REPORT #656

TAX SECTION

New York State Bar Association

COMMITTEE ON NEW FINANCIAL PRODUCTS
REPORT ON SECTION 988 TEMPORARY REGULATIONS

May 7, 1990

Table of Contents

Cover Letter : i

I. INTRODUCTION. 1

II. DEFINITION OF SECTION 988 TRANSACTIONS. 5

1. General Scope 5
2. Special Rules for Section 1256 Contracts. 13
   (a) Scope of Special Rules 13
   (b) Interaction with Other Code Sections 14
3. Intra-Taxpayer Transactions 18

III. EFFECTIVE DATE / CHANGE OF ACCOUNTING METHOD. 19

1. Overview 19
2. Relevant Authority 19
3. Suggested Approach 21
4. Mark-to-Market Method for Dealers 22

IV. RECOGNITION AND COMPUTATION OF EXCHANGE GAIN AND LOSS (TEMPORARY REGULATION SECTION 1.988-2T) 23

1. Disposition of Nonfunctional Currency 23
   (a) De Minimis Rule. The Temporary Regulations do not 23
   (b) Special Rules for QBUs with a Dollar Functional Currency 24
2. Foreign Currency Debt Securities 25
   (a) Description of Computation Rules 26
   (b) Critique of Computational Rules 28
   (c) Use of Trade Date or Settlement Date to Compute Exchange Gain or Loss 41
   (d) Convertible and Exchangeable Debt 43
3. Calculation of Exchange Gain or Loss For Short-term Trade Receivables and Payables 44
4. Derivative Instruments (Forwards, Futures and Options) 46
   (a) Offsetting Contracts 46
   (b) Contract Extensions 49

5. Notional Principal Contracts and Currency Swaps. 50
(a) General 50
(b) Notional Principal Contracts 50
(c) Currency Swaps. 51
6. Currency Swap Premium 55
V. CHARACTER OF EXCHANGE GAIN AND LOSS (TEMPORARY REGULATION SECTION 1.988-3T). 55
1. General Rules 55
2. Special Treatment for Certain Investment Positions 56
VI. SOURCE OF EXCHANGE GAIN OR LOSS (TEMPORARY REGULATION SECTION 1.988-4T) 56
1. Overview 57
2. Foreign Taxpayers 58
3. United States Taxpayers 61
VII. HEDGING TRANSACTIONS (TEMPORARY REGULATION SECTION 1.988-5T).......... 61
1. Fully-Hedged Debt Instruments 62
(a) General Rules. 63
(b) Transactions Part of a Straddle................................. 69
(c) Problems for Synthetic Assets 69
(d) Legging In and Legging Out 71
(e) Taxation of Qualified Hedging Transactions....................... 72
2. Hedged Executory Contracts 73
(a) Partially-Hedged Contracts 74
(b) Historic Rate Rollovers 74
(c) Legging Out Rules 76
3. Hedges of Trade Date-Settlement Date Period for Publicly Traded Securities 77
(a) Limitation to Cash Method Taxpayers.............................. 77
(b) Conforming Information Reporting Rules............................ 78
VIII. CONSISTENT TREATMENT UNDER SECTION 988(d)........................... 79

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TAX SECTION

New York State Bar Association

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May 8, 1990

The Honorable Fred T. Goldberg, Jr.
Commissioner of Internal Revenue
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

Dear Commissioner Goldberg:

I enclose our Report commenting on the Temporary Regulations issued under Section 988 of the Code, generally requiring that foreign currency gain or loss in respect of specified financial transactions be computed separately from other gain or loss on the underlying transaction and that it be characterized as ordinary income or loss sourced by reference to the residence of the taxpayer.

While the Report contains a number of detailed comments, there are two general themes to the recommendations. The first is to expand the extent to which the Temporary Regulations track the economic realities of business transactions (which requires the application of Section 988(d) principles more freely) and the second is to promote, where it can be accomplished without prejudice to the taxpayer or the fisc, greater simplicity. For example, the goal for simplicity underlies the subcommittee's recommendations that foreign currency gain or loss be computed for both cash and accrual taxpayers by reference to the proceeds received on settlement of a securities transaction, that foreign currency gain or loss on interest accruals and payments be treated as interest for tax purposes and that foreign currency gain or loss with respect to the principal portion of debt be considered as an adjustment to interest income and expense.

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The desire to avoid uneconomic results is the principal motivation for certain other subcommittee recommendations, such as the recommendation that the "hedging" provisions of the Temporary Regulations be expanded so as to permit more arrangements to be treated as single integrated transactions for tax purposes, or where complete integration treatment may not be feasible, that a consistency rule be adopted to prevent whipsaws that could unreasonably punish taxpayers or the Service.

We would be happy to discuss any of the subcommittee's recommendations more fully with you if; you desire.

Very truly yours,

Arthur A. Feder
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Enclosure

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Tax Report #656

NEW YORK STATE BAR ASSOCIATION TAX SECTION

COMMITTEE ON NEW FINANCIAL PRODUCTS

REPORT ON SECTION 988 TEMPORARY REGULATIONS

May 7, 1990

I. INTRODUCTION.[1]

In September, 1989, the Internal Revenue Service (the "Service") promulgated temporary regulations[2] under section 988 of the Internal Revenue Code.[3] Section 988, which was adopted as part of the Tax Reform Act of 1986 (the "1986 Act"),[4] generally requires that foreign currency gain or loss in respect of specified financial transactions be computed separately from other gain or loss on the underlying transactions.[5] Such foreign currency gain or loss generally is characterized as ordinary income or loss and sourced by reference to the residence of the taxpayer (with special rules for branch transactions). Section 988 further directs the Service to promulgate special rules for certain foreign currency hedging transactions.

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1 This report was prepared by a subcommittee of the Committee on Financial Instruments, chaired during the preparation of this report by Cynthia Beerbower, Peter C. Canellos and Edward D. Kleinbard. The report's principal authors were Suzanne F. Greenberg and Jodi J. Schwartz. Other subcommittee members participating in the drafting of the report were: Richard E. Andersen, Michael Barnes, Richard Blaker, Micah Bloomfield, Richard Hervey, Dan A. Kusnetz, William Moore, David Newman, Jeffrey Sion, Andrew Solomon, Skip Stiver and Karl Zimmerman. Helpful comments were received from Arthur A. Feder, William L. Burke, John A. Corry, Harvey P. Dale, Donald Shapiro, Kenneth R. Silbergleit, and Willard B. Taylor.

2 Treas. Reg. §§ 1.988-0T - 1.988-5T, T.D. 8265, 1989-43 I.R.B. 4.

3 In this report, section references are to the Internal Revenue Code of 1986, as amended and to the Treasury regulations thereunder, unless otherwise indicated.

4 Public Law No. 99-514, 100 Stat. 2085 (1986).

5 Section 988 uses the terms "foreign currency" and "nonfunctional currency" interchangeably; so too does this report. Similarly, sections 988(b)(1) and (b)(2) define "foreign currency gain" and "foreign currency loss", respectively. In order to avoid confusion between the use of these terms in the technical and colloquial sense, this report sometimes refers to "section 988 gain" and "section 988 loss," or to "exchange gain" and "exchange loss," in place of the statutory terms.

The temporary section 988 regulations (the "Temporary Regulations") define those transactions in foreign currency that are intended to be subject to the substantive rules of section 988, and clarify the character, source and, in some cases, the timing, of foreign currency gains and losses in respect of section 988 transactions. This report discusses certain provisions of the Temporary Regulations and suggests modifications to improve their application to foreign currency transactions.

The adoption of section 988 in 1986 represented an attempt to codify the generally prevailing view that foreign currency gain and loss should be treated as separate from gain or loss on the underlying asset or transaction. Section 988 arose from a statutory environment that differs substantially from that which prevails today.

Prior to the adoption of section 988, Congress and the Treasury Department expressed substantial concern regarding the distortions that might arise from the failure to account separately for the foreign currency gain or loss inherent in a financial or other transaction. Among the areas of concern were (1) the possibility that foreign currency gain or loss would be treated as capital gain or loss if realized in connection with a transaction involving a capital asset; and (2) the possibility that foreign currency gain in connection with the repayment of a taxpayer's borrowing in devalued currency could be treated as tax-favored cancellation of indebtedness income.

Obviously, the stakes have changed considerably. Taxpayer manipulation to achieve capital gains is, at present, less of a concern than the possibility that business losses will be converted into non-utilizable capital losses under Arkansas

Best. Likewise, the once favorable rules on cancellation of indebtedness have been eliminated outside of bankruptcy or insolvency.

Whatever its origins, the essential, mandate of section 988 to account for foreign currency gain or loss as a separate item remains. Rigorous application of that "bifurcation" approach can, however, generate excessive complexity, as well as unreasonable results. The Temporary Regulations depart from the "bifurcation" model in a number of instances in pursuance of greater simplicity and fairness. The subcommittee applauds this initiative. At the same time, the subcommittee believes that further departures from the theoretical "bifurcation" norm may be appropriate to achieve the goals of simplicity and fairness.

In particular, the subcommittee views simplicity goals as predominant in transactions involving many taxpayers, where the tax consequences of a simplified approach are not likely to be either tax avoidance strategies or unreasonable tax penalties for real business transactions. Simplicity concerns underlie, for example, our recommendation that foreign currency gain or loss be computed by reference to the proceeds received on settlement of a securities transaction for both cash and accrual-basis taxpayers. (Under the Temporary Regulations, accrual-basis taxpayers must account separately for a foreign currency receivable created on the trade date and paid on the settlement date.) Another recommendation based principally on simplicity concerns (but also reflecting the desire to avoid uneconomic results) is for the foreign currency gain or loss on interest accruals and payments to be subsumed to interest for tax purposes.[6] The report also

[6] The New York State Bar Association Tax Section has previously commented on the scope of the definition of interest for tax purposes. See Report No. 597 -- Report on Temporary Section 861 Regulations Concerning Allocation of Interest and Other Expense (December 21, 1988) and Report

raises the possibility of treating foreign currency gain or loss with respect to the principal portion of debt as an adjustment to interest income and expense.

The desire to avoid uneconomic results is the principal motivation for certain other recommendations. Thus the subcommittee strongly recommends that the “hedging” provisions of the Temporary Regulations be expanded so as to permit more arrangements to be treated as single integrated transactions for tax purposes. Furthermore, the report suggests that, in certain cases where complete integration treatment may not be feasible, a consistency rule should be adopted. Thus, the report recommends that foreign currency gain or loss on a United States parent's hedging of its foreign subsidiary's balance sheet should be sourced in a manner consistent with the sources of foreign currency gains or losses of the subsidiary. Both changes, like a number of others discussed below, are intended to prevent whipsaws that could unreasonably punish taxpayers or the fisc.

The remainder of this report contains the subcommittee's detailed comments on the Temporary Regulations. The report generally follows the sequence of subsections in the Temporary Regulations.

(Footnote Continued
No. 650 -- Report on Section 163(j) of the Internal Revenue Code (March 14, 1990). Obviously, any characterization of gain or loss as interest has consequences for these Code sections as well as others, such as Section 265.

II. DEFINITION OF SECTION 988 TRANSACTIONS.

1. General Scope. Temporary Regulation sections 1.988-1T(a)(1) through (3) define (and provide examples of) the types of transactions ("section 988 transactions") to which the substantive rules of section 988 and the Temporary Regulation apply. Temporary Regulation section 1.988-1T generally follows the organization of the statute in a noncontroversial manner: it first states that the disposition of nonfunctional currency is generally a section 988 transaction, and then lists three types of transactions that are section 988 transactions if the amount that the taxpayer is entitled to receive, or is required to pay, is denominated in terms of a nonfunctional currency or is determined by reference to the value of one or more nonfunctional currencies.[7] Those transactions are: (i) acquiring, or becoming a obligor under, a debt instrument, (ii) accruing, or otherwise taking into account, any item of expense, gross income or receipts that is to be paid or received after the date accrued or taken into account, and (iii) entering into or acquiring a forward contract, futures contract, option, warrant or similar financial instrument (hereafter a "Derivative Instrument").

Temporary Regulation sections 1.988-1T(a)(2)(i) and (ii) define, respectively, "debt instrument" and "payables and receivables" subject to section 988. Those definitions are almost verbatim transcriptions of the statutory language, adding only a routine definition of a debt instrument and a helpful,

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[7] Under section 985, a taxpayer's functional currency generally is the U.S. dollar; however, the functional currency of a foreign branch, subsidiary or other "qualified business unit" generally is the currency of the economic environment in which a significant part of such unit's activities are conducted and which is used to keep its books and records.

noncontroversial clarification that the payables/receivables class of transactions includes accruals of foreign taxes and of capital expenditures and receipts.[8] By themselves, these definitions appear straightforward, although, as discussed below, the intersection between the rule for debt instruments and that for Derivative Instruments can lead to counterintuitive results.

The third category, Derivative Instruments, necessarily involves difficult choices that leave transactions that are economically similar subject to different rules of taxation. Under Temporary Regulation section 1.988-1T(a)(2)(iii)(A), a futures contract, forward contract, option, warrant or similar financial instrument falls within the class of section 988 transactions only if the underlying property to which the instrument ultimately relates is a nonfunctional currency or another instrument that itself would constitute a section 988 transaction. Thus, as that section of the Temporary Regulations explains, an option to buy or sell a nonfunctional currency is a section 988 transaction in its entirety, but an option to purchase wheat denominated in a nonfunctional currency is not a section 988 transaction to any extent, because wheat is not a nonfunctional currency. For these purposes, a look-through rule applies to derivative or tiered arrangements, such as options on futures or forward contracts on debt securities.

The effect of this rule is to treat the entire gain or loss on nonqualifying Derivative Instruments as outside the scope of section 988 (and therefore generally as capital gain or loss) notwithstanding the fact that a component of the gain or loss may

[8] The Temporary Regulations understandably do not offer any guidance as to whether a particular foreign currency instrument will be treated as a debt obligation for U.S. tax purposes. Hybrid instruments therefore still must be examined on a case-by-case basis to determine whether they constitute debt instruments in the first instance before the Temporary Regulations can be applied.

be due to currency fluctuations.[9] If, as often will be the case (particularly after Arkansas Best), the underlying property is a capital asset, the entire gain or loss on such nonqualifying Derivative Instruments would become capital gain or loss. Thus, for example, the price of wheat can remain unchanged as measured in foreign currency units, but the value of the forward contract on that wheat may increase or decrease as the foreign currency moves against the dollar. The inherent foreign currency loss or gain in such a contract would not be characterized as ordinary income under section 988 and, depending upon the relationship of the transaction to the business of the wheat contract's purchaser, might give rise to capital gain or loss under Arkansas Best. If the taxpayer attempted to reduce its exposure to currency fluctuations in respect of its wheat contract, however, gain or loss on the foreign currency hedge generally would be ordinary under section 988 -- creating the possibility of serious character mismatch issues.[10] Moreover, except for a dealer in wheat or wheat products, such a hedging contract generally would be excluded from the favorable integration rules for executory contracts under section 1.988-5T(b), because the underlying wheat contract would not constitute property acquired or sold in the ordinary course of business.[11]

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[9] This analysis assumes that the current restrictive definition of capital assets articulated by Arkansas Best v. Commissioner, 108 S. Ct. 971 (1988) remains unchanged.

[10] In the area of mixed straddles, the possibility of generating short term capital gain and long term capital loss was dubbed the "killer rule." The risk described in the text of producing ordinary income offset by capital losses accordingly has been referred to colloquially as the "super killer rule."

