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U.S. Tax Treatment of Gains and Losses Realized on Foreign Currency Exchange Rate Hedging

by Edward A. Weinstein*

I. FOREIGN CURRENCY EXCHANGE AND THE NEED FOR HEDGING

A. Introduction

Any U.S. taxpayer who engages in commercial transactions outside of the country will most certainly deal in currencies other than the U.S. dollar. It is possible that when such taxpayer sells an asset purchased abroad or settles a liability arising from a foreign source, he or she may well have realized a gain or loss attributable solely to a change in the U.S. dollar value of the foreign currency. A change in the value of the foreign currency might also be relevant to the taxpayer's financial position and ultimate tax liability even before the transaction is closed. For example, when preparing personal financial statements or its U.S. income tax return, the taxpayer may need to translate any foreign currency transactions¹ into U.S. dollars.²

B. The Risks

The taxpayer engaged in multinational commercial activities faces

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¹ Typical foreign currency transactions include the following:

- a. Long-term notes issued by a foreign bank, municipality, or corporation, denominated in a foreign currency, and to be paid at a specified future date;
- b. Assets and liabilities of foreign branches which are reported in the taxpayer corporation's financial statements;
- c. Dividends from a foreign corporation or royalties from a foreign source to be paid at a specified future date; and
- d. Assets and liabilities of foreign subsidiaries which are reported as investments on consolidated financial statements.

See *U.S. Tax Aspects of Foreign Currency Transactions—Part V*, INTERNATIONAL TAX PLANNERS ALERT (January, 1984) (available on LEXIS: Fedtax library, International Tax file).

² A U.S. taxpayer might adopt as its accounting method the translation of its foreign currency transactions to a currency other than the U.S. dollar under section 446 of the Internal Revenue Code. See D. RAVENSCROFT, TAXATION AND FOREIGN CURRENCY ¶ 6/2, at 178-181 (1973); Johnson & Marino, *The U.S. Taxation of Foreign Exchange Gains and Losses: An Analysis of the Treasury Discussion Draft*, 59 TAXES 1031, 1033 n.16 (1981).

two different types of risks related to changes in foreign currency exchange rate: economic exposure and accounting exposure. Economic exposure exists when a domestic taxpayer has to pay more in U.S. dollars than originally anticipated to satisfy a liability denominated in foreign currency because the currency has increased in U.S. dollar value since the obligation was originally incurred. Similarly, economic exposure also exists where a U.S. creditor will be paid less in U.S. dollars than expected as satisfaction of an obligation denominated in a since-devalued foreign currency.³

Accounting exposure exists because most assets and liabilities denominated in a foreign currency, but nevertheless belonging on a domestic enterprise's balance sheet, must be translated into U.S. dollars at the applicable exchange rate prevailing at the reporting date.⁴ In addition, the resulting gains and losses from the exchange must be reflected in the domestic enterprise's net income for the current period.⁵ As a result, an enterprise having an overall exposed position in a volatile currency will incur a charge to its net income for financial accounting purposes if the exchange rate deteriorates between two consecutive reporting periods. Even though the resulting diminution in net income would not be due to a realized loss and would have no tax consequences, it might still reduce investor confidence in the enterprise's financial condition. Thus, accounting risk, like economic risk, is a legitimate concern for the multinational taxpayer and should be appropriately reckoned with through hedging techniques.⁶

³ For a discussion of "economic exposure" due to changes in foreign currency exchange rates, see Dinur, *Tax Consequences in Settlement of Currency Futures Unclear Despite Recent Decisions*, 51 J. TAX'N 282, 284 (Nov. 1979).

⁴ FINANCIAL ACCOUNTING STANDARDS BOARD STATEMENT NO. 52: *Foreign Currency Translation*, 1 ACCOUNTING STANDARDS 19251 ¶ 12 (Dec. 1981) (current text).

⁵ *Id.* ¶ 14.

⁶ Under Financial Accounting Standards Board Statement (FASB) No. 52 (issued by the Financial Accounting Standards Board in Dec. 1981), foreign currency translation gain or loss is reported as an adjustment to stockholders' equity and does not affect income. Previously, under FASB No. 8, gains and losses arising from translating the financial statements were required to be reported immediately as income. Thus, under FASB No. 8, businesses had a financial reporting reason to enter into hedging arrangements to reduce foreign currency loss for the period. Currently, under FASB No. 52 there is less accounting risk and therefore less overall incentive to engage in hedging activities. See FINANCIAL ACCOUNTING STANDARDS BOARD, *Statement of Financial Accounting Standards Board No. 8, Accounting for the Foreign Currency Financial Statement*, FINANCIAL ACCOUNTING STANDARDS, ORIGINAL PRONOUNCEMENTS AS OF JULY 1, 1978 (Oct. 1975); FINANCIAL ACCOUNTING STANDARDS BOARD NO. 52, *Foreign Currency Translation*, 1 ACCOUNTING STANDARDS 19251 (Dec. 1981) (current text); Johnson & Marino, *The U.S. Taxation of Foreign Exchange Gains and Losses: An Analysis of the Treasury Discussion Draft*, 59 TAXES 1031, 1035 (Dec. 1981); Schnee & Bindon, *Taxation of Foreign-Currency Transactions Varied and Uncertain*, 10 INT'L TAX J. 347, 353 (Jul. 1984).

C. *The Hedge*

The variety of protective transactions entered into to neutralize or "hedge" the potential economic and accounting exposure of engaging in business transactions which involves the use of a foreign currency is as "limitless as imagination and the tax law permit."⁷ There is, however, a technique which has become a "cornerstone"⁸ of foreign currency exchange rate management: the "forward exchange contract." Forward exchange contracts are used by multinational taxpayers to hedge⁹ their economic position with respect to a foreign-currency-denominated receivable or payable. They may be set up as either "forward purchase contracts" or "forward sale contracts."¹⁰

A forward purchase contract is used to protect the debtor of a foreign-currency-denominated payable. Such a payable requires the debtor to pay a certain amount of foreign currency at a specified future date. So as to protect against losses caused by appreciation in the foreign currency against the U.S. dollar from the date the underlying contract is written until the date the liability is paid off, the taxpayer enters into a forward purchase contract to acquire a certain amount of foreign currency in the future at a predetermined rate. The amount of foreign currency which the taxpayer will acquire, pursuant to the forward purchase contract, is the amount due from the taxpayer on the underlying liability. The taxpayer is thereby assured of being able to cover the foreign-currency-denominated liability. In effect, by entering into a forward purchase contract agreement, the taxpayer lessens the overall economic burden¹¹ caused by any interim appreciations in the foreign currency.

A forward sale contract is employed when the taxpayer is a creditor holding a foreign-currency-denominated receivable. The receivable suggests that a certain amount of foreign currency should be received at a specified future date. The creditor enters into a contract to sell the foreign currency when he or she receives it, pursuant to the underlying receivable, in order to protect against potential devaluations in the foreign currency measured against the U.S. dollar from the date the receivable was written until the date the foreign currency was ultimately received.

⁷ Terr & Muller, *Tax Treatment of Foreign Currency Forward Contracts — Current Status*, 25 TAX MGMT. MEMO. No. 2 at 19 (1984).

⁸ *Id.*

⁹ In theory, a perfect hedge serves as protection against fluctuations in the foreign currency with respect to the U.S. dollar. In a perfectly hedged business transaction, therefore, the only risk is that of the underlying transaction but not the added risk of loss or gain from foreign exchange fluctuations. See I.R.C. § 1256(e)(2). See, e.g., Dinur, *supra* note 3, at 284-85 (side-bar, *Hedging in a Nutshell*).

