TAXATION—SELECTION OF EXCHANGE RATE FOR TRANSLATION PURPOSES—WHERE MULTIPLE EXCHANGE RATES EXIST FOR A FOREIGN CURRENCY AND THE UNDERLYING TRANSACTION IS FINANCIAL IN NATURE, THE PROPER RATE FOR TRANSLATING COMPONENTS OF TAXABLE INCOME IS THE "FREE" MARKET RATE.

While residing in Argentina, taxpayer acquired certain raw materials,[1] necessary for the development of a drug[2] to be used in the treatment of cancer, by paying off a possessory lien held against the materials by a local financier.[3] Taxpayer then brought the raw materials into the United States[4] and entered into a partnership,[5] which subsequently manufactured

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[1] These raw materials were in the form of a powder derived from the blood serum of horses.

[2] The drug, later known as Krebiozen, was developed by taxpayer's brother. The drug proved controversial and gave rise to much litigation, *e.g.*, Durovic v. Palmer, 342 F.2d 634 (7th Cir. 1965); Durovic v. Richardson, 479 F.2d 242 (7th Cir. 1973), *cert. denied*, 414 U.S. 944 (1973).

[3] The lien was granted to an Argentine financier who invested 2,997,500 pesos in exchange for a right to one-half of any future profits. The financier lost interest in the venture when taxpayer's brother, developer of the drug, moved to the United States. The payment to the financier was made possible by a loan to taxpayer of 2,000,000 pesos by an Argentine bank. After the value of the peso began to decline with respect to the dollar, the lender approached taxpayer and successfully negotiated a reexpression of this loan to United States dollars. The conversion rate agreed to by the parties was 3.36 pesos per dollar, the "buying rate" in New York on January 30, 1950. "The rate used was the 'official rate' . . ., which was based on the 'buying rate' determined by the . . . Federal Reserve System in New York for the two weeks ended January 30, 1950." 487 F.2d 36, 46 (7th Cir. 1973). This conversion at 3.36 pesos per dollar was noted by the Seventh Circuit on the first appeal of this case as favoring the taxpayer's position.

> While we do not agree with appellant that this *post facto* recognition of an exchange rate to be used by agreement of the parties to the transaction binds the government in the collection of income taxes, neither are we impressed with the position of the Tax Court that . . . it is "the inescapable conclusion" . . . the commercial rate of exchange "actually determines the number of dollars which reasonable businessmen, dealing at arms length will be willing to pay for a commodity at a given time." For here, in the transaction under scrutiny, it did not. A figure different than the commercial rate was utilized, agreeable to the understanding of the parties.

Id.

[4] Taxpayer acquired the powder on January 26, 1950—the critical date for conversion purposes, as conceded by the Commissioner—and brought it into the United States on February 7 of the same year. For customs purposes, taxpayer identified the powder by weight only, stating it might have no value, depending on its medicinal effects. The court of appeals observed that this fact weakened taxpayer's argument for conversion at the "buying rate" specified in 32 U.S.C. § 372(c). See note 12 *infra* for a definition of "buying rate." The drug was considered exempt from duty as a "biological product" pursuant to 19 U.S.C. § 1202, Schedule 4, Part 3, Subpart B, Item 437.76 (1965). Section 1202 establishes the duty rates for certain imported substances, and Krebiozin qualifies for duty-free treatment. Taxpayer argued that the purchase of Krebiozen and its subsequent importation into the United States was a "commodity" transaction and thus the "basic buying rate" should be used. However, the Tax Court found that the purchase of the drug was a separate transaction from its exportation out of Argentina. The purchase was labeled a financial transaction as distinct from a commodity (import or export) transaction. 65 T.C. 480, 498 (1975).

[5] This was an equal partnership between taxpayer and his brother.

200,000 ampules[6] of the drug Krebiozen from the imported materials. For purposes of determining the taxpayer's income from the sale of the drug, the Commissioner of Internal Revenue agreed to consider M$N 3,005,000[7]—the amount paid to the lienholder in Argentine pesos—as taxpayer's basis[8] in the raw materials, a component of cost of goods sold.[9] A dispute arose, however, as to the currency exchange rate to be applied in translating this value expressed in pesos into its equivalent in United States dollars.[10] Taxpayer urged conversion[11] at the "basic buying rate"[12] of 3.36 Argentine pesos per United States dollar,[13] relying on the formula

[6] 63,903 of the ampules were distributed as free samples to the medical community and the remainder were sold.

