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Repayment of Foreign Currency, Even Though
Foreign Currency Is a Capital Asset, Results in an
Ordinary Loss as There Was No Sale or Exchange.
National-Standard Co. v. Commissioner, 80 T.C.
551 (1983)

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FEDERAL INCOME TAX — FOREIGN CURRENCY TRANSACTIONS — LOSS ON BORROWING AND REPAYMENT OF FOREIGN CURRENCY, EVEN THOUGH FOREIGN CURRENCY IS A CAPITAL ASSET, RESULTS IN AN ORDINARY LOSS AS THERE WAS NO SALE OR EXCHANGE. *National-Standard Co. v. Commissioner*, 80 T.C. 551 (1983).

A United States corporation borrowed funds from a foreign source¹ to obtain a fifty percent interest in a new European corporation. After liquidating this investment, the corporation refinanced its loan from another foreign source.² Subsequently, the corporation purchased foreign currency from a United States bank to pay off the loan.³ As a result of the fluctuations in exchange rates between the time of borrowing and the time of repayment, the corporation incurred a loss of \$1.75 million.⁴ Although the corporation reported this loss as ordinary,⁵ the Service maintained that the corporation had incurred a capital loss.⁶ The Tax Court of the United States considered the borrowing and repayment of the foreign currency separately from the underlying investment,⁷ and determined that the foreign currency was a capital asset.⁸ Nevertheless, the court held that the losses in question were ordinary since no sale or exchange occurred.⁹

The issue facing the court in *National-Standard* was whether the foreign currency exchange losses were deductible as ordinary or as capital losses. The corporation claimed a deduction for an ordinary loss, resulting in a dollar for dollar reduction against income.¹⁰ In arguing for capital loss treatment, the Service desired to limit the deduction as provided under Internal Revenue Code Section 165(f).¹¹

In characterizing a foreign currency transaction for tax treatment

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1. Because of government restrictions limiting the amount a domestic corporation could invest abroad, the corporation had to borrow funds abroad in order to contribute its fifty percent share of equity in a new European corporation. *National-Standard Co. v. Commissioner*, 80 T.C. 551, 552 (1983).
 2. *Id.* at 553. *But see* Opening Brief for Petitioner at 21, *National-Standard Co. v. Commissioner*, 80 T.C. 551 (1983) (in which petitioner argues that the first loan was not refinanced or extended but was extinguished).
 3. *National-Standard Co.*, 80 T.C. at 554.
 4. *Id.*
 5. *Id.*
 6. *Id.* at 556.
 7. *Id.* at 555.
 8. *Id.* at 559.
 9. *Id.* at 564.
 10. I.R.C. § 165(a) (1982) allows a “deduction [for] any loss sustained during the taxable year and not compensated for by insurance or otherwise.” Unless indicated otherwise, all code section references are to the Internal Revenue Code of 1954, 26 U.S.C., as amended.
 11. I.R.C. § 165(f) (1982) provides that “[l]osses from sales or exchanges of capital assets shall be allowed only to the extent allowed in sections 1211 and 1212.” Section 1211(a) places a limitation on capital losses for corporations: “losses from sales or exchanges of capital assets shall be allowed only to the extent of gains from such sales or exchanges.” Section 1212 deals with capital loss carrybacks and carryovers.

as a capital gain or loss, a three-part analysis must be used: (1) the gain or loss must arise from a sale or exchange of property; (2) the property must be a capital asset; and (3) there must be a sale or exchange of the asset satisfying the statutory requirement of sections 165(f) and 1211(a).¹² Courts, in analyzing foreign currency transactions, have used different rationales for employing this analysis in characterizing the resulting gain or loss as ordinary or capital.

