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The Scope of the Inventory Exclusion under I.R.C. 1221(1): Is It a Broad Exclusion That Should Be Narrowly Construed or a Narrow Exclusion That Should Be Broadly Construed or Is It Just an Illusion

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**THE SCOPE OF THE INVENTORY EXCLUSION
UNDER I.R.C. § 1221(1): IS IT A BROAD
EXCLUSION THAT SHOULD BE
NARROWLY CONSTRUED OR A
NARROW EXCLUSION THAT SHOULD BE
BROADLY CONSTRUED OR IS IT
JUST AN ILLUSION?**

*Patrick E. Hobbs**

I. INTRODUCTION

One of the most difficult terms to define in the Internal Revenue Code (Code) is "capital assets."¹ Indeed, even before the term entered the tax lexicon in the Revenue Act of 1921,² Congress struggled in its attempts to carve out a special category of property that would be entitled to preferential treatment of its gains and subject to certain limitations on its losses.³ The reason that capital gains should be treated differently than gains from noncapital assets is not the subject of this

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1. See I.R.C. § 1221 (1988).

2. Ch. 136, 42 Stat. 227.

3. See *infra* part II.A. Currently, for individuals, gains from the sale of capital assets are taxed at a maximum rate of 28%, whereas the top rate for ordinary income is 31%. See I.R.C. § 1 (West 1990 & Supp. 1992). Although a three percent margin may seem insignificant, tell that to the individual who has just realized a ten million dollar capital gain but does not qualify for the 28% capital gains rate, thus incurring an additional three hundred thousand dollars in tax liability. Corporations receive no preference on gains from the sale of capital assets; instead, recognized corporate income is taxed at a maximum rate of 34%. See *id.* §§ 11, 1201 (1988 & West Supp. 1992). Moreover, the major effect of capital asset classification for corporate entities is the limitation on the deductibility of losses. Corporations are allowed to deduct capital losses only to the extent they recognize capital gains. *Id.* § 1211(a) (1988). Corporations may, however, carry back unused losses three years and carry them forward five years to minimize tax liability. *Id.* § 1212(a) (1988 & West Supp. 1992). The net effect of these rules for a corporation that incurs substantial capital losses and little or no capital gains over a period of years is the harsh result of a complete denial of the loss.

This is the quandary faced by most of the corporate taxpayers in the cases discussed in this Article. Individuals fare a little better because they can use up to three thousand dollars of unused losses to offset ordinary income each year, and they are allowed to carry over unused losses indefinitely. *Id.* §§ 1211(a), 1212(b) (1988). These rules generally put taxpayers in the position of preferring that their gains be classified as "capital" and their losses "ordinary."

Article; that debate may never be settled.⁴ Instead, this Article focuses on how Congress and the judiciary have unsuccessfully attempted to define the line between capital assets and inventory—the first category of property excluded from the capital asset class under § 1221 of the Code.⁵

The term “capital asset” is defined in the Code by exclusion.⁶ The only way to know what qualifies as a capital asset is to know what does not qualify as a capital asset. In other words, the key to understanding

4. The debate over the tax treatment of capital gains appeared once again in the 1992 presidential election. See *Aid for the Rich, Not the Economy*, N.Y. TIMES, Aug. 22, 1992, at A20. The call for a reduction of the tax on capital gains resurrected long-standing, familiar arguments both in opposition to and in support of such a proposal. *Id.*

Supporters of a decrease in the current capital gains tax rate argue that the American economy should be revived with tax-cut incentives to spur new capital investment and to generate badly needed government revenues. *Bush's Need: An Economic Vision*, WASH. TIMES, Aug. 17, 1992, at E3; see also Donald Lambro, *Perils of Clinton's Economic Proposal*, WASH. TIMES, July 23, 1992, at G1 (stating that higher rates, which shrink after-tax return on capital, is “sure-fire prescription” for driving capital completely out of United States to countries with emerging economies such as Mexico and India); *The Politics and Principle of Capital Gains*, WASH. TIMES, July 30, 1992, at G2 (suggesting that with capital gains tax cut, “[e]ntrepreneurial activity would suddenly offer the prospect of substantially larger rewards in compensation for the risks that are always inherent in such undertakings,” meaning that investors could look forward to larger returns on investment because government would be taking smaller bite out of profit earned). Some avid proponents of decreasing the capital gains tax argue that prior cuts, such as those enacted in 1978 and 1981, set off the computer revolution and sparked seven years of uninterrupted growth. Lambro, *supra*, at G1; Robert S. McIntyre, *Bad Scholarship, Bad Economics*, USA TODAY, June 1, 1992, at 4B.

There are equally strong arguments voiced in opposition to a capital gains tax cut. Opponents argue that such a tax cut is merely a “reward for the wealthy . . . [that would] do nothing to spur investment.” *Aid for the Rich, Not the Economy, supra*, at A20; see also Steve Berg, *Bush Wants to Cut Taxes, but Not Now*, BURLINGTON STAR TRIB., Aug. 18, 1992, at 8A (stating that such relief does not ensure that wealthy Americans will invest their extra wealth in factories, machinery and equipment); Nancy Mathis, *Clinton Lashes Back, Calls Foe a 'Fearmonger'*, HOUS. CHRON., Aug. 22, 1992, at A1 (calling capital gains reduction proposal “cut for the wealthy, the fool's gold of an across-the-board tax cut in the face of a \$400 billion deficit”).

Indeed, as both proponents and opponents of a capital gains tax decrease remain firmly rooted in their arguments, it seems unlikely that the debate over the disparate treatment of capital assets will be resolved in the near future.

5. See I.R.C. § 1221(1).

6. See *id.* § 1221, which provides:

[T]he 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—

the term is to understand the exclusions. There are currently five categories of property that are excluded from the definition of a capital asset: (1) inventory or property held for resale; (2) depreciable trade or business purpose property or real property used in a trade or business; (3) property created through a taxpayer's personal efforts, such as a book; (4) trade or business accounts or notes receivable; and (5) United States government publications.⁷

Of these exclusions, only the inventory exclusion was contained in the original definition of capital assets.⁸ Significantly, this exclusion sets out the most basic economic distinction between what is and what is not a capital asset.⁹ For example, on a farm the actual land upon which the crops grow is the capital; the crops that are harvested from the land at summer's end are the inventory. Similarly, a mine from which coal is extracted qualifies as capital, whereas the coal mined is the stock in trade. Although the words of the inventory exclusion literally capture this distinction and theoretically draw the requisite bright line between capital and its produce, its application has proven far more difficult.

Indeed, in 1988 the United States Supreme Court proffered an interpretation of the inventory exclusion that blatantly exceeded the scope of its intended meaning.¹⁰ Epitomizing the impracticability of this expanded definition, a recent Claims Court decision, relying on the

(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 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 subparagraph (A).

Id. (emphasis added).

7. *Id.*

8. See *infra* notes 53-54 and accompanying text.

9. See generally LAWRENCE H. SELTZER, *THE NATURE AND TAX TREATMENT OF CAPITAL GAINS AND LOSSES* 25-29 (1951) (discussing development of legal concepts of capital and income).

10. See *Arkansas Best Corp. v. Commissioner*, 485 U.S. 212 (1988) (holding that all stock held by taxpayer was capital asset because it did not fall within any listed exclusion in I.R.C. § 1221). For an in-depth analysis of *Arkansas Best*, see *infra* part IV.A.

Supreme Court's delineation, held that under certain circumstances, shares of stock held by a taxpayer come within the scope of the inventory exclusion.¹¹ Should the inventory exclusion be so broadly construed as to include, under certain circumstances, shares of stock in a corporation? Alternatively, should it be read so narrowly as to encompass only property included in inventory under the Generally Accepted Accounting Principles (GAAP)?¹² Or, as is usually the case, is the answer somewhere in between?

These are the ultimate questions that this Article attempts to answer. Part II begins by briefly tracing the development of the distinction between "capital assets" and "other property" up to and including the Revenue Act of 1921, in which the term "capital assets" first appeared in the Code.¹³ This historical review is useful because it both highlights the difficulties Congress faced in determining what would qualify as a capital asset and provides insight into the meaning of the current definition. Parts III and IV examine the judiciary's treatment of the line that Congress drew between inventory and capital assets.¹⁴

Part III traces the period from the introduction of the term "capital assets" until the Supreme Court's landmark decision in *Arkansas Best Corp. v. Commissioner*.¹⁵ It analyzes how the judiciary, when faced with factual settings that presumably called for an inventory exclusion analysis, instead relied on the judicial exclusion now known as the *Corn Products* doctrine.¹⁶ Although the doctrine is now obsolete, many of these cases remain important because, remarkably, they are now cited as exam-

11. *Circle K Corp. v. United States*, 23 Cl. Ct. 665, 672 (1991) (citing *Arkansas Best Corp. v. Commissioner*, 485 U.S. 212, 216 (1988)). For a detailed discussion of the *Circle K* decision, see *infra* part IV.B.

12. The term GAAP refers to the body of professional standards and practices followed by members of the American Institute of Certified Public Accountants (AICPA). See generally HANDBOOK OF ACCOUNTING AND AUDITING (John C. Burton et al. eds., 1981) (discussing accounting profession's efforts to establish GAAP after stock market crash of 1929). These principles are reflected in the opinions of the Accounting Principles Board, in the statements of the Financial Accounting Standards Board and in Accounting Research Bulletins. *Id.* at 40-2 to 40-5.

13. See *infra* part II.

14. See *infra* parts III-IV.

15. 485 U.S. 212 (1988).

16. The *Corn Products* doctrine evolved from the Supreme Court's 1955 landmark decision in *Corn Products Refining Co. v. Commissioner*, 350 U.S. 46 (1955). The doctrine treats losses derived from assets integrally related to the taxpayer's business as ordinary. For a detailed discussion of the *Corn Products* decision, see *infra* notes 101-35 and accompanying text.

ples of the scope of the inventory exclusion and are collectively referred to as the "source of supply" cases.¹⁷

Part IV of this Article begins by revisiting the *Arkansas Best* decision in which the Supreme Court expressly rejected the existence of a judicial exclusion and rewrote its earlier decision in *Corn Products Refining Co. v. Commissioner*.¹⁸ The Court brought about this metamorphosis by relying on a broad reading of the inventory exclusion. The Court failed, however, to provide any guidelines or limitations on how broadly the exclusion should be read, leaving such details to future courts and Congress. The first court to explore the realm of this broad exclusion was the Claims Court in *Circle K Corp. v. United States*,¹⁹ which declared the continuing vitality of the "source of supply" doctrine.²⁰ This part of the Article ends by closely examining that decision and concluding that although the doctrine may still exist, the Claims Court's description of the doctrine and its holding are erroneous.²¹

The focus of part V of this Article is an attempt to glean the *true* meaning of the words "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"²²—the twenty-five words used by the Supreme Court in determining the scope of the inventory exclusion.²³ A review of the legislative history of the definition of capital assets suggests a far narrower reading than posited by the Supreme Court in *Arkansas Best*. Instead, it would seem that the only property within the ambit of those twenty-five words is property that is required by a taxpayer's accounting practice to be included in the calculation of year-end inventory. Although this may seem to be an unduly restrictive reading of the inventory exclusion—removing certain types of property from the scope of the exclusion that had previously been included—it is supported by both the language of the exclusion²⁴ and the legislative history.²⁵ Moreover, despite the fact that an argument can be made that some of these removed assets should be treated as ordinary in nature, excluding these assets from the capital assets category is the function of Congress, not the judiciary.

17. See *infra* notes 138-93 and accompanying text. The source of supply cases generally involve situations in which the taxpayer purchases a corporation's capital stock to ensure its inventory needs are met.

18. 350 U.S. 46 (1955).

19. 23 Cl. Ct. 665 (1991).

20. *Id.* at 672; see *infra* note 225 and accompanying text.

