TAX FOUNDATION

TAX FOUNDATION BACKGROUND PAPER #7

A Critical Analysis of the Taxation of Business Hedging and The Case for Comprehensive Congressional Legislation

By:

J. Dwight Evans, Esq.
Special Tax Counsel
Tax Foundation

January 14, 1994

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As a part of the Conference Report on the Omnibus Budget Reconciliation Act of 1993 (OBRA 1993), the Conference Committee states as follows regarding the taxation of hedges:

> Hedging transactions are part of a sound business strategy in fields as diverse as farming, banking, manufacturing and energy production. However, the conferees understand that there may be a level of uncertainty regarding the tax treatment of such hedging transactions following a decision by the United States Supreme Court in 1988, *Arkansas Best Corp. v. Commissioner*, 485 U.S. 212 (1988). Despite subsequent litigation (e.g., *Federal National Mortgage Association v. Commissioner*, 100 T.C. No. 36, June 17, 1993), the scope of the United States Supreme Court decision, and its effect on hedging transactions, may be unclear in some instances. The conferees believe that this is a significant issue. To the extent a solution to this issue may require coordination between the executive and legislative branches, the conferees urge the Administration, in the strongest terms, to advise the House Ways and Means and the Senate Finance Committees, within 90 days of the enactment of this Act, how best to proceed.

On October 18, 1993, the Secretary of the Treasury responded to the above request in a letter to the Chairman and ranking members of the House Ways and Means and Senate Finance Committees. The letter announced the issuance of temporary and proposed regulations dealing with the tax treatment of business hedges. The regulations are intended by the Treasury to:

> resolve uncertainties that arose after *Arkansas Best* regarding the character (ordinary or capital) of gains and losses from most common business hedges.

The Secretary acknowledged that the regulations "do not allow ordinary treatment for all business hedges" and that Congress "may decide that legislation is desirable to expand upon the approach that we have taken...." The Secretary offered the cooperation of the IRS and Treasury in this regard.

The purpose of this background paper is to explore the economic implications and tax policy concerns regarding the income tax characterization of business hedging transactions, namely, whether the gain or loss resulting from these transactions is to be treated as ordinary or capital gain or loss. The taxation of business hedges has a significant economic impact on the efforts of United States businesses to plan the management of financial risks successfully. These risks occur in both the domestic and foreign commerce of the United States and result from commodity price fluctuations, changes in interest rates, and fluctuations in foreign currency values caused by a variety of factors, both temporary and permanent, including changing expectations, political unrest, and natural and man-made disasters. A glossary of commonly used terms can be found at the end of this paper.

I. Introduction

The importance of the business hedge as a financial risk management tool has increased dramatically in recent years and continues to do so. Beginning with the worldwide inflation of commodity prices in the 1970s, the uncertainty about long-term commodity costs has made large segments of U.S. business very sensitive to pricing volatility and the need to hedge that risk. The savings and loan disaster highlighted interest-rate risks in the financial industry and the consequences of the failure to match through hedging long-term financial assets with short-term funding. Also, as U.S. international business has grown, companies have faced tremendous volatility in foreign exchange rates. The trouble with the European Exchange Rate Mechanism has recently underlined the importance of hedging foreign currency exposure.

To meet the needs to manage interest rate, foreign currency, and commodity price risks, the futures, options, and derivatives markets have expanded tremendously. According to the Futures Industry Association, the volume of futures and option contracts traded on U.S. futures exchanges has increased from 275 million contracts in 1987 to more than 364 million contracts in 1992. Similarly, the total amount of U.S. interest rate and currency swaps outstanding at year-end has increased from $0.41 trillion in 1987 to $1.35 trillion in 1992, while on a worldwide basis, the increase has been from $0.87 trillion in 1987 to $4.7 trillion at year-end 1992. [Commodity Futures Trading Commission Report, OTC Derivatives Markets, p. 24, Figure 1]

The economic purpose of a hedge, whether in the simplest or most sophisticated form, is to balance gain and loss through a transaction in which the value of the hedge will change inversely to the value of the hedged asset or liability. To accomplish this objective the income tax treatment of both sides of the transaction must be symmetrical. Otherwise, the after-tax gain and loss from the transaction may not be in balance.

For many years, based on the U.S. Supreme Court's 1955 decision in *Corn Products Refining Co. v. Commissioner*, 350 U.S. 46, a hedging transaction received symmetrical income tax treatment. The offsetting gain or loss resulting from each side of the transaction were taxed as ordinary gain or loss.

In 1988, the ordinary income tax characterization of gain or loss resulting from a hedge was placed in serious doubt by the Supreme Court's decision in *Arkansas Best Corp. v. Commissioner*, 485 U.S. 212. That case created uncertainty as to whether the gain or loss from a hedge is treated as ordinary or capital for tax purposes. This distinction is important. If the gain or loss from the hedge is capital, the after-tax result of the hedging transaction may not be in balance, in which case the economic purpose of the transaction is frustrated.

