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Hoover Company v. Commissioner: A Judicial One Way Street

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NOTE

Hoover Company v. Commissioner: A Judicial One Way Street

[T]he definition of a capital asset must be narrowly applied and its exclusions interpreted broadly. [1]

Recently, the tax court in *Hoover Company v. Commissioner*,[2] refused to apply the *Corn Products* doctrine[3] and found that a corpora-

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[1] Corn Products Refining Co. v. Comm'r, 350 U.S. 46, 52 (1955).

[2] 72 T.C. 206 (1979).

[3] Responding to the amorphous and incomplete statutory definition of "capital assets" in § 117(a) of the Internal Revenue Code, 1939, the Supreme Court, in Corn Products Refining Co. v. Commissioner, 350 U.S. 46 (1955), enunciated the doctrine that enlarged the exceptions to the capital assets definition. *See* Note, *Judicial Treatment of "Capital" Assets Acquired for Business: The New Criterion*, 65 YALE L.J. 401, 407 (1955-56), [hereinafter cited as YALE Note]. In the Note, the author argued that *Corn Products* evinced the Supreme Court's reaction toward "piecemeal . . . exclusionary clauses" in § 117 of the Code. *See also* Drachsler, *Alien Law in Federal Taxation: Characterization of Alien Juristic Concepts*, 33 TUL. L. REV. 751 (1959). Drachsler noted that *Corn Products* resulted from Congress' persistent failure to define "capital assets" under § 117.

The Internal Revenue Code of 1939, ch. 1, § 117(a), (now I.R.C. § 1221) provided:

> (1) CAPITAL ASSETS—The term 'capital assets' means property held by the taxpayer (whether or not connected with his trade or business), but does not include stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business, or property, used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 23(1);

The modern definition of capital assets is found in I.R.C. § 1221:

> For purposes of this subtitle, the term "capital asset" means property held by the taxpayer (whether or not connected with his trade or business), but does not include—
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> (1) stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business;
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> (2) property, used in his trade or business, of a character which is subject to the allowance for depreciation provided in section 167, or real property used in his trade or business;
>
> (3) a copyright, a literary, musical, or artistic composition, a letter or memorandum, or similar property, held by—

tion's forward sales agreements in foreign currencies were not hedging agreements.[4] The court concluded that such sales did not constitute an integral part of the business,[5] and thus losses from such transactions fell outside the protection of *Corn Products* and were afforded capital treatment.[6]

This note will suggest that the *Hoover* court, in focusing its deci-

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(A) a taxpayer whose personal efforts created such property,

(B) in the case of a letter, memorandum, or similar property, a taxpayer for whom such property was prepared or produced, or

(C) a taxpayer in whose hands the basis of such property is determined, for purposes of determining gain from a sale or exchange, in whole or part by reference to the basis of such property in the hands of a taxpayer described in subparagraph (A) or (B);

(4) accounts or notes receivable acquired in the ordinary course of trade or business for services rendered or from the sale of property described in paragraph (1);

(5) an obligation of the United States or any of its possessions, or of a State or any political subdivision thereof, or of the District of Columbia, issued on or after March 1, 1941, on a discount basis and payable without interest at a fixed maturity date not exceeding one year from the date of issue; or

(6) a publication of the United States Government (including the Congressional Record) which is received from the United States Government or any agency thereof, other than by purchase at the price at which it is offered for sale to the public, and which is held by—

(A) a taxpayer who so received such publication, or

(B) a taxpayer in whose hands the basis of such publication is determined, for purposes of determining gain from a sale or exchange, in whole or in part by reference to the basis of such publication in the hands of a taxpayer described in subparagraph (A).

In *Corn Products*, the Court held that hedging transactions in corn futures, although not explicitly mentioned in the statutory exclusions, warranted ordinary tax treatment because the transactions were not speculative or capital investments. The Court reasoned that the transactions provided a form of insurance against increases in the price of the company's raw materials and were thus, an integral part of the taxpayer's business. This line of analysis is widely known as the "integral part of business" test. 72 T.C. at 233. It is the presence of investment or speculative intent that prevents application of the *Corn Products* integral part of business doctrine. Conversely, hedging or protective transactions without such investment intent triggers the *Corn Products* doctrine. *See* YALE Note at 406. In the Note, the author stated that "*Corn Products* represents a significant change in the judicial application of section 1221. The decision in effect rewrites section 1221, excluding from the definition of 'capital assets' all property held, without investment intent, in connection with the taxpayer's business." (footnote omitted), *Id.* For a discussion of the *Corn Products* doctrine, *see* Javaras, *Corporate Capital Gains and Losses—The* Corn Products *Doctrine*, 52 TAXES 770 (1974); Note, *The Impact of* Corn Products: *Twenty-Three Years Later*, 12 SUFFOLK U.L. REV. 869 (1978).

It is important to note that *Corn Products* has not been limited to hedging transactions—instead, courts have given it broad application. *See* Schlumberger Technology Corp. v. United States, 443 F.2d 1115 (5th Cir. 1971); Chemplast, Inc. v. Comm'r, 60 T.C. 623 (1973); Steadman v. Comm'r, 424 F.2d 1 (6th Cir. 1970); Comment, *The* Corn Products *Doctrine and Its Application to Partnership Interests*, 79 COLUM. L. REV. 341 (1979).

