion for cash forward contracts originated in the Futures Trading Act of 1921. Excessive speculation and price manipulation had been occurring on the grain futures markets. In an attempt to limit the observed abuses in the futures markets, Congress imposed a tax at prohibitive levels (20 cents per bushel) on all futures contracts with two exceptions. Under one exception, the 1921 legislation exempted from the tax future delivery contracts entered into by owners and growers of grain, owners and renters of land on which the grain was produced and associations comprised of such persons. The legislation also exempted from the tax future delivery contracts made through (or by) members which had been designated as contract markets. As a result of objections raised on behalf of farmers and grain elevators, the Senate added language to the pending legislation excluding “any sale of cash grain for deferred shipment” from the term “future delivery.” In the hearings, it was made clear that the additional language on cash forward contracts was premised on the fact that both parties to the contracts deal in and contemplate future delivery of the actual grain. The Futures Trading Act of 1921 was declared unconstitutional in 1922 as an impermissible attempt to regulate using the taxing power. The Congress then enacted the Grain Futures Act of 1922 which regulated grain futures trading under the Commerce Clause of the US Constitution. The cash forward contract exclusion was included in the 1922 legislation. The exclusion was reworded in the Commodity Exchange Act of 1936 to except “any cash commodity for deferred shipment or delivery.” The 1936 legislation also deleted the express exemption for owner and growers of grain, owners and renters of land and associations of such persons. That move was justified on the grounds that the legislation excluded...
cash commodity contracts for deferred shipment or delivery; the specific exemption was, therefore, not needed.\textsuperscript{21}

The language excluding cash commodities for deferred shipment or delivery has been continued to the present. The 1974 amendments to the legislation reaffirmed that, in a cash forward contract, the parties contemplate transfer of the actual commodity.\textsuperscript{22} As the courts have noted, nothing in the legislative history suggests that Congress intended for the exclusion to embrace agreements for the future delivery of commodities sold for purposes of speculation.\textsuperscript{23}

The CFTC has issued several interpretative releases in recent years on the scope of cash forward contracts and the delivery requirement.

• In 1985, the CFTC tried to distinguish cash forward contracts from option contracts.\textsuperscript{24} The CFTC referred to a forward contract as “a binding agreement on both parties to the contract; one must agree to make delivery and the other to take delivery of the commodity.”\textsuperscript{25} The Commission also stated that the parties to the contracts must be “commercial entities that have the capacity to make or take delivery” and that delivery routinely occurs.\textsuperscript{26}

• In 1987, the Commission again addressed cash forward contracts —

“Although such transactions may be settled other than by delivery on more than an occasional basis, it appears that departure from the traditional requirement of settlement by delivery of the physical commodity occurs on the basis of privately negotiated agreements by principals who have the capacity to make or take delivery, who contemplate actual delivery or acceptance of delivery in some of those transactions, but who may be unable to determine at the inception of the transaction that delivery will not be required.”\textsuperscript{27}

• In 1990, CFTC took a somewhat more relaxed view of the delivery obligation by noting that in specific cases “...the transactions may ultimately result in performance through the payment of cash as an alternative to actual physical delivery or delivery of the commodity.”\textsuperscript{28} The Commission went on to state —

“...while such agreements may extinguish a party’s delivery obligation, they are separate, individually negotiated, new agreements, there is no obligation or arrangement to enter into such agreements, they are not provided for by the terms of the contracts as initially entered into, and any party that is in a position in a distribution chain that provides for the opportunity to book-out with another party or parties in the chain is nevertheless entitled to require delivery of the commodity to be made through it, as required under the contracts.”\textsuperscript{29}

Further guidance may be forthcoming from CFTC on the regulatory status of “cash forward contracts.”

**Applicability to hedge-to-arrive contracts.** An important question is whether the so-called “hedge-to-arrive” contracts are considered to be cash forward contracts and, therefore, within the statutory exception. For such contracts extending two to three years into the future, with rollovers permitted to later contract months, and with no expectation of delivery, it would seem that such contracts might not come within the exception. That outcome seems indeed likely if the seller does not have sufficient commodity on hand or expected to be produced to cover the amount specified in the contract. Thus, it would appear that at least some of the contracts may be “off-exchange” contracts which, as noted above\textsuperscript{30} may be illegal. A contract involving an off-exchange futures contract or trade option runs the risk of being held unenforceable by federal and state courts.

A careful review of contracts with legal counsel and those knowledgeable about risk management strategies is suggested. Contracts with the potential for deepening losses need immediate attention.

**Income tax treatment**

Hedges produce ordinary gains and ordinary losses and are not subject to the loss deferral rules and the “mark-to-market” provisions that are applicable to speculative transactions.\textsuperscript{31} Indeed, gains and losses from hedge transactions are treated like gains and losses from transactions involving the actual commodities. Losses from hedge transactions can be used to offset ordinary income from grain sales and from sales of livestock held for sale in the ordinary course of business.