[11] A similar mismatch issue could arise if foreign-currency denominated Derivative Instruments are held by a taxpayer's controlled foreign corporation. Temporary Regulation section 1.954-2T(g) generally treats a controlled foreign corporation's foreign currency gain or loss from section 988 transactions as subpart F income. Consequently, a foreign currency hedge contract may fall within the general subpart F regime (including the optional mark-to-market election of section 1.954-2T(g)(5)), while currency gains or losses on the related foreign

To a large extent, the dilemma faced by the drafters of the Temporary Regulations is the direct result of section 988(b)(3), added to the Code by the Technical and Miscellaneous Revenue Act of 1988 (the "1988 Act").[12] Section 988(b)(3) provides that the entire gain or loss from a Derivative Instrument described in section 988(c)(1)(B)(iii) constitutes section 988 gain or loss. This rule was intended as a helpful simplification for Derivative Instruments of section 988's general rule that treats overall gain or loss as foreign currency gain or loss only to the extent attributable to currency fluctuations. Prices of Derivative Instruments fluctuate not only as a result of changes in the prices of the underlying property to which they relate, but also as a result of changes in the "spreads" between derivative prices and spot prices. For example, gain or loss recognized in respect of a long-term forward contract on yen -- which intuitively is viewed by market participants as "pure" section 988 gain or loss -- often will not be strictly proportionate to fluctuations in the spot price of yen.

Before the addition of section 988(b)(3) by the 1988 Act, the general rule of section 988(b), as applied to a Derivative Instrument described in section 988(c)(1)(B)(iii), would have required a taxpayer disposing of a yen forward contract to bifurcate its gain or loss into a section 988 component (determined solely by reference to movements in spot

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(Footnote Continued)
currency denominated equity or commodity contracts are outside the scope of section 988, and therefore of subpart F. The resulting potential for mismatch in the character (and possibly the timing) of economically offsetting foreign currency gains and losses creates uncertainty for both taxpayers and the government.

[12] Public Law No. 100-647, 102 Stat. 3345 (1988).

currency rates) and a non-section 988 component. This result, in addition to being counterintuitive, was administratively burdensome, and created innumerable opportunities for ordinary income/capital loss mismatches, especially in light of the confusion concerning the character of hedging transactions created by the Arkansas Best case. These character issues, in turn, substantially complicated the application of section 1256(e)'s timing rules for hedging transactions that involved Derivative Instruments, given that section 1256(e) applies only to transactions that give rise exclusively to ordinary income or loss.

The 1988 Act, by treating as section 988 gain or loss all gain or loss in respect of a Derivative Instrument that is denominated in a foreign currency or whose value is determined by reference to a foreign currency, appropriately solved the immediate problem described above. The legislative history indicates that new section 988(b)(3) in fact was targeted at the special problems for options, forwards, futures and similar instruments on actual foreign currencies. The Joint Committee's description of the 1988 Act, for example, states:

> The bill provides that any gain or loss from a section 988 transaction is a foreign currency gain or loss if the transaction is a disposition of nonfunctional currency or a forward contract, futures contract, option or similar financial instrument with respect to a nonfunctional currency. This makes it clear that any gain or loss on such an instrument due to forward premium or forward discount is subject to the Act's rules for foreign currency gains and losses, regardless of movements in the spot rates of exchange between the booking and payment dates. Further, any gain or loss on a nonfunctional currency disposition is foreign currency gain or loss regardless of whether the difference

between acquisition and disposition prices is due to spot rate movements between acquisition and disposition dates, forward discount or premium, bid-asked spreads, or other-factors." (Emphasis added.)[13]

The language of section 988(b)(3), however, is broadly phrased to cover all Derivative Instruments that have a foreign currency element, including contracts that, while denominated in a foreign currency, refer to non-currency factors (such as commodities or equities) as their underlying property. As a result, section 998(b)(3) on its face could be viewed as bringing within section 988 gain or loss realized in respect of foreign currency denominated Derivative Instruments that has nothing to do with currency fluctuations.

The absurdity of this result created new pressure to limit the application of section 988(b)(3) to those classes of transactions intended to be assisted by the statutory change -- that is, Derivative Instruments that have foreign currencies as their underlying property. For example, since section 988 generally does not apply at all to foreign currency denominated stock, a rule that would treat a foreign currency denominated option to acquire that stock as producing entirely foreign currency gain or loss would create obvious tax tension. The drafters of the Temporary Regulations chose to resolve this dilemma by limiting the category of transactions treated as described in section 988(c)(1)(B)(iii) so as to exclude Derivative Instruments based on non-currency property entirely from the scope of section 988.[14]

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[13] Staff of the Joint Committee on Taxation, Description of the Technical Corrections Act of 1988, 100th Congress, 2nd Session at 316 (1988).

[14] The Temporary Regulations fail to clarify completely what it means for the underlying property of an instrument to be nonfunctional currency. For example, an option contract designed to hedge a portfolio of foreign equity securities might provide for the purchase of yen for a

The subcommittee agrees that a limitation on the application of section 988(b)(3)'s characterization rule is necessary and appropriate. Especially in light of current law's taxation of ordinary income and capital gain at the same tax rates, the Service must forestall the possibility of taxpayers opting into an ordinary income/loss regime by, for example, trading in Canadian Dollar wheat futures rather than U.S. dollar wheat futures. In our view, however, it is wrong to ignore the true foreign currency element of a foreign currency denominated Derivative Instrument.

A fundamental problem created by the Temporary Regulations' current approach to Derivative Instruments is the additional pressure to structure such instruments as embedded features of debt instruments. For example, under section 988 itself (and therefore, of course, under the Temporary Regulations as well) a yen-denominated warrant to acquire a Japanese equity security is wholly outside the scope of section 988. (That result presumably would not change even if the warrant were sold as part of a bond-warrant unit.) By contrast, the Temporary Regulations treat gain or loss incurred in respect of a yen-denominated convertible bond (convertible into the same Japanese equity security) as section 988 gain or loss to the extent that amount is attributable to currency fluctuations. It is certainly true that there are economic differences between, for example, a convertible bond and a bond-warrant unit, but those differences

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(Footer Continued)
specified dollar amount but in a quantity to be determined only at the time of exercise by reference to the level of an index of Japanese equities. The subcommittee believes that such an instrument should be viewed as primarily a foreign currency contract, the size or terms of which may vary according to noncurrency features. An example in the Temporary Regulations clarifying this result would allow such economically sensible hedging transactions to proceed without fear of tax anomalies.

have nothing to do with foreign currency exposures, which are the same in both cases.

The subcommittee believes that the Temporary Regulations would come closer to implementing the regime for Derivative Instruments intended by Congress in 1988 by imposing a limitation on the special characterization rules of section 988(b)(3), rather than on the general definition of a section 988 transaction in section 988(c)(1)(B)(iii). Under this approach, Derivative Instruments that had foreign currency (or another section 988 transaction) as their underlying property would continue to give rise exclusively to foreign currency gain or loss under section 988(b)(3). Derivative Instruments that had both currency and non-currency elements (such as the yen-denominated wheat futures contract or equity warrant described above) would be treated as 988 transactions under section 988(c)(1)(B)(iii); however, such contracts would <u>not</u> be covered by section 988(b)(3)'s special characterization rules, but instead, would be subject to the general "bifurcation" regime of section 988(a). Gain or loss from those contracts, like gain or loss from foreign currency denominated debt instruments, therefore would be treated as foreign currency gain or loss covered by section 988 only to the extent attributable to movements in exchange rates. By conforming to the principles applicable to foreign currency denominated debt instruments, our suggested approach would eliminate the incentive to recast Derivative Instruments as an embedded feature of debt securities.

Of course, even under our suggested approach to section 988(b)(3), certain anomalies would remain. For example, the effect of foreign currency fluctuations on the price of a foreign equity security would not be within the scope of section 988, while those same currency movements might create section 988 gain

or loss in respect of a foreign currency denominated option to purchase similar equities. Those tensions, however, have their roots in the restricted statutory definition of a 988 transaction, which excludes stock and commodities transactions, rather than in any logical deficiency in our alternative approach to section 988(b)(3).

The subcommittee ultimately would favor a broader solution that treats foreign currency denominated stocks and instruments in commodities as within the general scope of, section 988, under which gain or loss recognized on the, disposition of such instruments would be characterized as ordinary income or loss to the extent attributable to fluctuations in spot exchange rates. Nonetheless, we recognize that the Service lacks the authority to adopt such an expanded definition in the Temporary Regulations. Pending legislative action to resolve these tensions, the subcommittee believes that our suggested limitation on the scope of section 988(b)(3)'s characterization rules will produce results that are more consistent with the intent of the 1988 Act, and less frustrating to the economic expectations of taxpayers, than the current exclusionary rule of Temporary Regulation section 1.988-lT(a)(2)(iii)(A).

2. Special Rules for Section 1256 Contracts. (a) Scope of Special Rules. Section 988(c)(1)(D)(i) generally excludes from the definition of a section 988 contract "any regulated futures contract or nonequity option which would be marked to market under section 1256 if held on the last day of the taxable year." Subparagraph (ii) of that section, added by the 1988 Act, allows a taxpayer to elect out of this exclusion rule (i.e., to choose section 988 treatment) for its section 988 contracts that also are section 1256 contracts (generally, futures contracts and

nonequity options entered into or acquired after October 21, 1988). Temporary Regulation section 1.988-1T(a)(4) describes the procedures for making that election.[15]

The subcommittee believes it unfortunate that Congress chose to preserve the problems of prior law for the period between January 1, 1987 and October 21, 1988. The subcommittee also would have preferred that the 1988 Act have made section 988 treatment the general rule, rather than an alternative system that must be elected affirmatively.[16] Nonetheless, the subcommittee applauds the administrative simplicity of the procedures for making the election set out in the Temporary Regulations, including the transition rule in section 1.988-lT(a)(4)(v) that allows taxpayers to rely for these purposes on a prior statement filed in compliance with Notice 88-124, 1988-2 C.B. 534. The subcommittee also believes that the streamlined election mechanism, which generally requires only the one-time filing of a specified statement to have effect for all future taxable years, will serve well its intended tax policy function.

(b) <u>Interaction with Other Code Sections</u>. The subcommittee believes that it would be helpful if further guidance were provided with respect to the interaction of section

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[15] Similar language also appears in section 988(c)(1)(E) and Temporary Regulation section 1.988-lT(a)(5), but with opposite effect, in that it permits certain "qualified funds" to elect out of section 988 treatment with respect to any "instrument which would be marked to market under section 1256 if held on the last day of the taxable year". This provision was intended to allow "qualified funds" to elect capital gain treatment for forward contracts on foreign currencies.

[16] An elective rule has the potential for creating considerable mischief, for example treating long-dated forwards and swaps under one set of rules (ordinary income/loss under section 988) and futures and nonequity options under another (60-40 long term/short term capital gain/loss under section 1256). As discussed below, that mischief was further compounded by the Supreme Court's decision in <u>Arkansas Best</u>, which has limited the ability of taxpayers to argue that what otherwise are capital assets give rise to ordinary income or loss when used in business hedging transactions.

988 with sections 1256 and 1092 in light of the various elections available under those sections that can alter the application of mark-to-market principles to certain foreign currency contracts.

For example, if a taxpayer has a "mixed straddle" that consists partly of section 1256 contracts (e.g., regulated futures contracts or listed options on foreign currencies or certain forward contracts on foreign currencies) and non-section 1256 positions (e.g., bonds denominated in foreign currencies), the taxpayer may make one of several elections under section 1256(d), section 1256(e) or the regulations under section 1092(b). Such elections can simplify the application of the straddle rules under section 1092 and can avoid the conversion of long-term capital gains into short-term capital gains or the conversion of short-term capital losses into long-term capital losses under sections 1256 and/or 1092(b). Guidance would be helpful with respect to the effect of such mixed straddle elections on the applicability of section 988 in the following situations:

(i) If an election is made under section 1256(d), the mark-to-market rules under section 1256 do not apply to any section 1256 contract that is part of a mixed straddle properly identified under section 1256(d)(4). Thus, regardless of section 988(c)(1)(D)(ii), an election under section 1256(d) results in ordinary income or loss treatment under section 988 for any section 1256 contract subject to the election, because the contract would not be "marked to market" at year-end under section 1256. This point should be made explicit in final regulations.

(ii) Taxpayers may make "straddle-by-straddle" identifications with respect to mixed straddles under regulation

section 1.1092(b)-3T or a "mixed straddle account" election under regulation section 1.1092(b)-4T. The relevant regulations contain complex rules for determining the character and timing of gains and losses for positions covered by these elections. Although the governing principles contained in regulation section 1.1092(b)-3T and regulation section 1.1092(b)-4T employ mark-to-market concepts, these concepts are different from the rules of section 1256, and do not technically exempt section 1256 contracts in a mixed straddle subject to either type of election under section 1092(b) from the mark-to-market rules under section 1256. The subcommittee believes, however, that section 1256 contracts that are identified pursuant to sections 1.1092(b)-3T or 1.1092(b)-4T should be treated as if such contracts were in fact subject to mark-to-market "under section 1256," with the result that such contracts would be subject to the general rule of section 988(c)(1)(D)(i), absent an effective election into section 988 treatment under section 988(c)(1)(D)(ii).

(iii) Under section 1256(e), a taxpayer may elect to avoid the "mark-to-market" rules for certain "hedging transactions." This election is only available if the gain or loss on all components of the transaction is ordinary gain or loss. Section 1256(e)(2)(B). We understand that the Treasury and the Service are considering the scope of section 1256(e) in light of the U.S. Supreme Court's decision in Arkansas Best v. Commissioner, 108 S. Ct. 971 (1988), which dramatically narrowed the prior understanding of those situations in which hedging transactions can be characterized as ordinary income or loss transactions. Pending further guidance in this area, the interaction between section 988(c)(1)(D)(i) and section 1256(e) appears circular. If a taxpayer uses a regulated futures contract or listed currency option as a foreign currency "hedge" it can avoid mark-to-market treatment under section 1256(e) only if the

contract gives rise solely to ordinary income or loss; at the same time, the contract can qualify for ordinary treatment under section 988(c)(1)(D) only if it is excluded first from mark-to-market treatment under section 1256.[17] Interim guidance concerning the intended application of section 1256(e) to currency futures and listed options contracts would reduce unnecessary uncertainties for both taxpayers and the Service.

(iv) The Temporary Regulations also should clarify the interaction of section 988 with section 1091 and other "substituted basis" transactions. Temporary Regulation section 1.988—2T(d)(2)(i) provides that (except as otherwise provided in section 1.988-5T) exchange gain or loss is realized in accordance with the applicable realization section of the Code. Thus, for example, if the "wash sale" rules of section 1091 apply to disallow recognition of a loss as the result of an acquisition of "substantially identical" property within the prohibited 61-day period, the portion of such loss which is treated as an ordinary loss under section 988 also would be disallowed. Section 1091(d) provides, in effect, for an increase in the basis of the acquired "substantially identical" property, with the result that losses that are disallowed under 1091 are deferred until the disposition of the "substantially identical" property that triggered the application of section 1091

Under the general principles of section 988(a), gain or loss on the "substantially identical" property would be treated as foreign currency gain or loss to the extent arising from

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[17] The taxpayer in this situation could avoid possible character mismatch problems by making the one-time election to treat its foreign currency regulated futures contracts and listed options as section 988 contracts, as described above. Taxpayers may be reluctant, however, to make such a permanent election, which applies by its terms to all the taxpayer's subsequent positions, to cover a limited number of hedging positions.

exchange rate fluctuations. A special rule is needed in the Temporary Regulations to clarify that a "wash sale" transaction is ignored for purposes of computing section 988 losses on the subsequent disposition of the "substantially identical" property. The subcommittee suggests that, this case, the "booking date," as defined in section 988(c)(2), utilized to determine the section 988 gain or loss on the disposition of the "substantially identical" property be determined by reference to the original property held by the taxpayer.[18]

3. Intra-Taxpayer Transactions. Temporary Regulation section 1.988-lT(a)(7) provides that transactions between a taxpayer "and/or qualified business units of that taxpayer" are not section 988 transactions. The subcommittee has no quarrel with the general view that disregards intrataxpayer transactions for U.S. tax purposes. Where the U.S. branch of a foreign party makes or receives payments under a section 988 transaction with its home office, however, the intended interaction of this concept with the rules concerning "effectively connected" income under section 864 is unclear: should the gross (or net) cash flows on the section 988 transaction be taken into account in determining effectively connected income, and, if so, does a risk of U.S. withholding tax arise when payments are made by the U.S. branch? These issues are important to multinational taxpayers that use intrabranch transactions to manage global currency risks. Temporary Regulation section 1.988-lT(a)(7) provides only a general cross-reference to the rules concerning qualified business units under section 987. The subcommittee accordingly urges the Service to clarify the intended effect of Temporary

[18] A similar rule would be appropriate for tax-free exchanges of securities subject to section 988 pursuant to a corporate reorganization, partnership contribution or otherwise.