¹⁰ Terr & Muller, *supra* note 7, at 19.

¹¹ The economic burden, to which the taxpayer is subject, consists of both economic and accounting risks. See *supra* notes 3-5 and accompanying text.

In accordance with the terms of a forward sale contract, the creditor must deliver a certain amount of foreign currency in the future at a predetermined rate. Because the contract enables the creditor to unload the foreign-currency-denominated receivable at a predetermined rate, he or she is protected from any economic or accounting loss which could result from a U.S. dollar devaluation of the foreign currency during the interim period.

The discussion which follows focuses on the principal issues relative to the U.S. tax treatment of the gain or loss realized on forward exchange contracts: determination of whether or not a realization event has occurred; characterization of any gain or loss which was, indeed, realized; and allocation of the gain or loss as coming from either a foreign or domestic source, for purposes of the federal foreign tax credit limitations. The discussion includes analysis of the most recent case law as well as recent Rulings and Regulations promulgated by the Internal Revenue Service.¹² It also includes analysis of the Treasury Department's most recent positions put forth in this area of the tax law: the 1980 "Discussion Draft on Taxing Foreign Exchange Gains and Losses"¹³ and a small portion of its 1984 "Treasury Report on Tax Simplification and Reform."¹⁴ Finally, consideration will be given to the President's Tax Proposals to the Congress for Fairness, Growth and Simplicity¹⁵ and to the Tax Reform Bill of 1985.¹⁶

II. IN SEARCH OF THE INITIAL REALIZATION EVENT

A. Basic Principles

The act of closing a position in a forward exchange contract, either by purchasing an additional offsetting contract, canceling or selling the original contract, or actually picking up or delivering the currency due

¹² Hereinafter referred to as "I.R.S." or "Service."

¹³ Discussion Draft on Taxing Foreign Exchange Gains and Losses, 45 Fed. Reg. 81711 (Dec. 11, 1980) [hereinafter cited as Treasury Discussion Draft].

¹⁴ *Treasury Report on Tax Simplification and Reform*, STAND. FED. TAX REP. (CCH) Special No. 2, 350-51 (Dec. 6, 1984) (extra edition of Report No. 52) [hereinafter cited as STAND. FED. TAX REP.].

¹⁵ *President's Tax Proposals to the Congress for Fairness, Growth and Simplicity*, 72 STAND. FED. TAX REP. (CCH) No. 25 (Spec. No. 4) (May 29, 1985) [hereinafter cited as *President's Tax Proposals*].

¹⁶ H.R. No. 3838, 99th Cong., 1st Sess. (1985). Section 661 of the Tax Reform Bill of 1985, entitled *Treatment of Foreign Currency Translation*, deals specifically with the topic of foreign currency translation. It proposes modification of existing section 904 of the I.R.C. and addition of the following new sections to the I.R.C.:

§ 985 Functional Currency;

§ 986 Determination of foreign corporation's earning and profits and foreign taxes;

§ 987 Branch transactions booked other than in the dollar; and

§ 988 Treatment of certain foreign currency transactions.

under the contract, will generally constitute a realization event which triggers the recognition of gain or loss under basic tax principles.¹⁷ Any gain recognized on the close-out of a foreign exchange contract should be currently taxable to an accrual basis¹⁸ U.S. taxpayer under the "all events" test of Treas. Reg. §1.451-1(a).¹⁹ In the event that a loss is recognized, it must satisfy the multiple requirements that the loss be evidenced by a closed and completed transaction; that the loss be fixed by an identifiable event; and that the loss be actually sustained in the taxable year.²⁰

For purposes of ultimately determining the amount of gain or loss realized on the sale or exchange of the foreign exchange contract, the contract's basis²¹ equals the product of the U.S. dollar contract exchange rate (the forward rate) multiplied by the foreign currency face amount of the contract.²² The amount realized²³ equals the difference between this basis and the converted U.S. dollar value of the contract using the market exchange rate (the spot rate) at the time the contract is closed out.²⁴

B. Refinements to the Basic Realization Event

In addition to the application of these basic realization principles to gains and losses involving foreign exchange contracts, the special provisions of §1092,²⁵ which relate to straddles,²⁶ may operate to deny or postpone a loss which would otherwise be realized and recognized. Under §1092(a), a realized loss with respect to a foreign currency exchange con-

¹⁷ Terr & Muller, *supra* note 7, at 20. Both forward purchase and forward sale contracts are considered closed when the contract obligor makes or accepts delivery of the foreign currency. See *infra* notes 84-102 and accompanying text. When the requirements of the closed transaction principle are satisfied, a recognition event has occurred for U.S. income tax purposes. See I.R.C. § 1001 (1985) (provision relating to recognition of gain or loss on sale or exchange of property).

¹⁸ Under an accrual basis method of accounting, revenues from sales must be reported in the year during which the goods and services were actually sold, irregardless of when cash was collected. Likewise, the cost of commodities purchased should be accounted for in the year during which the purchase was not actually made, without respect to when cash was surrendered as payment. See C. NISWONGER & P. FESS, ACCOUNTING PRINCIPLES 607 (12th ed. 1977).

¹⁹ Treas. Reg. § 1.451-1(a). "Under an accrual method of accounting, income is includible in gross income when *all the events have occurred* which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy." Treas. Reg. § 1.451-1(a) (1985) (emphasis added).

²⁰ Treas. Regs. §§ 1.165-1(b) and (d). Gains and losses from such close-outs must satisfy the requirements of Treas. Regs. §§ 1.451-1(a), 1.461-1(a)(1), 1.165-1(b) and (d) in the alternative event that the taxpayer is on the cash basis method of reporting income and related expenses.

²¹ See I.R.C. § 1012 (1985) (property basis provisions).

²² Terr & Muller, *supra* note 7, at 20.

²³ The amount realized is the amount received from the other party upon disposition of the property. See I.R.C. § 1001(b) (1985).

²⁴ Terr & Muller, *supra* note 7, at 20.

²⁵ I.R.C. § 1092 (1985).

²⁶ See *infra* note 31.

tract may only be recognized to the extent it exceeds any unrecognized gain in an "offsetting position."²⁷ Under §1092(b),²⁸ the Treasury is directed to issue regulations applying rules to the straddle area which are similar to the "short sale" rules of §1233²⁹ and the "wash sale" rules of §1091.³⁰ The legislative history of §1092 indicates that the "wash sale" regulations developed by the Treasury will be developed so as to prevent a taxpayer from closing out its loss position in a straddle³¹ and then putting itself into another position of equal protective effect.³²

The §1092 provisions apply only if the taxpayer's position with respect to a forward exchange contract meets the definition of a "straddle"³³ under §1092(c).³⁴ A straddle involves "offsetting positions with respect to personal property."³⁵ An offsetting position is a "position" with respect to personal property which results in "a substantial diminution of the taxpayer's risk of loss from holding any position with respect to personal property by reason of his holding one or more other positions with respect to personal property (whether or not of the same kind)."³⁶ The term "position" means an interest in personal property³⁷ and, pursuant to §1092(d)(2)(A), specifically includes within its scope a "future or forward contract or option."³⁸ Finally, "personal property" means "any personal property (other than stock) of a type which is actively traded."³⁹

Forward exchange contracts are, indeed, typically used as protective devices to substantially diminish the risk with respect to a second interest

²⁷ I.R.C. § 1092(a) (1985).

²⁸ I.R.C. § 1092(b) (1985).