[7] M$N is the designation for "moneda national" (paper currency), *i.e.*, the Argentine peso.

[8] The "basis" of property for purposes of determining gain or loss from the disposition of that property is generally its cost. Treas. Regs. § 1.1011-1.

[9] The Tax Court noted "[i]t is fundamental to our tax system that the determination of the amount of the cost of goods sold . . . must be measured in U.S. dollars. *Cf.* Estate of Jan Willem Nienhuys, 17 T.C. 1149, 1163 (1952)." Durovic v. Comm., 65 T.C. at 484.

[10] Two collateral issues were also in dispute in this case. The first issue concerned $105,387 of expenses incurred by the partnership in research, sterilization, ampuling, and packaging the drug. Initially, the Tax Court allowed one-half this amount as part of the cost of goods sold but disallowed the other half as a non-deductible capital expenditure. The court of appeals in Durovic v. Comm., 487 F.2d 36 (7th Cir. 1973), held that the Tax Court erred in not allowing the full $105,387 as part of the cost of goods sold. The second dispute concerned the proper treatment of taxpayer's free distribution to the medical profession of 63,903 ampules as samples. The taxpayer argued this was a deductible advertising expense or an amortizable goodwill expense. On a second appeal, the court of appeals in Durovic v. Comm., 542 F.2d 1328 (7th Cir. 1976), affirmed the holding of the Tax Court that the cost of the freely distributed ampules was a non-amortizable goodwill expenditure.

[11] The parties use of the term "conversion" is misleading. "Conversion" generally means the actual exchange of one currency for another, whereas "translation" means restating account balances from one currency to another. G. MUELLER, INTERNATIONAL ACCOUNTING 167 (1967). The instant case is concerned with the selection of an appropriate exchange rate to "translate" the cost of goods sold from Argentine pesos to United States dollars.

[12] As used herein, a "buying rate" means the rate at which one can purchase Argentine pesos by giving up United States dollars. Taxpayer relied on the December 1950 issue of the Federal Reserve Bulletin as authority for his assertion that the "buying rate" in New York for cable transfers was 29.778 cents per Argentine peso (3.3582 pesos per dollar). Taxpayer argued this was the only rate applicable to Argentine goods imported into the United States and should have been applied to his "commodity" transaction.

[13] The parties had stipulated before the Tax Court that the "official rate of exchange" was 3.36 pesos per dollar up to August 29, 1950, and the "commercial rate of exchange" was 9.66 throughout 1950. On his first appeal the taxpayer requested that the court take judicial notice of the contents of the December 1950 issue of the Federal Reserve Bulletin as there was no evidence before the trial court of the "basic buying rate." Taxpayer relied on this publication as authority for his assertion that only one conversion rate existed at the time in question—the "buying" rate in New York for cable transfers. 65 T.C. at 484. On remand, the Tax Court received additional evidence from both parties and concluded that the following multiple rates did, in fact, exist in January, 1950:

described in 31 U.S.C. § 372(c) for use in Customs transactions.[14] The Commissioner argued for conversion at the "commercial exchange rate"[15] of nine pesos per United States dollar—a rate which would lower the taxpayer's basis in the raw materials and thus, increase substantially the taxable income attributable to taxpayer.[16] In a suit by taxpayer against the Commissioner, the Tax Court ruled that the "free" rate of nine pesos per United States dollar was the appropriate rate in a financial transaction

Exports	Pesos per dollar
For basic merchandise	M$N 3.3582
Preferential "A"	4.8321
Preferential "B"	5.7286
Special	7.1964

Since these rates involved the movement of goods, they are often referred to as "commercial" rates. Since they were established by the Argentine Government, they are also referred to as "official" rates and "controlled" rates. 65 T.C. at 492. The Tax Court indicated that it should give "much weight" to the rate schedule set forth in the Federal Reserve Bulletin, but it was only one of several sources to be considered. The court of appeals, on taxpayer's second appeal, concurred with the findings of the Tax Court regarding the existence of multiple exchange rates. "[M]ultiple exchange rates have resulted in recent years from measures for the control and restriction of foreign exchange and export transactions." Barr v. U.S., 324 U.S. 83, 90 (1944). Thus, the taxpayer was unsuccessful in his argument that only one rate existed with respect to export merchandise. He was able to produce an expert witness who testified on appeal that the "basic buying rate" of M$N 3.3582 should apply to this transaction, but to no avail. This testimony was unconvincing to the court of appeals, as it was based on the assumption that an export product was involved, and thus, was not consistent with the definitional requirements of the taxpayer's exhibit setting forth the export rates. The court of appeals observed that taxpayer's own exhibit suggested that an unlisted product, such as taxpayer's drug, was subject to the "Preferential Rate 'A' " of 4.8321 pesos per dollar.

