INTERNATIONAL TAXATION: CURRENCY SALES TO OFFSET VALUE DECLINE OF OVERSEAS INVESTMENTS — *Hoover Co. v. Commissioner*, 72 T.C. 206 (1979).

The United States Tax Court has held that losses from short sales of foreign currency are capital losses when United States corporations use such sales as hedges against declines in the dollar value of their foreign subsidiaries. By holding that such losses are capital expenditures, the court has eliminated past uncertainties in the use of agreements to sell currency for a set price at a set future date, permitting corporations better to ascertain the benefits and disadvantages of such agreements.

In 1968–1970, Hoover[1] had subsidiaries in twenty foreign states.[2] During these years, Hoover feared a devaluation of foreign currencies relative to the dollar.[3] Although the currency devaluations would not affect Hoover's corporate tax liability,[4] they would result in a lower dollar valuation of its subsidiaries on Hoover's financial statements.[5] Hoover believed that such reduced valuation would damage its reputation with its potential and existing stockholders.[6]

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1. Hoover Co. v. Commissioner, 72 T.C. 206 (1979).

2. *Id.* at 208–10.

3. During the late 1960's, the United States dollar was still tied to the gold standard under the Bretton Woods Agreement of 1944. *See, e.g.*, R. WARD, DEVELOPMENT PROBLEMS FOR THE 1970's 7–15 (1973).

The dollar was strong relative to other currencies, and United States companies were worried about foreign currency devaluations. For example, a 14% devaluation in the pound sterling in 1967 produced an exchange loss of over $3.5 million on Hoover's consolidated financial statements with respect to its British subsidiary. 72 T.C. at 214–16.

4. 72 T.C. at 216. The book profits and losses thus generated, as well as the United States taxes related to them which may be accrued on the financial statements, are not considered in determining the United States tax liability of the parent, since consolidation for tax purposes with a foreign subsidiary is not permitted. Leibowicz, *Hedging in Foreign Currency: Capital or Ordinary?* 56 TAX ADVISER 477, 478 (1976).

5. The accounting profession requires that exchange gains and losses be disclosed in financial reports. *See* FINANCIAL ACCOUNTING STANDARDS BOARD, STATEMENT OF FINANCIAL ACCOUNTING STANDARDS No. 8 at §§ 53–54 (1975) [hereinafter cited as FASB No. 8].

Such agreements are necessary because, under current financial accounting principles, a company's foreign assets and liabilities must be converted to dollar equivalents at the year end exchange rate, FASB No. 8.

6. 72 T.C. at 216. Corporations are often unwilling to risk distortion of their financial statements from such gains and losses, and the corresponding effect on their image in the investment community. Consequently, multinational corporations have turned to foreign currency hedge transactions to decrease the effect of such translation gains and losses. Leibowicz, *supra* note 4, at 472–478; *see also* Ravenscroft, *Taxation of Income Arising from Changes in Value of Foreign Currency*, 82 HARV. L. REV. 772 (1969); Costello, *Tax Consequences of Speculation and Hedging in Foreign Currency Futures*, 28 TAX LAW. 221 (1974); Polk, *Financial and Tax Aspects of Planning for Foreign Currency Exchange Rate Fluctuations*, TAXES — THE TAX MAGAZINE 131, 135 (Mar., 1978).

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To guard against that possibility, Hoover entered into eighteen "forward sales agreements"[7] in 1968–1970. In each agreement, Hoover contracted with an international bank to sell a specified amount of foreign currency at fixed future dates in return for a stated amount in United States dollars.[8] For each subsidiary, Hoover based the amount of foreign currency it sold forward on its "net exposure": the total amount of Hoover's interest that might be influenced by exchange rate changes.[9] In each agreement, Hoover tried to reach a contract price which would neutralize the effect of currency fluctuations on its financial statement.[10]

Hoover realized gain on two of its agreements and losses on all the others.[11] Hoover treated these losses as ordinary losses,[12] reasoning that

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7. Forward sales agreements, or contracts, are one means of protecting a company's foreign exchange position.

A forward sales agreement is a contract with five elements. First, an amount of foreign currency is specified (for example, 100 English pounds). Second, a price for that currency is set in United States dollars (250 dollars). Third, a date is set for the exchange to take place (next July 1). Fourth, the seller (in this case, Hoover) promises to deliver the foreign currency. Finally, the buyer (in this case, a bank) promises to accept the foreign currency and deliver the dollars. These mutual promises distinguish the forward sales agreement from a mere option to buy or sell.

