Gains and Losses From Foreign Currency Hedges After Arkansas Best Corp. v. Commissioner

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ARKANSAS BEST CORP. v. COMMISSIONER

The economic growth of the United States is dependent upon the successful competition of its business enterprises in the global marketplace. Although foreign markets provide great opportunity, the turbulence of the foreign exchange markets is a significant drawback. Fluctuations in foreign currency exchange rates

1 See Comment, United States Regulation of Foreign Currency Futures and Options Trading: Hedging for Business Competitiveness, 8 NW. J. INT'L L. & BUS. 405, 405 (1987) [hereinafter Business Competitiveness]. This author notes that due to the export trade deficit experienced annually by this country, Congress has been encouraging United States businesses to compete with their foreign counterparts as a means of remedying the trade imbalance. Id. See also Aland, The Treasury Report on Tax Havens - A Response, 59 TAXES 993, 993 n.1 (1981) (showing growth of U.S. investment in foreign countries): Business Competitiveness, supra, at 415 n.72 (as of 1987 more enterprises were competing in the international marketplace than at any previous time).

2 See Leibowicz, Hedging in Foreign Currency: Capital or Ordinary?, 7 TAX ADVISER 477, 477 (1976). “Multinational corporations have, in recent years, been subjected to the distorting effects of increasingly volatile foreign exchange markets, and the currency fluctuations which attend them.” Id. See also Business Competitiveness, supra note 1, at 415-16. The author proffers several reasons for the volatility of the foreign exchange markets. Id. Chief among them are the rapid growth of international trade and the linking of international financial markets which together translate into a greater number of currency transactions. Id.
may result in a gain or loss in many varied circumstances. To lessen the impact of volatile foreign exchange markets, multinational corporations often enter into foreign currency forward contracts as a hedge. It is the tax treatment of the resulting gains and losses from these forward contracts which is the subject of this Article. It is submitted that recent case law, as well as an incomplete statutory scheme promulgated under the Tax Reform Act of 1986 ("1986 TRA"), have created uncertainty as to the characterization of gains and losses resulting from these contracts. This Article will begin with a discussion of the concept of a capital asset as defined in the Internal Revenue Code and as interpreted by case law, addressing primarily the cases of Corn Products Refining Co. v. Commissioner and Arkansas Best Corp. v. Commissioner. It

3 Peckron, Tax Consequences of Currency Futures After Hoover, 6 INT'L TAX J. 165, 165 (1980). Gain or loss could result when foreign currency receipts are translated into U.S. dollars or when profits or losses from a foreign subsidiary of a U.S. parent are translated for the parent's U.S. financial statements. Id. See Leibowitz, supra note 2, at 477. Gain or loss may be effected solely by the year to year changes in the conversion rate. Id. Notwithstanding the lack of U.S. tax consequences, "corporations are unwilling in many instances to risk distortion of their financial statements and the corresponding effect on their 'image' in the minds of the investment community." Id.

4 See Peckron, supra note 3, at 165-66. Foreign currency forward contracts are agreements between two parties to exchange foreign currency at a future date at an agreed upon rate. Id. One party to this type of transaction is usually an international bank. Leibowitz, supra note 2, at 477-78. See also Boles, Foreign Currency Problems of the Multinational Corporation, 11 INT'L TAX J. 205, 207 (1985) ("A forward exchange contract is simply an agreement to exchange one currency for another at a fixed exchange rate at some point in the future."); Henrey, Economic Tax Aspects of Foreign Exchange Futures Contracts, 31 N.Y.U. J. INT'L L. & POL. 445, 446 (1978) (a foreign currency forward contract "is merely an agreement whereby one party agrees to deliver a specified amount of currency to another party against a specified amount of another currency at a future date").

Several of the reasons a corporation enters into a foreign currency forward contract include: to hedge against a decrease in foreign currency when a payment is to be received in foreign currency; to hedge against an increase in foreign currency when a debt is to be repaid in foreign currency; to hedge against translation losses caused by fluctuating exchange rates, and for speculation. See Rolle & Doupnik, Tax Implications of Forward Exchange Contract Gains and Losses, 12 INT'L TAX J. 29, 30 (1986).

Boles gives the following illustration of a foreign currency forward contract entered into for the purpose of hedging against a devaluation in foreign currency:

[A] company generating a receivable for 1,000,000 pesos at a time when the exchange rate is 25 pesos to $1 U.S. might agree to sell 1,000,000 pesos for $40,000 U.S. with delivery to occur in six months. In the meantime, should the peso be devalued so that 100 pesos equals $1 U.S., the company had protected itself against a $30,000 U.S. loss on the transaction.

Boles, supra, at 207.


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is submitted that both of these cases are vital to an understanding of the tax consequences of gains and losses from foreign currency hedges. Finally, this Article will discuss the tax treatment of gains and losses from foreign currency hedges during three distinct periods: prior to the 1986 TRA, after the 1986 TRA, and after Arkansas Best.

I. CAPITAL ASSETS: THE CODE

A capital asset is defined in section 1221 of the Internal Revenue Code as any "property held by the taxpayer (whether or not connected with his trade or business)." Section 1221 also expressly excludes the following five types of property from the capital asset definition: stock in trade, inventory, or other property sold in the ordinary course of business; property used in business which is subject to a depreciation allowance; certain copyrights, literary, musical or artistic compositions (with qualifications); certain accounts and notes receivable; and certain publications of the United States Government. Generally, only the sale or exchange

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8 I.R.C. § 1221 (1988). Section 1221 provides:

For purposes of this subtitle, the term "capital asset" means property held by the taxpayer (whether or not connected with his trade or business), but does not include:

(1) stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business;

(2) property, used in his trade or business, of a character which is subject to the allowance for depreciation provided in section 167, or real property used in his trade or business;

(3) a copyright, a literary, musical or artistic composition, a letter or memorandum, or similar property, held by:

