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## 1. Introduction

### 1.1. Summary

The US tax system provides that income is taxed on a worldwide basis. That is, all income is taxable, whether it is earned in the United States or a branch or office outside the United States. The tax is imposed at graduated rates, and the maximum rate for ordinary income and capital gain is 35 per cent; however, capital losses can only be offset against capital gains, thereby making the character of gain or loss significant. A foreign tax credit system, together with a comprehensive treaty network, is used to eliminate double taxation.<sup>1</sup> The United States imposes the same graduated rates on foreign corporations with effectively connected income; foreign corporations that are not engaged in a trade or business in the United States are subject to withholding taxation, at the rate of 30 per cent, on US source income and gain which is fixed or determinable, annual or periodical.<sup>2</sup>

Income is taxed on an accrual or cash basis, and gain is taxed only when realized. However, under section 475 of the Internal Revenue Code certain taxpayers who are dealers in securities may be taxed on a mark-to-market basis as if the securities were sold at year-end. That regime is also available to taxpayers (upon election) who are dealers in commodities or traders in securities or commodities. Foreign currency denominated instruments may be subject to the mark-to-market regime if the taxpayer is a dealer or trader in the instrument in question.<sup>3</sup> In addition, under section 1256, certain financial contracts are marked to market annually as if sold.

With the enactment of the Tax Reform Act of 1986, there has been a comprehensive statutory scheme that applies to foreign currency transactions. The principal sections of the Internal Revenue Code comprising the statutory scheme are section 985, dealing with the determination of a "functional currency"; section 988, dealing with the taxation of transactions in a non-functional currency (commonly referred to as "section 988 transactions"); and section 987, dealing with income that is earned through a branch that does not have the same functional currency as the taxpayer. In addition, section 986 deals with foreign taxes and

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<sup>1</sup> At the election of the taxpayer, foreign taxes may be deducted in lieu of being credited. See s. 164. All "section" references are to the Internal Revenue Code of 1986, as amended.

<sup>2</sup> S. 1442(a).

<sup>3</sup> S. 475(a), (c).

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earnings and profits, and section 989 provides important definitions relating to a “qualified business unit” and relating to foreign currency exchange rate determinations as well as regulatory authority to address a number of foreign currency-related issues. Under the new regime, as set forth below, foreign currency gain or loss is ordinary income or loss, not capital gain or loss as it was prior to the 1986 law changes. Section 988 does not apply to the expenses of an individual that are made for personal rather than business or investment purposes.<sup>4</sup>

Income that is earned through a foreign corporation is not currently taxed unless the corporation is a controlled foreign corporation (CFC) and the income in question is within a specified category of highly mobile income, which includes foreign personal holding company income.<sup>5</sup> In other cases, there is no taxation unless there is an actual remittance or an “investment in US property”, which is treated as a deemed remittance. One category of foreign personal holding company income is foreign currency gain; however, there are exceptions for the activities of dealers, specified business activities and persons engaged in hedging of certain activities that do not otherwise produce subpart F income.<sup>6</sup>

In addition, income that is earned through a passive foreign investment company (PFIC) is subject to a charge related to the deferral from US taxation. To be a PFIC, either (a) 75 per cent or more of the gross income of the corporation’s income for the taxable year must be passive income, or (b) the average percentage of assets held by the corporation during the taxable year that produce passive income, or that are held for the production of passive income, is at least 50 per cent.<sup>7</sup> In determining whether a company derives or produces passive income, and thus may be a PFIC, the provisions of section 954(c) relating to foreign personal holding income apply.<sup>8</sup>

As set forth below, in contrast to the system which existed previously (and at the time of the 1986 report), the taxation of foreign currency transactions is much more settled than it was previously. Additionally, the creation of a single currency for European Union countries has eliminated many of the instances where foreign currency gain or loss might arise (e.g. a United States corporation with a branch in France, but conducting business with Germany). On the other hand, the elective nature of the entity classification system has increased the likelihood that foreign currency gain or loss might result through a check-the-box election.<sup>9</sup>

## 2. Foreign exchange (FX) controls

No FX controls apply in the United States. In addition, US persons are permitted to engage in a variety of financial transactions involving foreign currency or derivatives based on foreign currency for both speculative and hedging purposes.

<sup>4</sup> S. 988(e)(1).

<sup>5</sup> S. 951(a).

<sup>6</sup> Reg. §1.954-2(g)(2)(ii)(C). See also reg. §1.954-2(a)(3)(ii)(B) (exception for gains that are bona fide hedging transactions).

<sup>7</sup> S. 1297(a).

<sup>8</sup> S. 1297(b).

<sup>9</sup> Reg. §301.7701-2 through 3.

### 3. Tax treatment of gains and losses attributable to currency fluctuations: general considerations

#### 3.1. Distinction between functional and non-functional currencies

Enacted in 1986, section 988 establishes rules for the taxation of foreign currency transactions. To fit within section 988, a transaction must involve a "non-functional currency". A non-functional currency is any currency other than the functional currency.<sup>10</sup> The term "functional currency" means the dollar, or, in the case of a qualified business unit, 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.<sup>11</sup> To the extent provided in regulations, the taxpayer may elect to use the dollar as the functional currency for any "qualified business unit" (QBU) if the unit keeps its books and records in dollars, or the taxpayer uses a method of accounting that approximates a separate transactions method.<sup>12</sup> The separate transactions method computes currency gain or loss on a transaction-by-transaction basis and was an allowable method for computing income earned through foreign branches prior to the Tax Reform Act of 1986.

A QBU is any separate and clearly identified unit of a trade or business of a taxpayer provided that separate books and records are maintained.<sup>13</sup> Every corporation, domestic or foreign is a QBU.<sup>14</sup> The activities of a corporation, partnership, trust, estate or individual can qualify as a QBU if the activities constitute a trade or business and a separate set of books and records is maintained with respect to the activities.<sup>15</sup>

Generally, the functional currency of any QBU is the dollar if activities of such unit are primarily conducted in dollars.<sup>16</sup> Additionally, the functional currency of a taxpayer or QBU must be the dollar regardless of the currency used in keeping its books and records in the following circumstances:

- (a) the taxpayer is not a QBU (e.g. an individual);
- (b) the QBU conducts its activities primarily in dollars;
- (c) except as otherwise provided by ruling or administrative pronouncement, the QBU has the United States, or any possession or territory of the United States where the dollar is the standard currency, as its residence);
- (d) the QBU does not keep books and records in the currency of any economic environment in which a significant part of its activities is conducted; or
- (e) the QBU produces income or loss that is, or is treated as, effectively connected with the conduct of a trade or business within the United States.<sup>17</sup>

A QBU is required to identify its "functional currency". The functional currency of a QBU that is not required to use the dollar as the functional currency is the

<sup>10</sup> Reg. §1.988-1(c); s. 985(b).

<sup>11</sup> S. 985(b)(1).

<sup>12</sup> S. 985(b)(3).

<sup>13</sup> S. 989(a); reg. §1.989(a)-1(b).

<sup>14</sup> Reg. §1.989(a)-1(b)(2)(i).

<sup>15</sup> Reg. §1.989(a)-1(b)(2)(ii).