[4] 72 T.C. at 240.

[5] *Id.* at 237.

[6] In its defintion of a "capital asset" in section 1221 of the Internal Revenue Code, Congress explained the term negatively. That is, first the legislators broadly premised that property held by a taxpayer is a capital asset; then, they listed a catalogue of exceptions to their definition.

For corporate tax purposes, losses from sales or exchanges of capital assets are given capital loss treatment and such losses are allowed only to the extent that they offset capital gains. I.R.C. § 1211(a). Whereas, non-capital asset losses and business expenses are deductible in full. I.R.C.

sion on the form of the taxpayer's transaction (i.e., whether it was a "bona fide" hedge), failed to properly apply the "integral part of business" doctrine. To buttress this thesis, the note will first compare *Hoover* to *Corn Products*. Then, the analysis will juxtapose *Hoover* with the *Corn Products'* progeny, *Wool Distributing Corp. v. Commissioner*[7] and *International Flavors & Fragrances Inc. v. Commissioner*[8]—two cases involving international currency hedges. Finally, the note will discuss the impact *Hoover* might have on a proliferating foreign currency futures market.[9]

THE HOOVER COMPANY

In *Hoover*, the taxpayer, a publicly held Delaware corporation with subsidiaries in foreign countries, was engaged in the business of manufacturing and distributing vacuum cleaners and sundry small appliances.[10] Hoover held over half of the outstanding shares of a British corporation, Hoover Ltd., which possesses wholly owned subsidiaries in seven countries.[11]

On November 18, 1967, the pound fell 14% in value, dropping

§§ 165, 162. In contrast, gains from sales or exchanges of capital assets are given capital gain treatment and usually receive less taxation than ordinary gains. I.R.C. §§ 1201(a), 11.

Whether a corporation's property is deemed a "capital asset" is an imperative issue for the corporate taxpayer. If the property is subject to capital tax treatment, (i.e., if the property is a "capital asset" under § 1221 of the Internal Revenue Code), significant losses on the sale or exchange of the property might be forever lost. Conversely, if these losses are taxed at ordinary rates, valuable tax deductions could result. Given today's corporations, including the large multinational, tremendous sums can be at issue. Oftentimes when Congress creates critical statutory concepts, vigorous legal debate follows and the courts must slowly delineate these terms. Through such judicial analyses, the term "capital asset" has evolved. *See* E. GRISWOLD, FEDERAL INCOME TAXATION 657-58 (6th ed. 1976).

7 34 T.C. 323 (1960).

8 62 T.C. 232 (1974), *rev'd*, 524 F.2d 357 (2d Cir. 1975). The Second Circuit did not reverse the tax court's analysis and application of the *Corn Products* doctrine to a foreign currency futures transaction in *International Flavors*. Instead, the court remanded the case to the tax court to decide whether International Flavors' sale of its future contract to a third party was a "sale" of property under section 1222(3) and subject to long term capital gain treatment. 524 F.2d at 360. Recognizing that its analysis of *Corn Products* was not reversed by the Second Circuit in *International Flavors*, the court in *Hoover* found it necessary to discuss its initial position in *International Flavors*. 72 T.C. at 236.

9 *See* notes 81-84 *infra* and accompanying text.

10 72 T.C. at 208.

11 The wholly owned subsidiaries were located in Australia, Austria, Denmark, Finland, Norway, Sweden and South Africa. The taxpayer also owned an aggregate interest in Hoover N.V., a Dutch corporation that owned subsidiaries in Belgium, France, Germany, Holland, Italy and Switzerland. In addition, Hoover had wholly owned subsidiaries in Canada and Panama. The Panamanian corporation in turn owned subsidiaries in Panama, Colombia, Brazil and Mexico. The taxpayer sold its products primarily in the United States, Canada and the Caribbean, whereas, Hoover Ltd. supplied the subsidiaries in Europe and South Africa. *Id.*

from \$2.80 to \$2.40.[12] Because of the devaluation, the translation produced an exchange loss of \$3,650,318 that the taxpayer recorded in its consolidated financial statement.[13] Hoover reported this exchange loss as an extraordinary charge against its consolidated earnings.[14] As a result of subtracting the extraordinary charge from its consolidated earnings, Hoover's earnings per share of common stock dropped from \$2.09 to \$1.54.[15] While the currency devaluation unfavorably affected Hoover's net earnings for financial purposes, it did not result in a recognized federal tax loss.[16]

Responding to the adverse impact of exchange losses on both its foreign stock investment and its financial image,[17] Hoover, in the years 1968 through 1970, engaged in eighteen forward sales contracts in an effort to protect itself against potential currency devaluations occurring in its subsidiaries' countries.[18] Unlike an earlier forward sales agreement[19] which only protected the taxpayer against the danger of devaluation within an expected dividend payment, these later transactions were made to offset Hoover's net exposure in the foreign subsidiaries. By estimating the net assets in a subsidiary exposed to risk and then by multiplying the fraction which represented Hoover's ownership interest in the subsidiary, the taxpayer calculated its "net exposure."[20] Hoover never intentionally "hedged" an amount exceeding its interest in the net value of the foreign subsidiary.[21]

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12 *Id.* at 215.