(A) a taxpayer whose personal efforts created such property,

(B) in the case of a letter, memorandum, or similar property, a taxpayer for whom such property was prepared or produced, or

(C) a taxpayer in whose hands the basis of such property is determined, for purposes of determining gain from a sale or exchange, in whole or part by reference to the basis of such property in the hands of a taxpayer described in subparagraph (A) or (B);

(4) accounts or notes receivable acquired in the ordinary course of trade or business for services rendered or from the sale of property described in paragraph (1);

(5) a publication of the United States Government (including the Congressional Record) which is received from the United States Government or any agency
of a capital asset could give rise to capital gain or loss. Any consequent gain which is characterized as "capital" may qualify for special tax treatment and any resulting capital loss may be subject thereof, other than by purchase at the price at which it is offered for sale to the public, and which is held by-

(A) a taxpayer who so received such publication, or

(B) a taxpayer in whose hands the basis of such publication is determined, for purposes of determining gain from a sale or exchange, in whole or in part by reference to the basis of such publication in the hands of a taxpayer described in subpara-

graph (A).

Id.

By reference to the statute's legislative history and the treasury regulations it is evident that the five exclusions in section 1221 is an exhaustive rather than illustrative list. See H.R. Rep. No. 1337, 83d Cong., 2d Sess. A273 (1954) (that "a capital asset is property held by the taxpayer with certain exceptions" indicates list is exhaustive); H.R. Rep. No 704, 73d Cong., 2d Sess. 31 (1934) (statement by member that "the definition includes all property, except as specifically excluded" supports view that section 1221 is exhaustive list); Treas. Reg. § 1.1221-1(a) (1987) (term "capital asset" includes all classes of property not specifically excluded by section 1221).

Legal scholars have also expressed the opinion that the language of section 1221 necessarily implies that every class of property is a capital asset except for the five enumerated exceptions. See Gallagher, Capital Gains and Losses: A Primer (Part One), 7 FLA. ST. U.L. REV. 3, 7 (1979) ("capital assets" includes all classes of property unless excluded specifically by that section"); Hjorth, An Introduction to Capital Gains and Losses, 41 WASH. L. REV. 764, 775 (1966) ("if the subject of a sale or exchange is in fact property, it qualifies as a capital asset unless specifically excluded by section 1221").

* See I.R.C. § 1222 (1988). Other various Code sections deem certain transactions to be a sale or exchange of a capital asset therefore giving rise to capital gain or loss. See generally I.R.C. § 165(g) (1988) ("If any security which is a capital asset becomes worthless . . . the loss . . . shall . . . be treated as a loss from the sale or exchange . . . of a capital asset.") Id.

When a non-business debt becomes worthless, the loss is treated as a loss from the sale or exchange of a capital asset. I.R.C. § 166(d)(1)(B) (1988). "[G]ain or loss from the short sale of property shall be considered as gain or loss from the sale or exchange of a capital asset to the extent that the property . . . used to close the short sale constitutes a capital as-

set . . . ." I.R.C. § 1233(a) (1988). A loss attributable to the failure to exercise an option to buy or sell property shall be considered a loss from the sale or exchange of a capital asset if the optioned property would have been a capital asset to the taxpayer. I.R.C. § 1234(a)(1) (1988). The transfer of property consisting of rights to a patent by any holder is considered the sale or exchange of a capital asset. I.R.C. § 1235(a) (1988).

In addition to the numerous "statutory sale" provisions in the Code, the "sale or exchange" requirement is satisfied by most routine dispositions of investment assets. See generally Bittker, Capital Gains and Losses - The "Sale or Exchange" Requirement, 52 HASTINGS L.J. 743 (1981) (discussing the "sale or exchange" requirement in depth).

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to limitations on its deductibility. The sale or exchange of an asset which falls into one of the five exclusions in section 1221 will produce "ordinary income," which is fully taxable, or "ordinary loss," which is entirely deductible, subject to various Code limitations. As a result of this disparate tax treatment, a taxpayer would prefer to have any gain characterized as capital and any loss characterized as ordinary. Until recently, the statutory definition of a capital asset in section 1221 was interpreted by Corn Products Refining Co. v. Commissioner. In Corn Products, the United States Supreme Court held that a capital asset may qualify for ordinary income or loss treatment if the asset was an integral part of the taxpayer's business.

II. THE CORN PRODUCTS DOCTRINE

The petitioner, Corn Products Refining Co., was a nationally

\[\text{11 See I.R.C. § 1211 (1988). In the case of corporations, "[l]osses from sales or exchanges of capital assets shall be allowed only to the extent of gains from such sales or exchanges." I.R.C. § 1211(a). For those taxpayers other than corporations, "[l]osses from sales or exchanges of capital assets shall be allowed only to the extent of the gains from such sales or exchanges, plus . . . the lower of $3000 . . . or the excess of such losses over such gains." I.R.C. § 1211(b).}

\[\text{12 See MERTENS, LAW OF FEDERAL INCOME TAXATION, Code Commentary, § 165:2 (1983) (discussing generally the rules for deduction of ordinary losses). In order for an individual to be able to deduct a loss, the loss must be incurred in a trade or business, or in any transaction entered into for profit, though not connected with a trade or business, or the loss must arise from fire, storm or from some other casualty. I.R.C. § 165(c) (1988). Any loss covered by insurance is not deductible. I.R.C. § 165(a) (1988). The Code also limits the amount of deductible gambling losses to the amount of gambling gains for the year. I.R.C. § 165(d) (1988). Furthermore, among other limitations, there are limits on the amount of deductible casualty losses, theft losses, hobby losses, and losses on sales between related taxpayers. See generally I.R.C. § 165(h) (1988); I.R.C. § 165(e) (1988); I.R.C. § 183 (1988); I.R.C. § 267 (1988).}

