TAX ASPECTS OF COMMODITY FUTURES TRADING

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In May 1977, the Internal Revenue Service (IRS) issued a ruling1 (the Ruling) which retroactively overturned previously established principles involving tax treatment of commodity futures straddles.2 This Ruling, which has touched off a wave of controversy among tax lawyers, accountants, investment advisors, and investors, already has had a noticeable impact on futures trading and will inevitably be challenged.3 This article will examine the Ruling within the context of established principles of taxation of commodity futures transactions.4


2. A straddle is a simultaneously held long and short position in different maturities of the same commodity. See text accompanying notes 39-43 infra.

3. See Letter from American Institute of Certified Public Accountants to Jerome Kurtz, IRS Commissioner (June 24, 1977), reprinted in DAILY EXECUTIVE REPORT (BNA), No. 125, G-9 (1977). The letter requested that the Ruling be withdrawn because: (1) the Ruling deals with the subjective intent of the taxpayer, would be difficult to administer, and could have pervasive effects; (2) the Ruling could have significant adverse impact on world commodity markets, currency exchange differentials, and possibly consumer prices and inflation; (3) despite wide publicity concerning the use of straddles, the IRS has consistently and routinely accepted such straddles as legitimate transactions on audit; (4) the Code, regulations, and case law do not support the technical conclusions reached in the Ruling; (5) the Ruling raises certain ambiguities which will create difficulties for tax practitioners and uncertainties of application (e.g., what would have happened if the taxpayer had made a profit from the "straddles"?). As an alternative to withdrawal of the Ruling, the letter requested that it be applied only prospectively, so that taxpayers relying on longstanding IRS positions not be penalized. See also Letter from Arthur Anderson & Co. to Jerome Kurtz, IRS Commissioner (July 21, 1977), reprinted in DAILY EXECUTIVE REPORT (BNA), No. 151, J-8 (1977).

4. This article presupposes that the reader has a degree of familiarity with commodity futures trading. For those without commodities background, see J. BAER & O. SAXON, COMMODITY EXCHANGES AND FUTURES TRADING 126-250 (1949); S. KROLL & I. SHISHKO, THE COMMODITY FUTURES MARKET GUIDE 9-26 (1973).
COMMODITY FUTURES AS CAPITAL ASSETS

Persons who trade commodity futures fall into two broad categories: (1) members of the public (commonly called investors or speculators) and floor traders on various exchanges (commonly called locals or scalpers), who seek to profit from the rise or decline in the price of a given commodity; and (2) businessmen (commonly referred to as hedgers) who produce, refine, use, finance, or deal in a given commodity and who seek to protect themselves from the effect of adverse price fluctuations in that commodity.\(^5\)

Commodity futures contracts are capital assets in the hands of an investor;\(^6\) gain or loss resulting from transactions involving commodities is capital gain or loss which may be either long-term or short-term according to the holding period.\(^7\) However, gain or loss realized by hedgers from futures contracts is regarded as a factor in the cost of inventory and is thus characterized as ordinary gain or loss.\(^8\) This rule is reflected in the Internal Revenue Code (the Code) section 1233(g),\(^9\) which removes hedging transactions from that provision's short sale rules. A taxpayer seeking to have a transaction classified as a hedge\(^10\) must prove\(^11\) that the transaction falls within IRS guidelines.\(^12\) These guidelines require: (1) a risk of loss by unfavorable changes in the price of a commodity expected to be used or marketed in one's business; (2) a possibility of shifting such risk to someone else through the purchase or sale of futures contracts; and (3) an intention and attempt to shift the risk.\(^13\)

Commodity futures contracts entered into by a commodities professional\(^14\) are capital assets.\(^15\) This contrasts with securities,

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5. Hedging is defined by 17 C.F.R. § 1.3(z) (1977). For a general discussion of persons who trade commodity futures, see J. BAER & O. SAXON, supra note 4, at 51-54 (hedgers and speculators); id. at 75 (floor traders or “scalpers”).
6. Commissioner v. Covington, 120 F.2d 768 (5th Cir. 1941), cert. denied, 315 U.S. 822 (1942).
7. See text accompanying note 17 infra.
9. I.R.C. § 1233(g).
10. Such a taxpayer usually is seeking an ordinary loss.
12. These guidelines may be found at 6 STAND. FED. TAX REP. (CCH) ¶ 4717.107 (1976).
13. These guidelines were approved by the Supreme Court. See Corn Prods. Ref. Co. v. Commissioner, 350 U.S. 46 (1955).
14. Commodities professionals include brokers, dealers, and futures commission merchants.
which are deemed inventory in the hands of a dealer unless specifically designated as held for investment.\textsuperscript{16}

Calculation of the length of a holding period to determine whether a capital gain or loss is long-term or short-term requires consideration of several special rules for commodities. First, futures contracts held for more than six months qualify for long-term capital gain or loss treatment; unlike the holding period for other capital assets, the holding period for commodity futures was not changed by section 1402(a) of the Tax Reform Act of 1976 to a longer period.\textsuperscript{17} Although the statute on its face applies to all futures contracts,\textsuperscript{18} the Conference Committee Report (the Report) on Public Law 94-455 describes this special rule as limited to “agricultural” commodity futures contracts.\textsuperscript{19} The Report does not justify the “agricultural” limitation, but this distinction may have been drawn because of the seasonal nature of agricultural commodities. Why this characteristic should affect the length of the holding period for capital gain or loss determination has not been explained; however, the only practical effect of that modification is to give certain futures markets a competitive advantage over others with respect to attracting the business of members of the trading public.\textsuperscript{20}

