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Foreign Currency
A Primer

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Agenda

- **Overview**
- **Measuring Universe**
  - QBUs
  - Functional currency
- **Transactions Involving Nonfunctional Currency**
  - Generally
  - Application of § 988
- **Translation Rules**
  - Branches
  - Foreign corporations

WARM-UP

EXAMPLE – personal property / medium of exchange

- Assume basic tax principles and that truck is not depreciable property
- Assess general tax results under the following scenarios

Scenario 1 Assume the *truck* is sold for $2

Scenario 2 Assume the truck is a *€1 coin* that is exchanged for $2 (i.e., exchange rate is $2:€1)

Scenario 3 Assume US Seller enters into contract with Italian Buyer, pursuant to which the *truck* is sold for €1 (exchange rate is $1.5:€1), but is not settled until 6 months later (exchange rate is $2:€1); the contract does not contain a provision addressing currency fluctuations

Conceptual Framework

- To understand foreign currency taxation, you must understand the following:

Our Tax System is US-Centric

US taxpayers pay US tax *in US dollars* on *worldwide income*

It's a Big World

There are over 150 currencies around the world; they fluctuate

Need to Accommodate

For the US system to work globally, it must:

(a) Accommodate transactions in (or in assets denominated in) currencies other than the US dollar

(b) Provide timing + character rules for the above transactions

(c) Translate the results into US dollars

Basic Ground Rules

Accordingly, US tax law sets forth the following ground rules:

Our focus today

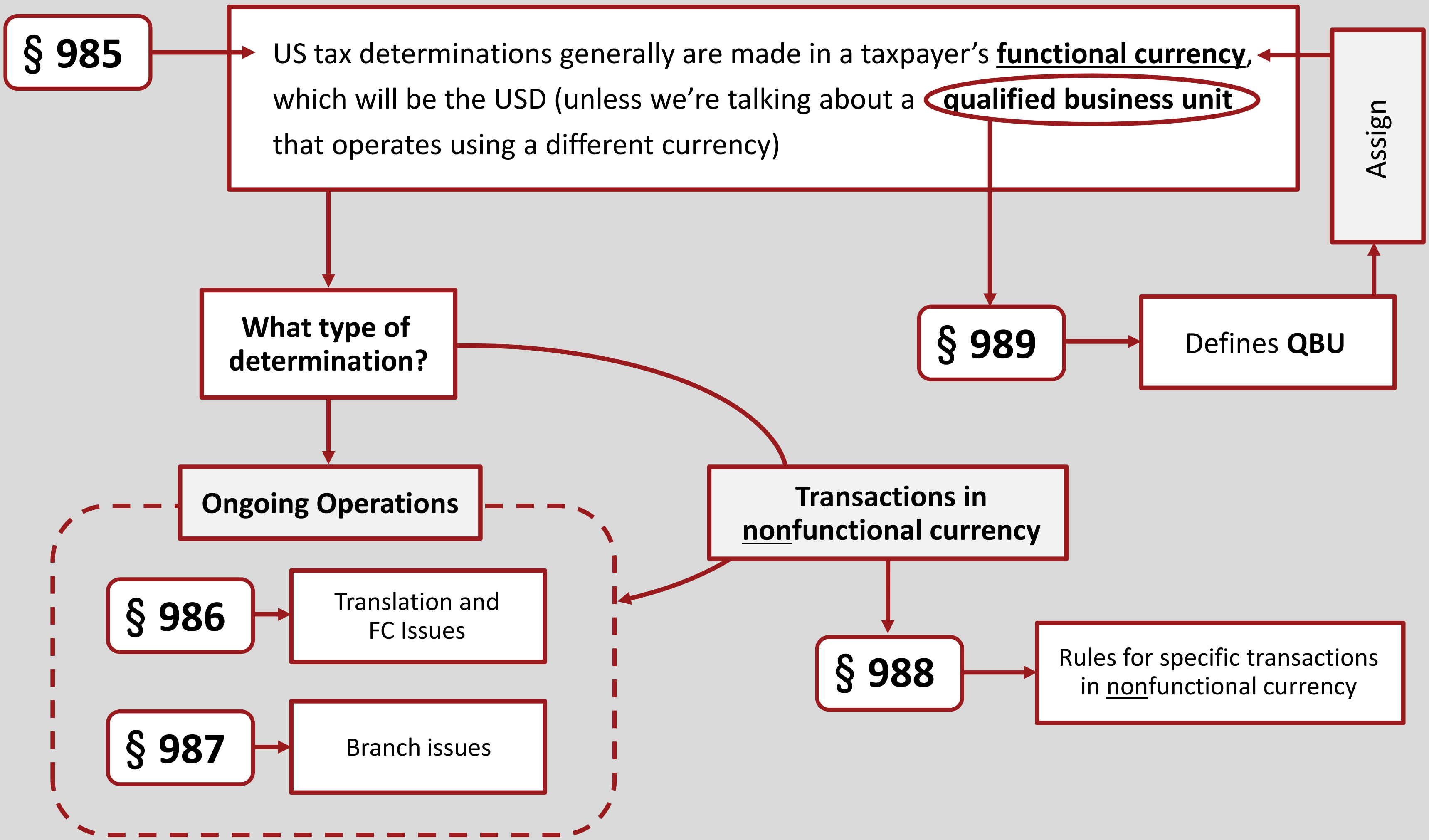
(a) Identify discrete measuring universes for a taxpayer

(b) Assign a "home" currency to such universes

(c) Address transactions in home and non-home currencies

(d) At some point, it must roll-up into the US system (translation)

STATUTORY FRAMEWORK



Measuring Universe

General Overview

GOAL: Identify a "baseline" currency which will serve as a frame of reference for tax purposes

- 1980 FASB origins – FAS 52 principles adopted by Treasury
- Baseline currency is known as "**functional currency**"

