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I.R.S. Seeks to Resolve Tax Treatment of Hedging Gains and Losses: Treasury Regulation § 1.1221-2

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I. INTRODUCTION

On July 13, 1994, the Internal Revenue Service (IRS) issued a final regulation addressing the tax treatment of investment hedges.[1] The IRS, by enacting Treasury Regulation § 1.1221-2,[2] sought to resolve confusion about whether gains and losses from hedging transactions should be characterized as ordinary or capital.[3] The confusion began when the United States Supreme

1. Treas. Reg. § 1.1221-2 (1994). Hedging usually involves simultaneously taking two economically connected, but offsetting positions in the market for the same asset or liability. BERNARD J. WINGER & NANCY MOHAN, PRINCIPLES OF FINANCIAL MANAGEMENT 666 (1991). See *infra* notes 22-102 and accompanying text for an extended discussion on the principles of hedging.

2. Treas. Reg. § 1.1221-2.

3. See *infra* notes 103-20 and accompanying text for a discussion of capital versus ordinary characterization of gains and losses.

Court, in *Arkansas Best Corp. v. Commissioner*[4] (*Arkansas Best*), abandoned the "Business Motive" test[5] which had historically been used to characterize hedging transactions.[6] From the Supreme Court's 1955 ruling in *Corn Products Refining Co. v. Commissioner*[7] (*Corn Products*) until the Court's 1988 ruling in *Arkansas Best*, the federal courts and the IRS have accepted the "Business Motive" test as an "extra-statutory exception"[8] to Internal Revenue Code (I.R.C.) § 1221[9] to characterize certain hedging gains and losses as ordinary.[10] In *Arkansas Best*, the Supreme Court ended the "extra-statutory exception" era by clarifying its earlier ruling in *Corn Products*.[11] The *Arkansas Best* Court explained that a proper interpretation of *Corn Products* required the hedging transaction at issue to conform to a broad reading of the inventory exception to capital assets contained in I.R.C. § 1221(1). In effect, the *Arkansas Best* Court narrowed the holding of *Corn Products* to a literal reading of § 1221 and refused to recognize an "extra-statutory exception" to § 1221.[12] The *Arkansas Best* Court further concluded that the taxpayer's motive in a hedging transaction is irrelevant to the transaction's characterization,[13] thus completing the evisceration of the "Business Motive" test.

Arkansas Best threw more than three decades of consistent interpretation of I.R.C. § 1221 into instant confusion. The IRS, based on the *Arkansas Best* Court's literal interpretation of *Corn Products*, began to characterize certain business hedges, which had historically been regarded as ordinary, as capital. After the Tax Court's ruling in *Federal National Mortgage Ass'n v. Commissioner* (*FNMA*),[14] the IRS, however, abandoned this position and attempted to

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4. 485 U.S. 212 (1988).

5. *Id.* at 223.

6. *See* Corn Prods. Ref. Co. v. Commissioner, 350 U.S. 46, 53 (1955) (creating the "Business Motive" test by holding that the characterization of hedging gains and losses depends on whether the business held the hedging device for a business purpose or for an investment purpose). See also *infra* notes 139-71 and accompanying text for a discussion of *Corn Products* and the *Corn Products* doctrine.

7. 350 U.S. at 53.

8. Edward D. Kleinbard & Suzanne F. Greenberg, *Business Hedges After* Arkansas Best, 43 TAX L. REV. 393, 409 (1988). See also *infra* notes 151-71 and accompanying text for a discussion of the "extra-statutory exception" as an interpretation of *Corn Products*.

9. I.R.C. § 1221 (1988). Section 1221 defines capital assets as all property held by the taxpayer that is not specifically excluded as an exception. *Id.* See *infra* notes 108-20 and accompanying text for a discussion of capital assets.

10. See *infra* notes 155-71 and accompanying text for a discussion of the expansion of the *Corn Products* doctrine.

11. Arkansas Best Corp. v. Commissioner, 485 U.S. 212, 220-22 (1988). The *Arkansas Best* Court held that the *Corn Products* decision "did not state explicitly whether the holding was based on a narrow reading of the phrase 'property held by the taxpayer' [in Code Section 1221], or on a broad reading of the inventory exclusion of § 1221." *Id.* at 220. The *Arkansas Best* Court, therefore, took the position that the proper interpretation of *Corn Products* was an expansive reading of the inventory exclusion of I.R.C. § 1221. *Id.*

12. *Id.*

13. *Id.* at 223.

14. Federal Nat'l Mortgage Ass'n v. Commissioner, 100 T.C. 541 (1993); *see infra* notes 201-17 and accompanying text (discussing *Federal Nat'l Mortgage Ass'n*).

resolve the issue by promulgating § 1.1221-2 of the Treasury Regulations.[15] In this Regulation, the IRS now takes the position that most hedging gains and losses must be classified as ordinary.[16] The IRS's current position on hedging will influence a multitude of business decisions in diverse sectors of the economy, and businesses seeking favorable tax treatment for their hedges must now structure their transactions to comply with the IRS's current position.

This Note discusses the provisions of Treasury Regulation § 1.1221-2 that are relevant for hedging transactions to receive ordinary characterization while advising that the Regulation be modified to include additional hedging strategies. First, Section II of this Note explains the basic concepts of hedging and the devices businesses employ to hedge transactions that are necessary to understand the Treasury Regulation.[17] Next, Section II describes the distinction between characterizing hedges as capital or ordinary.[18] Section III discusses the historical tax treatment of hedging.[19] Section IV analyzes the benefits and drawbacks of Treasury Regulation § 1.1221-2.[20] Finally, Section V of this Note concludes that while § 1.1221-2 demonstrates substantial progress for the treatment of hedging transactions, the IRS should amend the regulation in order to make it more comprehensive.[21]

II. Background

A. An Explanation of Hedging

Hedging is a complex financial transaction designed to reduce certain risks.[22] The many hedging devices available to businesses range from simple to highly integrated transactions. This Note will only discuss basic hedging concepts needed to understand hedging transactions. A comprehension of hedging transactions is required for a business to take full advantage of the benefits of Treasury Regulation § 1.1221-2.

The Treasury Regulations define hedging as a transaction entered into in the normal course of business to reduce risks associated with price changes or currency fluctuations regarding ordinary property or borrowings.[23] Two key

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15. Temp. Treas. Reg. 1.1221-2T (1993).

16. *See* Treas. Reg. § 1.1221-2 (1994); *see also infra* notes 103-20 and accompanying text (discussing the distinction between capital and ordinary property).

17. *See infra* notes 22-102 and accompanying text.

18. *See infra* notes 103-20 and accompanying text.

19. *See infra* notes 121-217 and accompanying text.

20. *See infra* notes 218-90 and accompanying text.

21. *See infra* note 291 and accompanying text.

22. See *infra* notes 27-45 and accompanying text for a discussion of hedging used to reduce risk.

23. Treas. Reg. § 1.1221-2(b)(1)-(2) (1994). As this Note discusses *infra*, one must determine if the hedge relates to ordinary or capital property. *See infra* notes 103-20 and accompanying text. The Regulation defines hedging as a:

> [T]ransaction that a taxpayer enters into in the normal course of the taxpayer's trade or business

components of the Regulation's definition are: (1) reducing risk of price and currency changes relating to assets; and (2) reducing risk of interest rates, price, or currency changes relating to obligations.[24] The Regulation's "reduce risk" language has sparked controversy because not all hedges actually reduce risk.[25] In fact, hedges can reduce the risk associated with some assets or obligations, while increasing the risk associated with other assets or obligations.[26]

Businesses use hedging to reduce risk from holding or buying assets or obligations. A business generally holds a long[27] or short[28] position in an actual asset or obligation.[29] When a business hedges, the business will take the offsetting position through the use of a hedging device related to the underlying asset or obligation. Hedging reduces risk by allowing companies to take two economically connected but offsetting positions in the same market[30] for an asset or liability.[31] A business uses hedging to control risks associated with price fluctuations beyond its control.[32] With price fluctuations controlled, the economic results for a period will more accurately reflect the value added by the business.[33] A business may hedge its exposure to market fluctuations, like price or interest rates, with respect to property held[34] or obligations incurred,[35]

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primarily-

(1) To reduce risk of price changes or currency fluctuations with respect to ordinary property . . . that is held or to be held by the taxpayer; or

(2) To reduce risk of interest rate or price changes or currency fluctuations with respect to borrowings made or to be made, or ordinary obligations incurred or to be incurred, by the taxpayer.

Id. See *infra* notes 220-40 and accompanying text for a discussion of the Regulation's definition of hedging.

24. Treas. Reg. § 1.1221-2(b)(1)-(2). The two main types of property hedged are assets and liabilities. Assets commonly hedged by financial institutions are commercial loans, fixed and adjustable rate mortgages, and securities. JOSEPH D. KOZIOL, HEDGING: PRINCIPLES, PRACTICES, AND STRATEGIES FOR THE FINANCIAL MARKETS 187 (1990). Liabilities commonly hedged by financial institutions include demand deposits, savings accounts, and certificates of deposit. *Id.*

25. For a discussion of the scope of the Regulation's definition of hedging, see *infra* notes 244-59 and accompanying text.

26. Sheila C. Blair et al., *The Worst of* Arkansas Best, 41 KAN. L. REV. 535 (1993).

27. A business holds the long position when the business actually owns the asset. See MEIR KOHN, MONEY, BANKING, AND FINANCIAL MARKETS 311 (2d ed. 1993). Suppliers customarily hold the long position since they own the asset they are supplying. *Id.* Holding the long position commonly indicates the expectation to sell the asset, here the supplier would expect to sell to the manufacturer. *Id.*

28. A business holds the short position when the business expects to buy the asset. *Id.* For example, a manufacturer of potato products usually holds the short position on potatoes since the manufacturer expects to buy potatoes from the supplier.

29. *Id.*

30. The market is a broad term for the various hedging tools available to businesses. Hedging devices include futures contracts, option contracts, and interest rate and currency swaps. See *infra* notes 63-102 and accompanying text for a discussion of these hedging devices.

31. WINGER & MOHAN, *supra* note 1, at 666.

32. Kleinbard & Greenberg, *supra* note 8, at 393.

33. *Id.* at 393-94.

34. Property being hedged can be either presently held or expected to be held. Treas. Reg. § 1.1221-2(b) (1994). Property presently held will usually represent the long position. KOHN, *supra* note 27, at 311. Property expected to be held usually represents the short position. For example, a business which has ordered an asset from a supplier but has not actually received the asset holds the short position. *Id.*

35. Obligations can be either presently incurred or expected to be incurred. Treas. Reg. § 1.1221-2(b).

by entering into a transaction that creates an equal but offsetting risk to its underlying exposure.[36]

For example, a supplier holding a long position by owning an actual asset could hedge by taking the offsetting short position in the asset to reduce risk from potential fluctuating prices. Taking a short position can be accomplished by selling futures contracts in a market similar to the underlying asset's market.[37] Conversely, a business holding the short position in the actual asset or obligation normally hedges by taking a long position in futures contracts.[38] A manufacturer which holds a short position because it expects to buy the asset could hedge by taking the offsetting long position by buying futures contracts.[39] Generally, market fluctuations beyond business' control cause businesses that do not hedge to experience wider profit fluctuation than businesses that do hedge.

Ideally, the offsetting position of a hedging device will closely approximate the underlying transaction's amount, time, and risk.[40] Hedges which exactly offset the underlying asset or obligation protect businesses from market fluctuations by, respectively, matching losses or gains on a transaction due to price fluctuations with losses or gains on its hedges.[41] More practically, however, it can be difficult to find hedging devices that correspond closely enough to the underlying transactions to completely protect against a loss.[42]

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36. Kleinbard & Greenberg, *supra* note 8, at 394-95.

37. A futures contract is a standardized contract sold on the market, which obligates a party to sell or purchase an asset or obligation at a future specified date. KOZIOL, *supra* note 24, at 191. See *infra* notes 63-69 and accompanying text for a discussion of futures contracts.

38. KOHN, *supra* note 27, at 311.

39. *See supra* note 27; *see* also *infra* notes 63-69 and accompanying text (discussing futures contracts).

40. Hedging transactions must approximate the size or quantity of the asset or obligation and the respective time involved in the actual underlying transaction to offset the risk of fluctuating prices in that transaction. MARK POWERS & DAVID VOGEL, INSIDE THE FINANCIAL FUTURES MARKETS 180 (1981). Most hedges are actually cross hedges which vary from the asset or obligation in the underlying transaction. KOZIOL, *supra* note 24, at 31-33. A hedge most effectively reduces risk if it closely approximates the underlying transaction. POWERS & VOGEL, *supra*, at 179.

