26 T.C. 198 (1956)

A gain realized from the repayment of a debt in devalued foreign currency, where the debt was incurred in the ordinary course of business, constitutes ordinary income, not capital gain.

Summary

America-Southeast Asia Co. (the taxpayer), purchased burlap from India, payable in British pounds sterling, which it borrowed to make payment. When the pound sterling was devalued, the taxpayer repaid the loan for less than the original equivalent value in U.S. dollars, realizing a gain. The U.S. Tax Court held that this gain was taxable as ordinary income, not a capital gain. The court reasoned that the foreign exchange transaction was an integral part of the taxpayer's business and the gain arose directly from the settlement of a debt incurred in that business.

Facts

The taxpayer, a New York corporation, purchased burlap from Indian shippers in June and July 1949. Payments were made with letters of credit in British pounds sterling. The taxpayer borrowed the necessary pounds from a bank to establish these letters of credit. The British pound was devalued in September 1949. The taxpayer repaid its loan to the bank with the devalued pounds, resulting in a gain. The taxpayer reported this gain on its income tax return but did not treat it as taxable income.

Procedural History

The Commissioner of Internal Revenue issued a deficiency notice, arguing the gain was taxable as ordinary income or short-term capital gain. The taxpayer agreed the gain was taxable but disputed whether it should be taxed as ordinary income or capital gain. The case was heard in the U.S. Tax Court.

Issue(s)

Whether the gain realized by the taxpayer from the repayment of its debt in devalued British pounds sterling, which were incurred in its trade or business, is taxable as ordinary income or as a short-term capital gain.

Holding

Yes, the gain is taxable as ordinary income because the foreign exchange transaction was an integral part of the taxpayer's ordinary trade or business.

Court's Reasoning

The court determined that while two transactions existed – the burlap purchase and the foreign exchange transaction – the latter was an integral part of the taxpayer's ordinary business. The court relied on precedent, holding that the gain arose directly out of the business from the settlement of a debt incurred therein. The court found that the taxpayer's foreign exchange dealings were a regular part of its business, not a separate investment or speculation, and the resulting gain was therefore ordinary income. The court distinguished the situation from a short sale, emphasizing that the pounds were borrowed as part of the business operations.

The court stated, "the gain in question must, therefore, be taxed as ordinary income realized in such trade or business."

Practical Implications

This case clarifies that gains or losses from foreign currency transactions that are integral to a business's operations should be treated as ordinary income or losses, not capital gains or losses. Businesses involved in international trade should be aware that foreign exchange transactions related to the purchase or sale of goods are generally considered part of their ordinary course of business. This means the tax treatment of currency gains or losses will be determined by the nature of the underlying transaction. The case emphasizes that the substance of the transaction, not just its form, determines its tax consequences, especially in situations where foreign currency is used to pay debts incurred in a business.