<sup>16</sup> S. 985(b)(2).

<sup>17</sup> Reg. §1.985-1(b)(1).

currency of the economic environment in which a significant part of the QBU's activities are conducted, if the QBU keeps or is presumed to keep, its books and records in such currency.<sup>18</sup> Identifying the functional currency is necessary for foreign branches of US corporations, such as banks, because the branches must compute their US taxable income in their functional currency<sup>19</sup> and recognize as exchange gain or loss the amount of any subsequent change in the functional currency's value against the dollar at the time that funds are remitted to the head office or transferred to another branch, if the head office or branch has a different functional currency.<sup>20</sup>

Taxpayers that operate in a hyperinflationary environment are required to use the dollar, but under the dollar approximate separate transactions method (DASTM).<sup>21</sup> The term "hyperinflationary currency" means the currency of a country in which there is cumulative inflation during the base period of at least 100 per cent as determined by reference to the consumer price index of the country listed in the monthly issues of the *International Financial Statistics* or a successor publication of the International Monetary Fund. If a country's currency is not listed in the monthly issues of *International Financial Statistics*, a QBU may use any other reasonable method consistently applied for determining the country's consumer price index.<sup>22</sup>

### 3.2. Recognition principles

Section 988 only applies to certain "section 988 transactions". Section 988 transactions include: (a) the disposition of non-functional currency; (b) if any amount that the taxpayer is entitled to receive or is required to pay by reason of such transaction is denominated in terms of a non-functional currency or is determined by reference to the value of one or more non-functional currencies: (i) acquiring a debt instrument or becoming an obligor under a debt instrument; (ii) accruing, or otherwise taking into account, any item of expense or gross income or receipts that is to be paid or received after the date on which so accrued or taken into account; and (iii) entering into or acquiring any forward contract, futures contract, option, warrant, or similar financial instrument.<sup>23</sup>

A forward contract, futures contract, option, warrant, or "similar financial" instrument is within section 988 only if the instrument ultimately relates to a non-functional currency of the taxpayer or a debt instrument denominated in a non-functional currency.<sup>24</sup> Thus, a forward contract to acquire a non-functional currency denominated bond is a section 988 transaction, whereas a forward contract to purchase wheat denominated in a non-functional currency is not a section 988 transaction.

A "similar financial" instrument includes a notional principal contract only if the payments to be made or received are determined with reference to a non-

<sup>18</sup> Reg. §1.985-1(c).

<sup>19</sup> S. 987(1).

<sup>20</sup> S. 987(c). See also former prop. reg. §1.987-2 (1991).

<sup>21</sup> Reg. §1.985-1(b)(2).

<sup>22</sup> Reg. §1.985-1(b)(2)(ii)(D).

<sup>23</sup> S. 988(c)(1)(A)-(B).

<sup>24</sup> Reg. §1.988-1(a)(2)(iii)(A).

functional currency. To be a notional principal contract, the underlying property must be money (e.g. functional currency), non-functional currency, or property, the value of which is determined by reference to an interest rate.<sup>25</sup> One type of notional principal contract is a currency swap, which is a contract involving different currencies between two or more parties to (a) exchange periodic interim payments on or prior to maturity of the contract, and (b) exchange the swap principal amount upon maturity of the contract. A contract may also require an exchange of the swap principal amount upon commencement of the agreement.<sup>26</sup>

FX gains or losses under section 988 are recognized when there is a realization event.<sup>27</sup> A realization event does not occur solely when a transaction is offset by another transaction. If a transaction is traded on an exchange where it is the general practice to terminate offsetting contracts, entering into a contract is considered a termination event.<sup>28</sup> Thus, a gain or loss is generally recognized only upon a sale or exchange.<sup>29</sup> The disposition of non-functional currency in settlement of a forward contract, futures contract, option contract, or similar financial instrument is considered to be a sale or disposition of the non-functional currency.<sup>30</sup> However, extension of the maturity date is considered a sale or exchange.<sup>31</sup>

Interest income or expense for an accrual basis taxpayer is translated at the average rate for the interest accrual period or, with respect to an interest accrual period that spans two taxable years, at the average rate for the partial period within the taxable year.<sup>32</sup> An election is available to use the spot rate at the time of payment if the last day of the interest accrual period is within five business days of the date of receipt or payment, in which case the taxpayer may translate interest income or expense at the spot rate on the date of receipt or payment.<sup>33</sup>

Additionally, when a debt instrument is paid or disposed of, or when the obligation to make payments is satisfied by another person, or extinguished or assumed by another person, exchange gain or loss is computed with respect to both principal and any accrued interest.<sup>34</sup> However, the sum of any FX gain or loss with respect to the principal and interest of any such debt instrument is realized only to the extent of the total gain or loss realized on the transaction.<sup>35</sup> This is sometimes referred to as the "ceiling rule".

The recognition of exchange gain or loss upon the sale or other disposition of non-functional currency is governed by the recognition provisions of the Internal Revenue Code that apply to the sale or disposition of property (e.g. section 1001) or, to the extent provided in regulations, section 1092 (relating to straddles).<sup>36</sup>

<sup>25</sup> Reg. §1.988-1(a)(2)(iii)(B)(2).

<sup>26</sup> Reg. §1.988-2(e)(2).

<sup>27</sup> Reg. §1.988-2(a).

<sup>28</sup> Reg. §1.988-2(d)(2)(ii)(A).

<sup>29</sup> If an offset produces an economic benefit, a sale or exchange, or termination pursuant to the rules of an exchange, is not required to produce a realization event. Reg. §1.988-2(d)(2)(ii)(B).

<sup>30</sup> Reg. §1.988-2(a)(1)(i).

<sup>31</sup> Reg. §1.988-2(d)(2)(v).

<sup>32</sup> Reg. §1.988-2(b)(2)(ii)(C).

<sup>33</sup> Reg. §1.988-2(b)(2)(iii)(B).

<sup>34</sup> Reg. §1.988-2(b)(3) through (7).

<sup>35</sup> Reg. §1.988-2(b)(8).

<sup>36</sup> Reg. §1.988-2(d)(3).

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For recognition purposes, currency swaps are analyzed as parallel loans in the respective currencies.<sup>37</sup> However, all gains or losses are treated as section 988 gains or losses.<sup>38</sup>

The straddle rules, which are contained in section 1092, are an important consideration in the application of rules relating to foreign currency. The straddle rules apply where there are offsetting positions with respect to personal property.<sup>39</sup> Under section 1092, if the taxpayer has two or more positions in a straddle, losses may be deferred to the extent of offsetting gains in other positions. A straddle is broadly defined as offsetting positions with respect to personal property, even if the personal property is not of the same kind. Personal property is defined as any personal property of a type that is actively traded. A position in turn means an interest (including a futures contract, forward contract, or option) in personal property. The straddle rules also apply to successor positions. A successor position is generally defined as a position entered into within a period beginning 30 days after disposition of the loss position and that offsets a second position that was offsetting with respect to the disposed loss position.<sup>40</sup> If there is unrealized gain in a straddle, then losses will be deferred to the extent that the amount of the loss exceeds the unrecognized gain (if any) on one or more positions that were offsetting positions for one or more positions from which the loss arose.<sup>41</sup> The taxpayer's position as an obligor in a foreign currency denominated debt instrument is a position in personal property for these purposes.<sup>42</sup>

In addition, carrying costs relating to a straddle may also be deferred under section 263. This provision requires a taxpayer that incurs interest expense to acquire or carry personal property that constitutes a position in a straddle to capitalize such interest expense, adding it to the basis of such property. If, for example, a taxpayer borrows money to finance the purchase of pounds and then hedges those pounds by entering into a one-year forward contract for the sale of pounds, any interest expense on the borrowing is not currently deductible and must instead be added to the basis of the pounds for purposes of calculating the gain or loss on the forward sale. As another example, assume a taxpayer who has the dollar as a functional currency has a foreign forward contract denominated in pounds. It also has issued a debt obligation in pounds. Assume that the taxpayer recognizes a loss with respect to the forward contract, but has an unrealized gain on the pound component of the debt instrument. The loss would be deferred under the straddle rules. Section 263(g) does not apply to a hedging transaction that has been properly identified as such by the taxpayer.

