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NOTES

THE ROLE OF THE CORN PRODUCTS DOCTRINE IN FOREIGN EXCHANGE TRANSACTIONS

I. INTRODUCTION

It is well recognized that the marketing of foreign exchange plays an integral role in maintaining the smooth operation of international commerce. The foreign exchange markets fulfill this role by providing commercial enterprises with a source of foreign currency that may be required as the medium of exchange for completing a foreign transaction. In addition to the role played in aiding international commerce, the foreign exchange markets, especially in recent years, have provided a new avenue for speculative activity predicated upon the fluctuations of the exchange rates of the various currencies. This speculative activity, which has developed with the growth of commercial foreign exchange trading, has greatly increased in the wake of the abandonment of the fixed exchange rates guaranteed by the Bretton Woods Agreement.[1]

In place of the fixed system contemplated by Bretton Woods, exchange rates have been allowed to float within a fairly broad range, free from official intervention in the markets or from exchange controls.[2] The principal drawback of the floating exchange rate system is that, unfortunately, foreign currencies are more susceptible to speculative attacks, causing currency instability and increased hedging. As a result, market exchange rates are often based upon the speculator's emotional reactions to political and economic developments.[3] Moreover, the foreign exchange markets

1. The Bretton Woods Agreement was entered into at the close of the Second World War to prevent a recurrence of the currency instability that followed the First World War. Under the Bretton Woods system of fixed exchange rates, the value of national currencies associated with the International Monetary Fund was fixed in terms of dollars and gold with the governments of the participating countries obligated to keep exchange rate fluctuations within a permissible narrow range agreed to by the parties. P. EINZIG, THE CASE AGAINST FLOATING EXCHANGE RATES 1, 12 (1970). [hereinafter cited as EINZIG].

2. *Id.* at 3.

3. Political and economic factors such as inflation (Wall Street J., Mar. 22, 1974, at 8, col. 2), foreign trade results (Wall Street J., April 3, 1974, at 22, col. 3), and rumors concerning Arab oil plans for investment (Wall Street J., Mar. 15, 1974, at 19, col. 4; Wall Street J., Aug. 16, 1974, at 4, col. 3) play a pivotal role

are subject to additional factors that create unrest such as devaluations and revaluations, [4] and large scale shifts between currencies by multinational enterprises[5] and nations[6] engaged in commercial or speculative activity. The result of these machinations is that the various foreign exchange rates do not reflect their nations' long term economic position but rather reflect the artificial supply and demand caused by speculative dealings.[7]

The principle underlying the operation of the various foreign exchange markets is that money may play a dual role either as a medium of exchange or as a commodity.[8] As a medium of exchange, money has no intrinsic value; rather, its value is reflected by its purchasing power in the market place. As a commodity, money may be bought and sold with the result that its value will be expressed in terms of some other medium of exchange. When money is traded as a commodity, whether to purchase foreign currency for commercial transactions or to speculate for profit, the resulting gain or loss on the foreign exchange transaction is termed exchange rate gain or loss and results from the fluctuation of the

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in the purchase and sale of foreign exchange and result in wide exchange rate fluctuations, catalyzed by the markets' reactions to the news and rumors.

4. On January 8, 1974, the Japanese yen was devalued 6.7% against the dollar—a move that was precipitated by heavy selling of the yen in the midst of the fuel crisis. Wall Street J., Jan. 8, 1974, at 3, col. 1.

On May 20, 1974, Iceland devalued its Krona 4 per cent against the dollar in an effort to boost its exports. Wall Street J., May 20, 1974, at 6, col. 3.

5. Multinational companies with their huge assets and ability to shift large amounts of money throughout the world have the capability to trigger currency crises.

6. Nations with large liquid assets such as the Middle Eastern states are suspected of engaging in profitable speculation by creating exchange rate fluctuations by the timed movement of large amounts of money in and out of various currencies. Wall Street J., Mar. 1, 1974, at 1, col. 6.

7. *See generally* EINZIG, *supra* note 2, at 112-37.

8. "A coin or note functions as money only within the territory in which that currency customarily circulates; elsewhere the coin or note commonly becomes a commodity." A. NUSSBAUM, MONEY IN THE LAW NATIONAL AND INTERNATIONAL 318 (1950).

In cases involving the taxation of foreign money, money has been considered a commodity or a security. Such a principle was clearly established in early tax cases. For example, in *James A. Wheatley*, 8 B.T.A. 1246, 1249 (1927), the Tax Board stated that "pesos were nothing more than a commodity." The Board held in *Theodore Tiedemann & Sons, Inc.*, 1 B.T.A. 1077, 1079 (1925) that German marks "are not to be treated differently from any securities which might have been purchased by the taxpayer." *See* Comment, *Income Tax Consequences of Foreign Currency Fluctuations*, 37 TUL. L. REV. 282 (1962).

value of one currency vis-a-vis another.[9] Thus, exchange rate gain or loss is distinguished from monetary gain or loss in which the profitability of a transaction is expressed in terms of the same currency that serves as the medium of exchange.[10]

Exchange rate gain or loss may result from fluctuations of exchange rates[11] or from formal governmental action such as revaluation and devaluation.[12] In evaluating the significance of foreign exchange transactions and their tax consequences, the types of transactions that produce exchange rate gain or loss must be distinguished. The first type of transaction is currency speculation in which exchange rate gain or loss is the only profit or loss realized. The second type of transaction involves the purchase and sale of inventory in which the exchange rate gain or loss is ancillary to the monetary gain or loss realized on the underlying commercial transaction. The last type is credit transactions involving the borrowing and repayment of foreign currency, which may produce exchange rate gain or loss on the closing of the transaction with currency purchased at a higher or lower exchange rate than at the time the transaction originated.

