Client Alert
December 20, 2017

Treasury Releases Important New Currency Regulations

Regulations Resolve Many Currency Issues

On December 18, 2017, the U.S. Treasury and IRS (collectively, "IRS") published proposed regulations (the "Proposed Regulations") that should help to resolve a number of vexing currency issues that taxpayers routinely experience. Although the regulations generally have a prospective effective date, the preamble expressly permits taxpayers to rely on the regulations for taxable years ending (or transactions entered into) on or after December 19, 2017. The most significant policy change the Proposed Regulations introduce is new Prop. Reg. §1.988-7 which would permit taxpayers to remeasure their nonfunctional currency assets and liabilities in a manner that is consistent with U.S. Generally Accepted Accounting Principles ("GAAP") and International Financial Reporting Standards ("IFRS"). Although the IRS has previously proposed such a rule back in 1992 (see Prop. Reg. §1.988-5(f)), this new provision can be relied on presently and is much more likely to be finalized.

This client alert proceeds in three parts. First, we explain some of the issues that taxpayers routinely face. Second, we address how the regulations impact those issues absent the taxpayer making an election under new Prop. Reg. §1.988-7. Third, we address the new Prop. Reg. §1.988-7 election.

The client alert assumes a basic working knowledge of: (i) GAAP/IFRS; (ii) sections 446, 475 and 1256; and (iii) Subpart F and Subpart J of the United States Internal Revenue Code of 1986, as amended. For a primer on, and examples of, the misalignment of the U.S. tax and accounting rules, see generally, John D. McDonald, et. al., *The Devil is in the Details: Problems, Solutions & Policy Recommendations with Respect to Currency Translation, Transactions and Hedgin*g, 89 Taxes 119 (2011). In brief, when a controlled foreign corporation ("CFC") generates currency gains in excess of currency losses under section 988, the net amount is usually considered foreign personal holding company income ("FPHCI"), a type of subpart F income. See §954(c)(1)(D). There is an exception, however, for transactions entered into the ordinary course of the taxpayer's business (or "bona fide hedges" thereof) that generate currency gains but do not generate other types of subpart F income. This exception is referred to as the "business needs" exception.

The Misalignment of Tax and GAAP Rules Create a Number of Vexing Issues

Whenever a taxpayer, like a U.S. corporation, operates outside of the U.S. in a non-U.S. dollar currency environment, or engages in transactions that are not denominated in the U.S. dollar, the taxpayer is subject to currency risk for accounting and U.S. tax purposes. The problem is that the accounting rules and tax rules for measuring and recognizing these exposures are loosely related, but are not the same. Moreover, the decision to hedge these exposures are often

driven by the taxpayer's treasurer or controller based on accounting considerations, not tax considerations. In many cases, the tax department may only discover these transactions after they've been entered into. Thus, taxpayers are often surprised by the tax consequences that inexorably follow.

U.S. GAAP and IFRS. In the accounting world, there are two different statements a gain or loss could appear on - the income statement or the balance sheet.

The income statement records gain or loss in currency transactions. These gains or losses (with one exception for instruments not anticipated to be repaid in the foreseeable future) are generally recognized on a current basis. This process is referred to as "remeasurement". It occurs even if the instrument is not repaid or sold. A common example would be a CFC with a Euro functional currency that owns a trade receivable denominated in GBP. The gain or loss inherent in the receivable is "remeasured" for GAAP purposes and reflected in the income statement at the end of the year even before the receivable is paid.

The balance sheet reflects increases or decreases in the size of the balance sheet (measured in U.S. dollars) due to equity investments in businesses conducted in non-U.S. dollar currency environments. These increases or decreases are reflected in the cumulative translation adjustment ("CTA") account associated with the investment and are recorded in the U.S. parent's other comprehensive income ("OCI") account.

Given that income statement changes impact earnings per share, and changes to the OCI account do not, companies tend to be more concerned about transactional currency gains or losses that show up on their income statement and create income statement volatility. Nevertheless, some companies that are regulated or subject to stringent debt covenants may also be concerned about balance sheet volatility. In all events, companies often seek to hedge these exposures, if they are material.

U.S. Tax Rules. At the risk of oversimplifying, the U.S. tax rules contain two workhorse sections - section 988 and section 987. They are roughly analogous to the income statement and balance sheet rules discussed above, but there are many significant differences.

