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# National Standard Company v. Commissioner: Will the Real Character of Foreign Currency Exchange Gains and Losses Connected with the Disposition of Foreign Debt Please Stand Up?

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# *National Standard Company v. Commissioner*: Will the Real Character of Foreign Currency Exchange Gains and Losses Connected with the Disposition of Foreign Debt Please Stand Up?

## I. Introduction

In *National Standard Company v. Commissioner*,[1] the Tax Court held that losses incurred by the taxpayer on the exchange of foreign currency used for the disposition of debt should be characterized as ordinary losses rather than capital losses.[2] Divisions among members of the court in resolving this case highlight the confused state of the law about the tax consequences of foreign currency transactions.[3] As a practical matter, *National Standard* clears the way for domestic companies investing abroad to reduce their tax liability substantially.[4] The decision allows these domestic companies to use foreign currency loans as offsets against ordinary income rather than limiting such losses to offsets against capital gains.[5]

Part II provides background on the principles and theories that were considered in the decision of this case. Part III presents a detailed view of the circumstances and transactions that gave rise to the controversy in the *National Standard* case. Part IV sets forth the majority, concurring and dissenting opinions. Part V presents an illustration of the legal and practical

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1. 80 T.C. 551 (1983), *aff'd*, 749 F.2d 369 (6th Cir. 1984).

2. *Id.* at 563-64.

3. For an early examination of the cases and theories regarding the tax treatment of gains and losses sustained on borrowings of foreign currency, see generally Roberts, *Borrowing in Foreign Currency*, 26 Taxes 1033 (1948) (advocates application of short sale analogy in tax treatment of foreign currency borrowing). *See also* Adams & Henrey, *Tax Consequences of Foreign Currency Fluctuations*, 30 Tax Exec. 301 (1978) (summary of tax consequences of various types of foreign currency transactions commonly entered into by a U.S. corporate taxpayer engaged in foreign operations).

4. For an illustration of the tax consequences on a foreign currency loss sustained by a domestic company, see *infra* text accompanying notes 220-21.

5. *National Standard*, 80 T.C. at 562-64. *See infra* text accompanying notes 220-21.

ramifications of this decision for foreign currency transactions and the tax law. Part VI concludes that although this case was correctly decided, it exemplifies the urgent need for clarification of the tax consequences arising from foreign currency transactions.

## II. Background

The courts have seldom considered the tax consequences of gains or losses sustained as a result of changes in the value of foreign currency. Early in the history of federal tax law, Justice Holmes lamented the absence of any definitive court decisions regarding the tax treatment of foreign currency exchanges.[6] Judge Drennen echoed the same sentiment in *National Standard*[7] when he characterized the case law in this area as being limited, inconsistent and indecisive.[8]

Although seldom discussed by commentators or courts, the tax ramifications of foreign currency gains and losses due to fluctuating exchange rates present both the attorney and the accountant with difficult problems.[9] Moreover, this area of tax law is taking on an ever-increasing significance in this age of extensive overseas investment by American corporations.[10]

To understand the tax treatment of foreign currency trans-

6. *See* Deutsche Bank Filiale Nurnberg v. Humphrey, 272 U.S. 517 (1926). In *Deutsche Bank*, an American citizen deposited marks in a demand account in a German bank. The bank failed to pay upon subsequent demand and the depositor sued the German bank in a U.S. court, asserting that the debt should be translated into U.S. dollars at the exchange rate prevailing when the demand was made. *Id.* at 518. The U.S. Supreme Court rejected depositor's assertion. The Court held that an individual incurring an obligation in terms of foreign currency takes the risk of currency fluctuations and the law takes no account of whether a debtor or creditor profits by the change. *Id.* at 519. Writing for the Court, Justice Holmes noted the conspicious lack of authority regarding the legal principles governing this case. *Id.* at 519-20. *See also* Comment, *Income Tax Consequences of Foreign Currency Fluctuations*, 37 TUL. L. REV. 282 (1963) (examining major categories of transactions subject to foreign currency fluctuations and discussing tax consequences of each, with focus particularly on inconsistencies which have developed in case law).

7. 80 T.C. 551, 556 (1983), *aff'd*, 749 F.2d 369 (6th Cir. 1984).

8. *Id.* Judge Drennen suggests that the reason for this confused state of the law is that past courts have tended to rest their decisions in this area on trivial factual differences, thereby causing a bevy of different results to spring from a line of cases with seemingly similiar fact patterns. *Id.*

9. *See* Adams & Henrey, *supra* note 3; Roberts, *supra* note 3.

10. Comment, *supra* note 6, at 296.

actions, it is necessary to examine the two-transaction principle,[11] the character of foreign currency gains and losses,[12] the effect of underlying transactions,[13] and the short sale analogy,[14] all of which were considered by the Tax Court in deciding *National Standard.*

## A. *The Two-Transaction Principle*

The two-transaction principle must be considered when foreign currency is purchased or borrowed for the purpose of financing another investment.[15] For tax purposes, American taxpayers must report income in United States dollars.[16] Transactions involving foreign currency are translated into dollars to determine tax liability.[17] Consequently, when a taxpayer obtains a loan of foreign currency, the loan is recorded by the taxpayer at the currency exchange rate prevailing on the date of the loan.[18] Any intervening appreciation or depreciation of the foreign currency against the dollar between the time the loan was made and the time it is repaid will constitute either a deductible loss or a taxable gain to the borrowing taxpayer.[19]

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11. *National Standard*, 80 T.C. at 555. For an expanded discussion of the two-transaction principle, see Miller *Foreign Currency Transactions: A Review of Some Recent Developments*, 33 TAX LAW. 825, 825-28 (1980). *See also infra* text accompanying notes 15-20.

12. *National Standard*, 80 T.C. at 558. For an expanded discussion of foreign currency gains and losses, see Miller, *supra* note 11, at 828-40; Ravenscroft, *Taxation of Income Arising from Changes in the Value of Foreign Currency*, 82 HARV. L. REV. 772, 793-94 (1969). *See also infra* text accompanying notes 35-67.

13. *National Standard*, 80 T.C. at 559. For an expanded discussion of the effect of underlying transactions, see Miller, *supra* note 11, 833-38; Newman, *Tax Consequences of Foreign Currency Transactions: A Look at Current Law and an Analysis of the Treasury Department Discussion Draft*, 36 TAX LAW. 225, 228-36 (1983); Comment, *supra* note 6, at 290-94. *See also infra* text accompanying notes 68-70.

14. *National Standard*, 80 T.C. at 566-71. For an expanded discussion of the short sale analogy, see Miller, *supra* note 11, 838-40. *See also infra* text accompanying notes 87-112.

15. *National Standard*, 80 T.C. at 555; Miller, *supra* note 11, at 825-26.

16. O.D. 419, 2 C.B. 60 (1920); Rev. Rul. 55-171, 1955-1 C.B. 80, 88.

17. Rev. Rul. 55-171, 1955-1 C.B. 80, 88.

18. *Id.*

19. America-Southeast Asia Co. v. Commissioner, 26 T.C. 198, 200 (1956); Church's English Shoes, Ltd. v. Commissioner, 24 T.C. 56, 59 (1955), *aff'd*, 229 F.2d 957 (2d Cir. 1956); Joyce-Kobel Co. v. Commissioner, 6 B.T.A. 403, 406 (1927); *Bernuth Lembcke Co.*, 1 B.T.A. 1051, 1054 (1925).