Unless there is a clear rule regarding the tax treatment accorded the many different forms of business hedging, taxpayers engaged in hedges cannot determine with reasonable certainty the after-tax cost of their efforts to manage the risk of loss resulting from cost fluctuations in the worldwide market place. Such uncertainty has a direct and substantially adverse impact on the commerce of the United States.

As pointed out in the Conference Report on OBRA 1993, uncertainty in the tax treatment of business hedges follows from the Supreme Court's decision in the *Arkansas Best* case and recent Tax Court litigation. While the foregoing is correct, the uncertainty regarding taxation of business hedges has its origins in Congress's failure in 1934 to deal with business hedging when it defined the term "capital asset" in connection with distinctions drawn in the Internal Revenue Code ("Code") between the taxation of capital gain or loss and ordinary income. To date, Congress has failed to correct this omission in a comprehensive way. Rather, to the extent that Congress has dealt with the taxation of hedging, it has done so on a piecemeal basis.

On October 18, 1993, the Treasury issued temporary and proposed Treasury Regulations in an attempt to resolve the uncertainty created by the Supreme Court's decision in *Arkansas Best*. These regulations are generally regarded as a welcome step in the right direction. Based on the tax law as interpreted by the Supreme Court in *Arkansas Best*, the Treasury has possibly gone as far as it can without new legislation in resolving by regulation the problem concerning the ordinary income characterization of gains and losses from business hedges.

As pointed out by the Treasury, its regulations do not resolve the existing tax characterization problem for all business hedges. In addition, important questions regarding the scope of the tax relief provided by the new regulations remain unresolved. This paper concludes that the remaining unresolved issues regarding business hedges are important and should not be left to a continued lengthy and uncertain litigation process. Rather, Congress should hold hearings and, acting on the suggestion by the Secretary in his letter of October 18, 1993, to the House Ways and Means and Senate Finance Committees, consider comprehensive legislation that fully deals with all aspects of the taxation of business hedges. Such legislation should be based on economic substance, recognizing that gain or loss generated by a hedge of price, interest, or currency risks is part of an ordinary and necessary business transaction designed to manage and minimize those risks.

II. Statement of the Income Tax Problem

A. The income tax problem results from distinctions created in the Code in the taxation of transactions involving "capital assets" as compared to "ordinary" income.

The central tax issue is whether the sale or exchange of an asset in a hedging transaction creates gain or loss which is ordinary or capital in character. If the sale creates a capital loss, then, with limited exceptions, the loss can only be deducted from capital gains. If the taxpayer's capital gains exceed or are equal to its capital losses, no problem results. However, if the taxpayer is a corporation and its capital losses exceed its capital gains, the excess loss cannot be deducted currently and must be carried back and deducted from any capital gain in the three tax years preceding the loss year. If a net capital loss still remains, it then can be carried forward for five years and deducted from any capital gain. If the taxpayer is an individual he or she may deduct up to $3,000 of the excess in capital loss against ordinary income, but any amount over $3,000 must be carried into a future tax period.

In contrast, if the sale of an asset in a hedging transaction creates ordinary loss, that loss may be deducted fully from current ordinary income.

The Code makes important arbitrary distinctions between income from the sale or exchange of a "capital asset" as distinguished from income from ordinary business operations. The problem is that the Code (Section 1221) defines the term capital asset broadly—"property held by the taxpayer (whether or not connected with his trade or business)"—with narrow exceptions. Those assets that fall under one of the exceptions are treated as assets whose sale produces ordinary gain or loss. The sale of all other assets produces capital gain or loss. The exceptions most relevant to hedging are:

1. stock in trade or property included in the taxpayer's inventory and property held primarily for sale to customers in the ordinary course of the taxpayer's trade or business (Section 1221(1));

2. accounts or notes receivable acquired in the ordinary course of trade or business for services rendered or from sale of property described above (Section 1221(4)); and,

3. a bond, debenture, note, certificate or other evidence of indebtedness held by a financial institution (Section 582).

In addition, a special exception is provided in the Code for depreciable property or real property used in a taxpayer's trade or business (Section 1221(2)). If there is a net gain from the sale of this property, it is treated as a capital gain whereas a net loss is treated as an ordinary loss deductible from ordinary income (Section 1231).

The other ordinary income exceptions enumerated in the Code (a copyright, literary, musical or artistic composition created by the taxpayer's personal efforts as well as letters or memorandum prepared by or for the taxpayer, and certain U.S. government publications) are not relevant to hedging. The rationale for the ordinary income exceptions is that the assets involved are either connected with a taxpayer's trade or business or with an income-producing activity deemed by Congress to be ordinary in character in order to close perceived "loop holes."

