Business Hedges After *Arkansas Best*

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I. INTRODUCTION

In *Arkansas Best Corp. v. Commissioner*, the United States Supreme Court held that a parent corporation's loss recognized on the sale of the stock of its subsidiary constituted a capital loss, regardless of the "business purposes" for which the stock was acquired.[1] This article does not quarrel with the result of *Arkansas Best* under the particular facts of that case. In reaching that result, however, the Supreme Court effectively rejected 30 years of settled administration of the tax consequences of bona fide hedging transactions by adopting an extraordinarily narrow interpretation of its own landmark 1955 decision in *Corn Products Refining Co. v. Commissioner*.[2]

The Supreme Court in *Corn Products* did not invent a common law of taxation for hedging transactions, and that same court in *Arkansas Best* did not wholly eviscerate the special tax regime that exists for hedges. Nonetheless, by adopting a restrictive view of the scope of the *Corn Products* doctrine, the *Arkansas Best* court has created substantial confusion as to the types of transactions that continue to qualify as hedges for tax purposes, and, accordingly, has left open the potential for serious tax whipsaws for both taxpayers and the Internal Revenue Service (the Service).

A business taxpayer uses hedges to reduce its economic exposure to price fluctuations beyond its control, so that the economic results of the taxpayer's business from year to year will reflect the value added by the taxpayer, rather than the effect of price fluctuations. A manufacturer, for example, might wish to protect the profit margins of its manufacturing operations by hedging against an increase in the price of the raw materials that go into its product, or against a decline in the market price of its unsold inventory. A financial institution or other taxpayer with substantial borrowings in turn might be interested in protecting its profitability from fluctuations in its cost of capital through movements in pre-

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1 83 T.C. 640 (1984), rev'd in part, 800 F.2d 215 (8th Cir. 1986), aff'd, 108 S. Ct. 971 (1988).

2 350 U.S. 46 (1955).

vailing interest rates. Similarly, a taxpayer that has payables or receivables denominated in a foreign currency might find it prudent to hedge against changes in prevailing currency exchange rates.

A business taxpayer may hedge its exposure to market fluctuations with respect to property held (or to be held) or obligations incurred (or to be incurred) by entering into a transaction that creates an equal but offsetting risk to its underlying exposure. If the taxpayer arranges exactly offsetting positions, it will be insulated as an economic matter from the effect of market changes on the price of the property or obligations being hedged, because a loss in respect of its underlying exposure will be matched by gain on its hedge, and vice versa. In practice, hedges may not match perfectly the characteristics of the underlying economic exposures to which they relate, but all business hedges fundamentally involve an attempt to reduce the risk of unanticipated market movements by taking simultaneous "long" (i.e., holding property) and "short" (i.e., owing property) positions in the same or similar property.

Taxpayers that primarily hedge exposure related to physical commodities, such as cotton, oil or foodstuffs, usually use the futures and options exchanges and the private forward markets as their principal hedging tools.[3] A producer that is long unsold physical commodities, for exam-

[3] An option is a contract that gives the holder the right, but not the obligation, for a specified period of time, to buy (a call) or sell (a put) a specified amount of the underlying property at a fixed or determinable price. Options with standardized terms are traded on securities and commodities exchanges; options with a wider range of terms are sold privately in the "over-the-counter" market. While options typically require delivery of the underlying property, in some cases (such as options on stock indices or interest rate sensitive securities) settlement may be made in cash.

A futures contract is a standardized contract to purchase (a long position) or sell (a short position) for a fixed price a specified amount of the underlying property at a specified future date. Futures are entered into exclusively through an exchange, which operates to match up offsetting long and short positions, and to reduce each party's credit exposure. Unlike an option, a party typically pays no consideration upon entering into a futures contract; however, since a futures contract effectively obligates each party to perform, a party's risk of loss under a futures contract is unlimited. In order to manage this risk, the exchange requires each party to a futures contract to post security, or "margin," in an amount that is adjusted periodically to reflect increases or reductions in the value of the party's open positions. If a party does not wish to take or make delivery under its futures position, it typically will close out that position by entering into an offsetting futures position that automatically is netted by the exchange against its existing position.

A forward contract is the private market equivalent of an exchange-traded futures contract, and involves functionally equivalent rights and obligations. Because a forward contract is privately arranged, it may have more flexible terms than a futures contract, but also involves substantial credit exposure of each party to the other. While parties may deposit collateral to reduce this exposure, the variable "margin" system applicable to futures contracts does not exist in the private forward market. A party that wishes to close out its forward position can do so by (1) assigning its contract to a third party (usually with the consent of the contract's counterparty), (2) entering into an offsetting forward contract with a new counterparty, or (3) terminating its contract with the original counterparty. As a very general matter, parties that actually contemplate taking or making physical delivery of the underlying property tend

ple, may protect against an interim price decline by entering into a short futures or forward contract (i.e., a contract to sell the commodity on a future date at a predetermined price). If the commodity's price in fact declines, the producer can choose either to make physical delivery under its futures or forward contract at the above-market contract price, or, more typically, to close out the contract at a gain that offsets the loss on the actual sale of its physical inventory. If the price of the commodity instead increases, the producer typically will close out the hedge contract at a loss that reduces its profit on the sale of inventory at the higher market price.

For taxpayers that have interest rate and foreign currency exposure, the simple mechanics of hedges that employ futures and forward contracts have been supplemented in recent years by hedges that rely on "notional principal amount" products, such as swaps, caps, and floors.[4] The flexible nature of notional principal amount products in many cases

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to use the private forward contract market, while those that wish to hedge against general price or rate fluctuations for a specific period may prefer the liquidity of exchange-traded futures contracts.

[4] A "notional principal amount" product can be described generally as a private, contractual arrangement pursuant to which the parties agree to make periodic payments determined by applying a fixed or floating interest rate to a specified notional principal amount. The notional principal amount serves only as a reference for determining payments, and (with the exception of certain currency swaps) is not actually borrowed or loaned between the parties. The most common types of notional principal amount products are (1) interest rate or currency swaps, and (2) interest rate caps, floors, and collars.

Under an interest rate swap, the parties agree to exchange for a specified period of time periodic payments measured by traditional interest rate formulae and based on the same notional principal amount. Typically, one party will make payments at a fixed rate, while the other party will make payments based on the level of a specified floating-rate index (e.g., 10% v. the 6-month Treasury rate). A currency swap involves similar two-way payments between the parties, except that the payments are denominated in different currencies and typically reflect prevailing fixed interest rates for the stated currencies (e.g., 10% U.S. dollars v. 6% Swiss francs). Swaps generally are used to insulate taxpayers from the risk of interest rate or exchange rate fluctuations in respect of assets held or obligations incurred by the taxpayer, and in that sense are analogous hedging tools to futures and forwards.

The economics of an interest rate cap, floor, or collar, in contrast, more closely resemble a series of interest rate options. Under a typical interest rate cap, the purchaser pays an initial premium in exchange for the seller's agreement to make a series of payments equal to the excess on each payment date of a floating-rate index over a specified fixed rate, each as applied to a notional principal amount (e.g., the excess of the 1-year Treasury rate over 8%). If, on a scheduled payment date, the relevant floating rate is less than the specified fixed rate, no payment is made. An interest rate floor is the converse of a cap. A floor contract provides that the seller will make payments equal to the excess of a specified fixed rate over the level of the floating-rate index. An interest rate collar, as its name suggests, combines the purchase of a cap and the sale of a floor. The implicit sales price of the floor covers the cost of the cap, so that no initial premium payment is made. A floating-rate borrower might enter into a collar, for example, to limit the fluctuations in its cost of borrowing to the range of the collar. Like options generally, interest rate caps, floors, and collars are attractive to taxpayers that want to hedge against adverse rate movements without eliminating the potential to profit from favorable rate movements. See Part V for a further discussion of hedging transactions using notional principal amount products.

allows a closer economic matching of the hedge contract to the exposure being hedged than might be available with traditional forwards or futures.

The characterization of a transaction as a hedge for tax purposes is relevant to the determination of both the character (ordinary or capital) and the time of inclusion of income or loss from that transaction. With respect to the character of gains and losses, the Service at an early stage recognized the potential for tax whipsaws to a taxpayer that, for example, entered into a forward or futures contract to hedge against a decline in market prices for unsold inventory. Absent a rule that conformed the character of gain or loss from such a hedge to that from the sale of the hedged inventory, the taxpayer could be left in the position of recognizing ordinary income with respect to an increase in the value of that inventory, coupled with a capital loss that could not be applied to offset that income.[5]

Classification as a hedge also can affect the timing of income or loss from a transaction. For example, hedging transactions described in § 1256(e) are excluded from the mark-to-market rules of § 1256 and the straddle rules of § 1092. The Service has further ruled that transactions constituting inventory hedges may be marked-to-market at year-end along with the hedged inventory.[6] Finally, in *Monfort of Colorado, Inc. v. Commissioner*, the taxpayer was permitted to take this analysis one step further by accounting for gains and losses from inventory hedges as part of the taxpayer's overall inventory costs.[7]

In the words of a leading early case, the appropriate scope of the "hedging" definition for tax purposes has "for years, defied concise and exact definition."[8] In an early case, the U.S. Supreme Court defined hedges as contracts used by taxpayers "to insure themselves against loss by unfavorable changes in price at the time of actual delivery of what

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[5] Capital losses realized by corporations may be applied only to offset capital gains, not ordinary income.

[6] Rev. Rul. 74-223, 1974-1 C.B. 23.

[7] 561 F.2d 190 (10th Cir. 1977). Ironically, the *Arkansas Best* decision adds some support to the taxpayer's position in *Monfort*, by framing its analysis of *Corn Products* as a case that holds that gains and losses from hedges of inventory are themselves subsumed into the term "inventory" for purposes of § 1221(1). Admittedly, *Arkansas Best* (and *Corn Products*) addressed solely the issue of the *character* of such gain or loss (and, by extension, the scope of § 1221(1)'s exclusion from the definition of "capital asset"), while *Monfort* addressed the question of the *timing* of such gain or loss. Nonetheless, the conclusion reached by *Monfort* that hedging gains or losses may be included as a component of the cost of acquiring the inventory being hedged can be viewed as a straightforward extension of the Supreme Court's thesis that inventory hedges are so integrally related to the inventory being hedged that they must partake of the same character.

[8] Battelle v. Commissioner, 47 B.T.A. 117, 125 (1942).

they have to sell or buy in their business."[9] The most frequently cited definition of a hedge for tax purposes, however, comes from the Fifth Circuit case of *Commissioner v. Farmers & Ginners Cotton Oil Co.*: "A hedge is a form of price insurance; it is resorted to by businessmen to avoid the risk of changes in the market price of a commodity. The basic principle of hedging is the maintenance of an even or balanced market position."[10] The difficulty of applying such a vague definition to a wide variety of factual situations explains in part the checkered development of the current system of taxation for hedging transactions.

This article attempts to assess the effect of the *Arkansas Best* decision on the taxation of business hedges by first examining the decision in the context of the judicial and legislative development of special rules for hedges, and then applying that learning to a variety of common hedging techniques. Part II describes the early development of hedging rules in the tax law up to the Supreme Court's landmark decision in *Corn Products*. Part III discusses the *Corn Products* case and the application of the doctrine that case inspired. Parts IV and V discuss, respectively, the *Arkansas Best* case itself and the projected effect of the case on three basic types of business hedging transactions: asset hedges, liability hedges, and foreign currency hedges. Part VI then suggests possible regulatory and legislative solutions to the issues raised in Part V.

II. Early Development of Tax Rules for Business Hedges

Before 1934, the concept of special rules for hedging transactions had no practical tax relevance, because, except in the case of stock and debt securities, the definition of the term "capital asset" included only assets held for more than two years.[11] Since the types of hedging transactions then available (however defined) invariably had terms shorter than two years, hedging transactions necessarily gave rise to ordinary income or loss. The Revenue Act of 1934, however, modified the definition of the term "capital asset" to eliminate any holding period requirement. Following that Act, therefore, taxpayers that used forward or futures contracts to hedge their inventory or other business costs were exposed for the first time to the potential tax whipsaw of recognizing ordinary busi-

[9] United States v. New York Coffee & Sugar Exch., Inc., 263 U.S. 611, 619 (1924). The Court compared "hedgers" with two other categories of participants in the futures market: "legitimate capitalists," who purchase or sell for future delivery hoping to profit from interim price changes, and "gamblers or irresponsible speculators."

[10] 120 F.2d 772, 774 (5th Cir. 1941). Cf. Carpenter v. Commissioner, 25 TCM (CCH) 965 (1966).

[11] The definitional requirement of a two-year holding period for the inclusion of stocks and bonds as capital assets was eliminated in 1932.

ness income matched by capital losses on their hedges.[12]

Neither the Revenue Act of 1934 nor its legislative history considered the application of the new definition of "capital asset" to hedging transactions. Notwithstanding this lack of statutory support, the Service quickly realized the inadvertent tax whipsaws to which commercial hedgers were exposed. In 1936, General Counsel Memorandum 17322 held that "true" hedges:

> are common trade practices and are generally regarded as a form of insurance . . . necessary to conservative business operation. Where futures contracts are entered into only to insure against the . . . risks [of price fluctuation in a cash position] inherent in the taxpayer's business, the hedging operations should be recognized as a legitimate form of business insurance. As such, the cost thereof (which includes losses sustained therein) is an ordinary and necessary expense . . .. Similarly, the proceeds therefrom in the form of gains realized upon hedging transactions are reflected in net income . . ..[13]

G.C.M. 17322 did not attempt to define a "true" hedging transaction, but instead considered two typical hedging situations: (1) The taxpayer who, having purchased quantities of raw materials for its future manufacturing needs, enters into futures sales contracts to protect against an interim decline in the price of those materials; and (2) the taxpayer who, having committed to deliver finished goods that require raw materials in excess of its current supply, enters into futures purchase contracts to protect against an interim increase in the price of those materials. In each case, the Memorandum concluded that the futures contracts should be treated as producing ordinary income or loss for tax purposes, on the theory that the transactions "are essentially to be regarded as insurance rather than a dealing in capital assets."[14] G.C.M. 17322 concluded with a warning: "Futures contracts which are not hedges against spot transactions are speculative [and thus subject to capital asset treatment] unless

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[12] In other contexts, courts had, of course, previously considered the issue of what constituted a hedge. See, e.g., United States v. New York Coffee & Sugar Exch., note 9.

For comprehensive histories of the early years of the taxation of hedging transactions, see Rich & Rippe, Tax Aspects of Commodity Futures Transactions with a Business Purpose, 2 Tax L. Rev. 541 (1947); Note, Taxation of Commodity Futures Used as Hedges, 13 Tax L. Rev. 87 (1957).

[13] G.C.M. 17322, XV-2 C.B. 151, 152 (1936) (hereinafter G.C.M. 17322), restated in part and superseded by Rev. Rul. 72-179, 1972-1 C.B. 57. G.C.M. 17322 also recognizes the special timing issues raised by hedging transactions, but concludes that the appropriate timing rules for hedges may vary from industry to industry depending on differing inventory valuation rules. In updating G.C.M. 17322, Rev. Rul. 72-179 does not include this discussion of timing considerations.

[14] G.C.M. 17322, at 155.

they are hedges against concurrent futures or forward sales or purchases."[15]

Four years later, the price insurance rationale of G.C.M. 17322 withstood its first judicial test. In *Ben Grote v. Commissioner*,[16] the taxpayers were wheat farmers who spent substantial amounts of time buying and selling wheat futures, although they never took delivery of wheat under any of their contracts. The Board of Tax Appeals found that the taxpayer's futures trades were "entirely for the purpose of protection against price fluctuation," and dismissed the assertions of the Commissioner that the trades were speculative in nature.[17] The Board of Tax Appeals, relying on this conclusion of fact, then determined, without further discussion, that the taxpayers' net losses from their futures trading were fully deductible, apparently on the theory that, if the trades were not speculative, the reasoning reflected in G.C.M. 17322 compelled that result.[18]

The cases that followed *Ben Grote* generally did not challenge the Service's authority to create an extra-statutory character rule for hedging transactions, but instead tended to agonize over the type of transaction that should qualify for this special rule. The struggle to develop a bright-line standard that could be applied to a variety of commercial situations is perhaps best reflected in the *Farmers & Ginners* case, which has become one of the most frequently cited cases of the period.[19]

Farmers & Ginners involved a taxpayer that manufactured crude cottonseed oil, a highly perishable commodity. The taxpayer's storage facilities were insufficient to allow the taxpayer to retain its finished products for any substantial time. As a result, the taxpayer occasionally was forced to sell its product at a time when, in the taxpayer's view, market prices were depressed. While no futures market then existed in cottonseed or in crude cottonseed oil, a futures market was available in refined cottonseed oil, and the price of the refined product tended to track closely the price of crude cottonseed oil. When forced to sell its crude cottonseed oil at what it viewed as artificially depressed prices, the tax-

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[15] Id.