> *Essentially, the **currency of the economic environment** in which a **significant part of activities are** conducted and in which books / records are kept"*

- Presume that functional currency is USD, unless

  (1) there is a "qualified business unit" (QBU) present, *and*

  (2) the QBU is not required to use USD as its functional currency

- Thus, requires a determination of what constitutes a **QBU**

QBUs

- QBU is the **<u>measuring universe</u>** (in which functional currency relevant)
  - Taxpayers generally isolate operations into QBUs, where possible

> *A QBU is a **<u>separate</u>** and **<u>clearly identified</u>** unit of a **<u>trade / business</u>** which maintains **<u>separate books / records</u>***

  - **QBUs**
    - <u>Corporation</u> (per se)
    - <u>Partnership</u> (is a QBU of the partner, per se)
    - <u>Trust</u> (is a QBU of a beneficiary, per se)
    - <u>Activities</u> of an entity – if unified grouping constitutes independent economic enterprise
      - Focus on eligibility for § 162 / § 212 deductions, and separate books/records
      - Every operation necessary to earn profit (e.g., not mere solicitation nor ancillary)
      - Need not be different from other QBUs – vertical, functional or geographic division fine

Functional Currency

- Once QBU is identified, must determine that QBU's functional currency
  - **US Dollar** – functional currency generally is USD in any of these scenarios:
    - QBU's activities primarily conducted in USD
    - The QBU's residence is the US
    - The QBU does not keep books / records in currency of any economic environment in which a significant part of activities conducted
    - Activities producing "effectively connected" income / loss (separate USD QBU)
    - Hyperinflation
  - **Other Currency** – if USD not required, QBU's functional currency is that (1) of the *economic environment* in which a *significant part of its activities conducted*, and (2) in which its books / records kept
    - Economic Environment – based on facts/circ., including local currency, the currency that QBU uses to transact business (sales, expenses, cash flows) and make pricing decisions
    - Multiple Currencies – QBU can choose if multiple currencies meet this criteria

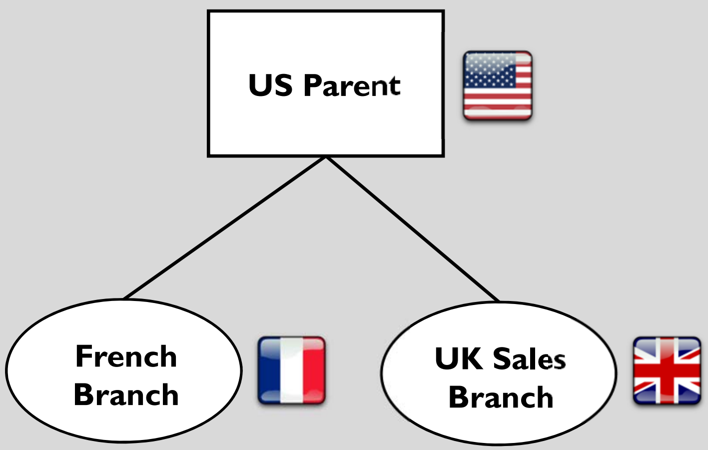
Other Notes on FC

- **Special rule** – for certain *foreign corporations*
  - If foreign corporation has 2+ QBUs that do not have same functional currency, then:
    - *First:* work from bottom-up (i.e., first determine functional currency of QBUs)
    - *Second:* conclude as to foreign corporation's functional currency at the end, taking into the corporation's activities *as a whole* (including those of the QBUs)
- **Accounting method**
  - Adoption of functional currency = treated as a *method of accounting*
  - Functional currency first adopted must be used thereafter, unless IRS grants permission to change; permission not easily obtained
  - Any change of a taxpayer's functional currency is treated as a *change in method of accounting*, subject to the rules of § 481

Summary: QBUs + FC

- **Step 1** – identify the QBU(s)
  - **QBU:** ❶ is separate / clearly identified unit of a trade / business, and ❷ maintains separate books / records (for financial reporting purposes)
- **Step 2** – determine functional currency for each QBU
  - **Generally:** ❶ Is currency of *economic environment* in which a *significant part* of QBU's activities *conducted*, and ❷ In which QBU's books / records kept, so long as ❸ QBU not required to use US dollar
  - **Required to use US dollar:** QBU must use USD if (1) use US residence (e.g., US entity or principal place of business in US), (2) ECI, (3) does not keep books / records in a currency of any economic environment in which significant part of activities conducted, (4) conducts activities primarily in USD, or (5) other scenarios (e.g., hyperinflation)
  - **Special rule for certain FCs:** If a foreign corporation has 2+ QBUs that do not have the same functional currency, then (1) each QBU determines functional currency, and then (2) FC determines its based on its activities as a whole (including those of QBUs)

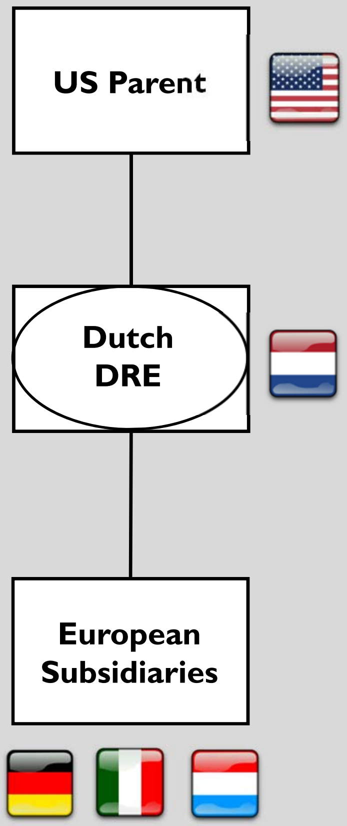
QBUs + FC – Ex. 1



EXAMPLE 1 – QBUs generally

- **Facts**
  - *US Parent* is corporate manufacturer
  - US Parent has *UK sales branch* that has its own employees, a robust sales function and maintains its own set of books / records
  - US Parent has *French branch* that performs administrative (back-office) functions
- **Analysis**
  - *US Parent* – per se QBU (USD functional)
  - *UK Branch* – is a QBU because its activities constitute trade / business and it maintains its own separate books (GBP functional)
  - *French Branch* – is *not* a QBU because its activities are merely ancillary and do not amount to a trade / business

