

1972

## Tax Consequences of Foreign Currency Fluctuations

Sheldon S. Cohen

Follow this and additional works at: <https://scholarship.law.vanderbilt.edu/vjtl>



Part of the [Taxation-Transnational Commons](#), and the [Tax Law Commons](#)

---

### Recommended Citation

Sheldon S. Cohen, Tax Consequences of Foreign Currency Fluctuations, 6 *Vanderbilt Law Review* 13 (2021)

Available at: <https://scholarship.law.vanderbilt.edu/vjtl/vol6/iss1/4>

This Symposium is brought to you for free and open access by Scholarship@Vanderbilt Law. It has been accepted for inclusion in Vanderbilt Journal of Transnational Law by an authorized editor of Scholarship@Vanderbilt Law. For more information, please contact [mark.j.williams@vanderbilt.edu](mailto:mark.j.williams@vanderbilt.edu).

# TAX CONSEQUENCES OF FOREIGN CURRENCY FLUCTUATIONS

SHELDON S. COHEN\*

## I. INTRODUCTION

This article concerns the United States federal income tax treatment of the gains and losses resulting from transactions involving currencies other than the United States dollar.<sup>1</sup> United States income taxes must be computed and paid in United States dollars. Therefore, when persons subject to United States income taxes engage in transactions involving foreign currencies, they must account for their profits in terms of dollars for United States income tax purposes.<sup>2</sup> This result follows even if the taxpayer does not actually convert the results of these transactions into dollars. Whether the failure to convert is voluntary, or results from legal restrictions imposed by foreign law, the result is the same.<sup>3</sup>

---

\* Member of the District of Columbia Bar. Member of the firm of Cohen & Uretz. Commissioner of Internal Revenue Service, 1965-1969. A.B., 1950, J.D., 1952, George Washington University. The author wishes to thank Barry J. London, who is also associated with the firm of Cohen & Uretz, for his assistance in preparing the manuscript for publication.

1. Except where otherwise indicated, the term "dollars," as used in this article, refers to United States dollars.

2. See Rev. Rul. 55-171, 1955-1 CUM. BULL. 80, 88; O.D. 459, 2 CUM. BULL. 60 (1920); O.D. 419, 2 CUM. BULL. 60 (1920). While § 6316 of the Internal Revenue Code of 1954 authorizes the Commissioner of Internal Revenue to allow payment of United States income taxes in foreign currency, the implementing regulations permit such action by a taxpayer only in very circumscribed circumstances. See INT. REV. CODE OF 1954 § 6316 [hereinafter cited as INT. REV. CODE]; Treas. Reg. §§ 301.6316-1 to 301.6316-9 (1956).

3. Some foreign countries limit or prohibit entirely the repatriation of earnings of business operations located in that country but owned by aliens. The consequences of such blockage on the United States income taxes payable by persons subject to United States taxation are beyond the scope of this article. For an analysis of this problem see Mimeograph 6475, 1950-1 CUM. BULL. 50, as amended by Mimeograph 6494, 1950-1 CUM. BULL. 54, and Mimeograph 6584, 1951-1 CUM. BULL. 19; Kramer, *Tax Problems Arising from Foreign Exchange Restrictions*, N.Y.U. 12th INST. ON FED. TAX 849 (1954); Raffel, *Some Tax Aspects of Foreign Currencies*, 14 TAX L. REV. 389, 400-11 (1959) Ravenscroft, *Taxation of Income Arising from Changes in Value of Foreign Currency*, 82 HARV. L. REV. 772, 786-91 (1969); Stuetzer, *Tax Problems Raised by*

The United States Constitution specifically authorizes Congress to regulate the valuation of foreign currency.<sup>4</sup> Presumably, such regulation would include the determination of the extent to which specified foreign currencies could qualify as legal tender for the payment of valid debts, including the taxpayer's federal income tax liability. Congress, however, with limited exceptions,<sup>5</sup> has not exercised its power in the federal income tax area. Since the Supreme Court has had little opportunity to contribute in this area, we have only the sporadic pronouncements of various courts of appeals, district courts, the Tax Court, and the Internal Revenue Service to assist us in attempting to solve these problems. Consequently, many of the problems in this area either are unresolved or have been resolved only partially in a sporadic, unorganized and somewhat chaotic fashion. In addition, unwarranted distinctions have been made in the federal income tax treatment of taxpayers in similar situations.

Before discussing these problems, we should begin with some elementary concepts which will insure that we all start from the same reference point. Money may serve either or both of two purposes. It may be used either as a medium of exchange or as a commodity. When used as a medium of exchange, money has no intrinsic value; it is worth only what it will buy. As a medium of exchange, money serves to organize the bartering process between individuals, thereby providing a much more orderly method for exchanging goods and services. Money may also function as a commodity; it may be bought or sold like any other property. Its usefulness, valuation, intrinsic worth and profitability will then be all expressed in terms of some other medium of exchange.

At this point we must distinguish between two types of gain or loss. First, there is monetary gain or loss. This is the profitability of a transaction expressed in terms of the currency that serves as a medium of exchange for the relevant country. If a United States taxpayer purchases 100 widgets in Mexico for 100 pesos and sells these widgets for 200 pesos, his monetary gain is 100 pesos. This monetary profit may be expressed also in terms of dollars: if one peso equals one dollar, the taxpayer has a monetary gain of 100 dollars.

---

*Foreign Currency Devaluation and Blocked Foreign Income*, 6 TAX. L. REV. 255 (1961). See also Rev. Rul. 55-171, 1955-1 CUM. BULL. 80, 88; Comment, *Income Tax Consequences of Foreign Currency Fluctuations*, 37 TUL. L. REV. 282 n.4 (1963); Note, *Income Tax Consequences of Fluctuations in Foreign Exchange*, 1955 U. ILL. L.F. 595 n.3.

4. U.S. CONST. art. I, § 8, cl. 5.

5. E.g., INT. REV. CODE §§ 964, 6316. See also Treas. Reg. §§ 1.964-1 to 1.964-5 (1966), §§ 301.6316-1 to 301.6316-9 (1956).

Secondly, there is exchange rate gain or loss. Exchange rate gain or loss results from the fluctuation of the value of one currency in terms of another currency. For instance, if in the above example we bought the 100 widgets at a time when one peso was the equivalent of one dollar, and sell the widgets for two pesos when one peso equals two dollars, our monetary profit is still 100 pesos. Expressed in dollars at the prevailing exchange rate of one peso equals two dollars, our monetary profit is 200 dollars. We also have profited from the change in exchange rate. Our original investment of 100 dollars allowed us to purchase 100 pesos. The price of pesos, however, has now increased; we now can sell 100 pesos for 200 dollars. We thus have profited 100 dollars from the fluctuation in exchange rates. The sum of our 200 dollar monetary gain and our 100 dollar exchange rate gain equals our net dollar gain, 300 dollars: we invested 100 dollars in the beginning and received 400 dollars when the investment terminated.

Exchange rate gain or loss may result either from market fluctuations in the exchange rates of the various currencies or from formal action of the issuing country's government. In the past, official devaluation (or an upward revaluation) of a nation's currency has occurred relatively infrequently; fluctuations in market rates continuously occur. It may be argued that a distinction justifying different income tax consequences could or should be made between currency fluctuations and currency devaluation. In principle, however, the exchange rate gain or loss realized from both is the same. Therefore, both should be treated similarly for United States income tax purposes. Currently, more currencies are being allowed to float, rather than having fixed, official exchange rates. Continuation of this policy further justifies similar treatment for both fluctuations and devaluations for United States income tax purposes. Therefore, for the purposes of this discussion, no distinction will be made between exchange rate gain or loss resulting from market fluctuations and exchange rate gain or loss resulting from formal governmental action.

We must first decide whether gains or losses resulting from fluctuations in currency exchange rates constitute income. Suppose a United States citizen speculates in pesos. He sells 100,000 pesos short when one peso equals two dollars, receiving 200,000 dollars. He later covers the short sale when one peso equals one dollar. He must only pay 100,000 dollars to satisfy his obligations. Is his 100,000 dollar gain taxable income?

