Agricultural Law Digest

An Agricultural Law Press Publication | Volume 5, No. 18 | September 16, 1994
Editor: Robert P. Achenbach, Jr. | Contributing Editor Dr. Neil E. Harl, Esq. | ISSN 1051-2780

FINAL REGULATIONS ON HEDGING

— by Neil E. Harl*

After the Internal Revenue Service lost in the Tax Court in 1993 on the issue of whether hedges produced capital gain or loss treatment,[1] the Department of the Treasury issued temporary and proposed regulations abandoning its position.[2] The Service and the Treasury in the regulations agreed that most hedging transactions are properly considered to produce ordinary gains and losses.[3] The regulations have now been made final with a few modifications from the regulations as proposed.[4]

Post-sale hedges

In the explanation accompanying the final regulations,[5] the point is made that "a transaction that is not entered into primarily to reduce risk" is not a hedging transaction.[6] That is in accord with the "insurance" test under which a taxpayer using futures transactions to offset price changes in actual commodities is engaging in a hedging transaction.[7]

The explanation goes on to say that a "store-on-the board" transaction in which a taxpayer disposes of commodities and then enters into a long futures or forward contract is not a hedging transaction; the long position does not reduce risk inasmuch as the actuals have already been sold.[8] This position is consistent with the case of *Nicholas C. Patterson*.[9] In that case, a farmer sold soybeans at harvest because of inadequate storage and bought soybean futures. The transactions were held to be speculative and not hedges on the grounds the taxpayer was not protecting against risk of loss as to the actual commodities. The court rejected the argument that the transaction should have been allowed as a "post hedge" on the grounds, as in *Corn Products Refining Co. v. United States*,[10] that the transaction was an integral part of the business.

The explanation accompanying the final regulations does, however, appear to sanction the hedging of deficiency payments —

> "The IRS and Treasury understand that there are situations in which a taxpayer engages in a store-on-the-board transaction as a hedge of an expected payment under an agricultural price support program. In this situation, a long futures or forward contract may qualify as a hedging transaction with respect to the expected payment."[11]

The "actual" in this case is the right to receive a payment based on the average price for the commodity during the marketing year.

Hedging less than all of the risk

One of the objections raised by IRS in *Federal Nat'l Mortgage Ass'n v. Commissioner* [12] was that the taxpayer was not hedging all of the risk and, therefore, should not be accorded hedging treatment. The final regulations make it clear that a taxpayer may hedge any part or all of the risk for any part of the period during which the taxpayer has risk.[13]

Moreover, the frequent entering into and termination of hedging positions is not relevant to whether transactions are hedges.[14] The regulations note that should be the outcome "even if done on a daily or more frequent basis."[15] The regulations state specifically that "if a taxpayer maintains its level of risk exposure by entering into and terminating a large number of transactions in a single day, its transactions may nonetheless qualify as hedging transactions."[16] This appears to represent a substantial easing of the position taken in some audits that frequent lifting of hedges was indicative of a speculative transaction rather than a hedge.

Reduction of overall risk

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 pursuant to the program reduced overall risk.[17] A hedge of a particular asset (or liability) is generally respected as reducing risk if it reduces the risk attributable to the asset or liability and if it is reasonably expected to reduce the overall risk of the taxpayer's operations.[18] Whether a transaction reduces a taxpayer's risk is determined based on all of the facts and circumstances surrounding the taxpayer's business and the transaction.[19]

Noninventory supplies

In general, property is ordinary property and thus eligible for ordinary gain or loss treatment in a hedge transaction only if a sale or exchange of property could not produce a capital gain or loss regardless of the holding period.[20] Thus, property used in the trade or business is not ordinary property and is not eligible for ordinary gain and loss treatment in a hedge transaction.[21]

Notwithstanding that fact, "noninventory supplies" may be hedged if only a negligible amount is sold.[22] A noninventory supply "is a supply that a taxpayer purchases for consumption in its trade or business and that is not an

* Charles F. Curtiss Distinguished Professor in Agriculture and Professor of Economics, Iowa State University; member of the Iowa Bar.

Agricultural Law Digest is published by the Agricultural Law Press, P.O. Box 5444, Madison, WI 53705, bimonthly except June and December. Annual subscription $100. Copyright 1994 by Robert P. Achenbach, Jr. and Neil E. Harl. No part of this newsletter may be reproduced or transmitted in any form or by any means, electronic or mechanical, including photocopying, recording or by any information storage or retrieval system, without prior permission in writing from the publisher. Printed on recycled paper by Accurate Business Service, Madison, WI.

asset described in sections 1221(i) through (5)" of the Internal Revenue Code.[23] This is the so-called "jet fuel" problem, which was not addressed in the proposed and temporary regulations, and which also affects the hedging of supplies acquired for use in a farm or ranch business.

