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THE NATURE OF COMMODITY FUTURES AS AN ECONOMIC AND BUSINESS INSTRUMENT†

The commodity futures contract has two separate and distinct parts, one relating to delivery at a future date and the other relating to deposits and settlements. The apparent preoccupation with the future delivery aspects of the contract has led to rulings, interpretations, accounting practices, and business decisions that appear to call for reevaluation. The present discussion examines in greater detail than previous discussions the anatomy of futures transactions and the nature of the incomes that flow from them. The dilemmas faced by accountants, by business managers making hedging decisions, and by the income tax authorities are all involved in this question. It is believed that much of the confusion surrounding this area can be resolved by a more careful look at the anatomy of the commodity future as an economic instrument.

THE NATURE OF THE COMMODITY FUTURES CONTRACT

In general terms the commodity futures contract consists of a firm, legal agreement between a buyer (or seller) and an established commodity exchange or its clearing house whereby the trader agrees to accept (or deliver) between designated dates, a carefully specified "lot" of a commodity meeting the quality and delivery conditions prescribed by the commodity exchange, with cash settlement on delivery date at a settlement price[1] to be prescribed; provided further—and this is most important—that the trader agrees to an arrangement with a qualified broker (or the clearing house) to:

1. Provide him with a margin deposit as required, and
2. Reimburse him or accept credit from him for all interim gains or losses in value of that futures contract resulting from day-to-day changes in its price on the floor of the established commodity exchange. Also,
3. That the trader have an option which permits him to close out his contract

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[1] There is a "settlement price" declared at the end of each trading session and all accounts are brought to this level. For transactions within the day, such as a new contract bought, that trade is moved from the transaction price to the day's settlement price, which ordinarily reflects the closing quotation or quotations on the trading floor. This is the same settlement price that is used in making deliveries.

at any time (at the market) simply by notifying his broker of his desire; and on the other side, it permits the broker to close out the commitment if the margin is impaired, by disposing of the contract at the market.

As a corollary to the above definition, it is necessary to recognize a number of other attributes of this basic commitment:

1. The contract defines a so-called par delivery specification which is the basic unit being traded on the exchange. This specification includes a precise set of terms relating to the quantity, the quality, the location, and services that must be met in making delivery.

2. In addition to the par delivery specifications there are usually alternatives available to the seller who chooses to make delivery of a commodity not precisely conforming to the par delivery specifications. Thus a scale of premiums or discounts is established for those deviations from the par delivery which are still permissible or "deliverable" under the terms of the contract. For instance, multiple locations of delivery may be permitted; variations in unit weights or tolerances in total quantity making up the delivery; grade deviations or penalties for imperfections; and similar premiums or penalties for other variations that are acceptable to the exchange. (These may not be refused by the person receiving delivery against a long contract.)

3. Delivery for most commodities is permitted to take the form of a warehouse receipt or, in some cases, a shipping certificate or a bill of lading, which is construed as an actual transfer of title.

4. As implied above, the individual holding a contract may be dealing directly with the commodity exchange clearing house (if he is a clearing member), or he may be dealing through a broker (or commission firm), in which case the exchange clearing house holds the commission firm responsible for the transaction.

5. In national emergencies or other extreme situations commodity trading has, on rare occasions, been stopped. In such cases there are usually arrangements for arbitration of outstanding commitments prior to recourse to the courts.

6. The operations of the exchanges are subject to various published trading rules, legal provisions, and regulations which may restrict individual trading in various ways. These rules may originate from the exchange or from the government.