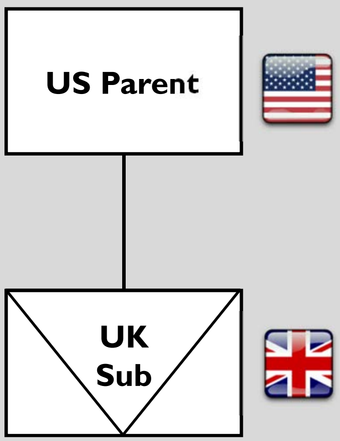
QBUs + FC – Ex. 2



EXAMPLE 2 – QBUs and DREs

- **Facts**
  - *US Parent* owns *Dutch DRE* (a Dutch BV that is treated as transparent for US tax purposes)
  - Dutch DRE serves as a holding company for US Parent's European subgroup, and maintains its own separate set of books / records
- **Analysis**
  - *US Parent* – per se QBU (USD functional)
  - *Dutch DRE* – is not a *per se* QBU; further, its *activities* are not likely sufficient to cause it to be considered a QBU. *See, e.g.*, Prop. Reg. § 1.987-1(b)(7) Ex. 1 (holding stock and servicing a liability does not amount to trade / business)
- **Query**
  - How would the results change if Dutch DRE served as a treasury for the European subsidiaries?

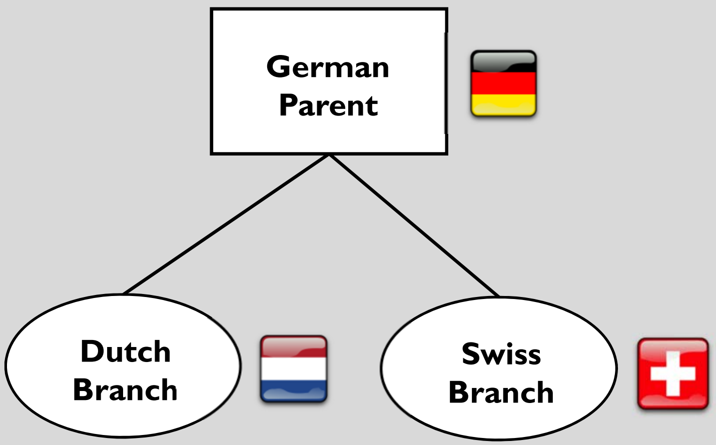
QBUs + FC – Ex. 3



<u>EXAMPLE 3</u> – Impact of conduct on currency

- **<u>Facts</u>**
  - *US Parent* owns *UK Sub* (a Scottish LP that is treated as a corporation for US tax purposes)
  - UK Sub is required to keep its books / records in GBP under local law; however, its only activities are financing US Parent and other US affiliates. Almost all of UK Sub's borrowing / lending transactions are conducted in USD
- **<u>Analysis</u>**
  - *US Parent* – per se QBU (<u>USD</u> functional)
  - *UK Sub* – is required to use <u>USD</u> as its functional currency, *notwithstanding* the fact that it keeps its local books / records in GBP. This is because its activities are *primarily conducted in USD*

QBUs + FC – Ex. 4



EXAMPLE 4 – Special rule for certain corps

- **Facts**
  - *German Parent* has a *Dutch branch* and a *Swiss branch*, the activities of each of which qualify as QBUs); all of German Parent's transactions (other than via branches) are conducted in EUR
  - *Dutch branch* activities conducted in EUR; *Swiss branch* activities conducted in CHF
- **Analysis**
  - *First* – must determine functional currencies of Swiss and Dutch branches
  - *Second* – The functional currency of German Parent is determined, taking into account the branch transactions
  - If the functional currency of German Parent and Dutch branch is EUR and the functional currency of Swiss branch is CHF, then for computing E&P of German Parent the P&L of the Swiss branch must be translated from CHF to EUR via § 987

Transactional Approach

General Principles

- Recall: *Non-functional* currency is both **<u>property</u>** and a **<u>means of exchange</u>**
  - Currency amounts to <u>personal property</u> when it is not one's typical unit of exchange
  - However, most view currency as a <u>means of exchange</u> (i.e., for transacting business)

