STATE OF NEW YORK

TAX APPEALS TRIBUNAL

In the Matter of the Petition	:	
of	:	
PETER H. HEMMERS	:	DECISION
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 an exception to the determination of the Administrative Law Judge issued on June 22, 1989 with respect to his 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). Petitioner appeared by William A. DeLorenzo, Esq. The Division of Taxation appeared by William F. Collins, Esq. (Michael Gitter, Esq., of counsel).

Both parties filed briefs on exception.

After reviewing the entire record in this matter, the Tax Appeals Tribunal renders the following decision.

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 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 and thus not allowed.

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.

FINDINGS OF FACT

We find the facts as determined by the Administrative Law Judge except that we modify finding of fact "8(b)". Such facts are set forth below.

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

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.

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

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.

The deficiency is based on the 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.

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).

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).

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.

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.

A future or forward contract is 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. 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.

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.

We modify finding of fact "8(b)" to read as follows:

> 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. Mr. Hamilton prearranged all of the trades involving Genora.[1]

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.

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 ($237,800.00 after commissions) and a gain in 1976 of $214,500.00 ($212,400.00 after commissions). A schedule of these transactions is appended to this decision (see Appendix 2).

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[1] We modified the Administrative Law Judge's finding of fact "8(b)" by adding the last sentence to accurately and completely present Mr. Hamilton's testimony concerning his relationship with Genora and that all their trades were prearranged.

Mr. Hemmers' 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.

Mr. Hemmers' 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.

OPINION

The Administrative Law Judge, relying principally on the Tax Court decision in DeMartino v. Commr. (TC Memo 1986-263, 51 TCM 1278; affd 862 F2d 400 [2d Cir 1988]; 88-2 USTC ¶9608) and the unrebutted testimony of Joseph R. Hamilton that all prices were pre-arranged, determined that (1) the losses claimed by petitioner from trading of crude oil futures contracts in 1975 could not be allowed because the transactions in question were a "sham"; (2) the doctrine of equitable recoupment was not applicable in this case and that petitioner was not entitled to a refund for any overpayments of taxes in 1976 because the petitioner did not timely file an application for such refund; and (3) the negligence penalty asserted under Tax Law section 685(b) must be cancelled.

The petitioner, on exception, reasserts his position at hearing, i.e., that he entered these transactions for the purpose of making a profit, that the contracts in which he was involved were not prearranged, that the market was not controlled, and that he was not privy to or part of the alleged rigging of trading of crude oil futures contracts. For the same reasons petitioner also asserts that he is entitled to a refund for overpayments made in 1976 and that the doctrine of equitable recoupment is applicable.

The Division, on exception, relies on the determination of the Administrative Law Judge.

We affirm the determination of the Administrative Law Judge.

We deal first with the issue of whether the losses claimed by petitioner were incurred in "sham" transactions, and if so, whether such losses should be allowed.

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) is the statutory provision relating to the deductibility of losses from commodity straddles claimed for tax years prior to 1982.

Congress enacted section 108 to clarify the application of the general loss deduction rule of section 165 of the Internal Revenue Code to straddle transactions. It did so because of concern with the continuing "uncertainty" about, and litigation over, loss deductions for pre-1982 straddle trading (see, Dewees v. Commr., 870 F2d 21 [1st Cir 1989]; 89-1 USTC ¶9224, at 87,470).[2] The crux of the controversy so amply dealt with by the federal courts is the interaction of section 108 with the special tax doctrine called "sham" in substance. We find DeMartino v. Commr. (supra), coupled with the testimony of Joseph R. Hamilton in the instant case, dispositive on the issue of whether petitioner is entitled to claim losses from the trading of crude oil futures contracts.