²⁹ I.R.C. § 1233 (1985). See *infra* notes 82-114 and accompanying text.

³⁰ I.R.C. § 1091 (1985). A "wash sale" as the combination of the sale and subsequent repurchase of the same security within a thirty day period. I.R.C. § 1091 (1985).

³¹ A "straddle" is a "put" and a "call" on the same security at the same exercise price and for the same time period. A put is a contract giving one party the option to sell specified securities during a specified time period for a specified price. A call is a contract giving one party the option to buy a security at a predetermined price within some specified time interval. The buyer of a straddle believes that the price of the optioned security will deviate from the exercise price (which is the same under both the put and call contracts), thereby enhancing the opportunity for gain, i.e., if the price increases then the holder of the straddle will: exercise his or her call option to purchase the securities at the relatively low exercise price; let the put option expire; and sell the securities in the open market at the relatively high prevailing rate. The writer of a straddle believes that the market price of the underlying security will not vary prior to expiration of the put and call options contracts. See J. FRANCIS, INVESTMENTS — ANALYSIS AND MANAGEMENT 405-13 (3d ed. 1980).

³² See Terr & Muller, *supra* note 7, at 20 n. 4 and accompanying text.

³³ See *supra* note 31.

³⁴ I.R.C. § 1092(c) (1985).

³⁵ I.R.C. § 1092(c) (1985).

³⁶ I.R.C. § 1092(c)(2)(A) (1985).

³⁷ I.R.C. § 1092(d)(2)(A) (1985).

³⁸ I.R.C. § 1092(d)(2)(A) (1985).

³⁹ I.R.C. § 1092(d)(1) (1985).

in personal property, as required by §1092(c)(2)(A).⁴⁰ Most currencies are actively traded on an exchange and therefore satisfy the requirements of §1092(d)(1).⁴¹ Finally, because forward exchange contracts are specifically included in the definition of interests in personal property under §1092(d)(2)(A),⁴² a forward exchange contract will be appropriately considered a "position" with respect to personal property (the actively traded foreign currency) to which an offsetting position may exist.⁴³

Because a forward sale contract is used to hedge the taxpayer/creditor's foreign-currency-denominated loan, the loan receivable therefore constitutes an interest in personal property in that it represents a contractual right to receive foreign currency in the future.⁴⁴ Thus, the loan and the forward contract together constitute offsetting positions for §1092 purposes.⁴⁵

The case of a forward purchase contract is more complicated. When a forward purchase contract⁴⁶ is entered into for the purpose of hedging a foreign-currency-denominated payable, it is not clear whether under §1092 the payable represents a position with respect to personal property. A taxpayer/borrower does acquire some interest in foreign currency at the time the foreign currency is borrowed and later when repaid.⁴⁷ The acquisition of this interest gives rise to a tax basis that may produce a foreign exchange gain or loss.⁴⁸ Any exchange gain or loss for tax purposes will be determined by the exchange rates at two isolated points: the time of the borrowing and the time the foreign currency is ultimately acquired from the forward purchase contract in order to repay the underlying borrowing.⁴⁹ Thus, it could be argued that a taxpayer's interest in the foreign currency at the time of borrowing and at the time of repayment, respectively, could be the interest in property that consti-

⁴⁰ See *supra* note 36 and accompanying text for the requirements of § 1092(c)(2)(A). Forward exchange contracts are actually used to "substantially diminish the risk in respect of a second interest in personal property" in that they are typically employed to "hedge" currency exchange rate fluctuation exposure, both of the economic and accounting type, with respect to foreign-currency-denominated loans, borrowings, trade accounts receivables, or the net asset or liability positions of foreign branches and subsidiaries. For a discussion of foreign currency exchange rate fluctuation exposure and the appropriate hedging techniques which might be applied thereto, see *supra* notes 3-11 and the accompanying text.

⁴¹ I.R.C. § 1092(d)(1) (1985). See *supra* note 39 and the accompanying text.

⁴² I.R.C. § 1092(d)(2)(A) (1985). See *supra* note 37 and the accompanying text.

⁴³ Terr & Muller, *supra* note 7, at 21.

⁴⁴ *Id.*

⁴⁵ It does not matter whether or not the underlying loan receivable is actively traded because the underlying foreign currency is actively traded and is considered personal property, while the loan should constitute the "interest" or "position" with respect to that property.

⁴⁶ See *supra* note 11 and accompanying text.

⁴⁷ Terr & Muller, *supra* note 7, at 21.

⁴⁸ *Id.*

⁴⁹ *Id.*

tutes a "position" under §1092.⁵⁰

It can also be argued that the "interest in property" requirement of §1092(d)(2)(A)⁵¹ is not satisfied by a forward purchase agreement. Under such an arrangement, the taxpayer only has a temporary interest in the foreign currency pursuant to the forward purchase agreement. Such a transitory interest may not be sufficient to constitute a position for purposes of §1092.⁵² A foreign exchange gain or loss which was realized from the repayment of a foreign currency borrowing might be compared to a gain or loss on contractual liability, which does not require the existence of an "interest" in "property".⁵³ Accordingly, the underlying foreign currency could be viewed as simply the measuring unit for any exchange gain or loss.⁵⁴ A transitory interest in the foreign currency at those times for measuring this exchange gain or loss would not reflect an interest in property as required under §1092.⁵⁵ Hopefully the regulations to be promulgated under §1092 will help to determine whether a taxpayer has a sufficient interest in a foreign currency borrowing, either in the borrowing itself or the underlying foreign currency, to constitute a "position" as required by §1092.⁵⁶

III. THE QUESTION OF CHARACTER

Once it has been determined that a foreign currency exchange gain or loss has been realized, the characterization of such gain or loss becomes an issue. If given a choice, taxpayers would generally prefer to secure ordinary losses and long-term capital gains.⁵⁷ The case law in this area fluctuates, but some broad conclusions can be reached. One observation is that the characterization of forward contract gain or loss generally depends upon whether the underlying currency represents a capital asset or an ordinary income item in the taxpayer's hands.⁵⁸

⁵⁰ *Id.*

⁵¹ *See supra* note 37 and accompanying text.

⁵² *Terr & Muller, supra* note 7 and accompanying text.

⁵³ *Id. citing* Petitioner's Reply Brief at 3, *National-Standard Co. v. Commissioner*, 80 T.C. 551 (1983), *aff'd* 749 F.2d 369 (6th Cir. 1984).

⁵⁴ *Id.* at 21-22.

⁵⁵ *Id.* at 22.

⁵⁶ *Id.*

⁵⁷ Ordinary losses are coveted because the Code provides for deduction of losses limited only by the amount of gains with any additional ordinary losses being afforded carryback and carryforward treatment. I.R.C. §§ 165 and 172 (1985). Capital losses, however, may not be taken for an amount in excess of \$3,000 for any one year. I.R.C. § 1211 (1985). When gain has been realized, long-term capital gain treatment is the most desirable because sixty percent of the amount of the net capital gain is allowed as a deduction from gross income. I.R.C. §§ 1202 and 1222 (1985). Ordinary gains are fully taxable and are not afforded any favorable treatment.

⁵⁸ *Terr & Muller, supra* note 7, at 32.