21. See *infra* part IV.B.

22. I.R.C. § 1221(1).

23. See *infra* notes 238-54 and accompanying text.

24. See I.R.C. § 1221(1).

25. See *infra* part V.

II. DEVELOPING A DEFINITION OF "CAPITAL ASSETS"

A. Pre-Revenue Act of 1921

Congress's struggle to define a class of property that would be afforded special treatment started in the early 1860s, when the government began to use income as a base for generating federal revenue.²⁶ Prior to this time, monies for the public fisc were derived primarily through tariffs, excise taxes and the sale of public lands.²⁷ The onset of the Civil War, however, brought about a dire need for increased revenue, and the federal government decided to meet this need with an "income tax."²⁸ Thereafter, Congress enacted the Revenue Act of 1862,²⁹ the first income tax statute to become effective.³⁰ The Revenue Act of 1862 provided for a tax of five percent upon the "annual gains, profits, or income of every person residing in the United States, whether derived from any kind of property, rents, interest, dividends or salaries or from any profession, trade, employment, or vocation . . . or from any source whatever," if such income exceeded six hundred dollars.³¹ Although the language of the Act was broadly worded, it did not specifically state that the term "income" included gains or profits from the sale of capital assets.³² The legislative history of the Revenue Act of 1864,³³ however, ended all speculation concerning this issue because it explicitly revealed that the Com-

26. See generally 1 BORIS I. BITTKER & LAWRENCE LOKKEN, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS ¶¶ 1.1.1-2 (2d ed. 1989) (discussing historical establishment of income tax stemming from Civil War); ROY G. BLAKEY & GLADYS C. BLAKEY, THE FEDERAL INCOME TAX 1-8 (1940) (discussing congressional response to fiscal crisis brought on by Civil War); RANDOLPH E. PAUL, TAXATION IN THE UNITED STATES 7-15 (1954) (discussing historical sources taxed and applicable tax rates); SELTZER, *supra* note 9, at 30-34 (discussing Civil War tax measures); JOHN F. WITTE, THE POLITICS AND DEVELOPMENT OF THE FEDERAL INCOME TAX 67-70 (1985) (discussing political pressures in establishing income tax).

27. 1 BITTKER & LOKKEN, *supra* note 26, at ¶¶ 1.1.1-2; BLAKEY & BLAKEY, *supra* note 26, at 2-4; PAUL, *supra* note 26, at 4-7.

28. 1 BITTKER & LOKKEN, *supra* note 26, at ¶¶ 1.1.1-2; BLAKEY & BLAKEY, *supra* note 26, at 2-4; PAUL, *supra* note 26, at 7-15.

29. Pub. L. No. 37-97, 12 Stat. 432.

30. Congress had originally drafted the Revenue Act of 1861, which generally provided for a tax of three percent on income in excess of eight hundred dollars. See H.R. 54, 37th Cong., 1st Sess. 292 (1861). This never went into effect. See H.R. 312, 37th Cong., 2d Sess. 89 (1862); see also SELTZER, *supra* note 9, at 31 (stating that Revenue Act of 1862 was first tax measure of Civil War period to become effective).

31. Revenue Act of 1862, Pub. L. No. 37-97, § 90, 12 Stat. 432, 473.

32. SELTZER, *supra* note 9, at 31. Although the inclusion of capital gains in income is no longer questioned, there was genuine doubt as to this issue when the Revenue Act of 1862 was enacted. *Id.* This confusion was probably attributable to the British practice of excluding such gains from income during this period. *Id.* at 28.

33. Pub. L. No. 38-148, 13 Stat. 223.

missioner of Internal Revenue (Commissioner) considered such gains taxable.³⁴

Two years later, Congress provided the first capital gains relief in the Revenue Act of 1864.³⁵ When the legislators convened to modify the 1862 Act, members of Congress expressed concern that the gain produced on the sale of a long-held asset should not be recognized as 100% income earned in the year of sale because such increase in value had accrued over time.³⁶ Congress addressed this issue, but in a manner quite different from today's approach. Rather than resort to the present, all-encompassing definition of capital assets, Congress instead focused on one specific type of property that it believed deserved special treatment.³⁷ Furthermore, the relief at stake was not a lower tax through the use of a preferential rate or deduction, but a complete exemption from taxation.³⁸ The 1864 Act exempted from tax all gains on the sale of real property held for more than one year.³⁹ No explanation was given, however, as to why such dramatic relief was granted only to real estate; perhaps most wealth during this period was held in that form. Interestingly, in June of 1864, when Congress amended the 1862 Act, it expressly provided that *all* income or gains from the sale of stock or other property, *real or personal*, was subject to taxation.⁴⁰

In subsequently enacted income tax statutes, Congress continued to manifest its confusion with the distinction between different types of

34. See CONG. GLOBE, 38th Cong., 1st Sess. 2516 (1864), reprinted in JACOB S. SEIDMAN, LEGISLATIVE HISTORY OF FEDERAL INCOME TAX LAWS: 1938-1861, at 1028 (1938); SELTZER, *supra* note 9, at 31.

35. See § 116, 13 Stat. at 223.

36. SEIDMAN, *supra* note 34, at 1028. Today, this is referred to as the "bunching effect." See 1 BITTKER & LOKKEN, *supra* note 26, ¶ 3.5.7, at 3-65 to 3-66; WILLIAM A. KLEIN ET AL., FEDERAL INCOME TAXATION 849 (1990).

37. The focus was on *real* as opposed to *personal* property. See SEIDMAN, *supra* note 34, at 1028.

38. See H.R. 405, 38th Cong., 1st Sess. (1864).

39. The Act did this by including in taxable income only gains realized from the sale of real estate held for less than one year. See Revenue Act of 1864 § 116. Specifically, § 116 of the 1864 Act provided: "[N]et profits realized by sales of real estate purchased within the year for which income is estimated shall be chargeable as income . . ." *Id.*

40. Revenue Act of 1864, ch. 173, 13 Stat. 223, 281. The 1864 Act is also notable because it arguably included the first inventory provision. See *id.* Specifically, § 117 provided:

In estimating the annual gains, profits or income of any person, . . . the amount of sugar, wool, butter, cheese, pork, beef, mutton, or other meats, hay, and grain, or other production of the estate of such person sold, not including any part thereof unsold . . . , shall be included and assessed as part of the income of such person . . .

Id. The sweeping language of the Act effectively included as income all revenues derived from the sale of products produced by capital, while excluding the taxpayer's ending inventory. Although this type of provision would seem strange in today's Code, it made sense at the time of enactment because the economy of the United States was primarily agrarian.

property warranting preferential treatment. For example, in the Revenue Act of 1867,⁴¹ Congress amended the 1864 Act by limiting the provision exempting gains realized from the sale of real estate to provide relief only to property held for over two years, instead of one year, as initially enacted.⁴² Concomitantly, however, Congress also removed the express language of the Act that included gains realized from the purchase or sale of "stocks or other property."⁴³ Thus, congressional attempts to define a group of capital assets that would be exempt from taxable income proved less than successful. Moreover, although there would be other income tax statutes to follow,⁴⁴ it would not be until after the ratification of the Sixteenth Amendment to the United States Constitution that Congress would attempt to develop an all-encompassing definition of capital asset.⁴⁵

41. Ch. 169, 14 Stat. 471.

42. *See id.* § 13, 14 Stat. at 478-79. It is plausible that the change was brought about by the need for additional military funding, but the retention of the two-year period in the Revenue Act of 1921 indicates that Congress was attempting to distinguish between a speculator's return on property, which it considered income, and the appreciation in property over time, which it considered capital. *See* H.R. 8245, 67th Cong., 1st Sess. (1921). The following dialogue during the Senate debate over the Revenue Act of 1921 is revealing:

Mr. Walsh

. . . .

Under the proposed amendment and bill a lawyer or any other professional man who derived as a fee from a large case or a merchant who through a substantial increase in sales derived an income of, say, \$100,000 per year is taxable upon the full amount of income. The speculator who derives an income of \$100,000 a year upon the New York Stock Exchange or in any other manner would be taxable only on 40 per cent of his net income, or \$40,000.

If there is any merit at all in the contentions made by those who are in favor of this amendment it seems to me in all fairness and equity to taxpayers other than those who are making money in a speculative way upon sudden increases in the value of property which they hold that there should be a limit in the time allowed for holding capital assets before the reduced rate of taxation would be applicable

. . . .

Mr. McCumber If the Senator would be satisfied with inserting the words "for more than two years" after the word "investment," in line 24, I think that would meet his suggestion.

61 CONG. REC. 6575-76 (1921) (statements of Sen. Walsh and Sen. McCumber).

43. Revenue Act of 1867 § 13, 14 Stat. at 478; *see also* *Gray v. Darlington*, 82 U.S. (15 Wall.) 63, 66-67 (1872) (holding that gains on sale of government bonds held for approximately four years were not taxable because increase in value was capital and therefore not income).

44. *See, e.g.*, Revenue Act of 1909, ch. 6, 36 Stat. 11; Revenue Act of 1870, ch. 255, 16 Stat. 256.

45. The necessity of the Sixteenth Amendment was dictated by the Supreme Court's decision in *Pollock v. Farmers' Loan & Trust Co.*, 157 U.S. 429 (1895) (declaring Revenue Act of 1864 unconstitutional), *overruled by* *South Carolina v. Baker*, 485 U.S. 505 (1988).

B. Revenue Act of 1921

The Sixteenth Amendment, ratified on February 25, 1913, provided Congress with the "power to lay and collect taxes on incomes, from whatever source derived."⁴⁶ Accordingly, the Revenue Act of 1913⁴⁷ came into effect eight months later, but without any provisions concerning capital assets.⁴⁸ In fact, it would be another eight years before the words "capital assets" would enter the Code.⁴⁹

The Revenue Act of 1921, drafted in the aftermath of World War I, stemmed from Congress's desire to reduce the overall tax burden—an economic move congressional leaders deemed essential to boost the Nation's economy.⁵⁰ One of the measures in the Act that was intended to stimulate the economy was a provision designed to relieve the tax burden on capital gains.⁵¹ This provision differed from the Civil War statutes in two ways. First, Congress did not completely exclude capital gains from taxable income: It merely provided a lower rate.⁵² Second, rather than addressing specific properties such as real estate, Congress granted relief to all property coming within the term "capital assets."⁵³ The essence of the definition was the distinction between property held as capital and "property of a kind which would properly be included in the *inventory* of

46. U.S. CONST. amend. XVI.

47. Ch. 16, 38 Stat. 114.

48. See *id.*

49. See Revenue Act of 1921, ch. 136, § 206(a)(6), 42 Stat. 227, 232.

50. See BLAKEY, *supra* note 26, at 189-222.

51. See Revenue Act of 1921 § 206, 42 Stat. at 232-33.

52. See *id.* § 206(b). Specifically, gains from the sale of capital assets, at the election of the taxpayer, could be taxed at 12½%, provided that the taxpayer did not pay less than 12½% overall on its total income. *Id.* The 1921 Act did not contain any limitation on capital losses. That limitation would not appear until the Revenue Act of 1924. See Revenue Act of 1924, ch. 234, § 208(c), 43 Stat. 253, 263.

53. See § 206(a) of the Revenue Act of 1921, which provided:

The term "capital assets" as used in this section means property acquired and held by the taxpayer for profit or investment for more than two years (whether or not connected with his trade or business), but does not include property held for the personal use or the consumption of the taxpayer or his family, or 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.

Revenue Act of 1921 § 206(a). To arrive at such an expansive definition, one would assume that Congress must have engaged in a long, intellectual dialogue enlisting tax experts and economists regarding what property should be afforded special treatment and what property should be exempt from this special treatment. Yet, a review of the legislative history reveals no such debate. Instead, there appears to have been some sort of telepathic communication of a definition from time immemorial. The only discussion of the term is by Dr. T.S. Adams, who testified before the Senate Committee on Finance as the Treasury Department's representative. See *Revenue Act of 1921: Hearings on H.R. 8245 Before the Senate Comm. on Finance*, 67th Cong., 1st Sess. 3 (1921) (testimony of Dr. T.S. Adams). When asked what type of

the taxpayer if on hand at the close of the taxable year."⁵⁴ Interestingly, the term "inventories" had entered the Code only three years earlier.⁵⁵

In the Revenue Act of 1918,⁵⁶ Congress, recognizing the evolution of the American economy from farms to manufacturing and merchandising,⁵⁷ provided:

That whenever in the opinion of the Commissioner the use of inventories is necessary in order clearly to determine the income of any taxpayer, inventories shall be taken by such taxpayer upon such basis as the Commissioner, with the Approval of the Secretary, may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income.⁵⁸

Notice two aspects of this provision: (1) Inventories are calculated according to rules prescribed by the Commissioner; and (2) in determining these rules the Commissioner is generally required to adhere to the accounting rules of the particular industry for which the rules are prescribed.⁵⁹ In other words, what constitutes "inventory" for tax purposes is essentially left to the discretion of the Commissioner.

Despite the existence of this inventory provision in the Code, Congress neither cross-referenced the definition of capital assets to it, nor did Congress specifically grant the Commissioner the authority to prescribe rules to clearly reflect the *character* of income.⁶⁰ Yet, it is at least argua-

property would receive this special relief, Dr. Adams simply replied, "capital property." *Id.* at 37.

Additionally, the words "for profit or investment" and the exclusion of property held for personal use were eliminated in the Revenue Act of 1924. *See* Revenue Act of 1924, ch. 234, 43 Stat. 253.

54. Revenue Act of 1921 § 206(a)(6) (emphasis added). Of course, the requirement that property be held for more than two years to qualify as a capital asset also operated as an exclusion. This use of the holding period in defining what qualified as a capital asset was, however, eliminated in the Revenue Act of 1934. *See* Revenue Act of 1934, ch. 277, § 117(b), 48 Stat. 680, 714 (codified as amended at I.R.C. § 1202 (1988)). Pursuant to the 1934 Act, the holding period would first be used to determine what level of preference a capital asset would be accorded, *see id.* § 117(a) (codified as amended at I.R.C. §§ 1221, 1222 (1988)), and later to distinguish between long and short term capital gains and losses, *see* I.R.C. § 1222 (1988).