Earlier courts dealt with the issue of whether foreign currency is considered property for income tax purposes. In *B.F. Goodrich Co. v. Commissioner*,¹³ a corporation borrowed eleven million francs from a Paris bank and then loaned the same francs to its wholly-owned subsidiary. Three years later it repaid the loan while its subsidiary's debt remained unpaid. Under this approach, the borrowing and repayment of foreign currency was viewed as merely a bookkeeping entry.¹⁴ The court reasoned that bookkeeping entries alone can not create a profit and therefore that a mere borrowing and returning of property can not result in a taxable gain.¹⁵

Later cases rejected the approach of the *B.F. Goodrich* court by treating the borrowing and repayment of foreign currency as property for income tax purposes.¹⁶ The issue was now focused on the characterization of the gain or loss realized on the foreign currency transaction; that is, on whether the property — borrowed and repaid foreign currency — is a capital asset. In *Church's English Shoes, Ltd. v. Commissioner*,¹⁷ the taxpayer imported merchandise on credit and later discharged its foreign currency obligation at a profit. The tax court rejected the taxpayer's argument for capital gain treatment by finding that the "purchase of foreign money was no more than a usual and recurring transaction in the ordinary course of its business."¹⁸ Simi-

12. *National-Standard Co. v. Commissioner*, 80 T.C. 551, 557 (1983); cf. *Gillin v. United States*, 423 F.2d 309, 315 (Ct. Cl. 1970) (Skelton, J., concurring) (citing *KVP Sutherland Paper Co. v. United States*, 344 F.2d 377 (Ct. Cl. 1965), for a similar three-part test in determining long-term capital gain treatment).

13. 1 T.C. 1098 (1943).

14. *Id.* at 1102-04.

15. *Id.* at 1103. This rationale was extended in *Coverdale v. Commissioner*, 4 T.C.M. (CCH) 713, 715 (1945). The *Coverdale* court held that not every accession to wealth or benefit results in a taxable gain. This principle is valid even though foreign currency may be considered as property for income tax purposes, and transactions in it may result in gain or loss. *Id.* For cases treating foreign currency as property for income tax purposes, see *Gillin v. United States*, 423 F.2d 309 (Ct. Cl. 1970); *Helburn, Inc. v. Commissioner*, 20 T.C. 740 (1953), *aff'd*, 214 F.2d 815 (1st Cir. 1954); *Joyce-Koebel Co. v. Commissioner*, 6 B.T.A. 403 (1927); *Bernuth Lembcke Co. v. Commissioner*, 1 B.T.A. 1051 (1925).

16. See generally Newman, *Tax Consequences of Foreign Currency Transactions: A Look At Current Law and an Analysis of the Treasury Department Discussion Draft*, 36 TAX LAW. 223, 229 (1983) (observing that *B.F. Goodrich* and *Coverdale* have not been followed for years); Samuels, *Federal Income Tax Consequences of Back-to-Back Loans and Currency Exchanges*, 33 TAX LAW. 847, 863 (1980) (same).

17. 24 T.C. 56 (1955), *aff'd per curiam*, 229 F.2d 957 (2d. Cir. 1956).

18. *Id.* at 59.

larly, where the taxpayer has borrowed foreign currency to purchase inventory, the tax court has denied a claim to capital gain treatment. In *America-Southeast Asia Co. v. Commissioner*,¹⁹ the tax court, in denying capital gain treatment, stated that "of overriding importance here is that petitioner's transaction in foreign exchange was an integral part of its ordinary trade or business."²⁰ The court cited *Corn Products Refining Co. v. Commissioner*,²¹ the judicial exception to the statutory definition of a capital asset, for this approach.²²

If it be concluded that the borrowed and repaid foreign currency is both property and a capital asset, it then must be determined whether a "sale or exchange" occurred before the ensuing gain or loss may be characterized as a capital one. In *Gillin v. United States*,²³ an individual taxpayer borrowed Canadian dollars and immediately converted them into United States dollars for personal investment purposes.²⁴ The court of claims analogized this foreign currency borrowing to a retirement of debt for less than face value.²⁵ The court reasoned that the conversion to foreign currency was an integral and necessary part of the borrowing transaction and not a separate and independent transaction.²⁶ Viewed in this light, the economic reality of the transaction was that the debt was repaid for less than face value.²⁷ This analysis is consistent with the previous decision in *United States v. Kirby Lumber Co.*²⁸ holding that the issuance and repurchase of a debt by the obligor for less than face value results in ordinary income. Thus, the court concluded that the gain was ordinary since "retiring one's own debt does not result in a sale or exchange."²⁹

Other courts have overcome the "sale or exchange" requirement by analogizing foreign currency transactions to a short sale.³⁰ In *Hoo-*

19. 26 T.C. 198 (1956).