The significant question raised by these foreign exchange transactions is the type of tax treatment to be accorded to the gains and losses realized. Do the gains or losses qualify for ordinary income or loss status or do they qualify for long or short term capital treatment? The answer to this question depends upon several factors including the type of foreign exchange transaction involved, the party's intent, and the status of the individual or corporation undertaking the transaction. The objective of this paper is to examine the tax consequences of foreign exchange transactions and the role played by the *Corn Products* doctrine in limiting long term capital gains treatment for such transactions.

II. Characterization of the Taxpayer

A. *Dealers v. Non-Dealers*

For tax purposes, the Internal Revenue Service distinguishes between dealers and non-dealers in foreign exchange. A dealer is

9. *See* Cohen, *Tax Consequences of Foreign Currency Fluctuations*, 6 Vand. J. Transnat'l L. 14 (1972).

10. Monetary gain occurs, for example, when a person purchases or produces an item at a cost of $10.00 and sells the item for $20.00; his monetary gain is $10.00.

11. *See* note 3 *supra*.

12. *See* note 4 *supra*.

defined as one who regularly engages in the purchase and resale of foreign currency to customers and profits from such transactions.[13] The distinction lies in the fact that a dealer may inventory his foreign exchange holdings and, consequently, for tax purposes he may account for those holdings at the lower of cost or market value[14] and receive ordinary loss treatment for declines in the value of his holdings. Since a dealer holds currency "primarily for sale to customers in the ordinary course of his trade or business,"[15] his foreign exchange holdings do not qualify as capital assets as defined by § 1221 of the Internal Revenue Code of 1954, and are therefore subject to ordinary income or loss treatment.

A non-dealer, on the other hand, is defined as "[o]ne who merely purchases foreign money on his own account or as an incident of his principal business."[16] In the hands of the non-dealer, foreign exchange, unless otherwise excluded from § 1221, is a capital asset with the gain or loss on the disposition of the foreign exchange subject to capital gains treatment.[17] Therefore, the tax consequences of capital or ordinary gain or loss treatment of foreign exchange transactions may be determined by the taxpayer's status as a dealer or non-dealer.

B. *Speculators*

Recognizing that money may serve either as a medium of exchange or as a commodity, the speculator views money only as a commodity to be traded on the foreign exchange markets. The speculator's investments in various currencies aim to achieve gain on transactions as a result of favorable exchange rate fluctuations. The speculator may acquire a long position in a currency in anticipation of the currency increasing in value, or may sell short his currency in anticipation of a reduction in the value of the currency.

The resulting exchange rate gain on the transactions constitutes taxable income to the speculator and raises the question of the type of treatment that should be accorded such foreign exchange profits. The answer to this question depends upon the speculator's status as a dealer or non-dealer. If he is a dealer, not speculating for his own account, his exchange rate gain constitutes ordinary

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13. O.D. 834, 4 CUM. BULL. 61 (1921).
14. Treas. Reg. § 1.471-4 (1974).
15. *See* note 13 *supra*.
16. *See* note 13 *supra*.
17. Rev. Rul. 74-7, 1974-1 CUM. BULL. 15, *superseding* I.T. 3810, 1946-2 CUM. BULL. 55.

income; if, however, the speculator is a non-dealer or a dealer speculating for his own account, he will be awarded capital treatment.

III. IMPACT OF THE CORN PRODUCTS DOCTRINE

A. *Inventory-Credit Transactions*

Under present United States tax law, all items that enter into the calculation of taxable income must be expressed in terms of United States dollars.[18] Therefore, the businessman's exchange rate gain or loss must be translated into dollars for tax purposes when the business has unpaid accounts payable and accounts receivable expressed in foreign exchange, which has been devalued or revalued in terms of United States dollars. These accounts may arise from the purchase or sale of inventory or services or represent an unpaid balance due in foreign currency arising from credit transactions with foreign businesses or banks.[19]

In those cases in which a business experiences gain or loss as a result of fluctuation in the value of foreign currency used to make a business purchase, the foreign exchange transaction is treated as separate and distinct from the purchase or sale of the goods.[20] The cost of the goods is determined at the dollar equivalent of the currency purchase price on the date of the purchase. Therefore, any gains or losses that are realized from the acquisition of foreign currency necessary to cover the purchase are treated as gains or losses from a separate transaction.[21] While at one point the Internal Revenue Service favored the integration of the credit exchange transaction with the underlying merchandise transaction,[22] the Tax Court rejected this approach and treated the extension of credit separately, stating:[23] "If the company, instead of making

18. *See* Rev. Rul. 55-171, 1955-1 CUM. BULL. 80, 88; O.D. 459, 2 CUM. BULL. 60 (1920); O.D. 419, 2 CUM. BULL. 60 (1920). While § 6316 of the Internal Revenue Code of 1954 authorizes the Commissioner to allow payment of United States income taxes in foreign currency, the implementing regulations permit such action by a taxpayer only in limited circumstances. *See* Treas. Reg. §§ 301.6316-1 to 301.6316-9 (1956).

19. *See* Hammer, *Taxation of Currency Exchange Transactions*, 22 TUL. TAX INST. 306, 308 (1973) [hereinafter cited as Hammer].

20. *See* Kalish & Korn, *Devaluation of the Pound: What are the Tax Consequences for U.S. Taxpayers*, 28 J. TAX. 17 (1968).