Under the two-transaction principle, if the foreign currency has been borrowed for investment purposes, the gain or loss due to currency fluctuation, sustained at the time of repayment will be considered a separate taxable event from any gain or loss sustained on the underlying investment.[20] These transactions are treated separately for tax purposes because they are treated as distinct for accounting purposes.[21]

The two-transaction principle was applied in *Church's English Shoes, Ltd. v. Commissioner.*[22] In *Church's*, the taxpayer purchased English merchandise on credit and computed the cost of the merchandise based on the value of the pound sterling in relation to the U.S. dollar at the time of the purchase.[23] Twelve years later, the taxpayer purchased pounds sterling and paid for the merchandise.[24] During the twelve years, the pound sterling was devalued in relation to the dollar.[25] Thus, the taxpayer was able to purchase an amount of pounds sterling to satisfy the debt for fewer dollars than it would have cost had the taxpayer purchased them at the same time the merchandise was obtained.[26] In holding that the taxpayer had realized a taxable gain, the court stated that the purchase of the merchandise and the foreign currency transaction represented separate transactions for both tax and accounting purposes.[27]

The two-transaction principle was also applied in *America Southeast-Asia Co. v. Commissioner.*[28] In *America*, the taxpayer borrowed foreign currency to purchase Indian burlap.[29] As part of its decision, the court stated that the purchase of the burlap and the transaction in foreign currency represented two separate transactions.[30]

20. America-Southeast Asia Co. v. Commissioner, 26 T.C. at 200; Church's English Shoes, Ltd. v. Commmissioner, 24 T.C. at 59; Joyce-Kobel Co. v. Commissioner, 6 B.T.A. at 406.

21. *National Standard*, 80 T.C. at 555; Church's English Shoes, Ltd. v. Commissioner, 24 T.C. at 59.

22. 24 T.C. 56 (1955).

23. *Id.* at 57.

24. *Id.*

25. *Id.*

26. *Id.*

27. *Id.* at 59.

28. 26 T.C. 198 (1956).

29. *Id.*

30. *Id.* at 200.

The two-transaction principle appeared recently in Revenue Ruling 78-281.[31] The taxpayer in this ruling had borrowed foreign currency to finance the purchase of a machine to be used in a foreign equipment rental business.[32] The ruling held that any gains or losses realized upon repayment of the loan due to foreign currency fluctuation should be characterized as ordinary.[33] In so holding, the ruling considered the purchase of the machine and the foreign currency transaction to be separate transactions.[34]

### B. *Character of Foreign Currency Gains and Losses*

The characterization of a particular gain or loss as either capital or ordinary is an important consideration for a taxpayer because it will dictate the rate of tax he will pay on gains and also determine the type of income against which he may offset his losses.[35] Section 165 (f) of the Internal Revenue Code sets forth the treatment of capital losses.[36] It provides that losses from sale or exchange of capital assets will be allowed to the extent permitted in sections 1211 and 1212 of the Internal Revenue Code.[37] Section 1211 places a limitation on capital losses. Subsection (a) provides that "in the case of a corporation, losses from sales or exchanges of capital assets will only be allowed to the extent of capital gains from such sales or exchanges."[38] Thus, in order for a gain or loss to be treated as capital, it must arise from the *sale or exchange* of a *capital asset.*[39]

31. 1978-2 C.B. 204.

32. *Id.* at 204-05.

33. *Id.* at 205.

34. *See id.*

35. For an explanation of the result of characterizing a loss or gain as capital or ordinary, see *infra* text accompanying notes 220-21. *See also National Standard* , 80 T.C. at 556-57.

36. I.R.C. § 165(f) (West 1984). Section 165(f) provides: "losses from sales or exchanges of capital assets shall be allowed only to the extent allowed in sections 1211 and 1212." *Id.*

37. *Id.* Section 1212 deals with capital loss carrybacks and carryovers. This section is essential to the treatment of losses after they have been determined to be capital. It is not pertinent for the purposes of this discussion, however, since the capital or ordinary determination is the subject here.

38. *Id.* § 1211 (a). This section means that capital losses may only be used to offset capital gains and may not be applied to offset ordinary gains.

39. *Id.* § 1211(a).

### 1. *The Capital Asset Requirement*

Section 1221 of the Internal Revenue Code generally defines a capital asset as any property held by the taxpayer, regardless of whether or not it is used in his business.[40] An exception to the section 1221 rule was created in 1955 by the Supreme Court's decision in *Corn Products Refining Company v. Commissioner.*[41] The taxpayer in that case manufactured corn products and purchased corn futures to hedge against increases in the price of corn and to ensure a supply of raw corn, the raw material from which its products were made.[42] In some instances the Corn Products Refining Co. (CPRC) accepted delivery of the futures

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40. *Id.* § 1221. This section provides:

For the purposes of this subtitle, the term "capital asset" means property held by the taxpayer (whether or not connected with his trade or business), but does not include—

(1) stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business;

(2) property, used in his trade or business, of a character which is subject to the allowance for depreciation provided in section 167, or real property used in his trade or business;

(3) a copyright, a literary, musical, or artistic composition, a letter or memorandum, or similar property, held by—

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

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

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

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

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

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

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

*Id.*

41. 350 U.S. 46 (1955).

42. *Id.* at 48.

and in other instances it resold the futures on the spot market.[43] Over a period of several years CPRC incurred both gains and losses from its futures tradings.[44] CPRC attempted to characterize these gains and losses as capital gains and losses, contending that the futures contracts constituted "property" separate and distinct from its manufacturing operation.[45] The Supreme Court found the contracts to be an integral part of CPRC's business, not separate and distinct from manufacturing.[46] The Court stated that Congress' motive in affording capital assets preferential treatment was to avoid excessive taxation of gains from the conversion of capital assets.[47] Consequently, the court held that gains and losses from commodity futures transactions that are found to be integral parts of a taxpayer's business, must be characterized as ordinary gains and losses.[48]

Generally, foreign currency is considered to be property for federal tax purposes.[49] Thus it is considered to be a capital asset, although the authority for this proposition is scant.[50] But if foreign currency is used by the taxpayer as an "integral part of his trade or business" then, pursuant to the *Corn Products* doctrine, the currency will not be treated as a capital asset.[51] The overall rule of section 1221 and the *Corn Products* exception enjoy longstanding and widespread acceptance despite frequent litigation about what actually constitutes an "integral part of everyday trade or business."[52]

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43. *Id.*

44. *Id.* at 48-49.

45. *Id.* In previous years, Corn Products Refining Company treated the gains and losses as ordinary gains and losses. *Id.* at 49. *See also* Note, *International Taxation-Hedging-Gains and Losses Resulting From Hedging in International Currencies May Be Characterized as Ordinary Gain or Loss Even if Such Hedging is Not an Integral Part of the Business Within the Meaning of the Corn Products Doctrine*, 13 VAND. J. OF TRANSNAT'L L. 825, 826 (1980).

46. Corn Products Refining Co. v. Commissioner, 350 U.S. at 50.

47. *Id.* at 52.

48. *Id.* at 50-54.

49. *See* Gillin v. United States, 432 F.2d 309, 311 (Ct. Cl. 1955); Helburn Inc. v. Commissioner, 20 T.C. 740, 743 (1953), *aff'd*, 214 F.2d 815 (1st Cir. 1954).

50. Miller, *supra* note 11, at 829; *see National Standard*, 80 T.C. at 556, 558.

51. Corn Products Refining Co. v. Commissioner, 350 U.S. at 51-52. *See also* America-Southeast Asia Co. v. Commissioner, 26 T.C. at 200.

