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ARKANSAS BEST: A RETURN TO THE REASONING OF *CORN PRODUCTS*

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With the increased profitability of the stock market, some corporations bypassed traditional investment opportunities to purchase equity interests in other corporations.[1] In an effort to avoid the economic hardships of a recession, a few corporations diversified their operations by purchasing smaller corporations with a different product base.[2] Still further, other corporations sold portions of their own corporations or their wholly-owned subsidiaries in an effort to raise much needed cash.[3] These transactions often combine the mixed motives of investment and the ordinary operation of a business. As a result of these mixed motives, many unique tax applications have been created.

These applications usually arise when the corporations sell their equity interests. The issue then arises as to whether any gain or loss realized should be treated as an ordinary gain or loss or a capital gain or loss.[4] The basis for examining the proper tax treatment of any such gain is founded upon the United States Supreme Court's ruling in *Corn Products Refining Co. v. Commissioner.*[5] Since 1955 various courts have interpreted this decision

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1. *See generally* Brandt, *Intel Gets Some Help From Its Big Blue Friend,* BUS. WK., October 20, 1986, at 84; *Clash of the Titans,* FORTUNE, July 22, 1985, at 10; Finn, *General Eclectic,* FORBES, March 23, 1987, at 74; MERGERS AND ACQUISITIONS, May/June, 1986, at 5 (In 1985, 3,165 merger and acquisition transactions worth $1,000,000 or more occurred. There were 24 mergers and acquisitions in excess of $1,000,000,000 in 1985, compared with 19 in 1984).

2. *See generally Different Cokes,* FORTUNE, July 22, 1985, at 12; *Edelman Lifts Bid for Burlington,* N.Y. Times, May 28, 1987, at D, col. 6; *Time, Inc. Moves into Textbooks,* BUS. WK., October 27, 1986, at 50; *Travenol, in Stock Deal, Will Acquire Caremark,* N.Y. Times, May 12, 1987, at D1, col. 1; *United's Low Road,* FORTUNE, July 22, 1985, at 11.

3. *Alleqis to Sell Canadian Hotels in move Viewed as Anti-Takeover Step,* Wall St. J., June 3, 1987, at 10, col. 2; *Allied to Sell Dillard 31 Stores in South,* N.Y. Times, April 14, 1987, at D5, col. 5; Deveny, *How Baxter Travenol is Treating its Digestion Problem,* BUS. WK., November 10, 1986, at 69; MERGERS AND ACQUISITIONS, March/April 1987, at 12, 67.

4. For a general discussion as to the effects of the *Corn Products* doctrine, see generally Troxell & Noall, *Judicial Erosion of the Concept of Securities as Capital Assets,* 19 TAX L. REV. 185, 187-88 (1964); Note, *The* Corn Products *Doctrine and its Application to Partnership Interests,* 79 Colum. L. Rev. 341 (1979).

5. 350 U.S. 46 (1955).

under different factual circumstances, creating a dichotomy among the jurisdictions.[6]

Consequently, it has been unclear whether any gain or loss recognized upon a distribution in exchange for an equity interest held in a corporation should be treated as an ordinary gain or loss or a capital gain or loss. The Supreme Court recently resolved these past uncertainties in *Arkansas Best Corp. v. Commissioner.*[7]

This Article examines the Supreme Court's decision in *Arkansas Best* and explores the development of the *Corn Products* doctrine. It investigates the decisions among the various jurisdictions and attempts to reconcile them in light of *Corn Products.* Finally, this Article shows that while a corporation purchasing stock in another corporation may have mixed motives for doing so, such stock should be treated as a capital asset since stock cannot readily be characterized as a "hedge" within the exception to Internal Revenue Code (I.R.C.) Section 1221 set forth in *Corn Products.*

I. *Corn Products Refining Co. v. Commissioner*

The Corn Products Refining Company was a nationally known manufacturer of corn by-products which purchased substantial amounts of corn for refining.[8] The majority of the company's contracts required shipment within thirty days at a set or market price on the date of delivery, whichever was lower. The company's facilities enabled it to maintain only a three week supply of corn, subjecting it to substantial risks from drastic changes in the market.[9]

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6. *See infra* notes 35-123 and accompanying text; *see also* Schlumberger Technology Corp. v. United States, 443 F.2d 1115, 1122 (5th Cir. 1971) (purchase of stock and loans to new company to obtain services of certain individuals); Waterman, Largen & Co. v. United States, 419 F.2d 845 (Ct. Cl. 1969), *cert. denied,* 400 U.S. 869 (1970); FS Services, Inc. v. United States, 413 F.2d 548, 555 (Ct. Cl. 1969) (taxpayer purchased stock in company to assure source of supply, and such stock was held to be non-capital asset); John J. Grier Co. v. United States, 328 F.2d 163, 165 (7th Cir. 1964) (purchase of stock in order to safeguard rights under lease covering premises used for a restaurant business); Booth Newspapers, Inc. v. United States, 303 F.2d 916, 921 (Ct. Cl. 1962) (purchase of stock of paper mill company to assure taxpayer's supply of newsprint at time of serious shortages of such paper); International Flavors & Frangrances Inc. v. Commissioner, 62 T.C. 232, 239 (1974), *rev'd and remanded,* 524 F.2d 357, 360 (2d Cir. 1975) (gain on sale of pound-sterling short-sale contract used to hedge investment in British subsidiary); Chemplast, Inc. v. Commissioner, 60 T.C. 623, 633 (1973) (loans to new corporation to acquire services of particular individual); Steadman v. Commissioner, 60 T.C. 369, 380 (1968), *aff'd,* 424 F.2d 1, 2 (6th Cir.), *cert. denied,* 400 U.S. 869 (1970) (advance of funds to corporation by attorney to protect his position as its secretary and general counsel); Electrical Fittings Corp. v. Commissioner, 33 T.C. 1026, 1031 (1960) (taxpayer purchased stock in company to assure source of supply, and such stock was held to be non-capital asset); Commissioner v. Bagley & Sewall Co., 20 T.C. 983, 989 (1953), *aff'd,* 221 F.2d 944, 947 (2d Cir. 1955) (loss on government bonds acquired for deposit in escrow to discharge contract obligation).

7. *Arkansas Best Corp. v. Commissioner,* 56 U.S.L.W. 4229 (U.S. March 7, 1988).

8. *Corn Prods. Refinery Co. v. Commissioner,* 350 U.S. at 48.

9. *Id.*

To avoid previous problems caused by market changes and to ensure an adequate supply of corn without expending substantial capital to build new storage facilities, the company entered the futures market.[10] In the fall of each year, the company purchased futures on the delivery of corn. It would take delivery on the contracts if unable to obtain a supply of corn and sell the remainder if a shortage failed to materialize.[11] If a shortage did occur, the company would sell the futures as it bought corn on the spot market. Through this investment strategy, the company was able to reach a balanced position as to any increase in spot corn prices.[12]

The company made a profit on its futures in some years but lost money in others.[13] It originally reported these figures as ordinary profits and losses for its manufacturing operations but later contended that the futures were "capital assets" and that any gains or losses should be treated as arising from the sale of capital assets.[14] It justified its position by claiming that the futures trading was a separate and distinct entity from its manufacturing operations and that its futures transactions were not "hedges" or "speculative dealings."[15]

The United States Tax Court rejected the company's arguments, finding that the company's futures activities were an integral part of its business, designed to ensure a continued supply of corn with the additional benefit of protecting against price increases.[16] Corn Products appealed.

The United States Circuit Court of Appeals for the Second Circuit upheld the Tax Court's decision finding that there was no indication or basis for determining that the futures constituted capital assets.[17] On appeal to the circuit court, Corn Products alleged that the commodity transactions in question constituted property under Section 117(a) of the I.R.C. It further argued that the courts had created a "judge-made exception" by denying capital gains treatment for commodity futures transactions when used in "hedging."[18] The Commissioner, however, claimed that the petitioner's commodity transactions were specifically excluded under Section 117(a) as "inventory" and thus were not entitled to capital gains treatment.[19] The court rejected Corn Products' arguments and held that gains or losses from commodity transactions for commercial purposes do not receive capital gain or loss treatment.