B. The economic objective of a business hedge.

A hedge, in either its simplest or most sophisticated form, involves a counter-balancing transaction designed to reduce or eliminate the risk of loss in another, underlying transaction—the hedged transaction. A business entity (corporation or individual) enters into a hedge to offset risk of loss associated with assets or liabilities that it incurs or expects to incur in connection with the operation of its business. The income from this underlying business transaction is taxed as ordinary income. To accomplish its economic purpose, the value of the hedge changes inversely to the value of the hedged asset or liability. The economic counterbalancing objective of a hedge is frustrated if the income tax results do not follow the economic results of the hedge, i.e., losses or gains from the hedge transaction cannot for tax purposes be offset against the gains or losses from the hedged business activity. Thus, for a business hedge to accomplish its economic objective after tax, the gain or loss resulting from the hedge must be ordinary in character for income tax purposes if the underlying activity produces ordinary income or loss.

C. The tax problem with hedging.

The tax problem with hedging is twofold. The first issue is statutory and poses the question whether the hedge transaction involves a sale or exchange of property treated under the Code as a capital or ordinary income asset in the hands of the taxpayer. The second issue is factual and poses the question whether the "hedge transaction" is a part of a taxpayer's ordinary business operations entered into for the purpose of managing (e.g., reducing) risk, or whether the transaction is in whole or in part an investment or speculation in a capital asset. In other words, is the transaction really a business hedge.

An adverse answer to either question results in an income tax mismatch which defeats the economic objective of a hedge to balance gain and loss. As pointed out hereafter, the Treasury and IRS, taxpayers and the courts have been wrestling with these issues since 1934.

III. An Examination of the Business Hedge from an Economic Standpoint

People often speak of hedging their bets, by which they mean that they expect a certain event to take place, but are not sure that it will occur and so they take some measure to protect themselves economically. For example, someone looking for a job may have a particular position with a specific firm in mind, but he or she will likely interview with other companies about other jobs in case the first choice goes to someone else. In this case, by interviewing with more than one company, the job seeker is hedging his or her bet. As this example shows, the act of hedging is fundamentally an act of insuring against less preferred outcomes.

In fact, the purchase of insurance is itself an act of hedging. Buying disability or life insurance is hedging against the loss of income (and the expenses) that would follow should an income-earner become ill or pass away. Fire or flood insurance is a hedge against the cost of replacing a home or other property lost due to fire or flood. Actors have been known to take out insurance on their smiles, dancers have taken out insurance on their legs, and sports figures have taken out insurance on their physical ability to perform, that is, to earn income in their chosen profession. In each case, the individual is hedging against an undesirable outcome.

Every business is subject to a wide variety of risks, some of which it chooses to bear and some of which it chooses to reduce or eliminate. One of the basic means by which a business protects itself from undesirable risks is through hedging. For example, sometimes it can protect itself from exceptional increases in the prices of the commodities it uses as factors of production, and sometimes it can protect itself from declines in the prices of its products.

Hedging is often confused for speculation because many of the tools of hedging are also the tools of speculating, such as the forward and futures contracts written on the financial exchanges. While there are many apparent and operational similarities, there is one enormous and basic difference between them: Hedging is an act of risk management by the hedger through risk reduction, whereas speculation is an act of taking on additional risk.

Businesses hedge as a means of reducing unwanted risk and, as such, hedging reduces a business' overall cost of production. Anything that raises the cost of hedging or otherwise restricts a business' ability to hedge, raises its cost of production, slows economic growth, and hinders the business' competitiveness.

The following examples demonstrate in greater detail how a business may engage in a hedge. The basic economic principles illustrated apply irrespective of the simplicity or complexity of the transaction, and irrespective of whether the transaction involves a commodity, interest rates, or foreign currency.

A. The futures contract.

A typical use of a commodity futures contract in a business hedge is the grain elevator operator who has contracted with farmers to purchase wheat at a specified price payable at a future date. The farmers have entered into this forward contract to guarantee what they perceive as a favorable price for their wheat and to shift the risk of adverse price movements to the grain elevator operator. The elevator operator bears the risk that the price of wheat will fall below the price guaranteed to the farmers, leaving the elevator operator with a potential loss on its sale of the wheat to a processor. To protect against this risk, the elevator operator can sell, i.e., "go short," in a commodity futures market the number of wheat futures contracts that matches the quantity of wheat that he is committed to buy from the farmers at the guaranteed price.

In the real world, very few futures contracts result in the delivery of the commodity. Instead, the holder of the futures contract liquidates the contract before delivery date by executing an equal and opposite contract in the futures market. Thus, to liquidate his position the grain elevator operator would buy a number of wheat contracts equal to the number it originally sold. If the price of wheat has fallen, the elevator operator receives a profit in the futures market which is offset by the higher price that the elevator operator has already committed to pay the farmers for their wheat. Conversely, if the price of wheat has risen, the elevator operator will have a loss on its futures position which is offset by the profit that the elevator operator realizes on his sale of the wheat to a processor at a price higher than he paid to the farmers. By shifting his price risk to the futures market, the grain elevator operator has minimized the risk of changes in the price of wheat between the time that he entered into the fixed price contracts with the farmers and the time that the farmers deliver their wheat and the elevator operator is in a position to sell the wheat to a processor.