<sup>37</sup> Reg. §1.988-2(e)(2). In describing the "timing and computation of periodic interim payments", these parallel transactions are described, in reg. §1.988-2(e)(2)(iii), as "a hypothetical borrowing that is determined in the currency in which payments are required to be made" and "payments received pursuant to a hypothetical loan that is denominated in the currency in which payments are received".

<sup>38</sup> Reg. §1.988-2(e)(1).

<sup>39</sup> S. 1092(c)(1).

<sup>40</sup> The wash-sale rules may also defer losses if the position sold is a security. See s. 1091. However, the straddle rules take precedence over the wash-sale rules where both rules might otherwise apply.

<sup>41</sup> S. 1092(a)(1).

<sup>42</sup> S. 1092(d)(7).

Finally, it should be noted that the US tax treatment of FX is independent of financial accounting. Thus, courts have ruled that financial accounting is not relevant for the determination of taxable income.<sup>43</sup> Notwithstanding, taxpayers may seek to apply accounting principles in order to determine taxable income if there is no guidance. Whether that approach will withstand scrutiny depends on whether the method of accounting clearly reflects income.

### 3.3. Character of FX currency gains and losses

An FX gain or loss is considered ordinary income or loss.<sup>44</sup> Importantly, it is not considered interest income, so this creates natural mismatches between many common transactions, including, for example, a loan and any related FX gain or loss. However, under the applicable regulations, certain interest income is treated as FX income.<sup>45</sup> Additionally, exchange loss realized by the holder of a debt instrument the interest on which is excluded from gross income under section 103(a) or any similar provision of law is treated as an offset to and reduces total interest income received or accrued with respect to such instrument.<sup>46</sup>

Also, a taxpayer may elect to treat FX gain or loss attributable to a forward contract, a futures contract, or option that is a capital asset in the hands of the taxpayer and which is not a part of a straddle (within the meaning of section 1092(c)), as capital gain or loss (as the case may be) if the taxpayer makes such election and identifies such transaction before the close of the day on which such transaction is entered into (or such earlier time as the Secretary may prescribe).<sup>47</sup>

Although section 988 applies to foreign currency contracts, foreign currency contracts are also subject to section 1256. Section 1256 sets forth special rules requiring the recognition of gain or loss for section 1256 contracts. Under section 1256, a gain or loss is recognized as though the contracts had been sold on the last day of the taxable year for fair market value. In addition, gain or loss recognized is 60 per cent long-term capital gain or loss and 40 per cent short-term capital gain or loss. Section 1256 contracts include: (a) regulated futures contracts, (b) foreign currency contracts, (c) listed non-equity options, and (d) dealer equity options.<sup>48</sup> Mark-to-market treatment of section 1256 contracts may be avoided by making a mixed straddle election under section 1256(d) or by making a hedging election under section 1256.<sup>49</sup>

A regulated futures contract is any contract the amount of which that is required to be deposited and allowed to be withdrawn depends on a system of

<sup>43</sup> See e.g. *Thor Power Tool Co. v. Comm'r*, 439 US 522 (1979) (finding there is no presumption that a practice "conformable to 'generally accepted accounting principles' is valid for income tax purposes"); *Frank Lyon Co. v. United States*, 435 US 561, 577 (1978) ("the characterization of a transaction for financial accounting purposes, on the one hand, and for tax purposes, on the other, need not necessarily be the same").

<sup>44</sup> S. 988(a)(1)(A); reg. §1.988-3(c)(1).

<sup>45</sup> Reg. §1.988-2(b).

<sup>46</sup> Reg. §1.988-3(c)(2).

<sup>47</sup> Reg. §1.988-3(b).

<sup>48</sup> S. 1256(b).

<sup>49</sup> Reg. §1.1256(e)-1(a) and (c) (identification for purposes of reg. §1.1221-2(f) is also an identification for purposes of the foregoing).



daily marking to market and which is treated on or is subject to the rules of a qualified board or exchange (i.e. a US exchange regulated by the Securities and Exchange Commission, Commodity Futures Contract Trading Commission, or certain foreign exchanges, including the Mercantile Division of the Montreal Exchange). A foreign currency contract is a contract (a) that requires delivery of, or the settlement of which depends on the value of, a foreign currency that is a currency in which positions are also traded through regulated futures contracts; (b) that is traded in the inter-bank market; and (c) that is entered into at arm's length at a price determined by reference to a price in the inter-bank market. These contracts presently include inter-bank forward contracts for the delivery of Australian dollar, Brazilian real, British pound, Canadian dollar, Chinese renminbi, Czech koruna, euro, Japanese yen, Korean won, Mexican peso, New Zealand dollar, Norwegian krone, Polish zloty, Russian ruble, South African rand, Swedish krona, Swiss franc, and Hungarian forint.<sup>50</sup> Multiple-payment foreign currency swaps entered into in the inter-bank market are not section 1256 contracts regardless of the currency in which they are denominated. While there was some ambiguity on this point until recently, the IRS has concluded that foreign currency options should not be considered foreign currency contracts for purposes of section 1256(g)(2).<sup>51</sup> However, foreign currency options may also be subject to section 1256 if they are non-equity options. A non-equity option is any option that is traded on (or subject to the rules of) a qualified board or exchange (i.e. a listed option) and is not an equity option. To be a non-equity option, the transaction must also be "listed" on a qualified board or exchange.<sup>52</sup>

Section 988 does not apply to a regulated futures contract or non-equity option subject to section 1256 unless the taxpayer elects to have those rules apply.<sup>53</sup> In this case, gain or loss is ordinary, but it is recognized as if the contract had been sold at the end of the year. The election must be made on or before the first day of the taxable year or, if later, on or before the first day during such taxable year on which the taxpayer holds such a contract.<sup>54</sup>

### 3.4. Calculating currency gain or loss

Exchange gain realized from the sale or other disposition of non-functional currency is the excess of the amount realized over the adjusted basis of such

<sup>50</sup> Ernst & Young, *International Tax Alert: Updated 2006 List of Foreign Currency Contracts Subject to Section 1256*, no. CM0587 (7 December 2006).