52. *See* International Flavors and Fragrances v. Commissioner, 62 T.C. 232 (1974), *rev'd*, 524 F.2d 357 (2d Cir. 1975); KVP Sutherland Paper Co. v. United States, 344 F.2d 377 (Ct. Cl. 1965); America-Southeast Asia Co. v. Commissioner, 26 T.C. 198 (1956). *See*

2. *The Sale or Exchange Requirement*

Although the capital asset requirement is rarely the subject of disagreement, there is a substantial difference of opinion regarding what actually constitutes a sale or exchange.[53] One school of thought supports the proposition that a sale or exchange occurs when foreign currency is used to discharge a debt payable in that particular currency.[54] Several cases, none of which deal with foreign currency, support the rule that the transfer of property in satisfaction of a debt constitutes the sale or exchange of an asset.[55] Proponents of this approach suggest that when this rule is applied to foreign currency transactions, the discharge of a foreign debt with foreign currency constitutes a sale or exchange of that currency.[56]

But there is authority to the contrary stating that the discharge of an obligation abroad with foreign currency does not constitute a sale or exchange of that currency.[57] The major cases cited for this proposition are *Church's English Shoes, Ltd. v. Commissioner*[58] and *Gillin v. United States*.[59] In *Church's English Shoes, Ltd.* an American taxpayer purchased English merchandise on credit.[60] Prior to the due date of the obligation, the pound sterling declined in value in relation to the dollar. As a result, the taxpayer realized a gain when he repaid his debt with foreign currency which, due to devaluation, cost less to purchase at the time of repayment than it would have cost at the time the

*generally* Corn Products Refining Co. v. Commissioner, 350 U.S. 46 (1955).

53. Some cases hold that the transfer of foreign currency in the discharge of a debt should not be treated as a sale or exchange. *See, e.g.*, America-Southeast Asia Co. v. Commissioner, 26 T.C. 198 (1956); Church's English Shoes, Ltd. v. Commissioner, 24 T.C. 56 (1955). At least one commentator has argued that such a transaction should be a sale or exchange. Costello, *Tax Impact of Currency Exchange Rate Fluctuations*, 26 TAX LAW 399, 433-34 (1973).

54. Costello, *supra* note 53, at 433-34.

55. *See, e.g.*, United States v. General Shoe Corp., 282 F.2d 9 (6th Cir. 1960), *cert. denied*, 365 U.S. 843 (1961); International Freighting Corp. v. Commissioner, 135 F.2d 310 (2d Cir. 1943); Commissioner v. Mesta, 123 F.2d 986 (3d Cir. 1941), *cert. denied*, 316 U.S. 695 (1942).

56. Costello, *supra* note 53, at 433-34.

57. Gillin v. United States, 423 F.2d at 313; Church's English Shoes, Ltd. v. Commissioner, 24 T.C. at 59.

58. 24 T.C. 56 (1955).

59. 423 F.2d 309 (Ct. Cl. 1970).

60. Church's English Shoes, Ltd. v. Commissioner, 24 T.C. at 57.

debt was incurred.[61] Although the Tax Court held the gain to be ordinary, based on the fact that the foreign currency purchase was made in the ordinary course of the taxpayer's business, the court stated emphatically, albeit in dictum, that "there was no sale or exchange of a capital asset" involved in the transaction.[62] In *Gillin v. United States*,[63] an individual borrowed Canadian currency and immediately converted it into United States dollars which were then used for his personal expenses.[64] He subsequently realized a gain when he purchased devalued Canadian currency which he used to repay the loan.[65] The Court of Claims, responding to the taxpayer's claim for capital gains treatment,[66] stated that the retirement of "one's own debt does not result in a sale or exchange or in capital gain."[67]

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61. *Id.* When the taxpayer purchased the goods on credit, the value stated on the invoice was expressed in pounds sterling. The taxpayer used the exchange rate prevailing at the date of purchase to convert the pounds sterling amount into dollars. The goods were valued in that dollar amount on his books for accounting purposes. Twelve years later, the taxpayer acquired pounds sterling to discharge the debt. During the interim, the pound sterling had devalued in relation to the dollar. Thus, upon repayment at the later date, it cost the taxpayer less dollars to obtain the pounds sterling than it would have cost had the taxpayer purchased the pounds sterling at the time of the original purchase. *Id.*

62. *Id.* at 59.

63. 423 F.2d 309 (Ct. Cl. 1970).

64. *Id.* at 310.

65. *Id.* at 311-14.

66. The taxpayer argued that the debt obligation itself constituted a capital asset and, since the obligation was held for more than six months, the gain on its disposition should receive capital treatment. The court noted that the Canadian dollars were converted into American currency almost immediately after the loan. Therefore, such U.S. currency could not be considered a capital asset since it was not in fact held, but rather was used for the taxpayer's personal expenses. *Id.* at 313.

67. *Id.* at 311-14. This rule is also stated in earlier cases. *See* Fairbanks v. United States, 306 U.S. 436 (1939). It must be noted that *Fairbanks* did not apply this rule to currency transactions. The *Fairbanks* Court held that the redemption of corporate bonds by the issuing corporation, before maturity, did not constitute a sale or exchange of capital assets. Resulting gains and losses should therefore be subject to ordinary treatment. *Id. See also* KVP Sutherland Paper Co. v. United States, 344 F.2d 377 (Ct. Cl. 1965) (applying this rule to foreign currency transactions). In *KVP Sutherland*, the taxpayer purchased Canadian currency in the United States, lent the proceeds to subsidiaries in Canada, and received notes in exchange. *Id* at 377-78. More than six months later, the subsidiaries paid the notes in Canadian dollars and the taxpayer converted them into U.S. dollars within the next six months. *Id* at 378. The court held that any gain to the taxpayer on the exchange due to currency fluctuation should be characterized as ordinary and not as short-term capital gain or long-term capital gain. *Id.* at 383.

### C. *The Underlying Transactions*

When foreign currency is purchased or sold to facilitate another transaction, it must be determined whether the character of the underlying transaction should control the character of the foreign currency transactions.[68] Authority in this area is scant, but the few cases dealing with this question suggest that the character of the underlying transaction should dictate the characterization of the related foreign currency exchange transaction.[69] Courts note that the gain or loss on the underlying transaction will be characterized as either capital or ordinary. Courts reason, therefore, that the character of any gains or losses on related foreign currency transactions should be controlled by the character of the underlying transaction. They may be netted against each other to provide a more accurate picture of income.[70] The leading case on this point is *Columbia Sand & Gravel Co. v. Commissioner*.[71] The taxpayer in *Columbia* was a corporation involved in securities investment.[72] In 1948, certain Canadian bonds owned by the taxpayer reached maturity and the taxpayer was paid in Canadian dollars.[73] The Canadian dollars were converted into U.S. dollars eight months later.[74] During that eight months, the Canadian dollar had devalued in relation to the U.S. dollar.[75] The taxpayer realized a loss amounting to the difference between the value of the Canadian dollars at the maturity date and the value of the Canadian dollars eight months hence at the date of conversion.[76] The Tax Court re-

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68. *See* Miller, *supra* note 11, at 833.

69. Columbia Sand & Gravel Co., 11 T.C.M. (P-H) 796 (1952); *see also* Bennett's Travel Bureau, Inc. v. Commissioner, 29 T.C. 350 (1957); America-Southeast Asia Co. v. Commissioner, 26 T.C. 198 (1956); Church's English Shoes, Ltd. v. Commissioner, 24 T.C. 56 (1955).