The price of a futures contract is determined by the thousands of buyers and sellers who meet in open competition in the commodity futures market where anyone who is financially qualified trades the same commodity with his own view of the facts concerning the supply and demand for the commodity. The participants in the commodity futures markets include producers, middlemen such as the grain elevator operator, and a wide variety of commercial users, processors and exporters, all of whom use futures contracts to protect against business losses as a result of fluctuations in commodity prices. In addition, professional investors participate in the commodity futures market, not to manage risk, but to make a profit based on price changes.

B. The swap contract.

Many business hedges are conducted outside of an organized futures market through so-called swaps between counterparties. A swap contract enables a party to lock in a price or rate. Whether the actual price or rate rises or falls, the party entering into the swap contract receives or pays a fixed price or rate for the hedged commodity, interest, or currency.

A simple example of a swap involves jet fuel, a commodity subject to considerable price fluctuation. A swap enables the airline to lock in a fixed price for its anticipated jet fuel consumption. In the swap contract the airline agrees to pay a fixed price for jet fuel to a so-called counterparty, e.g., a bank, and in return receives the spot price of jet fuel. At the end of each settlement period, if the spot price is greater than the fixed price, the airline receives from the bank the difference between the spot price and the fixed price multiplied by the quantity of jet fuel agreed to in the swap contract. If the fixed price is less than the spot price, the airline pays to the bank the difference in prices multiplied by the quantity of jet fuel. In effect, the swap contract stabilizes the price of jet fuel, a major operating cost of the airline. When spot jet fuel prices rise relative to the fixed contract price, the airline receives a payment which offsets increased jet fuel costs. When spot prices fall, the airline pays the bank the difference and forgoes the cost savings. The bank is paid an up front fee or premium for entering into the swap contract and may, in turn, hedge all or part of the risk it has assumed.

Business hedging is a vital and normal aspect of a modern economy. Neither tax nor regulatory policies impeding these transactions should be enacted without clear compelling reasons. Speculation is, likewise, a vital and normal activity in a modern economy, partly because speculation helps the market to discern the prices that will be charged for commodities in the future which can be important signals for allocating resources today. Also, speculators are essential to the efficient operation of the financial markets on which hedgers rely. Policies that inhibit speculators or otherwise raise their costs cause the markets to operate less efficiently and thereby inhibit the ability of hedgers to control their own costs.

IV. A Short History of the Taxation of the Business Hedge

A. The early development of a rule.

The potential for an income tax mismatch and a whipsaw in the economic consequences of a hedge resulted from a change in the capital gain/loss rules in the Revenue Act of 1934. Prior to the 1934 Act, an asset had to be held for two years to obtain capital gain or loss treatment. Because hedging techniques used at that time were of a shorter duration than two years, hedging transactions prior to 1934 necessarily gave rise to ordinary gain or loss. The Revenue Act of 1934 modified the definition of the term "capital asset" by eliminating the holding period requirement. At that point the question arose as to whether the asset sold or exchanged in the hedge was ordinary or capital in character. The Revenue Act of 1934 did not deal with hedging and there is no indication that Congress realized that it had created a problem in connection with the tax characterization of a business hedge.

In 1936, the IRS in General Counsel Memorandum ("GCM") 17322 dealt for the first time with the income tax consequences of a business hedge. GCM 17322 analyzed the issue from the standpoint of economic substance and concluded that "true hedges" should be treated as producing ordinary income or loss for income tax purposes since the transactions are a form of insurance rather than a "dealing in capital assets." GCM 17322 considered only two basic hedging transactions by way of example and did not attempt to define what was a "true hedge." The GCM warned that contracts in futures that are not hedges are speculative in nature and thus subject to capital asset income tax treatment.

The courts followed the GCM and adopted the cost of insurance rationale without seriously questioning whether the IRS had authority to create what was arguably a non-statutory exception to the definition of a capital asset. Considerable litigation ensued for twenty years, basically over factual issues as to what constitutes a true business hedge. Uncertainty as to the tax result existed where the taxpayer had an imperfect or partially balanced hedging position, i.e., the hedge was in an amount smaller or larger than the hedged asset or liability, was not simultaneous with the risk sought to be protected, or involved a different commodity, etc.

B. The Corn Products *case and the business versus investment motive test.*

In 1955 the U.S Supreme Court decided the case of *Corn Products Refining Co. v. Commissioner*, 350 U.S. 46, which appeared to broaden and simplify (at least for taxpayers) the tax rule regarding business hedging. The Corn Products Company was engaged in the sale of various products which it manufactured from corn held in inventory. To insure itself against adverse price fluctuations in this commodity, the company engaged in futures transactions that resulted in net gains in one year and a smaller net loss in a later year. In the U.S. Tax Court, Corn Products claimed capital asset treatment for these gains and losses, attempting to take advantage of the lower tax rate that then applied to a gain or loss from the sale of a capital asset. Corn Products argued that its transactions were not true hedges under the existing case law but, rather, were speculative and separate from its business, and thus capital in character.

