Avoiding Tax Casualties in the Currency War

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This article highlights the important transactional foreign currency tax issues that U.S. multinationals face and explains why those issues have taken on added importance in an era of volatile exchange rates. It also describes areas in which policymakers could reduce uncertainty regarding foreign currency tax issues by providing targeted guidance.

A. Why Think About Currency, and Why Now?

Although tax law evaluates all forms of microeconomic activity, only in a few areas do macroeconomic events directly lead to identifiable tax consequences for U.S. multinationals across almost all industries. One of those areas is foreign currency; tax professionals should take note when dollar exchange rates spike or plunge. This has happened with increasing frequency lately. The front pages of business publications worldwide have announced the first volleys in a new ''currency war''[1] — efforts by central banks and policymakers to depress the value of their countries' currencies to spur growth in an atmosphere of depressed demand.

This article maps some of the more treacherous U.S. tax foreign currency issues, which in normal times many tax professionals consider an afterthought, subordinated to their main diet of cross-border, corporate, and financial transaction tax rules. The currency rules represent a quirky patchwork of judgment calls and rules borrowed from financial accounting. They surround only one inexorable principle: Nonfunctional currency is property, not cash, for tax purposes. This means that a taxpayer must maintain tax basis denominated in its functional currency in some positions in nonfunctional currencies, just as if the nonfunctional currencies were property.[2] For example, a dollar-functional currency corporation must maintain a dollar-denominated tax basis in euros it owns. Sometimes the foreign currency rules run counter to more fundamental tax rules, and they are replete with both traps and planning opportunities. This article does not comprehensively analyze uncertain currency issues, and it is not directed at experts in subpart J (sections 985 through 989, which govern foreign currency). Rather, it aims to explain some of the pressure points to general tax executives, practitioners, and policymakers who might only occasionally deal with currency issues. Without a doubt, the importance of these issues will grow if the tax dollars at stake rise.

On November 3, 2010, Benjamin Bernanke, chair of the U.S. Federal Reserve, announced a plan to buy $600 billion in Treasury securities to stimulate the sluggish U.S. economy.[3] Several of America's trading partners criticized the move, which was dubbed ''QE2.''[4] They were concerned that it was an attempt to depress the value of the U.S. dollar, making U.S. exports comparatively more affordable and, correspondingly, making theirs less so.[5] Reactions to QE2 were loud enough that President Obama and Treasury Secretary Timothy Geithner found it necessary to defend the move in the days leading up to the November 2010 G-20 summit held in South Korea.[6] World financial leaders then emerged from the G-20 summit agreeing to support

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[1]*See, e.g.*, ''How to Stop a Currency War,'' *The Economist* (Oct. 14, 2010), *available at* http://www.economist.com/node/17251850.

[2]A taxpayer's functional currency is determined under section 985 and the regulations thereunder.

[3]*See* press release, Board of Governors of the Federal Reserve System (Nov. 3, 2010), *available at* http://www.federalreserve.gov/newsevents/press/monetary/20101103a.htm. The Federal Reserve indicated that it intended to purchase the Treasury securities by the end of the second quarter of 2011. *Id.*

[4]''QE'' stands for quantitative easing.

[5]*See* Kerri Shannon, ''United States to Face Attacks on Quantitative Easing Policy at G20 Summit as Currency War Rages On,'' *Money Morning* (Nov. 9, 2010), *available at* http://moneymorning.com/2010/11/09/united-states-face-attacks-quantitative-easing-policy-g20-summit-currency-war/.

[6]Ed Luce and James Lamont, ''Obama Defends QE2 Ahead of G20,'' *Financial Times* (Nov. 8, 2010), *available at* http://www.ft.com/cms/s/0/b416ccae-eb1a-11df-811d-00144feab49a.html#axzz15XpIqkzs.

Table 1. Average Quarterly Exchange Rates[a]

Unit of Currency	2009 Q1	2009 Q2	2009 Q3	2009 Q4	2010 Q1	2010 Q2	2010 Q3	Nov. 15, 2010[b]
Brazilian real	0.434	0.483	0.537	0.577	0.558	0.561	0.537	0.583
British pound	1.438	1.548	1.642	1.633	1.561	1.492	1.550	1.612
Canadian dollar	0.805	0.858	0.910	0.946	0.961	0.973	0.962	0.988
Euro	1.308	1.362	1.429	1.477	1.386	1.276	1.290	1.369
Indian rupee	0.020	0.020	0.021	0.021	0.022	0.022	0.022	0.022
Japanese yen	0.011	0.010	0.011	0.011	0.011	0.011	0.012	0.012
Mexican peso	0.070	0.075	0.076	0.077	0.078	0.080	0.078	0.081
Swedish krona	0.120	0.127	0.137	0.143	0.139	0.132	0.138	0.146
Swiss franc	0.874	0.900	0.941	0.979	0.947	0.904	0.968	1.020

[a]This table shows the average exchange rates for calendar quarters (*e.g.*, Q1 includes January 1 to March 31), *available at* http://www.oanda.com/currency/historical-rates. The exchange rates reflect the value in dollars of units of foreign currency.
[b]This column shows the average exchange rates on November 15, 2010, *available at* http://www.oanda.com/currency/historical-rates.

market-determined exchange rates.[7] What this means remains to be seen.

The United States hardly stands alone as an alleged currency manipulator. For example, on September 15, 2010, Japan's Ministry of Finance announced that it would intervene in the currency markets for the first time in six years by selling yen and buying U.S. dollars, ostensibly to depreciate the yen, which had reached a 15-year high against the dollar.[8] These events, however, reflect only the most recent chapter in an increasingly volatile global currency environment. The dollar has oscillated in recent years, generally depreciating against foreign currencies in 2007, appreciating rapidly in the midst of the financial crisis in late 2008, and depreciating in 2009 and 2010. The dollar depreciated against the yen, euro, and Canadian dollar from the fourth quarter of 2008 to November 15, 2010, by approximately 19, 3, and 16 percent, respectively.[9] Table 1 shows the average quarterly exchange rates for the dollar against various currencies for 2009 and 2010. An increase in the exchange rate reflects the depreciation of the dollar, and a decrease reflects appreciation.

There is also a longer-term trend worth noting: The dollar has fallen in the last decade against many of the currencies of the United States' trading partners. Table 2 shows the overall percentage appreciation or depreciation of the average dollar exchange rate against currencies of some major trading partners for specified years through the average rate on November 15, 2010. This illustrates the potential magnitude of currency tax issues. The percentage appreciation or depreciation of the dollar is indicative of the potential exposure to currency gain or loss a taxpayer might have in its positions in those currencies entered into around that time.

Given the variety and complexity of the geopolitical factors involved, the safe bet might be that exchange rates will continue to shift as countries emerge from the global slowdown in differing trade, fiscal, and monetary postures. One theme to keep in mind, however, is that the unpredictability of exchange rates itself may harm U.S. multinationals. To the extent a taxpayer cannot hedge away its positions in foreign currency, exchange rate volatility makes it harder to predict its overall U.S. tax liability, thus making it more difficult to evaluate the costs and benefits of other tax planning. Moreover, exchange rate volatility can magnify the importance of uncertainties in the tax law governing foreign currency.