[14] This Customs statute sets forth the method of converting foreign currency into United States dollars. Section 372(c)(1)(A) indicates that if the Secretary of the Treasury has not specified a conversion rate for the foreign currency, then conversion should take place "at a value measured by the . . . buying rate. . . ." As further authority for using the "buying rate," taxpayer cites Barr v. U.S., 324 U.S. 83 (1944). The Tax Court, however, noted that the purpose of this statute (and the holding in *Barr*) is limited to "assessment and collection of duties upon imports. . . ." 65 T.C. at 489. The court of appeals observed that taxpayer brought the drug into the United States "without the application of the buying rate established by 31 U.S.C. § 372(c) or any other rate inasmuch as there was no 'assessment or collection of duties' and no value whatsoever was ascribed to the Krebiozen," 542 F.2d 1328, 1330 (7th Cir. 1973). Applying taxpayer's contention here would result in a zero value of cost of goods sold. *Id.*

[15] "Commercial rates" are those involved in the movement of goods, *see* note 13 *supra*. Alternatively, the Commissioner urged the use of the "black market" rate of M$N 15.00 pesos per dollar.

[16] The impact upon cost of goods sold is as follows:

Conversion of M$N 3,005,000 into dollars	
at 3.36 pesos per dollar as urged by taxpayer	$894,345
at 9.00 pesos per dollar as urged by Commissioner	333,888
Decrease in cost of goods sold	$560,457

such as this.[17] On appeal to the United States Court of Appeals for the Seventh Circuit, *held,* affirmed. The appropriate rate of exchange for converting a taxpayer's basis in cost of goods sold expressed in foreign currency units into its United States dollar equivalent is the "free" market rate, the rate herein recognized by the foreign government for officially permitted financial transactions. *Durovic v. Commissioner of Internal Revenue,* 542 F.2d 1328 (7th Cir. 1976).

In expressing asset values and reporting the income derived from the sale of assets for tax purposes, the existence of multiple exchange rates causes a major problem when the value of the assets has been established only in terms of a foreign currency, such as when goods are purchased on a foreign market by the expenditure of local currency. The resulting problem centers upon the selection of an appropriate exchange rate[18] to be used in translating[19] asset cost as expressed in units of the foreign currency into United States dollars,[20] from which taxable income can be calculated upon sale of the goods.[21] The selection process is imprecise at best because the rate chosen must be based, at least in part, on the following determinations: (1) to what extent has the local government restricted the conversion into dollars of income earned or currency acquired in the foreign country, (2) to what extent can the foreign currency be used abroad (either locally or

[17] "The record in this case convinces us that the 'free' rate was an 'official' rate established by the Argentine Government for permitted financial transactions and we find that that rate was 9 pesos per U.S. dollar." 65 T.C. at 497. This terminology is likely to cause confusion as a "free" rate is generally understood to mean an uncontrolled rate, whereas an "official" rate is typically controlled to some extent. *See* note 23 *infra.*

[18] The exchange rate used must "reflect actual transactions conducted in a free market and involving representative amounts." If this can not be demonstrated, then one must use the exchange rate shown in the periodical "International Financial Statistics" or successor publications by the International Monetary Fund. Treas. Reg. § 1.964(d)(5) (1977). The Regulations provide little guidance when the recognized source discloses *multiple* rates.

[19] The selection of a translation exchange rate usually becomes an issue only after a conclusion has been reached that the item to be translated should be taxable. D. RAVENSCROFT, TAXATION AND FOREIGN CURRENCY 520 (1973) [hereinafter cited as RAVENSCROFT].

[20] *Id.* at 126.

