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TAXATION OF FOREIGN CURRENCY TRANSACTIONS

When Americans engage in transactions involving foreign currency, special tax problems arise. Fairness demands that residents with business or financial interests outside the United States be taxed on the same basis as individuals with dollar incomes. But two factors make equal treatment difficult. Fluctuation of exchange rates causes uncertainty in gain or loss determination. And governmental restrictions on use or conversion of currency may render it hard to measure in dollars. The growing significance of American business operations in foreign countries makes increasingly important a tax policy that deals realistically and equitably with these variables.

PREVAILING LAW

Freely Convertible Foreign Currency

Foreign currency frequently changes in value relative to American dollars. From an American's point of view, such currency is no different from stocks, real estate, or other forms of property. Because taxpayers in the United States are taxed only in dollars, gain or loss in foreign currency transactions must be determined for tax purposes by valuing the currency in American money. Even if the rate of exchange prevailing on a particular date is agreed upon, changes in rates and differing methods for ascertaining gain or cause litigation.

These problems have come before courts in various situations. The first is when an American firm doing business in a foreign country has net profit

1. See generally Roberts, Effect of Blocking of Currency on Gain or Loss in Proceedings of New York Univ. 7th Ann. Institute of Federal Taxation 1224 (1949) (discussion of blocked currency); Roberts, Taxability of Income Received in Blocked Currency, 86 J. Accountancy 231 (1948); Lassen, Blocked Accounts, 23 Taxes 238 (1948) (includes discussion of wartime blocking of foreign accounts by the United States); Stream, Earned Income from Foreign Sources, 25 Taxes 714 (1948) (discussion of Inr. Rev. Code § 116); Angel & Kramer, Some Questions on Taxability of Foreign Income Left Unanswered by Mimeograph 6475, 89 J. Accountancy 496 (1950) (discusses problems raised by the Mimeograph, from an accounting standpoint); Steutzer, Tax Problems Raised by Foreign Currency Decapulation and Blocked Foreign Income, 6 Tax L. Rev. 255 (1950) (discussion of case law and problems raised by Mimeograph 6475); Roberts, Borrowings in Foreign Currencies, 26 Taxes 1033 (1948) (criticism of tax treatment accorded loans payable in foreign currency); Klarmann, Taxation of Income in Blocked Currency, 23 Taxes 477 (1950). Discussions of various tax problems caused by foreign currency are also found in the Tax Services. For general treatment, see 1 CCH 1952 Fed. Tax Rep. ¶ 51,747 et. seq.; 1 P-H 1952 Fed. Tax Serv. ¶ 6033 et. seq.

2. See Note, Dollar Damage Award To Foreign Plaintiffs: Conversion and Revaluation of Foreign Currency, 61 Yale L.J. 758, 764 (1952).


measured by foreign currency, but the foreign currency has declined in dollar value. The dollar value decline may be sufficiently large to render the current assets of the firm measured in dollars less valuable at the end of the year than they were at the beginning, despite the "profit" in foreign currency. Whether shrinkage in dollar value of current assets may be considered in calculating net income for the year depends on whether the foreign business is conducted by a branch or subsidiary. *Frederick Vietor & Achelis v. Salt's Textile Mfg. Co.* held improper an attempt to tax the dollar value of a branch's "profit" in francs where the value of francs had declined. The court regarded gain or loss as the difference between the dollar value of the current assets measured at the beginning and at the end of the taxable year. Presumably this method would render taxable a branch's net operating loss in foreign currency if there was a rise in the dollar value of current assets. Subsidiaries, however, have been required by the Commissioner to translate net profit in foreign currency into dollars at year-end rates. A recent case would allow a branch to use either method, provided that the method chosen is used consistently. But subsidiaries abroad must apparently measure dollar income as before. The

5. 26 F.2d 249 (D. Conn. 1928).

6. *Id.* at 255-6. Taxpayer contended that whether it operated at a profit was to be determined by comparing the dollar value of its branch's current assets annually. The court agreed, using the following example: Taxpayer converts $100,000 into 500,000 francs for use in business. The business earns an additional 250,000 francs. But if after a change in exchange rates the 750,000 francs were together worth only $75,000, there would be loss, not gain, of $25,000. Gain, noted the court, is computed not in francs but in dollars. *Id.* at 255.

This procedure had been suggested earlier by the Bureau itself. 1920: O.D. 489, 2 Cum. Bull. 60 provided that where a corporation is engaged in business abroad, assets and liabilities (other than capital assets) recorded in foreign currency should be converted at the end of the taxable year at the current or market rate of exchange. See also A.R.R. 15, 2 Cum. Bull. 60 (1920).

7. G.C.M. 4954, VII-2 Cum. Bull. 293 (1928), provided that subsidiaries were not entitled to deduct losses due to shrinkage in foreign exchange, as shown by inventories of accounts receivable and accounts payable. The Bureau distinguished the *Salt's Textile* rule on the ground that *Salt's Textile* involved the method of computing the trading profit of foreign branches, rather than separate subsidiaries. The Bureau stated that subsidiaries must be regarded as separate and distinct entities for tax purposes. See Note, 1 Tax L. Rev. 232, 234 (1946). See also American Pad and Textile Co., 16 T.C. 1304, 1310 (1951), and materials cited.

8. American Pad and Textile Co., 16 T.C. 1304 (1951). The court noted the variance in methods, stating, "[T]he present problem of dealing with the foreign exchange accounting of a branch of another country will not necessarily yield any one perfect answer." *Id.* at 1309. However, taxpayers may not switch from one method to the other, depending on which promises the lower tax. The court made clear that the reason several methods are permissible is that any one used over the long run will yield correct results. *Id.* at 1311. See also O.D. 550, 2 Cum. Bull. 61 (1920).