A. The "Corn Products" Approach

In *International Flavors and Fragrances, Inc. v. Commissioner*,⁵⁹ the Tax Court found, on remand, that the sale of a forward sale contract to a bank was subject to long-term capital gain treatment.⁶⁰ The taxpayer in this case engaged in the worldwide manufacturing and distribution of flavoring extracts.⁶¹ Its activities were conducted through several foreign corporations which it owned or controlled.⁶² On the taxpayer's consolidated financial statements, the accounts of the foreign subsidiaries, which were expressed in foreign currencies for their individual internal reporting purposes, were converted into U.S. dollars.⁶³ One of the taxpayer's subsidiaries was owned and operated in the United Kingdom.⁶⁴ After becoming concerned that the value of the British pound sterling might decline, the taxpayer decided to sell short pounds sterling.⁶⁵ The taxpayer's short sale was made in order to cover any losses which might result from its investment in the United Kingdom affiliate.⁶⁶

After the British pound sterling did, in fact, decline in value, but prior to the delivery date specified in the forward sale contract, the taxpayer sold the forward sale contract at a gain and proceeded to claim long-term capital gain treatment.⁶⁷ Although agreeing that foreign currency met the definition of a capital asset, the Tax Court concluded that purchases and sales of foreign currency to offset losses resulting from exchange rate fluctuations are "part and parcel" of a multinational business.⁶⁸ Accordingly, the court found that the short sale was an ordinary income-related transaction, not an investment, and therefore ordinary income resulted.⁶⁹

⁵⁹ *International Flavors and Fragrances, Inc. v. Commissioner*, 62 T.C. 232 (1974), *rev'd. and rem'd.*, 524 F.2d 357 (2d Cir. 1975), *on remand*, 1977-58 T.C.M. (PH) ¶ 77,058 (Mar. 9, 1977).

⁶⁰ *International Flavors and Fragrances*, 62 T.C. at 239-240.

⁶¹ *Id.* at 233.

⁶² *Id.*

⁶³ *Id.*

⁶⁴ *Id.*

⁶⁵ *Id.* "Selling short" involves delivering a fixed amount of foreign currency, i.e., the British pound sterling, at a specified date and at a specified exchange rate.

⁶⁶ *Id.*

⁶⁷ *Id.* at 237.

⁶⁸ *Id.* at 239.

⁶⁹ *Id.* at 239-240. The Tax Court agreed with the Internal Revenue Service's argument for application of the principal judicial exception to normal capital asset treatment, the so-called "integral part of the business" exception. This exception developed in the noncurrency context in a series of cases and rulings, principally involving commodity hedging transactions, which culminated in *Corn Products Refining Co. v. Commissioner*, 350 U.S. 46 (1955). In *Corn Products*, the taxpayer engaged in the production of distilled products from corn. *Id.* at 48. The taxpayer purchased corn futures in order to protect itself against future price increases in the raw corn needed in its manufacturing operations. *Id.* In holding that the gain recognized by the taxpayer on its acceptance of delivery under some of the contracts and its sale of others was ordinary income, the Supreme Court

On appeal, the Tax Court's holding in *International Flavors and Fragrances* was reversed by the Second Circuit.⁷⁰ The Second Circuit noted that the Tax Court majority did not decide whether a bona fide sale of the forward sale contract occurred, or whether the transaction constituted merely a contract for the buyer of the contract to purchase British pounds sterling on behalf of the taxpayer so that the latter could meet its obligation under the short sale.⁷¹ The case was remanded for consideration of this issue.⁷² On remand, the Tax Court held that the taxpayer made a bona fide sale of its contracts to deliver the pounds and that the gain on the sale was a long-term capital gain.⁷³

With respect to providing certainty in the area of characterization of gains and losses realized on the sale or exchange of a forward sale contract, a weakness in the *International Flavors and Fragrances* opinion is that both the Tax Court and Court of Appeals neglected to address the Internal Revenue Service's "short sale" argument, which was made at the Tax Court level as an alternative to the *Corn Products*⁷⁴ argument. The I.R.S. made the following assertions as part of its "short sale" argument:

- (1) The forward sale contract entered into by the taxpayer constituted a "short sale" for purposes of Section 1233;⁷⁵
- (2) The taxpayer "purchased" the currency used to "close" the short sale after the date of the short sale and before the settlement date;⁷⁶
- (3) The currency constituted "substantially identical property" within the meaning of Section 1233(e)(1);⁷⁷ and
- (4) Therefore, the gain realized on the sale of the forward sale contract was subject to short-term capital gain treatment under Section 1233(b)(1).⁷⁸

The Tax Court did not address the above four-step argument and thereby left no clue as to whether it would ever sustain an attempt by the Internal Revenue Service to characterize currency futures as "commodity futures" falling within the scope of "substantially identical" property for

noted that the futures transactions "were vitally important to the company's business," and that "Congress intended that profits and losses arising from the every day operation of a business be considered as ordinary income or loss rather than capital gain or loss." *Id.* at 53-54.

⁷⁰ *International Flavors and Fragrances*, 524 F.2d 357.

⁷¹ *Id.* at 359-60.

⁷² *Id.* at 360.

⁷³ *International Flavors and Fragrances*, 1977-58 T.C.M. (PH) ¶ 70,058 (Mar. 9, 1977).

⁷⁴ See *supra* note 69 and accompanying text.

⁷⁵ See *International Flavors and Fragrances*, 62 T.C. at 240 (1974) (Tannenwald, J., dissenting).

⁷⁶ *Id.*

⁷⁷ I.R.C. § 1233(e)(1) (1985).

⁷⁸ I.R.C. § 1233(b)(1) (1985).

purposes of §1233(b).⁷⁹ Fortunately, subsequent Tax Court opinions have addressed the question of whether the §1233 “short sale” analogy is an appropriate approach to justifying short-term capital gain and loss treatment of the disposition of forward sale contracts.

B. *The Section 1233 Approach*

By the terms of §1233(a), the following conditions must be met in order for the gain realized from the disposition or settlement of a forward sale contract of foreign currency to be treated as short-term under §1233(b):

- (1) The forward sale contract of foreign currency is a short sale;⁸⁰
- (2) This short sale is closed by the use of “property” including a “commodity future”;⁸¹ and
- (3) Prior to such closing the taxpayer acquired “substantially identical property.”⁸²

1. Short Sale Requirement

Accordingly, the first issue which must be addressed in pursuit of short term capital gain treatment via §1233 is whether a forward sale contract of foreign currency is a “short sale.” A forward sale contract obligates the holder to make delivery of a specified quantity of currency on a specified date.⁸³ In addition, the holder is entitled to receive a specified price per unit of the currency upon delivery. The holder’s rights and obligations thereby resemble those of the holder of a short commodity future, which is specifically written into the statute as qualifying for short sale treatment.⁸⁴ Accordingly, there should be little doubt that a short commodity future is a short sale for purposes of §1233. The only remaining question, then, is whether foreign currency is a “commodity.” The case law involving the purchase or sale of property using foreign currency has generally segregated gains and losses due solely to exchange rate fluctuations from gains and losses resulting from the underlying transaction, because foreign currency is not “money”, but rather, a separate “commodity.”⁸⁵ It follows, therefore, that a forward sale contract of foreign currency is a “short sale” within the meaning of 1233(a).⁸⁶

⁷⁹ I.R.C. § 1233(b) (1985). See Dinur, *supra* note 3, at 282.

⁸⁰ I.R.C. § 1233(a) (1985). See *infra* notes 83-86 and accompanying text.

⁸¹ I.R.C. § 1233(a) (1985). See *infra* notes 87-105 and accompanying text.

⁸² I.R.C. § 1233(b) (1985). See *infra* notes 106-14 and accompanying text.

⁸³ See *supra* notes 7-14 and accompanying text.

⁸⁴ See *supra* note 81 and accompanying text.

