Modesto Dry Yard, Inc. v. Commissioner, 14 T.C. 374 (1950)

Losses from the sale of futures contracts for commodities, held for more than six months and not includible in inventory, constitute losses from the sale of capital assets and are excludable when computing excess profits net income under Section 711(b)(1)(B) of the Internal Revenue Code.

Summary

Modesto Dry Yard, Inc. sought to exclude a 1938 loss from its excess profits net income calculation for the base period, arguing the loss stemmed from the sale of capital assets (futures contracts for raisins) held for more than six months. The Tax Court agreed with the petitioner, finding that the contracts were indeed capital assets, not inventory, and had been held for the requisite period. Therefore, the loss was excludable under Section 711(b)(1)(B), resulting in a more favorable excess profits credit for the taxpayer.

Facts

Modesto Dry Yard, Inc. bought fresh fruits from farmers, dried them, and sold them unpacked to packers. In early 1937, the petitioner purchased, as a speculation, futures contracts for dried apricots and raisins from a broker named Gomperts. The contracts were for delivery in late 1937. The petitioner sold most of these contracts in late 1937, but 10,000 boxes of Thompson natural seedless raisins were sold in 1938, resulting in a loss of $3,689.92. The petitioner never took physical delivery of the raisins; the transactions involved only the rights to receive the raisins.

Procedural History

The Commissioner determined a deficiency in the petitioner’s excess profits tax. Modesto Dry Yard, Inc. petitioned the Tax Court for a redetermination of the deficiency, arguing that the 1938 loss should be excluded from the computation of excess profits net income. The Tax Court ruled in favor of the petitioner.

Issue(s)

1. Whether the loss sustained by Modesto Dry Yard, Inc. in 1938 from the sale of raisin futures contracts constituted a loss from the sale of capital assets under Section 117(a)(1) of the Revenue Act of 1938.
2. Whether the contracts were held for more than six months as required by Section 711(b)(1)(B) of the Internal Revenue Code.

Holding

1. Yes, because the contracts were not stock in trade, inventory, or property held primarily for sale to customers.
2. Yes, because the contracts were entered into in May 1937 and disposed of in

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June 1938, thus satisfying the holding period requirement.

Court’s Reasoning

The Tax Court reasoned that the raisin futures contracts did not fall within any of the exceptions to the definition of capital assets under Section 117(a)(1) of the Revenue Act of 1938. The court emphasized that the petitioner was dealing in contracts for commodities, not the commodities themselves. The contracts were not includible in inventory because title to the raisins had not passed to the petitioner; the petitioner only had the right to receive the raisins. The court cited *Commissioner v. Covington*, 120 F.2d 768, stating that “transactions in commodity futures are commonly spoken of as purchases and sales of a specific commodity… but the traders really acquire rights to the specific commodity rather than the commodity itself. These rights are intangible property which may appreciate or depreciate in value. They are capital assets held by the taxpayer.” Since the contracts were acquired in May 1937 and sold in June 1938, the holding period requirement of more than six months was met. Therefore, the loss was excludable when calculating excess profits net income.

Practical Implications

This case clarifies the treatment of commodity futures contracts for excess profits tax purposes. It establishes that losses from the sale of such contracts, if held for more than six months and not part of inventory, are considered capital losses and can be excluded from the computation of excess profits net income, potentially resulting in a lower tax liability. This ruling is relevant to businesses that engage in speculative trading of commodity futures and need to accurately calculate their excess profits credit. The key takeaway is the distinction between dealing in the actual commodity and dealing in the rights to receive the commodity, with the latter being treated as a capital asset. Later cases would distinguish this ruling based on whether the taxpayer was a hedger, in which case the futures contracts would be more closely tied to inventory.

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