B. Consequences to U.S. Multinationals

It is impossible to generalize whether a particular taxpayer will have currency gain or loss built into its assets and liabilities and the earnings of its foreign subsidiaries and its branches based solely on recent exchange rate movements. Those movements are relative rather than absolute measures and have different effects on taxpayers with different net positions in currency. Nonetheless, the recent depreciation of the dollar against some other currencies has several broad tax implications for U.S. multinationals.

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[7]*See* "The G20 Seoul Summit Leaders' Declaration November 11-12, 2010," *available at* http://www.g20.org/Documents2010/11/seoulsummit_declaration.pdf.

[8]*See* "Japan May Sell Yen for Second Day to Protect Economy," Bloomberg (Sept. 15, 2010), *available at* http://www.businessweek.com/news/2010-09-15/japan-may-sell-yen-for-second-day-to-protect-economy.html.

[9]For the fourth quarter of 2008, the average exchange rate for the yen, euro, and Canadian dollar was 0.010, 1.319, and 0.829, respectively. *See* http://www.oanda.com/currency/historical-rates.

Table 2. Percentage Appreciation (+) / Depreciation (-) of U.S. Dollar Against Specified Foreign Currency (Average Annual Exchange Rate to Exchange Rate on Nov. 15, 2010)[a]						
Unit of Currency	2001	2005	2006	2007	2008	2009
Brazilian real	-34.3%	-41.1%	-26.5%	-12.9%	-4.6%	-14.6%
British pound	-11.8%	11.5%	12.5%	19.5%	13.1%	-2.9%
Canadian dollar	-53.0%	-19.6%	-12.0%	-5.6%	-4.7%	-12.3%
Euro	-52.7%	-10.0%	-9.0%	0.1%	6.9%	1.8%
Indian rupee	-5.7%	1.4%	-1.3%	7.4%	2.9%	-8.5%
Japanese yen	-47.2%	-33.3%	-41.0%	-42.7%	-25.1%	-13.4%
Mexican peso	24.3%	11.7%	11.6%	11.4%	10.5%	-9.2%
Swedish krona	-50.3%	-8.6%	-7.3%	1.6%	5.1%	-10.8%
Swiss franc	-71.9%	-26.8%	-27.8%	-22.3%	-10.1%	-10.5%

[a]Based on exchange rates *available at* http://www.oanda.com/currency/historical-rates.

1. Foreign tax credit planning. Subject to limitations, a U.S. multinational may claim foreign tax credits for foreign income taxes paid by its foreign subsidiaries when the foreign taxes are deemed carried up by dividends paid by the foreign subsidiaries.[10] A depreciating U.S. dollar reduces the potency in dollar terms of those deemed paid foreign taxes. Just as inflation is a silent tax on savings, dollar devaluation is a silent tax on a foreign subsidiary's effective foreign tax rate for purposes of FTC planning. The flip side is that dollar appreciation increases the dollar potency of foreign taxes.

Earnings of foreign subsidiaries of a U.S. parent are maintained in the subsidiaries' respective functional currencies until the earnings are distributed, but foreign taxes paid or accrued by the subsidiaries are accounted for in dollars, with the foreign taxes translated at the average exchange rate for the year in which they were paid or accrued by the subsidiaries.[11] The U.S. parent's income inclusion on receiving a dividend is determined by translating the dividend into dollars at the exchange rate on the date of the actual or deemed distribution, however, regardless of whether the distributed earnings were worth more or less in dollar terms when they were earned by the foreign subsidiary.[12] Any currency fluctuations between the time the earnings originally are earned and when they ultimately are paid out as dividends are reflected in an increase or decrease to gross income to the parent.

The appreciation or depreciation of the foreign currency against the dollar, however, is not taken into account in calculating the foreign taxes carried up with the dividend, because the dollar amount of creditable foreign taxes is fixed in the year the taxes are paid or accrued by the foreign subsidiary.[13] Currency movements thus prevent a multinational's tax department from safely using a foreign subsidiary's nominal foreign effective tax rate as a shortcut in determining the amount of foreign taxes carried up by a particular repatriation, complicating FTC limitation planning.

If the subsidiary's functional currency steadily appreciates against the dollar, the amount of the dividend inclusion, when viewed against the dollar value of the subsidiary's income when it was earned, will carry up less than its proportionate share of the subsidiary's foreign taxes.[14] For example, assume a domestic corporation (USP) wholly owns a Canadian CFC (FS), which earned C$100 of non-subpart F income in 2001, when the average exchange rate was 0.646. Assume FS paid

[10]*See generally* sections 902 and 960(a).

[11]*See* section 986.

[12]*See* section 989(b).

[13]The amount of foreign taxes carried up equals the balance of the foreign subsidiary's post-1986 foreign tax pool, as maintained in dollars, multiplied by a fraction the numerator of which is the amount of the dividend and the denominator of which is the balance of the foreign subsidiary's post-1986 undistributed earnings pool, both of which are denominated in the foreign subsidiary's functional currency. *See* section 902(a).

[14]One could imagine an alignment of the translation rules for earnings of foreign subsidiaries and foreign taxes paid by the subsidiaries. For example, foreign taxes could be translated into dollars at the exchange rate in the year in which the foreign taxes are deemed paid by the U.S. parent. Indeed, such a rule was established in *Bon Ami Co. v. Commissioner*, 39 B.T.A. 825 (1939), which remained the law until the enactment of subpart J in the Tax Reform Act of 1986. *See also* Rev. Rul. 74-230, 1974-1 C.B. 187, *obsoleted by* Rev. Rul. 80-367, 1980-2 C.B. 386 (providing that deemed paid foreign taxes were translated using the exchange rate on the date of the distribution that carried up the taxes). One problem with the *Bon Ami* approach was that the dollar amount of the credits generated by the foreign taxes would not necessarily be commensurate with the economic burden incurred by the foreign subsidiary of paying the foreign taxes, as measured in dollar terms. The U.S. parent would in effect receive or be deprived of credits for the appreciation or depreciation of the foreign subsidiary's functional currency between the time the subsidiary paid or accrued the foreign taxes and the time of the distribution.

C$35 in Canadian taxes in 2001, so that its post-1986 undistributed earnings pool was C$65 (C$100 of earnings, less the C$35 of taxes) and its post-1986 foreign tax pool was $22.61 (C$35 x 0.646). If FS paid a dividend of C$32.50 (half its after-tax earnings) on November 15, 2010, at which time the exchange rate had risen to 0.988, the dividend would carry up foreign taxes of approximately $11.31 ((C$32.50/ C$65.00) x $22.61), and USP would have an income inclusion of approximately $43.42 (C$32.50 x 0.988, plus the section 78 gross-up amount of $11.31).[15] Thus, the earnings paid up as a dividend would carry an effective foreign tax rate of approximately 26 percent ($11.31/$43.42), less than the nominal Canadian tax rate imposed on the earnings, or 35 percent. Assuming a 35 percent U.S. federal corporate income tax rate, the U.S. tax on the dividend would be $15.20 ($43.42 x 35 percent), greater than the dollar amount of FTCs carried up, even though the United States and Canada have the same nominal rate in the example.