55. *See* Revenue Act of 1918, ch. 18, § 203, 40 Stat. 1057, 1060 (1919) (codified as amended at I.R.C. § 471 (1988)).

56. *Id.*

57. *See* H.R. REP. NO. 767, 65th Cong., 2d Sess. 4 (1918).

58. Revenue Act of 1918 § 203. This provision was the predecessor to today's I.R.C. § 471 (1988). Moreover, the language cited above is almost identical to the current version. *Compare* Revenue Act of 1918 § 203 with I.R.C. § 471 (1988).

59. *See* Revenue Act of 1918 § 203.

60. The term "character" refers to the type of income or gain received by the taxpayer such as ordinary, capital or tax exempt. *See* Revenue Act of 1921 § 206(a)(6).

ble that by defining the inventory exclusion as it did, Congress implicitly granted such authority to the Commissioner. Taking this statement to its logical conclusion, if the Commissioner had such authority, then presumably the rules developed by the Commissioner to determine what property may be included in "inventory" would also apply for purposes of determining what property comes within the scope of the exclusion. And just as the Commissioner has the authority to disregard the accounting practice utilized to clearly reflect income, he or she could also ignore the accounting practice employed to clearly reflect character—subject, of course, to ultimate review by the judiciary.⁶¹

III. THE JUDICIARY IGNORES THE INVENTORY EXCLUSION

A. *From General Counsel Memorandum 17,322 to Corn Products*

In 1936 the Commissioner issued General Counsel Memorandum 17,322.⁶² The effect of this memorandum on the judicial treatment of the definition of capital assets cannot be overstated. Moreover, the memorandum could easily have been read as an attempt by the Commissioner to exercise the authority outlined above.⁶³ But the courts, beginning with the Tax Court decision of *Ben Grote v. Commissioner*,⁶⁴ would cite this memorandum for a much broader proposition, making it the foundation upon which the now rejected judicial exclusion to the definition of capital assets was built.⁶⁵

The issue raised in General Counsel Memorandum 17,322 was whether losses incurred by a textile manufacturer in the cotton futures market,⁶⁶ entered in order to protect the manufacturer from fluctuations in the price of cotton, were capital or ordinary in nature.⁶⁷ The impor-

61. See I.R.C. § 471.

62. Gen. Couns. Mem. 17,322 (1936), in 15-2 C.B. 151 (1936). This memorandum was restated in part and superseded by Rev. Rul. 72-179, 1972-1 C.B. 57.

63. See *supra* notes 60-61 and accompanying text.

64. 41 B.T.A. 247 (1940).

65. See *Corn Prods. Ref. Co. v. Commissioner*, 350 U.S. 46, 52 (1955); *Trenton Cotton Oil Co. v. Commissioner*, 147 F.2d 33, 35 (6th Cir. 1945); *Fulton Bag & Cotton Mills v. Commissioner*, 22 T.C. 1044, 1051 (1954); *Estate of Makransky v. Commissioner*, 5 T.C. 397, 412 (1945), *aff'd per curiam*, 154 F.2d 59 (3rd Cir. 1946); *Farmers & Ginners Cotton Oil Co. v. Commissioner*, 1942 T.C.M. (P-H) 295, 295-96, *aff'd per curiam*, 130 F.2d 941 (5th Cir. 1942); *Ben Grote*, 41 B.T.A. at 249.

66. A futures contract is a standardized contract to purchase (long position) or sell (short position), at a fixed price, a specified amount of a commodity—such as cotton, corn or orange juice—at a fixed date in the future. Edward D. Kleinbard & Suzanne F. Greenberg, *Business Hedges After Arkansas Best*, 43 TAX L. REV. 393, 394 n.3 (1988). Such contracts are entered into on an exchange that operates to match long and short positions. *Id.*

67. Gen. Couns. Mem. 17,322, *supra* note 62, at 151. Cotton was the textile manufacturer's raw material. See *id.* at 152.

tance of this memorandum was not its holding that the losses incurred on the taxpayer's nonspeculative futures transactions were ordinary.⁶⁸ The significance of this memorandum was how the Commissioner arrived at this conclusion. Did the Commissioner clearly state that there are additional exclusions to the definition of capital assets or did the memorandum, taken as a whole, more easily fit within an inventory exclusion analysis? The reason for the mystery is the absence of authority used by the Commissioner to support his ultimate conclusion.

The Commissioner began his analysis by classifying a taxpayer's efforts to protect itself against price instability as "hedging transactions."⁶⁹ The Commissioner then identified two typical situations in which such hedges are necessary: (1) to protect against cotton price increases; and (2) to protect against cotton price decreases.⁷⁰ The Commissioner labeled these transactions "hedges" because they "tend to assure ordinary operating profits, are common trade practices and are generally regarded as a form of insurance."⁷¹ In other words, by eliminating the risk of inventory price fluctuation, the taxpayer would realize the expected return on the sale of the commodity.

The main discussion of General Counsel Memorandum 17,322 focused on accounting methods, comparing the inventory accounting method of the textile manufacturer to the inventory accounting method of the cotton dealer.⁷² But before arriving at that analysis, the Commis-

68. *Id.* at 155.

69. *Id.* at 152.

70. *Id.* The Commissioner described the taxpayer's procedure for insuring against such risks as follows:

(1) The taxpayer buys quantities of spot cotton, which will necessarily be on hand for some months before being manufactured into goods and sold. In order to be protected against losses which would be incurred if the cotton market declined during those months, the taxpayer, at the same time the above purchases are made, enters into futures sale contracts for the delivery of equivalent amounts of cotton a few months hence. As the above quantities of spot cotton are subsequently disposed of by sales from time to time of manufactured cotton goods, the above futures sale contracts are concurrently disposed of by futures purchase contracts which serve as offsetting transactions closing out the futures sale contracts.

(2) The taxpayer makes contracts for future delivery of cotton goods, the manufacture of which will require more cotton than the amount on hand or the amount which can be immediately purchased advantageously. In order to secure protection against a rising cotton market during the months that intervene between the date of the order for cotton goods and the agreed delivery date, the taxpayer, at the same time the above orders are taken, enters into futures purchase contracts for cotton in amounts necessary to provide the desired protection. As the taxpayer from time to time buys spot cotton for the manufacture of the goods specified in the above orders, the futures purchase contracts are disposed of by futures sale contracts which serve as offsetting transactions closing out the futures purchase contracts.

Id.

71. *Id.*

72. *Id.* at 153-55.

sioner used words that soon became the basis of the nonstatutory exclusion to the definition of capital assets, otherwise known as the *Corn Products* doctrine.⁷³ The Commissioner asserted:

Where futures contracts are entered into only to insure against the above-mentioned risks inherent in the taxpayer's business, the hedging operations should be recognized as a legitimate form of business insurance. As such, the cost thereof, which includes losses sustained therein, is an ordinary and necessary expense deductible under [the predecessor to I.R.C. § 162].⁷⁴

73. See generally Jesse V. Boyles, *The Supreme Court Kills the Corn Products Doctrine—But Will It Rest in Peace*, 66 TAXES 723 (1988) (discussing impact of *Arkansas Best* decision on *Corn Products* doctrine and arguing that *Corn Products* is still viable in federal tax law); Virginia L. Briggs & H. Ward Classen, *Arkansas Best: A Return to the Reasoning of Corn Products*, 44 WASH. & LEE L. REV. 1229 (1987) (arguing that *Arkansas Best* decision clarifies ambiguity in *Corn Products* doctrine by treating purchase of stock of one corporation by another corporation as capital asset); Virginia L. Briggs & H. Ward Classen, *Corn Products and Its Progeny: Where Do We Go From Here?*, 66 TAXES 74 (1988) (arguing that *Arkansas Best* rejects reasoning found in *Corn Products* progeny and instead adopts narrow holding of its prior decision in *Corn Products*); Kleinbard & Greenberg, *supra* note 66, at 405-14 (discussing application of *Corn Products* doctrine in subsequent cases); Allen J. Littman, *Ordinary Losses on Sales of Stock: Is Circle K an Unwarranted Expansion of Arkansas Best?*, 32 TAX MGMT. MEMORANDUM 343 (1991) (stating that close connection test in *Circle K* substantially expands *Corn Products* doctrine); Edward J. Schnee & Michael L. Roberts, *The Arkansas Best Decision*, 19 TAX ADVISER 813 (1988) (examining *Arkansas Best* decision that capital stock may not qualify for ordinary loss treatment and analyzing this decision's effect on *Corn Products* doctrine); D. Chase Troxell & Roger Noall, *Judicial Erosion of the Concept of Securities as Capital Assets*, 19 TAX L. REV. 185 (1964) (arguing that Supreme Court eroded traditional concept of capital assets and that Supreme Court should clarify distinction between business-connected and non-business-connected purchases of securities); Lars G. Gustafsson, Comment, *A Holding Company's Stock in a Subsidiary: A Capital or Ordinary Asset?*, 65 TEX. L. REV. 1029 (1987) (arguing that clear and workable test must be formulated to determine whether holding company's ownership of subsidiary's stock should be deemed capital or ordinary asset and advocating employment of simple registration method to ensure equitable application of tax laws); Deborah F. Marson, Note, *The Impact of Corn Products: Twenty-Three Years Later*, 12 SUFFOLK U. L. REV. 869 (1978) (arguing that Congress should enact additional exception to I.R.C. § 1221, which should give capital status to nondepreciable business property other than land); Michael E. Mermall, Comment, *Revitalizing the Corn Products Doctrine*, 64 WASH. U. L.Q. 217 (1986) (proposing business risk test to enable courts to define scope of *Corn Products* doctrine in accord with congressional intent); Maria E. O'Neill, Note, *Arkansas Best Corporation v. Commissioner—The Demise of the Corn Products Doctrine*, 35 WAYNE L. REV. 1481 (1989) (arguing *Arkansas Best* decision restricts *Corn Products* doctrine by eliminating intent factor in capital asset determination); Paul W. Reichel, Note, *When is Capital Stock Not a Capital Asset? Definition of a Capital Asset after Arkansas Best Corp. v. Commissioner of Internal Revenue*, 41 SYRACUSE L. REV. 831, 833 (1990) (analyzing *Arkansas Best's* interpretation of *Corn Products* and concluding that "ordinary income treatment for capital stock transactions is no longer appropriate in the source of income and business reputation cases").

74. Gen. Couns. Mem. 17,322, *supra* note 62, at 152.

Taken alone, this language indicates that the Commissioner felt unconstrained by the statutory definition of capital assets. If that is all General Counsel Memorandum 17,322 contained, then the subsequent use of this language by courts to support a judicial exclusion would be understandable.⁷⁵ The above-quoted passage, however, was contained in one introductory paragraph.⁷⁶ The focus of the remainder of General Counsel Memorandum 17,322 was not on forms of business insurance; instead, it focused on inventory accounting methods.⁷⁷

Moreover, the precise issue addressed in General Counsel Memorandum 17,322 was whether a different accounting method alone should determine the character of the gain or loss realized for different accrual-method⁷⁸ taxpayers holding similar property for a similar purpose.⁷⁹ In analyzing this question, the Commissioner began by reviewing the inventory accounting method of a cotton dealer.⁸⁰ The Commissioner stated that the accounting practice of the cotton dealer—considered the best for clearly reflecting income—required that the taxpayer use the mark-to-market method of reporting inventory.⁸¹ The Commissioner then explained that this method required the taxpayer to include in its inventory

75. See *Corn Prods. Ref. Co. v. Commissioner*, 350 U.S. 46, 52 (1955) (reading General Counsel Memorandum 17,322 to hold that “hedging transactions were essentially to be regarded as insurance rather than a dealing in capital assets”); *Trenton Cotton Oil Co. v. Commissioner*, 147 F.2d 33, 35 (6th Cir. 1945) (“Purchases and sales against price fluctuations are insurance against loss and such transactions have a direct relationship to profit realized or loss sustained in the conduct of a business.”); *Commissioner v. Farmers & Ginnery Cotton Oil Co.*, 120 F.2d 772, 774 (5th Cir.) (“A hedge is a form of price insurance; it is resorted to by businessmen to avoid the risk of changes in the market price of a commodity.”), *cert. denied*, 314 U.S. 683 (1941); *Fulton Bag & Cotton Mills v. Commissioner*, 22 T.C. 1044, 1053 (1954) (“[T]he futures transactions entered into by petitioner during the fiscal years were true hedging operations to insure it against the risks of the cotton market.”); *Estate of Makransky v. Commissioner*, 5 T.C. 397, 412 (1945) (“It has long been the practice of the Commissioner and the courts to treat losses from hedging transactions as essentially insurance and deductible as ordinary and necessary business expense rather than losses from dealings in capital assets.”), *aff’d per curiam*, 154 F.2d 59 (3rd Cir. 1946).