In a brief opinion on the hedging issue the Tax Court found that the purchases by Corn Products of corn futures were made to insure the profitable conduct of the business. The court ruled against Corn Products, reasoning that while the taxpayer's transactions might not technically meet the definition of a true hedge, they were an "integral part of its manufacturing business" and not speculative transactions of a capital nature. Thus, the Tax Court concluded that the gain and loss were ordinary in character.

The U.S. Court of Appeals for the Second Circuit ("Second Circuit") affirmed the decision of the Tax Court on appeal, but used a different legal analysis. The Second Circuit did not follow the economic substance argument developed by GCM 17322 that the cost of a true business hedge is an ordinary business expense because the hedge is insurance against market price fluctuations. Instead, the Second Circuit developed a new approach and looked at the statutory definition of a capital asset and the statutory exclusions from capital asset treatment. It concluded that Corn Products' dealings in corn futures came within the inventory exclusion (presently Code Section 1221(1)) from capital asset treatment. Thus the gains and losses were taxable under the ordinary income and not the capital gain/loss rules.

The Supreme Court's opinion in the *Corn Products* case appeared to ignore both the Tax Court's cost of insurance and the Second Circuit's statutory analysis. Instead, the court adopted a broad subjective test that looked to the business or investment motive of the taxpayer in connection with its hedging transactions. In rejecting the taxpayer's argument that its corn futures were transactions involving capital assets, the Supreme Court stated 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.

In summary, all three courts concluded that the gains and losses from the futures transactions were ordinary in character but used different reasoning in arriving at the conclusion:

- The Tax Court followed a cost of insurance rationale.

- The Second Circuit rejected that approach and looked to the statutory definition of a capital asset.

- Finally, the Supreme Court appeared to adopt a new rule, namely, whether the asset sold was acquired for use in the taxpayer's business.

Under the Supreme Court's *Corn Products* business motive test, the question whether a transaction was a "true hedge" was no longer important.

C. The result of the Corn Products *test.*

For some 30 years following the Supreme Court's decision in the *Corn Products* case, taxpayers, the lower courts, commentators, and eventually the IRS (but apparently not the U.S. Department of Justice) interpreted that decision as creating an exception from capital asset treatment for the sale or exchange of any asset used as an integral part of the taxpayer's business. The *Corn Products* test was extended to transactions having no relationship to business hedging, with the result that a wide variety of transactions were granted ordinary income or loss treatment, including gain or loss from the sale of another company's stock used in connection with the taxpayer's business.

The expansion of the *Corn Products* doctrine placed the IRS in a very difficult administrative situation. For example, if the taxpayer's transaction resulted in profit, then the taxpayer could claim that the asset sold was capital in character and was entitled to the favorable capital gains tax rate. However, if the transaction resulted in loss, the taxpayer could claim that the asset sold was acquired with a business motive and take an ordinary loss deduction against ordinary income taxed at the higher ordinary rate. The taxpayer was able to "whipsaw" the IRS.

As indicated in GCM 38178, it appears that the Justice Department, as distinguished from the IRS, interpreted *Corn Products* narrowly:

> 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 ... which we do not here reconsider. In [Office Memorandum] 18818, this office rejected the argument advanced by the Department of Justice...that the business investment purpose test underlying Rev. Rul. 75-13 should be abandoned and replaced by a literal approach to Section 1221.

This difference in the interpretation of the *Corn Products* decision eventually led to the *Arkansas Best* litigation.

D. The Arkansas Best *case and resulting confusion.*

The case of *Arkansas Best Corp. v. Commissioner*, 485 U.S. 212, was decided by the U.S. Supreme Court in 1988. The case did not involve hedging. It involved the sale of stock in a banking company. Arkansas Best was a holding company that owned 65% of the stock of a bank that began to experience financial difficulties. In an attempt to keep the bank from failing, and to protect its good reputation, Arkansas Best provided the bank with additional capital by purchasing additional stock. The rescue was unsuccessful and Arkansas Best sold the bank stock at a loss. For tax purposes, Arkansas Best took the position that the loss was ordinary based on the contention that it was in the business of acquiring and managing companies. The IRS disagreed as to the ordinary characterization of the loss and the case went to the U.S. Tax Court. The Tax Court relied on the conventional *Corn Products* analysis. It held that the original purchase of stock was an investment which resulted in a capital loss deductible only from capital gain. However, it found that the subsequent purchase of stock was business motivated (to protect the good reputation of Arkansas Best) and, therefore, that portion of the loss was ordinary in character and deductible from other ordinary income.

On appeal, the U.S. Court of Appeals for the Eighth Circuit agreed with the Tax Court's decision as to the original purchase of the bank's stock but held the subsequent purchase by Arkansas Best was also an investment, and therefore capital in character.

In a relatively brief opinion, the Supreme Court affirmed the decision of the Court of Appeals. In doing so, however, the Supreme Court appears to have completely rejected the business motive test and the broad interpretation which had been consistently given its *Corn Products* opinion for some 30 years. The Supreme Court, relying heavily on the reasoning of the 1954 Court of Appeals for the Second Circuit opinion in *Corn Products*, which it had earlier appeared to reject, interpreted its opinion very narrowly:

> In light of the stark language of Section 1221, however, we believe that *Corn Products* is properly interpreted as involving an application of Section 1221's 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 for the narrow proposition that hedging transactions that are an integral part of a business inventory-purchase system fall within the inventory exclusions of Section 1221.

