Durovic v. Commissioner, 65 T. C. 480 (1975)

The appropriate foreign currency conversion rate for tax purposes is the rate that reflects the true value of the foreign currency in the context of the transaction, not necessarily the rate used for customs duties.

Summary

In Durovic v. Commissioner, the U. S. Tax Court addressed the conversion rate for Argentine pesos to U. S. dollars and the tax treatment of free drug distributions. The case centered on the conversion of the cost of raw materials for Krebiozen from pesos to dollars and whether the free distribution of the drug constituted deductible expenses or non-amortizable capital expenditures. The court determined that the 'free' rate of exchange, not the 'basic buying rate' used for customs, should be applied due to the financial nature of the transaction. Additionally, the court ruled that the free distribution of Krebiozen was a capital expenditure for goodwill and research, not subject to amortization due to an indeterminable useful life.

Facts

Marko Durovic purchased raw materials for the drug Krebiozen in Argentina for 3,005,000 pesos on January 26, 1950. He brought these materials to the U. S. , where they were processed into 200,000 ampules. Duga Illinois, a partnership in which Durovic held a 50% interest, distributed 63,903 ampules free of charge to doctors and institutions for experimental purposes. The key issue was determining the appropriate exchange rate for converting the cost of raw materials to U. S. dollars and the tax treatment of the free distributions.

Procedural History

The case was initially decided by the Tax Court in 1970, which used the 'commercial' rate of exchange. Durovic appealed to the Seventh Circuit, which partially remanded the case in 1973 for reconsideration of the exchange rate and the tax treatment of the free ampules. After further proceedings, the Tax Court issued its supplemental opinion in 1975.

Issue(s)

1. Whether the 'basic buying rate' set forth in the Federal Reserve Bulletin should be used to convert Argentine pesos to U. S. dollars for tax purposes?
2. Whether the free distribution of 63,903 ampules of Krebiozen should be treated as deductible expenses or as non-amortizable capital expenditures?

Holding

1. No, because the transaction was financial in nature, the 'free' rate of 9 pesos per U. S. dollar should be used to reflect the true value of the peso in the context of the

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transaction.
2. No, because the free distribution of ampules was a capital expenditure for goodwill and research with an indeterminable useful life, and thus not subject to amortization.

Court’s Reasoning

The court applied the ‘free’ rate of exchange as it was the official rate for permitted financial transactions in Argentina at the time. This rate was deemed to reflect the true value of the peso more accurately than the ‘basic buying rate’ used for customs duties, which was artificially set to promote economic policy. The court rejected the ‘black market’ rate due to its volatility and unofficial nature. Regarding the free distribution of ampules, the court classified these as capital expenditures for goodwill and research, not subject to amortization because their benefits were indefinite and their useful life could not be reasonably estimated at the time of the expenditure.

Practical Implications

This decision clarifies that for tax purposes, the conversion rate used should reflect the economic reality of the transaction, which may differ from rates used for other purposes like customs duties. It also highlights the difficulty in amortizing expenditures related to goodwill or research when a useful life cannot be reasonably determined. Tax practitioners should carefully consider the nature of transactions involving foreign currency and the classification of expenditures to ensure accurate tax reporting. Subsequent cases have cited Durovic when addressing issues of foreign currency conversion and the tax treatment of goodwill and research expenditures.

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