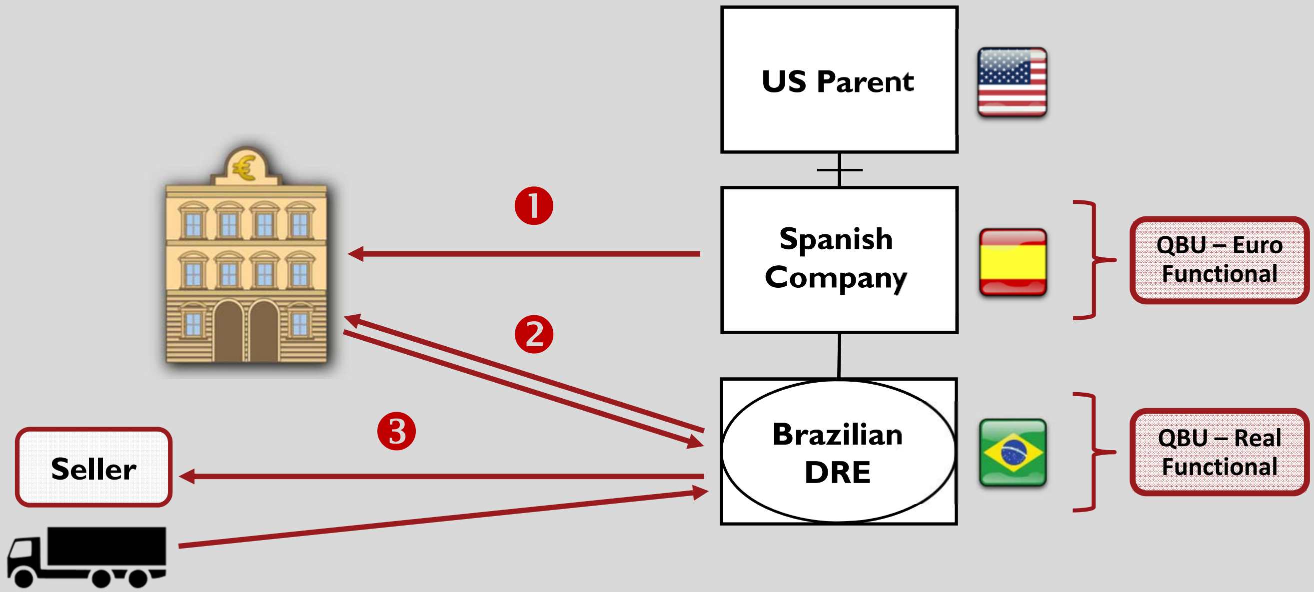
<u>Principle #1</u>: *When a QBU engages in business / transactions using its own <u>functional currency</u>, that currency is merely a <u>means of exchange</u> and not <u>property</u> in and of itself*

Thus, the QBU's accounts are maintained in the functional currency (i.e., <u>not</u> translated) until later events necessitate a translation into US dollars

However

<u>Principle #2</u>: *When a QBU engages in transactions involving <u>non-functional currency</u>, that currency generally is treated <u>property</u> and, as a result, a **<u>transactional approach</u>** to taxation is required*

QBU Dealings – Example *



EXAMPLE – basic tax consequence of QBU dealings?

❶ Spanish Co. deposits EUR in money-market account at bank?

❷ Brazilian DRE exchanges BRL for EUR? What if exchanges EUR for BRL?

❸ Brazilian DRE uses BRL to acquire truck? What if it uses EUR to acquire truck?

* Disregard existence of § 988

Advent of § 988

- **Brief review**
  - Operations in functional currency = generally wait, *translate* to USD later
  - For transactions involving nonfunctional currency = need special approach
- **History**
  - *Pre-1986* – fact-specific judicial / admin guidance, yielded inconsistent results
  - *TRA 1986* – Congress made significant changes in foreign currency arena, including by adding § 988 to address specific transactions
- **Key rule – Section 988**
  - Specific, comprehensive guidance for limited population of transactions denominated in / determined by reference to *nonfunctional* currency
  - Identifies transactions covered
  - Prescribes character / source / timing for *foreign currency gain / loss* (FX gain / loss)

§ 988 Overview

- Generally treats foreign currency as **property**
- Only applies to a "**Section 988 Transaction**"

§ 988 Transaction (generally)

Any of the transactions listed below if the amount taxpayer is required to pay (or is entitled to receive) via such transaction is denominated in (or determined by reference to the value of) a nonfunctional currency

Specific transactions:

1. Acquiring or disposing of non-functional currency itself
2. Becoming creditor or obligor on nonfunctional currency debt instrument
3. Accruing a nonfunctional account payable or receivable
4. Entering into or acquiring nonfunctional currency derivatives *

* Forwards, futures, options and swaps

Quick Detour

- **<u>Not</u> § 988 transactions**
  - Despite the coverage of §988, it does not capture all possible transactions
  - **Stock transactions** – gain / loss only in relation to stock, not FX, movements
    - See *Mariani Frozen Foods* (TC 1983)
  - **Intra-taxpayer transactions** – those between or amongst the taxpayer and/or its QBUs will not constitute § 988 transactions (even though involve nonfunctional currency)
- **Hedging and derivatives**
  - Huge area, subject to elaborate rules
  - Subject for its own discrete program