The Second Circuit closely examined the inventory exception under Section 117(a). It found that where futures are used for the purpose of

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10. *Id.*
11. *Id.* at 48-49.
12. *Id.* at 49.
13. *Id.*
14. *Id.*
15. *Id.* at 49-50.
16. Corn Products Refining Co. v. Commissioner, 16 T.C. 395, 399-400 (1951).
17. Corn Products Refining Co. v. Commissioner, 215 F.2d 513, 515-16 (2d Cir. 1954).
18. *Id.*
19. *Id.*

speculation for legitimate capital transactions, they do not come within the relevant exclusions of Section 117(a). In a hedge, however, such transactions do come within the relevant exclusions because the hedge is used as part of an inventory purchasing system whose purpose is to maintain a steady inventory at a reasonable price. Such an inventory strategy is an integral part of the manufacturing process, necessary to guarantee a sufficient supply of raw materials for manufacturing.[20] The property or inventory is held not for investment but for the protection of profit with the intent of disposing of such material when the manufacturer's purpose has been achieved. Consequently, the court concluded that material purchased under a hedge cannot reasonably be separated from the inventory items and that the cost of such operations must be considered part of the ultimate cost of the goods.[21]

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20. *Id.* at 516.

21. The court also rejected the contention that the "wash sales" provisions of Section 118 were applicable to the commodity transactions undertaken by Corn Products. It cited Harriss v. Commissioner, 143 F.2d 279 (2d Cir. 1944), and Valley Waste Mills v. Page, 115 F.2d 466 (5th Cir. 1940), *cert. denied,* 312 U.S. 681 (1941), as supporting its conclusion.

Section 118 prevented the deduction of losses sustained upon the sale and purchase of shares of stock or securities, if the stock and securities purchased were substantially identical to those sold. The court refused to accept the petitioner's argument that Section 118 was applicable to the commodities transactions undertaken in *Corn Products.* In its decision the Second Circuit quoted from the Tax Court's opinion:

> Furthermore, a new future commodity contract is not 'substantially identical' with any prior contract even though the quantity involved in each is identical. It would be purely accidental if the new contract was with the same party as the one who had agreed to sell the commodity in the earlier contract. The price would probably be different and the delivery date would certainly be different.

Corn Prods. Refining Co. v. Commissioner, 215 F.2d at 516-17 (quoting 16 T.C. 395, 399-400 (1951)).

The Second Circuit also cited the Tax Court's opinion for the proposition that commodities futures contracts are not securities:

> . . . it is apparent from the [*Valley Waste Mills*] opinion, that such a *future is not a security* in any generally recognized sense but simply a contract between two parties in which one agrees to supply at a designated time in the future, a stated quantity and the quality of goods, upon payment of a stated price and on which a part of the contract price, called a margin, has been paid by the buyer to his broker to bind him until the sale is consummated or the contract is sold. (Emphasis supplied.)

Corn Prods., 215 F.2d at 517 (quoting 16 T.C. at 400).

The concept that a commodity futures contract is not a "security" is limited and must be carefully examined. A commodities futures contract has been held not to be a security within the meaning of the Securities Act where the purchaser of the contract relied solely on the speculative hope that the market price of the underlying commodity would rise or fall. SEC v. Commodity Options International, Inc., 553 F.2d 628, 632 (9th Cir. 1977); Glazer v. National Commodity Research and Statistical Service, Inc., 547 F.2d 342, 343 (7th Cir. 1977); McCurnin v. Kohlmeyer, 340 F. Supp. 1338, 1341-42 (E.D. La. 1972). A very thin line exists, however, between a commodity futures contract and a security. An agreement authorizing a person to buy and sell commodity futures on a profit sharing basis has been found to be a security because the investors relied solely on the efforts of others to obtain profits. Ramsey v. Arate, 406 F. Supp. 435, 438 (N.D. Tex. 1975). A naked double commodity option has also been found to be a security. S.E.C. v. Commodity Options International, Inc., 553 F.2d

The Second Circuit stated that the tax treatment of hedges "is not a judge-made exception' to Section 117(a); it is simply a recognition by the courts that property used in hedging transactions properly comes within the exclusions of the section."[22] The court was careful to address the fact that the commodity transactions in *Corn Products* did not constitute true hedging and found that this difference was insignificant. The property purchased by Corn Products Corporation was used for essentially the same purpose and in the same manner as true hedging.[23] It maintained, however, that the company's purpose had been to stabilize inventory costs and protect its profit, regardless of whether complete or partial insurance was achieved.[24]

On *certiorari* the Supreme Court affirmed the lower courts' decisions.[25] It concluded that there was no justification for the company's argument that its futures activities were conducted separately and distinctly from its manufacturing business. The Court emphasized that the futures purchases constituted a form of insurance and that the company was still vulnerable to rises in the price of corn.[26]

The Supreme Court accepted the lower courts' findings that the futures "constitute[d] an integral part of its manufacturing business," but placed less emphasis on their conclusion that the commodity transactions were an integral part of the business because they were part of the inventory system.[27] Instead, the Court reasoned that capital gains treatment should be applied only to those transactions where the property involved is not a usual source of business income. It stated that the definition of a "capital asset" must be narrowly applied and that its exclusions should be broadly construed.[28] The *Corn Products* opinion cited previous letter rulings and decisions holding that gains and losses from "hedging transactions" should be treated as ordinary business gains and losses, as justifying its conclusions.[29]

628, 632-33 (9th Cir. 1977).

For a discussion of what constitutes a "security", see Neuwirth Inv. Fund, Ltd. v. Swanton, 422 F. Supp. 1187, 1194 (S.D.N.Y. 1975); Investment Co. Inst. v. Camp, 274 F. Supp. 624, 642 (D.D.C. 1967); *see also* 15 U.S.C. § 78(c)(10) (Supp. 1986) (§ 3 of Securities Exchange Act of 1934); I.R.C. § 6323(h) (1982); U.C.C. § 8-102(1) (1978).

22. *Corn Prods.*, 215 F.2d at 516.

23. *Id.* at 516-17.

24. *Id.*

25. Corn Prods. Refining Co. v. Commissioner, 350 U.S. 46, 54 (1955).

26. *Id.* at 51.

27. *Id.*

28. *Id.* at 52. Section 117 of the Internal Revenue Code of 1940 defined "capital asset" as:

> held by the taxpayer (whether or not connected with his trade or business), but does not include 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, or property, used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 23(l) . . . .

29. 350 U.S. at 52-53; *see* Gen. Couns. Mem. 17,322 (1936).

The Supreme Court's unanimous[30] decision in *Corn Products* indicates the Court's narrow interpretation of "capital asset."[31] This interpretation resulted from the Court's desire to uphold Congress' intent that profits and losses arising in the every day operation of a business be treated as ordinary income or loss rather than capital income or loss.[32]

II. The Dichotomy Among the *Corn Products* Progeny

The *Corn Products* decision has been interpreted by a number of jurisdictions including various federal circuit courts, the United States Tax Court, and the United States Court of Claims.[33] These jurisdictions have not been unanimous in their conclusions, however, giving rise to great disparity.[34]

A. *The "Substantial Investment Motive" Test*

One of the most important interpretations of the *Corn Products* doctrine was made in *W. W. Windle Co. v. Commissioner.*[35] In *W. W. Windle,* a processor of raw woolen stock promulgated the incorporation of a company to manufacture its product into cloth. The Windle Company had been faced with declining sales and encouraged the creation of the company to purchase its products. In doing so the Windle Company acquired seventy-two percent of the new corporations stock.[36] Ten years after its formation, however, the captive corporation was liquidated because of consistent operating losses. Consequently, Windle's stock interest became worthless, and it attempted to claim this loss as an ordinary loss.[37]

The United States Tax Court concluded that "stock purchased with a substantial investment purpose is a capital asset even if there is a more substantial business motive for the purchase."[38] It acknowledged that Windle had had a legitimate business purpose in creating a captive company to offset its declining sales but emphasized that Windle expected the company to become a profitable corporation thereby causing its initial investment to appreciate substantially.[39]

The court emphasized that where a substantial investment motive exists in a predominantly business acquisition of corporate stock, such stock is a

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30. The decision was 8-0 with Justice Harlan abstaining.

31. Traditionally the Court has construed narrowly the definition of a "capital asset." *See* Kieselbach v. Commissioner, 317 U.S. 399, 403 (1943); Hort v. Commissioner, 313 U.S. 28, 31 (1941).

32. *Corn Prods.*, 350 U.S. at 52. *See generally* Burnet v. Harmel, 287 U.S. 103, 106 (1932).

33. *See infra* notes 35-123 and accompanying text.

34. *Id.*

35. 65 T.C. 694 (1976).

36. *Id.* at 696.

37. *Id.* at 702.

38. *Id.* at 712.