70. Based upon the theory that the character of the underlying transaction controls the character of the foreign currency transaction, the underlying transaction and the foreign currency exchange are treated as part of the same overall transactions, suggesting that they be offset against each other. This theory prevails despite the existence of the two-transaction principle.

71. 11 T.C.M. (CCH) 794 (1952).

72. *Id.* at 795.

73. *Id.*

74. *Id.*

75. *Id.*

76. *Id.* at 795-96.

jected the taxpayer's claim of an ordinary loss.[77] *Columbia Sand* suggests that if the underlying transaction involves the disposition of a capital asset for foreign currency, any loss resulting from a change in the exchange rate should be characterized as a capital loss.[78]

*Gillin v. United States*[79] is sometimes cited as contrary authority.[80] In *Gillin*, the taxpayer borrowed Canadian currency and immediately converted it into U.S. dollars.[81] The taxpayer then used the U.S. dollars to satisfy certain personal obligations.[82] Later, he realized a gain when he purchased devalued Canadian currency and used it to repay the loan.[83] The Court of Claims denied the taxpayer long-term capital gains treatment, stating that the retirement of one's own debt did not result in a sale or exchange.[84] The court stated further that the Canadian currency was not held for the required six months, thus long-term capital treatment would have been denied even if a sale or exchange had occurred.[85] Significantly, in examining the possible effect of the character of the underlying transaction, the court stated that a relevant underlying transaction did not exist:

> [T]he borrowed money was immediately converted into United States funds and used in this country — for personal expenses and investment, and not in the carrying on of a trade or business. . . . There is, in short, no underlying transaction to concern us, nor any course of dealings, nor any taxpayer with other substantial economic connections with the foreign country. We have, instead, a pure borrowing of Canadian money . . . .[86]

### D. *The Short Sale Analogy*

When an American taxpayer borrows foreign currency to finance a foreign investment and, due to an intervening fluctua-

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77. *Id.* at 796.
78. *Id.* at 796-97.
79. 423 F.2d 309 (Ct. Cl. 1970).
80. Miller, *supra* note 11, at 837-38.
81. Gillin v. United States, 423 F.2d at 310.
82. *Id.*
83. *Id.*
84. *Id.* at 313.
85. *Id.*
86. *Id.* at 310.

tion in the value of foreign currency, sustains a gain or loss when he repays the loan, it has been argued that the gain or loss should be treated as a short sale for tax purposes.[87] Short sales and their tax treatment are governed by section 1233 of the Internal Revenue Code.[88] If section 1233 applies, a taxpayer's gain or loss is considered gain or loss from the sale or exchange of a capital asset, rendering it a capital gain or loss.[89] Short sales generally involve the sale of stock, although this is not always the case.[90] Typically, the short seller agrees to sell shares of stock which he neither owns nor controls but promises to deliver to the buyer at a future date.[91] To make the delivery, the seller must usually borrow the shares from a broker.[92] To discharge his obligation the seller must then purchase identical stock in the open market to repay the broker.[93] The short seller engages in this type of activity because he anticipates a drop in the market price of the stock following the sale of the borrowed stock.[94] If the drop occurs, the seller will realize a profit consisting of the difference between the price of the replacement stock and the price of the borrowed stock.[95] It is important to note that before the short sale analogy can be applied, there must have been a sale or exchange of a capital asset in the transaction.[96] The analogy between short sales and gains or losses sustained on the exchange of foreign currency for the disposition of foreign debt has been argued in various cases since 1926. In the vast majority of decisions, it has not been applied. The short sale analogy was considered in *Bowers v. Kerbaugh-Empire Co.*[97] In *Bowers*, German marks were lent to a taxpayer who immediately converted the marks into dollars. The taxpayer subsequently lent the funds to an American subsidiary that defaulted on the loan.[98] In

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87 *See infra* text accompanying notes 96-112.
88. I.R.C. § 1233(a) (West 1984).
89. *Id.*
90. 1981 Federal Tax Course ¶2209 (CCH 1980).
91. *Id.*
92. *Id.*
93. *Id.*
94. *Id.*
95. *Id.*
96. I.R.C. § 1233(a) (West 1984).
97. 271 U.S. 170 (1926).
98. *Id.* at 172.

the interim, the mark had declined in value against the dollar and the taxpayer was able to purchase marks to repay the loan with fewer dollars than would have been required on the original date of the loan.[99] The Commissioner proffered a short sale argument, but it was not accepted by the Supreme Court. The Court reasoned that the transaction did not resemble a traditional short sale.[100] Similarly, the short sale analogy was not accepted by the Tax Court in *America Southeast Asia Co. v. Commissioner.*[101] The court in *America* recognized a similarity between transactions in foreign currency and short sales. But it denied capital treatment because the taxpayer's transactions in the foreign currency exchanges were an integral part of its ordinary trade or business.[102] Thus, the taxpayer's gains on the currency transactions were taxed as ordinary income realized in the ordinary course of trade or business.[103] The short sale analogy was also not accepted by the Court of Claims in *Gillin v. United States.*[104] The court in *Gillin* held that the taxpayer's gain was ordinary because retirement of the taxpayer's debt had not resulted in a sale or exchange.[105]

The short sale analogy was accepted by the Tax Court recently in *The Hoover Co. v. Commissioner.*[106] Hoover had entered into currency forward sale agreements to offset potential declines in the value of its investments in certain foreign subsidiaries due to a devaluation in the home currencies of those subsidiaries.[107] Hoover also wanted to offset exchange losses which it was required to report on its financial statements.[108] The Tax Court held, in part, that the short sale analogy was appropriate

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99. *Id.* at 173.

100. *Id.* at 175. The Court stated that a short seller borrows what he sells and the purchase price goes to the lender as security for repayment. Such was not the case in *Bowers* because no funds were remitted to the lender prior to repayment. Rather, the seller kept the proceeds and expended them. *Id.*

101. 26 T.C. 198, 200 (1956).

102. *Id.* at 200.

103. *Id.*.

104. 423 F.2d 309, 313 (Ct. Cl. 1970).

105. *Id.* at 313-14.

106. 72 T.C. 206 (1979).

107. *Id.* at 213-24.

108. *Id.* at 215-16. Although these exchange losses would be unrecognized and unreported for tax purposes, they were required to be reported on the financial statements and Hoover was concerned with minimizing their negative impact thereon. *Id.*.

and applied Section 1233 of the Internal Revenue Code.[109] Thus, the losses sustained by Hoover as a result of the forward sale agreements constituted capital losses.[110] Significantly, the *Hoover* court stated:

> Section 1233(a) provides that gain or loss from a short sale shall be considered a gain or loss from the sale or exchange of a capital asset to the extent that property, including a commodity future, used to close a short sale constitutes a capital asset in the hands of the taxpayer. No limitation on the term "property" appears in section 1233(a) and, accordingly, we think that this provision clearly applies to the short sale of currency here.[111]

Prior to *Hoover*, the Tax Court had adopted a generally restrictive posture regarding the extension of section 1233 by analogy.[112] *Hoover* remains the only foreign currency case treated by analogy as a short sale.

## III. The Facts

The following facts and transactions gave rise to the controversy in *National Standard*.[113] In early 1970, National Standard Company (National),[114] an American corporation, entered into negotiations with Accerces Ruenies de Burback-Eich-Dudelange S.A. (ARBED),[115] a European corporation, which culminated in

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109. *Id.* at 243. Section 1233 provides:

> (a) Capital Assets. — For purposes of this subtitle, 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.