To determine a capital gain or loss holding period, a taxpayer may add the time that he held a futures contract to the holding period of any commodity acquired by taking delivery in fulfillment of that contract.\textsuperscript{21} In some cases, because of the longer holding period for physical commodities, a commodity’s sale after delivery may result in short-term treatment for gains or losses which

\begin{thebibliography}{99}
\bibitem{16} I.R.C. § 1236.
\bibitem{17} Pub. L. No. 94-455, § 1402(a), 90 Stat. 1520 (amending I.R.C. § 1222(1)-(4)). Section 1402(d) amended I.R.C. § 1223 by excluding commodity futures transactions from amendments made by § 1402(a) to the holding period.
\bibitem{18} On March 30, 1977, the Internal Revenue Service (IRS) announced a clarification of the amendment, stating that it is not limited to futures transactions in agricultural commodities. IRS News Release IR-1787.
\bibitem{20} \textit{See generally} The Special Committee on Commodities Regulation, \textit{Capital Gains Holding Period for Commodity Futures}, 32 REC. A.B. CITY NEW YORK 235 (1977).
\bibitem{21} I.R.C. § 1223(8).
\end{thebibliography}
would have been long-term had the futures contract itself been liquidated.

Special rules for short sales set forth in Code section 1233 and regulations thereunder are major aspects of the tax treatment of commodity futures transactions. These rules may be summarized as follows:

1. On the date of a short sale of a futures contract, if substantially identical property has been held for nine months or less, or if substantially identical property is acquired by the taxpayer after such short sale on or before the closing date thereof, then
   (a) gain on the closing of the short sale will be a short-term capital gain regardless of the holding period of the property used to close the short sale; and
   (b) provisions to the contrary notwithstanding, the holding period of the substantially identical property acquired during the defined period, when other such property is used to close the transaction, begins on the date of the closing of the short position.

2. A loss incurred by closing a short sale will be a long-term capital loss if, on the date of the short sale, substantially identical property has been held by the taxpayer for more than nine months.

The main problem in interpreting and applying these rules is ascertaining the meaning of "substantially identical" property. For example, is a commodity held by a taxpayer "substantially similar" to a futures contract involving that commodity? Code section 1233(e)(2)(B) provides:

[I]n the case of futures transactions in any commodity on or subject to the rules of a board of trade or commodity exchange, a commodity future requiring delivery in 1 calendar month shall not be considered as property substantially identical to another commodity future requiring delivery in a different calendar month . . .

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23. The Tax Reform Act of 1976 changed the holding periods under I.R.C. § 1233 to nine months for transactions entered into in 1977 and one year for transactions entered into thereafter. I.R.C. § 1402(b)(1)(T). Previously, the holding period had been six months.

24. See note 23 supra.

This section does not specifically preclude the consideration of a futures contract as substantially identical to a corresponding amount of the particular physical commodity owned by the trader and available for closing of the sale. The prevailing view\(^\text{26}\) is that a futures contract is substantially identical only to another contract for the same commodity requiring delivery in the same month. This opinion avoids potential conflict between Code section 1223(8) and Code section 1233.\(^\text{27}\)

**CASH-AND-CARRY TRANSACTIONS**

As noted above, a commodity owned by a trader is neither property subject to Code section 1233(b) or (d)\(^\text{28}\) nor property "substantially identical" to a futures contract for the same commodity.\(^\text{29}\) If the commodity was held for the statutory period,\(^\text{30}\) gain from using the commodity to close a short sale will be long-term. It is possible, therefore, subject to IRS challenge,\(^\text{31}\) to convert ordinary income in one year into capital gain in a later year through the so-called "cash-and-carry" transaction. For example, assume that in July 1977, a trader purchases 5000 ounces of physical silver for $4.62 per ounce ($23,100 total purchase price) and simultaneously sells short one July 1978 silver futures contract for $4.93 per ounce ($24,650 total sales price). The trader has a locked-in profit of $1550, which he will realize as long-term capital gain when he closes the short sale by delivering the physical silver in March 1979.

If the trader finances most of the purchase price of the physical silver, he is entitled to tax deductions for interest payments under Code section 163,\(^\text{32}\) and for storage fees and insurance under Code section 212.\(^\text{33}\) In the above example, if 80% of the purchase price was financed at a 7% interest rate,\(^\text{34}\) the interest payable over


\(^{27}\) I.R.C. §§ 1223(8), 1233. A different view would render I.R.C. § 1223(8) surplusage.

\(^{28}\) I.R.C. § 1233(b), (d). See text accompanying notes 22-24 *supra*.

\(^{29}\) See text accompanying notes 24-25 *supra*.

\(^{30}\) See text accompanying note 17 *supra*.

\(^{31}\) See text accompanying notes 37-38 *infra*.

\(^{32}\) I.R.C. § 163.

\(^{33}\) I.R.C. § 212.

\(^{34}\) Because the transaction is hedged, that is, sold short at fixed price, financial terms for such transactions are generally favorable. Also, while a lender may require additional payments if the price of the commodity declines, the variation margin received on the short futures position should substantially offset the required payments.
the twelve months that the silver is owned would be $1293. Storage fees and insurance costs would provide additional, although relatively small, deductions.

The IRS could challenge these tax consequences of cash-and-carry transactions by either of two approaches. First, it could argue that a physical commodity is property "substantially identical" to a futures contract and is therefore subject to the unfavorable short sale rules of section 1233. Second, the IRS could contend that Goldstein v. Commissioner, which disallowed deductions for losses incurred in transactions having tax avoidance as their sole purpose, should be applied; the only motivation for these transactions is tax avoidance. However, the courts have not yet adopted either interpretation. In fact, the potential for profit that exists in cash-and-carry transactions makes Goldstein's application to such transactions highly unlikely.