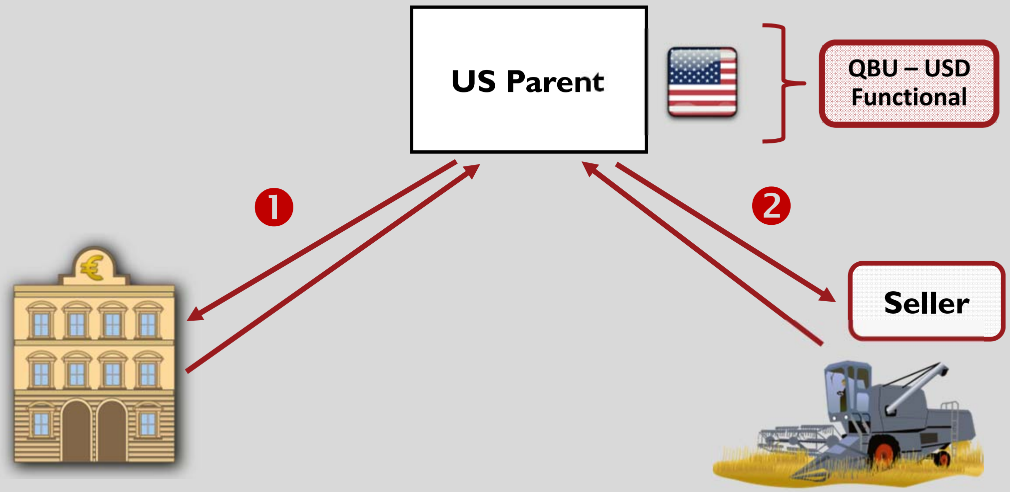
§ 988 Tax Consequences

- **FX gain / loss** – main focus
  - **Defined** – FX gain / loss is the amount of gain or loss realized on a § 988 transaction that is attributable to exchange rate movements between "booking" date (e.g., when A/P or A/R accrued, or date of acquiring / issuing debt instrument) and "payment" date
  - **Separate Computation** – FX gain / loss must be separately computed from other gain or loss that arises from the transaction, and also must be separately computed for each § 988 transaction. (Special exception: <u>all</u> gain / loss on nonfunctional currency derivatives are treated as FX gain / loss. *See* § 988(b)(3))
- **Character / source** – generally <u>ordinary</u> and based on <u>residence</u>
  - **Character** – FX gain / loss is generally <u>ordinary</u> (except for certain derivatives)
  - **Source** – FX gain / loss generally sourced to <u>residence of taxpayer</u> entering transaction
    - **Entities** – based on status as US person or not under § 7701(a)(30)
    - **QBU** – country of QBU's principal place of business

Additional § 988 Considerations

- **Timing**
  - **Generally** – § 988 really is not a timing section, and thus rules regarding FX gain / loss (while they may speak in terms of *realization*) generally defer to the normal Code rules regarding *realization* and *recognition* (e.g., §§ 1001, 1092, 1256, 475, hedge timing rules)
  - **Intra-taxpayer Transactions** – if § 988 transaction with a third party (e.g., note), then transfer of such item amongst the taxpayer and/or its QBUs is not FX gain / loss realization trigger unless, as a result of such transfer, the § 988 transaction either (a) loses its status as such, or (b) thereafter gives rise to a different sourcing
- **Debt instruments** – special considerations
  - **Principal / Interest** – there can be FX gain / loss on the *principal* and on the *interest* components of a nonfunctional currency debt obligation; must handle separately
    - **Principal** – basically determined by difference in spot rates on dates of initiation and payment of principal
    - **Interest** – *expense* (obligors) and *income* (lenders) for accrual taxpayers is calculated using *average exchange rates* for the accrual period; however, also possibility for FX gain / loss – determine by comparing the accrued item (using average exchange rate) vs the actual payment amount (using spot rate on date of payment). Note that for obligors, the *interest expense* is sourced differently than *FX loss*

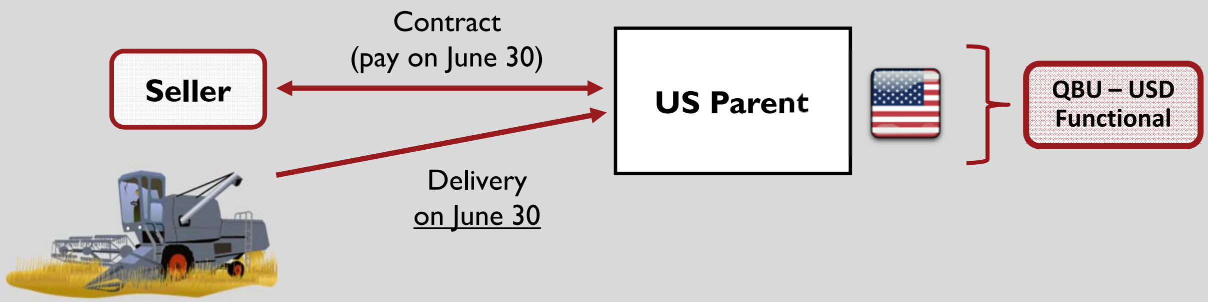
§ 988 Transactions – Ex. 1



EXAMPLE 1 – disposition of nonfunctional currency

- **Facts**
  - US Parent exchanges US$100 for €100 (i.e., USD : Euro exchange rate is 1:1)
  - USD depreciates against Euro
  - US Parent then buys tractor for €100 (i.e., USD : Euro exchange rate is 2:1)
- **Analysis**
  - Conversion of US$100 to €100 merely sets basis
  - US Parent recognizes US $100 FX gain (US$200 amt. realized less US$100 adj. basis)

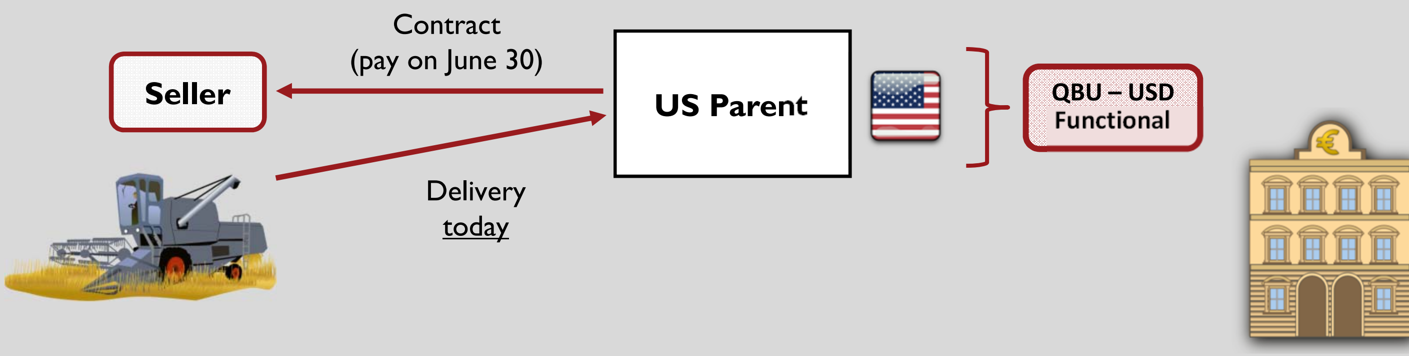
§ 988 Transactions – Ex. 2



EXAMPLE 2 – executory contracts / M&A

- **Facts**
  - US Parent enters into contract on Jan 1, 2014 to buy tractor for €100; delivery is to be made on June 30, 2014 (at which time payment will be made); at the time that the contract is signed, USD : Euro exchange rate is 1:1
  - USD depreciates against Euro, and USD : Euro exchange rate is 2:1 on June 30, 2014
  - On June 30, 2014, the tractor is delivered to US Parent for the contract price
- **Analysis**
  - This is not a § 988 transaction – US Parent's obligation is an executory contract, not a payable for which accrual is relevant (because there has not been *delivery*); merely entering into a contract to make a purchase in the future is not a taxable event
  - US Parent recognizes no FX loss (even though tractor has become more expensive)

