BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeals of)
)
JOHN T. AND JEAN PROHOROFF, and) No. 84A-384-KP
MORRIS PROHOROFF) 84A-385

For Appellants: Paul J. Dostart
Attorney at Law

For Respondent: Jon Jensen
Counsel

O P I N I O N

These appeals are made pursuant to section 18593[1/] of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protests of John T. and Jean Prohoroff and Morris Prohoroff against proposed assessments of additional personal income tax in the amounts of $14,760.54 and $12,069.83, respectively, for the year 1979.

1/ Unless otherwise specified, all section references are to sections of the Revenue and Taxation Code as in effect for the year in issue.

The issue presented by this appeal is whether respondent's characterization of a portion of the losses sustained by appellants from trading futures contracts as short-term capital gains was erroneous. Although there are two separate appeals presented, the facts and the issue of both appeals are identical. Therefore, the appeals have been consolidated for purposes of decision.

Appellants are partners in the Prohoroff Poultry Farms (Prohoroff). Prohoroff is in the business of producing eggs for sale to retailers. During the year at issue, Prohoroff's egg production was generated by 2,000,000 egg-laying chickens with 200,000 pullets available as replacement layers. Due to the number of chickens involved in its operation, Prohoroff's need for chicken feed, which consisted of corn and soybean meal, was substantial. In 1979, Prohoroff's corn requirements averaged 100 units a month (one unit of corn equals 56,000 pounds), while its soybean meal needs averaged 4.5 units a month (one unit of soybean meal equals 200,000 pounds). The partnership did not produce any of its own feed and it did not have the storage capacity for more than two to three weeks of food supplies.

Since 1977, appellants, through the partnership, engaged in the buying and selling of futures contracts for corn and soybean meal. Appellants sold and bought several futures contracts during the early part of 1979, but began buying contracts in earnest after June 1, 1979. During the months of June and July 1979, the partnership bought 600 corn futures contracts for September 1979: 1,100 corn futures contracts for December 1979; 30 soybean futures contracts for September 1979; and 45 soybean futures contracts for December 1979. Between July 27, 1979, and July 31, 1979, the partnership sold all of the above-described contracts for losses. Appellants, believing that their trading activities were hedges against increases in feed prices and, therefore, integrally related' to their trade or business, characterized the losses as ordinary losses which they deducted from ordinary income.

Upon review of appellants' returns, respondent determined that only 68 percent of the subject losses constituted ordinary losses. Respondent based this figure on Prohoroff's actual feed needs for the remainder of 1979 and added another 10 percent for error. Accordingly, the remaining 32 percent of the losses were characterized as short-term capital losses. The appropriate assessments reflecting respondent's determination were issued, appellants protested, the protests were denied, and these appeals followed.

These appeals revolve around the issue of whether appellants were attempting to protect themselves from increases in feed prices through "hedging" in the commodities market or'whether appellants were simply speculating in futures contracts of grains used in their trade or business. While this particular issue has not previously been addressed by this board, a considerable body of law addressing this issue has been developed at the federal level. As all of the federal statutes interpreted by that body of law-have equivalent California counterparts, the determinations of the federal courts construing the federal statutes are entitled to great weight in interpreting the corresponding state statutes. (Meanley v. McColgan, 49 Cal.App.2d 203 [121 P.2d 45] (1942).)

Section 17206, subdivisions (c)(1) and (2), limit an individual's loss deductions to those incurred in.a trade or business or a transaction entered into for profit. Section 17206, subdivision (f), limits the deductions for losses from the sale of capital assets to those provided for in section 18152. Section 18161 defines a "capital asset" as property held by a taxpayer and then enumerates several specific types of property to be excluded from that definition.

Gains or losses from trading in commodity futures contracts are normally treated as capital gains or losses. (Day v. United States, 734 F.2d 375 (8th Cir. 1984).) An exception to the literal language of the statute exists where futures transactions are an integral part of a taxpayer's trade or business. (Oringderff v. Commissioner, ¶ 79,093 T.C.M. (P-H) (1979).) Such transactions result in ordinary gain or loss. (Corn Products Refining Co. v. Commissioner, 350 U.S. 46 [100 L.Ed. 29] (1955).)

The most common form of the exception regarding commodities futures is "hedging" protection used by a business. (Day v. United States, supra.) The tax-court in Muldrow v. Commissioner, 38 T.C. 907, 913 (1962), has explained the difference between hedging and speculative activity:

> A hedge ... is not a transaction looking to a favorable fluctuation in price for the realization of profit on

> the particular futures contract itself, as in the case of a speculative or capital transaction, but is a form of insurance against unfavorable fluctuations in the price of a commodity in which a position has already become fixed or, as in the case of a producer such as a cotton grower, will become fixed in normal course and the sale, liquidation, or use of the commodity is to occur at some time in the future.