For example, a manufacturer of potato chips holding a short position might order twenty tons of potatoes from its supplier to be delivered in three months. The manufacturer would hedge this transaction by buying potato futures contracts, the long position. Futures contracts, like other hedging devices, have standardized amounts and dates. Chicago Mercantile Exchange, *Using Stock Index Futures and Options*, *in* THE HANDBOOK OF DERIVATIVE INSTRUMENTS 177, 180 (Atsuo Konishi & Ravi E. Dattatreya, eds., 1991) [hereinafter *Stock Options*]. The potato chip manufacturer would attempt to buy potato futures contracts that most closely approximate the transaction with the manufacturer's supplier, that is, 20 tons of potatoes. The manufacturer would also prefer that these potato futures contracts approximate the time period involved in his transaction with the supplier—three months. As a result of these hedges, if the supplier's price increases, the manufacturer would experience a similar appreciation in the value of its potato futures contracts. If all goes well, after three months the manufacturer will buy the potatoes from the supplier and cash out the futures contracts at the same time, without experiencing a gain or loss due to price fluctuation.

41. Kleinbard & Greenberg, *supra* note 8, at 393.

42. *Id.* at 394. The practical problem of matching hedging devices to the underlying transactions is referred to as cross hedging, which generally refers to the fact that a hedging device varies by some aspect or characteristic from the asset or obligation in the underlying transaction. KOZIOL, *supra* note 24, at 31-33. If every transaction had a futures contract "that exactly mirrored its characteristics, the futures market would yield very good hedges." POWERS & VOGEL, *supra* note 40, at 180. Since reality often departs from theory, hedging must be accomplished with existing futures contracts on the market which invariably result in

The relevant time period of a transaction is also difficult to match with a hedging device for the same reasons.[43]

The two most common types of situations where businesses use hedging to protect profit margins from fluctuations in the market are: (1) increases in the price of raw materials;[44] and (2) decreases in the business' product sales price.[45] These two situations arise through the use of forward transactions.

B. Types of Hedging Devices

Businesses utilize many devices to hedge against the risks from holding or buying an asset or obligation. In order to benefit from the Treasury Regulations, a business must understand how to use the different types of hedging devices available. This Note discusses three common types of hedging devices: (1) futures contracts; (2) option contracts; and (3) interest rate and currency swaps.[46] A forward contract, though not a hedging device, creates many of the risks that hedging devices are used to offset by buying or selling the underlying asset or obligation. Understanding forward contracts will help demonstrate the reasons why businesses employ hedging devices.

1. Forward Contracts

A forward contract, also referred to as a forward transaction, is commonly used by businesses to carry out everyday operations. Forward contracts generally create the risks that businesses desire to hedge against because

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imperfect matches between the futures contract and underlying transaction. *Id.*

For example, a potato chip manufacturer may find no hedging device that trades in potato chips. The manufacturer will have to find a hedging device that corresponds as closely as possible to potato chips, such as potato futures contracts, so that the risk between potato chips and potatoes approximate each other. If potato prices rise because of a bad harvest, then the bad harvest will force a somewhat similar price increase in potato chips.

43. A manufacturer might place an order with a supplier to have twenty tons of potatoes delivered in two months. Hedging devices, however, usually only deal with standard dates. KOHN, *supra* note 27, at 310-11. The manufacturer might find potato futures contracts only proscribed in three month periods. The manufacturer's hedge will be off by one month. Thus, the risk is approximate but not exact. The manufacturer may try to buy a hedging device that has one month expired and two months remaining to have the risk more closely approximate the risk in the underlying asset or obligation.

44. Kleinbard & Greenberg, *supra* note 8, at 393. An example would be a manufacturer's incoming inventory increasing in price. For purposes of this Note, the terms "inventory" and "raw materials" will be used interchangeably. A manufacturer of potato chips uses potatoes as raw materials. An increase in the price of potatoes forces the cost of the manufacturer's inventory to rise. The manufacturer, however, needs a continuing source of raw materials for the manufacturing process. The manufacturer, therefore, will have to order more potatoes at the higher price, forcing the cost of inventory up. This situation illustrates the classic risk which businesses try to minimize through hedging.

45. *Id.* Market forces can cause the sales price of a business' product to decline due to circumstances beyond the control of the business. Continuing with the example of a potato chip manufacturer, if potato chips were no longer in demand, sales prices for potato chips would drop. Assuming all costs of production remain constant, the manufacturer's profit margin will diminish as the sales price falls. A business will try to minimize the impact of this situation by hedging.

46. *See infra* notes 91-102 and accompanying text.

forward contracts call for the future delivery of some amount of a valued item at a specified price at a designated time.[47] Most large, integrated business transactions fall into the category of forward contracts. If a business wants to guarantee a supply of inventory and set its sale price for the final product in advance to determine its profit, the business may use a forward contract.[48] The use of a forward contract, however, subjects the business to price and interest rate risks by binding itself in advance to a set price for the inventory using either a fixed price or a floating price.[49] The risks arise from the delivery occurring after the parties agree on a price. If the market price changes, either increasing or decreasing at the time of delivery, the manufacturer will have a gain or loss, respectively. The manufacturer will have a gain if the price increases because the manufacturer bought raw materials at a price less than current market price. Conversely, if a decrease in price occurs, then the manufacturer experiences a loss.

Forward contracts have four important aspects.[50] First, the price in the forward contract generally differs from the current price of the asset or obligation.[51] Second, the forward contract is a leveraged agreement.[52] Third, forward contracts are customized agreements between two private parties which meet the unique needs of each party.[53] Finally, forward contracts carry symmetric risks to both parties.[54] Forward transactions also possess a number of disadvantages stemming from these four aspects. Forward transactions

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47. MARK PITTS & FRANK J. FABOZZI, INTEREST RATE FUTURES AND OPTIONS 6 (1990). Forward transactions usually have unique terms tailored to the parties' needs because the transaction is between private parties. ROBERT T. DAIGLER, MANAGING RISKS WITH FINANCIAL FUTURES: HEDGING, PRICING AND ARBITRAGE 1 (1993). A forward contract is the private market equivalent of a futures contract. Kleinbard & Greenberg, *supra* note 8, at 395. See *infra* notes 63-67 and accompanying text for a discussion of the similarities and dissimilarities between forward contracts and futures contracts.

48. DAIGLER, *supra* note 47, at 192. Hedging allows business' to obtain a more constant estimate of the cost of the product which benefits both society and the hedging party. *Id.* The hedge translates into a lower and more consistent price for the product. *Id.*

49. A floating price is the price the parties agree that is marked to a market indicator related to the asset or obligation, such as the Consumer Price Index and will become fixed at a future time. KOHN, *supra* note 27, at 310. The floating price becomes fixed either at the time of transaction or at the time of delivery. *Id.*

50. SUSAN ROSS MARKI, DERIVATIVE FINANCIAL PRODUCTS 6 (1991).

51. *Id.* The difference in price is usually attributable to the cost of holding the asset or obligation over the time period of the contract. *Id.* Price risk results from fluctuating prices in the current market during the time between the date of the agreement and the date of delivery. DAIGLER, *supra* note 47, at 194-95.

For example, assume a potato chip producer desires to ensure a supply of potatoes at a set price ahead of time. The potato chip producer wants the production process to continue smoothly with a guaranteed supply of potatoes. Further, the producer wishes to set its sales price based on the product's current price, thus stabilizing its profits by keeping control of its cash in-flows and out-flows. The producer, therefore, contracts with a supplier during planting season to sell at the current market price of $250 per ton to be delivered at harvest time. If the market price drops to $200 per ton at delivery time, then the producer will take a loss of $50 per ton. The supplier, however, made a gain of $50 per ton for the opposite reason, selling potatoes worth $200 per ton for $250 per ton. Conversely, if the potato crops were sparse and the market price rose to $300 per ton, then the producer would make a profit of $50 per ton since it paid $250 per ton for potatoes with a fair market value of $300 per ton. In this scenario, the supplier would experience a loss of $50 per ton for selling potatoes for $250 per ton that were worth the fair market value of $300 per ton.

52. MARKI, *supra* note 50, at 6.

53. *Id.*

54. *Id.*

involve price risk,[55] credit risk,[56] interest rate risk,[57] and risk involved in finding trading partners.[58] By the very nature of forward contracts, one of the parties will experience a gain on the transaction while the other party will experience a loss. The most common and dangerous risks are price and interest rate fluctuation.

Businesses may use spot transactions as an alternative to forward contracts. A spot transaction, also referred to as a cash transaction, occurs when the parties agree on the product, price, and quantity, and consummate the trade immediately.[59] While spot transaction may seem attractive for their simplicity, these transactions may be inconvenient and impractical today.[60] Spot transactions, however, do not carry many of the risks associated with forward transactions, because no credit is provided and no time passes between the transaction and the delivery.[61] Many businesses are too complex for spot transactions to be practical. Therefore, businesses generally use forward contracts to assure stable prices allowing businesses to easily calculate future expenses and profits.[62]

2. Futures Contracts

Futures contracts, one of the most common hedging devices, are used to hedge the risks created by forward contracts. A futures contract is similar to a forward contract; however, all of the terms in a futures contract are standardized except price.[63] Unlike forward contracts, businesses usually do not carry futures contracts out to delivery.[64] Instead, futures contracts are used to hedge

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55. Price risk is the "potential investment losses due to price declines after an asset [or obligation] is purchased." WINGER & MOHAN, *supra* note 1, at 355.

56. Credit risk is the "risk that borrowers will default on their loans." KOHN, *supra* note 27, at 273. Forward contracts involve credit risk because the two private parties must assess the likelihood that the other party will default on the agreement. *Id.* at 310. If the supplier does not have the resources to take a $50 per ton loss, then the supplier may not deliver. The legal enforcement of a contract may occur too late to take advantage of current market conditions. In addition, if the price drops, the producer may refuse delivery since it could purchase the potatoes cheaper elsewhere. Parties to forward contracts, therefore, must evaluate the credit risk of their trading partner before entering into the contract.

57. Interest rate risk involves fluctuations of the interest rates in the market which affect the value of the assets or obligations a business has bought or expects to buy. WINGER & MOHAN, *supra* note 1, at 139.

58. KOHN, *supra* note 27, at 310.

59. *Id.* at 309.

60. *Id.* With spot transactions, the buyer must have the money and the seller must have the goods at the time the bargain is struck. *Id.* Frequently, businesses have neither the funds nor the inventory available when a deal is consummated, making spot transactions difficult in today's business environment. *Id.*

61. When there is a delay between the time of transaction and delivery, market prices and interest rates may change. *See supra* notes 55, 57.

62. DAIGLER, *supra* note 47, at 192.

63. *Id.* at 2. The standardized terms include the time and place of delivery, and the quantity, quality and grade of the products. *Id.* See *infra* notes 63-67 and accompanying text for a discussion of the differences between future contracts and forward transactions.

64. DAIGLER, *supra* note 47, at 2-3; *see also* THOMAS A. HIERONYMUS, ECONOMICS OF FUTURES TRADING 28 (1971) (noting only 1-2% of futures contracts ever mature). Few hedging parties actually want to receive or deliver the asset or obligation. KOHN, *supra* note 27, at 319. Carrying the futures contract to delivery would require actual buying of or selling of the asset or obligation involved. Since most businesses

forward transactions. As a result, futures contracts usually are cashed out prior to maturity, thus resulting in a corresponding gain or loss on the sale.[65] Futures contracts differ from forward contracts two additional ways. First, futures contracts are traded on exchanges while forward contracts are arranged between private parties.[66] Second, unlike forward contracts, which do not have initial payments, futures contracts are leveraged and require a margin to be posted.[67]

Financial futures, a type of futures contract used primarily to hedge obligations and their related interest rate and currency risks, have become the dominant futures contracts used in the market. Financial futures account for approximately sixty-two percent of the total futures market in 1991.[68] Hedging is one of the dominant uses of financial futures because hedging "reduce[s] the interest rate risk in connection with debt issuance."[69] With debt issuance soaring, businesses must insure against interest rate risk. To accomplish this interest rate risk reduction and to hedge against other risks, businesses also use other hedging devices such as options,[70] interest rate or currency rate swaps,[71] and interest rate caps, floors, or collars.[72]

3. Option Contracts

Option contracts[73] provide the option holder with the right to purchase or sell property at a specified price, referred to as the strike price,[74] within a

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use futures contracts for hedging or other business related purposes, carrying out these contracts to delivery would defeat the contracts' purpose.

65. *See* KOHN, *supra* note 27, at 319. A hedging party can liquidate its position by taking the offsetting position in the same contract. PITTS & FABOZZI, *supra* note 47, at 27. To cash out a long position, the hedging party sells the identical number of contracts. *Id.* Conversely, a short position is cashed out by buying the identical number of contracts. *Id.*

66. MARKI, *supra* note 50, at 16.

67. *Id.* Margins are funds deposited with a broker for each futures contract, or other financial device, as a guarantee of satisfaction of the contract, similar to a security deposit. *Stock Options*, *supra* note 40, at 226.