21. Hammer, *supra* note 19, at 309.

22. O.D. 489, 2 CUM. BULL. 60 (1920).

23. Joyce-Koebel Co. v. Commissioner, 6 B.T.A. 403, 406 (1927).

payment at the time [of purchase], makes the purchase on credit, it is investing or speculating in foreign exchange. It may derive a profit or sustain a loss on the exchange operation, but the cost of the goods to it is not affected by such profit or loss." Thus, the taxpayer realizes monetary gain or loss when the goods are sold while exchange rate gain or loss is recognized when the foreign exchange obligation is closed. It does not matter whether the taxpayer purchases the goods on credit (making a later payment in foreign currency) or purchases the foreign currency in advance, for the exchange rate gain or loss is recognized only upon the closing of the credit transaction.[24]

In determining the tax consequences of such exchange rate gain or loss, courts generally have held that the exchange rate gain or loss should be accorded the same tax treatment as the gain or loss arising from the underlying transaction—usually ordinary income or loss treatment. The courts have justified their decisions on one of two grounds: first, that the open account transactions did not involve the sale or exchange of a capital asset as decided in *Church's English Shoes, Ltd.*[25]; and secondly, by the application of the *Corn Products Refining Co. v. Commissioner*[26] rationale that the transactions are integrally related to the taxpayer's trade or business.

The applicability of the *Corn Products* doctrine to inventory-credit transactions is clearly demonstrated by the *America-Southeast Asia Co., Inc.*[27] case in which the taxpayer purchased burlap in India and made payment for the goods with borrowed British pounds sterling. Subsequently, the taxpayer repaid the loan with devalued pounds and thereby realized a substantial gain on the transaction. The taxpayer maintained that capital gains treatment was applicable to the exchange rate gain since the foreign exchange transaction was separate and distinct from the burlap purchase, and since the taxpayer was not a dealer in foreign exchange. The court agreed that the deal involved two separate transactions, but determined that they were not unrelated. Rather, the court found that the foreign exchange transaction involved in the taxpayer's procurement of burlap was an integral part of its

24. *See* Willard Helburn, Inc. v. Commissioner, 214 F.2d 815 (1st Cir. 1954); Bennet's Travel Bureau, Inc., 29 T.C. 350 (1957); Bernuth Lembeke Co., 1 B.T.A. 1051 (1925).

25. 24 T.C. 56, 59 (1955).

26. 350 U.S. 46 (1955).

27. 26 T.C. 198 (1956).

ordinary trade or business and as such should be given ordinary income treatment under the *Corn Products* rationale. Clearly, the foreign exchange transaction served a pivotal role in furthering the taxpayer's trade or business in burlap, and because of this relationship between the foreign exchange transaction and the underlying inventory purchase the ordinary income treatment prescribed by the *Corn Products* doctrine was justified.

B. *Hedging Transactions*

In determining the tax consequences of futures in either commodities or foreign exchange, it is necessary to determine whether the transaction falls within the definition of a hedge. This decision dictates whether the gain or loss realized on the transaction will be treated as ordinary or capital gain or loss. It has long been recognized that hedging transactions require ordinary income or loss treatment even though the futures contract or the underlying commodity falls within the literal definition of a capital asset.[28] On the other hand, futures contracts, which are not hedges, are generally treated as capital assets held for speculation.[29] Therefore, the definition of a hedge or hedging transaction should be explored.

A hedge has been defined by the case law as a form of price insurance employed by businesses to avoid the risks of changes in the market price of a commodity used in its trade or business, and is based on the concept of maintaining a balanced market position.[30] The principal requirement of a hedge is that there be a direct relationship between the product that is the basis of the taxpayer's business and the futures purchased to offset the primary risk.[31]

In order to grasp the scope of hedging transactions under present law, one must first examine the Supreme Court's holding in *Corn Products Refining Co.* and its role in determining the applicability of capital gains or ordinary income treatment. During the 1930's, the taxpayer, a producer of refined corn sugar products, had expe-

28. *See, e.g.*, Mansfield Journal Co., 31 T.C. 902 (1959), *aff'd*, 274 F.2d 284 (6th Cir. 1960); J.C. Simplot Co., P-H 1967 TAX CT. REP. & MEM. DEC. ¶ 67,104.

29. Note, that if a speculator or trader buys and sells futures contracts in the same manner as he buys and sells securities, the resulting gain or loss is capital gain or loss. Faroll v. Jarecki, 231 F.2d 281 (7th Cir. 1956).

30. *See, e.g.*, Farmers & Ginners Cotton Oil Co. v. Commissioner, 120 F.2d 772 (5th Cir. 1941); Main Line Distrib., Inc., 37 T.C. 1090 (1962), *aff'd*, 321 F.2d 562 (6th Cir. 1963); Rev. Rul. 60-24, 1960-1 CUM. BULL. 171.

31. 3B J. MERTENS, LAW OF FEDERAL INCOME TAXATION, § 22.14, at 110 (1969).

rienced periods of fluctuation in the price of spot corn, its principal raw material, which raised the cost of its finished products and made them uncompetitive on the market against corn and beet sugar. To insure adequate supplies at reasonable prices without a heavy investment in new storage facilities, the taxpayer began purchasing long positions in corn futures as part of its corn buying program. The taxpayer took delivery on the contracts as business required, selling the remaining contracts.