In a transitional rule, the regulations acknowledge that a taxpayer may treat as hedging transactions all hedges of purchases of noninventory supplies for taxable years that ended prior to July 18, 1994, and were still open for assessment as of September 1, 1994, if, among other requirements, the taxpayer did not sell in any of those years more than 15 percent of the greater of the supply at the beginning of the year or the amount acquired during the year.[24]

FOOTNOTES

1 Federal Nat'l Mortgage Ass'n v. Comm'r, 100 T.C. No. 36 (1993). See generally 4 Harl, *Agricultural Law* § 27.03[8][d] (1994); Harl, *Agricultural Law Manual* § 4.02[6] (1994). See also Harl, "Income Tax Treatment of Hedges," 4 *Agric. L. Dig*. 165 (1993).

2 T.D. 8493, Prop. Treas. Reg. § 1.1221-2; Temp. Treas. Reg. § 1.1221-2T; Prop. Treas. Reg. § 1.446-4.

3 *Id.*

4 Treas. Reg. § 1.1221-2; Treas. Reg. § 1.1233-2; Treas. Reg. § 1.1256(e)-1.

5 59 Fed. Reg. 36361, July 18, 1994.

6 Treas. Reg. § 1.1221-2(c)(1).

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

8 59 Fed. Reg. 36361-36362, July 18, 1994.

9 T.C. Memo. 1981-43, *aff'd in unpub. op*. (8th Cir. 1982).

10 350 U.S. 46 (1955).

11 59 Fed. Reg. 36362, July 18, 1994.

12 100 T.C. No. 36 (1993).

13 Treas. Reg. § 1.1221-2(c)(1)(iv).

14 Treas. Reg. § 1.1221-2(c)(1)(vi).

15 *Id.*

16 *Id.*

17 Treas. Reg. § 1.1221-2(c)(1)(ii).

18 *Id.*

19 Treas. Reg. § 1.1221-2(c)(1)(i).

20 Treas. Reg. § 1.1221-2(c)(5)(i).

21 *Id.*

22 Treas. Reg. § 1.1221-2(c)(5)(ii).

23 *Id.*

24 Treas. Reg. § 1.1221-2(g)(3)(ii).

CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr.

BANKRUPTCY

GENERAL-*ALM* § 13.03.*

ESTATE PROPERTY. The debtor filed for Chapter 7 in January 1992. In February 1992, the debtor applied for disaster payments for 1990 and 1991 crop losses under the federal Disaster Payment Program. In April 1992, the ASCS paid the debtor $58,000 in disaster payments. The debtor argued that the disaster payments were post-petition income not subject to the bankruptcy case. The court held that the disaster payments were in the form of proceeds for the crops lost pre-petition; therefore, because the crops would have been estate property, the disaster payments were the proceeds of the crops and were estate property. ***In re* Ring, 169 B.R. 73 (Bankr. M.D. Ga. 1993)**.

EXEMPTIONS

AVOIDABLE LIENS. The debtor claimed a homestead exemption for a residence in which the debtor had $14,000 in equity and which was subject to judicial liens of over $280,000. The debtor sought to avoid the liens as impairing the homestead exemption. The Bankruptcy Court had held that the liens did not impair the exemption because, under Colorado law, judicial liens do not attach to homestead property. The District Court reversed, holding that because the mere existence of the liens could hamper the debtor's ownership rights in the property, the liens impaired the exemption, but the court also held that the liens could be avoided only to the extent of the debtor's equity in the property at the time of the bankruptcy filing. **Matter of Howard, 169 B.R. 71 (D. Colo. 1994)**.

HOMESTEAD. The debtors claimed a homestead exemption for their motor home in which they resided on land owned by a brother. The motor home was connected to utilities and sewage lines and was the debtors' only residence. The court examined the Idaho homestead exemption, Idaho Code § 39-4105(15), and found no prohibition against claiming a motor home as a homestead so long as the motor home was the intended residence. The court noted that the statute had removed case law requirements that the home be permanently affixed to land owned by the debtors. The court also noted that the only difference between motor homes and mobile homes, which were expressly allowed for the exemption, was that the motor home had a engine, a difference not covered by the exemption statute. ***In re* Peters, 169 B.R. 710 (Bankr. D. Idaho 1994)**.

CHAPTER 12-*ALM* § 13.03[8].*

PLAN. A Chapter 12 debtor had made four plan proposals which were not confirmed. On the fifth attempt, the court denied confirmation and dismissed the case because the debtor was unable to propose a confirmable plan for the following reasons: (1) the plan proposed that half of the trustee's fees be paid by the creditors; (2) the debtor was 60 years old and the plan provided for payments up to 20 years; (3) the debtor's farm equipment was very old and the plan made no provision for equipment repair; (4) the living expenses were far below the debtor's historical expenses; (5) a secured creditor would not receive either the collateral or payments equal to the secured claim, and (6) the plan's haphazard method of paying creditors and providing income and expense estimates indicated that the