13 *Id.*

14 *Id.* at 216.

15 *Id.*

16 *Id.*

17 Hoover contended that the extraordinary charge had an adverse impact on its economic reputation with potential and existing investors. Hoover argued that its reputation was damaged because it could not accurately predict consolidated earnings amidst an uncertain foreign exchange market. Most importantly, Hoover contended that the value of its stock investment was reduced in subsidiaries who were affected by their country's currency devaluation. Lastly, the taxpayer feared that these devaluations might affect the value of future dividend income from these subsidiaries. *Id.*

18 *Id.* at 218.

19 Early in 1967, the taxpayer was worried about a potential devaluation in the British pound since Hoover expected an interim dividend from Hoover Ltd. that was payable in British pounds on September 6, 1967. *Id.* at 214. In order to remove the risk of a devaluation of foreign currency, Hoover entered into a forward sale agreement on March 16, 1967, with Manufacturers Hanover Trust Co. whereby the latter agreed to purchase £300,000 from Hoover for delivery on September 6, 1967. *Id.* at 214-15. The taxpayer instructed Hoover Ltd. to make the dividend payment directly to the bank. Although no devaluation occurred prior to the September 6th dividend payment, Hoover was still concerned with a potential devaluation in the pound. *Id.* at 215.

20 *Id.* at 216-18.

21 *Id.* at 225.

A typical forward sale contract[22] by Hoover resulted in two transactions with the same bank. First, the taxpayer would sell currency for delivery on a certain date, and then, immediately before delivery was due, it would enter into another contract to purchase the same amount of currency at the new price. No currency physically changed hands—the bank simply debited or credited Hoover's account. In all but two of these eighteen transactions, the taxpayer had a loss.[23] Hoover treated all of these transactions as ordinary gains or losses for federal income tax purposes. The tax court, however, held that the transactions merited capital tax treatment.

THE *HOOVER* COURT'S MISAPPLICATION OF THE CORN PRODUCTS ANALYSIS

In its discussion of the appropriate tax treatment afforded hedging transactions, the tax court, in *Hoover*, cited[24] Treasury ruling G.C.M. 17322. In the ruling,[25] the Commissioner held that future transactions, if speculative in nature, deserve capital tax treatment; whereas, future transactions "which eliminate speculative risks due to fluctuations in the market price of [a commodity] . . . [and which] tend to assure ordinary operating profits, are common trade practices and are generally regarded as a form of insurance" and thus are entitled to ordinary tax treatment.[26] In an effort to distinguish its case from the ruling, the *Hoover* court interpreted the ruling narrowly and concluded that "it was readily apparent that a hedge in commodity futures represented an effort to offset actual purchases and sales of the commodity with an equivalent amount on a future sale or purchase contract respec-

22 "Commodity futures markets provide insurance opportunities to merchants and processors against the risk of price fluctuation. . . . A trader is termed a hedger if his commitments in the cash market are offset by opposite commitments in the futures market. An example would be that of a grain elevator who buys wheat in the country and at the same time sells a futures contract for the same quantity of wheat. When his wheat is delivered later to the terminal market or to the processor in a normal market, he buys back his futures contract. Any change of price that occurred during the interval should have been cancelled out by mutually compensatory movements in his cash and futures holdings. The hedger thus hopes to protect himself against loss resulting from price changes by transferring the risk to a speculator who relies upon his skill in forecasting price movements." 7 ENCYCLOPEDIA BRITANNICA 816-17 (15th ed. 1974). *See also* P. SAMUELSON, ECONOMICS 424-25 (10th ed. 1976).

23 72 T.C. at 219-20.

24 *Id.* at 229.

25 G.C.M. 17322, XV-2 C.B. 151-52 (1936). The taxpayer, a textile manufacturer, entered into cotton futures transactions in an attempt to protect himself against the fluctuation in the market price of cotton. The transactions resulted in a net loss but were afforded ordinary tax treatment. *Id.*

26 72 T.C. at 229.

tively."[27] In other words, according to the tax court, the Treasury ruling was an example of what the *Hoover* court defined as the archetypical bona fide hedge—the only hedge that warrants ordinary tax treatment.

In *Corn Products*, the Supreme Court interpreted the same ruling far less narrowly. The Court felt that the Treasury ruling, according to *Corn Products*, merely distinguished "speculative transactions in commodity futures from hedging transactions";[28] the latter were a form of protection similar to business insurance.[29] Hence, while the tax court interpreted the ruling as an illumination of bona fide hedges, the Supreme Court focused on the distinction between speculation and protection. Indeed, if the Supreme Court had, like *Hoover*, employed the narrow distinction between bona fide hedges and those that deserved capital treatment, the facts in *Corn Products* would have demanded a contrary holding.[30]

In his dissent in *Hoover*, Judge Chabot criticized the majority's narrow interpretation of the *Corn Products* doctrine. Quoting *Corn Products*, he noted that Congress intended that profits and losses arising from the everyday operation of a business be treated as ordinary income or loss, and the same congressional purpose required that the definition of a capital asset be narrowly applied and its exclusions interpreted broadly.[31] Comparing *Hoover* to the sharply dissimilar hold-