**Commodity Straddles**

**Background**

In its simplest form, a straddle consists of simultaneously held long and short positions of commodity futures in different maturities. The price discrepancy between the contracts in different months is known as the "spread" or "differential." For nonperishable commodities, the spread typically reflects carrying charges such as interest, insurance, and storage fees. For perishable commodities, it also reflects seasonal price differences and relative differences in supply and demand between old and new crop maturities.

Straddle transactions offer opportunity for profit and risk of loss because of the widening or narrowing of the spreads between the straddle months. While an investor who takes a long or short

35. I.R.C. § 162. See McIntosh Mills, 9 B.T.A. 301 (1927).
36. I.R.C. § 162.
38. Cash-and-carry transactions typically are entered into when the price differential between a nearby and a distant futures maturity exceeds the actual cost of carrying the physical commodity to the distant month.
39. E.g., long 10 October 1977 sugar contracts and short 10 July 1978 sugar contracts. Straddles can also involve intermarket transactions, such as long New York silver and short Chicago silver, and intercrop transactions, such as long corn and short wheat.
futures position seeks to profit by absolute price fluctuations, an
investor who effects a straddle seeks to profit by changes in price
differences. A straddle investor may not care whether the price of
a given commodity increases or decreases. His concern is the di-
rection in which price differences change.

There are various types of straddles. For example, assume
that silver futures are traded in what is called a full-carry market
(distant maturity price equals current month price plus interest,
storage, and insurance costs). A person expecting interest rates to
decline would go long in a nearby maturity and simultaneously sell
short in a distant one. If interest rates decline, the price of distant
silver relative to nearby silver should decline, resulting in a profit.
However, if the price of silver should rise materially, the potential
profit could be reduced: Although interest rates have declined, the
number of dollars needed to finance higher-priced silver has in-
creased, thereby increasing the carrying charges.

Another type of straddle involves potential short term supply
imbalance. For example, because of a threatened strike of United
States copper miners, the price of nearby copper may be high rela-
tive to distant copper. An investor who believes either that there
will be no strike or that the labor strife will be short-lived would
go short nearby copper and long a distant maturity. If that person's
forecast is correct, the price of nearby copper will decline relative
to that of the distant month.

Traders also enter into straddles because of potential changes
in currency values. A person anticipating a decline in the value of
the pound sterling relative to the dollar would buy London sugar
and sell New York sugar. This investor has no interest in the
movement of sugar prices. However, if the relative value of the
pound declines, the price of London sugar should rise relative to
the price of New York sugar.

The attractiveness of straddles for commodity futures traders
has been enhanced by certain tax benefits flowing from the above
principles. An investor who realizes short-term capital gains from
unrelated transactions could, by using straddles, defer them to
another year and, hopefully, convert them into long-term capital
gains. This serendipitous result occurs because Code section
1233(e)(2)(B) provides that "a commodity future requiring delivery

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40. For an extensive discussion of this subject, see S. KROLL & I. SHISHKO, supra
    note 4, at 237-57.

41. See text accompanying notes 6-7, 22-24 supra. See also short sale rules of
    I.R.C. § 1233.
in 1 calendar month shall not be considered as property substantially identical to another commodity future requiring delivery in a different calendar month . . . .”42

Thus, if in the first example above, silver declined in price, the nearby maturity could be closed out at a loss and replaced with a long position in another month. If the price increased, the distant position could be liquidated and replaced. The same could be done with the copper and sugar straddles described in the other two examples.

If the long side of the straddle were profitable and could be maintained for more than six months, short-term gain of the first year could be converted into long-term gain of the second year. As noted previously, the closeout of a short position by offset will always result in a short-term gain or loss, no matter how long the position has been maintained.43

The Ruling

On May 23, 1977, the IRS ruled44 that a taxpayer could not deduct the loss which resulted from simultaneously closing one side of a silver straddle and opening a new offsetting position in a different delivery month. This position was taken despite the significant economic loss resulting from the transactions which indicated that substantial profit might have been realized.45 Although the Ruling discussed only silver straddles, it was intended to apply to straddles in all commodity futures and is retroactive to 1974.46

The facts described in the Ruling are typical of a straddle in its simplest form. They do not differ materially from those set forth in the original ruling request, although the numbers and dates have been changed, apparently to disguise the taxpayer’s identity. The Ruling states that “[i]n order to minimize the tax consequences of a short-term capital gain of $150,000 realized from the sale of real property in 1975,”47 a taxpayer entered into the transactions in silver futures contracts shown in the following table:

42. I.R.C. § 1233(e)(2)(B).
43. See text accompanying notes 23-24 supra.
45. The market could just as easily have moved in a direction favorable to the straddler. Because of commission costs, however, potential net profit is not as great as potential net loss, if other factors are equal. This is true of all transactions which require a broker’s services and should not be material.
Silver Futures Contracts Transactions

<table>
<thead>
<tr>
<th>Date of Purchase (Sale)</th>
<th>Maturity Dates of Contracts</th>
<th>Gain (Loss) Before Commissions</th>
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<tbody>
<tr>
<td></td>
<td>March '76</td>
<td>May '76</td>
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<tr>
<td>8/1/75</td>
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<tr>
<td>8/1/75</td>
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<td>8/4/75</td>
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<td>2/18/76</td>
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<td>2/18/76</td>
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Because the taxpayer incurred a commission charge of 2x dollars on the closing of each transaction, the overall 1975 loss was 128x dollars, and the overall 1976 gain was 119x dollars (172x less 53x).49 Purchases and sales indicated as made on the same day were actually made simultaneously, so that the taxpayer consistently maintained a straddle position. The IRS noted that the books of the taxpayer's brokerage firm showed the August 4 transaction as a debit to the taxpayer's account until it was canceled out by the February 18, 1976 sale of the May 1976 futures contracts.50 The IRS further observed that because of the limited risk inherent in such spread positions, the margin requirement to finance the purchases and short sales amounted to .0025 of the aggregate number of futures contracts purchased, or about 10x dollars.51 The Ruling also stated that the taxpayer's change in position from a March/July straddle to a May/July straddle resulted in no change in economic position.52