7. While the exchange undertakes to maintain open public trading in the various contracts, it sets its own hours and rules of trading and may suspend trading or set limits beyond which prices may not move in a single day.[2]

Such are the chief attributes of the commodity futures contract. The act of using it consists of entering a commitment (to buy or sell), of closing out an

[2] When prices on the exchange for a particular contract reach the limit of permitted daily movement, trading is halted since only bids or offers within this limit can be executed. If the market closes at the limit, then this point becomes the base for measuring the limit on the following day. When trading encounters these limits, there may be a few orders "at the market" (either to buy or sell) which can be executed at the limit. For example, when the market is down the limit, it can be assumed that would-be sellers are numerous and buyers scarce. The few buy orders that come into market have to be distributed to sellers by some form of allocation, pooling arrangement, or lottery. In cases of severe and extended price movements in which a trader can neither maintain his margin nor liquidate because trading is halted by the daily limit, the clearing member is still responsible to the clearing house for the completion of his own or his clients' outstanding commitments for daily settlements.

open commitment, or of making or receiving delivery in accordance with the terms of an open commitment. Meantime, the required margin deposit is maintained at a prescribed level at all times, as prices go up or down. Trading is open to anyone who can meet the margin and other requirements as specified by a qualified broker.

Individual traders enter (and liquidate) their contract commitments by a bilateral trade on the floor of the exchange in which a current benchmark price is agreed upon. Thereafter the clearing house assumes the matching obligations of each trading partner, receiving and making daily payments as prices fluctuate. These details are discussed below.

It is important to reemphasize the two major dimensions of the commitment undertaken when a trader enters into a commodity futures contract. Indeed it is well to consider it a dual contract or at least a contract which stands on two equally important legs. The first is the commitment on the part of a short to deliver a commodity meeting the exchange specifications at a designated future date. This part of the contract merely promises delivery of the goods; the price at which the delivery occurs will be dependent not upon the price at which the commitment was entered but upon the settlement price at the time of delivery. The second leg of the contract involves a promise to keep up with daily price adjustments as quoted on the exchange through payment or receipt of cash at the clearing-house window. This daily settlement process has the effect of maintaining the validity of the delivery promise so that any cancellation of the delivery commitment can be accomplished without further transfer of funds. A transaction in commodity futures (unless and until settled by delivery) does not involve an exchange of any substantive value since only the process of daily adjustment generates income or loss. Nothing is borrowed in order to finance a purchase or sale of commodity futures, although a good-faith margin deposit is required of both buyer and seller. There are no debit balances in the entire futures operation other than the daily payment requirements which have to be made in cash; all net balances of traders are on the credit side. The trader is never allowed to be in debt.[3]

Most commodity futures contracts are terminated without actual delivery of the commodity. Such termination can be accomplished at the request of the trader simply by notifying his broker of his desire to terminate at a price in line with current quotations in the futures market. It can also be terminated by the broker if the customer fails to make prompt payment of any amounts due the broker as a result of day-to-day price changes. If actual delivery of the commodity is made, the final daily settlement price adjustment is applied to the contract, and then the seller, in order to meet his contract obligation, supplies the commodity and receives a price for it based upon the same settlement quotation determined on the exchange. The delivery process is officially initiated by the holder of a short contract who files a notice of intention to deliver through the clearing house. There is always a corresponding holder of a long position who must accept this deliverable commodity and pay the prescribed current settlement price subject to any quality discounts or premiums that may apply.

[3] This statement may be subject to qualification for certain commodities not under Commodity Exchange Authority regulation, like cocoa.

In order to make the significance of this distinction between the two aspects of the futures contract clear, we can say that the first portion—the daily settlement commitment at the clearing house based upon daily price fluctuations—is not a purchase or sale at all. The act of buying or selling occurs only after a delivery intent is declared. At this time the second aspect of the dual contract comes into operation: the clearing house exits from its position and a specific buyer and seller are paired up, each of whom is obliged to complete an actual purchase or sale at the then current settlement price. (The trade terminology speaks of "buying" or "selling" a contract to refer to the act of entering or liquidating a commitment. While we will use this terminology, it should be remembered that it would be better to speak of "taking a long, or a short, position" or to say "go long," "go short," "cover the short commitment," "liquidate the long commitment," for transactions short of delivery.)

