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BARRY LEIBOWICZ, Esq., *Assistant Professor, Dept. of Accounting and Information Systems, Queens College, CUNY, Flushing, N.Y.; partner, Leibowicz and Koch, New York, N.Y.*

Hedging in foreign currency: capital or ordinary?

Introduction

Multinational corporations have, in recent years, been subjected to the distorting effects of increasingly volatile foreign exchange markets, and the currency fluctuations which attend them. Under current financial accounting principles, the consolidation process requires foreign assets and liabilities to be converted to dollar equivalents at the year-end exchange rate. The difference between the asset and liability accounts subject to the effect of year-to-year currency exchange fluctuation is known as the "net exposure" of the parent corporation in its foreign subsidiaries. Since the conversion rate is subject to change, there may be a gain or loss produced solely on the basis of such a year-to-year difference in exchange rate.

The book profits and losses thus generated, as well as the U.S. taxes related to them which may be accrued on the financial statements, would, of course, not be considered in determining the U.S. tax liability of the parent, since consolidation for tax purposes with a foreign subsidiary is not permitted. Aside from the lack of U.S. tax consequences, however, corporations are unwilling in many instances to risk distortion of their financial statements and the corresponding effect on their "image" in the minds of the investment community. This, as well as other factors, has led multinational corporations to look for ways to lessen the effect of translation (currency conversion) gains and losses.

The device most often used for this purpose is the foreign currency hedge transaction. In such a transaction, a U.S. parent, through contracts be-

tween it and a third party (in most instances an international bank) agrees to buy or sell the appropriate foreign currency for a fixed dollar price at some future date. By keying these hedge transactions precisely to the amount of net exposure in each foreign subsidiary, it is hoped that a direct offset to, and neutralization of, the effect of the translational gain or loss will result. With the increased volatility of foreign exchange markets in recent years, these transactions have become a widely accepted response of corporate management to this problem.

Character of hedge gains and losses

The hedge transactions themselves, designed as the solution to one problem, pose others. Although the translation gains and losses which are to be offset have no effect on the U.S. corporate tax liability, those generated by the U.S. parent's hedge do.

Accordingly, in order to cope with the tax effect of the hedge transactions themselves, while providing the offset necessary to neutralize the translational gains and losses, the U.S. parent must hedge such amounts as will produce a net after-tax effect equal and opposite to the anticipated net exposure. It therefore becomes as important to accurately predict the tax cost of a given hedge as it is to estimate the subsidiary's net exposure. The significant question here is whether gains and losses resulting from the hedge will be capital or ordinary in character. Of primary importance is the predictability of a particular characterization, rather than the characterization itself; it is the after-tax gain or loss which must offset and neutralize the net foreign exposure. It should be noted at this point that of all the alternative forms of characterization available, characterization of a loss as capital would be particularly disadvantageous, since it could not offset ordinary corporate income. Despite the general desirability of gains, and the benefits to be derived from their treatment as capital, the inability of corporate management to predict the outcome of any particular transaction, as to gain or loss, would seem to imply that ordinary treatment of these items would lend itself to more effective hedge operations than the capital treatment alternative. This is particularly true in these transactions since their primary goal is not the generation of gain, but rather the neutralization for book purposes of translational gain and loss from year to year.

A gain or loss from the disposition of property will be ordinary in character, rather than capital, unless the transaction generating such gain or loss constitutes, or is deemed to be, a "sale or exchange of a capital asset."[1] In analyzing the tax effect of foreign currency futures transactions as hedges, it thus becomes necessary to determine whether

—the futures contracts are capital assets in the hands of the parent corporation, and

—the disposition of the assets which generates the gain or loss can be considered a "sale or exchange."