In the course of its dealings in corn futures, Corn Products realized a gain of approximately $680,000 in 1940 and a loss of approximately $110,000 in 1942. As a result, the company contended that the futures contracts were capital assets and that the two contracts should be offset with the gain receiving treatment as long term capital gain. The company maintained that its futures trading was separate and distinct from its manufacturing operations and that the futures were not purchased as a true hedging transaction. The Supreme Court, however, held that the futures trading by Corn Products was an integral part of its business designed to protect its manufacturing operations from the risk of loss resulting from fluctuations in the cost and supply of its chief raw material.

The company's argument that its futures trading was not a "true hedge," which protected the company against both increases and decreases, was unpersuasive since the Court felt it sufficient that the company was protecting itself against price increases. The Court agreed that the futures contracts did not fall within the literal language of the capital gains exclusions, but it reached the crux of its opinion stating:

> [T]he capital asset provision of § 117 [§ 1221] must not be so broadly applied as to defeat rather than further the purpose of Congress. *Burnet v. Harmel*, 287 U.S. 103, 108. Congress intended that profits and losses arising from the everday operation of a business be considered as ordinary income or loss rather than capital gain or loss. The preferential treatment provided by § 117 [§ 1221] applies to transactions in property which are not the normal source of business income.[32]

The Supreme Court's decision clearly establishes that the term "property" as employed in § 1221 means property that is not a "normal source of business income."[33] There remain, however, un-

32. 350 U.S. 46, 52.

33. *See* Troxell & Noall, *Judicial Erosion of the Concept of Securities as Capital Assets*, 19 TAX. L. REV. 185, 188 (1964).

settled questions concerning the scope of the term "property." The Court's *Corn Products* decision limited the scope of capital asset treatment under § 1221. In addition, the decision eliminated the prior restrictive view of the "true hedge" by recognizing the need to apply ordinary gain or loss treatment if the transaction provided protection against either an increase or decrease in price.

Although the *Corn Products* case has significantly affected United States tax law, it has also evoked criticism by commentators and tax analysts.[34] The principal criticism centers on the decision's overbroad redefinition of the concept of a capital asset in terms of investment intent versus business needs.[35] With this emphasis placed on the question of intent, commentators feared that uncertainty would result in the determination of whether to apply capital gain or loss or ordinary income or loss treatment. Also, questions were raised regarding possible attempts by businesses to create circumstances evidencing intent that would produce advantageous tax consequences depending upon the needs of the business. For example, the business would claim capital gains treatment evidenced by some form of investment intent upon realizing a large gain, or, if the business deal collapsed, it would claim ordinary loss treatment evidenced by some relationship to business operations. Thus, subjectivity may pose problems in determining the applicability of the *Corn Products* doctrine and its related tax consequences.

C. *Foreign Exchange Transactions*

The *Corn Products* doctrine has played a significant role in determining the tax consequences of foreign exchange transactions. While the majority of the cases covering hedging transactions focus on the purchase of futures to offset the risk of price fluctuations and loss of supply of commodities used as inventory or raw material, it is well recognized that assets subject to the risk of loss in value may be hedged by the purchase or sale of forward contracts in foreign currency. The exchange rate gain or loss realized on such hedging transactions requires ordinary income or loss treatment.[36]

34. *See, e.g.*, Brown, *The Growing Common Law of Taxation*, 34 So. CAL. L. REV. 235 (1961); Freeman, *Is There a New Concept of a Business Asset?*, 36 TAXES 110 (1958) [hereinafter cited as Freeman]; Surrey, *Definitional Problems in Capital Gains Taxation*, 69 HARV. L. REV. 985 (1956) [hereinafter cited as Surrey].

35. Surrey, *supra* note 34, at 993.

36. D. RAVENSCROFT, TAXATION OF FOREIGN CURRENCY 454-56 (1973) [hereinafter cited as RAVENSCROFT].

The principal case in the area of foreign exchange hedging transactions is *Wool Distributing Corp.*[37] Wool Distributing, an international wool dealer, maintained large quantities of sterling area and French wools in inventory. Fearing possible devaluations of the French franc and the British pound sterling and the effect that this would have on the value of its sterling area and French wool inventory, the taxpayer entered into forward short sale contracts in francs and pounds in an amount sufficient to cover the value of its inventory in those currencies. The expected devaluations did not occur, resulting in a loss on the foreign exchange transactions for the taxpayer. In deciding the proper tax consequences for the transactions, the court held that ordinary income treatment was applicable since the taxpayer's action constituted a bona fide hedging transaction.

The court noted that at the time of the transactions there were well-placed rumors concerning devaluation, that there was an actual risk of loss on the inventory value of the taxpayer's sterling area and French wool, and that the amount of currency sold short corresponded to the quantity of the respective foreign wools, indicating a direct relationship between the inventory and the forward foreign exchange contracts. These factors were clear evidence to the court of a valid hedging transaction. The court defined hedging transactions as a form of "price insurance connected so closely with the regular conduct of a trade or business as to defy classification as extraneous investments."[38] The court went on to point out that if the quantity of futures purchased exceeded the actuals subject to loss or if there had been an absence of price relationship between the two, then such a finding would suggest that the futures were acquired for investment rather than as a hedge.

The court rested its decision upon the *Corn Products* doctrine and its application to hedging transactions. Under the facts of *Wool Distributing*, the forward contracts were undertaken to provide protection for the value of the taxpayer's inventory, an asset clearly associated with the production of ordinary income or loss. Therefore, using the *Corn Products* rationale, the court found an integral relationship between the foreign exchange contracts and the taxpayer's regular business operations and consequently ordinary loss treatment was required.