20. *Id.* at 200.

21. 350 U.S. 46 (1955). This judicial exception to the statutory definition of a capital asset, see I.R.C. § 1221 (1982), is called the *Corn Products* doctrine. If an asset is an "integral part of the corporation's everyday business" it will give rise to ordinary income or loss. *Id.* at 51-52. This is in line with the Court's interpretation of I.R.C. § 61 (1982) to tax ordinary profits and their equivalents as ordinary income. 350 U.S. at 52.

22. *America-Southeast Asia Co.*, 26 T.C. at 200.

23. 423 F.2d 309 (Ct. Cl. 1970).

24. *Id.* at 310.

25. *Id.* at 313.

26. *Id.*

27. Retirement of one's own debt does not result in a sale or exchange; therefore, the gain cannot be a capital gain. See *Fairbanks v. United States*, 306 U.S. 436 (1939) (in which corporation redeemed its own bond before maturity).

28. 284 U.S. 1 (1931).

29. *Gillin v. United States*, 423 F.2d 309, 313 (Ct. Cl. 1970).

30. See I.R.C. § 1233 (1982) (gains and losses from short sales). A short sale is a contract for the sale of shares that have not yet been acquired by the seller. For tax purposes the sale is consummated when the shares are delivered to close the sale. See *Treas. Reg. § 1.1233-1* (1976); see also *Provost v. United States*, 269 U.S. 443 (1926) (giving a practical definition and example of a short sale).

ver Co. v. Commissioner,³¹ the taxpayer entered into forward sales agreements for foreign currency. This was to offset a potential decline in its foreign subsidiary investment, if a devaluation of the subsidiary's home currency occurred. The tax court concluded that the *Corn Products* doctrine was inapplicable³² and applied Internal Revenue Code section 1233(a).³³ Thus the court held that the gains and losses on the forward sales agreements were capital.³⁴ Once property is characterized as a capital asset under section 1233(a), the section 1211(a) requirement of a sale or exchange is automatically satisfied.³⁵ The analogy to a short sale has been made even when the asset is acquired prior to the "sale or exchange," the reverse of the normal chronological sequence of events in a short sale.³⁶

In *National-Standard*, prior to concluding that the taxpayer incurred ordinary losses in the foreign currency transactions, the tax court made three determinations. First, the court recognized that the foreign currency transaction must be considered separately from the underlying investment for purposes of measurement.³⁷ The transaction must be treated separately because of the required annual accounting for tax purposes. In addition, completion of the foreign currency transaction may occur years apart from the sale of the investment property. For example, in *National-Standard*, the foreign currency debt was paid off the fiscal year following the sale of the investment.

Second, the *National-Standard* court found that the foreign currency was a capital asset.³⁸ The court applied section 1221 and noted that the foreign currency did not fall within any of the enumerated statutory or judicial exceptions to section 1221.³⁹ Furthermore, the court stated that the acquisition and use of the foreign currency was

31. 72 T.C. 206 (1979).

32. *Id.* at 237.

33. *Id.* at 243.

34. *Id.* at 250.

35. I.R.C. § 1233(a) (1982) provides:

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.

36. *See* *Provost v. United States*, 269 U.S. 443, 450-52 (1926); *see also* *Bingham v. Commissioner*, 27 B.T.A. 186, 189 (1932). *But see* *Bowers v. Kerbaugh-Empire Co.*, 271 U.S. 170, 175 (1926) (holding no short sale to have occurred where asset is acquired prior to exchange).

37. *National-Standard Co. v. Commissioner*, 80 T.C. 551, 555 (1983); *see also* *America-Southeast Asia Co. v. Commissioner*, 26 T.C. 198, 200 (1956); *Helburn, Inc. v. Commissioner*, 20 T.C. 740, 743 (1953); *cf.* *Mariani Frozen Foods v. Commissioner*, 81 T.C. 448, 475-76 (1983) (indicating that the separate transaction rule will not be applicable where the taxpayer uses its own foreign currency to make a cash purchase, as there is not another transaction satisfying a credit obligation with foreign currency).

