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U. S. TAX CONSEQUENCES OF FOREIGN CURRENCY FLUCTUATIONS*

DONATELLO M. ROSIGNOLI**

The Internal Revenue Code and the Treasury Regulations thereunder do not, except in very minor ways, focus directly on the difficulties of the tax treatment of income arising from changes in value of foreign currency. Nor have the courts and commentators yet agreed upon a coherent set of rules for the various forces of the problem.

Gillin v. U. S., 423 F.2d 309 (1970).

In early May, 1971 central banks of certain major European countries temporarily suspended the use of the system adopted at Bretton Woods 25 years ago, which required the conversion of their national currencies into U. S. dollars at relatively fixed exchange rates. The overflow of U. S. dollars into the Deutsche Bundesbank weakened the belief that the German mark-U. S. dollar parity could be maintained, and, as a result, Switzerland and Austria increased their exchange rates 7% and 5% respectively, while Germany, Belgium and the Netherlands allowed their currencies to float against the dollar.

Contemporaneously, on another continent, opposite reactions took place, due to entirely different reasons. In Uruguay, a slight devaluation of the peso was instituted for the purpose of determining exchange rates on current account remittances, and Argentina underwent a mini-devaluation of about 1% on its *peso* in order to defray the impact of its trade deficit.

U. S. corporations engaged in international business and those persons dealing in transactions affected by foreign currencies will feel the

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**B.B.A., Pace College; M.B.A., New York University; C.P.A., Tax Manager, Lybrand, Ross Bros. and Montgomery, Miami. Mr. Rosignoli is initiating law studies at the University of Miami School of Law in September, 1971.

economic impact of these changes to a degree not covered by protective measures taken concurrently or prior to these events. It is to the U. S. tax consequences of such events that this article devotes its attention.

Origin of fluctuations

Two separate exchanges take place in each international transaction, namely:

- A commercial or financial exchange, and
- The transfer of one national currency into another in order to effect payment.¹

For example, a U. S. exporter selling in Italy prefers payment in U. S. dollars. As a result, the Italian importer must obtain the necessary U. S. dollars in exchange for his Italian lire, in order to liquidate his debt. The converse holds true for a U. S. importer purchasing in Italy—i.e., the U. S. importer must obtain Italian lire in exchange for his U. S. dollars, to liquidate his debt. One party, therefore, will seek conversion of a foreign currency, and will do so in the foreign exchange market, creating what is known as an “international monetary transaction.”²

Each international monetary transaction involves the exchange of one currency for another, based on a predetermined exchange rate which is the price of one currency in terms of another. As a result of the exchange, an American purchasing Italian lire will be in a more advantageous position if he receives 650 lire for one U. S. dollar rather than only 600. For the Italian purchasing the U. S. dollars, the reverse holds true.

Just as the price of goods is affected by the elasticity of supply and demand, so is the relative exchange rate of foreign currencies vis-à-vis one another. If the U. S. dollar-lira rate is 1.00:600 and the demand for lire decreases, the price of lire in terms of U. S. dollars will decrease (e.g., to 1.00:700), and the lira is said to have “depreciated.” If the converse happens (e.g., the rate increases to 1.00:500), the lira has “appreciated.”

Evaluation of the various elements of supply and demand and other factors which account for the day-to-day fluctuations in foreign exchange is beyond the scope of this article.³ It is sufficient to note that there are everyday fluctuations of a slight nature, and that there are occasional fluctuations which are more drastic and severe in size. The latter are usually the result of measures implemented by countries plagued by trade deficits in order to improve their balance of payments position, or, as seen lately, to raise their parity values vis-à-vis a declining U. S. dollar.

The tax questions

Devaluations and reevaluations of foreign currencies affect U. S. taxpayers with direct interests in foreign currencies (such as a dealer or speculator would have) or indirect interests (such as a parent of a foreign subsidiary would have). Currency fluctuations will give rise to financial gains or losses, depending upon the relative position of the holder with respect to the affected currency.

Example. A U. S. company has accounts receivable for 1,300,000 Italian lire and accounts payable for 2,600,000 lire. At the times the receivables and the payables arose (Stage I), 650 lire were worth one dollar; when the accounts were settled (Stage II), 600 lire were worth one dollar. As a consequence, the U. S. company sustained a loss of \$167, determined as follows:

	<u>Stage I</u>	<u>Stage II</u>	<u>Gain (Loss)</u>
Accounts payable	L. 2,600,000 \$ 4,000	L. 2,600,000 \$ 4,333	. \$(333)
Accounts receivable	L. 1,300,000 \$ 2,000	L. 1,300,000 \$ 2,166	. 166
Net financial loss (in U. S. currency)			<u>\$(167)</u>

Three tax questions arise:

- Whether such financial loss is deductible;
- If deductible, when (i.e., at time of the reevaluation of the foreign currency, at the time the actual transactions giving rise to the loss were consummated, or at some other point in time); and
- If deductible, what kind of loss is it?