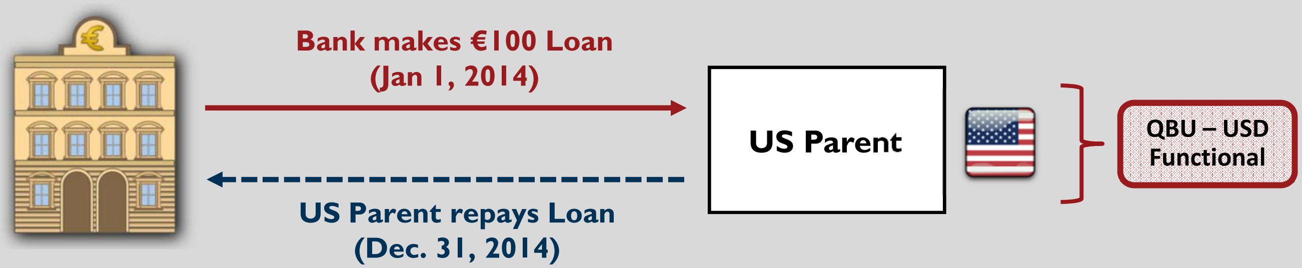
§ 988 Transactions – Ex. 3



EXAMPLE 3 – nonfunctional A/P

- **Facts**
  - Same as Ex. 2, except delivery is made today (when USD : Euro exchange rate is 1:1)
  - USD depreciates against Euro, and USD : Euro exchange rate is 2:1 on June 30, 2014
- **Analysis**
  - The acquisition of the tractor is not a § 988 transaction (US Parent has $100 basis)
  - The account payable is a § 988 transaction – US Parent booked a $100 payable on the original date (100 * $1), but paid $200 (€100 * $2) on June 30; accordingly, it has a ***$100 FX loss***, which is treated as *ordinary* and *US source* per § 988 (US residence)
- **Extra** – What if US Parent also enters into a forward contract with bank to buy €100 for $110 on June 30, 2014?

§ 988 Transactions – Ex. 4



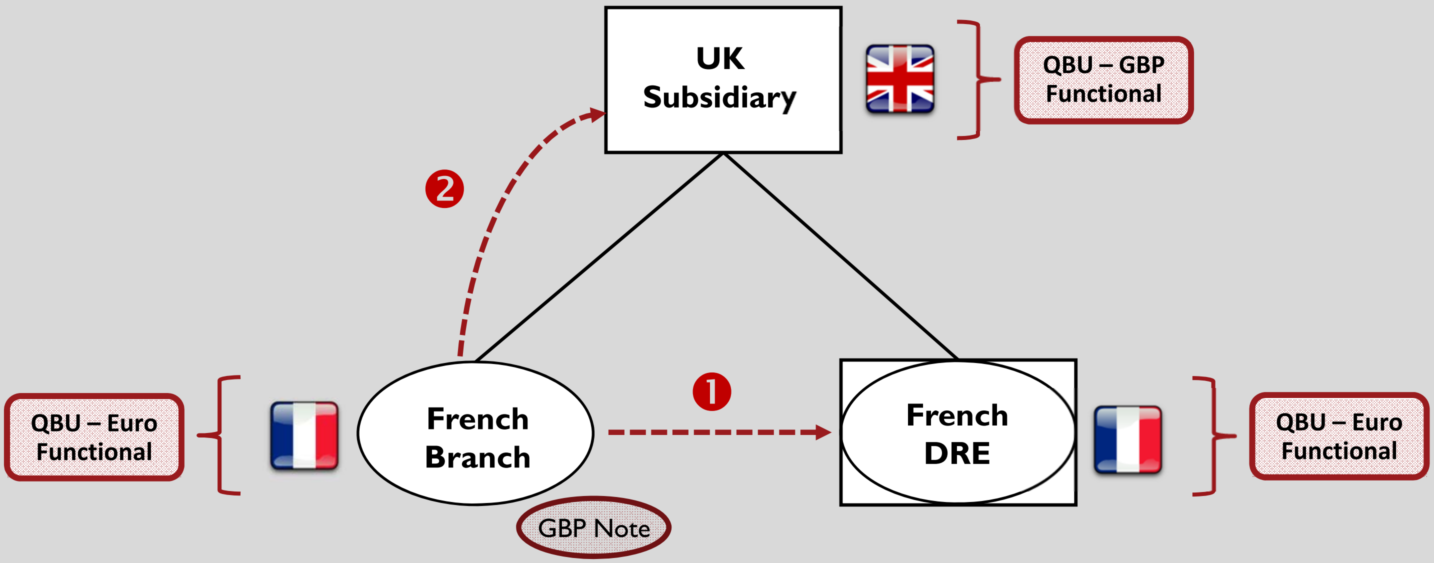
EXAMPLE 4 – nonfunctional debt instruments

FACTS. On January 1, 2014, US Parent borrows €100 from Bank at a 4% interest rate (payable annually). At the time of the borrowing, the USD : Euro exchange rate is 1:1; however, the USD *depreciates* against the Euro in 2014 (the average USD : Euro exchange rate is 1.25:1). On December 31, 2014, US Parent pays the bank €104 in repayment of the loan; at that time, the USD : Euro exchange rate is 1.5:1