2. Currency gain or loss on repatriations of previously taxed income. Another implication of maintaining a foreign subsidiary's earnings in the subsidiary's functional currency is that a U.S. parent recognizes currency gain or loss on a non-dollar functional currency CFC's actual distributions of earnings that previously were deemed distributed under the subpart F anti-deferral regime (previously taxed income, PTI).[16] Subpart F generally accelerates the taxation in the United States of certain types of mobile or passive income earned by foreign subsidiaries even though such earnings are not actually repatriated in the form of dividends until a later year. footnote: See generally section 951(a). If earnings are treated as distributed under subpart F, that PTI is not taxed in the United States a second time when the earnings are repatriated in an actual distribution.[17] If earnings are treated as distributed under subpart F, that previously taxed income (PTI) is not taxed in the United States a second time when the earnings are repatriated in an actual distribution.[18] A taxpayer-favorable ordering rule treats distributions of earnings by CFCs to first come out of PTI and, only once PTI is exhausted, out of other earnings.[19] The PTI-first ordering rule minimizes the timing distortions resulting from subpart F inclusions. In comparison, a PTI-last rule or pro rata rule would not give the U.S. shareholder full credit for incurring accelerated taxation under subpart F until all the CFC's earnings were distributed.

The amount of currency gain or loss on PTI is calculated based on the difference between the average exchange rate for the year in which the income is earned by the CFC and the exchange rate on the date the corresponding PTI is actually distributed. For example, assume that a domestic corporation (USP) wholly owns a Canadian CFC (FS), which has post-tax earnings in 2001 of C $65 when the average exchange rate was 0.646, and all the earnings constituted subpart F income. If FS paid out all of its earnings to USP on November 15, 2010, after the exchange rate had increased to 0.988, USP would have currency gain of approximately $22.23 ((C $65 x 0.988) - (C $65 x 0.646)). The effect is that the U.S. parent includes in income the economic value of the distribution of PTI in dollar terms as if it were a regular dividend but gets basis for the dollar value of the prior deemed inclusion under subpart F. The difference between the two amounts is taken into account as income of loss.

The steady depreciation of the dollar against a foreign subsidiary's functional currency creates an immediate tax disincentive to repatriate PTI,[20] because the PTI will have built-in currency gain that would be triggered on an actual distribution.[21] This means a multinational's tax department cannot assume that a repatriation of cash from a CFC will have no U.S. tax consequences merely because there is a sufficient amount of PTI to cover the distribution. Also, if one fears that the dollar will decline in the future, it may be better from a tax perspective to repatriate earnings sooner rather than later.

This discussion has so far ignored rules for identifying which PTI is carried up by a particular distribution and rules for determining the dollar basis in that PTI. The conventions used will govern the timing of, but not overall exposure to, currency gain or loss on distributions of PTI.[22] Several items

[15]The section 78 gross-up increases the dividend by the amount of foreign taxes deemed paid. This puts the U.S. parent roughly in the same FTC position it would be in if it conducted its foreign operations through a branch rather than through a foreign subsidiary.

[16]*See* section 986(c).

[17]*See* section 959(a).

[18]*See generally* section 951(a).

[19]*See* section 959(a).

[20]Currency gain or loss on PTI generally is triggered only on a distribution of PTI to the ultimate U.S. shareholder, not to an intermediate CFC. *See generally* Notice 88-71, 1988-2 C.B. 374; prop. reg. section 1.959-3.

[21]Ordering rules that treat distributions as first out of PTI and, only once PTI is exhausted, out of regular earnings (distributions of which do not trigger currency gain or loss but are included in income at the spot exchange rate) make this disincentive immediately apparent. *See* section 959.

[22]The ordering convention used will not affect the overall exposure to currency gain or loss if the timing of the payments

(Footnote continued on next page.)

of guidance have been issued regarding the ordering convention a taxpayer may or must use to allocate dollar basis to any particular distribution of PTI.

Notice 88-71, issued in 1988, required taxpayers to allocate dollar basis to distributed PTI using a pooling approach akin to the general post-1986 undistributed earnings pooling approach used to calculate deemed paid FTCs.[23] This pooling approach effectively blended or averaged the dollar basis of all a CFC's post-1986 PTI on an FTC-limitation, basket-by-basket basis. In comparison, proposed regulations issued in 2006 permit a taxpayer to either maintain annual PTI and dollar basis accounts and trace distributions of PTI to particular years on a last-in, first-out basis, or pool the dollar basis of all its PTI.[24] Annual layering would apply as a default unless the taxpayer made a dollar basis pooling election for the relevant CFC.[25]

Depending on the year-to-year exchange rate movements, a particular taxpayer might find that either annual layering or pooling provides a significant benefit over the other. For example, in an era of a steadily depreciating dollar, on a distribution of less than all of a CFC's PTI, the LIFO annual tracing approach would defer the recognition of currency gain compared with a pooling approach. Assuming the timing of the distributions is fixed, the amount realized on the distributions would be based on the exchange rates on the dates of the distributions and, thus, effectively fixed regardless of the convention used. However, the dollar basis of the PTI deemed distributed first — the most recent earnings — would be higher than the average dollar basis for all of the PTI. The higher recent relative value of the foreign currency against the dollar causes that recently earned PTI to be worth more in dollar terms when earned than PTI earned in earlier years. In this case, the annual layering method would backload the currency gain compared with a pooling approach.

Given that the dollar has depreciated significantly over the last decade against some currencies, annual layering could provide a significant benefit for U.S. multinationals with CFCs that use those currencies as their functional currencies. Determining just how comfortable a taxpayer should be in applying the 2006 proposed regulations before their finalization requires an administrative law analysis.[26] Finalizing the proposed regulations and providing practical transition rules would alleviate this uncertainty and benefit U.S. multinationals by giving them the freedom to elect either a layering or pooling convention.

3. Asymmetrical treatment of currency gains and losses under subpart F. Volatile currency markets also tend to give rise to negative subpart F consequences. Subject to important exceptions, a CFC's net currency gain recognized on specified financial assets and obligations denominated in or priced based on nonfunctional currency constitutes subpart F income, and thus can trigger taxable inclusions in the United States.[27] Further, currency gain from a CFC's foreign branch transactions can, under proposed guidance, constitute subpart F income.[28] Because subpart F does not contain comprehensive loss carryforward and carryback rules,[29] if a CFC oscillates between having net currency gains and losses from year to year, subpart F likely will overstate its net currency gain as viewed on a multiyear basis. The net currency gain years generally will give rise to subpart F inclusions, and the net currency loss years will not neutralize those subpart F inclusions.