I.R.C. § 1233(a) (West 1984).

110. Hoover Co. v. Commissioner, 72 T.C. 206, 249-51 (1979).

111. *Id.* at 243.

112. *See* Gillin v. United States, 423 F.2d 309 (Ct. Cl. 1970); America Southeast-Asia Co. v. Commissioner, 26 T.C. 198 (1956); Bowers v. Kerbaugh-Empire Co., 271 U.S. 170 (1926). (In all of the above cited cases the short sale analogy argument was proffered but it was not accepted by any of the courts.).

113. 80 T.C. 551 (1983), *aff'd*, 749 F.2d 369 (6th Cir. 1984).

114. National Standard Company (National) is a Niles, Michigan corporation, which operates 23 facilities in the United States as well as several others in England, Canada, France and South Africa. National is primarily engaged in the manufacturing of wire and other metal products predominantly used for incorporation into larger products. *Id.* at 551-52.

115. At the time of this negotiation, National and Accerces Ruenies de Buerback-Eich-Dudelange S.A. (ARBED) already shared ownership in manufacturing facilities op-

an agreement between the two to form a new corporation.[116] The new corporation, FAN International (FAN), would be located in Luxembourg and both ARBED and FAN would possess a fifty percent ownership interest.[117] Pursuant to the contract, both companies agreed to make an equity contribution of five million dollars to the new corporation.[118] In September of 1970, National borrowed two hundred and fifty million Luxembourg francs (LF) from Caisse D'Espargne De L'Etat (hereinafter Caisse), a Luxembourg bank, in order to obtain the proceeds with which to make its equity contribution to FAN.[119] On the date of the loan, the francs had an equivalent dollar value of five million.[120] On January 2, 1974, National sold its ownership interest in FAN to ARBED and, on its tax return for the fiscal year ending September 30, 1974, reported a long term capital gain on the sale.[121] Earlier that same year, National had considered refinancing the Caisse loan[122] but the bank would not refinance because National was planning to liquidate its interest in FAN.[123] Shortly thereafter, National agreed to borrow two hundred fifty million Belgian francs from Societe Generale Alsacienne De

erating in Germany, Luxembourg and Belgium. *Id.* at 552.

116. *Id.*

117. *Id.*

118. *Id.*

119. *Id.* at 552-53. United States government restrictions on the amount of money that American companies are permitted to invest abroad, forced National to borrow from Caisse D'Espargne De L'Etat (Caisse) in order to make the FAN International (FAN) equity contribution rather than borrowing from an American bank. National had to give assurances to the U.S. government that no funds from domestic sources would be used to repay the Caisse loan for at least seven years. *Id.* at 552.

120. *Id.*

121. *National Standard*, 80 T.C. at 553. In addition to selling its interest in FAN, National also sold to ARBED its ownership interests in a number of other jointly owned facilities. The total price paid by ARBED to National was $8,684,875 for all the facilities. *Id.*

122. *Id.* at 553. National desired to refinance the loan rather than repay it because European interest rates at that time were more favorable than U.S. interest rates. Petitioner's Opening Brief at 7, National Standard Co. v. Commissioner, 80 T.C. 551 (1983) (No. 8574-80). In addition, at the time the loan was coming due, National was experiencing cash flow problems because of recent expansion. *National Standard*, 80 T.C. at 553. Finally, an anticipated rise in the exchange value of the U.S. dollar as against European currencies also played a part in the decision to refinance. Petitioner's Opening Brief at 7, National Standard Co. v. Commissioner, 80 T.C. 551 (1983) (No. 8574-80).

123. *National Standard*, 80 T.C. at 553.

Banque (Societe Generale), a Belgian bank.[124] These francs were used to repay the Caisse loan on February 28, 1974.[125] On December 26, 1974, National purchased 266,944,444 Belgian francs from the First National Bank of Chicago and used the proceeds to repay the principal and interest of the Societe Generale loan.[126] For the fiscal year ending September 30, 1974, National reported an ordinary loss of $1,162,500 on its tax return.[127] This loss had been caused by a devaluation of the dollar in relation to the franc during the time lapse between receipt of the Caisse loan and its subsequent repayment proceeds from the Societe Generale loan.[128] In the following fiscal year, National reported another ordinary loss of $587,500 on its tax return.[129] This loss resulted from a further devaluation of the dollar in relation to the franc between the time of the Societe Generale loan and its subsequent repayment with the purchase of the Belgian francs from First National Bank of Chicago.[130] The Internal Revenue Service disagreed with National's characterization of the losses, ruling instead that they should have been characterized as capital losses.[131] The Tax Court in *National Standard* disagreed with the Commissioner, holding that the losses on the foreign currency exchange had been correctly characterized as ordinary losses.[132]

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124. *Id.* Throughout the time period pertinent to this case, the Luxembourg francs and the Belgian francs retained identical U.S. dollar values. *Id.*, n.1.

125. *Id.*

126. *Id.* at 554.

127. *Id.* at 554. Section 65 of the I.R.C. provides:

> For purposes of this subtitle, the term "ordinary loss" includes any loss from the sale or exchange of property which is not a capital asset. Any loss from the sale or exchange of property which is treated or considered, under other provisions of this subtitle, as "ordinary loss" shall be treated as loss from the sale or exchange of property which is not a capital asset.

I.R.C. § 65 (West 1984).

128. *National Standard*, 80 T.C. at 554.

129. *Id.*

130. *Id.*

131. *Id.* at 556.

132. *Id.* at 563-64.

## IV. The Decision

### A. *The Majority*

In *National Standard*,[133] a majority of the Tax Court began its analysis of the case by disposing of the threshold question, of whether the sale of FAN stock and the foreign currency exchange should be considered separate taxable events.[134] The majority resolved this question, quickly agreeing with the litigants that the transactions should be considered separately.[135]

The next step in the court's analysis dealt with the issue of whether the foreign currency should be considered a capital asset in National's hands.[136] The court noted at the outset that the foreign currencies did not fit into any of the statutory[137] or judicial[138] exclusions to section 1221. Acknowledging that foreign currency is generally considered "property" for tax purposes, the court observed that, under *Corn Products Refining Co. v. Commissioner*,[139] foreign currency is not a capital asset if it is used by the taxpayer as an integral part of its business.[140] National claimed that the foreign currency was not a capital asset under the *Corn Products* doctrine because the borrowing and purchasing of the foreign currency had been an integral part of its business operation. The court rejected this characterization, finding that the francs had been acquired for the sole purpose of the FAN investment, a capital transaction, and that nothing in the record showed that National regularly purchased or borrowed foreign currency as an integral part of its business.[141] Thus, it held that the francs were a capital asset.[142]

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133. 80 T.C. 551 (1983), *aff'd*, 749 F.2d 369 (6th Cir. 1984).

134. *National Standard*, 80 T.C. at 555 (1983).

135. *Id.* The court stated the reasons for separate treatment were apparent from the facts and that the requirement of annual accounting for tax purposes justified the separate treatment. *Id.*

136. *Id.*

137. *Id.* at 558. The exclusions to the general capital asset sale are enumerated in I.R.C. § 1221 (West 1984). *See supra* note 24.

138. *National Standard*, 80 T.C. at 558. *See* Corn Products Refining Co. v. Commissioner, 350 U.S. 46 (1956) (first case to establish a judicial exclusion to § 1221). *See supra* text accompanying notes 41-48.