Section 988 is designed to measure the amount, and then determine the character and source of, transactions that a taxpayer enters into in nonfunctional currency. The timing of section 988 gain or loss is generally governed by other rules of the Code, including sections 475 and 1256. For example, a CFC with a Euro functional currency that owns a trade receivable denominated in GBP recognizes its currency gain or loss under section 988 of the Code.

Section 987, in contrast, is designed to "translate" tax basis in assets and liabilities from one functional currency environment to another. A different currency environment is referred to as a qualified business unit or "QBU". So, for example, if a CFC with a Euro functional currency owns a branch or hybrid entity that uses the GBP as its functional currency, section 987 governs the movement of assets and liabilities from the CFC to the branch and back again. As assets

move down to the branch, section 987 dictates how the assets are translated from Euro to GBP, and vice-versa.

One might be tempted to conclude that sections 988 and 987 operate the same way as the above-described accounting rules for the income statement and balance sheet. There are very significant differences, however. Whereas the accounting rules constantly "remeasure" nonfunctional currency transactions regardless whether there has been a realization event, section 988 follows the normal realization provisions in the U.S. tax law. Similarly, whereas the accounting rules recognize changes in the CTA account every year due to changes in exchange rates, section 987 (absent an election) only requires the taxpayer to recognize gains or losses when assets are transferred ("remitted") from the branch to the home office. Moreover, the U.S. entity classification regulations (which are only relevant for U.S. tax purposes, not accounting purposes) compound these disconnects. For example, assume a CFC with the U.S. dollar as its functional currency, owns a disregarded entity with the GBP as its functional currency, and the disregarded entity has issued a GBP-denominated debt to the CFC. In this case, the controller may conclude that the debt is a transactional exposure that needs to be reflected on the income statement and needs to be hedged, whereas the tax department will conclude the debt instrument simply does not exist for U.S. tax and subpart F purposes.

The following example is used to illustrate a series of common problems that arise in the currency area. We discuss the problems, and then discuss how the Proposed Regulations help to ameliorate some of these problems.

<u>EXAMPLE</u>: USCO is a calendar year domestic corporation that uses the U.S. dollar as its functional currency and owns all of the outstanding shares of a controlled foreign corporation ("CFC") called CFC1. CFC1 uses the Euro as its functional currency. CFC1 acts as the treasury center for the offshore group and regularly takes in deposits from, and loans out currency to, various affiliates. CFC1 also purchases and sells some goods pursuant to accounts payable and receivable that are denominated in currencies other than the Euro. Some of these sales generate subpart F income and some do not. CFC1, in turn, owns a hybrid branch ("Branch") that is a QBU that uses the GBP as its functional currency. Branch is engaged in the active manufacture and sale of products, some of the profits of which generate subpart F income and some of which don't. CFC1 also owns a CFC ("CFC2") that uses the Polish Zloty as its functional currency. To alleviate the income statement volatility that would result from CFC1's receivables and payables, CFC1 enters into a series of rolling forward contracts to hedge its aggregate currency exposure to its various non-Euro accounts receivables and payables ("Hedge 1"). Due to concerns about the impact that CFC1's investment in Branch's and CFC2's operations have on USCO's balance sheet, USCO's treasurer decides to cause CFC1 to enter into a currency forward to sell GBP ("Hedge 2") and Zloty ("Hedge 3") to hedge its equity investment in Branch and CFC2, respectively. CFC1 designates Hedge 2 and Hedge 3 as "net investment hedges" of its investments in Branch and CFC2, respectively, for GAAP purposes. As a general rule, CFC1 chooses not to hedge its currency exposure on its affiliate borrowing and lending. Instead, it simply seeks to ensure that its liabilities and receivables denominated in currencies other than the Euro are roughly matched such that CFC1 is in a naturally hedged

position without the need to enter into a derivative ("Natural Hedges"). The one exception is for a sizable borrowing CFC1 made that was denominated in U.S. dollars. CFC1 chooses to enter into a series of rolling forwards to buy U.S. dollars ("Hedge 4") to hedge its currency exposure to this liability.

Although USCO's accounting objectives are achieved, the foregoing, seemingly innocuous, example generates a whole host of tax issues for USCO.