Section 61 of the Internal Revenue Code of 1954<sup>6</sup> defines gross

---

6. All section references are to the Internal Revenue Code of 1954, as amended, unless otherwise indicated.

income very broadly.<sup>7</sup> As mentioned above, the measure of income for United States taxing purposes is the dollar.<sup>8</sup> It would seem that when a taxpayer receives 200,000 dollars from a short sale, and needs only 100,000 dollars to cover, he has received a very real economic benefit—100,000 dollars. Consequently, it would seem that the gains or losses realized from exchange rate fluctuations constitute taxable income.<sup>9</sup>

While purposeful currency speculation would seem to generate taxable income, we still must decide when and at what rate this income should be taxed. Further, we must decide whether our taxing decision is any different in those instances in which the currency speculation is merely a necessary hazard of engaging in certain types of business transactions. The remainder of this article will be concerned with attempting to answer these questions.

At the outset, we must distinguish between various types of transactions that generate exchange rate gain or loss. First, there are currency speculations, in which exchange rate gain or loss is the only profit or loss realized. Secondly, there are sales and purchases of inventory items and other assets. In these transactions exchange rate gain or loss is often ancillary to the monetary gain or loss realized on the underlying transaction. Thirdly, there are credit transactions, involving the borrowing and repayment of foreign currency, which may or may not have exchange rate gain or loss as one of their principal objectives.

## II. SPECULATORS

Speculators view money only as a commodity. They do not realize a monetary gain or loss on their transactions; they realize only an exchange rate gain or loss, which may be expressed in gold or in a currency other than the one in which they are speculating. The economic gain or loss, however, realized from these transactions is just as real as any monetary profit from any other commodity transaction, and our tax law recognizes this fact: currency exchange profits derived from speculating constitute taxable income.<sup>10</sup>

---

7. INT. REV. CODE § 61(a) provides: "[G]ross income means all income from whatever source derived . . ." Derived from the sixteenth amendment, this section has been defined very broadly by the courts to encompass almost all economic gain or benefit realized by the taxpayer. *See, e.g.,* Commissioner v. Glenshaw Glass Co., 348 U.S. 426 (1955), and cases cited therein.

8. *See* note 2 *supra* and accompanying text.

9. *See* Willard Helburn, Inc. v. Commissioner, 214 F.2d 815, 818-19 (1st Cir. 1954).

10. For a discussion of this point see Comment, 37 TUL. L. REV. 282, 282-85 (1963); Note, 1955 U. ILL. L.F. 595, 598-600.

The Code distinguishes, however, between dealers and nondealers. A dealer is defined as:

One who regularly engages in the purchase and resale to customers of foreign money with a view to the gain and profits that may be derived therefrom.<sup>11</sup>

Dealers may inventory their foreign currency holdings just as other merchants inventory any other commodity.<sup>12</sup> The dealer may account for his foreign currency inventory for United States income tax purposes on the basis of either cost or the lower of cost or market.<sup>13</sup> If he elects the lower of cost or market method, a taxpayer who deals in foreign currencies may deduct currently unrealized foreign currency exchange losses. Because a dealer holds foreign currency "primarily for sale to customers in the ordinary course of his trade or business," his foreign currency holdings do not constitute capital assets.<sup>14</sup> His gains, therefore, do not qualify for preferable capital gains treatment. His losses, however, are fully deductible against ordinary income.<sup>15</sup>

A nondealer has been defined as: "One who merely purchases foreign money on his own account or as an incident of his principal business."<sup>16</sup> Nondealers are not permitted to inventory their foreign currency holdings.<sup>17</sup> Consequently, gain or loss is not realized until the taxpayer converts or otherwise disposes of his foreign currency.<sup>18</sup> Foreign currency, however, if not otherwise excluded by section 1221 of the Code, constitutes a capital asset; and gains from the sale or exchange thereof constitute capital gains.<sup>19</sup>

The distinction the law currently makes between dealers and nondealers seems equitable in light of our present income tax structure. The profits and losses of those who deal in foreign currency speculation receive the same tax treatment as the profits and losses from other businesses. The gains and losses resulting from nondealer

---

11. O.D. 834, 4 CUM. BULL. 61 (1921).

12. *Id.*

13. See Treas. Reg. § 1.471-4 (1958). See also Treas. Reg. § 1.471-5 (1958).

14. INT. REV. CODE § 1221(1).

15. See INT. REV. CODE § 165. Presumably, dealing in currency would constitute a trade or business.

16. O.D. 834, 4 CUM. BULL. 61 (1921).

17. *Id.*

18. *Id.* A substantial decline in the dollar value of the foreign currency, however, may generate a deduction either as a loss or as a bad debt. See Note, *Foreign Exchange—Tax Consequences*, 1 TAX. L. REV. 232, 233 & nn.11-13.

19. I.T. 3810, 1946-2 CUM. BULL. 55.

transactions receive the same preferential capital gains treatment that gains and losses from other nondealer transactions receive. Consequently, this area of the law needs no clarification at this time. It is neither better nor worse than the treatment afforded similar areas by the Code.

### III. DOLLAR DEPENDENT TAXPAYER

The economic consequences of currency fluctuations for a particular taxpayer depend upon his use of a particular currency as a medium of exchange. An American citizen who engages in transactions involving foreign currency, but who primarily depends on the dollar as a medium of exchange in satisfying most of his personal wants and needs, is more acutely affected by exchange rate gain or loss than one who depends primarily on the foreign currency involved as a medium of exchange. This fact must be considered in determining the appropriate United States income tax consequences of various taxpayers and the transactions in which they engage. Classifying taxpayers according to their dependency on the dollar as a medium of exchange, as one commentator has done,<sup>20</sup> will assist us in our analysis of this problem.

The dollar dependent taxpayer is best defined negatively: "one which does not have [a] substantial, permanent amount of capital invested abroad."<sup>21</sup> United States importers and exporters are prime examples of dollar dependent taxpayers. They are not likely to have a substantial commitment in foreign currency, or fixed assets such as plant and equipment, located abroad for any extended period of time. Rather, importers face a continuous and cyclical process of converting United States dollars into foreign currency, purchasing goods abroad, and selling them in the United States for dollars. Exporters face a reverse cyclical process. While the dollar dependent taxpayer may have short-term foreign currency obligations or investments, such as accounts payable or accounts receivable, he usually has few or no long-term foreign currency obligations. While our discussion will focus primarily on United States importers, the same considerations should apply in determining the appropriate United States income tax consequences for exporters.<sup>22</sup>

#### A. *Merchandise Transactions*

Cash transactions pose no problems since there is no exchange rate gain or loss. When an importer pays for goods purchased abroad with

---

20. Ravenscroft, *supra* note 3, at 772-74.

21. Ravenscroft, *supra* note 3, at 774.

22. See Comment, 37 TUL. L. REV. 282, 288-90 (1963).

dollars or contemporaneously purchases the necessary foreign currency, the cost of the goods purchased is the dollars paid, or the amount of dollars used to purchase the foreign currency necessary to pay for the goods.<sup>23</sup>

The potential for exchange rate gain or loss arises, however, when there is a time lag between the acquisition of the goods and the conversion of dollars into the appropriate foreign currency. For example, an American importer, intending to purchase widgets in Mexico, purchases 100,000 pesos when one peso equals one dollar. When he purchases the widgets, however, two pesos equals one dollar. Alternatively, suppose a bank loans the importer 100,000 pesos, or the supplier allows the importer to purchase the widgets on credit. At the time the widgets are acquired, one peso equals one dollar, but when the importer satisfied his 100,000 peso obligation, two pesos equals one dollar. These types of transactions pose two questions: first, when should the resulting exchange rate gain or loss be recognized for income tax purposes; and secondly, at what rate should the exchange rate gain or loss be taxed?

A basic income tax concept is that only realized gains and losses resulting when a transaction is closed should be considered for income tax purposes. Exchange rate gain or loss could be recognized either when the credit transaction is terminated or when the underlying merchandise transaction is completed. If the transactions are integrated, the taxpayer's basis in his inventory would be adjusted, and he would recognize any exchange rate gain or loss only when the inventory in question is sold. If the credit transaction is considered separately, the importer's exchange rate gain or loss would be recognized when he either pays his supplier or repays his loan. These events normally will not coincide with the taxpayer's disposal of the merchandise generating the credit transaction.

While an early Internal Revenue Service ruling favored integration of the credit transactions with the underlying merchandise transaction,<sup>24</sup> the Tax Court has rejected this approach and has treated the extension of credit as a separate transaction:

The company purchases goods, the purchase price being payable in pounds sterling. It may pay for those goods at the time of purchase by buying sterling at the then prevailing rate or it may choose to establish a credit and pay the account later. In any event, the cost of the goods must be arrived at by reducing sterling to dollars at the rate of exchange prevailing on the date of purchase. . . .