39. *Id.* at 713.

capital asset.[40] It stated that even though Windle's investment motive might have changed when the corporation began to experience economic problems, the assets would still be capital assets.[41]

More recently, the United States Court of Appeals for the Sixth Circuit in *Roth Steel Tube Co. v. Commissioner*[42] found that a substantial investment motive may exist at the time of the acquisition of stock or during the period in which stock is retained.[43] In *Roth* the Roth Steel Tube Company acquired a sixty-two percent interest in Remco Industries, Inc. which manufactured children's toys. Remco subsequently suffered serious financial problems which required Roth to provide an additional infusion of capital. Remco eventually ceased operations and Roth claimed an ordinary loss on its investment in Remco stock as well as for the advances made to Remco. The Commissioner of the Internal Revenue Service maintained that the losses suffered by Remco were capital losses and not ordinary losses.[44]

The United States Tax Court concluded that the amounts paid to acquire the stock of Remco and the advances made to it were capital in nature and that the losses suffered were capital losses.[45] On appeal the Sixth Circuit upheld the Commissioner's reasoning, finding that Roth's loss on its investment in Remco stock was a capital loss rather than an ordinary loss because Roth purchased the stock as an investment.[46] It concluded that the Tax Court's opinion, that a business purpose must persist without a substantial investment purpose throughout the purchase and holding period if the gain or loss is to be characterized as an ordinary gain under the *Corn Products* doctrine, was not clearly erroneous.[47]

One of the first interpretations of the *Corn Products* doctrine by the United States Court of Claims occurred in *Dearborn Co. v. United States.*[48] In *Dearborn* the Dearborn Company, a furniture manufacturer, acquired a total of 82,802 shares of a woodworking company. It later sold the stock

40. *Id.* at 712.

41. *Id.* at 713-14. In a more recent application, the United States Tax Court held that shares of capital stock will be treated as capital assets so long as there was a substantial investment purpose for holding them, even though a business purpose was predominant. Mariani Frozen Foods Inc. v. Commissioner, 81 T.C. 448, 480-81 (1983). The court recognized that a corporation's reasons for holding an asset may change over a period of time and thus the shareholder's intent for holding the stock must be made with reference to the corporation's reasons for holding the stock in the period during which the stock was sold. *Id.* at 479-80. Although the court found that the company's shares were held predominantly for investment motives, it cited *Windle* for the proposition that if a substantial investment motive had existed, the shares would have been treated as capital assets. *Id.* at 481 n.25.

42. 800 F.2d 625 (6th Cir. 1986).

43. *Id.* at 630-32.

44. *Id.* at 626-29.

45. Roth Steel Tube Co. v. Commissioner, 49 T.C.M. (CCH) 698, 706 (1985). The court stated: "[a] substantial investment motive at the time of acquisition or retention of the stock requires treatment as a capital asset." *Id.*

46. *Roth Steel Tube Co. v. Commissioner*, 800 F.2d at 632.

47. *Id.*

48. 444 F.2d 1145 (Ct. Cl. 1971).

at a loss and claimed an ordinary loss because it had purchased the stock in the ordinary course of business. The Dearborn Company argued that its actions were an integral and necessary act in conducting its furniture business.[49] The company's motivation in purchasing the stock was to obtain management control of the production supply facilities of the manufacturer, including a multi-year contract for the supply of hardwood timber.[50] The Commissioner rejected these arguments, however, and concluded that the company acquired the stock with a substantial investment purpose and maintained this purpose until its disposition of the stock.[51]

The Court of Claims concluded that the Dearborn Company acquired the stock and management control in order to receive revenue from the stock and to generate fee income from managing the supplier.[52] Thus, the court determined that the Dearborn Company was motivated by a substantial investment purpose even though it was also concerned with the acquisition of supply and production facilities. The *Dearborn* court emphasized that because the company was motivated by a substantial investment motive, the stock it acquired was a capital asset even though the principal reason for acquiring the stock was to acquire the company's supply and production facilities, a business purpose.[53]

In a subsequent case, *Agway, Inc. v. United States*[54] (*Agway I*), the Court of Claims relied on *Dearborn* to uphold a corporation's claim to capital gains treatment on the redemption of preferred stock in an agricultural cooperative.[55] In *Agway I*, Agway, Inc., a corporation operating as a farmer's cooperative, manufactured, purchased, and sold farm supplies and equipment.[56] Agway received shares of preferred stock in another cooperative as part of its annual patronage refund from the second cooperative. Subsequently, the shares were redeemed at a substantial profit to Agway.[57] Agway sought a refund of its taxes on the grounds that the gain on the redemption of its preferred stock in the agricultural cooperative should have been taxed as capital gains rather than ordinary income.[58] The IRS argued that the profit was ordinary income to the petitioner.[59]

The Court of Claims, following earlier decisions,[60] concluded that the income received by Agway from the redemption constituted a capital

49. *Id.* at 1147.
50. *Id.* at 1147-48.
51. *Id.* at 1148.
52. *Id.* at 1167-68.
53. *Id.*
54. 524 F.2d 1194 (Ct. Cl. 1975).
55. *Id.* at 1201.
56. *Id.* at 1196.
57. *Id.*
58. *Id.*
59. *Id.*
60. Dearborn Co. v. United States, 444 F.2d 1145 (Ct. Cl. 1971); Waterman, Largen & Co. v. United States, 419 F.2d 845 (Ct. Cl. 1969), *cert. denied,* 400 U.S. 869 (1970); FS Services, Inc. v. United States, 413 F.2d 548 (Ct. Cl. 1969); Booth Newspapers, Inc. v. United States, 303 F.2d 916 (Ct. Cl. 1962).

gain.[61] It refused to apply the *Corn Products* doctrine where there was a "substantial investment motive" as well as the need to acquire a source of supply.[62] The court emphasized that "Corn *Products* will be applied in this court to purchases of company stock to obtain a source of supply, only if there is no substantial investment intent."[63]

In a decision released the same day,[64] the Court of Claims expressed an opinion which is difficult to reconcile with *Agway I*.[65] In *Union Pacific Railroad Co. v. United States,*[66] the Union Pacific Railroad Company sought a tax refund claiming that stock it held in certain subsidiary railroad corporations did not constitute capital assets because the acquisition was not "a mere investment unrelated to the business operations of the plaintiff.[67] It was accomplished for an operating, business purpose, and the stock was held as part of the operation of plaintiff's business as a railroad."[68]

In analyzing *Union Pacific,* the Tax Court in *W. W. Windle*[69] concluded "that the Court of Claims is currently of the view that the existence, or at least the dominance, of a substantial business purpose for a stock acquisition suffices to preclude capital asset status, whether or not there is a concurrent hope of investment gain."[70] Thus the *Union Pacific* decision appears to cast serious doubt upon the continued acceptance of *Dearborn* and *Agway I* in the Court of Claims.[71]

More recently the Court of Claims has decided *Agway, Inc. v. The United States (Agway II)*[72], which involved identical facts and issues to those in *Agway I* except that the stock was issued and redeemed after the 1959 promulgation of Treasury Regulation Section 1.61-5.[73] The *Agway II*

61. *Agway I,* 524 F.2d. at 1200.

62. *Id.*

63. *Id.* at 1201. The court cited its previous holding in *Penn Yan Agway Corp. v. United States,* 417 F.2d 1372 (Ct. Cl. 1969), with disapproval. It stated that there was no need to convene an *en banc* court to formally overrule it. *Id.* at 1202.

64. The *Agway I* and *Union Pacific* decisions were both released October 22, 1975. Judge Nichols wrote for the majority in *Agway I* with Judge Durfee concurring in part and dissenting in part. In *Union Pacific* Judge Schwartz wrote for the majority with Judge Kunzig adopting the majority decision with minor modifications and Judge Nichols concurring in part and dissenting in part.

65. *See supra* notes 54-63 and accompanying text.

66. 524 F.2d 1343 (Ct. Cl. 1975).

67. *Id.* at 1359.

68. *Id.*

69. 65 T.C. 694 (1976); *see supra* notes 35-41 and accompanying text.

70. *Windle,* 65 T.C. at 711.

71. This interpretation has been widely accepted and was noted in the Tax Court's decision in *Windle,* 65 T.C. at 710. Since *Union Pacific* was decided by the full court, with only Judge Nichols, the author of the *Agway I* opinion dissenting, it appears more authoritative than *Agway I. Id.* at 711; *cf.* Norton v. United States, 551 F.2d 821 (Ct. Cl. 1977) (contract assuring logging business of a ready source of supply of timber was essential to and an integral part of the logging business so that a business use intention rather than an investment intent prevailed; gain on the sale of the contract was ordinary gain under *Corn Products* doctrine).

72. 81-2 U.S. Tax Cas. (CCH) ¶ 9700, 88,379 (Sept. 25, 1981).