In DeMartino the Court fully reviewed the facts and circumstances surrounding the trading of oil futures contracts at the New York Cotton Exchange (NYCE) for the period September 10, 1974 through July 2, 1976 and affirmed the Tax Court's determination that the transactions at issue were pre-arranged, contrived transactions conducted in a market rigged to produce tax losses and were a sham (DeMartino v. Commr., supra, 88-2 USTC ¶9608, at 85,929-85,930).[3]

Having concluded that the transactions were in fact sham transactions the court then concluded that section 108 was not applicable and disallowed the losses (DeMartino v. Commr.,

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[2]The extent of the federal litigation concerning straddle trading is noted in the concurring opinion of Circuit Court Judge Brown in Dewees v. Commr. (870 F2d 21 [1st Cir 1989]; 89-1 USTC ¶9224 at 87,476):

"This whole episode, [straddle litigation], although the outgrowth of over 1,000 cases consolidated by the Tax Court for trial and disposition, Glass v. Commissioner (CCH Dec. 43,495), 87 T.C. 1087 (1986), has now occupied the extended attention of six of the Courts of Apeals, resulting in seven decisions, all in favor of the Government."

[3]The Tax Court's determination that the transactions were a sham was based on the testimony of the participants, including Joseph R. Hamilton, and from other evidence.

supra, 88-2 USTC ¶9608, at 85,930). The circumstances and fundamental arguments asserted by petitioner herein are the same as those in DeMartino. Indeed, we have the unrebutted testimony of the same principal, Mr. Joseph R. Hamilton, that (a) he was involved in all but five or ten of the 30,000 crude oil futures contracts

traded on the Cotton Exchange betweeen December 1974 and January 1976, (b) that all such contracts were prearranged, and (c) that he prearranged all of the trades involving Genora Commodities, petitioner's broker. All of this leads us to conclude that the transactions so clearly lacked any significant possibility of profit (tax advantages aside) that the losses at issue were a "sham" and were properly disallowed by the Division. Petitioner's efforts to distinguish DeMartino on the grounds that he was not privy to and had nothing to do with market manipulation whereas in DeMartino there was direct testimony that the taxpayer met with and discussed with Mr. Hamilton "the use of crude oil futures straddles to produce artificial tax losses" (DeMartino v. Commr., supra, 88-2 USTC ¶9608, at 85,931) are not persuasive.

We find petitioner's "subjective intent" not relevant. Case law makes it clear that a taxpayer cannot deduct a "sham transaction" loss, irrespective of his subjective profit motive (see, Dewees v. Commr., supra; 89-1 USTC ¶9924, at 87,475).

We deal next with petitioner's assertion that he is entitled to a refund for overpayments made in 1976 and that the doctrine of equitable recoupment is applicable.

We affirm the determination of the Administrative Law Judge. First, it is clear that petitioner did not timely file an application for refund for the year 1976 and thus is not entitled to a refund for overpayments in such year. Second, Tax Law section 689(g) precludes the Tribunal and Division of Tax Appeals from determining that an overpayment was made for a year not otherwise in issue (1976) thus eliminating the application of the doctrine of equitable recoupment. Accordingly, we conclude petitioner is not entitled to a refund for overpayments made in 1976.[4]

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[4]The situation may be different at the federal level (see, DeWees v. Commr., supra; 89-1 USTC ¶9224 at 87,474 and 87,475) for a discussion concerning the application of the sham in substance doctrine in light of the "complete statutory framework" provided by sections 108(a), 108(b) and 108(c) which deal with straddles not entered for

Accordingly, it is ORDERED, ADJUDGED and DECREED that:

1. The exception of petitioner, Peter H. Hemmers, is denied;

2. The determination of the Administrative Law Judge is affirmed;

3. The petition of Peter H. Hemmers is granted to the extent provided in finding of fact "4(d)" and conclusion of law "C" of the Administrative Law Judge's determination but is otherwise denied; and

4. The Notice of Deficiency dated April 7, 1989 shall be modified in accordance with "3" above but is otherwise sustained.

DATED: Troy, New York
March 1, 1990

/s/John P. Dugan
John P. Dugan
President

/s/Francis R. Koenig
Francis R. Koenig
Commissioner

/s/Maria T. Jones
Maria T. Jones
Commissioner

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profit. In this case, however, neither petitioner nor the Division have introduced evidence concerning federal treatment for the years 1975 and 1976.

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.