[16] 41 B.T.A. 247 (1940), nonacq.

[17] Id. at 248. The Board did not explain why the futures transactions in question, which involved going both long and short (sometimes on the same day), furthered the purpose of protecting the taxpayers from price fluctuations. The failure of the Board's opinion to discuss the nature of "hedging transactions" was criticized by Judge Hill in his published dissent to the *Farmers & Ginners Cotton Oil Co. v. Commissioner* case discussed below. See 41 B.T.A. 1083, 1090 (1940) (Hill, J., dissenting).

[18] 41 B.T.A. at 249. Interestingly, the Board concluded that the Commissioner "interpreted and administered § 117 [the predecessor to § 1221] as excluding hedging transactions." Id. Thus, the Board squarely concluded that the extra-statutory rule providing ordinary income and loss treatment for hedges first proposed by G.C.M. 17322 was intended as an additional exception to the definition of capital asset, not, as later suggested, as a gloss on the scope of the inventory exception.

[19] See note 10 and accompanying text.

payer would take advantage of the similarly depressed futures market by purchasing futures contracts for the delivery of refined cottonseed oil. The taxpayer invariably would close out its long futures position, rather than taking delivery of refined cottonseed oil. The effect of holding such long futures positions, however, was to allow the taxpayer to participate in anticipated price increases for cottonseed oil in a manner that offset its prior economic losses from the forced sale of its perishable inventory.

The Board of Tax Appeals' opinion, from which four judges dissented, found the case analogous to *Ben Grote* and held on that basis that the taxpayer's losses from its futures transactions were ordinary losses from hedging transactions: "The only purpose which the petitioner had in buying futures in refined oil was to attempt to avoid loss upon the crude oil which it was manufacturing. This method was as effective a hedge against loss on its operations as was available to petitioner . . .. All of the transactions were directly related to its business of production and sale."[20]

The two dissenting Board of Tax Appeals opinions criticized the majority's finding that the futures contracts acquired by the taxpayer qualified as "hedging transactions" for tax purposes. Judge Hill's opinion, in particular, vehemently expressed the view that "such transactions had none of the elements of a hedge and in no way afforded insurance or protection against petitioner's existing or prospective investment risks, either in its raw materials or its crude oil. The purchase of such futures contracts operated only to create new and additional investments, fraught with new and additional investment risks, without any counterbalance of a hedge."[21] Foreshadowing the *Arkansas Best* analysis almost forty years later, Hill's opinion concluded: "Regardless of whether petitioner's transactions in such futures contracts constituted a trade or business or were entered into for profit, such contracts nevertheless were capital assets within the . . . statutory definition."[22]

The Fifth Circuit reversed the Board of Tax Appeal's decision, *not* on the basis of a close statutory analysis of the definition of "capital asset," but rather on the basis that the taxpayer's futures transactions did not amount to "true" hedging of the type contemplated by G.C.M. 17322. In the Fifth Circuit's view, the futures contracts in question did not protect the taxpayer from reduction in the price of its inventory, but rather permitted the taxpayer to speculate on future price fluctuations unrelated to the disposition of its inventory: "To exercise a choice of risks, to sell one commodity and buy another, is not a hedge; it is merely continuing

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[20] 41 B.T.A. at 1085.

[21] Id. at 1088. As noted above, Judge Hill took this opportunity to criticize the lack of analysis in the Board's opinion in the *Ben Grote* case, terming the earlier opinion "glaringly erroneous." Id. at 1090.

[22] Id. at 1090.

the risk in a different form. That is what the taxpayer did in this case. It did not retain its crude oil and sell refined; it sold crude and bought refined when it had no actual commodity on hand or future commitments to be protected from price variations."[23]

The Fifth Circuit's approach in *Farmers & Ginners*, which, as noted in the Introduction, applied the special tax rules for hedges only to transactions that produced an "even or balanced" position for a particular taxpayer,[24] rapidly became the touchstone for distinguishing "true" hedges from speculative activity. Yet that definition still left unanswered a number of crucial questions. The Fifth Circuit did not address, for example, the issue of exactly how balanced a hedge position must be: Should the presence of any discrepancies in quantity or timing of the hedge contract and the underlying exposure be fatal to hedge characterization?

Following *Farmers & Ginners*, the Tax Court, in particular, took a more relaxed view of the "even or balanced position" test than the Fifth Circuit's language in that case might suggest. In *Stewart Silk Corp. v. Commissioner*,[25] for example, a manufacturer of silk cloth, anticipating a decline in the price of raw silk, sold futures contracts for the delivery of silk in an amount sufficient to act as a hedge of part, but not all, of its unsold inventory. The Tax Court had little difficulty in concluding that the taxpayer's futures transactions nonetheless qualified as bona fide "hedging transactions" for tax purposes and that the taxpayer should be allowed to treat losses from the transactions as ordinary losses. "That it is not necessary that futures transactions be entered into simultaneously with the attaching of the risk sought to be protected against, and in exactly equivalent quantities, is recognized by G.C.M. 17322 . . .. It is enough that the offsetting transaction be made while the risk is extant."[26]

Similarly, in *Fulton Bag & Cotton Mills v. Commissioner*,[27] the taxpayer's futures position was closed out sometime after his cash position was liquidated, but within the same taxable year. The Tax Court did not attempt to break the futures transaction into "hedge" and "speculative" components; instead, the court concluded that the delay in liquidating the futures contract was not unreasonable, and that the transaction therefore constituted a bona fide hedge. Moreover, in *Kurtin v. Commissioner*,[28] the Tax Court recognized the principle that, despite the holding in *Farmers & Ginners*, a taxpayer could hedge its long position in an untraded commodity (cheese) by engaging in short futures transactions

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[23] 120 F.2d at 774.

[24] See the text accompanying note 10.

[25] 9 T.C. 174 (1947), acq., 1948-1 C.B. 3.

[26] Id. at 179.

[27] 22 T.C. 1044 (1954), acq., 1955-1 C.B. 4.

[28] 26 T.C. 958 (1956).

in another commodity (butter) that was traded on a commodities exchange, provided that the taxpayer otherwise maintained an "even or balanced position." Unlike the situation in *Farmers & Ginners*, the taxpayer in *Kurtin* entered into and closed out his short futures contracts on butter in an amount and at a time that matched the disposition of his long positions in cheese. Consequently, the Tax Court found that the butter futures were intended to act as a form of "price insurance" against a general decline in the taxpayer's long cheese position and that losses from such futures contracts appropriately could be treated as ordinary "hedging" losses.[29]

Despite these digressions from a narrow reading of the Fifth Circuit's language in *Farmers & Ginners*, these early Tax Court cases generally adhered to the central principle that an "even or balanced" position required the taxpayer to maintain a current cash position (either in the form of inventory on hand or a present contractual commitment to deliver future goods) in respect of the exposure being hedged. Unfortunately, this narrow view of what constituted a bona fide hedge for tax purposes often was at odds with commercial reality.

Consider, for example, the case of a processor of an agricultural commodity—a manufacturer of corn flakes, for example—one of whose principal costs is the cost of corn. A "true" hedge for this corn flakes manufacturer would consist of going long corn futures in an amount equal to the manufacturer's present obligation to deliver corn flakes to its customers in the future. But what if this manufacturer, rather than having present contractual commitments to sell corn flakes in the future, conducts the majority of its business through cash sales to wholesalers and grocery store chains?

The manufacturer probably knows from past experience that it can anticipate selling, for instance, 50,000 boxes of corn flakes six months hence, even though it has no buyer committed to those purchases at the present time. If the manufacturer does not use the futures market, the manufacturer will be required to price its corn flakes to reflect the current cost of corn. If corn prices suddenly jump because of a temporary shortage of corn, the manufacturer either will have to raise its prices, or absorb a loss. If the manufacturer raises prices, it risks losing sales to rival corn flakes manufacturers with larger inventories that can average down the cost of a temporary increase in the price of corn, as well as to its other rivals, the wheat flakes manufacturers. Finally, the manufac-

[29] In fact, because of an unexpected dislocation between butter and cheese prices, the taxpayer sustained losses on both his positions. The Tax Court held that this strange circumstance "no more deprives this arrangement of its qualities as an attempted hedging operation than would the fortuitous ineffectiveness of an insurance policy prevent premiums paid from being expended for insurance purposes." Id. at 961.

turer risks incurring the ire of its customers, who must adjust the price of corn flakes on their shelves to reflect the new price charged them.

Since no corn flakes manufacturer can hope to do business successfully if its prices oscillate wildly from week to week, our hypothetical corn flakes manufacturer will enter into forward purchase agreements for corn, or will go long corn futures to "hedge" its anticipated future needs, based on its prior experience of what those needs will be. Of course, if corn prices drop after the manufacturer enters into either a forward or a futures contract, the manufacturer will lose money on that contract, but will be able to purchase its current corn requirements at a lower price than it originally anticipated in calculating its profit margin. If, on the other hand, corn prices rise, then the manufacturer (assuming it will not or cannot jump the price of its corn flakes) will have protected its profit on its manufacturing operation from erosion due to higher costs of raw materials, either by considering its gains on any contracts it liquidates as, in effect, a reduction in its current cost of corn, or by standing for delivery at the contract price.

Thus, while our hypothetical corn flakes manufacturer is under no present obligation to deliver corn flakes in the future, the limitations on the manufacturer's ability to adjust prices continually places the manufacturer in exactly the same position with respect to the price of corn as if the manufacturer in fact were so committed. One would think, then, that if this corn flakes manufacturer "hedges" against anticipated cash sales in the future, the early cases would have concluded that it should recognize ordinary income or loss on its futures transactions, just as did the manufacturer with present commitments to deliver its product in the future. Yet the early cases distinguished between these two situations, holding that a transaction cannot be a "hedge" if there is no present cash position to be offset.

In *Estate of Makransky v. Commissioner*,[30] for example, the taxpayer was a partner in a major manufacturer of ready-to-wear men's wool suits. The partnership's fall and winter lines were manufactured from piece goods beginning in the previous June, based on orders obtained by the partnership's sales personnel in April and May. In September 1939, the partners, fearing that the outbreak of World War II would, at the very least, send wool prices skyrocketing, and possibly would make wool unobtainable at any price, went long March 1940 raw wool, with the intention of standing for delivery. The March wool contracts approximately equalled the quantity of wool the partnership estimated it would need to manufacture its fall and winter lines for 1940. The partnership also lined up mills to convert this raw wool into piece goods, from which it would manufacture its suits. March wool was purchased because up to three

[30] 5 T.C. 397 (1945), aff'd per curiam, 154 F.2d 59 (3d Cir. 1946).

months were required to convert raw wool to piece goods, and, as pointed out above, the partnership usually began manufacturing its fall and winter line in June. Unfortunately for the partnership, the price of wool declined in late 1939 and early 1940; as a result, the partnership closed out its long position in February 1940 at a substantial loss.

The Tax Court began its opinion by admitting that, had the partnership taken delivery of the raw wool, converted it into piece goods, manufactured the piece goods into suits, and priced those suits on the basis of the cost of wool in April 1940 (the time orders were taken), the resulting losses on the sales of those suits would have been ordinary in nature. Yet, concluded the court, because the contracts were settled by liquidation, the losses sustained on them had to be analyzed under the general rules applicable to futures transactions. Moreover, concluded the court, the partnership's transaction could not escape the general rule that trading in commodities futures gives rise to capital gain or loss; the special exception for hedges had no application to these facts, because the futures did not offset "present sales of its clothing suits."[31]

In contrast to the sad fate suffered by Mrs. Makransky, the taxpayer in *Battelle v. Commissioner*[32] obtained hedge treatment for an apparently similar quasi-hedge. In *Battelle*, a cotton farmer entered into short cotton futures contracts in amounts, and for delivery months, roughly corresponding to his anticipated next crop, but did so prior to the time of planting that crop. Although there was no physical cotton to be hedged at the time the short position was established, the Board of Tax Appeals concluded that the short cotton futures constituted a hedging transaction, on the grounds that the existence of the crop could reasonably be anticipated. The only apparent distinction between the *Battelle* and *Makransky* cases is the fact that *Battelle* involved an anticipatory hedge of future inventory while *Makransky* addressed a similar hedge of anticipated future sales. Nonetheless, the Tax Court in *Makransky*, when urged to consider the *Battelle* precedent, concluded: "We fail to see any similarity between the two situations."[33]

In sum, then, the case law concerning hedging transactions prior to *Corn Products* generally assumed the correctness of G.C.M. 17322 (without ever addressing the statutory basis for its conclusions),[34] and focused instead almost exclusively on applying G.C.M. 17322's apparent extra-statutory exception to the definition of capital asset to various fact patterns, in a search for the outer contours of "true" hedges. Immediately

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[31] 5 T.C. at 413.

[32] 47 B.T.A. 117 (1942).

[33] 5 T.C. at 413.

[34] As noted above, the opinion in *Ben Grote* explicitly concluded that G.C.M. 17322 created an entirely new exception to the definition of capital asset, not a gloss on the existing statutory exceptions. See note 18.

prior to the *Corn Products* case, hedging transactions generally were understood to be positions that "balanced" other cash positions (long or short) incurred by the taxpayer in the ordinary course of its business. At least in the view of the Tax Court, hedges did not have to create a perfect offset in amount or timing to the position being hedged, but some element of measurable risk reduction through price insurance was essential. Finally, the taxation of quasi-hedges was uncertain, at best, with the Tax Court in *Makransky* effectively ignoring its own earlier decision in *Battelle*. At this point, the Supreme Court granted certiorari in *Corn Products*, to resolve a conflict between the results of the Court of Appeals' decision in *Corn Products* (discussed below) and those of *Makransky* and *Farmers & Ginners*.

III. THE *CORN PRODUCTS* CASE AND THE *CORN PRODUCTS* DOCTRINE

A. The Corn Products *Case*

Corn Products Refining Co. v. Commissioner has a surprisingly complex judicial history, involving three separate Tax Court opinions[35] dealing primarily with wash sale and World War II excess profits tax issues, and only incidentally (and in a memorandum opinion) with the scope of the definition of the term "capital asset."[36]

In *Corn Products*, the taxpayer was a manufacturer of various products derived from corn (such as sugars, oils, and feeds). Raw corn obviously constituted a major portion of the taxpayer's cost of goods sold, but the taxpayer's corn storage facilities were large enough to hold less than a three-week supply.[37]

In general, the taxpayer sold most of its products for shipment within 30 days, at a price equal to the lower of the contract price or the market price on the date of delivery. Both to protect itself from exposure on its sales contracts, and to keep its products price competitive with, for example, beet sugar, the taxpayer instituted a regular practice, long predating the taxable years in controversy, of buying corn futures, in order to protect itself from a squeeze on corn prices if an annual harvest fell below normal levels:[38]

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[35] 16 T.C. 395 (1951); 11 TCM (CCH) 721 (1952); 20 T.C. 503 (1953).

[36] The three Tax Court opinions were consolidated in the appeal to the Second Circuit (215 F.2d 513 (2d Cir. 1954)), the decision of which, in turn, was affirmed by the Supreme Court (350 U.S. 46 (1955)).

[37] 16 T.C. at 396.

[38] Exactly such a squeeze occurred as a result of droughts in 1934 and 1936, which resulted in significant losses to the taxpayer. The taxpayer increased its futures purchases thereafter, resulting in the substantial gains and losses at stake in the litigated case. Id.

> [The taxpayer] engaged in those futures transactions as a part of its corn buying program and as the most economical method of obtaining an adequate supply of raw corn in view of its limited storage facilities and the expense of increasing those facilities sufficiently to take care of its needs. Purchases of futures were made when the price of corn was advantageously low. . .. The petitioner took delivery of corn on some of its future contracts, but usually sold most of its corn futures in early summer if it then appeared that there would be no shortage of corn and no great danger of increased prices, but if the crop was poor, or there was danger of an increase in price, it sold its futures gradually as it bought corn for grinding. The petitioner would begin to acquire additional futures contracts at harvest time each year.[39]

The taxpayer incurred substantial losses from its corn futures transactions for 1938 and 1939, and substantial income in 1940. The taxpayer did not treat its futures contracts as part of its corn inventory; instead, profits or losses were carried in a "Corn Miscellaneous" account.[40] Net loss in that account from 1938 and 1939 was added to taxpayer's cost of sales; net gain from 1940 was used to reduce the taxpayer's cost of goods sold.[41] The effect was to afford the taxpayer an ordinary loss on its futures losses, and ordinary income on its futures gains.[42]

In 1940, the taxpayer was charged by the Commodity Exchange Authority with speculating, rather than hedging, in corn futures by virtue of the large size of the taxpayer's open positions.[43] The taxpayer produced elaborate documentary evidence to demonstrate that its futures positions were not in excess of its business needs and that its futures transactions "were classifiable in character as hedging, rather than as speculative transactions."[44] The taxpayer's arguments before the Commodity Ex-

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[39] Id. at 396-97.

