2 T.C. 597 (1943)

Unrealized profits from open futures contracts on a commodity exchange cannot be used to offset unrealized losses reflected in inventory valued at cost or market, whichever is lower.

Summary

H. Elkan & Co., a hide dealer, sought to exclude unrealized profits from open futures contracts from its 1937 income, arguing that its consistent accounting method of valuing inventory at cost or market, whichever is lower, should prevail. The Commissioner of Internal Revenue argued that these unrealized profits should offset unrealized inventory losses. The Tax Court ruled in favor of the taxpayer, holding that unrealized profits are generally not taxable and that the Commissioner's attempt to treat futures contracts as current inventory conflicted with established accounting practices. The court also noted that the Commissioner selectively considered only profitable futures contracts, ignoring losses.

Facts

H. Elkan & Co. dealt in hides and skins, buying from producers and selling to tanners. The company maintained a physical inventory of hides. It was a member of the Commodity Exchange, Inc., buying and selling contracts for future delivery of hides. These futures contracts were sometimes used to ensure an adequate inventory or to protect against market declines, but they were not specifically linked to particular hides in the company's inventory. The company also engaged in futures trading for profit. At the end of 1937, the company had sold 73 March contracts and 22 September contracts for future delivery of hides, and purchased 54 June contracts. Because of a decline in hide prices, these contracts reflected an overall unrealized profit. The company valued its physical inventory at cost or market, whichever was lower.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in H. Elkan & Co.'s income and excess profits taxes for 1937, arguing that unrealized gains on open short sales contracts should be included in income to offset unrealized inventory losses. H. Elkan & Co. petitioned the Tax Court for a redetermination of the deficiencies.

Issue(s)

Whether the Commissioner can include unrealized profits from open futures contracts in a taxpayer's income for 1937 to offset unrealized losses on physical inventory, where the taxpayer consistently valued its inventory at cost or market, whichever is lower.

Holding

No, because unrealized profits are generally not taxable, and the Commissioner's attempt to treat futures contracts as current inventory conflicted with established accounting practices and the taxpayer's consistent method of valuing inventory.

Court's Reasoning

The court stated the general rule that appreciation in value, or unrealized profit, is not taxable until realized, citing *Eisner v. Macomber*, 252 U.S. 189. The court acknowledged that Section 22(c) of the Revenue Act of 1936 allows the use of inventories in determining income but requires that the basis for taking inventories be as prescribed by the Commissioner. However, the court found that the Commissioner's attempt to include unrealized profits from futures contracts as an offset to inventory losses was inconsistent with the taxpayer's established method of valuing inventory at cost or market, whichever is lower. The court found that this treatment of futures contracts as current inventory conflicted with Treasury Regulations requiring that only merchandise to which the taxpayer has title can be included in inventory. The court also noted the inconsistent application of the Commissioner's method as it considered only profitable futures contracts and did not account for contracts where the market had moved against the taxpayer. The court distinguished this case from rulings involving cotton and grain dealers, where the consistent accounting practice was to value all elements, including futures contracts, at market value.

Practical Implications

This case reinforces the principle that unrealized gains are not generally taxable and that taxpayers are entitled to consistently apply accepted accounting methods. It clarifies that the Commissioner's authority to prescribe inventory methods under Section 22(c) is not unlimited and cannot be used to force taxpayers to recognize income prematurely. The case highlights the importance of consistent accounting practices and the limitations on the Commissioner's ability to retroactively change those practices. Later cases would cite Elkan for the proposition that the tax court must consider the method of accounting regularly employed and if the method employed does not clearly reflect income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income.