C. Tax Aspects of Currency Hedging

Exchange rate volatility accentuates the business necessity of having a robust currency risk hedging program. A currency hedging program can provide greater certainty in dollar terms as to foreign sales revenues, supply costs, and financing costs, among other things. Unfortunately, the tax law on hedging does not accommodate all of the currency risk hedging a business might want to undertake. The principal tax issues implicated by currency hedging are the timing and, to a lesser extent, character (ordinary versus capital) of the items of income, gain, deduction, or loss generated by the financial instruments used to hedge the currency risk. The overarching tax problem is that the character or timing of these items will not necessarily match the character or timing of items generated by the

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is fixed because, regardless of the convention used, the aggregate amount realized by the U.S. shareholder would be the same, and its aggregate dollar basis in the PTI would be the same.

[23] *See* Notice 88-71, 1988-2 C.B. 374; section 902(a).

[24] *See* prop. reg. section 1.959-3(b).

[25] *Id.*

[26] The IRS as an administrative policy does not take litigating positions contrary to outstanding proposed regulations in specified circumstances. *See* CC-2003-014, *Doc 2003-11987*, *2003 TNT 93-7*.

[27] *See generally* reg. section 1.954-3(g) (including net gain from section 988 transactions in foreign personal holding company income, subject to exceptions including currency gain directly related to the business needs of the CFC).

[28] *See generally* prop. reg. section 1.987-6(b).

[29] Subpart F does contain a limited "qualified deficit" rule, and other subpart F income limitations also could come into play, such as the current earnings limitation. *See generally* section 952(c)(1)(B)-(C); section 952(c)(1)(A). These rules, even considered in the aggregate, are a far cry from a comprehensive loss carryover regime.

hedged assets, liabilities, or activities. Because of the operation of antiabuse tax rules, however, a character or timing mismatch generally is prevented unless it is taxpayer unfavorable.

The tax rules permit a taxpayer to match both the timing and character of the items generated by currency hedges against the items related to its currency risks, and in some cases they allow a taxpayer to avoid the currency rules altogether. There are several layers of relevant tax hedging rules. The first layer — the currency integration rules — has a narrow scope and can involve tax-motivated hedging. The second layer — the generally applicable hedge timing and character rules — provides special character and timing rules for some non-tax-motivated hedging transactions.

The types of currency risks a multinational wants to hedge (such as currency risks related to borrowings or sales contracts) and the location of the risks within its corporate organizational structure will determine the optimal tax hedging strategy. Obtaining the most favorable tax treatment requires paying careful attention to the identities of the entity undertaking the hedging and the entity whose risks are being hedged, as well as the nature and origin of the currency risk being hedged.

1. Hedges that allow a taxpayer to escape the currency tax rules altogether. The currency integration rules permit a taxpayer to hedge a particular foreign-currency-denominated asset, right, or obligation, such as a debt instrument or an account payable, and treat the combined hedge and hedged item as if it were a synthetic asset or liability denominated in the taxpayer's functional currency.[30] This effectively removes the asset or liability from the scope of the section 988 currency rules, discussed below, and it means that the taxpayer will not recognize exchange gain or loss on the sale or exchange of, or accrual of income or expense on, the asset or liability. The integration rules do not encompass hedges of aggregate currency risks of a business, and they cannot be used to avoid any currency tax rules other than those in section 988. For example, a taxpayer cannot estimate the overall currency risk faced by a foreign branch and use a hedge to avoid the section 987 currency rules applicable to activities of foreign branches. Similarly, a U.S. shareholder cannot use a currency hedge to avoid recognizing currency gain or loss on distributions of a CFC's PTI under section 986(c).

The integration rules are strict and generally require the hedge to offset precisely the currency risk inherent in the hedged asset or obligation.[31] The same taxpayer (and in some cases the same business unit) must enter into both the hedge and the hedged asset or liability.[32] Because the same tax entity must enter into both the hedge and the hedged asset or liability, a multinational that otherwise hedges all of its currency risks through a single entity (a hedging center) will need to establish a decentralized system, in which each entity hedges its own assets and liabilities, for purposes of the currency integration rules.

2. Hedge timing and character tax rules. The second layer of hedging rules, which are not limited to currency hedging, can affect the timing and character of gain or loss on some business hedging transactions.[33] Even these broader rules, however, do not accommodate all forms of currency risk hedging. A hedge can come within these rules only if it is entered into primarily to manage the risk of currency fluctuations for non-capital assets or ordinary borrowings or obligations, including debt denominated in foreign currency.[34] These rules, however, do not cover instruments used to hedge currency risk relating to capital investments, projected profitability of a foreign business, or dividend streams denominated in foreign currency.[35] Subject to some limited exceptions, the regulations interpret the "risk management" standard to mean "risk reduction,"[36] limiting the scope of the rules to instruments that either reduce a taxpayer's exposure to overall risk of currency fluctuations, or reduce its exposure to risk of currency fluctuations on particular assets or liabilities as long as the hedging is reasonably expected to reduce the overall exposure to currency risk.[37]

[30]*See* reg. section 1.988-5.

[31]*See, e.g.*, reg. section 1.988-5(a)(4)(i) (requiring a hedge of a nonfunctional currency debt instrument to allow the yield in the debt instrument to be determined in the taxpayer's functional currency).

[32]*See, e.g.*, reg. section 1.988-5(a)(4)(v).

[33]*See* reg. section 1.1221-2; reg. section 1.446-4.

[34]*See* reg. section 1.1221-2(b).

[35]Hedging currency risk relating to anticipated profitability of a foreign subsidiary or foreign branch should be distinguished from hedging currency risk relating to anticipated sales of inventory for which the sales revenue will be denominated in foreign currency. The latter appears to fall within the scope of the hedge character and timing rules. *See, e.g.*, reg. section 1.1221-2(f)(3)(i) (clarifying that hedges of anticipated asset acquisitions are covered); reg. section 1.1221-2(f)(3)(B) (same with respect to anticipatory debt issuances).

[36]Whether a transaction manages risk generally is a facts-and-circumstances inquiry, although some transactions are deemed automatically to satisfy the risk management standard. *See* reg. section 1.1221-2(c)-(d). Transactions entered into to reduce risk are deemed to satisfy the risk management standard. *See* reg. section 1.1221-2(d)(1).

[37]*See* reg. section 1.1221-2(d)(1)(ii).