Regulation section 1.988-lT(a)(7)'s exclusionary rule for other tax purposes.

III. EFFECTIVE DATE / CHANGE OF ACCOUNTING METHOD.

1. Overview. Section 988 significantly changed the pre-1986 Act tax treatment of most foreign currency transactions. Generally, section 988 is effective for taxable years beginning after December 31, 1986. The Temporary Regulations were promulgated on September 20, 1989. As a result, taxpayers filed their 1987 and (in many cases) 1988 tax returns based only upon the statute and the legislative history.

The Temporary Regulations, however, generally are effective for taxable years beginning after December 31, 1986. Moreover, in certain cases, the Temporary Regulations provide rules that differ from the anticipated interpretations adopted by many taxpayers in filing their 1987 and 1988 tax returns. To date, the Service has not issued any guidance concerning procedures available to taxpayers that must change their method of accounting for foreign currency transactions to comply with the Temporary Regulations.

2. Relevant Authority. There is authority permitting a taxpayer to use a "reasonable method" to account for an item if the Treasury has failed to promulgate regulations as directed by Congress.[19] However, the authorities do not specifically discuss the issue of using a reasonable accounting method when regulations in fact are issued and apply retroactively to open tax years.

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[19] See First Chicago Corporation v. Commissioner, 88 T.C. 663 (1987), aff'd, 842 F.2d 180 (7th Cir. 1988).

A long-standing position of both the Service and the courts has been that once a taxpayer adopts an erroneous method of accounting, it is bound by that method in future years.[20] Furthermore, prior tax returns generally cannot be amended to reflect a proper method, once an erroneous method has been adopted.[21] Therefore, in certain instances, the taxpayer must continue to use the erroneous accounting method, even though it is admittedly wrong, unless the taxpayer formally applies for a change of accounting method.[22]

Revenue Procedure 84-74, 1984-2 C.B. 736, provides detailed guidelines for requesting a change in accounting method. In determining whether the request should be granted, the Service will consider all facts and circumstances, including whether the method of accounting is consistent with the relevant statutory and administrative pronouncements as well as common law principles. To obtain Service approval, the taxpayer must agree to account for the "section 481(a) adjustment" in computing taxable income and earnings and profits over the appropriate number of taxable years.[23] In any event, the Revenue Procedure

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20 See section 446(f) and section 1.446-1(e)(2)(i). See also Diebold, Inc. v. United States, 16 Cl. Ct. 193 (1989); Wright Contracting Co. v. Commissioner, 316 F.2d 249 (5th Cir. 1963), acq., 1966-2 C.B. 7, Witte v. Commissioner, 513 F.2d 391 (D.C. Cir. 1975), and Commissioner v. O Liquidating Co., 292 F.2d 225 (3d Cir.), cert, denied, 368 U.S. 898 (1961).

21 Cf., American Can Co. v. Commissioner, 317 F.2d 604 (2d Cir. 1963), cert. denied, 375 U.S. 993 (1964), and Advertisers Exchange, Inc. v. Commissioner, 25 T.C. 1086 (1956), aff'd, 240 F.2d 958 (1957).

22 But see Sorelle v. Commissioner, 22 T.C. 459 (1954), acq., 1955-1 C.B. 6, and National Bank of Fort Benning v. United States, 79-2 USTC Par. 9627 (M.D. Ga. 1979).

23 See Section 4.04 of Rev. Proc. 84-74. The section 481(a) adjustment is the net adjustment necessary to prevent amounts from being duplicated or omitted from the computation of taxable income when it is calculated under of a method of accounting different from the method used for the preceding taxable year. See regulation section 1.481-1(a)(i) and

requires that any change is generally to be done on a prospective basis.

3. Suggested Approach. An approach that would require each taxpayer to apply independently for a change in accounting method to comply with the Temporary Regulations has obvious drawbacks. The administrative burden for the Service of evaluating each of such applications is clear. Moreover, an individualized approach would subject taxpayers to an inappropriate level of uncertainty, because submitting a request for a change of accounting method does not guarantee that it will be approved.[24]

The subcommittee suggests instead that the Service adopt procedures that allow taxpayers to obtain an automatic accounting method change to the extent necessary to comply with the Temporary Regulations. Taxpayers then should be allowed to apply the principles of Rev. Proc. 84-74 without requesting consent, and to spread any resulting section 481 adjustment over a specified period of years (e.g., five taxable years), or, if

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(Footnote continue)
Section 2.03 of Rev. Proc. 84-74. If the Section 481(a) adjustment is a positive amount, the adjustment period may not exceed three years. Section 5.06(1)(d) of Rev. Proc. 84-74. If the section 481(a) adjustment is negative, the entire adjustment must be taken into account in computing taxable income and earnings and profits in the year of change. Section 5.06(1)(c) of Rev. Proc. 84-74. The Revenue Procedure provides numerous exceptions to these rules, generally depending upon how long the taxpayer used the erroneous accounting method, the relative size of the adjustment, and whether the taxpayer is currently under audit. If the taxpayer has used the erroneous accounting method for less than three years, the Service requires the taxpayer to spread the change over the shorter number of years. See Section 5.06(1)(e) of Rev. Proc. 84-74 and PLR 8541004 (June 21, 1985). For example, assume a calendar year taxpayer is permitted to change its method of accounting for foreign currency transactions in 1990. If the taxpayer first used that method in 1988, it could only spread the section 481(a) adjustment over two years.

[24] See, e.g., regulation section 1.446-l(e)(3), Brown v. Helvering, 291 U.S. 193 (1934), and Section 7.04(3) of Rev. Proc. 84-74.

less, over the length of the period the taxpayer has used its former accounting method for foreign currency transactions. This alternative would be consistent with recent Service actions in other areas.[25]

4. Mark-to-Market Method for Dealers. The preamble to the Temporary Regulations states that the Service is considering adopting a mark-to-market accounting method for dealers in non-functional currency denominated financial products and invites comments on the scope and methodology of such a method. A detailed consideration of those issues is beyond the scope of this report. In general, however, the subcommittee supports the concept of an elective mark-to-market accounting method for dealers in foreign currency products (and other taxpayers that regularly engage in large numbers of foreign currency transactions) as a solution to the difficult timing issues that can arise with respect to a managed portfolio at foreign currency positions.[26] The subcommittee further urges the Service to act promptly in promulgating the anticipated mark-to-market regulations. Any substantial delay would require dealers to undertake the substantial cost and administrative burden of developing complex systems that comply with the general timing rules of the Temporary Regulations, only to face an entirely new

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[25] See, e.g., Rev. Proc. 89-16, 1989-10 I.R.B. 18 (allowing certain taxpayers to obtain expeditious consent to change their method of accounting to be in accordance with Rev. Rul. 89-23, 1989-10 I.R.B. 4); Rev. Proc. 89-17, 1989-10 I.R.B. 23; Announcement 89-98, 1989-32 I.R.B. 55 (Service considering modifying the transitional procedures of Rev. Proc. 89-16, supra, and 89-17, supra; stipulated filing deadlines to change existing accounting methods extended); Rev. Proc. 89-46, 1989-33 I.R.B. 28 (procedures for certain cash basis taxpayers to account for the increase in the redemption value of Series E or EE United States savings bonds under section 446(e)); Announcement 89-89, 1989-29 I.R.B. 36; and Notice 90-3, 1990 I.R.B. 10.

[26] In the subcommittee's view, any mark-to-market accounting method should be elective, given that mark-to- market calculations deviate from the realization principles generally followed elsewhere in the Internal Revenue Code.

regime when a mark-to-market tax accounting method ultimately becomes allowable and the possible need to make adjustments of the types described in Sections III (2)—(3) above.

IV. RECOGNITION AND COMPUTATION OF EXCHANGE GAIN AND LOSS (TEMPORARY REGULATION SECTION 1.988-2T).

1. Disposition of Nonfunctional Currency. The Temporary Regulations generally treat any disposition of foreign currency as a taxable event that triggers the recognition of foreign currency gain or loss. Section 1.988 2T(a)(1)(iii), however, lists several categories of transactions that are not considered recognition events for these purposes. These exceptions are limited essentially to (i) the exchange of units of a currency for different units of the same currency (i.e., making change) and (ii) the deposit, withdrawal or transfer of currency in respect of a demand or time deposit in a financial institution.

(a) De Minimis Rule. The Temporary Regulations do not include any de minimis rule that would exempt minor transactions from the recognition rules of section 1.988-2T. Thus, as a technical matter, every purchase made by an individual taxpayer while traveling abroad on business, such as newspapers, taxis or meals, will require a separate computation and recognition of foreign currency gain or loss in respect of the daily fluctuations of the relevant foreign currency against the U.S. dollar (or other functional currency of the taxpayer).[27] Similarly, in the absence of a de minimis rule, a U.S. individual taxpayer who resides abroad will be faced with dozens of section

[27] Section 988(e) generally exempts transactions by individuals from the scope of section 988 except in the case of business or investment related activities described in section 162 or section 212.

988 transactions every day with respect to his or her business activities.

On its face, the rule is both unenforceable and unadministrable; moreover, in light of the small size of such transactions, and the fact that taxpayers over time are as likely to lose money as to make a profit on such transactions, it is difficult to imagine what policy purpose is served by imposing on taxpayers burdens of compiling (and the Service of auditing) all of these foreign currency calculations for countless minor transactions. Accordingly, the subcommittee suggests that the general rules that treat any disposition of nonfunctional currency as a recognition event under section 988 be modified to exempt transactions that have a U.S. dollar value below a specified threshold amount (e.g., $10,000).[28] Alternatively, the regulations could seek to identify certain types of expenses (such as travel and entertainment expenses or expenses of U.S. individual taxpayers residing abroad) that should be excluded from section 988.

(b) Special Rules for QBUs with a Dollar Functional Currency. The recognition rules of section 988 apply, of course, only to the extent that a taxpayer engages in transactions in a "nonfunctional" currency. In general, a taxpayer's functional currency will conform to the local currency of the environment in which it conducts business. In some cases, however, the special rules of section 985 may require a non-U.S. taxpayer, such as a controlled foreign corporation, to treat the U.S. dollar (or another non-local currency) as its functional currency. In such cases, routine business expenses of the non-U.S. taxpayer, such

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[28] Compare the de minimis rule for investors in original issue discount obligations under proposed regulation section 1.1273-1(a)(3).

as rent or salary payments, technically must be treated as producing foreign currency gain or loss under the Temporary Regulations.

In the view of the subcommittee, the administrative complexity associated with this situation far outweighs any possible policy objectives in terms of achieving correct foreign currency calculations, particularly since, in the vast majority of such cases, payments are made from or received within a few weeks of accrual. Accordingly, the subcommittee suggests that the Temporary Regulations be amended to exempt such ordinary business expenditures of a qualified business unit from the recognition rules of section 1.988-2T(a)(1). For these purposes, a new subsection (6) could be added to Temporary Regulation section 1.988-2T(a)(1)(iii), to read as follows:

> (6) In the case of a qualified business unit treated under section 988(a)(3)(B) as having its residence outside the United States, but which uses or is required to use the U.S. dollar as its functional currency, the disposition of the currency of the local business environment in payment of expenses that would have been deductible under section 162 (other than costs and expenses of financing), if incurred by a U.S. person, and which customarily are paid in that local currency.

2. <u>Foreign Currency Debt Securities</u>. Temporary Regulation section 1.988-2T(b) provides detailed rules for calculating the amount and timing of foreign currency gain or loss on debt instruments that provide for payments in a <u>single</u> foreign currency and that do not provide for any <u>contingent</u> payments.[29] This section of the report first describes and then

[29] As noted above, the Temporary Regulations clearly define section 988 transactions to include more exotic forms of foreign currency debt

critiques those computational rules. The remainder of this section discusses related topics for foreign currency debt securities, including the special rules governing trade date-settlement date currency adjustments.

(a) Description of Computation Rules.

(i) Interest Payments. For accrual method taxpayers, Temporary Regulation section 1.988-2T(b)(2)(ii) requires that qualified periodic interest for each period under a foreign currency debt obligation be accrued in the foreign currency and then translated to the taxpayer's functional currency at the average exchange rate for the period. The resulting dollar amount is treated as interest for all relevant tax purposes. When the amount of accrued interest actually is paid or received (including amounts treated as accrued interest on disposition of a debt instrument), an accrual method taxpayer then recognizes additional foreign currency gain or loss, based on the difference between the average exchange rate used to translate the accrued interest and the spot exchange rate on the payment date[30] Pursuant to the general rule of section 1.988-3T(c), this foreign currency gain or loss is not treated as interest income or expense. Cash method taxpayers are not required to make this two-

(Footnote Continued)
securities, including dual currency obligations and foreign currency-denominated indexed instruments. In view of recent indications that the current proposed regulations concerning contingent payment obligations in general may be withdrawn, the need for specific guidance as to the tax treatment of foreign currency linked contingent obligations can be expected to increase. The subcommittee therefore urges the drafters of the Temporary Regulations to coordinate their efforts with those of their colleagues studying the general contingent payment rules in order to develop computation rules for both U.S. dollar and foreign currency contingent payment instruments expeditiously.

[30] A taxpayer that receives foreign currency payments on a foreign currency bond held as an asset may recognize additional foreign currency gain or loss when the foreign currency is exchanged for the taxpayer's functional currency.

step calculation for stated interest; instead, cash method taxpayers compute interest income or expense simply by translating the relevant foreign currency amounts at the spot exchange rate on the date when actually paid or received.

(ii) Original Issue Discount. Under Temporary Regulation section 1.988-2T(b)(2)(ii)(C), both cash and accrual method taxpayers must accrue original issue discount on a foreign currency debt instrument in the foreign currency and translate the accrued foreign currency amount at the average exchange rate for that period. Additional foreign currency gain or loss (which is not treated as interest) then is recognized on the payment or receipt of the foreign currency cash amounts attributable to the accrued original issue discount, based on the difference between the average exchange rates used to accrue that original issue discount and the spot exchange rate on the date that the foreign currency cash amounts are paid or received. Payments made or received are attributed for this purpose to the earliest accrual period for which original issue discount has accrued and to which prior payments have not been attributed.

(iii) Principal Payments/Dispositions. All taxpayers must recognize foreign currency gain or loss with respect to the payment or receipt of principal (whether at maturity or earlier) or on the disposition of a foreign currency debt obligation. Temporary Regulation section 1.988—2T(b)(5). Such foreign currency gain or loss is not treated as additional interest income or expense.

Generally, the amount of foreign currency gain or loss attributable to the principal amount of a debt security is the difference between the value of the obligation's principal amount in the taxpayer's functional currency (A) using the spot rate in

effect when the taxpayer issued or acquired the obligation (the "historic rate") and (B) using the spot rate on the day principal is paid or received or the obligation is disposed of. Gain or loss in excess of this foreign currency gain or loss (other than amounts attributable to accrued interest or original issue discount) is taxed under general tax principles. For these purposes, the "principal amount" of a debt security is defined as its original issue price, or, in the case of a security acquired or assumed subsequent to original issuance, its "adjusted issue price" (within the meaning of section 1272(a)(4)) at that time. For example, a zero coupon obligation that is issued for Y50 million and accretes to a final value of Y75 at maturity would be treated by the issuer as having a Y50 million "principal amount" for purposes of calculating the issuer's foreign currency gain or loss on payment of the security. (The additional Y25 million would be treated as a payment of accrued original issue discount that also would give rise to foreign currency gain or loss, as described above.)

Section 988's general "netting rule" limits the amount of foreign currency gain or loss recognized on payment or disposition of a foreign currency debt instrument to the amount of overall gain Or loss recognized on the transaction. For example, if a taxpayer sells a foreign currency obligation that would generate $100 of foreign currency gain but only $75 of overall gain, the taxpayer recognizes $75 of ordinary foreign currency gain and no offsetting loss.

(b) Critique of Computational Rules.