When the amount of foreign currency is tied to the asset value of the subsidiary in that foreign country, the forward sales agreement will tend to cancel out the changes in the value of the subsidiary (expressed in United States dollars). Of course, forward sales agreements ignore changes in the value of the foreign subsidiary due to its own business profits and losses.

8. The agreements were used to protect Hoover's net exposure in its French, Norwegian, Swedish, Canadian, and British subsidiaries. 72 T.C. at 219. For a thorough discussion of the mechanics of foreign exchange transactions of commercial banks, *see* Campbell and O'Conner, *Taxation of Foreign Exchange Activities of Commercial Banks*, 56 TAX ADVISER 541 (1976).

9. Hoover calculated the net exposure by first subtracting the foreign subsidiary's liabilities from the total assets. Next, the fixed assets of the subsidiary were subtracted because they were translated into United States dollars at the historical exchange rate and, therefore, not considered subject to the impact by devaluation or revaluation. Hoover's calculation also took into account liabilities payable by the subsidiary in other currencies. Finally, the net assets exposed to risk were multiplied by the fraction which represented Hoover's ownership interest in the subsidiary. 72 T.C. at 216–217.

10. *Id.* at 225.

11. *Id.* at 218–223.

Specifically, Hoover recognized gain on a December 1, 1967 contract with Chase Manhattan Bank in French francs and on its December 31, 1969 sale of a French francs contract to Manufacturer's Hanover, London Branch. In all other cases, the currencies were devalued more than Hoover had anticipated, so Hoover's account at each respective bank was debited to reflect its loss on the offset of the contracts. *Id.* at 218, 225.

12. Corporations cannot use capital losses to offset ordinary corporate income, I.R.C. § 1211(a).

Hoover settled its obligations under the future sales agreements in three ways: through a purchase agreement with the same bank with which it had made the future sales agreement; through currency purchased from a second bank and delivered in satisfaction of the contract; and through the sale of its forward contract to a second bank. 72 T.C. at 224–25.

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it had entered into the transactions to offset potential exchange losses on its consolidated financial report, with no expectation of gain in the speculative sense.[13]

The Internal Revenue Service (the Service), however, treated the agreements as capital transactions for three reasons. First, the Service maintained that the exchange losses that Hoover sought to eliminate had no direct economic effect on Hoover's day-to-day business operation income.[14] Second, it argued that there was no direct relationship between Hoover's "net exposure" in each subsidiary and the income it received from its subsidiaries.[15] Finally, the Service contended that Hoover did intend for the transactions to produce taxable gain.[16]

Hoover disputed the Service's adverse ruling and sought relief in the United States Tax Court, advancing two principal arguments[17] in favor of treating its gains and losses as ordinary. First, Hoover said the forward sales agreements were bona fide hedging transactions and thus excluded from capital gains treatment under section 1233(g) of the Internal Revenue Code (the Code).[18] It said that "hedge" should have its normal meaning, "to protect oneself financially."[19] Hoover argued that it was trying to protect the value of its stock investment in its subsidiaries, rather than speculating on the foreign exchange market

13. *Id.* at 224, 225.

14. *Id.* at 226.

15. Specifically, the Internal Revenue Service found that neither Hoover's accounts receivable from the subsidiary, nor the dividends to be paid by the subsidiary to Hoover, nor any other transfer of cash or assets was a factor in determining its devaluation risk. *Id.*

16. *Id.* at 225.

17. Hoover also advanced two minor arguments before the court. First, Hoover asserted that the currency it purchased in certain of these agreements was not a capital asset. Thus, I.R.C. § 1233, which provides for capital treatment for gain or loss from certain short sales, would not apply. Second, Hoover maintained that the offsetting purchase contracts it entered were merely releases. Therefore, the sale or exchange requirement of I.R.C. § 1233 was not met. *Id.* at 228.

18. *Id.* at 227.

I.R.C. § 1233(g) provides, in pertinent part:

> This section [holding that gain or loss from the short sale of property shall be considered as gain or loss from the sale or exchange of a capital asset to the extent that the property, including a commodity future, used to close the short sale constitutes a capital asset in the hands of the taxpayer] shall not apply in the case of a hedging transaction in commodity futures.