As support for the Ruling, the IRS relied upon regulation 1.165-1(b) which provides:

To be allowable as a deduction under section 165(a), a loss must be evidenced by closed and completed transactions, fixed by identifiable events, and, [with exceptions not here relevant] actually sustained during the taxable year. Only a bona fide loss is allowable. Substance and not mere form shall govern in determining a deductible loss.53

48. Id.
49. Id.
50. Id.
51. Id. at 8.
52. Id.
The IRS also based its position on two Tax Court opinions. In *Frederick R. Horne*, a taxpayer who owned a seat on the New York Coffee and Sugar Exchange, Inc., bought a new seat, and a few days thereafter, sold his original seat. The sale of the original seat, if viewed as an independent transaction, resulted in a deductible loss. The Tax Court ruled, however, that the loss could not be deducted, because the sale of the seat, when considered in conjunction with the taxpayer’s purchase of a new seat, was part of an overall plan resulting in no change in taxpayer’s position.

In *Gordon MacRae*, also relied upon by the IRS, taxpayer sought to deduct interest on money borrowed to purchase United States Treasury notes. The court disallowed the deduction because the transaction was an economic sham.

The IRS therefore concluded:

Under the rationale of section 1.165-1(b) of the regulations and of the *Horne* and *MacRae* decisions, the taxpayer in the instant case suffered no real economic loss in 1975. On August 1, 1975, the taxpayer had established a balanced position in silver futures contracts. After closing out the long position on August 4, 1975, the taxpayer continued a balanced position in silver contracts by immediately purchasing the 40 May 1976 contracts. After the sale and purchase of the silver futures contracts on August 4, the taxpayer was in exactly the same balanced position as before these transactions, with the only difference being the month of delivery of the replacement contracts. Thus, the August 4 sale resulted in no real change of position in a true economic sense, and does not represent a closed and completed transaction.

The Ruling also stated that the taxpayer could not deduct his out-of-pocket losses incurred in connection with the straddle transactions. In support of this position, the IRS cited *Knetsch v. United States* and *Brown v. United States* for the proposition

54. 5 T.C. 250 (1945).
55. Id. at 251.
56. See id. at 255.
57. 34 T.C. 20 (1960).
58. See id. at 27.
60. Id.
61. 348 F.2d 935 (Ct. Cl. 1965). This action to recover out-of-pocket losses arose from the same transaction litigated in *Knetsch v. United States*, 364 U.S. 361 (1960), see text accompanying notes 122-125 infra.
62. 396 F.2d 459 (Ct. Cl. 1968).
that deductions may not be claimed for out-of-pocket expenses incurred in transactions that lack economic substance. The IRS determined that the transactions had no economic substance, stating:

In the instant case, the taxpayer's dominant purpose for engaging in the above described silver futures transactions was to create an artificial short-term capital loss to offset a substantial short-term capital gain realized on the sale of real property, while insuring that no real economic effect resulted from such transactions. The taxpayer had no reasonable expectation of deriving an economic profit from the transactions.63

The structure of the Ruling is rather curious: The IRS asserted what would have been its strongest argument if factually accurate—that the taxpayer possibly had no reasonable expectation of profit from the transactions—only to support its position on the nondeductibility of out-of-pocket expenses.64 In contrast, the IRS based its finding with regard to the case's central issue upon the weaker argument that the loss transactions were not closed and completed transactions. This argument conflicts with accepted principles of realization of gain and loss, as well as with case law and previous revenue rulings.65 The reasons for the Ruling's final structure may be un-

63. Rev. Rul. 77-185, 1977-21 I.R.B. 7, at 8 (emphasis added). This factual conclusion is questionable, since the Taxpayer's Statement of Position re Request for Technical Advice (Apr. 29, 1975) [hereinafter cited as Statement] stated:

[P]rior to entering into the straddles . . . I, the attorney-in-fact, asked the representative of [the brokerage firm] if there was potential for substantial profit or loss relative to the investment and he said there was. If he had answered otherwise, I would have advised that they do not enter into the straddle. A copy of a letter addressed to me which confirms this is enclosed.

Id. at 1. Subsequently, the Statement noted: "Enclosed is copy of letter from . . . who I understand is [the brokerage firm's] top expert on commodity straddles. This letter shows that there was indeed substantial gain or loss potential. What is more, the taxpayers were personally liable to make good any loss over and above their margin." Id. at 2. In addition, the Internal Revenue Service National Office Technical Advice Memorandum (Sept. 20, 1975) [hereinafter cited as Memo of Sept. 20, 1975], which considered the request which gave rise to the Ruling, stated: "The commodity futures transaction entered into by the taxpayers in 1973 offered a valid opportunity for an economic profit, completely apart from the opportunity of obtaining a tax loss. Therefore, this transaction may not be disallowed by the Service as lacking economic reality." Id. at 6. Upon reconsideration in a later memorandum, the National Office still contended that the lack of profit potential in straddles was "too conjectural" for purposes of proving pure tax avoidance motivation. Internal Revenue Service National Office Memorandum re Reconsideration of Technical Advice Memorandum of Sept. 26, at 2 (Sept. 26, 1975) [hereinafter cited as Memo of Sept. 26, 1975]. See text accompanying note 74 infra.