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[27] *Id.* The tax court in *Hoover* acknowledged one exception to this bona fide hedge analysis. According to *Hoover, Corn Products* demonstrated that *non* bona fide hedges could merit ordinary tax treatment only if they were integral to the taxpayer's business. *Id.* at 234. The tax court concluded that Hoover's transactions did not come under this exception since the corporation's futures were not protecting the business operation, but were protecting the corporation's investment in its foreign subsidiaries. *Id.* at 237. Significantly, however, when the Supreme Court developed the integral part of business doctrine in *Corn Products*, it never focused on the particular business items which the taxpayer attempted to protect. Instead, the Court examined the intent of the taxpayer and then it applied ordinary tax treatment to protective transactions, and capital tax treatment to speculative transactions. *See* notes 28-29 and accompanying text *infra*.

[28] 350 U.S. at 5.

[29] *Id.* at 50.

[30] In *Corn Products*, the taxpayer manufactured products from corn. Concerned about an increase in corn prices and its inability to store more than a short supply, the taxpayer established a long position in corn futures as the most economical way to insure an adequate supply of corn without suffering the costs of additional storage facilities. Each fall when the corn prices were most favorable, it purchased futures in corn and took delivery on the contracts to meet its supply needs. If no shortages appeared, the corporation sold the excess futures the following summer. In this manner, the taxpayer "reached a balanced position with reference to any increase in spot corn prices . . . [but] made no effort to protect itself against a decline in prices." *Id.* at 49. The futures resulted in a net gain for the taxpayer. Although the transactions did-not constitute "true hedging" agreements (i.e., under its sales policy, the taxpayer could not guard against a fall in corn prices), the Court held that the gains should be taxed at ordinary rates. *Id.* at 53-54.

[31] 72 T.C. at 252-53 (quoting Corn Products, 350 U.S. at 51-52).

ing in *International Flavors*,[32] he warned, "I am concerned that we not embark on the evolution of a court-made 'one way street.' "[33] In addition, he argued that unlike the single transaction in *International Flavors*, those in *Hoover* recurred, and therefore, conformed with the principles promulgated by the Supreme Court in *Corn Products*.[34] Finally, he concluded that Hoover's transactions were created for the purpose of protecting aspects of the taxpayer's trade or business and not as investments to provide revenue.[35] This remark illuminates the protection and speculation dichotomy found in *Corn Products* and its progeny.[36]

Unlike *Hoover*, *Corn Products* did not decide the tax treatment issue by citing[37] doubtful precedent[38] like *Commissioner v. Farmers and*

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32 62 T.C. 232 (1974), *rev'd*, 524 F.2d 357 (2d Cir. 1975), *see* note 8 *supra* for further discussion of case history. *See also* notes 69-80 and accompanying text *infra*.

33 72 T.C. at 252.

34 *See* note 79 and accompanying text *infra*.

35 72 T.C. at 253.

36 The Sixth Circuit summarized the distinction between protective and speculative futures in United States v. Rogers, 286 F.2d 277 (6th Cir. 1961). In *Rogers*, the taxpayer, a livestock breeder, traded egg futures and the court held that losses from such transactions were capital. *Id.* at 282. The court refused to apply the *Corn Products* doctrine because there was no relationship between the taxpayer's business and the commodity futures in which he dealt. In other words, livestock prices had no connection with egg futures. The court noted that hedges, in contrast to speculative trading, secure protection with some degree of certainty because the prices of the commodity future fluctuate closely with the product or property in the business. *Id.* *Hoover* is distinguishable from *Rogers* because the taxpayer's business in *Hoover*, a multinational corporation, was certainly affected by foreign currency devaluations. As the result of such a currency devaluation, Hoover suffered financial report exchange losses that translated into lower net earnings from its foreign subsidiaries. 72 T.C. at 215-16. Thus in *Hoover*, currency futures were employed as an effective protective mechanism to insure against an adverse market impact upon the taxpayer's business.

The distinction between speculation and protection is also illustrated in Grote v. Commissioner, 41 B.T.A. 247 (1940). In *Grote*, the court held that the taxpayer, a wheat producer who sold wheat futures to protect against grain market price fluctuations, was entitled to ordinary loss treatment on such transactions. *Id.* at 249. The court reversed the Commissioner's ruling because he "thought that petitioners' transactions were merely speculations in future contracts having no relation to their production business." *Id.* Like the taxpayer in *Grote*, Hoover did not enter into its future contracts with a speculative purpose, but instead, employed them to protect the corporation from adverse market fluctuations.

A similar distinction is apparent in Dearborn Co. v. United States, 444 F.2d 1145 (1971). In *Dearborn*, the Court of Claims ruled that the taxpayer, a furniture seller, who purchased stock in a wood raw materials supplier and then suffered a loss on such transaction, deserved capital loss treatment. *Id.* at 1168. In reaching its conclusion, the court found that the petitioner had three substantial investment-speculation purposes for buying the stock. Nonetheless, in obiter dictum, the court concluded that losses from corporate stock purchases made as "an integral and necessary act in the conduct of the business . . . [and made] without investment intent" were ordinary. *Id.* at 1166.