73. *Id.* at 88,381.

court stated that the case warranted the same result as *Agway I* except for interpreting Treasury Regulation Section 1.61-5.[74] Thus, *Agway II* infers that sometime after the *Union Pacific* decision, the Court of Claims returned to the use of the "substantial investment motive" test enunciated in *Agway I.*

The Internal Revenue Service has also expressed the opinion in a Revenue Ruling[75] that stock purchases held with a substantial investment purpose are capital assets even though there was a more substantial business motive for the purchases.[76] The IRS has since enforced this interpretation through a number a private letter rulings[77] which have applied the *W. W. Windle* "substantial investment motive" test in varying factual contexts.[78]

B. *The "Investment Motivated Purpose" Test*

In contrast to those jurisdictions adopting the "substantial investment motive" test, the United States Court of Appeals for the Fifth Circuit has created its own interpretation of the *Corn Products* doctrine. It has stated that

> if securities are purchased by a taxpayer as an integral and necessary act in the conduct of his business, and continue to be so held until the time of their sale, any loss incurred as a result thereof may be fully deducted from gross income as a business expense or ordinary loss. If on the other hand, an investment purpose be found to have motivated the purchase or holding of the securities, any loss realized upon their ultimate disposition must be treated in accord with the capital asset provisions of the Code.[79]

This reasoning was set forth in the court's opinion in *Campbell Taggert, Inc. v. United States.*[80] In *Campbell Taggert,* the Campbell Taggert Corporation, a holding company, entered into an agreement to purchase fifty percent of the stock of a foreign corporation. Later, Campbell Taggert amended its agreement, purchasing twenty-five percent of the stock immediately and the remaining twenty-five percent at a future date. Prior to purchasing the remaining twenty-five percent, the corporation that was to be purchased suffered severe financial setbacks. Campbell Taggert's attorney advised the company that it was no longer obligated to consummate the transaction because there had been a "material adverse change."[81] Campbell

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74. *Id.*

75. Rev. Rul. 78-94, 1978-1 C.B. 58, *revoking* Rev. Rul. 75-13, 1975-1 C.B. 67.

76. *Id.*

77. *See, e.g.,* Priv. Ltr. Rul. 8,342,011 (July 15, 1983).

78. *Id.*

79. Campbell Taggert, Inc. v. United States, 744 F.2d 442, 456 (5th Cir. 1984) (citing Technology Corp. v. United States, 443 F.2d 1115, 1120 (1971) and quoting Booth Newspapers v. United States, 303 F.2d 916, 921 (Ct. Cl. 1962)).

80. 744 F.2d 442 (5th Cir. 1984).

81. *Id.* at 444-45.

Taggert, however, purchased the remaining stock to protect its business reputation and goodwill. Shortly thereafter it sold the stock at a loss and claimed an ordinary loss from the sale of the stock. The Commissioner disallowed the loss and Campbell Taggert brought suit for a refund.[82]

Campbell Taggert claimed that because it lacked an investment motive when it purchased the stock, it suffered an ordinary loss under the *Corn Products* doctrine.[83] The Commissioner argued that the corporation's original purpose in purchasing the stock, to acquire a capital asset, should control the nature of the transaction.[84] The United States District Court for the Northern District of Texas concluded that the corporation was entitled to an ordinary loss from the sale of the stock.[85] It held that Campbell Taggert's original investment motive was not determinative of whether the subsequent sale of the stock was the sale of a capital asset where Campbell-Taggert decided to complete the transaction to protect its goodwill as well as its business reputation and the original investment motive played no part in completing the bargain.[86]

On appeal, the United States Court of Appeals for the Fifth Circuit held that because Campbell Taggert had the initial intent of purchasing the stock for investment and had completed the transaction only to protect its reputation and goodwill, it was entitled to take an ordinary loss on the transaction.[87] The *Campbell Taggert* court recognized that a distinction exists between individuals and corporations as to whether investment activities constitute a trade or business for the purpose of capital or ordinary gain or loss treatment.[88] The court stated that the *Corn Products* doctrine is triggered by finding a business purpose as opposed to investment purpose in acquiring what would otherwise be a capital asset. Any inquiry into the taxpayer's purpose requires an objective evaluation of all circumstances surrounding the transaction including all relevant factors.[89]

One of the decisions on which the *Campbell Taggert* court based its holding was the Fifth Circuit's *decision in Schlumberger Technology Corp. v. United States*,[90] which in turn was based on *Booth Newspapers, Inc. v.*

82. *Id.* at 444-46.
83. *Id.* at 446.
84. *Id.*
85. Cambell Taggert, Inc. v. United States, 552 F. Supp. 355 (N.D. Tex 1982).
86. *Id.* at 358.
87. *Campbell Taggert*, 744 F.2d at 460.
88. *Id.* at 453.
89. *Id.* at 458. Relevant factors include: the taxpayer's statements of its objective intent at the time of the acquisition; the taxpayer's statements of its objective intent at the time of disposition; the needs of the particular business; the length of time the asset was held; the nature of the taxpayer's other business and investment activities; and the business and investment advantages that might reasonably be expected to flow from the acquisition or expenditure. Reliance on the taxpayer's purpose or motive, however, is not intended to place ordinary capital treatment at the whim of the taxpayer. *Id.*
90. 443 F.2d 1115 (5th Cir. 1971).

United States.[91] In *Schlumberger,* the taxpayer's primary business was the measurement of physical phenomena of the earth and atmosphere to aid in the discovery of oil, gas, and other minerals as well as for scientific space exploration.[92] Because of the very specialized nature of its operations and the high degree of reliability that was required by the purchasers of its equipment, the taxpayer designed and manufactured its own equipment.[93] Schlumberger acquired stock in American Systems, Inc. (ASI), which was organized for the purpose of designing, developing, manufacturing, and programming electronic systems, equipment, and components for military use. The Schlumberger Corporation believed that ASI's personnel could help it in obtaining markets for its electronic equipment. Unexpected adverse business conditions and ASI's failure to obtain any government contracts, however, caused Schlumberger to sell the stock at a loss.[94]

The Fifth Circuit held that while the taxpayer's investment in ASI was not designed to protect and improve its original and primary business, its investment did relate directly to a secondary business of obtaining large systems contracts with the government. The taxpayer's investments in the business were, therefore, integral and necessary acts in the conduct of its business and were not motivated by an investment purpose.[95] In reaching its decision, the Fifth Circuit looked to whether losses incurred on a sale of an asset are fully deductible as ordinary losses, creating a test which considered whether the asset had been acquired as an integral and necessary act in the conduct of business and continued to be so held until the time of sale.[96]

The *Schlumberger* court cited *Corn Products* for the proposition that transactions which are an integral part of the taxpayer's business give rise to ordinary gains and losses, not capital gains and losses.[97] The court explained that this "integrated business activities exception" was developed in *Booth Newspapers, Inc. v. United States.*[98] In *Booth Newspapers* a newspaper publisher desired to guaranty a sufficient supply of newsprint.

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91. 303 F.2d 716 (Ct. Cl. 1962). *Booth Newspapers* is a Court of Claims case which applied the "investment motivated purpose" test rather than the "substantial investment motive" test.

92. Schlumberger Technology Corp. v. United States, 443 F.2d 1115, 1116 (5th Cir. 1971).

93. *Id.* at 1117.

94. *Id.* at 1117-18.

95. *Id.* at 1121-22.

96. *Id.* at 1120-21.

97. *Id.* at 1119.

98. *Id.* at 1120; *see* Booth Newspapers Inc. v. United States, 303 F.2d 916 (Ct. Cl. 1962). Since *Booth Newpapers,* this doctrine has been utilized in several cases. *See* Steadman v. Commissioner, 424 F.2d 1 (6th Cir.), cert. *denied,* 400 U.S. 869 (1970); Hollywood Baseball Ass'n v. Commissioner, 423 F. 2d 494 (9th Cir. 1970); Waterman, Largen & Co. v. United States, 419 F.2d 845 (Ct. Cl. 1969), *cert. denied,* 400 U.S. 869 (1970); John J. Grier Co. v. United States, 328 F.2d 163 (7th Cir. 1964); Electrical Fittings Corp. v. Commissioner, 33 T.C. 1026 (1960); Pittsburgh Reflector Co. v. Commissioner, 27 T.C.M 377 (1968); Helen M. Livesley v. Commissioner, 19 T.C.M. 133 (1960).