---

23. See *Joyce-Koebel Co. v. Commissioner*, 6 B.T.A. 403 (1927). See also O.D. 489, 2 CUM. BULL. 60 (1920).

24. O.D. 489, 2 CUM. BULL. 60 (1920).



If the company, instead of making payment at that time, makes the purchase on credit, it is investing or speculating in foreign exchange. It may derive a profit or sustain a loss on the exchange operation, but the cost of the goods to it is not affected by such profit or loss.<sup>25</sup>

The taxpayer's basis, therefore, is the dollar equivalent of the purchase price converted at prevailing exchange rates<sup>26</sup> on the date the goods are purchased.<sup>27</sup> The taxpayer's monetary profit or loss is taxable when the goods are sold; his exchange rate gain or loss is recognized when the credit transaction is completed.<sup>28</sup> The courts generally have held that the exchange rate gain or loss is taxable in the same manner as the underlying transaction, notwithstanding the fact that they otherwise have fractured the transaction.<sup>29</sup> The courts have justified this conclusion either on the theory that there was no sale or exchange<sup>30</sup> or on the theory that such transactions were integrally connected with the taxpayer's trade or business.<sup>31</sup>

Before discussing the reasonableness of current law's separate transaction rule, we first must understand the basic problem with

25. *Joyce-Koebel Co. v. Commissioner*, 6 B.T.A. 403, 406 (1927). The Internal Revenue Service, however, may still be adhering informally to its original position. See Comment, 37 TUL. L. REV. 282, 286 n.34 (1963).

26. The applicable exchange rate is the free market rate, which may differ from the official rate of exchange. See O.D. 489, 2 CUM. BULL. 60 (1920); Note, *The Separate Tax Treatment of Import Transactions and Related Foreign-Exchange Fluctuations: The Case for Integration*, 68 YALE L. J. 497, 500 n.10 (1959).

27. For a good discussion of the ambiguities inherent in the phrase "time of purchase" see Note, 68 YALE L.J. 497, 501-02 & nn.14-18 (1959).

28. *Joyce-Koebel Co. v. Commissioner*, 6 B.T.A. 403 (1927). It makes no difference whether the taxpayer purchases the goods on credit, making payment in foreign currency later, or purchases the necessary foreign currency in advance. Any exchange rate gain or loss realized is recognized only upon the termination of the credit transaction. See *Willard Helburn, Inc. v. Commissioner*, 214 F.2d 815 (1st Cir. 1954) (funds borrowed to purchase merchandise); *Bennett's Travel Bureau, Inc.*, 29 T.C. 350 (1957) (purchases on open account); *Church's English Shoes, Ltd.*, 24 T.C. 56 (1955) (purchases on open account); *Joyce-Koebel Co. v. Commissioner*, 6 B.T.A. 403 (1927) (purchases on open account); *Bernuth Lembcke Co., Inc.*, 1 B.T.A. 1051 (1925) (foreign currency purchased in advance).

29. See, e.g., *America-Southeast Asia Co., Inc.*, 26 T.C. 198 (1956). See also Note, 68 YALE L.J. 497, 510-12 & nn.50-62 (1959).

30. E.g., *Church's English Shoes, Ltd.*, 24 T.C. 56 (1955).

31. E.g., *America-Southeast Asia Co., Inc.*, 26 T.C. 198 (1956). Such cases rely upon the reasoning in the United States Supreme Court's decision in *Corn Products Co. v. Commissioner*, 350 U.S. 46 (1955).

which we are dealing. At present, few people would seriously dispute that the exchange rate gain or loss realized in such transactions should be recognized for income tax purposes. The real question is when should this exchange rate gain or loss be taxed? The basic question, then, is a timing question. While timing is one of the most important questions in income taxation, the determination of the appropriate time at which income tax consequences should be recognized depends on an analysis of the realities of the underlying transaction producing the income to be taxed.

Here, exchange rate gain or loss results from an anticipatory purchase of foreign currency or an extension of credit, and subsequent satisfaction of the obligation in foreign currency. If this transaction is more appropriately considered apart from the underlying merchandise transaction, then exchange rate gain or loss should be recognized for income tax purposes when this separate transaction is closed. Under this view, exchange rate gain or loss would be considered in the same manner as any other period cost, such as interest, rent or miscellaneous income.

If, however, the foreign currency transaction is more appropriately considered an integral part of the underlying merchandise transaction, then exchange rate gain or loss should be recognized when the underlying merchandise transaction is completed,<sup>32</sup> as purchase discounts and freight-in expenses are currently treated.<sup>33</sup>

The courts have rationalized the separate transaction rule on the grounds that the taxpayer had the option to pay for the goods in dollars when purchased. Instead, the taxpayer chose to engage in foreign currency speculation, either by purchasing the foreign currency in advance or by obtaining credit from the seller or a third party. Thus, the courts seem to view all such transactions as inventory financing arrangements; none are viewed as purchase discount arrangements. Exchange rate gain or loss, therefore, seems to be treated as one of the normal expenses of doing business, such as interest expense, independent of the merchandise transactions constituting the underlying transaction.

In some cases, however, this view conflicts with commercial realities and the intentions of most businessmen engaged in such transactions. Presumably, most importers and exporters are in the

---

32. This result would be accomplished by adjusting the taxpayer's basis in the particular merchandise to reflect actual cost in dollars on the date of payment. For a detailed discussion of the integration approach discussed in the text see Note, 68 *YALE L.J.* 497 (1959).

33. See *Treas. Reg.* § 1.471-3(b) (1958).

business of buying and selling merchandise, not foreign currency. Foreign currency fluctuation would seem, therefore, to be a business hazard, not a profit-seeking, investment-oriented activity. Often, foreign credit is necessary for the businessman to complete the underlying transaction. If there is a devaluation of the foreign currency in the interim, so that the outstanding obligation may be satisfied for less dollars than originally anticipated, most businessmen probably would view this as a bargain purchase of merchandise, not a separate profit windfall. Similarly, an upward revaluation in the foreign currency is most probably viewed not as a speculation loss, but as a loss on the underlying inventory transaction, since competitors who paid cash purchased the same merchandise for fewer dollars.

Moreover, fracturing the merchandise acquisition into two transactions may pose inequitable cash flow problems when the foreign exchange transaction terminates in a year other than the one in which the underlying merchandise is sold. Under the separate transaction rule, the taxpayer may be required to make cash disbursements both for the merchandise purchased and in the income taxes resulting from the recognition of exchange rate gain in one taxable year. At that time, however, the taxpayer may not have sold the merchandise whose purchase generated the income tax consequences in question.

Integration of the foreign exchange transaction with the underlying merchandise transaction solves several of these problems. Integration would comport with the commercial realities of most of these transactions. Furthermore, exchange rate gain or loss would be recognized for income tax purposes as the merchandise is sold. Consequently, the taxpayer would have to pay income taxes at a time when he has the necessary funds.

The following example illustrates the different income tax and cash flow consequences of the separate transaction and integration rules.

#### FACTS:

In year 1, taxpayer purchases 1,000 widgets in country A at a cost of 10 pesos per widget, for sale in the United States. Total cost: 10,000 pesos. Contemporaneously, he borrows 10,000 pesos from a bank in country A to pay for the widgets. At the time of the loan and the purchase of widgets, the exchange rate is: 1 peso equals 2 dollars. The taxpayer imports the widgets into the United States and sells 500 widgets at 40 dollars per widget. The taxpayer repays the loan of 10,000 pesos to bank A at a time when the exchange rate is: 1 peso equals 1 dollar. Consequently, it cost only 10,000 dollars to repay the loan. In year 2, taxpayer sells the remaining 500 widgets at 40 dollars per widget.