The *Corn Products* doctrine

Capital assets are defined in Sec. 1221 as items other than those falling within the specified categories, such as depreciable property used in trade or business or inventory, specifically enumerated in the statute. Currency futures, not being literally within the scope of these categorical exceptions to capital asset status in Sec. 1221, would appear to be capital assets when held for hedge purposes. See *Midland Distributors, Inc.*[2] The definition of what is not a capital asset, however, has been expanded by the courts to deny capital asset status to assets involved in transactions which constitute an integral part of the taxpayer's ordinary business operations.[3]

The rule of law promulgated by the Supreme Court in *Corn Products* has been interpreted by the courts to provide, for example, that:

> If securities are purchased by a taxpayer as an integral and necessary act in the conduct of his business, and continue to be so held until time of their sale, any loss incurred as a result thereof may be fully deducted from gross income as a business expense or ordinary loss, but if an investment purpose motivated purchase or holding of securities, any loss realized upon their ultimate disposition must be treated in accord with the capital asset provisions of the Internal Revenue Code.[4]

Thus, to the extent currency futures transactions are so closely connected with the regular conduct of a multinational's trade or business operations as to form an integral part thereof, all gains and losses arising from them would be ordinary.[5] On the other hand, if they represent investment, rather than an outgrowth of ordinary routine business activity, they would be capital in character. Issues of capital or ordinary characterization are questions of fact in each case. While the format of Sec. 1221 would seem to imply a desire by Congress for a broad and expansive definition of capital asset items, courts have, since the *Corn Products* decision, expanded the exclusions from capital asset treatment broadly so as to narrow the

[1] See Sec. 1222.

[2] Midland Distributors, Inc., 481 F2d 730 (CA-5, 1973) (32 AFTR2d 73-5390, 73-2 USTC ¶9543), aff'g DC, Fla. (30 AFTR2d 72-5306, 72-2 USTC ¶9606).

[3] Corn Products Refining Co., 350 US 46 (1955) (47 AFTR 1789, 55-2 USTC ¶9746).

[4] Booth Newspapers, Inc., 303 F2d 916 (Ct. Cl., 1962) (9 AFTR2d 1693, 62-2 USTC ¶9550). Compare the recent case of W. W. Windle Co., 65 TC No. 62 (1976), on appeal to CA-1.

[5] Wool Distributing Corp., 34 TC 323 (1960).

scope of the definition of a capital asset.[6] Courts have even gone so far as to grant ordinary treatment to such a seemingly capital asset as stock in a subsidiary corporation.[7] Only one case has been decided to date which deals with the characterization of gains or losses resulting from currency futures contract hedge transactions designed to offset translational gain and loss effect on book profit.

The *International Flavors & Fragrances* case

In this case,[8] the taxpayer (IFF) created and manufactured flavors and fragrances used by other manufacturers in their products. The case arose out of a transaction in December, 1966, when IFF was apparently concerned about the effect an expected devaluation of the British pound would have on its annual statement. (The accounts of a British subsidiary were included in IFF's consolidated statement expressed in U.S. dollars.) At that time, IFF contracted to sell to *A*, a bank, 1.1 million pounds sterling at $2.80 per pound, delivery and payment to be made on Jan. 3, 1968. This amount covered, on an after-tax basis, the exposed net current assets of the British sub. In November, 1967, the pound was devalued from $2.80 to $2.40.

Two weeks before the Jan. 3, 1968, delivery date, IFF purportedly sold its contract with *A* to *B*, another bank, for $387,000. On the same day, *B* and IFF notified *A* of their agreement, and *B* agreed to assume liability thereunder. Also on the same day, *B* contracted to buy from *A*, at the new $2.40 rate and for delivery on Jan. 3, 1968, the pounds it needed to fulfill IFF's contract with *A*. On the next day, Dec. 21, 1967, *B* sent a check to IFF for $387,000, the agreed-upon price for purchase of the contract. On Jan. 3, 1968, *B* closed out the contract with the 1.1 million pounds sterling purchased from *A* on Dec. 20, 1967, making a net gain on the transaction of approximately $10,000.

At issue was the proper tax treatment of the $387,000 received by IFF from *B*. In the Tax Court, IFF argued that this sum was gain from the sale of a capital asset held over six months and was thus a long-term capital gain. The IRS took alternative positions: the transaction with *B* was not a bona fide sale of contract rights, but rather the purchase by IFF through *B* of the pounds necessary to fulfill its forward sale contract with *A*, and the resulting gain was therefore to be treated as short-term capital gain under Sec. 1233, governing short sales. Alternatively, IFF's contract with *A* was not a capital asset, and the gain on the sale was ordinary income under the *Corn Products* doctrine.