Instead of combining the hedge and a specific asset or obligation into a synthetic-dollar-denominated asset or liability for tax purposes, like under the currency integration rules, the hedge timing and character rules generally respect the hedge and the hedged item as separate and distinct for tax purposes. Given the factual link between the hedge and the hedged item, the rules match the timing and character (ordinary) of the tax items on the hedge to the timing and character of the items recognized on the hedged item. If a taxpayer jumps through the proper identification and documentation hoops, it can claim ordinary gain or loss on the sale or exchange of a currency hedge, even if it otherwise would constitute capital gain or loss. Ordinary treatment generally is a benefit for corporate taxpayers because they are ineligible for the preferential long-term capital gains rate and may have difficulty using capital losses. The hedge character rules, however, are of limited relevance in the currency hedging context. The foreign currency rules, as a default, treat gain or loss recognized on many financial instruments used to hedge currency risks as ordinary gain or loss, regardless of the application of the hedge character rules.[38] In contrast, the hedge timing rules fully apply to currency hedging and apply regardless of whether taxpayers identify the transactions as currency hedges.[39]

3. Tax traps for currency hedging. Because the currency integration and hedge timing and character rules frequently require taxpayers to make time-sensitive elections, documentations, and identifications, communication channels between corporate treasury and tax departments must be open. The best way to develop a successful tax hedging program is to get the tax department involved early in drawing up and documenting the strategy. The currency tax risks for U.S. multinationals with centralized hedging (hedging performed by a single legal entity) and those with decentralized hedging (hedging performed on an affiliate-by-affiliate basis) differ.[40] One difficulty in the foreign currency context is that foreign currency risk often is borne by foreign subsidiaries, and although the hedge timing and character rules allow groupwide hedging of risks of members of a U.S. consolidated group, they do not allow a domestic corporation to hedge the risks of foreign affiliates.[41] This means that a U.S. parent will be ineligible to match the tax timing and character of the instruments it uses to hedge currency risk of its CFCs to the timing and character of the transactions generating the risks. Also, separating the gain or loss on a hedged risk from the corresponding loss or gain on the hedge can give rise to immediate subpart F inclusions. For example, a CFC's currency gain recognized on a hedge of an affiliated CFC's currency risk generally would constitute subpart F income and thus give rise to current taxation in the United States.[42]

The added potential negative consequence of failing to qualify under the hedge character and timing rules is that several antiabuse tax regimes can apply. These regimes include the straddle loss deferral and holding period rules of section 1092, the section 1256 mark-to-market and special character rules, and the section 263(g) carrying cost capitalization rule. Each of these regimes addresses tax aspects of straddle transactions in which a taxpayer holds economically offsetting positions. Although these regimes were enacted to combat particular abuses that should not be implicated in ordinary business dealings, they were drafted in broad terms and provide only limited exceptions. They can overreach by imposing what amount to tax timing and character penalties, primarily deferring losses and treating some gains or losses as capital. They also can affect a taxpayer's holding period in currency positions, turning what would otherwise be long-term capital gain into short-term capital gain. However, the potential risk of character mismatch under these antiabuse regimes is mitigated by the treatment of gain or loss on most instruments that would be used to hedge currency risks as ordinary gain or loss under the currency rules.[43] The outer bounds of these antiabuse rules are poorly marked and can easily capture well-intentioned mistakes,[44] particularly when foreign

[38]*See* section 988(a)(1)(A)-(B); reg. section 1.1221-2(a)(4).

[39]If a transaction qualifies as a hedging transaction, the IRS takes the position that the timing rules apply regardless of whether it was identified as such. *See* Rev. Rul. 2003-127, 2003-2 C.B. 1245, *Doc 2003-27070*, *2003 TNT 248-9*.

[40]A multinational with a hedging center generally will want to treat all the members of its U.S. consolidated group as a single taxpayer for hedging purposes, which is the default treatment. *See* reg. section 1.1221-2(e)(1).

[41]*See* reg. section 1.1221-2(e); reg. section 1.954-2(a)(4)(ii)(A).

[42]*See generally* reg. section 1.954-2(g). *See, e.g.*, reg. section 1.954-2(g)(2)(ii)(D).

[43]*See* section 988(a)(1)(A). *But see* section 988(c)(1)(D).

[44]Under the straddle rules of section 1092, for example, loss can be deferred on a position in actively traded personal property, such as foreign currency, if the taxpayer holds another position that substantially reduces the economic risk of loss. *See* section 1092(c)(2). Common transactions not typically associated with tax abuses, such as being the obligor on a debt instrument denominated in actively traded foreign currency, could cause the taxpayer to enter into a straddle inadvertently if it otherwise holds a financial asset denominated in the currency. *See* section 1092(d)(7). Further, a ''substantial diminution'' of economic risk of loss is not well defined, and the IRS has suggested that positions in different currencies that move in

(Footnote continued on next page.)

currency transactions are frequent and scattered among different but affiliated domestic entities.[45]

Each of the antiabuse regimes provides an exception for properly identified ''hedging transactions,'' as that term is defined for purposes of the hedge character and timing rules.[46] The hedging transaction exceptions in these antiabuse rules appear to be too narrow and should encompass more forms of normal business transactions, and the identification requirements should be loosened when a lack of bad intent can be demonstrated. It seems unnecessary for these antiabuse wolves to chase taxpayers all the way to the doorstep of the narrowly tailored hedging character and timing rules.[47]

Finally, the generally applicable tax timing, character, and sourcing rules for derivatives also should inform which types of currency hedging instruments a U.S. multinational uses, since different combinations of financial instruments used to hedge currency risks can generate disparate tax results even if they have similar net effects on risk. If the hedging transaction character rules are not satisfied, for example, some exchange-traded currency futures and options, and over-the-counter currency forwards denominated in currencies traded through futures contracts, generally can be subject to mark-to-market accounting and (sometimes) special character rules, whereas over-the-counter currency options, swaps, and forwards in currencies other than those traded in futures are not.[48] All of these types of instruments can be used to hedge net positions in foreign currency, and the potential disparities in tax treatment reinforce the importance of the tax department's role in developing a hedging strategy.

D. Transactional Aspects of Currency Tax Rules

The currency rules also can warp the tax consequences of discrete corporate transactions. There are several potential sources of surprises, including section 988, which governs the tax treatment of financial transactions denominated in a taxpayer's nonfunctional currency; section 367 (and by cross-reference, section 985), which can trump or recharacterize what otherwise would be a corporate nonrecognition transaction in the cross-border context; and section 987, which governs the currency aspects of activities undertaken through a foreign branch. If there is a common thread among these rules, it is to expect the unexpected.

1. Financial transactions denominated in nonfunctional currency. The section 988 rules generally require a taxpayer separately to identify and recognize exchange gain or loss on select financial transactions in which the taxpayer is entitled to receive, or required to pay, an amount denominated in, or determined by reference to, nonfunctional currency (the separate transaction principle). Section 988 transactions include, subject to some exceptions, acquiring and disposing of nonfunctional currency, acquiring or becoming an obligor under a debt instrument denominated in nonfunctional currency, accruing an account receivable or payable denominated in nonfunctional currency, and entering into a forward, futures, or option contract denominated in nonfunctional currency.[49] Under the separate transaction principle, exchange gain or loss is determined independently for each section 988 transaction and is not netted against non-section 988 gain or loss recognized on the underlying transaction.[50]

The section 988 rules contain the fewest surprises of the transaction rules discussed herein, because they largely follow generally applicable realization and recognition principles.[51] Some exceptions can arise, however. For example, a corporation must realize exchange gain or loss as a result of a transfer between divisions of the corporation if a section 988 asset or liability loses its status as such or if the source of currency gain or loss on the item could change.[52] This should be the case only if the transfer

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correlation can be caught by the straddle rules. *See* Notice 2003-81, 2003-2 C.B. 1223, *Doc 2003-25811*, *2003 TNT 234-4*.