76. See Gen. Couns. Mem. 17,322, *supra* note 62, at 152.

77. See *id.* at 153-55.

78. Under the accrual method,

income is to be included for the taxable year when all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy. Under such a method, deductions are allowable for the taxable year in which all the events have occurred which establish the fact of the liability giving rise to such deduction and the amount thereof can be determined with reasonable accuracy.

Treas. Reg. § 1.446-1(c)(ii) (1960).

79. Gen. Couns. Mem. 17,322, *supra* note 62, at 154.

80. *Id.* at 153.

81. *Id.*; see also I.R.C. § 1256 (1988) (inventories held by taxpayer at close of taxable year are treated as if sold for fair market value on last business day of such taxable year, with gain or loss taken into account for that tax year).

calculation any open hedges that were not held for speculation.⁸² As a result, the taxpayer indirectly reported these unrealized gains and losses as ordinary income or loss in its year-end inventory. Thus, the inventory accounting method of the cotton dealer provided that futures contracts, held for nonspeculative purposes, were property "of a type properly includable in the inventory of the taxpayer if on hand at the close of the tax year."⁸³ Presumably then, even if these futures contracts were closed out before year end, because they were a type of property includable in inventory, the gain or loss recognized would be classified as ordinary, not capital.

The Commissioner then turned to the textile manufacturer.⁸⁴ The Commissioner explained that, unlike the cotton dealer, the textile manufacturer did not take into account unrealized gains and losses from futures transactions in its year-end inventory. Instead, good accounting practice required that such gains and losses be reported in the year that the futures contract was closed out.⁸⁵ Implicitly then, the Commissioner was being asked whether the gain or loss produced by these hedges was capital in nature simply because the textile manufacturer used a different accounting method than the cotton dealer, even though both taxpayers used the hedges for the same purpose: to protect against inventory price fluctuation. In this context at least, the Commissioner stated that regardless of the accounting or inventory methods employed, futures contracts held to protect against fluctuations in the price of inventory are *not* capital assets.⁸⁶

The judiciary could have interpreted General Counsel Memorandum 17,322 in one of two ways. It could have concluded that this was a situation in which the Commissioner, in attempting to determine what was within the scope of the inventory exclusion, decided to ignore the inventory accounting method employed by the taxpayer because the hedges were part of the inventory system developed by the taxpayer. Alternatively, the judiciary could have found that General Counsel Memorandum 17,322 had nothing to do with inventory, and instead clearly stated that the statutory exclusions to the definition of capital assets are merely illustrative and not exhaustive. Remarkably, the courts steadily adopted the latter interpretation over the next fifty years.⁸⁷

82. Gen. Couns. Mem. 17,322, *supra* note 62, at 153.

83. I.R.C. § 1221(1) (1988).

84. Gen. Couns. Mem. 17,322, *supra* note 62, at 154.

85. *Id.*

86. *Id.* at 155.

87. *See supra* note 75.

The first court to adopt this approach was the Board of Tax Appeals⁸⁸ in *Ben Grote v. Commissioner*.⁸⁹ *Ben Grote* involved wheat farmers who actively bought and sold wheat futures.⁹⁰ In 1935 the taxpayers incurred losses in their wheat futures trading, which they presumably took as an ordinary deduction on their federal income tax return.⁹¹ Apparently, the Commissioner disallowed the deduction, claiming that they were losses from the sale of capital assets and could only be offset against capital gains.⁹² As part of the court's findings of fact, it determined that the farmers invested in wheat futures to protect themselves against a fluctuation in the price of wheat.⁹³ Based on this fact alone, the court, citing General Counsel Memorandum 17,322, found that the gains and losses resulting from the taxpayers' futures transactions were not capital in nature.⁹⁴ Unlike the Commissioner in General Counsel Memorandum 17,322, however, the court was not compelled to inquire into the inventory accounting methods employed by the taxpayer—a finding of non-speculative hedging was enough to assure ordinary loss treatment.⁹⁵

With the *Ben Grote* decision paving the way, it would be seventeen years before a court would engage in an inventory exclusion analysis when dealing with hedging transactions.⁹⁶ Indeed, rather than develop a set of rules to determine what effect a taxpayer's inventory accounting method should have in determining the character of the realized gain or loss on the sale of property, or how broadly the phrase "property of a type includable in inventory"⁹⁷ should be read, courts instead focused on various aspects of a taxpayer's hedging transactions.⁹⁸ For example, if

88. The Revenue Act of 1924, Pub. L. No. 68-176, § 900, 43 Stat. 253, 336, established the Board of Tax Appeals. The Revenue Act of 1942, Pub. L. No. 77-753, § 504, 56 Stat. 798, 957 (codified as I.R.C. § 7441 (1988)), changed its name to the Tax Court of the United States.

89. 41 B.T.A. 247 (1940).

90. *Id.* at 248.

91. The brevity of the opinion requires several procedural assumptions. *See id.*

92. *Id.* at 249.

93. *Id.* at 247.

94. *Id.* at 249 (citing General Counsel Memorandum 17,322 (1936), in 15-2 C.B. 151 (1936)).

95. *Id.* Although the Board did take note of the fact that the taxpayers used inventories in keeping their books, its only concern with this fact was addressing the issue of whether wheat covered by a futures contract should be included in inventory. *See id.* The court then stated that it did not know the answer to this question, but that it was irrelevant because the taxpayers had no inventory of any kind on hand at the end of the taxable year. *Id.* at 248-49.

96. *See* *Corn Prods. Ref. Co. v. Commissioner*, 215 F.2d 513 (2d Cir. 1954), *aff'd*, 350 U.S. 46 (1955).

97. I.R.C. § 1221 (1988).

98. *See, e.g., Trenton Cotton Oil Co. v. Commissioner*, 147 F.2d 33, 37 (6th Cir. 1945) (holding that cottonseed oil producing corporation's purchase of cottonseed oil futures constituted capital loss because purchases were not made to protect corporation against loss); *Fulton*

the transaction at issue fit within the court's notion of a "non-speculative hedge," the gains and losses realized were treated as ordinary; if not, they were characterized as capital.⁹⁹ In making this determination, courts concentrated on, among other things, the timing of the hedge, the quantity of commodity hedged and the type of property used to hedge.¹⁰⁰ It was not until the United States Court of Appeals for the Second Circuit decided *Corn Products Refining Co. v. Commissioner*¹⁰¹ that a court would return to an examination of the scope of the inventory exclusion in this context.¹⁰²

As its name suggests, the taxpayer in *Corn Products* was involved in the manufacture and sale of corn-based products.¹⁰³ The taxpayer's business required large amounts of corn, yet the corn had a maximum storage durational capacity of less than three weeks.¹⁰⁴ The sales policy of the taxpayer generally provided that a shipment of goods would be sold at the lower of the contract price or the market price on the date of delivery.¹⁰⁵ Consequently, the taxpayer's profit margins were left exposed during periods of rising corn prices, which were most often the

Bag & Cotton Mills v. Commissioner, 22 T.C. 1044, 1052-53 (1954) (holding that losses incurred in cotton futures constituted hedging transaction because contracts related directly to manufacturing business); *Stewart Silk Corp. v. Commissioner*, 9 T.C. 174, 177 (1947) (holding that transactions in silk futures for purpose of protecting inventory against competition with synthetic fabric companies were hedges); *Estate of Makransky v. Commissioner*, 5 T.C. 397, 413 (1945) (finding that cottonseed oil dealer's purchases of refined oil futures to make up for insufficient crude oil facilities were not hedges because dealer merely switched market risk from crude to refined oil), *aff'd per curiam*, 154 F.2d 59 (3rd Cir. 1946); *Tennessee Egg Co. v. Commissioner*, 47 B.T.A. 558, 560 (1942) (holding that futures purchases are not hedges when there is no counterbalancing sales transaction); *Battelle v. Commissioner*, 47 B.T.A. 117, 125 (1942); (holding that futures purchases of crops to be delivered before offsetting crops were planted were not hedges); *Farmers & Ginn's Cotton Oil Co. v. Commissioner*, 1942 T.C.M. (P-H) 295, 296 (holding that taxpayer, who was manufacturer of crude cottonseed oil, could not include futures for refined cottonseed oil in inventory, when taxpayer did not deal in refined cottonseed oil), *aff'd per curiam*, 130 F.2d 941 (5th Cir. 1942). For an excellent discussion of the early judicial treatment of hedging transactions, see Clifford H. Rich & Benjamin N. Rippe, *Tax Aspects of Commodity Futures Transactions With a Business Purpose*, 2 TAX L. REV. 541 (1947).

99. Rich & Rippe, *supra* note 98, at 548.

100. *Id.*

101. 215 F.2d 513 (2d Cir. 1954), *aff'd*, 350 U.S. 46 (1955).

102. *Id.* at 515-16. Three separate Tax Court opinions were consolidated on appeal to the Second Circuit. *Corn Prods. Ref. Co. v. Commissioner*, 20 T.C. 503 (1953), *aff'd*, 215 F.2d 513 (2d Cir. 1954), *aff'd*, 350 U.S. 46 (1955); *Corn Prods. Ref. Co. v. Commissioner*, 11 T.C.M. (CCH) 721 (1952), *aff'd*, 215 F.2d 513 (2d Cir. 1954), *aff'd*, 350 U.S. 46 (1955); *Corn Prods. Ref. Co. v. Commissioner*, 16 T.C. 395 (1951), *aff'd*, 215 F.2d 513 (2d Cir. 1954), *aff'd*, 350 U.S. 46 (1955).

103. *Corn Products*, 215 F.2d at 514. Specifically, the taxpayer manufactured sugars, starches, oils and feeds. *Id.*

104. *Id.*

105. *Id.* at 515.

result of droughts.¹⁰⁶ In an effort to avoid the harsh results of escalating prices, the taxpayer began to establish a long position in corn futures,¹⁰⁷ believing this to be a more economical method of maintaining a reasonably priced supply of corn than building additional storage facilities.¹⁰⁸ The results of the taxpayer's investment in the corn futures were not included in the taxpayer's inventory; instead, the profits and losses were shown in an account entitled "Corn Miscellaneous"—an account used to determine the cost of goods sold.¹⁰⁹ In 1940 the taxpayer made substantial profits on its investment in the corn futures, posted them in the Corn Miscellaneous account, and included them in its calculation of cost of goods sold.¹¹⁰ While litigating a separate matter in the Tax Court, however, the taxpayer sought to have these profits treated separately as gains from the sale of capital assets.¹¹¹

The Tax Court addressed this issue by employing the hedge examination framework that evolved from *Ben Grote*.¹¹² Finding that the taxpayer's investments in corn futures were subject to ordinary treatment, the Tax Court stated:

[A]lthough perhaps not conforming technically to the definition of a hedge, it seems indisputable as our findings show that petitioner's practice of purchasing corn futures was an integral part of its manufacturing. It would hence be anomalous to view them as purely speculative transactions of a capital nature, . . . and the burden here is on petitioner to show that it incorrectly treated the losses as ordinary on its original tax returns.¹¹³

On appeal to the Second Circuit, the taxpayer presented alternative arguments.¹¹⁴ The taxpayer first maintained that none of the exclusions under § 117 of the Code—the predecessor to § 1221—applied, and that the judicially created exception regarding hedging transactions was not

106. *See id.*

107. *See supra* note 66 for a definition of a long position corn future.

108. *Corn Prods. Ref. Co. v. Commissioner*, 350 U.S. 46, 48 (1955).

109. *Corn Prods. Ref. Co. v. Commissioner*, 11 T.C.M. (CCH) 721, 723 (1952), *aff'd*, 215 F.2d 513 (2d Cir. 1954), *aff'd*, 350 U.S. 46 (1955).

110. *Corn Products*, 215 F.2d at 515.

111. *Corn Prods. Ref. Co. v. Commissioner*, 16 T.C. 395, 398 (1953), *aff'd*, 215 F.2d 513 (2d Cir. 1954), *aff'd*, 350 U.S. 46 (1955).

112. *See Corn Products*, 11 T.C.M. (CCH) at 726 (citing *Estate of Makransky v. Commissioner*, 5 T.C. 397 (1945), *aff'd per curiam*, 154 F.2d 59 (3d Cir. 1946); *Tennessee Egg Co. v. Commissioner*, 47 B.T.A. 558 (1942); *Battelle v. Commissioner*, 47 B.T.A. 117 (1942); *Ben Grote v. Commissioner*, 41 B.T.A. 247 (1940)). *See supra* notes 89-95 and accompanying text for a discussion of *Ben Grote*.

113. *Corn Products*, 11 T.C.M. (CCH) at 726 (footnotes omitted) (citations omitted).