"Thus, where a hedge is made, a position is taken in the futures market to offset a risk with respect to actual commodities." (Day v. United States, supra, 734 F.2d at 376.) "The basic principle of hedging is the maintenance of an even or balanced market position." (Commissioner v. Farmers & Ginners Cotton Oil Co., 120 F.2d 772 774 (5th Cir. 1941)) Whether a taxpayer was involved'with hedging, rather-than speculation, is a factual inquiry. (Day v. United States, supra.)

On appeal, respondent, rather than arguing that its assessments are correct as issued, contends that it could easily have determined that the character of all of the losses was capital rather than ordinary. Respondent bases its argument on the following determinations: there was no direct relationship between the buying and selling of futures contracts and Prohoroff's operations; appellants never took delivery of any grain under the contracts; appellants were overhedged in the futures contracts.; and, appellants held the contracts for a relatively short period of time.

We begin by addressing respondent's determination that there was no direct connection between Prohoroffs' purchases and its business. In support of its position, respondent cites two cases, Gee v. Commissioner, ¶ 64,162 T.C.M. (P-H) (1964), and Soeder v. Commissioner, ¶ 54,073 T.C.M. (P-H) (1954), for the proposition that mere trading in futures contracts of commodities bought or sold by a taxpayer in his trade or business does not establish the necessary link to make the activities an integral part of the taxpayer's trade or business. While we agree with that proposition, a close examination of the facts in each of the cited cases distinguishes them from the appeals before us.

First, the court in Gee focused on the fact that the taxpayer's trading infutures contracts failed to provide any price protection; rather, the trading was done in such a manner that both the futures transactions and the sale of similar goods by the taxpayer were subject to the same risk, a drop in prices. In the appeal before us, appellants' actions reflect the thinking of a person worried about the rising prices of the two commodities most essential to his finished product.2/ Appellants apparently began watching the price of commodities futures after January 1979, and became alarmed at the rising cost of feed. Over the next several months, the prices of corn and soybean meal rose steadily, while, during the same period, the price of eggs remained fairly constant and the market for eggs began to dwindle. The only logical move for a taxpayer in the egg-producing business was to cut or stabilize costs. (See Fulton Bag and Cotton Mills v. Commissioner, 22 T.C. 1044 (1954); Stewart Silk Corp. v. Commissioner, 9 T.C. 174 (1947).) Accordingly, appellants embarked on a pattern of purchasing corn and soybean meal futures contracts, thereby fixing an upper limit on the price of their feed purchases in a market that appeared to be rising in price. Furthermore, appellants did not sell their contracts when the prices temporarily dipped, as an investor would, but continued to buy contracts, taking advantage-of the temporarily lowered prices. This pattern of behavior continued until the end of July 1979, when the crops' harvests began and the true yield of the two crops became known. Consequently, we find that appellants have established a pattern of behavior consistent with taking a true hedging position, a position of insurance.

2/ Compare Day v. United States, 734 F.2d 375 (8th Cir. 1984), where the taxpayer bought and sold futures contracts in the same commodities he produced: Commissioner v. Farmers & Ginners Cotton Oil Co., 120 F.2d 772 (5th Cir. 1941), where the taxpayer bought and sold futures contracts of a product produced by a third party from the raw material sold by the taxpayer; Gee v. Commissioner, ¶ 64,162 T.C.M. (P-E) (1964), where the taxpayers bought and sold futures contracts for commodities raised on land leased by the taxpayers. But compare Corn Products Refining Co. v. Commissioner, 350 U.S. 46 [100 L.Ed. 291 (1955), where the taxpayer bought futures contracts in commodities directly used in the processing of its final products.

Second, the court in Soeder was faced with a situation where the taxpayer simply failed to produce evidence to directly connect his futures trading with his cattle business. Among other things, the taxpayer in Soeder failed to show how his purchases related to his true need for feed.

Respondent, seizing upon this requirement, takes'issue with the amount of feed Prohoroff contracted to buy, noting that if Prohoroff had taken delivery of all of the contracts it would have had a 13-month supply of feed by December 1979. Respondent emphasizes that the partnership had storage facilities large enough for only three weeks of feed.