## INCOME TAX CONSEQUENCES:

*CURRENT LAW*

## YEAR 1

Sales: 500 widgets at \$40 per widget		\$20,000
Cost: Purchases: 1,000 widgets at \$20 per widget	\$20,000	
Ending Inventory: <sup>34</sup> 500 widgets at \$20 per widget	<u>10,000</u>	
Cost of Goods Sold:		<u>10,000</u>
Net Income:		\$10,000
Exchange Gain:		
Borrow 10,000 pesos (1 peso equals 2 dollars)	\$20,000	
Repay 10,000 pesos (1 peso equals 1 dollar)	10,000	
Taxable Exchange Gain		<u>10,000</u>
Total Taxable Income		<u>\$20,000</u>
United States Income Tax at 50% Rate <sup>35</sup>		<u>\$10,000</u>

34. It is assumed for the purposes of this example that the taxpayer values his inventory on the cost basis. *See* Treas. Reg. § 1.471-3 (1958). If the taxpayer values his inventory on the lower of cost or market method, it is not clear under present law whether the determination of market price would include an adjustment for exchange rate fluctuations. If market includes an adjustment for exchange rate fluctuations, this may, in some cases, accomplish the same result as the integration approach discussed in the text. When the foreign currency involved has depreciated relative to the dollar, foreign goods may now be purchased for fewer dollars. The lower of cost or market method would require a downward basis adjustment to reflect this fact. This downward basis adjustment will offset some of the exchange rate gain, which the taxpayer must recognize under the separate transaction approach. *Cf. Joyce-Koebel Co. v. Commissioner*, 6 B.T.A. 403 (1927). If the applicable exchange rate has not changed between the date the credit transaction was terminated and the inventory valuation date, the basis adjustment will offset exactly the exchange rate gain attributable to merchandise still on hand. If the foreign currency involved has appreciated in value relative to the dollar, the credit transaction would result in a loss, no part of

## YEAR 2

Sales: 500 widgets at \$40 per widget	\$20,000
Cost of Goods Sold:	
500 widgets at \$20 per widget	<u>10,000</u>
Taxable Income	<u>\$10,000</u>
United States Income Tax at 50% Rate	<u>\$ 5,000</u>

## INTEGRATION

## YEAR 1

Sales: 500 widgets at \$40 per widget	\$20,000
Cost of Goods Sold:	
Purchases: 1,000 widgets at \$20 per widget	\$20,000
Adjustment for net exchange gain	<u>10,000</u>
Net Purchases	\$10,000
Less: Ending inventory—500 widgets at \$10 per widget	<u>5,000</u>
Cost of Goods Sold	<u>5,000</u>
Taxable Income	<u>\$15,000</u>
United States Income Tax at 50% rate	<u>\$ 7,500</u>

---

which would be offset by a basis adjustment under the lower of cost or market method.

The lower of cost or market method may thus indirectly reach the same results as the approach discussed in the text in some circumstances. This, however is merely coincidence; it does not reflect any purposeful policy decisions. Furthermore, only those taxpayers using the lower of cost or market method may obtain these results. It would seem to be more equitable to make this result available to all taxpayers without requiring them to adopt the lower of cost or market method of valuing their inventories.

35. For purposes of simplicity the tax rate is assumed to be 50% in all examples. If the taxpayer is an individual, the timing question also affects the taxpayer's aggregate income tax liability. See Note, 68 YALE L.J. 497, 499-500 & nn.10-13 (1959).

YEAR 2

Sales: 500 widgets at \$40 per widget	\$20,000
Cost of Goods Sold:	
500 widgets at \$10 per widget	<u>5,000</u>
Taxable Income	<u>\$15,000</u>
United States Income Tax at 50% Rate	<u>\$ 7,500</u>

CASH FLOW:

CURRENT LAW

YEAR 1

Receipts:		
Sales:		\$20,000
Disbursements:		
Purchases:	(\$10,000)	
Income Tax:	<u>(10,000)</u>	<u>(20,000)</u>
Net Cash Balance for Year 1		<u><u>-0-</u></u>

YEAR 2

Receipts:		
Sales:		\$20,000
Disbursements:		
Income Taxes:		<u>(5,000)</u>
Net Cash Balance for Year 2		<u><u>\$15,000</u></u>

## INTEGRATION

## YEAR 1

## Receipts:

Sales:		\$20,000
--------	--	----------

## Disbursements:

Purchases:	(\$10,000)	
Income Taxes:	<u>(7,500)</u>	<u>(17,500)</u>

Net Cash Balance for Year 1		<u>\$ 2,500</u>
-----------------------------	--	-----------------

## YEAR 2

## Receipts:

Sales:		\$20,000
--------	--	----------

## Disbursements:

Income Taxes		<u>(7,500)</u>
--------------	--	----------------

Net Cash Balance for Year 2		<u>\$12,500</u>
-----------------------------	--	-----------------

When the foreign currency portion of the integrated transaction results in an exchange rate loss, the question then arises whether the taxpayer must defer recognition of this loss until he disposes of the goods in question, or whether he should be able to deduct this loss currently. While deferral would be consistent with the integration theory, the same conservative accounting principles that permit a taxpayer to elect to value his inventory on the basis of cost or market, whichever is lower,<sup>36</sup> should apply here: anticipated losses should be recognized, even though unrealized gains are not.<sup>37</sup>

Exchange rate loss in these types of transactions is analogous to other market fluctuations that affect the resale value of inventory. If the dollar is devalued, or if other currencies strengthen in relation to the dollar, the dollar price of imported goods will rise. Integration would require that the taxpayer increase his basis in the goods to reflect the exchange rate loss; however, the taxpayer may never be able to dispose of these goods, or may only be able to dispose of them

---

36. See Treas. Reg. § 1.471-4 (1958).

37. See AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, ACCOUNTING RESEARCH BULLETIN No. 43, at 30-34 (1961).

at a price much lower than their adjusted basis. These very real, anticipated losses should be currently deductible as are losses from fluctuations in the market value of such goods.

In practice, integration may cause other problems. The accounting complexities and resulting costs of integration, when a large number of transactions are involved, may far exceed the theoretical and practical advantages of integration. For this reason, adoption of the integration proposal, like most other accounting methods, should be at the taxpayer's option. If adopted, integration would apply to all of the taxpayer's merchandise transactions. The election, once made, could then be changed only with the Commissioner's approval.<sup>38</sup>

Furthermore, integration should not be allowed when foreign currency speculation is more than merely ancillary to the underlying merchandise transaction. When the speculation is deemed purposeful, rather than merely a necessary hazard of the taxpayer's business, separate transaction accounting should be required.

To assist in the determination whether the taxpayer's foreign currency transactions constitute purposeful speculation, a commercially reasonable period of time should be used as a rule of thumb: perhaps somewhere between 30 and 120 days. This period should give due regard to the exigencies of foreign commercial transactions.<sup>39</sup> Foreign currency and merchandise transactions, both of which occur during this period of time, could be integrated; those separated by greater periods of time could be integrated only if the taxpayer adequately demonstrates that the two transactions are, in fact, related.

Integration also would provide a more rational basis for disposing of taxpayers' arguments that exchange rate gain results in capital gain. As discussed above,<sup>40</sup> the courts have been forced to resort to various arguments in refuting taxpayers' contentions that exchange rate gain qualifies for capital gain treatment. Integration, even if optional,

---

38. INT. REV. CODE § 446(e).

39. The use of a specified time period during which the transactions will be presumed to be connected allows the taxpayer some control over the income tax consequences of his business transactions. Consequently, the time period used should not be arbitrarily determined; rather, it should be one that also has business consequences for the taxpayer. For example, in domestic transactions a purchaser will often have a reasonable period of time, perhaps 30 days, after presentation to pay his bill without the seller imposing financial charges. Presumably, a similar grace period is permitted in most international transactions. The allowable time period for integration should be such that business as well as tax considerations will affect the taxpayer's decision, thus minimizing the influence of the tax aspects of the decision.

40. See notes 29-31 *supra* and accompanying text.



would indicate clearly the close relationship of such foreign currency transactions to the taxpayer's trade or business.

Sometimes a taxpayer will purposefully speculate in foreign currency in order to protect his inventory investment. He may either purchase foreign currency in advance of purchasing merchandise or sell foreign currency short in order to protect a previous merchandise purchase. In either event, although the taxpayer purposefully speculates, his main purpose is to protect his merchandise investment against possible foreign currency fluctuation. The resulting exchange rate gain or loss is taxable. To the extent that such activity is integrally related to the taxpayer's trade or business, the exchange rate gain or loss realized constitutes ordinary income or loss.<sup>41</sup> In some instances, however, the speculation, while purposeful, may be also related to an inventory transaction. The same arguments concerning integration would apply here. The burden of proof should, of course, be on the taxpayer: to the extent he can demonstrate an integral relationship between the speculation in question and a merchandise transaction, the taxpayer should be able to integrate the two transactions. The same commercially reasonable rule of thumb discussed above<sup>42</sup> might be useful here in satisfying the taxpayer's burden of proof.