As a result of an unprecedented demand for newsprint and a subsequent shortage, Booth and another newspaper purchased 100% of the stock of a small paper mill to ensure their own source of supply of newsprint.[99] When Booth later assured itself of a newsprint supply, it sold the stock.[100]

The *Booth Newspapers* court articulated a test for determining whether a transaction falls within the *Corn Products* exception:

> if securities are purchased by a taxpayer as an integral and necessary act in the conduct of his business, and continue to be so held until the time of their sale, any loss incurred as a result thereof may be fully deducted from gross income as . . . [an] ordinary loss. If, on the other hand, an investment purpose be found to have motivated the purchase or holding of the securities, any loss realized upon their ultimate disposition must be treated in accord with the capital asset provisions of the Code.[101]

The *Booth Newspapers* court held that rather than characterizing the stock purchase as a mere purchase of plant and equipment, it was more accurate to characterize it as the acquisition of a source of inventory. The court therefore concluded that the stock purchase was motivated by business considerations and was an integral act in the conduct of the company's business.[102] In view of this finding, the *Booth Newspapers* court held that the stock was not a capital asset and produced ordinary losses on its sale.[103]

Relying on *Booth Newspapers* the *Schlumberger* court held that the acquisition of the ASI stock was an integral and necessary act in the conduct of the company's secondary business of obtaining government contracts[104] and, consequently, qualified for ordinary, rather than capital asset treatment.[105] It is interesting to note that the Commissioner argued in the *Schlumberger* case that the Fifth Circuit should apply the "temporary business expedient" test—a test which considers whether the transactions are necessary as a temporary business expedient such as to acquire an inventory or protect a source of supply.[106]

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99. *Booth Newspapers,* 303 F.2d at 917.

100. *Id.*

101. *Id.* at 921.

102. *Id.* at 921-22.

103. *Id.* at 922.

104. Schlumberger Technology Corp. v. United States, 433 F.2d 1115, 1121-22 (5th Cir. 1971).

105. *Id.*

106. It is clearly discernable how this test was protracted from the *Corn Products* decision, and it would probably be a successful test to the extent it was only applied to *inventory* "expediencies" since these situations would keep the cases squarely within *Corn Products* and Section 1221. In support of its "business experience test," the government cited numerous cases. *See* Booth Newspapers, Inc. v. United States, 303 F.2d 916 (Ct. Cl. 1962); Commissioner v. Bagley & Sewall Co., 221 F.2d 944 (2d Cir. 1955); Edwards v. Hogg, 214 F.2d 640 (5th Cir. 1954); Chase Candy Co. v. United States, 126 F. Supp. 521 (Ct. Cl. 1954); Mid-State Products Co. v. Commissioner, 21 T.C. 696 (1954); Clark v. Commissioner, 19 T.C. 48 (1952);

C. *A Narrow Reading of* Corn Products

The United States Court of Appeals for the Eighth Circuit rejected the reasoning of the *Campbell Taggert*[107] court in *Arkansas Best Corp. v. Commissioner.*[108] In *Arkansas Best* the Arkansas Best Corporation, a diversified holding company, purchased sixty-five percent of the outstanding stock of the National Bank of Commerce in 1968.[109] As the result of legislation enacted by Congress shortly thereafter,[110] the corporation was required to sell its stock. It encountered difficulty in selling the stock and from 1969 to 1976 had to purchase further shares to stabilize the price of the stock. Ultimately, in 1975, the corporation was able to sell most of its stock but at a substantial loss.[111] On its tax return Arkansas Best claimed an ordinary loss for the disposition of its stock.[112] The Commissioner disallowed these ordinary losses, and Arkansas Best challenged his decision.[113]

Arkansas Best argued that it purchased the stock to protect its business reputation and, therefore, was entitled to ordinary loss treatment for the loss realized on the sale of the stock acquired after 1972.[114] The tax court found that the loss realized on the stock acquired between 1968 and 1972 was a capital loss but that the purchases made after 1972 were made to protect the bank's business reputation which enabled the bank to take an ordinary loss deduction.[115] It concluded that the stock acquisition from 1968 through 1972 was motivated primarily by investment purposes and that the acquisition of stock from 1973 through 1976 was motivated primarily by business purposes.[116]

On appeal the Eighth Circuit reversed the Tax Court finding that the losses sustained by Arkansas Best upon the sale of the stock were not entitled to ordinary loss treatment regardless of the reason why the stock

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Western Wine & Liquor Co. v. Commissioner, 18 T.C. 1090 (1952).

In the alternative, the Commissioner argued for the implementation of the "protection expansion test" which provides that an "acquisition made to protect an existing business would qualify for ordinary loss treatment, while an acquisition made to expand the business would qualify for capital loss treatment." *Schlumberger Technology,* 443 F.2d at 1120.

It is difficult to imagine, however, what temporary expediency has to do with the *Corn Products* rule and one is left to wonder what "expediencies" other than inventory expediencies taxpayers might argue are applicable. *See* Western Wine & Liquor Co. v. Commissioner, 18 T.C. 48 (1952).

107. Campbell Taggert v. United States, 744 F.2d 442 (5th Cir. 1984); *see supra* notes 80-90 and accompanying test.

108. 800 F.2d 215 (8th Cir. 1986), *cert. granted,* 107 S. Ct. 1564 (1987).

109. *Id.* at 217.

110. Bank Holding Company Act, Pub. L. No. 91-607, Title 1, § 103, 84 Stat. 1763 (codified at 12 U.S.C. § 1841-50).

111. *Arkansas Best Corp. v. Commissioner,* 800 F.2d at 217.

112. *Id.*

113. *Id.*

114. *Id.*

115. Arkansas Best Corp. v. Commissioner, 83 T.C. 640 (1984).

116. *Id.* at 654-58.

was acquired.[117] The court concluded that the stock held by Arkansas Best was a capital asset because it did not fall into one of the categories excluded from the definition of a "capital asset" by Section 1221[118] of the I.R.C.[119]

The *Arkansas Best* court interpreted *Corn Products* as neither requiring nor permitting courts to decide if capital stock can be anything other than a capital asset under Section 1221.[120] The court stated that courts lack the authority to decree exceptions to Section 1221 that Congress did not choose to make.[121] In so holding, the court directly rejected the Fifth Circuit's reasoning in *Campbell Taggert*.[122] Furthermore, it criticized the use of the *Corn Products* doctrine by previous courts because it "foster[ed] subjectivity and uncertainty" in the tax laws, "leading to increased recourse to the administrative and judicial processes to resolve conflicting contentions about taxpayers' motivations in purchasing capital stock."[123]

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117. *Arkansas Best*, 800 F.2d at 221.

118. I.R.C. § 1221 (Supp. 1986). Section 1221 of the Internal Revenue Code provides:

> For 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 the 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).

119. *Arkansas Best*, 800 F.2d at 218.

120. *Id.* at 221.

121. *Id.*

122. *Id.* at 220-21.

123. *Id.* at 221.

The Supreme Court, in a very short opinion, affirmed the Eight Circuit's decision. It concluded that "a taxpayer's motivation in purchasing an asset is irrelevant to the question" of whether the asset falls within the broad definition of a "capital asset" under Section 1221.[124] *The Arkansas Best* Court rejected the argument that *Corn Products* stood for the proposition that any asset acquired and held for business purposes should be entitled to ordinary asset treatment. It concluded that *Corn Products* must be viewed for the narrow holding that any hedging transaction, which is an integral part of a business' inventory-purchase system falls within Section 1221's property exception allowing the asset to be included in the taxpayer's inventory.[125]

Because Arkansas Best was not a securities dealer, its stock fell outside Section 1221's inventory exception. The stock clearly fell within Section 1221's definition of a "capital asset" and was thus outside the classes of excluded property. Consequently, the loss arising from its sale was found to be a capital loss.[126]

The Court correctly recognized that *Corn Products* involved an application of Section 1221's inventory exception. Furthermore, it made the important distinction that in *Corn Products* the futures transactions were an integral part of the company's business and a hedge against future price increases. It specifically stated that "*Corn Products* . . . has no application to [the *Arkansas Best*] case."[127] The *Arkansas Best* Court also noted that a business connection is only important "in determinig the applicability of certain of the statutory exceptions including the inventory exception." In doing so, the Court rejected the use of the business motive test.

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124. Arkansas Best Corp. v. Commissioner, 56 U.S.L.W. 422 (U.S. March 7, 1988). A number of tests had previously been proposed for the proper application of the *Corn Products* doctrine. *See generally* Irwin v. United States, 558 F.2d 249, 252 (5th Cir. 1977) ("motive . . . to promote [taxpayer's] business"); FS Services, Inc. v. United States, 413 F.2d 548, 554 (Ct. Cl. 1969) ("proper and valid business considerations rather than an intent to make a capital investment"); Mansfield Journal Co. v. Commissioner, 274 F.2d 284, 286 (6th Cir. 1960) ("motive . . . of a capital investor . . . [or] of a far-sighted manufacturer"); John J. Grier Co. v. United States, 328 F.2d 163, 165 (7th Cir. 1964) ("incident to conduct of . . . business and not for investment"); Booth Newspapers, Inc. v. United States, 303 F.2d 716, 721 (Ct. Cl. 1962) ("eminently reasonable [business] expedient," not "investment-minded"); Pittsburg Reflector Co. v. Commissioner, 27 T.C.M. 377, 379 (1968) ("investment purpose" or "directly related to . . . business"); Tulane Hardwood Lumber Co. v. Commissioner, 24 T.C. 1146, 1150 (1955) ("reasonable and necessary act in the conduct of its business.")