One may conclude, therefore, that under present case law, represented by *Corn Products* and *Wool Distributing*, hedging is predi-

37. 34 T.C. 323 (1960).
38. *Id.* at 331.

cated upon a price relationship between the risk property and the futures purchased and that they need not be the same commodity so long as their prices move in relation to one another. Further, one may deduce that the type of property hedged may be determinative of the tax consequences of the transaction, and, since one normally hedges items related to the production of income, it is not surprising that ordinary income treatment results.

IV. INTERNATIONAL FLAVORS & FRAGRANCES

The Tax Court's decision in *International Flavors & Fragrances*[39] represents a significant development in determining the tax consequences of gain or loss realized from foreign exchange transactions. The *Corn Products* case played a pivotal role in the court's holding that the taxpayer should not receive ordinary income treatment on its foreign exchange profit. Because of its role in the decision, questions arise concerning both the applicability of *Corn Products* to similar fact situations, and the impact that its application will have on other foreign exchange transactions, especially in the area of achieving capital gains treatment. Finally, if the *Corn Products* doctrine applies too broadly to foreign exchange transactions, what type of limitations should be imposed?

International Flavors & Fragrances, Inc. (IFF) and its foreign affiliates were engaged in the global production and distribution of flavoring extracts. In late 1966, IFF, the parent corporation, was concerned about the effect of a possible devaluation of the British pound sterling upon its British operations, IFF-Great Britain. IFF's British operations were structured such that IFF-Great Britain was a wholly-owned subsidiary of IFF-Netherlands, a wholly-owned subsidiary of IFF. In particular, the IFF management feared a reduction in value of IFF-Great Britain as expressed by its net current assets.[40] These assets, stated in pounds, were translated into their dollar value and reported on IFF's consolidated financial statement. The accounts of IFF's foreign affiliates were not, however, reported on a consolidated basis for tax purposes.[41]

In anticipation of an impending devaluation of the pound sterling, IFF, the parent corporation, entered into a short sale contract on December 29, 1966, with First National City Bank of New York (Citibank) under which it agreed to sell 1.1 million British pounds

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39. International Flavors & Fragrances, Inc., 62 T.C. 232 (1974).

40. Brief for Petitioner, at 6, International Flavors & Fragrances, Inc., 62 T.C. 232 (1974) [hereinafter cited as Brief for Petitioner].

41. Brief for Petitioner at 6.

sterling for delivery on January 3, 1968, at an exchange rate of $2.7691 per pound. The contract's exchange rate, which was less than the prevailing market price for pounds, represented Citibank's consideration for entering the contract.

As expected, the British Government devalued the pound from $2.80 to $2.40 approximately eleven months following the execution of the short sale contract. On December 20, 1967, IFF sold its foreign exchange contract to Amsterdam Overseas Corporation, an international banking concern, for $387,000. Citibank was duly informed of the sale of the contract and raised no objections to the transaction. Immediately after purchasing the contract from IFF, Amsterdam purchased an offsetting contract for 1.1 million pounds sterling from Citibank due January 3, 1968, at the exchange rate of $2.4080. As a result, Amsterdam froze its position. Utilizing the pounds purchased at the lower exchange rate, Amsterdam closed out the contract it had purchased from IFF and realized a profit on the transaction of $10,210.

On its tax returns for the year, IFF reported the $387,000 it received from the sale of its short sale contract as long term capital gain. The Commissioner, however, disagreed and claimed a deficiency stating that the gain should be treated as ordinary income. The Tax Court, therefore, was confronted with the issue of whether IFF's sale of its foreign exchange contract constituted the sale or exchange of a capital asset within the provisions of § 1221.

In his brief, the Commissioner presented a two-pronged attack. First, he claimed that IFF's assignment of its foreign exchange contract to Amsterdam was taxable as short term capital gain on the short sale of the pounds themselves.[42] He reasoned that IFF had not made a bona fide sale of its contract but, in effect, the company closed out its short sale position by assigning its contract right to Amsterdam, which covered the transaction with devalued pounds acquired the same day as the contract. Under this view, Amsterdam had merely acted as an agent for IFF and assured the profit on the transaction without being subject to the risks of the market place.[43]

The Commissioner maintained that the assignment of the short sale contract was analogous to the situation in *Frank C. La Grange*[44] in which the taxpayer, having made two short sale contracts for British pounds, sold the contracts to his broker's firm

42. Brief for Respondent at 12, International Flavors & Fragrances, Inc., 62 T.C. 232 (1974) [hereinafter cited as Brief for Respondent].
43. Brief for Respondent at 12-24.
44. 26 T.C. 191 (1956).

prior to the contract's delivery date. The *La Grange* court held that the taxpayer's sale of his foreign exchange contracts was not a bona fide transaction since the taxpayer gave no consideration other than the required round trip commission paid the broker at the time the short sale contract was made, and since the taxpayer had agreed to remain liable to the broker for the risk of loss upon the closing of the short sale contract. In determining that the broker was, in effect, the taxpayer's agent in closing out the short sale which gave rise to short term capital gain, the court stated:

> The significant fact which persuades us that the contract purchase transactions were not what petitioner contends is that the petitioner remained fully liable as the short seller until the sales were finally consummated and closed out by delivery of English pounds sterling to the purchasers.[45]

On the basis of *Frank C. La Grange*, the Commissioner sought short term capital gains treatment for IFF's gain on its sale of its short sale contract.