Of course, if a gain had resulted, the same "whether, when, and what kind" questions would arise as to the taxation of the gain.

Limited guidelines available

Generally, the Code and regulations do not specifically provide for the tax treatment of gains and losses arising from foreign currency fluctuations.⁴ Ordinarily, income derived from such fluctuations is included in taxable income under Sec. 61's broad definition of gross income; losses are deductible if they qualify as business or income-producing expenses under Sec. 162 or 212.

Through the years, certain guidelines which now govern the U. S. tax treatment of the financial and economic results brought about by both devaluations and revaluations of foreign currencies have been established mainly as a result of cases litigated in the courts. Unfortunately, however, the guidelines derived from court decisions, especially those of old vintage, may be construed narrowly when applied to different fact patterns, thus creating uncertainty and controversy. For example, in order to have a recognizable gain and/or a deductible loss, the transaction giving rise to such gain or loss must be, *in most instances*, a "closed transaction."⁵ The qualification, "*in most instances*," is necessary because this rule will be considered inapplicable in "*certain instances*." This will be true of many of the other general principles which will be discussed.

Classes of transactions and taxpayers

The diversity in tax results is partly attributable to the diversity in classification of transactions in foreign currencies and in the taxpayers who engage in them. Foreign currency, from a U. S. taxpayer's viewpoint, can be classified as a commodity,⁶ as a capital asset,⁷ or an inventory-like asset.⁸

The multi-faceted tax consequences of foreign currency fluctuations will be discussed under the following headings:

- Dealers,
- Speculators and investors,
- Foreign branches of U. S. corporations,
- Foreign subsidiaries of U. S. corporations,
- Purchases of goods and services,
- Sales of goods and services,
- Repayment of foreign currency loans,
- Hedging, and
- Blocked currencies.

Dealers

A dealer in foreign exchange is ". . . one who regularly engages in the purchase and resale to customers of foreign money with a view to the gains and profits that may be derived therefrom" This type of person engages in foreign exchange transactions as a matter of course

in his trade or business, with foreign exchange as his stock in trade. A dealer can inventory foreign currency held for sale, as any other businessman would do with his particular commodity. Particularly in this case, foreign currency is equated to a commodity or a security, and can be valued at the year-end at cost or market, whichever is lower.¹⁰

The foregoing accounting treatment offers one tax advantage to the dealer in that he is not bound by the "closed transaction" rule (previously mentioned) in order to recognize losses on declines in value of the foreign currency within his possession.¹¹ Under the lower of cost or market method of inventorying, a dealer secures an ordinary loss for the decline in value of foreign currency which occurred within the taxable year.

Speculators and investors

Persons who purchase foreign exchange with the predetermined intent to sell it for a profit—but not in the ordinary course of business—are viewed as investors. In this case the foreign currency is considered held as a capital asset under Sec. 1221's definition of such term.¹² OD 764¹³ precludes the recognition of shrinkage in value of such currency due to a fall in the rate of exchange, and gain (or loss) is only recognized at the time of sale. At that time, the amount to be recognized as a capital (long or short-term) gain or loss¹⁴ will be the difference between the tax basis (ordinarily the cost of the foreign currency) and the amount received at the time of disposition.¹⁵

Foreign branches of U. S. corporations

A U. S. corporation can appraise the assets and liabilities (except capital assets) of its foreign branches at the close of each taxable year, at the rate of exchange prevailing on that date.¹⁶ Under the "net worth method," gains and losses arising from currency fluctuations during the year are reflected in income, even though no completed transaction has taken place.¹⁷ An alternative method,¹⁸ known as the "net income method," is to first compute the net profits of the branch in foreign currency, subtracting the remittances to the home office (also in foreign currency). The profits remitted to the home office are then converted into U. S. dollars, using the exchange rate applicable on the date of the remittances, and the remaining undistributed profits are converted at the rate of exchange applicable on the last day of the taxable year. The IRS has given some recognition to the latter method, and the decision in *American Pad & Textile*¹⁹ somewhat strengthens the correctness of its use in

reporting foreign branch operations—as long as there is consistency in its use.