139. 350 U.S. 46 (1955).

140. *National Standard*, 80 T.C. at 558.

141 *Id.*

142. *Id.* at 559.

Despite finding that the francs were a capital asset, the court questioned whether a sale or exchange had occurred within the meaning of Internal Revenue Code sections 165(f) and 1211(a).[143] It rejected the Commissioner's contention that the capital character of the underlying transaction should control the character of the foreign currency losses that would have rendered them capital.[144] The court noted at the outset that the loss had been caused by the increased value of the franc in relation to the dollar.[145] The litigants themselves agreed that, under established case law,[146] the basis[147] of the FAN stock should not be adjusted to reflect the value fluctuations of the currency which had been used to purchase the stock.[148] As a result, the court viewed the gain from the sale of the FAN stock as unrelated to the loss which had resulted from the currency fluctuation. The court noted that, although the nature of the underlying transaction often influences the character of the currency transaction, the two are theoretically unrelated. Therefore, if the two-transactions are viewed individually, the underlying transaction will not necessarily control the character of the foreign currency transaction.[149] The court concluded that, since the basis of the FAN stock had not been adjusted to reflect the change in the value of the francs, the character of the foreign currency transaction should be determined independently and without regard to the purpose for which the francs were borrowed.[150]

The court characterized the loss in *National Standard* based on its decision in *Gillin v. United States*.[151] In *Gillin*, an

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143. *Id.* Section 165(f) of the I.R.C. limits losses from sales or exchanges of capital assets to the extent allowed in sections 1211 and 1212. I.R.C. § 165(f) (West 1984). Section 1211(a) limits capital losses by corporations to losses from sales or exchanges of capital assets to the extent of gains from such sales or exchanges. *Id.* § 1211(a).

144. *National Standard*, 80 T.C. at 560.

145. *Id.*

146. *See* Helburn, Inc. v. Commissioner, 20 T.C. 740, 742-43 (1953); America-Southeast Asia Co. v. Commissioner, 26 T.C. 198, 199-200 (1956); Church's English Shoes, Ltd. v. Commissioner, 24 T.C. 56, 58-59 (1955), *aff'd*, 229 F.2d 957 (1956).

147. In the context of this case, basis is generally used to describe the value of an asset at the time of purchase for the purpose of determining gain or loss on its sale or transfer. *See* I.R.C. § 1012 (West 1984).

148. *National Standard*, 80 T.C. at 560.

149. *Id.*

150. *Id.*

151. 423 F.2d 309 (Ct. Cl. 1970).

individual borrowed Canadian dollars which he immediately converted into American dollars. He then used them to satisfy various personal and investment expenses. Subsequently, when he was able to purchase the Canadian dollars needed for fewer American dollars than would have been required at the time of the original borrowing, he repaid the loan.[152] In *Gillin*, the Court of Claims concluded that the Canadian dollars had been purchased to discharge a debt.[153] Looking to *Fairbanks v. United States*,[154] which held that satisfying one's own debt does not constitute a sale or exchange,[155] the *Gillin Court* found the taxpayer's gain to be ordinary rather than capital.[156] The Tax Court found the *National Standard* and *Gillin* cases to be similar because both involved "foreign currency which was acquired to satisfy indebtedness."[157] Consequently, the court found the *Fairbanks* rule controlling.[158] Therefore, the court concluded that the currency transaction in *National Standard* had not been a sale or exchange and the resulting loss should be afforded ordinary treatment.[159]

The court cited Revenue Ruling 78-281 as additional support for its decision.[160] As noted earlier, this ruling analyzed the situation in which a taxpayer had borrowed foreign currency to build a machine for use in a foreign equipment rental business.[161] It stated that any gain or loss from repayment of the loan due to currency fluctuations would be ordinary.[162]

In sum, the *National Standard* majority found the losses to be the result of the repayment of indebtedness with more dollars than had been originally borrowed. Hence, under the *Fairbanks* rule, no sale or exchange occurred. Accordingly, the court held that National's losses must be characterized as ordinary

152. *Id.* at 310.
153. *Id.* at 310-11.
154. Fairbanks v. United States, 306 U.S. 436 (1939).
155. *Id.* at 437.
156. Gillin v. United States, 423 F.2d 309, 313-14 (Ct. Cl. 1970).
157. *National Standard*, 80 T.C. at 562.
158. *Id.* at 562-64.
159. *Id.* at 563-64.
160. Rev. Rul. 78-281, 1978-2 C.B. 204. *See supra* text accompanying notes 31-34.
161. *Id.*
162. *Id.* at 205.

losses.[163]

B. *The Concurrence*

The concurring judges[164] agreed with the majority's analysis except for its reliance on Revenue Ruling 78-281.[165] The concurrence noted that the Tax Court had found that the ruling was of no aid to the taxpayer in *Hoover Co. v. Commissioner*,[166] a factually similar case.[167] Revenue Ruling 78-281 was inapplicable in *Hoover* because "from a tax viewpoint there is generally little similarity between a piece of equipment and a share of stock in a foreign corporation."[168] The concurrence asserted that the ruling was similarly inapplicable in the *National Standard* case.[169] Instead, the concurrence stated that *Fairbanks* provided sufficient authority on which to base the decision in *National Standard*.[170]

C. *The Dissent*

The dissenting judges[171] disagreed with the majority's characterization of the losses as ordinary, and asserted instead that, pursuant to the short sale analogy, the losses were capital in character.[172] The dissent agreed with the majority that the transactions should be treated separately and that the foreign currency constituted a capital asset.[173] But the dissent voiced strong disagreement with the majority's conclusion that no sale or exchange had taken place.[174] The dissent stated that the ma-

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163. *National Standard*, 80 T.C. at 563-64.
164. The concurring opinion was written by Judge Dawson. Judges Fay, Wiles, and Hamblen agreed with Judge Dawson's opinion.
165. *National Standard*, 80 T.C. at 564-65 (Dawson, J., concurring). *See supra* text accompanying notes 160-62.
166. 72 T.C. 206 (1979).
167. *National Standard*, 80 T.C. at 565 (Dawson, J., concurring).
168. *Id.* (quoting Hoover Co. v. Commissioner, 72 T.C. at 248).
169. *Id.* at 566.
170. *Id.* at 565.
171. The dissenting opinion was written by Chief Judge Tannenwald. Judges Simpson, Sterrett, Parker, Körner, Shields, and Cohen agreed with Judge Tannenwald's opinion.
172. *National Standard*, 80 T.C. at 566-71 (Tannenwald, C. J., dissenting).
173. *Id.* at 566.
174. *Id.* at 567-68.

jority had mistakenly analyzed the sale or exchange requirement by treating the francs as money similar to dollars, despite the majority's recognition that francs are treated as property for federal tax purposes.[175] Furthermore, it argued that the *Fairbanks* rule, — mere satisfaction of indebtedness does not result in a sale or exchange — was inapplicable in this case.[176] *Fairbanks* concerned the case of a taxpayer who received U.S. dollars to retire a corporate bond.[177] The dissent in *National Standard* contended that *Gillin,* a case in which the *Fairbanks* rule had been applied to a foreign currency exchange situation, was wrongly decided because it dealt with the transfer of property in satisfaction of a debt rather than the transfer of dollars.[178] The dissent asserted that the foreign currency transaction should be treated as a short sale.[179] In the opinion of the dissent, National had effectively sold the francs short when it borrowed them because, at the time of borrowing, it agreed to return an identical amount of francs at a future date.[180] Additionally, National closed the short sale by acquiring francs to repay the loan.[181] The dissent cited *Hoover* as a recent instance in which the tax court accepted the short sale analogy.[182]

The dissent also criticized the majority's reliance on Revenue Ruling 78-281, contending that it was not applicable to the facts of the *National Standard* case.[183] The dissent asserted that the ruling had turned on the issue of whether the borrowing of foreign currency had been an integral part of the taxpayer's business, and that this was not an issue in the *National Standard* case.[184]

Ultimately, the dissent found that the foreign currency transaction in *National Standard* was a short sale for tax pur-

175. *Id.* at 567.