ANALYSIS. The loan is a § 988 transaction, as US Parent is obligor on nonfunctional currency debt instrument. To properly analyze it, must break it into its constituent components – principal and interest

- **Interest Expense** – **$5** (i.e., €4 * $1.25 average exchange rate). This is treated as interest expense and would be sourced based on the normal expense allocation rules of Reg. § 1.861-9T (e.g., based on location of assets)
- **FX Loss on Interest** – actually paid **$6** (i.e., €4 * $1.50), but accrued only $5 of interest expense, yielding a ***$1 FX loss*** on interest. This is *ordinary* loss and is *US source* per § 988 (US residence)
- **FX Loss on Principal** – repaid €100 on Dec. 31st at a higher USD cost; thus borrowed $100 of value (€100 * $1) but repaid **$150** (€100 * $1.50), yielding ***$50 FX loss*** on principal. This is *ordinary* loss and is *US source* per § 988 (US residence)

§ 988 Transactions – Ex. 5



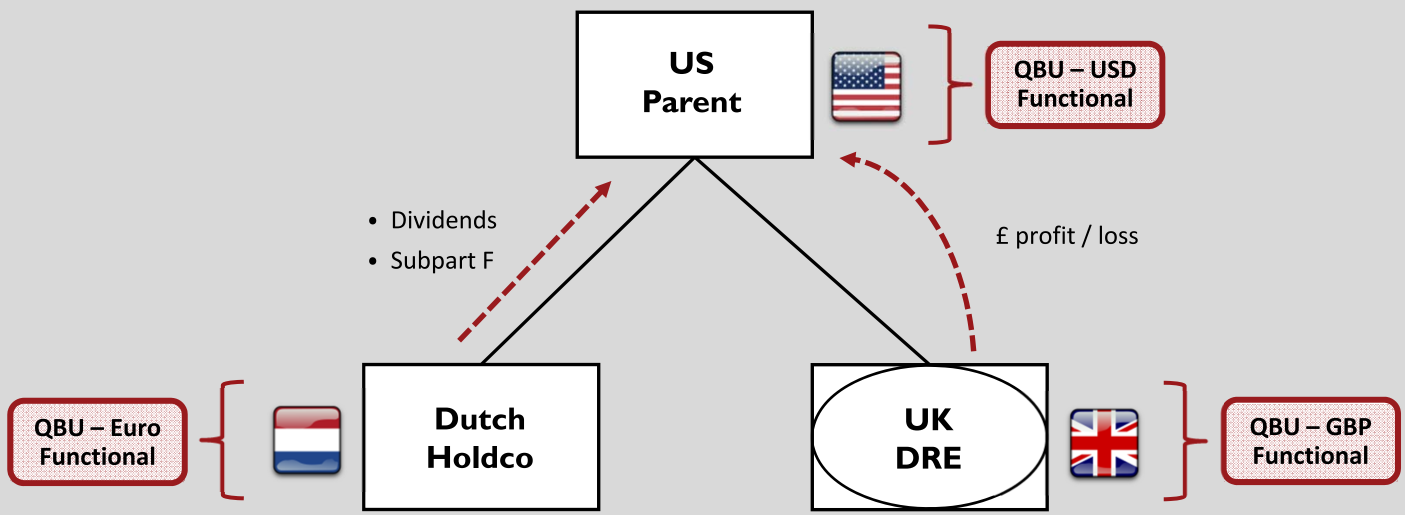
EXAMPLE 5 – intra-taxpayer transactions

- **Facts**
  - French Branch holds a third-party GBP-denominated note, and transfers it either (1) to the French DRE, or (2) to the UK Subsidiary
- **Analysis**
  - Transfer to French DRE does not trigger realization of FX gain / loss; but see § 987
  - Transfer to the UK Subsidiary does trigger realization of FX gain / loss because the note loses its character as a § 988 transaction; see also § 987

Translation

Translation – Conceptually

GOAL: **Identify rules for determining how, and tax impact, when a QBU's functional currency results roll-up to USD world**



- **Branches** – immediate consequences, potential consequences later
- **Foreign corps** – timing may or may not be deferred

Translation – Initial Issues

- **Expression vs. remittance**
  - **Expression** – translation of a QBU's functional currency operations into USD (e.g., for *taxable income* purposes when dealing with a branch, or for *earnings and profits* purpose when dealing with a foreign corporation) sets the stage for potential FX gain / loss later
  - **Remittance** – when funds associated with previously-translated operations are *actually* repatriated to the US taxpayer, an occasion for FX gain / loss arises (e.g., on remittance of previously-included income of a branch, or on a CFC's distribution of PTI)
- **Foreign tax credits**
  - A US MNE, whether operating via QBUs that are *branches* or *foreign corporations*, normally will be entitled to claim a foreign tax credit for taxes paid by the QBU – either in the form of § 901 credits (branch) or § 902 credits (foreign corporations)
  - Although such taxes typically will be paid in the QBU's functional currency, the general rule is that such taxes are converted into a USD expression immediately
  - For accrual basis taxpayers, translated foreign taxes paid into USD at <u>average exchange rate</u> for the tax year to which such taxes relate

Branch Translation

- **Foundations**
  - Translation virtually required in real-time, because includible in US taxpayer's tax results
  - However, funds do not move to US taxpayer simply because translation occurs; instead, QBU branch continues its business in functional currency. Sets stage for FX gain / loss
- **History**
  - *Pre-1986* – two principal methods for branch translation (net worth and P&L methods)
  - *TRA 1986* – Congress restricted translation to P&L method – set out in § 987
- **Section 987**
  - Branches that constitute QBUs must use P&L method
  - Translate QBU's functional currency P&L to USD using <u>average exchange rate</u> for year
  - FX gain / loss generally recognized when earned amount remitted to home office; usually characterized as <u>ordinary</u> and sourced <u>to branch</u> (unless derived from US sources)