68. *See* Blair et al., *supra* note 26, at 539. On the Chicago Board of Trade, the largest exchange, financial futures accounted for 73% of total trading in 1991. KOHN, *supra* note 27, at 312-13. A discussion of financial futures is beyond the scope of this Note.

69. Blair et al., *supra* note 26, at 539.

70. *See infra* notes 73-90 and accompanying text.

71. *See infra* notes 91-102 and accompanying text.

72. This Note does not discuss interest rate caps, floors, and collars.

73. An option contract is generally a standardized contract sold on the market in common trade exchanges; options traded off the exchange are between private parties, and as such, the terms may vary. KOZIOL, *supra* note 24, at 191-92. The option feature sets this hedging device apart from others. Buying an option contract entails paying a premium, which grants the purchaser the right to exercise the option to buy or sell an asset or obligation at the specified price. PITTS & FABOZZI, *supra* note 47, at 6. Thus, if the price moves favorably, the option holder will exercise the option, netting a gain on the transaction. If the price does not move favorably, however, the option holder's loss is limited to the premium. *See infra* notes 78-90 and accompanying text.

74. The price of the underlying asset or obligation which may be bought or sold is commonly referred to as the strike price. *See* MARKI, *supra* note 50, at 32.

specified time period.[75] Conversely, the seller of an option contract grants the buyer the right to purchase or sell property at the strike price within a defined time period. The consideration for an option is commonly referred to as a premium and is nonrefundable.[76] The primary difference between futures and options is that futures focus on obligations while options focus on rights.[77]

Option contracts can be either calls or puts, both are considered unilateral contracts.[78] A call option allows the holder of the option to obtain, for a specified time, the right to buy the asset or obligation at the agreed contract price.[79] If the price of the underlying asset or obligation increases, the holder may exercise the call option and receive the asset or obligation at the lower contract price. In such a situation, the holder of the option will realize a profit.[80] If, however, the price does not rise above the premium,[81] or if the price

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75. Kleinbard & Greenberg, *supra* note 8, at 394 n.3. The holder has the option to buy or sell a specified amount of property at a fixed or floating price. *Id.* A "call" is an option contract to buy the property at a specific price. *Id.* A "put" is an option contract to sell the property at a specific price. *Id.*

76. PITTS & FABOZZI, *supra* note 47, at 6. The owner of the option contract pays the option price up front. The option can be exercised at any time until maturity. MARKI, *supra* note 50, at 32-33. The holder also can let the option lapse without exercising the option. *Id.* The seller's compensation for accepting the risk of loss, if the option is exercised, is the nonrefundable premium and the strike price. KOHN, *supra* note 27, at 323.

77. *See* PITTS & FABOZZI, *supra* note 47, at 8. Another difference between futures and options is that a futures contract buyer does not pay the seller to accept the obligation of performance, while the buyer of an option contract pays the seller the non-refundable premium. *Id.*

78. *See* KOZIOL, *supra* note 24, at 295.

79. Few option contract holders actually assert the right. Instead, option contracts, like futures contracts, are cashed out. Blair et al., *supra* note 26, at 536.

80. A call is referred to as "in-the-money" when the underlying asset or obligation's price is higher than the call's strike price. Chicago Mercantile Exchange, *Using Short-Term Interest Rate Futures & Options*, *in* THE HANDBOOK OF DERIVATIVE INSTRUMENTS 15, 28 (Atsuo Konishi & Ravi E. Dattatreya eds., 1991). For example, the potato chip producer might purchase a call option, the right to buy the underlying asset or obligation, for $5 per ton with a strike price of $250 per ton. Assume the market price increases above the premium and the strike price, ($5 + $250) per ton, to $ 270 per ton. The producer will now exercise the call option to buy potatoes for $250 per ton that are worth $270 per ton in the open market. The manufacturer will have realized a profit of $15 per ton.

81. When a call's strike price is exactly equal to the underlying asset or obligation, the option is referred to as being "at-the-money." MARKI, *supra* note 50, at 33. When a call option reaches the "at-the-money" position, the option may or may not be exercised. For example, the manufacturer might purchase a call option for $5 per ton with the strike price of $250 per ton. Assume the price is either $250, $253, or $255 per ton.

The manufacturer may or may not want to exercise the option if the price is at $250 per ton. If the manufacturer exercises the option, then it will lose $5 per ton ($250 market price - $250 strike price - $5 premium = -$5 per ton). If the manufacturer does not exercise the option, then the manufacturer will still lose the $5 per ton nonrefundable premium. Therefore, the manufacturer's decision to exercise the option will not flow from economic considerations since the monetary loss will be the same whether or not the manufacturer exercises the option.

If the price is at $253 per ton, the manufacturer will want to exercise the option to limit its loss to $2 per ton, the market price minus the strike price minus the premium ($253 - $250 - $5 = -$2 per ton). Since the manufacturer can buy the underlying asset or obligation in the open market for $253, the manufacturer will lose $5 per ton, the nonrefundable premium, if it does not exercise the option. If the manufacturer exercises the option, the manufacturer will pay $255 per ton ($250 strike price and $5 premium). If the manufacturer does not exercise the option, the manufacturer will pay $258 per ton ($253 market price plus the $5 falls,[82] then the holder would not want to exercise the option.[83] Because an option holder may choose not to exercise the option, the holder's loss is limited to the premium paid. The call seller, however, receives the premium for the risk and the seller's loss is unlimited if the option is exercised.[84]

The opposite results occur with put options. If the market price drops below the total of the premium and the strike price of the put option, the holder could exercise the option and realize a profit.[85] If the market price drops, but not less than the premium amount, the holder could still exercise the option to limit the holder's losses.[86] If the market price is above the strike price, however, the holder could not exercise the option, limiting the holder's loss to the premium.[87] Hedging with options "protects [the holder] against an adverse

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nonrefundable premium).

If the price is $255 per ton, then the manufacturer will want to exercise the option. If the manufacturer exercises the option, the manufacturer will not realize a loss or a gain ($255 market price - $250 strike price - $5 premium = $0). If the manufacturer does not exercise the option, then the manufacturer will lose the $5 per ton nonrefundable premium.

82. When a call's strike price is above the underlying asset's or obligation's price, the option is referred to as being "out-the-money." *Id.* For example, the manufacturer might purchase a call option for $5 per ton with the strike price of $250 per ton. Assume the market price decreases to $240 per ton. The manufacturer will not want to exercise the option. Exercising the option will result in a loss ($240 market price - $250 strike price - $5 premium = -$15 per ton). The manufacturer would want to limit its loss to the $5 per ton premium and simply buy the asset on the open market for $240 per ton.

83. For example, the potato chip producer might purchase a call option, the right to buy the product, in the potato market at $5 per ton. If the market price does not rise above $255 per ton, the manufacturer will not exercise the option. Exercising the option at a price below $255 per ton, for instance at $252 per ton, will produce a $3 per ton loss for the manufacturer since the manufacturer can purchase the product in the market at $252 per ton.

84. MARKI, *supra* note 50, at 33.

85. When a put's strike price is above the price of the underlying asset or obligation's market price, the option is referred to as being "in-the-money." *Id.* at 33-34. For example, a supplier might purchase a put option (the right to sell) for $5 with a strike price of $250 per ton. If the price decreases to $240 per ton, the supplier makes a profit of $5 per ton ($250 strike price - $5 premium - $240 market price = $5 per ton). The supplier may sell the underlying asset for $250 per ton when the asset is worth only $240 per ton in the open market.

86. When the market price of the underlying asset or obligation equals the strike price, the option is referred to as being "at-the-money." Chicago Mercantile Exchange, *Using Currency Futures and Options*, *in* THE HANDBOOK OF DERIVATIVE INSTRUMENTS 373, 388 (Atsuo Konishi & Ravi E. Dattatreya eds., 1991). When a put option is between the put's strike price and the premium, the holder must carefully evaluate whether or not to exercise the option in order to limit losses. For example, a supplier might purchase a put option for a $5 premium with a $250 per ton strike price. Whether the supplier exercises the option depends on whether the market price is $250, $247, or $245 per ton. If the market price is $250 per ton, the supplier may or may not exercise the option since the strike price does not provide any advantage or disadvantage over the market price. Either way, the supplier will limit its loss to the $5 premium. If the market price drops to $247 per ton, then the supplier would want to exercise the option to decrease its loss to $2 per ton ($250 strike price - $247 market price - $5 premium = -$2 per ton). If the supplier does not exercise the option, then the supplier's loss will be the $5 per ton premium. If the market price decreases to $245 per ton, the supplier will want to exercise the option. Exercising the option will net neither a gain nor a loss ($250 strike price - $245 market price - $5 premium = $0). The supplier will have a $5 per ton loss, however, by not exercising the option due to the premium.

87. When the market price of the underlying asset or obligation is higher than the strike price, the option is referred to as being "out-the-money." *Id.* at 387-88. For example, a supplier might purchase a put option for a $5 premium with a $250 per ton strike price. If the market price rises to $260 per ton, the supplier will

price movement while leaving open the possibility of profit from a favorable one."[88] The option holder's disadvantage is the substantial up-front cost of the nonrefundable premium that the holder pays.[89] The put seller, however, receives the premium for the risk while being exposed to unlimited losses.[90]

4. Interest Rate and Currency Swaps

Interest rate and currency swaps usually occur with financial futures. Swaps typically involve two businesses exchanging floating interest-rate payments for fixed interest-rate payments.[91] Some businesses prefer swaps over other hedging devices for two primary reasons. First, swaps have minimum reporting requirements for their balance sheets.[92] Second, although swaps are not as liquid as other devices, swaps do not depend on standardized contracts and do not require margins.[93]

An interest rate swap involves one party holding a debt instrument with a fixed rate of interest and the other party holding a debt instrument with a floating rate of interest.[94] Basically, interest rate swaps occur when two companies take out loans or issue debt instruments, such as bonds, and one company pays the interest owed by the other company rather than paying the interest incurred on its own debt.[95] One side of the swap might have issued a floating rate of debt[96] and want to hedge its risk in that debt by becoming the fixed payor.[97] In exchange, the obligor on the floating debt would receive floating payments.[98] A company that has the fixed rate of debt has the opposite goal of paying the floating rate and receiving the fixed payments. Financial

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not want to exercise the option. If the supplier exercises the option, the supplier will lose $15 per ton ($250 strike price - $260 market price - $5 premium = -$15 per ton). The supplier, therefore, limits its loss to the $5 per ton premium by not exercising the option.

88. KOHN, *supra* note 27, at 324. "The maximum amount that an option [holder] can lose is the [premium]." PITTS & FABOZZI, *supra* note 47, at 8. There is no inherent limit on the profit a holder may realize. MARKI, *supra* note 50, at 34. Gains from the option being "in-the-money" depend upon the underlying market price of the asset or obligation. *Id.* at 33-34. If the option is "in-the-money," then the holder, therefore, can potentially realize a large profit without fearing large losses. *Id.* If the option is "out-the-money," then the holder simply will not exercise the option and limit its loss to the premium. *Id.*

89. KOHN, *supra* note 27, at 324.

90. MARKI, *supra* note 50, at 34.

91. KOZIOL, *supra* note 24, at 190. Swaps, though usually done with liabilities, can also be done with assets. *Id.*

92. *Id.*

93. *Id.*

94. *See* Robert K. Sharp, *Financial Products in the Municipal Market, in* TAX EXEMPT FINANCING 1994, 1, 4 (PLI Tax Law and Estate Planning Course Handbook Series No. J4-3669, 1994).

95. KOHN, *supra* note 27, at 326.

96. The floating debt ties its interest rate to another market indicator that has some nexus with it. Floating debt may come in a variety of forms, such as a 30-year bond where the interest rate is tied to the U.S. Treasury Bills.

97. Sharp, *supra* note 94, at 4.

98. *Id.*

institutions usually participate on one side of a swap, offsetting their risk with further swaps with other financial institutions.[99]

A currency swap usually occurs between two companies doing business in separate countries.[100] The currency swap enables businesses to "borrow where its cost is least and still obtain funds in the currency it needs."[101] In general, businesses use currency swaps to hedge because currency swaps reduce the risk of interest and exchange rate fluctuations.[102] Accordingly, currency swaps occur most frequently between companies with global interests.

C. Distinctions Between Ordinary and Capital Property

Once a business understands the basic concepts and devices of hedging, a business must realize the potentially substantial federal tax implications attached to hedging transactions. The tax consequences of hedging transactions flow from the characterization of the resulting gains and losses as either capital or ordinary.