[45]Section 1092 treats a domestic corporate taxpayer as holding any position held by a member of its U.S. consolidated group for purposes of determining if it is holding offsetting positions. *See* section 1092(d)(4).

[46]The straddle loss deferral rules, section 1256 mark-to-market and special character rules, and section 263(g) carrying cost capitalization rule provide exceptions for ''hedging transactions,'' defined by cross-reference to the definition used for purposes of the special character and timing rules. *See* sections 1092(e), 1256(e)(2), and 263(g)(3). These rules require, without exception, same-day identification of hedging transactions, which is even more stringent than the section 1221 character identification rules, which permit an exception from same-day identification for inadvertent error. *Compare* reg. section 1.1256(e)-1(a) *with* reg. section 1.1221-2(g)(2)(ii).

[47]It could be more appropriate, for example, to exclude all currency transactions entered into in the ordinary course of business.

[48]*See* sections 1256(b), 988(a)(1)(B), and 988(c)(1)(D); *Summitt v. Commissioner*, 134 T.C. 12 (2010), *Doc 2010-11286*, *2010 TNT 98-15*.

[49]*See* section 988(c)(1)(B); reg. section 1.988-1(a)(1)-(2).

[50]*See* reg. section 1.988-1(e).

[51]Regulations under section 988 generally condition the trigger of currency gain or loss on the occurence of recognition events. *See* reg. section 1.988-2(a) (following generally applicable recognition and nonrecognition rules on the disposition of nonfunctional currency); reg. section 1.988-2(b)(6) (same regarding debt instruments); reg. section 1.988-2(c)(1) (same regarding accounts payable and receivable); reg. section 1.988-2(d)(3) (same regarding nonfunctional currency forward, future, and option contracts).

[52]*See* reg. section 1.988-1(a)(10)(ii). Although this last chance rule requires a taxpayer only to realize the accrued currency

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is from the corporation's main books and records to those of a foreign branch qualified business unit (QBU) that reports in a different functional currency than the corporation (a branch QBU, which under proposed regulations can take the form of a pure branch or a partnership interest); from a branch QBU to the corporation; or from one branch QBU to another. For example, assume a domestic corporation (USP) that uses the U.S. dollar as its functional currency has a Canadian branch QBU that uses the Canadian dollar as its functional currency. USP historically has held C$100 on its financial books but decides to capitalize the branch's operations by transferring the C$100 to the branch. The transfer causes USP to realize exchange gain or loss on the C$100, because the Canadian dollars cease to constitute section 988 assets in the hands of the Canadian branch. Further, the IRS has discretion to require a taxpayer to recognize currency gain if it enters into a nonrecognition transaction to avoid section 988 consequences.[53]

2. Transactions involving CFCs. Under section 367, any time a CFC is involved in a corporate nonrecognition transaction — whether in internal restructurings, mergers and acquisitions, or joint ventures — currency issues should be on the tax checklist. As an example, any time a U.S. parent must pick up a deemed dividend in an inbound or foreign-to-foreign liquidation or asset reorganization transaction under section 367(b) or section 1248, it may be required to recognize currency gain or loss on all of its PTI regarding the CFC as if the CFC distributed the PTI before the transaction.[54] This could result in the U.S. parent recognizing a significant amount of currency gain or loss on an otherwise innocuous internal restructuring.

Even for transactions that otherwise would not trigger any negative section 367 or section 1248 consequences, if a CFC or a branch QBU of a CFC changes its functional currency in the transaction, the U.S. parent may be required to recognize currency gain or loss on the CFC's PTI, and the CFC could be required to recognize currency gain or loss on its section 988 transactions.[55] The section 367(b) rules cross-reference "last chance" currency rules that typically apply when a QBU, whether a corporation or a branch, changes its functional currency. These rules require the QBU that changes its functional currency to recognize exchange gain or loss on its section 988 transactions denominated in the functional currency that it adopts in the change.[56] And in the case of a CFC that changes its functional currency to the U.S. dollar, the rules require its U.S. shareholders to recognize any currency gain or loss on their PTI with respect to the CFC as if the CFC distributed all of the PTI immediately before the change.[57] When nonfunctional currency borrowings and intercompany notes are in play, the potential tax consequences can balloon. These issues should be central to cross-border M&A tax planning given the recent exchange rate volatility.[58]

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gain or loss, recognition typically will follow under section 1001(c) because generally applicable nonrecognition rules do not cover intra-taxpayer transfers. This last chance rule applies to currency gains and losses alike, but if the transaction would alter only the source of the gain or loss and does not have a significant business purpose, the IRS has discretion to defer the gain or loss. *See* reg. section 1.988-1(a)(10)(ii)(B).

[53]*See* reg. section 1.988-1(a)(11). The example provided in the regulations applies this rule when an individual transfers nonfunctional currency to a newly formed corporation in a section 351 transaction and immediately thereafter sells the stock of the corporation. *See* reg. section 1.988-1(a)(11)(ii). The example concludes that the sale of the stock is a substitute for the sale of the nonfunctional currency, so that the IRS would have authority to recharacterize the sale as a section 988 transaction.

[54]*See* reg. section 1.367(b)-2(j)(2).

[55]*See* reg. section 1.367(b)-2(j)(1); reg. section 1.985-5. *See, e.g.*, reg. section 1.367(b)-2(j)(1)(ii) (providing an example of the rule applied to a branch QBU of the acquiring CFC in an foreign-to-foreign asset reorganization).

Although the current final regulations reserve on whether a U.S. person must recognize currency gain or loss on its capital investment in a foreign subsidiary that liquidates in an inbound liquidation or is acquired in an inbound upstream asset reorganization, the tax law currently does not require that recognition of currency gain or loss. *See* reg. section 1.367(b)-3(b)(3)(iii). Policymakers appear to have moved away from the view that U.S. persons should be subject to currency gain or loss on capital investments in foreign operations, either in branch or corporate form, as evidenced by the current proposed regulations under section 987. This view can be contrasted with the view taken in proposed regulations issued in 1991 under both section 987 and section 367, but in both cases, the regulations have since been withdrawn. *See* former prop. reg. section 1.367(b)-3(b)(2)(ii); former prop. reg. section 1.987-1 through -3. The 1991 proposed regulations would have exposed a U.S. person to currency gain or loss on its capital investment in a branch QBU or CFC that used a different functional currency.

[56]*See* reg. section 1.985-5(b).

[57]*See* reg. section 1.985-5(e).