⁸⁵ See Gillin v. U.S., 423 F.2d 329 (Ct. Cl. 1970); KVP Sutherland Paper Co. v. U.S., 344 F.2d 377, 381 (Ct. Cl. 1965); Dinur, *supra* note 3, at 286; Khokhar & McCawley, *The Application of § 1233 to Foreign Currency Forward Sale Contracts*, TAX MGMT. INT’L J. 3 (Aug. 1980).

⁸⁶ This conclusion is substantially supported by the Tax Court in Hoover Co. v. Commissioner,

2. Closure Requirement

The next question is whether the sale or assignment of a forward sales contract of foreign currency constitutes the "closing" of a short sale as required by §1233(b).⁸⁷ The closing of a short sale is generally brought about by the delivery of the property sold short.⁸⁸ Treas. Reg. §1.1233-1(a)(1) provides: "For income tax purposes a short sale is not deemed to be consummated until delivery of property to close the short sale."⁸⁹

In accordance with the Regulations, an agricultural commodity future contract is considered "consummated" when the holder of the contract purchases the same quantity of the same commodity with the same delivery date and then assigns both his long and short contracts to the exchange clearing house.⁹⁰ The clearing house will in turn "set off" the two contracts and make payment based on the difference between the respective contract prices.⁹¹ Similarly, when the holder of a foreign currency short futures contract satisfies his obligations under the contract either by entering into an offsetting purchase contract or by making delivery of the underlying currency, the closure requirement of 1233(a) should be considered to have been met.⁹²

A different situation involving the closure requirement occurred in *American Home Products v. U.S.*⁹³ The case involved the assignment of a foreign currency short futures contract.⁹⁴ In an assignment, neither the delivery of property nor the entering into of an offsetting long position is involved. Thus, satisfaction of the closure requirement is not readily apparent.

In *American Home Products*, a domestic corporation had a controlling interest in five United Kingdom subsidiaries.⁹⁵ Because it expected to receive dividends from its five British subsidiaries and believed that the British pound sterling would drop in value, the taxpayer corporation cautiously entered into forward sales contracts as a hedge.⁹⁶ Shortly before delivery date pursuant to the forward sales contracts, the taxpayer

72 T.C. 206 (1979). In *Hoover*, the Tax Court held that "[n]o limitation on the term 'property' appears in § 1233(a) and, accordingly, . . . this provision clearly applies to the short sale of currency" *Id.* at 243.

⁸⁷ See *supra* note 81 and accompanying text.

⁸⁸ See, e.g., *Khokhar & McCawley*, *supra* note 85, at 7. For a discussion of short sales, see *supra* note 65.

⁸⁹ Treas. Reg. § 1.1233-1(a)(1) (1985).

⁹⁰ *Khokhar & McCawley*, *supra* note 85, at 7.

⁹¹ *Id.*

⁹² *Id.* at 7-8.

⁹³ *American Home Products v. U.S.*, 601 F.2d 540 (Ct. Cl. 1979).

⁹⁴ *Id.* at 546.

⁹⁵ *Id.* at 542.

⁹⁶ *Id.* at 542-43.

assigned two of the contracts to an unrelated party for \$336,000.⁹⁷ The taxpayer characterized gain from the assignment as long-term capital gain.⁹⁸ The I.R.S. argued that the foreign currency short futures contract had been "closed" under §1233(a) and that, as a result, short-term capital gain treatment should be afforded.⁹⁹ It analogized the sale of currency not yet received to the assignment of a contract to sell "when-issued" stock, because Congress, when adopting §1233, apparently recognized the assignment of a contract to sell "when-issued" stock as an appropriate closing of a short sale.¹⁰⁰ The Court of Claims, however, was not persuaded by the Service. It believed that the scope of §1233 was meant to be very narrow and would not stand for its being broadened by analogies.¹⁰¹ Thus, the Court of Claims rejected §1233 application to an assignment of a foreign currency short futures contract and upheld the taxpayer's long-term capital gain treatment.¹⁰²

Even though defeated in the Court of Claims, the I.R.S. remains persistent with its argument that an assignment of a forward sales contract of foreign currency should be given §1233 short-term capital gains treatment. In Letter Ruling 8016004, the I.R.S. advised that an assignment of a forward sale contract of foreign currency resulted in short-term capital gain even though the contract had been held for the requisite long-term holding period.¹⁰³ The Service argued that the assumption by the assignee of the assignor's rights and obligations under the contract should be considered both the acquisition of substantially identical property and the closing of the contract.¹⁰⁴ With the §1233(a) requirements so satisfied, it argued, short-term capital gain treatment of the gain realized on the assignment appropriately followed.¹⁰⁵

3. Substantially Identical Property

The final requirement for §1233 short-term characterization is that "substantially identical property" had been held short-term at the time of short sale or had been acquired thereafter but before the short sale was

⁹⁷ *Id.* at 543-44.

⁹⁸ *Id.* at 544.

⁹⁹ *Id.* at 550.

¹⁰⁰ *Id.* See H.R. REP. NO. 2319, 81st Cong., 2d Sess. 95 (1950); Khokhar & McCawley, *supra* note 85, at 8.

¹⁰¹ American Home Products, 601 F.2d at 550.

¹⁰² *Id.* at 551.

¹⁰³ *Letter Rul. 8016004*, I.R.S. LETTER RULINGS (CCH) No. 164 (Dec. 18, 1979).

¹⁰⁴ *Id.* However, to fully convince any court that an assignment of a short currency futures contract fully satisfies the § 1233(a) closure requirement, the I.R.S. must somehow prove that the "short sale" is closed by the "use of property." Such proof will be hard to compile because an assignment does not involve delivery of the property sold short or an assignment of an offsetting long futures contract. See, e.g., Khokhar & McCawley, *supra* note 85, at 8.

¹⁰⁵ *Letter Rul. 8016004*, *supra* note 103.

closed.¹⁰⁶ In order to attempt to answer this question, analogy to commodity futures is, once again, necessary. Section 1233(e)(2)(B) provides:

[I]n the case of futures transactions in any commodity on or subject to the rules of a board of trade or commodity exchange, a commodity future requiring delivery in [one] calendar month shall not be considered as property substantially identical to another commodity future requiring delivery in a different calendar month.¹⁰⁷

Thus, when a short commodity future is involved, a long commodity future calling for delivery in the same calendar month as the short future contract is "substantially identical property."¹⁰⁸ Accordingly, for §1233(b) to be applicable to the holder of a short currency futures contract, it must be shown that, prior to closing, the holder acquired an offsetting long futures contract calling for the purchase of an equal amount of currency deliverable in the same calendar month as the maturity date of the short contract.¹⁰⁹ More simply put, where a taxpayer settles a short currency futures contract by entering into an offsetting forward purchase contract, the "substantially identical property" requirement is met.¹¹⁰

Satisfaction of the "substantially identical property" requirement by the sale or assignment of a short currency futures contract also poses some difficult problems. In Letter Ruling 8016004, the Service took the position that the assumption by the assignee of the assignor's obligation to settle the contract by either purchasing the currency or entering into an offsetting forward contract is the equivalent of the acquisition by the assignor of "substantially identical property."¹¹¹ This position, however, has been rejected by the courts in *International Flavors and Fragrances, Inc. v. Commissioner*¹¹² and *American Home Products v. U.S.*¹¹³ These cases held that so long as the assignment was made "without recourse" and the assignee was thereby theoretically and legally free to hold the short position open for speculation, the fact that the assignee might have been expected to obtain cover through his entering into an offsetting long position does not, in and of itself, constitute an acquisition of such position by the assignor.¹¹⁴

¹⁰⁶ See *supra* note 82 and accompanying text.