Hedge 1 – Hedges of Accounts Receivables and Payables. Hedge 1 can qualify as a "hedge" under section 1221 principles if it is properly identified as such. It can even qualify as a "bona fide hedge" under the subpart F rules and Treas. Reg. §1.954-2(a)(4)(ii). The problem is that although many (perhaps even most) of the underlying transactions being hedged do not generate subpart F income, the fact that more than a *de minimis* portion of them do, means that the gains and losses on Hedge 1 cannot qualify for the business needs exception to FPHCI found in Treas. Reg. §1.954-2(g)(2)(ii). Thus, a currency gain on Hedge 1 generates FPHCI even though there is an equal and offsetting currency loss on accounts payable or receivable that qualify for the business needs exception.

Hedge 2 – Net Investment Hedge of a Foreign Branch. The results of Hedge 2 have historically been uncertain. Some taxpayers have attempted to argue that derivatives like Hedge 2 can be considered hedges of an anticipated receipt of ordinary income by Branch and so qualify as "hedges" within the meaning of section 1221, and "bona fide hedges" under the section 954 regulations to which the business needs exception to FPHCI can apply. The IRS has not previously endorsed this position, however. If it is not a hedge, or a bona fide hedge, then the gains on Hedge 2 would simply be FPHCI and would not be reduced or offset by any corresponding currency loss from CFC1's investment in Branch.

Hedge 3 – Net Investment Hedge of a Foreign Subsidiary. Hedge 3 does not (and cannot) meet the definition of a "hedge" for tax purposes because it hedges stock in CFC2, and stock is not considered "ordinary property" under the section 1221 regulations. Instead, any gain is simply considered foreign personal holding company income ("FPHCI"), a type of subpart F income. This currency gain is not offset or reduced by any offsetting loss in the Zloty denominated stock/investment.

Hedge 4 – Hedge of a Liability. Hedge 4 can qualify as a tax hedge under section 1221, if the hedge is properly identified. Thus, gains and losses on CFC1's nonfunctional currency denominated interest-bearing liabilities should be recognized in the same period as the losses and gains on the hedge under Treas. Reg. §1.446-4. Unfortunately, however, that is not the end of the story. This is because the FPHCI regulations contain a special sourcing rule in Treas. Reg. §1.954-2(g)(2)(iii) which provides that currency gains (or losses) incurred by a CFC with respect to interest-bearing liabilities are apportioned between subpart F and non-subpart F income in the same manner that interest expense with respect to the liability is apportioned. The special sourcing rule does not mention "hedges", however. Thus, it is unclear whether gains and losses on Hedge 4 would be apportioned in the same manner as the gains and losses on the underlying interest-bearing liability would be.

Natural Hedge. Perhaps the most surprising problems are those created by CFC1's borrowing and on-lending activities that are naturally hedged because these activities economically offset one another. Although CFC1 is perfectly hedged from a GAAP perspective (via the offsetting loans receivable and payable denominated in the same currency), that is not the case from a U.S. tax perspective. As a preliminary matter, the back-to-back loans in the same currency cannot qualify as "tax hedges" due to Treas. Reg. §1.1221-2(d)(5). Thus, CFC1 has a timing issue. If CFC1 is not a "dealer" within the meaning of section 475, any losses it recognizes on either its long or short position may be subject to the section 1092 straddle rules, which defers losses. This may cause CFC1 to recognize FPHCI in a year when it has no economic income.[1] Even if CFC1 is a dealer, it is not clear whether CFC1 can mark its liabilities to market. The preamble to the Proposed Regulations notes that many taxpayers do take the position that they can mark their liabilities to market, and the preamble did not indicate that position was wrong. Nevertheless, the IRS has not explicitly adopted this position and it's conceivable that an IRS agent may argue on audit that Treas. Reg. §1.475(c)-2(a)(2) prevents nonfunctional currency denominated liabilities from being marked. This would then create a timing mismatch for CFC1 whereby gains on receivables are recognized while losses on payables are not. This can generate more FPHCI to CFC1 even though CFC1 has no economic income. Moreover, even if the timing issue is solved, the special subpart F sourcing rule in Treas. Reg. §1.954-2(g)(2)(iii) that is described above still applies for interest-bearing liabilities but not for the receivables and so can cause CFC1 to have more subpart F than it otherwise would.