[58]Other transactional currency issues remain open. For example, it is unclear whether a U.S. parent determines its carryover basis in the assets of the liquidating foreign subsidiary by translating the subsidiary's basis into dollars using the spot exchange rate on the date of the liquidation or another exchange rate, such as the historical exchange rate, on the date the subsidiary acquired the assets. *See* Richard L. Doernberg and Michael Thompson, "Recognition of Foreign Currency Exchange Gains or Losses on a U.S. Inbound Event," *Tax Notes*, Jan. 6, 2003, p. 105, *Doc 2003-646*, or *2003 TNT 4-45*; Robert A. Katcher, "Back to Basis: Crossing the U.S. Frontier," *Tax Notes*, Oct. 28, 2002, p. 547, *Doc 2002-24169*, or *2002 TNT 209-27*; Philip D. Morrison, "Currency Translation for Asset Basis in a Section 332 Liquidation," 32 *Tax Mgm't Int'l J*. 316 (June 13, 2003). *Cf.* ILM 200303021, *Doc 2003-1581, 2003 TNT 13-18*.

As an example, assume that a domestic corporation directly owns all the stock of two foreign subsidiaries (CFC1 and CFC2) that use the dollar and the euro as their functional currencies, respectively. If CFC1 and CFC2 combine in an otherwise tax-free reorganization but the successor CFC uses the dollar as its functional currency, CFC2 must recognize currency gain or loss on its dollar-denominated financial instruments, which could result in subpart F inclusions to USP. Also, USP must recognize currency gain or loss on its PTI with respect to CFC2.

3. Transactions involving foreign branches. Perhaps the greatest potential for currency tax surprises comes from the section 987 rules for branch QBUs. These rules are particularly pertinent in a check-the-box world, since it is easy and common to establish a foreign hybrid entity that keeps a separate set of financial books in the currency of its country of organization. Section 987 needs some introduction: Conceptually, it applies in lieu of separately accounting under section 988 for the currency consequences on all the potentially numerous foreign-currency-denominated transactions conducted through a foreign branch (a branch QBU).[59] It involves both accounting aspects, such as how to translate a branch's earnings and losses into the ''owner's'' functional currency, and transactional aspects, such as to what extent currency gain or loss is triggered by transactions involving the owner, transfers between a branch QBU and its owner, or transfers between branch QBUs. A decline of the dollar is likely to increase a U.S. parent's (or a dollar functional currency CFC's) built-in currency gain in its branch QBUs, provided the branches hold financial assets exceeding their financial liabilities. In any event, it is safe to conclude that exchange rate tumult magnifies the consequences under section 987.

Branch currency issues can arise even if a U.S. multinational operates through foreign subsidiaries rather than foreign branches, because section 987 can apply to foreign branches of CFCs as well as domestic corporations.[60] Proposed regulations provide that section 987 gain or loss can constitute subpart F income to the extent the branch assets otherwise generate subpart F income,[61] and that gain or loss can affect the amount of indirect FTCs a U.S. parent can claim on distributions from a foreign subsidiary by increasing or decreasing, and affecting the basketing or sourcing of, the CFC's earnings and profits.[62] A U.S. parent that conducts most of its foreign operations through disregarded entities rather than foreign corporate subsidiaries, whether or not underneath a holding corporation, will be more exposed to section 987 consequences. Thus, section 987 will be increasingly relevant if the section 954(c)(6) subpart F look-through rules for payments between related CFCs eventually lapse and U.S. multinationals seek to avoid subpart F inclusions on intercompany payments the old-fashioned way — by conducting foreign operations through disregarded entities rather than CFCs.

Planning under section 987 is complicated (or made unnecessary, depending on one's view of the statute and the proposed regulations) by the uncertain state of the law. The statute itself includes only skeletal and vague principles, and final regulations have yet to be issued. Proposed regulations were issued in 1991,[63] but they were later withdrawn and replaced by new proposed regulations in 2006 that took a fundamentally different approach.[64] Under the 1991 approach, a taxpayer effectively was exposed to currency gain or loss on all the assets contributed to the branch, plus any retained E&P of the branch. The 2006 proposed regulations departed from this approach, exposing a taxpayer to currency gain or loss only on section 988-type financial assets

[59]The separate transaction principle becomes unwieldy when a taxpayer conducts regular transactions in nonfunctional currency, such as when it operates a business through a foreign branch. In light of this, section 987 requires the taxpayer to account for foreign branch transactions in the branch's functional currency, without the need to compute exchange gain or loss on each individual transaction that would otherwise be subject to section 988. Instead, the owner of the branch translates items such as income and loss into the owner's functional currency, pools the currency exchange gain and loss from the branch transactions, and recognizes all or a portion of that gain or loss on the occurrence of specified transactions.

[60]Section 987 applies to a CFC that has a branch QBU that uses a different functional currency than the CFC.

[61]Under since-withdrawn 1991 proposed regulations, the character and source of section 987 gain or loss is determined based on the method the taxpayer uses to allocate and apportion interest expense under section 861. *See* former prop. reg. section 1.987-2(f). Under currently outstanding 2006 proposed regulations, a taxpayer must use the asset method, meaning that section 987 gain or loss recognized by a CFC with respect to a foreign branch constitutes subpart F income to the extent the branch's assets generate subpart F income. Prop. reg. section 1.987-6(b). These rules contrast with the rules for currency gain recognized under section 988 on specified financial assets and obligations, which generally constitutes subpart F income unless it satisfies one or more exceptions. *See* reg. section 1.954-2(g).

[62]*See generally* James A. Riedy, ''Proposed Code Sec. 987 Regulations — Impact on Code Sec. 902 Earnings and Profits Pools,'' 33 *Int'l Tax J.* 9 (2007).

[63]*See generally* INTL-965-86.

[64]*See generally* REG-208270-86, *Doc 2006-18640, 2006 TNT 173-6*.

and obligations denominated in the branch's functional currency. This limits the exposure to currency gain or loss to assets and liabilities the value of which are closely tied to the value of the branch's functional currency, and not on the branch's fixed assets or the entire branch's capital. Generally, then, the 2006 approach reduces a taxpayer's exposure to currency gain or loss, which in a volatile currency market is a particularly good thing.

Given the uncertain state of the law, U.S. multinationals are confronted with a threshold question that has yet to be answered definitively: What does section 987 require?[65] Some taxpayers have not adopted either the 1991 or 2006 proposed approaches and simply translate earnings of a foreign branch into dollars using the appropriate exchange rate. Others continue to apply the 1991 method, and some have adopted the 2006 method or some variant thereof.