THE CLEARING HOUSE RECORDS

The essence of the commodity futures contract can be illustrated by tracing a single transaction. Assume that a trader instructs his broker to buy one contract—representing five thousand bushels—in December wheat at $1.50 at Chicago. The broker (being assured that his customer has a sufficient uncommitted credit balance, or satisfied that a cash deposit will be made promptly to cover the initial margin) instructs his floor trader to make the purchase at that price. The trade will be made only if a seller is available and willing to trade at $1.50. (The seller may be entering a new short contract position or surrendering a previously held long contract. In either event, the transaction will only take place when two traders, a buyer and a seller, get together.) Up to this point the clearing house is not involved.

However, once the trade is consummated on the exchange floor, the clearing house takes over as intermediary (see *3*, pp. 113–32; *6*, pp. 37–40; *5*). It enters on its books the obligations—one long and one short—of the two brokers who made the trade. (If the brokers are not clearing members, each must have a clearing member who acts on his behalf.[4])

It is important to note that, once the clearing house has confirmed the trade and the specific price at which it was entered, the individual transaction loses its identity so far as the clearing house itself is concerned. Several things happen henceforth:

(a) No one cares who was the seller who paired up with this particular buyer; instead, each party is directly obligated to the clearing house.

(b) Each party (through his clearing member) is held responsible for maintaining an unimpaired credit balance sufficient to cover the required deposit against all open commitments.

(c) This deposit (which, for regulated commodities at least, must be maintained in segregated funds by all parties) is charged each day with the amount by which prices changed that day.

(d) The clearing house has records for each clearing member to show the

[4] A "clearing member" may handle accounts of other (non-clearing) members as well as its own, thus reducing the number of accounts carried by the clearing house.

aggregate positions, long and short, for which that member is responsible. It does not care at what prices these contracts were initially entered, because each one has been brought up to last night's settlement price and the accounts are charged and credited daily. Since there is a short for every long contract, the clearing house is always in balance with a zero net position.

(e) The clearing house can thus operate without having any record to identify the original price at which a particular contract was entered. This is a matter for the broker and the trader, not the clearing house.

(f) By virtue of the process of making cash settlements each day to reflect the daily price changes on the exchange floor, all profits and losses are settled at once—all losses are paid and profits are credited. Any two positions, one short and one long, in a particular contract can be paired up and closed out simply by a "close-out" transaction without any additional cash changing hands (except for commission charges and any price differences since the previous night's settlement quotations). In fact the close-out operation releases back to the traders the cash they had deposited as their required margin.

(g) If the buyer who entered a long commitment in December wheat at $1.50 decides to take delivery, he will receive through the clearing house a notice of intention to deliver from a seller which in effect does two things. First, it closes out the buyer's contract account with the clearing house on the specified settlement date and at the settlement price set on that date. This cancels the buyer's obligation to make further daily settlements at the clearing house. (Matching this action, a short contract was cancelled when the wheat delivery tender was presented.) The second part of the delivery process is the actual change of title of the wheat delivered and the payment of cash to the party making the delivery. This is accomplished by use of the same settlement price as that which closed out the futures contracts, namely the current price on the exchange for a "par delivery" quality and location of wheat deliverable under the rules of the exchange, adjusted for whatever prescribed premiums and discounts apply to the grain actually delivered.

It can be seen that the trader who originally went long at $1.50 per bushel may have had to pay a very different cash price when he took delivery—perhaps $1.75 or $1.25 depending upon what happened in the market quotations for December futures up to the time of delivery. However, he would have paid or received interim cash credits or charges which could be balanced out against the cost of his delivery wheat to give him a net cost equivalent to that at which he entered the contract.

THE BROKER OR COMMISSION FIRM RECORDS

In contrast to the accounts maintained by the clearing house, the broker has to meet the needs of his individual clients. He therefore carries a record of the individual transactions of each client in each contract classification, and he also maintains a record of the current status of the account including the daily updating of debits and credits resulting from price changes, together with the cash transfers and the net credit balances of the customer. This latter record also shows the number of open contracts in the account as a basis for calculating the credit balance required by minimum margin regulations, to be checked against

the actual credit balance. As stated earlier, the broker calls for more cash when margins fall below a prescribed maintenance level (see *4*); otherwise he will close out enough contracts to bring the amount of margin required by the rules into line with the available credit balance. Finally, the broker customarily compiles a monthly statement for his clients, recording the summary of transactions and status of the account. This statement can be drawn up to show the results of all contract positions closed out during the month, together with cash transfers, in or out, and the current status of open contracts, together with a summary of end-of-month credit balances and margin requirements. A simple illustration of a position statement, developed by the author for teaching purposes, is presented as Exhibit I.

