Agricultural Law Press
Publisher/Editor
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Issue Contents

Agricultural Law Digest

Volume 24, No. 6 March 15, 2013 ISSN 1051-2780

Hedging Versus Speculation: The Key Points to Watch

-by Neil E. Harl*

After the Internal Revenue Service lost a key case, on June 17, 1993, *Federal National Mortgage Association v. Commissioner,*[1] the IRS position that futures market transactions involving the purchase of puts (short hedges) were not hedges and were to be treated as capital assets was demolished.[2] The Department of the Treasury agreed that gains and losses from most hedging transactions were to be treated as ordinary gains and losses and immediately commenced a major effort to rewrite the regulations governing futures transactions to reflect that position. The proposed regulations were issued four months later[3] and final regulations were promulgated in October of 1994.[4]

Reaction to the regulations

Although there were some facets of the final regulations that raised eyebrows,[5] in general taxpayers and tax practitioners were relieved to be able to hedge without incurring capital losses and also by the provision that allowed taxpayers on the cash method of accounting with less than $5,000,000 of gross receipts for all taxable years ending on or after September 30, 1993,[6] to sidestep the more onerous features of the regulations.

However, in the nearly 20 years since the proposed and temporary regulations have been issued the agricultural sector has been through a veritable revolution with rapidly expanding farming and ranching operations, record-setting commodity prices and dramatic increases in risk management involving, in particular, futures trading. The $5,000,000 figure has not been adjusted for inflation and has been reached or exceeded by a significant number of farming and ranching operations. The consequences of reaching or exceeding the $5,000,000 gross receipts figure can be significant on audit of income tax returns. Moreover, it is noted that the requirement that operations be on the cash method of accounting to be eligible for the $5,000,000 "safe harbor" has left accrual accounting taxpayers subject to the reach of the final regulations since 1994.

The $5,000,000 gross receipts "safe harbor"

Under the $5,000,000 gross receipts limit for those on the cash method of accounting, a taxpayer is not required to account for hedging transactions under the rules adopted in 1994 ". . . for any trade or business in which the cash receipts and disbursements method of accounting is used or in which § 1.471-6 is used for inventory valuation if, for all prior taxable years ending on or after September 30, 1994, the taxpayer met the $5,000,000 gross receipts test. . . or would have met that test if the taxpayer were a corporation or partnership."[7] As noted, the "safe harbor" is a one-way street – once the taxpayer reaches $5,000,000 of gross receipts the protection of the $5,000,000 figure is lost.[8]

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Agricultural Law Digest is published by the Agricultural Law Press, 127 Young Rd., Kelso, WA 98626 (ph 360-200-5666), bimonthly except June and December. Annual subscription $90 by e-mail. http://www.agrilawpress.com Printed on recycled paper.

Consequences of losing the "safe harbor"

Once a taxpayer reaches the limits of the protection afforded by the $5,000,000 "safe harbor," the consequences are perfectly predictable. The regulations specify that the method of accounting used by a taxpayer for a hedging transaction *must clearly reflect income*.[9] To clearly reflect income, the method of accounting used must reasonably match the timing of income, deduction, gain, or loss from the hedging transaction with the timing of income, deduction, gain, or loss from the item or items hedged (the actual commodities).[10] As a final warning, in the part of the regulations denominated as for "recycled hedges," the taxpayer must match the built-in gains or losses at the time of the "recycling" (which seems to refer to long-running hedges that may hedge more than one crop in succession) with the gain or loss on the hedged item. Thus, the gains and losses on the hedges must be associated with the gains and losses on the futures.

For those farming operations that are well in excess of the $5,000,000 limit, the task on audit is to dig through massive paperwork on the hedges and equally massive paperwork on the sale of commodities and attempt to match up the gains and losses on the commodities hedged with the offsetting gains and losses on the hedges in the futures market.

Another worry

As farming or ranching operations have grown in size, many have made significant changes in how their operation (or operations) are organized. If corresponding changes were not made in how the futures contracts were written, the shift in organizational structure has meant that the entity entering into the futures contracts no longer owns the actual commodities.[11] The result is a speculative transaction rather than a hedging transaction with gains and losses being treated as capital gains and losses. For individual taxpayers, capital losses can offset capital gains and up to $3,000 of ordinary income each year[12] but for corporate taxpayers capital losses can offset capital gains but are not otherwise deductible.[13]

ENDNOTES

[1] 100 T.C. 541 (1993). See Harl, "Income Tax Treatment of Hedges," 4 *Agric. L. Dig.* 165 (1993).

[2] See Letter, Stuart L. Brown, Associate Chief Counsel, Domestic, Internal Revenue Service, to Henry Bahn, United States Department of Agriculture, January 27, 1993.

[3] T.D. 8493, 1993-2 C.B. 255. See Prop. Treas. Reg. § 1.1221-2; Temp. Treas. Reg. § 1.1221-2T; Prop. Treas. Reg. § 1.446-4.

[4] T.D. 8555, 1994-2 C.B. 180. See Treas. Reg. § § 1.1221-2, 1.446-4.). See also Harl, "Final Regulations on Hedging," 5 *Agric. L. Dig.* 137 (1994). See generally 4 Harl, *Agricultural Law* § 27.03[10] (2013); Harl, *Agricultural Law Manual* § 4.02[6] (2013); 1 Harl, *Farm Income Tax Manual* § 2.17[5] (2013 ed.); Harl, 608-3rd T.M. *Reporting Farm Income* Part VIII (2012).

[5] See the requirements for identification of hedges (taxpayers were required to identify hedges when entered into along with the item or items hedged before the close of the day on which the taxpayer acquired, originated or entered into the transaction). I.R.C. § 1221(a)(7); Prop. Treas. Reg. § 1.1221-2(f)(1). The regulations were later revised to eliminate the penalty for failure to identify hedges.

[6] Treas. Reg. § 1.446-4(e)(6).

[7] Treas. Reg. § 1.446-4(a)(1).

[8] *Id.*

[9] Treas. Reg. § 1.446-4(b).

[10] *Id.*

[11] See Pine Creek Farms, Ltd. v. Comm'r, T.C. Memo. 2001-176 (C corporation engaged in production of corn, soybeans, cattle and hogs spun off hog operation into two new C corporations; losses incurred by those newly-formed corporations on hogs were speculative and were not deductible for the corporations). See also Welter v. Comm'r, T.C. Memo. 2003-299 (shareholder of two family-farm corporations engaged in commodity trades in own name after incorporation; result was capital gains and capital losses).

[12] I.R.C. § 1211(b).

[13] I.R.C. § 1211(a).

AGRICULTURAL TAX SEMINARS

by Neil E. Harl

On the back cover, we list the agricultural tax seminars coming up in the spring of 2013. Here are the dates and cities for the seminars later this summer and fall 2013:

August 28-29, 2013 - Ames, IA
September 16-17, 2013 - Moorhead, MN
September 19-20, 2013 - Sioux Falls, SD
October 3-4, 2013 - Council Bluffs, IA
October 10-11, 2013 - Davenport, IA
October 18-19, 2013 - Honey Creek Resort, Moravia, IA
November 7-8, 2013 - Indianapolis, IN
November 14-15, 2013 - Bloomington, IL
November 18-19, 2013 - Mason City, IA

More information will be posted on www.agrilawpress.com and in future issues of the *Digest*.