114. *Corn Products*, 215 F.2d at 515.

supported by the statute.¹¹⁵ In the alternative, the taxpayer argued that if the court adhered to the notion of the existence of a hedge exception, then the taxpayer's gains were still capital in character because the taxpayer's actions did not amount to true hedging within the meaning of the exception.¹¹⁶

Expressly rejecting the existence of a nonstatutory or a judicially created exception to the definition of a capital asset, the Second Circuit found that these transactions fit within the inventory exclusion because they were part of the taxpayer's inventory purchase system.¹¹⁷ In so holding, the court stated:

In the hedge, . . . the property is used in such a manner as to come within the exclusions, for it is a part of the inventory purchase system which is utilized solely for the purpose of stabilizing inventory cost. It is an integral part of the productive process in which the property is held not for investment but for the protection of profit with the intent of disposition when that purpose has been achieved. As such it cannot reasonably be separated from the inventory items and the cost (or profit) from such operations would necessarily be entered in the books of account of the business as part of cost of goods sold. The tax treatment of hedges, then, is not a "judge made exception" to Section 117(a); it is simply a recognition by the courts that property used in hedging transactions properly comes within the exclusions of the section.¹¹⁸

Accordingly, the circuit court concluded that the gains were to be given ordinary treatment.¹¹⁹

As evidenced by the above quoted passage, the Second Circuit focused on the taxpayer's *motive* for holding the property rather than the *type* of property the taxpayer held.¹²⁰ Furthermore, like the Commissioner in General Counsel Memorandum 17,322, the circuit court referred to the transaction as an effort by the taxpayer to *insure* against price fluctuation.¹²¹ But unlike General Counsel Memorandum 17,322,

115. *Id.*

116. *Id.*

117. *Id.* at 516.

118. *Id.*

119. *See id.*

120. *See id.*

121. *Id.*; see Gen. Couns. Mem. 17,322, *supra* note 62, at 152. In dismissing any need to concern itself with whether this was true hedging, the court borrowed the insurance analogy from General Counsel Memorandum 17,322, stating that "[f]utures contracts were entered into to stabilize inventory costs and thus protect profit, and whether complete or only partial

the Second Circuit made clear that gains and losses resulting from this insurance activity were within the scope of the inventory exclusion and not a separate exclusion for hedges.¹²² Moreover, although it had been over a decade since the issuance of General Counsel Memorandum 17,322 and the Board of Tax Appeal's decision in *Ben Grote*, the circuit court's opinion in *Corn Products* unequivocally replaced the deeply entrenched reasoning that had been consistently used to analyze the tax consequences of a taxpayer's dealings in futures contracts with an inventory exclusion analysis.¹²³ In doing so, however, the Second Circuit failed to discuss how the taxpayer's investment in the futures contracts came within the actual language of the exclusion.¹²⁴ Instead, the court was satisfied that the futures activities of the taxpayer in *Corn Products* were part of the taxpayer's inventory purchase system.¹²⁵ This return to inventory exclusion analysis would be short-lived because in affirming the circuit court's decision, the United States Supreme Court decided the case without resorting to a strict statutory analysis.¹²⁶

The Supreme Court took a much more philosophical approach to resolving the case. Indeed, rather than concern itself with aspects of hedges and specific exclusions, the Court pondered the true meaning of the term "capital assets."¹²⁷ Writing for a unanimous Court,¹²⁸ Justice Clark declared that Congress "intended that profits and losses arising from the everyday operation of a business be considered as ordinary income or loss rather than capital gain or loss."¹²⁹ Moreover, Justice Clark characterized the taxpayer as a "far-sighted manufacturer" whose business transactions were designed to protect its manufacturing operations against an increase in the price of its principal raw material and to assure a ready supply for future manufacturing requirements.¹³⁰ Unfortunately, just as it was difficult to decipher the rationale behind the issuance of General Counsel Memorandum 17,322,¹³¹ it was unclear what

insurance was thereby obtained is simply a difference in degree, not in kind." *Corn Products*, 215 F.2d at 516.

122. *Corn Products*, 215 F.2d at 516.

123. *See id.*

124. *See id.*

125. *Id.* The court neglected to state how it would define "inventory purchase system" for other taxpayers in the future. *See id.* The same failing would occur 33 years later in *Arkansas Best Corp. v. Commissioner*, 485 U.S. 212 (1988).

126. *See Corn Prods. Ref. Co. v. Commissioner*, 350 U.S. 46 (1955).

127. *Id.* at 52. The Court stated that the definition "must not be so broadly applied as to defeat rather than further the purpose of Congress." *Id.*

128. Justice Harlan took no part in the consideration or decision of the case. *Id.* at 54.

129. *Id.* at 52.

130. *Id.* at 51.

131. *See supra* notes 66-87 and accompanying text.

rule the Supreme Court was adopting in *Corn Products*. Over three decades later, in *Arkansas Best Corp. v. Commissioner*,¹³² the Supreme Court would claim that it had engaged in an inventory exclusion analysis.¹³³ But, during that thirty-three year period, taxpayers felt that as long as they could show that a loss was derived from the sale of an asset that was integrally related to its business, the character of that loss would be characterized as ordinary. This approach became known as the *Corn Products* doctrine or the "business purpose" test.¹³⁴ Significantly, many of the cases employing the doctrine would have nothing to do with inventory.¹³⁵

Even though taxpayers no longer found it necessary to demonstrate a nexus between the asset being disposed of and inventory, a line of cases decided during the *Corn Products* doctrine's reign did; these cases are commonly referred to as the source of supply cases.¹³⁶ Like the taxpayer in *Corn Products*, these cases involve efforts by taxpayers to assure a ready supply of inventory. The one great difference in these cases is that the property used by the taxpayers to guarantee this supply was not a futures contract, it was the capital stock of another corporation—property that is often thought of as the quintessential capital asset.¹³⁷

B. *The Source of Supply Doctrine Develops*

In a typical source of supply fact pattern, a taxpayer purchases a corporation's capital stock to assure an ample supply of that corporation's products, enabling the taxpayer to meet its future inventory needs.¹³⁸ To treat such stock as a capital asset, however, creates an ad-

132. 485 U.S. 212 (1988). For a detailed discussion of the *Arkansas Best* decision, see *infra* part IV.A.

133. *Id.* at 220.

134. See *supra* note 73.

135. See, e.g., *Campbell Taggart, Inc. v. United States*, 744 F.2d 442 (5th Cir. 1984) (to protect its reputation as business acquirer, holding company purchased stock in supermarket chain); *Steadman v. Commissioner*, 424 F.2d 1 (6th Cir.) (attorney purchased stock in employer to protect his position as general counsel), *cert. denied*, 400 U.S. 869 (1970); *Hagan v. United States*, 221 F. Supp. 248 (W.D. Ark. 1963) (salesman purchased stock in client in order to ensure continuing sales of products); *Southeastern Aviation Underwriters v. Commissioner*, 25 T.C.M. (CCH) 412 (1966) (agency purchased stock in insurance company to obtain management contract).

136. See *infra* part III.B.

137. See *Agway, Inc. v. United States*, 524 F.2d 1194, 1200 (Ct. Cl. 1975).

138. See, e.g., *FS Servs., Inc. v. United States*, 413 F.2d 548 (Ct. Cl. 1969) (wholesaler purchased stock in refinery to maintain ample supply of petroleum products); *Booth Newspapers, Inc. v. United States*, 303 F.2d 916 (Ct. Cl. 1962) (newsprint case); *Journal Co. v. United States*, 195 F. Supp. 434 (E.D. Wis. 1961) (publisher purchased stock in paper mill to maintain ample supply of newsprint); *Smith & Welton, Inc. v. United States*, 164 F. Supp. 605 (E.D. Va. 1958) (retailer purchased stock in supplier's corporation to maintain ample supply of

ministrative nightmare. Specifically, if the taxpayer sells securities at a loss, the taxpayer can claim the securities were held for the business purpose of guaranteeing a source of supply and, therefore, should not be characterized as capital assets. On the other hand, few taxpayers could resist disavowing this business purpose if a disposition results in a gain, and if such gains would then be taxed at favorable capital gains rates.

The question of how to treat such securities actually began with the Tax Court's decision in *Logan & Kanawha Coal Co. v. Commissioner*,¹³⁹ ten years before the Supreme Court's pronouncement in *Corn Products Refining Co. v. Commissioner*.¹⁴⁰ *Logan* involved a taxpayer who was in the business of selling coal of various sizes and grades to customers throughout the United States.¹⁴¹ In order to "maintain a favorable relation" with certain suppliers, the taxpayer would sometimes acquire shares of stock in their companies.¹⁴² In 1937 one of the taxpayer's suppliers, Standard Banner Coal Co. (Standard), promised to supply the taxpayer with the entire output of the company, provided that the taxpayer purchase the thirty percent interest of a disgruntled stockholder.¹⁴³ The taxpayer purchased the shares, and within four years Standard was in receivership.¹⁴⁴ Thereafter, the taxpayer sold the stock at a substantial loss, which it took as an ordinary deduction on its federal income tax return.¹⁴⁵

ladies' suits); Hogg v. Allen, 105 F. Supp. 12 (M.D. Ga. 1952) (retailer purchased stock in distilling company to maintain ample supply of whiskey), *aff'd in part, rev'd in part sub nom. Edwards v. Hogg*, 214 F.2d 640 (5th Cir. 1954); Livesley v. Commissioner, 19 T.C.M. (CCH) 133 (1963) (distributor purchased stock in potato company to maintain ample supply of potatoes); Electrical Fittings Corp. v. Commissioner, 33 T.C. 1026 (1960) (manufacturer purchased stock in foundry to maintain ample supply of electrical castings); Tulane Hardwood Lumber Co. v. Commissioner, 24 T.C. 1146 (1955) (lumber wholesaler purchased debentures in plywood manufacturer to maintain ample supply of plywood); Flom v. Hofferbert, 56-1 U.S. Tax Cas. (CCH) ¶ 9236 (D. Md. 1955) (whiskey case); McGhee Upholstery Co. v. Commissioner, 12 T.C.M. (CCH) 1455 (1953) (furniture manufacturer purchased stock in spring manufacturer's company to maintain ample supply of furniture springs); Clark v. Commissioner, 19 T.C. 48 (1952) (whiskey case); Western Wine & Liquor Co. v. Commissioner, 18 T.C. 1090 (1952) (whiskey case); Wm. M. Young Co. v. Commissioner, 11 T.C.M. (CCH) 863 (1952) (lumber case); Hoffman Lumber Co. v. Commissioner, 11 T.C.M. (CCH) 579 (1952) (retailer purchased stock in lumber manufacturer to maintain ample supply of lumber); *Logan & Kanawha Coal Co. v. Commissioner*, 5 T.C. 1298 (1945) (coal retailer purchased stock in wholesaler's business to maintain ample supply of coal). *See generally* Troxell & Noall, *supra* note 73, at 192-204 (discussing concept of securities as capital assets).

139. 5 T.C. 1298 (1945).

140. 350 U.S. 46 (1955).

141. *Logan*, 5 T.C. at 1299.

142. *Id.*

143. *Id.* at 1300.

144. *Id.*

145. *Id.*

Upon the Commissioner's denial of the ordinary loss, the taxpayer petitioned the Tax Court.¹⁴⁶ Even though the facts clearly demonstrated that the taxpayer had invested in the stock to gain access to Standard's output of coal, the Tax Court—adopting a literal interpretation of the definition of capital assets—concluded that the stock qualified as a capital asset.¹⁴⁷ The Tax Court focused solely on the *form* of the property, dismissing as irrelevant the taxpayer's *business motive* in holding the property.¹⁴⁸ *Logan* was the last decision to adopt such a literal approach in defining capital assets when dealing with a source of supply scenario. Later courts would consider evidence of the taxpayer's motive to be paramount.¹⁴⁹

Courts frequently grappled with taxpayers' motives for acquiring stock during World War II, when many goods were in short supply and the Office of Price Administration set price ceilings on thousands of items.¹⁵⁰ In order to circumvent their adherence to these ceilings, suppliers would often require purchasers to acquire the supplier's stock, either at an inflated price,¹⁵¹ or subject to the supplier's option to repurchase

146. *Id.*

147. *Id.* The taxpayer argued that the purchase of the shares of stock was similar to a hedging transaction and therefore entitled to special treatment. *Id.* at 1303. In contrast, the Tax Court listed the exclusions under § 117 of the Code and ruled that none were applicable. *Id.* This provision, now codified in I.R.C. § 1221, defined capital assets as follows:

[T]he 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 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.

Revenue Act of 1938, ch. 289, § 117(a)(1), 52 Stat. 447, 500 (codified at I.R.C. § 1221(1)-(2) (1988)).

148. *Logan*, 5 T.C. at 1304.