<sup>51</sup> Notice 2003-81, 2003-2 CB 1223 (transactions in which individuals or entities assign offsetting currency option contracts to charities and claim a loss on the assignment of the contracts, but fail to report a gain on offsetting non-section 1256 contracts are treated as a listed transaction); Notice 2007-71, 2007-35 IRB 472 (clarified Notice 2003-81 to indicate that foreign currency options, whether or not the underlying currency is one in which positions are traded through regulated futures contracts, are not foreign currency contracts as defined in s. 1256(g)(2)).

<sup>52</sup> Non-equity options generally include options to purchase or sell foreign currency. Specifically, non-equity options are options traded on or subject to a qualified board of trade that are not options to buy or sell stock, and the value of which is not determined directly or indirectly by reference to any stock or stock index. See FSA 199947006 (9 August 1999).

<sup>53</sup> S. 988(c)(1)(D); reg. §1.988-1(a)(7).

<sup>54</sup> Reg. §1.988-1(a)(7)(iv).

currency, and the exchange loss realized is the excess of the adjusted basis of such currency over the amount realized.<sup>55</sup> General tax principles apply in determining the calculation of the amount realized and tax basis. This means using the spot rate at the time of sale or purchase. A spot rate convention may be used for a payable or a receivable denominated in a foreign currency.<sup>56</sup>

### 3.5. Currency revaluation

Currency inflation or deflation is not taken into account until there is a realization event, including, for example, a repatriation (as discussed below).<sup>57</sup> Thus, foreign currency denominated tax accounts should not be revalued unless an event occurs.

### 3.6. Source

Source is an important consideration for taxpayers because of the withholding rules and the foreign tax credit system. Withholding on foreign corporate persons under section 1442 applies only to US source income. The foreign tax credit is dependent on foreign source income. That is, the more foreign source income, the greater the foreign tax credit limitation. In calculating the foreign tax credit, interest expense is allocated among all the taxpayer's assets under the notion that interest expense is fungible. As a result, with some exceptions for certain integrated transactions and non-recourse debt, interest expense adversely impacts the foreign tax credit limitation, regardless of how the proceeds of the borrowing are actually used, so long as the taxpayer has foreign source assets. The foregoing rules also apply to interest equivalents.<sup>58</sup>

The general rule is that the source of foreign exchange gain or loss is the taxpayer's residence.<sup>59</sup> In the case of a QBU, the residence of such unit is the country in which the principal place of business of such QBU is located.<sup>60</sup> There are also other exceptions.

A special source rule is employed in order to prevent abuse of the source rules for foreign tax credit limitation purposes. Where a loan is made by a United States person or a related person to a 10 per cent owned foreign corporation that is denominated in a currency other than the dollar and bears interest at a rate at least 10 percentage points higher than the federal mid-term rate at the time such loan is entered into, (a) for purposes of section 904 only, the loan is marked to market on an annual basis and (b) any interest income earned with respect to the

<sup>55</sup> Reg. §1.988-2(a)(2).

<sup>56</sup> Reg. §1.988-1(d)(3).

<sup>57</sup> See discussion relating to s. 989 below.

<sup>58</sup> See reg. §1.861-9T(b)(2), which provides that if a taxpayer borrows in a non-functional currency at a rate of interest less than the applicable federal rate, "any swap, forward, future, option, or similar financial arrangement" entered into by the taxpayer or related person (under reg. §1.861-8T(c)(2)) that substantially diminishes currency risk on the borrowing or interest expense is presumed to hedge the borrowing. The taxpayer can avoid this if it is able to demonstrate the transactions are unrelated.

<sup>59</sup> Reg. §1.988-4(a).

<sup>60</sup> Reg. §1.988-4(d)(2).

loan for the taxable year is treated as income from sources within the United States to the extent of any loss attributable to clause (a).<sup>61</sup>

### 3.7. Transfer pricing

While the applicable transfer pricing rules make note of foreign currency considerations, there is limited guidance provided in determining the appropriate transfer price. For instance, there is a safe harbor for loans between related persons that is measured by comparison to the applicable federal rate. However, this rule is not applicable where the loan is denominated in foreign currency.<sup>62</sup> Other transfer pricing regulations specify that foreign currency risk is one of the considerations in determining the arm's length price, but provide no specific guidance.<sup>63</sup> This is an area where additional guidance would be helpful.

## 4. Typical transactions

### 4.1. Purchase and sale of goods

Section 988 gains or losses only apply to a section 988 transaction. Thus, the purchase and sale of goods denominated in a non-functional currency are not subject to the provisions of section 988. Instead, a gain or loss is recognized merely by determining cost and sales prices using the spot rates at the time of purchase or sale. However, the accrual of a non-functional currency amount for payment after the accrual date is a section 988 transaction. For example, assume on 1 January 2010 that X (a US corporation on the accrual method of accounting) sells and delivers inventory to Y for 10,000 Canadian dollars for payment on 1 April 2010. Under X's method of accounting, 1 January 2010, is the accrual date. Because X is an accrual basis taxpayer, the accrual of a non-functional currency denominated item of gross receipts for payment after the date of accrual is a section 988 transaction.<sup>64</sup>

As another example, on 1 January 2010, X (a US corporation on the accrual method of accounting) acquires 10,000 Canadian dollars. On 15 January 2010, X uses the 10,000 Canadian dollars to purchase inventory. The acquisition of the 10,000 Canadian dollars is a section 988 transaction for purposes of establishing X's basis in the Canadian dollars. The disposal of the 10,000 Canadian dollars is a section 988 transaction.<sup>65</sup> The taxpayer would establish a basis in its functional currency, though, by translating its cost into its functional currency.

<sup>61</sup> Reg. §1.988-4(e)(1).

<sup>62</sup> Reg. §1.482-2a(2)(iii)(E).

<sup>63</sup> Reg. §1.482-3 (foreign currency risk is a factor in determining comparability in connection with comparable uncontrolled price method, resale price method and cost plus method).

<sup>64</sup> Reg. §1.988-1(a)(6), example 5.

<sup>65</sup> Reg. §1.988-1(a)(6), example 1.

#### 4.2. Purchase of other assets

The same would apply in the case of depreciable securities, real estate, or intangible property, such as goodwill. In such a case, the purchase price would be established at the spot rate at the time of purchase. This rate would also be used to compute depreciation or amortization.

#### 4.3. Purchase of stock

Similarly, the purchase of stock or a forward contract to purchase stock that is denominated in a non-functional currency is not subject to section 988.<sup>66</sup> However, a gain or loss may be recognized if currency is purchased and later used to pay for the stock. For example, assume X purchases one hundred shares of Royal Dutch Shell at EUR 50 a share, for a total of EUR 5,000. The spot rate at the time of the order is EUR 1.00 equals USD 1.25. To complete the purchase five days later, the taxpayer buys EUR 5,000 for USD 6,250. Subsequently, the dollar appreciates so that EUR 1.00 equals USD 1.30. Foreign exchange gain is recognized on the disposition of the euros for EUR 1.00 equals USD 1.30. The taxpayer's basis in the shares is EUR 5,000 times USD 1.30 or USD 6,500, reflecting the increased value of the euro on the date of settlement. Thus, ordinary gain in the amount of USD 250 (USD 6,500 less USD 6,250) is recognized on the disposal of the euros. An integrated transaction regime exists for stocks or securities that are traded on an established securities market. This regime is described below.