(i) Foreign Currency Gain or Loss Treated as Separate from Interest. As noted above, Temporary Regulation section 1.988-3T(c) provides that, except in very limited circumstances,

foreign currency gain or loss is not treated as interest income or expense.[31] The subcommittee believes that the broad application of this rule misses an important opportunity to rationalize the tax treatment of foreign currency debt instruments by integrating foreign currency gains and losses with interest income and expense in appropriate circumstances.

As described above, under Temporary Regulation section 1.988-2T(b), foreign currency "interest" payments made or received by an accrual method taxpayer are treated in part as interest for tax purposes (based on average exchange rates for each accrual period) and in part as foreign currency gain or loss (based on spot exchange rates on the date payments actually are made or received). Because different source rules apply to interest and to foreign currency gain or loss for U.S. foreign tax credit purposes, this bifurcation approach creates significant foreign tax credit uncertainties for investors and issuers of foreign currency debt instruments, as well as for the fisc.[32] For example, foreign withholding tax on interest typically will be calculated by reference to the gross foreign currency interest payments. However, a portion of those payments when received by a U.S. investor will be treated as U.S.-source foreign currency gain or loss -- a result that might increase or decrease the available U.S. foreign tax credit attributable to the foreign tax actually imposed. Similarly, a U.S. issuer of a foreign currency debt instrument generally must allocate its interest expense between U.S. and foreign sources according to the principles of regulation sections 1.861-8T through 1.861-14T.

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[31] One appropriate exception treats foreign currency loss in respect of a tax-exempt debt instrument as an offset to otherwise tax-free interest income.

[32] The need for two separate calculations in respect of each interest payment on a foreign currency debt instrument also will make compliance difficult for taxpayers that have substantial numbers of foreign currency debt instruments as assets or obligations.

Under the bifurcation approach of Temporary Regulation section 1.988-2T(b), the amount treated as allocable interest expense, as opposed to U.S. source foreign currency gain or loss, will fluctuate in each period with movements in average exchange rates.

If a U.S. issuer hedges the foreign currency exposure on its debt obligation in a manner that falls short of the requirements for integrated treatment under Temporary Regulation section 1.988-5T(a), it faces an even more arbitrary regime. For foreign tax credit purposes, regulation section 1.861-9T(b)(1) generally would treat any loss recognized on that currency hedge as an "interest equivalent" subject to the allocation rules. Any <u>gain</u> recognized on the hedge, however, would not be allowed as an offset to the foreign currency interest expense on the taxpayer's debt obligation. In the case of interest rate hedges (<u>i.e.</u>, hedges that provide for payments in the <u>same</u> currency as the hedged obligation), regulation section 1.861-9T(b)(6) now allows a taxpayer to offset gains on identified hedges against its otherwise allocable interest expense. Foreign currency hedges, however, are governed by regulation section 1.861-9T(b)(7), which limits the application of these favorable netting principles to foreign currency gain or loss "that is treated as an adjustment to interest expense under regulations issued under section 988 ...." In failing to treat foreign currency gain or loss as interest in most situations, Temporary Regulation section 1.988-3T(c) thus effectively <u>precludes</u> application to hedged foreign currency debt obligations of the rational interest allocation rules now available for hedged U.S. dollar borrowings.

In the subcommittee's view, most of these difficult issues would not arise if Temporary Regulation section 1.988-3T(c) were modified to treat foreign currency gain or loss

recognized in respect of interest payments on a debt instrument described in section 988(c)(1)(B) as an adjustment to the taxpayer's interest income or expense for all tax purposes. The problems described above make a compelling case for adoption of such a rule for interest payments.

The subcommittee recognizes that Congress explicitly rejected a pure "interest equivalency" approach in enacting section 988. What Congress rejected, however, was the theory that all foreign currency gain or loss is always in the nature of interest, regardless of the underlying transaction to which that gain or loss relates. There is a world of difference between this rejected theory and the proposition and concluding that foreign currency gain or loss associated with <u>actual</u> interest income or expense should also be treated as interest (the approach suggested here). Moreover, authority for such a rule appears in section 988(a)(2). Moreover, the subcommittee firmly believes that the practical improvement in anticipated taxpayer compliance as a result of replacing the current "bifurcation" rules for interest on foreign currency debt instruments with a new "unitary" principle would outweigh by far any possible diminution in theoretical purity of the Temporary Regulations' overall bifurcation approach to foreign currency gains and losses.

The subcommittee recognizes that, if the final section 988 regulations adopt our recommendation to treat foreign currency gain or loss associated with interest income or expense as subsumed to interest, correlative adjustments to the regulations will be needed to deal with the sourcing of interest hedges. Imagine, for example, that a taxpayer owns a Swiss Franc-denominated bond issued by a foreign issuer, and that the taxpayer hedges the currency exposure associated with one or more of its interest coupons. In the absence of a special rule, and if

our recommendation with respect to interest is adopted, the taxpayer's interest income from its bond will be entirely foreign source, while its hedge gains or losses will be U.S. source (under the general residence-based sourcing rules of Temporary Regulation section 1.988-4T).

Indeed, the subcommittee understands that a partial explanation for the current statutory regime (under which foreign currency gain or loss in not treated as interest, except by regulation) is that the drafters of the statute believed that most foreign currency assets and obligations are hedged: since the consistency rules of section 988 (d) (discussed in Part VIII, below) are not self-executing, the drafters of the statute in effect assured consistency in sourcing prior to the promulgation of comprehensive section 988(d) regulations by treating foreign currency gain or loss associated with interest as separate from that interest, and therefore (like the associated hedge that the drafters believed would also be present) subject to the general residence-based sourcing rules of section 988.

The subcommittee has no quarrel with the interim solution adopted by the drafters of section 988, or even with the premise that most taxpayers hedge most foreign currency flows most of the time. As described above, however, even when currency flows are fully hedged, the rough-and-ready interim solution adopted by the statute produces its own anomalies, and the premise underlying that interim solution (that all flows are hedged) is certainly untrue in a substantial number of cases.

In the context of comprehensive regulations, the resolution of the dilemma is straightforward -- and, we would argue, expressly contemplated by section 988(a)(2). Foreign currency gain or loss associated with actual interest income or

expense should be subsumed to interest, and, under expanded section 988(d) regulations, <u>hedges</u> of the foreign currency component of interest or expense should be sourced consistently with that interest. Thus, in our view, the potential for source mismatches highlights more the need for expanded section 988(d) regulations to provide consistent rules than it does any conceptual flaw in a unitary approach to foreign currency interest payments.

Although the arguments are not quite so compelling, the subcommittee believes that an interest characterization rule also appropriately could be applied to any foreign currency gain or loss recognized with respect to the principal amount of a debt instrument. Currency fluctuations on the principal amount of a debt instrument in large part serve as an economic adjustment for changes in the prevailing interest rates in each currency, and thus can be considered one component of a taxpayer's overall borrowing cost or investment return in connection with a foreign currency denominated debt instrument. A rule that treated foreign currency gain or loss recognized on retirement or disposition of a debt instrument in the same manner as interest on that instrument therefore would accord in most cases with economic reality, while reducing the sourcing anomalies described above. The subcommittee recognizes, however, that a rule recharacterizing a portion of the principal amount of a debt security in effect as interest income or expense would represent a significant theoretical departure from existing principles, and may prove more difficult to implement than the “unitary” approach to foreign currency interest payments suggested above.

(ii) <u>Average Exchange Rates</u>. Temporary Regulation section 1.988-2T(b) requires the computation of an average exchange rate for a number of purposes, including, as discussed

above, the determination Of the rate at which interest income and interest expense accrue in the case of taxpayers using the accrual method of accounting and the rate at which original issue discount accrues for all taxpayers. Temporary Regulation section 1.988-2T(b)(2)(iii) provides that an average exchange rate for a period shall be an average daily rate for each business day in the period "or other average exchange rate ... reasonably derived and consistently applied by the taxpayer." The Temporary Regulations contain no explanation of the types of "other" calculations of average exchange rates that will be considered to be "reasonably derived".

Average exchange rates will need to be calculated by many taxpayers on whom the cost of a complicated average exchange rate calculation should not be imposed, including cash method taxpayers computing original issue discount and accrual method taxpayers whose resources or whose section 988 transactions do not justify the cost. The flexibility allowed to taxpayers in adopting spot rate conventions for payables and receivables under Temporary Regulation section 1.988-lT(d)(3) does not obviate the need for simplified average rate computations in other contexts. The Temporary Regulations, therefore, should make clear that simplified methods of determining an average exchange rate generally are acceptable if consistently applied. These methods should include, for example, in appropriate circumstances, averaging the spot rates at the beginning or end of each accrual period.

(iii) <u>Special Issues for Original Issue Discount Obligations</u>. The unique nature of debt instruments issued with original issue discount creates special complexities where such instruments are denominated in a foreign currency. Under section 1272, the holder of an original issue discount obligation is

required to include original issue discount in income as that discount accrues over the term of the obligation, in advance of the receipt of the cash attributable to that income. The amount so included in income then effectively is added to the "principal" of the obligation (as an increase in the "adjusted issue price") for purposes of computing the income deemed accrued in subsequent periods.[33] Consequently, the amount of original issue discount accrued in each period takes on a dual nature -- as both "interest" and "principal" on the obligation. Where the obligation provides for payments in a taxpayer's functional currency, the dual nature of those payments raises no special tax issues. For payments denominated in a nonfunctional currency, however, the dual nature of those payments clashes squarely with the differing rules for measuring foreign currency gain or loss with respect to interest and principal amounts.

Temporary Regulation Section 1.988-2T(b)(2)(ii)(C), following the method suggested in the legislative history to the 1986 Act,[34] provides for accrued original issue discount to be translated into a taxpayer's functional currency based on the average exchange rate for the accrual period -- the same rule that applies to the translation of accrued interest on a "par" obligation. Unlike interest on a classic par obligation, the accrued amounts of original issue discount are not periodically paid to investors. Thus, there is no opportunity for periodic adjustment to account for differences between average and spot rates. Moreover, no recognition of variations between historic and spot rates occurs when the accrued foreign currency original issue discount effectively is added to the principal of the

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[33] Section 163(e) provides corresponding rules for the deductions allowed to the issuer of an original issue discount obligation.

[34] See S. Rep. No. 99-313, 99th Congress, 2nd Session at 461-463 (1986).

obligation. Consequently, as an economic matter, a distortion occurs in the functional currency amount reported in respect of the accrued foreign currency original issue discount in each period.

The extent of this distortion can be seen by com-paring the tax results for the issuer of a foreign currency zero coupon obligation with those of a transaction that produces identical cash flows -- issuing a foreign currency “par” obligation and purchasing an annuity contract that effectively defeases the issuer's periodic coupon obligations on its par bond. In the latter case, the issuer will deduct for each period the coupon interest paid on its par obligation, in a net amount based on the spot exchange rate on the payment date (i.e., accrued average rate plus payment date foreign currency adjustment). In addition, the issuer will receive a payment on its annuity contract that has both an interest component (translated at a net spot rate) and a principal component (translated at the payment date spot rate with an adjustment for differences from the historic rate for the annuity). The issuer's net deduction for the transaction thus can be expressed as (x) the excess of the coupon interest on the par obligation over the interest portion of the annuity (translated at the net spot rate for the payment date), (y) reduced or increased by the currency adjustment for the principal component of the annuity payment.

As the following tables illustrate, the results obtained for a foreign currency original issue discount obligation by following the Temporary Regulation's mandate to translate at the average exchange rate for each period will differ markedly from the treatment of the paradigm par bond plus annuity. These tables further indicate that the appropriate similarity in results for these two cases would be obtained by translating accrued original

issue discount at the historic rate for the obligation. This reflects the fact that foreign exchange gain or loss is not in fact realized until payment is made in the devalued or revalued foreign currency. Although use of the historic rate, rather than a spot or average rate, might seem counterintuitive, it can be seen that the combined effects of the currency adjustments for principal (historic vs. spot) and interest (average vs. spot) payments on the corresponding par bond and annuity are equivalent economically to a rate that simply applies the historic rate to accrued original issue discount. Each table below uses a hypothetical 3-year Deutschmark obligation and assumes, for simplicity, a historic exchange rate of DM1/$1. The value of the Deutschmark then is assumed to decline by DM0.5 per dollar in each period (e.g., to DM1.5/$1, etc.).

TABLE 1

8% Deutschmark Zero Coupon Bond -- Translating at Average Exchange Rates for Each Period

Year	Adjusted Issue Price (Beg. Year in DM	Accrued OID(in DM)	$Value of Accrued OID
1.0	DM 79.03	(DM 3.16)	$2.53(DM 1.25/$1)
1.5	82.19	(3.29)	1.88(DM 1.75/$1)
2.0	85.48	(3.42)	1.52(DM 2.25/$1)
2.5	88.90	(3.56)	1.29(DM 2.75/$1)
3.0	92.46	(3.70)	1.14(DM 3.25/$1)
3.5	96.16	(3.84)	1.03(DM 3.75/$1)
		(DM 20.97)	$9.39

TABLE 2

8% Deutschmark Par Bond Plus Annuity to Defease Semiannual DM4 Coupon Payments (in Deutschmarks)

Year	Princ. Balance Of Annuity	Princ. Portion of Annuity Payment	Int. Portion of Annuity Payment	Coupon on Par Bond	Net Deduction
1.0	DM 20.97	DM 3.16	DM 0.84	(DM 4)	(DM 3.16)
1.5	17.81	3.29	0.71	(4)	(3.29)
2.0	14.52	3.42	0.58	(4)	(3.42)
2.5	11.10	3.56	0.44	(4)	(3.56)
3.0	7.54	3.70	0.30	(4)	(3.70)
3.5	3.84	3.84	0.16	(4)	(3.84)
					(DM 20.97)

TABLE 3

Year	Princ. Portion Of Annuity Payment (at Payment Date Rate)	Currency Loss on Princ. Portion of Annuity (Historic vs. Spot)	Int. Portion of Annuity Payments (at Net Payment Date Rate	Coupon on Par Bond (at Net Payment Date Rate)	Net Deduction (in $)
1.0	DM 3.16/$2.11 [DM 1.5/$1]	($1.05)	DM 0.84/$0.56	(DM 4/$2.67)	($ 3.16)
1.5	DM 3.29/$1.65 [DM 2.0/$1]	($1.64)	DM 0.71/$0.35	(DM 4/$2.00)	($ 3.29)
2.0	DM 3.42/$1.37 [DM 2.5/$1]	($2.05)	DM 0.58/$0.23	(DM 4/$1.60)	($ 3.42)
2.5	DM 3.56/$1.19 [DM 3.0/$1]	($2.37)	DM 0.44/$0.15	(DM 4/$1.34)	($ 3.56)
3.0	DM 3.70/$1.05 [DM 3.5/$1]	($2.64)	DM 0.30/$0.09	(DM 4/$1.15)	($ 3.70)
3.5	DM 3.84/$0.96 [DM 4.0/$1]	($2.88)	DM 0.16/$1.04	(DM 4/$1.00)	($ 3.84)
					($20.97)

Based on the above tables, it would appear correct, from an economic standpoint, to amend the Temporary Regulations to provide for translation of accrued original issue discount at an obligation's historic exchange rate. Utilizing historic exchange rates for accrued original issue discount also makes sense, given that the foreign currency amounts in question in fact are not paid or received currently by the taxpayer. Nonetheless, the subcommittee is sensitive to the issues raised by the contrary method suggested in the 1986 Act legislative history. We therefore suggest that this area be studied carefully as a subject for possible future modifications to the Temporary Regulations. In this respect, it may be worth considering

adopting a rule that utilizes historic exchange rates for original issue discount obligations that do not exceed a specified maturity (perhaps 5 years), in order to limit the disparities between the results achieved under such a regime and the results reached under the more intuitively structured approach of the Temporary Regulations.

One other special problem for foreign currency denominated original issue discount obligations can easily be resolved, however. The Temporary Regulations provide that, for purposes of calculating foreign currency gain or loss, the principal amount of a foreign currency debt instrument acquired after original issuance is determined by reference to its "adjusted issue price." This calculation rule produces appropriate results for the majority of cases where an obligation in fact is acquired for a purchase price roughly equal to its adjusted issue price. In cases, however, where a taxpayer purchases a foreign currency denominated original issue discount obligation in the secondary market at a market discount or premium to its adjusted issue price, a rule that looks to the obligation's adjusted issue price distorts the proper calculation of foreign currency gain or loss on retirement or disposition of the obligation.[35] Again, this distortion results from the special dual nature of amounts accrued on an original issue discount obligation, and the mechanisms that adjust a taxpayer's accrual schedule to account for market discount or premium.