[21] An alternative to the rate selection problem is translation at a judicially created *ad hoc* hybrid rate based on expert testimony. This approach is proper only in unusual circumstances such as those in Estate of Swan v. Comm., 24 T.C. 829 (1955). At the time of his death, the decendent was residing in Holland and owned Dutch certificates representing ownership of an interest in certain United States corporations. These certificates were located in Holland and were subject to severe transfer restrictions arising from the German occupation. The court recognized that "diminution in value caused by war and governmental restrictions must be reflected in determining the fair market value of property." The unorthodox valuation method suggested by taxpayer and upheld by the Tax Court began with the unrestricted dollar value on the New York stock exchange of securities similar to those included in the estate. This value on the date of death was translated from dollars into guilders at the last official exchange rate before the German occupation, and finally this was translated back into dollars at a rate which approximated a free rate at the date of decedent's death. *See also* Estate of Nienhuys, 17 T.C. 1149 (1952) and Estate of Fokker, 10 T.C. 1225 (1948).

in third countries), and, finally, (3) what is the objective value (or values) of the foreign currency?[22] The problem is further complicated by the use of confusing exchange rate terminology,[23] a dearth of clear *ratio decidendi* in Tax Court and court of appeals decisions and the Commissioner's uneven application of subtantive rules.[24]

In those cases where the problem of exchange rate selection has arisen, the Commissioner has generally argued for the selection of that rate which would result in the greatest tax liability, whether it be the official rate, an unofficial rate,[25] or the local black market rate. The inconsistent positions taken by the Commissioner contrasts sharply with the more consistent approach taken by the Tax Court—an approach which seems to be based on the policy of applying that exchange rate which most fairly represents the actual economic benefit received by the taxpayer. This approach is demonstrated by the Tax Court's preference for the use of an unofficial rather than an official rate when a disparity exists between the two.[26]

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[22] RAVENSCROFT, *supra* note 19, at 482. There are two main principles of taxation of income subject to foreign exchange restrictions. First, income earned abroad is generally included in gross income only to the extent it can actually be converted into United States dollars, and the valuation in dollars of this income is based on the available conversion rate. The second principle is that, despite the fact that the foreign currency cannot be converted into United States dollars, the income earned abroad is includible for United States tax purposes if it can be used within the foreign country. *See* text at notes 36 and 37 *infra*.

[23] Difficulty is encountered in applying translation principles to the instant case because of the confusion caused by the imprecise terminology used by the parties. The taxpayer advocated a translation rate of M$N 3.36 pesos per dollar, and he described this as "the basic buying rate," "the buying rate in New York for cable transfers," and the "commodity trading rate." The Commissioner's terminology is equally confusing as he urges a conversion rate of M$N 15.00 pesos per dollar which he describes as the "parallel," "black market," "curb," "uncontrolled free," and "unofficial free" rate of exchange. Alternatively, the Commissioner argued for the use of the "free," "commercial," "legal financial," "controlled free," "official financial," and "financial" rate of M$N 9.00 pesos per dollar. This rate was referred to by others as the "free exchange buying," "current exchange," and "interbank" rate. Further confusion results from the official recognition by the Argentine Government of multiple exchange rates applicable to commodity transactions.

[24] *See* RAVENSCROFT, *supra* note 19, at 126.

[25] *E.g.*, the free market rate in New York for financial transactions.

[26] One of the earliest cases to consider the issue of choice of exchange rate was Credit & Investment Corporation v. Comm., 47 B.T.A. 673 (1942). There a taxpayer purchased bonds of a German corporation payable in dollars. Subsequently, German law restricted the payments of such bonds to marks. The German corporation paid the taxpayer in blocked marks which the taxpayer reinvested in other German securities that were later sold at a loss for more blocked marks. Finally, these blocked marks were sold for dollars at the free market rate. Taxpayer argued that his basis in the securities for purposes of loss recognition should be calculated using the official German rate of exchange applicable to free marks ($0.40) since the marks could be used freely within Germany. The Commissioner, however, argued successfully that the basis of the securities should be the price of blocked marks quoted on the New York market (*i.e.*, the free market rate) at the time the securities were purchased ($0.1437).