37 72 T.C. at 230-31.

38 *See* Annot., *Transactions in comodity futures as giving rise, for federal income tax purposes, to capital gains and losses*, 100 L.Ed. 36 (1955). The author noted that "the holding [in *Corn Prod-*

Ginners Cotton Oil Co.[39] and *Trenton Oil Co. v. Commissioner*.[40] In these cases, ordinary treatment resulted only when the transaction fit within their narrowly prescribed definition of a "true" hedge. Instead of employing this narrow definition, the Court in *Corn Products* went directly to the Internal Revenue Code's capital asset provision and exposed[41] the legislative purpose for creating capital tax treatment. According to the Court, capital tax treatment was merely intended as a tool to relieve the taxpayer from undue tax burdens when converting capital investments, and thus, capital asset definitions were construed narrowly.[42] In developing the "integral part of business" rule in *Corn Products*, the Court focused upon the taxpayer's intent in entering the transaction. Once the Court found a protective intent and not a speculative one, it concluded that such intent was contrary to the activity of a "legitimate capitalist,"[43] and thus, the activity was an integral part of business and exempt from capital treatment.[44]

Under the *Corn Products* analysis, the transactions in *Hoover* merit ordinary tax treatment. Like the taxpayer in *Corn Products*, Hoover routinely conducted its transactions in the course of business over a period of years. The taxpayer did not have a speculative purpose, but simply attempted to protect its business from adverse market fluctuations.[45] Instead of following the Supreme Court's twofold analysis of taxpayer intent and Congressional purpose, the tax court looked at the form of the transaction.[46] In arguing that the crucial issue in *Hoover* was whether the taxpayer's futures were bona fide hedges,[47] the

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ucts] would appear to have thrown some doubt upon the continued authoritative weight of certain earlier decisions of lower federal courts" like *Farmers & Ginners* and *Trenton*. *Id.* at 39. Likewise illustrating the cases as worn precedent, the author of the YALE Note stated that "[u]ntil Corn Products, however, courts [like Farmers & Ginners and Trenton] tended to define a 'true' hedge narrowly, holding that losses from transactions in commodity futures by a business taxpayer which were not 'true' hedges were deductible only as capital losses." YALE Note at 404, n.17.

39 120 F.2d 772 (5th Cir. 1941).

40 147 F.2d 33 (6th Cir. 1945).

41 *Corn Products* reflects the first time that the Supreme Court has unequivocally noted that the legislative definition of capital assets encompasses simply investments. *See* YALE Note at 406.

42 The Court expressly found that "Congress intended that profits and losses arising from the everyday operation of a business be considered as ordinary income or loss rather than capital gain or loss." 350 U.S. at 52.

43 *Id.* at 51.

44 *Id.* at 53.

45 *See* note 29 and accompanying text *supra*.

46 This approach also conflicts with 3B MERTENS, LAW OF FEDERAL INCOME TAX. In his analysis of *Corn Products*, Professor Mertens noted that the "point of this decision appears to be that the courts are to look not merely to the subject matter of a transaction but also to its purpose in the context of the taxpayer's course of business." *Id.* at 100.

47 72 T.C. at 229.

tax court ignored *Corn Products* and the legislative policy articulated by the Supreme Court.

Wool Distributing Corp.: *The Protection-Speculation Analysis*

Hoover is also inconsistent with tax court opinions which discuss the *Corn Products* doctrine as it applies to an international setting. In *Wool Distributing Corp. v. Commissioner*,[48] the tax court held that a wool dealer's losses from future transactions in foreign currencies, made in order to protect his holdings in foreign wools, were entitled to ordinary loss treatment.[49] Instead of enunciating a precise rule which clearly defined future transactions which deserve ordinary tax treatment, the court generally concluded that the taxpayer entered into such transactions "with the bona fide intent of providing a particular form of price insurance" against a "temporary threat posed by the reasonably anticipated possibility of currency devaluation."[50] The futures were thus sufficiently within the nature of hedging operations as to be exempt from capital asset tax treatment.[51] While generally distinguishing these protective transactions from purely speculative transactions, the court likened the former to a type of insurance and reasoned that such are so closely connected with the regular conduct of business as to repel classification as extraneous investments.[52]

Like the entrepreneur in *Wool*, the taxpayer in *Hoover* was concerned with foreign currency devaluations and their potentially adverse consequences upon its business. Analogous to the investment of foreign goods in *Wool*, the investment in *Hoover* involved the corporation's interest in its subsidiaries abroad. A devaluation of foreign currency in either instance would likely have effected an immediate reduction in the value of the investment. Thus, the taxpayers in both cases were employing futures as critical protective measures. Indeed, the court in *Hoover* admitted that Hoover's futures were designed to offset a potential decline in the value of its ownership interest in its foreign subsidiary.[53] Furthermore, once the taxpayers in both cases estimated their exposed interest at risk in the foreign country, neither held currency futures that exceeded such risk.[54] This last factor was