[40] 11 TCM (CCH) at 723.

[41] 16 T.C. at 397-98.

[42] As an aside, it is interesting to note (although the Tax Court opinions are a little vague on the point) that the taxpayer's apparent method of reporting its futures gains and losses as an adjustment to cost of goods sold in effect foreshadowed the taxpayer's method of "inventorying" hedging gains and losses in *Monfort*, note 7. In *Monfort*, of course, the treatment of hedging gains as a reduction in inventory costs worked an indefinite deferral in tax liability, because of the taxpayer's use of LIFO accounting. In *Corn Products*, by contrast, where the taxpayer employed FIFO (LIFO not then being a permitted tax accounting method), and where the taxpayer's inventory turned over very rapidly, treating futures gains and losses as an adjustment to the cost of goods sold would appear to produce essentially the same tax result as recording those gains and losses as entirely separate ordinary income/loss transactions.

[43] 11 TCM (CCH) at 723. Presumably, those open positions violated the Commodity Exchange Act's margin rules or absolute size of position rules, both of which were stricter for speculators than for hedgers.

[44] Id. at 724.

change Authority were sustained, and the enforcement action was dismissed.[45] The Tax Court similarly held, as an ultimate conclusion of fact, that the taxpayer's purchases of corn futures "did not constitute speculative transactions for profit, but were consummated in order to obtain business protection and to insure the profitable conduct of its business."[46]

Before the Tax Court, the taxpayer argued that, despite the consistent positions taken on its tax returns, its gains and losses from corn futures transactions should give rise to capital gain or loss, apparently on the theory that its futures activities were not "true" hedges.[47] In two brief paragraphs, the Tax Court conceded that the transactions may not have conformed "technically to the definition of a hedge," but went on to conclude that "it seems indisputable. . . that petitioner's practice of purchasing corn futures was an integral part of its manufacturing business."[48] The Tax Court also cited, essentially without discussion, G.C.M. 17322, and distinguished *Makransky* on the grounds that, in the latter case, "the venture in question was an isolated transaction and not a component of a regular practice of balancing transactions systematically conducted."[49]

The taxpayer appealed to the Second Circuit, where it argued that future contracts were within the statutory definition of "capital assets" and that the "judge-made exception" of hedging transactions from the scope of that definition (assuming that such "judge-made exception" could be supported by the statute) did not apply to its futures activities, because they did not constitute "true" hedging.[50]

The Second Circuit, like the Tax Court, acknowledged that the taxpayer's long futures positions were not "hedges," in the most technical sense of the word, because the taxpayer in general was not under contractual commitments to sell corn products at fixed prices. The Second Circuit nonetheless concluded that the taxpayer's activities served the same purpose as classic hedging transactions:

> The futures transactions of this petitioner, it is true, did not constitute what is known as "true" hedging. The true hedge can occur only when forward sales prices are fixed and the relation between commodity purchase and later sales price is insured against both increase and decrease of commodity prices. As the forward sales prices here were based mainly on the lower of order or market prices, the petitioner was protected

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[45] Id.

[46] Id.

[47] See, e.g., the discussion of the *Makransky* case, notes 30-31 and accompanying text.

[48] 11 TCM (CCH) at 726, citing *Ben Grote* and *Battelle* (footnote omitted).

[49] Id.

[50] Corn Prods. Ref. Co. v. Commissioner, 215 F.2d 513, 515 (2d Cir. 1954).

> only against increases in commodity prices and did not have the complete insurance of the true hedge. But this is a distinction presently of no significance. The property here was used for essentially the same purpose and in the same manner as in true hedging. Futures contracts were entered into to stabilize inventory costs and thus protect profit, and whether complete or only partial insurance was thereby obtained is simply a difference in degree, not in kind.[51]

The Second Circuit, however, obviously was troubled by the notion that the taxation of hedging transactions was predicated on an extra-statutory exception to the definition of "capital asset." Without confronting directly the fact that G.C.M. 17322 and *Ben Grote* clearly contemplated just such an extra-statutory exception, the Second Circuit adopted a novel approach that reached the same result—one to which the Supreme Court in *Arkansas Best* would return 30 years later:

> Where futures are dealt with for the purposes of speculation or what is called legitimate capital transactions, they obviously fall outside the possibly relevant exclusions of Section 117(a) [the predecessor to § 1221]. In the hedge, however, the property is used in such a manner as to come within the exclusions, for it is a part of the inventory purchase system which is utilized solely for the purpose of stabilizing inventory cost. It is an integral part of the productive process in which the property is held not for investment but for the protection of profit with the intent of disposition when that purpose has been achieved. As such it cannot reasonably be separated from the inventory items and the cost (or profit) from such operations would necessarily be entered in the books of account of the business as part of cost of goods sold. *The tax treatment of hedges, then, is not a "judge-made exception" to Section 117(a); it is simply a recognition by the courts that property used in hedging transactions properly comes within the exclusions of the section.*[52]

The Second Circuit's reasoning was ingenious: It avoided the issue of whether courts could correct on their own initiative a perceived substantive shortcoming in the drafting of the Internal Revenue Code, while at the same time that reasoning produced an appropriate result in the case under consideration. By concluding that the term "hedging" should be read broadly, so long as the transactions in question fairly could be construed as part of an "inventory purchase system . . . utilized . . . for the

[51] Id. at 516.

[52] Id. (emphasis added).

purpose of stabilizing inventory cost,"[53] the Second Circuit neatly resolved, in a manner favorable to taxpayers, most of the remaining ambiguities as to whether quasi-hedges or imperfect hedges of inventory could qualify for hedging treatment for tax purposes. Finally, because all the hedging cases to that date in fact involved the hedging of finished goods or raw materials, the Second Circuit's rationale could be applied with equal force and effect to the prior hedging cases that had been decided in taxpayers' favor.

Once more the taxpayer appealed, this time to the Supreme Court.[54] Once more the Commissioner prevailed, although this time under a rationale that squarely followed G.C.M. 17322, *Ben Grote*, and the extra-statutory exception school of analysis:

> Nor can we find support for petitioner's contention that hedging is not within the exclusions of § 117(a). Admittedly, petitioner's corn futures do not come within the literal language of the exclusions set out in that section. They were not stock in trade, actual inventory, property held for sale to customers or depreciable property used in a trade or business. But the capital-asset provision of § 117 must not be so broadly applied as to defeat rather than further the purpose of Congress. *Burnet v. Harmel*, 287 U.S. 103, 108. Congress intended that profits and losses arising from the everyday operation of a business be considered as ordinary income or loss rather than capital gain or loss. The preferential treatment provided by § 117 applies to transactions in property which are not the normal source of business income . . ..
>
> The problem of the appropriate tax treatment of hedging transactions first arose under the 1934 Tax Code revision. Thereafter the Treasury issued G.C.M. 17322, *supra*, distinguishing speculative transactions in commodity futures from hedging transactions. It held that hedging transactions were essentially to be regarded as insurance rather than a dealing in capital assets and that gains and losses therefrom were ordinary business gains and losses. The interpretation outlined in this memorandum has been consistently followed by the courts as well as by the Commissioner. While it is true that this Court has not passed on its validity, it has been well recognized for 20 years; and Congress has made no change in it though the Code has been re-enacted on three subsequent occasions. This be-

[53] Id.

[54] Corn Prods. Ref. Co. v. Commissioner, 350 U.S. 46 (1956).

speaks congressional approval.[55]

The Supreme Court's broad assertions as to the purpose of the capital gain/loss rules effectively swept away any need to rely on the prior learning regarding "true" and not-so-true hedges. In effect, the Supreme Court's decision replaced the prior objective test, which had focused on whether a purported hedge produced an "even or balanced" position, with a subjective test that looked to the taxpayer's motive for engaging in a particular transaction.[56] As the discussion that follows demonstrates, for the next 30 years, the famous aphorism that "profits and losses arising from the everyday operation of a business [must] be considered as ordinary income or loss" effectively answered virtually every hedging question before it could seriously be raised.

B. The Corn Products *Doctrine*

Following the Supreme Court's decision, taxpayers and courts alike read *Corn Products* as creating an exception from capital asset treatment for any asset held as an integral part of the taxpayer's business. The result was an explosion of cases that relied on *Corn Products* to convert capital gain or loss to ordinary treatment in situations having no relationship at all to the facts of *Corn Products*, or to the hedging transactions considered in this article. Over time, the *Corn Products* doctrine was cited as authority for allowing ordinary income or loss treatment in connection with transactions involving such diverse situations as: (1) insuring a steady source of inventory or raw materials;[57] (2) locking-in an advantageous agency relationship or other business benefit;[58] and,

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[55] Id. at 51-53 (footnotes omitted).

[56] See, e.g., Javaras, Corporate Capital Gains and Losses—The *Corn Products* Doctrine, 52 Taxes 770 (1974), Miller, The Unpleasant Taste of *Corn Products*, 53 S. Cal. L. Rev. 311 (1979).

[57] See, e.g., Edwards v. Hogg, 214 F.2d 640 (5th Cir. 1954) (minority stock interest acquired by a liquor distributor to ensure access to liquor supplies); Booth Newspapers, Inc. v. United States, 303 F.2d 916 (Ct. Cl. 1926) (stock acquired to ensure continuing source of newsprint); Clark v. Commissioner, 19 T.C. 48 (1952). Cf. Gulftex Drug Co., Inc. v. Commissioner, 29 T.C. 118 (1957) (loss on distilling company stock held for eight years after securing whiskey supply held to be capital loss on the grounds that taxpayer's motive had changed to investment).

[58] See, e.g., Norton v. United States, 551 F.2d 821 (Ct. Cl. 1977), cert. denied, 434 U.S. 831 (1977) (timber-cutting contracts held by timber company); Hollywood Baseball Ass'n v. Commissioner, 423 F.2d 494 (9th Cir. 1970), cert. denied, 400 U.S. 848 (1970) (baseball player contracts held by minor league baseball team); John F. Grierz Co. v. United States, 328 F.2d 163 (7th Cir. 1964) (stock of subsidiary acquired to secure benefits of favorable lease); Mansfield Journal Co. v. Commissioner, 274 F.2d 284 (6th Cir. 1960) (rights to purchase paper at a favorable price held by newspaper company); Hagan v. United States, 221 F. Supp. 248 (W.D. Ark. 1963) (stock purchased to ensure continuing agency relationship with prime customer).

(3) most important, selling the stock of a subsidiary that arguably constituted part of a taxpayer's "integral business."[59]

After a series of judicial defeats, the Service formally conceded, in Revenue Ruling 58-40,[60] that gains or losses from the sale of otherwise capital assets, including the stock of subsidiaries, would be ordinary in character if those gains or losses were demonstrated to arise from the everyday operation of the taxpayer's business. Beyond its narrow factual holding, however, Revenue Ruling 58-40 is significant for its express reliance on *Corn Products* to extend the concept of an extra-statutory exception to the definition of "capital asset" beyond the narrow area of inventory hedging transactions. As a result, for the more than three decades between the Supreme Court's decisions in *Corn Products* and *Arkansas Best*, the overwhelming consensus among tax professionals and the Service was that the scope of § 1221's definition of "capital asset" was limited by an extra-statutory exception for assets used in the everyday operation of a taxpayer's business.[61] So read, the application of § 1221 to commercial hedging transactions was reduced to a trivially easy example of a broad-reaching principle of tax law. It is not surprising, therefore, that little development occurred in the common law of the taxation of business hedges between *Corn Products* and *Arkansas Best*—there simply was no need to draw nice distinctions between different degrees of perfection in taxpayers' hedging techniques when even nonhedges could qualify for ordinary income/loss treatment.[62]

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[59] See, e.g., Campbell Taggart, Inc. v. United States, 744 F.2d 442 (5th Cir. 1984) (discussed below); Schlumberger Technology Corp. v. United States, 443 F.2d 1115 (5th Cir. 1971) (stock of subsidiaries acquired by manufacturer to help in development of new technologies). Cf. Rev. Rul. 75-13, 1975-1 C.B. 67 (loss on worthlessness of corporate stock held to be capital loss because the taxpayer's "predominant motive" was investment), revoked and superseded by Rev. Rul. 78-94, 1978-1 C.B. 58 (replacing the "predominant motive" test with the "substantial investment motive" test in determining capital or ordinary treatment on sales of corporate stock).

For a detailed discussion of the *Corn Products* doctrine as applied to stock and securities, see Javaras, note 56.

[60] 1958-1 C.B. 275.

[61] See, e.g., Rev. Rul. 72-179, note 13; Rev. Rul. 70-64, 1970-1 C.B. 36 (losses incurred by member of agricultural cooperative on redemption of "qualified notices of allocation" held to be ordinary losses). See also Rev. Rul. 82-204, 1982-2 C.B. 192, which, while finding a capital loss on its stated facts, noted that "[a] further exception [to the definition of capital asset] was established in *Corn Products*. . . ."

At least one commentator during this period lamented the failure of the Supreme Court to limit its holding in *Corn Products* to the rationale advanced by the Second Circuit, but even that commentator acknowledged that the law as then understood was not so limited. B. Bittker, 2 Federal Taxation of Income, Estates and Gifts, ¶51.10.3.

[62] There were, of course, a number of cases during this period in which taxpayers that suffered losses (typically, in commodities transactions) decided that they had been hedgers all along, but, in almost all of these cases, the taxpayer was unable to demonstrate either an integral relationship between the transactions in question and the taxpayer's business operations, or how the transactions at issue could be viewed as hedging any other position of the

Perhaps the most interesting articulation of the common understanding of *Corn Products* during this period is contained in G.C.M. 38178.[63] That Memorandum not only addressed the Service's understanding of the scope of the *Corn Products* doctrine, but also identified an ongoing controversy between the Service and the Justice Department that goes a considerable distance to explaining how the issue in the *Arkansas Best* case came to be framed in such a narrow fashion:

> It is our view that the Service has interpreted *Corn Products Refining Co. v. Commissioner* as holding that futures acquired in hedging are not capital assets because they fall within a judicial exception to section 1221 rather than because the futures are property described in section 1221(1). Otherwise stated, the fact that a hedge may be made with respect to property which is described in section 1221(1) (or section 1221(4)) does not mean that the actual futures are property described in either of these subsections. . ..
>
> The fact that the Service has adopted the conclusion that futures purchased for hedging produce ordinary income pursuant to a judicial exception to section 1221 rather than pursuant to section 1221(1) is, we believe, firmly established by [Off. Mem. 18818 (May 20, 1977)], which we do not here reconsider. In O.M. 18818, this office rejected the argument advanced by the Department of Justice to the First Circuit in *W.W. Windle Co. v. Commissioner*, 550 F.2d 43 (1st Cir. 1977), *cert. denied*, 431 U.S. 966 (1977), that the business investment purpose test underlying Rev. Rul. 75-13 should be abandoned and replaced by a literal approach to section 1221. Brief for Appellee, 20 *et seq.*

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taxpayer, no matter how charitably the term "hedging" was construed. See, e.g., Staple Gin Co. v. United States, 164 F. Supp. 919 (S.D. Tex. 1958); Patton & Richardson, Inc. v. Commissioner, 42 TCM (CCH) 70 (1981); Hendrich v. Commissioner, 40 TCM (CCH) 997 (1980); Meade v. Commissioner, 32 TCM (CCH) 200 (1973); Estate of Laughlin v. Commissioner, 30 TCM (CCH) 227 (1971). A recent Tax Court case indicates that taxpayers continue to make, and to lose, this argument with respect to losses incurred on commodities transactions. See Heggestad v. Commissioner, 91 T.C. No. 50 (Oct. 17, 1988).

Another line of authorities in effect dealt with "hedges" (in the economic sense) of investment assets. Thus, G.C.M. 39191 (Mar. 13, 1984) held that a corporation engaged solely in futures-futures arbitrage could not be said to be engaged in hedging, notwithstanding the fact that its positions were offsetting, on the theory that hedges only "offset any operational losses that might be incurred in the day-to-day business operations of an enterprise," and in this case no such day-to-day business operations existed. G.C.M. 39191 might thus best be understood as holding that a "hedge" of an investment position is another investment, not an ordinary income/loss transaction. To the same effect are G.C.M. 39447 (Nov.19, 1985) and LTR 8548016 (Aug. 29, 1985) ("hedges" of investments held by regulated investment company, despite price protection aspect of "hedges," are in fact "straddles," because underlying positions being hedged are not ordinary income/loss assets).

[63] G.C.M. 38178 (Nov. 27, 1979).