The broker thus is able to provide a record of (1) all transactions, (2) daily results, (3) open commitments, (4) margin requirements, and (5) the current equity status of the account. These accounts include data showing the specific outcome of each contract entered and terminated.

INDIVIDUAL TRADERS

So far as the individual trader is concerned, the records he needs for accounting and for decision purposes can vary widely. It all depends upon his purposes and his total situation. If he is a speculator, he is presumably following a plan; and he must have enough information regarding his own situation and the relevant factors operating in the market to enable him to see how he is doing and how well his plans are working. If the trader is one who uses the futures market as a business management tool, he must be able to relate the futures market experience to his commercial transactions and positions, and this calls for additional or different kinds of information.

For our present purposes we will confine ourselves to the actual transactions and adjustments affecting the financial status of the individual trader. If he is a speculator, he may have a number of instructions for his broker—standing orders, stop orders, and the like—which become effective under certain market conditions. Beyond this he undoubtedly maintains a volume of information which will be useful to him in decision-making. However, for purposes of measuring income or loss and current position, the information outlined in Exhibit I covers most of what he needs.[5]

The commercial trader needs to have his information in a form that will fit into his total accounting system. For instance, he may use the futures market to hedge his inventory position and will in most cases want to price his inventories of this particular commodity at market and adjust their price for the net gains or losses on open futures contracts. In business uses of this sort it is a common practice to assign the gains and losses from closed futures contracts as an adjustment in the calculations of cost of goods sold. (Futures profits would reduce the cost and thus increase earnings, while losses on futures would increase costs, reducing earnings.)

There are a good many other uses of commodity futures in connection with

[5] This summary position statement would normally enable him to ascertain the length of time which a particular contract commitment has been held so that he can comply with present income tax requirements regarding capital gains and losses.

EXHIBIT I

WEEKLY FUTURES TRADING POSITION STATEMENT

NAME_____ UNITS (BU., LB., ETC.)
WEEK ENDING_____ PER CONTRACT_____
EXCHANGE_____ MIN. FLUCT. = _____PTS.
NAME OF COMMODITY_____ MIN. FLUCT. = $_____PER CONTRACT

Profit or (Loss) on Open Contracts

1	2	3	4	5	6	7	8	9	10
Delivery Month	No. of C's	Total Margin $'s	Long or Short (L or S)	Bought or Sold at (price)	Price at Fri. Close	No.Min.Fluct. Units Gained or Lost Per Contract	Min.Fluct. Units X No. Cont.	Results to Date	
								Gain	Loss
Totals									

Net Dollar Gain or (Loss) on All Open Contracts

Profit or (Loss) on Contracts Closed During the Week

1	2	3	4	5	6	7	8	9	10
Delivery Month	No. of C's	Total Com-mission $'s	Long or Short (L or S)	Orig. B or S Price	Price at Close Date	No.Min.Fluct. Units Gained or Lost Per Contract	Min.Fluct. Units X No. Cont.	Gain	Loss
Totals									