149. *See, e.g.*, *FS Servs., Inc. v. United States*, 413 F.2d 548, 555 (Ct. Cl. 1969) (deciding that taxpayer's acquisition of stock was based upon proper and valid business considerations rather than intent to make capital investment); *Booth Newspapers, Inc. v. United States*, 303 F.2d 916, 921 (Ct. Cl. 1962) (holding that taxpayer's motivation in purchasing securities may determine treatment under I.R.C.); *Electrical Fittings Corp. v. Commissioner*, 33 T.C. 1026, 1031 (1960) (holding that "the tax treatment of the loss on the sale of . . . stock depends upon the purpose for which the petitioner acquired the stock").

150. Exec. Order No. 8734, 3 C.F.R. 921 (1938-1943). The Office of Price Administration (OPA) was created shortly before the United States entered World War II to prevent undue price increases and to provide a fair distribution of products in short supply. *Id.* Starting in April, 1942, the OPA began a list of price ceilings that would eventually extend to eight million items. The OPA was absorbed into the Office for Emergency Management on June 1, 1947. Exec. Order No. 9809, 3 C.F.R. 591 (1943-1948), *repealed by* Pub. L. No. 89-554, 80 Stat. 632, 651 (Sept. 6, 1966).

151. *See, e.g.*, *McGhee Upholstery Co. v. Commissioner*, 12 T.C.M. (CCH) 1455 (1953).

the stock at a reduced price.¹⁵² In turn, after receiving the goods, the shareholder would sell the stock and incur a loss that it would then include as part of the true cost of acquiring the goods, thereby effectively treating the loss as an ordinary loss derived from the sale of a non-capital asset.¹⁵³ Accordingly, the Commissioner would object to such treatment, claiming simply that stock in a corporation was a capital asset.¹⁵⁴

The courts that decided these cases followed a different line of reasoning than the court in *Logan & Kanawha Coal Co.* Indeed, instead of examining the exclusions from the definition of capital assets to determine whether any applied, the courts performed a substance over form analysis: If the taxpayer could prove that the purchase of the stock was only incidental to the acquisition of the merchandise, the court would allow the taxpayer to treat the losses as part of the cost of goods sold.¹⁵⁵ Therefore, the focus was on the taxpayer's *motive* for purchasing and holding the stock rather than its mere purchase and possession. In most of these World War II period cases, the taxpayer's motive was presumed to be "inventory acquisition" if the taxpayer disposed of the stock shortly after acquiring the inventory.¹⁵⁶

One of the most unique methods developed by a supplier is illustrated by *Western Wine & Liquor Co. v. Commissioner*.¹⁵⁷ In *Western Wine*, the taxpayer was a liquor retailer who found it difficult to obtain

152. See, e.g., *Wm. M. Young Co. v. Commissioner*, 11 T.C.M. (CCH) 863 (1952); *Hoffman Lumber Co. v. Commissioner*, 11 T.C.M. (CCH) 579 (1952).

153. See, e.g., *McGhee Upholstery Co.*, 12 T.C.M. (CCH) at 1455.

154. See, e.g., *Edwards v. Hogg*, 214 F.2d 640, 643 (5th Cir. 1954).

155. For example, in *Hoffman Lumber Co.*, 11 T.C.M. (CCH) 579, the court stated:

In the instant case the evidence leaves no room for doubt that the overpayments were part of the costs of the lumber . . . purchased by [the taxpayer]. While [the taxpayer] went through the formality of subscribing for shares of [the supplier] in purchasing lumber, it never became a bona fide stockholder of that company and never intended to do so. The stock purchase transaction was an obvious sham to circumvent the O.P.A. regulations.

Id. at 580; see also *Wm. M. Young Co.*, 11 T.C.M. (CCH) at 865 (stating that amounts paid "nominally for stock were in fact payments for lumber and as such constituted a part of the cost of goods sold"). But see *McGhee Upholstery Co.*, 12 T.C.M. (CCH) at 1456 ("The record is entirely too meager on which to conclude that the transaction that [the taxpayer] had with [the supplier] was other than what it purported to be, the purchase and sale of shares of stock, and the loss that was suffered by [the taxpayer] must be treated as a long-term capital loss.").

156. See, e.g., *McGhee Upholstery Co.*, 12 T.C.M. (CCH) at 1456; *Wm. M. Young Co.*, 11 T.C.M. (CCH) at 865 ("The evidence is clear, we think, that the payments were solely for the purchase of lumber we have so found.").

157. 18 T.C. 1090 (1952); see also *Hogg v. Allen*, 105 F. Supp. 12 (M.D. Ga. 1952) (taxpayer bought stock in whiskey wholesaler for procurement rights attached to stock), *aff'd in part, rev'd in part sub nom.* *Edwards v. Hogg*, 214 F.2d 640 (5th Cir. 1954); *Flom v. Hofferbert*, 56-1 U.S. Tax Cas. (CCH) ¶ 9236 (D. Md. 1955) (taxpayer purchased stock of liquor company pursuant to plan where he received options to purchase company's liquor for resale).

an adequate supply of whiskey.¹⁵⁸ In order to meet its needs, the taxpayer took advantage of a unique stock offering made by one of its principal suppliers, American Distilling Company (American), which provided that holders of its stock would be entitled to purchase a proportional share of the company's inventory at a predetermined price.¹⁵⁹ The plan required that the taxpayer buy shares of stock in American and then notify the company of its intention to exercise the inventory purchase rights by tendering its shares of stock.¹⁶⁰ American would then ship the whiskey along with the taxpayer's shares, which would be stamped to indicate that the inventory purchase rights had already been exercised.¹⁶¹ The stock would then be sold at a substantial loss.¹⁶² The taxpayer engaged in several of these transactions and included the resulting losses in its calculation of cost of goods sold.¹⁶³

Applying a substance over form analysis,¹⁶⁴ the Tax Court determined that the taxpayer's sole motivation for purchasing the company's stock was to acquire inventory and that the purchase of the American shares was only a necessary expedient. The court stated:

We think this taxpayer acquired the Distilling stock incident to the conduct of its business and not for investment and that it held the stock only long enough to acquire the whiskey and then sold it to reduce the cost of the whiskey as much as possible. In the circumstances and as contended by the taxpayer, the sale of the securities became an incident of the business.¹⁶⁵

Accordingly, the court held that the loss was properly included in the taxpayer's cost of goods sold.¹⁶⁶

The cases that followed the Supreme Court's landmark decision in *Corn Products Refining Co. v. Commissioner*¹⁶⁷ took the source of supply analysis one step further, though most bore little factual resemblance to their predecessors. Indeed, unlike the incidental stock purchases in *Western Wine*, the taxpayers in these later cases held the stock for extended periods and became active managers in the companies in order to

158. 18 T.C. at 1090.

159. *Id.* at 1093-94.

160. *Id.* at 1093.

161. *Id.* at 1092-93.

162. *Id.* at 1095-96.

163. *Id.* at 1096.

164. See 1 BITTKER & LOKKEN, *supra* note 26, ¶ 4.3.3, at 4-35 to 4-44 for a discussion of a substance over form analysis.

165. *Western Wine*, 18 T.C. at 1099.

166. *Id.*

167. 350 U.S. 46 (1955).

guarantee an adequate inventory supply.¹⁶⁸ The one fact that remained constant, however, was the taxpayer's attempt to treat a subsequent loss on the sale of the stock as ordinary. Armed with the expansive reasoning of *Corn Products*, taxpayers were often successful.¹⁶⁹ Two Court of Claims cases, *Booth Newspapers, Inc. v. United States*¹⁷⁰ and *FS Services, Inc. v. United States*,¹⁷¹ are representative of this trend.

Booth Newspapers involved two newspaper publishers who were faced with a severe shortage of newsprint just after the end of World War II.¹⁷² Initially, the publishers tried to meet their needs by buying newsprint on the spot market, often at double the normal price.¹⁷³ Seeking a more economical alternative, in 1947 the publishers purchased all of the outstanding stock of the Michigan Paper Company.¹⁷⁴ Although at the time of purchase the company only manufactured high quality writing and book paper, the taxpayers had been assured that the equipment could be modified to manufacture newsprint.¹⁷⁵ Only a part of the machinery was converted, however, because the taxpayers believed that the continued production of the other products would keep the company attractive for resale once the newsprint shortage had ended.¹⁷⁶ By 1954, the taxpayers were satisfied that the shortage had abated and sold their shares of stock in the company at a price far below their original purchase price, deducting the full amount of the loss as an ordinary deduction.¹⁷⁷ The Commissioner disallowed the deduction on the ground that the losses sustained were capital in nature.¹⁷⁸ The taxpayers paid the deficiencies, sought a refund and, after receiving no satisfaction, petitioned the Court of Claims.¹⁷⁹

168. See, e.g., *Dearborn Co. v. United States*, 444 F.2d 1145 (Ct. Cl. 1971); *FS Servs., Inc. v. United States*, 413 F.2d 548 (Ct. Cl. 1969) (per curiam); *Booth Newspapers, Inc. v. United States*, 303 F.2d 916 (Ct. Cl. 1962); *Journal Co. v. United States*, 195 F. Supp. 434 (E.D. Wis. 1961); *Electrical Fittings Corp. v. Commissioner*, 33 T.C. 1026 (1960); *Livesley v. Commissioner*, 19 T.C.M. (CCH) 133 (1960). But see *Smith & Welton, Inc. v. United States*, 164 F. Supp. 605 (E.D. Va. 1958).

169. See, e.g., *FS Servs.*, 413 F.2d at 555; *Booth Newspapers*, 303 F.2d at 922; *Journal Co.*, 195 F. Supp. at 440; *Electrical Fittings*, 33 T.C. at 1032; *Livesley*, 19 T.C.M. (CCH) at 140.

170. 303 F.2d 916 (Ct. Cl. 1962).

171. 413 F.2d 548 (Ct. Cl. 1969).

172. 303 F.2d at 917.

173. *Id.*

174. *Id.* at 918.

175. *Id.*

176. *Id.* For this reason, the taxpayers did not take any dividends, choosing instead to reinvest their profits by replacing faulty and aging equipment. *Id.* at 919.

177. *Id.*

178. *Id.*

179. *Id.* Beginning on October 1, 1982, the Court of Claims was thereafter referred to as the Claims Court. Gen. Order No. 1, 1 Cl. Ct. XXI (1983).

The Court of Claims began by explaining that although the shares of stock held by the taxpayers fell within the literal definition of capital assets, a more flexible approach to the concept of capital assets had developed.¹⁸⁰ According to the court, this flexible approach required an examination of “the circumstances of the transaction [which include] . . . its factual background, the necessities of the particular business involved, and the intentions of the taxpayer, both at the time the securities were originally purchased and at the time they were disposed of.”¹⁸¹ Examining the record, the court stated that “rather than characterizing the transaction as a mere purchase of plant and equipment, it seems more accurate to characterize it as the acquisition of a vital source of inventory.”¹⁸² Accordingly, the court concluded that the acquired stock was not a capital asset because the publishers were motivated to purchase the company “solely as a temporary expedient to insure an adequate inventory of newsprint during the period of shortage.”¹⁸³

*FS Services, Inc. v. United States*¹⁸⁴ provides another good example of this approach to the source of supply scenario. The taxpayer in *FS Services* was a wholesaler of feeds, fertilizers and petroleum products to farm cooperatives.¹⁸⁵ Like the taxpayers in *Booth Newspapers*, the taxpayer, FS Services, was having a difficult time maintaining an adequate supply of products because a post-war shortage had developed.¹⁸⁶ Seeing no reasonable alternative, the taxpayer purchased all the shares of stock of a small refinery.¹⁸⁷ Thereafter, even though the shortage subsided within one year, it would take substantial capital infusions and more than six years before the taxpayer could resell the stock.¹⁸⁸ The sale of the stock resulted in a loss of more than seven hundred thousand dollars, which the taxpayer took as an ordinary deduction.¹⁸⁹ Not surprisingly,

180. *Booth Newspapers*, 303 F.2d at 920.

181. *Id.* at 921.

182. *Id.* at 922.

183. *Id.* Even though a clear nexus existed between the taxpayer's inventory and its stock acquisition, the court did not engage in any dialogue regarding the inventory exclusion. Yet, the Claims Court later cited *Booth Newspapers* as an example of the scope of the inventory exclusion. See *Circle K Corp. v. United States*, 23 Cl. Ct. 665, 672 (1991).

184. 413 F.2d 548 (Ct. Cl. 1969).

185. *Id.* at 549. The petroleum products accounted for approximately 60% of the taxpayer's annual sales. *Id.*

186. *Id.* Some of the products were unavailable in the open market, while others were only available at prices so inflated that the taxpayer could not pass them on to its customers. *Id.*

187. *Id.* at 550. The taxpayer also joined with several other wholesalers in purchasing the stock of additional refineries. *Id.*

188. *Id.* at 551-52.

