Federal National Mortgage Association v. Commissioner, 100 T. C. 541 (1993)

Hedging transactions that are integrally related to a taxpayer's business can generate ordinary gains and losses if they offset risks associated with assets that are not capital assets.

Summary

The Federal National Mortgage Association (FNMA) engaged in hedging transactions to mitigate interest rate risk associated with its mortgage portfolio and debt issuance. These transactions involved futures contracts, short sales of Treasury securities, and options. The Tax Court ruled that FNMA's hedging activities produced ordinary gains and losses because they were integral to managing its mortgage commitments and debt, which were treated as ordinary assets. However, the court disallowed losses claimed from currency swap transactions related to yen-denominated debt, as the basis of the yen was determined by the swap agreements, resulting in no realized gains or losses in the year in question.

Facts

FNMA, a government-sponsored enterprise, purchased residential mortgages and financed these through issuing debentures. To manage the risk of rising interest rates, FNMA implemented a hedging program in 1984 and 1985. This program included: short positions in futures contracts, short sales of Treasury securities, and options on futures contracts. FNMA hedged certain debenture issuances and mortgage commitments, including commitments to purchase notes from the Alaska Housing Finance Corporation and convertible mortgage commitments. Additionally, FNMA issued yen-denominated debt and engaged in related currency swap agreements to manage foreign exchange risk.

Procedural History

The IRS issued a notice of deficiency to FNMA for the tax years 1974 and 1975, disallowing net operating loss carrybacks from 1984 and 1985. FNMA filed a petition with the U. S. Tax Court, contesting the disallowance. The Tax Court considered the character of FNMA's hedging gains and losses and the treatment of its foreign currency transactions.

Issue(s)

1. Whether the gains and losses from FNMA's hedging transactions should be treated as ordinary income or loss.
2. Whether FNMA's methodology for calculating gains and losses from short sales of Treasury securities and options was correct.
3. Whether FNMA recognized ordinary gains or losses from its disposition of yen pursuant to currency swap agreements in 1985.

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Holding

1. Yes, because the hedging transactions were an integral part of FNMA's system of purchasing and holding mortgages, which were treated as ordinary assets under section 1221(4).
2. No, because the interest expense from a short sale closed out in 1986 should not have been included in 1985's loss calculation.
3. No, because the basis of the yen was determined by the currency swap agreements, resulting in no realized gains or losses in 1985.

Court's Reasoning

The court applied the principles from *Arkansas Best Corp. v. Commissioner*, concluding that hedging transactions related to ordinary assets could be treated as ordinary. FNMA's mortgages were considered ordinary assets under section 1221(4) as they were acquired for services rendered in enhancing the secondary mortgage market. The hedging transactions were deemed integral to FNMA's business operations, thus qualifying for ordinary treatment. Regarding the currency swaps, the court rejected FNMA's method of calculating gains and losses, determining that the swap agreements fixed the yen's basis, resulting in no gain or loss in 1985. The court also found no basis for integrating the yen debt obligations and their related swap agreements under the step transaction doctrine, as each step had economic substance.

Practical Implications

This decision clarifies that hedging transactions can generate ordinary income or loss when they are integrally related to the taxpayer's business and offset risks associated with ordinary assets. Legal practitioners should analyze hedging strategies in light of this ruling, ensuring that such transactions are closely tied to the business's core operations. The case also underscores the importance of properly calculating the basis in foreign currency transactions, particularly when swap agreements are involved. Subsequent cases, such as *Azar Nut Co. v. Commissioner*, have followed this reasoning, emphasizing the need for a close business connection between the hedge and the underlying asset or liability. Businesses engaging in hedging should ensure their documentation and strategy align with this case's principles to secure favorable tax treatment.

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