Although *Arkansas Best* did not involve hedging, the Supreme Court's apparent repudiation of the business motive test put 30 years of lower court case law and IRS administrative decisions regarding the taxation of hedging into serious doubt. In Notice 87-68, the IRS suspended all of its rulings under the so-called *Corn Products* doctrine pending the Supreme Court's decision in *Arkansas Best.* During the five years following the *Arkansas Best* decision neither the Treasury nor the IRS published any guidance regarding the appropriate tax treatment of hedges. Without this guidance, IRS auditors have been free to challenge and have challenged numerous business hedging transactions. These challenges included transactions entered into prior to the *Arkansas Best* decision in which the taxpayer relied on the long-standing law regarding hedging as it was then commonly understood. The first of these cases to reach the courts involved hedging transactions conducted by the Federal National Mortgage Association (FNMA).

E. The FNMA case and the rejection of the Treasury's litigating position.

FNMA is a federally chartered corporation whose purpose is to provide liquidity in the secondary market for home mortgages. It purchases home mortgage loans from lenders which permits these lenders to make additional loans. FNMA acquires funds to purchase home mortgages through the issuance of its debt obligations and had a hedging program designed to manage its interest rate risks in connection with both the purchase of mortgages and its debt financing program. Net losses incurred in this hedging program were claimed as ordinary losses. The IRS disagreed and the case went to the Tax Court.

In its arguments for capital treatment of FNMA's hedging losses, the IRS urged a very narrow and strict interpretation of the Supreme Court's decision in *Arkansas Best*. The Service argued that:

1. FNMA's losses resulted from a sale of capital assets as defined in Code Section 1221 since none of the statutory exceptions apply; and, in all events

2. business hedging should be narrowly defined and cannot involve short hedging positions.

Contrary to the narrow IRS litigating position, the Tax Court held in *Federal National Mortgage Association v. Commissioner*, 100 T.C. No. 36, that, based on the facts regarding FNMA's "service" business, the hedges in question came within the statutory capital asset exception for "accounts or notes receivable acquired in the ordinary course of trade or business for services rendered," (Code Section 1221(4)). The court also rejected the Service's narrow view of what constitutes a hedge. In the Tax Court's opinion, a hedge may offset either a current actual (cash) position or an anticipated position and may be either a short or long position. Also, a hedge is not limited to transactions that create an even or balanced position. A hedge may be partial in effect and protect only a portion of a taxpayer's total risk of loss.

In reaching its decision that FNMA's hedging losses were ordinary in character, the Tax Court followed the capital asset exception test used by the Supreme Court in *Arkansas Best*, namely, did the hedging transaction come within one of the statutory exceptions in the Code to capital asset treatment.

F. The Treasury's new position on business hedging.

In a letter dated October 18, 1993, to the chairman and ranking members of the House Ways and Means and Senate Finance Committees, Treasury Secretary Lloyd Bentsen announced a dramatic reversal in the government's position on the taxation of the business hedge. Under the new position announced in temporary and proposed regulations, the Treasury has taken a major step toward allowing ordinary income tax treatment for loss realized from a business hedge. However, because of the capital asset exception test prescribed by the Supreme Court in *Arkansas Best*, on which the Treasury's new regulations are based, the Treasury does not, and arguably cannot, under the existing statute provide for ordinary treatment of all business hedges unless there is corrective legislation by Congress.

The temporary regulations provide the exclusive method whereby taxpayers can achieve ordinary gain or loss with respect to hedging transactions. The preamble to Temporary Regulation Section 1.1221-2T specifically states that a taxpayer cannot claim ordinary gain or loss for hedges under a business insurance rationale. Under the Treasury's new interpretation of *Arkansas Best*, its ability to extend ordinary income or loss treatment to a business hedge is arguably limited by the capital asset exceptions presently found in the Code.

The Treasury's temporary regulations define hedging as a transaction that a taxpayer enters into in the normal course of business primarily to reduce the risk of interest rate, price or currency fluctuations with respect to ordinary property (as defined) held or to be held, borrowings made or to be made, or ordinary obligations incurred or to be incurred by the taxpayer.

"Ordinary property" is defined as property which, if sold by the taxpayer, could never produce capital gain or loss regardless of the length of time which the property has been held. Similarly, an "ordinary obligation" is defined as an obligation which, if performed or terminated, could never produce a capital gain or loss.

The Treasury's definition of "ordinary property and obligations" clearly provides ordinary gain or loss treatment for inventoried property (including debt securities held by a bank) and many business liabilities and obligations. The regulations will, however, exclude from ordinary income tax treatment hedging gains or losses on a number of traditional and important business hedges.