64. See text accompanying notes 121-131 infra.

65. See text accompanying notes 76-115 infra.
derstood by examining the development of the IRS position as evidenced by certain IRS interoffice memorandums.

According to a Request for Technical Advice Submitted to the National Office, the initial position taken by the agent who received the ruling request was that the straddle losses should be disallowed.66 In support of this contention, the agent advanced the following arguments:67

1. The transactions offered no realistic expectation of profit, and hence were initiated solely for tax avoidance.

2. *Corn Products*68 holds that taxpayers are not permitted “to transmute ordinary income into capital gain at will”69 via hedging transactions. In the case of straddles, hedging locked-in gains to delay realization creates just such a transmutation.

3. The low margin requirement for straddles evidences the lack of economic substance to the transactions.

4. Taxpayer employed the cash basis method of accounting and incurred no out-of-pocket loss in the year of the claimed deductions.

5. (Alternate Position) The entire series of transactions should be treated as a single transaction, resulting in realization of only a single short-term capital loss in the final year.

The agent emphasized that to keep margin requirements low and to minimize risk, the taxpayer only entered into paired simultaneous transactions. In addition, graphs of the silver futures prices plotted against time demonstrated nearly constant spreads between silver futures contracts expiring on different dates.70 An article from *Barron's* magazine underscored the proposition that “straddles are not expected to generate any net gain or loss.”71

The IRS National Office initially asserted that the transactions could not be disallowed on any of the grounds suggested by the

67. See id.
70. See Request for Technical Advice Submitted to the National Office by the District Office in Los Angeles, California 5 (1975).
71. Id. at 4 (quoting Briloff, *Commodity Shelters Turn Short-Term Capital Gain Long*, *Barron's*, March 25, 1974).
agent. In Corn Products, it reasoned, dealt with hedgers and had no application to speculators. In addition, the National Office dismissed claims of lack of economic substance to the transactions, stating, "it does appear that straddle transactions do offer a very real opportunity for profits to a taxpayer, aside from any tax savings involved."

Upon reconsideration, the National Office decided that the deductions should be disallowed, but remained unwilling to base the Ruling upon the ground that the transactions were without economic substance. The National Office explained its position: "Although the hypotheticals . . . presented do tend to illustrate that silver straddles have the potential for creating a tax loss for an individual, this information is too conjectural for purposes of proving that the taxpayer's motive for entering into the straddle transactions was purely to generate a tax loss."

Although the National Office ultimately reached the same conclusion as was reached in the Ruling, it did not suggest the basis for disallowing the deductions eventually relied upon in the Ruling: the Code section 165(c) and regulation 1.165-1(b) requirements of profit motive in a loss transaction and the existence of a bona fide loss. The merits of the IRS' argument finally relied upon to justify the Ruling will now be discussed in detail.

Analysis

A sale or exchange of property is an event which causes the realization of gain or loss. Regulation 1.165-1(b) indicates that a deduction for a loss resulting from such a sale or exchange is allowable only if it is a bona fide loss on a closed and completed transaction. However, Frederick R. Horne and Gordon MacRae, the cases relied upon by the IRS in the Ruling, are readily distinguishable from the facts described in the Ruling.

Frederick R. Horne involved a taxpayer who owned one seat on the New York Coffee and Sugar Exchange, Inc., bought a second seat, and shortly thereafter sold his original seat. The critical distinction between the facts in Horne and those which are the sub-

72. See Memo of Sept. 20, 1975, supra note 63.
73. Id. at 5.
74. Id.
77. 5 T.C. 250 (1945). See text accompanying notes 54-56 supra.
78. 34 T.C. 20 (1960). See text accompanying notes 57-58 supra.
ject of the Ruling is that seats on an exchange are identical in all respects, while futures contracts involving different delivery months are not. This characterization of futures contracts has been recognized judicially on several occasions. Thus, reliance upon Horne would be appropriate only if the taxpayer, in an effort to realize an accrued gain or loss, had closed out a futures position and simultaneously reestablished the same position in the same delivery month. However, this would be a wash sale prohibited by the Act.

Reliance upon Gordon MacRae is more inapposite. Although this opinion contained language which, when taken out of context, might initially appear to be in point, the case involved a sham transaction in which the taxpayer, as conceded in the Ruling, "did not purchase the notes, did not borrow large sums of money, and did not pay any amount deductible as interest." By contrast, a commodity futures contract confers genuine rights and imposes real obligations upon the buyer or seller.

In addition to its scant support in the cases cited, the Ruling's thesis—that the straddle losses did not arise from a closed and completed transaction—conflicts with both other revenue rulings and case law more nearly in point than Horne or MacRae.

In Revenue Ruling 71-568, the IRS concluded that the wash sales provisions of Code section 1091 do not apply to commodity futures contracts, because such contracts are neither stocks nor securities. This ruling resolved a conflict between the Sixth Circuit, which had held wash sale rules to be applicable to commodity futures, and other circuits, which had held to the contrary.

