

# Michigan Law Review

---

Volume 54 | Issue 5

---

1956

## Taxation - Federal Income Tax - Treatment of Gains from Commodity Futures Transactions of Manufacturing Consumer

Neil Flanagin S.Ed.

*University of Michigan Law School*

Follow this and additional works at: <https://repository.law.umich.edu/mlr>



Part of the [Commercial Law Commons](#), [Securities Law Commons](#), [Taxation-Federal Commons](#), and the [Tax Law Commons](#)

---

### Recommended Citation

Neil Flanagin S.Ed., *Taxation - Federal Income Tax - Treatment of Gains from Commodity Futures Transactions of Manufacturing Consumer*, 54 MICH. L. REV. 719 (1956).

Available at: <https://repository.law.umich.edu/mlr/vol54/iss5/18>

This Recent Important Decisions is brought to you for free and open access by the Michigan Law Review at University of Michigan Law School Scholarship Repository. It has been accepted for inclusion in Michigan Law Review by an authorized editor of University of Michigan Law School Scholarship Repository. For more information, please contact [mlaw.repository@umich.edu](mailto:mlaw.repository@umich.edu).

TAXATION—FEDERAL INCOME TAX—TREATMENT OF GAINS FROM COMMODITY FUTURES TRANSACTIONS OF MANUFACTURING CONSUMER—Taxpayer, a manufacturer of products made from corn, purchased and sold corn futures contracts as a part of its regular buying program in order to protect itself against a possible shortage of raw materials. Taxpayer contended that the gains realized on these transactions should receive capital asset treatment. The Tax Court and the court of appeals held that the gains constituted ordinary income.<sup>1</sup> On appeal, *held*, affirmed. The transactions, though not true hedges, were entered into for business purposes and as an integral part of taxpayer's operations. Consequently, they should be treated the

<sup>1</sup> *Corn Products Refining Co.*, 16 T.C. 315 (1953), 20 T.C. 503 (1953), *affd.* (2d Cir. 1954) 215 F. (2d) 513.

same as hedges, and the gains from the transactions taxed as ordinary income. *Corn Products Refining Co. v. Commissioner*, 350 U.S. 46, 76 S. Ct. 20 (1955).

The problem presented by the principal case is common to consumers of commodities traded on futures markets, as it is customary for them to buy and sell futures contracts in the commodities in which they deal. The most frequent practice of this type is hedging, a form of insurance against price fluctuations secured by purchasing futures contracts, and then closing them out if the purchaser's requirements can be met by dealing in the cash market, or taking delivery if the cash market price goes up.<sup>2</sup> The reverse process is often used by producers of commodities.<sup>3</sup> The theory of hedging rests on the premise that the cash and futures prices roughly parallel each other, so that a loss in one will be offset by a gain in the other, if a balanced position is maintained between them. The purpose of the transactions in the principal case was not to insure against unfavorable price fluctuations in raw materials, but to insure against fluctuations in the amount of available raw materials, and to secure an alternative to the expense of obtaining greater storage capacity. Generally, the law has distinguished hedging from speculative transactions or capital investments.<sup>4</sup> However, hedging and related transactions have had a varied history under the federal income tax. Since 1934 hedging transactions have come within the definition of capital asset transactions.<sup>5</sup> They also came within the language of the short sales provision of the code.<sup>6</sup> However, shortly after 1934, the Treasury recognized that true hedges should be excluded from the capital asset provisions, and that gains from these transactions should be treated as ordinary income and losses deductible in full as business expenses.<sup>7</sup> To the extent that futures gains compensate for losses in cash transactions in the same commodities, there is no income, but merely compensation for the losses.<sup>8</sup> The first judicial acceptance of this exception

<sup>2</sup> See Patterson, "Hedging and Wagering on Produce Exchanges," 40 YALE L. J. 843 (1931); 51 YALE L. J. 505 (1942).

<sup>3</sup> Kenneth S. Battelle, 47 B.T.A. 117 (1942).

<sup>4</sup> *Brown v. Thorn*, 260 U.S. 137, 139, 43 S.Ct. 36 (1922); *United States v. New York Coffee and Sugar Exchange*, 263 U.S. 611, 44 S.Ct. 225 (1924). The Court in the latter case distinguished between hedges, legitimate capital investments, and speculation, defining hedges as transactions entered into by businessmen "... to insure themselves against loss by unfavorable changes in price at the time of actual delivery of what they have to sell or buy in their business. . . ." 263 U.S. 611 at 619.

<sup>5</sup> Before 1934 capital assets were defined, *inter alia*, as property held for at least two years. Revenue Act of 1932, 47 Stat. L. 192, §101 (c) (8). No futures contract is ever held that long. The two-year requirement was discarded in 1934. Revenue Act of 1934, 48 Stat. L. 714, §117 (b), reenacted in I.R.C. (1939), §117 (a) (1). See Rich and Rippe, "Tax Aspects of Commodity Futures Transactions With a Business Purpose," 2 TAX L. REV. 541 (1947). Commodity futures contracts are not property held primarily for sale to customers or includible in taxpayer's inventory within the language of the capital asset definition of the code. O. L. Burnett, 40 B.T.A. 605 (1939).

<sup>6</sup> *Commissioner v. Banfield*, (9th Cir. 1941) 122 F. (2d) 1017.

<sup>7</sup> G.C.M. 17322, XV-2 Cum. Bul. 151 (1936). This applies only to imperfect hedges; in theoretically perfect hedges, the losses in one equal the gains in the other.