#### B. *Credit Transactions*

A United States taxpayer borrows 1,000,000 pesos from a Mexican Bank when one peso equals one dollar, but when he must repay the loan two pesos equals one dollar. Consequently, the taxpayer satisfies his obligation for 50,000 dollars, even though the equivalent of 100,000 dollars was advanced to him. The question then arises whether the gain from this transaction constitutes taxable income for United States income tax purposes.

The Tax Court has held that no taxable income or loss results when a taxpayer repays a foreign currency loan at a lesser or greater dollar cost as a result of foreign exchange fluctuations.<sup>43</sup> In so doing, the Tax Court reasoned that a foreign currency was merely a commodity in the hands of a United States taxpayer, and that no taxable gain or loss results from the borrowing and repayment of a commodity. The Tax Court, therefore, seems to have viewed every unit of foreign currency as being equal to every other unit regardless

---

41. See, e.g., *Bernuth Lembcke Co.*, 1 B.T.A. 1051 (1925). See also Note, 1955 U. ILL. L.F. 595, 603 & nn.52-53.

42. See note 39 *supra* and accompanying text.

43. *William H. Coverdale*, 1945 P-H Tax Ct. Mem. ¶ 45240.

of the time it was acquired or disposed of by a United States taxpayer. In so doing, the court is, in essence, viewing the foreign currency for these purposes in the same manner as dollars are viewed in the United States: a medium of exchange having no intrinsic value as a commodity.<sup>44</sup> In this view, foreign currency, like the United States dollar for domestic transactions, is fungible. Notwithstanding inflation or deflation, a United States citizen who borrows 100 dollars in 1950 need only repay 100 dollars in 1970. Although the price index may indicate that the 1950 dollar had a greater purchasing power than the 1970 dollar, the borrower need only return 100 1970 dollars to satisfy the obligation incurred by borrowing 100 more valuable 1950 dollars. Similarly, the Tax Court reasons that the taxpayer's obligation is only to repay the amount of foreign currency borrowed, notwithstanding any change in the value of this currency in terms of United States dollars.

While the Tax Court's theory may have some superficial attractiveness, its reasoning appears to be erroneous. The dollar is the sole measure of the profitability of a given transaction for United States income tax purposes. While the dollar may be fungible for all domestic transactions, foreign currencies are not. United States income tax consequences are determined by the net change in the taxpayer's dollars. When a taxpayer has more dollars at the end of a transaction than at the beginning of the transaction, he has an economic benefit that is or should be taxable.<sup>45</sup> A foreign currency transaction must be evaluated in terms of dollars for United States taxing purposes; credit transactions may thus result in gain or loss that should be recognized for United States income tax purposes.

In *Bowers v. Kerbaugh-Empire Co.*,<sup>46</sup> the taxpayer borrowed funds from a German bank, repayable in German marks. The borrowed sums were then advanced to the taxpayer's wholly-owned

---

44. The term "medium of exchange," as used in the text, denotes a currency's function in promoting the bartering process. When used for this purpose the particular currency is fungible, and no gain or loss can be realized even though its value in terms of another medium of exchange may fluctuate. The term "commodity," as used in the text, denotes the valuation of one currency in terms of a second currency, when the second currency functions as a medium of exchange. When viewed as a commodity, gain or loss may be realized from exchange rate fluctuation. While some authorities actually refer to foreign currency in this latter situation as a commodity, an analysis of their conclusion indicates that they are actually viewing the foreign currency as a medium of exchange, which has no intrinsic value. See, e.g., Raffel, *supra* note 3, at 395-400; Comment, 37 TUL. L. REV. 282, 290-94; Note, 1955 U. ILL. L.F. 595, 604-05.

45. See Gillin v. United States, 423 F.2d 309 (Ct. Cl. 1970).

46. 271 U.S. 170 (1926).

subsidiary, which used them in the performance of construction contracts. The subsidiary's operations resulted in losses, which were reflected on the subsidiary's income tax returns. Because of a later devaluation of the mark, the taxpayer was able to repay the original loan for fewer dollars than it originally received. The subsidiary's losses exceeded the exchange rate gain realized on the loans' repayment. The Supreme Court held that the realized exchange rate gain did not constitute taxable income. The Court viewed the repayment at a more favorable exchange rate as merely a minimization of the taxpayer's loss on the subsidiary's operations that had been financed by the loans in question.

The Court's theory is not clear from its opinion. If the Court intended to say that credit transactions cannot generate taxable income, this would seem to be erroneous, as discussed above.<sup>47</sup> Even if the Court was holding merely that the minimization of loss does not result in taxable income, this also would appear to be erroneous. The losses had previously been allowed for income tax purposes. Hence, it would seem that any subsequent gain should have been included in income, at least to the extent of any previous tax benefit.<sup>48</sup> The Court may have been attempting to formulate an integration rule that such gains or losses should not be recognized for income tax purposes until the taxpayer's investment in its subsidiary is terminated,<sup>49</sup> and that such interim transactions should result only in adjustments to basis. If so, the opinion fails to clearly enunciate this theory.

In two recent cases, the Court of Claims has held that credit transactions may generate taxable gain or loss.<sup>50</sup> In the more recent decision, *Gillin v. United States*,<sup>51</sup> the taxpayer borrowed Canadian dollars during the years 1957-1960. The Canadian dollars were then converted to United States dollars and used for various personal and investment expenses. In 1961 the taxpayer purchased Canadian dollars to repay the loans at a cost approximately 20,000 fewer United States dollars than he had received from the conversion of the original loan proceeds.

---

47. See text accompanying note 45 *supra*. See also *United States v. Kirby Lumber Co.*, 284 U.S. 1 (1931).

48. The tax benefit rule had not yet been enunciated. See *Dobson v. Commissioner*, 320 U.S. 489 (1943).

49. In *B. F. Goodrich Co.*, 1 T.C. 1098 (1943), the Tax Court implied that such might actually be the rule.

50. *Gillin v. United States*, 423 F.2d 309 (Ct. Cl. 1970); *KVP Sutherland Paper Co. v. United States*, 344 F.2d 377 (Ct. Cl. 1965).

51. 423 F.2d 309 (Ct. Cl. 1970).

The taxpayer first contended that no taxable income resulted from this transaction, relying on those cases espousing the fungibility theory of foreign currency loans.<sup>52</sup> Alternatively, the taxpayer contended that the resulting gain was only taxable as long-term capital gain.

The Court of Claims rejected both contentions. First, rejecting the borrowed commodity theory, the court held that by converting the loan proceeds into United States dollars, the taxpayer engaged in foreign currency speculation. Consequently, the court concluded that the taxpayer realized taxable income when he closed out the transaction on a favorable economic basis. Secondly, the Court of Claims held that the taxpayer's gain constituted ordinary income, relying on the principle enunciated by the Supreme Court in *United States v. Kirby Lumber Co.*<sup>53</sup> The Court in *Kirby Lumber* held that satisfaction of an indebtedness for less than the amount borrowed constituted ordinary income. In so doing, the Court rejected the taxpayer's argument that the debt obligation constituted a capital asset that was sold or exchanged after being held for more than six months.<sup>54</sup>

The Court of Claims' conclusion on the realization of taxable income from the transaction appears to be correct. This result should follow, however, regardless of whether the taxpayer immediately converted the loan proceeds into United States dollars before repaying the loan. The determinative factor is the taxpayer's net change in United States dollars as a result of the transaction in question, not whether an interim step included the conversion of the foreign currency to United States dollars. If the transaction in its entirety results in an increase in the taxpayer's United States dollar holdings, it would appear that he has realized a taxable gain.

In holding that this income was taxable as income arising from the discharge of indebtedness, the Court of Claims in *Gillin* relied upon *Kirby Lumber Co.* and section 61(a)(12) of the Code. While *Kirby Lumber* does support the court's conclusion, the discharge of indebtedness theory, as stated in section 61(a)(12), does not. In *Kirby Lumber*, the taxpayer retired some of its outstanding bonds for less than par. The transaction thus involved the favorable satisfaction of a liability, rather than the sale of an asset.

The Supreme Court, nevertheless, held that economic gain resulting from such loan transactions can result in taxable income. In

---

52. *E.g.*, *B. F. Goodrich, Co.*, 1 T.C. 1098 (1943); *William H. Coverdale*, 1945 P-H Tax Ct. Mem. ¶45240. *See* 423 F.2d at 312.

53. 284 U.S. 1 (1931).