9. In speaking of the *Salt's Textile* net-worth comparison method, the court in *American Pad* noted: "The method so described, while available for foreign branch, is different from that permissible in the case of a foreign subsidiary. G.C.M. 4954, supra," 16 T.C. 1304, 1310 n.2 (1951).
effect of using one method instead of another is slight; a subsidiary's gain or loss from change in the value of current assets is recognized when the current assets are disposed of.

Gain or loss determination must also be made when a change in rates affects the dollar value of currency held by the taxpayer. As is the case with other property, gain or loss is not ordinarily recognized unless there is some taxable disposition of the currency: exchange for dollars or property. And losses occurring on exchange must be claimed. If the loss is not taken, it will not be allowed when property received from the exchange is later sold. Thus in Credit and Investment Corp., taxpayer held a German bond which he had purchased for dollars. Under a German regulation, the bond was paid off in marks whose value in dollars was less than the price of the bonds. No loss was taken. The marks were used to purchase German securities, which taxpayer sold later at a slight loss. To obtain recognition of the loss resulting when the bond was paid in marks, the taxpayer claimed the cost basis of the securities was the cost of the bond. The court rejected this argument, and held that the only deductible loss was that occurring between the time the securities were bought and sold.

Courts must also ascertain gain or loss when taxpayers make or receive loans in a foreign currency and the rate of exchange shifts prior to repayment. Suppose taxpayer borrows francs, converting them into dollars. If francs at maturity are cheaper, repayment of the francs requires less dollars than taxpayer originally received. Nevertheless courts hold that taxpayer receives no taxable gain; borrowing and repaying the same amount of foreign currency does not give rise to gain or loss even if rates fluctuate. This treatment had its roots in Bowers v. Kerbaugh-Empire Co., where the Supreme Court held that if borrowed funds were used unprofitably in the borrower's business, so that the actual loss exceeded the gain from easier repayment, no tax could be recognized only after disposition, whereas decline in value of a firm's current assets may be deductible loss. See 1 CCH 1952 Fed. Tax Rep. ¶51,747 et seq. See also Note, 1 Tax L. Rev. 232, 234 (1946).


13. A 1933 regulation suspended dollar payment and provided for payment of an equivalent amount in marks measured at the official rate, which was $.40. The market value of the marks was $.14. Id. at 675-6.

14. "The Ostdeutsch bond transaction was concluded in 1935 when petitioner received 440,000 blocked marks. Its subsequent investment of 360,771.89 blocked marks in other securities was a separate transaction. The cited case . . . [Bowers v. Kerbaugh-Empire Co., 271 U.S. 170 (1926)] . . . does not sanction the postponement of realized losses." Id. at 682.
levied. The Court apparently viewed the borrowing, use of the funds by the debtor, and repayment as a single transaction. In subsequent dicta the Board of Tax Appeals broadened this doctrine: the Board thought that borrowing and repaying currency could never result in gain or loss. And its most recent holding clearly establishes this rule. In Wm. H. Coverdale, taxpayer borrowed Canadian dollars, immediately exchanging them for an equal number of United States dollars. When his debt had been partly repaid, the Canadian dollar fell. For only $237,165 (U.S.) taxpayer purchased $290,037 (Can.) and retired the loan. The Tax Court held the $52,872 not taxable gain.

The Second Circuit, however, recently refused to adopt this position on analogous facts. In Waterman v. Commissioner, a creditor-taxpayer died while a loan in foreign currency was outstanding. The court permitted the executor a loss deduction representing the difference between the “value of the obligation in dollars at the decedent’s death and the value in dollars at the date of payment.” The Commissioner unsuccessfully urged application of the rule that borrowing and paying back property does not result in gain or loss. But the court ignored the rule on the ground that the executor was a new taxpayer, distinct from the original taxpayer making the loan.

Gain or loss recognition following rate change is also necessary to correct errors in prior tax treatment. Where, for example, goods are purchased abroad on credit for a price measured in foreign currency, rates may change prior to the date of payment. Both the Bureau of Internal Revenue and courts have held that the cost of the goods is the foreign currency price translated

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15. 271 U.S. 170 (1926). Taxpayer borrowed marks and converted them to dollars, promising to pay back in marks at a later date. The dollars were then used in an investment which resulted in net loss to the taxpayer. Repayment, since made following World War I, was effected with relatively few dollars, compared with the $1,983,000 received by taxpayer initially. Nevertheless, “the excess of . . . loss over income was more than the amount borrowed.” Id. at 175.

Kerbaugh-Empire has been extensively criticized. Roberts, Borrowings in Foreign Currencies, 26 Taxes 1033 (1948), states that the Kerbaugh-Empire position has been abandoned in every field except that of foreign currency.

16. See B. F. Goodrich Co., 1 T.C. 1098, 1103-4 (1943); “A mere borrowing and returning of property does not result in taxable gain. . . . Suppose the petitioner had borrowed 11 bars of metal with an obligation to return their equivalent rather than their money value, and, after using that particular metal, the petitioner has spent some of its United States funds to obtain 11 new bars which it turned over to the lender in satisfaction of its obligation. It would seem clear that no real gain or loss could result from the mere borrowing and return of fungible property.”


18. The court followed the dictum in B. F. Goodrich, supra note 16. It also suggested that Kerbaugh-Empire was still a precedent. Id. at 801.

19. 195 F.2d 244 (2d Cir. 1952).