¹⁰⁷ I.R.C. § 1233(e)(2)(B) (1985).

¹⁰⁸ *Khokhar & McCawley, supra* note 85, at 9.

¹⁰⁹ *Id.*

¹¹⁰ *Id.*

¹¹¹ *Letter Rul. 8016004, supra* note 103.

¹¹² *International Flavor and Fragrances*, 62 T.C. 232. See *supra* notes 65-73 and accompanying text.

¹¹³ *American Home Products*, 601 F.2d 540. See *supra* notes 90-99 and accompanying text.

¹¹⁴ *Khokhar & McCawley, supra* note 85, at 9.

C. *The Discussion Draft Approach*

In 1980, the Treasury Department issued a Discussion Draft, "Taxing Foreign Exchange Gains and Losses."¹¹⁵ Under the Treasury Discussion Draft, the proposed characterization of the gain or loss realized on forward exchange contracts would essentially mirror the treatment of the income or expense, as the case may be, of the underlying asset, liability or income stream which is being hedged. For example, the gain or loss on a forward sale contract hedging the principal amount of a foreign-currency-denominated receivable would be characterized in the same manner as an increase or decrease in interest received from the receivable.¹¹⁶ Interest received is treated as ordinary income under the Internal Revenue Code.¹¹⁷ In the case of a forward purchase contract, the Treasury Discussion Draft suggests that any gain or loss realized on such contract, which was used for the purpose of hedging the principal amount of a specific foreign-currency-denominated liability, be characterized in the same manner as interest paid on the liability.¹¹⁸ Interest is treated as either an ordinary and necessary business expense or as a personal itemized deduction.¹¹⁹

Four years later, the Treasury Department has remained consistent in its stance that gains or losses realized on the sale of a forward exchange contract used to hedge a foreign-currency-denominated asset or liability should be treated as interest received from or paid on the underlying asset or liability. In its "Treasury Report on Tax Simplification and Reform,"¹²⁰ the Treasury Department advised the President that gain or loss on a forward contract should be treated as an adjustment to the related interest.¹²¹ It cited as its reasoning for such treatment the propositions that foreign exchange gains and losses adjust for differences in interest rates across currencies; that with hedging transactions, the adjustment is almost perfect in the short run; and that, therefore, its proposal for adding gains and losses to interest would make tax treatment correspond to business and economic reality.¹²²

Certainly, if this proposal were adopted, there would finally be some

¹¹⁵ Treasury Discussion Draft, *supra* note 13. The Treasury Discussion Draft represents a "suggested approach to U.S. tax treatment of foreign exchange gains and losses" and is not meant to "represent positions which may be taken . . . by the Treasury or the Internal Revenue Service." *Id.* For a detailed description of the Treasury Discussion Draft's contents, see Johnson & Marino, *supra* note 2.

¹¹⁶ Treasury Discussion Draft, *supra* note 13, at 81713.

¹¹⁷ I.R.C. § 61(a)(4) (1954).

¹¹⁸ Treasury Discussion Draft, *supra* note 13, at 81713.

¹¹⁹ I.R.C. § 163(a) (1954).

¹²⁰ STAND. FED. TAX REP., *supra* note 14, at 350-51.

¹²¹ *Id.* at 350.

¹²² *Id.*

certainty to the treatment of gains and losses on foreign currency hedging devices. Tax planning in the foreign currency area would be much less of a gamble if the treatment of forward exchange contracts was finally embedded in the Internal Revenue Code. The actual approach, in substance, proposed by the Treasury Department is somewhat novel in that it virtually assures that a taxpayer will not be able to treat a gain as a long-term capital gain and thereby take advantage of the long-term capital gain deduction provisions.¹²³ Most of the case law, in contrast, has afforded long-term capital gain treatment.¹²⁴

The following example demonstrates the potential effects of adoption of the Treasury's proposals regarding characterization of gain on forward contract sales:

A U.S. corporation, Usco, Inc., has a note receivable for 300,000 Belgian francs, which arose from its loaning 300,000 francs to Belco, Inc., a Belgian corporation. The terms of the note call for annual interest payments of 20,000 Belgian francs and redemption of the note after four years. At the time the note is issued, the Belgian franc is worth \$.40. During the period the note is outstanding, the Belgian franc depreciates in value to \$.30/BF

Usco, believing that the value of the franc will further decline in value before the note is due, enters a forward sale contract to sell the francs, when received, at a predetermined rate of \$.35/BF. Usco's economic loss is reduced as follows:

Funds loaned:		
300,000 BF × \$.40	=	\$120,000
Amount received on redemption		
300,000 BF × \$.30	=	90,000
Economic loss		<u>(\$ 30,000)</u>
Amount received on sale via forward contract:		
300,000 BF × \$.35	=	105,000
Amount received on redemption:		<u>90,000</u>
Economic loss achieved from use of hedge		<u>(\$ 15,000)</u>
Reduction in economic loss from use of hedge		<u><u>\$ 15,000</u></u>

¹²³ I.R.C. § 1202(a) (1982).

¹²⁴ See, e.g., *American Home Products*, 601 F.2d 540 (Ct. Cl. 1979). See *supra* notes 90-100 and accompanying text.

Using the forward sale contract, Usco has a \$15,000 economic loss. How will it be characterized? Under the Treasury's proposal, it would be netted against Usco's interest income:

Economic loss		(\$ 15,000)
Interest income:		
20,000 BF/yr. × 4 yrs. × \$.40/BF	=	32,000
Net ordinary income		<u>\$ 17,000</u>

Under the case law methods, the economic loss would be treated as long-term capital loss:

Economic loss	\$ 15,000	LTCL
Interest income	32,000	

Assuming no other transactions, Usco would have \$29,000 of ordinary income (\$32,000 — 3,000. cap. loss) with a \$9,000 LTCL carryforward (\$15,000 — 6,000).¹²⁵

In the above example, the fictitious taxpayer, Usco, comes out ahead using the Treasury's proposed method because of the opportunity which it affords to net an economic loss against interest income received from the underlying receivable.¹²⁶

D. The President's Proposal

On May 29, 1985 the Reagan Administration released its long-awaited tax reform proposal.¹²⁷ Fortunately, the Administration chose to address complicated and previously unresolved areas of foreign currency treatment.¹²⁸ With respect to the characterization of gain or loss realized on forward exchange contracts, the President's proposals¹²⁹ are, for the most part, similar to the approach espoused by the Treasury Department in its 1980 Discussion Draft.¹³⁰

For example, the Reagan Administration, like the Treasury Department, advocates "interest equivalency"¹³¹ for the characterization of gain or loss on foreign-currency-denominated assets and liabilities. The President proposes that any exchange gain or loss on a forward sale contract structured to hedge the principal amount of a foreign-currency-denomi-

¹²⁵ See I.R.C. §§ 1211 and 1212 (limitation and carryback/carryforward provisions re long-term capital losses).

¹²⁶ For an additional example, see *U.S. Tax Aspects of Foreign Currency Transactions — Part VI*, INTERNATIONAL TAX PLANNERS ALERT (Feb. 1984) (available on LEXIS: Fedtax library, International tax file).

¹²⁷ See *President's Tax Proposals*, *supra* note 15.

¹²⁸ *Id.* at 409-22 (ch. 1504).

¹²⁹ *Id.* at 419.

¹³⁰ See *supra* notes 115-124 and accompanying text.

