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INCOME TAX TREATMENT OF HEDGES

— by Neil E. Harl

After aggressively pressing the position that commodity hedges, including short sales, produced capital gain or loss treatment,1 IRS lost a key decision on June 17, 1993.2 Now, the Department of the Treasury in temporary and proposed regulations, has abandoned its previous position and agrees that gains and losses from most hedging transactions are considered to be ordinary gains and losses.3 Under the authority of Arkansas Best Corp. v. Comm'r,4 IRS had contended that such losses were capital in nature which could offset capital gains and, for individuals, up to $3,000 of ordinary income.5 The temporary and proposed regulations are very good news for those hedging commodities and essentially confirm the position adopted in the FNMA case.6

**FNMA**

In the FNMA case, the Federal National Mortgage Association had hedged debentures and mortgages with short sales of U.S. Treasury securities. IRS objected, citing Arkansas Best Corp.,7 for the proposition that the gains and losses were properly from capital transactions.

The Tax Court held that the FNMA transactions were hedges and that closing out the hedges resulted in ordinary gains and losses. The court noted that the transactions were meant to offset the risk of changes in interest rates and were, therefore, true hedges. In response to the IRS argument that FNMA had not offset all of its risk, an argument sometimes made with commodity futures transactions, the court said:

"A taxpayer is not required to negate its entire risk, nor must it hedge every transaction in order to lock in a particular return, since hedges by their very nature are meant to avoid risk of loss (similar to insurance), but not necessarily all risk, to which a taxpayer is exposed."8

In deciding that the losses on the hedges were ordinary losses rather than capital losses, the court concluded that short positions as well as long positions could reduce price risk and that it was not necessary for ordinary gain or loss treatment for the hedge to be in the same asset that the taxpayer owns or intends to acquire. The court noted that, for the hedging position to be eligible for ordinary gain or loss treatment, the hedging transactions must have been integrally related to the purchasing and holding of the assets hedged. In the FNMA case, the court concluded that the hedges bore a close enough relationship to FNMA's mortgages to be excluded from the definition of a capital asset.8

**New regulations**

The temporary and proposed regulations are published in three parts. The first part contains temporary regulations covering transactions involving interest-rate, currency and price risks.9 To receive ordinary loss treatment for hedges entered into on or after January 1, 1994, the regulations require taxpayers to identify hedges when entered into, along with the item or items hedged.10 This provision is designed to discourage taxpayers from declaring transactions to be hedges after the arrangement can be seen likely to produce losses.

Under the second set of proposed regulations, specific guidelines are provided for taxpayers to follow in identifying hedges as the hedge transactions are entered into.11

The final set of regulations governs when gains and losses are to be reported.12 Taxpayers other than farmers and other small businesses are generally required to take a gain or loss from a hedge into account in the same period as the income, deductions, gain or loss is reported on the item being hedged.13 For farm and small business taxpayers on the cash method of accounting, the simpler methods previously used can continue to govern reporting of hedge transactions if the taxpayer has no more than $5,000,000 of gross receipts.14

The new regulations do not apply to Section 1231 assets (used in a trade or business) or capital assets.15

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**FOOTNOTES**

2 T.D. 8493, Prop. Treas. Reg. § 1.1221-2T.
5 I.R.C. § 1211.
6 Charles F. Curtiss Distinguished Professor in Agriculture and Professor of Economics, Iowa State University; member of the Iowa Bar.
EXEMPTIONS-ALM § 13.03[3] *

ANNUITY. Prior to filing for bankruptcy, the debtor sold some non-exempt assets and purchased three annuity contracts. The debtor claimed the three contracts as exempt under Calif. Code of Civ. Proc. § 704.100(c). The court held that the annuity contracts were not eligible for the exemption because the annuities did not represent benefit payments from matured life insurance policies. In re Pikush, 157 B.R. 155 (Bankr. 9th Cir. 1993).

AVOIDABLE LIENS. The debtor claimed a homestead exemption under Section 522(f) and sought to avoid judicial liens which impaired the exemption. The liens against the house included a first priority unavoidable mortgage, four next priority judicial liens and a sixth priority unavoidable tax lien. The total of the liens substantially exceeded the value of the house. The trustee argued that the first and sixth priority liens were avoidable and exceeded the value of the house, the judicial liens did not impair the exemption. The court held that the impairment occurred when the liens, taken in order of priority, first exceeded the value of the house less the exemption amount; however, the impairment only affected the priority of the liens by placing the debtor’s exemption amount in the priority scheme. Because the IRS lien could not be avoided by the change in priority, the last judicial lien was bifurcated into a seventh priority portion equal to the exemption amount. The affect of this solution is that (1) no actual avoidance of a lien occurs but the debtor receives the exemption amount upon sale of the collateral and (2) the lien which caused the total of liens to exceed the value of the exempt property less the exemption amount became unsecured by the exemption amount. In re Bellenoit, 157 B.R. 185 (Bankr. D. Mass. 1992).

HOMESTEAD. The debtor had claimed a homestead exemption under Cal. Code of Civil Proc. § 703.140. The trustee objected to the exemption because the bankruptcy case was not an attempt to sell the residence to enforce a money judgment. The court held that because the Bankruptcy Code gives the trustee the status as hypothetical creditor, the exemption was allowed in a bankruptcy case. In re Norman, 157 B.R. 460 (Bankr. C.D. Calif. 1993).

IRA. The debtor opened an IRA in 1987 and filed for bankruptcy in 1992, claiming the IRA as exempt. The debtor was 54 years old and was facing unemployment due to a shutdown of the company for which the debtor worked. The court found that the debtor’s income just exceeded the debtor’s expenses but after unemployment, the expenses would exceed income. However, because the debtor had never made withdrawals from the IRA and that demonstrated that the debtor did not need all of the account for living expenses, the court held that half of the account must be turned over to the trustee. The court also ordered the debtor and trustee to share in the cost of the federal taxes and penalties resulting from the early withdrawal from the IRS. In re Metzner, 157 B.R. 332 (Bankr. N.D. Ohio 1993).

The debtor owned two IRA’s, one for $2,000 and one for $5,500, which the debtor claimed as exempt. The debtor was 58 years old and on medical leave for stress. The debtor was planning to separate from her spouse and was under a threat of losing her job. The debtor had more debt payments and personal expenses than would be covered by payments from the IRAs. The court held that only the $2,000 IRA was not reasonably necessary for the debtor’s support and not exempt. The debtor was required to pay any taxes and penalties resulting from the early withdrawal from the IRS. In re Bogart, 157 B.R. 345 (Bankr. N.D. Ohio 1993).

OBJECTIONS. The debtor claimed real property as exempt in the bankruptcy petition in April 1992 but did not provide any statutory basis for the exemption. In September 1992, the debtor amended the exemption schedules to include an automobile but did not otherwise amend the exemptions. The trustee filed an objection to the real property exemption in September 1992, arguing that the objection should be allowed because it was made within 30 days after an amendment to the exemptions. The court held that the objection was untimely because the amendment did not change the exemption claim for the real property. The

*Agricultural Law Manual (ALM). For information about ordering the Manual, see the last page of this issue.