Net Dollar Gain or (Loss) on All Contracts Closed During the Week

SUMMARY OF FUTURES TRADING ACCOUNT

Last Week's NET CAPITAL POSITION ON ALL COMPLETED BUSINESS	_____	
Gain or (Loss) on Contracts Closed during week	_____	
Less Commissions incurred during week	_____	
Cash transferred to (+) or received from (-) broker	_____	
NET CAPITAL POSITION ON ALL COMPLETED BUSINESS		_____
Plus Net BOOK gain (loss) on OPEN contracts	_____	
NET EQUITY (available to margin open contracts		_____
MARGIN requirements on OPEN contracts	_____	
Net uncommitted credit in margin account	_____	

commercial businesses. The futures may be a procurement instrument or a method of earning storage. They may be indirect or cross-hedges, and they may be in the nature of an anticipatory hedge against commercial expectations rather than against firm commitments. A long hedge, for instance, may be used as a device for fixing the cost of a raw material which will be used at a future date without tying up nearly as much capital as would be involved if the physical product were to be acquired and held until needed. Without going into detail, it should be clear that the accountant is confronted with many possible ways of interpreting and accomplishing the accounting requirements. It is sufficient for our present purpose merely to affirm that the results of futures transactions are expected to be entered into current operating results of the business and may not be interpreted as capital gains or losses. It is not entirely clear whether gains or losses from open contracts (as distinct from closed contracts) need to be taken up currently or may be deferred until each contract is closed. Some are handled in each way. Certainly, open contracts are taken into account on a cumulative basis when they are used in the process of adjusting inventory prices, but it is not at all clear that such treatment is necessary in all situations.

TAX STATUS OF COMMODITY FUTURES OPERATIONS

Operations in commodity futures have been the subject of a number of tax rulings. These have made certain situations clear but have left other operations unclear. A situation which seems quite straightforward at first glance becomes highly complex upon further scrutiny. The involvement seems to center upon the question of whether or not a futures contract is "property," and whether or not income is generated while contracts are still open or whether the income is deferred until the contract interest is terminated.

In ordinary accounting practice, commodity futures contracts themselves are not a balance sheet item to the holder. They are neither an asset nor a liability on the books, but rather a cancellable agreement. In contrast to short sales in the securities market, there has been no borrowing and delivery of a stock certificate to the buyer as evidence of a title transfer. At the same time there is a tangible asset in the form of a margin deposit or "receivable from broker" credit which is usually a current account receivable.

The impacts of price fluctuations upon open futures contracts, however, are clearly a significant factor in financial results.

Certain pragmatic rulings have been affirmed which can be summarized as follows:

(a) Speculative futures contracts on the long side apparently are "capital assets." Losses on long speculative positions have been required to be treated as capital losses rather than as current operating expenses.[6] However, no rulings were found to substantiate actual experience with such losses (or gains) as "long term," although according to Internal Revenue Service practice and to "non-court" tax opinions, long speculative positions held over six months can receive long-term capital gains treatment (cf. *1*, p. 136).

[6] See *Tennessee Egg Company, petitioner, v. Commissioner of Internal Revenue*, 47BTA, August 18, 1942, as reaffirmed by *Frank B. Polachek, petitioner, v. Commissioner of Internal Revenue*, 22TC 858, July 9, 1954.

(b) On short-sale, speculative positions (as distinct from hedges), total gain or loss is a short-term gain or loss. Apparently an open short-sale contract is not legally a "capital asset" (i.e., it is not "property") except in very unusual circumstances.[7] Apparently, however, when a long contract is purchased for the purpose of canceling the short position, the long contract is "property" which instantaneously takes on the loss or gain resulting from the prior short commitment. Thus, the net loss or gain from speculative short positions must be treated as short-term in nature (cf. 2).

(c) For a firm dealing in futures as a part of its regular commercial operations, both the futures contract and the matching commodity commitment are ordinarily valued at, or adjusted to, current market, so there is no tax liability involved in the paired transactions, assuming the hedge is perfect.[8] The courts have also regarded a futures transaction (even though not matched against a trade commitment) as producing only current operating profits or losses if the commodity is intimately involved in the day-to-day dealings of the business.[9]

While accounting practices vary from one situation to another, Exhibit II describes, as nearly as we could ascertain, the major categories of tax treatment that prevail today in the United States.

