STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petition	:	
of	:	
PETER H. HEMMERS	:	DETERMINATION
for Redetermination of a Deficiency or for	:	
Refund of Personal Income Tax under Article 22		
of the Tax Law for the Year 1975.	:	

Petitioner, Peter H. Hemmers, 1227 Garden Street, Hoboken, New Jersey 07306, filed a petition for redetermination of a deficiency or for refund of personal income tax under Article 22 of the Tax Law for the year 1975 (File No. 800242).

A hearing was held before Nigel G. Wright, Administrative Law Judge, at the offices of the Division of Tax Appeals, Two World Trade Center, New York, New York, on June 22, 1988 at 9:15 A.M. Petitioner appeared by William A. DeLorenzo, Esq. The Division of Taxation appeared by William F. Collins, Esq. (Michael Gitter, Esq., of counsel).

ISSUES

I. Whether losses claimed from trading in commodities futures prior to 1982 may be deducted under the special provisions of section 108 of the Tax Reform Act of 1984 as amended by section 1808(d) of the Tax Reform Act of 1986 (see Appendix 1) as losses incurred in a trade or business or losses incurred in any transaction entered into for profit, or whether, in fact, such losses were fictitious and a sham.

II. Whether a deficiency resulting from a denial of the deduction of losses in 1975 from trading in commodities may be offset by an overpayment in 1976 which is also from trading in commodities, even though a refund claim has not been filed and such claim would now be time-barred.

III. Whether penalties can be imposed for negligence under Tax Law § 685(b) and for the failure to pay tax required to be shown on a return under Tax Law § 685(a)(3).

FINDINGS OF FACT

1. Petitioner, Peter H. Hemmers, during 1975, resided with his wife at 460 State Street, Long Beach, Nassau County, New York.

2. Petitioner, with his wife, filed a 1975 New York income tax return on April 15, 1976. He filed, again with his wife, an amended return on November 11, 1976.

3. Petitioner filed a series of consents fixing the limitation period upon assessment for 1975 at April 15, 1982.

4. (a) A Notice of Deficiency was issued to petitioner on April 7, 1982 for tax of $33,098.36, plus a penalty for fraud under Tax Law § 685(e) of $16,549.18 and interest of $17,908.20, for a total amount due of $67,555.74.

(b) The deficiency is based on the Audit Division's disallowance of claimed short-term capital losses of $237,800.00 from crude oil transactions. Petitioner reported short-term losses of $23,451.05 on schedule D of his 1975 Federal return. The disallowance resulted in a short-term gain of $214,348.95.

(c) In its answer to the petition in this case, the Division of Taxation asserted as an alternative to the fraud penalty a negligence penalty under Tax Law § 685(b).

(d) At the hearing, the Division of Taxation withdrew the fraud penalty, continued to assert the negligence penalty and, for the first time, asserted a penalty for failure to pay tax required to be shown on a return under Tax Law § 685(a)(3).

5. Petitioner is a broker and a member of the New York Coffee and Sugar Exchange. He lists his business address as his home in Long Beach. He also had an office at 70 Pine Street, Manhattan. He traded in coffee and sugar through his own office. Petitioner also traded in platinum, potatoes, wheat and crude oil. In all, he engaged in over 2,000 transactions through various brokers during the audit period.

6. Petitioner traded in the crude oil market maintained by the "Petroleum Associates" of the New York Cotton Exchange through a registered broker named Genora Commodities, Inc. That firm was owned by Richard Esposito and Norman Sirota.

