Report 1287

NEW YORK STATE BAR ASSOCIATION TAX SECTION

REPORT ON

SUBPART F ISSUES INVOLVING CURRENCY GAIN AND LOSS

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New York State Bar Association Tax Section

Report on Subpart F Issues Involving Currency Gain and Loss

I. INTRODUCTION

This report[1] comments on the treatment of foreign currency gain as subpart F income,[2] and related issues, under selected circumstances. In particular, we understand that in a variety of commonplace circumstances, when a "controlled foreign corporation" (a "**CFC**") engages in certain "treasury center" and other routine hedging activities, the subpart F rules relating to currency gain and loss (together with related rules) frequently produce U.S. tax results for the U.S. owner of the CFC that are inconsistent with its economic position. Because of this potential divergence between the tax consequences and the economic consequences, these economically neutral, routine business transactions are often accompanied by significant tax uncertainty.

Broadly, this report will comment on three fact patterns: First, there are many situations in which a CFC that is a member of a U.S. multinational group acts as a financing entity for other group members, typically by borrowing from

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[1] The principal author of this report was Michael Farber, with substantial assistance from Isaac MacDonald, Avinash Venkatesh and Ankur Dalal. Helpful comments were received from Kim Blanchard, William Burke, Bob Cassanos, Peter Connors, Lucy Farr, Kevin Glenn, Josh Gordon, Mike Schler, Yaron Reich and Diana Wollman. This report reflects solely the views of the Tax Section and not those of the NYSBA Executive Committee or the House of Delegates.

[2] Section 954(c)(1)(D); Treasury regulations Section 1.954-2(g). "Section" references are to the Internal Revenue Code of 1986, as amended (the "**Code**") or the regulations thereunder, unless otherwise indicated.

banks in various currencies (often not the CFC's own functional currency) and "on-lending" those amounts to other group members that require funding. As we will describe in Part III, this very simple and relatively non-volatile activity may produce enormous tax volatility for the CFC's U.S. parent under current law. This volatility arises from the interplay among several regimes, including Treasury regulations Section 1.954-2(g), Section 475 and Treasury regulations section 1.1221-2.

The second fact pattern involves a CFC that hedges its investment in a subsidiary CFC that operates in a different functional currency from that of the parent CFC (often called a "**net investment hedge**" or a "***Hoover* hedge**").[3] The third fact pattern is similar except that here the CFC's subsidiary is a "qualified business unit" (a "**QBU**") of the CFC that operates in a functional currency different from that of the CFC. In this third fact pattern, the CFC is hedging its exposure to ordinary property held by the QBU (we refer to this as a "**QBU hedge**"). As we discuss in Parts IV and V, while it is quite clear that under current law the currency gain or loss from a *Hoover* hedge is included in the computation of subpart F income (*i.e.*, not eligible for exclusion), it is unclear under current law whether the currency gain or loss from a QBU hedge may in fact be excluded from the computation of subpart F income.

We note that "treasury center " CFCs (to which we will refer as "**TCFCs**") will typically engage in a variety of transactions, only some of which are discussed in this report. We also understand that TCFCs frequently engage in

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[3] This fact pattern is discussed in Part V, while the third fact pattern is discussed in Part IV.

more than one or all of the types of transactions we discuss in this report. Thus, as we will discuss at various points, there are circumstances in which the issues raised by the different fact patterns may coexist and affect each other.

We understand from informal comments made by IRS and Treasury personnel that it is broadly accepted that the subpart F regime (and other rules discussed herein) can operate in connection with certain routine business and commercial currency transactions to produce tax results that do not match the economics, and that in some cases this may be inefficient and possibly unfair. Thus, this report investigates whether these regimes can (and should) be interpreted under current law ("as is" or with minimal interpretive guidance from Treasury and the IRS) to eliminate or minimize potential unpredictable and/or adverse consequences resulting from customary treasury center and hedging activity, or whether instead one or more of these regimes should be modified (and if so how) to make clear, or clearer, that certain activity does not produce unpredictable or unreasonable tax consequences.[4] In all events, we believe that Treasury and the IRS have the authority to make clear, by modification of the relevant regulations, that gain and loss associated with the activities we describe

[4] The issues discussed in this report, and others, have been laid out thoroughly by various commentators. *See, e.g.*, L.G. "Chip" Harter et al., *Financing International Operations*, 37 INT'L TAX J. 11 (Sept.-Oct. 2011); J.D. McDonald et al., *The Devil Is in the Details: Problems, Solutions and Policy Recommendations with Respect to Currency Translation, Transactions and Hedging*, 89 TAXES 199 (Mar. 2011); Jeffrey L. Shore, *Subpart F: Hedging Currency Risk in a Branch Context*, 38 INT'L TAX J. 33 (Nov.-Dec. 2012).

in this report are excluded from the computation of subpart F income, under a provision to which we refer as the "Business Needs Exception."[5]

As noted above, Part III of this report discusses a very simplified fact pattern involving "back-to-back lending" by a TCFC. We explore a number of possible interpretations of current law of which taxpayers might avail themselves in order to minimize the potential tax volatility associated with this activity, although it is difficult to conclude with a high degree of confidence (absent further guidance) that any of these possible interpretations would prevail under current law, and in any event it is unlikely that any tax position available under current law would permit a taxpayer to eliminate completely the resulting tax volatility. Whether this tax volatility should be eliminated entirely is a matter of policy, and as we will discuss, there are indications in the existing regulations that the drafters of the regulations were aware, and intended, that some amount of tax volatility would result from economically relatively non-volatile activity. While we do not understand *why* that would be the case, at this time we are not recommending that it be completely eliminated because we recognize that there may be policy reasons for it of which we are not aware.[6]

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[5] Section 954(c)(1)(D); Treas. reg. Section 1.954-2(g)(2)(ii), discussed in further detail in Parts III.B.4 and IV.B.

[6] As will be seen principally in Part III, taxpayers' ultimate results would be very similar in either of two conceptually very different ways: Either all currency gain or loss from the transactions we describe in this report could be excluded from the computation of subpart F income, or the currency gain or loss from the relevant positions could be "matched" for subpart F purposes (*i.e.*, realized at the same time and allowed to be netted against each other).

The notion of matching the timing and character of related gain and loss items in the context of hedging or otherwise "paired" transactions is obviously a key policy objective of (…continued)

Parts IV and V discuss QBU hedges and *Hoover* hedges. The analysis of the treatment of QBU hedges under current law is quite complex, and the "correct" result is unclear. We understand from IRS and Treasury personnel that there is a clear perception that currency gain resulting from QBU hedges is ***not*** currently eligible for exclusion from the computation of subpart F income under the Business Needs Exception; although our own analysis does not lead us to that conclusion, we acknowledge the uncertainties surrounding both whether QBU hedges can be treated as within the scope of the Business Needs Exception as currently drafted and how they would be treated if they were. We also note that the ultimate resolution of the question may depend to a large extent on how the regulations under Section 987 are ultimately finalized. We will in Part V articulate a possible argument for treating gain and loss from a *Hoover* hedge as excluded from the computation of subpart F income under current law, but it is an attenuated argument that has essentially been rejected (by the court in *Hoover*). Even though it is very clear after *Arkansas Best* that a U.S. corporation's *Hoover* hedge of a subsidiary stock position is not eligible to be treated as a hedge for tax purposes, we attempt to articulate a possible rationale for CFCs being eligible for different treatment. We do in any event conclude that it would be a reasonable extension of the Business Needs Exception if it were modified to permit the currency gain or loss from a *Hoover* hedge to be excluded from the computation of subpart F income.

(continued…)

numerous provisions of the tax law, including the hedging rules and the straddle rules, and has its origin in the clear reflection of income doctrine of Section 461. We are thus motivated by a general belief that minimizing the various mismatches that can arise in the context of the transactions we discuss in this report is a good policy objective.

II. SUMMARY OF DISCUSSION AND FINDINGS

A summary of the discussion and findings of this report follows:

In Part III, we review six possible approaches under current law to minimizing tax volatility associated with back-to-back loans entered into by TCFCs (some of which are clearly appropriate, and others of which are subject to a greater or lesser degree of uncertainty as to whether they are available). We conclude that several alternatives that are likely available under current law do not efficiently minimize tax volatility, and that several alternatives are not likely available under current law. Of these, we conclude that modifying current law to permit them would either implicate other areas of the law in ways that either would need to be fully considered or would not efficiently minimize tax volatility. We conclude by identifying a number of ways of efficiently minimizing tax volatility, all of which would require modifications of current law. However, we think that several such alternatives could be done in a narrow fashion so as not to implicate other areas of law significantly. One such alternative, described in Part III.B.1, would permit TCFCs to (1) identify non-functional currency borrowings as "Section 475 hedges" of their loan assets and (2) allocate currency gain or loss from those borrowings to subpart F and non-subpart F income in the same way that currency gain or loss from the relevant loan assets is allocated, at least to the extent of such gain or loss. Another, described in Part III.B.2, would permit TCFCs to "bifurcate" a non-functional currency borrowing into a functional currency borrowing and a "currency swap," which could be efficiently "matched" with the related loan asset in several ways.

