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CARE NEEDED TO ASSURE HEDGING RESULT
— by Neil E. Harl*

The line between hedging and speculation is critical, especially if a loss occurs. Although gains from speculative transactions are capital gains, losses are capital losses. Gains or losses arising from speculative transactions are treated as if they were 60 percent long-term and 40 percent short-term without regard to the actual holding period. 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.

On the other hand, gains and losses from hedges are exempt from the “market-to-market” rules for speculative transactions and are treated as gains and losses from the actual commodities. Thus, gains are reported as ordinary income and losses are ordinary losses.

A July, 2001, Tax Court case has dramatized the importance to taxpayers of watching closely the requirements for a hedge. In particular, it is important to be sure the hedging account is held by the entity producing the actual commodities involved.

Tests for “hedge” status

The regulations, which became final in 1994, relaxed some of the requirements for a hedge. A taxpayer may hedge any part or all of its risk for any part of the period during which it has risk. Moreover, the frequent entering into and termination of hedging positions are not relevant to whether transactions are hedges. For a hedging program undertaken to reduce the overall risk of the taxpayer’s operation, the taxpayer generally does not have to demonstrate that each hedge entered into under the program reduced overall risk.

Basically, however, the courts have emphasized two tests in evaluating commodity futures transactions as hedges or as speculative ventures. Insurance test. If the taxpayer uses futures trading to offset price changes in actual commodities, (the “actuals”), the futures transactions are ordinarily treated as hedges. Even if the taxpayer did not own the actuals, the U.S. Supreme Court has...
held that futures trading was hedging and not speculation if the commodity transactions were an integral part of the taxpayer’s business and the taxpayer acquired the actuals in the course of business. Thus, “pre-hedging” is permitted (before a crop is planted and before feeder animals are acquired) but “post-hedging” which involves attempts to hedge after the commodity is sold is not a hedge but is speculation.

“Direct relation” test. Under the direct relation test, there must be a reasonable quantitative relationship between the taxpayer’s involvement with the actuals and the commodity market transaction if the transaction is considered to be a hedge. For the direct relation test to be met, the amount of futures trading in the particular commodity involved and the timing of purchases and sales must be related to the position of the taxpayer in the actuals.

Wrong entity hedging

A problem that is becoming increasingly common with multiple-entity business plans, with the overall farming or ranching operation divided between or among entities, is in having the hedging transactions carried on by the correct entity. In Pine Creek Farms, Ltd. v. Comm’r, a corn, soybean, cattle and hog operation was divided among several entities. The taxpayer, a C corporation, was engaged in producing corn, soybeans and cattle; the hog operation was handled by two other corporations, one for farrowing and one for finishing. The taxpayer corporation in the tax year in question had $40,934 of hedging losses of which $6,305 was from hog hedges. IRS determined the $6,305 was a capital loss for the taxpayer and the Tax Court agreed. IRS argued that the taxpayer was not engaged in the hog business and could not have hedging transactions in hogs. It didn’t matter that a shareholder of the taxpayer C corporation engaged in hog production through the other two corporations.

A 1997 private letter ruling addressed a similar question. In that ruling, a dairy farm was carried on by an S corporation but a shareholder attempted to hedge feed supplies. The S corporation’s business was not attributed to the shareholder for hedging purposes.

In conclusion

Among other points to watch, it is vital for hedging status that the hedging transactions be carried on by the correct entity.

FOOTNOTES

2 See I.R.C. § 1256(a)(3).
3 I.R.C. § 1256(a)(3).
4 I.R.C. § 1211(b).
5 I.R.C. § 1256(e)(1).
6 Pine Creek Farms, Ltd. v. Comm’r, T.C. Memo. 2001-176.
7 Treas. Reg. § 1.1221-2.
8 Treas. Reg. § 1.1221-2(c)(l)(iv).
9 Treas. Reg. § 1.1221-2(c)(1)(vi).
10 Treas. Reg. § 1.1221-2(c)(1)(ii).
12 E.g., Stewart Silk Corp. v. Comm’r, 9 T.C. 174 (1947).
13 E.g., Corn Products Refining Co. v. United States, 350 U.S. 46 (1955). See also, Crisp v. Comm’r, T.C. Memo. 1989-668 (futures transactions required as part of loan agreement were integral part of cattle raising business; gains were ordinary income).
14 Patterson v. Comm’r, T.C. Memo. 1981-43, aff’d in unpub. Op., 676 F.2d 705 (8 th Cir. 1982) (farmer sold soybeans at harvest because of inadequate storage and bought soybean futures; transactions were held to be speculative, not hedges, on grounds taxpayer was not protecting against risk of loss as to actual commodities).
15 See, e.g., Comm’r v. Banfield, 122 F.2d 1017 (9 th Cir. 1941) (mere fact of purchase and sale of wheat futures by wheat farmer did not make commodity transactions hedges).
16 E.g., Lewis v. Comm’r, T.C. Memo. 1980-334 (volume of futures trading by cattle feeder was three to five times the cattle on hand).
17 T.C. Memo. 2001-176.
18 Id.
19 Id.

CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr.

ANIMALS

CRIMINAL NEGLECT. The defendant operated for several years a boarding house for the defendant’s and other’s horses. The defendant was convicted of two counts of violating Iowa Code § 717.2(2) for failing to properly feed two horses. The case does not disclose any reasons for the lack of care. The two dead horses were discovered by a sheriff’s deputy at the edge of a field, observable from a road. The deputy took several photographs from a neighboring property and obtained a search warrant to have a veterinarian examine the horses for cause of death. The defendant claimed that the horses died in a storm; however, the expert witnesses testified that the horses died from...