\[\text{13 See Del Cotto, "Property" in the Capital Asset Definition: Influence of "Fruit and Tree", 15 BUFFALO L. REV. 1, 1-2 (1965). Del Cotto observes that taxpayers driven by the desire to obtain capital gain treatment are always eager to test the breadth of the capital asset definition. Id. See also Gallagher, supra note 8, at 6 ("[I]n many instances taxpayers have attempted, ingeniously, to structure their transactions to avoid the capital asset exceptions, and to bring them within the more favorable provisions."); Hjorth, supra note 8, at 765 ("[T]his disparity in rates does give taxpayers a strong incentive to arrange their transactions in such a form that income from the transactions will qualify as capital gains."); Note, The Corn Products Doctrine and its Application to Partnership Interests, 79 COLUM. L. REV. 341, 344 (1979) [hereinafter Partnership Interests] (taxpayer is likely to seek capital asset treatment in cases of gain and ordinary treatment in cases of loss).}

\[\text{14 350 U.S. 46 (1955), reh'g denied, 350 U.S. 943 (1956) (Justice Clark delivered unanimous opinion of the court).}

\[\text{15 Id. at 47.} \]
known manufacturer of corn products.\textsuperscript{16} To protect itself against sharp increases in the price of corn, the petitioner bought corn futures as part of its corn buying program.\textsuperscript{17} It would either take delivery of the corn futures or sell them, depending on the needs of the business.\textsuperscript{18} In 1940, the company made a profit of more than $680,000 on the sale of corn futures, but in 1942, it suffered a loss of nearly $110,000.\textsuperscript{19} The petitioner sought to characterize this gain and loss as capital rather than ordinary,\textsuperscript{20} on the ground that the futures were "property" and therefore capital assets within the meaning of section 117.\textsuperscript{21} The petitioner further argued that the futures did not fall within any of the capital asset exclusions listed in that section.\textsuperscript{22}

\textsuperscript{16} Id. at 48. Corn Products was a very large company which ground approximately 35 to 60 million bushels of raw corn per year to manufacture starch, sugar, feeds and corn oils. Id. The majority of its products were sold under contracts that required shipment within 30 days at a predetermined price or market price on the date of delivery, whichever was lower. Id.

\textsuperscript{17} Id. In 1934 and again in 1936, the price of corn rose dramatically due to droughts in the corn belt. Id. Corn Products was unable to avoid the effect of a long term drought by storing up extra corn in anticipation of a shortage because it only had storage capacity for a three week supply. Id. The purchase of corn futures was the most economical way for Corn Products to protect itself. Id. It was not economically feasible to resolve this dilemma by expanding its storage capacity since the cost of such an expansion would have been prohibitive. Id.

\textsuperscript{18} Id. Petitioner bought futures each year at harvest time when the price was favorable. Id. The following quote explains the petitioner's strategy:

\begin{quote}
It would take delivery on such contracts as it found necessary to its manufacturing operations and sell the remainder in early summer if no shortage was imminent. If shortages appeared, however, it sold futures only as it bought spot corn for grinding.

In this manner it reached a balanced position with reference to any increase in spot corn prices. It made no effort to protect itself against a decline in prices.
\end{quote}

\textsuperscript{19} Id. at 48-49.

\textsuperscript{20} Id. Initially, in computing its taxable income for 1940 and 1942, Corn Products reported those figures as ordinary profit and loss from its manufacturing operations. Id.

\textsuperscript{21} Id. at 50. See I.R.C. § 117 (1939). Section 117 of the 1939 Internal Revenue Code, the predecessor to section 1221 which was in effect at the time of Corn Products, was essentially the same as section 1221, and read in part:

\begin{quote}
(1) Capital Assets- The term "capital assets" means property held by the taxpayer (whether or not connected with his trade or business), but does not include stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business, or property, used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 23(1). . . .
\end{quote}

\textsuperscript{22} See Corn Products, 350 U.S. at 51. The petitioner further argued that it was dealing in the futures market as a "legitimate capitalist" and therefore the futures were capital assets.
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The Supreme Court held that although the futures did not come within the literal language of the exclusions set forth in section 117, the futures constituted ordinary assets in the taxpayer’s hands. The Court further concluded that a narrow reading of the definition of “capital assets” was necessary to effectuate the congressional purpose behind the capital asset provisions in the Code. That purpose, the Court found, was to treat profits and losses arising from the everyday operation of a business as ordinary income and loss. Capital gain and loss treatment was to be afforded all transactions in property which were not the normal source of business income. Since the petitioner’s corn futures were integrally related to its business operations, the consequent gains and losses were treated as ordinary. The doctrine enunciated by the Court is that assets which are traditionally capital assets will be taxed as ordinary assets if they are held for use in the everyday operations of a business, as opposed to being held for investment purposes. Although the doctrine was highly criticized and blamed for creating confusion, it nevertheless be-

Id. at 50. The Court rejected that argument by saying such a label was not supported in the record because petitioner’s own officers testified that in entering the futures market, the company was trying to protect a part of its manufacturing costs, and further that “its entry was not for the purpose of ‘speculating and buying and selling corn futures’ but to fill an actual ‘need for the quantity of corn [bought] . . . .’” Id. at 51.

The United States Tax Court and the United States Court of Appeals also rejected the claim that Corn Products’ futures were capital assets within the meaning of section 117. See Corn Products Refining Co. v. Commissioner, 16 T.C. 395 (1951); Corn Products Refining Co. v. Commissioner, 215 F.2d 513 (2d Cir. 1954). The Second Circuit maintained that the petitioner’s futures transactions were not even “true” hedges. Id. at 516. The Second Circuit reasoned that “[f]or the same reasons that the true hedge is not accorded capital treatment under section 117(a), the kind of transactions with which we are now concerned are not to be regarded as capital ones either.” Id.