Ordinary property is "any property that, if sold, will result in the recognition of ordinary income."[103] For tax purposes, ordinary income or loss is fully taken into account when computing taxable income.[104] The I.R.C. defines ordinary income as including "any gain from the sale or exchange of property which is [not] a capital asset."[105] Conversely, ordinary loss is defined as including "any loss from the sale or exchange of property which is not a capital asset."[106] A business' inventory produces ordinary income when sold. Accordingly, only hedges integrally related to an underlying ordinary asset (here inventory) or obligation are characterized as ordinary for tax treatment purposes.[107]

The I.R.C.'s definition of capital assets is more problematic.[108] I.R.C. § 1221 defines a capital asset as all property except for an excluded list of property.[109] The legislative history indicates that § 1221's phrase "does not

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99. *Id.*

100. "A currency swap involves similar two-way payments [as interest rate swaps] between the parties, except that the payments are denominated in different currencies and typically reflect prevailing fixed interest rates for the stated currencies." Kleinbard & Greenberg, *supra* note 8, at 395 n.4; *see also* KOHN, *supra* note 27, at 332-33 (describing how currency swaps work).

101. KOHN, *supra* note 27, at 333.

102. Kleinbard & Greenberg, *supra* note 8, at 394.

103. LARRY D. CRUMBLY ET AL., WEST'S FEDERAL TAXATION: INDIVIDUAL INCOME TAXES 11-23 (William H. Hoffman et al. eds., 1992 ed. 1991).

104. *See* JOHN J. BOLAND, FEDERAL INCOME TAXATION OF SECURITIES 1 (3d ed. 1969) (ALI/ABA Taxation Practice Handbook No. 10, 1969).

105. I.R.C. § 64 (1988).

106. *Id.* § 65 (1988).

107. *See infra* notes 152-208 and accompanying text (discussing an interpretation of I.R.C. § 1221 permitting hedges integrally related to the underlying asset or obligation to be accorded ordinary treatment).

108. I.R.C. § 1221 (1988).

109. *Id.* § 1221(1)-(5).

include"[110] means only the classes of property specifically mentioned are excluded from classification as a capital asset.[111] For example, § 1221 specifically excludes inventory, real or depreciable business property, copyright or other intangible property, and accounts receivable.[112] More generally, § 1221 excludes from classification as a capital asset property that generates ordinary income or loss upon sale. Property held for investment purposes generally receives capital treatment.[113]

The tax consequences resulting from characterizing property as either capital or ordinary may be considerable and therefore may tremendously impacts a business' bottom line. The I.R.C. allows ordinary income to be fully offset by ordinary losses in the current taxable year.[114] Capital gains,[115] however, are fully taxable in the year of sale.[116] A corporation cannot use capital losses to offset ordinary income.[117] Rather, a corporation may only use capital losses to offset capital gains to the extent of capital gains that are recognized in the same year.[118] Corporate taxpayers, however, may use excess capital losses not offset by capital gains, that would otherwise be nondeductible, to adjust capital gains for prior and future tax periods through carrybacks and carryovers.[119] Thus, while capital losses have limited use and duration, ordinary losses may be used to a greater extent, including offsetting net capital gains. Although corporate capital gains are currently taxed at the same rate as

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110. *Id.* § 1221(a).

111. Arkansas Best Corp. v. Commissioner, 485 U.S. 212, 218 (1988); *see also* H.R. Rep. 704, 73d Cong., 2d Session, 31 (1934); H.R. Rep. 1337, 83d Cong., 2d Sess., A273 (1954). The Treasury Regulations also support this interpretation. *See* Treas. Reg. § 1.1221-1(a) (1994) ("The term *capital assets* includes all classes of property not specifically excluded by section 1221.").

112. I.R.C. § 1221(1)-(4).

113. *See* CRUMBLEY ET AL., *supra* note 103, at 16-3. Historically, property held for investment was treated as a capital asset. See *infra* notes 151-71 and accompanying text for a discussion of the *Corn Products* doctrine and the "Business Motive" test. Investments generally are still treated as capital assets. Since *Arkansas Best* rejected the "Business Motive" test, one must determine if the investment qualifies as a bona fide hedge under Treasury Regulation § 1.1221-2. See *infra* notes 219-40 and accompanying text for a discussion on the implications of Treasury Regulation § 1.1221-2.

114. *See* I.R.C. § 165(a) (Supp. V 1993); *see also* CRUMBLEY ET AL., *supra* note 103, at 3-29.

115. For purposes of this Note, the distinction between long term and short term capital gains and losses will be disregarded.

116. *See* I.R.C. § 1201 (1988 & Supp. V 1993).

117. *See* 4 JACOB MERTENS, JR., MERTENS LAW OF FEDERAL INCOME TAXATION § 22.75 (1994). A corporation may not use capital losses in excess of capital gains to offset ordinary income. *See id.* §§ 22.73, 22.74.

118. "[L]osses from sales or exchanges of capital assets shall be allowed only to the extent of gains from such sales or exchanges." I.R.C. § 1211(a) (1988); *see also* CRUMBLEY ET AL., *supra* note 103, at 3-31; 4 MERTENS, *supra* note 117, §§ 22.73, 22.74. The Code provides a similar limitation on capital losses for taxpayers other than corporations. An individual with capital losses exceeding capital gains is allowed to deduct from ordinary income the lower of $3,000 or the excess of the losses. I.R.C. § 1211(b) (1988); *see also* 4 MERTENS, *supra* note 117, § 22.74.

119. *See* I.R.C. § 1212 (1988). The excess capital loss for corporations first becomes a carryback for each of the three preceding years. *Id.* § 1212(a). Any capital loss remaining after a carryback becomes a capital loss carryover for the five taxable years succeeding the loss. *Id.*; *see also* 4 MERTENS, *supra* note 117, §§ 22.81-22.83 (discussing carryovers and carrybacks for corporate and noncorporate taxpayers).

ordinary gains,[120] Congress may lower the capital gains rate in the future; consequently, corporations consistently characterizing their gains as capital will allow corporations to take advantage of possible lower future tax rates. Accordingly, a corporation will generally attempt to characterize its gains as capital and its losses as ordinary.

III. HISTORICAL BACKGROUND OF THE TAX TREATMENT OF HEDGES

In order to understand the issues that might effect the application of Treasury Regulation § 1.1221-2, an overview of the historical background of hedges is necessary. Prior to 1934, characterizing hedging gains or losses as either capital or ordinary was not an issue. The term "capital asset" in the pre-1934 I.R.C. only included assets held more than two years.[121] Businesses usually hold hedges for less than a year before disposition or delivery, well within the two-year time frame for capital assets.[122] Most hedges, therefore, received ordinary treatment.

A. General Counsel Memorandum 17322

The Revenue Act of 1934 (the Act) modified the definition of a capital asset and abolished the two year holding period.[123] These changes created a potential problem known as a tax whipsaw.[124] A tax whipsaw typically occurs when a business' gains or losses on the underlying asset or obligation are mismatched against gains or losses on hedges from the same asset or obligation.[125] Thus, the two economically related transactions receive diametric characterizations for tax purposes. A hedging tax whipsaw can occur when the business sells the underlying asset for an ordinary gain, while a hedging loss under the modified definition, would be characterized as capital. Taxpayers could transmute unfavorable capital hedging losses into ordinary losses by carrying out the hedge to delivery while keeping favorable capital hedging gains. As a result, the characterization of gains and losses were subject to manipulation by taxpayers.

The IRS quickly recognized the potential for abuse in the Act's definition and reacted by issuing General Counsel Memorandum 17322[126] (GCM 17322)

120. The Tax Reform Act of 1986 modified the computation of the alternative tax for corporations. *See* Pub. L. No. 99-514, § 311, 100 Stat. 2085, 2219 (1986) (codified as amended in scattered sections of 26 U.S.C.). The modification provides that a corporate taxpayer pays tax on its net capital gains at the same alternative tax rate as ordinary income, currently 34%. *See* 4 MERTENS, *supra* note 117, § 22.02.

121. *See* Blair et al., *supra* note 26, at 541.

122. *Id.*

123. *See* Kleinbard & Greenberg, *supra* note 8, at 397.

124. *Id.*

125. *See* Blair et al., *supra* note 26, at 541. In a typical tax whipsaw, the sale of the underlying inventory results in ordinary gain or loss, while the sale of the hedge of the inventory produces a capital gain or loss.

126. Gen. Couns. Memo. 17322, XV-2 C.B. 151 (1936) (restated in part and superseded by Rev. Rul.

in 1936 to rectify the whipsaw problem.[127] GCM 17322 stated that true hedges "are common trade practices . . . . Where futures contracts are entered into only to insure against . . . risks inherent in the taxpayer's business, the hedging operations should be recognized as a legitimate [cost] of business insurance."[128] According to GCM 17322, true hedging costs, therefore, were an "ordinary and necessary expense."[129]

GCM 17322 does not define a "true" hedge, but instead provides two typical examples of business hedges.[130] The first example involved a manufacturer that sold futures to protect against an interim fall in the price of raw materials which the manufacturer had purchased for future use.[131] The second example involved a manufacturer that bought futures to avoid a rise in the price of the raw materials needed to produce goods the manufacturer had already contracted to sell.[132] The IRS accepted these hedges as "business insurance," in effect creating an extra-statutory exception to the definition of capital asset.[133] As long as a business did not use hedges to speculate, the IRS regarded the hedges as producing an ordinary income and loss.[134]

The challenges that followed GCM 17322 did not focus on whether the IRS had the authority "to create . . . an extra-statutory exception to the definition of 'capital asset,'" but rather focused on what constituted a "true" hedge.[135] The test for a "true" hedge became whether the business maintained an "even or balanced" position against the current property being hedged.[136] In practice, the test for a true hedge proved difficult to apply.[137] The confusion created by GCM 17322 was that an even or balanced position received different interpretations from different courts.[138] Thus, businesses had no

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72-179, 1972-1 C.B. 57).

127. Blair et al., *supra* note 26, at 541.

128. Gen. Couns. Memo. 17322, XV-2 C.B., at 152.

129. *Id.* (characterizing hedging costs as legitimate business costs, thus treating hedging gains and losses as ordinary gains and losses).

130. *Id.* at 155.

131. *Id.* The manufacturer that sells futures holds the long position in the futures market and the short position in the physical asset. Therefore, the manufacturer will use its long position in the futures market to hedge against a decline in prices of the underlying physical asset. *See supra* notes 27-39 and accompanying text (discussing the long and short position).

132. Gen. Couns. Memo. 17322, XV-2 C.B., at 155.

133. *See* Blair et al., *supra* note 26, at 542 (commenting that by accepting the "business insurance" rationale, the IRS created another statutory exception that became a de facto accepted definition of a "capital asset" by subsequent courts' focus on what constitutes a "true hedge" instead of the "business insurance" rationale).

134. Gen. Couns. Memo. 17322, XV-2 C.B., at 155.

135. Blair et al., *supra* note 26, at 542.

136. Kleinbard & Greenberg, *supra* note 8, at 404-05. A hedging transaction maintains an "even or balanced" position when the hedge balances against the underlying position. *Id.* To demonstrate the business insurance aspect, the hedge must approximate the characteristics of the underlying transaction, primarily price and timing. *Id.*

137. *Id.*

138. Blair et al., *supra* note 26, at 542.

guidance on what constituted an even or balanced position because the law provided little predictability.