> Under this argument, because stock is not expressly excluded from the statutory definition of a capital asset, gain or loss from its sale or exchange, with a few exceptions relating to inventory acquisition, would be capital gain or loss. The Justice Department analyzed *Corn Products Refining Co.* as merely concluding that the inventory exclusion clause now contained in section 1221(1) was broad enough to cover the corn futures held by the taxpayer, and that subsequent cases interpreting the case as if it created an additional nonstatutory exception to the statutory definition of a capital asset had completely misinterpreted the Supreme Court's opinion. Rejecting the Justice Department analysis, in [Off. Mem. 18818], this office concluded:
>
> > *Corn Products Refining Co.* in its entirety can be read to suggest that the Court believed that Congressional intent would best be served if an additional integral business purpose exception was deemed to be part of the statute.
>
> We recognize, as Justice argues in its brief, that the business/investment purpose test is not grounded in the statutory language. Rather the business/investment purpose test is based on the Supreme Court's decision in *Corn Products* and the twenty-two years of judicial and scholarly analysis which have followed that decision. Thus, although the facts of the case and some portion of the language of the opinion support a restrictive view, we believe the business/investment purpose test accepted by this office and the Service in Rev. Rul. 75-13 is the position which should be followed . . ..
>
> Although the predominant purpose test adopted in G.C.M. 36007, O.M. 18818, and Rev. Rul. 75-13 was revoked by Rev. Rul. 78-94 and O.M. 18887, which adopted the substantial investment purpose standard, Rev. Rul. 78-94 and O.M. 18887 do not retreat from the position that ordinary income may be produced by the sale or exchange of property which does not fit within the five exceptions of section 1221 but fits within the judicial exceptions to capital asset status, including *Corn Products Refining Co.*[64]

With the effective acquiescence of the Service, the *Corn Products* decision quickly came to stand for the proposition that transactions having nothing to do with hedging (however broadly interpreted), or even with the day-to-day operations of a business, could give rise to ordinary income or loss upon the demonstration of the requisite business motive. The application of *Corn Products* to the sale of the stock of a subsidiary

[64] Id. (footnotes omitted).

was a dramatic case in point, and one that exposed the Service to essentially insoluble pragmatic whipsaws. A leading commentator observed the impossible audit position into which the Service was forced by the extension of the *Corn Products* doctrine to sales of stock:

> Among these . . . cases, there are few if any in which the IRS has succeeded in taxing a gain realized on the sale of stock as ordinary income. It is possible that taxpayers rarely realize profits on selling stock purchased for business reasons, but a more plausible explanation for the prevalence of losses in the litigated cases is that losses supply an incentive for disclosing the business objective for which the stock was acquired and held—or imagining such an objective if a plausible rationale can be conjured up. By contrast, if a profit is realized, mum's the word; and since capital gain is the normal outcome when stock is sold at a profit, the IRS is not likely to scratch beneath the face of the return.[65]

Particularly following the taxpayer's victory in *Campbell Taggart, Inc. v. United States*,[66] in which a pure holding company was permitted for the first time to claim an ordinary loss on the sale of the stock of a subsidiary, on the grounds that the stock had been acquired in the first instance to protect the taxpayer's business reputation, it became increasingly obvious that the continuing expansion of the *Corn Products* doctrine had placed the Service in an untenable administrative position.

IV. The *Arkansas Best* Case

In retrospect, one can imagine some straightforward administrative solutions to the Service's whipsaw problems concerning the character of gains and losses from the sale of corporate stock—for example, a requirement that taxpayers identify their *Corn Products* assets when *acquired*, not when sold.[67] Indeed, a bill that would have added such a specific identification requirement for securities to the Internal Revenue Code was introduced into Congress in 1976, but never was enacted.[68] In *Ar-*

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[65] B. Bittker, note 61, at 51-66 (footnotes omitted).

[66] 744 F.2d 442 (5th Cir. 1984).

[67] B. Bittker, note 61, at 51-66; Miller, note 56, at 346-354. Compare the contemporaneous identification requirements of § 1256(e) (hedges) and § 1236 (investment account positions of securities dealers).

[68] H.R. 10902, 94th Cong., 2d Sess., reprinted in H.R. Rep. No. 1360, 94th Cong., 2d Sess. 6-7 (1976). The bill would have created a new § 1254 to read as follows:

SEC. 1254. CERTAIN SECURITIES NOT TREATED AS CAPITAL ASSETS.

(a) Notification Required for Ordinary Loss Treatment. — Loss from the sale or exchange of any security shall in no event be considered as a loss from the sale or exchange of property

kansas Best, however, the Supreme Court sought to solve the Service's audit difficulties with respect to stock sales, not by pruning the *Corn Products* doctrine back to its original hedging roots, but rather by denying that the doctrine (as understood by both the Service and the tax bar for 30 years) ever existed in the first place. This revisionist approach ultimately will not eliminate tax whipsaws for the Service, but rather will create new anomalies in areas wholly ignored both by the Supreme Court in its opinion and by the Justice Department in its briefing of the case.

The taxpayer in *Arkansas Best* was a holding company that in 1968 acquired 65 percent of the stock of a commercial bank. In 1970, Congress amended the Bank Holding Company Act of 1956, the effect of which amendment was to classify the taxpayer as a bank holding company. In order to comply with the Bank Holding Company Act, the taxpayer in 1971 irrevocably committed to the Federal Reserve System to divest itself of its bank affiliate by 1981. The taxpayer sold a 51% block of the stock of its bank subsidiary in 1975, and the remaining 14% over the next several years pursuant to an option granted to another party in 1976.[69] Although the bank experienced substantial financial difficulties beginning in 1972, as late as 1974, the taxpayer had hopes of

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which is not a capital asset unless the taxpayer, before the expiration of the 30th day after the date of the acquisition of the security, notified the Secretary or his delegate that the security was not acquired by the taxpayer as an investment. Such notification shall be made in such manner as may be required under regulations prescribed by the Secretary or his delegate, and shall contain such information with respect to the reason for the acquisition of the security as may be required under such regulations.

(b) Treatment as Ordinary Gain. — If the notification provided for under subsection (a) has been given with respect to any security, any gain on the sale or exchange of such security shall be treated as gain from the sale or exchange of a security which is not a capital asset.

(c) Definitions and Special Rules —

(1) Security defined. — For purposes of this section, the term "security" has the meaning assigned to such term by section 165(g)(2).

(2) Treatment of securities which become worthless. — For purposes of this section, if a security (other than a security described in section 165(g)(3)) becomes worthless during the taxable year, the loss resulting therefrom shall be treated as a loss arising from the sale or exchange of the security.

(3) Exceptions from application of section. — This section shall not apply —

(A) with respect to a security acquired by a taxpayer who is a dealer in securities at the time of the acquisition of the security,

(B) in the case of a financial institution to which section 585, 586, or 593 applies, with respect to a bond, debenture, note, or certificate or other evidences of indebtedness, and

(C) with respect to any stock described in section 1242 (relating to losses on small business investment company stock), 1243 (relating to loss of small business investment company), or 1244 (relating to losses on small business stock).

(4) Transitional rule for notification. — In the case of a security acquired before the date of the prescribing of the final regulations first prescribed pursuant to subsection (a), the period for making the notification provided for under subsection (a) shall not expire before the day which is 30 days after the date of such prescribing.

[69] Arkansas Best Corp. v. Commissioner, 83 T.C. 640, 649 (1984).

selling its subsidiary at a profit, and intended to report that profit as capital gain.[70] During the "problem" period of 1973 through 1976, the bank made voluntary capital calls on its shareholders, pursuant to which the taxpayer (along with other shareholders) acquired additional shares in the bank.

The Tax Court, after considerable rumination as to whether a holding company could have a trade or business to which the *Corn Products* doctrine could apply,[71] concluded that the taxpayer originally acquired its interest in its banking subsidiary as an investment, and that the loss sustained on that investment therefore could only constitute a capital loss. At the same time, however, the Tax Court held that the additional investments made by the taxpayer during the bank's "problem" period were made solely to protect the taxpayer's business reputation. The Tax Court therefore held that the losses sustained on the sale of the shares represented by the additional investments should be treated as ordinary losses, based on the authority of *Corn Products*.[72]

The Eighth Circuit affirmed the Tax Court's decision as to the taxpayer's original investment, but reversed as to the taxpayer's additional investments during the bank's "problem" period, holding that the entire loss was a capital loss. The Eighth Circuit began with an analysis of § 1221, which, on its face, treats stock (except in the hands of a securities dealer) as a capital asset. The Court of Appeals then acknowledged that: "Although a literal reading of section1221 clearly requires capital stock to be treated as a capital asset, the decision of the Supreme Court in [*Corn Products*] placed a judicial gloss on the section."[73] The Court of Appeals did not explain precisely what that gloss was, but chose instead to quote extensively from the Supreme Court's *Corn Products* opinion. The Eighth Circuit then observed: "Our Court has declined all previous invitations to extend *Corn Products* beyond its facts,"[74] and reviewed a number of cases in the Eighth Circuit and elsewhere dealing with the asserted application of *Corn Products* to sales of real estate and the stock of corporate subsidiaries. Finally, the Court concluded:

> We do not read *Corn Products* as either requiring or permitting the courts to decide that capital stock can be anything other than a capital asset under section 1221. It seems to us that one of the last places where the legal system deliberately should foster subjectivity and uncertainty is in the tax code. *Corn Products* and its progeny, which we respectfully view as

[70] Id. at 648.
[71] Id. at 651-53.
[72] Id. at 656-57.
[73] Arkansas Best Corp. v. Commissioner, 800 F.2d 215, 219 (8th Cir. 1986).
[74] Id.

> misbegotten, have done precisely that, leading to increased recourse to the administrative and judicial processes to resolve conflicting contentions about taxpayers' motivations in purchasing capital stock. Congress could have written section 1221 to incorporate some sort of exception regarding capital stock, just as it recognized the unique position of securities dealers in 26 U.S.C. § 1236, but it did not do so. We believe that the judiciary lacks authority to create exceptions to section 1221 that Congress did not choose to make.[75]

The Eighth Circuit's opinion is a model of ambiguity; had the Supreme Court not granted certiorari, tax lawyers would be able to amuse themselves indefinitely with debates as to whether the above-quoted passage meant that the Eighth Circuit drew the line at extending the *Corn Products* doctrine to sales of stock of subsidiaries, or, instead, adopted the reasoning of the Second Circuit in *Corn Products*, that no extra-statutory exception to § 1221 can exist. For better or for worse, the Supreme Court's decision in *Arkansas Best* foreclosed that speculation by coming down squarely on the side of the latter interpretation.

The Supreme Court affirmed the Eighth Circuit's decision in a relatively brief opinion that relied heavily on the Second Circuit's reasoning in *Corn Products*, and adopted a tone of mild surprise at the suggestion that its own decision in *Corn Products* could ever have been interpreted as condoning an extra-statutory exception to § 1221:

> In light of the stark language of § 1221, however, we believe that *Corn Products* is properly interpreted as involving an application of § 1221's inventory exception . . ..
>
> Petitioner argues that by focusing attention on whether the asset was acquired and sold as an integral part of the taxpayer's everyday business operations, the Court in *Corn Products* intended to create a general exemption from capital-asset status for assets acquired for business purposes. We believe petitioner misunderstands the relevance of the Court's inquiry. 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. The close connection between the futures transactions and the taxpayer's business in *Corn Products* was crucial to whether the corn futures could be considered surrogates for the stored inventory of raw corn . . .. We conclude that *Corn Products* is properly interpreted as standing

[75] Id. at 221.

> 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.[76]

It is difficult to argue with the result reached in *Arkansas Best* on the facts of the case, but it is remarkable that the Supreme Court would so disingenuously describe its earlier opinion in *Corn Products*. The *Arkansas Best* Court's discussion of *Corn Products* conspicuously fails to offer any explanation of the apparently conscious choice of that earlier Court, not simply to adopt the Second Circuit's reasoning in the same or similar words, but to expand upon that reasoning. It is also extraordinary that the Supreme Court in *Arkansas Best* never acknowledged that the Service itself had consistently, and publicly, interpreted *Corn Products* as creating an extra-statutory exception to § 1221.[77]

In fairness to the Supreme Court, neither the petitioner nor the respondent discussed in their briefs, even in passing, the consistent interpretation of *Corn Products* articulated by the Service, or the importance of the *Corn Products* doctrine to both taxpayers and the Service in reaching consistent results in business hedging transactions having nothing to do with inventory, such as liability and foreign currency hedging.[78] Instead, the petitioner appears to have assumed the existence of the *Corn Products* doctrine (that is, the existence of an extra-statutory exception to the definition of "capital asset"), and phrased the bulk of its argument in terms of defining the outer contours of that doctrine.[79] The respondent, freed of any obligation to explain away 30 years of consistent administrative practice to the contrary, concentrated instead (as might be expected) on (1) the literal language of § 1221, (2) the fact that the Second Circuit's reasoning in *Corn Products* could have been sufficient to explain the re-

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[76] Arkansas Best Corp. v. Commissioner, 108 S. Ct. 971, 976-77 (1988) (footnote omitted).

[77] The Service, in contrast, recognized the problem caused by its prior ruling policy. Shortly after the Eighth Circuit's opinion in *Arkansas Best*, the Service issued Notice 87-68, 1987-2 C.B. 378, suspending the application of all published rulings that relied on the *Corn Products* doctrine, including the rulings cited in notes 59-61. The fate of the suspended rulings in the wake of the Supreme Court's *Arkansas Best* opinion remains uncertain.

[78] Of course, to complete the circle of fairness, it is not unreasonable that the petitioner, faced with a potential tax liability arising from its treatment of the sale of the stock of a subsidiary, chose not to litigate the issue of the appropriate tax treatment of, for example, liability hedging. Moreover, the Supreme Court was not the only one to misread the unsettling effects of retroactively adopting a narrow interpretation of the *Corn Products* case. See, e.g., Miller, note 56, at 344, which, years earlier, proposed an interpretation of *Corn Products* similar to that described by the Supreme Court in *Arkansas Best* as a potential solution to the Service's exposure to whipsaws in respect of sales of corporate stock. While discussing certain problems of such a narrow approach to *Corn Products*, Miller failed entirely to consider the impact on bona fide business hedges unrelated to stock investments.

[79] Thus, for example, the petitioner's analysis in its brief essentially began with *Booth Newspapers*, note 57, and moved forward from that point.

sult reached by the Supreme Court in that case,[80] and (3) the administrative difficulties of a judicial exception to § 1221 that looked primarily to the taxpayer's intent in acquiring an asset. Faced with these diametrically opposing arguments, and with no support in either brief for a middle ground, the Supreme Court's opinion is understandable—although no less unfortunate for that fact.[81]

V. Business Hedges After *Arkansas Best*

A. Overview

This Part V reviews the application of the *Arkansas Best* decision to three typical categories of business hedging transactions: asset hedges, currency hedges, and liability hedges. The discussion considers both the scope of the damage done by *Arkansas Best* to certain straightforward hedging transactions (particularly liability hedges) and the remedies (such as they are) available to taxpayers. Because those remedies are insufficient to restore appropriate tax results in some areas, and can produce potential tax whipsaws (for both the Service and taxpayers) in others, Part VI considers how *Arkansas Best* might be limited to its appropriate scope through administrative and legislative initiatives.

At the time *Corn Products* was decided, the stakes in the case reflected only the different tax treatment of capital gain or loss, on the one hand, and ordinary income or loss, on the other. With the introduction in 1981 of the "straddle" rules, however, the *Corn Products* doctrine took on additional importance, because the determination of whether a transaction qualified as a hedge within the meaning of *Corn Products* frequently determined the *timing*, in addition to the character, of hedge losses under the straddle rules. In order to appreciate the consequences of *Arkansas Best*, therefore, it is necessary to begin with a brief summary of the "straddle" rules of the Code, and the role formerly played therein by the *Corn Products* doctrine.

B. Straddle Transactions and Section 1256(e) Hedges

Beginning in the mid-1970's, the Service, and later Congress, became alarmed at the use by many taxpayers of tax straddles to "roll" income

[80] The respondent was required, of course, as was the Supreme Court itself in *Arkansas Best*, to skirt delicately the question of why the Supreme Court in *Corn Products* chose not to limit the language of its opinion to those wholly sufficient grounds advanced by the Second Circuit.