Foreign subsidiaries of U. S. corporations

Ordinarily, where the foreign business of a U. S. corporation is conducted through one or more foreign subsidiaries, the U. S. parent does not report any gains or losses arising from the appreciation or shrinkage of foreign currencies held by the subsidiaries. Only at the time of liquidation can fluctuations in the value of the subsidiaries' assets be taken into account.²⁰

However, with respect to the reporting of subpart F income, the exchange gains and losses computed under Regs. Sec. 1.964-1(e) must be allocated between subpart F income and non-subpart F income for any taxable year in which both types of income exist.²¹

For purposes of computing the foreign tax credit on dividends paid or deemed paid by a foreign subsidiary, the earnings and profits of such subsidiary is adjusted only with respect to "realized" gains and losses. However, Regs. Sec. 1.964-1(e)(1), pursuant to specific calculations, allows the offset of both realized and unrealized gains and losses against earnings and profits if a "minimum distribution" election under Sec. 963 is made.

Purchases of goods and services

Fluctuations in foreign exchange occurring after an obligation is incurred are usually recognized at the time payment for the goods (or services) is made.²² As a result, where the exchange rate at the time of purchase of the goods is lower than the exchange rate at time of payment, no loss can be recognized. Conversely, no taxable gain is realized if the foreign currency appreciates subsequent to the date of purchase.

The foregoing theory espouses the recognition of the purchase of the goods or services and the foreign exchange purchase as one transaction. Such rationale, however, has been successfully contested in several cases, resulting in the creation of a "separate transaction" theory—which considers the purchase of goods as a separate tax event from the purchase of foreign money and, in effect, infers an intent of speculation by the purchaser.

*Bernuth-Lembcke Co.*²³ In this case, *T* contracted to purchase 110,000 pounds sterling at \$3.86 per pound in early 1920. In late 1920, when the pound had dropped to \$3.50, *T* paid for the foreign exchange and used

it to purchase creosote oil from England. As a result, *T* paid \$39,600 more for the 110,000 pounds sterling (and for the creosote oil) than if he had purchased the foreign currency on the date he paid for the creosote oil. This amount was held deductible in 1920 as an exchange loss, on the theory that the creosote oil had to be inventoried at a value corresponding to the one determined by translating its cost in U. S. dollars at an exchange rate of \$3.50 to 1 pound sterling, and not at the amount represented by the contract to purchase pound sterling at \$3.86. The contract for pound sterling was deemed to be a separate transaction from the purchase of the creosote oil. It is stressed that, in this case, the foreign exchange was purchased prior to the creosote oil—a fact which strongly supports the separation of the two transactions.

*Joyce-Koebel Co.*²⁴ Relying on the *Bernuth-Lembke* theory, this landmark case also separated the inventory purchase from the foreign currency transaction. In *Joyce-Koebel Co.*, *T* purchased merchandise on credit in London, and discharged his obligations with respect to such purchases with pounds sterling acquired in New York. The cost of goods was determined on the basis of the exchange rate prevailing at the date of purchase of the goods, and the sterling gain and loss by taking the difference between the exchange rates at the date of purchase and at the date of payment.

The Board of Tax Appeals reasoned as follows: (1) *T* purchased goods with the price payable in pounds sterling; (2) payment could have been made either by purchasing pounds on the same date of purchase of the goods or by establishing credit for payment at a future date; (3) cost of goods, in any event, had to be recorded as of the date of purchase (*Bernuth-Lembke* theory); (4) the purchase on credit involved a speculation in foreign exchange; and (5) any gain or loss on the foreign exchange phase of the transaction should not influence the cost of the goods. In view of the foregoing, the Board concluded that the proper method of accounting was to record the purchases of goods at the rate of exchange prevailing on the date of acquisition, and to account for the fluctuations in foreign exchange as a separate transaction.

Evaluation. Although upheld in a number of subsequent cases,²⁵ the “separate transaction” theory is subject to criticism. That is, the speculative aspect of the transaction (especially in cases such as *Joyce-Koebel*) is not created by the taxpayer willfully for the purpose of speculation, but is merely a by-product of the basic “purchase of goods” transaction. The separate transaction doctrine can give rise to large gains (or losses) where a drastic currency fluctuation occurs between the date of purchase of the goods and the date of payment.

Exchange gains and losses resulting from the foregoing transactions have been ruled as being of an ordinary and not a capital nature. Importers' attempts to parallel separate transaction gains to normal capital gains have always been denied.²⁶ It appears, therefore, that the classification of this type of income and losses as ordinary has become an accepted doctrine.

Sales of goods and services

In order to prevent losses from foreign currency devaluations, U. S. exporters prefer to require payment of their receivables in U. S. dollars. This practice, however, cannot always be implemented; at times, receivables are collectible in foreign currency.