In Part IV, we analyze a CFC's ability to treat currency gain or loss items arising from an identified hedge of ordinary property of its non-functional currency QBU as excluded from the computation of subpart F income under the Business Needs Exception. We conclude that while the technical issues involved in this analysis are quite complex and somewhat unclear, it is likely that this result is appropriate under current law, although because of the significant complexity and the unfavorable consequences that can arise from erroneously identifying, or failing to identify, a position as a hedge, guidance should be issued clarifying the point.

In Part V, we analyze a very similar issue to that addressed in Part IV, but where the hedge is of the CFC's "net investment" in ***another*** CFC (a *Hoover* hedge). We conclude that it is very unlikely that the currency gain or loss arising from the hedge in this circumstances can be excluded from the computation of subpart F income under current law, although we think it would be reasonable to modify the law to permit this result.

III. FOREIGN CURRENCY GAIN AND LOSS ON BACK-TO-BACK LOANS BY A TCFC

A. Background

This Part addresses issues that arise when a CFC acts as a "treasury center" (a TCFC**)** by borrowing (typically from unrelated banks) and on-lending to its affiliates various amounts, often of currencies other than its functional

currency. We understand it is typically the case, and therefore assume, that TCFC is a "dealer in securities" within the meaning of Section 475(c)(1), but is not a dealer in securities within the meaning of Section 954(c)(2)(C).[7] The activity analyzed in this section is highlighted in the following Example 1, illustrated in Figure 1, below: TCFC is organized and resident in Country X and has the U.S. dollar as its functional currency. TCFC regularly, and in the ordinary course of its business, provides funding to related CFCs through loans denominated in (from TCFC's perspective) nonfunctional currencies. Borrower CFC is organized and resident in Country Y and has the euro as its functional currency. Borrower CFC

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[7] This is very commonly the case. Section 475(c)(1) defines a dealer in securities to include a taxpayer that "regularly purchases securities from ***or*** sells securities to customers in the ordinary course of a trade or business; or regularly offers to enter into, assume, offset, assign or otherwise terminate positions in securities with customers in the ordinary course of a trade or business." (Emphasis added.) Whereas Treasury regulations section 1.954-2(a)(4)(iv) defines a "regular dealer" as a CFC that, "[r]egularly and actively offers to, and in fact does, purchase property from ***and*** sell property to customers ***who are not related persons*** . . . in the ordinary course of business; or [r]egularly and actively offers to, and in fact does, enter into, assume, offset, assign or otherwise terminate positions in property with customers ***who are not related persons*** . . . in the ordinary course of a trade or business." (Emphasis added.) Thus, for a CFC's income from "dealer" activity to be exempt from subpart F, it must generally purchase ***and*** sell property to customers, and those customers must be ***third parties***. Treasury center CFCs typically "purchase" property (the borrower's debt) from "customers" (their affiliated CFCs, *e.g.*) but do not "sell" property to customers (the banks from which they borrow are not their customers). And of course, a Treasury center's "customers" are in any event almost always merely its affiliates, which itself precludes the application of Section 954(c)(2)(C).

Neither of these limitations applies under Section 475. Indeed, Treasury regulations Section 1.475(c)-1(a)(3) makes explicit that a dealer's customers can in general be its affiliates, and Section 1.475(c)-1(c) provides a special rule for taxpayers that regularly purchase securities from customers (including making loans to customers) but engage in no more than "negligible sales" of the securities so acquired (as defined), providing that the taxpayer is ***not*** a dealer unless it so elects (by simply filing a return marking securities positions to market) or it accounts for any of its securities as inventory under Section 471. We understand it is commonly the case that TCFCs operate such that they could take advantage of this "negligible sales" rule and "opt out of" (more precisely, not opt into) Section 475, but that, whether advertently or otherwise, they typically do not do so, and we have assumed in our example that TCFC has not done so (*i.e.*, is treating itself as a Section 475 dealer).

conducts an operating business and generates little or no subpart F income. Parent, organized and incorporated in the United States, owns 100% of the stock of TCFC and Borrower CFC. During a taxable year, the following events take place:

> On January 1, TCFC borrows €100X from an unrelated bank (the "**Borrowing**") and immediately lends €100X (the "**Lending,**" and the Borrowing and Lending collectively, the "**Back-to-Back Loans**") to Borrower CFC. Both the Borrowing and the Lending are payable in ten years and bear adequate stated interest.
>
> The exchange rate on January 1 is $1.30:€1.
>
> The exchange rate on December 31 is $1:€1.
>
> This fact pattern is illustrated as follows:

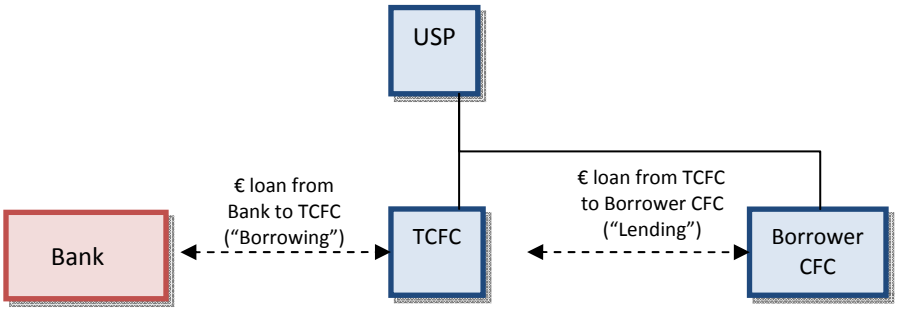

Figure 1

1. Accounting treatment[8]

Financial Accounting Standard (FAS) 52, codified in Accounting Standards Codifications 830 and 815, governs the accounting treatment of transactions denominated in a "nonfunctional" currency of the relevant entity (which, similar to the tax analysis, is determined based on a multifactor test). Under FAS 52, nonfunctional currency monetary assets and liabilities are "remeasured" (in functional currency terms) as of each balance sheet date using the spot rate, and the remeasurement is reflected in the income statement. In the case of "back-to-back" non-functional currency loans, this "remeasurement" results in equal and offsetting currency-related income and loss, and thus no net income statement impact. As discussed further in the next section, this neutral accounting treatment contrasts substantially with the likely tax results under current law.

2. Tax treatment under current law

Under current law, because TCFC is a securities dealer for Section 475 purposes, the Lending is generally required to be marked to market at the end of the taxable year (we assume December 31), under Section 475. However, the Borrowing appears to be neither required nor permitted by Section 475 to be marked to market.[9] Further, currency gain or loss with respect to the Lending is very likely to be treated as (a component of) foreign personal holding company

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[8] We note that we are not accounting experts, and the discussion of accounting in this report is based on our understanding of the relevant financial accounting rules.

[9] Treasury regulations Section 1.475(c)-2(a)(2).

income ("**FPHCI**"),[10] while currency gain or loss with respect to the Borrowing will, unless some other rule applies, be allocated under a "special rule" for interest-bearing liabilities between TCFC's subpart F and non-subpart F income in the same manner as interest expense associated with the Borrowing.[11]

The result, again absent a different interpretation of the various rules or the application of some other regime, is that TCFC will realize for subpart F purposes currency (and other) gain or loss annually with respect to the Lending

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[10] Absent some other exception (such as the dealer exception in Section 954(c)(2)(C), for which TCFC is not eligible), the excess of currency gain over currency loss of a CFC attributable to any section 988 transaction (including a nonfunctional-currency-denominated debt instrument, see Section 988(c)(1)(A)(i), (B)(i)) is generally subpart F income unless the Business Needs Exception applies. Treasury regulations Section 1.954-2(g)(2)(i).

[11] Treasury regulations Section 1.954-2(g)(2)(iii), cross-referencing Treasury regulations sections 1.9861-9T and -12T. Oddly, this appears to be the case even if the Borrowing is within the Business Needs Exception; the relevant provision states that, "[e]xcept as provided in [a special rule for liabilities incurred by "regular dealers," which TCFC is not] . . . foreign currency gain or loss arising from an interest-bearing liability is characterized as subpart F income and non-subpart F income in the same manner that interest expense associated with the liability would be allocated and apportioned between subpart F income and non-subpart F income under ss. 1.861-9T and 1.861-12T." There is no express exception in this provision or the Business Needs Exception, Treasury regulations Section 1.954-2(g)(2)(ii), for interest-bearing liabilities described in the latter provision. Thus, the two provisions are arguably in direct conflict in the case of an interest-bearing liability of an entity that is not a "regular dealer" that is within the Business Needs Exception. In this regard, it is at least instructive that the preamble to the proposed version of the current regulations indicated that the special rule for interest-bearing liabilities would apply "notwithstanding the 'business needs' exception." 67 Fed. Reg. 31995 (May 13, 2002).