54. 423 F.2d 309.

its opinion, the Court distinguished *Kerbaugh-Empire Co.* on the grounds that in the latter case the transaction as a whole had resulted in a loss. Analyzing these two cases together, it appears that they delineate the general rule that the repayment of a loan for fewer dollars than originally received may result in taxable income.

The discharge of indebtedness theory, as expressed in the Code, appears to be merely a narrow application of *Kirby Lumber Co.* The danger of this misunderstanding is not the inclusion of such income in gross income required by section 61(a)(12), but the applicability of the benefits granted the taxpayer, at his option, by sections 108 and 1017. These sections allow the taxpayer, in certain circumstances, to exclude from gross income gain resulting from the discharge of indebtedness. In such circumstances, the taxpayer may make a corresponding basis adjustment. Application of the discharge of indebtedness theory in this area results in an unwarranted deferral of exchange rate gain.<sup>55</sup> Exchange rate gain generally is a windfall, having no relation to the debtor's financial situation. Consequently, the policy considerations which might support postponement of the income realized from the discharge of indebtedness on a favorable basis do not apply in the context of exchange rate gain.

The Court of Claims also concluded that such income did not constitute a long-term capital gain for federal income tax purposes, finding no capital asset that the taxpayer had held for more than six months and then sold or exchanged. This aspect of the decision illustrates the necessity for clarifying legislation in this area. While capital gains treatment may not be justified when a taxpayer engages in foreign credit transactions as part of his ordinary business activities, such treatment should be permitted for other transactions, such as those in *Gillin*.

Integration would provide useful guidelines in this area. The purpose for which the funds were borrowed would determine the tax treatment afforded any exchange rate gain or loss realized on the credit transaction.

#### IV. FOREIGN CURRENCY DEPENDENT TAXPAYERS

Prior to this point we have been discussing the United States income tax consequences of dollar dependent taxpayers, those who do not have a "substantial, permanent amount of capital invested abroad."<sup>56</sup> The balance of this article concerns the United States

---

55. See *Kentucky & Indiana Terminal R.R. Co. v. United States*, 330 F.2d 520 (6th Cir. 1964), *aff'g* 208 F. Supp. 589 (W.D. Ky. 1962).

56. *Ravenscroft*, *supra* note 3, at 774.

income tax consequences of foreign money dependent taxpayers, those who do have substantial and permanent capital investments abroad. These taxpayers usually have branches or subsidiary corporations that are more than merely sales or purchasing agents for their United States owners. The foreign establishment uses foreign money for its entire operating cycle; it is not continuously converting from dollars to foreign currency and back again. Consequently, exchange rate gain or loss must be considered only, if at all, in computing the results of the foreign operations for United States income tax purposes.

At present, no rational, coherent policy governs the United States income taxation of such foreign money dependent operations. While the income tax consequences vary according to whether the foreign operation is organized as a branch or a subsidiary corporation, these differences do not reflect any uniform approach to the problem. Rather, the law seems to have developed in a haphazard and piecemeal manner, with little or no regard either to consistency or to overall policy considerations. In some situations, the taxpayer may choose the manner in which to compute the taxable income from such foreign operations with little or no restriction on his choice. Taxpayers similarly situated, therefore, may bear significantly different income tax burdens.

#### A. *Foreign Branches*

If a United States taxpayer conducts his foreign operations as a branch of his domestic operations, he must report the results of these branch operations currently for United States taxing purposes. Since United States income taxes must be computed and paid in dollars, the results of such foreign branch operations must be converted into dollar terms. There are two basic approaches to this conversion problem: the income statement approach, and the balance sheet approach. Each approach has variations.

The income statement approach involves primarily the computation of taxable income for United States income tax purposes by first determining the profitability of operations in terms of the local currency involved, and converting the resulting figure to dollars. This computation may be made on a transaction basis, which recognizes exchange rate gain or loss, or the translation of profits method, which does not.

The transaction method requires the results of each transaction to be expressed in terms of dollars. Both sales and cost figures are converted to dollars at the time the costs are incurred or the sales made. Exchange rate gain or loss, resulting from foreign currency fluctuations in the interim, are thus recognized. This method is most

frequently used by dollar dependent taxpayers, and has been discussed in greater detail previously.<sup>57</sup> Use of this method is not officially limited to such taxpayers. The costs of accounting for numerous such transactions, however, as in the case of a foreign dollar dependent branch, would seem to prohibit its use in such cases.

The translation of profits method, authorized by an early Internal Revenue Service ruling,<sup>58</sup> requires that the taxpayer first compute the branch's net profits in foreign currency. Remittances to the home office during the taxable year, expressed in the foreign currency, should then be eliminated from this net profit figure. Net profits in dollars, for United States income tax purposes, is then computed by converting the remittances at the exchange rate prevailing on the date made, and converting the balance of the net profits at the exchange rate prevailing at the end of the taxable year. The sum of these two amounts constitutes the branch's net profits, in dollars, for United States income tax purposes. Since the conversion rates used are those prevailing either when funds are remitted to the United States or at the end of the year when income for United States income tax purposes is computed, no exchange rate gain or loss is recognized.<sup>59</sup>

Proponents of the income statement method argue that it is inappropriate to recognize exchange rate gain or loss on an investment in foreign assets which has not yet been terminated. Exchange rates may fluctuate several times before the investment is converted to dollars, if it is ever converted at all. Unrealized gains and losses are generally not recognized for United States income tax purposes, and there is no justification for deviation from that rule here, argue the income statement proponents.<sup>60</sup>

Under the balance sheet approach, taxable income is computed primarily by analyzing changes in different portions of the balance sheet during the taxable year. The taxpayer's balance sheet, in dollars, at the beginning of the taxable year is compared with the balance sheet, in dollars, at the end of the taxable year. The difference is the taxpayer's net income for United States income tax purposes. There

---

57. See notes 23-31 *supra* and accompanying text.

58. O.D. 550, 2 CUM. BULL. 61 (1920).

59. Exchange rate gain or loss thus is not recognized until the taxpayer repatriates his investment. At present, it is not clear whether exchange rate gain or loss is recognized on a pro rata basis or only when the branch's operations are completely terminated. Postponement until termination of the branch's activities results in unwarranted tax deferral and potential for abuse. Consequently, exchange rate gain or loss should be recognized on a pro rata basis. See Ravenscroft, *supra* note 3, at 781-82.

60. Ravenscroft, *supra* note 3, at 781-82.

are many variations of this approach that have been accepted either explicitly or tacitly by the courts or the Internal Revenue Service, or both. These variations result from the manner in which fixed assets and long-term liabilities are accounted for in the computations.

Under one method, set forth in an early ruling,<sup>61</sup> taxable net income is the difference between current assets and liabilities at the beginning of the taxable year converted to dollars at the then prevailing exchange rate, and current assets and liabilities at the end of the taxable year converted to dollars at the exchange rate prevailing then. This variation ignores fixed assets and noncurrent liabilities entirely.

Other variations may include noncurrent liabilities in the computation converted to United States dollars at the rates of exchange prevailing at the balance sheet date,<sup>62</sup> or may exclude such liabilities entirely.<sup>63</sup> Fixed assets, however, if included at all in the computations, are included at their cost in dollars when acquired.

The only variation of the balance sheet approach that takes into account the effect of exchange rate fluctuations on all balance sheet items, including fixed assets and long-term liabilities, is the net worth method. Total assets less total liabilities, both current and noncurrent, at the beginning of the taxable year, converted to dollars at the exchange rate then prevailing, is compared to total assets less total liabilities at the end of the taxable year, converted to dollars at the exchange rate prevailing then. The difference in the taxpayer's net worth at the beginning and end of the taxable year is his taxable net income from the branch for United States taxing purposes. This method restates the original foreign currency cost of both fixed assets and long-term liabilities in current dollar terms each year rather than historic dollar terms. In analyzing this approach, it must be remembered that fixed assets are not being revalued to account for unrealized asset appreciation or depreciation. Historical foreign currency cost is used. It is merely restated in terms of current United States dollars, however, as opposed to historical United States dollars.

The theory behind the net worth approach, as aptly discussed by one commentator,<sup>64</sup> is that the translation of profits method does not

---

61. A.R.R. 15, 2 CUM. BULL. 60 (1920).

62. *Anderson, Clayton & Co. v. United States*, 168 F. Supp. 542 (Ct. Cl.1958); O.D. 489, 2 CUM. BULL. 60 (1920).