7. A future or forward contract is simply a present agreement to purchase or sell a commodity at a specified future date at a specified price. Each contract is between the holder, or "writer", of the contract and the commodity exchange. The price set in such a contract will reflect the price of the commodity and also the present interest rate and any carrying charges on the commodity. Naturally where the commodity is subject to large price variations, the contract also will be subject to large price variations thus entailing large risk. A "straddle" is a combination of a sale contract and a purchase contract undertaken at the same time. In this case, the sale and purchase would differ in their delivery dates so that a straddle would typically result in a present agreement to purchase (or sell) a commodity at a future date and to sell (or purchase) the same commodity at a later date. As the prices of the commodity and of the contracts change, they will, of course, cause a gain or loss in any contract position. But as the positions of the straddle are both a buy and a sell, any gain or loss in one of the positions will be offset by an opposite change, hopefully equal, in the other position. The offsetting positions of the straddle reduce risk to a minimum. During the time before the first delivery date, any change in risks of the two positions would be reflected equally in the prices of both the future sale and future purchase so that there would theoretically be no change in the net risk. One factor that would cause a change in the risk of the two contracts would be changes in short-term and long-term interest rates so that small changes in the "differential" between the contract prices of the positions might occur. The opposite gain and loss positions of a straddle can be disposed of separately and at different times so that the gain or loss can be reflected in a tax return in different years. When one position is disposed of separately, a straddle can be maintained, and risk remains at a minimum, by the simultaneous acquisition of a position of the same character which extends to a later time. Usually the taxpayer disposes of a loss position in an early year when he can offset it against other income and disposes of the gain position in a later year so as to defer tax as much as possible.

8. (a) Genora Commodities, Inc., petitioner's broker, executed its trades in petroleum through a broker, Mr. Joseph R. Hamilton, who was a specialist in crude oil at the Cotton

Exchange.

(b) Mr. Hamilton, testifying by deposition and under immunity from prosecution (granted by the New York County District Attorney's Office), stated that of the 30,000 contracts traded on the Cotton Exchange between December 1974 and January 1976, he was involved in all except about 5 or 10 and that the ones he was involved in were all "prearranged". "Prearranged" means the fixing of prices at other than market value. Some of these prearranged trades were for tax purposes, some were "money transfers" and others were "80/20" trades. (The meaning of "money" trades and "80/20" trades has not been explained by the parties.) As part of his activities in prearranging trades, Mr. Hamilton, in late 1974, met with Mr. Sirota, Mr. Esposito and others of Genora Commodities at their office. Mr. Hamilton agreed with the principals of Genora that he would "engineer" buys and sells of straddles for some people he knew and for others he did not know.

(c) Mr. Hemmers and Mr. Hamilton never at any time knew each other or met each other. At all times Mr. Hemmers has cooperated with authorities in the investigation of commodity matters.

9. Between December 1974 and January 1976, petitioner engaged in 200 pairs of contracts (straddles) buying or selling with each contract 5,000 barrels of light Arabian crude oil for future delivery to Rotterdam, Holland at an average cost of more than $500,000.00 on each of the 400 contracts. He was "at risk" for $11,326,500.00 on the "buy" side and $11,306,000.00 on the "sell" side, and incurred $4,700.00 in commissions. These transactions resulted in a loss in 1975 of $235,000.00 ($237,600.00 after commissions) and a gain in 1976 of $214,500.00 ($212,400.00 after commissions). (The figure of $237,600.00 representing petitioner's losses as found here differs from the figure of $237,800.00 representing disallowed losses as found in paragraph 2. The parties have not explained this difference.) A schedule of these transactions is appended to this determination (see Appendix 2).

10. Mr. Hemmers's 1976 return, filed with his wife, reports his Federal figure for income from capital gains as $117,720.00 and total income after adjustments as $115,350.00. A

minimum tax was computed on a capital gain of $105,000.00.

11. Mr. Hemmers's purpose in trading was to make a profit. While petitioner was aware that the price differential between the contracts with different delivery dates remained the same, he believed this might have been due to inactivity in the market. He did not suspect the manipulation of prices.

CONCLUSIONS OF LAW

A. (1) The controlling law, at least initially, for losses from straddle transactions entered into before 1982 is the special provision of section 108 of the Tax Reform Act of 1984 (PL 98-369), as amended by section 1808(d) of the Tax Reform Act of 1986 (PL 99-514) (see Appendix 1). That provides that any loss from the disposition of any position in a straddle shall be allowed if incurred in a trade or business or in a transaction entered into for profit. Furthermore, any loss incurred by a dealer is deemed to be in a trade or business. Mr. Hemmers is considered a dealer within this provision despite the fact that he is a dealer only in commodities other than the oil futures which he traded (HR Rep No. 426, 99th Cong, 2d Sess 911, reprinted in 1986-3 C.B. 911; HR Rep No. 841, 99th Cong 2d Sess II-845, reprinted in 1986 US Code Cong & Admin News 4933; King v. Commr., 87 TC 1213, 1219). However, even where a dealer is involved, the presumption of section 108(b) will not be available in cases "where the trades were fictitious, prearranged, or otherwise in violation of the rules of the exchange..." (HR Rep No. 426, 99th Cong 2d Sess 911, reprinted in 1986-3 C.B. 911; Cook v. Commr., 90 TC 975).