Somewhat relatedly, we note that a prior version of the regulations included a specific exclusion from FPHCI for currency gain or loss associated with borrowings that met certain conditions. Prior Treas. reg. Section 1.954-1T(g)(3)(ii)(B) (1988). This exclusion was considerably broader (at least in this regard) than the current Business Needs Exception, although it does not appear to us that it alone would have excluded currency gain or loss with respect to the Borrowing from the computation of subpart F income (the prior regulations also contained a hedging exception). However, there was no "special rule" for currency gain or loss associated with liabilities that did not meet these exclusions, so it appears ***all*** such gain or loss would have been FPHCI.

(though losses may be deferred or capitalized under the "straddle" rules or otherwise), while under a literal reading of Treasury regulations Section 1.475(c)-2(a)(2), it would appear that other than with respect to payments of interest (which might also be subject to deferral or capitalization under the "straddle" rules, including Section 263(g)), no currency gain or loss (or other items) with respect to the Borrowing will be recognized before maturity or earlier retirement – and when recognized, those amounts will be allocated between subpart F and non-subpart F income in accordance with the rules for allocating interest expense, even though gain and loss with respect to the "matched" Lending was not so treated.[12]

As indicated, the "harm" being done here stems from multiple "mismatches," including (1) marking one of two exactly offsetting positions to market but not the other,[13] (2) treating the tax items that do arise from the two positions differently from the perspective of what is and is not subpart F income,[14]

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[12] A possible avenue for mitigating this result is to consider "integrating" the Borrowing and the Lending under Treasury regulations Section 1.988-5. However, although both the Borrowing and the Lending are "qualifying debt instruments" within the meaning of Treasury regulations Sections 1.988-5(a)(3)(i) and 1.988-1(a)(2)(i), a debt instrument cannot be a "Section 1.988-5(a) hedge," without which integration under that regime is not possible.

[13] As noted in footnote 18, there might not in fact be perfect economic matching, if one takes into account the potential difference between the credit risk of the TCFC and that of the Borrower CFC.

[14] In this regard, however, we note that the example in Treasury regulations Section 1.954-2(g)(2)(ii)(D) very clearly allows for such a mismatch. That example describes a "currency coordination center" CFC (a "**CCC**") that is not a "regular dealer" and that aggregates currency risks for its group and hedges them with third parties. In the example, another CFC sells yen 30 days forward to the CCC, which sells yen 30 days forward to a third-party bank. The example concludes that the CCC's currency gain and loss from the offsetting contracts is FPHCI. The example does not indicate (and it does not appear to be relevant) whether the CCC is a Section 475 dealer in securities. It describes a fact pattern where the "net" result may appear to be more or less (…continued)

and (3) the possible application of the straddle rules. Two obvious "solutions" that entirely eliminate all of these potential mismatches would involve significantly expanding the scope of the Business Needs Exception: (i) the regulation could be expanded to treat a TCFC as a dealer in property under Section 954(c)(2)(C) (we note this solution but do not address it in detail because it is a much larger undertaking that is well beyond the scope of this report), or (ii) both positions could be made subject to the Business Needs Exception ***and*** it could be made explicit that the special rule that allocates currency gain/loss from interest-bearing liabilities between subpart F income and non-subpart F income does not apply to liabilities to which the Business Needs Exception applies. The former would clearly require a change of law. For reasons we will discuss further in Part III.B.4, the latter very likely would as well; it is extremely difficult to conclude that both positions do or can come within the Business Needs Exception, at least under all reasonably likely scenarios, and it is far from clear under current law that the special rule for interest-bearing liabilities does not affect positions that are within the scope of the Business Needs Exception.

An alternative with ultimately very similar results, discussed in Part III.B.1, would be to treat the Borrowing as a hedge of the Lending for purposes of Section 475 (which we think may be permissible under current law, although this

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(continued…)

the same in any case, but that may well not be the case: A "currency contract" entered into with a bank is a "Section 1256 contract" that is subject to mark-to-market accounting. Thus, but for the fact that these are short-term positions, this example contemplates, or at least allows the possibility of, a significant subpart F timing mismatch, in a case in which a CFC is conducting what appears to be routine business activity.

is not entirely clear) and also to provide (or make clear) that in that scenario, the currency gain/loss from a borrowing is not subject to the special rule for interest-bearing liabilities, at least to the extent of recognized currency loss/gain from the "hedged" Section 475 security (which we think would require a regulatory change, although this is not entirely clear). Because this alternative (which would require a regulatory change) is narrowly tailored to a case where it is clear that an interest-bearing currency liability is very closely tied to an associated position, so that its gains and losses should be "matched" with those of the related position for tax purposes, we think this alternative has the benefit of accomplishing substantially all of the results we think appropriate in the context of these transactions without having a potentially broader impact on unrelated areas of the law.

Another alternative that would achieve very similar results is discussed in Part III.B.2. That involves permitting TCFCs to "bifurcate" a non-functional currency borrowing into a functional currency borrowing and a "currency swap," which as discussed in that section can be efficiently "matched" with the associated non-functional currency Lending in several possible ways. While it is not clear whether this alternative is available under current law, we think if narrowly tailored to permit this bifurcation only where, for example, the resulting currency swap is subject to mark-to-market accounting under Section 475 or used in an "integration,"[15] this would be an efficient solution to the mismatching problems identified in this Part.

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[15] *See supra* note 12.

In any event, all of these alternatives require regulatory changes (or at least substantial clarification), and involve policy considerations that are at least to some extent beyond the scope of this report. We think any of these alternatives would be appropriate in the context of the transactions we describe in this Part, although we tend to favor the two alternatives described in the preceding two paragraphs, because our perception is that they can be relatively narrowly tailored to address the issues identified in this report while minimizing the impact on other areas of the law. For completeness, this Part also discusses a number of other possible alternatives to address the issue of "mismatching" of items arising from back-to-back loans entered into by TCFCs, but concludes for various reasons set forth herein that these alternatives are inefficient, impracticable, or in need of further consideration in light of their potential impact on other areas of the law.

B. **Potential Solutions**

1. Treat the Borrowing as a hedge of the Lending under Section 475

The Borrowing might be treated as a hedging transaction with respect to the Lending under Section 475. Indeed, we believe this argument is probably technically correct, although as we will discuss, this conclusion is not at all clear.

Treasury regulations Section 1.475(c)-2(a)(2) excludes a "debt instrument issued by the taxpayer" (such as our Borrowing) from being a Section 475 security. However, under Section 475(c)(2)(F), a position that is not a "security" described in Sections 475(c)(2)(A)-(E) (which, as discussed in Part III.B.2, it is not at all clear that any portion of the Borrowing is) may nonetheless be a Section

475 "security" if it is a *hedge* with respect to a security that is described in Section 475(c)(2)(A)-(E), and is properly identified as such.[16] A Section 475 hedge is "any position that manages the dealer's risk of interest rate or price changes or currency fluctuations."[17] Because TCFC's foreign currency gains (or losses) with respect to the Borrowing will exactly offset any foreign currency losses (or gains) with respect to the Lending,[18] the Borrowing – in its entirety – would appear to be eligible to be treated as a hedge of a Section 475(c)(2) security (the Lending) and, therefore, to be marked to market (again, provided TCFC properly identifies the Borrowing as a hedge of the Lending).

Of course, there is a question whether this result would be inconsistent with Treasury regulations Section 1.475(c)-2(a)(2). However, it is not clear to us that this regulation is inconsistent with the application of Section 475(c)(2)(F) to the Borrowing. This is because Section 475(c)(2)(F) by its terms can apply to the Borrowing only *because* it is not (in the first instance) a security within the meaning of Section 475(c)(2)(A)-(E). The question is whether the regulation, in specifying that a borrowing is not a Section 475(c) security, was intended to preclude a borrowing from being identified as a hedge of a Section 475(c) security, and thus being marked to market under Section 475(c)(2)(F). Many

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[16] Section 475(c)(2)(F).

[17] As will be discussed further below, this definition is meaningfully more liberal than the equivalent definition in Treasury regulations Section 1.1221-2, because Section 475 does not require that the hedge ***"primarily"*** manage (in relevant part) currency fluctuations.

[18] In other words, the Borrowing is a position that manages the TCFC's risk of currency fluctuations with respect to a Section 475 security. The statute does not require that the ***reason*** the hedge was entered into be to manage that risk (although we think in this fact pattern, currency risk management typically is one very significant reason), only that the relevant position in fact does so.

taxpayers would understandably be reluctant to rely on the Section 475(c)(2)(F) argument absent guidance on the point, but we note that treating the Borrowing as a security by identifying it as a hedge of the Lending does appear to be a technically proper application of that provision, and one that is arguably not inconsistent with Treasury regulations Section 1.475(c)-2(a)(2).

