14 T.C. 1333 (1950)

A taxpayer who reports income on the accrual basis and receives payment in foreign currency can deduct losses resulting from fluctuations in the exchange rate between the time the income was accrued and the time the currency was converted to U.S. dollars; such losses are ordinary losses if the foreign currency is held primarily for sale in the ordinary course of business.

Summary

The Foundation Company ("Foundation") contracted with a Peruvian corporation to perform construction work, with payment to be made in Peruvian soles. After the debt accrued but before Foundation converted all soles into dollars, the value of the sole declined. Foundation, which reported income on an accrual basis, sought to deduct these currency exchange losses. The Tax Court held that Foundation could deduct the losses as ordinary losses, not capital losses, because the soles were not a capital asset but were held primarily for sale in the ordinary course of its business. The Court also addressed and rejected the deductibility of certain prepaid expenses and a loss deduction related to a lawsuit against the Chilean government.

Facts

Foundation performed construction work for a Peruvian corporation, Sociedad Anonima Limitada Propietaria del Country Club ("Sociedad"), and by January 1, 1928, Sociedad owed Foundation 1,836,000 Peruvian soles. At that time, the exchange rate was 2.50 soles to the U.S. dollar, representing $734,400. Foundation accrued this amount as gross receipts in prior tax returns. Sociedad made payments in soles between 1937 and 1941, which Foundation immediately converted to U.S. dollars at prevailing exchange rates, which were less favorable than the rate when the debt originally accrued. Foundation deducted the differences between the value of the soles when the debt accrued and the value when converted in its 1940 and 1941 tax returns.

Procedural History

The Commissioner of Internal Revenue disallowed Foundation's deductions for the currency exchange losses in 1940 and 1941, arguing they were not deductible losses or allowable as net operating loss carry-overs. Foundation petitioned the Tax Court for review. The Tax Court considered the deductibility of the currency exchange losses, as well as other deductions, in determining Foundation's tax liability for 1942 based on net operating loss carry-overs from prior years and a carry-back from 1943.

Issue(s)

1. Whether Foundation sustained a deductible loss in 1940 or 1941 upon the conversion of Peruvian soles it received as payment for services rendered.

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2. If a loss was sustained, whether the loss resulted from the sale or exchange of capital assets under Section 122(d)(4) of the Internal Revenue Code.

Holding

1. Yes, because Foundation accrued the income represented by the soles and suffered an actual loss when the soles were converted into fewer U.S. dollars than originally anticipated due to the depreciated exchange rate.

2. No, because the soles were not a capital asset but were held by Foundation primarily for sale to customers in the ordinary course of its business.

Court's Reasoning

The Tax Court distinguished this case from *B. F. Goodrich Co., 1 T.C. 1098*, where a mere borrowing and returning of property did not result in taxable gain. Here, the debt resulted from construction work performed in the ordinary course of Foundation's business, giving rise to tax consequences. The court emphasized that Foundation properly accrued the soles as gross receipts and reported them in U.S. dollars at the prevailing exchange rates at the time. When Foundation later received and converted the soles, it realized fewer dollars than previously reported, entitling it to deduct the loss. The court determined that the losses were recognizable in the years the soles were received and converted, rejecting the Commissioner's argument that recognition should be deferred until the entire debt was closed out.

The court found that the soles were not capital assets because Foundation was in the business of performing engineering work and receiving payments in foreign currencies. The receipt and disposition of the soles were normal incidents of its business. Foundation immediately converted the soles into U.S. dollars and never intended to utilize them for investment. Therefore, the losses were ordinary losses and includible in the net operating loss carry-overs without limitation.

Practical Implications

This case provides guidance on the tax treatment of foreign currency transactions for businesses that operate internationally and receive payments in foreign currencies. It clarifies that losses due to exchange rate fluctuations can be deductible, especially when the foreign currency is received in the ordinary course of business and promptly converted. It is important to understand that this case emphasizes the factual nature of determining whether an item is a capital asset, focusing on whether it is held primarily for sale to customers. Following *Foundation Co. v. Commissioner*, businesses should carefully track the exchange rates at the time income is accrued and when foreign currency payments are received and converted to accurately report gains or losses for tax purposes. This case highlights the significance of contemporaneous documentation and consistent accounting practices in substantiating the characterization of foreign currency holdings.

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