28 Corn Products, 350 U.S. at 47.
29 Id. at 52. Also, in order to effectuate the purpose of Congress, the Court felt compelled to interpret the exclusions of section 117 broadly. Id.
30 Id.
31 Id.
32 Id. at 50.
33 See generally Cunnane, Acquiring Capital Items for Noncapital Purposes, or When Is a Capital Asset Not a Capital Asset?, 29 N.Y.U. Inst. on Fed. Tax’n 705, 708 (1971) (Corn Products established that assets not held for investment but for use in business are to be treated as noncapital assets even though not specifically within a capital asset exclusion); Javaras, Corporate Capital Gains and Losses - The Corn Products Doctrine, 52 Taxes 770, 771 (1974) (“Court’s holding is that assets which are traditionally capital assets are to be taxed as ordinary assets based upon the taxpayer’s motive or business purpose in acquiring them.”).
came the basis for ordinary income treatment in a wide variety of transactions.\(^{31}\)

An especially troublesome area after *Corn Products* concerned the question of when an asset was sufficiently related to the everyday operations of a business so as to warrant ordinary income treatment on its disposition; that is, whether the *Corn Products* doctrine should apply to the asset. This area was complicated by the creation of various tests\(^{32}\) which at one time or another con-

(1961) (the opinion was entirely unnecessary and disruptive to the statutory scheme); Freeman, *Is There a New Concept of Business Asset?*, 36 *Taxes* 110, 110 (1958) (criticisms of the doctrine include: failing to define objective distinction between “business” and “investment”; failing to follow Second Circuit’s opinion which treated futures as inventory; rewriting section 117; giving taxpayers the power to treat capital gains as ordinary): See Kauffman, *A Second Look at the Corn Products Doctrine*, 41 *Taxes* 605, 608 (1963) (“the Court could have found the gain here realized by the taxpayer to be ordinary income on a number of theories without doing such violence to the statute”); Surrey, *Definitional Problems In Capital Gains Taxation*, 69 *Harv. L. Rev.* 985, 993 (1956) (“The Court . . . placed . . . section 117 gently to one side and then decided the case on its own concept[s] . . . ”).

\(^{30}\) See Javaras, supra note 28, at 771 (“the Court has, as a result of this decision, created wild uncertainty”); Note, *Taxpayer Motivation and the Corn Products Doctrine*, 29 *Tax Lawyer* 660, 675 (1976) [hereinafter *Taxpayer Motivation*] (“taxpayer faced with an acquisition with potential *Corn Products* implications is faced with considerable uncertainty about the tax consequences”); Note, *Judicial Treatment of “Capital” Assets Acquired for Business: The New Criterion*, 65 *Yale L.J.* 401, 409 (1956) [hereinafter *Judicial Treatment*] (“the decision does not provide workable standards”).

The doctrine has also been criticized for giving taxpayers the ability to characterize the nature of their gains and losses. See, e.g., Note, *Judicial Treatment*, supra, at 408. The author notes that the *Corn Products* doctrine will create administrative difficulties for the Commissioner of Internal Revenue. *Id.* If securities are acquired for a business purpose and sold at a loss, the taxpayer will apply the *Corn Products* doctrine and deduct the full amount as an ordinary loss. *Id.* If the property is sold at a profit, the taxpayer will report it as a capital gain without mentioning that the property was bought for a business purpose. *Id.* Since all reported capital gains cannot be scrutinized, some taxpayers will be able to obtain capital gain treatment on securities which could have been disposed of as ordinary losses. *Id.* at 409. *See also* Freeman, supra note 29, at 110. Freeman says that the *Corn Products* doctrine gives the taxpayer the power to prove a full loss by stressing the business relationship, and allows him to report only a capital gain by playing down the business relationship. *Id.* The *Corn Products* doctrine could also create taxpayer “whipsaw.” *Partnership Interests*, supra note 13, at 344. Taxpayer “whipsaw” occurs when a taxpayer is able to claim, from the sale or exchange of the same asset, capital asset treatment in the case of a gain and ordinary asset treatment in the case of a loss. *Id.*

\(^{31}\) See generally *Partnership Interests*, supra note 13, at 343 (author observed that the *Corn Products* doctrine has been asserted in transactions involving assets such as bonds, debentures, currency, contracts and shares of stock.)

\(^{32}\) See Campbell Taggert, Inc. v. United States, 744 F.2d 442, 456-57 (5th Cir. 1984) (“if we were to canvass the cases and mechanically extract language from them, we could come up with innumerable ‘tests’ for application of the *Corn Products* doctrine”); Javaras, supra note 28, at 772 (author identifies four tests). *See also* Briggs & Classen, *Arkansas Best: A
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trolled the doctrine’s application. Of these various tests the one that ultimately controlled, until Arkansas Best, was called the sub-

Return to the Reasoning of Corn Products, 44 Wash. & Lee L. Rev. 1229, 1234 (1987) (two tests identified by authors: substantial investment motive test, and investment motivated purpose test); Partnership Interests, supra note 13, at 344 (two tests: business purpose-investment purpose test and substantial investment purpose test).

See Booth Newspapers Inc. v. United States, 303 F.2d 916 (Ct. Cl. 1962). The first test developed by the courts, the business purpose-investment purpose test, used to determine when a capital asset should be accorded ordinary asset treatment was stated by the Booth Court as follows:

[If] securities are purchased by a taxpayer as an integral and necessary act in the conduct of his business, and continue to be so held until the time of their sale, any loss incurred as a result thereof may be fully deducted from gross income as a business expense or ordinary loss. If, on the other hand, an investment purpose be found to have motivated the purchase or holding of the securities, any loss realized upon their ultimate disposition must be treated in accord with the capital asset provisions of the Code.