In Revenue Ruling 74-223, the IRS stated that dealers who hedge physical or forward commodity positions on the futures mar-

81. 34 T.C. 20 (1960).
84. I.R.C. § 1091.
85. See Trenton Cotton Oil Co. v. Commissioner, 147 F.2d 33 (6th Cir. 1945).
87. 1974-1 C.B. 23.
ket may offset gains or losses on those positions with hypothetical gains or losses on the futures market; those hypothetical gains or losses are based upon the market value of their open futures positions.\textsuperscript{88} More importantly, the IRS noted that speculators cannot engage in such offsets and must actually close their futures positions before realizing any gain or loss therefrom.\textsuperscript{89} Such a view is inconsistent with the Ruling, which in effect requires that speculators offset a closed futures position with an open one to delay realization of loss.\textsuperscript{90}

The issues raised in Valley Waste Mills v. Page\textsuperscript{91} parallel those addressed by the Ruling. In Valley Waste Mills a taxpayer closed out its long cotton futures position and simultaneously established a new long position in a more distant delivery month. Taxpayer argued that recognition of the gain which resulted from closing out the initial long position should be deferred until liquidation of his new long position.\textsuperscript{92} Contrary to the Ruling, the IRS asserted that closing out the initial position made the transaction complete for tax purposes; that the taxpayer had simultaneously opened a new long position was irrelevant.\textsuperscript{93}

Both the Tax Court\textsuperscript{94} and the Fifth Circuit\textsuperscript{95} concurred with the IRS. The Fifth Circuit stated:

It is appellant's contention that taxable gains or deductible losses from its transactions resulted only when it, in closing out a cotton contract, did not simultaneously purchase another contract for the future delivery of a like amount of cotton; but we cannot accept this view under the facts set forth in the agreed statement. There is no dispute about the profit that was made on these purchases, and the fact that other contracts for the purchase of an equal quantity of cotton of the same grade, staple, and character were simultaneously made by it is not sufficient to relieve the appellant of the tax upon the profit actually realized upon the contract which was finally closed out during the taxable year.

\textsuperscript{88} Id.
\textsuperscript{89} Id.
\textsuperscript{90} See generally Rev. Rul. 74-227, 1974-1 C.B. 120.
\textsuperscript{91} 40-1 U.S. Tax Cas. 9973 (M.D. Ga.), aff'd, 115 F.2d 466 (5th Cir. 1940), cert. denied, 312 U.S. 68 (1941).
\textsuperscript{92} Id.
\textsuperscript{93} Id. at 9975.
\textsuperscript{94} Valley Waste Mills v. Page, 40-1 U.S. Tax Cas. 9973 (M.D. Ga.), aff'd, 115 F.2d 466 (5th Cir. 1940), cert. denied, 312 U.S. 68 (1941).
\textsuperscript{95} Valley Waste Mills v. Page, 115 F.2d 466 (5th Cir. 1940), cert. denied, 312 U.S. 68 (1941).
Appellant argues that the effect of its operations was merely to switch the delivery dates of its futures contracts . . . ; [however,] it is admitted that switching of delivery dates is not permissible under the rules of either of the exchanges on which these sales and purchases were made. Each contract was treated as separate and independent by the parties themselves, doubtless separate commissions were charged for each transaction, and the appellant should not be permitted to combine, for income-tax purposes, that which the parties have elected to make separate and independent for all other purposes.96

The Second Circuit reached a similar conclusion in Corn Products Refining Co. v. Commissioner.97 In Corn Products petitioner, a manufacturer of corn products, used large quantities of corn in its business and could store only about a three weeks’ supply at a given time.98 To insure a stable price for the corn and to offset the impact of price fluctuations caused by temporary supply shortages, petitioner purchased corn futures.99 Petitioner did not attempt to protect itself from price declines, although it did have some future sales commitments, predominantly of unfixed character.100 Purchases and sales of such futures resulted in a gain of approximately $680,000 in 1940 and a loss of approximately $110,000 in 1942.101 Petitioner argued that such gains and losses were capital under Code section 117(a).102 It contended that the judicial exception to Code section 117(a) for hedging transactions was improper; alternatively, petitioner asserted that that section was inapplicable to it. Its transactions were atypical hedges, because they were designed to protect petitioner against price rises but not against price declines.103 In addition, petitioner argued that many of its past purchases and sales of futures contracts were wash sales within the meaning of Code section 118; consequently, the losses from such transactions should have increased the basis of the futures sold in 1940 and 1942.104

The Second Circuit noted that the Tax Court had held that petitioner’s futures transactions gave rise to ordinary income and

96. Id. at 467-68.
98. Id. at 514.
99. Id.
100. Id. at 515.
101. Id.
102. Id.
103. Id.
104. Id. at 516.
loss, because its systematic purchases of corn futures were an integral part of its business. The circuit court indicated that the so-called “judge-made exception” to Code section 117(a) for hedging was misnamed; courts merely had recognized that the nature of hedging transactions made them logically inseparable from such business expenditures as inventory purchases. As a result, such transactions fall within the statutory exclusions of Code section 117(a). While perhaps not a “true” hedge, petitioner’s futures transactions were very similar to a hedge and were in fact a form of partial price insurance.

On the wash sale question, both the Second Circuit and the Tax Court held against petitioner, reasoning that (1) commodity futures contracts which are identical except for price and delivery month are not “substantially identical” properties, and (2) commodity futures contracts are not securities. With respect to the former ground, the Tax Court stated:

A new future commodity contract is not “substantially identical” with any prior contract even though the quantity involved in each is identical. It would be purely accidental if the new contract was with the same party as the one who had agreed to sell the commodity in the earlier contract. The price would probably be different and the delivery date would certainly be different . . . . Sales of such contracts are completed [sic] transactions when made, the gain or loss is recognized at that time, and there is no postponement of the gain or loss for tax purposes.

In addition, numerous courts have considered whether losses sustained in transactions involving a sale or purchase of stocks and securities are deductible. In Pennsylvania Co. for Insurance, losses from a sale of bonds, most of which were repurchased by the seller on the same day, were held to be deductible. The wash sale rules had not yet been enacted, and the court found no evidence that the transactions were not bona fide. The concept of bona fide transactions led to a different result in Esperson v.

