International Flavors & Fragrances Inc. v. Commissioner, 56 T. C. 448 (1971)

Gains from short sales of foreign currency by multinational corporations to hedge against currency fluctuations are taxable as ordinary income under the Corn Products doctrine.

Summary

International Flavors & Fragrances Inc. (IFF) entered into a short sale of British pounds to hedge against potential devaluation, which occurred in 1967. IFF sold the contract to Amsterdam Overseas Corp. before the closing date, treating the gain as long-term capital gain. The Tax Court, applying the Corn Products doctrine, held that the transaction was part of IFF's ordinary business operations and thus the gain should be taxed as ordinary income. The court rejected IFF's attempt to classify the gain as capital, emphasizing that the transaction was a hedge against currency risk inherent in its business operations.

Facts

In late 1966, IFF, concerned about a possible devaluation of the British pound, entered into a short sale contract with First National City Bank (FNCB) to sell 1. 1 million pounds at $2. 7691 per pound, with delivery set for January 3, 1968. On November 18, 1967, the pound was devalued from $2. 80 to $2. 40. On December 20, 1967, IFF sold the contract to Amsterdam Overseas Corp. for $387,000, which Amsterdam used to purchase pounds at the new rate to close the contract on January 3, 1968, realizing a gain of $10,210. IFF reported the $387,000 as long-term capital gain on its 1967 tax return.

Procedural History

The Commissioner of Internal Revenue asserted a deficiency against IFF for the taxable year 1967, arguing that the gain should be treated as ordinary income. The case proceeded to the Tax Court, where the Commissioner's arguments were upheld.

Issue(s)

1. Whether the gain realized by IFF from the short sale of British pounds, sold to Amsterdam before the closing date, is taxable as ordinary income under the Corn Products doctrine.
2. Alternatively, whether the gain should be taxable under section 1233 as if Amsterdam acted as a broker for IFF in purchasing the pounds sterling to close out the short sale.

Holding

1. Yes, because the short sale was part of IFF’s ordinary business operations as a hedge against currency fluctuations, and thus falls under the Corn Products doctrine, making the gain taxable as ordinary income.
2. The court did not need to decide this issue due to its ruling on the first issue, but noted that Amsterdam’s role appeared to be more of a broker than a purchaser.

Court’s Reasoning

The Tax Court applied the Corn Products doctrine, which states that gains from transactions closely related to a taxpayer’s business operations should be treated as ordinary income rather than capital gains. The court determined that IFF’s short sale of pounds was a hedge against potential currency devaluation affecting its subsidiary’s earnings, which were part of IFF’s business operations. The court rejected IFF’s argument that the transaction was an investment, emphasizing that the gain was a nonrecurring one aimed at offsetting potential losses in earnings, not a capital transaction. The court also noted that even if IFF had directly closed the short sale, the gain would have been taxed as ordinary income, and the sale to Amsterdam did not change this characterization. The court cited previous cases like Wool Distributing Corporation and America-Southeast Asia Co. to support its application of the Corn Products doctrine to foreign currency transactions.

Practical Implications

This decision clarifies that multinational corporations cannot treat gains from short sales of foreign currency as capital gains when such transactions are hedges against currency fluctuations inherent in their business operations. Legal practitioners should advise clients that such gains will be taxed as ordinary income, impacting tax planning for multinational businesses. Businesses engaged in international operations must carefully consider the tax implications of currency hedging strategies. The ruling aligns with the IRS’s efforts to prevent the conversion of ordinary income into capital gains, affecting how similar cases are analyzed in the future. Subsequent cases, such as Schlumberger Technology Corp. v. United States, have applied this principle, reinforcing the tax treatment established in this case.