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48 34 T.C. 323 (1960).
49 *Id.* at 332.
50 *Id.*
51 *Id.*
52 *Id.* at 330.
53 72 T.C. at 226.
54 The court, in *Wool*, noted that "[a]t no time did . . . [taxpayer's] holdings of currency futures exceed its inventory of those wools." 34 T.C. at 332. Similarly, the taxpayer in *Hoover*

crucial in the *Wool* decision. In distinguishing investment from protection, the court noted that a larger amount of futures than actual ownership interests (i.e., actuals), or an absence of price relationship[55] between the two, "will suggest that the futures were acquired as an investment and not as a hedge."[56]

The transactions in *Hoover* fall within the protection prong dichotomy elucidated in *Corn Products* and *Wool*. Underscoring this conclusion, the tax court admitted that the taxpayer in *Hoover* "did not enter into [the future transactions] . . . with the intent to speculate in the pejorative sense."[57] More importantly, according to the court, "a lack of speculation" in the transaction, by itself, was not enough to trigger ordinary tax treatment.[58]

The reasoning in *Hoover* is inconsistent with the logic in *Wool* in still another way. In *Hoover*, the court concluded that the futures were not hedges since they did not protect Hoover's balanced market position in its currency holdings but only protected against a "theorized loss in stock value."[59] Simply stated, the taxpayer's currency futures were not protecting holdings in foreign currency. In *Wool*, however, the tax court expressly rejected this approach when it dismissed the Commissioner's argument that the taxpayer deserved capital loss treatment since he purchased currency futures, and not wool futures, to protect his wool investments.[60] The court, in *Wool*, concluded that the taxpayer was entitled to examine different methods of shielding itself

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"never intentionally 'hedged' an amount in excess of its interest in the net value of the foreign subsidiary." 72 T.C. at 225.

55 *See* Kurtin v. Comm'r, 26 T.C. 958 (1956). Ordering ordinary tax treatment, the court in *Kurtin* held that the taxpayer's butter futures were appropriate hedges for petitioner's cheese business since the price of butter and cheese "normally" fluctuated in the same fashion. *Id.* at 962.

56 34 T.C. at 331.

57 72 T.C. at 226-27.

58 72 T.C. at 240. W.W. Windle Co. v. Commissioner, 65 T.C. 694 (1976), is another recent tax court decision at variance to *Hoover*. In *Windle*, the taxpayer—wool processor, in order to create a captive customer and to make a profitable investment, developed Nor West, a corporation that operated a woolen textile mill. Subsequently, the taxpayer suffered losses on Nor West stock transactions. The tax court held that while the taxpayer had a protective purpose in purchasing the stock, it also had a speculative motive, and hence, the losses were capital. Thus *Windle* found that a substantial investment motive precluded the applicability of *Corn Products*. Although speculative motive was the dispositive issue in *Windle*, the *Hoover* court ignored Hoover's complete lack of speculative intent. This conflicts with the general principle that "*Corn Products* treatment will be accorded assets acquired and retained without substantial investment intent." *See* Comment, *supra* note 3, at 354. Finally, although the author of Comment, *Section 741 and Corn Products: A Logical Extension?*, 31 U. FLA. L. REV. 90 (1978), noted that in 1978 the tax court "strictly adhered" to the *Windle* court analysis, *Id.* at 117, the *Hoover* court retreated substantially from the *Windle* court reasoning.

59 72 T.C. at 238.

60 34 T.C. at 332.

"from potentially adverse effects of devaluation and simply chose the one that seemed best suited to its needs."[61] Hence, the tax court's analysis in *Wool* is in sharp contrast to its narrow interpretation of hedging in *Hoover*.

Since the transactions in *Hoover* are similar to the protective futures in *Wool, Hoover* may also be distinguished from cases where speculative intent preempted application of ordinary tax treatment. In *Muldrow v. Commissioner*,[62] the tax court ruled that the taxpayer's losses in cotton futures were capital because in the taxable year, Muldrow neither owned, held an inventory in, nor produced cotton.[63] The court reasoned that a speculative transaction seeks a favorable fluctuation in price to realize profit on the future itself;[64] whereas, a hedge is a form of insurance against adverse fluctuations in the price of a commodity that has already become fixed or will become fixed in the normal course of business, and "the sale, liquidation, or use of the commodity is to occur . . . in the future."[65]

The tax court made a similar ruling in *Battelle v. Commissioner*.[66] In *Battelle*, the court held that the taxpayer's wheat future losses were capital because they exceeded Battelle's actual or prudently anticipated holdings in wheat.[67] The court, however, concluded that Battelle's cotton futures were hedges since the taxpayer "did not short himself in a greater amount than he might reasonably have anticipated harvesting."[68] Unlike the taxpayers in *Muldrow* and *Battelle* who made future transactions without actuals, the taxpayer in *Hoover* carefully calculated its exposure to foreign exchange risk, and, only after cautious pre-

61 *Id.* at 333.

62 38 T.C. 907 (1962).

63 *Id.* at 914.