105. See id. at 515.
106. See id. at 516.
110. I.R.C. § 1091.
In *Esperson* taxpayer sold stock to agents who transferred the stock back to taxpayer. The court denied the loss deduction, stating that "no real sale is made where by one and the same transaction the same number of shares are both bought and sold at the same time and at the same price." A loss deduction was also denied in *Commissioner v. Dyer*, where taxpayers sold stock in a corporation to the wholly-owned subsidiary of that corporation, thereby incurring a loss. Thirty-four days later, taxpayers returned the notes which had been used for payment, thereby repurchasing the stock. The court found that the repurchase had been prearranged and held that no loss could be realized, because the taxpayers had never really lost ownership of the stock. In *Marston v. Commissioner*, however, a trustee who sold stock to a trust and later reacquired the stock was allowed to deduct a loss incurred from the sale, because the absence of a prearranged plan made the sale bona fide.

In *Schoenberg v. Commissioner*, which the Tax Court relied on in *Horne*, the court compared *Dyer* and *Marston*; the Schoenberg court concluded that the presence or absence of a prearranged plan to reacquire the property sold to establish the loss determines whether a sale followed by a repurchase is bona fide. Thus, the Ruling's main thesis is a departure from precedent.

The Ruling also appears to rely in part on the taxpayer's ability to generate a short-term capital loss of $128x from a minimal investment of $10x as margin. This, however, is irrelevant. Investors in some areas, most notably real estate, can obtain tax benefits substantially in excess of funds invested or committed unless the Tax Reform Act of 1976 specifically provides otherwise.

Furthermore, the Ruling's statement that a taxpayer's change of position from a March/July straddle to a May/July straddle resulted in no change in economic position is demonstrably incorrect. Analysis of price differentials in March 1974, May 1974, and July 1974 silver on Commodity Exchange, Inc., for the period from March 1, 1973 to February 18, 1974 discloses that a person who

111. 49 F.2d 259 (5th Cir. 1931).
112. Id. at 260.
113. 74 F.2d 685 (2d Cir. 1935).
114. 75 F.2d 936 (2d Cir. 1935).
115. 77 F.2d 446 (8th Cir. 1935).
118. The transactions which were the subject of the Ruling actually involved straddles entered into in 1973 and liquidated in February 1974. Id. at 7.
effected a March/July straddle on March 1, 1973, and carried that position until February 26, 1974, would have sustained a far more substantial loss than a person who switched into a May/July straddle at different points during the year.\textsuperscript{119} Indeed, a person who effected such a switch on October 10, 1973, would have realized a profit (before commissions) of $100 per straddle as compared to a loss (before commissions) of $310 by not switching at all.\textsuperscript{120}

If the facts as stated in the Ruling are accurate, the entire Ruling could have been based more convincingly on the transactions' lack of economic substance. The difficulty with this ground is that it would have required the IRS to assume that the facts stated in the Request for Technical Advice showing "substantial profit and loss potential"\textsuperscript{121} were false.

\begin{footnote}{119} The differentials between March 1974 silver and July 1974 silver, and between May 1974 silver and July 1974 silver on Commodity Exchange, Inc., on the dates listed below, as reported by \textit{The Wall Street Journal}, were:

<table>
<thead>
<tr>
<th>Straddle</th>
<th>Date</th>
<th>Differential in Points$^*$</th>
</tr>
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<tbody>
<tr>
<td>Long Short</td>
<td></td>
<td></td>
</tr>
<tr>
<td>March 1974/July 1974</td>
<td>5/1/73</td>
<td>500</td>
</tr>
<tr>
<td>&quot;</td>
<td>9/4/73</td>
<td>670</td>
</tr>
<tr>
<td>&quot;</td>
<td>10/12/73</td>
<td>260</td>
</tr>
<tr>
<td>&quot;</td>
<td>12/3/73</td>
<td>470</td>
</tr>
<tr>
<td>&quot;</td>
<td>2/26/74</td>
<td>810</td>
</tr>
<tr>
<td>&quot;</td>
<td>10/12/73</td>
<td>130</td>
</tr>
<tr>
<td>&quot;</td>
<td>12/3/73</td>
<td>210</td>
</tr>
<tr>
<td>&quot;</td>
<td>2/26/74</td>
<td>270</td>
</tr>
</tbody>
</table>

$^*$100 points equals $.01. In 1973, a silver futures contract on Commodity Exchange, Inc., was for 10,000 troy ounces of silver. Accordingly, a change in the differential of 100 points equals a profit or loss of $100.

Thus, an investor who effected a March/July straddle on March 1, 1973, and
(i) did not liquidate that position until February 26, 1974, would have sustained a loss of $310 before commissions (500 minus 810 equals $310); (ii) switched to a May/July straddle on September 4, 1973, and liquidated that position on February 26, 1974, would have sustained a loss of $110 before commissions (500 minus 670 equals $130; 330 minus 270 equals 60; 60 plus $130 equals $190); (iii) switched to a May/July straddle on December 3, 1973, and liquidated that position on February 26, 1974, would have sustained a loss of $30 before commissions (500 minus 470 equals 30; 210 minus 270 equals 0; 30 plus 0 equals 0).

\textsuperscript{120} An investor who entered into a March/July straddle on March 1, 1973, and switched to a May/July straddle on October 12, 1973, would have realized a profit of $240 (500 minus 260). However, on liquidating the May/July straddle on February 26, 1974, the investor would have lost $140 (130 minus 270), resulting in a net profit of $100 before commissions. See note 119 \textit{supra}.

\textsuperscript{121} See note 63 \textit{supra} and accompanying text.
This economic reality test often is applied in cases involving transactions having virtually no purpose other than a reduction in taxes. It is derived from *Knetsch v. United States*.122 In *Knetsch* a taxpayer purchased long-term deferred annuity savings bonds from an insurance company. The principal was paid by nonrecourse notes secured by the bonds, while a portion of the interest was prepaid.123 In addition, the taxpayer borrowed against nearly the entire excess of the bond value over his indebtedness, once again prepaying the interest. The taxpayer then deducted the prepaid interest on his income tax return.124 The Supreme Court concluded that the transactions were nondeductible shams, because "there was nothing of substance to be realized by Knetsch from this transaction beyond a tax deduction."125 *Knetsch* stands, then, for the proposition that losses from transactions which have no economic substance are not deductible.