Cases that contain "necessary and integral act" language seem to utilize the phrase as a synonym for "business purpose." On one hand, they contrast business motive with investment motive, while on the other, they speak in terms of a necessary and integral business act as the antithesis of an act motivated by an investment purpose. *See, e.g.,* Midland Distributors, Inc. v. United States, 481 F.2d 730, 734 (5th Cir. 1973) ("taxpayer purchased the assets as an integral and necessary act in the conduct of its business rather than being motivated by an investment purpose.")

125. Arkansas Best Corp. v. Commissioner, 56 U.S.L.W. 422 (U.S. March 7, 1988).

126. *Id.*

127. *Id.*

III. The Application of the *Corn Products* Doctrine

I.R.C. Sections 117 and 1221[128] exclude from the definition of "capital asset" stock in trade, inventory, and property held primarily for sale to customers.[129] Interpreting these exclusions, in light of Section 1221, the Second Circuit in *Corn Products* held that gain and loss from commodity futures transactions will not be given capital treatment when they have been utilized for commercial purposes such as "hedging."[130]

"Hedging" is a method of dealing in commodities futures whereby a person or business protects itself against price fluctuations at the time of delivery of the product which the individual or entity buys or sells.[131] The Second Circuit in *Corn Products* described three sub-categories of hedging: speculation, legitimate capital transaction, and hedging.[132] According to the Second Circuit, in a hedge, property is used in such a manner as to come within the Section 1221 exclusion "for it is a part of the inventory purchase system which is utilized solely for the purpose of stabilizing inventory cost. As such it can not reasonably be separated from the inventory items . . . ."[133] Consequently, the tax treatment of hedges under *Corn Products* is not a "judge-made exception" to Section 1221.[134] The *Corn Products* Court simply recognized that property used in a hedging transaction falls within the Section 1221 capital asset exclusion for inventory.[135]

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128. I.R.C. Section 1221 (Supp. 1986) is identical for our purposes to I.R.C. Section 117(a)(1954) which was in effect at the time of the *Corn Products* decision. For purposes of consistency, the text will refer to Section 1221 instead of Section 117(a) hereinafter.

129. *See supra* notes 28 and 118.

130. Corn Prods. Refining Co. v. Commissioner, 215 F.2d 513, 515 (2d Cir. 1954).

131. *Id.*; *see also* United States v. N.Y. Coffee and Sugar Exchange, 263 U.S. 611 (1924).

132. The *Corn Products* court borrowed these classifications from *N.Y. Coffee, Corn Prods.*, 215 F.2d at 56, (citing *N.Y. Coffee*, 263 U.S. at 619). Since then, these classifications have been adopted as informal guidelines to determine the proper tax treatment of futures transactions. *See generally* Trenton Cotton Oil Co. v. Commissioner, 147 F.2d 33 (6th Cir. 1945); Covington v. Commissioner, 42 B.T.A. 601, *aff'd*, 120 F.2d 768 (5th Cir.), *cert. denied*, 315 U.S. 822 (1941); Farmers & Ginners Cotton Oil Co. v. Commissioner, 41 B.T.A. 1083, *rev'd*, 120 F.2d 772 (5th Cir. 1940); Makransky's Estate v. Commissioner, 5 T.C. 397, *aff'd*, 154 F.2d 59 (3rd Cir. 1946); Tennessee Egg Co. v. Commissioner, 47 B.T.A. 558 (1942).

133. *Corn Products*, 215 F.2d at 516. The Supreme Court in *Corn Products* relied on General Counsel Memorandum 17,322 to distinguish "speculative transactions in commodity futures" from "hedging transactions." Corn Products Refining Co. v. Commissioner, 350 U.S. 46, 52 (1955). That Memorandum ruled that hedging transactions were essentially "insurance" rather than a dealing in capital assets, and gains and losses were, therefore, ordinary. *See id.* at 52-53.

134. *See, e.g.*, Arkansas Best Corp. v. Commissioner, 56 U.S.L.W. 4229, (U.S. March 7, 1988).

135. *See Corn Products*, 215 F.2d at 516. The Supreme Court stated that "admittedly," the corn futures were not actual inventory and, therefore, were not within the literal language of Section 117(a). The Court then held that the exclusions under Section 117(a) should be interpreted broadly. *Corn Prods.*, 350 U.S. at 51, 52. It then turned immediately to a discussion of hedging transactions. *See id.* at 52-53.

The courts deciding *Corn Products* issues after *Corn Products* seized upon the Supreme Court's analysis of Congress' intentions in enacting Section 117(a) to expand the *Corn Products*

The question, therefore, that the courts attempting to apply the *Corn Products* doctrine should have asked is: was the taxpayer involved in a hedging transaction in which property was used as part of an inventory purchase system solely for the purpose of stabilizing inventory costs? If the answer is yes, then the property falls within the broadly construed exclusion for inventory set forth in Section 1221. If the answer is no, the property does not properly fall under Section 1221 or, therefore, within the *Corn Products* doctrine.

What have the courts done with the *Corn Products* doctrine? A study of existing case law indicates that most courts have focused on an entirely different question. Instead of focusing on the inventory exception of Section 1221, the courts have moved to a more easily manipulated issue—motive.[136] By focusing on the taxpayer's motive, (business motive versus investment motive), the courts, after *Corn Products,* have indeed created a judge-made, non-statutorily based exception.

Do any of the cases following *Corn Products* actually fall within the *Corn Products* doctrine? Do the facts of *W. W. Windle*[137] fit within the inventory exclusion of Section 1221 as broadly construed by the *Corn Products* Court? The Windle Company bought stock in a manufacturing company in order to secure a market for its unprocessed products.[138] The Tax Court concluded that since the stock acquisition had a substantial investment motive which counterbalanced a more predominant business motive, the stock did not fit within the *Corn Products* doctrine and was, therefore, capital in nature.[139]

The "substantial investment motive" test used in *W. W. Windle*[140] was derived from the Supreme Court's reliance in *Corn Products* on an inter-

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doctrine beyond the scope of the Section 117(a) inventory exception, to encompass any expense which is an integral part of the taxpayer's business. *See, e.g.,* Campbell Taggert, Inc. v. United States, 744 F.2d 442, 448 (5th Cir. 1984). The opportunity for this type of expansive reading was left open by the Supreme Court since it was not as explicit as the lower courts in its emphasis of the inventory exception of Section 117(a). The Court's emphasis of the broad construction of exceptions to Section 117(a) was noted and expanded beyond any basis in inventory. *Id.*

136. This line of reasoning arose as a result of the wording of the Supreme Court's opinion in *Corn Products. See Corn Products,* 350 U.S. at 52; *see also, e.g.,* Wright v. Commissioner, 756 F.2d 1039, 1041-42 (4th Cir. 1985); *Campbell Taggart,* 744 F.2d at 458; Agway, Inc. v. United States, 524 F.2d 1194, 1201 (Ct. Cl. 1975); Union Pacific Railroad Company, Inc. v. United States, 524 F.2d 1343, 1355-599 (Ct. Cl. 1975); Midland Distributors, Inc. v. United States, 481 F.2d 730 (5th Cir. 1973); Dearborn Company v. United States, 444 F.2d 1145, 1166 (Ct. Cl. 1971); Schlumberger Technology Corp. v. United States, 443 F.2d 1115, 1121 (1971); Booth Newspapers, Inc. v. United States, 303 F.2d 916, 921 (Ct. Cl. 1962); W. W. Windle Company v. Commissioner, 65 T.C. 694, 707-14 (1976); Electrical Fittings Corp. v. Commissioner, 33 T.C. 1026, 1031 (1960). *But see* Arkansas Best Corp. v. Commissioner, 800 F.2d 215, 221 (8th Cir. 1986), *cert. granted,* 107 S. Ct. 1564 (1987).

137. W. W. Windle Co. v. Commissioner, 65 T.C. 694 (1976); *see supra* notes 35-41 and accompanying text.

138. *Id.* at 695-703.

139. *Id.* at 704.