In the second prong of his argument, the Commissioner contended that the receipt of $387,000 by IFF represented the proceeds of a hedging transaction that constituted an integral part of the taxpayer's trade or business and thus should be accorded ordinary income treatment pursuant to the holding in *Corn Products Refining Co.*[46]

The majority of the Tax Court found the Commissioner's argument requiring the application of the *Corn Products* doctrine persuasive and, therefore, found it unnecessary to determine whether IFF's sale of its foreign exchange contract to Amsterdam was a bona fide sale for tax purposes. The majority opinion held that although foreign currency and foreign exchange contracts might fall within the definition of capital assets, the potential loss that IFF had "sought to offset by the short sale of pounds sterling was a loss to which its British affiliate was exposed in its everyday operation." The majority opinion further stated that "[p]urchases and sales of foreign currency . . . for the purpose of offsetting losses which might result from fluctuations in exchange

45. 26 T.C. at 197.

46. Brief for Respondent at 24. In his brief reply, the Commissioner refocused his argument, contending that the *Corn Products* doctrine should apply and, alternatively, that IFF should be accorded short term capital gain treatment. *Id.* at 9, 25.

rates are part and parcel of a multinational business."[47] Therefore, the court viewed the purchase and sale of the foreign exchange contract as a transaction related to ordinary income rather than an investment since the purchase and sale of the foreign exchange contract constituted a "loose hedge," which, under the *Corn Products* doctrine, required ordinary income treatment for the gain realized on the transaction.

The concurring judges,[48] however, based their decision on the fact that IFF had failed to meet the burden of proving that its sale of its foreign exchange contract to Amsterdam was a bona fide sale. They found that IFF had not produced sufficient evidence to prove that "[n]o arrangement was made between IFF and Amsterdam to close the short sale."[49] From the facts, the concurring judges felt that it was reasonable to infer that Amsterdam's contract to purchase devalued pounds was a condition precedent to the acquisition of IFF's foreign exchange contract. At that point, the only transaction required was to offset the two contracts on the January 3, 1968, delivery date—a transaction which they felt was hardly subject to the risks of the market place.

In effect, the concurring opinion supported the Commissioner's contention that Amsterdam was merely acting as an agent for IFF in purchasing the pounds from Citibank used to close out the short sale contract. Moreover, IFF was entitled to the gain represented by the $2.7691 sale price and the $2.4080 closing price; the profit of $10,210 realized by Amsterdam constituted a commission for its role in closing the transaction.

IFF, however, was not without support in the proceedings, for as the dissent written by Judge Hall flatly stated that IFF's short sale contract with Citibank was a capital asset within the provisions of § 1221 and, as such, should be accorded long term capital gains treatment on its sale to Amsterdam. The dissenting judge distinguished the application of the *Corn Products* doctrine and stated that *Corn Products* dictated capital gains treatment for "transactions in property which are not a normal source of business income."[50] In support of this view, Judge Hall pointed out that the short sale contract and the underlying property (pounds) were not a normal source of IFF's business income. Further, this was a non-

47. International Flavors & Fragrances, Inc., 62 T.C. 232, 239 (1974) (Quealy, J.).

48. International Flavors & Fragrances, Inc., 62 T.C. 232, 241 (1974) (Tannenwald, J.).

49. 62 T.C. at 244.

50. *Id.*

recurring transaction, suggesting investment intent. As additional justification for capital gains treatment, the dissent found that since the transaction was intended to offset an anticipated decline in the dollar value of the British subsidiary's stock, there was a closer relationship to the stock—a capital asset for IFF—than to the subsidiary's everyday business activities. The majority's opinion that currency hedges were "part and parcel of a multinational business" failed to sway the dissent since there was no evidence that IFF routinely engaged in currency speculation or hedging so that the gain would warrant ordinary income treatment. The dissent also believed that the majority had erred in ignoring the separate corporate entities of the parent and its British affiliate.

Judge Hall then took issue with the concurring opinion and pointed out that following the devaluation of the pound, IFF's foreign exchange contract was a readily marketable capital asset and that no evidence demonstrated anything but a bona fide arms length transaction between IFF and Amsterdam. That Amsterdam froze its profits by acquiring the requisite covering pounds on the day it purchased the short sale contract did not alter the status of the sale, for IFF had divested itself of title to the contract and was entitled to its sale price. In conclusion, the dissent found that the transaction involved a bona fide sale of a capital asset held for more than six months, and IFF was thereby entitled to treat its gain as long term capital gain.

V. The Corn Products Doctrine after International Flavors & Fragrances

The Tax Court's decision that capital gains treatment was inappropriate for IFF's disposition of its short sale contract raises some significant questions regarding future treatment of gain and loss in foreign exchange transactions regardless of whether the sales or purchases involved are "long" or "short" positions that otherwise meet the requirements for long term capital gain or loss treatment. One might also question the justification of the judicial extension of the *Corn Products* doctrine to transactions that apparently comply with the requirements for capital asset status but are tainted by some aspect of current or non-capital value that relegates the gain or loss involved to ordinary income status.

Application of the *Corn Products* doctrine to the situation in *International Flavors & Fragrances* perhaps overextends the com-

mon law of taxation. By its finding that IFF's foreign transactions were a "loose hedge," which requires ordinary income treatment under the *Corn Products* doctrine, the Tax Court raises serious questions for businesses that engage in foreign exchange transactions as a part of their trade or business. What types of foreign exchange transactions will be eligible for long term capital asset treatment? What constitutes a "loose hedge"? Are a business' foreign exchange transactions related to the purchase and sale of goods and services such an integral part of the business' everyday operation that speculative investments by the company would be relegated to ordinary income treatment under the *Corn Products* doctrine? Is there business or investment intent involved in the transaction? The basic problem with the application of the *Corn Products* doctrine in *International Flavors & Fragrances* is that the taxpayer has no objective standards which mark the *Corn Products* doctrine's applicability.