64 Recently, in Oringderff v. Commissioner, 79,093 T.C.M., (P-H) (1979), the tax court applied capital treatment to futures losses where the taxpayer sought a profit on the futures transactions themselves. The taxpayer, a cattle farmer, did not employ cattle futures to protect his business inventory in cattle from harmful market fluctuations. Instead of holding cattle futures until it was time for future delivery, and thus locking in his profit at a set market price, Oringderff closed out the futures months before the delivery date whenever he anticipated lucrative trends in the futures market. The court concluded that the taxpayer's movement in and out of the market destroyed the futures' protective features, placed the taxpayer at the mercy of the market, and proved that the transactions were speculative. *Id.* at 416-17. In contrast to Oringderff, Hoover consistently held its position in the market. Hoover never closed out its currency futures earlier than a week before delivery was due under each contract. By retaining its position in the futures market until moments before delivery, Hoover preserved the protective element of the futures transactions and shielded itself from adverse market fluctuations.

65 38 T.C. at 913.

66 47 B.T.A. 117 (1942).

67 *Id.* at 127.

68 *Id.*

diction, entered the futures market to protect against such risk.[69] The transactions in *Hoover* are analogous to those of a farmer who carefully predicts the amount of his harvest and then purchases futures to protect against adverse market fluctuations.

International Flavors: *The Integral Part of Business Doctrine*

Ironically, the tax court itself, in *International Flavors & Fragrances Inc. v. Commissioner*,[70] made the most potent argument for applying *Corn Products* to a factual setting like that in *Hoover*. The facts are strikingly similar to those in *Hoover*:[71] the corporate taxpayer with subsidiaries abroad was concerned about the devaluation of the pound and entered into a currency futures contract to "offset a possible write-down of the net current assets of" their British subsidiary when preparing its annual consolidated financial statements.[72]

Although the goverment argued, in *International Flavors*, that *Corn Products* did not apply because the taxpayer was protecting investment property,[73] the tax court rejected this analysis and held that the transaction was not an investment. Rather, the futures contract was integral to the business as a transaction that offset corporate losses, and thus, the resultant gain merited ordinary tax treatment under the *Corn Products* rationale.[74] The court reasoned that "[p]urchases and sales of foreign currency . . . are part and parcel of a multinational busi-

69 Generally, the courts have applied capital tax treatment to transactions where there is a substantial disparity between futures and actuals. In Meade v. Commissioner, 73,046 T.C.M. (P-H) (1973), the taxpayer, a cattle farmer, engaged in futures transactions without regard to his actuals. The court held that losses from such contracts deserved capital treatment because a "large discrepancy between futures and actuals . . . [is] cogent evidence that the futures were acquired as an investment and not a hedge." *Id.* at 73,213. Refusing to apply *Corn Products*, the court concluded that the transactions were merely a form of speculation that provided no protective business function, and accordingly, were not integrally related to Meade's business. In stark contrast to the random futures trading in *Meade*, the transactions in *Hoover* corresponded to Hoover's careful estimate of its exposed foreign exchange risk.

The tax court employed a similar analysis in Carpenter v. Commissioner, 66,188 T.C.M. (P-H) (1966). In *Carpenter*, the court held that losses from the taxpayer's futures transactions were capital for two reasons. First, Carpenter, a soybean and corn farmer, had futures in rye and wheat—grains he did not produce. Second, taxpayer's soybean transactions far exceeded his actuals. Hence, unlike the transactions in *Hoover*, the futures contracts in *Carpenter* did not correspond to Carpenter's actuals.

70 62 T.C. 232 (1974).

71 Taxpayers in both *International Flavors* and *Hoover* entered the futures market in response to the November 18, 1967 devaluation of the British pound. 62 T.C. at 237, 72 T.C. at 215.

72 62 T.C. at 238.

73 72 T.C. at 235.

74 62 T.C. at 239-40.

ness."[75] Furthermore, the court noted that the taxpayer conducted its foreign business through a branch of the parent corporation rather than a British subsidiary, "applicability of the *Corn Products* doctrine to such transaction" could hardly be questioned; therefore, conducting business through subsidiaries rather than branches did not "warrant applicability of a different rule."[76]

Aware of the conflict between its reasoning and that in *International Flavors*, the court in *Hoover* simply discarded the latter reasoning when it wrote, "[t]o the extent that this view is inconsistent with our original holding in *International Flavors* . . . we will no longer follow that position."[77] In refusing to apply the *Corn Products* doctrine, the tax court argued that seemingly capital property transactions deserve ordinary treatment only when the transactions are an integral part of the taxpayer's business operation; the fact that Hoover engaged in numerous futures transactions does not make it an integral part of the business.[78]

The *Hoover* court's reasoning also conflicts with the dissent's analysis in *International Flavors*. In her dissent, Judge Hall stated that "*Corn Products* teaches that capital gain treatment is reserved for 'transactions in property which are not the normal source of business income.' "[79] The judge stated that *Corn Products* did not apply to *International Flavors* because the transaction in the latter was not the normal source of income since there was "no indication that the transaction was recurring."[80] Moreover, she contended that the currency hedge in *International Flavors* could not be part and parcel of a multinational business since there was no evidence that the transaction was routine or customary for the taxpayer.[81] The facts in *International Flavors* diverge from those in *Hoover* in only one significant way. Although there was merely a single transaction in *International Flavors*, there were several transactions in *Hoover*. Hence, the *Hoover* interpretation does not only directly conflict with the majority opinion in *International Flavors*, but also is sharply inconsistent with the dissent.