Respondent's own assessment of Prohoroff's feed needs actually goes farther to supporting appellants' position that it goes to contradicting it. Prohoroff's feed needs and costs cannot be determined on a calendar year cycle for it is the yearly harvest yield of corn and soybeans that affected their production costs. If there was one bad harvest or the demand for corn and soybean meal throughout the market increased during a year, the price would remain high until the next year's crops came in. Viewed in terms of a yearly plan, Prohoroff's yield from its futures contracts was roughly equivalent to its yearly feed needs; that year being the time until the 1980 harvest was in. As Prohoroff's feed needs were affected by the price of grain as determined from harvest to harvest, its purchases were not overhedges but corresponded with its yearly needs. (Cf. Oringderff v. Commissioner, supra.)

'Furthermore, appellants stated that they never intended to take delivery of the grain purchased under. the futures contracts. Rather, appellants were using the contracts as a hedge against a perceived rise in feed prices over the next growing season. Despite respondent's argument to the contrary, there is no need for a taxpayer engaged in hedging to actually take delivery of the commodities purchased under the contracts to support a finding that the hedging was integrally related to the taxpayer's trade or business. (See Corn Products Refining Co. v. Commissioner, supra, wherein the taxpayer sold its futures contracts as it bought grain on the spot market; see also Fulton Bag & Cotton Mills v. Commissioner, supra.) What must be shown is that the hedging provided price protection for the taxpayer. (See Muldrow v. Commissioner, supra.) This protection must, however, reasonably relate to the actual need of the taxpayer. (See Fulton Bag & Cotton Mills v. Commissioner, supra.) As discussed above, appellants' purchases did reasonably relate to the actual needs of the partnership. Consequently, had appellants been correct and their plan been implemented, by later selling the futures contracts before they came due, they would have been able to reduce their true feed costs over the next seasonal year.

As it turned out, appellants guessed wrong. Upon harvesting the two crops, it was discovered that the yields were better than anticipated and the price of corn and soybeans and their respective futures dropped. Therefore, as the risk of higher feed prices over the next season was effectively diminished, the need for appellants' hedging protection was dramatically reduced, and appellants sold their contracts. As stated by the court in Fulton Bag & Cotton Mills v. Commissioner, supra, 22 T.C. at 1052:

> Nor is a true hedging transaction converted into a speculative one by the failure of the hedger to close out its future contracts simultaneously with the sale of its spot goods. It is sufficient that such closeout transactions take place within a reasonable time following the elimination of the risk factor ....

We find that appellants were correct in closing out their futures contracts when the price of feed over the next season became considerably more predictable. Consequently, the loss.sustained by appellants was properly characterized as a business loss.

For the above-stated reasons, respondent's action in this matter must be reversed.

Appeals of John T. and Jean Prohoroff, et al.

O R D E R

Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED; ADJUDGED AND DECREED, pursuant to section 18595 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protests of John T. and Jean Prohoroff and Morris Prohoroff against proposed assessments of additional personal income tax in the amounts of $14,670.54 and $12,069.83, respectively, for the year 1979, be and the same is hereby reversed..

Done at Sacramento, California,. this 6th day of January , 1987, by the State Board of Equalization, with Board Members Mr. Collis, Mr. Dronenburg, Mr. Bennett, Mr. Carpenter and Ms. Baker present.

Conway H. Collis-, Chairman

Ernest J. Dronenburg, Jr., Member

William M. Bennett, Member

Paul Carpenter, Member

Anne Baker*, Member

*For Gray Davis, per Government Code section 7.9

87-SBE-009

BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeals of) No. 81A-1331-SW
CHARLES AND VIRGINIA H. WIESE) 81A-1332
JACK D. AND MARJORIE KAHLO) 81A-1333
JACK M. NICHOLS)

For Appellants: Cecil G. Toftness
Attorney at Law

For Respondent: Terry Collins
Counsel

O P I N I O N

These appeals are made pursuant to section 18593[1/] of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protests of Charles and Virginia H. Wiese, Jack D. and Marjorie Kahlo, and Jack M. Nichols against proposed assessments of additional personal income tax in the amounts of $27,882.24, $27,310.46, and $27,669.40, respectively, for the year 1978.

1/ Unless otherwise specified, all section references are to sections.of the Revenue and Taxation Code as in effect for the year in issue.

Appeals of Charles and Virginia H. Wiese,
Jack D. and Marjorie Kahlo, and Jack M. Nichols

The issue presented in these appeals is.whether appellants are entitled to the benefits of section 17402 relative to the recognition of gain from the liquidation of a corporation. Because of the identity of facts, issue, and legal principles involved in each case, the three appeals are consolidated for purposes of this opinion.