An examination of the possible tax consequences and the court's reasoning in *International Flavors & Fragrances* provides a better understanding of the problems involved in the application of the *Corn Products* doctrine.

If the IFF management had decided to close out its short sale contract rather than sell it to Amsterdam, IFF would have recognized its gain on the sale as short term capital gain; although a capital asset, the foreign exchange purchased to close out the contract would not have met the holding period requirement of § 1222(4) for long term capital gains treatment. In *International Flavors & Fragrances*, the devaluation of the pound occurred just one and one-half months prior to the closing date for the short sale contract, making it impossible for IFF to purchase and hold the devalued pounds for a sufficient length of time to qualify as a long term capital asset. Even had IFF held the devalued pounds in excess of six months, the Commissioner might have argued that § 1233(b) applied to the transaction and required the recognition of the gain as short term capital gain.[51]

Prompted by the inevitable consequences of short term capital gains treatment upon the closing of its short sale contract, IFF endeavored to achieve more favorable long term capital gains treatment by the sale of the contract itself prior to the delivery date. At the time IFF sold its short sale contract to Amsterdam, the principal case in the area, *Frank C. La Grange*, indicated that

51. *See* Dale, *Tax Consequences of Currency Fluctuations: Occasional Transactions*, 32 N.Y.U. INST. FED. TAX 1683, 1696 (1974).

a bona fide arms length sale of a foreign exchange contract held in excess of six months would qualify for long term capital gains treatment; IFF's transaction was structured to accommodate that holding: the transaction was supported by consideration on both sides; no prior course of dealing between IFF and Amsterdam indicated that the transaction was not arms length; and, perhaps most importantly, the sales agreement was without recourse, divesting IFF of all risk in the transaction. Until the decision in *International Flavors & Fragrances*, were the *Frank C. La Grange* criteria met, presumably the sale of a foreign exchange contract would produce long term capital gain.[52] The Tax Court's application of the *Corn Products* doctrine, however, precluded such tax consequences.

The Tax Court found the Commissioner's contentions persuasive and agreed that IFF's short sale of British pounds in a quantity corresponding to IFF-Great Britain's net current assets amounted to a hedge against the loss of ordinary income as governed by the *Corn Products* case and therefore required ordinary income treatment for IFF's subsequent exchange rate gain. Under the court's reasoning, the fact that IFF's foreign exchange contract or the underlying currency qualified as a capital asset would be unpersuasive in an attempt to achieve long term capital status as long as there is a corresponding current account that could be regarded as the hedged account.

Whether items such as net current assets are the type of property that the Supreme Court intended to come within the purview of *Corn Products Refining Co.* is questionable. It seems that the decision in the *Corn Products* and *Wool Distributing* cases are particularly applicable to the problems of hedging and foreign exchange transactions. Those cases pointed out that ordinary income or loss consequences resulted from hedging operations related to transactions that are an integral part of the everyday operations of a trade or business, such as services or inventory. Although IFF-Great Britain's net current assets were "exposed" to the risk of exchange rate loss through devaluation[53] and represent the end result of IFF-Great Britain's business of manufacturing flavoring extracts, it does not seem that this account qualifies as property that is integrally related to IFF's everyday operations.

This conclusion is justified because IFF-Great Britain is a sepa-

52. *See* Hammer, note 19 *supra*, at 321-22.
53. Brief for Petitioner at 6-7.

rate and distinct corporate entity from IFF. Whatever income is received by IFF from IFF-Great Britain must come in the form of dividends, which under IFF's corporate structure must first be paid to IFF-Netherlands and then remitted directly to the parent before IFF may enjoy the fruits of its subsidiary's labors. The current net assets of IFF-Great Britain, as translated into dollars on IFF's consolidated financial statement, do not necessarily represent IFF's dividends, for IFF-Great Britain would hardly pay the entire value of its current net assets as dividends. There are also additional factors that might limit IFF's receipt of its subsidiary's dividends, such as possible governmental restrictions by either Great Britain or Holland on the remittance of dividends overseas—a realistic factor for a country experiencing heavy nationalistic sentiments or weakness in its balance of payments and currency. Moreover, according to one commentator,[54] a forward sale of foreign currency in an amount equal to dividends not yet includable in a corporation's net income does not constitute a hedge since the prospective dividends are not receivables and are not necessarily due for payment.

While corporate dividends are subject to ordinary income treatment, their underlying source is the taxpayer's stock, which constitutes a capital asset in the hands of the shareholder. Perhaps in considering the applicability of the *Corn Products* doctrine one should look to the source of the income as determinative: in the case of dividends that source would be corporate stock, a capital asset rather than an integral part of the corporation's everyday business. Therefore, in the case of dividend income, the *Corn Products* doctrine would be inapplicable since the underlying source of the dividend is generally a capital asset rather than an income producing item such as inventory.

It has been suggested by one commentator that to provide an objective definition of a capital asset and discernible limits on the application of the *Corn Products* doctrine, *Corn Products* reasoning should be restricted to property acquired to protect inventory, stock in trade and property held for ordinary sales to customers.[55] Such a restriction might provide an objective distinction between investment and ordinary business activities. The Seventh Circuit in *Faroll v. Jarecki*[56] found this view persuasive and refused to apply the *Corn Products* doctrine unless the futures transaction

54. RAVENSCROFT, note 36 *supra*, at 476.
55. Freeman, note 34 *supra*, at 10.
56. 231 F.2d 281 (7th Cir. 1956).

was a hedge by a company engaged in using the product covered by the future.