This interpretation of the Section 475 hedging rule would have broader consequences under Section 475, which are beyond the scope of this report,[19] although in this case those consequences would arise only in the narrow context in which a borrowing is "hedging" (in a Section 475 sense) the risk of a Section 475 security and the borrower so elects. And while this solution (marking to market the entire Borrowing) would ameliorate significant aspects of the mismatching issues identified above (including straddle and Section 263(g) implications),[20] it would not avoid the application of the "special" rule for interest-bearing liabilities, which would allocate both the interest and the currency

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[19] Most notably, and obviously, the ability to mark one's own issued debt to market permits the possibility of "benefitting" from the strengthening of one's credit quality, because the resulting increase in the "value" of the liability will result in an incremental mark-to-market deduction. On the other hand, where the result is being achieved only in a "matched-book" lending business with an affiliated borrower on the "other side," this seems less likely to be a concern in practice. Also, of course, valuation may be an issue, although this is not likely to be as difficult an issue when the counterparty is a bank, as they typically mark their assets to market for accounting and other purposes and so could presumably provide indications of value to the TCFC.

[20] We do not in this report focus in detail on the straddle issues associated with the transactions at issue, other than to note that they exist. Very generally, however, Section 475 "solves" most straddle issues. First, Section 475(d) provides that Section 263(g), which can require capitalization of interest and certain other expenses associated with straddles, does not apply to securities marked to market under Section 475(a). And while Section 1092 does apply to those securities, it very generally has little significance for marked-to-market positions.

gains and losses from the Borrowing in a manner inconsistent with the equivalent items under the Lending.[21]

Thus, this result does not fix the entire mismatching problem unless, in addition, the special rule for interest-bearing liabilities is also amended to exclude from its scope liabilities that are treated as securities under Section 475(c)(2)(F). While a full analysis of the special rule for interest-bearing liabilities is beyond the scope of this report, we think it worth noting that the subpart F currency regime was finalized shortly after Section 475 was enacted, and it is not clear to us that consideration was given to the application of the special rule for interest-bearing liabilities (or the "regular dealer" exclusion in Section 1.954-2(g)(2)(ii)(C)) to CFCs that are dealers in securities for purposes of Section 475. As has been mentioned, it does seem to us appropriate, if a borrowing is acting as a hedge of dealer securities under Section 475(c)(2)(F), that items of currency gain or loss resulting from the borrowing should be "matched" with the items of currency loss or gain from the Section 475 security or securities being hedged

[21] There is an "election" available to taxpayers that would appear to avoid the mismatching consequences of the special rule for interest-bearing liabilities, although it like Treasury regulations Section 1.954-2(g)(2)(ii) is not explicitly carved out of the special rule for interest-bearing liabilities. Treasury regulations Section 1.954-2(g)(4)(i) permits a CFC to elect to include in the calculation of FPHCI the net gain or loss from essentially all section 988 transactions (and certain other items), which would include issued debt denominated in a nonfunctional currency. This election does not affect the timing of items, and in any event because it is "all or nothing," it is a rather drastic solution to the problems created by the special rule for interest-bearing liabilities.

(that is, that both sets of items should either be included in or excluded from the computation of subpart F income).[22]

2. *Treat the embedded currency position in the Borrowing as a Section 475 security*

Although, as discussed in the prior section, Treasury regulations Section 1.475(c)-2(a)(2) excludes a "debt instrument issued by the taxpayer" from being a Section 475 security (and therefore from being marked to market under that Section, subject to the discussion in the prior section of borrowings that hedge Section 475 securities), it is not clear whether that provision is intended to apply in general (*i.e.*, without regard to whether the borrowing is hedging a Section 475 security) to borrowings in *nonfunctional currencies*. Indeed, there appears to be some statutory support for the argument that the Borrowing, or at least the foreign currency position embedded therein,[23] ***is*** a Section 475 "security." Under Section 475(c)(2)(E), a "short position . . . in . . . a currency" is a security. Very generally, a person who borrows a fixed amount of a nonfunctional currency has a short

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[22] We note that this result could be reached instead by modifying the rules under Section 861, which are cross-referenced in Treasury regulations Section 1.954-2(g)(2)(iii). Whether the result described in the text would be appropriate generally under the sourcing rules (indeed, whether this "analogy" to the sourcing rules for the subpart F treatment of currency gain or loss arising from borrowings is an apt one) is well beyond the scope of this report.

[23] For example, a €100X debt instrument paying €5X per year for nine years and €105X at maturity at year 10 could be thought of as a dollar-denominated (say $130X) instrument coupled with a "currency swap contract" as defined in Treasury regulations Section 1.988-2(e)(2)(ii), in which the Borrower agree to exchange the $130X it "notionally" borrowed for €100X at inception, to receive periodic flows of some number of dollars in exchange for €5 annually for nine years, and to pay €100X at maturity in exchange for the $130X it needs to repay its "notional" dollar borrowing. *See, e.g.*, Treasury regulations Section 1.988-5T(a)(9)(iv), Example 11. *Cf.* Treas. reg. Section 1.246-5(b)(3) (treating as a "position with respect to property" an "interest . . . in property or any contractual right to a payment, whether or not severable from stock or other property").

position in that currency, in the simple sense that s/he has an obligation to return a (typically the same) fixed amount of that currency (plus interest, typically also denominated in that currency). Moreover, for purposes of the straddle rules, an "obligor's interest in a nonfunctional currency denominated debt obligation," which would include the Borrowing, "is treated as a position in the nonfunctional currency."[24] Of course, however, the *absence* of such a rule in subpart F (or more specifically, in Section 988, to which the Treasury regulations Section 1.954-2(g)(2) cross-refers) might be read to imply that a nonfunctional-currency debt obligation should ***not*** for those purposes be treated as (in whole or part) a short position with respect to the currency.

From a policy perspective, it would appear that the principle underlying Regulations Section 1.475(c)-2(a)(2) is the same principle under which loan proceeds are not included in income when received, namely that the loan will be paid in full with the issuer's after-tax money.[25] Accordingly, although the value of a functional currency obligation may vary, these variations may be viewed as economically irrelevant from the issuer's perspective, as long as the obligation is ultimately expected to be paid in accordance with its terms. This principle would, however, not apply to variations in the value of a ***nonfunctional*** currency obligation (to the extent attributable to the issuer's exposure to the nonfunctional currency), because in that case, even if the obligation is paid in accordance with

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[24] Section 1092(d)(7).

[25] It can be noted that this logic is not inexorable, particularly if the issuer or any of its affiliates "makes a market" in the issued debt, so that it is in a position to experience economic consequences of changes in the value of the position. Even if not, entities that manage their assets and liabilities, *e.g.*, for accounting purposes, may have a strong interest in the value of their liabilities. This issue is however beyond the scope of this report.

its terms, the obligation's value in the issuer's functional currency (and accordingly the issuer's tax consequences) may have permanently changed as a result of changes in the relevant exchange rate.

Accordingly, a possible solution is that the Borrowing might be "bifurcated" into a functional-currency debt obligation (that remains not a Section 475 "security") and a currency swap that is a short position with respect to the foreign currency and therefore a Section 475 security. However, under current law this argument has significant potential weaknesses. Among them, it arguably stands in contrast to the weight of authorities that generally indicate that a single financial contract is not "bifurcated" into its constituent components.[26] Moreover, it would appear to be inconsistent with Section 988(b)(1), which provides that "foreign currency gain" is any gain from a "section 988 transaction" (which includes a debt instrument denominated in a foreign currency[27]) to the extent not in excess of gain attributable to exchange rate fluctuations. If it was generally appropriate or required to bifurcate a currency debt instrument into a currency derivative and a non-currency debt instrument, this rule would be superfluous; conversely, bifurcation could cause a violation of this statutory limit.[28]

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[26] *See generally Chock Full O'Nuts Corp. v. United States*, 453 F.2d 300 (2d Cir. 1971) (treating a convertible bond as a single instrument because the right to payment of interest and principal can not be legally separated from the right to convert).

[27] Sections 988(c)(1)(A)(i), (B)(i).

[28] *Cf.* T.D. 8400, 1992-1 C.B. 101, 102 ("Bifurcation of transactions described in § 1.988(c)(1)(B)(iii) is prohibited by section 988(b)(3) which provides that any gain or loss from a transaction described in section 988(c)(1)(B)(iii) is treated as foreign currency gain or loss."). We note also that Representative Camp's "discussion draft" proposal to mark to market "derivatives" would appear to be consistent with this concern. The proposed provision would define such (…continued)

In addition, there could be some administrative difficulty in properly determining the terms of the bifurcated instruments and in properly valuing (and marking to market) the resulting currency swap contract. Further, if this argument is correct, it is correct not only for purposes of subpart F but for all purposes of Section 475, a conclusion with obviously broader ramifications that are beyond the limited scope of this report.