¹³¹ Horst, *Foreign Exchange Gains and Losses: What are the Issues?*, 28(12) TAX NOTES 1393 (Sept. 16, 1985).

nated financial asset should be treated as an increase or decrease in the interest received with respect to the asset.¹³² Similarly, the Administration proposes, exchange gain or loss on a forward purchase contract hedging the principal amount of a foreign-currency-denominated financial liability should be characterized in the same manner as interest paid with respect to that liability.¹³³ This approach to characterization of forward contract gain or loss is often referred to as "integration."¹³⁴

The Reagan Administration offers logical justification for its adoption of the Treasury Department's "interest equivalency" approach. It argues that multinational companies borrowing or lending foreign currency anticipate, in their financial planning, that the foreign exchange gain or loss on ultimate repayment will offset the differential between interest payable on the foreign-currency-denominated asset or liability and the interest which would have been payable on a comparable dollar-denominated transaction.¹³⁵ The President's proposals of "interest equivalency" and integration of forward exchange contracts together assure that fully hedged foreign currency borrowing or lending incur the same tax treatment as an economically equivalent dollar-denominated transaction.¹³⁶ A problem with the "interest equivalence" concept is that fluctuations in the value of foreign currency are not necessarily tied to interest rate variations.¹³⁷ Therefore, including gains and losses realized on foreign currency transactions with interest income and expense is arguably a mismatch.¹³⁸

Where the President's approach differs drastically from the Treasury Department's 1980 Discussion Draft is in the Administration's "carr[ying] the interest equivalence concept to its logical extreme"¹³⁹ by calling for accrual of the fictional "interest" prior to its realization. The Administration proposes that "anticipated" foreign exchange gains and losses on foreign-currency-denominated assets or liabilities be recognized currently as an accrual.¹⁴⁰ This "anticipated" ¹⁴¹ gain or loss is defined as the difference between the stated foreign currency rate of interest under rules comparable to those enacted as part of the Deficit Reduction

¹³² *President's Tax Proposals*, *supra* note 15, at 419.

¹³³ *Id.*

¹³⁴ Horst, *supra* note 131, at 1394.

¹³⁵ *Id.*

¹³⁶ *Id.*

¹³⁷ Terr, *President's Tax Reform Proposal on Foreign Currency*, 14-8 TAX MGMT. INT'L J. 279, 280 (1985).

¹³⁸ *Id.*

¹³⁹ *Id.* at 279

¹⁴⁰ *President's Tax Proposals*, *supra* note 15, at 418.

¹⁴¹ *Id.*

Act of 1984¹⁴² for imputing interest with respect to obligations issued for property.¹⁴³ The proposal provides that “unanticipated” gain or loss equal to the difference between the actual gain or loss realized on the transaction and the previously recognized “anticipated” gain or loss should ultimately be recognized when realized.¹⁴⁴

The Administration’s accrual proposal has some problematical consequences. Under this proposal, a multinational corporation might have to accrue “anticipated” gain when, during that tax period, it is actually experiencing an overall unrealized loss, and vice versa.¹⁴⁵ The ultimate “unanticipated” gain or loss would exceed the total gain or loss actually realized.¹⁴⁶ A “bunching” of reported gain or loss results in the period during which the “unanticipated” gain or loss is reported.¹⁴⁷ Taxable income is distorted in each period affected, mandating additional income tax planning in an attempt to offset the distortions.

E. The Congressional Approach

In its “Tax Reform Bill of 1985,”¹⁴⁸ the House Ways and Means Committee addressed the issue of characterization of gains and losses realized on foreign currency exchange rate hedging transactions. The Bill provides that, in most instances, exchange gain or loss should be characterized as interest income or expense¹⁴⁹ and thus follows the “interest equivalence” approach adopted by both the Treasury Department¹⁵⁰ and the Reagan Administration.¹⁵¹ The Committee cites as its reason for proposing application of the “interest equivalence” theory its belief that the dollar price of foreign currency in the forward market is directly related to the market interest rate for such currency relative to the dollar.¹⁵² The Committee specifically rejected the Administration’s prescription¹⁵³ for general accrual treatment of exchange gains and losses.¹⁵⁴ It anticipated problems (in accruing for exchange gains and losses) with requiring income inclusions or deductions due to exchange

¹⁴² Deficit Reduction Act of 1984, Pub. L. No. 98-369, 1984 U.S. CODE CONG. & AD. NEWS 494.

¹⁴³ I.R.C. §§ 1271-88.

¹⁴⁴ *President’s Tax Proposal*, *supra* note 15, at 418.

¹⁴⁵ Horst, *supra* note 131, at 1394.

¹⁴⁶ *Id.*

¹⁴⁷ *Id.*

¹⁴⁸ See H.R. 3838, *supra* note 16.

¹⁴⁹ *Id.* § 661, at 484 (1985) (proposed I.R.C. § 988(a)(2)).

¹⁵⁰ See *supra* notes 115-22 and accompanying text.

¹⁵¹ See *supra* notes 131-38 and accompanying text.

¹⁵² HOUSE WAYS AND MEANS COMMITTEE REPORT ON TEXT OF H.R. 3838, 99th Cong., 1st Sess., 467 (Dec. 7, 1985) [hereinafter cited as COMMITTEE REPORT].

¹⁵³ See *supra* notes 139-147 and accompanying text.

¹⁵⁴ COMMITTEE REPORT, *supra* note 152, at 467.

gain or loss that could be lost through subsequent exchange rate fluctuations.¹⁵⁵ The Committee considered the possibility of treating only "unanticipated" exchange gain or loss on a financial asset or liability as a capital gain or loss, subject to tax on realization.¹⁵⁶ It chose not to follow this approach because of the inherent difficulty in distinguishing "anticipated" from "unanticipated" exchange gain or loss."¹⁵⁷ It noted that although anticipated gain or loss could be measured with reference to the premium or discount element in a forward contract, forward contracts are not available in all currencies and do not trade at all maturities.¹⁵⁸ The Committee came to the logical conclusion that determination of anticipated gain or loss on the basis of an unascertainable premium or discount would be no simple matter.

The Committee established two exceptions to its proposed general treatment of exchange gain or loss: (1) exchange gain or loss should be accrued currently in the case of certain hedging transactions that in substance are equivalent to U.S.-dollar-denominated assets or liabilities;¹⁵⁹ and (2) gain or loss on foreign-currency-denominated section 1256¹⁶⁰ contracts that are not a part of a hedging transaction should be excluded from the rules of this bill.¹⁶¹ Therefore, in the specific area of hedging transactions, the Committee essentially concurred with the Reagan Administration's proposal for accruing exchange gain or loss realized therein.

IV. SOURCE

A. *Current Status of the Law*

The last issue which must be addressed relative to gains and losses realized on foreign currency forward contracts is whether they should be allocated to U.S. income under §861(b)¹⁶² or to foreign income under §862(b).¹⁶³ The Code contains no express provision for the airtight determination of the geographic source of a foreign currency gain.¹⁶⁴ Sections 861(a)(6) and 862(a)(6) provide that "[g]ains, profits, and income

¹⁵⁵ *Id.*

¹⁵⁶ *Id.*

¹⁵⁷ *Id.*

¹⁵⁸ *Id.*

¹⁵⁹ *Id.*

¹⁶⁰ I.R.C. § 1256(b) defines a "Section 1256 Contract" as including: (1) any regulated future contract, (2) any foreign currency contract, (3) any nonequity option, and (4) any dealer equity option.

¹⁶¹ COMMITTEE REPORT, *supra* note 152, at 467.