20. Id. at 245.

21. See Brief for Respondent, p. 18, Waterman v. Commissioner, 195 F.2d 244 (2d Cir. 1952).
into dollars at the rate prevailing when the purchase is made. But if rates change before payment the real price of the goods has also changed. Recognition of gain or loss resulting from the rate fluctuation compensates for erroneous tax treatment resulting from the false valuation of the goods. Thus when the real price of the goods in dollars is higher than dollar cost at date of contract, valuation at the contract rate will overstate profits when the goods are sold. Loss recognition compensates for this error. Similar adjustment has been made where services are performed abroad on credit for a price in foreign money. If the price was reported in income at the rate prevailing when the services were rendered, gain or loss caused by fluctuation is recognized.

**Blocked Currency**

Tax problems of foreign currency become more complex when the currency is wholly or partially “blocked.” Blocking—a common phenomenon since the start of World War II—consists of various types of restrictions imposed by foreign governments on the use or exchange of their currency.

When currency is blocked, the central bank of the foreign country is usually

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22. The Bureau's first ruling was O.D. 489, 2 Cum. Bull. 60 (1920). It provided that the cost of goods purchased should be measured by the rate of exchange prevailing at the time payment for the goods is actually made. This was altered by a subsequent ruling, O.D. 590, 3 Cum. Bull. 75 (1920), which provided that cost was to be measured by the rate at date of purchase, with recognition being given to later gain or loss upon payment.

23. “[W]hen property was purchased abroad, the price being payable in foreign currency, we held that the cost was the value of the foreign currency at the date of the purchase, that if payment was not made at the time there was a venture in foreign exchange and that gain or loss on such venture was to be reported as from a sale of foreign currency and did not affect the purchase price of the goods.” John C. Moore, 15 B.T.A. 1140, 1143 (1929). This treatment was first sanctioned by Bernuth Lembcke Co., 1 B.T.A. 1051 (1925), and followed in Joyce-Koebel Co., 6 B.T.A. 403 (1927). For general discussions see Roberts, Borrowings in Foreign Currencies, 26 Taxes 1033 (1948) and Stuetzer, Tax Problems Raised by Foreign Currency Decimation and Blocked Foreign Income, 6 Tax L. Rev. 255 (1951).

24. Foundation Co., 14 T.C. 1333 (1950). Petitioner performed engineering and construction services for Sociedad, a Peruvian firm. The soles earned were worth $734,400 at the rate then prevailing. This amount was reported in taxpayer's 1923 tax return. Payment could not be made at once, and the debt was paid off gradually. Petitioner claimed, and was allowed, losses representing the difference between the dollar value of the soles owned in 1928 and the value actually received upon conversion in 1940.

25. Restrictions on exchange and, in some cases, on use within the blocking country, may be illustrated by a summary of the Argentine statute:

"4. Entry and Withdrawal of Foreign Capital. The entry of capital into Argentina from abroad requires the approval of the Central Bank and an official exchange rate is established for such cases. Withdrawal of capital from Argentina, whether derived from the sale or liquidation of industries or commercial establishments and by private individuals, or through payments of dividends, etc., also requires the authorization of the Central Bank, which may or may not approve the withdrawal...

"5. Blocked Funds of Foreigners [restricted as to use within Argentina]. These blocked funds are usually in the hands of commercial banks, but may also be held by
given an official monopoly on exchange.\textsuperscript{20} It buys and sells its currency at fixed rates and under certain prescribed conditions.\textsuperscript{27} Usually holders of foreign currency may obtain dollars from the central bank's dollar reserve only if they have permission to do so.\textsuperscript{28} Permission is in most cases granted only to those who need dollars to pay for government approved imports.\textsuperscript{29}

private enterprises, with the knowledge and consent of the Central Bank. Any movement of such funds (purchase of domestic stocks and bonds or shares in local business) requires the approval of the Central Bank.

"Local banks, as depositaries of blocked funds, may pay interest... but... payment requires the consent of the Central Bank, which will grant the corresponding foreign exchange; otherwise, without such authorization, the interest remains blocked with the principal.

"If a foreigner who is a direct beneficiary of blocked funds takes up permanent residence in Argentina and as such obtains the cedula of identity issued by the Federal Police, the Central Bank, after an examination of each specific case, will free the funds in question and they shall thereafter have unrestricted movement within the country."


For a list of restrictions by countries, see \textit{Chase National Bank, Import and Exchange Regulations of the Principal Countries of the World} (1951). Canada, Switzerland and the United States are the only major countries which do not restrict currency flow.

\textsuperscript{26} \textit{Escher, Modern Foreign Exchange} 163 (1935). See also \textit{Laws of Argentina, op. cit. supra note 25}. In some cases dividends from investment may be convertible into dollars, while the investment capital itself is blocked. Brazil permits 8\% remission of invested capital. Remission of amounts over 8\% may be effected only with permission.


\textsuperscript{27} Rates are published in New York City newspapers.

\textsuperscript{28} See \textit{Pan Am. Union, op. cit. supra note 25}, at 31. Other typical restrictions are contained in the Union of South Africa decree, in force during World War II and following:

"3. (1) Subject to any exemption which may be granted by the Treasury, no person shall, except with permission granted by the Treasury—

"(a) take or send out of the Union any bank notes, gold securities or foreign currency, [or]... [b]... transfer any security or acknowledge any debt, so that a right (whether actual or contingent) to receive a payment in the Union is created or transferred as consideration—

"(i) for receiving a payment, or acquiring property, outside the Union, or

"(ii) for a right (whether actual or contingent) to receive a payment or acquire property, outside the Union, or make any payment as such consideration." Emergency Finance regulations, Union of South Africa, 1939, cited in Morris Marks Landau, 7 T.C. 12, 14 (1946). Restrictions imposed by other countries, with detailed information about rates at which exchange may be made if the holder has a permit, are found in \textit{Chase Bank Bulletin, op. cit. supra note 25}.

\textsuperscript{29} Goods must be cleared through customs before the expiration date of the permit. And exchange may be obtained only after clearance of the goods or after approval of documents by exchange authorities.