19. *Id.* at 228.

Hoover also argued that there was no statutory justification for allowing the Commissioner to define "hedge" in terms of the limited examples in section 1.1233-1(b) of the Income Tax Regulations, Treas. Reg. § 1.1233-1(b), T.D. 6494, T.D. 6207. 72 T.C. at 238.

Section 1.1233-1(b) provides, in pertinent part: "Under section 1233(g), the provisions of section 1233 and this section shall not apply to any bona fide hedging transaction in commodity futures entered into by flour millers, producers of cloth, operators of grain elevators, etc., for the purpose of their business."

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for profit. This was shown, Hoover said, by the fact that it had tied the hedged amounts to the subsidiaries' net assets, not to the value of its stock ownership in them.[20]

Hoover's second argument was that the losses incurred through the forward sales agreements represented an insurance expense.[21] Thus, the losses in the forward sales agreements would be ordinary and necessary business expenses, deductible under section 162 of the Code.[22]

In considering Hoover's arguments, the court concentrated on determining whether the forward sales agreements were hedges used to protect business income as defined in the Code,[23] and thus eligible for ordinary tax treatment.

First, the court found two previous decisions concerning the taxation of hedging transactions inapposite. The court agreed with both Hoover and the Commissioner that *Corn Products Refining Company v. Commissioner*[24] did not apply to the forward sales agreements.[25] In that case, the taxpayer sold futures contracts for a gain. Even though futures contracts are normally considered a capital asset, the United States Supreme Court refused to treat the gain as a capital gain because the sales were the kind which produced ordinary business income for that taxpayer, and because the sales protected the taxpayer's ordinary business income.[26] Hoover's agreements, the Tax Court found, were geared to the protection of a stock investment, not to business operations.[27] The court also held that its initial holding in *International Flavors & Fragrances, Inc. v. Commissioner*[28] did not apply here.[29] In that case, an

20. 72 T.C. at 237.

21. *Id.* at 240.

22. Section 162 provides, in pertinent part: "There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business." I.R.C. § 162.

23. *Id.* at 240.

24. 350 U.S. 46 (1955), *aff'g*, 215 F.2d 513 (2d Cir. 1954), *aff'g*, 16 T.C. 395 (1951), *as supplemented* 20 T.C. 503 (1953). Discussed in 72 T.C. at 233–237. For a detailed discussion of *Corn Products*, *see* Leibowicz, *supra* note 4, at 478–479.

25. 72 T.C. at 237.

26. 350 U.S. at 46.

27. 72 T.C. at 237.

28. 62 T.C. 232 (1974), *rev'd, and remanded*, 524 F.2d 357 (2d Cir. 1975).

In *International Flavors*, the Tax Court initially held that a foreign currency forward sales contract constituted a "loose hedge" designed to protect the company against its subsidiaries' operational losses. The Tax Court had refused to fashion separate rules for corporations with foreign subsidiaries and those with foreign branches: in both cases a United States corporation was held to be engaged in the same business operations as its foreign counterpart. Therefore, foreign currency transactions designed to protect that business gave rise to ordinary income and loss.

The Second Circuit reversed the Tax Court, holding that the futures contracts were capital assets. That court said that the major flaw in the Tax Court's reasoning was the idea that International Flavors was engaged in the foreign subsidiary's business. The

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acquisition of foreign currency by a United States corporation to protect against its subsidiaries' operational losses gave rise to ordinary income and loss, since such a corporation was considered to share its foreign counterpart's business operations. In contrast, the court again found that Hoover's agreements were not devised to protect its business operations, but merely protected Hoover's stock investment.[30]

The court next turned to Hoover's principal argument that "hedge" should be used in its everyday meaning in interpreting section 1233(g). This would result in ordinary income treatment for the losses. The court refused to accept Hoover's construction.[31] The court found that Hoover entered into the agreements to protect against a potential decrease in stock value of its subsidiaries as determined by asset value in United States dollars.[32] Thus, these agreements were not designed to protect its market position in its holdings of currency. Second, "a hedge has always been viewed as a means of protecting ordinary operating profits realized in the day-to-day operations of the business enterprise."[33] The court found that none of the day-to-day operating assets of Hoover were involved. None of its receivables from sales payable in foreign currency were hedged, nor were its purchases expressed in foreign currency.[34]