A majority of the Tax Court accepted the second IRS argument and did not decide the merits of the first. Three judges dissented, holding that *Corn Products* did not apply because the contract and the underlying property (pounds) were not the "normal source" of IFF's business income, and that the sale of the contract to *B* was bona fide. Judge Tannenwald, joined by two other judges, concurred on different grounds. He avoided issues relating to the *Corn Products* doctrine and Sec. 1233. Instead, he concluded that short-term capital gain treatment was proper because *B* was in reality acting on behalf of IFF, and there was no bona fide sale of property to *B*. The facts were that IFF settled its forward *sale* agreement with *A* on Dec. 20, 1967, by entering into an offsetting forward *purchase* agreement, through *B*, with *A*. The inference that the transaction with *B* was not bona fide was based on the facts that *B*, at the time it purchased IFF's contract with *A*, also purchased pounds sterling from *A* to cover *B*'s liability to produce pounds, and that IFF failed to prove that it did not participate in, or know of, the latter transaction.

On appeal to the Second Circuit, IFF argued that the dissenting Tax Court judges were correct. The IRS, however, no longer relied on either the *Corn Products* doctrine (the basis of the Tax Court decision in its favor) or Sec. 1233, but instead adopted the analysis of Judge Tannenwald's concurring opinion. The Second Circuit reversed and remanded for a resolution of this issue—i.e., whether the transaction was a sale of property to *B* under Sec. 1222(3) or a contract for *B* to purchase pounds on IFF's behalf. The majority of the Tax Court, having previously decided that the *Corn Products* doctrine was applicable to characterize such gains and losses as ordinary, was thus neither affirmed nor reversed upon this issue. The confusion generated by the case as a result of the three-way split in the Tax Court was compounded by the decision of the Service, on IFF's appeal to the Second Circuit, to drop the argument for the applicability of *Corn Products* despite its earlier success on this issue. Ostensibly, the Service's action on appeal was taken because *Corn Products* ". . . has not heretofore been applied in a case in which a hedging operation was entered into by one corporation as protection against a potential inventory loss of another corporation, even where the second corporation is a subsidiary of the first."[9] Although the abandonment by the Service of the *Corn Products* argument may have been, according to the Court of Appeals, "well advised," the fact remains that the only court to date to have decided the issue of the application of the *Corn Products* doctrine to this kind of transaction has

[6] C. W. Steadman, 50 TC 369, aff'd, 424 F2d 1 (CA-6, 1970) (25 AFTR2d 70-926, 70-1 USTC ¶9328). Compare W. W. Windle Co., note 4.

[7] See, e.g., Schlumberger Technology Corp., 443 F2d 1115 (CA-5, 1971) (28 AFTR2d 71-5019, 71-1 USTC ¶9473). Compare W. W. Windle Co., note 4.

[8] International Flavors & Fragrances, Inc., 62 TC 232, rev'd and rem'd, 524 F2d 357 (CA-2, 1975) (36 AFTR2d 75-6054, 75-2 USTC ¶9770).

[9] Id.

been the Tax Court in its opinion in this case (the Second Circuit having no occasion, as the result of the Service's position on appeal, to rule on the issue).

The purpose of currency hedges

The application of the *Corn Products* doctrine to hedge transactions requires an inquiry into the character of the underlying asset being hedged. The character of the underlying asset, in turn, depends on its function in the business enterprise. If the underlying asset constitutes inventory,[10] trade or business property[11], or accounts receivable derived from business operations,[12] the resulting gain or loss must be ordinary. And when such ordinary assets require protective hedging to facilitate their functioning within the course of the corporation's ordinary business operations, the hedges themselves then constitute an integral part of that enterprise, and should be characterized as ordinary. The Service was able to argue successfully in the Tax Court that the assets underlying the IFF currency futures were the ordinary assets of the foreign subsidiary, and that the hedge itself was thus a part of ordinary business operations, with the resulting gain or loss on the hedge ordinary in character under *Corn Products*. IFF, in its argument before the Tax Court, asserted that the asset underlying the hedge was the stock in the subsidiary, admittedly a capital asset in its hands, and that therefore the resulting gains and losses were capital in character.