§ 987 Overview

§ 987

In the case of any taxpayer having 1+ QBUs with a functional currency other than USD, the taxable income of the taxpayer shall be determined as follows

FIRST

Compute taxable income/loss for each QBU separately (compute in QBU's functional currency)

SECOND

Translate the results of each QBU separately computed using the average exchange rate for the year

P&L Method

THIRD

Make "proper adjustments" for transfers of property between QBUs of taxpayer having different functional currencies

Two sets of regs proposed:

- **1991 Proposed Regs**
- **2006 Proposed Regs**

In other words, remittances from a QBU to the home office may trigger FX gain / loss

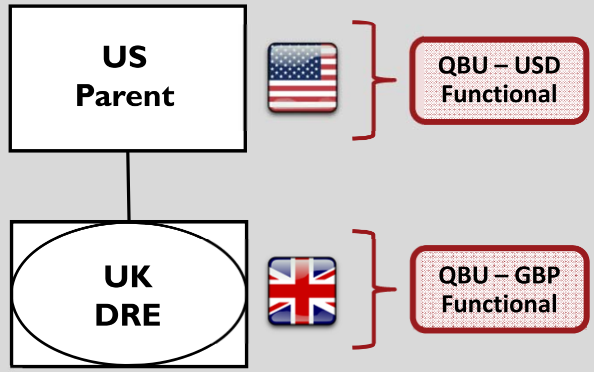
Two Sets of § 987 Proposed Regs.

- **Dramatically different approaches** – for assessing FX gain / loss
  - **1991 proposed regs** – "equity pool" method
    - "Equity pool" is undistributed capital and earnings of QBU (set in functional currency); "basis pool" is basis of the items in the equity pool (expressed in taxpayer's functional currency, usually USD); remittance of equity pool gives rise to potential for FX gain / loss (look at value of equity pool remitted (computed using spot rate), against basis associated with such amount)
    - Criticized as flawed, particularly because on a remittance the equity pool effectively takes into account <u>capital</u> (incl. retained earnings), <u>contributions</u> and <u>PPE</u> in assessing potential FX gain / loss. *Cf.* Notice 2000-20 (noting circular flows / remittance plays to trigger FX losses)
  - **2006 proposed regs** – "foreign exchange exposure pool" (FEEP) method
    - Rejects the "equity pool" method and withdraws 1991 proposed regs
    - Makes several changes, including (1) QBU's income translated by looking at items of income or deduction, etc. and translating at average rates, but historic assets (PPE) translated at historic rate so depreciation/amortization follows, and (2) FEEP method identifies *only* assets tending to generate FX gain / loss ("marked" items) and pools results for later recognition on remittance
  - **Merely proposed regs, so other approaches seemingly open**

Example – 1991 PR Approach

Description	Asset		Liability	
	Equity	Basis	Equity	Basis
Cash	£ 100	$100		
Land	£ 700	$700		
Tractor	£ 200	$200		
Obligations			£ 50	$50
TOTALS	£ 1000	$1000	£ 50	$50

Equity Pool £950
Basis Pool $950



EXAMPLE – equity pool method

- **Facts** – US Parent has UK DRE with opening balance sheet and equity/basis pools shown above (all assets contributed when USD : GBP exchange rate is 1:1)
  - During Year 1, UK DRE earns £100 ($150); average USD : GBP exchange rate for year is 1.5:1 Equity/basis pool adjusts as follows: **Equity Pool £1050** **Basis Pool $1100**
  - UK DRE distributes its entire equity pool at end of year; average USD : GBP exchange rate is 2:1
- **Analysis** – using the 1991 proposed regs "equity / basis" pool approach, branch equity (£1050) is translated at the year-end rate, yielding $2100. US Parent's basis pool associated with the remittance is $1100. Thus, US Parent has $1000 ($2100 - $1100) of ordinary § 987 FX gain

Foreign Corp. Translation

- **Background**
  - CFC's E&P normally maintained in functional currency until actual / deemed remittance, whereas foreign taxes generally converted to USD in year to which they relate (for post-97 foreign taxes, use average exchange rate for relevant year); but PTI is different
    - PTI – is a special case, because US tax has been paid and thus it no longer is E&P that effectively "floats" (i.e., there is a USD basis for the year of inclusion); but functional currency supporting the PTI remains with the foreign company
  - Non-CFCs – a PTI-like concept may be present (e.g., for QEF-elected foreign corps)
- **Section 986(c)**
  - FX gain / loss is recognized with respect to distributions of PTI attributable to exchange rate movements between dates of inclusion and distribution; gain ordinary
  - The amount of FX gain / loss taken into account for a *specific PTI distribution* will be dependent on how USD basis is allocated to the distributed PTI. (Because locked in a particular year, but possibly not distributed, PTI can accumulate within a company at different exchange rates.) See Notice 88-71 and 2006 proposed § 959 regs

Thank you…

J. Brian Davis

BRIAN DAVIS is a partner in the Washington, D.C. office of Ivins, Phillips & Barker. He has practiced in all areas of U.S. federal income taxation, with considerable experience assisting public and private businesses with U.S. and global tax planning matters. He regularly serves as a trusted tax adviser to Fortune 200 companies and high net worth individuals, and has also worked in industry as Director of International Tax for Viacom Inc. Brian is known amongst corporate and tax executives for his technical proficiency and pragmatic approach.

Brian regularly speaks at events sponsored by TEI (where he previously served as a Vice Chair of the International Tax Committee), the International Fiscal Association and the American Bar Association. He also periodically teaches a course on corporate taxation at the George Mason University School of Law. Brian earned his LL.M. in Taxation from New York University School of Law, and his J.D. and B.S. from the University of Oregon.

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