The separate transaction doctrine, applied to import dealings, has also been applied to export transactions in which the sale price is collected in a foreign currency. In such cases, income and losses are recognized to the extent of the difference between the U. S. dollars which would have been realized from the amount of the foreign currency due at the time of the closing of the export transaction and the U. S. dollars subsequently obtained upon exchange of the foreign currency received in settlement of the open account.

*Foundation Company.*²⁷ Exemplary of the foregoing treatment is *Foundation Company. T*, a U. S. construction company, built various facilities for a Peruvian corporation, with periodic payments falling due as the construction progressed. At one point in time, the Peruvian corporation fell in arrears, creating a substantial indebtedness. At the time the indebtedness was incurred, the U. S. dollar was worth 2.50 Peruvian soles, and *T* accrued the aggregate amount of the receivables at that rate on its books and income tax returns. *T* and the Peruvian company, thereafter, entered into an agreement which allowed the accumulated indebtedness to be repaid over a five-year period (which was subsequently extended). In the final analysis, *T* succeeded in collecting a substantial portion of the total amount of soles due, but they were worth less in terms of U. S. dollars than at the times the amounts were booked. The resulting losses were deducted as ordinary losses by *T* in the years in which payments were actually received. The IRS disallowed the losses on the theory that the debt agreement required the repayment to be made in soles, and *T* did, in fact, receive the amount of soles due to him.

The IRS relied on *B. F. Goodrich Co.*,²⁸ where a U. S. borrower's repayment on a franc loan from a French bank was held not to give rise to taxable income, even though the borrowers purchased the French

francs used in the payment at a lower exchange rate than the one prevailing at the time the debt was incurred. The Tax Court recognized that "a mere borrowing and returning of property does not result in taxable gain," but nevertheless decided in favor of *T*. It was reasoned that the indebtedness in *Foundation* arose in the course of *T*'s ordinary business which, as distinguished from a mere repayment of a debt as in *Goodrich*, created a taxable event. The receipt of U. S. dollars in a lesser amount than the sum accrued and reported as taxable income caused a loss and entitled *T* to recover the basis previously established via an ordinary tax deduction.

With respect to timing, the IRS contended that the loss deduction should have been allowed only in the year in which the total indebtedness was repaid in full, "closing out" the whole transaction. However, the Tax Court found for *T* on this issue as well, ruling that the losses became fixed and certain upon receipt and conversion of each payment.

The last issue in this case involved the classification of the loss. The IRS argued that the loss should have been a capital loss, contending that the receipt and disposition of the soles constituted the "sale or exchange of a capital asset." Again disagreeing, the Tax Court classified the soles converted by *T* as "property held for sale to customers in the ordinary course of business" and not held for investment purposes. As a consequence, the losses were ruled to be of an ordinary nature.

*Columbian Rope Co.*²⁹ In this case, citing *Foundation Co.*, the Tax Court held that *T* realized a loss when the U. S. dollar equivalent received three years after the un-blocking of a foreign currency was less than the amount reported as an accumulated profit at the time of such un-blocking. The IRS has acquiesced to this decision.³⁰ This acquiescence, of course, strengthens the tax theories espoused in *Foundation Co.*

Question. It is again stressed, however, that the decisions and the theories discussed were the product of a particular set of facts, and one cannot readily extrapolate what tax results would have been created under slightly different circumstances. For example, would *Foundation Co.* have been decided differently if the Peruvian company had paid its debt in soles at the time the receivable was accrued by *T* and if the soles were converted at intervals during succeeding years, at different rates of exchange? Possibly, if the soles had not been immediately converted, their subsequent conversion could have given rise to a capital gain or loss, on the theory that they were held over time for speculative reasons.

Repayment of foreign currency loans

One of the most controversial areas involves the treatment of exchange gains and losses arising from the repayment of foreign currency loans.

Gillin,³¹ *Goodrich*,³² and *Coverdale*.³³ In *Gillin*, the most recent decision, the Court of Claims held that the exchange profit realized on the repayment of borrowed Canadian dollars which had been immediately converted into U. S. dollars for personal and investment purposes, was taxable as ordinary income from the discharge of an indebtedness for less than the amount owed.

In a comprehensive opinion, the Court analyzed a line of previous cases dealing with this issue. *Goodrich* (discussed above) was distinguished because of the dissimilarity of the facts; moreover, the broad generalization in *Goodrich* that "a mere borrowing and returning of property does not result in taxable gain" was rejected. In this context remember that, in *Goodrich*, *T* did not purchase the French francs for one amount and later resold them for a larger amount, but merely entered into a foreign exchange transaction only once—i.e., at the time the French francs were required to repay the debt.