The problem presented to the Tax Court in the *IFF* case by these arguments, and the probable cause of the sharp differences between the judges' conclusions, is in all likelihood due to the fact that none of the arguments presented by the parties was representative of the actual underlying motivation for the transactions. It is in reality neither the value of the subsidiary stock, nor the ordinary assets of the foreign subsidiary, for which protection is most often sought in these hedge transactions. In many instances, as was the case in *IFF*, the stock of the controlled foreign subsidiary is not offered, nor intended to be offered, for sale on the open market, and thus its market value at a given time is less than critical. In a similar vein, parent corporations concerned with the disparity in effect of translational items for book and tax purposes do not often contemplate regular distributions from their foreign subsidiaries. One of the incentives for the use of a foreign corporate subsidiary is the deferral of U.S. taxation of the profits of the subsidiary until an eventual, but delayed, actual distribution. Thus, absent a desire for regular distributions from the foreign subsidiary, the dollar value of the foreign subsidiary's assets at a given time has little relevance to the regular business operations of either the parent or subsidiary. But the dollar value of such holdings can have importance indirectly through their effect on the parent corporation's financial statements, and through them upon the value of the parent's stock on the open market.

The hedges with which this inquiry is concerned are in fact designed to protect the "image" of the parent corporation, and, in turn, the value of the parent's stock in the marketplace, by minimizing the effect of translation items on the corporate financial statements. Thus, the parent corporation's stock itself is the asset underlying the hedge. And neither the intangible "image" of the parent corporation nor the value of the parent's stock which a favorable image protects serves a function within the business enterprise which would place it within the scope of the ordinary assets enumerated in Sec. 1221 or the *Corn Products* doctrine. The maintenance of a ready market for the parent corporation's equity securities, through attempts at making the corporate "image" as favorable as possible to the investment community, is simply not the sort of direct involvement of a transaction in the ordinary day-to-day regular business operations of a corporation which has been required by the courts for characterizing the resulting gains and losses as ordinary under the *Corn Products* doctrine.

This analysis, although reflecting, in an economic sense, the most accurate explanation for the hedge transactions, presents much conceptual and theoretical difficulty in determining the character of resulting gains and losses. Perhaps this would account for the avoidance by both the Service and IFF of the issue in their arguments. Instead, both parties chose to argue an artificial relationship of hedge to underlying asset so that, at least superficially, conventional theory could be used to characterize gain or loss as desired. But it is obvious from the division in the Tax Court in response to these arguments that the course chosen by the parties did much to obscure, rather than clarify, the issues involved. The direct cause of the vague result presented by the *IFF* case, which has been made even more vague by the Service decision to abandon the *Corn Products* question on appeal, is not the result of any conceptual difficulty in the application of the *Corn Products* doctrine to the economic and business reality of the transaction, but rather the result of a misinterpretation of that reality by the parties involved.

The character of currency hedges

A loss on a transaction designed to protect corporate "image" would appear to be very much like the advertising expenses incurred in the mass media by corporations who have no direct contact with the consumer public other than through the sale of their stock on the marketplace. The rule

[10] Sec. 1221(1).
[11] Sec. 1221(2).
[12] Sec. 1221(4).

for the current deduction of such "institutional" or goodwill advertising centers upon its relationship to the "patronage the taxpayer might reasonably expect in the future."[13] It would thus seem that the goal of the advertising is determinative of its deductibility. Where that goal is the patronage of the business by the consumer public, regardless of the size of that public, advertising costs would constitute an expense which is ordinary and necessary to the business enterprise, and therefore deductible under Sec. 162. But where corporations engage in "institutional" advertising for the sole purpose of increasing the value of their equity securities in the investment markets, the expenditure neither serves, nor seeks to serve, any purpose in the ordinary business operations of the parent and is apparently not deductible. To allow a deduction for such capital-related expenses would conflict with the plain meaning of the "ordinary and necessary" requirement of the statute. These corporations would seem to be incurring such expense to protect their "image"—an expense that would be, like the currency hedge, protective only of equity values. When the asset to be protected, whether by advertising or a currency hedge, is outside of the scope of ordinary business activities, the expense or loss should be treated as capital, rather than ordinary.