In *International Flavors & Fragrances*, the majority opinion characterized IFF's purchase of a foreign exchange contract as a "loose hedge" against possible loss on the devaluation of the pound. If, however, the application of the *Corn Products* doctrine is generally tied to the concept of hedging, its application in *International Flavors & Fragrances* was unwarranted. IFF, as the parent corporation, was the principal shareholder in its subsidiary's operations and so should have fallen within the view that a forward sale of foreign currency by a shareholder based on the value of the corporation's current net assets should not be treated as a hedging transaction since the risk of the foreign exchange loss lies with the corporation, not with the stockholder.[57] To term the transaction a hedge by the shareholding parent company treats the subsidiary's corporate status as a sham, and inconsistently with the recognition of the subsidiary for other tax purposes.

As the dissent argued, the majority opinion disregarded IFF-Great Britain as a corporate entity on unjustified grounds. The case cited by the majority, *Schulmberger Technology Corp. v. United States*,[58] as standing for the proposition that the corporate entity does not warrant recognition if the companies are engaged in a similar trade or business, is inapplicable to the facts in *International Flavors & Fragrances*. In *Schlumberger*, the taxpayer acquired two subsidiaries related to its course of business both of which required sizeable infusions of money. Nevertheless, both subsidiaries proved economically unfeasible, and the taxpayer terminated his interest in the companies and claimed the loss as a bad debt deduction.[59] The Commissioner, however, disallowed the deduction and treated the unpaid balance of the loans as capital loss under § 1232(a)1. The Court of Appeals held that ordinary income treatment should be granted under the *Corn Products* rationale as applied in *Booth News Papers, Inc. v. United States*,[60] which dictated ordinary loss treatment upon the sale of securities purchased by a taxpayer as an integral act in the conduct of its business. *International Flavors & Fragrances* does not involve the disposition of the securities of its subsidiaries, but the recognition of a viable corporation as a separate corporate entity.

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57. *See generally* RAVENSCROFT, note 36 *supra*, at 476-77.
58. 443 F.2d 1115 (5th Cir. 1971).
59. INT. REV. CODE OF 1954, § 166(a).
60. 303 F.2d 916 (Ct. Cl. 1962).

IFF-Great Britain's separate status was evidenced by the fact that it did not file a consolidated tax return with its parent and affiliates—a distinction that differentiates its operations from those of a foreign branch. Therefore, had IFF-Great Britain been the party engaged in offsetting its potential exchange rate losses, the Tax Court's decision to apply the *Corn Products* doctrine would have been more palatable; but, as the dissent noted, there was no justification for the majority to ignore the separate corporate identities of IFF and its subsidiaries.

VI. Conclusion

The application of the *Corn Products* doctrine to require ordinary income or loss treatment for the gain or loss realized on foreign exchange transactions like the inventory-credit transaction of *America-Southeast Asia Co., Inc.*[61] and hedging transactions as in *Wool Distributing Corp.*[62] is clearly warranted. For in both types of transactions, the exchange rate gain or loss realized on the foreign exchange transaction is integrally related to the taxpayer's everyday operations which produce ordinary income or loss. Therefore, to grant long term capital gains treatment to such gain would be incompatible with the Supreme Court's reasoning in *Corn Products Refining Co.*

The line between investment in foreign exchange and ordinary business purchases is not clearly drawn, as demonstrated by the Tax Court's decision in *International Flavors & Fragrances*. The Tax Court's application of the *Corn Products* doctrine raises some serious questions concerning the tax consequences of a business' foreign exchange transactions. Of particular concern is the possibility that the decision in *International Flavors and Fragrances* might be utilized by businesses that employ foreign exchange in the conduct of their businesses to treat the gain or loss from foreign exchange transactions as ordinary income or loss regardless of whether their purpose is business or investment on the grounds that the foreign exchange transactions are an integral part of their trade or business. Such an application of the *Corn Products* doctrine would preclude long term capital gains treatment for those businesses and would have the effect of eliminating the long-recognized distinction between a dealer and non-dealer in foreign exchange since both would receive ordinary income treatment on their transactions.

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61. 26 T.C. 198 (1956). *See* text accompanying note 27 *supra*.
62. 34 T.C. 323 (1960). *See* text accompanying note 37 *supra*.

Another disturbing factor of *International Flavors & Fragrances* is the concurring opinion's position that the burden of proof should be upon the taxpayer to justify his claims. In the foreign exchange area, such reasoning might be utilized to deny investment treatment to a foreign exchange transaction, resulting in ordinary income treatment.

The subjective nature of the *Corn Products* doctrine and its attendant uncertainties place the taxpayer in an indefinite position regarding the proper tax treatment for his gain or loss, particularly in foreign exchange transactions. To what extent may a transaction have the taint of ordinary income yet still be accorded capital gains treatment? To provide greater certainty in the application of the *Corn Products* doctrine, the *Corn Products* doctrine should be limited to the property or accounts for which a business may claim ordinary loss treatment. Such a limitation is consistent with the holdings in *Corn Products* and *Wool Distributing*, and, under this limitation, the question of whether a transaction constitutes a "loose hedge" would be eliminated, for there would be a readily discernible relationship between the hedging transaction and one's "normal source of business income" as prescribed by the *Corn Products* decision. Therefore, gain on a foreign exchange transaction would, if it otherwise qualified, receive long term capital gains treatment unless the property or accounts underlying the foreign exchange transaction are subject to deductions for ordinary loss. This result would provide certainty in foreign exchange transactions that is not found in *International Flavors & Fragrances* which leaves the scope of the *Corn Products* doctrine undefined.

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