However, we note that this solution, unlike several of the others we address, would solve for the mismatching issue caused by the "special" rule for interest-bearing liabilities in Treasury regulations Section 1.954-2(g)(2)(iii) (without the need for a modification of that rule), because the "disaggregated" currency swap would not be an interest-bearing liability. Moreover, the disaggregated currency swap might be eligible to be "integrated" with the Lending (as discussed briefly in note 12), which would eliminate all subpart F exposure (during the term of the integration) with respect to the two positions (although again, it would leave TCFC exposed to the tax effects of its integrated dollar-denominated synthetic Lending and of its "disaggregated" dollar-denominated Borrowing, which would not match perfectly, because the synthetic Lending would be subject to mark-to-market under Section 475).

It is not clear whether this "solution" is available under current law. It would however be a material improvement for those taxpayers faced with facts

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(continued…)

"derivatives" to include positions embedded in debt instruments, but would explicitly exclude "vanilla" nonfunctional-currency debt instruments. See proposed Section 486(d)(2)(B)(i).

similar to the back-to-back loans engaged in by TCFC. If it is not viewed as the correct result under current law, we would support modifying the law to impose this bifurcation, if the ability to do so were materially limited, for example to situations in which the resulting bifurcated instrument was viewed as part of a Section 475 hedging or an "integrated" transaction.

3. Treat the Lending as a hedge of the Borrowing

Another alternative is that it is possible under current law that TCFC may be able to take the position that the ***Lending*** is a hedge of the ***Borrowing***, which as we have discussed is a security to which Section 475(a) does not apply, and, therefore, that the Lending is ***not*** marked to market (if the taxpayer properly identifies the Lending, as required by Section 475(b)(2)). Section 475(b)(1)(C) provides that the mark-to-market regime of Section 475(a) does not apply to "any security which is a hedge with respect to . . . a position, right to income, or [] liability which is not a security in the hands of the taxpayer," again if the taxpayer properly identifies it as such. The Borrowing is clearly a liability of TCFC. Further, as described above, Regulations Section 1.475(c)-2(a)(2) specifies that the Borrowing is not a Section 475(c) security. If, therefore, the Lending were treated as a "hedge" of the Borrowing, the Lending would not be subject to mark-to-market treatment under Section 475(a).

Some may say that it is an inappropriately inverted application of these rules to the facts to say that the Lending hedges the Borrowing, because the funding provided by the Borrowing is an essential prerequisite to the Lending, and, more fundamentally, the Borrowing was entered into in order to effectuate the Lending, which suggests that the Lending was not entered into to hedge the currency risk of the Borrowing. Nevertheless, it is not clear to us whether this ordering of events or causality of events is relevant to the statutory inquiry. The

statute defines a hedge to include "any position that manages the dealer's risk of . . . currency fluctuations." It is clear that any change in the value of the Lending caused by currency fluctuations will be almost perfectly offset (ignoring differences in credit) by a corresponding change in the "value" of the Borrowing, and *vice versa*. The statute does not include any requirement that one position be entered into for reasons unrelated to hedging and the other be entered into solely to hedge the first. Of course, this leads to what might be viewed as a logical paradox – namely, that the Lending is hedging the Borrowing, ***and*** the Borrowing is hedging the lending. And Section 475 has directly conflicting rules addressing these relationships. However, the "paradox" is arguably broken, at least as a practical matter, by the observation that both of these rules are subject to a condition that the taxpayer make an appropriate identification. It thus appears at least plausible that a taxpayer under these circumstances may elect to treat as marked-to-market securities ***both*** positions (by making an identification under Section 475(c)(2)(F)), ***neither*** position (by making an identification under Section 475(b)(2)) or ***one but not the other*** (by making no Section 475 identification at all).

Treating the Lending as a hedge of the Borrowing would result in neither being marked to market. This would tend to create greater matching of items between the two than marking to market the Lending but not the Borrowing, though less perfect matching than marking to market both positions. In addition, it would (like most of the available solutions) not ameliorate the consequences of the "special" rule for interest-bearing liabilities, and it may cause material

complexity under the straddle rules, including possibly under Section 263(g).[29] It has the virtue of being quite defensible under current law (although not perfectly clear), without implicating Treasury regulations Section 1.475(c)-2(c)(2). Like many of our possible solutions, it has broader ramifications under Section 475, which would need to be considered. On balance, we view this as a reasonably strong position under current law but not a terribly satisfying solution to the issue. Of course, the result could be improved if in addition, it were made clear that the special rule for interest-bearing liabilities does not apply to the Borrowing in these circumstances. However, the idea of permitting "matching" of items arising from a liability to those arising from an asset in a context where the positions are being treated as ***not*** being "dealer securities" (*i.e.*, not being treated as held together in the ordinary course of business) seems somewhat logically inverted. And because in any case there will be material potential straddle issues, as discussed above, we think other alternatives discussed in this Part would be preferable solutions.

4. Treat the Borrowing as a hedge of the Lending under Section 1.1221-2

Another way to treat the Borrowing as a hedge of the Lending, in addition to that discussed in Part III.B.1, is under Treasury regulations Section 1.1221-2. That regime has numerous conditions that must be met in order for a position (here, the Borrowing) to be treated as a hedge of another position (here, the Lending). Among them, the "hedged" position, when it is property, must be "ordinary property," which means its sale or exchange could not produce capital

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[29] *See supra* note 20.

gain or loss under any circumstances.[30] In the case of property held as such by a dealer in securities (which the Lending is), we think this condition is likely met.[31] And most importantly, the hedge must be entered into "primarily . . . to manage risk of price changes or currency fluctuations with respect to ordinary property . . . held or to be held by the taxpayer."[32]

The Regulations do not define the term "primarily," but they do specify certain circumstances in which a transaction will ***not*** be treated as primarily managing risk. In particular, Treasury regulations Section 1.1221-2(d)(5) provides that, "[e]xcept as otherwise determined in published guidance or private letter ruling, the purchase or sale of a debt instrument . . . is not a hedging transaction even if the transaction limits or reduces the taxpayer's risk with respect to ordinary property, borrowings, or ordinary obligations." Neither the regulation nor its preamble clarifies whether a "sale" of a debt instrument encompasses an original issuance of debt.[33] Treasury regulations Section 1.1221-

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[30] Treas. Reg. Section 1.1221-2(c)(2).

[31] We note, however, that there are circumstances in which positions being marked to market under Section 475(a) "could" generate capital gain or loss, including if they come to be held other than in connection with the taxpayer's activities as a dealer in securities, *see* Section 475(d)(3)(B)(ii), and if the taxpayer ceases to be a dealer in securities and changes its method of accounting. *See* Rev. Rul. 97-39, discussed *infra* note 41. Thus, there is at least a theoretical question whether it can be said that a sale or exchange of dealer property "could not produce capital gain or loss under any circumstances."

[32] Treas. reg. Section 1.1221-2(b)(1).

[33] In a technical tax sense, the issuer of debt (here, TCFC) is not selling any debt instrument, because it had no debt instrument to sell. This is perhaps a somewhat sophistic argument, as it is plain that the lender is buying a debt instrument from the issuer, and in plain English it is difficult to say with confidence that the issuer is not selling that instrument (even if it's being created in the process of the sale). Nonetheless, it is a reasonable question whether the intent of the language of the regulation was rather to provide that a ***short sale*** of third-party debt is (…continued)

2(d)(5), therefore, might well be read to prevent the Borrowing from qualifying as a Section 1221-2 hedging transaction.

However, some support for the position that this is not the intended outcome can be found in the three examples illustrating this limitation. The examples, involving purchases of a floating rate bond, mutual fund shares and variable annuity contracts, respectively, involve transactions that are primarily investments from the taxpayer's perspective, and that only secondarily manage risk with respect to the ostensibly hedged positions.[34] Further, as a policy matter, these examples reflect the historic concern with transactions that, if deemed to be hedging transactions, could result in the deferral of income under the hedging rules, which is not an issue when the "hedging position" is a borrowing. Indeed, it is difficult to discern any policy reason not to permit a borrowing to be a hedge – and particularly when the purpose is to permit the position to be marked to

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(continued…)

not a hedging transaction. We believe that reading would be supported by what we understand to be the policy underpinning of this limitation, which was to prevent the inclusion of income – essentially, time value – on "investments" (including potentially the investment of short sale proceeds) from being deferred under the hedging rules.

In this regard, it is instructive that a prior version of the hedging regulations, Treasury regulations Section 1.1221-2(c)(3), T.D. 8555 (1994), provided that "borrowings generally are not made primarily to reduce risk." This language was retained in proposed regulations that preceded the current regulations, but the final amended regulations excluded all references to borrowings. The preamble to the final regulations states, "[t]he rule has been restated in the final regulations to refer specifically to investments in debt instruments, equity securities, and annuity contracts so as to provide greater certainty in its application." T.D. 8985 (2002). While this indicates that the drafters of the final regulations did not intend to exclude borrowings categorically, it obviously does not answer the question whether a particular borrowing (or even any borrowing) "primarily" manages risk of ordinary property.

[34] Treas. reg. Section 1.1221-2(d)(5)(ii).

market in a way that (in general, *i.e.*, ignoring some of the inefficiencies of subpart F discussed above) will nearly perfectly match the items on the "hedged" position.