The situation in the event of a hedge gain is more difficult to analogize, since a corporation dealing in an underlying asset which is its own stock would normally not even recognize any realized gain at all.[14] It would seem unlikely, however, that a gain would meet the requirements of Sec. 1032, or any other non-recognition provision, when realized upon in a currency hedge transaction. But the same argument should apply to hedge gains as hedge losses—i.e., a gain realized in a transaction designed to protect stock values should be capital rather than ordinary.

As already discussed, hedges in foreign currency designed to protect against currency fluctuation do not fall within any of the classes of items listed in Sec. 1221 as non-capital. Neither would such hedge contracts be subject to ordinary treatment under the *Corn Products* doctrine if the view that the image of the parent corporation, or its stock, both capital assets, underlies the transaction. Accordingly, the hedge contracts, realistically viewed as protecting the parent stock by supporting its "image" in the marketplace, and serving no purpose in the ordinary, day-to-day business activities of the parent, should be characterized as capital.

Neither the Service nor the taxpayer in the *IFF* case dealt with the realistic view that corporate image, and its effect on the value of the parent's stock, was the asset underlying the transaction for purposes of characterizing the resulting gain or loss. Similarly, the Tax Court itself failed to deal with this issue. Instead the parties argued that application of the *Corn Products* doctrine to the hedge contracts would turn on choosing between the shares of the subsidiary or the ordinary business assets of the subsidiary as the assets for which hedge protection was sought. A majority of the Tax Court, accepting these arguments as exclusive and basing their decision on a choice between them, found for the Service—i.e., that the asset hedged was the inventory of the foreign subsidiary. It would appear, however, that even when the issue is limited to the choice of stock or inventory, the appropriate decision would be that the subsidiary's stock was the asset being hedged, which was the finding of the dissent in *IFF*.

The character of subsidiary stock

The *IFF* majority assumed, without qualification, in the very first sentence of its opinion, that the parent corporation ". . . both directly and indirectly through its foreign affiliates engaged in the preparation and distribution of flavoring extracts." Ordinary characterization under *Corn Products* was thereby rendered inevitable. That is, the assumption that subsidiary and parent were engaged in a unified singular business enterprise, albeit on a multinational scale, was determinative of the result of the application of the *Corn Products* doctrine. Such a unity of business enterprise has never been recognized as a general rule in our tax law with regard to foreign subsidiary operations—which are usually classically viewed as distinct separate enterprises—and hedge transactions like those in *IFF* do not warrant taking a view contrary to the general rule.

It may be of interest to note that in a prior case[15] dealing with similar issues, which was settled by stipulation and therefore resulted in no court opinion, the Service took the same position as did the taxpayer in *IFF*—i.e., that foreign currency hedge transactions, undertaken with regard to net exposure in such currency in a foreign subsidiary, are designed to protect the investment in the foreign subsidiary stock; that the stock is a capital asset representing an equity investment in the subsidiary rather than a part of the routine business operations of the parent; that the character of a hedge contract derives from the underlying asset for which protection is sought; and that therefore the hedge contracts protecting the subsidiary's stock's value are capital assets. Although this argument was rejected by the Tax Court majority in *IFF* it would appear that such argument, and the opinion of the dissent which embraced it, was correct on the basis of the facts presented and prior case law.

A common thread running through the reasoning of those cases holding that the stock of a sub-

[13] Regs. Sec. 1.162-20(a)(2).

[14] Sec. 1032.

[15] Virginia Industries, Inc., TC Docket No. 4480-71.

sidiary corporation is an ordinary asset in the hands of the parent under the *Corn Products* doctrine is that the stock was acquired not for investment but to further the routine business activities of the parent, and for the primary purpose of increasing and expanding the active business of the parent itself.[16] The goal of the acquisitions in these cases was not to derive a profit from the business operations of the subsidiary, but to make use of the subsidiary to further the business enterprise of the parent. The stock, being an asset used in the parent's own business operations, therefore was characterized as an ordinary asset.