Appellants were the sole shareholders of Harbor Village, Inc., a corporation which on December 1, 1978, adopted a plan of liquidation. The corporation timely filed the necessary certificates and elections to dissolve with the Secretary of State and with the Internal Revenue Service. Appellants did not, however, file Form 3512, "Election of Shareholder under Section 17402" with the Franchise Tax Hoard during the statutory 30-day election period. A copy of the federal election under section 333 of the Internal Revenue Code was attached to the Wieses' 1978 income tax return filed with the Franchise Tax Hoard on June 14, 1979. The record does not reveal whether similar copies were attached to the returns of the other appellants.

Respondent noted that the elections under section 17402 had not been filed during the statutory period and each appellant was individually sent a notice of additional tax being assessed. Appellants, in contesting the assessments, contend that their filing an election with the Internal Revenue Service meets the filing requirements of section 17402, subdivision (d).

Section 17402 provides that under certain circumstances shareholders may elect to not recognize their gain on the complete liquidation of their corporation. The election, however, must be timely. Subdivision (d) of this section requires that a written election must be made in conformance with the regulations of the Franchise Tax Hoard and must be filed within 30 days after the date of the adoption of the plan of liquidation. Appellant contends that when the necessary forms were filed with the Internal Revenue Service, the requirements of section 17402 were met. We cannot agree.

Respondent's regulation, which was in effect during December of 1978, when the election was to have been made, provided, in part, that:

> An election to be governed by Section 17402 shall be made on the form

> prescribed by the 'Franchise Tax Board and in accordance with this regulation. The original and one copy shall be filed by the shareholder or by the liquidating corporation with the Franchise Tax Board within 30 days after the adoption of the plan of liquidation or by May 13, 1954, whichever is the later. Under no circumstances shall Section 17402 be applicable to any shareholders who fail to file their elections within the 30-day period prescribed. ...

This regulation was repealed effective June 13, 1981. (Cal. Admin. Code, tit. 18, reg. 17402(c), repealer filed May 14, 1981 (Register 81, No. 20).) More specifically, therefore, the basic question presented by these appeals, is whether, in view of the fact that regulation 17402 has been repealed, the appellants made a timely election to have their gain go unrecognized.

In the Appeals of Leonard S. and Erlene G. Cohen and Estelle Grossman, decided by this board on April5,1983, the taxpayers liquidated their corporation in September of 1976. They filed the necessary forms with the Internal Revenue Service but failed to file timely elections with the Franchise Tax Board. This board held that the-taxpayers had not shown that they complied with the election requirement of section 17402, subdivision (d). In support of this finding we stated:

> This board has also had occasion to consider the precise issue raised here. (Appeals of Horace C. Mathers, et al., Cal. St. Bd. of Equal., April 24, 1967; Appeals of John and Elvira C. Costa, et al., Cal. St. Bd. of Equal., March 7, 1967; and Appeal of Mathew Berman and the Estate of Sonia Berman, Cal. St. Bd. of Equal., June 28, 1965.) In each of these cases, we have concluded that the 30-day election requirement imposed by section 17402, subdivision (d), is clear, explicit, and mandatory, leaving no room for the exercise of discretion. In Appeals of Horace C. Mathers, et al.,' supra, as in the instant case, the taxpayers'- representative directed a letter to the Franchise Tax Board requesting a tax clearance certificate within 30 days of adopting a plan of liquidation. That letter read, in part, as follows: "We are desirous

> of dissolving [the corporation] in the month of October, 1963, and would greatly appreciate your mailing us a tax clearance." As in the instant case, within 30 days from the adoption of the plan of liquidation, each shareholder filed a Form 964 with the Internal Revenue Service. However, nothing purporting to be an election under section 17402 was filed with the Franchise Tax Board within those 30 days.

(Appeals of Leonard S. and Erlene G. Cohen and Estelle Grossman, Cal. St. Bd. of Equal., Apr. 5, 1983.)

Although the specific issue raised in this appeal was not raised in the Grossman appeal, we must conclude that for several reasons our holding in Grossman is consistent with our findings in this case.

The primary rule of statutory construction is that the intention of the legislature must be ascertained. (Marina Village v. California Coastal Zone Conservation Commission, 61 Cal.App.3d 388 [132 Cal.Rptr. 120] (1976).) Section 17402, subdivision (d), provided that the written election had to be filed in such a manner as not to be in contravention of regulations of the Franchise Tax Board. Clearly, the California Legislature did not intend the Franchise Tax Board to pass regulations depicting the procedure used to file an election with the Internal Revenue Service.[2] The only reasonable interpretation of their intent is that the regulations would define a procedure for filing the election with the Franchise Tax Board.