The categories outlined in Exhibit II reveal distinct contrasts in the method of treating—for tax purposes at least—the income or losses generated by commodity futures operations. In the case of speculative accounts, the results may be taken up as taxable income or loss when the contract is closed out, whereas most commercial users take them up on a current basis. This is the official position, even though cash may change hands on a daily basis and no one who is involved in the operation acknowledges an accrual of values due him except in the form of a credit balance with the broker. This balance may be drawn down on demand with no strings attached, so long as it does not drop below the level of the good-faith margin requirement which is a constant amount per contract set up when the contract is opened and released when it is closed.

On long speculative contracts the final results are treated for tax purposes as long- or short-term capital gains or losses, depending on how long the particular contract position remained open. This situation seems anomalous in view of the fact that profits may have been realized and spent from day to day and no additional settlement is made (other than release of the required margin) when the position is terminated.

In view of these facts relating to long contracts, it appears that the long contract, even though it may be defined as "property" or "capital asset,"[10] must *a fortiori* be regarded as having a zero value at any given time. All accruals become cash values divorced from the contract, while the contract itself can be liquidated at any time without any cash settlement (other than release of the required reserve or margin).

[7] See U.S. Internal Revenue Code 1. 1233-1(b) and 1. 1233-1(d. 2).

[8] In some cases the accounting adjustment of both the inventory price and the matching futures contracts are deferred until the goods are sold and the hedge is closed. The income effects are still substantially the same since the two sides of the hedge compensate each other.

[9] See *Corn Products Refining Co. v. Commissioner of Internal Revenue*, 1958, U.S. Supreme Court decision.

[10] It should be remembered that a short-sale contract is denied the status of "property" or "capital asset," since it is apparently interpreted as selling something you do not have.

EXHIBIT II

TAX TREATMENT OF COMMODITY FUTURES CONTRACT RESULTS

Open Contracts	Closed Contracts
I	
Speculator Gains on Long Positions	
Results are capital gains; they must be deferred till contract is closed. They may not be accrued to reflect current market, even though cash in margin account is withdrawn and spent.	Results may qualify as long-term capital gains if the particular contract is held for the prescribed length of time. Certain switching operations are permitted without breaking continuity of holding.
II	
Speculator Losses on Long Positions	
These are capital losses; they must be deferred, even though cash must be paid out as prices fall.	Must be regarded as capital losses, not as current operating expense.

Note on I and II: Long contracts are legally regarded as "property," or "capital assets." However, see comment in text.

III	
Speculator Gains or Losses on Short Positions	
Outcome must be deferred until contract is disposed of.	Must be regarded as short-term (non-property) income or loss realized at date of closing a contract commitment. It may not be accrued on a current basis.

Note on III: Short futures contracts are not legally regarded as "property," but the cancellation of the speculative short position is interpreted as requiring the acquisition momentarily of a long contract which <u>is</u> "property" and hence can generate only an instantaneous (short-term) capital gain or loss.

IV	
Gains and Losses from Futures Contracts Qualified as Hedging	
Contract results normally kept on current market basis. Many methods of handling through the books, including (a) variance accounts, (b) reserve adjustments, (c) posting to raw material costs, or (d) entering as cost of goods sold.	Must be taken up on closed contracts, if not already covered earlier.

Note on IV: Hedging is regarded as an adjustment to inventory or cost of goods sold. It is thus a current operating expense or credit.

Moreover, in cases where the contract is terminated in actual delivery, it is settled by a cash transaction at the current futures market settlement price (assuming par-delivery specifications are met) rather than at the original contracted price, whether the market is higher or lower. All interim price changes will already have been absorbed in the transfers of clearing house and brokers' balances. The clearing house (as distinct from the broker or clearing member) need not know nor care at what price the futures commitment was entered.

This interpretation would imply that speculative capital gains or losses from the price impacts upon long commodity futures contracts should be regarded as realized on a current day-to-day basis, not as deferred capital gains or losses. At the same time we do not attempt to define the tax status of the margin account itself, the "receivable from broker" item. If this is a capital asset account in which capital gains and losses accumulate over long periods before a "realization" occurs, there may still be a basis for claiming long-term capital gains treatment, but it would appear difficult to associate such "realizations" with the specific entering or liquidating of a particular commodity futures contract.