In any event, we do view it as unclear whether in light of the Borrowing's significant function as a ***source of funding***, it is properly considered entered into "primarily" to manage risk with respect to the Lending. And of course, this is once again an issue with ramifications well beyond the scope of this report.

If the Borrowing is a "good" Section 1221-2 hedge of the Lending, Treasury regulations Section 1.446-4, which provides the timing rules for accounting for items with respect to hedging transactions, specifies that, "[i]n the case of a transaction that hedges an item that is marked to market under the taxpayer's method of accounting, marking the hedge to market clearly reflects income."[35] Thus if the Borrowing is a "good" Section 1221-2 hedge, it may (indeed, likely must) be marked to market, with the results (good and bad) described in Part III.B.1.

As a further observation, if the Borrowing could be viewed as a Section 1221-2 hedge of the Lending (and even if it could not, if it could meet the "loosened" criteria necessary to qualify as a Treasury regulations section 1.954-2(a)(4)(ii) "*bona fide* hedging transaction"[36]), then it would be at least

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[35] Treas. reg. Section 1.446-4(e)(2).

[36] As discussed in more detail below at note 53 and accompanying text, a *bona fide* hedging transaction under the Business Needs Exception need not be strictly a "good" Section 1221-2 hedge, in that it is sufficient for this purpose that the property being hedged, even if not (…continued)

theoretically possible to conclude that the currency gain/loss with respect to ***both*** positions is excluded from the computation of subpart F income, under the Business Needs Exception – but ***only*** if it was possible to conclude that the Lending "does not itself (and could not reasonably be expected to) give rise to subpart F income other than foreign currency gain or loss."[37] Very briefly, in order for gain/loss with respect to a position to qualify for the Business Needs Exception as set forth in the regulations, the gain/loss must in relevant part (simplifying significantly) either (1) arise from property (other than a hedging transaction, and excluding currency forward contracts, futures, options or similar contracts) that is used or held for use in the course of a business and that does not and could not reasonably be expected to give rise to any subpart F income (other than currency gain), and be clearly determinable as being derived from that property, or (2) arise from a "*bona fide* hedging transaction" (very generally, a Section 1221-2 hedge, with certain modifications and limitations, mentioned briefly in note 36) with respect to property described in (1).

Very generally, it is likely in practice to be impossible to conclude that the Lending does not and could not reasonably be expected to give rise to subpart F income other than currency gain/loss. That is because the Lending is a security of an affiliate of the CFC, and thus will generate interest income that will be treated as subpart F income and non-subpart F income, depending upon the income of the

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(continued…)

producing ordinary income or loss in all circumstances, as required by Treasury regulations Section 1.1221-2, is (in relevant part) a "section 988 transaction[]," which the Lending clearly is.

[37] Treas. reg. Section 1.954-2(g)(2)(ii)(B)(*1*)(*ii*).

Borrower CFC.[38] Even if the Borrower CFC in fact has no subpart F income (which will be very rare, at best), it is difficult to say with confidence that it could not reasonably be expected to have some, which is a condition to the application of the Business Needs Exception to the Lending, which is itself a condition to the application of that exception to the Borrowing.

Thus, even if the Borrowing could be a good Section 1221-2 hedge of the Lending (itself a difficult issue), in order to "optimize" the mismatching issues by excluding both positions under the Business Needs Exception, it would be necessary to expand that exception to permit the Lending to be Business Needs Property. Alternatively, as discussed in prior sections, this "solution" could be materially improved if in addition to the Borrowing being treated as a Section 1221-2 hedge of the Lending, the "special rule for interest-bearing liabilities" was turned off for Borrowings that are hedges within the meaning of Treasury regulations Section 1.1221-2. However, because we view the question of qualification as a Section 1221-2 hedge as a more difficult one than the question of qualification as a Section 475 hedge, we would not strongly support this solution, either under current law or by clarification or amendment of the relevant regulations.

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[38] Under Section 954(c)(6), interest received from a CFC that is a related person is characterized as subpart F and non-subpart F income by reference to how the corresponding *deduction* for the interest is allocated among the categories of income of the related person. Treasury regulations Section 1.954-1(c)(i)(*1*)(*C*), by cross referencing the "interest soak-up" rule in Treasury regulations Section 1.904-5(c)(2), generally allocates related party interest expense of a borrower first to the borrower's FPHCI. Thus, interest received by TCFC will be characterized as subpart F income to the extent of Borrower CFC's FPHCI, and only the excess will be characterized as non-subpart F income.

5. Treat each "currency loan book" as a separate QBU.

Another possibility would be to allow TCFCs (and perhaps only TCFCs, as defined in some manner) to treat each "book" of nonfunctional-currency lendings and borrowings as a separate QBU in that loan book's nonfunctional currency. This would likely require some clarification (which could probably be done through a revenue ruling or a notice) of the rules relating to QBUs,[39] but would eliminate any currency gain and loss associated with back-to-back borrowings and lendings, because all the relevant positions would be in a QBU with the relevant foreign currency as its functional currency.[40] One obvious difficulty with this potential approach is that the TCFC's expenses (including overhead, etc.), which would be likely to be denominated in some non-functional currency (from the perspective of the relevant QBU – *e.g.*, dollars, or whatever the CFC's functional currency is) would need to be allocated among its various "loan-book QBUs," which could itself create currency gain and loss for each of the QBUs. In addition, this "solution" would bring the TCFC's loan-book QBUs within the scope of Section 987, which as discussed in Part IV is a complex and imperfect regime. Nonetheless, while we consider other alternatives described above as simpler and more straightforward solutions to the mismatching issue, we recommend that Treasury and the IRS consider this as a possibility if none of those is considered acceptable.

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[39] *See* Sections 985(b)(1)(B), 989(a).

[40] A distribution ("remittance") from the QBU back to the TCFC (including a liquidation of the QBU) could give rise to "Section 987 gain or loss," as discussed in some detail in Part IV.

6. The negligible sales exception from Section 475

TCFC may be able to avoid being classified as a dealer altogether, if (as we understand is often the case) it falls within the "negligible sales" exception to dealer status, discussed above in note 7, and it does not elect to be treated as a dealer in securities. In that event, none of its positions would be marked to market.[41]

To review the negligible sales exception briefly, Treasury regulations Section 1.475(c)-1(c)(1) provides that, "a taxpayer that regularly purchases securities from customers in the ordinary course of business of a trade or business (including regularly making loans to customers in the ordinary course of a trade or business of making loans) but engages in no more than negligible sales of the securities so acquired is not a dealer for the purposes of Section 475(c)(1)." A taxpayer engages in negligible sales if either it sells fewer than 60 securities in a year or the adjusted basis of the securities sold in the year is less than 5% of the total basis of its securities acquired in that year, measured in each case immediately after acquisition.[42] This exception applies in any year for which a TCFC meets these criteria unless it elects to be treated as a dealer, which it does

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[41] However, under Revenue Ruling 97-39, once a taxpayer has used the Section 475 method of accounting for securities, it may not change that method of accounting without the consent of the Commissioner. Revenue Ruling 97-39 specifically notes that if a taxpayer was eligible for the negligible sales exception but nonetheless chose to mark its securities positions to market, permission for a change in the method of accounting will be granted only in exceptional circumstances. As such, the practical availability of this option for a pre-existing entity may be significantly limited.

[42] Treas. reg. Section 1.475(c)-1(c)(2).

simply by filing a federal income tax return in which it marks position to market under Section 475(a).[43]

Taking advantage of the negligible sales exception is a way of achieving the results achieved by treating a Lending as a hedge of a Borrowing, discussed above, except that it will apply to ***all*** of TCFC's positions (*i.e.*, TCFC would not be permitted to mark to market any positions pursuant to Section 475 for the relevant year). We are skeptical that many TCFCs will wish to make such a significant decision, given that they may be engaging in a range of other activities for which marking to market is viewed as an efficient method of tax accounting.[44] In addition, TCFC cannot know if it will be eligible for the negligible sales exception in any year until the end of the year.

The negligible sales exception has the virtue of being clearly available under current law (when it is available, factually). However, like the solution of treating the Lending as a hedge of the Borrowing, it solves only a relatively small component of the potential mismatch between Borrowings and Lendings.[45] And it is a fairly draconian, all-or-nothing, determination that may have consequences

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[43] Treas. reg. Section 1.475(c)-1(c)(1)(ii).

[44] And this "solution" will not generally be available for pre-existing dealers that did not initially choose this option. *See supra* note 41.

[45] Even if a TCFC had the foresight to avoid the timing mismatch otherwise potentially caused by Section 475 by not electing mark-to-market status, it would still suffer from the mismatch created by the application of the special rule for interest-bearing liabilities, discussed throughout this Part. In addition, one might argue that it is not good policy to be discouraging mark-to-market treatment generally, even for taxpayers who have the right to elect out, given the general belief that marking to market more clearly reflects income than realization/accrual accounting

for unrelated positions of TCFC and that TCFC cannot know is available until year-end.