2/ Section 17024.5, subdivision (d), provides:

(d) Whenever this part allows a taxpayer to make an election, the following rules shall apply:

(1) A proper election filed in accordance with the Internal Revenue Code or regulations issued by "the secretary* shall be deemed to be a proper election for purposes of this part, unless otherwise provided in this part or in regulations issued by the Franchise Tax Board.

(2) A copy of that election shall be furnished to the Franchise Tax Board upon request.

(continued on next page)

The facts show that at the time appellants were to have acted in making their election, there was no question as to the procedure to be followed. The regulation directed that the notice be filed with the Franchise Tax Board and yet appellants failed to do so. Appellants now seek to estop respondent from considering the repealed regulation. The doctrine of estoppel was created to insure fairness to those who relied on the old rule or law. [4 Davis, Administrative Law Treatise § 20.7 (2d Ed. 19831.1 In this case, there is no possibility that appellants relied to their detriment on the 1981 repeal of respondent's regulation as their failure to act occurred in 1978. We cannot conclude that appellants have been treated unfairly. Consequently, the doctrine of estoppel will not apply. (See California Employment Commission v. Black-Foxe Military Institute, 43 Cal.App.2d 868, 876 (110 P.2d 729] (1941).)

We note that appellants make numerous arguments concerning the constitutionality of section 17402. In conformance with article III, section 3.5 of the California Constitution, we must conclude that this board has no authority to declare a state statute unconstitutional. (Appeals of Fred R. Dauberger, et al., Cal. St. Bd. of Equal., Mar. 31, 1982.)

For the above-stated reasons, the action of respondent will be affirmed.

2/ (continued)
This section became effective on January 1, 1983. The intent of the Legislature from this date on is the position taken by appellants. An election filed with the Internal Revenue Service will be effective notice for the Franchise Tax Board. However, the Legislature specifically made this intention applicable only to taxable years beginning on or after January 1, 1983. Had the Legislature intended this procedure to be applicable to earlier taxable years, presumably it would have so provided.

Appeals of Charles and Virginia H. Wiese, Jack D. and Marjorie Kahlo, and Jack M. Nichols

O R D E R

Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor,

IT IS BEREBY ORDERED, ADJUDGED AND DECREED, pursuant to section 18595 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protests of Charles and Virqina H. Wiese, Jack D. and Marjorie Kahlo, and Jack M. Nichols against proposed assessments of additional personal income tax in the amounts of $27,882.24, $27,310.46, and $27,669.40 respectively for the year, 1978, be and the same is hereby sustained.

Done at Sacramento, California, this 6th day of January, 1987, by the State Board of Equalization, with Board Members Mr. Collis, Mr. Dronenburg, Mr. Bennett, Mr. Carpenter and Ms. Baker present.

Conway H. Collis, Chairman

Ernest J. Dronenburg, Jr., Member

William M. Bennett, Member

Paul Carpenter, Member

Anne Baker*, Member

*For Gray Davis, per Government Code section 7.9

BEFORE THE STATE BOARD OF EQUALIZATION

OP THE STATE OF CALIFORNIA

In the Matter of the Appeals of)) No. 81A-1332-SW
CHARLES AND VIRGINIA H. WIESE) 81A-1333
JACK D. AND MAJORIE KAHLO) 81A-1331
JACK M. NICHOLS)

ORDER DENYING PETITION FOR REHEARING

Upon consideration of the petition filed February 2, 1987, by Charles and Virgina H. Wiese, Jack D. and Majorie Kahlo, and Jack M. Nichols for rehearing of their appeals from the action of the Franchise Tax Board, we are of the opinion that none of the grounds set forth in the petition constitute cause for the granting thereof and, accordingly, it is hereby denied and that our order of January 6, 1987, be and the same is hereby affirmed,

Done at Sacramento, California, this 7th day of May, 1987, by the State Roard of Equalization, with Board Members Mr. Collis, Mr. Dronenburg, Mr. Bennett, Mr. Carpenter and Ms. Baker present.

Conway H. Collis, Chairman

Ernest J. Dronenburg, Jr., Member

William M. Bennett, Member

Paul Carpenter, Member

Anne Baker*, Member

*For Gray Davis, per Government Code section 7.9