For some taxpayers that apply a reasonable approach other than the 2006 approach, the 2006 proposed regulations provide a noteworthy planning opportunity. They permit two alternative methods of transitioning to the proposed rules. One method — the deferral method — generally preserves any accrued but unrecognized currency gain or loss in branch QBUs, whereas the other — the fresh start method — expunges any previously accrued but unrecognized currency gain or loss.[66] Although the fresh start method does not completely wipe the slate clean, it limits the built-in section 987 gain or loss to that which would exist had the taxpayer used the 2006 proposed method historically.[67] For U.S. multinationals that use section 987 methods involving greater exposure to section 987 gain or loss than the 2006 method (such as the 1991 method) and that have significant built-in currency gain in their branch QBUs, the opportunity to start fresh might be too good to pass up. Struggling with the complexity of administering the new rules appears to be the penance. If Treasury and the IRS finalize the regulations, it would seem equitable and practical given the longstanding uncertainty in the area to keep some form of a fresh start transition method.

The transactional aspects of the proposed section 987 rules contain dangerous traps for the unwary. Currency gain or loss is triggered under both the 1991 and 2006 approaches on remittances (transfers from a QBU branch to its corporate owner) and terminations of a QBU branch. Conditioning the recognition of section 987 gain or loss on a remittance is atypical in that a remittance otherwise could be disregarded for U.S. tax purposes and could have little if any non-tax economic significance. For example, the movement of cash from one branch QBU's financial books to another's could give rise to a remittance. The termination rules also can unexpectedly trigger currency gain or loss under both the 1991 and 2006 approaches, because a nonrecognition transaction involving the corporate owner of a branch QBU (such as a corporate liquidation, asset reorganization, or capital contribution) can cause the branch QBU to terminate, even if the branch activities continue on as before.[68] In short, the proposed branch currency rules could

[65]Practitioners and executives also might struggle with the building-block issue of what constitutes a branch QBU. It is questionable, for example, whether the activities of a fiscally transparent entity that merely holds stock of subsidiaries or intellectual property, or acts as a treasury or financing vehicle for related entities, qualifies as a branch QBU. *See* Riedy, ''Code Sec. 987 and Qualified Business Units,'' 5 *J. Tax'n of Global Transactions* 11 (2005) (noting the uncertainty regarding holding and financing entities under the 1991 proposed regulations and arguing that those entities should not constitute QBU branches). Unlike the check-the-box rules, which make identifying and classifying taxable units straightforward except in fringe situations, the currency rules define branch QBUs based on activities. Generally, a branch QBU must maintain separate financial books and have a different functional currency from its corporate owner and must conduct a trade or business (*i.e.*, ''an independent economic enterprise carried on for profit, the expenses related to which are deductible under section 162 or 212''). *See* reg. section 1.989(a)-1(c).

The trend has been toward interpreting the trade or business requirement more restrictively. The 2006 proposed regulations, for example, would preclude a mere holding entity from constituting a QBU branch. *See* prop. reg. section 1.987-1(b)(7), Example 1. However, testing QBU status by reference to the deductibility of expenses under section 162, as appears to be required under the only finalized guidance on point, could be more inclusive. *See, e.g.*, reg. section 1.989(a)-1(e), Example 6. For example, several courts have held that a corporation that acts as a holding company is engaged in the trade or business of managing its investments and thus may deduct related expenses under section 162. *See Allied Chem. Corp. v. United States*, 305 F.2d 433, 442 (Ct. Cl. 1962); *Ark. Best Corp. v. Commissioner*, 83 T.C. 640, 653 (1984); *Allegheny Corp. v. Commissioner*, 28 T.C. 298, 303 (1957). Depending on the circumstances, a U.S. multinational may or may not want a branch QBU to exist, since it could affect its tax compliance burden. More substantively, whether a branch QBU exists could affect the corporate owner's exposure to currency gain or loss (particularly if it uses a method other than the 2006 approach) and in any event could have timing, character, and source consequences.

[66]*See* prop. reg. section 1.987-10(c)(4)(i).

[67]A taxpayer transitioning to the 2006 method would be required to translate its basis in the branch's assets using the historical exchange rate in place on the date the assets were acquired. *See* prop. reg. section 1.987-10(c)(4)(ii). Thus, any built-in currency gain or loss on the specified financial assets and obligations on which the 2006 method calculates section 987 gain or loss is preserved and taken into account under the new method.

[68]*See generally* former prop. reg. section 1.987-3; prop. reg. section 1.987-8.

cause simple internal transactions to have unexpected and unwelcome tax consequences. One could argue that these termination rules could be improved on the margins by harmonizing them, to the fullest extent possible, with more fundamental corporate nonrecognition rules and the section 367 rules.

E. Who Should Care?

As this article attempts to show, currency tax consequences can creep into all manner of cross-border activities, including restructurings, acquisitions, sales, or repatriations. If there is a theme, it is that there are many areas in which policymakers could reduce uncertainty by plugging holes in the law and finalizing guidance. That is not to say that developing guidance would be an easy task — far from it, as one can only imagine the number of difficult policy calls required in balancing administrability and theoretical purity in developing rules under section 987. In an era in which a volatile dollar is the norm, however, the task takes on added importance, and the lack of consistent currency tax principles suggests that if and when possible, new rules should be reconciled with existing tax accounting and cross-border transactional principles.[69] Guidance should be practical and buck the trend of allowing perfect international tax theory to be the enemy of the good enough international tax policy.

[69]Policymakers have acknowledged the tension between "administrability" and "philosophical purity" in developing the section 987 regulations in the context of finding the right balance between tax policy and financial accounting treatment. *See* Amy S. Elliott, "Distressed Debt Guidance Expected This Plan Year," *Tax Notes*, Nov. 22, 2010, p. 872, *Doc 2010-24473*, or *2010 TNT 220-4*.

Economic Substance Doctrine: Unconstitutionally Vague?

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Cullinan and Lord discuss the uncertainty regarding when the IRS would apply the codified economic substance doctrine and whether it should be concerned that too much uncertainty is bad tax policy that could render the new doctrine vulnerable to constitutional challenges. The views expressed herein are those of the authors and are not necessarily shared by any other attorney at Sutherland.

During the disruptive years of the 1960s, the city of Cincinnati passed an ordinance making it a criminal offense for "three or more persons to assemble . . . on any of the sidewalks . . . and there conduct themselves in a manner annoying to persons passing by." The new law was tested on December 7, 1967, when Dennis Coates — a student participating in a demonstration — was charged under the statute. The record does not indicate exactly what Coates did to be annoying, but those passing by said they felt annoyed, and he was arrested and convicted. Coates challenged his conviction on the ground that the ordinance was unconstitutionally vague — how could he know with certainty whether another person passing by would be annoyed by him? Having read about Coates, we are certain that some people would likely always be annoyed by him, while others would find him quite charming. Coates appealed his annoyance case all the way to the U.S. Supreme Court, which agreed with him and held:

> Conduct that annoys some people does not annoy others. Thus, the ordinance is vague, not in the sense that it requires a person to conform his conduct to an imprecise but comprehensible normative standard, but rather in the sense that no standard of conduct is specified at all. As a result, men of common intelligence must necessarily guess at its meaning.[1]

Accordingly, the Supreme Court struck down Cincinnati's annoyance law as unconstitutionally vague.

[1]*Coates v. City of Cincinnati*, 402 U.S. 611, 614 (1971).