Even though Hoover said that its purpose in entering into the agreements was to protect the value of its stock investment in its subsidiaries, the court pointed out that the market price or value of the stock is subject to many factors besides the value of the foreign currency. The forward sales agreements did not protect against a real risk of economic loss, the court said, because the subsidiaries continued to operate with the same assets and earning potential as before.[35]

The court accepted Hoover's assertion that it had no speculative motive for the agreements. However, actual gains and losses, rather than an offset, resulted. The court concluded that the lack of speculation did not make the agreements hedges; rather, they were simply a wise investment technique to offset "poor" financial figures and prevent a negative financial image for Hoover.[36] The court thus limits the term

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United States parent's real interest, according to the Second Circuit, was merely that of a controlling shareholder.

Leibowicz, *supra* note 4, at 479–480. *See also* Polk, *supra* note 7, at 136–138.

29. 72 T.C. at 237.
30. *Id.* at 236–237.
31. *Id.* at 240.
32. *Id.* at 238.
33. *Id.*
34. *Id.*
35. *Id.* at 239.
36. *Id.* at 240.

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"hedge" to those transactions used to protect ordinary operating profit in the day-to-day operations of a business enterprise.

The court then decided that the losses resulting from the "hedges" should not be regarded as a form of insurance, deductible under section 162.[37] The court said that since the agreements were not hedges for purposes of section 1233(g),[38] as discussed above, they were not hedges for purposes of an "insurance" analogy either. Moreover, the reason for not regarding the agreements as hedges — *i.e.,* that there was no real risk of loss being "hedged" — also precluded viewing them as a form of insurance.[39]

Having dismissed Hoover's arguments that the realized gains and losses were ordinary in nature, the court determined whether the respective gains and losses were short-term or long-term on a transaction by transaction basis. The court held, pursuant to section 1222, that one forward sale agreement resulted in long-term capital gain because the contract, a capital good, was held for more than six months.[40] Hoover's physical delivery of currency to close other agree-

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37. *Id.* at 240–243. See note 22 *supra.*

38. See note 19 *supra.*

39. 72 T.C. at 241.

The court also considered Hoover's arguments that certain of its currency purchases were not § 1221(1) capital assets and that it was released from its performance obligations in certain sales transactions. It determined that § 1233 was generally applicable to these forward currency sales. It then pointed out that if Hoover's currency purchases were not § 1221(1) assets, then §§ 1233(b) and (d) would be severely limited. These sections convert what would otherwise be long-term gain to short-term gain and short-term loss to long-term loss. Under Hoover's argument, these sections would cover only short sales of stocks, securities, and commodity futures, although the general rule under § 1233(a) covers a short sale of any property. The court found unacceptable the result that, following Hoover's argument, anyone who sells short and then buys to cover would have ordinary income or loss. 72 T.C. at 245.

The court also disagreed with Hoover's argument that it neither sold nor exchanged the currency, but merely obtained a release from its obligation, finding that Hoover had completed a sale or exchange in all its futures transactions. Hoover closed the forward sales by physical delivery of currency, entry into offsetting purchase agreements, and sales to third parties. *Id.* at 248.

Section 1221(1) states that "property held by the taxpayer primarily for sale to customers in the ordinary course of his sale or business" is not a capital asset. I.R.C. § 1221(1).

I.R.C. § 1233(b) provides, in essence, that the short-term capital gain status of any gain sustained on a short sale is determined as of the time the taxpayer enters into the short sale contract. If, at that time, the taxpayer has held property "substantially identical" to that sold short for less than one year, any gain on closing the sale is given short-term treatment. Income Tax Regulations, Treas. Reg. § 1.1233-2. Similarly, I.R.C. § 1233(d) provides that the long-term capital loss status of a loss sustained on a short sale is determined at the time the contract is entered. If, at that time, the taxpayer has held "substantially identical" property for more than one year, any loss on closing the sale is given long-term treatment. Income Tax Regulation, Treas. Reg. § 1.1233-4.

40. Section 1222 provides, in pertinent part: "Long-term capital gain means gain from the sale or exchange of a capital asset held for more than one year." I.R.C. § 1222.