B. The Corn Products *Doctrine*

The confusion over GCM 17322 led to the United States Supreme Court case, *Corn Products Refining Co. v. Commissioner.*[139] In *Corn Products*, the company was in the business of refining corn products, but had little storage space for its raw materials.[140] The company, therefore, took a long position in corn futures as the most economical method of ensuring a steady supply of corn at a stable price without building costly storage space.[141] If shortages of supply arose, then the company took delivery from the futures. If supplies were adequate, then the company sold the excess futures. Through these hedging transactions, the company realized a $680,000 gain in 1940 and experienced a loss of $110,000 in 1942.[142]

The company sought capital tax characterization for both its 1940 hedging gains and 1942 hedging losses.[143] The company contended that its position was not balanced, that the futures were distinct from its manufacturing business, and that the futures were an investment.[144] The Commissioner took the position that the futures fell within the business insurance extra-statutory exception and, therefore, should be treated as ordinary income.[145]

The United States Supreme Court agreed with the Commissioner.[146] The Supreme Court admitted that "petitioner's corn futures do not come within the literal language of the exclusion . . . . But the capital-asset provision of § 117 [predecessor to I.R.C. § 1221] must not be so broadly applied as to defeat rather than further the purpose of Congress."[147] The Court went on to note that "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."[148] To effectuate the basic congressional purpose, the Supreme Court stated, "[T]he definition of a capital asset must be narrowly applied and its exclusions interpreted broadly."[149] The Court, therefore, refused to extend

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139. 350 U.S. 46 (1955).
140. *Id.* at 48.
141. *Id.*
142. *Id.* at 49.
143. *Id.* The company originally included the gains and losses as ordinary income. *Id.* Once the Commissioner brought suit, however, the company changed its position and claimed that the gains and losses were "capital gains and losses." *Id.* at 51.
144. *Id.* at 49.
145. *Id.* at 50. The statute at issue in *Corn Products* was I.R.C. § 117, the predecessor to I.R.C. § 1221.
146. *Id.* at 52.
147. *Id.*
148. *Id.*
149. *Id.*

I.R.C. § 117's favorable capital gain tax treatment and apply it to hedges integrally related to inventory.[150]

Pursuant to what came to be known as the *Corn Products* doctrine, the *Corn Products* opinion was interpreted to require reading beyond the literal language of the statute, and thus creating a judicial "extra-statutory exception" to the capital treatment of hedges under I.R.C. § 1221. The *Corn Products* doctrine expanded the inventory exception to I.R.C. § 1221 from "property of a kind which would properly be included in the inventory of the taxpayer"[151] to include hedges that "constitute an integral part of [the taxpayer's] manufacturing business."[152] The Court prevented the creation of a loophole in § 117 of the I.R.C. by foreclosing taxpayers from manipulating ordinary gain into capital gain.[153] An unintended side effect of the opinion was that it allowed taxpayers to change capital losses into beneficial ordinary losses by arguing that their hedging was part of the "profits and losses arising from the everyday operation of business" that Congress intended to be considered ordinary.[154] Taxpayers could argue that the hedges were ordinary even if the hedge fell outside the literal language of the inventory exception to § 1221 by showing that the taxpayer's intent to purchase the hedging device was for ordinary business purposes.

The *Corn Products* doctrine evolved into a subjective test to determine if a business entered into the hedge for ordinary purposes of the business or for investment purposes.[155] Courts and the IRS no longer relied exclusively on the I.R.C. when deciding the characterization of hedging gains and losses. Instead, I.R.C. § 117, its successor Code § 1221, and the inventory exception all fell by the wayside as courts and the IRS looked to the subjective intent of the taxpayers to determine whether the taxpayer purchased the hedge for investment or business purposes. Under the *Corn Products* doctrine, the taxpayer's investment motive for hedging required capital treatment. Conversely, any hedge relating to an asset held as an integral part of the taxpayer's business was treated as ordinary income because the hedge acts as a surrogate for inventory.[156]

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150. *Id.*

151. I.R.C. § 117(1) (1988).

152. *Corn Prods. Ref. Co.*, 350 U.S. at 51.

153. *Id.* at 53-54 (holding that a loophole in the statute would be created if the sale of a futures contract created a capital transaction while delivery of the underlying commodity created an ordinary transaction).

154. *Id.* at 52.

155. *See* M. Kevin Bryant, Comment, *The* Corn Products *Doctrine After* Arkansas Best, 14 OKLA. CITY U. L. REV. 131, 134 (1989).

156. *See* Kleinbard & Greenberg, *supra* note 8, at 410. For example, a hedge of a manufacturer's inventory, a § 1221(1) exception to capital assets, is directly related to the business' operations. The hedge, therefore, would be characterized as an ordinary asset.

In the thirty-three years following *Corn Products*, courts broadened the *Corn Products* doctrine so that most types of hedging and even certain non-hedging transactions were classified as ordinary using the "business motive" test, thereby expanding the interpretation of *Corn Products* beyond its facts.[157] *Corn Products* reinforced, and the IRS accepted,[158] traditional hedging as a form of insurance under GCM 17322 and permitted bona fide hedging transactions and certain non-hedging transactions to be accorded ordinary treatment.

As a result, the focus of many of the cases following *Corn Products* had little to do with inventory or traditional hedging devices. Instead, taxpayers began asserting that the purchase of capital stock, the preeminent capital asset, in certain circumstances fit into the *Corn Products* doctrine under the auspices of "source of supply" language in *Corn Products* that recognized that hedging devices may be used to assure a source of supply of inventory.[159] Taxpayers argued that purchasing supplier's capital stock to assure a ready source of inventory fell within the doctrine's broad purpose of providing ordinary treatment to everyday business transactions because assuring a source of inventory supply fit within the business purpose test, even though capital stock was not related to, or a surrogate for, inventory.[160]

Courts accepted this broad reading of *Corn Products*, and provided ordinary treatment to these transactions, thus expanding the doctrine even further.[161] *Booth Newspapers, Inc. v. United States*[162] is a leading example of a "source of a supply" case. In *Booth Newspapers*, newspaper publishers, confronted with a severe shortage of newsprint after World War II, bought all the stock of a newsprint mill in order to ensure the publishers with an adequate

157. *See* Harrop A. Freeman, *Is There a New Concept of Business Asset?*, 36 TAXES 110, 110-13 (1958); *see also* Campbell Taggert, Inc. v. United States, 744 F.2d 442 (5th Cir. 1984) (purchasing stock in subsidiary company to protect its reputation); Booth Newspapers, Inc. v. United States, 303 F.2d 916 (Ct. Cl. 1962) (purchasing of capital stock of paper producer by publisher to assure supply of paper); Southeastern Aviation Underwriters v. Commissioner, 25 T.C.M. (CCH) 112 (1966) (acquiring stock in insurance company to obtain a contract); Waterman, Largen and Co. v. United States, 419 F.2d 845 (Ct. Cl. 1969) (acquiring stock to become the exclusive sales agent for yarn producer); Steadman v. Commissioner, 424 F.2d 1 (6th Cir. 1970) (acquiring of stock by attorney in employer to protect his position as general counsel).

158. *See* Rev. Rul. 58-40, 1958-1 C.B. 275.

159. *Corn Prods. Ref. Co.*, 350 U.S. at 50.

160. *See* Booth Newspapers, Inc. v. United States, 303 F.2d 916 (Ct. Cl. 1962).

161. *See, e.g.*, F.S. Servs., Inc. v. United States, 413 F.2d 548 (Ct. Cl. 1969) (purchasing of refinery by wholesaler of fertilizers to assure supply); Livesley v. Commissioner, 19 T.C.M. (CCH) 133 (1963) (purchasing stock in potato company by distributor to maintain supply of potatoes); Electrical Fittings Corp. v. Commissioner, 33 T.C. 1026 (1960) (acquiring of stock in foundry to assure supply of electrical castings); Smith & Welton, Inc. v. United States, 164 F. Supp. 605 (E.D. Va. 1958) (purchasing stock in supplier by retailer to assure supply of ladies' dresses); Edwards v. Hogg, 214 F.2d 640 (5th Cir. 1964) (acquiring stock to assure supply of liquor); Tulane Hardwood Lumber Co. v. Commissioner, 24 T.C. 1146 (1955) (purchasing of debentures by wholesaler to maintain supply of plywood).

162. 303 F.2d 916.

supply of newspaper.[163] When the shortage subsided, the publishers sold the stock at a loss.[164] The court permitted ordinary treatment for the loss by stating that:

> [I]f securities are purchased by a taxpayer as an integral and necessary act in the conduct of his business [any resulting gain or loss will be treated as ordinary]. If, on the other hand, an investment purpose be found to have motivated the purchase or holding of the securities [any resulting gain or loss will be accorded capital treatment].
>
> Thus, the circumstances of the transaction . . . are of crucial importance . . . . The fact that securities are 'property,' in the broad sense of that term [within the meaning of I.R.C. § 1221], is not conclusive.[165]

The situation in *Booth Newspapers* also identified the problem with applying the business motive test. The subjective motive test created uncertainty that allowed businesses to challenge and manipulate the characterization of their hedges. The line of cases following *Corn Products* frequently involved situations where hedges were made with mixed motives. To resolve this problem, courts developed the "predominant motive" test[166] and the "substantial investment purpose" test.[167] In *W.W. Windle Co. v. Commissioner*,[168] the Tax Court gave a classic example of the operation of the substantial purpose test. In the *W.W. Windle Co.* case, a wool processor formed a company that manufactured wool products. W.W. Windle owned the majority of the manufacturer's stock, ensuring itself a loyal customer for its wool in times of declining sales. A subsequent sale of this stock produced losses. The court found that "while [W.W. Windle's] principal motive was to acquire a captive customer, it had a substantial subsidiary investment motive, which prevented it from being entitled to an ordinary loss."[169] In a Revenue Ruling, the IRS had adopted the "substantial investment purpose" test.[170] The *Corn Products* doctrine was widely followed until *Arkansas Best Corp. v. Commissioner*.[171]

C. Arkansas Best *and Its Implications*

The United States Supreme Court, in *Arkansas Best*, rejected the *Corn Products* doctrine.[172] The Court held that the case turned on a literal reading

163. *Id.* at 918.
164. *Id.* at 919.
165. *Id.* at 921.
166. *See id.*; *see also* Lance J. Miller, Note, *The Unpleasant Taste of* Corn Products, 53 S. CAL. L. REV. 311 (1979) (discussing the "predominant motive" test).
167. *See, e.g.*, Wright v. Commissioner, 756 F.2d 1039 (4th Cir. 1985); Miller v. Commissioner, 70 T.C. 448 (1978).
168. 65 T.C. 694 (1976), *aff'd* 550 F.2d 43 (1st Cir.), *cert. denied*, 431 U.S. 966 (1977).
169. *Id.* at 704.
170. Rev. Rul. 78-94, 1978-1 C.B. 58. The Service suspended the Revenue Ruling pending the outcome of *Arkansas Best*. I.R.S. Notice 87-68, 1987-2 C.B. 378.
171. Arkansas Best Corp. v. Commissioner, 485 U.S. 212, 216 (1988).
172. *Id.*

of I.R.C. § 1221, regardless of whether the business purchased and held the stock for a business purpose or for an investment purpose.[173] In *Arkansas Best*, a holding company acquired a majority interest in a commercial bank.[174] The bank experienced financial difficulties after a declining real estate market resulted in the defaults of a significant number of loans.[175] In an effort to add capital to the bank, the holding company purchased additional shares of the bank's stock.[176] The holding company eventually sold the bank's shares at a loss, which the company characterized as ordinary.[177] The IRS challenged the ordinary treatment of the loss.[178] The Supreme Court concluded that the initial purchase and the additional investment should be characterized as capital in nature.[179] The holding company's losses, therefore, received capital loss tax treatment.[180]

The *Arkansas Best* Court rejected the prevailing interpretation of *Corn Products* which created an extra-statutory exception. The *Arkansas Best* Court reasoned that the *Corn Products* Court simply applied I.R.C. § 1221 and the inventory exception, but did not judicially expand the section and exception. The *Arkansas Best* Court stated that "in light of the stark language of [I.R.C. §] 1221 . . . we believe that *Corn Products* is properly interpreted as involving an application of § 1221's inventory exception."[181] The *Arkansas Best* Court brought the *Corn Products* interpretation back within a literal reading of the statute.

In § 1221 of the I.R.C., "capital asset" is meant to be broadly defined "as property held by the taxpayer."[182] Even after Arkansas Best acknowledged that the Bank stock fell within the literal definition of capital asset and not within the statutory exclusions, Arkansas Best contended that the stock was held for business purposes and therefore should be accorded ordinary treatment.[183] In other words, Arkansas Best was asserting the business motive test of the *Corn Products* doctrine. The Court rejected this argument despite prior case law which had accepted this interpretation.[184]

The *Arkansas Best* Court recognized that the *Corn Products* doctrine had been expanded beyond the language of I.R.C. § 1221, and attempted to realign

173. *Id.*
174. *Id.* at 214.
175. *Id.*
176. *Id.*
177. *Id.*
178. *Id.*
179. *Id.* at 215.
180. *Id.*
181. *Id.* at 220.
182. *Id.* at 217.
183. *Id.* at 216.
184. The Court stated: "[Arkansas Best's] reading of Corn Products finds much support in the academic literature and in the courts. Unfortunately for [Arkansas Best], this broad reading finds no support in the language of § 1221." *Id.* (footnotes omitted).

caselaw and return to the literal language of the I.R.C. rather than relying upon an extra-statutory exception. The Court concluded that the corn futures in *Corn Products*, though not actual inventory, were used as part of an integral part of the taxpayer's inventory system.[185] This led the *Corn Products* Court to treat the futures as substitutes for inventory allowing the futures to fall within a broad reading of the inventory exception.[186] *Arkansas Best* held that *Corn Products* "stand[s] for the narrow proposition that hedging transactions that are an integral part of a business' inventory purchase system fall within the inventory exclusion of § 1221."[187] Since Arkansas Best's transactions were not hedges, the transactions did not fall within the inventory exclusion.