(2) The trades in a straddle case are "fictitious, prearranged or otherwise in violation of the rules of the exchange" and thus the losses from such trades are not deductible (DeMartino v. Commissioner, 51 TCM 1278). The DeMartino case, like the instant case, involved crude oil futures on the New York Cotton Exchange. The contracts involved had delivery months of June 1977, December 1977 and March 1978. The straddles traded were for June - December and December - March. The trading occurred from September 1975 through January 1976. During this time, while the prices of each contract varied by as much as 20 percent, the "differentials" of the prices between any two contracts remained the same on each

day the straddles existed, except for one day. The court determined from the testimony of participants, including Joseph R. Hamilton, and from other evidence, that the prices of the contracts sold were "prearranged" in that these prices were not free market prices but were chosen by the parties for their own convenience. The parties were, it concluded, "creating" the market itself and did not engage in bona fide transactions. In upholding the deficiency against a petitioner who claimed he had been ignorant of these defects in the market, the court quoted from a case, Lynch v. Commissioner (273 F2d 867), which said that only objective realities and not subjective intent were important. That case, disallowing an interest deduction, had held that the parties "did not in fact produce the transactions [debt] which they simulated" (id__. at 871). The court in DeMartino apparently assumes that the "prearrangement" of the prices by dealers entails the unenforcability of the contracts between the customer and the exchange under local law. Brown v. Commissioner (85 TC 968) involved "Ginnie Mae" and "Freddie Mac" contracts. The court in Brown stated, "We conclude, therefore, that the losses claimed by petitioners are not allowable because the disputed transactions constituted factual shams...." (Id__. at 1000.) In the instant case, the straddles in question must also be held to be "sham" because of the nature of the crude oil market operations. The testimony of Mr. Hamilton, who was involved in all but a few trades, that all prices were prearranged must be given great weight. Petitioner did nothing to rebut this testimony. The Division of Taxation, therefore, properly disallowed, as sham, the 1975 straddle losses.

B. (1) Even though a deficiency may be due because of the denial of losses claimed in 1975, this deficiency may be offset by a refund of an overpayment in 1976 caused by the related gains arising from these straddles even though no refund claim was filed for that year and such a claim would now be time-barred. This can be done under the doctrine of equitable recoupment as recognized by both the New York State courts (Matter of National Cash Register Co. v. Joseph, 299 NY 200) and the Federal courts (Bull v. United States, 295 US 247). Under Federal practice, a claim of recoupment can be made at the audit level (Rev Rul 71-56, 1971-1 C.B. 404, 405) and as a defense to a collection suit (United States v. Lease, 1963-2 U.S. Tax Cas.

¶ 9503). There is clearly an overpayment of tax in 1976 which is now time barred and which is available for a claim of recoupment. This overpayment is due to the payment by petitioner of tax in 1976 on the profits of the sale of straddles. Insofar as the straddle transactions were "factual shams" or "fictitious" in the loss year, then the gains they produced in the next year were equally fictitious (Price v. Commissioner, 88 TC 860; Smith v. Commissioner, 78 TC 350, 384, 26). The losses disallowed in 1975 are obviously from the same transaction as the profits erroneously reported in 1976. Since petitioner had to have at all times offsetting sale and purchase contracts so as to reduce his risk to a minimum, it was essential that when petitioner sold a contract at whatever price, prearranged or not, that he buy a position in the same commodity but with a later delivery date. Naturally, the prices of the sale and of the purchase would be closely related and, in fact, from an inspection of petitioner's purchases and sales (see Appendix 2), the prices of the transactions on any single day were closely related. The proof, therefore, that the price of a sale was prearranged or fixed must also prove that the price of the accompanying purchase was also prearranged or fixed. If that price was too low so that the sale was at a loss (in 1975), then the same, or closely related, price on the purchase would be too low so as to produce more of a gain when that position was later sold (in 1976). It appears that as a matter of fact the Internal Revenue Service, when it disallows a straddle loss in one year, will cancel the related gain in another year (see___ Katz v. Commissioner, 90 TC ___ No. 75; Lasker v. Bear, Stearns & Co., 757 F2d 15, 17).