The Court of Claims also refused to follow *Coverdale*. In *Coverdale*, the Tax Court applied the *Goodrich* rationale to dissimilar facts. That is to say, in *Coverdale*, *T* obtained a loan in foreign currency and converted such currency into U. S. dollars which were used in the U. S. At a later date, *T* repaid the loan with a foreign currency repurchased at a more advantageous (lower) rate of exchange than existed at the time of borrowing. As a result, in *Coverdale* (as in *Gillin*) there were two separate foreign exchange transactions; on the other hand, in *Goodrich* only one foreign exchange transaction took place, i.e., at the time of repayment. Would the result in *Gillin* have been different if the Canadian dollars borrowed had been used in Canada, and U. S. dollars had been involved only in the purchase of the Canadian dollars necessary to repay the loan?

In *Coverdale* the Court also cited the fact that *T*'s dealings to which the currency borrowed was applied resulted in a loss, and therefore the recognition of an exchange gain would not have given rise to any tax;³⁴ this consideration was not entertained by the Court in *Gillin*. Reasons for the recognition of income in *Gillin* were, in part, related to the reasoning advanced in *Willard Helburn, Inc.*³⁵ and *KVP Sutherland Paper Co.*³⁶

Willard Helburn. Here, *T* purchased lambskins from New Zealand on 120-day sight drafts, payable to an intermediary merchant banker in

pound sterling. There was a substantial devaluation of the pound sterling between the date of issuance of the 120-day sight drafts and the date of their payment by *T*, both dates falling within the same taxable year. As a result, *T* was able to purchase the necessary covering pounds at a rate materially lower than if the exchange rate had remained constant. In its tax return, *T* priced the purchased goods at the *higher conversion rate* existing at the date of purchase, but did not recognize any income on the gain which arose from the repayment of the sight drafts with pound sterling purchased at the *lower conversion rate*. The Court of Appeals ruled the gain taxable as ordinary income. The Court theorized that *T* engaged in a speculation in foreign exchange by having the pound sterling drafts drawn on itself and endorsed in blank, when it could have borrowed U.S. dollars on 120-day promissory notes and used such dollars to discharge the pound sterling obligation immediately, thus avoiding any possible currency fluctuations.

The apparent distinguishing facts in *Willard Helburn* (as compared to *Goodrich* and *Coverdale*) are that a purchase of goods was involved and a distinct economic gain inured to *T* from the tax advantage of an overstatement in inventory values and the gain on foreign exchange. Additionally, in *Goodrich* and *Coverdale*, the foreign currency was treated as a commodity, while in *Willard Helburn* it was recognized as a medium of exchange which was used to purchase stock in trade. But what happened to the "commodity theory" in *Gillin*? Obviously it was not recognized, giving way to an "economic benefit windfall" theory applied in its narrowest sense, with the imposition of the all-embracing sweep of Sec. 61(a).³⁷

KVP Sutherland Paper Co. This decision also rejected the treatment of foreign exchange as a commodity, although no purchase of goods was involved and the lender was a U.S. person. This decision was relied upon in *Gillin* to circumvent and negate the "commodity theory" adopted in *Goodrich*, and to deny capital gain treatment on the income realized as a result of the foreign exchange fluctuations.

KVP Sutherland is noteworthy in that it tackles the problem of foreign exchange gains to a U.S. lender, as opposed to the more common situation involving a U.S. borrower. In this case, a U.S. parent made loans to its Canadian subsidiary in Canadian dollars, secured by notes. The notes were thereafter repaid in Canadian dollars, which were subsequently converted into U.S. dollars. At the date of repayment, the value of the Canadian dollar had increased vis-à-vis its value in terms of U.S. dollars on the date the loans were made. The IRS sought to have the gain realized on the date of repayment taxed as ordinary income (as

well as the further gain realized on the later conversion into U.S. currency) on the ground that the Canadian dollars converted were not capital assets in the hands of the taxpayer. The Court recognized the notes as capital assets but nevertheless treated the gain on repayment as ordinary income. The Court reasoned that the repayment of a debt instrument does not constitute a "sale or exchange" within the meaning of Sec. 1222. The Canadian dollars were also classified as capital assets, but the gain was short-term inasmuch as such dollars had been held by *T* less than the period required for long-term treatment.

Summary. Before the *Gillin* decision, *Goodrich* and *Coverdale* allowed U.S. borrowers (in similar situations) to escape taxation. On the other hand, U.S. lenders were (and are) taxed on the gains resulting from a favorable change in the exchange rate,³⁸ and could (and can) deduct a loss arising from a decline in value of the debt but not until the repayment of the loan had (has) taken place.³⁹

As a result of *Gillin*, it appears unlikely that U.S. borrowers will escape taxation of their exchange gains in the future; instead their treatment will compare with the one accorded U.S. lenders.