189. *Id.* at 552.

the Commissioner disallowed the deduction,¹⁹⁰ and the Court of Claims reviewed the case on appeal.

As in *Booth Newspapers*, the court used the "flexible method" analysis, looking to the taxpayer's motivation in acquiring and holding the subject property.¹⁹¹ The court considered the following factors in deciding that the stock was not a capital asset: (1) the taxpayer's lack of stock holdings in other companies; (2) the unattractiveness of the investment; (3) the taxpayer's intent not to hold on to the stock any longer than necessary; (4) the lack of available alternatives; (5) the actual use by the taxpayer of the source of supply; and (6) the sale of stock at the earliest reasonable opportunity.¹⁹² Clearly, a more defined standard was necessary, and once again the Supreme Court stepped in.¹⁹³ Interestingly, it would not be a source of supply case that would necessitate the Supreme Court's revisiting the definition of capital asset; rather, it was the ever expanding reach of the *Corn Products* doctrine into fact situations having absolutely no relation whatsoever to hedging transactions or guaranteeing a source of supply of inventory.

IV. THE RETURN TO THE INVENTORY EXCLUSION

A. Arkansas Best Rewrites *Corn Products* and Defines an Exclusion

*Arkansas Best Corp. v. Commissioner*¹⁹⁴ was not an inventory case,¹⁹⁵ yet the Supreme Court examined the scope of the inventory ex-

190. *Id.* at 548.

191. *Id.*

192. *Id.* at 554-55.

193. See *Arkansas Best Corp. v. Commissioner*, 485 U.S. 212 (1988).

194. 485 U.S. 212 (1988).

195. *Arkansas Best Corp.* was a holding company that in 1968 acquired 65% of the stock of a Dallas bank. *Arkansas Best Corp. v. Commissioner*, 83 T.C. 640, 643 (1984), *rev'd in part, aff'd in part*, 800 F.2d 215 (8th Cir. 1986), *aff'd*, 485 U.S. 212 (1988). In 1972 the bank developed problems when the Dallas real estate market collapsed. *Id.* at 647. Consequently, significant capital infusions were necessary to avoid failure. *Id.* at 648. *Arkansas Best* provided this capital in return for additional shares of stock believing that a failure to do so would tarnish its reputation and jeopardize its ability to secure financing in the future. *Id.* In 1975 the holding company divested itself of most of the bank's stock, incurring a loss of almost ten million dollars, which it took as an ordinary deduction in its federal income tax return. *Id.* at 650. Thereafter, the Commissioner denied the deduction, claiming that the loss resulted from the sale of a capital asset and was only deductible to the extent of capital gains. *Arkansas Best Corp. v. Commissioner*, 800 F.2d 215, 217 (8th Cir. 1986), *aff'd*, 485 U.S. 212 (1988). The Tax Court determined that the stock representing the initial 65% interest was capital in nature and that the stock representing the taxpayer's effort to protect its business reputation was ordinary in nature. *Arkansas Best*, 83 T.C. at 655, 660. On appeal, the Eighth Circuit adopted a literal reading of I.R.C. § 1221 and found that all of the stock held by the taxpayer was a capital asset because it did not fall within any of the listed exclusions. *Arkansas Best*, 800 F.2d at 218. The Supreme Court affirmed. *Arkansas Best*, 485 U.S. at 223.

clusion, employing the case as a vehicle to rewrite its decision in *Corn Products Refining Co. v. Commissioner*.¹⁹⁶ For over three decades, courts and commentators assumed that the *Corn Products* decision had unequivocally affirmed the existence of an extra-statutory business exception to the definition of capital assets.¹⁹⁷ In *Arkansas Best*, however, the Supreme Court expressly rejected any possibility that such an extra-statutory exception ever existed and stated that its earlier decision had been based solely on the inventory exclusion.¹⁹⁸ Authoring the opinion for a unanimous Court,¹⁹⁹ Justice Marshall explained:

The Court in *Corn Products* proffered the oft-quoted rule of construction that the definition of "capital asset" must be narrowly applied and its exclusions interpreted broadly, but it did not state explicitly whether the holding was based on a narrow reading of the phrase "property held by the taxpayer," or on a broad reading of the inventory exclusion of § 1221. In light of the stark language of § 1221, however, we believe that *Corn Products* is properly interpreted as involving an application of § 1221's inventory exception.²⁰⁰

After justifying its assertion that the *Corn Products* decision was based solely on an inventory exclusion analysis, the Court in *Arkansas Best* nevertheless neglected to delineate how such an analysis should be conducted in the future.²⁰¹ The Court merely stated it believed the inventory exclusion should be interpreted broadly and that the futures contracts held by the taxpayer in *Corn Products* fit within that interpretation.²⁰² Apparently then, all that is necessary is a determination of whether the property held by the taxpayer was an "integral part of the taxpayer's business inventory-purchase system."²⁰³ This would be determined through an examination of the taxpayer's motive.²⁰⁴

The Court opined that the relevance of the issue of motive had been misunderstood; specifically, Justice Marshall averred that motive is irrelevant for purposes of determining whether property is a capital asset, but

196. 340 U.S. 46 (1955).

197. See *supra* notes 73, 75 and part III.B.

198. 485 U.S. at 220. For a complete description of the *Arkansas Best* decision, see Kleinbard & Greenberg, *supra* note 66, at 414-19; O'Neill, *supra* note 73, at 1487-90; and Reichel, *supra* note 73, at 840-43.

199. *Arkansas Best* was decided unanimously, 8-0; Justice Kennedy did not participate in the consideration or decision of the case. *Arkansas Best*, 485 U.S. at 223.

200. *Id.* at 220.

201. See *id.*

202. *Id.* at 221.

203. *Id.*

204. *Id.* at 220-23.

it is relevant in determining whether one of the exclusions applies.²⁰⁵ Referring to the facts in *Corn Products*, Justice Marshall illustrated this point by stating:

The close connection between the futures transactions and the taxpayer's business in *Corn Products* was crucial to whether the corn futures could be considered surrogates for the stored inventory of raw corn. For if the futures dealings were not part of the company's inventory purchase system, and instead amounted simply to speculation in corn futures, they could not be considered substitutes for the company's corn inventory, and would fall outside even a broad reading of the inventory exclusion.²⁰⁶

The Supreme Court's opinion in *Arkansas Best* left many questions unanswered. For example, what types of property could be considered "an integral part of the taxpayer's inventory purchase-system"—any property, or just nonspeculative futures? The latter would certainly be too narrow a reading of a broad exclusion. Furthermore, how would the Court handle a taxpayer that could not protect itself against price fluctuations or supply shortages by investing in futures contracts? In other words, what about the "source of supply" doctrine? Thus, that a case like *Circle K Corp. v. United States*²⁰⁷ would come along was not just predictable, it was certain.

B. Circle K Tests a Definition

*Circle K*²⁰⁸ is the first post-*Arkansas Best* decision to test the parameters of the Supreme Court's standard for determining the applicability of the inventory exclusion. The Claims Court's decision revealed that the standard is unworkable. Circle K Corporation operates a chain of over twelve hundred convenience stores.²⁰⁹ Well over half of its stores include self-service gasoline facilities, which report overall sales forty

205. *Id.* at 223.

206. *Id.* at 221-22.

207. 23 Cl. Ct. 665 (1991).

208. The decision in *Circle K* was issued in three separate orders. The first order, issued on May 16, 1991, was in favor of the taxpayer. See *Circle K Corp. v. United States*, 23 Cl. Ct. 659, 665 (1991). On June 5, 1991, the court directed the clerk to vacate the judgment because the amount due the taxpayer had been miscalculated and all issues had not been decided. *Id.* at 660. On August 2, 1991, the court issued another order reinstating a modified version of its May 16 order and denied the government's motion for reconsideration. *Id.* at 660, 665. On the same day, the court also denied the government's motion for partial summary judgment. *Circle K*, 23 Cl. Ct. at 673.

209. *Circle K*, 23 Cl. Ct. at 666.

percent in excess of those without such facilities.²¹⁰ Because of the importance of gasoline sales to its earnings, the taxpayer wanted to avert any extended interruption in its supply of gasoline.²¹¹ During the 1960s and 1970s, the taxpayer had tried various methods of securing a steady source of supply, including efforts to obtain a long-term contract or purchase a refinery, to no avail.²¹²

In 1980 the taxpayer took a different approach by acquiring 12.3% of NuCorp Energy, Inc. (NuCorp), an oil and gas exploration and development company that owned both oil and gas producing reserves.²¹³ In addition to acquiring the stock, the taxpayer entered into both an exploration/development agreement and a consulting/training agreement with NuCorp.²¹⁴ The exploration and development agreement entitled the taxpayer to a ten percent share in any oil produced, which the taxpayer could take in kind.²¹⁵ In 1981, in return for 376,000 additional shares and an option to purchase crude oil from NuCorp, the taxpayer relinquished its rights under the exploration and development agreement until January 2, 1983.²¹⁶ Nevertheless, the taxpayer never exercised the option.²¹⁷

NuCorp generated large losses during the period the taxpayer held its stock and, in 1982, NuCorp filed for Chapter 11²¹⁸ protection.²¹⁹ Shortly thereafter, the taxpayer sold its NuCorp stock, incurring a loss in excess of twenty-seven million dollars, which it claimed on its federal income tax return as an ordinary deduction.²²⁰ The Commissioner determined that the loss was capital and thus only allowed the taxpayer to use it to offset its capital gains.²²¹ The taxpayer paid the resulting deficiency, filed a claim for a refund, which was subsequently denied, and then

210. *Id.*

211. *Id.*

212. *Id.*

213. *Id.* at 666-67.

214. *Id.* at 666.

215. *Id.* at 667.

216. *Id.* at 668. The taxpayer could have exercised this option twice a year by designating from which wells it wanted to purchase the oil. *Id.* Moreover, as long as that well's production was not already committed to a third party, the taxpayer could purchase the oil at market price for a period running from the exercise date of the option through December of 1988. *Id.*

217. *Id.* at 668-69.

218. 11 U.S.C. §§ 1101-1174 (1988). Chapter 11 provides for business reorganization under the supervision of the bankruptcy court with the debtor company normally permitted to continue operations. *Id.*

219. *Circle K*, 23 Cl. Ct. at 669.

220. *Id.*

221. *Id.*

sought relief in the Claims Court.²²² On a motion for summary judgment, the court determined that the shares of NuCorp stock held by the taxpayer were *not* capital assets.²²³ In so holding, the Claims Court used a source of supply analysis it believed came within the standard for determining the inventory exclusion's applicability established by the Supreme Court in *Arkansas Best*.²²⁴ In assessing the validity of the analysis employed, Judge Tidwell, who decided *sua sponte* the motion for summary judgment in the taxpayer's favor, stated that the *Arkansas Best* decision did not specifically address the source of supply doctrine and that

in the absence of any definite indication to the contrary, the court feels that a source of supply analysis . . . still is valid. Therefore, the court finds that a source of supply stock purchase may qualify as a hedging transaction if it is an integral part of plaintiff's inventory-purchase system.²²⁵

Essentially, the court stated that as long as the taxpayer was attempting to protect itself against inventory price fluctuations or was trying to ensure a continuous and adequate source of supply, the type of property used by the taxpayer to achieve this result should not matter. In other words, stock should not be treated any differently than futures contracts, as long as the taxpayer can demonstrate that the property was held for the same purpose, namely, as an integral part of the taxpayer's inventory purchase system.²²⁶ Moreover, the *Circle K* court averred that a broad reading of the inventory exclusion should not be available only to taxpayers who can hedge against inventory shortages on a commodities market.²²⁷ For better or for worse, this is the effect of the standard announced by the Supreme Court in *Arkansas Best*. Thus, the *Arkansas Best* Court may have closed the door on a taxpayer's argument that property held for a *business* purpose was not capital, but it opened the door to a taxpayer's argument that property held for an *inventory* purpose was not capital.

The Claims Court erred, however, in its method of determining whether the stock held by Circle K was an integral part of the taxpayer's inventory purchase system. Judge Tidwell proclaimed that according to *Arkansas Best*, evidence of motive or intent is irrelevant.²²⁸ Instead, the Claims Court stated that resolution of the issue depended on whether the

222. *Id.*

223. *Id.* at 673.

224. *Circle K*, 23 Cl. Ct. at 664.

225. *Id.* at 672.

226. *See Arkansas Best*, 485 U.S. at 221.

227. *See Circle K*, 23 Cl. Ct. at 672.