#### 4.4. Foreign currency denominated debt

Interest on a foreign currency denominated debt instrument must be translated into the functional currency, and when paid or received, FX gain or loss is realized. As an example, assume an instrument is denominated in sterling. It provides for interest at a rate of 10 per cent. A basis will be determined in US dollars at the time of purchase. As interest accrues, it must be translated at the average rate during the period (or, at the taxpayer's election, the spot rate at the time of payment).<sup>67</sup> Assume that the interest accrues at an average rate of USD 1.50 to the pound, but at the time of settlement, the pound is at USD 2.00. When the interest is collected, FX gain must be recognized on the difference between the foreign currency accrual rate and the spot rate at the time of collection. At settlement, FX gain or loss must be recognized on the principal based on the difference between the spot rate at the time of purchase and the spot rate at the time of settlement.<sup>68</sup> However, as discussed above, the "ceiling rule" provides that foreign exchange gain or loss cannot exceed overall economic gain or loss on the instrument.<sup>69</sup> Similar rules apply when the taxpayer is the issuer of the debt instrument.

<sup>66</sup> Reg. § 1.988-1(a)(2)(ii)(A).

<sup>67</sup> Reg. § 1.988-2(b)(2)(iii).

<sup>68</sup> The issuer of an obligation can also realize exchange gain with respect to the principal amount of a debt instrument. See reg. § 1.988-2(b)(6).

<sup>69</sup> Ss. 988(b)(1) and (2); reg. § 1.988-2(b)(8).

## 4.5. Hedging

### 4.5.1. In general

Due to the differing treatment of foreign currency and of the income from the underlying transaction, a hedging regime is very important. Several sets of regimes potentially apply.<sup>70</sup>

### 4.5.2. Hedging transactions

First are the hedging accounting rules under regulation section 1.446-3. These rules require matching of the timing of hedging transactions with the underlying transaction. Hedging gains or losses must “reasonably match” income from the underlying transaction. To qualify as a “hedging transaction”, contemporaneous identification of the hedging instrument and the transaction being hedged is required.<sup>71</sup> Identification of hedging transactions is important in the foreign currency context as it permits taxpayers to avoid application of both the straddle and carrying cost provisions that are discussed above.<sup>72</sup> (In the non-currency context, qualification is important in that it enables the hedging transaction to receive ordinary income or loss treatment.)<sup>73</sup>

These rules do not address all the differences in the way foreign currency transactions are taxed relative to the transaction being hedged. For example, while a hedge of a foreign debt instrument produces ordinary income or loss, the item being hedged may generate interest expense. The source rules for interest expense and FX gain or loss are not the same. Another point of controversy is whether the underlying transaction has the potential to produce capital gain. Under the hedging rules, the transaction being hedged must be with respect to ordinary property or ordinary obligations – that is, the underlying transactions must not produce capital gain or loss in any circumstance.<sup>74</sup> Debt instruments denominated in a foreign currency produce ordinary income. However, the non-currency element may result in capital gain or loss for a holder, creating uncertainty in the application of the hedging rules for these types of instruments.

### 4.5.3. Integrated hedges

Second are rules that permit the complete integration of a transaction and a hedging transaction. The integration regimes apply to three broad categories of transactions. The first relates to debt transactions, the second relates to executory contracts, and the third relates to stock purchases.<sup>75</sup> Under the regimes, all aspects

<sup>70</sup> Peter J. Connors and Chip Harter, “Taxation of Hedging Transactions”, in *Controlling and Managing Derivatives Risks: A Handbook for Corporate Directors, Treasurers and Institutional Investors*, Irwin Financial Press 1995.

<sup>71</sup> Reg. §1.1221-2(f).

<sup>72</sup> S. 1092(e).

<sup>73</sup> Reg. §1.1221-2(a)(1).

<sup>74</sup> Reg. §1.1221-2(c)(2).

<sup>75</sup> Reg. §1.988-5(a)(1), (b)(1), (c).

of taxation, except withholding, are determined by treating the transaction and the hedging transaction as a single transaction.<sup>76</sup> The first regime, relating to debt transactions, applies to an integrated economic transaction that includes a “qualifying debt instrument”, which is a debt instrument described in regulation section 1.988-1(a)(2)(i), regardless of whether denominated in, or determined by reference to, non-functional currency (including dual-currency debt instruments, multi-currency debt instruments, and contingent payment debt instruments).<sup>77</sup> However, a qualifying debt instrument does not include accounts payable, accounts receivable, or similar items of expense or income.<sup>78</sup> A “hedge”, for the purposes of this provision, is a spot contract, futures contract, forward contract, option contract, notional principal contract, currency swap contract, or similar financial instrument, or series or combination thereof, that when integrated with a qualifying debt instrument permits the calculation of a yield to maturity in the currency in which the synthetic debt instrument is denominated.<sup>79</sup>

With some exceptions, an executory contract is an agreement entered into before the accrual date to pay non-functional currency (or an amount determined with reference thereto) in the future with respect to the purchase of property used in the ordinary course of the taxpayer’s business, or the acquisition of a service (or services), in the future, or to receive non-functional currency (or an amount determined with reference thereto) in the future with respect to the sale of property used or held for sale in the ordinary course of the taxpayer’s business, or the performance of a service (or services), in the future. On the accrual date, the agreement ceases to be considered an executory contract and is treated as an account payable or receivable.<sup>80</sup> A contract to buy or sell stock is considered an executory contract.<sup>81</sup> (Thus, for example, a contract to sell stock of an affiliate is an executory contract for this purpose.) A “hedge”, for purposes of this executory contract provision, is a deposit of non-functional currency in a hedging account, a forward or futures contract or combination thereof, which reduces the risk of exchange rate fluctuations by reference to the taxpayer’s functional currency with respect to non-functional currency payments made or received under an executory contract. It also includes an option contract, but only if the option’s expiration date is on or before the accrual date.<sup>82</sup>

A third set of integrated hedging rules apply to purchases of stock. Under these provisions, if a taxpayer purchases or sells stocks or securities, which are traded on an established securities market and:

- (a) hedges all or part of such purchase or sale for any part of the period beginning on the trade date and ending on the settlement date; and
- (b) identifies the hedge and the underlying stock or securities as an integrated transaction;

then any gain or loss on the hedge shall be an adjustment to the amount realized or the adjusted basis of the stock or securities sold or purchased (and is not

<sup>76</sup> Reg. §1.988-5(a)(9)(i)(A), (b)(4)(i).

<sup>77</sup> Reg. §1.988-5(a)(3)(i).

<sup>78</sup> *Ibid.*

<sup>79</sup> Reg. §1.988-5(a)(4).

<sup>80</sup> Reg. §1.988-5(b)(2)(ii)(A).

<sup>81</sup> Reg. §1.988-5(b)(2)(ii)(A), (C).

<sup>82</sup> Reg. §1.988-5(b)(2)(iii)(A).

taken into account as foreign currency gain or loss).<sup>83</sup> In this context, the term “hedge” means a deposit of non-functional currency in a hedging account, or a forward or futures contract, which reduces the risk of exchange rate fluctuations for any portion of the period beginning on the trade date and ending on the settlement date.