<sup>8</sup> G.C.M. 18383, 1937-2 Cum. Bul. 244; I.T. 3137, 1937-2 Cum. Bul. 164.

was in *Ben Grote*<sup>9</sup> where the Board of Tax Appeals held that losses from hedging transactions were deductible in full and not subject to the limitation on capital loss deductions.<sup>10</sup> While the courts gave a relatively broad interpretation to the term "hedge,"<sup>11</sup> they were slow to expand the exception to embrace any similar transactions, such as insuring against a potential shortage of raw materials.<sup>12</sup> It has been said that each of these cases must turn on its particular facts,<sup>13</sup> and the courts have been quick to determine whether there is any purpose to insure against unfavorable price fluctuations,<sup>14</sup> or whether the facts of the case indicate that the futures contracts actually operate as hedges.<sup>15</sup> If a general rule can be gleaned from the cases prior to the principal case, it is that futures transactions entered into for price insurance constitute hedges and are within the exception, but that any other kind of business insurance purpose will not take the futures transaction out of the capital asset provisions.<sup>16</sup> The Court in the principal case takes a much broader view by excluding from capital asset treatment transactions which are not technically hedges, but which were entered into for protection against potential adverse business conditions other than price fluctuations.<sup>17</sup> In light of the Court's decision, it appears that those earlier cases<sup>18</sup> restricting non-capital asset treatment to futures transactions entered into for price insurance are overruled by implication. The fact that most of those cases dealt with the treatment of losses rather than gains, is not a significant distinction. To be consistent, the Supreme Court would have to hold that losses from such protective transactions should be treated in

<sup>9</sup> 41 B.T.A. 247 (1940).

<sup>10</sup> Net losses on capital asset transactions were deductible only to the extent of \$2,000. Revenue Act of 1934, 48 Stat. L. 715, §117 (d). Cf. I.R.C. (1954), §1211.

<sup>11</sup> Kenneth S. Battelle, note 3 supra; S. Steinberg & Co., 11 P-H T.C. Mem. Dec. ¶42,592 (1942); Stewart Silk Corp., 9 T.C. 174 (1947). An oft-quoted definition of hedging is found in *Commissioner v. Farmers and Ginners Cotton Oil Co.*, (5th Cir. 1941) 120 F. (2d) 772 at 774, cert. den. 314 U.S. 683, 62 S.Ct. 185 (1941): "A hedge is a form of price insurance; it is resorted to by businessmen to avoid the risk of changes in the market price of a commodity. The basic principle of hedging is the maintenance of an even or balanced market position."

<sup>12</sup> *Estate of Dorothy Makransky*, 5 T.C. 397 at 412 (1945), affd. (3d Cir. 1946) 154 F. (2d) 59, holding that the purchase of wool futures to protect a clothing manufacturer against an anticipated shortage of raw materials were capital asset transactions. See also *Tennessee Egg Co.*, 47 B.T.A. 558 (1942); *Commissioner v. Covington*, (5th Cir. 1941) 120 F. (2d) 768, cert. den. 315 U.S. 822, 62 S.Ct. 912 (1942).

<sup>13</sup> Kenneth S. Battelle, note 3 supra, at 125.

<sup>14</sup> *Staerker v. United States*, (D.C. Tex. 1938) 23 A.F.T.R. 1284; *O. L. Burnett*, note 5 supra; *W. H. Wilson, Inc.*, 10 P-H T.C. Mem. Dec. ¶41,015 (1941); *Trenton Cotton Oil Co. v. Commissioner*, (6th Cir. 1945) 147 F. (2d) 33, reh. den. (6th Cir. 1945) 148 F. (2d) 208.

<sup>15</sup> *Commissioner v. Covington*, note 12 supra; *W. H. Wilson, Inc.*, note 14 supra; *Commissioner v. Farmers and Ginners Cotton Oil Co.*, note 11 supra.

<sup>16</sup> MONTGOMERY, *FEDERAL TAXES ON CORPORATIONS* 369 (1946); Rich and Rippe, "Tax Aspects of Commodity Futures Transactions," 2 *TAX L. REV.* 541 at 556 (1947).

<sup>17</sup> An additional basis for the Court's decision is its traditional narrow definition of capital asset transactions. *Stratton's Independence, Ltd. v. Howbert*, 231 U.S. 399 at 414, 34 S.Ct. 136 (1913); *Hort v. Commissioner*, 313 U.S. 28, 61 S.Ct. 757 (1941).

<sup>18</sup> See note 12 supra.

the same manner as insurance premiums, and be allowed a full business deduction.

Until 1954 there was no provision for hedging transactions in the code, but in drafting the 1954 code Congress expressly excluded these transactions from the short sales provision.<sup>19</sup> However, no mention is made of transactions like those of the principal case which do not come within the technical definition of hedges. A statutory exclusion of all futures contracts entered into essentially for protection against potential adverse business conditions from capital asset treatment would be preferable, but in view of the decision in the principal case, it may not be necessary.

*Neil Flanagin, S.Ed.*

<sup>19</sup> I.R.C. (1954), §1233 (a). See S. Rep. 1622, 83d Cong., 2d sess., p. 437 (1954); H. Rep. 1337, 83d Cong., 2d sess., p. A278 (1954). I.R.C. (1954), §1233 (e) deals further with commodity futures generally. See Treas. Reg. 118, §39.117 (1)-2.