C. Conclusion and recommendation

If Treasury and the IRS want to ensure that the currency gain/loss generated by Borrowings in the context of back-to-back arrangements engaged in by TCFCs is excluded from the computation of subpart F income, there are two obvious "solutions" that entirely eliminate all potential mismatches, though they would both involve significantly expanding the scope of the Business Needs Exception. Those solutions are that: (i) the regulation could be expanded to treat a TCFC as a dealer in property under Section 954(c)(2)(C) or (ii) both positions could be made subject to the Business Needs Exception and it could be made explicit that the special rule that allocates currency gain/loss from interest-bearing liabilities between subpart F income and non-subpart F income does not apply to liabilities to which the Business Needs Exception applies. The former would clearly require a change of law (with potentially significant broader consequences for the regime), and as discussed in Part III.B.4 and note 11, the latter very likely would require several such changes.

Another possible solution, perhaps more narrowly tailored to the issue than either of those described above, would be to indicate that TCFCs may treat Borrowings as hedges of Lendings under Section 475(c)(2)(F) (which could probably be done without issuing a regulation), accompanied by a regulatory modification to the special rule for interest-bearing liabilities so that currency gain/loss from any such liability that is properly treated as a security under Section 475(c)(2)(F) is matched with the associated items of currency loss/gain from the "hedged" Section 475 security (at least to the extent thereof).

A fourth possible solution, which would likely require a regulation and might even require a statutory change, would be to permit (or require) "bifurcation" of non-functional currency borrowings into a functional currency borrowing and a "currency swap," perhaps limited to cases where the resulting currency swap will be treated as a hedge of, or integrated with, an associated asset.

In any event, we note that the special rule for interest-bearing liabilities, while generally beyond the scope of this report, seems to us fairly arbitrary, at least in a situation where the liability in question is clearly directly attributable to another position, and we suggest that it would be worthy of careful study to determine the extent to which it produces desirable results or serves a valid policy function in those circumstances. We would be happy to assist in this review.

IV. HEDGE BY A CFC OF FOREIGN CURRENCY EXPOSURE TO A QBU

In this Part IV, we consider whether a CFC with economic foreign currency exposure as a result of a transaction entered into by the CFC's Section 987 "qualified business unit" (a "**Section 987 QBU**") can enter into a foreign currency transaction that economically hedges that exposure and qualify the income or loss from that hedge for exclusion from the computation of subpart F income under the Business Needs Exception. We conclude that the Business Needs Exception should be available in such a case, notwithstanding some complications in the analysis resulting from how the rules under Section 987 work and accordingly some uncertainty as to that conclusion. However, as described further below, taxpayers bear a significant tax burden if they wrongly identify as a hedge a position that is not in fact eligible to be treated as a hedge, or if they wrongly fail to identify as a hedge a position that the IRS determines should have

been treated as a hedge. Accordingly, given the uncertainty and the difficulties this creates for taxpayers, we recommend that clarifying guidance be issued.

A. Background

Once again, we illustrate the issue with a simple example ("**Example 2**," depicted in Figure 2, below). A CFC organized and resident in Country X ("**USD CFC**") has as its functional currency the U.S. dollar. USD CFC has a wholly owned legal subsidiary, organized and resident in Country Y, that has as its functional currency the euro, that is enaged in an operating business and that has elected to be disregarded as an entity separate from USD CFC for U.S. tax purposes and is accordingly treated as a Section 987 QBU (the "**Euro Branch**"). In the ordinary course of business, the Euro Branch purchases inventory in euros from unrelated manufacturers and sells inventory in euros to unrelated customers. During USD CFC's taxable year (the calendar year), the following transactions take place:

> On October 1, USD CFC purchases €100X (then valued at $130X) and transfers this amount to the Euro Branch, which in turn purchases inventory for €100X;
>
> On October 1, USD CFC enters into a forward currency contract with an unrelated bank to sell €130X (then valued at $169X), which is the Euro Branch's forecasted sales revenue with respect to the purchased

inventory, for $169X,[46] with settlement on November 30 (the "**Euro Contract**");

On November 30, Euro Branch sells the purchased inventory for €130X and transfers €130X to USD CFC (together with the October 1 purchase and transfer of €100X and Euro Branch's purchase of inventory, the "**Inventory Transactions**"); and

On November 30, USD CFC settles the Euro Contract by selling €130X (then valued at $156X) to the unrelated bank for $169X.

The euro-dollar exchange rate is $1.3:€1 on October 1 and $1.2:€1 on November 30, and the average annual euro-dollar exchange rate for the taxable year is $1.4:€1.

This fact pattern is illustrated as follows:

[46] €130X * $1.3:€1, the spot rate on October 1. (In reality, it is likely that the "forward" exchange rate would be different from the spot rate.)

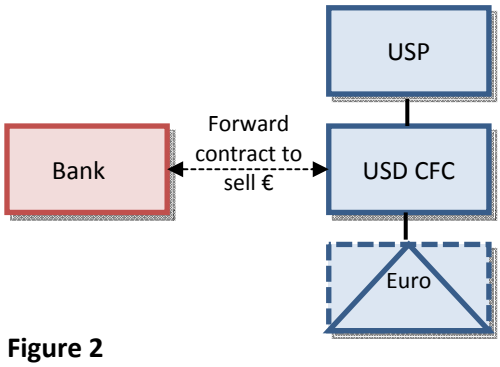

Figure 2

As a result of the Inventory Transactions, USD CFC has a net economic gain of $26X.[47] If there had been no fluctuation in the euro-U.S. dollar exchange rate during the relevant period, USD CFC would have had an economic gain of $39X attributable to the Inventory Transactions,[48] which implies that USD CFC's net economic gain of $26X reflects an economic loss of $13X that is attributable to the interim depreciation of the euro relative to the U.S. dollar. Indeed, upon settlement of the Euro Contract, USD CFC has a gain of $13X with respect to the Euro Contract,[49] and this amount exactly offsets USD CFC's economic foreign currency loss with respect to the Inventory Transactions. Thus, by entering into the Euro Contract, USD CFC has economically neutralized the currency exposure and ensured that total gain equals the $39X that the Inventory Transactions would have generated had there been no embedded foreign currency exposure.

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[47] Value of proceeds (€130X x $1.2:€1) – value of cost (€100X x $1.3:€1) = $156X - $130X.

[48] Value of proceeds at "historic" exchange rate (€130X x $1.3:€1) – value of cost (€100X x $1.3:€1) = $169X - $130X.

[49] $169X – value of €130X at $1.2:€1 = $169X - $156X.

At this point (before considering any effects of Section 987), it appears that the Euro Contract hedges USD CFC's currency exposure (through its Euro Branch) arising from its anticipated receivable from the sale of inventory. At this point, it seems that the requirements of the Business Needs Exception are met such that the currency gain/loss from the Euro Contract would be eligible to be excluded from the computation of subpart F income. However, for reasons discussed below, once the effect of the rules under Section 987 is taken into account, some uncertainty about this conclusion develops. While we ultimately conclude that USD CFC should nevertheless be eligible to treat currency gain/loss with respect to the Euro Contract as excluded from the computation of subpart F income under the Business Needs Exception, we recommend that guidance clarifying this be issued.

B. Accounting treatment[50]

Appropriate U.S. GAAP accounting for foreign currency derivatives, including hedging derivatives, depends on the rationale for using the derivative and whether the instrument satisfies the requirements for hedge accounting. Unlike tax, derivatives accounting does not distinguish between "realized" and "unrealized" results.

Absent hedge accounting treatment, a derivative is recorded as an asset or liability at its fair market value, and it is revalued on each balance sheet date (with changes reflected in the income statement). However, if the derivative is intended

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[50] Again, as noted in note 8, above, we are not accounting experts, and the discussion of accounting in this report is based on our understanding of the relevant financial accounting rules

as a foreign currency hedge and is appropriately documented as such, then one of three possible accounting treatments might apply (which applies depends upon the specific facts): (i) fair value hedge accounting, (ii) cash flow hedge accounting or (iii) accounting for hedges of net investments in foreign operations.

Under fair value hedge accounting, which applies when the hedge offsets changes in the fair value of any recognized asset, liability or firm commitment (not including an equity investment in a consolidated subsidiary), the hedge is accounted for in the manner described in the preceding paragraph (*i.e.*, it is revalued on each balance sheet date, with changes reflected in the income statement). The carrying value of the exposure being hedged (the "hedged item"), however, is also adjusted each accounting period to reflect changes in value due to currency fluctuations. The income statement impacts of the hedge and the hedged item would thus largely offset one another.

