Carborundum Co. v. Commissioner, 74 T. C. 730 (1980)

Forward currency contracts sold prior to maturity can be treated as long-term capital gains if held for more than six months.

Summary

The Carborundum Company sold forward contracts for British pounds sterling to protect against currency devaluation. The contracts were sold to third parties just before maturity, resulting in gains. The Tax Court ruled that these gains qualified as long-term capital gains under Section 1222(3) because the contracts were held for over six months, and neither the short-sale rules of Section 1233 nor the assignment-of-income doctrine applied. This decision clarifies the tax treatment of such financial instruments, providing guidance on how to structure similar transactions to achieve favorable tax outcomes.

Facts

In 1967, Carborundum Co. entered into forward-sales contracts with Brown Bros. Harriman & Co. and First National City Bank to sell British pounds sterling at specified rates to hedge against potential devaluation. Following the devaluation of the pound in November 1967, Carborundum sold these contracts to third parties one day before their respective maturity dates in February and April 1968, realizing significant gains. The contracts were held for over six months before sale, and Carborundum reported the gains as long-term capital gains on its 1968 tax return.

Procedural History

The Commissioner of Internal Revenue determined a deficiency in Carborundum's 1968 tax return, arguing the gains should be treated as short-term capital gains. Carborundum petitioned the U. S. Tax Court, which held that the gains were properly reported as long-term capital gains.

Issue(s)

1. Whether the sale of forward currency contracts just before maturity constitutes a short sale under Section 1233, thereby classifying the gains as short-term capital gains?
2. Whether the sale of these contracts constitutes an assignment of income, requiring the gains to be treated as short-term capital gains?

Holding

1. No, because the contracts were sold to third parties and Carborundum did not hold 'substantially identical property' as required by Section 1233(b).
2. No, because Carborundum had no fixed right to the income at the time of sale, and the assignment-of-income doctrine did not apply.

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Court’s Reasoning

The court rejected the application of Section 1233(b) because Carborundum did not hold ‘substantially identical property’ at the time of the short sale, which is a prerequisite for the section’s applicability. The court also distinguished forward currency contracts from ‘when issued’ securities, refusing to extend Section 1233 by analogy. On the assignment-of-income issue, the court relied on *S. C. Johnson & Son, Inc. v. Commissioner*, stating that Carborundum had no fixed right to income until the currency was delivered, and the mere expectation of income was insufficient to trigger the doctrine. The court emphasized the bona fide nature of the sales to independent third parties and the absence of an agency relationship.

Practical Implications

This decision provides clarity on the tax treatment of forward currency contracts sold before maturity. It allows taxpayers to structure such transactions to achieve long-term capital gain treatment if held for the required period, without fear of recharacterization under Section 1233 or the assignment-of-income doctrine. The ruling underscores the importance of the holding period in determining the character of gains from financial instruments. It may influence how companies manage currency risk and report gains from hedging strategies. Subsequent cases, such as *American Home Products Corp. v. United States*, have cited this decision in similar contexts.

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