Thus, in *Schlumberger*,[17] stock in a subsidiary was acquired as a means of obtaining computer expertise and marketing know-how, and was held to be an ordinary asset within the purview of *Corn Products*. But where investment in a subsidiary corporation, such as occurred in *IFF* and *Virginia Industries*,[18] is motivated by a desire to share in the profits of a subsidiary's own individual business enterprise, rather than to use the stock as a tool to further the parent's business operations, such stock is an "investment" and therefore a capital asset, with *Corn Products*'s recharacterization being inappropriate.[19] Indeed, the Tax Court has recently held that where a substantial investment motive exists in a predominantly business-motivated acquisition of stock, such stock is a capital asset.[20]

Foreign subsidiaries rarely contribute to the day-to-day business activities of the parent, and their separate business identities must be respected absent such contributions to the parent. The stock is in most cases an equity investment from which an investment-type return is anticipated.

The holding by the *IFF* majority, that the unquestioned applicability of *Corn Products* recharacterization to hedges conducted for a foreign *branch operation* requires a similar holding when such operations are in *subsidiary form*, is inappropriate. The dissenters took the view that treatment of a corporation and its foreign branches as a unified entity does not per se necessitate similar treatment when operations are in parent-subsidiary form. A selective piercing of the corporate veil of the subsidiaries where disadvantageous to a taxpayer, by denying capital asset status to the hedges, while simultaneously refusing to pierce the veil where it is advantageous to the taxpayer, would be unjust. As the dissenters suggested in *IFF*, the facts in the case did not justify ignoring the separate identity of parent and subsidiary, and the business of the subsidiary was not the business of the parent.

[16] See, e.g., Southeastern Aviation Underwriters, Inc., TC Memo 1966-75; Pittsburgh Reflector Co., TC Memo 1968-75. See also note 4.

[17] See note 7.

[18] See note 15.

[19] See note 2.

[20] See W. W. Windle Co., note 4.

The problem of translational gain and loss is peculiar to the parent-subsidiary form of foreign investment due to discrepancies between financial and tax accounting rules, and the foreign currency hedge is a reasonable and widely-accepted solution to the problems posed by it. Under the *Corn Products* rule, the character of a hedge contract depends on that of the asset underlying it for which protection is sought. Whether one looks at the economic reality of the transaction and finds the corporate image and therefore the underlying parent stock to be the asset hedged, or looks to the dissent in the *IFF* case, and finds that the stock of the subsidiary itself, and not inventory, is the asset being hedged, the underlying asset is capital in character. The gains and losses produced by such hedges must then also be capital in character if there is a sale or exchange.

Capital gains and ordinary losses

Once a determination is made that a hedge in foreign currency designed to offset and neutralize translation gains and losses is a capital asset, the nature of the gain or loss realized and recognized upon its disposition will depend on the type of disposition chosen. Absent a sale or exchange, or a transaction deemed to be one, any gain or loss, even upon an admittedly capital asset, will be ordinary. It is obvious that in most cases possibilities exist for manipulation of the disposition transaction so as to produce the characterization most advantageous to the taxpayer under the prevailing circumstances. Although capital gains are often desirable, capital losses for corporations are usually to be avoided; they cannot be offset against ordinary business income and absent corresponding capital gains against which they could be offset, either in current, carryback or carryover years, they would produce no tax benefit. To the extent the capital asset can be disposed of in a sale or exchange when gain is produced, and in a manner other than a sale or exchange when loss is produced, the best of all possible alternatives could always be obtained. Since the choice of disposition method may be made when the outcome of the hedge has been determined to a significant extent, possibilities for advantageous manipulation of character are available at most times.

Capital gains. It has been held in the case of certain transactions in stock or securities that where there is a bilateral contract with mutual rights and obligations, the assumption of such rights and obligations for payment constitutes a sale or exchange.[21] Also, the courts have held that the bundle of rights which are represented by commodity futures contracts can constitute capital assets productive of capital gain or loss in a

[21] M. J. Stavisky, 34 TC 140, aff'd, 291 F2d 48 (CA-2, 1961) (7 AFTR2d 1539, 61-2 USTC ¶9494).

sale or exchange transaction.[22] By analogy then, either the receipt from a third party of payment for an advantageous foreign exchange futures contract, or payment to such a third party for an assumption of an onerous one, would constitute a sale or exchange of the contract.