Hedging

A person dealing in international markets can avoid unfavorable changes in foreign exchange by creating an offsetting liability or asset in the foreign currency at the time the commitment to receive or pay monies in the future is made. For example, an American exporter who is due to receive a payment in Italian lire 120 days from now, might immediately borrow the lire in Milan and sell them for dollars. Such a precaution involves an interest cost (or profit)—i.e., the difference between the interest paid to the Italian lender and the interest that can be earned on the U.S. dollars. To the same effect, an importer could also maintain bank accounts in foreign currencies abroad or even with a local U.S. bank. At the time an obligation payable in foreign currency in the future is incurred, the foreign currency necessary to repay it could be purchased and placed in the bank accounts so as to be available at time of payment.⁴⁰

The foregoing "protection" methods, however, require a current tie-up of capital. A comparable degree of "protection" and avoidance of capital stagnation, however, can be achieved by purchasing foreign exchange currently for delivery at a future date.

An American exporter who is due to collect 10 million lire in 90 days knows that the value of the lire can decline to his disadvantage during

that period. In order to minimize his risk, he can sell 10 million lire forward. That is to say, he makes a contract to exchange 10 million lire in 90 days at a specified exchange rate, called the forward rate. By so doing, he is sure to receive the desired amount of dollars. This transaction is commonly known as a "hedge." Its purpose is to minimize the exchange risk by securing forward cover for the export transaction.⁴¹

Declines in currency values will also cause a decline in the value of those assets held in the country of devaluation which are valued in that country's currency. The forward exchange market can offer protection against this type of risk as well. For example, inventories and short-term investments held abroad can be protected with short sales of the foreign currency in which they are denominated.

A short sale of foreign exchange, in effect, is similar to a short sale of securities. The seller is obligated to deliver a fixed amount of foreign currency at an agreed-upon future date, at a price fixed on the date of the short sale. On the date of delivery, the seller purchases the foreign currency necessary to "cover" his short sale at the rate of exchange prevailing on such date. The difference between the exchange rate agreed upon at the time of the short sale and the exchange rate on the date of "cover" gives rise to an exchange gain or loss to the seller.

Ordinary vs. capital gain or loss. Various questions have to be answered in order to classify, for U. S. tax purposes, the type of gain or loss resulting from hedging transactions. Again, unfortunately, the answers must be sought in tax cases—rather than Code sections or regulations.

In order to have an ordinary gain or loss, there must be a true and definite "hedge," undertaken for the sole purpose of temporarily protecting one or more assets, as opposed to an investment in foreign currency futures. In a leading case, *Wool Distributing Corp.*,⁴² an international wool dealer sold short pounds sterling and French francs in amounts necessary to cover the losses which a possible devaluation of these currencies could have caused as a consequence of its wool holdings in the respective foreign currencies. The short sales resulted in losses to *T*, which he deducted as ordinary against income derived from transacting in wool futures. The Tax Court held for *T*, on the theory that the foreign exchange futures were, under the circumstances, a ". . . form of price insurance and thus connected so closely with the regular conduct of a trade or business as to defy classification as extraneous investments."⁴³

The Court indicated that "currency hedging" gains and losses will be classified as "capital" where there is a larger amount of futures than

of actuals, or an absence of price relationship between the two—i.e., there would be a transaction entered into for investment and not for hedging purposes. According to this dictum, the presence of the foregoing facts will result in the transaction being treated as a sale or exchange of a capital asset.

Litigation involving future contracts, in the main, deals with commodities in their true form, such as inventories. From such litigation, we can extrapolate the rule that, where inventories are involved and the presence of actual hedging can be sustained, the tax consequences thereof will be deemed as ordinary income or loss arising from the conduct of a trade or business.

Of course, if a capital asset is hedged against, the foreign exchange gain or loss will be capital. There seems to be no authoritative pronouncement, however, for computing the holding periods when foreign exchange is sold short to minimize the risk of an investment in a foreign capital asset, e.g., a foreign corporation's stock. As a consequence, it will be necessary to decide whether the closing of the short sale of the foreign exchange results in a short-term capital gain or loss (even though the hedged-against stock has been held over six months), or whether it is the holding period for the stock which determines the character of the gain or loss from such short sale. Additionally, it should not be overlooked that under a far-fetched interpretation of Sec. 1233 the gain or loss from both the stock investment and the foreign exchange transactions may be characterized as short-term.

Blocked currencies

It is often assumed that foreign currencies, by whatever means acquired, can be converted into U. S. dollars at the will of the holder. Over the past years, as well as in the present, this assumption has been made unrealistic by various foreign exchange controls instituted by many countries in order to curtail the outflow of "home currency." Additionally, no ready market or determinable exchange rates exist for certain currencies, which makes their conversion into U. S. dollars impossible.