In Morris Marks Landau, 7 T.C. 12 (1946), taxpayer was prevented from withdrawing funds from South Africa due to currency transfer restrictions. He made a gift in trust to his children

Typically, the official and unofficial exchange rates differ because any exchange restrictions imposed by the exchange control country tend to overvalue the local currency.[27] The courts have found the most reliable measure of a restricted currency's value to be the exchange rate obtainable

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(who resided in South Africa) of £27,500; this transaction did not involve any transfer of funds out of the Union of South Africa. For gift tax purposes, he translated the trust corpus at $2.00 per pound. The Commissioner valued the gift at $3.98 per pound, the official rate of exchange for free (unblocked) pounds. The court held that value, for gift tax purposes, should be determined by taking into account the governmental exchange restrictions, and, thus, the official exchange rate for free pounds was inappropriate.

In *Eder* et al v. Comm., 138 F.2d 27 (1943), taxpayer's foreign personal holding company was permitted, under Colombian law, to transfer funds to its United States stockholder, but not in excess of $1,000 per month. The Tax Court upheld the Commissior's position that income of the undistributed pesos (*i.e.*, those in excess of $1,000 per month) should be recognized at the exchange rate applicable to free pesos. The Second Circuit held this to be error as those pesos in excess of $1,000 per month were "blocked" and the exchange rate for free pesos was inappropriate as it overvalued the blocked pesos.

The Commissioner, citing *Eder* and *Ceska Cooper, infra,* as authority for the proposition that "no inflexible formula" can be used for translation purposes, has now promulgated Rev. Rul. 64-307. This Revenue Ruling addresses itself to the question of whether income from foreign properties owned by an individual, who died while domiciled in the United States, should be reported by the executor at the free market rate of exchange rather than the official rate. The Revenue Ruling stated:

> In general, where an actual conversion of foreign currency into American currency is made, the rate of exchange at which the conversion is made is controlling as to the particular transaction. Where currency restrictions exist, and no conversion into American dollars is actually made, the problem of translating the foreign income into American dollars arises. . . .
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> Thus, a taxpayer who has income represented by a restricted foreign currency should translate such income to United States currency by using the rate of exchange that will most properly reflect his income. He does not have a free election to use whatever rate he wishes.

1964-2 C.B. 163, 166.

A similar result was reached in the later case of Ceska Cooper, 15 T.C. 757 (1950), Acq. 1951-1 C.B. 2. The taxpayer had been credited with salary and dividends in blocked British pounds while she was a resident alien in the United States during World War II. The Commissioner assessed a deficiency based on the official rate of exchange for the pound, but the court, citing *Landau* and *Edmond Weil, Inc., infra,* concluded the free market value of *blocked* British pounds should be used to measure taxpayer's income.

In Edmond Weil, Inc. v. Comm., 150 F.2d 950 (1945), taxpayer owned stock in a Brazilian corporation, and this stock was converted into a loan to a new partnership which succeeded the corporation. For purposes of calculating the taxpayer's gain on the disposition of this stock, the Commissioner translated the loan at the official rate of exchange. The Tax Court (affirmed by the Second Circuit) disagreed and held that the commercial rate should be used, thereby reducing taxpayer's recognized gain.

[27] One example of conversion at an unfavorable rate is the typical "blocked" currency case in which the foreign government imposes exchange restrictions for some reason. A number of these cases arose out of the German occupation in World War II. *See* note 26 *supra* and note 29 *infra.* The term "blocked" currency denotes "foreign currency which is not . . . readily convertible into dollars." Munsche, *Exchange and Other Problems in the Taxation of Foreign Income,* 17 N.Y.U. INST. FED. TAXATION 425, 429 (1959).

in a major financial market,[28] that is, the "free" market rate.[29]

In a recent case, *Cinelli v. Commissioner*,[30] the Sixth Circuit held that the "commercial" rate of exchange rather than the official rate of exchange was preferred when translating asset values from local currency to United States dollars. In so holding, the court observed that the free market or commercial rate was "a proper measure of how many U.S. dollars a particular unit of foreign currency actually purchases in arms' length transactions. It measures actual market value, real purchasing power, of one currency in terms of another."[31] The court further observed that, "the courts have been virtually unanimous in rejecting official exchange rates and in adopting commercial exchange rates as the proper media for translating foreign currency into U.S. dollar values. . . . Official exchange rates are seldom proper measures of the actual U.S. dollar value of foreign currency or property."[32] Thus, the court held that when no commercial rate[33] exists, the fair market value of United States dollars in Italian lire is best indi-

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[28] *E.g.*, New York, London.