38. *National-Standard Co.*, 80 T.C. at 559.

39. *Id.* at 557.

clearly to purchase an investment in a foreign corporation.⁴⁰ Accordingly, the foreign currency should be characterized as the underlying investment, that is, as a capital asset.

Third, after finding that the foreign currency was a capital asset, the court held that the repayment of the debt did not constitute a sale or exchange.⁴¹ Since no sale or exchange transpired, the foreign currency losses were held to be ordinary losses.⁴² The court relied on the previous cases of *Fairbanks v. United States*⁴³ and *Gillin v. United States*,⁴⁴ which held that satisfaction of indebtedness alone does not constitute a sale or exchange.⁴⁵

The analysis used by the majority in *National-Standard*, relying on *Fairbanks* and *Gillin* to decide the question of repayment of a foreign currency debt, is faulty.⁴⁶ In *National-Standard* and *Gillin* the foreign currency borrowed was repaid in full. Since the identical amount of the debt was repaid and not retired for less than face value, the respective losses and gain were only the result of a fluctuation in the foreign exchange rate.⁴⁷

The court should not adopt a narrow interpretation of the language "sale or exchange."⁴⁸ Internal Revenue Code section 1001(a) provides that gain or loss is to be computed on the "sale or other disposition" of property.⁴⁹ Language of "sale or exchange" used in section 1211 should be coextensive with the phraseology used in section 1001(a), as section 1001(c) uses the phrase "sale or exchange" but applies to the same area as that covered under section 1001(a).⁵⁰

40. See *supra* note 1 and accompanying text.

41. *National-Standard Co.*, 80 T.C. at 564.

42. *Id.*

43. 306 U.S. 436 (1939).

44. 423 F.2d 309, 313 (Ct. Cl. 1970).

45. *National-Standard Co.*, 80 T.C. at 564.

46. See *id.* at 571 (Tannenwald, C.J., dissenting).

47. *Id.*; *Gillin v. United States*, 423 F.2d 309, 314-15 (Ct. Cl. 1970) (Skelton, J., concurring); see also Miller, *Foreign Currency Transactions: A Review of Some Recent Developments*, 33 TAX LAW. 825, 838 (1980) (Judge Skelton's "convincing" reasoning makes it unlikely that the rationale of *United States v. Kirby Lumber*, 284 U.S. 1 (1931) concerning discharge of indebtedness would be applied to a case similar to *Gillin* in the future).

48. But see *Helvering v. William Flaccus Oak Leather Co.*, 313 U.S. 247 (1941) (requiring strict adherence to "sale or exchange" requirement of § 117(d) of the Revenue Act of 1934 (current version at I.R.C. § 1211 (1982))).

49. I.R.C. § 1001(a) (1982) provides:

The gain from the *sale or other disposition* of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 1011 for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized. (Emphasis supplied).

50. See *Vickers v. Commissioner*, 80 T.C. 394, 404 n.8 (1983); Bittker, *Capital Gains and Losses - The "Sale or Exchange" Requirement*, 32 HASTINGS L.J. 743, 743-46 (1981) (battle of wits with the Service as to what satisfies "sale or exchange" requirement of § 1222).

Further evidence of the accidental difference in phraseology exists in section 1234A, created by the Economic Recovery Tax Act of 1981.⁵¹ The legislative history of section 1234A expressly disapproves of treatment of dispositions by lapse, cancellation or abandonment of contract rights as resulting in ordinary income.⁵² These dispositions are the functional equivalent of a "sale or exchange" of a capital asset and should result in a capital gain or loss.⁵³ If the termination of a mere contract right results in capital treatment, surely the repayment of an obligation as in *National-Standard* should be considered a "sale or exchange," that is, a completed transaction.