A total impossibility of conversion will usually trigger a deferral or elimination of U.S. income, while limited convertibility will create income to the extent of conversion rates established by the IRS or the courts. In the case of blocked currencies, the deferral of U.S. income can be elective.⁴⁴ The election allows the payment of tax to be deferred until the year in which the income loses its "deferrable" status.⁴⁵ Consequently, the exchange rate of the blocked currency may change in the period beginning at the

time the income should have been recognized and ending when it is finally recognized.

This occurred in *Columbia Rope Co.*⁴⁶ where *T* operated a branch in the Philippines. *T* elected under Mim. 6475⁴⁷ to defer 1951 profits blocked by currency controls imposed by the Philippine Government. Six years later, in 1957, nonresidents were authorized to use the blocked currency to purchase gold bullion, provided it was resold to the Philippines Government. This authorization caused the deferred income to lose its status, and *T* included in 1957 income the blocked 1951 profits, converting the branch profits into U. S. dollars at the 1957 rate of 3.64 pesos to a dollar. *T*, however, was not able to purchase and sell any gold until 1960, three years later, at which time the conversion rate for the Philippine peso had declined to 4.285 pesos per dollar. *T* claimed the loss resulting from the devaluation of the peso as an ordinary deduction under Sec. 165 in the year the gold was sold. The IRS contended that the transaction was closed in 1957, the year in which the branch income was no longer deferrable under Mim. 6475. The Tax Court held for *T*, on the theory that the payment of U. S. tax on the foreign currency established a tax basis for such currency to the extent of its value in 1957.

Since the decision has been acquiesced to,⁴⁸ it seems that the IRS now agrees that the separate transaction theory espoused with respect to import dealings also applies in the case of blocked foreign currency. That is to say, the recognition of the blocked income as U. S. taxable income upon the loss of its restricted status (first transaction) establishes a tax basis for the foreign exchange pursuant to the exchange rate prevailing at the time of such recognition. The subsequent actual conversion into U. S. dollars (second transaction) will determine the amount economically realized upon sale or exchange. The difference (if any) between the two will be recognized as income or loss which apparently will bear the taxable taint of the first transaction, i.e., ordinary or capital.

Selecting the applicable exchange rate

A basic question inherent in the tax treatment of foreign currency fluctuations, which has not been covered in this article, is: What exchange rates should be used in converting from or to a given foreign currency? The U. S. value of foreign currencies can, of course, cover a span with different limits, and exchange rates for the same currency can vary at the same point in time.

From a U. S. tax viewpoint, the rate of exchange which most clearly reflects income should be used—of course. But the selection of the appro-

priate rate is often complicated by the exchange regulations enacted by various foreign countries. Where multiple exchange rates exist, it would seem that the selection should conform with the circumstances surrounding the taxpayer's operations.

The courts appear to prefer the use of the New York free market value, or an estimate thereof based on personal, corporate, military, political and economic circumstances. On the other hand, the IRS prefers to use the official rate of exchange.

Legislation needed

An attempt has been made to capsule within a few pages the myriad of rules applied by the courts—not necessarily in a consistent manner—in a tax area for which the Code and regulations fail to specifically provide guidelines.

Today, more than ever, specific legislation is sorely needed in this area, but it appears that nothing serious is in the offing. The international monetary authorities are attempting to create a system of exchange rates which will hold currency fluctuations to a minimum, as an integral step toward solving the overall problem of international liquidity; but it may be decades before anything significant develops.

For the time being, therefore, existing problems can only be solved by removing the dust from the old case books, and letting one's tax creativity "do its thing."

FOOTNOTES

¹Of course, there may not be a foreign exchange phase to each international transaction. For example, an importer may purchase enough foreign currency to cover payments for several prospective purchases.

²For discussion purposes, it is assumed that a purchaser of goods or a borrower of money in an international transaction will make payments in the domestic currency of the seller or the lender. Of course, this is not always true. For example, a seller may agree to accept payment in the currency of the purchaser and leave the currency on deposit in a bank located within the purchaser's country or use such funds to satisfy indebtedness owed in the currency of the purchaser. Thus, an importer of goods from Italy may deposit U. S. dollars in a U. S. bank account in the seller's name; the latter may then use the funds to discharge obligations to U. S. creditors.

³For a complete treatise on the foreign exchange market, see Ingo Walter, *International Economics—Theory and Policy* (New York: The Ronald Press Company, 1968).

⁴Limited exceptions are provided in the regulations under subpart F, which will be discussed under the heading "Foreign subsidiaries of U. S. corporations."