Speculative transactions are treated differently. Gains from speculative transactions are treated as capital gains; losses are reported as capital losses. In general, positions in regulated futures contracts are subject to the “mark-to-market” rules and are treated as if sold on the last day of the year.\textsuperscript{32} Gains or losses arising under those calculations are treated as if they were 60 percent long-term and 40 percent short-term without regard to the actual holding period. Hedging transactions are exempt from these rules.\textsuperscript{33}

Long-term capital losses can be used to offset long-term capital gains, and, for individuals, up to $3,000 of ordinary income each year.\textsuperscript{34} Excess capital losses can be carried forward indefinitely for individuals\textsuperscript{5} and for up to five years for corporate taxpayers.\textsuperscript{36} Losses from regulated futures contracts can be carried back by individuals to the three prior years.\textsuperscript{37} The maximum loss that may be carried back to any carryback year is the regulated futures gain in that year (without regard to regulated futures losses) that is the lesser of the net capital gain for the year, taking into account only gains and losses from regulated futures contracts or the net capital gain income for the tax year.\textsuperscript{38}

**Requirements for a hedge**

To be considered a hedge, the futures transaction must have the effect of reducing price (or interest rate) risk. Courts have emphasized two tests in evaluating commodity futures transactions as hedges or speculative venture.

**Insurance test.** If futures trading is used to offset price changes in actual commodities (the “actuals”), the transactions should be viewed as hedges.\textsuperscript{39} That means gains on the actual commodities should be offset by losses on the futures trade. Similarly, losses on the actual commodities should be offset by gains on the futures transactions.

Typically, someone purchasing a commodity would sell a contract on the futures market in order to avoid price risk. When the commodity is sold, the futures contract is repurchased. Gains on one offset losses on the other. Thus, hedges usually involve ownership of actual commodities.

**Direct relation test.** Under the direct relations test, there must be a reasonable relationship between the amount of actuals involved and the amount of the trading in the futures market.\textsuperscript{40} In cases where the volume of futures trading

\textsuperscript{*}Agricultural Law Manual (ALM). For information about ordering the Manual, see the last page of this issue.
greatly exceeded the amount of actuals, the transactions have been held to be speculative in nature.41

Recently issued regulations

Final regulations were issued in late 1994 providing guidance on reporting hedging and speculative transactions involving futures.42 Taxpayers other than farmers and other small businesses are required to take gains and losses from hedges into account in the same period as the income, deductions and gains or losses on the item hedged.43 However, for farm and small business taxpayers on the cash method of accounting, the simpler methods used previously and allowing the reporting of gains and losses on a cash accounting basis can continue to govern the reporting of hedge transactions if the taxpayer has no more than $5,000,000 of gross receipts.44

Taxpayers are required to identify hedges when entered into, along with the item or items hedged.45

FOOTNOTES

2 I.R.C. § 1256(e)(2).
3 7 U.S.C. § 2(i).
6 7 U.S.C. § 1a(11).
7 Id.
9 CFTC v. Co Petro Mktg. Group, Inc., 680 F.2d 573, 579-80 (9th Cir. 1982);
12 Treas. Reg. § 1.1221-2; Treas. Reg. § 1.446-4(b).
13 Id., Sec. 4(b).
15 See Cong. Rec. 4762, Aug. 9, 1921.
16 See Cong. Rec. 4762, Aug. 9, 1921.
20 Id.
25 Id. at 39657-39658.
26 Id.
29 See In re Bybee, 945 F.2d 309, 315 (9th Cir. 1991) (application of exchange trading requirement precluded; CFTC “Statutory Interpretation” given great weight).
30 See n. 2 supra.
31 I.R.C. §§ 1092(e), 1256(e)(1).
32 I.R.C. § 1256(a)(1).
33 I.R.C. § 1256(a)(3).
34 I.R.C. § 1211(b).
35 I.R.C. § 1212(b).
36 I.R.C. § 1212(a).
37 I.R.C. § 1212(c)(1).
38 I.R.C. § 1212(c).
39 See, e.g. Stewart Silk Corp. v. Comm’r, 9 T.C. 174 (1947).
40 Hendrich v. Comm’r, T.C. Memo. 1980-322 (pattern of futures trading did not provide protection for wheat held by taxpayer).
41 See, e.g., Lewis v. Comm’r, T.C. Memo. 1980-334 (volume of futures trading by cattle feeder was three to five times cattle on hand).
42 Treas. Reg. § 1.1221-2; Treas. Reg. § 1.446-4.
43 Treas. Reg. § 1.446-4(b).
44 Treas. Reg. § 1.446-4(a)(1).
45 Treas. Reg. § 1.1221-2(a).

CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr.

ANIMALS

CATTLE. The plaintiff was injured when the plaintiff’s car struck a steer owned by the defendant on a public highway. The steer had wandered 1400 feet to the highway through an open gate. The defendant had testified that the gate was closed when the defendant last used it the day before the accident. The plaintiff provided no evidence of any negligent act by the defendant which resulted in the gate being left open. After noting that Fla. Stat. § 588.15 required a showing of intentional or negligent act by the defendant before liability would attach for livestock running at large on a public road, the trial court granted summary judgment for the defendant. The plaintiff argued that the statute, as interpreted by the trial court, placed too high a burden on the plaintiff. The plaintiff also argued that the “dog bite” statute subjected dog owners to a strict liability standard; therefore, the plaintiff argued that Section 588.15, as interpreted by the trial court, violated the plaintiff’s equal...