Imports are often categorized in order of necessity. Thus Uruguay places essential raw materials, capital goods and consumer goods in one preferred group for which import licenses are not needed. For semi-essential and luxury goods, permits are required.
Rationing of currency protects scarce dollar reserves by restricting imports to essentials. Dollar reserves are also augmented by the requirement that holders of dollars who wish to purchase the foreign currency must pay dollars to the official bank rather than to private holders of foreign currency.

But the official rate usually sets too high a dollar value on the foreign currency. Many people seek to sell foreign currency for dollars at prices below the official rate. And since the blocking restrictions do not bind buyers abroad, a ready market exists for the cheaper foreign currency. Some conversion takes place in ways permitted by official regulations. First, small amounts of currency may legally be carried out of the blocking country by travellers. This may be sold at a discount in the United States. Second, holders of the currency may purchase property and sell it for dollars. For example, taxpayers who hold blocked British pounds may use them to purchase British securities. At maturity the securities may legally be sold at a discount to Americans for dollars.

But most conversion of blocked currency takes place in violation of the blocking country's laws. Holders of foreign currency sell it to an agent of a New York foreign exchange broker. The broker credits the seller with dollars at the market rate. The foreign currency is later sold for dollars to Americans who need it abroad and wish to avoid paying the more expensive official rates. When these customers arrive in the foreign country, they receive foreign currency from the broker's agent. Such transactions take place daily on a large scale. Only when holdings are too great or are blocked in a special account are such transactions sometimes impossible.

The government will release one dollar of exchange for 1.90 Uruguayan pesos, if needed to pay for favored-category imports. But for luxury goods, the importer must pay 2.45 pesos for each dollar of exchange. Such restrictions are common; Chase Bank Bulletin, op. cit. supra note 25. For a case in which operating profits in exchange were released at the official rate, see American Pad and Textile Co., 16 T.C. 1304, 1312 (1951).

30. See, e.g., Ceska Cooper, 15 T.C. 757 (1950).

31. New York banks as well as foreign exchange brokers will buy actual bills of foreign money, even though it is not clear how the holder brought them to the United States. The discount is dependent upon the number of persons wanting such bills. This in turn depends on whether the currency can be carried abroad for use without being noticed and confiscated, and also upon the number of legal uses for it. The exchange brokers will also buy currency that has not left the issuing country, even though this may be illegal under that country's laws. Since there are some legal uses, the broker cannot successfully be accused of knowingly selling to persons who are going to smuggle. Pounds, for example, may not only be carried into England in amounts up to £10, but may be spent freely aboard English ships.


33. This determines the so-called market rate for blocked currency, which the courts use as a measurement when currency is blocked but is freely usable within the blocking country. Even where currency is not freely usable, there may be a market rate. See Credit and Investment Corp., 47 B.T.A. 673 (1942), where kreditspermarks held by taxpayer had a market value in New York of §14-§11 over a period of several years although conversion generally was not permitted.
Judicial Treatment. Blocked currency tax problems first reached courts in *International Mortgage and Investment Corp.* Taxpayer had received German marks whose conversion into dollars was prohibited. In addition, use of the marks inside Germany was severely restricted; they could only be invested in long term bonds. No market for such marks existed in the United States. On these facts the Board of Tax Appeals held that taxpayer had received no taxable gain. The next case, *Stuart, James & Cooke, Inc.*, was substantially similar. Taxpayer received rubles for engineering services performed in Russia. The rubles could not be converted into dollars. Moreover, their use inside Russia was restricted; taxpayer could use the rubles only to meet payroll expenses. Whether there was a market in this country for rubles of this kind did not appear. The Board followed *International Mortgage*. Thus it appeared settled that where restrictions on conversion and on internal use were present, there could be no tax.

A different situation was presented in *Phanor J. Eder v. Commissioner*. Taxpayer was a stockholder in a foreign holding company which received income in Colombian pesos. Taking the pesos out of Colombia apparently was prohibited, and the funds had not been distributed as dividends. Nevertheless the Board of Tax Appeals upheld a tax on taxpayer's pro rata share of profits, measured at the official rate of exchange. The Board based its decision on the presence of a special statute taxing undistributed profits.

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34. 36 B.T.A. 187 (1937).
35. *Ibid.* However, the Board did not indicate which of the factors was crucial in its decision. It said: "None of the marks . . . could be removed from Germany either physically or by way of credit during . . . the taxable year. The dollar equivalent of those marks could not be obtained. The petitioner did not have unrestricted use and enjoyment of the marks . . . . It could not use the marks . . . as it desired to do." *Id.* at 190. But the court also declared: "Just at the end of the year there was a regulation . . . which permitted reinvestment . . . . But proceeds of such reinvestment would likewise be blocked and . . . in no way benefited the petitioner during 1931. The petitioner had no way of obtaining these funds during 1931 . . . . Thus it appears that these particular marks . . . were subject to a very serious restriction and were in no sense the equivalent of free marks. It was therefore improper to compute a gain to the petitioner . . . ." *Id.* at 190.
36. 7 P-H 1938 BTA MEM. DEC. ¶ 38,095 (1938).
38. At the same time, Credit and Investment Corp., 47 B.T.A. 673 (1942), established that if conversion was possible, that factor alone made receipts in foreign currency taxable.
39. 138 F.2d 27 (2d Cir. 1943).
40. The court's opinion, after admitting that "the evidence does not make it clear whether or not owners of 'blocked' pesos could have sold them for dollars to citizens of this country wishing to invest or spend the pesos in Colombia," *id.* at 28, proceeds on the assumption that inconvertibility had been established.
42. Section 337 of the Revenue Act of 1938, taxing stockholders of foreign holding companies on their pro rata share of undistributed Supplement P net income.
of foreign holding companies; it presumed that Congress intended to impose a tax regardless of whether accumulated profits were in blocked currency. On appeal, the Second Circuit agreed that a tax could be levied. But while the court adopted the "special statute" argument advanced by the Board, the decision was also put on a broader ground: that the taxpayer received "economic satisfaction" because he had opportunity in the course of visits to Colombia to use the funds freely there. Moreover, the Second Circuit disagreed with the Tax Court's measurement of the peso's value at the official rate. The appellate court remanded the case with the suggestion that "economic satisfaction" could best be measured by a comparison of relative price indexes in the United States and Colombia, resulting in an estimate of costs in the United States of goods and services taxpayer's pesos would purchase abroad.