These regimes apply to both US and foreign corporations. In addition, a regime for hedging (the “business needs exception”) also exists with respect to foreign personal holding company income. This regime is discussed below.

## 5. Foreign currency issues related to foreign branches or permanent establishments

### 5.1. Measuring branch income and FX effects

#### 5.1.1. In general

Under section 987, taxpayers having a QBU are required to report taxable income from the QBU annually and to translate such income at the “appropriate exchange rate”.<sup>84</sup> Section 987 further provides that it is necessary to make proper adjustments (as prescribed by regulations) for transfers of property between QBUs of the taxpayer having different functional currencies, including:

- (a) treating post-1986 remittances from each such unit as made on a pro rata basis out of post-1986 accumulated earnings; and
- (b) treating gain or loss arising from the remittance as ordinary income or loss, respectively, and sourcing such gain or loss by reference to the source of the income giving rise to post-1986 accumulated earnings.<sup>85</sup>

#### 5.1.2. The 1991 proposed regulations

Regulations proposed in 1991 addressed the treatment of branch exchange gain or loss from QBUs.<sup>86</sup> The 1991 proposed regulations provided generally that the net income of a QBU having a functional currency different than that of the taxpayer is determined annually. The determination is based on the profit and loss appearing on the QBU’s books and records, adjusted to conform to US tax principles, and translated into the functional currency of the taxpayer using the weighted average exchange rate for the taxable year.<sup>87</sup> The 1991 proposed regulations also provided for the recognition of exchange gain or loss upon a remittance from the QBU’s equity pool.<sup>88</sup> This approach of recognizing translating gain is often referred to as the net profits method.<sup>89</sup> It is in contrast to the net

<sup>83</sup> Reg. §1.988-5(c).

<sup>84</sup> S. 987.

<sup>85</sup> *Ibid.*

<sup>86</sup> Former prop. reg. §§1.987-1 through -3 (1991).

<sup>87</sup> Former prop. reg. §§1.987-1(b)(1) (1991).

<sup>88</sup> Former prop. reg. §1.987-2(a)(1) (1991).

<sup>89</sup> Rev. rul. 75-107, 1975-1 CB 32.

worth method, which compares the taxpayer's balance sheet at the beginning and end of the year, translated at the appropriate rates.<sup>90</sup> Another approach used prior to the Tax Reform Act of 1986 was the separate transactions method.

Under the 1991 proposed regulations, the equity pool consists of the undistributed capital and earnings of the QBU, determined in the QBU's functional currency.<sup>91</sup> The 1991 proposed regulations also provided for a basis pool, which consists of the basis of the capital and earnings in the equity pool, expressed in the functional currency of the taxpayer.<sup>92</sup> The portion of the basis pool, expressed in the functional currency of the taxpayer, that is attributable to a remittance was generally determined according to the following formula:<sup>93</sup>

$$\frac{\text{Amount remitted in the QBU's functional currency}}{\text{Equity pool in the QBU's functional currency reduced by prior remittances}} = \frac{\text{Basis pool in the taxpayer's functional currency reduced by prior remittances}}{\text{Basis pool in the taxpayer's functional currency reduced by prior remittances}}$$

Under the 1991 proposed regulations section 987, gain or loss equaled the difference between the value of the remittance from the QBU translated into the taxpayer's functional currency at the spot rate on the date the remittance is made, less the basis associated with the remittance as determined above.<sup>94</sup> Under this paradigm, all branch equity gives rise to exchange gain or loss, regardless of whether or not that equity is held in a form that actually exposes the QBU's owner to currency fluctuations (e.g. compare assets such as cash or indebtedness to assets such as equipment).

For example, if a US bank has a French branch that uses the euro as its functional currency, the French branch would recognize exchange gain or loss every time it repatriates funds to the US head office. In addition, the functional currency becomes the basis for the determination of whether transactions in certain financial instruments including currency, become section 988 transactions. The same rule applies when the taxpayer is a foreign subsidiary with a branch using a different currency; for example, a UK corporation that is deemed to have a French branch as a result of the application of the check-the-box regulations.

### 5.1.3. Comments regarding the 1991 proposed regulations

The 1991 proposed regulations required the QBU to keep track of its net transfers for each day.<sup>95</sup> In Notice 2000-20,<sup>96</sup> the Treasury and the Internal Revenue Service (IRS) indicated that they have become aware that some taxpayers argue that the rule requiring daily netting of contributions and distributions in the proposed section 987 regulations allows them to recognize foreign currency losses

<sup>90</sup> Rev. rul. 75-106, 1975-1 CB 31.

<sup>91</sup> Former prop. reg. §1.987-2(c)(1) (1991).

<sup>92</sup> Former prop. reg. §1.987-2(c)(2) (1991).

<sup>93</sup> Former prop. reg. §1.987-2(d)(2) (1991).

<sup>94</sup> Former prop. reg. §1.987-2(d)(1) (1991).

<sup>95</sup> Former prop. reg. §1.987-2(b)(2) (1991).

<sup>96</sup> See Notice 2000-20, 2000-1 CB 851.



prematurely with respect to purported transfers that do not constitute actual economic remittances (i.e. from transactions that are undertaken for tax purposes and lack meaningful non-tax economic consequences). This opportunity exists when the spot rate is less than the historical rate used to determine the amount of capital and earnings in the basis pool. According to the IRS, taxpayers have attempted to use circular cash flows consisting of a transfer of property from the QBU branch to the taxpayer on one day followed closely by a transfer of property from the taxpayer to the QBU branch on another day to recognize foreign currency losses without economically affecting the net asset position of the QBU branch.<sup>97</sup> Such transfers are abusive, according to the IRS, because they allow a taxpayer to recognize foreign currency losses prematurely with respect to purported transfers that do not constitute actual economic remittance.

Another criticism of the 1991 proposed regulations was that the rules differed from the rules governing CFCs. In the case of foreign corporations, foreign currency gain or loss is only recognized with respect to distributions of earnings. As discussed above, under the 1991 proposed regulations, no distinction is made between exchange gain or loss on earnings or capital.

## 5.2. The 2006 proposed regulations

### 5.2.1. Background

The 2001 regulations were withdrawn in 2006 and replaced with new proposed regulations.<sup>98</sup> The 2006 proposed regulations adopt the “FX exposure pool method”. The 2006 proposed regulations do not apply to banks, insurance companies, and similar financial entities (including, solely for this purpose, leasing companies, finance coordination centers, regulated investment companies and real estate investment trusts).<sup>99</sup> The preamble to the proposed regulations indicates that the IRS and Treasury intend to expand the scope of the proposed regulations to cover these types of entities in subsequent guidance but that they believe it is appropriate to request comments regarding how the regulations need to be precisely tailored to address issues unique to financial entities.