75 *Id.* at 239.
76 *Id.*
77 72 T.C. at 237.
78 *Id.*
79 62 T.C. at 244 (quoting Corn Products, 350 U.S. at 52).
80 62 T.C. at 244.
81 *Id.* at 239.

THE IMPACT OF *HOOVER*

In 1979, foreign currency futures made up 3%[82] of the total volume of futures activity.[83] According to the Futures Industry Association, these currency futures accounted for 2,222,978 of the 75,966,471 total volume of commodity contracts traded.[84] Moreover, since 1977, the total volume of foreign currency futures has not only proliferated, but this volume has constituted a greater portion of the total volume of commodities traded.[85]

With the continuing acceleration of foreign currency futures activity, *Hoover* might have a profound impact upon both the international currency market and the total commodity volume. By abandoning *Corn Products* and its progeny, *Hoover* shattered the stability of slowly evolving case law and became precedent for dangerous judicial discretion. Free either to ignore or employ Supreme Court precedent, future tax courts might develop result-oriented opinions that lead the taxpayer down a one way street of capital losses and ordinary gains. United States corporations that, like Hoover and International Flavors & Fragrances, employ international currency futures as protective mechanisms against adverse market fluctuations might be deterred from engaging in such activity when there is the added risk of both capital loss and ordinary gain treatment. Without the protection of a stable

82 FUTURES INDUSTRY ASSOCIATION, ASSOC. BULL. No. 6062 (1979).

83 Instead of citing the estimated dollar value of foreign currency futures, this note considers only volume estimates since the latter provide a more precise measurement of the relative importance of a given commodity in the futures market. Charles E. Robinson, Vice President of Futures Industry Association, articulated this more fully in a letter to the author:

> [T]he estimated value of commodity futures contracts is no longer computed by the Futures Industry Association. That figure is not and never has been a good measure of industry activity. Further, such data cannot be used to compare the relative importance of trading in different commodities.
>
> A good illustration is obvious from examining the kind of data you would realize if you used the estimated value figures for 1979. For T-bills traded on the Chicago Mercantile Exchange, that figure would approach $2 trillion. As you probably are aware, the gross national product last year only slightly exceeded the $2 trillion figure. Similarly, if we compare trading in soybean futures on the Chicago Board of Trade with trading in T-bill figures on the Chicago Mercantile Exchange we would find that soybean trading amounted to approximately $350 billion, approximately one-sixth of the value of T-bill futures. Obviously, the 9-plus million contracts of soybean futures traded were much more important to the futures community and to the nation's economy than the 1.9 million T-bill contracts traded.

Letter from Charles E. Robinson to Raymond Slomski (April 8, 1980).

84 FUTURES INDUSTRY ASSOCIATION, ASSOC. BULL. No. 6062 (1979).

85 For example, in 1977, the estimated volume of foreign currency futures traded was 586,428 which constituted 1.4% of the total volume of commodities traded. COMMODITY FUTURES TRADING COMMISSION, ANNUAL REPORT 1978 14 (1978). In 1978, the estimated foreign currency volume of 1,560,749 equaled 2.7% of the entire volume. FUTURES INDUSTRY ASSOCIATION, ASSOC. BULL. No. 6062 (1979).

body of tax law, these corporations might abandon the foreign currency futures market.

CONCLUSION

The tax court, in *Hoover Company v. Commissioner*[86] ordered capital tax treatment for any future transaction which was outside the court's narrowly defined concept—the "bona fide" hedge. Such analysis retreats from *Corn Products* and recent tax opinions which employ the "integral part of business" doctrine. Unlike *Hoover*, these cases distinguished hedging transactions from speculative futures contracts simply by analyzing the intent of the taxpayer. If the taxpayer employed the transactions as insurance mechanisms which shielded some interest of the taxpayer from damaging price fluctuations, the courts unanimously applied ordinary tax treatment. On the other hand, if the transactions were speculative ventures which were expected to produce profit themselves—not to counter a market price flux—the courts ordered capital tax treatment.

An explanation for *Hoover*'s departure from the *Corn Products* doctrine is that this line of cases arguably failed to articulate a rule providing clear guidance to subsequent judiciaries. Even if the *Hoover* court's decision is a reaction to the amorphous law surrounding *Corn Products, Hoover*'s rule fails to remove the ambiguity. By focusing its opinion on the form of the transaction, *Hoover* ignored the Congressional purpose behind the "capital asset" definition that was articulated in *Corn Products*—namely, that capital tax rates were exclusively reserved for speculative transactions. The *Hoover* analysis will provide certainty only if one assumes that a taxpayer who uses a hedge as a protective mechanism will always have a "bona fide" hedge. But the *Hoover* rule fails since a taxpayer may hedge for insurance or protective purposes, and yet, such hedge might be accorded capital tax treatment by the courts if it lies outside the narrow "bona fide" hedge definition.

Raymond J. Slomski, Jr.

86 72 T.C. 206 (1979).