As a theoretical matter, the correct calculation of foreign currency gain or loss for such an obligation could be obtained by requiring a separate foreign currency adjustment in each accrual period to take account of the change from historic

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[35] See the comment letter on this point by Jeffrey M. O'Donnell of Baker & McKenzie, dated December 14, 1989, 89 Tax Notes Today 255-42 (December 20, 1989).

exchange rates as applied to the amortized premium or market discount amount. A much simpler, and equally precise, solution, however, is simply to use the <u>purchase</u> <u>price</u> of a foreign currency denominated original issue discount security, rather than its adjusted issue price, for purposes of the foreign currency calculations required under Temporary Regulation section 1.988-2T(b)(5).

(c) <u>Use of Trade Date or Settlement Date to Compute Exchange Gain or Loss</u>. Under section 453(k), taxpayers generally are required to calculate the amount paid or received in connection with the purchase or sale of publicly-traded stocks or securities as of the trade date. Temporary Regulation section 1.988-2T(a)(2)(iv) provides a special rule that allows a <u>cash method</u> taxpayer to avoid separately calculating foreign currency gain or loss for such a purchase or sale during the trade date-settlement date period, and instead simply to compute the relevant amounts using the exchange rate as of the transaction's settlement date. This rule applies whether the stock or securities are denominated in a functional or nonfunctional currency.

Taxpayers using an accrual method of accounting, however, apparently are required to use the trade date to compute exchange gain or loss for the period from acquisition to disposition of a nonfunctional currency debt instrument, and to create a short-term payable (with respect to the acquisition of an instrument) or a short-term receivable (with respect to the disposition of an instrument), in each case from the trade date to the settlement date.[36] Temporary Regulation section 1.988-

[36] Under Temporary Regulation section 1.988-2T(b)(5), the appropriate exchange rate to be used for retirement of an obligation, as versus a disposition, appears to be inconsistent. With respect to retirement of nonfunctional currency debt instruments, the reference to the date payment is "received from the obligor" appears to refer to the

2T(c). In most cases, the amount of exchange gain or loss realized during that short period will be small, and calculation of exchange gain or loss for that period will result in unnecessary additional complexity in complying with section 988. The subcommittee believes that the Service should exercise its regulatory authority to extend the special trade date-settlement date rule of Temporary Regulation section 1.988-2T(a)(2)(iv) to accrual method taxpayers, at least where normal settlement periods (i.e., five days) are involved.

Moreover, the subcommittee believes that this rule of convenience should be extended to apply to dispositions or acquisitions of non-exchange-traded foreign currency stocks and securities, again, assuming relatively short periods between trade date and settlement date. Such a rule need not interfere with general tax principles that determine the taxable year in which an acquisition or disposition is deemed to occur, but would alleviate coordination issues with other substantive tax rules. To the extent that Temporary Regulation section 1.988-2T(b)(5) requires calculation of exchange gain or loss on the settlement date, for example, it may be internally inconsistent (to the extent calculations also appear to be based on the trade date) and in-consistent with the broker reporting rules. The broker reporting rules require brokers to report sales of stock and securities as occurring on the trade date. See Announcement 88-6, 1988-3 I.R.B. 52. In addition, absent a simplifying assumption as

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(Footnote continued)
settlement date, while, with respect to dispositions, the reference to the date the instrument is “disposed of” appears to refer to the trade date. With respect to acquisitions of nonfunctional currency debt instruments, the reference to the date the instrument is “acquired” appears to refer to the trade date. Wholly apart from the other modifications suggested in the text, the subcommittee believes that this language should be clarified so that the Temporary Regulations specify either that the trade date or the settlement date exchange rate is to control for both acquisitions and all forms of dispositions of foreign currency debt instruments.

to the general application of settlement date exchange rates, brokerage firms and others that are required to file information statements and that provide the relevant exchange rates to their customers will be required to report exchange rates for both the trade date and the settlement date of each transaction, because they will not know whether their customers are cash or accrual method taxpayers. That additional compliance cost and complexity favors use of the same exchange rate rule for all purchases and sales of foreign currency stocks and securities that are settled within a reasonable period that conforms to standard industry settlement practice.

(d) Convertible and Exchangeable Debt. Temporary Regulation section 1.988-2T(b)(13) provides that, on the acquisition of a foreign currency debt instrument by the obligor in exchange for its stock (whether pursuant to the terms of the debt instrument or otherwise), the holder and the obligor will recognize foreign currency gain or loss with respect to the principal "and accrued interest" on the debt instrument.

The subcommittee recommends that this provision be expanded to apply to exchanges; of debt for equity in entities other than corporations, e.g., partnerships and trusts. In addition, the application of this rule to "accrued interest" in certain circumstances should be clarified. Many convertible and exchangeable debt instruments provide that no interest will be paid with respect to the period from the last interest payment date to the date of conversion or exchange, and in those cases the obligor receives no deduction for interest accrued during that period.[37] Holders of convertible and exchangeable debt similarly recognize no income with respect to that accrued

interest upon a conversion or exchange.[38] The Temporary Regulations should clarify that no foreign exchange gain or loss will be recognized with respect to interest accrued to the date of such an exchange to the extent that, in the case of the holder, the interest is, not taken into account as interest income and, in the case of the obligor, the interest is not deductible.

3. Calculation of Exchange Gain or Loss For Short-term Trade Receivables and Payables. Temporary Regulation section 1.988-2T(c) requires an accrual method taxpayer to compute foreign currency gain or loss on trade receivables and payables for the period beginning on the booking date and ending on the payment date. In the case of short-term trade receivables and payables, a requirement that a separate foreign currency gain or loss be computed can substantially and unnecessarily increase the cost of complying with section 988.

The Temporary Regulations should permit an election to exclude short-term trade receivables and payables from the "bifurcation" principles of section 988. Section 988(c)(1)(B) provides authority for that result; it grants the Service authority in this context[39] to exclude from the scope of section 988 transactions "any class of items the taking into account of

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[37] See, e.g., Tandy Corporation v. United States, 626 F.2d 1186 (5th Cir. 1980) (convertible debt); Husky Oil Company v. Commissioner, 83 T.C. 717 (1984) (debt ex-changeable into parent stock).

[38] In a recapitalization exchange of securities for stock (and other property, if any), however, a holder is taxable on accrued interest to the extent stock (and any other property) received is attributable to accrued interest. See section 354(a)(2)(B).

[39] Section 988(c)(1)(B) provides for regulations to exclude transactions from the application of section 988(c)(1)(B)(ii), which provides that "accruing (or otherwise taking into account) ... any item of expense of gross income or receipts which is to be paid or received after the date on which so accrued or taken into account" is a section 988 transaction.

which is not necessary to carry out the purposes of this section by reason of the small amounts or short periods involved, or otherwise." The legislative history of section 988(c)(1)(B) specifically contemplated that short-term trade receivables and payables would be excluded:

> "The Secretary is authorized to prescribe regulatory rules that exclude certain transactions from the definition of a section 988 transaction. The bill contemplates that regulations will except any class of items the taking into account of which is not necessary to carry out the purposes of the rules for foreign currency gain or loss derived from section 988 transactions. Examples of items that are within the scope of the Secretary's regulatory authority are trade receivables and payables that have a maturity of 120 days or less, and any other receivable or payable with a maturity of six months or less that would be eligible for exclusion under section 1274 (relating to the determination of issue price of debt issued for nonpublicly traded property)." S. Rep. No. 99-313, 99th Cong., 2d Sess. 460 (1986) (emphasis added).[40]

The subcommittee recommends that the Service exercise its regulatory authority by permitting accrual method taxpayers to elect to apply rules similar to the special trade date-settlement date rules for exchange-traded stocks and securities described above for foreign currency payables and receivables that have a maturity of 60 days or less.[41] Under such a rule, the timing of recognition of accrued amounts would not be affected, but the functional currency amount of those items would be determined by reference to the spot exchange rate on the date

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[40] To the same effect is Staff of the Joint Committee, General Explanation of the Tax Reform Act of 1986, 1097 (1986).

[41] We propose limiting the rule to 60 days, among other reasons, so as to ensure that taxpayers will have the information available to calculate year-end gains and losses prior to the due dates of returns.

payment was made or received. To the extent this rule were limited to payables or receivables with a 60-day term, a taxpayer would have information concerning the relevant payment date exchange rates before the due date of the taxpayer's return, even in respect of payables or receivables incurred on the last day of a taxable year. Any possibility for abuse of this rule could be restricted by requiring a taxpayer to elect such simplified treatment for all of its affected payables and receivables.

4. Derivative Instruments (Forwards, Futures and Options). Temporary Regulation section 1.988-2T(d) provides certain rules for the realization of foreign currency gain or loss with respect to what this report terms "Derivative Instruments" -- that is, forward contracts, futures contracts and option contracts that are treated as section 988 transactions. In general, that section treats all gain or loss from Derivative Instruments that qualify as section 988 transactions (see Section II.1. above) as foreign currency gain or loss.

(a) Offsetting Contracts. Temporary Regulation section 1.988-2T(d)(2)(i) provides that foreign currency gain or loss with respect to a section 988 forward, futures, or option contract generally is realized in accordance with the applicable realization sections of the Code. Temporary Regulation section 1.988-2T(d)(2)(ii) provides generally that foreign currency gain or loss shall not be realized solely because such a transaction is offset by another transaction (or transactions), even with the same counterparty.[42] An exception to this rule applies if a taxpayer derives, by pledge or otherwise, an economic benefit

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[42] An exception to the general rule applies to forward, futures, or options contracts traded on an exchange, where it is the general practice of the exchange to terminate offsetting contracts. Temporary Regulation section 1.988-2T(d)(2)(ii)(C).

(e.g., the proceeds from a borrowing) from any gain inherent in such offsetting positions.

The subcommittee agrees with the general principle that entering into an offsetting forward or futures contract at -- least with a third party -- is not a realization event unless the offsetting contract results in a termination of the contracts under the rules of a securities or commodities exchange. A forward contract on foreign currency, for example, is merely an executory contract to buy or sell the underlying currency at a future date. If a taxpayer with a position in a forward contract enters into an offsetting contract with a third party the taxpayer economically has two separate legal obligations, even though the terms of the two contracts are offsetting. In such case there are different credit risks with respect to each contract: if the other party on one of the contracts were to enter into bankruptcy, or otherwise default on the contract, the taxpayer still would be required to perform and would be able to derive gain or loss from the other contract. In addition, if either of the offsetting contracts are terminated, the other contract still would be outstanding and additional gain or loss could be recognized on such contract. Accordingly, such third party offsetting contracts should be treated as remaining open for tax purposes until there is delivery of the underlying currency or until the contracts are actually terminated. This treatment is consistent with the treatment of economically similar offsetting positions, including "short sales against the box" (which do not result in realization of gain or loss until the closing of the short sale).[43]

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[43] See regulation section 1.1233-1(a); Bingham v. Commissioner, 27 B.T.A. 186 (1932); Richardson v. Commissioner, 121 F.2d 1 (2d Cir. 1941).

If a taxpayer has a position in a forward contract with a counterparty and enters into an identical offsetting forward contract with the same counterparty, the different credit and other factors described above do not exist.

[44] Accordingly, the subcommittee believes that the Service could justify a modification to Temporary Regulation section 1.988-2T(d)(2)(ii) that constructs a realization event at the time that a taxpayer enters into an offsetting contract with the same (or related, within the meaning of section 267(b)) counterparty, even if the contracts are not formally terminated. Any other rule effectively permits taxpayers to choose whether gain or loss should be recognized depending solely on the form of the transaction in a situation where the form has little or no effect on the underlying economics.

The subcommittee also notes that in some, cases the failure to reat economically offsetting contracts as closed may result in anomalies. For example regulated investment companies which are required to distribute taxable income may be subject to "tax ransom" if they terminate one position but a counterparty in the offsetting contract is reluctant to terminate also. The subcommittee therefore suggests that taxpayers be allowed to make a one time election similar to that under section 988(c)(1)(D)(ii) (which would not be revocable without the consent of the Service) to recognize gain or loss at the time

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[44] The subcommittee recognizes that, at least under the bankruptcy laws of the United States, there may exist differences between cashing out an executory contract position, on the one hand, and holding offsetting positions with the same counterparty, on the other. We do not believe, however, that as a commercial matter market participants enter into such offsetting swaps with counterparties that pose meaningful bankruptcy risks. Accordingly, the Temporary Regulations should not treat these possible U.S. bankruptcy law anomalies as having greater weight than a taxpayer's ability to elect to defer the recognition of built-in gain with minimal economic risk (through an offsetting position with the same counterparty), or recognize currently built-in loss (through terminating its position).

that foreign currency Derivative Instruments economically are offset with identical contracts entered into with third parties, even where those contracts do not effect a formal termination of the taxpayer's offsetting positions. Such an election would apply to all of a taxpayer's foreign currency contracts which are so offset and should only apply in situations where the taxpayer adopts the same treatment for financial accounting purposes.

(b) Contract Extensions. Temporary Regulation section 1.988-2T(d)(2)(v) treats the extension of the maturity date for a forward, future or option contract as a taxable sale or exchange of the expiring contract for its fair market value and the establishment of a new contract on the extension date. If, under the terms of the contract extension, the time value of any such implicit gain or loss is used to adjust the pricing of the extended contract (as in a so-called “historic rate rollover”), that time value amount is treated as interest, rather than foreign currency gain or loss, paid between the parties. As further described in Part VII, below, this rule will create practical difficulties for business taxpayers that typically use extended contracts for bona fide hedging purposes and that are unable to comply with the requirements for integrated treatment under Temporary Regulation section 1.988-5T(b).

5. Notional Principal Contracts and Currency Swaps.(a) General. The legislative history to the 1986 Act indicates that foreign currency notional principal con-tracts are intended to qualify as Derivative Instruments described in section 988(c)(1)(B)(iii), and accordingly are covered by the rules of section 988(b)(1)(C), which provide that "any gain or loss from such transactions shall be treated as foreign currency gain or loss ..." Temporary Regulation section 1.988-2T(e) has two sets of timing rules for these notional principal contracts, a general rule for notional principal contracts that are not currency swaps and a group of specific rules which deal with currency swaps. In each case the rules assume that gain or loss on such contracts is treated entirely as foreign currency gain or loss. Some commentators have indicated confusion, however, about the use of the terms "gain and loss" in place of the broader "income and expense," particularly in light of the characterization uncertainties caused by the Arkansas Best case. To avoid any potential for confusion concerning the intended application of the Temporary Regulation's substantive rules to foreign currency notional principal contracts, the subcommittee recommends that Temporary Regulation section 1.988-2T(e) also include a general computational rule similar to that for forwards, futures and options under Temporary Regulation section 1.988-2T(d)(4) that clarifies that all income (or expense) in respect of foreign currency notional principal contracts and currency swaps is to be treated as "foreign currency gain" or "foreign currency loss" subject to the general rules of section 988.

(b) Notional Principal Contracts. Notional principal contracts are defined as interest rate swaps, caps, floors, collars or similar financial instruments that provide for payments by one party to another at specified intervals measured by interest rates and notional principal amounts, in exchange for

specified consideration or a promise to pay similar amounts. The general timing rule for notional principal contracts (other than currency swaps) requires that "exchange gain or loss ... shall be realized according to the taxpayer's method of accounting, so long as that method clearly reflects income." Temporary Regulation section 1.988-2T(e)(1). That section goes on to restate the principle of Notice 89-21, 1989-1 C.B. 651, that, where a payment received in one year relates to an obligation to make payments in other years, "a method of accounting that properly recognizes the payment received over the life of the contract clearly reflects income."

The vagueness of this section of the Temporary Regulations apparently results from a determination that the question of the proper timing of income or expense from notional principal contracts (other than currency swaps) should be resolved in the same fashion whether or not a nonfunctional currency is involved, and that these timing issues are to be resolved in the forthcoming regulations implementing Notice 89-21. The subcommittee is strongly in favor of this conformity approach, but urges the Service to issue those regulations in a timely fashion in order to avoid further confusion in the growing market for notional principal contracts.