A major example is a hedge of non-inventory supplies. The Treasury has excluded this type of hedge from favorable tax treatment because non-inventory supplies, by definition in the Code, are a capital asset if sold, irrespective of the fact that when non-inventory supplies are consumed in the taxpayer's business, they give rise to an ordinary deduction in producing ordinary income or loss. By way of example and as pointed out in the Secretary's letter, the failure of the Treasury Regulation to include non-inventory supplies within the definition of "ordinary property" will adversely affect the income tax consequences of hedging by airlines of their supply of jet fuel.

Another exception in the Treasury's definition of "ordinary property" relates to depreciable property or real property used in the taxpayer's trade or business. As pointed out earlier in this paper, such property is specifically excluded from capital asset treatment by the Code (Section 1221(2)). However, because the Code (Section 1231) provides this property a special benefit in that a net gain on the sale of such property is treated as capital while a net loss is treated as ordinary, the Treasury proposes that it is inappropriate to have a loss on a hedge treated as ordinary when gain on the item hedged could be treated as capital gain. This position appears to conflict with Congress' desire to confer a special benefit on gain or loss from the sale of trade or business property. The Treasury's position could adversely affect business hedging by the equipment leasing industry of contractual obligations to purchase equipment which is to be leased or rented.

V. The Need for Comprehensive Congressional Legislation

Clearly, as Secretary Bentsen states, Treasury's proposal does not completely resolve all of the outstanding issues concerning the tax characterization of hedging transactions. This omission goes far beyond just the airline industry and would exclude from favorable income tax treatment numerous important and normal types of business hedges.

For example, under the temporary and proposed regulations, a trucker cannot obtain ordinary income tax treatment of a gain or loss on a hedge against adverse changes in diesel fuel prices. The same will be true for railroads (diesel fuel) and ocean shipping (bunker fuel). Similarly, an electric utility cannot obtain favorable tax treatment of its hedges in connection with its fuel requirements, e.g., coal, natural gas or residual fuel oil. The operators of large office and commercial buildings cannot successfully hedge in connection with the supply of heating oil.

Manufacturers and other business operations will also suffer adverse income tax treatment. For example, steel manufacturers may not be able to use a hedge successfully in connection with its coal requirements because of the tax liability mismatch. Likewise, a cattle feed lot operator will not receive ordinary gain or loss treatment of its hedge of the price of non-inventoried corn used to feed cattle. One of the rapidly developing areas of business hedging includes the hedge of electric power costs. The Treasury Regulation's exclusion of non-inventoried supplies from favorable "ordinary property" treatment appears to make this type of hedging transaction uneconomic and may seriously impact large consumers of electrical energy such as the aluminum industry.

In addition to the foregoing issues, a number of substantial issues remain unresolved under the Treasury's temporary and proposed regulations. For example, the hedge of a related party's risk will not receive ordinary tax treatment. In multicorporate groups it is not uncommon for hedging to be centralized in one company, e.g., the parent company hedges interest, currency or price risks incurred by subsidiaries. On the other hand, the regulations do not deny ordinary income treatment for hedges of obligations to, or property dealings with, related parties so long as the risk hedged is the taxpayer's and the hedge is a part of the normal course of the taxpayer's business. Another important issue is whether the particular transaction satisfies the "risk reduction" requirement of the regulations. For example, an interest rate swap that converts a fixed payment liability to a floating payment liability, while clearly risk management, may arguably not constitute risk reduction. This type of transaction is in widespread use today and a clear resolution of its tax treatment is desirable.

To date, Congress has dealt with the taxation of business hedges on an *ad hoc* basis. As a result, provisions regarding business hedging are found in numerous places in the Code, e.g., Section 1256 (contracts marked-to-market), Section 988 (foreign currency transactions), as well as recently enacted Section 475 (securities dealers' inventories). Nowhere in the Code has Congress dealt with hedging comprehensively. Nor does it appear that Congress has ever held hearings focused clearly and comprehensively on the economic reality of the business hedge, namely, that it is a normal cost of business in managing financial risks. The explosive increase in the use of business hedges, as well as the development of a huge sophisticated market in derivatives, coupled with the new Treasury Regulations and the hearings in connection with such regulations, provide Congress with a unique opportunity to examine economic and tax policy concerns involved in business hedging.

While it is outside the scope of this paper to deal in detail with the revisions to the Code necessary to establish a sound tax policy for the taxation of business hedging, the Treasury's new proposals in connection with the definition of a business hedge, the procedure for the identification of a business hedge and record-keeping requirements, the timing and accounting rules, and effective dates clearly establish that the ground work has been laid for comprehensive legislation on the taxation of business hedging. Likewise, the Treasury's proposal to provide ordinary income tax treatment for "most" business hedges should go a long way toward minimizing revenue concerns associated with any proposed legislation.

To resolve fully the existing income tax problem regarding the character of gains and losses from all business hedges, Congress should consider enacting legislation recognizing the economic reality of the hedging transaction, and should be clear whether it intends that the gain or loss from all hedges be treated as ordinary in character when those gains or losses result from the ordinary and necessary business management of price, interest, or currency risks.