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ments resulted in short-term capital losses because the holding period of the currency was less than six months.[41] The court also determined that Hoover's use of offsetting purchase contracts to close some of the agreements resulted in short-term capital loss, except for one transaction which resulted in short-term capital gain, since the offset purchase contracts were entered into within six months of the closing date.[42]

Judge Tannenwald filed a concurring opinion, joined by Judge Drennan. Although they agreed with the result, they believed that *Corn Products* might apply to some situations involving currency transactions by corporations having foreign operations.[43]

Judge Chabot, in dissent, stated that the general doctrine enunciated in *Corn Products* was applicable and that its application would have led the court to find for Hoover.[44] Chabot disagreed with the majority's determination that the agreements were not primarily for the purpose of protecting assets of Hoover's trade or business. He believed instead that they related to the everyday operation of Hoover's business, and would thus be treated as ordinary income or loss under *Corn Products*.[45]

The Tax Court's holding that Hoover's gains and losses incurred on forward sales agreements geared to its net exposure through subsidiary investment were capital gains and losses demonstrates a narrow definition of "business purpose." This definition is in line with the Second Circuit's rationale in *International Flavors,* that a United States corporation's interest in a foreign subsidiary is merely that of a stockholder.[46] Thus, the United States parent is not considered to be in the business of the subsidiary.

The *Hoover* decision thus injects a fixed standard for the treatment of foreign currency exchange agreements: United States corporations' forward sales agreements to protect stock investments in subsidiaries will receive capital gains treatment. This treatment is in contrast to that accorded to branch investments following *Corn Products:* United States corporations entering into similar currency transactions to protect overseas branch investments will be subject to ordinary tax treatment.

In its finding that Hoover's agreements were not a hedge, the court emphasized its determination that Hoover's currency transactions did not protect against a real risk of economic loss, since Hoover had no intention of selling or liquidating its subsidiaries and since the value of Hoover's stock reflected more than merely foreign currency considera-

41. 72 T.C. at 250.
42. *Id.* at 250–251.
43. *Id.* at 251.
44. *Id.*
45. *Id.*
46. 524 F.2d at 357.

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tions.[47] Such dependence leaves open the question whether similar currency transactions would constitute a hedge if the respective taxpayer had a stronger case for economic loss, such as a pending forced divestiture of the subsidiary.[48] If a corporation entered into forward sales agreements to protect its ordinary operating profits from economic risk posed by a subsidiary's precarious condition, such agreements might not be covered by *Hoover*. Thus, the holding in *Hoover* is arguably limited to currency agreements which are independent of possible economic loss to the parent.

Moreover, the *Hoover* decision, by stressing Hoover's shareholder status with regard to its subsidiaries in holding for capital treatment, ignores certain similarities found in branch and subsidiary operations, such as centralized planning and management. Nevertheless, subsidiaries and branch operations receive differing tax treatment. For example, by operating through subsidiaries, Hoover gains certain deferral rights[49] which do not accompany branch operations. Similarly, the Commission's unconcern with the valuation of foreign operations is unique to the parent-subsidiary form of business organization. Hoover, by its initial decision to operate through subsidiaries, implicitly opted for the benefits and disadvantages of a certain tax regime. In this light, *Hoover*'s special treatment for subsidiary operations seems to correlate with the broader differences in the tax treatment accorded to each form of operation.

Finally, although the United States dollar is no longer as strong, relative to other currencies, as it was when the *Hoover* transactions occurred, United States corporations still seek to minimize fluctuations on their accounting statements which result from changes in relative currency values and the false impressions of corporate strength or weakness they impart.[50] However, to maximize their potential benefits from forward sales agreements, such corporations need certainty with regard to tax treatment of currency purchases and sales. In spite of some ambiguity in the opinion, *Hoover* eliminates some uncertainty with regard to forward sales agreements based on subsidiaries' assets. Thus, *Hoover* permits United States corporations better to ascertain the benefits and disadvantages of protecting their overseas subsidiary investments from currency fluctuations through forward sales agreements.

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47. 72 T.C. at 239.

48. Such divestiture could be caused, for example, by local equity requirements or nationalization policies of developing countries.

49. D. TILLINGHAST, TAX ASPECTS OF INTERNATIONAL TRANSACTIONS 172 (1978).

50. *See* WARD, *supra* note 3; Leibowicz, *supra* note 4, at 477.

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