Hedging or Speculation: Watch Who Does the Hedging

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Lessons from Australian agriculture, continued from page 4

Iowa farmers and Victoria farmers can evaluate their situations using the same basic principles. They need to have clear goals and objectives, be able to realistically assess available resources, and determine the best way to use these resources to achieve the desired goals.

Several years ago ISU Extension sponsored a conference called “Four Roads to the Future of Agriculture.” This conference spelled out different approaches farmers could take in adjusting to the current situation in agriculture. I have slightly modified the roads that were identified at the conference. In a general sense, the four roads are commodity production where you try to make a living using volume to overcome the tight profit margin; specialty production where you try to widen the margins to make a living; getting off-farm income to supplement farm income; or simply leaving agriculture.

Within each of these categories there are many options, but the general idea is that farmers have a range of alternatives and they need to decide the best course of action based on their own circumstances.

A simple comparison between Victoria and Iowa offers stark contrasts to the role of government in production agriculture. Iowa has substantial government commodity programs while Victoria does not. In spite of these programs, Iowa farmers are facing many of the same problems that Victoria’s farmers are facing and the four roads are exactly the same paths. Like us, they have choices. They may not like the choices, but they have choices.

Hedging or Speculation: Watch Who Does the Hedging

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It’s a fundamental principle of tax law that hedging a commodity produces ordinary gains and ordinary losses, with the futures gains or losses treated just like gains and losses from the commodity involved. Likewise, gains from speculative transactions are treated as capital gains; losses are reported as capital losses.

One problem that arises periodically is that, even though the insurance test and the direct relation test are met, the commodity trades may nonetheless be considered speculative because the taxpayer reporting the commodity trades is not the same taxpayer as owns the commodity supposedly hedged. The two cases to date and a private letter ruling are ample evidence that a review of the commodity futures program is in order any time there is a significant change in the business plan for a farming operation.

Private letter ruling

In a 1997 private letter ruling the taxpayer was a shareholder in a dairy farming business carried on by an S corporation. The taxpayer was responsible for the feeding program in the dairy operation and, in the capacity of shareholder, bought and sold commodity futures contracts to protect against price increases in the feed ingredients.

The ruling notes that a corporate shareholder could not attribute the business of the corporation (in which the shareholder owns stock) to the shareholder as the shareholder’s business. The ruling concludes that such a shareholder, to treat the gains and losses from commodity trades as hedges, must establish that the shareholder was engaged in a trade or business separate from that of the corporation and that


continued on page 6
the commodity trades were entered into as hedges in the shareholder’s trade or business.

The 2001 tax court case
A Tax Court case decided in 2001, Pine Creek Farms, Ltd. v. Commissioner, involved a corporation, Pine Creek Farms, Ltd., which raised corn, soybeans and cattle. Two other corporations were engaged in hog production. One, Grow Pork, Inc., was engaged in hog farrowing; the other, Reis Ag, Ltd., was engaged in hog finishing. All three corporations had one shareholder in common, John Reis. Reis owned 51 percent of Pine Creek Farms, Ltd. (his wife owned the other 49 percent), 50 percent of Reis Ag (his brother owned the other 50 percent) and 20 percent of Grow Pork, Inc. (there were four other 20 percent shareholders).

Dating back to the period prior to the incorporation of Pine Creek Farms, Ltd., Reis had maintained a commodities account in his own name which was used as a hedge account. That account was transferred to Pine Creek Farms, Ltd. when Pine Creek Farms, Ltd. was formed. That account was used to handle the hedging transactions for all three corporations. IRS argued that because Pine Creek Farms, Ltd. was not engaged in the hog business, it could not have hedging transactions in hogs. Therefore, the losses were considered to be capital losses, not ordinary losses.

The Tax Court, mindful of the well-settled rule that a corporation is an entity separate and distinct from its shareholders, and that a corporation’s business is not attributable to its shareholders absent exceptional circumstances, held that the business transactions of Reis Ag and Grow Pork could not be attributed to Reis and from Reis to Pine Creek Farms, Ltd. The court could find no exceptional circumstances which would cause the court to ignore the corporate entities and attribute the production of hogs to Pine Creek Farms, Ltd.

The 2003 tax court case
The latest case, decided on October 29, 2003, Welter v. Commissioner, involved a taxpayer, Welter, who formed two C corporations after farming in unincorporated form for several years. Welter retained ownership of the land and leased it to the corporations. Each of the C corporations maintained its own records and bank account and filed a federal income tax return.

Before incorporation of the two C corporations, Welter engaged in commodity trading through several brokerage accounts. Welter continued to engage in futures trading through the same accounts after incorporating the new corporations without transferring the accounts to the corporations.

Citing the Pine Creek Farms, Ltd. case with approval, the Tax Court held that the business activities of the corporations could not be attributed to Welter so the gains and losses attributed to the commodity futures transactions were capital gains and capital losses. The deduction for the losses was limited to $3,000 per year.

In conclusion
The increasing use of futures trading, as a component of a risk-management program, makes it essential that the relationship of the futures trading activity to the production of the commodities in question be reviewed periodically. It is particularly important to examine the futures trading plan whenever a structural change has been made in the production of the commodities or in the ownership of the commodities.