The dissent in *National-Standard* uses another approach to the "sale or exchange" issue by analogizing to a short sale.⁵⁴ The analogy to a short sale would fulfill the requirement of a "sale or exchange."⁵⁵ Recently, cases and commentators have favored the analogy to a short sale and the application of section 1233(a) when foreign currency is borrowed and repaid.⁵⁶ In foreign currency borrowing, however, the usual situation of a short sale is reversed because acquisition of the asset precedes the sale or exchange.⁵⁷ The problem with this approach is that section 1233 is a very narrow and specific statute that should not be extended by analogy.⁵⁸ The Supreme Court took this restrictive view regarding extension of section 1233 in *Bowers v. Kerbaugh-Empire*

51. § 507(a) of the Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, 95 Stat. 172, 333 (1981) (only applicable to property acquired after June 23, 1981). I.R.C. § 1234A (1982), as amended by § 105(e) of the Technical Corrections Act of 1982, Pub. L. No. 97-448, 86 Stat. 2365 (1983), entitled "Gains or Losses from Certain Terminations," provides:

Gain or loss attributable to the cancellation, lapse, expiration, or other termination of

(1) a right or obligation with respect to personal property (as defined in section 1092(d)(1)) which is (or on acquisition would be) a capital asset in the hands of the taxpayer, or

(2) a regulated futures contract (as defined in section 1256) not described in paragraph (1) which is a capital asset in the hands of the taxpayer, shall be treated as gain or loss from the sale of a capital asset.

52. S. REP. NO. 97-144 97th Cong., 1st Sess. 105 (1981) (also reported at 1981-2 C.B. 412, 480).

53. *But cf.* Newman, *supra* note 16, at 237 (1983) (with a strict reading of § 1234A an argument can be made that a discharge of a foreign currency debt does not fall within this section).

54. *National-Standard Co. v. Commissioner*, 80 T.C. 551, 567 (1983) (Tannenwald, C.J., dissenting).

55. *Hoover Co. v. Commissioner*, 72 T.C. 206, 248-50 (1979).

56. *See Hoover Co. v. Commissioner*, 72 T.C. 206 (1979); *International Flavors & Fragrances, Inc. v. Commissioner*, 62 T.C. 232 (1974); D. RAVENSCROFT, *TAXATION AND FOREIGN CURRENCY* 219-21 (1973); Ravenscroft, *Taxation of Income Arising From Changes in Value of Foreign Currency*, 82 HARV. L. REV. 772, 794 (1969); Roberts, *Borrowing in Foreign Currencies*, 26 TAXES 1033 (1948); Samuels, *supra* note 16, at 875-77.

57. *See National-Standard Co. v. Commissioner*, 80 T.C. 551, 567-68 (1983) (Tannenwald, C.J., dissenting).

58. *See National-Standard Co. v. Commissioner*, 80 T.C. 551, 565 n.3 (1983) (Dawson, J., concurring). *But cf.* *Bingham v. Commissioner*, 27 B.T.A. 186, 189 (1932).

Co.,⁵⁹ and this view should bar application by analogy to a short sale for cases similar in facts to *National-Standard*.

Due to the nuances and complexities of foreign currency transactions, there is a need to clarify the facts and issues in each case.⁶⁰ Section 1221, in defining a capital asset, notes that "the term 'capital asset' means property held by the taxpayer."⁶¹ In *National-Standard*, the corporation never held property, that is, foreign currency. The proceeds of the foreign currency debt were immediately invested in the stock of the new foreign corporation.⁶² Since the taxpayer never held the foreign currency, it cannot be considered a capital asset under section 1221. The losses in question must therefore be considered as ordinary.

Even if one analogizes the foreign currency transaction to a short sale, the taxpayer must still hold property to result in characterization as a capital asset. Section 1233 finds a sale or exchange of a capital asset only if the property used to close the short sale is a capital asset in the hands of the taxpayer.⁶³ This qualification requires a dependence on another code section such as 1221 to determine whether the property involved is considered a capital asset. Furthermore, in a short sale, there is a requirement for the taxpayer to hold "substantially identical property"⁶⁴ for not more than one year.⁶⁵ Since in *National-Standard* the corporation did not hold property,⁶⁶ the foreign currency cannot be construed as a capital asset.