(2) Unfortunately, the doctrine of recoupment cannot be allowed by the Division of Tax Appeals or the Tax Appeals Tribunal in a personal income tax case. This is because the recoupment would require a determination of an overpayment for a year not otherwise in issue, in this case 1976. Such a determination would be prohibited by Tax Law § 685(g). Tax Law § 685(g) provides explicitly that there is "no jurisdiction to determine whether or not the tax for any other year has been overpaid or underpaid". This language was patterned after section 6214(b) of the Internal Revenue Code and was placed in the Tax Law by Laws of 1962, Chapter 1011, to establish conformity between New York and Federal tax procedures (see, Governor's

memo, 1962 Legislative Annual, 402, 406). Thus, the doctrine of recoupment cannot be asserted in a deficiency case since those cases are brought in this forum (nor can it be asserted in a refund case since, unlike the Federal procedure, refund cases are also brought in this forum). Whether the doctrine could be asserted at other times where it would be available on the Federal level would depend on the decisions of the New York courts (see___, 58 NY Jur, Taxation § 74). In any event, because of Federal conformity relief based on recoupment cannot be granted at this time.

C. (1) The negligence penalty under Tax Law § 685(b) must be cancelled. In a similar case, DeMartino v. Commissioner (51 TCM 1278), the court stated that this issue depended on the state of petitioner's knowledge, and finding such knowledge it upheld the penalty. In this case, the issue was raised for the first time after the deficiency notice was issued. The burden of proof is on the Division of Taxation (Tax Law § 689[e][3]). Here, there is no direct evidence that this petitioner knew of any "prearrangement" of the prices of the straddles. Petitioner denies such knowledge. In fact, the Division of Taxation insists, for purposes of the deficiency itself, that such knowledge is not necessary and it made no different or additional argument with respect to the penalty. There is of course no question that the deduction of straddle losses, absent any such prearrangement, have traditionally been deductible (see___ United States v. Winograd, 686 F2d 279, 281). It was not until 1977 that such losses were first denied (see___ Rev Rul 77-185, 1977-1 C.B. 48).

(2) The penalty asserted for failure to pay taxes required to be shown on a return under Tax Law § 685(a)(3) must be cancelled. The penalty cannot be imposed if the failure to include the income is due to reasonable cause and not due to willful neglect. As stated above, the burden would be on the Division of Taxation to show that petitioner was not ignorant of the price rigging in this case. It has not done so. Absent such knowledge, the petitioner had every reason to take his losses.

D. The petition herein is granted. The deficiency in issue is redetermined to allow a reduction for the amount of tax paid in 1976 due to the inclusion in 1976 income of the gains from the straddle sales. The penalties are cancelled.

DATED: Albany, New York

ADMINISTRATIVE LAW JUDGE

APPENDIX 1

Tax Reform Act of 1984 (PL 98-369) section 108
as amended by
Tax Reform Act of 1986 (PL 99-514) section 1808(d)

SEC. 108. TREATMENT OF CERTAIN LOSSES ON STRADDLES ENTERED INTO BEFORE EFFECTIVE DATE OF ECONOMIC RECOVERY TAX ACT OF 1981.

(a) GENERAL RULE--For purposes of the Internal Revenue Code of 1954, in the case of any disposition of 1 or more positions--

(1) which were entered into before 1982 and form part of a straddle, and

(2) to which the amendments made by title V of the Economic Recovery Tax Act of 1981 do not apply, any loss from such disposition shall be allowed for the taxable year of the disposition "if such loss is incurred in a trade or business, or if such loss is incurred in a transaction entered into for profit though not connected with a trade or business"

(b) LOSS INCURRED IN A TRADE OR BUSINESS--For purposes of subsection (a), any loss incurred by a commodities dealer in the trading of commodities shall be treated as a loss incurred in a trade or business.