The facts of the next case, United Artists Corp. of Japan, were closer to International Mortgage than to Eder. Conversion of Japanese yen was prohibited, and their use within Japan was severely restricted. The Tax Court held that receipt of blocked yen was not a taxable gain. It distinguished Eder, however, on the narrow ground that in United Artists there was no special legislation. What effect special legislation would have had in a United Artists situation was left uncertain.

43. "In enacting section 337, supra, and Supplement P, in which that section is included, legal transfer to the United States of its distributed earnings by the foreign personal holding company was not made a condition precedent to the laying of the tax. Nothing there appears remotely suggesting that foreign laws or regulations may affect the imposition of the tax." Phanor J. Eder, 47 B.T.A. 235, 240 (1942).

44. After pointing out that Congress meant to deal harshly with "incorporated pocket-books" (foreign holding companies), the court noted that if a corporation "finds itself, because of the way it was organized... within the scope of a statute primarily designed to make the failure to distribute actual net income too expensive to be worthwhile and was, therefore, taxed when it did not in fact do what the statute was aimed to discourage, it must endure its misfortune as best it may." Eder v. Commissioner 138 F.2d 27, 28, 29 (1943).

45. "But even if we assume that such a transaction was not lawfully possible under the laws of Colombia... still there can be no denying that the taxpayers could have invested, or spent the blocked pesos in Colombia and, as a result, could there have received economic satisfaction." Eder v. Commissioner, 138 F.2d 27, 28 (1943).

46. "There is nothing in the record to show how economic satisfaction in Colombia can be measured in American dollars. Perhaps it can be measured on the basis of the respective price indices in the United States and Colombia, restricting the commodities included in the indices to those which could readily be purchased in Colombia in the taxable year; perhaps there are other available legitimate bases." Id. at 23. The court then remanded the case to the Tax Court to consider the appropriate measure of valuation. The Tax Court's opinion on remand is reported at 3 CCH 1944 TC Memo. Dec. ¶ 460 (1944).


48. Id. at page 683.
Later decisions revealed that the existence of special legislation was not essential to validate a tax on inconvertible funds freely usable in the foreign country. In estate and gift tax cases such currency was held to have present value to taxpayer, measured by the market rate in New York for blocked currency that had been exchanged. And in Ceska Cooper, decided in 1950 by the Tax Court, a British citizen who resided in the United States was taxed on receipt in England of blocked pounds which, though they could not be taken to the United States or exchanged for dollars, could be used anywhere within the sterling area. There was no special legislation. The court distinguished International Mortgage on the sole ground that there no market existed for the German marks. Income was measured in dollars by the market rate for blocked pounds. Moreover, the recent Second Circuit decision in Waterman v. Commissioner held that when the executor of an estate received payment in blocked pounds on a debt owed to decedent, the executor realized the value in dollars of the pounds, despite the fact that the pounds could not be converted. Apparently the pounds could be used in the sterling area, although the court did not discuss the question.

49. A dictum in Weil v. Commissioner, 150 F.2d 950, 951 (1945), hinted that tax would be imposed where inconvertible funds could be used by taxpayer, even in the absence of special legislation. However, this was not necessary to the holding, since the court found that taxpayer had not proved the funds inconvertible.

Another case following Eder, Max Freudmann, 10 T.C. 775 (1948), was similar in that the funds were freely usable, and were taxed under special legislation. The court levied tax, based on a valuation of the Canadian dollar stipulated by the parties.

50. In Morris Marks Landau, 7 T.C. 12 (1946), taxpayer had blocked South African pounds. They were freely usable within South Africa. Taxpayer, who resided in the United States, was completely unable to convert his pounds, and gave them to relatives in Africa. A gift tax was assessed, based on a rate declared by expert testimony to be the value of blocked pounds in the United States. And in Estate of Anthony H. G. Fokker, 10 T.C. 1225 (1948), the court also taxed inconvertible funds. The valuation was based on the free market rate in New York for blocked guilders.

51. 15 T.C. 757 (1950).

52. "It is true that under British law and British Treasury regulations these credits could not have been brought to the United States in cash. But, as we have already said, they were freely expendable by petitioner anywhere in the sterling area and we think that makes them taxable income to petitioner." Id. at 764-5.

53. 175 F.2d 244 (2d Cir. 1952).

54. Id. at 245. Since the value realized in dollars was less than the value of the note when it was used to measure the gross estate, the executor was allowed a loss. But he claimed as loss only the difference between the official value of the pound when the estate tax was levied and the lower official value prevailing when the note was paid. The blocked pounds received were in fact worth less than the official rate. The court noted that "it may be that the loss was actually more than claimed for that has been computed by the taxpayer on the basis of unblocked pounds while blocked pounds were presumably worth less. However, it is obvious that the loss was at least as great as that claimed." Ibid. As a result, the court did not have to select an appropriate measure of the value of the pounds.
The upshot of the blocked currency cases appears to be this: if conversion of currency is prohibited but taxpayer fails to show that use of the currency within the foreign country is restricted, a tax will be upheld whether or not special legislation exists. If taxpayer cannot even use the currency in the foreign country, the doctrine of *International Mortgage* may prevent a tax. However, while *International Mortgage* has never been overruled, its applicability has been steadily restricted; indeed, *Ceska Cooper* suggests that it may be limited to extremely rare situations where no market for blocked currency exists.

