

MEMO# 3617

March 25, 1992

IRS REGULATIONS ON SECTION 988 FOREIGN CURRENCY TRANSACTIONS

11/ While the functional currency of most taxpayers is the U.S. dollar, in certain cases the functional currency of a "qualified business unit" may be the currency of the economic environment in which a significant part of the unit's activities are conducted. March 25, 1992 TO: TAX MEMBERS NO. 19-92 ACCOUNTING/TREASURERS MEMBERS NO. 16-92 CLOSED-END FUND MEMBERS NO. 16-92 INTERNATIONAL COMMITTEE NO. 8-92 RE: IRS REGULATIONS ON SECTION 988 FOREIGN CURRENCY TRANSACTIONS

Attached are two sets of regulations, one proposed and one final, relating to the taxation of gain or loss under Code section 988 arising from certain foreign currency transactions. In general, section 988 and the related regulations provide rules under which exchange gain or loss is realized, on a transaction-by-transaction basis, whenever the amount to be paid or received with respect to three types of transactions -- (i) the acquisition of a debt instrument, (ii) the accrual of any item of expense, income or receipt which is paid or received after the accrual date and (iii) the entering into or acquisition of forward contracts, futures contracts, options or similar financial instruments -- is denominated in or determined by reference to a nonfunctional currency. 1/1 Rules are also provided for the computation, timing, character and source of gain or loss that is due to fluctuations in exchange rates and for certain integrated hedging transactions. The final regulations replace temporary and proposed regulations under section 988 that were issued in 1989. (See Institute Memorandum to Tax Members No. 39-89, Closed-End Fund Members No. 53-89, International Funds Task Force No. 17-89 and Accounting/Treasurers Committee No. 45-89, dated October 10, 1989.) As you may know, in 1989 a subcommittee of the Tax Committee identified three concerns with the proposed and temporary regulations; the Institute submitted written comments expressing these concerns. (See Institute Memorandum to Tax Committee No. 19-89, Closed-End Fund Committee No. 51-89, 22/ The final regulations do not adopt the Institute's third suggestion, that RICs be permitted to treat (at least retroactively) the acquisition of a foreign-currency-denominated certificate of deposit ("CD") as a recognition event. Instead, Treas. Reg. Sec. 1.988-2(a)(iii) retains the rule in the proposed and temporary regulations issued in 1989 that no exchange gain or loss is generally recognized on the deposit of nonfunctional currency into a CD, the withdrawal of nonfunctional currency from a CD, the receipt of nonfunctional currency by reason of the maturity or other termination of a CD, or the transfer of nonfunctional currency from one CD to another. - 1 - International Funds Task Force No. 19-89 and Accounting/ Treasurers Committee No. 50-89, dated November 21, 1989.) The three suggestions made by the Institute in 1989 were as follows. First, the Institute proposed that a convention be provided to eliminate the creation of foreign currency gains and losses attributable to unhedged payables and receivables arising from

the purchase and sale by a regulated investment company ("RIC") of foreign-currency-denominated stock and securities. Second, the Institute suggested that the hedging rules under the section 988 regulations be expanded to encompass hedges of payables and receivables arising from the purchase and sale by RICs of stock and securities. Finally, although it did not appear to be a problem of widespread concern, the Institute urged that RICs that may have treated the acquisition of a foreign-currency-denominated certificate of deposit as a recognition event be permitted to continue that practice, or at a minimum that the nonrecognition treatment set forth in the regulations not be applied retroactively. We are pleased to inform you that the Institute's two principal concerns have generally been resolved by the final regulations.^{2/2} First, the final regulations permit accrual basis taxpayers (for taxable years beginning after March 17, 1992) to elect to translate units of nonfunctional currency, paid or received with respect to purchases or sales of stock or securities traded on an established securities market, into functional currency at the spot rate on the settlement date of the purchase or sale. Treas. Reg. Sec. 1.988-2(a)(2)(iv) and (v). Previously, the ability to translate foreign currency using the spot rate on the settlement date was limited to cash basis taxpayers. Under the final regulations, accrual basis taxpayers may elect this spot rate method by filing a statement with the taxpayer's first tax return in which the election is effective clearly indicating that the election has been made. If the election is made, it must be applied consistently from year to year and cannot be changed without the consent of the - 2 - Commissioner. Second, the final regulations permit all taxpayers to integrate hedges of payables and receivables that are created when a taxpayer purchases or sells stocks or securities which are traded on an established securities market. Treas. Reg. Sec. - 3 - 1.988-5(c). Under the regulations, the hedge may be for any part of the period beginning on the trade date and ending on the settlement date. The hedge must be identified by entering into a record before the close of the date the hedge is entered into a clear description of the executory contract and the hedge. Treas. Reg. Sec. 1.988-5(b)(3). A hedge includes a deposit of nonfunctional currency in a hedging account, defined in Treas. Reg. Sec. 1.988-5(b)(2)(iii)(D) as "an account with a bank or other financial institution used exclusively for deposits of nonfunctional currency used to hedge executory contracts." These hedging rules apply to trade date/settlement date hedges entered into on or after September 21, 1989, even if the transaction being hedged was entered into or acquired prior to such date. The final regulations make numerous other changes, some of which may affect RICs. For example, Treas. Reg. Sec. 1.988-1(d) has been expanded to permit the spot rate convention to be determined at intervals of one quarter year or less (rather than one month or less) for purposes of computing exchange gain or loss with respect to payables and receivables denominated in a nonfunctional currency that are incurred in the ordinary course of business with respect to the acquisition or sale of goods or the obtaining or performance of services. This change is effective for taxable years beginning after December 31, 1986. Similarly, Treas. Reg. Sec. 1.988-2(b)(2)(ii) and (iii)(B) permit accrual basis taxpayers to elect to translate interest income and expense at the spot rate on the last day of the interest accrual period (and in the case of a partial accrual period, the spot rate on the last day of the taxable year). This change is effective for taxable years beginning after March 17, 1992. In addition, the final regulations provide that the Commissioner may issue an advance ruling addressing the income tax consequences of taxpayer systems for hedging net nonfunctional currency exposure and anticipatory hedges of items of income or expense. Simultaneously with the issuance of the final regulations, the Treasury has issued proposed regulations which would provide additional guidance regarding the treatment of a variety of instruments, including contingent payment debt instruments, dual currency debt instruments, debt instruments denominated in hyperinflationary currencies and forward contracts, futures contracts, option contracts and currency contracts where payments to be made or received are

denominated in hyperinflationary currencies. In addition, proposed Treas. Reg. Sec. 1.988-5(f) would provide a mark-to-market method of accounting for section 988 transactions. Any taxpayer making the mark-to-market election would be required to use the method to account for all section 988 transactions, other than those subject to the special hedging rules of Treas. Reg. Sec. 1.988-5. Under the mark-to-market method, taxpayers would realize for the taxable year exchange - 4 - gain or loss on section 988 transactions resulting from changes in exchange rates between the dates a financial period begins and - 5 - closes (but no less frequently than quarterly), provided that such treatment is consistent with the taxpayer's method of accounting for financial reporting purposes (and the method conforms to U.S. generally accepted accounting principles). Comments and requests for a public hearing on the proposed regulations must be received by May 18, 1992. Please inform the undersigned by May 1, 1992 of any comments that you would like the Institute to submit on these regulations. We will keep you informed of developments.

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