Sale or exchange treatment would most often be sought by a parent corporation on its hedges when a gain is to be realized, and would normally result from a transfer of the contract to a third party for consideration equal to the gain inherent in the contract. However, any parent corporation engaging in such a sale must take care to do so in a manner that will avoid restructuring of the transaction as a delivery through an agent under the contract, rather than a sale.

Two alternative methods of reconstructing the transaction, so as to view the third-party purchaser as an alleged agent of the obligor under the contract, are available to the IRS. The first assumes a transaction in which the alleged agent acquires an offsetting futures contract on the currency with which he closes the original contract. Since the offsetting contract would be held only for a short time in such a situation, and then sold to the original obligee to close the prior transaction, short-term capital gain or loss would result. This approach was taken by Judge Tannenwald, in his concurring opinion in the *IFF* case, and was the issue on which the parties joined on appeal, and on which the Second Circuit's reversal and remand was based. The second alternative, like the first, would assume the third-party "purchaser" to be a mere agent of the obligor under the hedge contract, but would hold that any delivery to the original obligee, whether of a capital asset or not, would produce ordinary gain, since the delivery under the contract would not constitute the sale or exchange required for capital gain treatment.[23]

All such recharacterization as an agency relationship would be based upon the step transaction theory. In order to avoid this result, therefore, it is necessary to make the sale to the third party sufficiently in advance of the delivery date under the futures contract so as to make the purchaser's risks under the contract economically significant.[24] Absent such economic risk, recharacterization of the sale as a mere delivery through an agent would be inevitable and would preclude a finding of the sale or exchange necessary for capital gain treatment.

Ordinary losses. Of course, if a loss is to be realized upon the foreign exchange futures contract, it would most often be beneficial to obtain characterization of such losses as ordinary, rather than capital. Since the futures contracts with which this inquiry is concerned are most often capital assets, the only way to avoid capital loss characterization is by disposing of the contract by other than a sale or exchange. As discussed above, a sale or exchange would arise from a payment by or to a third party for the assumption of contract rights and obligations. Techniques of novation and compensation, however, may be available which could successfully permit avoidance of sale or exchange treatment of the disposition and characterization of the resultant loss as capital. A novation or compensation would consist of a release by the obligee under the contract of the obligor's required performance in exchange for a cash payment. The payment would, of course, be keyed to the relative fair market values of the underlying foreign currency at the time the novation or compensation arrangement is entered into. (Note that merely closing the hedge contract probably won't produce the desired ordinary loss; according to Judge Tannenwald's dissent in *IFF*, it will usually result in a short-term capital loss.)

The lack of any provision in the Code defining the terms "sale or exchange," so crucial to any attempt at characterizing the gain or loss produced upon the disposition of a capital asset, requires that our inquiry be focused upon judicial definitions of the terms. In *Brown*,[25] the term "sale" was held to be, as ordinarily used, "a transfer of property for a fixed price in money, or its equivalent." Courts have, accordingly, viewed transactions whereby various contract rights and obligations are satisfied by performance, or released from a required performance for compensation, not as a transfer of such rights in a sale, but rather as merely the coming to an end of such rights and obligations. They are held to simply vanish, and therefore cannot be the subject of a transfer.[26] The mere "cancellation or release of a contract right does not transfer the rights to the transferee-payor, and is thus not a sale."[27] There is thus authority for the proposition that a novation or compensation transaction is not a sale or exchange, thereby mandating ordinary treatment of resulting gains or losses, even where such assets are capital in nature.[28]

It should be noted, however, that authority also exists to the effect that a negotiated exchange of a right to sell under a contract for a cash payment not in the form of a liquidated damages provision for breach, would be considered a sufficient sale

[22] J. Maloney, 25 TC 1219 (1956).

[23] Spray Water Power & Land Co., TC Memo 1961-73; W. M. Hort, 313 US 28 (1941) (25 AFTR 1207, 41-1 USTC ¶9354).

[24] See note 8, 62 TC 232, at p. 240, for Judge Tannenwald's concurring opinion.

