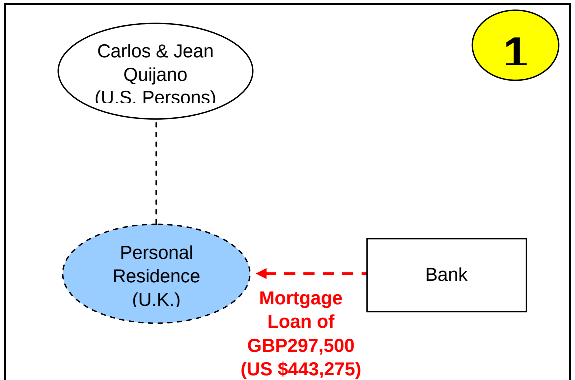
Quijano v. United States
93 F.3d 26 (1st Cir. 1996)

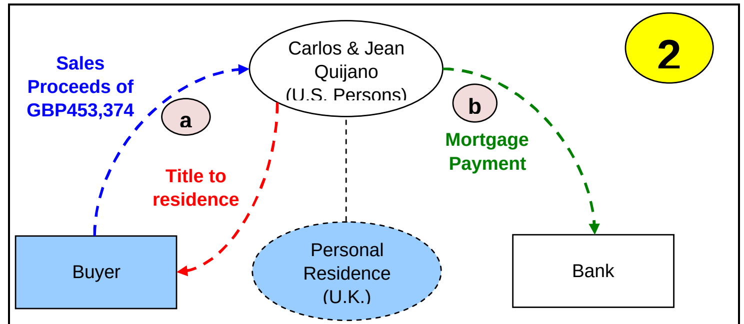
No Netting of Currency Loss on Foreign Mortgage With Gain on Residence Sale

Purchase of U.K. Residence (1986)



Total purchase price GBP 297,500/US$443,275
Mortgage Loan GBP 297,500/US$443,275

Sale of Residence (1990)



	Local Currency	US$	Exchange Rate
Amount Realized	453.374	825,141	$1.82 to GBP1
Less Original Cost	(297,500)	(443,275)	$1.49 to GBP1
Less Improvements	(45,647)	(73,055)	various (avg. $1.60 to GBP1)
Gain on Sale	110,227	308,811	← Taxable Gain
Debt "Basis" in Mortgage	330,180	500,327	various (avg. $1.52 to GBP1)
Less Mortgage repayment	(330,180)	(600,928)	$1.82 to GBP1
Gain (Loss) on repayment	0	(100,601)	← Non-deductible personal loss

The Taxpayers acquired their residence for 297,500 pounds sterling on September 30, 1986. The entire purchase price was financed through a mortgage loan in pounds sterling. The loan was later increased by 45,647 pounds for capital improvements to the residence. No U.S. funds were used either to purchase or improve the residence. On July 27, 1990, it was sold for 453,374 pounds, net of selling expenses, and the mortgage loan was retired. The government agreed that the Taxpayers sustained a loss in their mortgage loan transaction, since the value of the dollar declined, as against the pound sterling, from the time of the mortgage loan to the date of its repayment. Nonetheless, the government successfully argued that the Taxpayers may not offset their mortgage-loan-transaction loss against their real-estate-transaction gain, because "the borrowing and repayment of the mortgage loan is a separate transaction from the purchase and sale of the personal residence." Rev. Rul. 90-79. Moreover, since the mortgage-loan-transaction loss was not "incurred in an activity or as the result of an event described in section 165(c) . . . [,] . . . [it] may not [be] deduct[ed] . . . ." .

The Taxpayers 1990 joint federal income tax return originally reported a $308,811 capital gain, utilizing the exchange rate at date of purchase ($1.49 to 1 pound) to calculate the adjusted cost basis, but using the exchange rate at date of sale ($1.82 to 1 pound) to calculate the sale price. The Taxpayers later amended their 1990 return to claim a $30,610 refund arrived at by utilizing the exchange rate at date of sale ($1.82 to 1 pound) to determine the adjusted cost basis as well as the sale price, thus resulting in a reduced capital gain. The Taxpayers agreed that the 453,374 pounds received for their residence should be translated into U.S. dollars at the $1.82 exchange rate prevailing at the date of sale. They argued, however, that the 343,14 pound adjusted cost basis of the residence, consisting of the 297,500 pound purchase price and the 45,647 pounds paid for capital improvements, likewise should be expressed in U.S. dollar terms as of the date of the sale. The Taxpayers correctly stated that, viewed "in the foreign currency in which it was transacted," the purchase generated a 110,227 pound gain as of the date of the sale, which translates to approximately $200,000 at the $1.82 per pound exchange rate. Therefore, they say, the difference between the approximate $300,000 gain under the government's computation, and the $200,000 gain appellants suggest, approximates a $100,000 unrealized foreign exchange gain on the residence that resulted from the increase in the dollar-pound exchange rate between the dates the residence was bought and sold. However fair and reasonable their argument may be, it amounts to an untenable attempt to convert their "functional currency" from the U.S. dollar to the pound sterling. Under Section 985(b)(1), use of a functional currency other than the U.S. dollar is restricted to qualified business units ("QBU"s). The functional currency of a QBU that is not required to use the dollar is "the currency of the economic environment in which a significant part of such unit's activities are conducted and which is used by such unit in keeping its books and records." Section 985(b)(1)(B) . Although the Taxpayers correctly assert that their residence was purchased "for a pound-denominated value" while they were "living and working in a pound-denominated economy," under Section 989(a) a QBU must be a "separate and clearly identified unit of trade or business of a taxpayer which maintains separate books and records." Section 989(a). Since the Taxpayers concede that the purchase and sale of their residence was not carried out by a QBU, the district court properly rejected their plea to treat the pound as their functional currency.