¹⁶² I.R.C. § 861(b) (1984).

¹⁶³ I.R.C. § 862(b) (1977).

¹⁶⁴ See Miller, *Foreign Currency Transactions: A Review of Some Recent Developments*, 33 TAX L. REV. 825, 841-45 (1980).

derived from the purchase of property" with one country "and its sale or exchange" with a second country, should be treated as having their source within the second country, the country in which the sale or exchange actually took place.¹⁶⁵ Under Treas. Reg. §1.861-7, the place of sale is normally the site where "the rights, title, and interest of the seller in the property are transferred to the buyer."¹⁶⁶ The regulation further provides that a special "substance of the sale" test will be substituted for the normal "title-passage" test when the transaction can be proven to have been arranged for tax avoidance purposes.¹⁶⁷ In such case, the place of sale will be determined on the basis of all pertinent factors, including "negotiations, the execution of the agreement, the location of the property, and the place of payment."¹⁶⁸

It is certainly difficult to even think about applying the "title-passage" test to foreign currency transactions because the underlying asset being sold, the foreign currency, is not really ever physically exchanged between the seller and the buyer.¹⁶⁹ But even if the forward contract gains would be treated as foreign source under the general title-passage test, such gains will, in turn, be "re-sourced" back to the U.S. under §904(b)(3)(C)¹⁷⁰ in the event that the contract is characterized as a capital asset, which is the general status of the case law.¹⁷¹ There are two exceptions to §904(b)(3)(C), by which the deemed U.S. source rule will not apply: if the forward contract terminating transaction occurs in a country where the contract was used in the taxpayer's trade or business or from which the taxpayer derived more than fifty percent of its gross income for the three-year period preceding the transaction; or if the gain is subject to at least a ten percent rate of foreign tax.¹⁷²

Because the repayment of a note generally should constitute a "sale or exchange" to the holder,¹⁷³ §904(b)(3)(C) could very well be effective in treating exchange gains realized on the collection of foreign currency loans as U.S. source.¹⁷⁴ If, however, the gain realized on the collection of a loan or other obligation were considered ordinary under an "integral part of the business" exception,¹⁷⁵ then §904(b)(3)(C) could not apply and, rather, the general title-passage rules would control.¹⁷⁶

¹⁶⁵ I.R.C. §§ 861(a)(6), 862(a)(6) (1985).

¹⁶⁶ Treas. Reg. § 1.861-7(c) (1985).

¹⁶⁷ *Id.*

¹⁶⁸ *Id.*

¹⁶⁹ Terr & Muller, *supra* note 7, at 38.

¹⁷⁰ I.R.C. § 904(b)(3)(C) (1985).

¹⁷¹ Terr & Muller, *supra* note 7, at 38.

¹⁷² *Id.*

¹⁷³ I.R.C. § 1232(a)(1) (1985).

¹⁷⁴ Terr & Muller, *supra* note 7, at 38.

¹⁷⁵ See *supra* note 69.

¹⁷⁶ Terr & Muller, *supra* note 7, at 38.

When the forward contract terminating transaction produces a loss, the allocation rules of §§861(b) and 863(a)¹⁷⁷ should apply for sourcing purposes. Under these rules, a loss generally is allocated to a class of gross income and is then accorded the same source as the particular class of income to which it is allocated.¹⁷⁸ In the event that the loss cannot be allocated to a particular class of gross income, it may be apportioned between U.S. and foreign sources based on the source "mix" of the taxpayer's entire gross income.¹⁷⁹ Under Treas. Reg. §1.861-8(e)(7)(i) a loss is considered a deduction which is definitely related and allocable to the class of gross income to which such property or asset normally gives rise.¹⁸⁰ Because a forward contract is not typically viewed as a property item that produces income in and of itself, the prescription of Treas. Reg. §1.861-8(e)(7) cannot be applied easily. There is no clear answer to whether the Regulation's reference to "such property or asset" means the particular property to which the income is related or all property which could produce such income.¹⁸¹ As an additional problem, even if the regulation applies otherwise to losses incurred on forward contracts, it may not apply on the grounds that the forward contract is found to qualify as an ordinary asset.¹⁸² In *National-Standard Co. v. Commissioner*,¹⁸³ for example, the Sixth Circuit upheld the Tax Court in finding that no foreign currency losses will be capital in character and that foreign currency borrowings do not give rise to a sale or exchange and are ordinary in character, even without any consideration to the use of the foreign currency involved.¹⁸⁴

B. Proposed Changes

Under the Treasury Discussion Draft,¹⁸⁵ the gain or loss would be sourced in the same manner as would be the income or expense, as the case may be, generated by the asset, liability, or income stream which is being hedged through the use of a forward exchange contract.¹⁸⁶ For example, the gain or loss on a forward sale contract hedging the principal amount of a specific foreign-currency-denominated receivable would be sourced in the same manner as an increase or decrease in interest re-

¹⁷⁷ I.R.C. §§ 861(b), 863(a) (1985).

¹⁷⁸ Terr & Miller, *supra* note 7, at 38.

¹⁷⁹ *Id.*

¹⁸⁰ Treas. Reg. § 1.861-8(e)(7)(i) (1985).

¹⁸¹ Terr & Muller, *supra* note 7, at 38.

¹⁸² *Id.* at 144.

¹⁸³ *National Standard Co.*, 80 T.C. 551.

¹⁸⁴ *National Standard Co.*, 749 F.2d at 371-73.

¹⁸⁵ See *supra* note 115 and accompanying text.

¹⁸⁶ Treasury Discussion Draft, *supra* note 13, at 81711-14.

ceived from that receivable.¹⁸⁷ Similarly, the gain or loss on a forward purchase contract, used to hedge the principal amount of a specific foreign-currency-denominated payable, would be sourced in the same manner as interest paid which is due on that payable.¹⁸⁸

The Reagan Administration did not differ from the Treasury Department in that it too proposed sourcing exchange gain or loss on a forward purchase contract in the same manner as interest received or paid with respect to the underlying asset or liability.¹⁸⁹ The House Ways and Means Committee, believing that its overriding consideration should be to provide certainty regarding the source of exchange gain or loss,¹⁹⁰ also opted for sourcing exchange gain or loss in the same manner as interest income or expense is sourced.¹⁹¹

VI. CONCLUSION

Because of market pressures to conduct business outside of the country, U.S. businesses cannot escape the issues raised in this note. Foreign currency exchange rates will remain volatile and, accordingly, multinational businesses will cautiously hedge their overseas investments through the use of forward sale contracts and forward purchase contracts. If, for some reason, the business surrenders possession of the hedging device, issues arise as to whether a realization event has occurred; whether, if such realized gain or loss is capital or ordinary; and finally, whether the source of the amount realized is domestic or foreign. This note has shown that the case law, statutes, and Treasury Regulations and Rulings collectively provide a confusing set of answers to these vital questions. The Treasury Discussion Draft, Reagan Administration proposals, and Tax Reform Bill of 1985 collectively provide workable answers and, more importantly, would, if enacted, create some certainty in the tax treatment of multinational hedging transactions. It is hoped that Congress will move faster in its efforts at working with the Treasury Department and President to ultimately codify a new tax bill which addresses these foreign currency translation issues.

¹⁸⁷ *Id.* at 81713.

¹⁸⁸ *Id.*

¹⁸⁹ *President's Tax Proposals*, *supra* note 15, at 419.

¹⁹⁰ COMMITTEE REPORT, *supra* note 152, at 466.

¹⁹¹ *Id.*