The *Arkansas Best* Court declared that a taxpayer's motivation for purchasing an asset is irrelevant in determining whether the asset is a capital asset.[188] Further, the *Arkansas Best* Court asserted that a taxpayer's motive is not mentioned in I.R.C. § 1221. In addition, the taxpayer's motive directly conflicted with the "whether or not connected with his trade or business"[189] language in the definition of capital asset.[190] The Court correctly pointed out that the business motive test created the very same whipsaw problem that *Corn Products* attempted to abolish. When capital stock is purchased and subsequently sold for a loss, taxpayers may seek ordinary treatment by arguing that the taxpayer originally held the stock for a business purpose. Yet the same transaction, if the capital stock is sold for a gain, would yield a capital gain.[191]

The *Arkansas Best* opinion, however, created new confusion and uncertainty. First, the Court did not completely reject the business motive test. The Court stated that "[a] business connection, although irrelevant to the initial determination of whether an item is a capital asset, is relevant in determining the applicability of certain of the statutory exceptions, including the inventory exception."[192] Thus, little guidance is given on future application of the business motive test. A company purchasing capital stock in a supplier to assure a supply of inventory[193] cannot predict whether the stock will be accorded ordinary or capital treatment. One argument is that stock purchases, which assure a source of supply, are an ordinary business purpose integral to the business' inventory, thereby falling within the inventory exception. This argument elevates substance over form. The opposing argument, applying *Arkansas Best's* literal interpretation of I.R.C. § 1221, is that capital stock is

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185. *Id.* at 221.
186. *Id.*
187. *Id.* at 222.
188. *Id.* at 223.
189. I.R.C. § 1221 (1988).
190. *Arkansas Best Corp.*, 485 U.S. at 218.
191. The Court stated it was "unaware of a single decision that has applied the business-motive test so as to require a taxpayer to report a gain from the sale of stock as an ordinary gain." *Id.* at 223.
192. *Id.* at 221.
193. *See supra* notes 159-65 and accompanying text.

clearly within the literal language of the capital asset definition regardless of the business purpose for which the stock was held.[194]

A 1991 Claims Court, in *Circle K Corp. v. United States*, addressed this issue and declared that the taxpayer's motive is irrelevant in source of supply cases.[195] The *Circle K* court stated that "a source of supply analysis . . . is still valid. Therefore, the court found 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."[196] The problem with the Claims Court case is that the taxpayer did not assert that the purpose behind the stock purchases was to assure a source of supply.[197] The problem of how to characterize stock purchases made to assure a source of supply, left in limbo by *Arkansas Best*, therefore, remains unresolved.

The *Arkansas Best* opinion also created confusion because a literal application of I.R.C. § 1221 seems to preclude holding companies from treating stock in their subsidiaries as ordinary.[198] An application of *Arkansas Best* in this manner would have a widespread impact on the business community since major companies structure their corporations as holding companies which acquire subsidiaries through a stock purchase. The argument against ordinary treatment is that capital stock is a capital asset and subsequent gains or losses upon sale of that stock should be characterized as capital. An argument for ordinary characterization is that the subsidiaries are an integral part of the holding company's business. This argument, however, implies the application of the business motive test to an capital asset exception. Once again, uncertainty persists as to the proper treatment of capital stock in business purpose situations.

Typical business hedges, discussed *supra*, are left largely untouched after *Arkansas Best*. The *Arkansas Best* Court maintained that hedges, which are integral to a business' inventory purchase system, acting as surrogates for inventory, would be accorded ordinary treatment. This presents a problem that hedges with a tenuous link to underlying inventory may not receive ordinary treatment. Applying the business motive test to the inventory exception would characterize the hedge as ordinary since the hedge was purchased to reduce risk to the inventory. *Arkansas Best*, however, implies capital treatment of the same

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194. *See* David P. Tolman, Note, *The* Arkansas Best *Decision: Taking* Corn Products *off the Taxpayer Menu*, 8 VA. TAX REV. 705, 738-39 (1989).

195. Circle K Corp. v. United States, 23 Cl. Ct. 665 (1991).

196. *Id.* at 672.

197. *See* Patrick E. Hobbs, *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?*, 26 LOY. L.A. L. REV. 289, 320-22 (1993); *see also* Joseph Bryon Cartee, Note, *A Historical Essay and Economic Essay of the Capital Asset Definition: The Taxpayer and Courts are Still Mindfully Guessing While Congress Doesn't Seem to (Have a) Mind*, 34 WM. & MARY L. REV. 885, 923-31 (1993) (discussing *Circle K Corp.*).

198. *See* Tolman, *supra* note 194, at 725-26, 737.

transaction because the hedge may not be considered an integral part of the inventory.

The third problem created by *Arkansas Best* is the characterization of liability hedges. A liability hedge, by its nature as a hedge of an obligation rather than inventory, falls outside a literal reading of I.R.C. § 1221 altogether. Section 1221 deals with "property," and obligations are not within the literal meaning of "property."[199] The status of liability hedges, therefore, is uncertain.

Based on *Arkansas Best*, the IRS took a narrow reading of I.R.C. § 1221 and began challenging business' characterization of hedging transactions. The IRS, though, abandoned that position after *Federal National Mortgage Ass'n v. Commissioner (FNMA)*.[200] As discussed *supra*, the *Arkansas Best* Court's decision generated substantial confusion as to the proper tax treatment of hedges.

D. Federal National Mortgage Ass'n

In the first post-*Arkansas Best* Tax Court decision, *FNMA*, the Tax Court addressed the impact of the United States Supreme Court's recent decision. In *FNMA*, the taxpayer purchased home mortgage loans from financial lenders and issued debentures to fund these acquisitions.[201] The taxpayer wanted to protect against the risk from interest rate changes on the mortgages that it held or had committed to buy and on the debt obligations.[202] Three types of hedging transactions were involved: (1) anticipated issuances of debentures; (2) commitments to purchase notes of the Alaska Housing Finance Corporation; and (3) convertible commitments.[203] The hedging was accomplished through: "(1) [s]hort positions in futures contracts on debt securities and call options on such contracts; (2) short sales of U.S. Treasury securities; [and] (3) put options in futures contracts on Treasury securities."[204]

The Tax Court held that the mortgage notes involved were "notes receivable" under the I.R.C. § 1221(4) exception.[205] The court, applying *Arkansas Best*, then found that the hedges were integrally related to the mortgage notes, close enough as to act as surrogates for the notes.[206] The Tax Court affirmed the substitution doctrine,[207] permitting a hedge integrally related

199. *See* Kleinbard & Greenberg, *supra* note 8, at 419-44 (discussing the effects of *Arkansas Best* on liability hedges and other business hedges).

200. 100 T.C. 541 (1993).

201. *Id.* at 545.

202. *Id.* at 546-47.

203. *Id.* at 550.

204. *Id.* at 551 (footnotes omitted).

205. *Id.* at 576.

206. *Id.*

207. The substitution doctrine provides that an item that substitutes for another item should receive the same tax treatment as the item being replaced. *See* Blair et al., *supra* note 26, at 549.

to an ordinary asset to be accorded ordinary treatment. The losses from the hedges were then characterized as ordinary since the hedges "bear a close enough connection to its section 1221(4) mortgages to be excluded from the definition of capital asset."[208] Thus, even though the hedges did not fall within the literal language of I.R.C. § 1221's exceptions, the court permitted ordinary treatment for the hedging losses.

The *FNMA* decision is important for taxpayers for many reasons. "The result reached by the court avoids the character mismatches that result from treating business hedges as capital [assets]. Moreover, it comports with substantial evidence that Congress has long assumed that business hedges give rise to ordinary gain or loss."[209] One of the issues in the case was whether micro hedges, hedging of specific liabilities or assets, were protected as a bona fide hedge.[210] The court clearly accepted micro hedges as an acceptable form of hedging.[211] The court further concluded that "it is not necessary for the ordinary treatment of a hedge under § 1221 that it be in the asset that the petitioner actually holds or intends to acquire."[212] Thus, taxpayers do not have to hedge in the identical property as the underlying property that is being hedged. This creates a problem, however, since the court gave no guidance on how close a link is needed to maintain ordinary treatment. Hedging is a common practice and matching hedges closely to the underlying property is a practical problem.

The IRS argued that the hedges related to the debentures were liability hedges and not assets within any exception to I.R.C. § 1221.[213] The court looked to I.R.C. § 1256(e),[214] which defines hedging within the context of marked to market rules for support.[215] The court concluded that it would be inconsistent for Congress to make an exception to marked to market rules and not have liability hedges an exception to I.R.C. § 1221.[216] Liability hedges integrally related to an inventory purchase system, therefore, should be characterized as ordinary.

FNMA expanded *Arkansas Best* to apply to all of I.R.C. § 1221's exceptions. Taxpayers do not have to fit their hedges into the inventory exception. The taxpayers, however, must still demonstrate their business hedges are integrally related to one of the exceptions. As a result, *FNMA*'s

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208. *Federal Nat'l Mortgage Ass'n*, 100 T.C. at 579.

209. Preamble, Temp. Treas. Reg. 1.1221-2T, 58 Fed. Reg. 54,038 (1993).

210. *Federal Nat'l Mortgage Ass'n*, 100 T.C. at 569. The IRS asserted that only global hedging, hedging an entire pool of assets and liabilities, was permitted. *Id.* at 570 nn.27-28.

211. *Id.* at 569-70.

212. *Id.* at 576.

213. *Id.* at 576-77.

214. The I.R.C. defines hedging as transactions that "reduce risk of interest rate or price changes . . . with respect to borrowings made or to be made." I.R.C. § 1256(e)(A)(ii) (1988).

215. *Federal Nat'l Mortgage Ass'n*, 100 T.C. at 577.

216. *Id.*

application of *Arkansas Best* would include most common business hedges as falling within one of the exceptions. One situation not addressed by either *Arkansas Best* or *FNMA* is when a business hedges the purchase of supplies. Since supplies do not fit into the inventory exception, or any other exception to I.R.C. § 1221, the hedge can not be integrally related to an exception.

FNMA's application of *Arkansas Best* and *Corn Products* allowed most hedging transactions to be characterized as ordinary. Overall, *FNMA* relieved many taxpayers because the decision rejected many of the IRS's arguments which would have inhibited many hedging practices. Tax Court cases following *FNMA* have reaffirmed *FNMA's* holding.[217] The IRS adopted the *FNMA* position with the issuance of a Treasury Regulation in an effort to stop the ensuing litigation spawned by confusion created by *Arkansas Best.*

IV. ANALYSIS OF TREASURY REGULATION § 1.1221-2

The IRS, in Treasury Regulation § 1.1221-2, clears up some of the confusion from *Arkansas Best* and provides hedging guidance for taxpayers. The IRS generally agrees with the result reached in FNMA and takes the position that most hedging gains and losses should be characterized as ordinary for tax purposes. First, this Section provides an overview of Regulation § 1.1221-2, which provides the requirements that hedges must conform to in order to be characterized as ordinary.[218] This Section then illustrates how the Regulation needs to be more comprehensive because it fails to adequately address the following issues: (1) broadening the scope of the hedging definition;[219] (2) ensuring the availability of goods;[220] and (3) related third parties.[221]

A. Overview of Treasury Regulation § 1.1221-2

The Regulation defines hedging to avoid the problems of *Arkansas Best* and *FNMA*. The IRS molded the definition of hedging after I.R.C. § 1256(e)(2)(A).[222] Section 1.1221-2's definition of hedging, therefore, is broad enough for most hedging transactions to be characterized as ordinary.

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217. *See, e.g.*, Lester v. Commissioner, 70 T.C.M. (CCH) 77 (1995) (holding that a security trader's stocks and options, which were not part of his inventory, purchased to maintain his employment status were capital in nature); First Chicago Corp. v. Commissioner, 69 T.C.M. (CCH) 2089 (1995) (holding that a business' acquisition in capital stock of bank to protect its reputation, factually similar to *Arkansas Best*, were capital in nature).

218. *See infra* notes 222-40 and accompanying text.

219. *See infra* notes 244-65 and accompanying text.

220. *See infra* notes 266-71 and accompanying text.

221. *See infra* notes 272-90 and accompanying text.

222. I.R.C. § 1256(e)(2)(A) (1988) (discussing marked to market rules as applied to hedges). The IRS, applying *FNMA*'s rationale, believes that Congress intended hedging for marked to market rules to be treated consistently with hedging transactions for other purposes. Preamble, Treas. Reg. § 1.1221-2, 59 Fed. Reg. 36,361 (1994).