Id. at 921. See, e.g., Schlumberger Technology Corp. v. United States, 443 F.2d 1115, 1121 (5th Cir. 1971) (applied business purpose-investment purpose test and concluded stock was an ordinary asset); Mansfield Journal Co. v. Commissioner, 274 F.2d 284, 286 (6th Cir. 1960) (because petitioner had business purpose in acquiring stock it was ordinary asset under business purpose-investment purpose test). But see Missisquoi Corp. v. Commissioner, 37 T.C. 791, 798 (1962) (stock was capital asset under business purpose-investment purpose test because petitioner held stock as investment): Gulftex Drug Co. v. Commissioner, 29 T.C. 118, 121 (1957) (stock held as an investment so it was capital asset under above test). Under the business purpose-investment purpose test, if an asset was purchased with both a business and investment motive then the predominant motive was determinative. See Rev. Rul. 75-13, 1975-1 C.B. 67 in which the I.R.S. stated:

In the light of the Corn Products case, subsequent courts have indicated that whether the sale or exchange of shares of stock gives rise to ordinary, as opposed to capital, gain or loss depends upon whether the taxpayer purchased and held the stock with a predominant business motive as distinguished from a predominant investment motive. Motive is determined by analyzing all the surrounding facts and circumstances.

Id. at 68.

A less prominent test, the temporary business expedient test, states that if a transaction is necessary as a temporary business expedient, such as to acquire an inventory or protect a source of supply, then any gain or loss therein will be treated as ordinary even if the transaction involved a capital asset. See Schlumberger Technology Corp., 443 F.2d at 1120-21. For examples of cases which would apparently support the temporary business expedient test see FS Servs. Inc. v. United States, 413 F.2d 548, 549 (Ct. Cl. 1969) (taxpayer acquired stock in petroleum refinery to assure adequate supply of petroleum products; the stock gave rise to ordinary loss on sale); Electrical Fittings Corp. v. Commissioner, 33 T.C. 1026, 1031 (1960) (stock purchased to assure adequate supply of metal castings needed in taxpayer’s business was an ordinary asset); Smith & Welton v. United States, 164 F. Supp. 605, 608 (E.D. Va. 1958) (stock bought by taxpayer to protect supply of merchandise for sale in its department store was ordinary asset); Western Wine & Liquor Co. v. Commissioner, 18 T.C. 1099, 1099 (1952) (stock acquired to assure supply of spirits was ordinary asset), appeal dismissed, 205 F.2d 420 (8th Cir. 1953).

A third test, the “protection-expansion” test, stated that an acquisition made to protect an existing business would qualify for ordinary asset treatment, whereas an acquisition made to expand the business would qualify for capital asset treatment. See Schlumberger Technology Corp. v. United States, 443 F.2d 1115, 1120 (5th Cir. 1971).
stantial investment motive test.\textsuperscript{34} That test stated that if the acquisition of an asset was motivated primarily by a business motivation, but also motivated by a subsidiary but substantial investment motivation, the asset was a capital asset which would give rise to capital gain or loss.\textsuperscript{35} For the \textit{Corn Products} doctrine to apply to an asset purchased with a business motive, an absence of a substantial investment motive was necessary.\textsuperscript{36}

For over three decades the \textit{Corn Products} doctrine went unquestioned by the United States Supreme Court. As is the case with any longstanding doctrine, \textit{Corn Products} fostered reliance and gave individuals a powerful argument whenever the characterization of their assets as ordinary was challenged. Recently, the United States Supreme Court reexamined the doctrine in \textit{Arkansas Best Corp. v. Commissioner}.\textsuperscript{37}

### III. Arkansas Best Corp. v. Commissioner

In \textit{Arkansas Best}, the taxpayer, a bank holding company, originally acquired a controlling interest in the stock of a bank for investment purposes.\textsuperscript{38} Later, as the bank suffered large losses, the taxpayer acquired more bank stock in order to protect its business

\textsuperscript{34} See \textit{Dearborn Co. v. United States}, 444 F.2d 1145, 1148 (Ct. Cl. 1971) (acquisition of stock motivated by “substantial investment purpose and intent” fatal to plaintiff’s case). \textit{See also} \textit{Agway, Inc. v. United States}, 524 F.2d 1194, 1201 (Ct. Cl. 1975) (“substantial investment purpose” test of \textit{Dearborn} recognized). This test did not gain widespread acceptance because on the same day \textit{Agway} was decided the court of claims failed to apply the test in a similar factual setting. \textit{See} \textit{Union Pacific R.R. Co., Inc. v. United States}, 524 F.2d 1343, 1388 (Ct. Cl. 1975) (Nichols, J., dissenting) (\textit{Dearborn} is “strangely forgotten” and test not used), cert. denied, 429 U.S. 827 (1976).

The substantial investment motive test was again announced by the Tax Court in an opinion that fostered that tests ultimate judicial approval. \textit{See} \textit{W.W. Windle Co., Inc. v. Commissioner}, 65 T.C. 694 (1976), cert. denied, 431 U.S. 966 (1977).

\textsuperscript{35} See \textit{W.W. Windle Co., Inc. v. Commissioner}, 65 T.C. at 712.

\textsuperscript{36} See \textit{Mariani Frozen Foods Inc. v. Commissioner}, 81 T.C. 448, 481 n.25 (1983) (“in order to meet its burden of proof on the issue, therefore, petitioners would have to establish that there was no substantial investment purpose”); Briggs & Classen, \textit{supra} note 32, at 1237 (under substantial investment motive test “\textit{Corn Products} will be applied . . . only if there is no substantial investment intent”); \textit{Partnership Interests, supra} note 13, at 349 (“A taxpayer attempting to obtain ordinary asset treatment under this formulation must show not only that business motivation predominated in the transaction but also that substantial investment intent did not exist”).

\textsuperscript{37} 108 S. Ct. 971 (1988) (Justice Marshall delivered the unanimous opinion of the Court).