176. *Id.* at 570-71 (citing Fairbanks v. United States, 306 U.S. 436 (1939)).

177. Fairbanks v. United States, 306 U.S. 436 (1939).

178. *National Standard* 80 T.C. at 571 (Tannenwald, C.J., dissenting) (citing Gillan v. United States 423 F.2d 309 (Ct. Cl. 1970)).

179. *Id.* at 567.

180. *Id.* at 567-68.

181. *Id.* at 567.

182. *National Standard,* 80 T.C. at 569-70 (Tannenwald, C.J., dissenting) (citing Hoover Co. v. Commissioner, 72 T.C. 206 (1979)).

183. *Id.* at 571 (citing Rev. Rul. 78-281, 1978-2 C.B. 204).

184. *Id.*

poses, and characterized the losses as short-term capital losses rather than ordinary losses.[185]

## V. Analysis

### A. *The Legal Implications*

The court in *National Standard* held that gains and losses sustained as a result of the exchange of foreign currency in connection with the disposition of foreign debt should be characterized as ordinary.[186] It reasoned that although the currency was a capital asset, under the *Fairbanks* rule, it had not been sold or exchanged.[187] The struggle of both the majority and the dissent to present logical analyses based on precedent illustrates the confused history and perplexing state of the law in this area. *National Standard*[188] highlights the need for clarification of the tax treatment of foreign currency transactions.

#### 1. *The Majority Opinion*

The Tax Court reached a proper result but its reasoning is not convincing. The majority began its analysis by applying the two-transaction principle to *National Standard.*[189] It determined that the foreign currency exchange and the FAN investment were separate taxable events.[190] This premise laid a solid foundation with which even the dissent could agree.

Next, the majority determined that the foreign currency constituted a capital asset in National's hands.[191] Having concluded that foreign currency was property,[192] the court found ample support within the broad definition of section 1221 that it was a capital asset.[193] Furthermore, the currency did not come within the *Corn Products* exception since nothing in the record

185. *Id.* at 571.

186. National Standard Co. v. Commissioner, 80 T.C. 551, 560-64 (1983), *aff'd* 749 F.2d 369 (6th Cir. 1984).

187. *Id.* at 562 (citing Fairbanks v. United States, 306 U.S. 437 (1938)).

188. *Id.*

189. *Id* at 555.

190. *Id.* at 560.

191. *Id.* at 558.

192. *Id.* All parties agreed with the general principle that foreign currency constitutes property.

193. *Id.* (citing I.R.C. § 1221 (West 1984)). *See supra* note 40.

indicated that the purchase and sale of foreign currency was an integral part of National's business; instead, the evidence supported the conclusion that the francs had been purchased solely for use in connection with the FAN investment.[194]

The third step in the majority's reasoning is an analysis of the "sale or exchange requirement."[195] It has a fatal weakness because the court relies on *Fairbanks v. Commissioner* [196] and *Gillin v. United States.*[197] The analysis of the "sale or exchange" requirement in these cases is not clearly applicable to the facts in *National Standard.* The court adopted the *Fairbanks* rule that the retirement of a debt does not constitute a "sale or exchange."[198] But the *Fairbanks* case did not involve foreign currency at all. Instead, it dealt with the redemption of corporate bonds.[199]

The court then relied on *Gillin* which applied the *Fairbanks* rule to a foreign currency transaction.[200] Both *Gillin* and *National Standard* involved gains or losses sustained due to foreign currency fluctuations in connection with the repayment of a foreign loan. Although this factor is significant, the cases remain easily distinguishable. *Gillin* prefaced its analysis noting that there is no coherent set of principles for the tax treatment of income or loss resulting from foreign currency transactions.[201] The *Gillin* court carefully examined the facts of the case, restricting its "discussion to the specific facts and the relatively narrow area they encircle."[202] It attached significance to recognition that the taxpayer had used the converted foreign currency for personal expenses and investment.[203] Emphasizing that the taxpayer had not used the borrowed funds for a trade or business, the court concluded that there was no relevant underlying

194. *Id.*

195. *Id.* at 559.

196. 306 U.S. 436 (1939). *See supra* note 67.

197. 423 F.2d 309 (Ct. Cl. 1970). *See supra* text accompanying notes 63-67, 79-86, 104-05, 151-56.

198. *National Standard,* 80 T.C. at 564.

199. *See* Fairbanks v. United States, 306 U.S. 436 (1939).

200. *National Standard,* 80 T.C. at 562 (citing Gillin v. Unites States, 423 F.2d 309, 313 (Ct. Cl. 1970)).

201. Gillin v. United States, 423 F.2d at 310.

202. *Id.*

203. *Id.*

transaction with which the court had to be concerned.[204] Rather, Gillin's dealings in foreign currency were a speculative venture to realize profit from the fluctuating exchange rates.[205] The facts of *National Standard Co. v. Commissioner* are quite different. The taxpayer borrowed foreign currency in order to make an equity contribution to a new foreign corporation.[206] The purchase and subsequent sale of FAN stock clearly constituted an underlying *capital* transaction. There is no suggestion that National borrowed foreign currency as a speculative venture. Its borrowings were prompted by U.S. Government regulations which limited the amount a domestic company can invest abroad.[207]

*National Standard* relies solely on *Gillin* as precedent for applying the *Fairbanks* "sale or exchange" analysis to a situation in which foreign currency is a capital asset.[208] But a close reading of *Gillin* finds that the court denies capital treatment of the taxpayer's loss without clearly requiring application of the *Fairbanks* rule. Before discussing the applicability of *Fairbanks, Gillin* concludes that the transaction did not qualify for capital treatment because the taxpayer had not held the asset for the required six month period.[209] Thus, as is mentioned by the majority in *National Standard,* when presenting the Commissioner's position, *Gillin's* statement about the "sale or exchange" requirement is dictum.[210] Taken as a whole, to rely on *Gillin* to decide the complex issues in *National Standard* is to rely on dubious precedent.

Despite weak reasoning, this decision affords an equitable result. The gain or loss question posed in *National Standard* is similar to that posed in other cases such as *Church's English Shoes, Ltd. v. Commissioner*[211] and *America Southeast Asia Co. v. Commissioner.*[212] In both of those cases, the taxpayer realized a gain on the foreign currency transaction and sought capital

204. *Id.*
205. *Id.* at 310-11.
206. *National Standard,* 80 T.C. at 552.
207. *Id.*
208. *Id.* at 562-64 (citing Gillin v. United States, 423 F.2d at 313).
209. Gillin v. United States, 423 F.2d at 312-13.
210. *National Standard,* 80 T.C. at 559-60 (citing Gillin v. United States, 423 F.2d at 313).
211. 24 T.C. 56 (1955), *aff'd,* 229 F.2d 957 (2d Cir. 1956).
212. 26 T.C. 198 (1956).

treatment for the gain in order to minimize his tax liability. The Commissioner opposed capital treatment of the gain and argued that the gain should be characterized as ordinary so that it could be taxed at the higher ordinary rate. This was the traditional stance of the Commissioner since the dollar's strength on the currency exchange market usually had caused taxpayers to realize gains on foreign currency transactions. In addition, the courts have almost uniformly accepted the Commissioner's position that gain on foreign currency exchange be given ordinary treatment.[213] The taxpayer in *National Standard*, however, represented a somewhat atypical situation because it had incurred a loss due to devaluation by the U.S. dollar on the currency exchange markets. The Commissioner responded by reversing his position and arguing that what was ordinary yesterday is capital today. The court in *National Standard* acted to protect the taxpayer, and properly decided to prevent the Commissioner from benefiting from a clearly inconsistent position.