[29] *See* Foundation Co. v. Comm., 14 T.C. 1333 (1950) ("[S]ince the dollar equivalent of the pesos could not be obtained at the 'official' rate [due to severe exchange restrictions], we conclude that it should not be used in valuing the pesos. . . .") and Ternovsky v. Comm., 66 T.C. 695 (1976) (A stamp collection had been bought in Hungary, and since the official rate was held not to reflect actual market value, the court used the "black market rate.") In *Ternovsky*, which was decided after *Durovic*, the use of a "buying power" exchange rate was urged by the taxpayer. This approach was logically appealing, as the taxpayer had used local currency to derive "economic satisfaction" by purchasing goods locally. The question was not the number of dollars required to purchase a stamp collection priced at 280,000 forints (the unit of Hungarian currency), but rather the dollar value of a stamp collection acquired at a cost of 280,000 forints. The former approach assumes a hypothetical conversion of dollars to forints *prior* to the purchase transaction followed by a translation of the historical cost of the asset from forints to dollars. The latter approach makes no such assumption. As noted in *Durovic*, the black market rate would seem to undervalue the purchasing power of the local currency, especially when viewed in the context of a transaction requiring merely a *translation* of the actual cost of an asset expressed in terms of local currency rather than a hypothetical *conversion* of one currency into another at the time of the transaction. *See* note 11 *supra*.

[30] 502 F.2d 695 (6th Cir. 1974). The taxpayer inherited real property in Italy in 1942. The proper translation of the 1942 fair market value of the property would determine the amount of a deductible loss subsequently incurred in taxpayer's trade or business. Italy's official exchange rate was 19.1 lire to the dollar, and the free market (or black market) rate was 719 lire to the dollar (note the extreme difference in the rates). The Tax Court held that the free market rate should be used rather than the official rate as the official exchange rate resulted from wartime conditions and did not reflect the actual worth of United States currency.

[31] *Id.* at 699. In footnote 8, the court conceded that the commercial rate was not a "perfect measure of the value in U.S. dollars of particular property with a foreign currency price. . . . [But] commercial rates are an available and roughly accurate measure of purchase power equivalence, and in the absence of a better indication of the actual U.S. dollar value of foreign property, they are usually the best available yardstick."

[32] *Id.* at 697-98.

[33] *I.e.*, the exchange rate occurring in the organized markets dealing in foreign exchange transactions.

cated by the Italian black market rate, which was based on actual dollar-to-lire transactions at the time of the event in question.[34]

The nature and severity of exchange restrictions imposed by a foreign government are significant factors which must be given adequate consideration in analyzing the tax consequences of transactions involving foreign currency. The Commissioner has endeavored to negate the tax impact of exchange restrictions on income earned abroad[35] by utilizing the so-called "economic benefit" or "convertibility" test which states that "foreign currency receipts are not includible in gross income if such receipts are not convertible into dollars either directly or through sale for dollars outside the foreign country, unless an economic benefit can be obtained from the use of such foreign currency."[36] That is, the Commissioner has argued that although the local currency might not be exchanged for United States dollars without resorting to the black market, the taxpayer would be able to derive "economic benefit" by using the currency for numerous purposes within the foreign country, and thus, it should be included in taxable income.[37] The Tax Court has not found this argument compelling, however, as demonstrated by their ruling in *Morris Marks Landau.*[38] There the court held that since the donees of a gift of South African currency lived in South Africa, full economic satisfaction had been realized by the United States donor, and the value of the gift should be translated without regard to existing currency transfer restrictions.[39] The rejection of the Commissioner's argument in *Landau* demonstrates that while economic satisfaction may be an appropriate test of *taxability,* it should not be used in determining the proper rate for *translation* purposes.[40]

In *Durovic* the Commissioner relied upon certain "blocked currency" cases—cases where the foreign currency could not be used to purchase dollars from exchange control authorities—but the court took the view that these cases were not applicable.[41] Such cases could, however, be helpful to the court by analogy, when, as here, though the currency is not officially blocked, consequences similar to those caused by blockage exist as shown by a disparity between the official exchange rate and the equilib-

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[34] 502 F.2d at 698.

[35] Income earned abroad is not at issue in the instant case, but, due to the factual similarity between income earned abroad and the acquisition abroad of a component of cost of goods sold, a consideration of the "convertibility" test may offer some insight into the Commissioner's viewpoint.