\textsuperscript{38} \textit{Arkansas Best Corp. v. Commissioner}, 85 T.C. 640, 644-45 (1984).
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reputation and the value of its bank stock, both of which would have been adversely affected if the bank failed.\(^{39}\) Arkansas Best later sold most of the bank stock at a loss and claimed an ordinary loss deduction on its tax return.\(^{40}\) The Tax Court found that the loss on the sale of the later purchases of stock was an ordinary loss because the stock was acquired for business purposes.\(^{41}\) The Court of Appeals for the Eighth Circuit reversed the Tax Court, finding that the stock did not belong to any of the exclusionary categories in section 1221 of the Code, thus concluding the stock and resulting loss were capital in nature.\(^{42}\)

The United States Supreme Court affirmed the Eighth Circuit's decision and held that since the stock bought by Arkansas Best did not fall into any exclusion in section 1221, it was a capital asset.\(^{43}\) The Court concluded that a taxpayer's motivation for purchasing an asset was irrelevant to the question of whether the asset falls within the definition of a capital asset in section 1221.\(^{44}\) The Court rejected the motive tests and found such tests to be in direct conflict with the statute.\(^{45}\) It further concluded that Corn Products is correctly interpreted as holding that hedging transactions which are an integral part of a business's inventory-purchase system fall within the inventory exclusion of section 1221 and are

\(^{39}\) Id. at 648. Another reason for purchasing shares in the bank, even after the bank was suffering losses, was to prevent suits by minority shareholders that might arise if the bank failed. Id.

\(^{40}\) Arkansas Best Corp. v. Commissioner, 800 F.2d 215, 217 (8th Cir. 1986), aff'd, 108 S. Ct. 971 (1988). The loss sustained was almost $10,000,000. Id.

\(^{41}\) Arkansas Best, 83 T.C. at 657. The Tax Court also held that the loss realized on the original purchases of bank stock was a capital loss because the purchases were made with an investment motive. Id. at 655. The Tax Court applied the substantial investment motive test to reach its result. Id.

\(^{42}\) Arkansas Best, 800 F.2d at 221. In rejecting Corn Products the court stated:

We do not read Corn Products as either requiring or permitting the courts to decide that capital stock can be anything other than a capital asset under section 1221. It seems to us that one of the last places where the legal system deliberately should foster subjectivity and uncertainty is in the tax Code. Corn Products and its progeny, which we respectfully view as misbegotten, have done precisely that, leading to increased recourse to the administrative and judicial processes to resolve conflicting contentions about taxpayer motivations in purchasing capital stock.

Id.

\(^{43}\) Arkansas Best, 108 S. Ct. at 977.

\(^{44}\) Id. at 974.

\(^{45}\) Id. Specifically, the Court found any reference to motive to be in conflict with the parenthetical phrase of section 1221 which states "whether or not connected with his trade or business." Id.
therefore ordinary assets. The Arkansas Best Court viewed the futures in *Corn Products* as substitutes for the company's corn inventory and as such they came within the inventory exclusion of section 1221. Following the same reasoning, the futures would fall into the capital asset definition if they were not considered an inventory substitute.

It is submitted that *Corn Products* and *Arkansas Best* are crucial to the determination of the tax consequences of gains and losses from foreign currency forward contracts because currency falls literally within the capital asset definition in section 1221. This Article will now examine how the gains and losses have been treated in the years since *Corn Products*.

IV. TAXATION OF FOREIGN CURRENCY HEDGING TRANSACTIONS

A. Before the 1986 TRA

Prior to the 1986 TRA, there was very little statutory guidance concerning the characterization of gains and losses from foreign currency hedges. One of the few places guidance could be found was in the mark to market rules of section 1256. In general, section 1256 states that gains and losses from foreign currency forward contracts which fall within section 1256 are to be treated as capital gain or loss, but such contracts which are used as hedges

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46 Arkansas Best, 108 S. Ct. at 977.
47 Id.
48 Id.
49 See infra note 68.

Not all foreign currency forward contracts fall within the scope of section 1256. See Schnee & Bindon, Taxation of Foreign-Currency Transactions — Varied and Uncertain, 10 INT’L TAX J. 347, 356 (1984). To come within the reach of section 1256 the foreign currency forward contract must be traded in the interbank market at a price determined by reference to the price in the interbank market and the contract must require the delivery or cash settlement of foreign currency which is traded through regulated futures contracts. Id. Currencies which are traded through regulated futures contracts include the British pound sterling, the Canadian dollar, the Dutch guilder, the French franc, the West Ger-
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are exempt from the rules of section 1256. The Code and regulations provide when and in what circumstances, the gain or loss will be ordinary in nature.

To determine if the transaction is entitled to ordinary income or loss treatment, which may then qualify it as a "hedging transaction" within section 1256, a taxpayer would have to resort to an examination of case law. The taxpayer could argue that the Corn

man mark, the Japanese yen, the Mexican peso and the Swiss franc. See Dickensen, New Foreign Currency Translation and Transaction Rules, 65 Taxes 463, 469 (1987).

I.R.C. § 1256(e) (1988). Section 1256(e) provides in pertinent part:

(e) Mark to market not to apply to hedging transactions.
   (1) Section not to apply. Subsection (a) shall not apply in the case of a hedging transaction.
   (2) Definition of hedging transaction. For purposes of this subsection, the term "hedging transaction" means any transaction if-
   (A) such transaction is entered into by the taxpayer in the normal course of the taxpayer's trade or business primarily-
      (i) to reduce risk of price change or currency fluctuations with respect to property which is held or to be held by the taxpayer, or
      (ii) to reduce risk of interest rate or price changes or currency fluctuations with respect to borrowings made or to be made, or obligations incurred or to be incurred, by the taxpayer, or
   (B) the gain or loss on such transactions is treated as ordinary income or loss, and
   (C) before the close of the day on which such transaction was entered into (or such earlier time as the Secretary may prescribe by regulations), the taxpayer clearly identifies such transaction as being a hedging transaction.