The Proposed Regulations Help Resolve Some (But Not All) of These Problems

Hedge 1 – Hedges of Accounts Receivables and Payables. The Proposed Regulations depart from the cliff effect in the current regulations and instead adopt a more common sense rule in Prop. Reg. §1.954-2(g)(2)(ii)(C)(1) whereby currency gain can qualify for the business needs exception ***to the extent*** the gain relates to property that does not generate subpart F income. Thus, if USCO can determine that 60% of the underlying transactions being hedged do not generate subpart F income, then USCO can claim the business needs exception for 60% of the gain on Hedge 1. This is a welcome change and reflects the reality that USCO's treasury department will tend to hedge "aggregate" currency risk and it is simply not practical to (at the time the hedge is entered into) decide which exposures relate to subpart F generating transactions and which do not. The preamble to the Proposed Regulations indicates that this provision may be applied even before finalization for any transaction entered into on or after December 19, 2017.

Hedge 2 – Net Investment Hedge of a Foreign Branch. The Proposed Regulations for the first time acknowledge that a CFC's hedge of its currency exposure to its equity investment in a QBU can qualify for the business needs exception to FPHCI the extent that the gain on the hedge is allocable to non-subpart F income. To qualify for this rule, the hedge must be a net investment

[1] CFC1 has no economic income, because it has an equal and offsetting loss, but section 1092 prevents it from recognizing that loss, thereby causing it to recognize FPHCI.

hedge for accounting purposes, the results of which are reflected in the CTA account associated with the QBU. The taxpayer allocates the gain on the hedge to non-subpart F sources in the same manner that it allocates section 987 gain. *See* Prop. Reg. §1.954-2(g)(2)(ii)(C)(2). Thus, if CFC1 can demonstrate that only 10% of Branch's section 987 gain would be allocable to subpart F income, CFC1 can claim that 90% of its gain on Hedge 2 qualifies for the business needs exception to FPHCI and is not considered subpart F income. The preamble suggests that this rule may be applied by taxpayers in any taxable year ending on or after December 19, 2017. Thus, if CFC1 entered into Hedge 2 in March 2017, it can rely on the Proposed Regulations to take this position in its 2017 tax return filing. Interestingly, the Proposed Regulations do not subject these hedge gains to the matching rules of Treas. Reg. §1.446-4. The IRS has asked for comments on this issue in the preamble.

Hedge 3 – Net Investment Hedge of a Foreign Subsidiary. The Proposed Regulations do not alter the current law with respect to Hedge 3. The preamble, however, requests comments on this situation.

Hedge 4 – Hedge of a Liability. The Proposed Regulations assist CFC1 by making it clear that if CFC1 enters into a hedge with respect to an interest-bearing nonfunctional currency liability that is subject to the special sourcing rule in Treas. Reg. §1.954-2(g)(2)(iii), the currency gain or loss on the hedge is apportioned in the same manner as the loss or gain on the underlying liability. See Prop. Reg. §1.954-2(g)(2)(iii).

CFC1's Natural Hedge. The Proposed Regulations introduce new Prop. Reg. §1.954-2(a)(4)(ii)(A), which allows taxpayers to treat nonfunctional currency denominated loan receivables as "bona fide hedges" of nonfunctional currency denominated interest-bearing liabilities for subpart F purposes. In addition, Prop. Reg. §1.446-4(a) would modify existing Treas. Reg. §1.446-4(a) to provide that any "bona fide hedge" has to be accounted for under the section 446 regulations rules accounting for hedges. The combination of these two changes would allow CFC1 to ensure that the timing of any currency gain (or loss) on its receivables is appropriately matched in the same year as the corresponding loss (or gain) on CFC1's liabilities. In addition, when the gains and losses are recognized, the changes to the special sourcing rule (described above in the discussion of Hedge 4) would apply to ensure the gains (or losses) on the loan receivables are characterized as subpart F or non-subpart F in the same manner as the liabilities.

CAUTION 1: Taxpayers have to "identify" their bona fide hedges. Thus, to take advantage of these common sense simplification rules, the taxpayer must ensure that it has adequate documentation in place to satisfy Treas. Reg. §1.954-2(a)(4)(ii)(B).

