12-6-1996

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REPORTING HTA LOSSES

— by Neil E. Harl

Hedge-to-arrive contracts, which in recent years had spread throughout Midwestern agriculture like a virus,1 pose important but difficult issues on how the losses are reported for federal income tax purposes. Some guidelines are well known2 and are relevant in determining whether losses are from hedges and thus are ordinary3 or are capital in nature.4 Ordinary losses offset ordinary gains but long term capital losses can only affect long-term capital gains and, for individuals, up to $3,000 per year of ordinary income.5 Excess capital losses can be carried forward indefinitely for individuals6 and for up to five years for corporate taxpayers.7

Calculating gains and losses from hedges

In some instances, hedge contracts are closed out at the time the actual commodities are sold. In that case, the calculation of gains or losses on the hedging contract and on the actual commodities is straightforward with the gains and losses reported on Schedule F (or the appropriate business schedule for non sole proprietors).

But in other instances, the factual circumstances surrounding the close out of the hedge is less clear. The regulations8 provide guidance on how the transactions should be handled.

As a general proposition, the accounting approach used by the taxpayer where hedges are involved must clearly reflect income.9 To clearly reflect income, the method used must reasonably match the timing of income, deductions, gains or losses from the hedging transactions with the timing of income, deductions, gains or losses from the items being hedged.10 Taking gains and losses into account in the period in which they are realized generally reflects income clearly for hedging transactions.11 For hedges of inventory, gains or losses on the hedge may be taken into account in the same period that it would be taken into account if the gains or losses were treated as related to inventory.12 The records are to contain a description of the accounting approach used.13

The regulations provide considerable latitude in adopting an approach to handling hedges. But once adopted, the method must be used consistently.14

Taxpayers on cash accounting with less than $5,000,000 of gross receipts for all taxable years after September 30, 1993, are not required to use these rules.15 Most farm taxpayers fall into that category. However, the regulations point out that those taxpayers may, nonetheless, use an approach consistent with these rules.16

In the event a taxpayer hedges an item and then disposes of or terminates its interest in the item but does not dispose of or terminate the hedge, the taxpayer must "appropriately" match the built-in gain or loss on the hedging transaction to the gain or loss on the disposed item.17 Thus, hedges may be "marked-to-market" on the date the actuals are disposed.18

For "recycled" hedges, with the hedge later used to serve as a hedge of a different item, the taxpayer must match the built-in gain or loss at the time of the recycling to the gain or loss on the original hedged items. Gains or losses attributable to the period after recycling must be matched to the new hedged item.19

Such recycling has been common with hedge-to-arrive contracts. In numerous instances, 1995 crop in storage was hedged. However, the crop in storage was sold on the cash market as prices rose with the hedge "rolled over" to the 1996 crop -- even beyond. It appears that the gain or loss on a hedge contract is calculated at the time the actual commodities are sold. This creates a basis for the hedging contract for purposes of calculating gain or loss at the time the actual commodities are sold. This creates a basis for the hedging contract for purposes of calculating gain or loss at the time the new hedged item is sold.

Failure to identify hedges

To receive ordinary loss treatment, taxpayers must identify hedges when entered into along with the item or items hedged.20 Hedging transactions entered into on or after January 1, 1994, must be identified as such before the close of the day on which the taxpayer enters into the hedge.21

The regulations impose a stern set of penalties for failure properly to identify hedges.

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1 Charles F. Curtiss Distinguished Professor in Agriculture and Professor of Economics, Iowa State University; member of the Iowa Bar.
• If a taxpayer identifies a transaction as a hedging transaction, and it is not a hedge, gains from the transaction are ordinary but losses are capital losses. 22
• In the event a transaction meets the definitions of a hedge but it is not identified as a hedge, gains from the transaction are nonetheless ordinary and losses are capital losses. 23

Thus, compliance with the regulations has been made the exclusive way to receive treatment as a hedge. That result has been criticized. 24

**Treatment as a "regulated futures contract"**

Positions in "regulated" futures contracts are subject to the "marked-to-market" rules and are treated as if sold on the last day of the year. 25 Gains or losses arising from those calculations are treated as if they were 60 percent long-term and 40 percent short-term without regard to the actual holding period. 26 Hedging transactions are exempt from these rules. 27

It would appear that hedge-to-arrive contracts are not "regulated futures contracts." 28 A regulated futures contract must be "traded on or subject to the rules of a qualified board or exchange." 29 Hedge-to-arrive contracts appear to have been outside the ambit of regulated futures activity. 30

**FOOTNOTES**


2 See 4 Harl, supra n. 1, § 27.03[8][d]; Harl, supra n. 1, § 4.02[6].

3 See Treas. Reg. § 1.1221-2(b) (defines hedges which produce ordinary losses). See also I.R.C. §§ 1092(e), 1256(e)(i).

5 I.R.C. § 1212 (h).
6 I.R.C. § 1212(a).
7 Treas. Reg. § 1.446-4.
8 Treas. Reg. § 1.446-4(b).
9 Id.
10 Id.
11 Id.
12 Treas. Reg. § 1.446-4(e)(3).
13 Treas. Reg. § 1.446-4(d).
14 Treas. Reg. § 1.446-4(c).
15 Treas. Reg. § 1.446-4(a)(1).
16 Id.
17 Treas. Reg. § 1.446-4(a)(6).
18 Id.
19 Treas. Reg. § 1.446-4(e)(7).
20 Treas. Reg. § 1.1221-2(e).
21 Treas. Reg. § 1.1221-2(e)(1). The identification must be made “substantially contemporaneously” with entering into the hedge. An identification does not meet that test if made more than 35 days after entering into the hedging transaction. Treas. Reg. § 1.1221-2(e)(2)(ii).
25 I.R.C. § 1256(a)(1).
26 I.R.C. § 1256(a)(3).
27 I.R.C. § 1256(e)(1).
28 See I.R.C. § 1256(g)(1)(B).
29 Id.

**CASES, REGULATIONS AND STATUTES**

by Robert P. Achenbach, Jr.

**ANIMALS**

**CATTLE.** A veterinarian informed the state police that neglected cattle were on the plaintiff’s property. One defendant, a state trooper, accompanied the veterinarian to the plaintiff’s farm and investigated the condition of the animals. The trooper filed a report with the county prosecutor who obtained a warrant for the seizure of some of the animals. The second defendant, also a state trooper, assisted in executing the warrant under which the cattle were seized by the local humane society which eventually sold the animals to cover maintenance costs. As a result of the second visit, another warrant was issued for seizure of the remaining animals. The third defendant, a state trooper, accompanied the humane society as it seized the animals. The plaintiff was eventually exonerated of animal neglect charges but by then all of the animals had been sold. The plaintiff sued all parties, with the state troopers as the only defendants in the current case. The plaintiff alleged that the state troopers violated the plaintiff’s due process rights and brought an action under 42 U.S.C. § 1983. The court upheld the dismissal of the case against the troopers because the troopers were properly executing court orders or were too removed from the sale of the animals to have participated in deprivation of the plaintiff’s property. **Campbell v. Chappelow, 95 F.3d 576 (7th Cir. 1996).**

**BANKRUPTCY**

**GENERAL-ALM § 13.03.**

**ADMINISTRATIVE EXPENSES.** The debtor was a family farm partnership which operated a grain and dairy farm. The partners and their spouses also filed individual bankruptcy cases which were consolidated with the debtor’s case. During the pendency of the debtor’s case, a seed supplier sold on credit corn seed, fertilizer and two herbicides to the debtor for producing one year’s crop. The crop did not do well and the debtor complained to the...