Hedging or Speculation: Watch Who Does the Hedging

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Watch Who Does the Hedging

— by Neil E. Harl*

It is 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 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).

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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

FOOTNOTES


2 Meade v. Comm’r, T.C. Memo. 1973-46 (soybean farmer was long in futures; speculative activity). See Day v. United States, 734 F.2d 375 (8th Cir. 1984) (futures trading in cotton and soybean contracts “was not restricted to the seasonal period in which they planted or harvested their crops” with many positions opened and closed in a period of a few days; taxpayers engaged in speculative transactions, not hedges).

3 E.g., Stewart Silk Corp. v. Comm’r, 9 T.C. 174 (1947).

4 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).

5 Welter v. Comm’r, T.C. Memo. 2003-299 (shareholder, not family farm corporation, engaged in commodity futures trading); Pine Creek Farms, Ltd. v. Comm’r, T.C. Memo. 2001-176 (corporation engaged in futures trading was not raising hogs, which were the subject matter of trades). See Ltr. Rul. 9720003, January 15, 1997 (shareholder of S corporation engaged in dairy farming was responsible for futures trading involving feed for dairy cows).

6 See note 5 supra.


8 Id.

9 T.C. Memo. 2001-176.

10 Id.

11 Id.

12 Id.

13 Id.


16 Id.

17 Id.

18 T.C. Memo. 2003-299.

19 Id.

20 T.C. Memo. 2001-176.


22 Id., footnote 4.