CAUTION 2: Although the foregoing rule may help CFC1 avoid a timing and character mismatch, it exacerbates the tax-GAAP conflict. Specifically, under GAAP, CFC1 will remeasure its liabilities and its loan receivables on a current basis in all events. If CFC1 is a dealer but determines that it cannot remeasure its liabilities due to 1.475(c)-2(a)(2), and yet chooses to identify its loan receivables as hedges of its loan payables, it will not remeasure either its liabilities ***or*** its receivables for tax purposes. This will increase (not decrease) the

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tax vs. accounting disconnect that currently exists. The way out of this conundrum is to consider making the election described below under Prop. Reg. §1.988-7.

Flexibility in Revoking (g)(3) and (g)(4) Elections. Many taxpayers made elections for their CFCs under Treas. Reg. §1.954-2(g)(3) (characterizing currency gains and losses in the same subpart F category as the underlying transaction) and (g)(4) (characterizing all currency gains and losses as FPHCI) to try and minimize the impact of currency gains on their subpart F computations. In recognition of the fact that the Proposed Regulations adopt more common sense rules and give the taxpayer new tools to avoid unwarranted subpart F inclusions, the regulations also provide taxpayers with additional flexibility to revoke (g)(3) and (g)(4) elections that were previously made for their CFCs. Historically, these elections could not be revoked without the IRS's consent.

PLANNING POINTER: Taxpayers should revisit their existing (g)(3) and (g)(4) elections for their CFCs in light of the Proposed Regulations and consider whether these elections should be revoked.

The Proposed Regulations Contain a New Timing Rule in Treas. Reg. §1.988-7

Back in 1992, the IRS issued Prop. Reg. §1.988-5(f). *See* 57 Fed. Reg. 9217 (Mar. 17, 1992). Had it been finalized, it would have allowed a taxpayer under specific conditions to remeasure its nonfunctional currency denominated assets or liabilities that were governed by section 988 of the Code. We use the term "remeasure" instead of "mark to market" (like the regulations) because the regulation did not permit the taxpayer to take into account interest rate movements and credit ratings when marking nonfunctional currency denominated assets and liabilities to market for tax purposes. Instead, the taxpayer was simply permitted to follow the remeasurement provisions under GAAP and recognize the inherent currency gain or loss in a financial statement asset or liability that would otherwise be recognized if the asset or liability were sold or repaid.

The foregoing rule would have been extremely helpful for those taxpayers, like CFC1, that had significant offsetting currency exposures but could not qualify for "dealer" status under section 475, or could qualify but were concerned that the IRS would refuse to permit them to remeasure their liabilities under Treas. Reg. §1.475(c)-2(a)(2). Unfortunately, the regulations were prospectively effective and the IRS never finalized them.

The Proposed Regulations introduce an entirely new timing regulation, Prop. Reg. §1.988-7. Like the 1992 regulations, the Proposed Regulations only permit the taxpayer to "remeasure" its nonfunctional currency assets and liabilities. It does not permit a true mark to fair market value. Unlike the 1992 regulations, however, the preamble to the Proposed Regulations states that taxpayers may rely on the regulation for any tax year ending on or after December 19, 2017. This should provide significant assistance to many offshore treasury centers (or even U.S. companies) that have significant offsetting currency positions and that are concerned about the ability to match the gains and losses in the same

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accounting period due to the application of the section 1092 straddle rules or other reasons.

PLANNING POINTER: Calendar year taxpayers should seriously consider applying the new Prop. Reg. §1.988-7 rules to their 2017 year. To do this, the taxpayer will have to file a statement with its original return for the 2017 tax year.

Conclusion

The Proposed Regulations represent a common sense approach to solving a number of vexing currency issues that have plagued taxpayers for years. Although the regulations do not solve all of the potential disconnects that can arise between GAAP and tax in this area, the Proposed Regulations at least attempt to resolve many of these issues. Any taxpayer that engages in material nonfunctional currency denominated transactions should carefully study these new regulations. Taxpayers should then consider whether they should apply the regulations now, before the regulations are published as final. Taxpayers should also identify those CFCs for whom an election has been made under Treas. Reg. §1.954-2(g)(3) and (g)(4) and consider whether it is advantageous to continue those elections.

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