(c) Currency Swaps. (i) Definitions. Currency swaps are subject to more specific timing rules than other notional principal contracts. Temporary Regulation section 1.988-5T(a)(4)(ii) generally defines a "currency swap" as a contract between two or more parties to: (x) exchange periodic interim payments ("periodic payments") in different currencies at a single "swap exchange rate," where the payments in each currency are computed by reference to a specified interest index as applied to the swap principal amount ("swap principal"); and (y)

exchange the swap principal amounts at maturity of the contract (and, if desired, at inception of the contract) at the same swap exchange rate. The interest index can differ for each currency. For example, the currency swap definition would cover an agreement for A to pay B $150 at the end of two years and to pay 10% of the dollar swap principal amount at the end of each of the two years, coupled with an agreement for B to pay A £100 at the end of two years and to pay 12% of the pound swap principal amount at the end of each of the two years. See Temporary Regulation section 1.988-2T(e)(5), Example 1.

By requiring that each set of periodic payments be determined by reference to a single swap exchange rate and a single interest rate index, this definition technically fails to describe a variety of contracts that taxpayers normally would think of as currency swaps. For example, it is common for currency swaps involving an initial exchange of principal payments to use different exchange rates for that initial exchange and for all other cash flows under the swap. Similarly, the Temporary Regulations' definition would not include swaps that provide for non-level payments over the contract term. In fact, the definition of a currency swap in Temporary Regulation section 1.988—5T(a)(4)(ii) does not cover certain examples of currency swaps described elsewhere in the Temporary Regulations. See, e.g., Temporary Regulation section 1.988-2T(e)(5), Example (2), which illustrates the special timing rules for currency swaps, as described below.

In the subcommittee's view, the crucial distinguishing features of a currency swap involve the agreement by the parties for the bilateral exchange of periodic payments in different currencies over a specified term, where the payments due on each scheduled date (or the method of determining those amounts) in

each currency are specified in advance. Provided that the contract clearly indicates the payments to be made on each date, there is no need to limit their calculation to a single exchange rate or a single interest index, or even to require that swap principal be exchanged exclusively at maturity. Because Temporary Regulation section 1.988-2T(e) generally provides sensible tax accounting rules for currency swaps that are not part of a qualified hedging transaction, an expansive definition presents no opportunity for tax avoidance. The anti-abuse rules set out in Temporary Regulation section 1.988-5T(a)(4)(iii) also provide the Service with the authority to defer recognition of questionable income or expense under a purported currency swap until maturity of the contract.

The subcommittee therefore believes that the definition of "currency swap" in Temporary Regulation section 1.988-5T(a)(4)(ii) can be simplified substantially, for example to read as follows:

> "A currency swap contract is a contract between two or more parties to exchange one or more payments in one currency for more than one payment in a different currency according to a fixed schedule, where the payments to be made on each date in each currency, or the method used to compute those payments, is clearly indicated in the contract."

(ii) General Timing Rules. The timing, but not the source or character, of the foreign currency gain or loss for a currency swap which has no upfront payments ("swap premium") generally is determined as if the swap consisted of two debt obligations, except that all gain or loss from the transaction is treated as exchange gain or loss. Under the rules applicable to foreign currency debt obligations (see Part IV.2 above), foreign

currency gain or loss generally is recognized when a payment of swap principal is made or when a periodic payment accrued is actually paid. For currency swaps, the amount that would constitute net interest income or expense on each of the two hypothetical loans is also recognized as exchange gain or loss when it is paid or accrued.

We agree with the general approach taken by the Temporary Regulations that the timing of foreign currency gain or loss on a complex currency, swap should be determined by treating a swap as two hypothetical debt obligations. As pointed out earlier, however, we believe that the Temporary Regulations unnecessarily complicate the analysis of foreign currency loans themselves, by treating, for example, every interest coupon paid or received by an accrual method taxpayer as involving two (or, in some cases, three) separate taxable events. The extension of the foreign currency bond rules to currency swaps should lend still greater weight to our argument that the simplification of the foreign currency bond rules is highly desirable.[45]

Similarly, the subcommittee does not understand the rationale behind the rule of Temporary Regulation section 1.988-2T(e)(2)(iii), which provides that foreign currency gain or loss in respect of swap principal payments is to be realized only when swap principal amounts are exchanged at maturity, irrespective of the fact that, under the general timing principles described above, a portion of certain periodic swap payments in some cases might be characterized as a partial principal payment. <u>See</u> Example 2 of Temporary Regulation section 1.988-2T(e)(5). To the

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[45] Little purpose would seem to be served, for example, in requiring an accrual method taxpayer to create a receivable for the period between the accrual and payment dates of each periodic swap payment, given that all the amounts in question will qualify as foreign currency gain or loss.

extent that the drafters of the Temporary Regulations intended to conform the treatment of currency swap positions to the timing rules developed for debt instruments, a better approach would be to require recognition of implicit foreign currency gain or loss on the receipt or payment of amounts representing swap principal, regardless of whether those amounts arise at or prior to maturity of the swap contract.

6. Currency Swap Premium. For currency swaps with swap premium, the portion of the premium which is due to differences between the exchange rate under the swap contract (the "swap exchange rate") and the spot rate on the date the contract is entered into is taken into account as an item of income or expense only at maturity of the contract. The portion of the premium attributable to differences in the present value of the periodic payments (at the swap exchange rate) to be made and received by each party (i.e., interest rate differences) is taken into account over the term of the contract on a constant-yield basis similar to the amortization of bond premium on a debt security. The purpose of taking the exchange rate and interest rate differentials into account in this manner is to construct a regime that conforms the after-tax yield of a premium or discount swap to a market-rate swap that does not have swap premium or discount. While the subcommittee agrees with this result, we would have preferred to see the operative principles set out in greater detail, rather than being implied through examples.

V. CHARACTER OF EXCHANGE GAIN AND LOSS TEMPORARY REGULATION SECTION 1.988-3T).

1. General Rules. Temporary Regulation section 1.988-3T implements section 988's direction that foreign currency gain or loss attributable to a section 988 transaction generally be

treated as ordinary income or loss. Temporary Regulation section 1.988-3T(a) appropriately clarifies that ordinary treatment under section 988 is intended to override other special character rules, including 60/40 capital gain or loss treatment for section 988 transactions that also are section 1256 contracts, and the capital gain or loss rules under sections 1233, 1234 and 1236.

2. Special Treatment for Certain Investment Positions

Temporary Regulation section 1.988-3T(b) allows a taxpayer to elect capital gain or loss treatment for a foreign currency forward contract, futures contract or option contract, provided that the contract (i) is a capital asset in the hands of the electing taxpayer, (ii) is not part of a straddle (defined without regard to the exceptions for qualified covered call options or section 1256(e) hedging transactions), (iii) is not a section 1256 contract that the taxpayer has elected to treat as a section 988 transaction under section 988(c)(1)(D), and (iv) is contemporaneously identified on the taxpayer's books and records and described in a verification attached to the taxpayer's tax return. For transactions in taxable years ending prior to September 21, 1989, the identification and verification requirements of Temporary Regulation section 1.988-3T(b) are deemed to be satisfied by "any reasonable contemporaneous election procedure that satisfies the same-day identification requirement of section 988(a)(1)(B)". These rules appear well suited to the limited class of taxpayers that use foreign currency contracts for bona fide investment, rather than business hedging, purposes.

VI. SOURCE OF EXCHANGE GAIN OR LOSS (TEMPORARY REGULATION SECTION 1.988-4T).

1. Overview. Temporary Regulation section 1.988-4T(a) repeats the general statutory rule of section 988(a)(3)(A) to the effect that the "residence" of the taxpayer determines the source of foreign currency gain or loss.[47] Temporary Regulation section 1.988-4T(b) reflects the statutory exception to the general rule for sourcing exchange gain or loss of qualified business units, by providing that, if an item of exchange gain or loss is properly reflected on the books of a qualified business unit of the taxpayer, the residence of that qualified business unit, as opposed to the residence of the taxpayer, will govern the source of the item. Temporary Regulation section 1.988-4T(c) supplies an additional sourcing rule not found in the statute by providing that exchange gain or loss that arises from the conduct of a United States trade or business (determined under principles similar to those set forth in regulation section 1.864-4(c)) shall in all cases be treated as U.S. source and, in addition, shall also be treated as effectively connected with the conduct of a United States trade or business.

Source determinations generally are relevant to two different classes of taxpayers. Foreign taxpayers primarily are concerned about the source of an item of income because it determines in part whether such item of income is taxable by the United States and, if so, whether such income is subject to withholding tax. United States taxpayers most often are affected by source determinations because the source of their income is

[47] The Temporary Regulations state that "the source of exchange gain or loss shall be determined by reference to the residence of the taxpayer." Technically, under the general taxing pattern of subchapters N and 0 of the Code, loss has no source; rather, items of loss are allocated or apportioned to specific or residual items of income that themselves can have a source in accordance with the usual rules. Even though it reflects the statute correctly, section 1.988-4T of the Temporary Regulations should be amended throughout to clearly distinguish between the source of income or gain, on the one hand, and the allocation or apportionment of loss to items of income or gain from various sources, on the other hand.

directly relevant to their ability to claim foreign tax credits after application of the foreign tax credit limitation contained in section 904. The rules of Temporary Regulation section 1.988-4T affect both these classes of taxpayers.

2. Foreign Taxpayers. Under the Temporary Regulations, situations where withholding on a section 988 transaction would be required are likely to be relatively rare. In most cases the residence based source rules of Temporary Regulation section 1.988-4T will eliminate withholding risks; a foreign person generally will receive foreign source payments and a foreign person with a U.S. trade or business that receives the payments will not be subject to withholding on such payments to the extent that such payments are effectively connected with such trade or business and the payee files a Form 4224. The source rule for qualified business units contained in Temporary Regulation section 1.988-4T(b), however, presents a potential problem for a limited class of taxpayers.

In the case of a foreign taxpayer, the residence based source rule will create U.S. source income for which a withholding tax liability may arise if (i) the transaction is properly reflected on the books of a United States qualified business unit of the taxpayer, (ii) the transaction gives rise to "fixed or determinable annual or periodical income" and (iii) the income is not effectively connected with the conduct of a U.S. trade or business. It appears to be an unspoken premise of the Temporary Regulations that, in such a case, any income from the transaction necessarily would be effectively connected with the conduct of a U.S. trade or business by that taxpayer through that qualified business unit and therefore would be exempt from withholding.

If this assumption has been made by the drafters of the Temporary Regulations, it is wrong; not all income properly reflected on the books of a qualified business unit is effectively connected with the conduct of a U.S. trade or business. For example, a foreign taxpayer may trade in foreign currency securities for its own account, even through a U.S. qualified business unit, and still not be treated as engaged in the conduct of a U.S. trade or business by virtue of section 864(b)(2) of the Code with respect to the income from such activity if such trading is not effectively connected to some other activity of the qualified business unit. Even if the transaction does not involve a qualified business unit, the residence based sourcing rule would treat foreign currency gain as U.S. source when received by a U.S. partnership with foreign partners, potentially subjecting the partners to U.S. withholding tax if the foreign currency gains were fixed determinable annual or periodical income. Also, under Temporary Regulation section 1.988-4T(b), however, it appears that foreign currency gain on a foreign currency securities trade by such a foreign taxpayer might nevertheless be U.S. source (regardless of the source of the underlying gain or loss) and, if such foreign currency were to be treated as fixed or determinable annual or periodical income, a liability to withhold tax under section 1441 or 1442 of the Code might be imposed on the taxpayer's counterparty. Brokers and other middlemen also could be subject to liability as withholding agents in such a situation.

It would appear that the possibility of an independent withholding tax liability for foreign currency gain in such case is unintended and could increase the costs and uncertainties effecting cross-border currency transactions. Therefore, the subcommittee recommends that Temporary Regulation section 1.988-4T be amended to either (1) provide that foreign currency gain is

considered gain from the sale or exchange of property and thus is not fixed or determinable annual or periodical income, within the meaning of sections 871 and 881 of the Code, or (2) state that sections 1441 and 1442 shall not apply to require withholding of tax on any U.S. source foreign currency gain recognized under section 988 by a foreign person.

The second area of concern to foreign taxpayers relates to the special source rule for qualified business units contained in Temporary Regulation section 1.988-4T(c). This rule states that foreign currency gain (or loss) treated as arising out of the conduct of a United States trade or business automatically will be sourced to the United States and treated as effectively connected with the conduct of a United States trade or business, notwithstanding the residence of the taxpayer or the extent of the taxpayer's operations in the United States. This rule bears a distant relationship to the sourcing rule of section 865(e)(2)(A).

There are no special characteristics of exchange gain or loss from a section 988 transaction that properly warrant a per se sourcing rule at odds with the normal rules for other classes of income. On its face, this special sourcing rule would violate the terms of numerous income tax treaties to which the United States is a party. Many such treaties preclude treatment of income as effectively connected to the conduct of a United States trade or business unless the item is attributable to a permanent establishment of the foreign taxpayer in the United States. In addition, certain income tax treaties to which the United States is a party contain source rules of their own. Little policy justification exists for overriding a treaty obligation of the United States on the question of sourcing foreign currency gain (or apportioning loss) arising from the conduct of a United

States trade or business. Moreover, we doubt whether Treasury regulations, as opposed to a statute, can unilaterally override the treaty obligations of the United States. Therefore, the subcommittee recommends that Temporary Regulation section 1.988-4T(c) be amended to provide that the rule contained therein applies only to the extent not prohibited by or inconsistent with the application of an income tax treaty to which the United States is a party.

3. United States Taxpayers. As noted above, U.S. taxpayers generally are concerned with the source of income because of its effect on the section 904 limitation for foreign tax credits. With respect to foreign currency gain (or loss), the general source rule of Temporary Regulation section 1.988-4T(a) may work a distortion in the application of section 904 in certain cases.[48] (See, in particular, the discussion in Part VIII, below suggesting a consistent rule for the source of income or loss in connection with hedges of foreign currency exposure incurred by related parties.)

VII. HEDGING TRANSACTIONS (TEMPORARY REGULATION SECTION 1.988-5T).

Temporary Regulation section 1.988-5T implements the Congressional instruction in section 988(d) to provide integrated (or otherwise consistent) tax treatment for "988 hedging transactions" -- generally, transactions entered into to reduce the risk of currency fluctuations with respect to a taxpayer's current or future assets or liabilities. Temporary Regulation

[48] The difficulties created by the rules that bifurcate foreign currency interest payments into "interest" and "foreign currency" components, as described above, are one obvious example See discussion in Part IV.2(a)(ii).

section 1.988-5T allows integrated treatment for three categories of currency hedging transactions: (i) certain fully-hedged debt instruments, (ii) fully or partially hedged executory contracts and (iii) hedges of the trade date-settlement date period for the purchase or sale of stocks and securities traded on an established securities market. In general, the rules of Temporary Regulation section 1.988-5T are adequate to provide integrated treatment for the most common hedging structures in each category. As applied to less traditional hedging practices, however, certain aspects of Temporary Regulation section 1.988-5T require refinement in order to fulfill their stated purpose and to avoid unnecessary (and in some cases apparently unintended) limitations.

1. Fully-Hedged Debt Instruments. The rules concerning hedged foreign currency debt securities in Temporary Regulation section 1.988-5T(a) generally follow the guidelines established in Notice 87-11, 1987-1 C.B. 423 ("Notice 87-11"), with some important modifications in scope and operative rules. Specifically, Temporary Regulation section 1.988-5T(a) allows integrated treatment for a "qualified hedging transaction" consisting of a "qualifying debt instrument" and a "section 1.988-5T(a) hedge" that form an "integrated economic transaction" and meet certain requirements. As discussed below, the definitions of these terms appear intended to allow more flexibility in hedging strategies than the strict requirements of Notice 87-11, but will require some modifications to achieve this objective.