### 2. *The Dissenting Opinion*

Despite weaknesses in the majority's reasoning, the analysis of the dissenters is even less convincing. Arguing that the majority mistakenly casts the issue as one involving discharge of indebtedness, the dissent contends that the proper analysis is by analogy to a short sale.[214] With the exception of *Hoover v. Commissioner*,[215] the short sale analogy has not been accepted in foreign currency transaction cases.[216] Despite lack of precedent, the short sale theory has superficial appeal because the elements of the *National Standard* case are similar to those found in a short sale. It can be argued that National entered a short sale on the date the francs were borrowed because the taxpayer promised to deliver an equivalent number of francs at a later time. Acquisition and repayment of the requisite amount of francs can be likened to closing the short sale. But, it is extremely significant that the transaction in *National Standard* was conducted to fa-

213. *See* Opening Brief for Petitioner at 14-16, National Standard Co. v. Commissioner, 80 T.C. 551 (1983) (No. 8475-80).

214. *National Standard*, 80 T.C. at 567 (Tannenwald. C.J., dissenting).

215. 72 T.C. 206 (1979).

216. *See supra* text accompanying notes 96-105.

cilitate a separate capital investment, rather than to engage in a speculative venture.[217] By contrast, the short seller agrees to sell stock he neither owns nor controls for the express purpose of profiting from an anticipated drop in the market price of that stock.[218] Application of the short sale by analogy to the facts of *National Standard* is not appropriate. That approach applies a statute that was enacted to provide for the tax treatment of inherently speculative trading in stock, securities, and commodity futures.[219] The statute was not meant to apply to foreign currency transactions.

### 3. *Need for Action by Congress*

Both the majority and dissenting opinions rely on questionable precedent. This is due to lack of definitive legislative or judicial authority regarding the tax consequences of foreign currency transactions connected with the disposition of debt. The confused case law in the area explains why neither the majority nor the dissenting opinions in *National Standard* could present solid statutory or precedential support for their positions. This illustrates that effective reform by the judicial branch would be difficult. Instead, the problem must be remedied by Congress through an amendment to the Internal Revenue Code that should determine how such transactions should be treated.

## B. *Practical Application and Impact*

A hypothetical case best illustrates how the characterization of a foreign currency loss affects a taxpayer like National. In taxable year X, Taxpayer Corporation earned ten million dollars in ordinary income. In addition, Taxpayer Corporation realized two million dollars in capital gains on the sale of a foreign capital investment. However, it sustained a loss of two million dollars on the foreign loan used to finance the asset because of a devaluation of the dollar between the time the loan was received and the time it was repaid. The prevailing tax rate on ordinary income for corporations earning in excess of one hundred thou-

217. *See supra* text accompanying note 207.
218. *See supra* text accompanying notes 91-95.
219. Miller, *supra* note 11, at 838.

sand dollars in ordinary income is forty-six percent.[220] The tax rate on capital gains is twenty-eight percent.[221] Finally, Internal Revenue Code section 165 allows ordinary losses to be deducted from ordinary income, while section 1211 provides that capital losses may only be used as an offset against capital gains. If the foreign currency loss in this case were to be characterized as capital, as the Commissioner argues, the following tax consequences result:

| | Income | | Tax Rate | Tax Liability |
|---|---|---|---|---|
| taxable ordinary income | 10m. | x | 46% | 4.6m. |
| capital gains 2m. | | | | |
| less capital loss (2m.) | | | | |
| taxable capital gain | 0 | x | 28% | 0 |
| TOTAL TAX LIABILITY | | | | $4.6m. |

If the foreign currency loss is characterized as ordinary, as it was in the *National Standard* case, the following tax consequences would result:

| | Income | | Tax Rate | Tax Liability |
|---|---|---|---|---|
| ordinary income 10m. | | | | |
| less ordinary loss(2m.) | | | | |
| taxable ordinary income | 8m. | x | 46% | 3.68m. |
| taxable capital gains | 2m. | x | 28% | .56m |
| TOTAL TAX LIABILITY | | | | $4.24m. |

The characterization of the loss as ordinary rather than capital, allows the Taxpayer Corporation to reduce its tax liability in year X by three hundred and sixty thousand dollars.

Clearly the practical ramifications of *National Standard* will have an impact on domestic companies involved in foreign currency transactions. The expanding growth in global trade heightens the importance of this decision for corporate financial planners. If the decision stands, it will encourage domestic companies to utilize foreign currencies in their financial dealings

220. I.R.C. § 11(b)(5) (West 1984).
221. I.R.C. § 1201(a)(2) (West 1984).

abroad because *National Standard* will serve as a safety net allowing losses sustained through devaluation of the foreign currency to be characterized as ordinary losses. If, however, the decision is reversed it may cause financial planners to use U.S. dollars to finance foreign investments. They would seek protection against a loss from fluctuating currency exchange rates which would be useful only as offsets against capital gains.

## VI. Conclusion

The court in *National Standard Company v. Commissioner*[222] held that losses sustained on the exchange of foreign currency in connection with the disposition of foreign debt should be characterized as ordinary losses. This decision is significant in several respects. The case illustrates the lack of definitive authority regarding the tax consequences of foreign currency transactions connected with the disposition of debt. Accordingly, it points out the need for judicial or legislative clarification of this field of law. As a practical matter, the decision will allow taxpayers in National's circumstances to minimize their tax liability and will cause corporate financial planners to consider currency exchange rates in planning the financing of foreign capital investments.

## Addendum

The Court of Appeals for the Sixth Circuit unanimously affirmed the tax court decision in *National Standard Company v. Commissioner.*[223] Relying on the rule of *Fairbanks v. United States,*[224] the court agreed that payment of a debt does not involve a sale or exchange.[225] Although the the form of repayment may have a bearing on determining whether the property involved is a capital asset, the Sixth Circuit concluded that it does not change the fact that the repayment discharged a debt.[226] Gain or loss sustained as a result of fluctuating foreign currency exchange rates, when a debt is discharged with foreign currency,

222. 80 T.C. 551 (1983).
223. 80 T.C. 551 (1983), *aff'd*, 749 F.2d 369 (6th Cir. 1984).
224. 306 U.S. 436 (1939).
225. National Standard Co. v. Commissioner, 749 F.2d 369, 372 (6th Cir. 1984).
226. *Id.*

is attributed to payment of the debt. As a result, the Sixth Circuit concluded that the taxpayer in *National Standard Company* realized an ordinary loss because the transaction at issue had not involved a sale or exchange.[227]

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227. Because the absence of a sale or exchange established that the losses were not capital losses, the Sixth Circuit did not decide whether the francs were capital assets. *Id.* at 373.