140. *Id.* at 704-12.

pretation of Congress' intent in drafting Section 1221.[141] Unfortunately, the Supreme Court's focus on the intent of Section 1221 and whether it should be construed broadly or narrowly obscured the Court's more important point. As more clearly stated in the Second Circuit's *Corn Products* opinion, the primary issue was whether the item falls within an exception to Section 1221.[142] A secondary question was whether the inventory exclusion should be broadly construed to include the hedging expenses of the Corn Products Company within the definition of "inventory." The question the court asked in order to ascertain whether the future contracts were in essence inventory was whether the transaction constituted an integral part of the taxpayer's ordinary business operations.[143] This second question was only significant in so far as it shed light on whether the items were inventory. The question as to whether or not there was a business motive standing alone is meaningless in the context of what the *Corn Products* Court narrowly ruled. Furthermore, the question is misleading in that it broadens the scope of the *Corn Products* opinion beyond the field of hedging and its uses for bolstering inventory.[144]

The primary issue is not, as *W. W. Windle* stated, "whether the securities were purchased not for investment, but for business reasons."[145] To shift the focus in this manner obscures the factually narrow holding of *Corn Products.* What the *Corn Products* Court did say was that the commodities futures purchases were found to " 'constitute an integral part of its manufacturing business . . . .' "[146] This finding was important in that it exposed the issue of whether the futures contracts could be construed as inventory, as it is broadly construed under Section 1221 and its legislative history. The business purpose was, then, a secondary issue, important only to the extent that illustrated that the contracts were in actuality held as inventory.

The *W. W. Windle* court focused on the "motive" rather than the inventory exclusion of Section 1221 and, thus, set in motion a judge-made exception never intended by the *Corn Products* Court.[147] Later courts applying a "motive" test to resolve a *Corn Products* doctrine issue cite *W. W. Windle*[148] or *Booth Newspapers*[149] to support the proposition that

141. *Id.* at 706-12.

142. Corn Prods. Refining Co. v. Commissioner, 215 F.2d 513, 514-16 (2d. Cir. 1954).

143. *Id.* at 516.

144. *See Corn Products Refining Co. v. Commissioner*, 350 U.S. at 46.

145. *W.W. Windle,* 65 T.C. at 707.

146. *Corn Products,* 350 U.S. at 51.

147. *W. W. Windle,* 65 T.C. at 703-714.

148. The *W. W. Windle* court cited *Booth Newspapers, Inc. v. United States,* 303 F.2d 916 (Ct. Cl. 1962), as justifying its reasoning.

> [I]f securities are purchased by a taxpayer as an integral and necessary act in the conduct of his business, and continue to be so held until the time of their sale, any loss incurred as a result thereof may be fully deducted from gross income as a business expense or ordinary loss. If, on the other hand, an investment purpose be found to have motivated the purchase or holding of the securities, any loss realized

such a test is relevant.[150] These courts have strayed from the narrow holding of *Corn Products* and perpetuated tests which "lack a basis in the statutory language . . . ."[151]

If the *W. W. Windle* court had focused instead on whether or not the stock bought could be broadly construed as inventory, the court probably would have arrived at the same answer—the stock does not fall within the inventory exclusion and is, therefore, capital—but would have set forth a more narrow holding, less subject to manipulation by the judiciary, taxpayers, and the Commissioner. The *W. W. Windle* court should have concluded under the *Corn Products* doctrine that the stock was not used as a hedge since it was not used in such a manner as to be within the Section 1221 inventory exclusion. The stock could not be considered a part of an inventory purchase system which was utilized *solely* for the purpose of stabilizing inventory costs, so that the stock could not reasonably be separated from the raw woolen inventory items.[152]

Although the *W. W. Windle* court shifted its focus to motive, their analysis was successful. By focusing on the facts showing that the taxpayer bought the stock not only to ensure a market for its products (and, therefore, to enhance production of its inventory), but also as an investment in the operations of a corporation, the court in a circuitous way found that the stock was not purchased solely for the purpose of stabilizing inventory costs. The court, therefore, produced the right result but for the wrong reason.[153] The analysis was correct but the focus was wrong. This has created problems in subsequent cases which perpetuated the wrong reasoning and sometimes produced an incorrect result.

In contrast to *W. W. Windle,* the *Booth Newpapers* decision applied the *Corn Products* doctrine accurately. The Booth Company's purchase of stock to secure a supply of newsprint was described by the Court of Claims as an integral and necessary act in the conduct of its business and, therefore,

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> upon their ultimate disposition must be treated in accord with the capital asset provisions of the Code.

W. W. Windle, 65 T.C. at 708 (citing *Booth Newspapers,* 303 F.2d at 921).

149. 303 F.2d 916 (Ct. Cl. 1962).

150. *See, e.g.,* Wright v. Commissioner, 756 F.2d 1039, 1041-42 (4th Cir. 1985); Campbell Taggert, Inc. v. United States, 744 F.2d 442, 456 (5th Cir. 1984); Agway, Inc. v. United States, 524 F.2d 1194, 1200 (Ct. Cl. 1975); Union Pacific R.R. v. United States, 524 F.2d 1343, 1359 (Ct. Cl. 1975); Midland Distributors, Inc. v. United States, 481 F.2d 730 (5th Cir. 1973); Dearborn Co. v. United States, 444 F.2d 1145, 1166-68 (Ct. Cl. 1971); Schlumberger Technology Corp. v. United States, 443 F.2d 1115, 1120-21, nn.7-8 (1971); Electrical Fittings Corp. v. Commissioner, 33 T.C. 1026, 1031 (1960).

151. *See* Arkansas Best Corp. v. Commissioner, 800 F.2d 215 (8th Cir. 1986), *cert. granted,* 107 S. Ct. 1564 (1987).

152. *See W. W. Windle,* 65 T.C. at 706; *see also supra* notes 38-44 and accompanying text.

153. This reasoning applies equally to the *Roth Steel Tube* case, and to the IRS's position in Revenue Ruling 78-94. *See* Roth Steel Tube Co. v. Commissioner, 800 F.2d 625 (6th Cir. 1986); Rev. Rul. 78.94, 1978-1 C.B.58.

ordinary rather than capital in nature.[154] While this is probably not the desired conclusion, the *Booth Newspapers* court did base its decision in Section 1221 by finding that the stock purchase was best characterized as "the acquisition of a vital source of inventory."[155] Thus, the Court of Claims managed to keep its holding within the *Corn Products* Court's narrow inventory exception, although its finding that stock, as opposed to futures contracts, can be used as a hedge was probably erroneous.[156]

A particularly egregious holding was set forth by the United States Court of Appeals for the Fifth Circuit in *Campbell Taggert.*[157] There the court ruled that an investment company can avail itself of the *Corn Products* rule of ordinary, rather than capital gain or loss, treatment for otherwise capital asset transactions if there was no investment purpose when the asset was acquired solely as an *indirect* means of acquiring a deductible business expense.[158] The *Campbell Taggert* court's application of the "investment motivated purpose" test not only obscured the Section 1221 statutory basis of the *Corn Products* doctrine, but also broadened the doctrine[159] in such a way that it was no longer founded in Section 1221's inventory exception but in the Section 162 business expense deduction.[160]

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154. Booth Newspapers, Inc. v. United States, 303 F.2d 916, 921-22 (Ct. Cl. 1962).

155. *Id.* at 922.

156. *See infra* notes 158-63 and accompanying text.

157. Campbell Taggert, Inc. v. United States, 744 F.2d 442 (5th Cir. 1984); *see supra* notes 79-89 and accompanying text.

158. *Campbell Taggert,* 744 F.2d at 451. The *Campbell Taggert* court stated that the business deduction section of the Internal Revenue Code, I.R.C. § 162 (1982), "defines the boundaries of the narrowest formulation of the *Corn Products* doctrine. . . ." *See Campbell Taggert,* 744 F.2d at 452-53. Unfortunately, the court ignored the *Corn Products* decision's grounding in Section 117(a)'s inventory exception which is certainly narrower than the Section 162 general business deduction section.

159. Ironically, the Fifth Circuit stated:

> *Corn Products* involved the characterization of gain resulting from repetitive, every day transactions 'vitally important to the taxpayer's business.' (citation omitted). Subsequent decisions, however, have seized upon the Court's departure from the constraints of the literal statutory definition and have applied its reasoning in a variety of factual settings less compelling than that before the Court in *Corn Products* itself.

Campbell Taggert, 744 F.2d at 450.

The court's first sentence, however, foreshadowed that it would follow those cases which have departed from *Corn Products* since the court was obviously focused on gain from general business operations rather than gain from hedging transactions used as a source of inventory.

160. The Fifth Circuit's reasoning in *Schlumberger* also ignored the Section 1221 statutory basis of the *Corn Products* doctrine. The court's holding that stock purchases were integral and necessary acts in the conduct of its business does not pursue the requirement that the stock be linked to an inventory system and thus excepted from Section 1221 under *Corn Products.* It is interesting to note that in so holding, the *Schlumberger* court ignored the finding in *Booth Newspapers,* the case it cited as precedent, that the stock purchase in question was most accurately characterized as an acquisition of a source of inventory. *See* Booth Newspapers, Inc. v. United States, 303 F.2d 916, 921-22 (Ct. Cl. 1962).