A logical approach is to look at the nature of the underlying transaction for characterization of the foreign currency transaction for income tax purposes. In *Church's English Shoes, Ltd. v. Commissioner*⁶⁷ and *America-Southeast Asia Co. v. Commissioner*,⁶⁸ the foreign currency transactions were treated as partially separate transactions.⁶⁹

59. 271 U.S. 170, 175 (1926). *Kerbaugh-Empire* has been severely criticized by cases and commentators. See *National-Standard Co. v. Commissioner*, 80 T.C. 551, 569 (1983) (Tannenwald, C. J., dissenting). The reason, however, not to extend § 1233 by analogy is still applicable.

60. See Seghers, *Capital Gain Treatment of Foreign Exchange Sale*, 27 TAX EXECUTIVE 37 (1974) (court should look at events that actually transpire and not at what might have occurred).

61. Cf. Treas. Reg. § 1.1221-1(a) (1975) ("In determining whether property is a 'capital asset', the period for which held is immaterial.").

62. *National-Standard Co. v. Commissioner*, 80 T.C. 551, 553 (1983).

63. I.R.C. § 1233(a) (1982).

64. See *American Home Products v. United States*, 601 F.2d 540, 549-50 (Ct. Cl. 1979); *Carborundum Co. v. Commissioner*, 74 T.C. 730 (1980). Concerning the question whether foreign currency is property under § 1233(b), see I.R.C. § 1233(e)(2)(A) (1982); Adams and Henrey, *Tax Consequences of Foreign Currency Fluctuation*, 30 TAX EXECUTIVE 301, 314 (1978); Newman, *supra* note 16, at 238 n.94.

65. I.R.C. § 1233(b) (1982).

66. See *supra* note 62 and accompanying text.

67. 24 T.C. 56 (1955), *aff'd per curiam*, 229 F.2d 957 (2d Cir. 1956).

68. 26 T.C. 198 (1956).

69. See Johnson and Marino, *The U.S. Taxation of Foreign Exchange Gain and Losses: An Analysis of the Treasury Discussion Draft*, 59 TAXES 1031, 1042 (1981).

Those cases found that the foreign currency transaction was a "usual and recurring transaction in the ordinary course of [taxpayer's] business"⁷⁰ or an "integral part of [taxpayer's] ordinary trade or business."⁷¹ This approach looks at the nature of the underlying transaction to determine if the foreign currency transaction should be characterized as a capital or as an ordinary transaction.⁷²

Revenue Ruling 78-281,⁷³ cited in *National-Standard*,⁷⁴ supports this approach. A United States corporation borrowed foreign currency to purchase a machine used in its equipment rental business. The Service ruled that the taxpayer realized ordinary gain or loss on each loan payment. Such gain or loss was equal to the difference between the original dollar value of the loan principal discharged and the dollar value of the foreign currency used to make the repayment on the date such payment was made. One can infer that ordinary treatment followed from the use of the foreign currency to purchase an asset that generated ordinary income (rental income).

Foreign currency transactions, because of required annual accounting, are considered separately from the underlying transaction for tax purposes.⁷⁵ Even considering the annual accounting requirement, it is still possible to have the character of the underlying transaction control the character of the foreign currency transaction. In *Arrowsmith v. Commissioner*,⁷⁶ a taxpayer received liquidating distributions on his stock which he reported as capital gains.⁷⁷ A few years later he was required to pay a judgment that was rendered against the old corporation.⁷⁸ The taxpayer claimed that this loss was ordinary as no sale or exchange took place in the year of the loss.⁷⁹ The Supreme Court rejected the taxpayer's claim and characterized the loss as a capital loss.⁸⁰ Even though each year is a separate unit for tax purposes, the Court "related back" the loss to the earlier related liquidating distributions.⁸¹ From the rationale of *Arrowsmith*⁸² one can observe that, in characterization for tax purposes, related transactions may be inte-

70. *Church's English Shoes, Ltd.*, 24 T.C. at 59.

71. *America-Southeast Asia Co.*, 26 T.C. at 200.

72. Where the purpose for borrowing the foreign currency is clear, the nature of the underlying transaction will characterize the nature of the foreign currency transaction, that is, whether the currency is a capital asset. *National-Standard Co. v. Commissioner*, 80 T.C. 551, 560 (1983).

73. 1978-2 C.B. 204.