[81] As noted in Part III, the government's litigating position in *Arkansas Best* (that is, that the *Corn Products* doctrine represented a judicial expansion of the inventory exception to § 1221, rather than an additional, extra-statutory, exception to § 1221) was foreshadowed by the debate between the Service and the Justice Department discussed in G.C.M. 38178 (Nov. 27, 1979). See notes 63-64 and accompanying text.

from one year to the next, and to convert short-term capital gain (or even ordinary income) to long-term capital gain.[82] Congress finally responded to the problem in 1981, with the introduction of §§ 263(g), 1092 and 1256 into the Code.[83] Since that time, the tax consequences of hedging transactions have been determined, not simply by case law and rulings, but also by § 1256(e), which excludes "hedging transactions," as defined therein, from the straddle rules of § 1092 and the mark-to-market rules of § 1256(a).[84]

Section 1256(a) imposes what is known as the "60/40" and mark-to-market tax regime for "section 1256 contracts." Section 1256 contracts, include such mainstays of commercial hedging as regulated futures contracts, certain foreign currency forward contracts, and certain exchange-listed options on property other than stock. Under the rules of § 1256, gain or loss on the disposition (or deemed disposition) of a § 1256 contract is treated as 60% long-term capital gain or loss, and 40% short-term capital gain or loss, regardless of the holding period of that position. Under the mark-to-market rule of § 1256(a), any § 1256 contract held at the close of a taxpayer's year is generally deemed to have been sold on that date for its fair market value, and the resulting gain or loss is recognized for tax purposes—unless, of course, any such loss is deferred by virtue of the straddle provisions of § 1092.

Section 1092 is the heart of the Code's straddle provisions and contains the basic operative rules: A loss on a position that is part of a straddle cannot be deducted if at year end there exists unrealized gain on any other position in that straddle (or in certain "successor positions"). Section 1092(c)(1) defines a "straddle" for these purposes as "offsetting positions with respect to personal property." Section 1092(c)(2)(A), in turn, concludes that one position offsets another if there is a "substantial

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[82] The Service attempted to address the problem—or at least to staunch the hemorrhaging—in Rev. Rul. 77-185, 1977-1 C.B. 48, which held that losses sustained from "lifting" and replacing one leg of a "balanced position" not arising in the ordinary course of business were not recognizable until the balanced position was closed out. In light, however, of the complete absence of statutory authority for the proposition advanced in Rev. Rul. 77-185, as well as the difficulties of determining what in fact constituted a "balanced position," both the Treasury and Congress wisely concluded that a comprehensive statutory solution was required.

[83] These provisions had a complex genesis, dating back to H.R. 7541, introduced by Representatives Vanick and Rosenthal in 1980, and continuing through S. 626 (the Commodity Straddles Tax Act of 1981) and S. 1432 (the Straddle Tax Act of 1981), both introduced in 1981 by Senator Moynihan. S. 1432 ultimately became the basis of the provisions adopted in the Economic Recovery Tax Act of 1981.

[84] Technically, other exceptions to the mark-to-market rules of § 1256(a) may exist for a hedge (in the colloquial sense) that is not a hedging transaction (in the § 1256(e) sense). These other exceptions (which take the form of various "mixed straddle" elections) do not, however, solve the more fundamental problem of possible loss deferral under the straddle rules of § 1092, and consequently are not considered further in this article.

diminution" of risk of holding the first position by virtue of holding the second.

The straddle rules of § 1092 apply only to offsetting "positions" in "personal property." The term "position" for these purposes means any "interest (including a futures or forward contract or option) in 'personal property."[85] The term "personal property" is defined more idiosyncratically as "any personal property of a type which is actively traded."[86] A taxpayer therefore holds a "position" in personal property if either (1) the property underlying its interest is actively traded personal property (because any interest in such property will be a position whether or not the interest itself is actively traded), or (2) the particular interest in the underlying property is actively traded personal property (because the interest itself then will be actively traded personal property and ownership of such an interest necessarily will be a position). Thus, for example, a futures contract in respect of non-actively traded personal property will be considered a position under § 1092(d).[87]

While every business hedge is a straddle in the colloquial sense, in that the purpose of the hedge is to substantially diminish the risk of loss associated with another position of the taxpayer, not every hedge is a straddle within the meaning of § 1092. The obligor under a United States dollar borrowing, for example, does not have an interest in personal property as that term is defined in § 1092(d)(1). United States currency itself is not treated as personal property for tax purposes,[88] and the debtor's obligation to repay the loan cannot be viewed as personal property of the obligor, because, while a borrowing creates a property interest in the creditor, it creates no property interest in the debtor:

> [D]ebts owing by corporations, like debts owing by individuals, are not property of the debtors in any sense; they are obliga-

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[85] Section 1092(d).

[86] Section1092(d)(1). Stock generally is excluded from the definition of "personal property" by § 1092(d)(3)(A) unless that stock is held in a straddle of the type described in § 1092(d)(3)(B).

[87] See, e.g., Staff of Joint Committee on Taxation, 97th Cong., 1st Sess., General Explanation of the Economic Recovery Tax Act of 1981, at 289 (Comm. Print 1981):

> [A] futures contract, forward contract, option (other than a stock option) or other interest, while constituting a position in other property, is also personal property as defined in the Act if it is actively traded. Thus, for example, a debt instrument is a contractual right entitling its holder to an amount of cash on a future date and also constitutes personal property if it is actively traded. Similarly, a futures contract that does not require delivery of personal property but calls for a cash settlement predicated on the future price of deposits, obligations, stock, securities, or other assets is itself personal property if actively traded.

[88] Id. at 289: "U.S. currency does not constitute personal property as defined since only property or interests in property that may result in gain or loss on their disposition are subject to the straddle limitations."

> tions of the debtors, and only possess value in the hands of the creditors. With them they are property. . . . To call debts property of the debtors is simply to misuse terms. All the property there can be in the nature of things in debts of corporations, belongs to the creditors, to whom they are payable. . . .[89]

Despite these nice limitations on the scope of the term "personal property," as a practical matter, it typically is important that a business hedge qualify as a hedging transaction under § 1256(e), in order to avoid the Code's loss deferral and mark-to-market provisions.[90] To avoid disrupting traditional hedging activities, Congress enacted § 1256(e), which exempts qualifying "hedging transactions" from the substantive rules of §§ 1092 and 1256. Section 1256(e) sometimes has been referred to as a codification of the *Corn Products* doctrine (at least as limited to the original facts of the case). In fact, it would be fairer to characterize § 1256(e) as simply a procedural provision requiring a taxpayer adequately to identify a position as a *Corn Products* hedge when that position is established in order to claim the benefits of exemption from §§ 263(g), 1092, and 1256.[91]

Section 1256(e) imposes four requirements for a transaction to be characterized as a hedge:

> (1) The transaction must be entered into by the taxpayer in the normal course of its trade or business;
>
> (2) The transaction's primary purpose must be: (a) to reduce the risk of price changes or currency fluctuations with respect to property held or to be held by the taxpayer; or (b) to reduce the risk of interest rate or price changes or currency fluctuations with respect to borrowings made or to be made, or obligations incurred or to be incurred, by the taxpayer;
>
> (3) The gain or loss on "such transactions" —that is, both the transaction being hedged and the hedge thereof—must be treated solely as ordinary income or loss;[92] and
>
> (4) The transaction must be properly identified as a hedge when the position is established.[93]

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[89] In re State Tax on Foreign-Held Bonds, 82 U.S. (15 Wall.) 300, 320 (1872).

[90] Thus, although an obligor that hedges its U.S. dollar interest rate exposure with a regulated futures contract does not have a straddle, it nonetheless ordinarily will rely on § 1256(e) to avoid the mark-to-market rules of § 1256(a) with respect to that futures contract.

[91] As such, § 1256(e) can be analogized to the identification rules contained in § 1236 for investment accounts maintained by securities dealers.

[92] IRC § 1256(e)(2)(B). See also General Explanation of the Economic Recovery Tax Act of 1981, note 87, at 299: "Gain or loss on dispositions both of the hedged property and of the hedge itself must be ordinary to qualify under § 1256(e)."

[93] The legislative history indicates that special identification rules apply to large scale hedgers: "Taxpayers, such as banks or securities dealers, who may conduct thousands of hedging

The first and second requirements of § 1256(e) (i.e., the normal course of business and the risk reduction purpose restrictions) are, of course, entirely consistent with the application of *Corn Products* at the time § 1256(e) was enacted, and, in that sense, simply crystalize the case law and administrative precedent summarized in Parts II and III of this article. It is the ordinary income requirement of § 1256(e)(2)(B), however, that turns § 1256(e)—if read literally—from a substantive codification of *Corn Products* into largely a procedural provision that *assumes* the application of *Corn Products* prior to its reinterpretation by *Arkansas Best.*

The legislative history makes clear that § 1256(e) presupposes, rather than replaces, the *Corn Products* doctrine. Thus, the Senate Finance Committee Report to § 1256(e) states: "For a transaction *which would generate ordinary income or loss under normal tax principles* to qualify as a hedging transaction, the transaction must be clearly identified in the taxpayer's records . . .."[94] Similarly, in earlier testimony before the Senate Finance Committee when it considered S. 626 (one of the predecessor bills to the straddle rules as ultimately enacted), the Assistant Secretary of the Treasury for Tax Policy stated: "Treasury does not intend for its [straddle] proposal to interfere with the normal hedging activities that are carried on as part of an active business . . .. The futures contracts to which we are referring are already treated as ordinary income assets under a decision of the Supreme Court."[95]

Thus, read literally, § 1256(e) does *not* independently operate to characterize a hedge as giving rise to ordinary income or loss, but rather permits certain income or loss that otherwise is determined to be ordinary under general principles of tax law to be recognized without regard to the timing rules of §§ 263(g), 1092, and 1256. In even the most straightforward case of, for example, inventory hedging, it is the common law of hedge taxation, including *Corn Products* (and now, *Arkansas Best*), not any statutory provision, that creates the ordinary income/loss characterization of the hedge. As a result, if a hedging transaction is outside the

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transactions to hedge property held or to be held in their accounts, may identify such accounts as hedged accounts without marking individual items as hedges or hedged property, provided such accounts deal only with ordinary income (or loss) items." S. Rep. No. 144, 97th Cong., 1st Sess. 151 (1981).

[94] S. Rep. No. 144, note 93 (emphasis added).

[95] Hearings on S. 626 before the Senate Finance Committee, 97th Cong., 1st Sess. 64 (1981) (testimony of John E. Chapoton).

See also Shashy, The Long and the Short of Straddles as a Tax Saving Device: New Law, 40 N.Y.U. Tax Inst. § 17, at 17-13 n.32 (1982): ("[Section 1256(e)(2)(B)] will increase the importance of the decision in *Corn Products*. . ., and its progeny.") Shashy appears incorrect, however, in worrying that § 1256(e)(2)(B) cannot operate correctly in the case of a borrower that hedges its interest rate exposure, on the grounds that the transaction being hedged — the borrowing — cannot give rise to ordinary income or loss to the borrower. In fact, repaying a loan at a discount or premium gives rise to gain or loss to the borrower, which in either case is characterized as ordinary. IRC § 108; Reg. § 1.163-3(c).

scope of *Arkansas Best*, that hedge (assuming no substantive Code provision produces a different result) typically will generate capital gain or loss. If that capital gain/loss position is part of a straddle (which, outside of the case of hedging U.S. dollar liabilities, very often will be the case), loss recognized on *either* leg of the straddle will be subject to the loss deferral rules of § 1092.[96]

One particularly bizarre result of *Arkansas Best*'s limitation on the scope of § 1256(e) is the relationship between that provision and § 1256(f)(1). Section 1256(f)(1) provides, in effect, that, if a taxpayer identifies a position in personal property as part of a § 1256(e) hedging transaction, and if that transaction in retrospect does not constitute a hedging transaction, the taxpayer's *gain* (but not loss) on the hedge nonetheless will be treated as ordinary income. The apparent purpose of § 1256(f)(1) is to prevent taxpayers from electing § 1256(e) treatment for straddles; presumably the fear was that, in the case of a hedge loss, the taxpayer would play the audit lottery, and, in the case of a hedge gain, would "discover" its error and claim capital gain.

It is not clear whether § 1256(f)(1) in fact acts to curb any realistic abuse potential; what is certain, however, is that, since *Arkansas Best*, § 1256(f)(1) can produce extraordinarily unfair results. If § 1256(f)(1) is applied indiscriminately by the Service, a taxpayer that prior to *Arkansas Best* properly elected § 1256(e) hedging treatment under an accurate reading of the *Corn Products* doctrine as then understood, but in circumstances where *Arkansas Best* would produce a different result, will now discover, not that its hedge in fact gave rise to capital gain or loss, but rather that the hedge yielded *ordinary* income or *capital* loss. In the case of a taxpayer that in good faith entered into a great many such transactions, the result could be catastrophic, because losses recognized on some such hedges will not offset the gains recognized on others. By contrast, if the results of the hedges were recharacterized as entirely capital gain or loss in light of *Arkansas Best*, at least hedge gains could be offset by hedge losses (to the extent the loss deferral rules of the straddle provisions permitted), even if any net loss could not offset the taxpayer's ordinary income from its other business operations.

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[96] Thus, for example, § 1092 can operate to defer a loss on the disposition or yearend markdown of inventory where that loss is offset by an unrealized gain on another position that is not within the scope of § 1256(e) post-*Arkansas Best*. Cf. Temp. Reg. § 1.1092(b)-5T(d). This example is a little strained, in that most inventory hedges should still qualify as hedging transactions under § 1256(e) (as discussed in Part V.C.). One interesting question raised by *Arkansas Best*, however, is whether courts will revisit the holdings of such cases as *Kurtin*, note 28, in which butter futures were used to hedge inventories of cheese, on the theory that the "inventory surrogate" analysis of *Arkansas Best* is difficult to apply to hedges that employ interests in property that itself would not constitute inventory.

C. *Asset Hedging After* Arkansas Best

The *Arkansas Best* decision will have less effect on the tax treatment of traditional asset hedges than it will in other areas. Most business asset hedges should continue to qualify for ordinary income or loss treatment under *Arkansas Best*'s analysis on the grounds that they pertain to a category of property listed as an exception to § 1221.[97] One such area, of course, is the hedging of inventory and other assets described in § 1221(1). In such cases, the Second Circuit's opinion in *Corn Products* makes clear that taxpayers need not demonstrate that their transactions are "true" hedges, but rather simply that those transactions serve the purpose of stabilizing the taxpayer's inventory costs.

Section 1221(1) is not the only exception to § 1221, and, in light of the analysis adopted in *Arkansas Best*, some of those exceptions that, to date, have received only modest attention may warrant further scrutiny as avenues for achieving hedge treatment. In particular, § 1221(4), which excludes from the definition of capital asset "accounts or notes receivable acquired in the ordinary course of trade or business for services rendered or from the sale of property described in [§ 1221(1)]," may prove to be more useful after *Arkansas Best* than it might appear on its face.

In *Burbank Liquidating Corp. v. Commissioner*,[98] for example, the Tax Court considered the treatment of mortgage notes originated by a savings and loan association in the course of its ordinary business, which notes were later sold at a loss when the taxpayer encountered financial difficulties. Appropriately rejecting the concept that the notes constituted "inventory" of the taxpayer under § 1221(1), the Tax Court nonetheless allowed an ordinary loss deduction on the grounds that the mortgage notes were "notes receivable acquired . . . for services rendered," within the meaning of § 1221(4). In a published revenue ruling, the Service reached the same result in the case of mortgage loans made by a real

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[97] Even prior to *Arkansas Best*, transactions designed to hedge investment assets generally were not considered to qualify for special ordinary income treatment under the *Corn Products* doctrine, because the underlying exposure could not be viewed as part of a taxpayer's ordinary business operations. See note 62. A narrower scope for the *Corn Products* doctrine after *Arkansas Best* therefore should not disturb any expectations in respect of such asset hedges.

The *Arkansas Best* decision also recognizes, in a footnote, that certain transactions that purport to involve sales of what otherwise would be a capital asset in fact constitute no more than an assignment of a future ordinary income stream without the underlying income-producing property, and accordingly should be treated as giving rise to ordinary income or loss. See, e.g., Commissioner v. P.G. Lake, Inc., 356 U.S. 260 (1958); Hort v. Commissioner, 313 U.S. 28 (1941). While the *Arkansas Best* decision did not address this issue, it would appear in conformity with the rationale of that decision that a transaction designed as a hedge of such a quasi-asset arguably could be viewed as giving rise to ordinary income or loss.

[98] 39 T.C. 999 (1963), acq. 1965-1 C.B. 5, modified on other grounds, 335 F.2d 125 (9th Cir. 1964).

estate investment trust.[99] Although the issue apparently has never been litigated, taxpayers that regularly engage in the business of originating loans, as well as taxpayers simply holding accounts payable, can argue persuasively that a hedge of, for example, the interest rate exposure inherent in those assets should be subsumed within the class of property excepted from capital asset treatment by virtue of § 1221(4), in the same manner that hedges of inventory costs are treated effectively as within the category of inventory for § 1221(1) purposes under the *Arkansas Best* analysis.