[36] Munsche, *supra* note 27, at 431.

[37] *See* note 22 *supra.*

[38] 7 T.C. 12 (1946).

[39] *Id.* at 15-16.

[40] Raffel, *Some Tax Aspects of Foreign Currencies,* 14 TAX L. REV. 407, 409 (1959).

[41] On remanding *Durovic* to the Tax Court, the Seventh Circuit remarked that the blocked currency cases relied on by the Commissioner might not be appropriate as this was not a case of blocked currency. 487 F.2d at 48.

rium exchange rate observed in the market place.[42] The economic and political pressures which lead a government to completely block the exchange of currency may also require it to impose less drastic restrictions,[43] thus creating a disparity between the official and unofficial exchange rates. Examples of these partial, restrictive measures include permitting currency exchange only for certain types of transactions or at unfavorable rates which effectively overvalue the local currency as well as creating multiple official rates for various types of transactions, as in this case. If blockage or other less onerous exchange restrictions are caused by essentially equivalent factors, then decisions dealing with blocked currency would seem to apply with equal force to the case of a currency which is restricted to a lesser extent, such as the instant case, in which multiple official rates existed for various types of transactions.

The courts have almost invariably preferred the use of a free market rate for translating a given blocked currency on the theory that an uncontrolled rate will more accurately reflect the actual market value of the currency in question than would an official exchange rate based, at least in part, on governmental policy.[44] When multiple exchange rates exist the fundamental inquiry is: at what rate would translation of the results of the underlying transaction most accurately reflect the objective value of the benefit received by the taxpayer?[45] The results of such an inquiry in the

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[42] *I.e.*, the free or uncontrolled rate.

[43] *E.g.*, currency exchange might be permitted only for certain types of transactions or at unfavorable rates which effectively overvalue the local currency.

[44] The court said:

> The Argentine Government set the export and import rates in October 1949 in an effort to implement its economic policy directed at increasing foreign trade, promoting production, and establishing protection for the country's national industry. To accomplish those objectives, export goods, which were more difficult to place in the export market were granted a more favorable exchange rate to stimulate sales. On the other hand, the importation of essential raw materials and primary consumer goods not available in Argentina were granted lower rates than nonessential or luxury-type articles.

65 T.C. at 493.

[45] Nine possible translation rates have been suggested by one expert in the field:

> 1. The exchange rate used if a conversion to dollars is actually made in the year in which the income is received or accrued or credited to the taxpayer's account.
> 2. The official exchange rate if conversion through official channels is possible. If there are multiple official rates, then presumably the rate to be used is the highest official rate available.
> 3. The exchange rate that appears to be the prevailing rate in the exchange control country for foreign exchange that is not captured by the official regulatory machinery. *Foundation Company, supra* note 29; Treas. Reg. § 1.964-1(d)(5).
> 4. The exchange rate that could be obtained on a market in the United States for . . . assets in the exchange control country. *Credit & Investment Corporation* and *Edmond Weil, supra* note 26; Treas. Reg. § 1.964-1(d)(5).
> 5. The exchange rate at which the taxpayer in the same year has converted other amounts in the same category. *Credit & Investment Corporation, supra* note 26.

instant case are inadequate at best. Rather than addressing squarely the question of the value of the transaction to the taxpayer, the Tax Court viewed the pivotal issue not as the selection of the most appropriate exchange rate, but rather as the determination of the nature of the underlying transaction based on an analysis of the surrounding circumstances. The Tax Court opined that a *financial* transaction would call for translation at one rate whereas a different rate should be used if this was deemed a *commodity* transaction.

The Commissioner argued that the transaction in question was *financial* in nature while the taxpayer claimed it was a *commodity* transaction.[46] In reaching its conclusion that the transactions were essentially financial in nature, the Tax Court relied heavily on the fact that taxpayer "purchased the drug . . . while residing in Argentina from another Argentine resident, making payment in pesos. The value [taxpayer's cost in pesos] was determined largely by the amount of seller's advances [to taxpayer's brother] . . . to finance the production and exploitation of the drug."[47] The Tax Court seems to have viewed the payment to the lienholder as an isolated event, rather than as a single step in a more or less continuous series of events which comprised one larger transaction designed to free the drug from a possessory lien and get it to laboratory facilities in the United States for development and distribution. The "step transaction" doctrine[48] would

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6. The exchange rate that an expert witness estimates a U.S. bank dealing in foreign currency would pay for the right to the income. *See Eder, supra* note 26 (on remand).