Conclusion

As a result of the lack of comprehensive statutory rules in the Internal Revenue Code, the Treasury and IRS, as well as taxpayers and the courts have been struggling over a period of 60 years with the taxation of business hedging. The successful management of worldwide price, interest, and currency risks through business hedging is vitally important to the successful operation of the domestic and international commerce of the United States. A comprehensive system of income taxation which is consistent with the economics of risk management through business hedging is essential to the successful operation of U.S. business. That system does not exist in the Code today.

While the Treasury's temporary and proposed regulations are a welcomed major step, they concededly do not resolve all of the outstanding issues concerning the taxation of hedging transactions.

Quite possibly, under the present provisions of the Code, the Treasury cannot fully resolve many of these issues. Left for legislative action are important issues such as the tax treatment to be accorded a hedge of a taxpayer's supplies, property used in the taxpayer's trade or business, and related party hedges. In addition, there is a basic question whether the concept of "risk reduction" utilized in the regulations should not be expanded to a more realistic concept of "risk management." These, and possibly other substantive and procedural issues which have been left unresolved or uncertain under the Treasury's new regulations need to be resolved by Congress.

The Treasury's new proposals regarding hedging gives Congress, with the joint cooperation of taxpayers, a unique opportunity at this time (possibly for the first time since 1934) to hold hearings and enact a comprehensive statutory system for the taxation of the business hedge which fully resolves existing tax problems inherent in the Code.

GLOSSARY

Terms Used in Connection with Business Hedging

Cap: A contract for which the buyer pays a fee, or premium, to obtain protection against a rise in a particular price or rate above an agreed level. For example, an interest rate cap may cover a specified principal amount of a loan over a designated period such as a calendar quarter. If the covered interest rate rises above the rate ceiling, the seller of the rate cap pays the purchaser an amount of money equal to the average rate differential times the principal amount times one-quarter.

Floor: A contract under which the seller agrees to pay to the purchaser in return for the payment of a fee or premium the difference between a current price or rate and an agreed (strike) price or rate times the notional amount should prices or rates fall below the agreed price or rate.

Cash Commodity: The physical or actual commodity as distinguished from a futures contract. Sometimes called the spot commodity or actuals.

Collar: The simultaneous purchase of a cap and the sale of a floor with the aim of maintaining prices or rates within a defined range. The premium income from the sale of the floor reduces or offsets the cost of buying the cap.

Derivative/Derivative Contract: A financial instrument traded on or off an exchange, the price of which is directly dependent upon (i.e., derived from) the value of one or more underlying securities, commodities, debt instruments, equity indices, other derivative instruments or any agreed upon pricing index or arrangement. Derivatives involve the trading of rights or obligations based on the underlying product but do not directly transfer property. They are used to hedge risk or exchange a floating rate of return for a fixed rate of return.

Forward/Forward Contract: A commitment to buy (sell) an asset at a future date for a price determined at the time of commitment. A forward may be applied to commodities, currencies, equities or other assets.

Futures Contract: An exchange-traded contract generally calling for delivery of a specified amount of a particular grade of commodity or a financial instrument at a fixed rate in the future.

Hedge/Hedging: To reduce risk by taking a position which offsets existing or anticipated exposure to a change in market rates or prices.

Long: (1) One who has bought a futures contract to establish a market position; (2) a market position which obligates the holder to take delivery; or (3) one who owns the commodity or financial instrument which is traded.

Option - Call/Put: The contractual right, but not the obligation, to buy or sell a specified amount of a commodity or given financial instrument at a fixed price before or at a designated future date. A call option confers on the holder the right, but not the obligation, to buy ("call") the commodity or financial instrument. A put option involves the right, but not the obligation, to sell ("put") the commodity or financial instrument.

Position: An interest in a market, either long or short, in the form of one or more open contracts.

Short: (1) The selling side of an open futures contract; (2) a net position in the futures market showing an excess of open sale over open purchases; or (3) one who does not own the commodity or financial instrument that is being traded, i.e., a sale before purchase with a view of purchasing at a future time at a lower price for delivery.

Spot Market: Market of immediate delivery and immediate payment.

Strike Price/Exercise or Contract Price: The agreed price at which the underlying futures contract or commodity will move from seller to buyer.

Swap: The exchange of one asset or liability for a similar asset or liability for the purpose of lengthening or shortening maturities, or raising or lowering coupon rates, to maximize revenue or minimize financing costs. In securities, this may involve selling one issue and buying another; in foreign currency, it may involve buying a currency on the spot market and simultaneously selling it forward. Swaps may also involve exchanging income flows. For example, exchanging the fixed rate interest stream of a bond for a variable interest rate payment stream, while not exchanging the principal component of the bond.

Swaption: An option to enter into (or cancel) a swap, i.e., the right, but not the obligation, to enter into (or cancel) a specified type of swap at a specified future date.

Underlying/Underlying Transaction: The designated commodity or financial instrument which must be delivered in completion of an option contract or a futures contract.