Id. See A. KRAMER, TAXATION OF SECURITIES, COMMODITIES, AND OPTIONS (1986). Kramer explains, and provides examples of, the four requirements of section 1256(e) that must be satisfied for a contract to qualify as a "hedging transaction." Id. at 21-4 - 21-9. See also Rolfe & Doupnik, supra note 4, at 33 (discussing statutory requisites for qualification as "hedging transaction").

I.R.C. § 1256(e)(2)(b) (1988). See Cathcart, Effect of Arkansas Best on Foreign Currency Transactions, 39 Tax Notes 397, 399-400 (1988) (hedging transaction exempt from market-to-market rules only if gain or loss is ordinary); Rudnick, Carlisle & Dailey, Federal Income Tax Treatment of Commodity Transactions, 24 B.C.L. Rev. 301, 336 (1983) (same); Schnee & Bindon, supra note 51, at 356 (same). See also Rolfe & Doupnik, supra note 4, at 33 (criticizing drafters of hedging exemption since purpose of provision is to identify transactions entitled to ordinary treatment, requirement that income or loss be ordinary is not very helpful).

See Cathcart, supra note 53, at 400. Cathcart agrees that whether or not ordinary income or loss is generated depends entirely upon nonstatutory law. Id. He further offers that Congress should provide the necessary guidance. Id.

See Joint Committee on Taxation, 97TH CONG., 2D SESS., GENERAL EXPLANATION OF THE ECONOMIC RECOVERY TAX ACT OF 1981, 300 (Joint Comm. Print 1981) (committee explains that pre-ERTA case law is still applicable). See also Kramer, supra note 52, at 21-6 ("To determine whether the transaction generates ordinary income or loss, one must look to the case law . . . "). Rudnick, Carlisle & Dailey, supra note 53, at 328 (prior law contin-
Products doctrine permitted ordinary treatment because the hedges were integrally related to its business operations. If that argument failed, the taxpayer could argue that the hedge qualified as a "bona fide hedge." Gains and losses from a forward contract which constituted a "bona fide hedge" were treated as ordinary income or loss because a futures contract was viewed as a form of business insurance. To constitute a bona fide hedge, the forward contract must have been entered into only to insure against price fluctuations in the commodity actually sold or purchased in the taxpayer's business. It was not necessary that the commodity bought under the forward contract be the same as the one with which the taxpayer dealt in his everyday business. A taxpayer could achieve a bona fide hedge by merely demonstrating that it
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created a balanced market position in that there was a close relationship between the price fluctuations of his business’ commodity and futures contract. If the futures contract was entered into for mere speculation or if the price relationship was not sufficiently direct, the futures contract did not constitute a bona fide hedge, and any gains and losses sustained on the contract were characterized as capital in nature.

In Wool Distributing Corp. v. Commissioner, the taxpayer, an international dealer in wools, expected a devaluation of foreign currencies which would lower the market price of foreign wools and thereby lower the market value of its inventory. To insure against any potential loss in the value of its inventory, the taxpayer contracted to sell currency short in an amount that was approximately equal to its inventory in foreign wools. Thus, if the

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* See, e.g., United States v. Rogers, 286 F.2d 277 (6th Cir.), cert. denied, 366 U.S. 951 (1961). In Rogers, the court held that the taxpayer did not have a balanced market position between the price of his commodity and his livestock business. Id. at 282. The taxpayer’s livestock business faced four risks of loss: price declines, shrinkage and damage to livestock in transit, market losses, and accounts receivable losses. Id. at 278. To “insure” against these losses Rogers was advised to deal in commodities futures such as wheat, oats, corn, lard, soybeans, cotton and eggs. Id. at 279. Rogers conceded that this was not a "true hedge," and was unable to support the theory that it was a hedge rather than mere speculation. Id. at 282. There was no relationship between the movement in the price of livestock and the commodity futures. Id. Thus, there was no balanced market position. Id. See also Trenton Cotton Oil Co. v. Commissioner, 147 F.2d 33, 35 (6th Cir. 1945) (price relationship between crude oil and refined oil so “intimate” that futures in refined oil may be used to offset losses incurred from sale of crude oil); Stewart Silk Corp. v. Commissioner, 9 T.C. 174, 180 (1947) (silk manufacturer’s dealings in silk futures were offsetting or balancing transactions constituting a hedge rather than mere speculation).

Since the purpose of a hedge is to insure against losses in a commodity that the taxpayer has, a balanced market position cannot be created if no commodity is on hand. See Commissioner v. Farmers & Ginners Cotton Oil Co., 120 F.2d 772, 774 (5th Cir.) (court found that futures transactions were not hedges to achieve a balanced market position because the taxpayer bought futures when it possessed no commodity that needed to be protected against price fluctuations), cert. denied, 314 U.S. 683 (1941). See also Makransky v. Commissioner, 5 T.C. 397, 413 (1945) (wool contracts bought by taxpayer were not balancing transactions against sale of clothing), aff’d, 154 F.2d 59 (3rd Cir. 1946).

See Hoover Co. v. Commissioner, 72 T.C. 206, 239-40 (1979) (although futures transactions in foreign currency were not purely speculative they were more akin to an investment than a hedge so the gains and losses thereon were capital). Absence of speculation in an investment plan does not convert it into a hedge. Id. at 240.

34 T.C. 323 (1960).

Id. at 327-28. Wool Distributing Corporation bought wool from New Zealand, Australia, South Africa and England and paid in pounds sterling. Id. at 324. Wool was also purchased in France, Belgium, South America and the United States. Id.

Id. at 328.
devaluation did occur the taxpayer would realize a gain on the sale of futures in an amount nearly equal to the decrease in the value of its inventory. The Tax Court held that those transactions were bona fide hedges and therefore the losses incurred were ordinary.66

Because a taxpayer must first resort to case law to determine the character of the hedging gain or loss before determining whether the mark to market rules apply, it is submitted that section 1256 does not resolve the tax treatment of hedging gains and losses.