Similar arguments for protection under § 1221(4) can be made in the case of a taxpayer that is a *dealer* in notional principal amount products, such as interest rate swaps, caps, or floors.[100] Like the mortgage notes in *Burbank Liquidating*, it is clear that such transactions are part of a dealer's ordinary business dealings with its customers, but may not come within the technical definition of inventory under § 1221(1).[101] If notional principal amount positions entered into by dealers with their customers are viewed as § 1221(4) assets in the hands of those dealers, hedges entered into to reduce the risk of interest rate fluctuations in respect of those notional principal amount products arguably should be assimilated into the ordinary income or loss character of the underlying positions. Absent an analysis that allows dealers in notional principal amount products protection under § 1221(1) or 1221(4), however, transactions designed as hedges of such positions would subject dealers to the character and timing whipsaws described above—a paradigmatic case of the problems created by the *Arkansas Best* analysis.

D. Foreign Currency Hedging After Arkansas Best

Unlike § 1256(e), § 988, added to the Code in 1986, does have a substantive impact.[102] Section 988(a) provides that foreign currency gain or loss attributable to a "section 988 transaction," which includes most fi-

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[99] Rev. Rul. 80-57, 1980-1 C.B. 157. See also Rev. Rul. 72-238, 1972-1 C.B. 65 (gain realized by creditor bank that purchased mortgaged property at foreclosure sale for less than its fair market value held to be ordinary income on the grounds that the mortgage note in the bank's hands was excluded from the definition of a capital asset under § 1221(4)). Cf. G.C.M. 38090 (Sept. 12, 1979); G.C.M. 36877 (Sept. 30, 1976).

[100] A swap, cap, or floor position held by the dealer's customer, however, generally would not be within the arguable scope of § 1221(4), since the customer presumably could not demonstrate the requisite connection with services performed or property sold as part of its ordinary business. See generally note 4 for a brief description of swaps, caps, floors, and similar notional principal amount products.

[101] It is awkward to argue, for example, that a dealer's willingness to enter into a bilateral swap agreement constitutes property that is "held for sale to customers" as required by § 1221(1).

[102] Section 988 is discussed at length in Stodghill, Taxing the Yen for Foreign Currency: The Statutory Experience, 7 Va. Tax Rev. 57 (1987).

nancial transactions, is treated as ordinary income or loss.[103] This general ordinary income or loss rule, in turn, permits a taxpayer to rely on protection from adverse timing rules under § 1256(e), assuming that the other requirements of that section are satisfied.[104] Accordingly, the potential tax whipsaw problem of offsetting transactions generating ordinary income and capital loss, so worrisome in other areas after *Arkansas Best*, should have relatively little impact on transactions within the scope of § 988.

The above discussion should not be taken to suggest that no controversies remain in the area of foreign currency hedging. In particular, transactions designed to hedge a U.S. corporation's foreign currency exposure in respect of the balance sheet of a foreign subsidiary—so-called "FASB 52" hedges[105]—raise a number of difficult issues. While the character of income or loss from such foreign currency hedges generally should be ordinary under § 988(a), timing issues under the straddle rules remain a serious concern. As noted earlier, in general, stock is not personal property for purposes of § 1092.[106] It is not clear whether a taxpayer that hedges its net foreign currency exposure represented by its investment in the stock of a subsidiary (by shorting futures contracts, for example) therefore should view the hedge as outside the scope of the straddle rules, because the property being hedged (its stock in the foreign subsidiary) is not personal property for this purpose, or instead should treat the foreign currency component of that stock investment as a separate property in-

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[103] The Technical Corrections and Miscellaneous Revenue Act of 1988 recently passed by the Congress resolves two important ambiguities in § 988 as originally enacted. First, the Act treats as ordinary income or loss all gain or loss from transactions described in § 988(c)(1)(B)(iii)—generally, forwards, futures, options and similar contracts—rather than simply the component of gain or loss attributable to spot foreign currency movements from the "booking date" to the "payment date." This change generally eliminates the possibility that such positions could give rise to split capital/ordinary gain or loss and therefore simplifies the application of § 1256(e) to such contracts. The second change expands the scope of § 988 to cover previously excluded "section1256 contracts"—an exclusion that produced potentially complex and irrational results for foreign currency hedging transactions. A summary of these problems under prior § 988 appears in Kleinbard, International Financial Transactions, Tax Strategies for Corporate Financings and Definancings: The New Financial Products, PLI Course Handbook No. 260, at 63-70 (1987).

[104] Section 1092(d)(7)(A), for example, now explicitly confirms that an obligor's implicit short position in foreign currency represented by a foreign currency borrowing is a position for purposes of § 1092(d)(2). Absent protection under § 1256(e), a hedged foreign currency borrowing therefore would be subject to the straddle rules of § 1092.

[105] So named after the Financial Accounting Standards Board, Statement of Financial Accounting Standards No. 52, Foreign Currency Translation (Dec. 1981). Paragraph 20 of that statement provides that gains and losses from foreign currency transactions that are designated as an economic hedge of a company's net investment in a foreign entity are not required to be included in determining the company's "net income" for financial accounting purposes, but instead are reported as a separate component of equity.

[106] IRC § 1092(d)(3)(A).

terest that is personal property.[107]

As a further complication, a famous colloquy between Senators Dole and Moynihan accompanying the enactment of § 1256 concluded that the definition of a "hedging transaction" under § 1256(e) included hedges of the foreign currency exposure attributable to a foreign subsidiary's stock—a conclusion that presumably would have been unnecessary if such a hedge were not a § 1092 straddle in the first place.[108] The colloquy also fails to explain how its conclusion comports with the express requirement of § 1256(e) that all parts of a hedging transaction, including in this case gain or loss from the sale of the foreign subsidiary stock, give rise to ordinary income or loss—a result that would have been difficult to achieve prior to *Arkansas Best*, and virtually impossible thereafter.[109] Accordingly, it is not clear whether, if one concludes that a FASB 52 hedge does create a straddle, the Dole-Moynihan colloquy requires § 1256(e) to be read in a manner that overrides the straddle rules of § 1092.

The appropriate forum in which answers to these and similar questions should be developed are the regulations to be promulgated under § 988(d). Section 988(d) introduces a new concept of "988 hedging transactions," and authorizes the Treasury Department to promulgate regulations producing consistency in character, source, and timing for transactions within its scope. Somewhat confusingly, § 988(d) uses the term "hedging transaction" in a manner much broader than the definition of that term under § 1256(e). It is clear, for example, that § 988(d) is intended to apply to a transaction that hedges the foreign currency

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[107] Section 1092(d)(7)(A) provides for just such a bifurcation in the case of a foreign currency borrowing, but is silent in other cases. As discussed below, the Tax Court in *Hoover Co.* explicitly rejected the theory that a FASB 52 hedge should be viewed as a hedge of the subsidiary's underlying assets, and held, instead, that a FASB 52 hedge must be viewed as a hedge (in the colloquial sense) of the stock of the subsidiary. 72 T.C. at 237. On the other hand, no one would disagree that, if a taxpayer were to "hedge" the foreign currency (but not the interest rate) component of a foreign currency bond held as an investment asset, the bond and the "hedge" would constitute a straddle for tax purposes. The difficulty with this analogy, of course, is that an offshore stock investment, unlike a foreign currency-denominated bond, typically involves only indirect exposure to exchange rate fluctuations.

[108] Cong. Rec. S8643-S8644 (July 28, 1981).

[109] Under § 1248, gain recognized on the sale of stock of a controlled foreign corporation that is attributable to the earnings and profits accumulated by that subsidiary while owned by the U.S. parent is recharacterized as ordinary income. Any gain in excess of accumulated earnings and profits remains capital gain, however, and any loss recognized on such a sale is a capital loss. While it is possible that the hypothetical sale of the stock of a foreign subsidiary for a price thought to reflect its fair market value at a particular time might be characterized as producing entirely ordinary income under § 1248, it is equally possible that such stock, when actually sold, would yield a capital gain or loss. It does not appear that a hypothetical ordinary income result for the sale of stock of a foreign subsidiary should be sufficient to meet the general ordinary income or loss requirement of § 1256(e).

component of a capital asset. In this sense, then, § 988(d) uses the term "hedge" to mean something closer to "identified straddle."

Section 988(d) has substantive effect only as and when the Service issues implementing regulations. To date, the Service has exercised this authority only in the form of a notice providing summary guidance concerning certain perfectly hedged foreign currency borrowings.[110] A discussion of the problems that the drafters will face in fashioning more comprehensive § 988(d) regulations is beyond the scope of this article.[111]

Section 988, of course, applies only to foreign currency gain or loss recognized in taxable years beginning after December 31, 1986. In the period following *Corn Products* and before the introduction of § 988, a number of cases relied on the *Corn Products* doctrine to conclude that gains and losses from foreign currency transactions (including, but not limited to, hedging transactions) were ordinary in character. Since *Arkansas Best*'s reinterpretation of the meaning of *Corn Products* in effect is retroactive to 1955, substantial questions still exist as to the appropriate characterization of taxpayers' foreign currency hedges in pre-1987 open years (other than transactions otherwise protected as hedges of § 1221(1) or § 1221(4) assets).

In some cases, such as a foreign currency dealer's hedging of its own inventory, the same result could have been reached even under the narrow interpretation of *Corn Products* applied by the *Arkansas Best* decision. In fact, the two leading pre-§ 988 cases involving the hedging of foreign currency exposure might well have come to be the same result even after *Arkansas Best*.[112] In *Wool Distributing Co. v. Commissioner*,[113] for example, the taxpayer held wool inventories acquired for U.K. pounds sterling and French francs. Fearing a devaluation of those currencies (which would make its inventories on hand more expensive in U.S. dollar terms than replacement inventory), the taxpayer hedged its exposure by selling short the two foreign currencies. Although the Tax Court struggled more than might be expected with the concept that a

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[110] Notice 87-11, 1987-1 C.B. 423.

[111] See Kleinbard, note 103, at 70-101, for a tentative effort to identify some of those problems.

[112] This article does not discuss such cases as America—Southeast Asia Co. v. Commissioner, 26. T.C. 198 (1956), in which the Tax Court relied on *Corn Products* to conclude that unhedged foreign currency losses incurred in the ordinary course of business gave rise to ordinary, rather than capital loss, despite the fact that foreign currency itself is a capital asset. On this subject, see also Rev. Rul. 78-281, 1978-2 C.B. 204.

For a more complete discussion, see Costello, Tax Consequences of Speculation and Hedging in Foreign Currency Futures, 28 Tax Law. 221 (1975); Miller, Foreign Currency Transactions: A Review of Some Recent Developments, 33 Tax Law. 825 (1980); Newman, Tax Consequences of Foreign Currency Transactions: A Look at Current Law and an Analysis of the Treasury Department Discussion Draft, 36 Tax Law. 223 (1983); Samuels, Federal Income Tax Consequences of Back-to-Back Loans and Currency Exchanges, 33 Tax Law. 847 (1980).

[113] 34 T.C. 323 (1960), acq.

taxpayer can hedge the foreign currency component of its wool inventory without hedging the inventory itself (in U.S. dollar terms), that court ultimately concluded, on the authority of both *Corn Products* and G.C.M. 17322, that the taxpayer's currency transactions were "a form of price insurance and thus connected so closely with the regular conduct of a trade or business as to defy classification as extraneous investments."[114] Presumably, because the exposure being hedged related to the taxpayer's inventory costs, the *Wool Distributing* court would have reached the same result even under an *Arkansas Best* approach to § 1221.

In *Hoover Co. v. Commissioner*,[115] by contrast, the taxpayer hedged its financial balance sheet exposure to currency fluctuations on the carrying value of its U.S. dollar investment in the stock of certain foreign subsidiaries. (The hedge also arguably protected the taxpayer in real U.S. dollar terms from a decline in the U.S. dollar value of that stock attributable to foreign currency devaluations.) The Tax Court rejected the taxpayer's argument that, either under G.C.M. 17322 or *Corn Products*, the losses it sustained as a result of those hedges should be characterized as ordinary:

> Petitioner's business was the manufacture and sale of appliances. None of its receivables from intra or intercompany sales payable in foreign currency were hedged, nor were its purchases expressed in foreign currency hedged. Its inventory was not hedged. Simply put, none of the day-to-day operating aspects of petitioner were in any way involved. Rather, petitioner has specifically stated that its purpose was to protect its ownership interest as expressed in stock. Stock is, except in limited circumstances, a capital asset. Assuming for the moment that the value of petitioner's investment declined as a result of a devaluation, its loss, if any, would be capital.[116]

Obviously, the *Arkansas Best* analysis would lead to the same result.

Cases predating § 988 that involved the hedging of foreign currency exposure not associated with inventory, however—particularly hedges of foreign currency denominated liabilities—required reliance on the Supreme Court's broader doctrine of an extra-statutory exception to the definition of a capital asset.[117] To that extent, both taxpayers and the

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[114] Id. at 331.

[115] 72 T.C. 206 (1979).

[116] Id. at 238.

[117] Thus, in LTR 8127100 (April 13, 1981), the Service held that hedges by a U.S. oil company of its exposure to foreign currency fluctuations with respect to its liability for foreign taxes paid by its foreign branch gave rise to ordinary income or loss under the *Corn Products* doctrine. The Service reached a similar result in TAM 7847004 (Aug. 9, 1978) with respect to a taxpayer's hedge of its net foreign currency exposure attributable to the "net current assets" of a foreign branch.

Service are now left in an uncertain situation. Moreover, the ambiguity need not always work in favor of the government; some taxpayers that reported gains from pre-1987 foreign currency hedges as ordinary income, on the theory that *Corn Products* permitted no other result, may find it advantageous to file refund claims on the basis that those gains in fact were capital in nature.[118]

A very recent case, *Barnes Group, Inc. v. United States*,[119] demonstrates the application of *Arkansas Best* to pre-1987 foreign currency hedges. In *Barnes*, the taxpayer in 1978 entered into a FASB 52 hedge of its balance sheet exposure to fluctuations in the value of Swedish krona as a result of its investment in a Swedish subsidiary. The krona unexpectedly increased in value, and the taxpayer incurred a loss on its short krona forward contracts. The taxpayer argued (and the district court apparently agreed) that *Hoover Co.* interpreted the *Corn Products* doctrine as meaning that losses on a FASB 52 hedge had the same character as the gain that would be recognized on the sale of the stock of the foreign subsidiary in question.[120] Since, in the case of the taxpayer in *Barnes*, gain recognized on the sale of the Swedish subsidiary's stock for its fair market value would have been predominantly recharacterized as ordinary income by virtue of § 1248, the taxpayer argued that, to the extent of such potential § 1248 gain, its foreign currency loss on its hedge should be characterized as ordinary.

The district court held, however, that the *Hoover* decision "must be examined in the light of the Supreme Court's latest pronouncement concerning the characterization of capital gains and losses on the sale of property."[121] The taxpayer attempted to distinguish the holding of *Arkansas Best* on the grounds that the *Arkansas Best* facts did not involve a purported hedge of an ordinary income asset. The court rejected this argument, and instead concluded that since the taxpayer could not demonstrate that its currency exchange transactions were a surrogate for any of the types of property exempted from capital asset treatment under § 1221, "following *Arkansas Best*, the loss incurred [from those currency

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[118] Whether such capital gain would be short- or long-term would depend not only on the period during which the hedge was open, but also on the effect of the straddle rules on holding periods of straddle positions. See, e.g., Temp. Reg. § 1.1092(b)-2T(a). Even short-term capital gain, however, can prove useful to a taxpayer with otherwise nondeductible capital losses.

[119] No. H-84-1008 (MJB), (D. Aug. 29, 1988) Lexis No. 11746.

[120] The rationale advanced by the taxpayer in *Barnes* certainly is one possible explanation for the *Hoover* court's holding that loss on a FASB 52 hedge of foreign subsidiary stock was capital loss. In our view, however, a better interpretation is that the *Hoover* court, having concluded that the taxpayer's ownership of the stock of its subsidiary constituted an investment, rather than any ordinary business asset, simply found that the foreign currency forward contracts designated as a hedge of that stock failed to satisfy the "everyday operation of a business" test necessary for ordinary loss treatment under *Corn Products*. See text accompanying note 116.

[121] — F. Supp. at —, citing *Arkansas Best*.

transactions] was entirely capital in nature."[122]

E. Liability Hedging After Arkansas Best

It is in the area of liability hedging—that is, hedging the U.S. dollar interest rate volatility risks of borrowings incurred or to be incurred—that *Arkansas Best* has worked the greatest mischief to date. Since the mid-1970's, with the rapid growth of exchange-traded options and futures on interest rate sensitive instruments and the development of notional principal amount products,[123] along with broadened familiarity with how to use those products, it has become common for corporate borrowers to hedge their cost of funds in much the same manner that they hedge the cost of their raw materials or the value of their finished inventory.[124] Liability hedging techniques can be complex, but they raise essentially the same tax whipsaw risks for a corporate borrower as faced by the merchants considered in G.C.M. 17322 in connection with hedging their inventories.