### 5.2.2. The FX exposure pool method

The foreign exchange exposure pool method provides that the income of a QBU that is subject to section 987 (section 987 QBU) is determined by reference to the items of income, gain, deduction, and loss booked to the QBU in its functional currency, adjusted to reflect US tax principles.<sup>100</sup> A section 987 QBU means the activities of an individual, corporation, partnership, or an entity disregarded as an entity separate from its owners if (a) the activities constitute a trade or business; (b) a separate set of books and records is maintained with respect to the activities, assets, and liabilities used in conducting such activities; and (c) the activities are

<sup>97</sup> *Ibid.*

<sup>98</sup> Prop. reg. §§1.987-1 through -4; prop. reg. §§1.987-6 through -11.

<sup>99</sup> Prop. reg. §1.987-1(b)(3)(iii).

<sup>100</sup> Prop. reg. §1.987-3(a)(1)(i).

not subject to DASTM.<sup>101</sup> As under the 1991 proposed regulations, there are generally two components to income from section 987 QBU. The first is the QBU's income, translated into the owner's functional currency, and the second is the portion relating to the change of the "owner functional currency net value".

After the income has been adjusted to reflect US tax principles, it is then translated into the owner's functional currency.<sup>102</sup> Generally, this is done at the yearly average exchange rate for the taxable year, although the owner may elect to use the spot rate for the day in which the item is properly taken into account.<sup>103</sup> By contrast, depreciation, depletion, and amortization deductions are computed in historic rates.<sup>104</sup> Thus, if the income in question relates to the sales of inventory, sales income would be determined by translating the income into US dollars, at the average exchange rate for the year, and comparing that to the cost of the inventory sold also translated into US dollars at the average exchange rate for the year.<sup>105</sup> By contrast, under the 1991 proposed regulations, all profit and loss would be determined in the functional currency of the QBU and then translated into US dollars at the weighted average exchange rate for the taxable year.<sup>106</sup>

The second aspect of the 2006 proposed regulations involves the determination of "section 987 gain" of the section 987 QBU. While the terminology is similar to that of the 1991 proposed regulations, the methodology is different as it adopts a net worth approach. This is a seven-step process that under step 1 involves translating the balance sheet of the "section 987 QBU" at the beginning and ending of the year using a combination of spot and historic rates into "owner functional currency net value".<sup>107</sup>

Under step 2, this is further increased by the aggregate assets increased from the section 987 QBU to its owner. Under step 3, the aggregate amount is decreased by the total amount of assets transferred from the owner to section 987 QBU during the taxable year. Under step 4, this is decreased by the aggregate amount of liabilities transferred from the section 987 QBU to the owner. Under step 5, this amount is increased by the liabilities transferred by the owner to the section 987 QBU. Under step 6, this is increased by the section 987 taxable loss. Finally, under step 7, it is decreased by the section 987 taxable profit.

Financial assets (section 987 marked items) would be translated at spot rates. However, other assets would be translated at their historic rates.<sup>108</sup> The amount determined would be unrecognized section 987 gain. Historic items do not give rise to exchange gain or loss under section 987.

Generally, according to the preamble, three components are reflected in the change in owner functional currency net value of the section 987 QBU for a taxable year. First, taxable income or loss of the section 987 QBU will result in increases or decreases in net assets, and will therefore affect net value. Second, transfers of assets or liabilities to or from the section 987 QBU will affect net

<sup>101</sup> Prop. reg. §1.987-1(b)(3).  
<sup>102</sup> Prop. reg. §1.987-3(a)(1)(ii).  
<sup>103</sup> Prop. reg. §1.987-3(b)(1).  
<sup>104</sup> Prop. reg. §1.987-3(b)(2)(i).  
<sup>105</sup> Prop. reg. §1.987-3(f), example 1.  
<sup>106</sup> Former prop. reg. §1.987-2(a)(1) (1991).  
<sup>107</sup> Prop. reg. §1.987-4(d).  
<sup>108</sup> Prop. reg. §1.987-4(e)(2).

value. Finally, any remaining change in net value (as measured in the owner's functional currency) results from changes in the value of the section 987 QBU's marked assets and liabilities. In order to isolate the change in value due to foreign currency movements with respect to section 987 marked assets and liabilities of the QBU, the other changes must be reversed out. According to the preamble, that is the function of steps 2 through 7 of proposed regulation section 1.987-4(d).

It is then necessary to determine recognized section 987 gain. This is accomplished by comparing the amount of the remittance to the basis of the assets that are reflected on the balance sheet at the end of the year, and the remittance.<sup>109</sup> This produces the remittance percentage. Unlike under the 1991 proposed regulations, the amount of the remittance is the total of all amounts transferred from the section 987 QBU to the owner during the taxable year over the amounts transferred from the owner to the section 987 QBU, and is determined at the end of the owner's taxable year.<sup>110</sup>

### *5.2.3. Effective date*

The 2006 proposed regulations would apply to taxable years beginning one year after the first day of the first taxable year following the date of publication of a Treasury decision adopting this rule as a final regulation.<sup>111</sup> An election is available to apply the rules for the year in which the final regulations are published.<sup>112</sup>

### *5.2.4. Criticism of the 2006 proposal regulations*

Whether the 2006 proposed regulations will be adopted in their current form remains unclear as considerable controversy has been evoked. While the revisions to the rules regarding when a remittance occurs have been favourably received, the complexity that results from using multiple exchange rates to compute QBU income and the implicit adoption of the net worth method, which is arguably contrary to the legislative mandate, has been criticized.<sup>113</sup>

## **6. Foreign currency issues relating to foreign subsidiaries**

### **6.1. Measuring CFC income and FX effects**

#### *6.1.1. In general*

In general, income or loss is not realized until funds are remitted. However, certain categories of income – namely, foreign personal holding company income –

<sup>109</sup> Prop. reg. §1.987-5(b).

<sup>110</sup> Prop. reg. §1.987-5(c).

<sup>111</sup> Prop. reg. §1.987-11(a).

<sup>112</sup> Prop. reg. §1.987-11(b).

<sup>113</sup> See New York State Bar Association, "Report on the Proposed Regulations under Section 987", 2008 TNT 3-15 (3 January 2008).

are taxable prior to distribution under section 951. As an example, under the provisions of subpart F, when more than 50 per cent of the vote or value of a corporation is owned by five or fewer US shareholders (that is, a shareholder owning 10 per cent of the corporation's voting powers), then the corporation's foreign personal holding company income is subject to immediate US taxation. One category of foreign personal holding company income is FX gain. For these purposes, FX gain is the excess of foreign currency gains over foreign currency losses attributable to any section 988 transactions.<sup>114</sup> This determination is made in the functional currency of the CFC. If a CFC has net foreign currency losses for the year, such losses do not offset other foreign personal holding company income. However, if an election is made, the excess of foreign currency losses over foreign currency gains to which the election would apply may be apportioned to, and offset by, other categories of foreign personal holding company income.<sup>115</sup>

The income of a foreign corporation, which is included as a deemed distribution, is translated at the average rate for the taxable year.<sup>116</sup>

### *6.1.2. Exception for business needs*

FX gain or loss directly related to the "business needs" of the CFC is excluded from foreign personal holding company income.<sup>117</sup> FX gain or loss is directly related to the business needs of a CFC if either (a) the FX gain or loss (i) arises from a transaction (other than a hedging transaction) entered into, or property used or held for use, in the normal course of the CFC's trade or business, other than the trade or business of trading foreign currency; (ii) arises from a transaction or property that does not itself (and could not reasonably be expected to) give rise to subpart F income other than foreign exchange gain or loss; (iii) does not arise from a transaction described in section 988(c)(1)(B)(iii); and (iv) is clearly determinable from the records of the CFC as being derived from such transaction or property; or (b) the FX gain or loss arises from a "bona fide hedging transaction", with respect to a transaction or property that satisfies the foregoing requirements of (i) and (ii) above, provided that any gain or loss arising from such transaction or property that is attributable to changes in exchange rates is clearly determinable from the records of the CFC as being derived from such transaction or property.<sup>118</sup> However, identification of a transaction as a hedge is not necessarily elective as there are adverse consequences arising from not making the identification.<sup>119</sup>

### *6.1.3. Recognition of foreign currency gain or loss on deemed distributions and remittances*

As is the case with domestic corporations, the earnings and profits of a foreign corporation must be calculated. This is done in the functional currency of the

<sup>114</sup> S. 954(c)(1)(D).