B. After the 1986 TRA

Subpart J was added to the Code as part of the 1986 Tax Reform Act67 as an attempt by the legislature to provide statutory guidance in the perplexing area of foreign currency transactions.68 The premise behind the new sections69 is that the disposition of foreign currency should be treated as an ordinary income or loss transaction.70 A special rule under section 988 provides

66 Id. at 332. The court viewed the currency futures transactions as being entered into with a bona fide intent of providing a form of insurance against anticipated losses due to currency devaluations. Id. The court concluded that since the futures contracts were in the nature of hedging transactions they were not capital assets. Id.


68 See Staff of the Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1986, 1086 (Joint Comm. Print 1986). In explaining the need for legislation, the Joint Committee said:

Prior law was unclear regarding the character, the timing of recognition, and the source of gain or loss due to fluctuation in the exchange rate of foreign currency . . . . The result of prior law was uncertainty of tax treatment for many legitimate business transactions, as well as opportunities for tax motivated transactions. Id. See e.g., Financial Transactions, supra note 51, at 1020 (noting the inadequacy of the law prior to the addition of Subpart J); Foreign Currency, supra note 67, at 168. Prior to the 1986 TRA there was no comprehensive body of law governing the tax treatment of gains and losses from foreign currency transactions. Id. See also O'Neill & Lee, supra note 67, at 185 (“There was limited statutory guidance and only a collection of older inconsistent cases.”).

69 See Foreign Currency, supra note 67, at 168. The new sections include sections 985 to 989. Id.

70 See A. Kramer, supra note 67, at 272. Section 988 is the section that governs the
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that a foreign currency gain or loss attributable to a forward contract, futures contract or option which is a capital asset and not part of a straddle, may be treated as a capital gain or loss if the election is made and the taxpayer identifies the transaction before the close of the day on which he effected it. Thus, Subpart J also addresses foreign currency hedging transactions. The effect of the hedging provisions is that exchange gains or losses arising from a section 988 hedging transaction that consists of a section 988 transaction will be integrated with the underlying transaction. However, it is submitted that the hedging provisions are of little practical importance because their implementation is dependent upon regulations which have yet to be issued. It is further submitted that even when these provisions do become effective, prior case law will still be important for determining the tax treatment of gains and losses of hedging transactions that do not fall within the precise definition of section 988(d).

C. Post Arkansas Best Treatment

As previously noted, the Arkansas Best Court held that Corn Products stands for the limited proposition that hedging transactions which are an integral part of a business' inventory-purchase system, fall within the inventory exclusion of section 1221 and are therefore ordinary assets. It is submitted that Arkansas Best narrows Corn Products in two ways. First, it is narrowed in that the character of the income or loss. O'Neill & Lee, supra note 67, at 185. But, to be governed by section 988, the transaction must qualify as a "Section 988 transaction". See Financial Transactions, supra note 51, at 1021 (detailed definition of a "Section 988 transaction").

3 I.R.C. § 988(d)(1) (1988). A section 988 "hedging transaction" is defined as: any transaction
(A) entered into by the taxpayer primarily
(i) to reduce risk of currency fluctuations with respect to property which is held or to be held by the taxpayer, or
(ii) to reduce risk of currency fluctuations with respect to borrowings made or to be made, or obligations incurred or to be incurred, by the taxpayer, and
(B) identified by the Secretary or the taxpayer as being a 988 hedging transaction.

See supra text accompanying notes 42-44.
only transactions which may qualify for ordinary income and loss treatment are hedging transactions. It is further narrowed because the only hedging transactions which will qualify for ordinary treatment are those which are related to the inventory-purchase system of a business. It is suggested that any other hedging transaction, such as a hedge against financial statement translation losses, will not receive ordinary treatment.

A recent case, *Barnes Group, Inc. v. United States*, decided by the United States District Court for the district of Connecticut after *Arkansas Best* appears to confirm this analysis. In *Barnes*, the taxpayer, an American corporation, owned all of the stock of a Swedish company. Because of significant devaluations of the Swedish kroner, it showed paper losses on its domestic financial statements when its Swedish holdings were translated from krona to American dollars. Expecting further devaluations of the kroner, the corporation entered into a futures contract for the sale of krona to a bank. If the kroner devalued as expected, the taxpayer would have been in a position to buy the krona necessary to perform the contract at a price which was less than the bank agreed to pay. When the kroner unexpectedly increased in value, the taxpayer entered into a contract with the bank to buy back the exact amount of krona that it previously agreed to sell. The price at which the taxpayer agreed to purchase exceeded the price at which the bank agreed to buy resulting in a loss to the taxpayer.

The *Barnes* court, in construing *Arkansas Best* ruled that the taxpayer's purpose for entering into the transaction was irrelevant; thus, the loss was deemed to be a capital loss since the taxpayer did not claim that the hedging transactions were a substitute for any of the section 1221 capital asset exclusions. The *Barnes* court noted that the transaction should have been treated
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as giving rise to an ordinary loss, but because of Arkansas Best, it was powerless to reach that result.84 The court observed that until Congress provides a solution, this type of hedging transaction will be treated as giving rise to capital gain or loss.85

CONCLUSION

Under the present tax Code, the treatment of gains and losses from foreign currency hedges often depends on resorting to non-statutory law. Unfortunately, the case law in this area remains uncertain. After Arkansas Best, the circumstances in which ordinary income or loss treatment will be accorded a foreign currency hedge have been severely narrowed. It is submitted that all hedges, except those for mere speculation, entered into by prudent businessmen should be treated as giving rise to ordinary income or loss. Congress should propose legislation, or at least regulations, to achieve such a result.

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84 See id. at 597 n. 7.
85 Id.