To take a simple case, consider a "short hedge," in which a corporate borrower finds current interest rates attractive, but is unable (for example, for regulatory reasons) to immediately access the capital markets. That borrower can immunize itself against fluctuations in the U.S. Treasury component of its borrowing costs simply by selling short U.S. Treasuries of comparable maturity to its contemplated borrowing.[125] When

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[122] In a footnote, the *Barnes* court admitted that the *Arkansas Best* decision creates potential problems for transactions designed to hedge ordinary business assets. The court was quick to point out, however, that the resolution of those problems "will have to await a legislative solution," and pointed to § 1256(e) as an example of this type of legislative solution. — F. Supp. at — n.7. In our view, however, it would read too much into this brief reference to § 1256(e) to conclude that the *Barnes* court read § 1256(e) as having independent operative significance—particularly since § 1256 was not part of the Code for the year in controversy.

Since the taxable year at issue in *Barnes* was 1978, the case did not need to consider how the straddle rules of §§ 1092 and 263, or the exception to those rules for hedging transactions under § 1256(e), might apply to a FASB 52 hedge. If the rationale of the *Barnes* case is extended to treat FASB 52 hedges as yielding capital gains or losses for taxable years between 1981 (when the straddle and mark-to-market rules were enacted) and 1987 (when ordinary income treatment for currency transactions came into effect under § 988), taxpayers may find that an election made in respect of such hedges under § 1256(e) is retroactively disallowed on the ground that the hedges violate that section's ordinary income or loss requirement. In that case, as noted above, taxpayers could find that § 1256(f)(1) may operate to create asymmetric results, by treating gains from such disallowed "hedging transactions" as ordinary income and losses from those transactions as capital losses.

[123] See note 3 for a general description of exchange-traded options and futures contracts. See note 4 for a general description of notional principal amount products.

[124] For a summary of some of these techniques, see Hedging Strategies for the Corporate Borrower (Salomon Brothers Inc., 1985).

[125] U.S. dollar corporate borrowings generally are priced at a spread over U.S. Treasuries of comparable maturity. Both the interest rates on these underlying Treasuries and the spread over Treasuries at which issuers can borrow fluctuate. The short hedge described in the text

the issuer is able to come to the market, it will close out its short position; if interest rates in general have increased during the period, the issuer's interest expense will be greater than would have been the case had the issue come to market sooner, but the present value of that increased interest expense will be roughly offset by gain from closing out the short Treasury position. If prevailing rates go down, the converse will be the case: in that circumstance, the issuer will seek to deduct its loss on the short hedge as, in effect, an offset to the reduction in interest expense it obtains because of the decline in prevailing rates. In the usual case, a short sale of U.S. Treasuries (along with positions in futures, forwards, and similar securities) by a taxpayer that is not a securities dealer gives rise to capital gain or loss.[126] Prior to *Arkansas Best*, however, taxpayers that engaged in short hedges or other forms of liability hedging traditionally relied on the *Corn Products* doctrine to assure that their hedges of borrowing costs (which costs certainly should be considered an integral part of ordinary business operations) gave rise to ordinary income or loss that matched the ordinary nature of the underlying borrowings.

The Service also relied on *Corn Products* to produce symmetry in tax character in the case of liability hedging. Thus, in Technical Advice Memorandum 8623003,[127] a savings and loan association employed futures contracts to hedge against the risk that its short-term borrowings (six-month certificates of deposit) would be rolled over at higher rates. The Service, relying on *Corn Products*, concluded that gains or losses from those futures contracts were ordinary in character.[128] The Service reached a similar result in Letter Ruling 8742061,[129] in which an insurance company used Treasury futures to hedge its interest rate exposure under guaranteed investment contracts and similar financial products that it issued prior to the date of permanently funding those obligations. The Service concluded that those futures transactions gave rise to ordinary income or loss under the *Corn Products* doctrine:

> The transactions described herein are regularly entered into by Corp X in the normal course of its trade or business of selling

immunizes the borrower from movements in Treasury rates, but not from fluctuations in the spread.

[126] IRC § 1233.

[127] TAM 8623003 (Feb. 11, 1986).

[128] Similarly, in LTR 8435054 (May29, 1984), a consumer finance company made long-term, fixed rate loans to customers and temporarily funded those assets with commercial paper. The taxpayer used futures contracts on Treasury Bills and Certificates of Deposit to hedge its exposure to fluctuations in interest rates from the time it made loans to customers to the time it funded those assets with long-term debt. The Service concluded (without citing *Corn Products*) that the futures positions qualified as hedges under § 1256(e), which presupposes that the transactions gave rise only to ordinary income or loss.

[129] LTR 8742061 (July 23, 1987).

> guaranteed investment contracts, SPACs [Single Premium Annuity Contracts] and funding agreements. These transactions are entered into for the purpose of reducing the risk of interest rate changes with respect to obligations incurred or to be incurred by Corp X, thereby assuring the profitability of such business despite changes in prevailing interest rates. Because the transactions constitute an integral part of Corp X's business, any gain or loss resulting from these transactions will be reported by Corp X as ordinary rather than capital gain or loss. See *Corn Products Refining Co.*[130]

Similarly, in enacting § 1256(e) as part of the 1981 Tax Act, Congress defined a "hedging transaction" for these purposes to include transactions entered into to reduce the risk of interest rate fluctuations with respect to borrowings incurred or to be incurred by a taxpayer. In drafting the technical requirements of § 1256(e), Congress therefore must have assumed that a hedge of an ordinary course liability (like any payment on the liability to which the hedge related) would give rise to ordinary income or loss, presumably by application of the *Corn Products* doctrine. It is inconceivable that Congress would first explicitly contemplate that the hedge of a debt obligation could constitute a hedging transaction and then draft detailed technical requirements under which such a hedge necessarily would fall outside the definition (on the grounds that it did not give rise to ordinary income or loss).

The Supreme Court's analysis in *Arkansas Best* effectively limits the broad *Corn Products* doctrine to, at most, a doctrine that assimilates hedges of assets described in one of the enumerated exceptions of § 1221 into the (generally ordinary) character of these exceptions. However, it is difficult to assimilate liability hedge products, such as forwards, futures, short physicals, and similar positions, into any exception to § 1221 in the manner available for inventory hedges, for the simple reason that the exposure being hedged (the taxpayer's own obligation) by definition is not "property" for tax purposes,[131] and therefore is wholly outside the reach of § 1221.

Thus, to return to the short hedge described above, the taxpayer that engages in such a transaction today is in considerable jeopardy that any loss recognized on that short Treasury position would be characterized as capital loss, despite the fact that, as an economic matter, the short Treasury position was designed to immunize the taxpayer from exposure to volatility in its deductible interest expense. Moreover, if the taxpayer's short position were a § 1256 contract held over a taxable year end, it

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[130] Id.

[131] See In re State Tax on Foreign Held-Bonds, note 89 and accompanying text.

generally would be subject to the mark-to-market rules of § 1256, because the transaction would not qualify as a hedging transaction for purposes of § 1256(e).[132]

It is possible to imagine several plausible arguments available to a taxpayer already caught in this untenable situation. A taxpayer might assert, for example, that the *Arkansas Best* decision leaves undisturbed the original concept of G.C.M. 17322—that a hedging transaction is one that acts as a form of "price insurance" in respect of the exposure being hedged. Since an interest rate hedge, such as shorting Treasuries, effectively locks in the Treasury component of a taxpayer's costs of borrowing in the same manner that the hedges considered in G.C.M. 17322 locked in inventory costs, it is not ludicrous to assume that G.C.M. 17322 might have ruled favorably on such interest rate hedges had the concept existed at that time. Nonetheless, in the wake of *Arkansas Best*'s revisionist history, only a remote possibility exists that any lower court would seize upon the opportunity to create a new extra-statutory exception to § 1221.

Alternatively, a taxpayer might make a more complex argument based on the Supreme Court's attempt in its *Arkansas Best* opinion to distinguish *P.G. Lake* and other assignment of income cases.[133] Given the Supreme Court's acknowledgement that certain sales transactions should be treated as not involving any form of property for purposes of § 1221, might a court not be amenable to a similar nonproperty analysis of an obligor's own liability that would allow that liability to be analyzed outside the scope of § 1221? Even assuming that a court accepted this nonproperty approach to liabilities, however, it would have to make a further, more difficult, analytical leap in order to treat the gain or loss on a liability hedge (which hedge generally would be characterized on its own as a property interest) as "assimilated" into the taxpayer's overall nonproperty borrowing costs by analogy to the assimilation theory used by the *Arkansas Best* case in respect of inventory hedges. In the absence of regulatory approval,[134] it would seem that such a complex and metaphysical argument, while theoretically interesting, might be practical only as the taxpayer's last resort.

As a result of these difficulties, one practical effect of the *Arkansas Best* case has been substantially to eliminate the interest of corporate borrowers in simple short hedges of the type described above. Instead, borrowers have discovered that, by using interest rate swaps and similar

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[132] As described above, this timing dilemma is particularly frustrating in light of the explicit language of § 1256(e), which clearly contemplates that transactions entered into to reduce the risk of interest rate fluctuations with respect to borrowings incurred or to be incurred by taxpayers will fall within its scope.

[133] See note 97.

[134] See the discussion in Part VI concerning interim solutions under consideration by the Service.

notional principal amount products, rather than classic forwards, futures, or short physicals, they can advance convincing arguments that losses incurred in their liability hedging are ordinary in character, and, in addition, through controlling their closing transactions, can argue that any gains on their hedges are capital gain.

Consider, for example, the taxpayer anticipating a future borrowing that previously would have created a short hedge as described above. Instead of shorting physical Treasuries, the taxpayer could establish an economically similar hedge by entering into an interest rate swap, under which it agrees to pay fixed rate amounts and receive floating rate amounts. If prevailing interest rates increase between the time the issuer establishes the swap and the time it comes to market with its debt offering, the taxpayer's higher cost of borrowing should be offset by a built-in profit on its swap position; conversely, if rates decline, the issuer's lower coupon on its debt will be offset by a built-in loss on its swap position.

If the taxpayer wishes to "monetize" its position in respect of the swap, it can dispose of its rights and obligations under the swap agreement in one of two ways: by terminating the agreement with the original counterparty, or by assigning the swap position (including both rights and obligations) to an unrelated third party. Although these disposition methods are economically similar, the absence of a "sale or exchange" in the case of a termination with the original counterparty permits a taxpayer to make persuasive arguments under current law for differences in the character of gain or loss depending on the method of disposition.[135]

Under the so-called "extinguishment" doctrine, payments made between parties in consideration for the termination of a contractual arrangement are not considered to arise from the sale or exchange of property, and therefore cannot give rise to capital gain or loss (which, under § 1222, presupposes such a sale or exchange).[136] By extension of

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[135] For a discussion of the sale or exchange doctrine in the context of the ordinary income/capital gains debate, see Note, The Troubled Distinction Between Capital Gain and Ordinary Income, 73 Yale L.J. 693, 701-704 (1964).

[136] See, e.g., Fairbanks v. United States, 306 U.S. 436 (1939) (gain realized on call of corporate bonds treated as ordinary income); Watson v. Commissioner, 27 B.T.A. 463 (1932) (loss realized on redemption of bonds purchased at a premium treated as ordinary loss). The enactment of § 1232 (the predecessor to current § 1271), which treats the retirement of corporate debt obligations as involving a sale or exchange for tax purposes, put a stop to the extinguishment doctrine as applied to corporate bonds; however, ordinary income or loss treatment under the extinguishment doctrine continues to be the rule for amounts received on redemption of debt obligations not covered by the statutory sale or exchange rule (such as residential mortgages and other debt obligations of individuals). See, e.g., Riddle v. Scales, 406 F.2d 210 (9th Cir. 1969); Wegner v. Commissioner, 42 B.T.A. 225 (1940), aff'd per curiam on other grounds, 127 F.2d 523 (6th Cir.), cert. denied, 317 U.S. 646 (1942).

Moreover, the extinguishment doctrine has been applied to the termination of certain other contractual arrangements. See, e.g., Commissioner v. Pittston Co., 252 F.2d 344 (2d Cir.), cert. denied 357 U.S. 919 (1958) (payment for termination of coal production contract held ordinary income); General Artists Corp. v. Commissioner, 205 F.2d 360 (2d Cir.), cert. denied,

this learning, a payment made to or received from the original counterparty to a swap for the termination of a swap position would generate ordinary income or loss.[137] Section 1234A (which treats as capital any gain or loss from the termination of a right or obligation with respect to personal property as defined by § 1092(d)(1)) should not change this result, because an interest rate swap is not personal property within the meaning of § 1092: Interest rate swaps themselves are not property of a type which is actively traded, and, as discussed above, the underlying property in which that swap is a position (U.S. dollars) is not considered personal property for these purposes. On the other hand, the assignment by one party of an in-the-money swap position to an unrelated third party is generally viewed under current law as the sale or exchange of a property right that, according to the *Arkansas Best* analysis, normally would constitute a capital asset.[138] Consequently, in the absence of an

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330 U.S. 826 (1953) (payment received for cancelling exclusive contract arrangement with a singer held ordinary income); Commissioner v. Starr Brothers, 204 F.2d 673 (2d Cir. 1953) (payment received in return for waiving non-competition covenant in contract held ordinary income).

See also Pressed Steel Car Co. v. Commissioner, 20 T.C. 198 (1953), acq. 1956-2 C.B. 198 (ordinary deduction allowed for payment made by manufacturer to extinguish liability under disputed manufacturing agreement); Olympia Harbor Lumber Co. v. Commissioner, 30 B.T.A. 114 (1934), acq. XIII-1 C.B. 12 (ordinary deduction allowed for payment to cancel contract requiring taxpayer to pay another company to dispose of waste from taxpayer's sawmill); Appeal of Metro Pictures Film Exch., 1 B.T.A. 721 (1925), acq. IV-1 C.B. 3 (ordinary deduction allowed motion picture distributor for remaining basis in terminated distribution contract).

[137] Although interest rate swaps involve payments measured by traditional interest rate formulae, swap contracts themselves cannot fairly be equated with corporate indebtedness that is excluded by statute from the scope of the extinguishment doctrine. As described in note 4, the notional principal amount of an interest rate swap is not borrowed or loaned between the parties. Thus, unlike a classic borrowing, a traditional interest rate swap (that is, one that does not provide for irregular cash flows) does not furnish either party with cash proceeds to spend currently in exchange for a promise to return that cash (with interest thereon) in the future.

[138] Due to the lack of definitive authority concerning the nature of a swap position for tax purposes, the appropriate tax treatment for the assignment of a swap position is far from settled. For example, since the assignment of an interest rate swap position typically requires the consent of the swap's counterparty, the assignment possibly could be viewed as a novation, with the counterparty entering into a new swap with the assignee, and the assignor being treated in all events under the termination analysis presented above. This approach, if carried to its logical conclusion, would mean that the counterparty would create a taxable event for itself by consenting to the assignment—a result that would surprise a great many counterparties in the swap markets today, and would run plainly counter to the law in analogous areas (for example, the assignment of franchises, where the franchisor's consent typically is required, and where the assignment nonetheless is treated as a sale or exchange).

Another possible analysis is that a swap position is not a unitary item of property at all, but rather represents a simple income stream matched with a simple expense stream, the assignment of which might give rise to ordinary income by analogy to the cases involving, for example, sales of mortgage servicing contracts. See, e.g., Bankers Guarantee Title & Trust Co. v. United States, 418 F.2d 1084 (6th Cir. 1969); General Guarantee Mortgage Co. v. Tomlinson, 335 F.2d 518 (5th Cir. 1964); Bisbee-Baldwin Corp. v. Tomlinson, 320 F.2d 929 (5th Cir. 1963). In the view of the authors, however, these cases were wrongly decided, in that they fail

applicable rule regarding liability hedging transactions, payments received in exchange for the assignment of a valuable swap position in general would be thought to constitute capital gain.[139]

This difference in the character of gain or loss from the termination or assignment of swap positions may allow taxpayers to effectively elect ordinary or capital treatment simply by altering the method of disposing of a position.[140] From the taxpayer's perspective, this distinction merely creates a trap for the unwary by maintaining the potential for the recognition of capital losses on poorly planned swap dispositions. From the perspective of the Service, however, this difference in treatment could set the stage for serious tax whipsaws. Should a tax rate differential for capital gains be reintroduced, taxpayers would have an incentive to claim capital gain and ordinary losses for swap dispositions by assigning their gain positions to third parties and terminating their loss positions.[141]

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to distinguish between the assignment of a right to receive previously earned income and the assignment of a right to earn that income. Compare *P.G. Lake*, note 97, with United States v. Dresser Indus., 324 F.2d 56 (5th Cir. 1963). Moreover, since a swap plainly can give rise to either net gain or net loss from year to year, the better argument is that a swap position is a form of property, and not a simple right to income, for tax purposes.