7. The exchange rate that could be realized by the purchase of property or services in the foreign country and the sale in the United States or some other country in which U.S. dollar foreign exchange or third-country foreign exchange convertible into U.S. dollars can be acquired.

8. The exchange rate that is the ratio between the value in U.S. dollars and the value in foreign currency of those goods and services which can be purchased with the foreign currency in the foreign country. Although *Eder* states that this rate may be used, it has not been used.

9. Value of property exchanged or received in exchange; there are no decisions on valuation where the income is derived from barter transactions.

RAVENSCROFT, *supra* note 19, at 520-22. All nine alternatives appear to be based on the premise that if translation is appropriate in a given transaction then it should be carried out in such a way as to most accurately reflect the actual, fair market value of the benefit realized by the United States taxpayer.

[46] If the transaction is classified as a commodity transaction (import-export) the official rates for such transactions would seem to apply. A financial transaction, on the other hand, would call for application of the "free" rate for "limited permitted remittances other than the payment of exports and imports." 65 T.C. at 484.

[47] *Id.* at 497.

[48] *Step transactions.* A business transaction, like the rest of life, has no sharp beginning or clearly defined end, but it is necessary in practice to cut it, usually chronologically, into segments for tax purposes. If the segment is too thin, however, the tax results may be unfair to the taxpayer, to the government, or to both. In viewing a dynamic whole, the courts often say that an integrated transaction must

be appropriate in these circumstances, and its application would favor the taxpayer, as the payment to the lienholder would be subsumed under the umbrella of a larger export transaction.

The taxpayer argued the Krebiozen powder was, in effect, an export commodity; the facts tend to support his contention. At the time of the agreement between taxpayer and seller it was taxpayer's intent to transport the Krebiozen powder to the United States for packaging and development. No preparations had been made to sell the drug in Argentina, but arrangements were being made by taxpayer's brother in the United States to continue research and testing of the drug. Taxpayer's intent was further demonstrated by the shortness of the period of time between his acquisition of the drug and his departure for the United States (12 days).[49] Indeed, the Tax Court gave recognition to the fact that taxpayer intended, at the time of purchase, to export the drug to the United States.[50] Thus, it would seem that in the eyes of the Tax Court, the nature of the transaction, and thus the exchange rate to be used for translation purposes, was determined, not by the manifest intent of the parties, but by the agreed terms of the financial arrangements. This view of the transaction would, in the words of the Tax Court, appear unlikely to "capture the realities of the situation in question."[51]

The court of appeals agreed with the Tax Court that the removal of the drug to the United States was unrelated to its earlier acquisition by taxpayer.[52] The court pointed out that taxpayer continued to operate a laboratory in Argentina for six years after coming to the United States. "Consequently . . . the taxpayer could have as conveniently left the supply of Krebiozen in Argentina as taken it to the United States."[53] The Seventh Circuit's reliance on the availability to the taxpayer of an alternate method of disposing of the drug suggests that taxpayer's intent at the time of acquisition is not controlling.

> not be broken into independent steps or, conversely, that the separate steps must be taken together in attaching tax consequences. The so-called step-transaction doctrine is often encountered in the taxation of corporations and shareholders, but its scope is much broader.

B. BITTKER AND J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS, 1-19 (abr. ed. 1971).

[49] *See* note 4 *supra*.

[50] This was shown by the court's statement that:

> It was the intention of Marko and Stevan that, as of the date of the above agreement, the ampules to be derived from the drug X substance would be the subject matter of a partnership (for the distribution and sale of drug X in the United States) in which each would have a 50-percent interest. Soon, thereafter, Marko left for the United States bringing with him the entire supply of drug X. Drug X (or Krebiozen) was never licensed in Argentina.

54 T.C. 1364, 1375 (1970).

[51] 54 T.C. at 1390.

[52] 542 F.2d at 1331.

[53] *Id.*

Due to the unique underlying facts and the tendency of both the Tax Court and the Seventh Circuit to focus on the facts surrounding the exchange transaction, the precedent value of the instant case is likely to be limited. However, it does represent a continuation of the line of cases favoring the use of uncontrolled exchange rates for translation purposes.

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