63. *Frederich Vietor & Achelis v. Salt's Textile Mfg. Co.*, 26 F.2d 249 (D.C. Conn. 1928).

64. *Patty, Reporting Foreign Business Income After Currency Devaluation*, in 3 COMMITTEE ON WAYS AND MEANS, TAX REVISION COMPENDIUM 2189 (1959) [hereinafter cited as *Patty*].



reflect accurately the results of foreign branch operations. While the translation of profits method may be adequate in some instances, when significant amounts of foreign currency assets are involved, or significant foreign exchange fluctuations occur, only the balance sheet approach reflects accurately the total results of foreign branch operations for United States taxing purposes.<sup>65</sup> The translation of profits approach seems to ignore completely exchange rate gain or loss until the branch's activities are terminated and the profits repatriated.<sup>66</sup> Proponents of the balance sheet approach reject the translation of profits approach as unrealistic in the case of foreign currency dependent taxpayers. What appears to be a profit from operations actually may be a loss if the foreign currency has devalued in relation to the United States dollar.

By definition, a dollar dependent taxpayer has no substantial fixed investment overseas. Further, the dollar dependent taxpayer is constantly converting his assets to dollars as part of his ordinary business operational cycle. Consequently, any exchange rate gain or loss on his transactions will be recognized during his normal business cycle. Whether separately recognized, or integrated with the underlying merchandise transactions, exchange rate gain or loss will be accounted for as an income or expense item. Thus, the translation of profits method reflects adequately the dollar dependent taxpayer's operations.

The foreign currency dependent taxpayer, however, normally does not convert his foreign asset holdings to dollars as part of his normal business operational cycle. Rather, he depends entirely on foreign currency to satisfy the economic necessities of his business operations. Expressed in foreign currency terms, his income statement reflects the success of his operations on the basis of the purchasing power of that currency, and in relation to his assets and liabilities also expressed in the same foreign currency terms. The amount of profits generated by his operations reflects the capital available either for reinvestment in additional foreign assets or to satisfy outstanding foreign currency liabilities.

In order to reflect accurately the results of such operations, a complete translation from one purchasing power standard (foreign currency) to another standard (dollars) must be made. The translation of profits method, it is argued, does not accurately accomplish this goal because it assumes that foreign net income, if converted to dollars, reflects accurately the purchasing power of such income. This

---

65. See Patty, *supra* note 64, at 2193.

66. See note 59 *supra*.

assumption, the net worth method proponents argue, is erroneous. The results of the business' operations, as shown in the income statement, is integrally related to the business' foreign currency purchasing power, as indicated by the balance sheet. The balance sheet, not the income statement, more accurately reflects the change in the business' financial position each year. The income statement is merely a detailed analysis of the factors that resulted in the changes in the taxpayer's financial position, as reflected by the balance sheet. Consequently, the balance sheet approach should be adopted in the case of foreign dollar dependent taxpayers for United States taxing purposes.

If the balance sheet approach is adopted, the effect of foreign currency fluctuations on all assets and liabilities must be included in the calculations, in order that here, too, the results not be distorted. Freezing the value of fixed assets at the original United States dollar conversion value, proponents of the net worth method argue, results in precisely the kind of distortion which should be avoided.

Fixed assets and noncurrent liabilities should be included in the balance sheet at historical foreign currency cost converted to United States dollars for several reasons. First, however, a distinction must be made between the unrealized appreciation in the intrinsic value of an asset resulting from the market forces of supply and demand, and unrealized exchange rate gain or loss resulting from changes in the value of one currency relative to another currency. Only the latter is recognized for United States income tax purposes under the net worth method. The taxing principle of deferring unrealized appreciation or depreciation in the intrinsic value of an asset—which reflects its usefulness and the availability and usefulness of alternative assets—until the ultimate disposition of the asset in question is not affected by the net worth method.

Having determined that the net worth method only restates the asset's original foreign currency cost in current United States dollars, it becomes evident that the net worth method does not depart from the basic tax principle of not taxing unrealized appreciation or depreciation until the taxpayer disposes of the asset. Further, it becomes apparent that continued use of the historical United States dollar cost actually results in an abandonment of the historical cost principle—violating the very principle it attempts to satisfy—and distorts the current results of the taxpayer's foreign operations.

The historical cost principle would seem to assume the same common currency denominator for all purposes. Its intention is to avoid the recognition of any unrealized appreciation or depreciation in the asset's intrinsic value until the asset's disposition. Here, however, the operation's results must be expressed in terms of two currencies:

the foreign currency and the United States dollar. As long as the asset's cost remains unchanged in terms of the primary currency—the foreign currency on which the taxpayer is primarily dependent—it would seem that the historical cost principle has been satisfied; and converting all of the taxpayer's assets and liabilities to United States dollars at the current exchange rate for the special purpose of measuring accurately the entire results of the taxpayer's operations for United States taxation purposes would not seem to violate this principle.

Indeed, it can be argued that freezing the foreign asset's cost at its historic United States dollar cost further violates the historic cost principle by first, overvaluing arbitrarily that asset in foreign currency terms when the foreign currency has declined in value relative to the dollar, and secondly, depreciating arbitrarily its value in foreign currency terms when the foreign currency has appreciated in value relative to the dollar. When the historic dollar cost is converted into its foreign currency equivalent using current exchange rates, it can be seen that the resulting foreign currency cost figure is completely arbitrary. In such cases, it bears no relation to the original foreign currency cost, which is what the taxpayer is actually dependent on in his operations. Furthermore, the resulting valuation of this asset in foreign currency terms may have no relationship to the economic situation then existing in the foreign country.

For example, if a taxpayer acquires a plant for 10,000,000 pesos when ten pesos equals one dollar, the historic United States dollar cost of the plant is 1,000,000 dollars. If, at the end of the taxable year in question, twenty pesos equals one dollar, the use of 1,000,000 dollars as the plant's cost for United States income tax purposes is the equivalent of a cost of 20,000,000 pesos, an upward revaluation of the building's cost of 100 per cent. Thus, use of the plant's historic dollar cost violates the very principle it attempts to follow.

Use of historic dollar cost also conflicts with economic reality. When the foreign currency has devalued relative to the United States dollar, use of historic dollar cost results in an upward revaluation of the fixed asset, as illustrated above. This result would seem to be entirely unwarranted if existing economic conditions are such that the country's currency is declining in value relative to the dollar.<sup>67</sup> Conversely, if the foreign currency appreciates in value relative to the dollar, use of historic dollar cost results in the fixed assets being written down. This result would seem to be artificial and unwarranted, given what appears to be a very stable foreign economy.

---

67. See Patty, *supra* note 64, at 2205-12.

Converting the historic foreign currency cost to dollars at current exchange rates does result, as some have argued, in the fixed asset's cost being restated downward when the foreign currency has declined in value relative to the dollar. Conversely, when the foreign currency has appreciated in value relative to the dollar, the fixed asset's cost will be restated upward. Actual historic cost, in foreign currency terms, however, has not been changed. The change results from the requirement that the results of the foreign operations be stated in dollars. This change is not connected with the value of the asset; rather, it depends upon the relative values of the dollar and the foreign currency involved. The resulting exchange rate gain or loss is real. It is a necessary corollary in attempting to value the results of such foreign operations in dollars. Furthermore, using historic dollar cost results in an arbitrary and artificial restatement of the asset's cost, a result opposite from the one intended.

Nor is the use of current exchange rates for fixed assets a rejection of the basic accounting principle that assets should be valued at their book value, rather than their sale or liquidation value. This principle would be violated if the historic foreign currency cost of the asset were abandoned and the current fair market value of the asset in foreign currency substituted. The asset's historic foreign currency cost, however, has not been abandoned. Any change results from restatement of this historic cost in current United States dollars. This reflects the change in values between the two currencies, not any revaluation of the asset.

Finally, it must be remembered that these traditional accounting principles usually are applied in a situation in which the reporting currency is the one on which the entity involved depends for the satisfaction of its economic requirements. All concerned view that currency as their medium of exchange. The results of operations thus reported may be evaluated in terms of the purchasing power of the reporting country's currency in its society. Given the same expectation of that currency's purchasing power, the allocation of the society's tax burden among the various taxpayers in proportion to their respective abilities to bear this burden seems reasonable.