Precedents give the Tax Court a choice of methods of valuation to employ in measuring gain for tax purposes. Either the market rate or *Eder's* price index scale might be used. In only one case, however, was the *Eder* method even attempted, so the market rate is apparently the prevailing determinant of value.66

*Administrative Treatment.* In 1950 the Bureau of Internal Revenue issued a ruling designed to facilitate measurement of blocked currency. Mimeograph 6475 classifies foreign currency income as deferrable or non-deferrable. Deferrable income is that "received by, credited to the account of, or accrued to a taxpayer which, owing to monetary exchange or other restrictions imposed by a foreign country, is not readily convertible into United States dollars." Taxpayers may elect to use a method of accounting in which the reporting of "deferrable income" is delayed until the income ceases to be deferrable. This occurs in any of the following situations:

1. It becomes "readily convertible" into dollars.
2. The foreign currency is in fact converted, even illegally.
3. The income is used for non-deductible personal expenses, is disposed of by way of gift, bequest devise or inheritance, by dividend

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56. The market rate was used to determine the value of currency that was inconvertible in Morris Marks Landau, 7 T.C. 12 (1946) (gift tax); Estate of Anthony H. G. Folker, 10 T.C. 1225 (1948) (estate tax); Max Freudmann, 10 T.C. 775 (1948) (income tax governed by special legislation; parties had stipulated the rate); Ceska Cooper, 15 T.C. 757 (1950) (income tax). *But cf.* S.E. Boyer, 9 T.C. 1163 (1947), where the official rate was used. Taxpayer was an Army officer, stationed in England and France. He was paid in pounds and francs, measured at the official rate. He claimed that his dollar income should not be measured by the official rate, since the market value of the currency was less. However, the court found that upon leaving England or France taxpayer could have received dollars at the official rate.
or other distribution, or, in the case of a resident alien, when a taxpayer terminates his residence in the United States.

If income has been deferred for several years and ceases to be deferable in a later year, the entire amount is taxed as if it had been received in the later year; it may not be allocated among prior years in which it was earned.60 Other provisions permit charging off costs and expenses attributable to deferable income only as the income ceases to be deferable.60 A later ruling limits the time for election to defer to the due date for the regular tax return of that year.61 When deferable income is used to purchase investment or business property, the cost basis of the property is the value of the currency when it ceases to be deferable.62

If income is deferable, the taxpayer will have to decide whether to exercise his option. Assuming the income to be presently taxable,63 the taxpayer will base his decision primarily on whether he would rather pay annually or in a lump sum later. Assuming the income to be non-taxable under the International Mortgage rule, taxpayers might decline the deferment option in the hope that, when the currency was later exchanged either for dollars or for other goods, the income would be taxed at capital gains rates.64

**Evaluation of Current Law**

Courts in most situations determine gain or loss in foreign currency transactions fairly. True, in any single year the Salt’s Textile method of comparing dollar values of a firm’s net current foreign assets at the beginning and end of the tax year may result in a figure different from that computed simply by converting net profit in foreign currency to dollars at the end of the year. Under the first method, rate changes occurring during the year are recognized, even though the assets have not been converted or exchanged.65 Under the second method, recognition of changes in the value of assets takes place only when the assets are finally disposed of. The attitude of the Tax Court is

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59. Taxpayer "waives any right to claim that the 'deferable income' or any part thereof, was includible in his gross income for any earlier year." Mimeo. 6475, 1950-1 Cum. Bull. 50, 51.

60. See Mimeo. 6475, supra note 59, at 52, 53 for explanation of cost and expense deduction where costs and expenses, either in foreign income or in dollars, were incurred in the production of deferable income.

61. Mimeo. 6584, 1951-1 Cum. Bull. 19 states: "An election to use the method of accounting prescribed under this mimeograph shall be made no later than the time prescribed by law (including any extension thereof) for filing the income tax return for the first taxable year for which the election is to be applicable."


63. See Ceska Cooper, 15 T.C. 757 (1950).

64. The question of what happens when non-taxable currency is converted has not been decided. In International Mortgage the court noted that taxpayer had not transferred his marks until 1935. But nothing is said about tax at that time.

65. This inconsistency is noted in I C CH 1952 Fed. Tax Rep. § 51.747 et seq.
TAXATION OF FOREIGN CURRENCY

that either method employed regularly will reflect dollar income accurately over the long run.66 This view seems justified. The Code and the Bureau permit domestic business to adopt various methods of accounting, so long as the method is followed consistently.67 Over a single year, no two methods will necessarily yield identical results. Moreover, in determining the value of inventory at the end of the tax year local taxpayers are given the option of valuing inventory at cost or market price, whichever is lower.68 This allows recognition of value change in current assets without disposition, similar to the treatment in Salt's Textile. Consequently availability of two methods of income determination for foreign business operations merely puts them on the same tax footing as firms operating solely in the United States.

The tax treatment of credit purchases of foreign goods could, however, be simplified. If exchange rates prevailing when the contract was made alter before payment, fairness requires gain or loss recognition of the change in currency values. Where payment occurs in a later tax year, this method is justified, since the value of final payment is unascertainable when the tax is paid. But when payment is made in the taxable year, it would be simpler to measure the cost of the goods by rates prevailing when final payment is made,69 or, in the case of installment purchases, when each installment is paid. This procedure would value the payments correctly, and adjustment would be unnecessary.