[25] C. B. Brown, 380 US 563 (1965) (15 AFTR2d 790, 65-1 USTC ¶9375).

[26] See Starr Bros., Inc., 204 F2d 673 (CA-2, 1953) (43 AFTR 973, 53-2 USTC ¶9410).

[27] Billy Rose's Diamond Horseshoe, Inc., 322 F Supp 76 (DC, N.Y.) (27 AFTR2d 71-524, 71-1 USTC ¶9158), aff'd, 448 F2d 549 (CA-2, 1971) (28 AFTR2d 71-5563, 72-1 USTC ¶9622).

[28] See C. L. Pounds, 372 F2d 342 (CA-5, 1967) (19 AFTR2d 514, 67-1 USTC ¶9191); see also note 27.

or exchange to produce capital gain or loss treatment.[29] In *Ferrer*, a substance over form position was taken by the Court, despite the earlier decision in *Starr Bros.*,[30] and, citing the fact that the obligor under the contract in question ". . . did not care a fig . . ." whether there was an annulment of the contract involved or a conveyance of it, held the release of the contract rights to be a sufficient sale or exchange to produce capital gain or loss treatment. *Ferrer* has been held not to overrule *Starr Bros.* and similar prior cases[31] and the latter continues to be cited for the proposition that "a release is not a sale."

To the extent the novation or compensation device avoids sale or exchange characterization of the disposition transaction, it creates a seemingly ideal device for selectively obtaining capital or ordinary treatment as desired. But although these techniques for avoiding capital treatment are supported by the literal language of statutory and case law, the very fact that enormous manipulative possibilities are presented, as well as the existence of those cases applying substance over form theories rather than such a literal interpretation, would seem to dictate that undue reliance upon such techniques is to be avoided. They would of course have utility as a means of reinforcing the arguments for ordinary treatment already present in a transaction, or where other alternative arguments for ordinary treatment are unavailable.

Conclusion

As we have seen, corporate management, faced with the distorting effect of potential translational gain or loss on financial statements, must deal with a multitude of uncertainties as to the tax effect of hedge transactions designed to neutralize the translational items. They can at this point be certain of neither the character of the asset (the futures contract itself) nor whether the transactions disposing of it will meet the requirements of a sale or exchange. To this must be added the additional problem of determining the holding period of any gain, requiring a difficult determination of the applicability of the short sale rules of Sec. 1233 to the hedge transactions involved.[32] Without a firmly predictable determination of the character of any gain or loss resulting from currency hedge transactions, and the holding period attributable as well when the gain or loss is capital, management is not able to properly estimate the amount which must be hedged to offset a given net exposure, thereby severely limiting the advantages to be obtained by engaging in such hedge activity.[33] ■

[29] U.S. Freight Co. & Subsidiaries, 422 F2d 887 (Ct. Cl., 1970) (25 AFTR2d 70-670, 70-1 USTC ¶9244); J. Ferrer, 304 F2d 125 (CA-2, 1962) (9 AFTR2d 1651, 62-2 USTC ¶9518).

[30] See note 26.

[31] See, e.g., A. F. Brook et al., 360 F2d 1011 (CA-2, 1966) (17 AFTR2d 1009, 66-1 USTC ¶9422).

[32] See note 8, 75-2 USTC ¶9770, at note 3, citing Costello, "Tax Consequences of Speculation and Hedging in Foreign Currency Futures," 28 *Tax Lawyer* 221, 225-228 (1975). See also Sec. 1233(e)(2)(A).

[33] There is an alternative which seems to be available in many cases, however, which avoids the problems inherent in *IFF*-type hedge transactions. This involves severing the hedge transactions from the U.S. corporation by having such activities conducted by those foreign subsidiaries that are within jurisdictions most favorable to such activities. (See Lipner, Alan J., "Devaluation of Foreign Currency: Tax Planning Moves for U.S. Taxpayers," *J. of Tax.*, October, 1969.) If such activities are sufficiently removed from U.S. contacts and control, the desired effect on consolidated financial statements can be obtained, while any effect for U.S. tax purposes on the parent corporation's liability can be avoided entirely.