Temporary Regulation section 1.988-5T(a)(6) also provides rules that allow taxpayers to "leg in" or "leg out" of integrated treatment for hedged debt instruments -- principles that represent an important step forward in increasing the

utility of integrated hedge treatment. Again, certain minor modifications in the Temporary Regulations' rules will improve their intended application. Finally, Temporary Regulation section 1.988-5T(a)(6) describes the intended effect of integrated tax treatment for qualified hedging transactions. These rules work well for purely domestic transactions, but should be modified to include provisions that contemplate cross-border transactions that might attract foreign withholding or other foreign taxes.

(a) General Rules. (i) "Qualifying Debt Instrument". Temporary Regulation section 1.988-5T(a)(3) defines a "qualifying debt instrument" by reference to the definition in Temporary Regulation section 1.988-2T(b)(i), but specifically includes within the definition of a qualifying debt instrument "an instrument under which the payments are denominated in, or determined by reference to, more than one currency." Temporary Regulation section 1.988-5T(a) thus eliminates one of the definitional restrictions that impeded the utility of Notice 87-11, by allowing integrated treatment for fully hedged dual currency debt instruments.

The use of a definitional cross-reference to Temporary Regulation section 1.988-2T(b)(i) is unfortunate, however, for several reasons. First, Temporary Regulation section 1.988-2T(b)(2)(i) describes only debt instruments "where all payments are denominated in, or determined by reference to, a single nonfunctional currency." By reference, Temporary Regulation section 1.988-5T(a) therefore technically allows integrated treatment only in the case of nonfunctional currency debt instruments that are fully hedged into a functional currency, and not vice versa. This result appears contrary to the spirit of the debt instrument hedging rules, which otherwise generally conform to the substance of Notice 87-11, and to the language of the

remainder of Temporary Regulation section 1.988-5T(a), which carefully is phrased to apply to synthetic debt instruments denominated in either a functional or nonfunctional currency.

If, as it appears, this restriction on the scope of integrated treatment for debt instruments was unintentional, the subcommittee suggests that the existing cross-reference to Temporary Regulation section 1.988-2T(b)(i) in Temporary Regulation section 1.988-5T(a)(3) be replaced with a cross-reference to the definition of a debt instrument in Temporary Regulation section 1.988-lT(a)(2)(i). Such a cross-reference should make clear that it is not intended to incorporate the provisions of Temporary Regulation section 1.988-1T(a)(1)(ii) concerning nonfunctional currency payments.

Temporary Regulation section 1.988-2T(b)(2)(i) further specifies that it does not apply to any "contingent payment debt instrument." Temporary Regulation section 1.988—2T(b)(2)(i) does not define a contingent payment debt instrument of these purposes, but repeats the language, first issued in Announcement 86-92, 1986-32 I.R.B. 46, that a debt instrument is not considered a contingent payment debt instrument "merely because some or all of the payments are denominated in, or determined by reference to, a nonfunctional currency." It is not clear from this language whether the intent was to exempt from contingent status only those debt instruments with payments that otherwise represent a determinable amount in a nonfunctional currency (e.g., fixed-rate debt instruments denominated in Yen) or the broader class of debt instruments with payments "indexed" to, but not necessarily determinable in, one or more nonfunctional currencies (e.g., debt instruments with payments determined by reference to a formula that depends on the relationship between

two or more currencies, so that the amount to be paid cannot be predetermined in any currency as of the issue date).[49]

By referring to Temporary Regulation section 1.988 2T(b)(2)(i), Temporary Regulation section 1.988-5T(a) incorporates this confusion into the definition of a qualifying debt instrument. It is unclear, for example, whether currency "indexed" debt instruments should be viewed as "contingent" for purposes of the Temporary Regulations and therefore excluded from integrated treatment under Temporary Regulation section 1.988-5T(a) even if fully hedged into a non-contingent synthetic debt instrument. Alternatively, such instruments could be viewed as covered by the language of Temporary Regulation section 1.988-5T(a)(3), quoted above, concerning dual currency obligations. Informal comments by certain Service officials suggest that the drafters in fact may have intended to include currency "indexed" debt instruments within the scope of qualifying debt instruments. Because, the language in the Temporary Regulations is ambiguous, and the potential adverse tax consequences for indexed transactions that do not qualify for integrated treatment could be severe, many taxpayers nonetheless are unwilling to structure financing transactions using currency indexed instruments without more explicit guidance on this issue. The subcommittee therefore urges that Temporary Regulation section l.-988-5T(a) be modified to specify clearly the intended treatment of fully-hedged debt instruments that are currency indexed or that otherwise provide for payments that are contingent on a currency formula.

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[49] Compare, e.g., "Student Loan Marketing Association's 12 1/8% Principal Exchange Rate Linked Securities ("PERLS"), Offering Circular dated March 12, 1987 (principal payable in U.S. dollars, based on then-CJ.S. dollar value of Australian dollar issue price) with Ford Motor Credit Company's 11% Reverse Principal Exchange Rate Linked Securities ("Reverse PERLS"), Due May 19, 1992, Prospectus Supplement dated May 6,

In the subcommittee's view there is no tax policy benefit to be served by excluding currency "indexed" obligations from integrated treatment, and a potential for tax-motivated transactions is presented by the failure to allow integrated treatment for such transactions. The subcommittee accordingly recommends that currency indexed debt instruments specifically be included in the definition of a "qualified debt instrument." This result could be accomplished, for example, by modifying the definition in Temporary Regulation section 1.988-5T(a)(3) to include "debt instrument under which the payments are denominated in, or determined by reference to, more than one currency, or to a formula based on more than one currency (irrespective of whether such formula precludes the taxpayer from determining in advance the amount of those payments)." Of course, the subcommittee does not intend that this suggested modification override the general requirement that a currency indexed instrument independently be treated as a debt instrument under general tax principles in order to qualify for integrated treatment under Temporary Regulation section 1.988-5T(a).

More generally, we believe that no policy purpose is served in excluding all contingent debt instruments from integrated treatment. We understand the concern that, in light of the absence of definitive administrative guidance on the taxation of contingent interest in general, it would be inappropriate to extend the class of transactions falling in that category to include synthetic contingent payment obligations. Where, however, through options, swaps or other Derivative Instruments, a contingent interest obligation is hedged into a noncontingent obligation, no such concern exists. Accordingly, while we recommend that, at a minimum, the current ambiguity surrounding

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1987 (principal payable in U.S. dollars, based on a formula measuring the then-relationship of U.S. dollars to Yen).

currency indexed obligations should be explicitly resolved, we believe that the more comprehensive answer is that Temporary Regulation section 1.988-5T(a)(3) should apply to any debt instrument, so long as the synthetic instrument that results is noncontingent.

(ii) Section 1.988-5T Hedge. The definition of a "section 1.988-5T(a) hedge" (a "hedge") in Temporary Regulation section 1.988-5T(a)(4) specifically excludes "an option or similar instrument which does not permit the calculation of a yield to maturity" in connection with the hedged debt instrument. For certain currency indexed debt securities, however, an option or similar instrument used as a hedge will allow the calculation of a fixed yield to maturity. If the Temporary Regulations are modified to allow integrated treatment for certain contingent debt instruments, as suggested above, the restriction on the use of options as hedges should be modified accordingly.

In addition, the Temporary Regulations should be modified to clarify the intended application of the "yield to maturity" concept in the case of qualifying debt instruments that provide for put or call features. It would appear most logical for this purpose specifically to incorporate the existing rules in proposed regulation section 1.1272-1(f)(4) in determining the yield of putable or callable qualified debt instrument and the effect of a hedge in creating a yield for synthetic debt instrument. For example, if a qualifying debt instrument would be presumed to be called prior to its stated maturity date under the principles of proposed regulation section 1.1272—1(f)(4) a hedge that extends only through that presumed call date (and that otherwise provides a fixed yield) should be treated as qualifying hedge under Temporary Regulation section 1.988-5T(a)(4). The same principles should apply for purposes of calculating the effect of

a currency swap or similar instrument that provides for a put or call feature. Thus, a callable swap should be treated as a hedge of a qualifying debt instrument that provides for call on matching terms.

Temporary Regulation section 1.988-5T(a)(5) further requires that a hedge not be entered into with any "related party," within the meaning of section 267(b) or 707(c)(1). This rule represents a liberalization of the restrictions in Notice 87-11, which prohibited either the debt instrument or the hedge from involving a related party. However, many taxpayers, in particular many financial institutions, have affiliates that are independently engaged in business as currency dealers, and with which those taxpayers typically will find it most convenient to hedge their qualified debt instruments. The dealer affiliate, in turn, will hedge its currency exposure with unrelated parties as part of its normal dealer activities.[50] The subcommittee sees little potential for manipulation in this situation, because any differential from arm's-length terms on the intercompany hedge necessarily will be reflected in the currency dealer's net income or loss when it hedges its own exposure with unrelated parties. Accordingly, the subcommittee recommends that Temporary Regulation section 1.988-5T generally be modified to provide an exception to the rules prohibiting hedges between related parties in cases where at least one of the parties to the hedge is a currency dealer which is actively engaged in the conduct of business, predominantly with unrelated parties. The Service's discretion to disallow integrated treatment for improperly

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[50] Many financial institutions effectively are required to adopt holding company structures for non-tax regulatory purposes. In such cases, the holding company typically does all the capital markets borrowing for the group, but is not in the best position to arrange foreign currency those borrowings. By restricting intercompany arrangements between such holding companies and their dealer affiliates, the Temporary Regulations create an intractable hedging problem.

identified qualified hedging transactions would protect against abusive intercompany hedging transactions by taxpayers with affiliates that are not bona fide currency dealers.

(b) Transactions Part of a Straddle. Temporary Regulation section 1.988-5T(a)(7) provides the Service with discretion to disallow integrated treatment for a qualified hedging transaction if the qualified debt instrument is part of a straddle prior to the time the transaction is so identified. The policy underlying this section is not apparent, given that the rules concerning "legging in" to a qualified hedging transaction (as described below) are designed to prevent any acceleration of inherent loss (or gain) in a qualified debt instrument. A "legging in" transaction therefore should not interfere with any prior application of the straddle rules to a qualified debt instrument. Nonetheless, this broad rule could produce adverse results for a taxpayer that has a number of positions in a currency, and that might be surprised to find its transaction disqualified from integrated treatment on the grounds that its otherwise qualified debt instrument previously constituted part of a straddle. The subcommittee therefore recommends that the Service's. discretion to disallow integrated treatment under Temporary Regulation section 1.988-5T(a)(7) should be restricted to situations involving debt instruments that previously were identified by the taxpayer or the Service under section 1092 or section 1256 as constituting part of a straddle.

(c) Problems for Synthetic Assets. Temporary Regulation section 1.988-5T(a) clearly contemplates integrated treatment for synthetic debt instruments held as assets. Nonetheless, the identification requirements of Temporary Regulation section 1.988-5T(a)(8), like those of Notice 87-11, will inhibit the

development of any significant public market for such synthetic assets.

One can imagine, for example, a financial institution or other sponsor forming a grantor trust into which it contributes foreign currency denominated debt securities and a currency swap that hedges all the cash flows on the debt into U.S. dollars. The sponsor then would sell certificates of interest in the trust to unrelated investors.[51] Each certificate would correspond to a synthetic U.S. dollar debt instrument at an attractive yield. Under Temporary Regulation section 1.988-5T(a)(8), however, integrated tax treatment would not apply to any investor's certificate unless that investor independently identified its interest in the underlying assets as a qualified hedging transaction. This need for affirmative identification by subsequent investors creates a trap for unwary purchasers of synthetic assets, as well as potential opportunities for sophisticated investors that can choose whether integrated or separate taxation is most beneficial for any particular investment.

The subcommittee believes that the sponsor of such a structure should be allowed to make a qualified hedging transaction election for all the components involved. If the election were made, every subsequent purchaser of an interest in the structure should be required to treat its synthetic asset as an integrated transaction for U.S. tax purposes. If no election were made by the sponsor, subsequent purchasers should be precluded from electing integrated treatment for their interests in the structure. This approach would remove tax impediments to the marketing of synthetic assets in the U.S. capital markets,

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[51] Such a transaction would, of course, be subject to the rules of regulation section 301.7701-4(c).

and would impose a desirable uniformity of result on similarly situated purchasers of otherwise identical investment assets.

(d) Legging In and Legging Out. Temporary Regulation section 1.988-5T(a)(6) provides rules that allow a taxpayer to create a qualified hedging transaction using an outstanding qualified debt instrument ("legging in") or to dispose of one component of a qualified hedging transaction prior to its stated maturity ("legging out"). These rules represent an important liberalization of the guidelines under Notice 87-11, which effectively required that all components of an integrated transaction be acquired and disposed of on the same day. In general, the legging in and legging out rules appear to be well designed to allow taxpayers maximum flexibility to create economic hedging structures for outstanding debt obligations, without leaving open unwarranted opportunities for tax avoidance transactions. Clarification of several issues, however, would increase the utility of these principles.

(i) Restrictions on Legging In Transactions. Temporary Regulation section 1.988-5T(a)(5) effectively precludes the use of outstanding hedge contracts as part of a qualified hedging transaction, by requiring that the hedge be entered into on the date the transaction is identified. The rationale behind this restriction is not apparent. If a taxpayer has outstanding an otherwise qualifying currency hedge that could be matched with a qualified debt instrument, it seems unfortunate to require the taxpayer to incur the transaction costs necessary to dispose of that outstanding hedge position, and to acquire a substantially similar position, solely for the purpose of obtaining integrated treatment of the resulting synthetic debt instrument. The discipline imposed by a mark-to-market regime for legging in transactions would appear sufficient to prevent transactions

designed solely to accelerate or defer recognition of gain or loss for tax purposes. Accordingly, the subcommittee suggests that this requirement for integrated treatment be eliminated.

(ii) Consequences of Legging Out Transactions. Temporary Regulation section 1.988-5T(a)(6)(ii) indicates that, in the case of a legging out transaction, the position retained is marked to market on the leg out date, and any resulting gain or loss, including amounts attributable to factors other than currency fluctuations, is recognized currently. The section further provides that, thereafter, the "spot rate on the leg-out date shall be used to determine exchange gain or loss" on the retained position. Implicit in these requirements is an assumption that the retained position should be viewed for tax purposes as if reacquired on the leg out date using current interest rates, as well as current exchange rates. The subcommittee suggests that this assumption be expressed clearly in the language of Temporary Regulation section 1.988-5T(a)(6)(ii).

(e) Taxation of Qualified Hedging Transactions. Temporary Regulation section 1.988-5T(a)(9) generally provides for the components of a qualified hedging transaction to be integrated and treated as a single transaction for tax purposes. A sensible exception in Temporary Regulation section 1.988-5T(a)(9)(i)(C) disregards integrated treatment solely for U.S. withholding tax purposes in the case of a transaction entered into by a foreign person that gives rise to U.S. source income that is not effectively connected with a U.S. trade or business. Thus, if U.S. withholding tax were imposed, for example, on the qualified debt instrument comprising a qualified hedging transaction, the amount withheld appropriately would be measured by reference to interest payments on the qualified debt instrument itself, rather than on the net amount treated as interest on the synthetic debt instrument.

Unfortunately, the Temporary Regulations do not provide a corresponding rule in the case of U.S. persons that might receive payments under a qualified debt instrument that are subject to foreign withholding taxes or other foreign taxes. While the amount of any foreign withholding tax is not likely to be affected by a debt instrument's status as a qualified hedging transaction in the hands of U.S. taxpayer, the taxpayer's inability to identify the tax with the actual payments on which that tax is imposed could hinder the appropriate application of U.S. foreign tax credit principles. For example, a foreign tax that, when measured against actual interest paid on a qualified debt instrument would be placed in the "high withholding tax interest" basket for foreign tax credit purposes, instead might qualify for the broader "passive income" basket when measured against the amount treated as interest on a synthetic debt instrument. These types of characterization problems are unpredictable, and could adversely affect overall tax results for both taxpayers and the Service. Accordingly, the subcommittee recommends that a special rule be added to Temporary Regulation section 1.988-5T(a)(9) that would allow a taxpayer to disregard integrated treatment for a qualified hedging transaction solely for purposes of determining the foreign tax credit consequences of any non-U.S. tax imposed on a component of the transaction.