When business operations dependent on one currency must report the results of their operations in another currency for taxation purposes, different principles must apply in order that such results may be reported as accurately as possible. Translation of profits alone does not reflect accurately the purchasing power disparity existing between the two economies. The balance sheet approach, by attempting to evaluate the changes in the taxpayer's financial position in terms of the taxing currency, comes much closer to achieving purchasing power parity. To be accurate, however, the net worth

variation of the balance sheet method, accounting for all exchange rate gain or loss, must be used.

### B. *Foreign Subsidiaries*

When foreign operations are conducted through subsidiary corporations, different rules apply. If the foreign corporation constitutes a Controlled Foreign Corporation (CFC), as defined by the Code,<sup>68</sup> certain types of the CFC's income must be included in the parent's taxable income currently.<sup>69</sup> In this case the regulations provide specific rules for computing the results of the CFC's operations for tax purposes.<sup>70</sup> Profit or loss is first determined using a variation of the translation of profits method. Taxable income is then computed by adjusting this profit or loss figure by the exchange rate gain or loss recognized for the taxable period.<sup>71</sup> The exchange rate gain or loss that must be recognized for United States income tax purposes is determined using a variation of the balance sheet method. Under the variation specified by the regulations, most current assets and liabilities are translated into United States dollars at the average of the exchange rates prevailing throughout the taxable period.<sup>72</sup> Fixed assets, noncurrent liabilities and paid-in capital are translated into United States dollars at the appropriate exchange rate prevailing when the asset was acquired, the liability incurred or the capital paid into the corporation.<sup>73</sup>

If the CFC's income need not be reported currently by the parent for United States tax purposes, then the parent need only recognize income when it receives dividends from the foreign subsidiary. It is not clear, however, how a dividend of foreign money is treated for United States income tax purposes. If the foreign currency is regarded as money, the dividend must be included in income when received.<sup>74</sup> If regarded as property, however, it must be included in income when distributed.<sup>75</sup> For purposes of computing the foreign tax credit, the

---

68. INT. REV. CODE § 957.

69. INT. REV. CODE § 951.

70. See Treas. Reg. §§ 1.952-2 (1965), 1.964-1 (1964).

71. See Treas. Reg. §§ 1.952-2(b), (c)(2)(v) (1965).

72. Treas. Reg. § 1.964-1(d)(2) (1964). Special rules are provided for those balance sheet items that may carry over from one taxable year to another, such as inventory items, prepaid expenses and fixed assets. See Treas. Reg. §§ 1.964-1(d)(1), 1.964-1(e)(4) (1964).

73. See Treas. Reg. §§ 1.964-1(e)(4)(ii), (viii), (ix) (1964).

74. Treas. Reg. § 1.301-1(b) (1955). See Ravenscroft, *supra* note 3, at 796.

75. Treas. Reg. § 1.301-1(b) (1955).

amount of the credit is the United States dollar equivalent of the foreign tax at the time the tax is paid.<sup>76</sup>

The dollar value of the income when earned is thus ignored in these instances. No exchange rate gain or loss is recognized until complete liquidation of the subsidiary or until the parent sells its stock in the subsidiary, when any net exchange rate gain or loss will be reflected in the net profit or loss resulting from the investment.

### *C. Proposed Changes*

The lack of a uniform, rational policy for taxing the results of foreign operations of foreign currency dependent taxpayers results in unwarranted confusion. A taxpayer may choose to ignore completely exchange rate gain or loss by using the translation of profits method. If the taxpayer chooses the balance sheet approach, he is free to determine how much exchange rate gain or loss he will recognize by the particular variation of the balance sheet approach which he decides to adopt. The taxable net income of such foreign operations may vary materially, depending on the method chosen. Consequently, this area of our tax law seems to violate one of the basic tenets of an equitable income tax system: taxpayers similarly situated will be taxed in a similar manner, each bearing an equitable share of the tax burden.

Present law avoids completely the basic policy question of taxation in this area: should all or any portion of the exchange rate gain or loss be recognized and taxed currently, even though the taxpayer's investment may not be repatriated until some time in the future, if at all? If not, then the translation of profits method should be adopted, and exchange rate gain or loss recognized for United States income tax purposes only when the taxpayer repatriates his investment. The law also should provide that exchange rate gain or loss be recognized on a pro rata basis, as profits are repatriated, rather than deferred until the foreign operations are terminated.

If Congress determines that exchange rate gain or loss should be currently recognized for United States income tax purposes, then some variation of the balance sheet method should be used. Only the net worth variation of this method provides a complete and reasonably accurate picture of the results of the taxpayer's foreign operations. The other variations, by excluding either fixed assets or noncurrent liabilities or both from the calculations (or by freezing such items at historic dollar cost), materially distort such results.

Exchange rate gain or loss resulting from the translation of fixed assets and noncurrent liabilities to dollars at the current exchange rate

---

76. See S.M. 4081, IV-2 CUM. BULL. 201 (1925).

is not directly attributable to any revaluation of these items. Instead, it results from an attempt to evaluate the results of foreign operations in terms of dollars. Nonetheless, it may be argued that the resulting exchange rate gain or loss may have an economically unjustifiable effect on the taxpayer's taxable income for United States income tax purposes. While theoretically unjustifiable, one practical alternative might be to recognize the exchange rate gain or loss resulting from the translation of current assets and current liabilities currently, and recognize the exchange rate gain or loss attributable to noncurrent assets and liabilities pro rata over a reasonable period of time—five or ten years.<sup>77</sup>

Under this approach a special tax account, the "deferred exchange account," would be maintained by each taxpayer when necessary. At the end of each year the balance in this account would be adjusted for the current net exchange rate gain or loss attributable to the noncurrent items of the taxpayer's balance sheet.<sup>78</sup> One-fifth, or one-tenth, of the adjusted balance of this account would then be currently recognized, as an adjustment to taxable income for United States income tax purposes.

For example, suppose the net exchange rate gain attributable to noncurrent balance sheet items at the end of 1973, the first year of the taxpayer's foreign operations, is 50,000 dollars. One-fifth, 10,000 dollars, would be recognized for United States income tax purposes in 1973, and the remainder, 40,000 dollars, carried in the deferred exchange account. In 1974, if the net exchange rate loss attributable to such balance sheet items is 10,000 dollars, the balance in the deferred exchange account would be adjusted to reflect this item. One-fifth of the adjusted balance of 30,000 dollars, or 6,000 dollars, would be recognized for United States income tax purposes in 1974, and the remainder, 24,000 dollars, deferred.

---

77. Theoretically, under this approach it would seem proper to amortize the exchange rate gain or loss attributable to each balance sheet item over the useful life of that item. Exchange rate gain or loss attributable to current assets and liabilities thus would be entirely deductible currently, since these items, by definition, will expire within one taxable year. The exchange rate gain or loss attributable to such items as fixed assets and long-term liabilities would be amortized over the useful life of such items. Problems would arise under this approach, however, in the case of items such as goodwill, which have no determinable useful life. An amortization period might be chosen arbitrarily for these items. It is evident, however, that application of this method in practice would seem to be very complicated. Consequently, the proposal suggested in the text seems preferable.

78. The computation would also include the exchange rate gain or loss attributable to such items as goodwill.

Use of this proposed method would adhere to the basic principles of the net worth method, but recognize the potentially undesirable economic effects that recognition of substantial amounts of exchange rate gain or loss each year might have on a taxpayer.<sup>79</sup> The taxpayer should have the option of using the net worth method or the deferred method proposed above, but the election, once made, should be irrevocable.<sup>80</sup>

Regardless of which approach is adopted, it is clear that either the Commissioner<sup>81</sup> or Congress must act. The present multitude of alternatives does not distribute the income tax burden equitably among taxpayers similarly situated. In fact, there is an element of pure chance in the results from year to year. This intolerable situation should be remedied.

---

79. This is particularly true if the value of the dollar depreciates in value. A taxpayer would then realize exchange rate gain due to his investment in foreign assets. He would probably not have the necessary funds available, however, to pay the United States income taxes attributable to such exchange rate gain.

80. Alternatively, the Commissioner might be given the discretion to permit a change in election, provided the taxpayer is willing to make the adjustments necessary to protect the revenue. *See, e.g.*, INT. REV. CODE § 481.

81. It is not clear, at present, whether the Commissioner possesses sufficient authority to promulgate these rules administratively. In *American Pad & Textile Co.*, 16 T.C. 1304 (1951), *acquiesced in* 1951-2 CUM. BULL. 1, the Tax Court indicated that the treatment of exchange rate gain or loss was an accounting problem susceptible of several solutions. 16 T.C. at 1310-12.