228. *Id.*

stock purchase, "solely on its face, had a substantially close connection to [the taxpayer's] business so that it fairly can be characterized as an integral part of [the taxpayer's] inventory-purchase system."²²⁹

Judge Tidwell's understanding of the relevance of motive according to *Arkansas Best* is misguided. Merely demonstrating a close connection between the property held, such as stock in an oil company, and the inventory needs of the taxpayer, such as oil products, is not enough. The Court in *Arkansas Best* did not state that motive was irrelevant. On the contrary, the Court explicitly deemed motive essential in determining whether any of the specifically enumerated exclusions to capital assets apply.²³⁰ A mere showing that property, solely on its face, has a close connection to a taxpayer's inventory would provide a much broader exclusion than that set forth in *Arkansas Best*. Corn futures have a close connection to the business of corn products, yet the Supreme Court in *Arkansas Best* stated that even with this close connection, such futures would not come within the inventory exclusion if entered into for speculative purposes.²³¹ The only way to accurately assess whether a taxpayer holds stock in another company for inventory purposes is to examine motive.

Because the Claims Court foreclosed motive as a basis for determining the applicability of the inventory exclusion, the remainder of the opinion is strained.²³² If, however, the court had examined the taxpayer's motive, using the pre-*Arkansas Best* source of supply cases as a

229. *Id.*

230. *See Arkansas Best*, 485 U.S. at 221.

231. *See id.* at 222.

232. It appears the court concluded that the inventory exclusion was applicable because the shares represented an interest in an energy company and the taxpayer held an option to purchase crude oil from that company. *See Circle K*, 23 Cl. Ct. at 673. Indeed, in rendering its decision, the Claims Court stated: "In light of the special place that gasoline held in terms of [the taxpayer's] earnings and profitability, the court feels that [the taxpayer's] investment in NuCorp bore the legally requisite 'close connection' with its business to warrant application of the inventory exception." *Id.* With respect to the failure of the taxpayer to ever exercise its option, the court continued: "[The taxpayer] should not have to forfeit this interpretation simply because the supply of gasoline never reached a point where [the taxpayer] needed to exercise its options." *Id.*

Furthermore, the court seemed indifferent to the fact that the taxpayer's option was to acquire crude oil and not gasoline. The court stated:

Obviously [the taxpayer] could not sell NuCorp's crude oil at its retail convenience stores without refinement into gasoline but, as [the taxpayer] explained, NuCorp's crude oil could be a substitute for a supply of gasoline because of the practice in the energy field of trading product. Through this practice, crude oil produced in one section of the country can be exchanged for refined gasoline at distant and diverse locations. Had the oil crisis worsened, product trading would have become an important part of [the taxpayer's] inventory purchase program.

Id. at 668.

guide, it is doubtful that Circle K would have prevailed. Unlike the taxpayers in both *Booth Newspapers, Inc. v. United States*²³³ and *FS Services, Inc. v. United States*,²³⁴ an acquisition of a source of supply was not the primary intent of Circle K.²³⁵ Instead, the corporation repeatedly asserted that its investment in NuCorp was primarily intended to diversify the company and not to guarantee access to an ample supply of inventory.²³⁶ NuCorp's expression that its stock might someday be used to acquire gasoline was, at most, an afterthought.²³⁷ Consequently, it is difficult to imagine that *Circle K* presents a successful source of supply argument under the *Corn Products* doctrine, let alone under the standard set forth in *Arkansas Best*.

It was inevitable that an opinion like *Circle K* would follow *Arkansas Best*. In fact, anomalous decisions will continue to find their way into casebooks as long as the judiciary is convinced that a broad reading of the inventory exclusion under § 1221(1) is required. One must question, however, whether Congress envisioned such an expansive reading of the exclusion. A review of the legislative history of the inventory exclusion and an examination of subsequent amendments to the definition of capital assets suggest otherwise.

V. DETERMINING CONGRESSIONAL INTENT

It is difficult to discern Congress's true intent when it formulated the definition of capital assets in the Revenue Act of 1921 because the legislative history regarding that section of the Act is scant at best.²³⁸ The committee reports cite only a desire to provide relief to farmers and other long-term holders of property from the bunching effect.²³⁹ There are no statements as to why Congress employed the language it did or chose the exclusions it created. Indeed, the only mention of inventory in the 1921 Act is in the statute itself. Congress simply excluded from capital assets,

233. 303 F.2d 916 (Ct. Cl. 1962).

234. 413 F.2d 548 (Ct. Cl. 1969).

235. See *Circle K*, 23 Cl. Ct. at 667-68.

236. On December 15, 1980, the taxpayer filed a proxy statement and prospectus with the Securities and Exchange Commission detailing a plan of reorganization designed to allow the company greater flexibility in its diversification efforts. *Id.* at 667. The taxpayer identified the gas and oil business as the first industry targeted in its diversification efforts and stated that it had invested in NuCorp for that reason. *Id.*

237. The court, however, stressed the fact that the taxpayer always had qualified its diversification statements by adding "that its plans were subject to change depending on the availability of gasoline." *Id.* at 668.

238. See H.R. REP. NO. 486, 67th Cong., 1st Sess. 20 (1921).

239. S. REP. NO. 275, 67th Cong., 1st Sess. 12-13 (1921). For a discussion of the bunching effect, see 1 BITTKER & LOKKEN, *supra* note 26, ¶ 3.5.7, at 3-65 to 3-66.

stock in trade 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."²⁴⁰ It is this original language to which the Supreme Court ascribes its broad reading.²⁴¹ Congress, however, did not state whether such words should be interpreted broadly or narrowly. Subsequent amendments to the definition of capital assets, however, do provide insight into the actual meaning of these twenty-five words and reveal a much narrower exclusion than that set forth in *Arkansas Best*.²⁴²

In its history, the inventory exclusion has only been amended twice. The Revenue Act of 1924 added to the existing words of "stock in trade or other property of a kind properly includable in inventory if on hand at the close of the taxable year," the words, "or property held primarily for sale by taxpayer in the ordinary course of his trade or business."²⁴³ The Revenue Act of 1934 modified this amendment to read "or property held by taxpayer primarily for sale *to customers* in the ordinary course of his trade or business."²⁴⁴ Certainly, the added language would be unnecessary if, as claimed by the Supreme Court in *Arkansas Best*, the original twenty-five words were meant to be broadly interpreted.

This language cannot stand for the proposition professed by the Supreme Court. On the contrary, the legislative history of the amendments discloses that Congress added the amendments because it was concerned that the existing exclusion was actually too narrow and needed expansion. Indeed, Representative Green of Iowa, who proposed the 1924 amendment, stated:

[T]he object . . . was to expand a little further the words "stock in trade," as they might possibly be construed to mean just the stock that the merchant or other party happened to hold in his business house at the time, the idea of the committee being that the definition of "capital assets" should exclude not only what was in the business house at the time but goods in the process of manufacture and other articles that eventually would be-

240. Revenue Act of 1921, ch. 136, § 206(a)(6), 42 Stat. 227, 232 (emphasis added).

241. In *Arkansas Best*, the Court, discussing its earlier opinion in *Corn Products*, stated:

[A]lthough corn futures were not "actual inventory," their use as an integral part of the taxpayer's inventory-purchase system led the Court to treat them as substitutes for the corn inventory such that they came within a broad reading of "property of a kind which would properly be included in the inventory of the taxpayers" in § 1221.

485 U.S. at 221.

242. See, e.g., Revenue Act of 1924, ch. 234, § 208(a)(8), 43 Stat. 253, 263; Revenue Act of 1934, ch. 277, § 117(b), 48 Stat. 680, 714.

243. Revenue Act of 1924 § 208(a)(8).

244. Revenue Act of 1934 § 117(b) (emphasis added).

come a part of the stock and were held for that purpose and, therefore, would have to be included in the inventory.²⁴⁵

Thus, the words "or property held for sale to customers in the ordinary course" must denote the outer boundary of § 1221(1).²⁴⁶

The meaning of the original twenty-five words is found in the Senate Finance Committee Report to the Revenue Act of 1924.²⁴⁷ Reiterating the need to expand the original language, the report states that the amendment was necessary to show that property held for resale "was not a capital asset whether or not it is the type of property *which under good accounting practice would be included in inventory.*"²⁴⁸ Implicitly then, Congress was saying that the words upon which the Court in *Arkansas Best* would later rely, extended only to property that the taxpayer's accounting practice required to be included in inventory if on hand at the close of the tax year. The added language was necessary to cover property that, although not of a type includable in the taxpayer's year-end inventory, the taxpayer nevertheless held for resale.²⁴⁹ Essentially, Congress was saying that goods held for resale might not be includable in year-end inventory for financial accounting purposes, but they do constitute property within the scope of the inventory exclusion.

Congressional recognition of this dichotomy helps to explain the actions of the Commissioner in General Counsel Memorandum 17,322. As previously discussed, the question addressed by the Commissioner in General Counsel Memorandum 17,322 was whether the same type of property—a futures contract—held by two different taxpayers—a cotton dealer and a textile manufacturer—had a different character in the hands of each taxpayer because one taxpayer included the property in inventory at year-end while the other did not.²⁵⁰ At least in the situation in which both taxpayers held the property for the same purpose—to protect against inventory price fluctuation—the Commissioner found that the property had the same character and decided to disregard the taxpayer's accounting method in determining the applicability of the exclusion.

The addition of other business asset exclusions to the definition of capital assets further supports this narrow reading. In 1938 Congress added the predecessor of § 1221(2) by excluding depreciable trade or

245. 65 CONG. REC. H2842 (1924) (statement of Rep. Green); SEIDMAN, *supra* note 34, at 717.

246. For an in depth discussion of the judicial treatment of this phrase, see 2 BITTKER & LOKKEN, *supra* note 26, ¶ 51.2.

247. S. REP. NO. 398, 68th Cong., 1st Sess. 22 (1924).

248. *Id.* (emphasis added).

249. *Id.*

250. See *supra* notes 66-87 and accompanying text.

business property from the capital asset category.²⁵¹ The scope of this exclusion was extended in 1942 to include real property used in a trade or business.²⁵² Further, in 1954 Congress added § 1221(4), which excluded accounts and notes receivable acquired in the ordinary course of business.²⁵³ By adding these very specific, supplementary business exclusions, a reasonable inference can be drawn that each business exclusion should not be read to include property beyond the actual property identified. To do otherwise creates the potential for a particular business asset to be excluded under more than one provision. For example, a very broad reading of the inventory exclusion might arguably include storage facilities such as grain silos for storing corn as "inventory." Yet, this property is explicitly excluded under § 1221(2) as depreciable trade or business property. That Congress would have intended such an overlap is unsupported and highly unlikely.

As a matter of fact, an extremely broad reading of these business exclusions theoretically could exclude virtually all business property from the capital asset category. This could be called the reverse *Corn Products* doctrine. The United States Supreme Court, however, emphatically rejected any cumulative, illustrative use of the business exclusions, stating: "These exclusions would be largely superfluous if assets acquired primarily or exclusively for business purposes were not capital assets."²⁵⁴ Yet, it is difficult to reconcile this statement with the Court's steadfast belief that the inventory exclusion should be interpreted to include property beyond actual inventory.

VI. CONCLUSION

The issue of determining which assets qualify as capital assets under § 1221 has had a long and tortured history. Nowhere has this been more apparent than with the continued difficulty exhibited by the judiciary while engaging in futile attempts to define the line between capital assets and "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."²⁵⁵ In 1988 the United States Supreme Court declared that the inventory exclusion under § 1221(1) enveloped any and all property that a taxpayer could prove was an integral part of the taxpayer's inventory purchase

251. See Revenue Act of 1938, ch. 289, § 117(a)(1), 52 Stat. 447, 500.

252. See Revenue Act of 1942, ch. 619, § 151(a), 56 Stat. 798, 846 (codified as amended at I.R.C. § 1221(2) (1988)).

253. See Revenue Act of 1954, ch. 736, § 1221(4), 68A Stat. 3, 322 (codified at I.R.C. § 1221(4) (1988)).

254. *Arkansas Best Corp. v. Commissioner*, 485 U.S. 212, 218 (1988).

255. I.R.C. § 1221(1) (1988).

system. The Claims Court's recent decision in *Circle K*, announcing the survival of the source of supply doctrine under the *Arkansas Best* standard, confirms that the Supreme Court's standard is unworkable. Cases like *Circle K* will continue to pervade the courts as long as the judiciary continues to adhere stringently to the flawed notion that the exclusions to the definition of capital assets were meant to be interpreted broadly. That belief is flawed because a careful review of the legislative history of the definition of capital assets reveals a congressional intent antithetical to that which is now becoming deeply entrenched judicial precedent.

Section 1221(1) excludes property that a taxpayer would be required to include under good accounting practices in inventory if it were on hand at the end of the taxable year.²⁵⁶ It also excludes any other property that a taxpayer holds for resale, even if such property does not fall within the traditional definition of inventory. Section 1221(1), however, includes shares of stock held by nonsecurities dealers regardless of the taxpayer's motive for acquiring and retaining the stock. Therefore, it is time for Congress or the Supreme Court to espouse a much stricter interpretation of § 1221(1) and bury the source of supply doctrine in the graveyard of defunct tax doctrines, right alongside the *Corn Products* doctrine.

256. *Id.* § 1221(1).