[139] Not surprisingly, less consensus exists with respect to the appropriate tax treatment of the more unusual case involving a party that assigns an out-of-the-money swap position. Because the assignor in that case generally is required to make, rather than to receive, a net payment in connection with the assignment, the transaction takes on more of the character of payment for relief from a burdensome liability than the sale of a valuable property right. The authority that appears most closely analogous concerns the issue of payments made by a property owner to induce a potential purchaser to assume an unfavorable lease or liability associated with the property. In those cases, which generally address tax consequences to the purchaser, not the seller, courts have held the net payments to be a reduction in the purchase price paid and therefore in the purchaser's tax basis for the property. See, e.g., Oxford Paper Co. v. Commissioner, 194 F.2d 190 (2d Cir. 1952). Unlike those cases, the assignor of a loss swap position receives no net proceeds that could be subject to reduction. Moreover, according to currently accepted wisdom, a swap party is thought to have no tax basis in its swap position. The concept of recognizing a capital loss, which generally is defined as the excess of the seller's tax basis in property over the amount received on resale, thus is difficult to apply in respect of assigning a loss swap position.

An intriguing alternative analysis would be to view a swap position as a hybrid instrument that takes on the characteristics of a property interest when it has positive value and the characteristics of a liability when its value turns negative. Under this approach, payments received by the assignor of a swap position generally would be treated as capital gain under *Arkansas Best*, while amounts paid by the assignor to induce an unrelated party to assume a loss position would constitute ordinary losses.

[140] This distinction also creates the possibility of a novel form of tax extortion: A swap counterparty, recognizing the importance to the taxpayer of extinguishing, rather than assigning its swap position, might extract a premium from the taxpayer to terminate the swap.

[141] It should be noted that a similar choice for the taxpayer (and whipsaw potential for the Service) would exist in respect of another broad category of notional principal amount products—interest rate caps and floors—to the extent that the Service views such products as not involving any specific "underlying property," as has been suggested by some commentators. (See note 4 for a general description of interest rate caps and floors.) To the extent that a cap or floor is viewed as involving a series of actual cash settlement options, however, § 1234 apparently would require that the scheduled payments under a cap or floor give rise to the

Ironically, it was precisely this sort of tax whipsaw that the Service was attempting to prevent when it originally litigated the *Corn Products* case.

An alternative theory available to taxpayers that use notional principal amount products as hedges (either of liabilities or of noninventory business assets) would be to analyze such products as "depreciable property" excepted from the general definition of a capital asset by virtue of § 1221(2). Like a patent, which clearly is within the scope of § 1221(2), a taxpayer's position in respect of a notional principal amount product might be viewed as an intangible asset with a limited useful life. Similarly, in the absence of authority superseding the "economic performance" standard of § 461(h), most taxpayers have assumed that any initial premium paid in respect of a notional principal amount product can only be recovered through amortization over the term of the product in a manner that economically resembles deductions allowable for the "depreciation" of patents and other intangible assets. The fact that (at least in the case of interest rate swaps) no initial premium is paid in respect of a traditional "at the market" position should not affect this analysis, any more than one would argue that equipment with a tax basis of zero thereby loses its character as property "of a character which is subject to the allowance for depreciation."[142]

Admittedly, to fall within the exception of § 1221(2), a notional principal amount product also must be "used" by the taxpayer in its trade or business.[143] The word used works well when applied to machinery or even patents, but fits awkwardly, at best, in the case of swaps or similar executory contracts entered into (in the typical case) to insure against interest rate exposure.[144] Would one ordinarily say, for example, that fire insurance premiums are used in a taxpayer's trade or business?

It should be noted that characterizing interest rate swaps and similar notional principal amount products as § 1221(2) property would not necessarily foreclose the possibility of unintended characterization results.

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same character of income as the underlying property in the hands of the taxpayer. Because the underlying property for a cap or floor, such as a Eurodollar future or hypothetical debt instrument, typically would constitute a capital asset (other than for dealers in such products), this analysis normally would cause cap or floor payments to generate capital gain or loss. Similarly, under this analysis, the disposition of a cap or floor prior to its scheduled maturity generally would produce capital gain or loss by virtue of the rules of § 1234A, regardless of whether structured as a cancellation of the agreement with the original counterparty or as an assignment to a third party.

[142] IRC § 1221(2).

[143] Section 1256(e), by contrast, requires only that the transaction in question be "entered into by the taxpayer in the normal course of the taxpayer's trade or business."

[144] As noted above, *dealers* in notional principal amount products can advance an additional—and much more plausible — argument that, in their hands, notional principal amount contracts constitute § 1221(4) accounts or notes receivable. See text accompanying notes 100-101.

A § 1221(2) asset, once held for more than one year,[145] metamorphasizes into a "section 1231" asset, the gain or loss from which is tossed into the taxpayer's § 1231 "hotchpot." As a result, a loss recognized, for example, with respect to the disposition of an interest rate swap that ends up in a taxpayer's § 1231 hotchpot may have the effect of offsetting gain that otherwise would be taxed as long-term capital gain. Because of § 1231's pro-taxpayer asymmetry of result, however, a net loss that emerges from the hotchpot will be allowed as an ordinary loss. Although certainly not dispositive of any intent to exploit these asymmetrical results, it is instructive to note that taxpayers' interest in characterizing interest rate swaps as § 1221(2) assets mushroomed dramatically in the weeks that followed the release of the Supreme Court's decision in *Arkansas Best*.

VI. Repairing the Damage

Because *Corn Products* universally was read both broadly and pragmatically for over 30 years, the Supreme Court's decision in *Arkansas Best* has created a void in the application of hedging concepts to straightforward commercial and financial transactions that U.S. corporations enter into on a daily basis. Moreover, the Supreme Court's narrow reading renders § 1256(e) inoperative in broad areas—such as liability hedging—to which it was plainly intended to apply. With the repudiation of concepts clearly relied on by Congress (in enacting § 1256(e)) and the Service (in both published and private letter rulings), both taxpayers and the government are now exposed to unpredictable tax whipsaws.

By phrasing its opinion as an interpretation of the original *Corn Products* decision, the *Arkansas Best* Court made its repudiation of the *Corn Products* doctrine effective retroactive to the creation of that doctrine (circa 1955); accordingly, in the absence of an administrative or legislative initiative, the Service could challenge positions taken in all open taxable years of taxpayers that in good faith relied on *Corn Products* as widely interpreted at the time. To apply *Arkansas Best* retroactively to such transactions will mean, in practice, that Congress and the Service will have required taxpayers to rely on the then-common understanding of *Corn Products* to elect § 1256(e) hedging treatment, only for those taxpayers now to discover that they were the victims of a bizarre trap, in which their now-failed § 1256(e) hedges in retrospect may be treated as giving rise to ordinary income and capital loss under § 1256(f)(1).[146] Such a result is so palpably unfair as to demand a prompt administrative

[145] Six months, if acquired before January 1, 1988.

[146] As described in Part V.B., § 1256(f)(1) precludes a taxpayer from treating gain arising from a transaction designated as part of a § 1256(e) hedge as anything other than ordinary income.

remedy.[147]

To its credit, the Service has indicated that it is aware of the inappropriate results reached by *Arkansas Best* in several areas, particularly liability hedging, and the Service is apparently struggling to develop administrative solutions to some of those problems.[148] This search for an administrative response must focus on both the retroactive and prospective application of the *Arkansas Best* case to business hedges.

The Service would appear to have the authority to administer the tax laws without giving retroactive effect to *Arkansas Best*. Section 7805(b) gives the Service authority to prescribe the extent to which "any ruling or regulation . . . shall be applied without retroactive effect."[149] Of course, a Supreme Court decision is neither a ruling nor a regulation within the meaning of § 7805(b). As frequently observed in the course of this article, however, during its heyday, the *Corn Products* doctrine found articulation, not merely in the minds of taxpayers, but also in a substantial number of published revenue rulings.[150] Taxpayers plainly were entitled to rely on those revenue rulings prior to their suspension in Notice 87-68.[151] Moreover, under § 7805(b), the Service has the power to revoke those rulings prospectively, rather than retroactively. Ironically, then, it would appear that the Service's own "mistaken" rulings that relied on the prior understanding of *Corn Products* give the Service a substantial degree of authority to protect taxpayers indirectly from the retroactive application of *Arkansas Best*.

The same result can be reached in a more pragmatic fashion. If the Service were to issue a notice concluding that, as a matter of administrative comity, *Arkansas Best* would be applied with prospective effect only, what party would have standing to complain? Taxpayers that might be attracted by the prospect of filing amended returns to claim capital gain treatment for hedge gains almost always will be stymied by § 1256(f)(1). While it is true that a taxpayer might on some occasions prefer a capital loss to an ordinary one, over the course of many years of hedging transactions, it is unlikely that there will exist many taxpayers that will find it advantageous to have hedge losses consistently treated as capital, and

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147 One open question is whether any limitation on the retroactive application of the *Arkansas Best* decision should protect all transactions entered into before the release of the Supreme Court's opinion, or only transactions entered into before the release of Notice 87-68, note 77, which suspended the Service's published revenue rulings that relied on or applied the *Corn Products* doctrine pending the Supreme Court's decision in *Arkansas Best*.

148 Matthews & Evans, IRS Officials Review New Financial Product Developments, 40 Tax Notes 1327 (1988).

149 For an interesting discussion of the history behind § 7805, see Helvering v. Griffiths, 318 U.S. 371, 397 n.49 (1943).

150 See notes 59-61.

151 See note 77.

post-1981 hedge gains treated as ordinary (by virtue of § 1256(f)(1)).[152]

Turning to the prospective application of *Arkansas Best* to business hedges, the discussion in Part V of this article has suggested that the greatest damage done by *Arkansas Best* with respect to future business hedges is in the area of liability hedging—an activity that Congress plainly thought resulted in ordinary income/loss treatment, as indicated by the language of § 1256(e), but one that is particularly difficult to fit within the framework of *Arkansas Best*. In this regard, the Service is thought to be considering two possible interim solutions. The first such approach would be to adopt the argument suggested earlier, under which hedges of liabilities would be assimilated into those liabilities;[153] since a liability itself gives rise only to ordinary income or loss to an obligor, the argument would be that the assimilated liability hedge would take on the same character as the liability being hedged, in much the same manner that *Arkansas Best* suggests that inventory hedges should be assimilated into the taxpayer's inventory costs (at least for character, if not timing, purposes).

One difficulty with this approach, of course, is that it is susceptible of being extended too far, thereby recreating the very problems with the *Corn Products* doctrine that *Arkansas Best* sought to resolve. Moreover, as discussed above, in the area of liability hedging, the assimilation argument must deal with the troublesome fact that most liability hedges, which are themselves clearly property interests, would become excluded from the scope of § 1221 by "assimilation," not into one of the statutorily protected types of property (as suggested was appropriate in *Arkansas Best*), but rather into nonproperty (the indebtedness being hedged). In light of *Arkansas Best*'s admonition that § 1221 must be read literally, it is not clear that the Service would be on sound technical ground in using an assimilation theory to resolve the current tax ambiguities in liability hedging.

The second approach said to be under consideration by the Service would restore Congress' intended purpose for § 1256(e) by reading that provision to be a substantive characterization rule, under which transactions that qualified as § 1256(e) hedges of ordinary income or loss positions would themselves be characterized as giving rise exclusively to

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[152] Of course, one can imagine certain hypothetical situations in which taxpayers nonetheless might find filing amended returns advantageous (e.g., net hedge gains prior to the 1981 effective date of §§ 1256(e) and 1256(f)(1), and break-even hedge results thereafter), but those hypotheticals seem improbable in the context of large-scale business hedging operations. Accordingly, the possibility of such a taxpayer emerging and winning a lawsuit challenging the Service's authority to limit the retroactive effect of *Arkansas Best* should not overcome the more substantial unfairness that would result if *Arkansas Best* were applied retroactively.

[153] See text accompanying notes 133-34.

ordinary income or loss.[154] Such a substantive reading of § 1256(e), while addressing problematic timing issues for many hedging transactions, might not be sufficient to solve issues of mismatches in the character of gain or loss on certain other common hedges. As discussed in Part V.B. for example, a hedge of a U.S. dollar liability does not create a straddle for purposes of § 1092. Accordingly, a hedge of a U.S. dollar liability that employs positions that are not themselves described in § 1256 (for example, an interest rate swap or a short position in Treasury securities) is not subject to either § 1092 or § 1256, and therefore presumably is outside the scope of § 1256(e)'s exception to those provisions. As a result, a substantive reading of § 1256(e) would produce matching character treatment of gains and losses when, for example, interest rate futures contracts were used as liability hedges, but not when some other forms of hedge vehicles were employed.

To resolve this second problem, the Service is said to be considering a rule that essentially would adopt the extinguishment argument advanced earlier in respect of interest rate swaps and similar notional principal amount products.[155] Taxpayers would be able to assure themselves of ordinary losses on such swaps and similar arrangements used as liability hedges by closing out those contracts with their counterparties; as a temporary concession to the orderly administration of the tax laws, the Service presumably would tolerate the whipsaw risk of taxpayers selling gain positions to third parties and claiming capital gain treatment.[156]

Two objections can be raised to this approach. First, while Congress no doubt would have drafted § 1256(e) differently had it been prescient enough to predict the reasoning adopted by the *Arkansas Best* case, in fact, Congress viewed the *Corn Products* doctrine as a necessary condition to the largely procedural operation of § 1256(e).[157] A substantive reading of § 1256(e) thus would do justice to congressional intent, but considerable violence to the words of the statute. The second objection that might be raised to the proposed solution is its stop-gap nature, in that it does not address all liability hedging vehicles (e.g., the short hedge using Treasury securities described above), and may require the cooperation of counterparties to notional principal amount contracts in order to implement any extinguishment safe harbor that may be created. Having made these observations, it must be conceded that an imperfect solution is much to be preferred over no solution at all.

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154 Matthews & Evans, note 148, at 1328.

155 Id.

156 Id. See notes 138-39 and accompanying text for a discussion of the tax characterization in general of gain or loss recognized on the assignment of an interest rate swap or similar notional principal amount contract.

157 See notes 94-95 and accompanying text.

There exists a third possible administrative solution to the issue of liability hedging that to date appears not to have been considered by the Service, but that has the considerable advantage of being clearly within the scope of the Service's authority, while at the same time resolving the difficult *timing* issues raised by liability hedges—a problem that predates (and possibly is unaffected by) *Arkansas Best*.[158] This third solution would be to develop a new tax accounting regime for the cost of debt capital, under the Service's broad authority to create tax accounting rules where necessary to provide a "clear reflection of income."[159] As part of that tax accounting system, *all* the costs of a taxpayer's liabilities (including any hedges or offsets thereto) would be treated as components of the taxpayer's overall cost of financing, and amortized as increases or reductions in those costs over the life of the taxpayer's borrowings. Such an "integration" system would bring the tax law into conformity with both financial accounting and the pretax economics of liability hedging.[160] Admittedly, however, such a solution would represent a radical (albeit logical) departure from past practice, and might take longer to formulate than either of the two other possible solutions said to be under active consideration.

Despite the Service's earnest efforts, it thus appears unlikely that a timely administrative solution to the problems created for business hedges by *Arkansas Best* can be developed that will be comprehensive, fair, and within the scope of the Service's authority to promulgate. All such administrative approaches therefore should be approached as stopgap or partial solutions to a problem that demands immediate legislative attention. The task before Congress it not particularly daunting from a drafting point of view: All that is required is to (1) correct § 1256(e) to take what had been an implicit premise—that hedges of ordinary income or loss activities described therein would themselves give rise to ordinary gain or loss—and make that premise into an explicit operative rule; and (2) make that rule a stand-alone Code section not limited in its application to § 1256 contracts or § 1092 straddles. Such a rule would restore ordinary commercial and financial hedging to its pre-*Arkansas Best* set-

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[158] For example, if the taxpayer in the short hedge example discussed in Part V.E. recognizes a gain on its short Treasury position, that gain will be offset economically by the higher interest that the taxpayer will pay over the life of its borrowing. In contrast, the taxpayer's hedge gain (regardless of its character) will be immediately includable in income. In the converse case (hedge loss and lower cost of borrowing), however, the taxpayer is at considerable jeopardy that its hedge loss will be viewed as a cost of its financing and, therefore, amortized over the life of the borrowing. These and similar timing anomalies can cause considerable difficulties in structuring liability hedges that produce after-tax results consistent with their pretax economics.

[159] IRC §§ 446, 461.

[160] Compare the limited integration rules now available for certain foreign currency hedges under Notice 87-11, note 110.

tled state of mandatory ordinary income or loss, while at the same time preserving the result of the *Arkansas Best* case itself, under which the sale of stock of a subsidiary must give rise to capital gain or loss. In the absence of such legislative (or, conceivably, administrative) action, *Arkansas Best* will mark the end of the *Corn Products* doctrine, but the beginning of many decades of litigation concerning the tax consequences of a wide range of ordinary course of business hedging transactions—litigation in which taxpayers and the fisc both may find themselves in jeopardy from case to case.