74. 80 T.C. 551, 562 (1983).

75. *See Hoover Co. v. Commissioner*, 72 T.C. 206, 250 (1979).

76. 344 U.S. 6 (1952).

77. *Id.* at 7.

78. *Id.*

79. *Id.*

80. *Id.* at 8.

81. *Id.* This is necessary to avoid unfair tax windfall. *See United States v. Skelley Oil Co.*, 394 U.S. 678, 685 (1969).

82. 344 U.S. 6 (1952).

grated.⁸³ The approach taken in *Church's English Shoes, Ltd.*,⁸⁴ *America-Southeast Asia Co.*,⁸⁵ and Revenue Ruling 78-281⁸⁶ is consistent with *Arrowsmith*. In cases such as *National-Standard* the foreign currency losses should "relate back" and be integrated with the underlying transaction of the sale of the corporation's investment. This approach would result in characterization of the losses as capital losses.

A practical alternative would be to treat a loss on a foreign currency transaction as interest expense, permitting an ordinary deduction under section 162(a).⁸⁷ Conversely, gain would reduce the taxpayer's interest expense. This "interest equivalency" approach has been proposed by the Treasury Department.⁸⁸ Various factors may motivate a United States taxpayer to borrow funds abroad. If the American dollar is weak in relation to the foreign currency, the taxpayer will pay less interest than if he had borrowed dollars. If the American dollar is strong in relation to the foreign currency, the taxpayer will pay more interest than if he had borrowed dollars. Therefore, in economic terms, a foreign currency transaction can be viewed as a reduction or an increase in the real cost of borrowing.⁸⁹ This "interest equivalency" approach would avoid the need to find a "sale or exchange" or to trace and to "relate back" to and integrate with the underlying transaction.

Few areas of federal income taxation are as unsettled and fraught with confusion as foreign currency transactions.⁹⁰ Today, with a strong American dollar, a case with similar facts to *National-Standard* would result in ordinary gain. The Service's approach leads to inconsistent results, since it seems to use the most favorable approach under the circumstances.⁹¹ To avoid problems inherent in a tracing of related transactions as in *Arrowsmith* or *Corn Products*, the courts should adopt

83. *But see* *National-Standard Co. v. Commissioner*, 80 T.C. 551, 559 n.8 (1983) (stating that *Arrowsmith* is distinguishable). The *National-Standard* court seems to base this distinction on the satisfaction of the "sale or exchange" requirement provided in *Arrowsmith* by I.R.C. § 115(c) (1939). But under the rationale of *Arrowsmith* it seems that related transactions may be integrated for tax purposes, that is, characterization of events, even if there is no "sale or exchange" in the latter event.

84. 24 T.C. 56 (1955), *aff'd per curiam*, 229 F.2d 957 (2d Cir. 1956).

85. 26 T.C. 198 (1956).

86. 1978-2 C.B. 204.

87. *Adams and Henrey*, *supra* note 64, at 315.

88. U.S. Treasury Department Discussion Draft on Taxing Foreign Exchange Gains and Losses, 45 Fed. Reg. 81,711 (1980) [hereinafter cited as Discussion Draft].

89. Discussion Draft, *supra* note 88, at 81,713.

90. *See, e.g.*, *Adams and Henrey*, *supra* note 64; *Roberts, Borrowing in Foreign Currencies*, 26 TAXES 1033 (1948). There is little case law in the area of foreign currency loans. Saltoun, *Tax Aspects of International Exchange Transactions*, 40 INST. ON FED. TAX'N 34-1, 34-39 to -48 (1982).

91. The Service would like to characterize gains as ordinary and losses as capital. *See* Opening Brief for Petitioner at 13-14, *National-Standard Co. v. Commissioner*, 80 T.C. 551 (1983); *see also* Dale, *Tax Consequences of Currency Fluctuations: Occasional Transactions*, 32 INST. ON FED. TAX'N 1683, 1704 (1974); *but see* Reply Brief for Respondent at 8, *National-Standard Co. v. Commissioner*, 80 T.C. 551 (1983).

an “interest equivalency” approach. This would bring consistency and stabilization to this confusing and unsettled area of income taxation.

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