(c) NET LOSS ALLOWED--If any loss with respect to a position described in paragraphs (1) and (2) of subsection (a) is not allowable as a deduction (after applying subsections [a] and [b]), such loss shall be allowed in determining the gain or loss from dispositions of other positions in the straddle to the extent required to accurately reflect the taxpayer's net gain or loss from all positions in such straddle.

(d) OTHER RULES--Except as otherwise provided in subsections (a) and (c) and in sections 1233 and 1234 of such Code, the determination of whether there is recognized gain or loss with respect to a position, and the amount and timing of such gain or loss, and the treatment of such gain or loss as long-term or short-term shall be made without regard to whether such position constitutes part of a straddle.

(e) STRADDLE--For purposes of this section, the term "straddle" has the meaning given to such term by section 1092(c) of the Internal Revenue Code of 1954 as in effect on the day after the date of the enactment of the Economic Recovery Tax Act of 1981, and shall include a straddle all the positions of which are regulated futures contracts.

(f) COMMODITIES DEALER--For purposes of this section, the term 'commodities dealer' means any taxpayer who--

(1) at any time before January 1, 1982, was an individual described in section 1402(i)(2)(B) of the Internal Revenue Code of 1954 (as added by this subtitle) or

(2) was a member of the family (within the meaning of section 704(e)(3) of such Code) of an individual described paragraph (1) to the extent such member engaged in commodities trading through an organization the members of which consisted solely of--

(A) 1 or more individuals described in paragraph (1) and

(B) 1 or more members of the families (as so defined) of such individuals.

(g) REGULATED FUTURES CONTRACTS--For purposes of this section, the term "regulated future contracts" has the meaning given to such term by section 1256(b) of the Internal Revenue Code of 1954 (as in effect before the date of enactment of this Act).

(h) SYNDICATES--For purposes of this section, any loss incurred by a person (other than a commodities dealer) with respect to an interest in a syndicate (within the meaning of section 1256(e)(3)(B) of the Internal Revenue Code of 1954) shall not be considered to be a loss incurred in a trade or business.

APPENDIX 2

DATE	REF.	BOUGHT	SOLD	PRICE	PURCHASE VALUE	SELLING VALUE	GAIN/LOSS	COMMISSION	NET GAIN/LOSS
Dec. 16, 1974	(F)	10 Mch. (76)		9,590	479,500				
	(A)		10 Sept. (76)	9,480		474,000			
Year 1974 Total							0	0	0
Jan. 2, 1975	(A)	10 Sept. (76)		10,920	546,000		(72,000)	500	(72,500)
	(B)		10 June (76)	10,920		546,000			
Jan. 7, 1975	(C)	50 Dec. (76)		11,270	2,817,500				
	(G)		40 Sept. (76)	11,340		2,268,000			
	(D)		10 Sept. (76)	11,340		567,000			
Jan. 10, 1975	(B)	10 June (76)		10,595	529,750		16,250	500	15,750
	(G)		10 Sept. (76)	10,535		526,750			
	(H)	50 June (76)		10,595	2,648,750				
	(C)		50 Dec. (76)	10,455		2,613,750	(203,750)	1,300	(205,050)
Jan. 14, 1975	(D)	10 Sept. (76)		10,850	542,500		24,500	300	24,200
	(E)		10 Dec. (76)	10,790		539,500			
Year 1975 Total							(235,000)	2,600	(237,600)
Jan. 15, 1976	(E)	3 Dec. (76)		12,500	187,500				
	(E)	7 Dec. (76)		12,500	437,500		(85,500)	300	(85,800)
	(F)		10 Mch. (76)	12,620		631,000	151,500 (LT)	300	151,200
	(G)	25 Sept. (76)		12,540	1,567,500				
	(G)	25 Sept. (76)		12,560	1,570,000		(342,750)	750	(343,500)
	(H)		25 June (76)	12,560		1,570,000			
	(H)		25 June (76)	12,560		1,570,000	491,250 (LT)	750	490,500
Year 1976 Total							214,500 (LT)	2,100	212,400
Audit Period		200 contracts	200 contracts		11,326,500	11,306,000	(20,500)	4,700	(25,200)