A different principle, but one frequently applied in cases factually similar to *Knetsch*, was developed in *Goldstein v. Commissioner*.126 Taxpayer in *Goldstein* won the Irish sweepstakes and thereafter purchased United States Treasury notes by obtaining loans secured by these notes.127 Although the comparative interest rates of the loan and the notes made the transactions inherently unsound from an economic viewpoint, the taxpayer's ability to take a large deduction for prepaid interest during the year in which she won the Irish sweepstakes, yielded her a substantial tax saving which would have more than compensated her for out-of-pocket losses.128 In disallowing the interest deductions, the Second Circuit specifically rejected the sham rationale of *Knetsch* in favor of a more flexible formulation that has since become well-known:

[A] deduction for interest paid . . . in loan arrangements . . . that can not with reason be said to have purpose, substance, or utility apart from [its] anticipated tax consequences [is not permitted].

... [T]he deductibility of interest [should be permitted only] when a taxpayer has borrowed funds and incurred an obligation to pay interest in order to engage in what with reason

123. Id. at 362.
124. Id. at 363.
125. Id. at 366.
126. 364 F.2d 734 (2d Cir. 1966), cert. denied, 385 U.S. 1005 (1967).
127. Id. at 736.
128. Id. at 738-39.
can be termed purposive activity, even though he decided to
borrow in order to gain an interest deduction rather than to fi-
nance the activity in some other way.\textsuperscript{129}

Comparing \textit{Knetsch} with \textit{Goldstein} clarifies that \textit{Goldstein} was
only intended to apply where tax benefits are the \textit{sole} reason for
the questioned transaction. In a case of mixed motives, interest
deductions should not be disallowed under \textit{Goldstein},\textsuperscript{130}
apparently any nontax goal should suffice.\textsuperscript{131}

Numerous cases have followed \textit{Knetsch} and \textit{Goldstein} in disal-
lowing deductions for losses incurred through sham transactions
and transactions having tax avoidance as their sole purpose;\textsuperscript{132}
onetheless, no case has gone so far as to deny a tax deduction for
a transaction in which at least some profit motive, however subor-
dinate to a tax avoidance purpose, is present. In some cases,
though, the taxpayer's contention that profit motive existed for a
particular transaction has been rejected as spurious,\textsuperscript{133} in others,
the burden of proving profit motive has been placed upon the
taxpayer.\textsuperscript{134}

None of the above cases or principles support the Ruling. At
worst, from a taxpayer's viewpoint, the cases hold that to deduct a
loss from a commodity straddle transaction, taxpayer must establish
that the transaction gave rise to a reasonable potential for profit,
and thus had economic substance. Apart from the Ruling, there is
no support for the proposition that a taxpayer's dominant purpose
for engaging in a transaction should determine the tax treatment of
such a transaction. Probably the most serious criticism of a test
based on weighing relative motives and purposes is that uncertain-
ity will result from the difficulty in applying such a test uniformly.\textsuperscript{135}

\textsuperscript{129} \textit{Id.} at 740-41 (citations omitted).
\textsuperscript{130} "[T]he interest deduction should be permitted whenever it can be said
that the taxpayer's desire to secure an interest deduction is only one of mixed mo-
tives that prompts the taxpayer to borrow funds . . . ." \textit{Id.} at 741.
\textsuperscript{131} \textit{See} Blum, \textit{Motive, Intent, and Purpose in Federal Income Taxation}, 34 U.
\textsuperscript{132} \textit{E.g.}, Campbell v. Cen-tex, Inc., 377 F.2d 688 (5th Cir. 1967). \textit{See} cases
cited notes 133 & 134 infra.
\textsuperscript{133} \textit{See}, \textit{e.g.}, Lifschultz v. Commissioner, 393 F.2d 232 (2d Cir. 1968).
\textsuperscript{134} \textit{See}, \textit{e.g.}, Brown v. United States, 396 F.2d 459 (Ct. Cl. 1968).
\textsuperscript{135} \textit{See} Blum, \textit{supra} note 131, at 515. Professor Blum argued that the IRS
should use an objective test, such as one focusing on the economic reality of a trans-
action. Tests which are vague and difficult to apply, involving motive, intent, and
purpose, should be discarded. \textit{See id.} Professor Blum further indicates that courts
consistently have recognized this danger and have attempted to avoid making subjec-
tive judgments. \textit{See id.} at 532.
Based on Knetsch and Goldstein, it can be argued that the individual straddle transactions which lack a profit-and-loss potential can be struck down as shams. However, this would require a factual determination on a case-by-case basis, rather than an IRS ruling based on the factually erroneous conclusion that no such potential exists.

CONCLUSION

The Ruling appears to have little basis under the Code, the regulations adopted thereunder, or judicial precedent. It conflicts with earlier IRS rulings which ostensibly had settled the only areas of uncertainty with respect to tax treatment of commodity straddles, and which had, therefore, given assurance to the tax bar that the IRS would continue to recognize commodity straddles as legitimate transactions. If the IRS can demonstrate, however, that a tax straddle offered a taxpayer no expectation of profit—a factual issue not easily determined—then the disallowance of a loss resulting from such straddle is likely to be sustained based on Knetsch and its progeny.

136. See generally Selig, supra note 26, at 66.
137. See text accompanying notes 63, 131-135 supra.