It is only in dealing with repayment of foreign currency loans that courts have failed to achieve equitable tax treatment. The rule that repayment after rates have changed is not taxable disposition giving rise to gain or loss is inconsistent with holding profit taxable if stock is borrowed, sold, repurchased and paid back with profit to the borrower.70 This is the common short sale. Both stock and foreign currency have the characteristics of property. The short sale analogy, though urged and rejected in Kerbaugh-Empire, thus appears applicable. Gain and loss recognition in loan cases would prevent untaxed windfalls and would be more consistent with treatment of credit sales.

In most cases involving blocked currency, courts have properly assumed that taxpayer received some value and have tried to measure it.71 Three possible measures—official rates, "economic satisfaction," and market rates

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69. This was the method first suggested by the Bureau, in O.D. 459, 2 Cum. Bull. 60 (1920).
70. See Roberts, Borrowing in Foreign Currencies, 26 Taxes 1033, 1034 (1948).
71. Phanor J. Eder v. Commissioner, 133 F.2d 27 (2d Cir. 1943); Max Freudmann, 10 T.C. 757 (1950); Ceska Cooper, 15 T.C. 757 (1950); Waterman v. Commissioner, 175 F.2d 244 (2d Cir. 1952). See also Morris Marks Landau, 7 T.C. 12 (1946); Estate of Fokker, 10 T.C. 1225 (1948).
for blocked currency—have been considered. As courts have recognized, official rates are usually unrealistic. Normally they greatly overvalue blocked foreign currency. If the taxpayer had an opportunity during the taxable year to spend his funds in the foreign country, the Eder method is a valid measure of dollar gain. But the Eder test is unworkable. Courts cannot undertake a study of the cost of living in foreign nations; they lack time and equipment to do such a job even assuming precise answers could be obtained. In the one case where the Tax Court actually tried to use the formula it heard evidence on such matters as the "variable between prices at which the same or similar foods commonly used by citizens of this country living in Colombia sold in the United States and Colombia." In addition, a banking expert testified as to the peso's value. The court then "found" that the value of the peso was $.2853. But this sum was to the last decimal exactly one half of the official rate of $.5706 originally employed by the Commissioner. The Tax Court has since avoided all mention of the relative price method.

Market rates thus appear to be the most satisfactory guide to determine the value of blocked currency. They give the most accurate indication of the dollar value of the currency, taking into consideration any restrictions on its use. Indeed, if currency is valued at market rates no logical justification would remain for retaining a distinction between the Ceska Cooper and International Mortgage situations; when the use of inconvertible currency is severely restricted, those restrictions should be reflected in lower market rates. Courts might therefore establish a uniform rule that all gains in foreign currency are immediately taxable.

Taxation upon receipt does not, however, seem the best way to solve problems of inconvertible foreign currency. Even the market rate may not be a fair measure, because taxpayer has by definition been unable to make use of the market. Moreover, taxpayer may in fact be unable to make any use of his receipts during the taxable year. If both A and B receive their entire income in inconvertible foreign currency and A is able to use it to finance his business while B is not, the unfairness of imposing the same tax on both is obvious. An equitable rule, on the other hand, would tax A and B at the point where each spent his money or was able to convert it. This is the solution attempted by the Mimeograph.

But Mimeograph 6475 is not an entirely satisfactory rule, for it is doubtful whether many taxpayers will elect to defer. If taxpayer defers, income might become unblocked at a rate equal to or greater than the value that would have been assessed earlier. And individual taxpayers, subject to progressive tax

72. See, e.g., Phanor J. Eder v. Commissioner, 138 F.2d 27 (2d Cir. 1943), and Ceska Cooper, 15 T.C. 757 (1950).
74. Id. at 461.
75. Ibid.
76. See, e.g., Max Freudmann, 10 T.C. 775, 797 (1948), where the court quoted at length from Eder without mentioning the relative price method.
rates, would not wish to have income of many years taxed all at once.77 Moreover, corporations, while not subject to the same progressive tax rates, may fear excess profits tax liability if a large amount of income were reported in one year.78 The Mimeograph should therefore be amended to provide that when income ceases to be deferable it will be pro-rated among the years in which it was earned.

Postponement of taxes on inconvertible funds makes important the factual problem of ascertaining convertibility. Does the possibility of black market transfer make funds readily convertible? The Mimeograph does not discuss this. But it seems clear that black market conversions, no matter how common, could not be required of taxpayers. On the other hand, legal but roundabout transactions, such as purchase and sale of securities, should render currency convertible. Hence the Mimeograph should permit taxpayers to defer whenever there is no direct or indirect legal method of converting their receipts.

But if the law achieved only equality, its policy would be shortsighted. The law should also be geared to American foreign investment policy embodied in Point Four.79 Numerous factors—fear of expropriation, prohibitive taxation by foreign governments, blocking, etc.—deter investors from employing capital in backward foreign areas.80 Needed investment can come from two sources: the government and private investors.81 Direct government investment may take the form of loans or outright gifts.82 Indirect governmental