⁵Wheatley, 8 BTA 1246, acq. in method of determining loss only; Louis Roessel, 2 BTA 1141, acq.; and Joyce-Koebel, 6 BTA 403, acq.

⁶B. F. Goodrich Co., 1 TC 1098, acq.

⁷IT 3810, 1946-2 CB 55.

⁸OD 834, 4 CB 61.

⁹See note 8. For specific attributes identifying dealers, see Albert Fried, 299 US 175 (18 AFTR 621, 37-1 USTC ¶9004); and C. E. Wilson, CA-10, 76 F2d 476 (15 AFTR 1156, 35-1 USTC ¶9245).

¹⁰See note 8. Regs. Sec. 1.471-5 permits dealers in securities to use "cost," "cost or market," or "market" only.

¹¹See note 10.

¹²No section of the Code precludes the classification of foreign currency as a capital asset. See also Bittker and Ebb, *United States Taxation of Foreign Income and Persons* (Branford, Conn.: Federal Tax Press, Inc., 1968), p. 489.

¹³4 CB 155.

¹⁴IT 3810, 1946-2 CB 55.

¹⁵L. D. Beaumont, 25 BTA 474, acq.; P. Cannizzaro & Co., 19 BTA 380; and J. A. Wheatley, 8 BTA 1246, acq. In IT 3810 (note 14), the IRS considered a capital transaction the mere depositing of U. S. dollars in a Mexican bank by a U. S. tourist seeking conversion into Mexican pesos and their subsequent re-conversion into U. S. dollars at a loss.

¹⁶The rates of exchange used in the conversion will be subject to check upon audit by the IRS. The rate to be used is the one which most clearly will reflect income, either being the official rate of exchange, the open market rate, or some other rate. See Special Ruling, February 26, 1935, 35-3 CCH ¶6201. Also see the discussion under "Selecting the applicable exchange rates" and the table of exchange rates on page 398.

¹⁷OD 489, 2 CB 60. Salt Textile Mfg. Co., 26 F2d 249 (6 AFTR 7686, 1 USTC ¶274).

¹⁸OD 550, 2 CB 61.

¹⁹American Pad & Textile Co., 16 TC 1304, acq.

²⁰GCM 4954, VII-2 CB 293.

²¹Regs. Sec. 1.952-2(c)(2)(v).

²²OD 489, note 17.

²³1 BTA 1051.

²⁴6 BTA 403.

²⁵Willard Helburn, Inc., CA-1, 214 F2d 815 (45 AFTR 1830, 54-2 USTC ¶9513); Church's English Shoes, Ltd., 24 TC 56; America-Southeast Asia Co., 26 TC 198; and Bennett's Travel Bureau, Inc., 29 TC 350.

²⁶Church's English Shoes, Ltd. and America-Southeast Asia Co., note 25.

²⁷14 TC 1333.

²⁸1 TC 1098.

²⁹42 TC 800.

³⁰1965-1 CB 4.

³¹John A. Gillin, Ct. Cls., 423 F2d 309 (25 AFTR2d 70-864, 70-1 USTC ¶9341).

³²Goodrich, see note 6.

³³William H. Coverdale, 4 TCM 713.

³⁴The same reasoning was applied in Kerbaugh-Empire Co., 271 US 170 (5 AFTR 6014, 1 USTC ¶174).

³⁵Willard Helburn, Inc., note 25.

³⁶KVP Sutherland Paper Co., Ct. Cls., 344 F2d 377 (15 AFTR2d 919, 65-1 USTC ¶9358). IT 2404, VII-1 CB 84.

³⁷" . . . all income from whatever source derived. . . ."

³⁸See KVP Sutherland Paper Co., note 36.

³⁹Haviland, CA-2, 20 F2d 905 (6 AFTR 6879, 1927 CCH ¶7224).

⁴⁰Leland B. Yeager, *International Monetary Relations*, (New York: Harper & Row, 1966), pp. 218-219.

⁴¹For a discussion of the mechanics of the forward market for foreign currencies, see Ingo Walter, *International Economics—Theory and Policy* (New York: The Ronald Press Company, 1968), pp. 235-238.

⁴²34 TC 323.

⁴³See also Corn Products Refining Co., 350 US 46 (47 AFTR 1789, 55-2 USTC ¶9746); and America-Southeast Asia Co., note 25.

⁴⁴Mim. 6475, 1950-1 CB 50 (as amended by Mim. 6494, 1950-1 CB 54); and Mim. 6584, 1951-1 CB 19.

⁴⁵For the criteria under which "blocked" income is no longer deferrable, see Announcement 59-32, IRB 1959-13, 38.

⁴⁶See note 29.

⁴⁷See note 44.

⁴⁸1965-1 CB 4.