A futures contract differs from a stock or bond in that no evidence of title is passed, and no specific value inheres to the contract beyond the daily settlement adjustments. No security is borrowed to effect a delivery as in a short sale of a stock. A futures contract, long or short, is not a pledgeable asset; a deficiency in the broker's or clearing account has to be settled at once in cash, while a favorable accrual is available as cash, not merely as a trial-balance credit.[11]

In contrast to the long position, the short speculative contract enjoys only short-term capital gains treatment, no matter how long the short-sale commitment has been in effect. However, the fact that gains or losses from such transactions (under present tax rules) are accrued until the contract is closed or repurchased has the effect of permitting the deferral of incomes or losses, pending liquidation, despite the actual practice of daily settlements.[12]

The net outcome of our examination suggests that commodity futures contracts are current items which are in fact maintained at a net value of zero through a continuous cash settlement process. They are not the same thing as buying and holding a tangible asset which ties up resources over a period of time and can yield a gain or loss only when it is liquidated.[13]

[11] "One of the most important concepts of the Clearing Corporation system is daily settlement in cash for all price variations in every commodity traded on the Board of Trade. The Clearing Corporation pays out cash daily to those Clearing Members having a net gain due to favorable price movements during the previous trading day. At the same time, the Clearing Corporation requires immediate payment from those Members having a net loss as the result of the same price movements." (See *5*.)

[12] A speculator with capital gains from other sources may use this deferral provision to shift such income from one year to the next on a relatively riskless basis. In October he may open a "spread" transaction (e.g., long April and short June). Then, whichever direction the futures price swings he can, before his tax year ends, liquidate the side which shows a loss, replacing it with a different delivery month (*7*).

[13] One of the leading commodity brokerage houses (Hayden Stone) in its "Commodity Commentary" for February 2, 1970 includes the following statement in citing some of the advantages of speculating in commodities as compared with stocks: "There is no interest charged on debit balances used to buy or sell commodity futures. This is true because commodity futures don't yet exist and the margin put up is simply a performance deposit, not a partial payment against a purchase or sale total price."

The Chicago Board of Trade monograph affirms the same position in its statement "Commodity margins do not represent 'down payments' for goods received and should not be confused with margins required of buyers of securities" (*5*).

What would be involved if the interpretation we are exploring were to be adopted? Essentially the "capital asset" or "property" classification of the long contract itself might or might not be retained, but if so, all gains or losses would be considered as realized on a current day-to-day basis, which is what actually happens. Similarly the short contract, assuming it continues to be denied the status of "capital asset" or "property," would be regarded as generating day-to-day (not deferrable) ordinary income or losses. In either long or short speculative operations, of course, these daily income adjustments could readily be accumulated between accounting or fiscal closing dates without detailing each daily increment.

For the commercial use of commodity futures in conjunction with a business, the treatment of all results as ordinary income or loss would require no change except that the logic of the present interpretation would make it mandatory without exception to record all price changes affecting open contracts on a current accrual basis, rather than to permit the (apparently occasional) practice of not taking up results until the contracts are closed.

It should be recognized that the questions and suggestions presented here would have the effect of moving the essential focus of commodity futures operations in the direction of current adjustments to current market factors and less toward the use of the futures markets for securing favored tax treatment. Nevertheless, the extremely high leverage that is characteristic of futures trading should cause little doubt that commodity markets would remain a highly attractive vehicle for speculators.

We have been discussing the nature of income and losses generated by the operating of the commodity futures market. These gains and losses can be thought of as self-contained results so far as speculators are concerned. For the commercial business, however, the futures contracts are, almost by definition, an instrument used in conjunction with other business activities including buying, selling, inventory and other trade commitments. Once the immediate nature of the outcome of commodity futures operations has been defined, the more involved problems of incorporating these results into the commercial accounting system of the firm must still be resolved. As with many other accounting procedures the answer must be found in light of the unique needs of the industry or the individual firm, and a considerable variety of specific applications can be expected.

CITATIONS

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