The Regulation defines hedging as a transaction entered into in the normal course of business primarily to reduce risk.[223] The definition has three elements: (1) the hedge must be entered into in the normal course of business;[224] (2) the hedge must reduce the risk of price changes, interest rate changes or currency fluctuations;[225] and (3) the hedge must correspond to the taxpayer's ordinary property, borrowings, or ordinary obligations.[226] Taxpayers should keep records which demonstrate that hedging transactions were entered into to reduce risk to support a contention that hedges reduce risk. Even though motive is irrelevant in determining if a transaction is a hedge, a taxpayer's motive, evident from the taxpayer's records, may be relevant in determining whether the transaction was entered into to reduce risk.

The Regulation resolved a problem left after *FNMA* about whether a hedge acting as a surrogate for the underlying asset or obligation should be characterized as ordinary.[227] Section 1.1221-2 settled the uncertainty that existed after *FNMA* as to how close a link is needed for a hedge to act as a surrogate for the underlying asset or obligation by abolishing the taxpayer's need to show such a link. The transaction now must simply fall within the Regulation's definition to qualify as a hedge. Section 1.1221-2 provides that a hedging transaction "is not made ordinary on the grounds that property involved in the transaction is a surrogate for a noncapital asset, that the transaction serves as insurance against a business risk, [or] that the transaction serves a hedging function."[228] Taxpayers, therefore, cannot merely rely on the fact that a hedge is integrally related to the underlying asset or obligation or serves as insurance. The Regulation rejects prior caselaw and GCM 17322 as providing the sole grounds for ordinary treatment. Taxpayers must demonstrate that the hedge fits within the Regulation's definition of hedging in order to ensure ordinary treatment.

The Regulation also specifically addresses certain hedges whose status had been uncertain following *Arkansas Best* and *FNMA*. Under § 1.1221-2 of the Treasury Regulations, micro hedges are accorded ordinary treatment if the hedge "reduces the risk attributable to the asset or liability and if it is reasonably expected to reduce the overall risk" of the business.[229] Hedges of obligations also are specifically addressed in the Regulation. The definition of

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223. Treas. Reg. § 1.1221-2(b)(1)-(2).

224. A taxpayer's "normal course" of business is defined broadly to include most business hedges. *Id.* § 1.1221-2(c)(4). The frequency of which a taxpayer enters into hedging transactions is irrelevant.

225. To determine whether the hedging transaction reduces risk, the Service will look at "all of the facts and circumstances surrounding the taxpayer's business and the transaction. In general, a taxpayer's hedging strategies and policies, as reflected in the taxpayer's minutes or other records, are evidence of whether particular transactions reduced the taxpayer's risk." *Id.* § 1.1221-2(c)(1)(i).

226. *Id.* § 1.1221-2(b)(1)-(2).

227. *See supra* notes 206-12 and accompanying text.

228. Treas. Reg. § 1.1221-2(a)(3).

229. *Id.* § 1.1221-2(c)(ii).

hedges permits ordinary treatment for hedges of obligations if the performance or termination of the obligation could not produce a capital income stream.[230] The sale of a negligible amount of noninventory supplies may also be hedged.[231] The Regulation acknowledges that fixed-to-floating hedges[232] and written options[233] may reduce risk, thereby qualifying as a hedge. Hedges of aggregate risk, sometimes referred to as global risk, qualify for ordinary treatment if all but a de minimis amount of the risk is with respect to ordinary property, obligations and borrowings.[234]

The Regulation requires a business to unambiguously identify a transaction as a hedge on the same day it enters into the transaction.[235] The identification of the hedged item must be made contemporaneously with the hedging transaction and must specify the item or items or aggregate risk being hedged.[236] In addition, the hedged item must be included on the business' books and records.[237]

The Regulation penalizes taxpayers for nonidentification and misidentification of a transaction. Taxpayers are bound to any transaction identified as a hedge for gain purposes only, thus any gain so identified will be ordinary.[238] The mere identification of a transaction as a hedge, however, will not transmute a capital loss into a ordinary loss. Transactions not identified as hedges will be binding on taxpayers as nonhedging transactions. Failure to identify a hedging transaction where "no reasonable grounds [exist] for treating the transaction as other than a hedging transaction," however, will cause the gain to be characterized as ordinary.[239] The Regulation prevents inadvertent error from binding the taxpayer for misidentification or nonidentification if the taxpayer can demonstrate the true nature of the transaction and that the error was inadvertent.[240] The Regulation could be more comprehensive, though, by addressing the scope of the hedging definition,[241] ensuring the availability of goods,[242] and related third parties[243] as discussed below.

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230. *Id.* § 1.1221-2(c)(5).

231. *Id.* § 1.1221-2(c)(5)(ii). A noninventory supply item is an item purchased for consumption in the business, e.g., an airliner's jet fuel, which is not one of the exceptions listed in § 1221(1)-(5). *Id.*

232. *Id.* § 1.1221-2(c)(1)(ii)(B). Fixed-to-floating hedges are transactions that "economically converts an interest rate or price from a fixed price or rate to a floating price or rate." *Id.*

233. *Id.* § 1.1221-2(c)(1)(iii).

234. *Id.* § 1.1221-2(c)(7).

235. *Id.* § 1.1221-2(e)(1).

236. Certain hedging transactions necessitate different identification requirements, e.g., anticipatory asset hedges, § 1.1221-2(e)(3)(i); inventory hedges, § 1.1221-2(e)(3)(ii); hedges of a business' debt, § 1.1221-2(e)(3)(iii); and hedges of aggregate risk, § 1.1221-2(e)(3)(iv).

237. *Id.* § 1.1221-2(e)(2).

238. *Id.* § 1.1221-2(f)(i).

239. *Id.* § 1.1221-2(f)(2)(iii).

240. *Id.* § 1.1221-2(f)(ii).

241. *See infra* notes 244-65 and accompanying text.

242. *See infra* notes 266-71 and accompanying text.

243. *See infra* notes 272-90 and accompanying text.

B. Scope of the Hedging Definition

The definition of hedging contained in Treasury Regulation § 1.1221-2 uses the terms "reduce risk . . . with respect to ordinary property . . . borrowings . . . or to be made, or ordinary obligations."[244] The IRS intended the hedging definition to be broadly interpreted through an expansive definition of a taxpayer's "normal course" of business and by including several rules to add flexibility to the definition of hedging.[245] The scope of the definition, however, needs to be broadened to include some common hedging transactions such as risk management hedges and hedges that reduce risk but do not necessarily reduce the macro risk of the enterprise.

1. "Risk Management" versus "Risk Reduction"

Businesses utilize various methods to manage economic exposure to fluctuations in the market.[246] A particular method, however, may not necessarily be classified as "reducing risk" as the phrase is used in Treasury Regulation § 1.1221-2. The Regulation provides that, "a hedge of a particular asset or liability generally will be respected as reducing risk if it reduces the risk attributable to the asset or liability *and* if it is reasonably expected to reduce the overall risk of the taxpayer's operations."[247] This two prong test for micro hedges, however, unnecessarily excludes some commonly used hedges. For example, both partial[248] and managed hedges may increase risk in some areas while reducing risk in others.[249] A common managed or partial hedge, therefore, may not qualify as a hedge if the hedge reduces the risk of the hedged asset or liability while not reducing the overall risk of the business' operations.

The IRS noted in the preamble to the Regulation that many commentators advocated the use of the phrase "risk management" rather than "risk reduction."[250] The IRS, however, decided against adopting the more appropriate terminology of "risk management" because the IRS believes the phrase "reducing risk" best portrays congressional intent with respect to business

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244. Treas. Reg. § 1.1221-2(b)(1)-(2).

245. The regulation adds flexibility by addressing such issues as micro and macro hedges, § 1.1221-2(c)(1)(ii)(A), fixed-to-floating hedges, § 1.1221-2(c)(1)(ii)(A), partial hedges, § 1.1221-2(c)(1)(iv), and dynamic hedging.

246. *See supra* notes 63-102 and accompanying text (discussing various hedging devices).

247. *Id.* § 1.1221-2(c)(1)(ii) (emphasis added).

248. *Id.* § 1.1221-2(c)(1)(iv). Businesses do not need to be fully hedged with respect to an underlying transaction for the hedge to be qualified as legitimate. Treas. Reg. § 1.1221-2(c)(1)(iv); *see also* American Petroleum Institute, *Complete Version: API Finds Hedging Regs Too Restrictive*, 94 Tax Notes Today 25-57, Feb. 7, 1994, *available in* LEXIS, Taxana Library, TNT File.

249. Treas. Reg. § 1.1221-2(c)(1)(iv).

250. Preamble, Treas. Reg. § 1.1221-2, 59 Fed. Reg. 36,361 (1994).

hedges.[251] The IRS relies on the application of the Regulation to "ensure that the definition of hedging transaction is applied reasonably to include most common types of hedging transactions."[252] Risk management hedging strategies are not completely exclusive of risk reducing hedging strategies. Common risk management strategies exist, however, that will fall outside the Regulation's realm of risk reduction and consequently will be accorded capital treatment.[253] The IRS, therefore, must broaden the scope of the definition to include these common hedging strategies. Allowing the language "reduce risk" to remain without adding "risk management" will unnecessarily constrain the use of common hedging transactions.

The Regulation should provide for hedging transactions that are part of an overall risk management strategy, regardless of whether a particular hedge reduces risk.[254] If one or more hedges are "reasonably expected to offset the possible economic results of one or more underlying transactions," then the hedges should be accorded ordinary treatment.[255] A combination of hedges and hedging devices, such as ones used in a business marketing plan,[256] are closer related to managing risk than reducing risk.[257] Risk management, while sometimes not involving risk reduction, does consist of risk shifting.[258] A business will shift risk from hard to control areas to easier to control areas.[259] Shifting risks could increase some risks while reducing others. Whether such a risk management strategy will qualify as a bona fide hedge is left unresolved by the Regulation. Risk shifting hedging transactions might be accorded

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251. *Id.*; *see also Final Regs Provide Rules for Tax Treatment of Hedging Gains and Losses*, 94 Tax Notes Today 136-2, July 14, 1994, *available in* LEXIS, Taxana Library, TNT File; Jan Lyons, *Livestock Association asks for Changes in Hedging Rules*, 94 Tax Notes Today 4-35, Jan. 6, 1994, *available in* LEXIS, Taxana Library, TNT File.

252. Preamble, Treas. Reg. § 1.1221-2, 59 Fed. Reg. 36,361 (1994).

253. Yield adjustment transactions are an example of a financial hedging transaction which would not qualify under the Regulation as a bona fide hedge because yield adjustment transactions do not reduce risk. Frank Hertz et al, *Taxation of Hedging Transactions: Final and Proposed Regs Leave Many Questions Unanswered*, 64 TAX NOTES 1597, 1610 (1994). Another example of a hedging transaction that would not qualify under the Regulations would be a corporation which issues a debt device, such as a 10-year bond, and at the same time the corporation sells an interest rate "swaption," a combination of an interest rate swap and an option contract, to a bank. *Id.* The corporation receives a premium for the swaption. *Id.* The corporation may perceive that the swaption will not be exercised, thus the corporation can effectively use the premium to reduce the borrowing cost. *Id.* The IRS, however, may contend that the swaption did not reduce its risk of interest rate changes on the corporation's borrowings. *Id.* Then the transaction would not qualify as a bona fide hedge and would be treated as capital. *Id.*

254. *See* Stephen L. Gordon & Deborah L. Paul, *Hedging Regs Should Be More Comprehensive*, 94 Tax Notes Today 21-45, Feb. 1, 1994, *available in*, LEXIS, Taxana Library, TNT File.

255. *Id.*

256. One commentator stated that as long as hedging transactions reflect the marketing plan of the producer, the hedge should receive ordinary treatment if the income is treated as ordinary. Jan Lyons, *supra* note 252. The commentator explained that, "land grant universities and farm management specialists have provided educational programs explaining the use of options as 'windows' to manage risk in the production of livestock and grain." *Id.*

257. *Id.*

258. American Petroleum Institute, *supra* note 248.

259. *Id.*

capital treatment since it is arguable that the hedges do not reduce risk. The IRS, therefore, should amend Treasury Regulation § 1.1221-2 to allow for "risk management."

2. Macro Hedges

Hedges are often entered into to manage the overall risk of the business. Treasury Regulation § 1.1221-2 gives consideration to risks in a business' overall operations in determining if the corresponding hedging transaction qualifies as a macro hedge.[260] The corresponding macro hedge, also referred to as enterprise risk, must reasonably be expected to reduce the overall risk of the business' operations.[261] A hedge might not fit within the boundaries of a macro hedge if it increase some risks.[262] The Regulation focuses on enterprise risk, which can be materially different than transaction risk.[263] Net risk [264] is another form of enterprise risk. It is unclear from the language of Treasury Regulation § 1.1221-2 whether net hedging would qualify as a hedge. Since the hedge offsets the net risk, though not necessarily reducing the overall risk, it should qualify as a hedge under the Regulations.