Section 162 of the Internal Revenue Code of 1986 provides that "There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business . . . ." I.R.C. § 162 (Supp. 1986).

The Fifth Circuit's conclusion in *Campbell Taggert* that the stock was purchased without any investment motive led it to hold that the stock was entitled to ordinary asset treatment.[161] But even if the stock was bought for a business purpose and was acquired solely as an indirect means of acquiring a deductible business expense, one is left to wonder what happened to the *Corn Products* requirement that the asset be bought and held as part of an inventory system solely for the purpose of stabilizing inventory costs so that it is not capital under Section 1221. Was the stock in this case used to stabilize inventory? The only way a corporation can buy stock and hold it as inventory, in the literal sense of the term, is if the corporation is a broker-dealer.[162] The only way a corporation can buy stock and hold it as inventory in the broad sense of that term so as to fall within the Section 1221 inventory exception is if the stock transaction can be characterized as a hedge as set forth in *Corn Products.*

The possibility of hedging inventory with stock purchases seems virtually unachievable because it is hard to imagine a situation where stock can be bought and held *solely* to stabilize inventory in a manner such as that used in commodities futures hedges. At the heart of a stock purchase is the purchase of ownership of a corporation rather than the simple purchase of a commodity. Even if a stock purchase is primarily motivated by a desire to control a corporation to stabilize inventory, there will almost always be an investment purpose in a stock purchase because the purchaser acquires much more than what the *Corn Products* Court called "an inventory system."

Allowing a taxpayer to testify that his sole purpose for purchasing stock in a corporation was to secure a source of inventory only invites manipulation of the standard. Like it or not, the purchaser is an owner, and as such an investor with motives beyond inventory. Consequently, it will be a rare case in which a court can say that stock is purchased as anything other than a capital asset since the *Corn Products* doctrine cannot readily be applied to stock. Any interpretation that a corporation can hedge through stock transactions carries the *Corn Products* doctrine beyond the realm of its statutory basis in Section 1221.

IV. Where Do We Go From Here?

"We do not read *Corn Products* as either requiring or permitting the courts to decide that capital stock can be anything other than a capital asset under Section 1221."[163] These are the words of the Eighth Circuit in

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161. *Campbell Taggert,* 744 F.2d at 460.

162. *Booth Newspapers* held that except for stock sold by dealers in the usual course of their business, capital stock does not fall within any of the express exclusions of Section 1221 which exclude from the concept of capital assets such items of property as stock in trade, inventory, property held for sale to customers and depreciable real property used in a taxpayer's trade or business. *Booth Newspapers,* 303 F.2d at 920.

163. Arkansas Best Corp. v. Commissioner, 800 F.2d 215, 221 (8th Cir. 1986), *cert. granted,* 107 S. Ct. 1564 (1987).

its *Arkansas Best* opinion which the United States Supreme Court has subsequently reviewed.[164] This statement exposes two major problems with the *Corn Products* doctrine as it has been developed by the courts. First, a finding that an asset is not a capital asset must be grounded in the statutory exceptions set forth in Section 1221. Second, because of the nature of stock, it does not fit readily within the inventory exception for commodities hedging as proposed by the *Corn Products* Court.

While a typical application of the *Corn Products* doctrine states that the definition of what is not a capital asset denies that status to assets involved in transactions which constitute an integral part of the taxpayer's ordinary business operations,[165] the Second Circuit's opinion in *Corn Products* demonstrates that this rule was used in the context of a hedging transaction which could be statutorily based in the inventory exclusion of Section 1221.[166] The corn futures contracts in the *Corn Products* case represented ownership of a commodity, and a commodity is inventory in the broad sense because it is used as a stabilizing factor for an inventory system.[167] On the other hand, stock represents ownership in a corporation. Can a purchase of a corporation's stock be considered an inventory system in the sense set forth in *Corn Products?* The analogy between commodities and stock in the context of Section 1221 is a tenuous one.

By continually expanding the *Corn Products* doctrine to include factual situations, such as the purchase of stock, which can not fit within the inventory exception of Section 1221, the courts have used *Corn Products* to create a judge-made exception. It was not the *Corn Products* Court which created this exception, but the courts which subsequently have manipulated the *Corn Products* decision to allow the *Corn Products* doctrine to apply to factual situations outside the commodity hedging transactions for which the exception was created. Ironically, it was the court in *W. W. Windle* which pointed out: "[w]ords are not infinitely elastic."[168]

While many of these cases have fostered the "right" result by holding that stock should be a capital asset, the courts have been "led down the garden path." The *Corn Products* court found that commodities hedges fall within the inventory exception of Section 1221.[169] In describing why commodities hedges are inventory, the Supreme Court looked at the motive of the taxpayer.[170] Because the corn futures were bought for business purposes, they were not an investment.[171] But the analysis must be taken one step further; because the commodities futures bought for the business were in essence inventory, the futures fall within the Section 1221 exception.

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164. *See* Arkansas Best Corp. v. Commissioner, 56 U.S.L.W. 4229 (U.S. March 7, 1988).
165. *See, e.g., Booth Newspapers,* 303 F.2d at 921.
166. Corn Prods. Refining Co. v. Commissioner, 215 F.2d 513, 516 (2d Cir. 1954).
167. *Id.*
168. W. W. Windle Co. v. Commissioner, 65 T.C. 694, 713 (1976).
169. *Corn Products,* 215 F.2d at 515-16.
170. Corn Prods. Refining Co. v. Commissioner, 350 U.S. 46, 51 (1955).
171. *Id.* at 51-52.

The *W. W. Windle,*[172] *Campbell Taggert,*[173] and *Schlumberger*[174] courts failed to make this final distinction. Yes, these stock holdings have, or do not have, a business purpose without an investment purpose, but, above and beyond that, can the stock be fit within the broadly construed Section 1221 exception for inventory because it is held by the business solely to stabilize inventory?

Put in this context the answer with respect to stock transactions will almost always be no. Stock purchases are purchases of ownership in a business. Even if the purchaser is primarily concerned, as in *W. W. Windle,* in stabilizing his inventory, there will most likely be an investment above and beyond inventory in the purchase of stock. This additional investment will necessarily make the stock purchase not solely for purposes of augmenting an inventory system.

For the first time in over 30 years, the Supreme Court reviewed the *Corn Products* doctrine which it created. Their original holding has come a long way and has been applied in a multitude of contexts since its inception. In deciding *Arkansas Best* the Court heeded the Eighth Circuit's admonishment that "the judiciary lacks authority to create exceptions to Section 1221 that Congress did not choose to make."[175] With this is mind, the Court de-emphasized the "substantial investment motive" and "investment motivated purpose" tests and focused on the narrow holding of *Corn Products.* The Court found that the *Corn Products* doctrine has been expanded beyond the point where it can still be considered statutorily based. The *Corn Products* doctrine was limited to the scope initially perceived by the Supreme Court in 1956.[176] The Court could not ground in statute a finding that stock, rather than commodities, is anything other than capital in nature.

V. Conclusion

In *Arkansas Best Corporation v. Commissioner,*[177] the United States Supreme Court clarified the ambiguities surrounding the use of the *Corn Products* doctrine. The great diversity that existed among the district and circuit courts had created confusion, inequitable results, and an unnecessary burden on the judicial system in an attempt to establish the apportionment of tax liability. The Court's *Arkansas Best* decision is important because it will strongly impact the investment strategies of many businesses.

The Court's reasoning in the *Arkansas Best* decision rejects the reasoning exhibited by the *Corn Products* progeny, recognizing that the *Corn Products*

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172. 65 T.C. 694 (1976); *see supra* notes 35-41 and accompanying text.

173. 744 F.2d 442 (5th Cir. 1984); *see supra* notes 79-89 and accompanying text.

174. 443 F.2d 1115 (5th Cir 1971); *see supra* notes 90-97 and accompanying text.

175. Arkansas Best Corp. v. Commissioner, 800 F.2d 215, 221 (8th Cir. 1986), 56 U.S.L.W. 4229 (U.S. March 7, 1988).

176. *See generally Corn Products,* 350 U.S. at 46-54.

177. Arkansas Best Corp. v. Commissioner, 56 U.S.L.W. 4229 (U.S. March 7, 1988).

progeny went beyond the intentions of the drafters of Section 1221, and instead reaffirmed the narrow holding of *Corn Products*. The *Arkansas Best* decision will restore the integrity of the *Corn Products* decision while providing a definitive standard which can be easily and equitably applied.

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