77. See Angel & Kramer, Some Questions on Taxability of Foreign Income Left Unanswered by Mimeograph 6475, 89 J. Accountancy 496 (1950).
78. INT. REV. CODE § 430 et seq. For general explanation of how income becomes subject to the excess profits tax, see Note, 61 YALE L.J. 561, 563 (1952).
80. See 59 YALE L.J. 1277, 1286-92 (1950). See also Brown, Treaty, Guarantee and Tax Inducements for Foreign Investments in Symposium, U. S. FOREIGN INVESTMENT IN UNDEVELOPED AREAS, 40 AM. ECON. REV. 486 (Supp. 1950). In arguing that some guaranty to foreign investment should be given, the author states: "The two great risks of inconvertibility of the proceeds of investment and of the appropriation of property without prompt, adequate and effective compensation are, for the time being, so important that some form of guaranty . . . may be in the public interest." Id. at 493, 494.
81. For discussion of need to increase investment, and of the type of investment that should be encouraged, see generally Singer, The Distribution of Gains Between Investing and Borrowing Countries in Symposium, op. cit. supra note 80, at 473 et seq. See also Domar, The Effect of Foreign Investment on the Balance of Payments, 40 AM. ECON. REV. 805 (1950).
82. See 59 YALE L.J. 1277, 1280 (1950). In the peacetime period from 1946-1950, government loans and grants totaled 25 billion dollars. Private investment during the period was $2.5 billion. Public funds—from the United States and Canada—have accounted for over 50% of total foreign investment since World War II. COUNCIL OF ECONOMIC ADVISORS, THE ECONOMIC REPORT OF THE PRESIDENT, Table C-35, and C-37, cited id. at n.8.
action—the tariff reduction, subsidies, tax reductions, and insuring investment is, of course, already being undertaken. But present military expenditures and pressure for reduced government spending limit seriously the practicality of increasing either loans or gifts to backward areas. Probably only indirect governmental action in the form of financial incentives and guarantees is feasible.

A general program of incentives and guarantees would help private investors bridge the gap. Possible incentives cover a wide range of governmental action, and include reduction of present taxes on some receipts in foreign currency. Returns on investment which produces goods for native markets are in the form of foreign currency. Goods produced for native markets may be consumed or exported. If they are consumed, they may replace goods previously imported. If exported, they help bolster dollar reserves. The result in either case is desirable. Such investment is sensitive to changes in the tax rates applicable to foreign currency income.

While little can be done in the short run to persuade foreign governments to lift currency restrictions, the deterrent effect on investment of blocking can be lessened. Even changes in the Mimeograph would work toward this objective. A stronger incentive would be reduction or elimination of taxes on

83. For discussion of proposals, see generally Lyons, supra note 79. See also Comment, 59 Yale L.J. 1277 (1950).

The National Foreign Trade Council proposed that capital service—interest, dividends—be given priority in exchange for dollars. See Symposium, op. cit. supra note 80, at 487.

In July of 1949 the Herter Bill was introduced. It provided in general that the Export-Import Bank guarantee American investment abroad. See Comment, 59 Yale L.J. 1277, 1312 et seq. However, the bill died in committee. See Hearings before the Committee on Banking and Currency on H.R. 5594, 81st Cong., 1st Sess. (1949).

84. The President in his budget message reiterated the need for Point Four appropriations. See N.Y. Times, Jan. 17, 1952, p. 14, col. 4. But the budget has been severely criticised, see id., Feb. 23, 1952, p. 6, col. 2, 8 ("Sen. Taft and Sen. Kefauver agree that cuts are necessary"), and even essential military expenditures have been slashed. At this time it seems most unlikely that Point Four appropriations will even remain at current levels.

85. See discussions of incentives in Lyons, supra note 79, and Comment, 59 Yale L.J. 1277 (1950).

86. Lyons, supra note 79, at 921. Other proposals cover revision of the tax credits, guarantees of investment, negotiations of favorable trade treaties and easing the application of antitrust legislation to corporations operating abroad. See generally Comment, 59 Yale L.J. 1277 (1950).

87. In Symposium, op. cit. supra note 80, the problem of investment in extractive industries versus industries producing for the market in the foreign country is discussed from the point of view of a writer from an "exploited" area. See Singer, The Distribution of Gains between Investing and Borrowing Countries, id. at 473, 476: "The most important contribution of an industry is not its immediate product . . . but . . . its effect on the general level of education, skill, way of life, inventiveness, habits, store of technology, creation of new demand, etc. And this is . . . why manufacturing industries are so universally desired by underdeveloped countries; namely, that they provide the growing
foreign income that does become reportable. But this incentive should perhaps not be applicable to all foreign income. It might fail to aid those foreign areas which most need investment. Blanket rate slashes might simply attract capital to "safe" areas such as Canada, giving investors an unnecessary and unfair windfall, while keeping capital away from the less lucrative and more unstable areas that need Point Four aid. One answer to this problem might be to confine preferential tax treatment to specific areas claiming Point Four priority.

**CONCLUSION**

The problem of encouraging the investment envisaged by Point Four is complex. Possible incentives differ as to probable effectiveness, long run consequences, and cost. But general reduction of tax rates on at least some foreign currency receipts together with certain changes in the Mimeograph appear to merit inclusion in any incentive program. While the effect of such measures is hard to predict, there seems little doubt that they would help. The goal of fairness should be sought where incentive is unnecessary. This characterizes all situations except where business operation abroad, or investment abroad, yields foreign income. Here abandonment of fairness in favor of frankly preferential treatment seems justified by policy considerations.

points for increased technical knowledge, urban education, the dynamism and resilience that goes with urban civilization."

It has also been argued that the dollar shortage is a chronic condition, caused by the fact that United States industrialization has caused demand for our exports to be relatively greater than the exports of agricultural areas. Industrialization of raw material areas is possibly the only real answer to the problem of the dollar shortage. See generally KINDELBERGER, THE DOLLAR SHORTAGE (1950).

88. The whole theory of taxation as an incentive is criticized, Comment, 59 YALE L.J. 1277 (1950), on the ground that taxes are not considered by businessmen who invest abroad, and that tax incentives therefore do little more than add to the inequity of the tax structure. Cf. Lyons, supra note 79, at 925, stating that the effect of tax incentives cannot be measured beforehand.

89. See Comment, 59 YALE L. J. 1277, 1298 (1950).