<sup>115</sup> Reg. §1.954-2(g)(2)(i).

<sup>116</sup> S. 989(b)(3).

<sup>117</sup> S. 954(c)(1)(D); reg. §1.954-2(g)(2)(ii)(A).

<sup>118</sup> Reg. §1.954-2(g)(2)(ii)(B).

<sup>119</sup> Reg. §1.954-2 (a)(1)(ii)(c).

corporation. However, the earnings and profits are not calculated into the owner's functional currency until there has been a remittance, a deemed distribution or they are otherwise taken into account.<sup>120</sup> Thus, exchange gain does not arise merely because there has been a fluctuation in rates. However, to the extent the inclusion of income under subpart F is limited by the foreign corporation's earnings and profits, the relevant earnings and profits are translated into US dollars at the average rate for the taxable year of the foreign corporation.<sup>121</sup>

When certain events occur, it is necessary to translate the amount in question at the appropriate exchange rate. This is done at the "appropriate exchange rate" which varies depending on the transaction. Thus, (a) in the case of an actual distribution of earnings and profits, the spot rate on the date such distribution is included in income; (b) in the case of an actual or deemed sale or exchange of stock in a foreign corporation treated as a dividend under section 1248, the spot rate on the date the deemed dividend is included in income; and (c) in the case of any amounts included in income as deemed dividend under subpart F (as discussed above) or under the PFIC rules, the average exchange rate for the taxable year of the foreign corporation is utilized.<sup>122</sup>

Finally, any amount included in income under section 951(a)(1)(B) as an investment in US property is treated as an actual distribution made on the last day of the taxable year for which such amount was so included.<sup>123</sup>

## 7. Translation of foreign taxes

### 7.1. Translation of direct taxes

Foreign taxes must be translated for purposes of the foreign tax credit provisions. Under the applicable provisions, if a taxpayer claims the foreign tax credit and accounts for foreign tax on an accrual basis, these taxes are translated at the average exchange for the year in which the taxes rate.<sup>124</sup> The foregoing rule does not apply to taxes paid before the beginning of the accrual year or more than two years after the year of accrual. In that case, the taxes must be translated at the exchange rate prevailing at the time of payment.<sup>125</sup> Taxpayers using the cash method of accounting for foreign taxes must use the time of payment rule.<sup>126</sup> It is also possible to use the time of payment rule for taxes paid which the taxpayer is liable for in a currency other than the taxpayer's functional currency.<sup>127</sup>

<sup>120</sup> S. 986(c)(1).

<sup>121</sup> S. 989(b)(3).

<sup>122</sup> S. 989(b).

<sup>123</sup> *Ibid.*

<sup>124</sup> S. 986(a)(1).

<sup>125</sup> *Ibid.*

<sup>126</sup> S. 986(a)(2)(A).

<sup>127</sup> S. 986(a)(1)(D)(i).

## 7.2. Translation of taxes paid by US shareholders of foreign corporations

Foreign taxes must also be translated for purposes of the foreign tax credit provisions when a taxpayer receives a dividend from a foreign corporation and is a domestic corporation which owns 10 per cent or more of the voting stock of the foreign corporation from which it receives dividends. However, in this case, the tax is considered an indirect credit.<sup>128</sup> A similar credit is allowed with respect to tax relating to income that is deemed paid by a US corporation and is required to include income under subpart F.<sup>129</sup> In such a case, the foreign taxes are translated into US dollars at the average rate for the year in which the taxes are accrued if the taxpayer uses the accrual basis. In the case where the taxpayer uses the cash method of accounting for foreign taxes, the taxpayer will use the spot rate prevailing when the taxes were paid.<sup>130</sup>

## 8. Other foreign currency issues

The comprehensive nature of rules adopted in 1986, together with previously adopted straddle rules under section 1092, have left very little opportunity for tax arbitrage. However, the disparate treatment of interest income and foreign currency gain or loss has made use of the hedging regimes of increasing importance. As a result, there is a greater need for clarification on the instances in which gain or loss can be subject to either hedge treatment or integration. For instance, in the context of the integration regimes, there is uncertainty as to whether an account receivable can qualify as a debt instrument and be eligible for the hedging rules. As a debt instrument, it would be eligible; but as merely an account receivable, it would not.<sup>131</sup>

## 9. Foreign currency gains and losses and tax treaties

Tax treaties to which the United States is a party have no specific reference to foreign currency issues. Moreover, while the treaties will have specific provisions regarding the attribution of profit from branches and sourcing of income to prevent double taxation, they do not specifically address FX effects on the computation of income attributed to branches, the sourcing of income, the distinction between business and other income, and the measurement of income for foreign tax credit purposes. Rather, these issues are left for interpretation by the jurisdiction having the right to tax the income in question or to grant the credit for the

<sup>128</sup> S. 902(a)(1).

<sup>129</sup> S. 960(a)(1).

<sup>130</sup> S. 986(a)(2)(A).

<sup>131</sup> Reg. §1.988-5(a)(3).

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taxes in question.<sup>132</sup> However, US treaties often address issues of double taxation by providing sourcing rules that apply for the determination of the foreign tax credit and the resolution of disputes concerning double taxation. Transfer pricing often gives rise to instances of double taxation.<sup>133</sup>

<sup>132</sup> United States model income tax convention of 15 November 2006, art. 3(2). In the application of the convention, any term used but not defined in the convention will have the meaning that it has under the law of the state whose tax is being applied, unless the context requires otherwise or the competent authorities have agreed on a different meaning pursuant to the mutual agreement procedure provisions. If the term is defined under both the tax and non-tax laws of the state, the definition in the tax law will take precedence over the definition in the non-tax laws. Finally, there also may be cases where the tax laws of a state contain multiple definitions of the same term, in which case, the definition used for purposes of the particular provision at issue, if any, should be used. The reference to the domestic law of a state means the law in effect at the time the treaty is being applied, not the law as in effect at the time the treaty was signed. See also United States model technical explanation accompanying the United States model income tax convention of 15 November 2006.

<sup>133</sup> 2006 US model treaty, art. 23(3) (income sourced in location where taxed) and art. 25 (mutual agreement procedure).