2. Hedged Executory Contracts. Temporary Regulation section 1.988-5T(b) for the first time provides rules that allow integrated treatment for certain currency hedges of non-financial executory contracts. The technical requirements for integrated treatment of a hedged executory contract generally follow those for integrated treatment of a hedged debt instrument under Temporary Regulation section 1.988-5T(a), and to that extent are subject to some of the same weaknesses described above. With some

fine-tuning, however, these rules will simplify tax planning for the increasing number of taxpayers that choose to hedge the foreign currency exposure of a cross-border executory contract.

(a) Partially-Hedged Contracts. Unlike the rules for hedged debt instruments, Temporary Regulation section 1.988-5T(b) allows integrated treatment for partially-hedged executory contracts Where a hedge is identified as allocable only to part of an executory contract, a taxpayer effectively is required to bifurcate the transaction, and to report separately gain or loss in respect of the unhedged portion of the executory contract based on current exchange rates as of the contract's accrual date.[52] Temporary Regulation section 1.988-5T(b)(2)(i)(C) limits the benefit of the rules for partially hedged executory contracts by restricting integrated treatment to the period during which "the amount of the executory contract that is hedged is not decreased," although that amount may be increased. The reference to the "amount" of the contract hedged in this context is confusing; the need for a currency hedge arises precisely because the amount in U.S. dollars of payments called for under a foreign currency denominated executory contract will not be constant. A better reference in this context would be to the "proportion" (or even the "proportionate amount") of the contract that is covered by a hedge.

(b) Historic Rate Rollovers. Temporary Regulation section 1.988-5T(b)(2)(iii)(C) provides special rules for "historic rate rollovers" used to hedge an executor contract. A "historic rate rollover" is defined for these purposes as:

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52 It is unclear to the subcommittee why the drafters of the Temporary Regulations chose to permit the administrative complexity of a regime that contemplates partial hedges in the case of executory contracts, but failed to incorporate this liberalization in the more familiar area of hedged debt instruments.

> "an extension of the maturity date of a forward contract where the new forward rate is adjusted on the rollover date to reflect the taxpayer's gain or loss on the contract as of the rollover date plus the time value of such gain or loss through the new maturity date."

Under the special rules of Temporary Regulation section 1.988-5T(b)(2)(iii)(C), an historic rate rollover can qualify as part of a hedge of an executory contract provided that the period hedged by a rolled over contract does not exceed 183 days. In such case, the rules of Temporary Regulation section 1.988-2T(d)(2)(v), which generally treat the time value component of a historic rate rollover as interest income or expense, do not apply, and all amounts ultimately recognized on the rolled over hedge instead are treated as an adjustment to payments made or received on the executory contract.

The subcommittee applauds the concept of providing an exception to the interest imputation rules for short-term historic rate rollovers. It is the subcommittee's view, however, that such an exemption should apply for purposes of the general rules for historic rate rollovers in Temporary Regulation section 1.988-2T(d), and should not be limited to transactions identified as hedges of executory contracts under Temporary Regulation section 1.988-5T(b). The vast majority of historic rate rollovers are entered into by business taxpayers in an effort to simplify their overall currency hedging programs. It seems inappropriate to create a tax trap for such taxpayers if they should fail to meet the requirements for integrated treatment under Temporary Regulation section 1.988-5T(b) for those contracts. The subcommittee believes that any minor potential for deferral of the time value of a historic rate rollover under a general short-term exemption would be outweighed substantially by the administrative complexities for taxpayers absent such a rule.

(c) Legging Out Rules. Unlike the case for hedged debt instruments, Temporary Regulation section 1.988-5T(b) provides for different results when legging out of a hedged executory contract, depending on whether the taxpayer disposes of the executory contract or the hedge. In either case, the retained instrument must be marked to market on the leg out date. If the retained instrument is the hedge, the resulting gain or loss is recognized currently; however, if the retained instrument in the executory contract, recognition of the mark-to-market gain or loss on the hedge is deferred and is treated as an adjustment to the payments ultimately made or received on the executory contract.

The subcommittee believes that nonconforming treatment for legging out transactions provides undue opportunities for tax-motivated transactions, with taxpayers disposing of appreciated hedges at year end to lock in currency gains that will be subject to tax only when the offsetting executory contract matures in a subsequent taxable year. The subcommittee therefore recommends that the rules concerning legging out of integrated treatment for hedged executory contracts be modified to conform to the consistent approach used for hedged debt instruments, by requiring current recognition of implicit currency gain or loss on the retained position irrespective of whether that position is the hedge or the executory contract. In the case of a retained executory contract, however, only the currency component should be subject to such a mark-to-market rule, because the contract's underlying property or services normally would not be amenable to the objective valuation criteria that justifies a full mark-to-market approach for debt instruments under Temporary Regulation section 1.988-5T(a).

3. Hedges of Trade Date-Settlement Date Period for Publicly Traded Securities. Temporary Regulation section 1.988-5T(c) allows a cash method taxpayer that purchases or sells stocks or securities on an established securities market to obtain integrated tax treatment for an identified currency hedge of the relevant foreign currency payments during the period between the trade date and the settlement date for the transaction. Many taxpayers routinely enter into a separate currency hedge for the open period between the trade date and the settlement date, in order to lock in the expected purchase or sale price determined using trade date rates. Temporary Regulation section 1.988-5T(c) facilitates what otherwise might be a series of complicated calculations, by allowing a cash method taxpayer to rely on the locked in trade date amounts for general tax purposes. The requirements for integrated treatment of such hedges effectively are identical to those governing hedged executory contracts under Temporary Regulation section 1.988-5T(b).

(a) Limitation to Cash Method Taxpayers. The subcommittee supports the provisions of Temporary Regulation section 1.988-5T(c) as providing useful simplifying principles for common currency hedging situations. As noted above with respect to Temporary Regulation section 1.988-2T(a)(iv), however, it is not clear to the subcommittee what purpose is served by limiting this rule to cash method taxpayers. Accrual method taxpayers also are subject to the trade date-settlement date disparities created by section 453(k), and often may have positions far more numerous and complicated than would be typical for cash method taxpayers. Accordingly, we recommend that Temporary Regulation section 1.988-5T(c) be extended to all taxpayers, at least in the case of “regular way” trades (i.e.,

trades settled in accordance with the normal procedures for securities of the type under consideration).

(b) Conforming Information Reporting Rules. The subcommittee also notes that the simplifying principles of Temporary Regulation section 1.988-5T(c) may be frustrated if the substantive rules are not accompanied by corresponding changes in the regulations under section 6045 to allow integrated information reporting by brokers of trade date-settlement date currency hedges. For example, if a taxpayer elects integrated treatment for its sale of a foreign currency-denominated debt security and its trade date- settlement date currency hedge of the sale proceeds, the taxpayer currently would receive separate information statements showing the foreign currency proceeds of its sale and the results of its currency hedge. In many cases, a cash method taxpayer may not equipped to process the information in these separate statements so as accurately to report the integrated results in conformity with the principles of Temporary Regulation section 1.988-5T(c). The subcommittee therefore suggests that, in the common case where the taxpayer arranges both the purchase or sale and the associated trade date-settlement date hedge through the same broker, and where that hedge qualifies as integrated under Temporary Regulation section 1.988-5T(c), the information reporting rules of section 6045 allow the broker to provide a single statement showing the integrated results of any election by the taxpayer under Temporary Regulation section 1.988-5T(c).

VIII. CONSISTENT TREATMENT UNDER SECTION 988(d).

Section 988(d) authorizes the Service to provide rules that integrate all transactions that are part of a section 988 hedging transaction or otherwise to treat such transactions "consistently". While Temporary Regulation section 1.988-5T implements the integration concept of section 988(d), no rules are provided under the "consistency" clause of section 988(d). In many situations, a full integration approach for currency hedges is not appropriate. Currency hedging transactions entered into by taxpayers for bona fide reasons can create significant distortions in their foreign tax credit positions. In other cases, the absence of section 988(d) regulations appears to have forced the drafters of the Temporary Regulations to adopt rules for unhedged positions that have their own internal inconsistencies.

In the subcommittee's view, the most pressing need is for section 988(d) regulations that would provide consistent sourcing results for taxpayers that hedge their foreign currency exposure. By contrast, since section 988 generally characterizes foreign currency gain or loss as ordinary, rather than capital, character mismatches are now relatively infrequent.[53] Similarly, while timing mismatches are a frequent byproduct of currency hedging, those mismatches are not materially different in kind or degree than the timing mismatches arising from any other form of business hedging.

One example of the anomalies that follow from not developing section 988(d) sourcing regulations has already been

[53] The problem of character of gain or loss was substantially more important prior to the adoption of section 988(c)(1)(D)(ii), permitting section 1256 contracts to come within the scope of section 988.

described: the treatment of exchange gain or loss associated with interest income or expense. As described in Part IV.2.(b).(i)., above, the subcommittee believes that such exchange gain or loss should be subsumed to interest. To protect both taxpayers and the fisc from sourcing whipsaws, a correlative section 988(d) regulation would also be required to source any hedges of such exchange gain or loss consistently with the source of the underlying interest income or expense.

Another acute sourcing problem that arises frequently in practice is the treatment of hedges of a foreign subsidiary's net equity. For example, consider the case of a United States multinational corporation that has a foreign subsidiary. The U.S. company is concerned that fluctuations in the value of its subsidiary's local currency (the "Y") will have an unpredictable effect on the group consolidated financial statements. Furthermore, the foreign subsidiary's balance sheet and economic position may well be such that it does not have access to the currency markets on terms as advantageous as are available to the U.S. parent corporation. On these assumptions, the U.S. parent corporation may enter into a currency transaction to hedge its exposure to fluctuations in the Y with respect to its foreign subsidiary. This hedge, colloquially known as a "Hoover hedge" (after Hoover Company v. Commissioner, 72 T.C. 206 (1979)) or a "FASB 52 hedge" (after relevant financial accounting authority) cannot qualify as a "section 988(d) hedge" under Temporary Regulation section 1.988-5T(a), because it is not related to an identifiable instrument or executory contract of the U.S. parent company.[54] Instead, the hedge effectively protects the U.S. parent company against changes in the value of future dividends paid (or deemed paid under the Subpart F rules) by its foreign

[54] See Temporary Regulation sections 1.988-5T(a)(5)(vi) and 1.988—5T(b)(2)(i)(F). See also the discussion of the restrictions on intercompany hedges as qualifying for integrated treatment under Temporary Regulation section 1.988-5T in Part VII above.

subsidiary as a result of fluctuations in the Y/dollar exchange rate.

Fluctuations in the value of the Y, of course, will not trigger taxable gain or loss to the foreign subsidiary, because the Y represents its "functional currency." Under section 986, however, the subsidiary's Y-denominated earnings and profits must be translated into U.S. dollars when distributed (or deemed distributed) to the U.S. parent company.[55]

Assume, to continue with the example, that, as a result of its currency hedge, the U.S. parent company's economic income in respect of its foreign subsidiary will remain constant in U.S. dollar terms. The portion of that overall income derived from the actual or deemed distributions of its foreign subsidiary (as opposed to gain or loss On its currency hedge), however, will fluctuate with changes in the Y-dollar exchange rate. Under Temporary Regulation section 1.988-4T, the U.S. company's gain or loss from its currency hedge will be treated as derived from U.S. sources. The U.S. dollar amount of distributions from the foreign subsidiary, in contrast, generally will be foreign source income to the U.S. parent company. Consequently, fluctuations in the Y/dollar exchange rate will affect -- in a totally unpredictable fashion -- the relative mix of foreign and U.S.-source income to the U.S. company in respect of its foreign subsidiary. To the extent that these sourcing anomalies produce an increase in

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[55] In general, an actual distribution of earnings and profits from a foreign subsidiary is translated at the exchange rate in effect on the date that the recipient includes the distribution in income. A deemed distribution is translated at the weighted average exchange rate for the foreign corporation's taxable year; foreign currency gain or loss then is recognized as the result of exchange rate fluctuations between the time of deemed distribution and the actual distribution of that previously taxed income ("PTI"). Foreign currency gain or loss on PTI is sourced in the same manner as the associated income from the deemed distribution. Complex transition rules apply to the transition rules of pre-1987 earnings and profits. See Notice 88-70, 1988-2 C.B. 369.

foreign source income (that generally would not bear any increased foreign tax) and a corresponding U.S. expense, the fisc, as well as taxpayers, is at risk of adverse results.

In the subcommittee's view, "Hoover" or "FASB 52" hedges of a foreign subsidiary's net functional currency exposure have special characteristics, due to the fact that a foreign taxing jurisdiction typically will not treat fluctuations in the value of its own currency as affecting the taxable income of its taxpayers.[56] Accordingly, we believe that these hedges require a special consistency rule under section 988(d).

At its simplest, such a consistency rule would address the sourcing anomalies described above by providing that, if a U.S. taxpayer hedges its net exposure to its foreign subsidiary's functional currency through an identified "Hoover hedge," then the source of any foreign currency gain or loss on that hedge will be the same as the source of dividends received from the subsidiary (i.e., in general foreign source).[57]Such a source consistency rule works well in the case of a foreign subsidiary that generates exclusively subpart F income, because the foreign

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[56] For simplicity, the text assumes that the foreign subsidiary's functional currency is also the currency of the jurisdiction in which it does business and pays local tax.

In contrast, the subcommittee believes that there is less potential for anomalous tax results in cases where a U.S. parent corporation enters into a hedge designed to protect against currency fluctuations with respect to transactions by a foreign subsidiary that are denominated in a nonfunctional currency as to the foreign subsidiary (e.g., a German subsidiary that borrows in Yen), if that foreign subsidiary is allowed to claim a loss (or required to report income) in respect of its nonfunctional currency position. In such cases, an appropriate increase or reduction in actual foreign taxes will accompany the corresponding adjustment to foreign source earnings distributed to the U.S. parent.

[57] Again, we contemplate that the rule would apply only to (i) hedges of a foreign subsidiary's functional currency where (ii) that functional currency is also the currency of the jurisdiction in which the subsidiary pays local income tax.

subsidiary's income will be includible in the U.S. parent's income as earned. In the case of a foreign subsidiary that earns "active" (i.e., non-subpart F) income, however, a simple source consistency rule can expose the fisc to serious timing whipsaws: if the currency hedge generates gain, the U.S. parent could simply defer bringing up a dividend from its foreign subsidiary whose currency has depreciated, while generating foreign source income (with no corresponding foreign tax) by disposing of the hedge.[58]

To deal with the timing whipsaws that would be created for the fisc by a simple source consistency rule, we propose a rule, analogous to the rules for interest rate hedges under regulation section 1.861-9T(b)(6), that would treat foreign currency gain or loss realized by a U.S. taxpayer on an "identified balance sheet hedge" of a foreign affiliate as an adjustment to the amount of income realized by that taxpayer in respect of actual or deemed distributions from that foreign subsidiary. Under this rule, the source and foreign tax credit limitation category of foreign currency gain or loss from such hedging transactions automatically would correspond to the characteristics of the hedged distributions.[59]

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[58] Although the matter is not entirely clear, we believe that the better view of current law is that "Hoover hedges" are not subject to the tax straddle rules of section 1092, because stock of a foreign subsidiary is not a "position in personal property" for these pur¬poses. In any event, the straddle rules defer only loss, not (as is the case in the text's example) gain.

[59] As with regulation section 1.861-9T(b)(6), the Service ultimately would need to prescribe consistent timing rules for such currency hedges in order to prevent artificial acceleration of recognized currency gain or loss on hedges that offset unrecognized currency loss or gain in a foreign subsidiary's balance sheet and to properly assign the foreign tax credit characteristics of hedge gains and losses to distributions in various years. Moreover, a proportionality rule might be necessary to address sourcing issues for distributions that would be subject to the resourcing rules of section 904(g).

For this purpose, we suggest that a taxpayer be required to identify each "identified balance sheet hedge," and the foreign subsidiary to which that hedge relates, no later than the close of the day on which the hedge first is entered into or acquired. In addition, to ease tax audit issues and reduce taxpayer "gaming" opportunities, "identified balance sheet hedges should be limited to those that the taxpayer also records as FASB 52 or similar hedges for financial accounting purposes.