Whether transactions qualify as macro hedges depends on the facts and circumstances. The Regulation considers the hedge and the risk in the perspective of the whole enterprise's hedging strategies and policies.[265] Businesses are given little guidance on how courts will classify macro hedges

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260. Treas. Reg. § 1.1221-2(c)(1)(ii)(A) (1994).

261. Hertz et al., *supra* note 253, at 1610.

262. The Treasury Regulation does not provide a definition for a macro hedge. Treas. Reg. § 1.1221-2(c)(1)(ii)(A).

263. Hertz et al., *supra* note 253, at 1610. Transaction risk is the price and interest rate risk involved in a financial transaction. Financial statements focus on transaction risk while tax accounting focuses on enterprise risk. *Id.* Therefore, businesses can not rely on whether a transaction qualifies as a hedge under financial accounting, but instead, rely on the tax accounting concept of enterprise risk. *Id.*

264. An example of net risk is the wholesaler that buys its inventory at a floating price and resells it at a floating price plus a premium. American Petroleum Institute, *supra* note 248. Sometimes the wholesaler will have bought beyond sales from one set of operations while, at the same time, have sold beyond its purchases on another set of operations. *Id.* The overall net result is an open position, either long or short. *Id.* The wholesaler will then determine the net position and buy or sell a hedging device to eliminate the price risk. *Id.* Thus, the hedging that was used to offset the net risk should qualify as a bona fide hedge.

265. Hertz et al., *supra* note 253, at 1610. A micro hedge, a hedge of a particular asset or liability, will qualify if it reduces the risk attributable to the asset or liability and if it is reasonably expected to reduce the overall risk of the business operations. Treas. Reg. § 1.1221-2(c)(1)(ii)(A). A hedge of a specific transaction, however, may increase the business' overall risk while reducing the risk of that particular transaction. This Note proposes that a hedge of such a transaction should also qualify as a bona fide hedge. Peter F. G. Schuur, *New York City Bar Committee Comments On Hedging Regs*, 94 Tax Notes Today 71-32, April 13, 1994, *available in* LEXIS, Taxana Library, TNT File. For example, a business might have the strategy of borrowing on a fixed rate and lending on a floating rate. *Id.* Hedges to fix the effective cost of anticipated borrowings may increase the overall exposure to falling interest rates. *Id.* The business could fix the cost of its anticipated borrowings in other ways to produce ordinary income or loss without using the hedging rules. *Id.* Thus, the business should not be "forced to choose between economically equivalent financial strategies based on different anticipated tax results." *Id.*

which manage the overall risk instead of reducing risk. Therefore, the courts must decide this issue on an ad hoc basis.

C. Hedges Entered Into to Ensure the Availability of Goods

Further, Treasury Regulation § 1.1221-2 does not provide ordinary treatment to hedges made to ensure the availability of goods. Although problematic, the Regulation does address hedges of noninventory supplies.[266] Regulation § 1.1221-2, however, does not accord ordinary treatment to the disposition of stock where the stock was acquired to ensure the availability of goods or to protect a business' reputation.[267] The IRS dismissed the argument that the acquisition of capital stock to ensure a source of supply is integral to the business' inventory[268] since hedges are not made ordinary on the ground that the transactions acts as a surrogate for the non-capital asset.[269] In issuing Regulation § 1.1221-2, the IRS endorsed *Arkansas Best*'s and *FNMA*'s reasoning for the capital treatment of stock by not allowing a taxpayer's purpose for buying capital stock determine the characterization of the gains and losses from the capital stock. Buying capital stock to ensure a source of supply, therefore, will not qualify for ordinary treatment.

The capital treatment of these hedges appear to contradict the purpose of Regulation § 1.1221-2. A commentator stated that "As an economic matter, a transaction entered into to ensure the availability of goods is virtually synonymous with a transaction entered into to reduce [the] risk of price changes."[270] A business, therefore, may assert that the transaction is primarily a hedge of price rather than supply.[271] The IRS has limited Regulation § 1.1221-2 with respect to hedges made to ensure the availability of goods, which may restrain the development and use of certain hedging devices. Even though the acquisition of capital stock presents an administrative problem for the IRS in determining whether it is a valid hedging transaction, this should not preclude the IRS from amending the Regulation to allow hedges made to ensure the availability of goods to be characterized as ordinary.

D. Affiliated Third-Party Hedging Transactions

Another aspect of Regulation § 1.1221-2 that the IRS needs to address is the hedging transactions of related third parties. Contemporaneous with

266. Treas. Reg. § 1.1221-2(c)(5)(ii). The Regulation permits the business to hedge only a negligible amount of noninventory supplies. *Id.* The Regulation does not define negligible amount, thus leaving the business uncertain as to whether a hedge of the noninventory supplies is a bona fide hedge.

267. Preamble, Treas. Reg. § 1.1221-2, 59 Fed. Reg. 36,362 (1994).

268. *See supra* notes 193-94 and accompanying text.

269. Treas. Reg. § 1.1221-2(a)(3).

270. *Philadelphia Bar Tax Section Criticizes Hedging Regs*, 94 Tax Notes Today 81-30, Apr. 27, 1994, *available in* LEXIS, Taxana Library, TNT File.

271. Gary A. Herrmann & Steven C. Malvey, *New Rules for Business Hedges Resolve Many Uncertainties of* Arkansas Best, 80 J. TAX'N 132 (1994).

Regulation § 1.1221-2, the IRS issued Proposed Regulation § 1.1221-2(d), (e)(5), (f)(3), and (g)(4).[272] The Proposed Regulation addresses the issue of hedging transactions made by members of a consolidated group.[273] In particular, the Proposed Regulation applies to hedges made by one member of a group either to hedge the risk of another member or to hedges entered into with another member. The IRS should allow hedging transactions of related third parties, which reduce or manage the risk of the group, to be characterized as ordinary. Additionally, the IRS should allow the single entity election[274] to be retroactive.

Related party hedging is a common business practice for complex businesses which often enter into transactions to hedge another member's risk.[275] This allows all hedging transactions to be controlled by a single member of the consolidated group with knowledge or expertise to efficiently manage the finances of all members and to take advantage of economies of scale.[276] The Proposed Regulation adopts a single-entity approach to consolidated groups.[277] Essentially, Proposed Regulation § 1.1221-2(d) treats the members of the consolidated group as separate divisions of a single corporation. Under Proposed Regulation § 1.1221-2(d), "intercompany transactions are not hedging transactions because they are treated as transactions between divisions of a single corporation and thus do not reduce the risk of the group."[278] Nevertheless, intercompany transactions by consolidated members could qualify for ordinary treatment if the transaction would qualify as a hedging transaction had the member transacted with an unrelated party[279] and the unrelated party's position is marked to market.[280]

The business, however, could elect for separate-entity treatment under the Proposed Regulation. The separate-entity election allows a consolidated group to elect that the risks of one member not be treated as the risk of other members.[281] The election permits the consolidated group to bypass the general rule.[282] The election made by the group is binding on all of its members and may only be revoked with the consent of the Commissioner.[283]

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272. Prop. Treas. Reg. § 1.1221-2(d), 59 Fed. Reg. 36,394 (1994).

273. *Id.*

274. The single entity election allows a consolidated group to elect separate-entity treatment for its hedges, contrary to the general rule that the risk of one member is treated as the risk of the other members. *Id.*

275. For example, a holding company might have several companies that conduct vastly different activities. A financial member of the group would have the expertise and connections to hedge the risk of the group as a whole.

276. Schuur, *supra* note 265; Gordon & Paul, *supra* note 254.

277. Prop. Treas. Reg. § 1.1221-2(d)(1), 59 Fed. Reg. 36,394 (1994).

278. *Id.*

279. *Id.* § 1.1221-2(d)(2)(ii)(A).

280. *Id.* § 1.1221-2(d)(2)(ii)(B).

281. *Id.* § 1.1221-2(d)(2).

282. *Id.* § 1.1221-2(d)(1). The general rule is that risks of one member are treated as the risks of other members, as if all members of the group were divisions of a single corporation.

283. *Id.* § 1.1221-2(d)(2)(iv).

1. The Scope of Consolidated Members

As written, the Proposed Regulation only applies to hedges of consolidated group members. The scope of the final Regulation § 1.1221-2(d), however, should be expanded to reach more related party risks. The scope of the Proposed Regulation should not be limited to affiliated corporations within the same consolidated group. The final Regulation should allow partnerships to be included in related party transactions. Partnerships are pass-through businesses in which the partnership's income and losses are passed through to the partner.[284] A hedge by one partner is a hedge of the entire partnership's risk because the partnership's risks are also the risk's of the individual partners.[285] Thus, a hedge by one partner of the partnership's risk should be accorded ordinary treatment to be consistent with the characterization of the partnership's income and losses which are passed through to the partners.[286]

In addition to partnerships, affiliated groups should also be included in the final Regulation as a consolidated group.[287] An affiliated group that does not file a consolidated return, such as a foreign subsidiary, would not qualify as a consolidated group under the current version of the Proposed Regulation. Substance over form must take precedence in these situations. The affiliated group may be essentially the same entity as the group that filed a consolidated return. As long as there is no material distortion of income, these affiliated groups therefore should qualify as do consolidated groups.

2. Making the Timing of the Final Regulation Retroactive

Proposed Regulation § 1.1221-2(d) currently would only apply to hedges entered into sixty days after the date the regulation becomes final.[288] The final Regulation should allow consolidated groups to apply the regulation to all open years. Applying the final Regulation to all open years would permit a consolidated group to take the separate-entity election retroactively for hedging transactions.

Proposed Regulation § 1.1221-2(d) characterizes transactions by consolidated groups. It is consistent with other character regulations to apply transactions retroactively.[289] Once the election is made by a business for prior

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284. *Dewey Ballantine Applauds Hedging Regs, But Queries Scope And Effective Scope*, 94 Tax Notes Today 196-25, Oct. 5, 1994, *available in* LEXIS, Taxana Library, TNT File [hereinafter *Dewey Ballantine*].

285. *Id.*

286. *Id.*

287. I.R.C. § 1052 (1988).

288. Prop. Treas. Reg. § 1.1221-2(g)(4), 59 Fed. Reg. 36,394 (1994).

289. Chip K. Collins & Robert T. McCahill, *Price Waterhouse Advocates Retroactive Application of Character Rules For Hedging Transactions By Consolidated Groups*, 94 Tax Notes Today 196-24, Oct. 5, 1994, *available in* LEXIS, Taxana Library, TNT File. Examples of precedent character regulations consistently applying retroactively are: "Treas. Reg. section 1.985-3(a)(2) (relating to Dollar Approximate

periods, the election should be binding for all transactions in those prior periods. Businesses should not be allowed to make the election on a transaction by transaction basis. The election for present and future years, however, should be a separate decision. The prior periods should not be held to the same decision as future periods. Businesses should not be held to a separate-entity election made in a prior period because the business entered into these transactions prior to an issuance of a regulation. Allowing the Proposed Regulation only to apply prospectively leaves the status of consolidated groups' hedging transactions of prior periods perched on a precarious precipe. Applying the rule retroactively will dampen litigation on the character of transactions prior to the date of publication.[290]

IV. CONCLUSION

The law of hedging has evolved over time. GCM 17322 provided ordinary treatment under the business insurance doctrine. Then came *Corn Products* which both the IRS and the courts interpreted as creating a Business Motive test that provided ordinary treatment for hedges as an extra-statutory exception to § 1221. The *Arkansas Best* Court recognized the misinterpretation of *Corn Products* and attempted to realign caselaw with the proper interpretation. The *Arkansas Best* Court eradicated the extra-statutory exception and brought the interpretation of *Corn Products* back within the Code's statutory literal exception of inventory. *Arkansas Best*, however, created some uncertainty concerning the law of hedging.[291]

The issuance of Treasury Regulation § 1.1221-2 clears up some of the remaining uncertainty with respect to hedging transactions. Transactions which qualify as hedge under the Regulation will be characterized as ordinary. Businesses now have better guidance on which transactions will be characterized as ordinary or capital, thus allowing businesses to plan accordingly. A few changes, however, are necessary to make the Regulation more comprehensive. The scope of the definition of hedging ought to be broadened to provide ordinary treatment for risk management strategies, net hedges, and hedges made to ensure the availability of goods. In addition, the Proposed Regulation relating to consolidated groups should include related third parties and be applied retroactively. A Regulation that includes these changes will provide businesses with comprehensive guidance consistent with common hedging practices.

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Separate Transaction Method); Treas. Reg. Section 1.1502-20(h) (relating to loss disallowance rules); and Treas. Reg. Section 1.56(g)-1(f)(3)(vi) (relating to the ACE LIFO recapture adjustment)." *Id.*

290. *Dewey Ballantine*, *supra* note 284.

291. *See supra* notes 192-200 and accompanying text.