

## Hedge or Speculation?

### Background

Commodity futures contracts which are used by farmers to hedge against price fluctuations of farm inventory represent an ordinary income or loss item, and upon closing of the transaction are reported on Schedule F.

Farmers might also speculatively enter into commodity futures contracts with the intention of making a profit on the transaction itself. These speculative contracts are given capital asset status and result in Schedule D reporting as a capital gain or loss. Open positions at year-end are marked-to-market and taxed on the unrealized gain or loss. Any position that does not meet the specific requirements for a hedge is considered speculative.

### Knowing a Call from a Put

A farmer might indicate that all he does is hedging, but the IRS may not see it that way. Farmers routinely take futures positions they believe are hedges but are actually speculation under the tax law. The key is to understand the difference between puts and calls. A Put is an exchange-traded contract for the sale of a fixed amount of a commodity at a future date for a fixed price. This is sometimes called a "short" position. A Call is a similar contract for the purchase of a commodity, and is sometimes referred to as a "long" position. An option contract gives the right, but not the obligation, to enter into a futures contract, and is generally treated the same under the tax law as a futures contract.

### What it takes to be a hedge position

Since hedge transactions are entered into to manage risk, they must be in the commodities the farmer is raising and be within the normal range of production. The contract must also be opposite the farmer's physical position in the commodity on hand or to be acquired, so as to constitute a price hedge [IRS Publ. 225, Page 52].

A farmer raising a commodity for sale is hedging if he takes a Put position to sell the commodity at a given price. The hedge protects in the event market prices for the commodity drop before sale. Hedges also apply to farmers who will be purchasing grain for feed, having delivery obligations to a value-added cooperative, or purchasing livestock to be grown out. But the risk protection is in the opposite direction. Here, a Call position protects in the event market prices for the commodity increase before purchase. Producers can hedge a commodity on both sides where, for example, they need price protection for purchase of livestock and to establish a floor when those livestock are later sold. Either Puts or Calls may constitute hedge positions for such producers (provided it is within the range of production for that commodity).

### Whatever isn't a hedge is speculative

Speculative positions are marked-to-market at their liquidation value on the last day of the year (on all contracts, not just closed contracts) [IRC Sec. 1256(a)(1)]. Reporting is on Form 6781 which, by statute, allocates capital gains and losses as 40% short-term and 60% long-term.

For individuals, speculative gains clearly give a better tax result than hedging gains (ordinary rates and subject to self-employment tax). But capital loss deductions are limited to capital gains plus \$3,000 per year, with unlimited carryover. C corporation taxpayers do not have the benefit of the favorable capital gain tax rates and can be severely penalized on capital losses - only available to offset gains and only a five year carryover. The bottom line for our closely held corporate farmers is to rarely, if ever, engage in speculative trading. Those trades are best left at the 1040 level.

### Hedge positions must be contemporaneously documented

As stated above, any transaction that is not properly identified as a hedge or that fails to meet the definition of a hedging transaction is considered a speculative transaction involving a capital asset [Reg. 1.1221-2(g)(2); IRC Sec. 1256(e)(1)]. This is the one area where most farmers fail. Hedge positions must be clearly identified as hedging before the close of the day on which the transaction was entered into [IRC

Sec. 1221(a)(7)]. The ideal way of documenting this might be to have separate trading accounts for hedge and speculative transactions.

In addition, the taxpayer must identify the item or risk being hedged in a substantially contemporaneous manner. Under the regulations, this must occur not more than 35 days after taking the position [Reg. 1.1221-2(f)(2)]. The 35 day rule appears to give time for the farmer to receive a monthly brokerage statement and make notations directly on it to document the hedge. These notations must identify the commodity and risk being hedged.

The IRS has provided some relief for failing to satisfy the documentation requirements. Where the omission was due to inadvertent error, and taxpayer has no reasonable grounds for treating the transaction as other than a hedging transaction, then gain from the transaction is ordinary [Reg. 1.1221-2(g)(2)].

### **Other traps for the unwary**

A taxpayer may hedge all or any portion of a risk for all or any part of the period during which it is exposed to the risk. "Range of Production" is not clearly defined in the regulations, however. It appears that more than one year's crop could be hedged simultaneously since hedges can take place at any time farmers have the commodity under production, have it on hand for sale, or reasonably expect to have it on hand [IRS Publ. 225 Chap. 8].

Selling crop at harvest and buying it back "on the board" might have great merit in reducing grain storage costs and risks and easing the physical burden of delivering grain in the dead of winter. Be aware, however, this could rarely, if ever, be considered a hedge. Such a Call futures position is taken specifically with the intent of making a profit on the transaction. No risk is being hedged since the actual sale of the commodity has already occurred.

Watch out for hedging another entity's risk protection. A member of a consolidated group of corporations may enter into hedge transactions for another member, but since 1997 this exception no longer applies to other entities under common control using the Sec. 267(c) definition [Reg. 1.475(b)-1(d) and (e)]. Pine Creek Farms learned this the hard way in Tax Court where a C corporation raising corn and beans also took hedge positions in hogs for related entities that farrowed and finished hogs. The court would not allow the taxpayer to attribute the business risks of hog production in the related corporations to its hog futures transactions. Unfortunately, the corporations could not meet the consolidated group definition [Pine Creek Farms, Ltd. V. Comm., TC Memo 2001-176, 7/17/01].