Under cash flow hedge accounting, which applies when the hedged item pertains to a variable or uncertain cash flow (including for example certain forecasted receivables, whether of the entity or of its subsidiaries), the hedge is accounted for by considering the hedge's effectiveness. Under Accounting Standards Codification 815, the "effective portion" (as described below) of the gain or loss on the hedge is reflected in "other comprehensive income" and is taken into income as the hedged transaction impacts income, while the "ineffective portion" is generally reflected in the income statement immediately. Hedge "effectiveness" refers to the extent to which changes in the fair market value of the hedge offset changes in the fair market value of the underlying hedged item.

Under net investments hedge accounting, which applies to certain hedges of foreign currency exposure relating to foreign operations (including operations of certain subsidiaries) but would not apply to a hedge of forecasted earnings, gain or loss from the hedge (as well as the hedged operations) are recorded in a "cumulative translation adjustment" in shareholders' equity. A cumulative translation adjustment is not reflected in the income statement of the relevant entity until a substantial liquidation or disposition of the relevant operations occurs.[51]

On our facts in Example 2, it seems likely that USD CFC would use both cash flow hedge accounting ***and*** net investments hedge accounting, as its hedge is in part of a net investment in the Euro Branch and in part a hedge of a forecasted receivable. We understand that these methods can significantly minimize the impact of exposure to fluctuations in the rate of exchange between the group's functional currency (for accounting purposes) and a nonfunctional currency to which the group has economic exposure. In all events, this neutral accounting treatment once again contrasts substantially with the tax treatment, as described further in the next section.

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[51] We note the difference in treatment between net investment hedge accounting and the approach taken in both the 1991 and 2006 Proposed Regulations under Section 987, discussed further below, both of which may account for some portion of the tax items analogous to the CTA prior to liquidation or termination of the relevant operations (the "**QBU**").

C. Eligibility for exclusion from subpart F income

The Euro Contract is a "section 988 transaction"[52] to USD CFC, and gain recognized by USD CFC upon settlement of the Euro Contract will, therefore, be treated as currency gain and included in FPHCI unless this gain is eligible for exclusion under the Business Needs Exception.

As discussed above, the Business Needs Exception, generally excludes from FPHCI currency gain or loss that arises from:

(1) a non-hedging transaction entered into, or certain property used or held for use, in the normal course of the CFC's trade or business that does not and could not reasonably be expected to give rise to subpart F income (other than foreign currency gain or loss) and that satisfies certain other requirements (to which we will refer as a "**Business Needs Transaction**" and "**Business Needs Property**," respectively) or

(2) a "*bona fide* hedging transaction" with respect to a Business Needs Transaction or Business Needs Property, provided that any gain or loss arising from the hedged transaction or property that is attributable to a change in exchange rates is "clearly determinable" from the records of the CFC as being derived from the hedged transaction (a "**Business Needs Hedge**").

A *bona fide* hedging transaction is defined generally as an appropriately identified "hedging transaction," as defined in Treasury regulations Section 1.1221-2, except that the risk being hedged may be with respect to ordinary

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[52] Section 988(c)(1)(A)(i), (B)(iii).

property, section 1231 property[53] or a section 988 transaction (as well as a borrowing or ordinary obligation).[54] In each case, the transaction must hedge the CFC's own risk.[55] That is, a *bona fide* hedging transaction does not include a transaction that hedges the liabilities, inventory or other assets of a related person or that is entered into to assume or reduce the risk of a related person.[56]

In analyzing whether any gain from the Euro Contract may be excluded from the computation of USD CFC's FPHCI under the Business Needs Exception on the grounds that the Euro Contract is a Business Needs Hedge with respect to Business Needs Property,[57] *i.e.*, the QBU's inventory, several questions are raised:

First, could (or should) the Euro Branch be considered for this purpose a "related person" with respect to USD CFC, in which case USD CFC could not hedge the Euro Branch's inventory in a *bona fide* hedging transaction? If not,

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[53] Very generally, Section 1231 property is property (including real estate and other specified types of property) that is used in a trade or business and for which depreciation is allowable, that is not inventory, held for sale to customers or certain literary or artistic materials or rights, and that is held for more than one year.

[54] Treas. reg. Section 1.954-2(a)(4)(ii)(A).

[55] Treas. reg. Sections 1.954-2(a)(4)(ii)(A); 1.1221-2(b)(1) to -2(b)(3).

[56] Treas. reg. Section 1.954-2(a)(4)(ii)(A). A "related person" is defined in Treasury regulations Section 1.954-2(a)(4)(ii) by cross-reference to Section 954(d)(3), and generally is a person that "controls" the CFC or is controlled by the same person that controls the CFC, in each case where control involves greater than 50% of the voting power or value, subject to certain attribution rules.

[57] There is a question whether the Euro Contract hedges Business Needs Property (the Euro Branch's inventory) or instead a Business Needs *Transaction* (the Euro Branch's contemplated sale of the inventory). We think that under Treasury regulations Section 1.1221-2(f)(3)(ii), this is better considered Business Needs Property, though it is not entirely clear. Happily, it does not matter to our analysis, which is the same in either case.

then the Euro Branch is a part of the same person as USD CFC, in which case the related person prohibition would not apply.

Second, is the Euro Contract a hedge of Business Needs Property held by USD CFC (through the Euro Branch), or is it in some sense a hedge of a "tax attribute" (an item or items to be accounted for by USD CFC under Section 987 upon "remittance" of amounts relating to the Euro Branch's inventory sales), in which case the Euro Contract would not constitute a Section 1.1221-2 hedge (and therefore also not a Business Needs Hedge)? Relatedly, in order for the Euro Contract to be a Business Needs Hedge, does the Euro Contract need to hedge a position that will involve items recognized by the taxpayer (here, USD CFC) as foreign currency gain or loss?

Third, if the Euro Contract is a hedge with respect to Business Needs Property held by USD CFC (through its Euro Branch), is the gain or loss (in our example, loss) that is attributable to a change in exchange rates that arises from the hedged inventory not "clearly determinable" from the records of USD CFC as being derived from the Euro Branch's inventory sales, as a consequence of the Section 987 regime (in which case the clearly determinable requirement of the Business Needs Exception would not be met)?

We believe the answer to each of these questions should be "no," for the reasons that follow.

1. The Section 987 rules generally

Section 987 generally addresses the computation and translation of taxable income in respect of a Section 987 QBU and the recognition of gain or loss in connection with remittances from a Section 987 QBU to its owner. Prior to its

enactment, domestic taxpayers were generally permitted to report income attributable to foreign branch operations using either the "net worth" method (also described as the "balance sheet" method) or the "profit and loss" method.[58] Under the net worth method, in each taxable year, the taxpayer's income in respect of a foreign branch was equal to the difference between the "branch net worth" at the beginning and at the end of the year, with remittances of foreign currency added back to the year-end balance sheet. In determining branch net worth, the value of current assets and liabilities was translated at the spot rate on the applicable measurement date, the basis of each noncurrent asset and liability was translated at the applicable historic spot rate and each remittance was translated at the spot rate on the date it was remitted to the taxpayer.[59] Under the profit and loss method, in each taxable year, the taxpayer's income in respect of a foreign branch was equal to the sum of all remittances of profits (in foreign currency) during the year, each converted at the spot rate on the date it was remitted to the taxpayer, and non-remitted profits, converted at the spot rate on the last day of the year. Neither method contemplated the recognition of foreign currency gain or loss as a result of a remittance of property (other than the foreign currency of the branch).

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[58] Rev. Rul. 75-106, 1975-1 C. B. 31 (describing the "net worth" method), *obsoleted by* Rev. Rul. 2003-99; Rev. Rul. 75-107 (describing the "profit and loss" method), 1975-1 C.B. 32, *obsoleted by* Rev. Rul. 2003-99. *See also Travelers Ins. Co. v. United States*, 303 F.3d 1373 (Fed. Cir. 2002), *cert denied*, 124 S. Ct. 101 (2003).

[59] In effect, the net worth method required foreign exchange gain or loss on current assets and liabilities to be marked to market.

The Tax Reform Act of 1986 added subpart J (Sections 985-989) to the Code.[60] Among other things, subpart J mandates the use of a profit and loss method of computing foreign branch income,[61] the translation of such income at the average exchange rate for the taxable year[62] and the reconciliation of any unaccounted-for exchange gain or loss inherent in accumulated earnings or branch capital upon the remittance of property (not just foreign currency) from a foreign branch.[63] The legislative history of subpart J indicates that Congress believed that there were fundamental problems with the net worth method, including the potential to give tax effect to items of loss that are subject to limitation, that the measurement of income or loss under the profit and loss method would bear a close relation to taxable income computed by the relevant foreign jurisdiction and that use of an average exchange rate, rather than the year-end spot rate, for translation of income or loss would result in less distortion of income.[64] The

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[60] P.L. 99-514, 100 Stat. 2085 (Oct. 22, 1986).

[61] Sections 987(1), (2).

[62] Sections 987(2), 989(b)(4).

[63] CONF. REP. NO. 99-841, at II-675 ("[A]ny remittance of property (not just currency) will trigger exchange gain or loss inherent in accumulated earnings or branch capital."). The Conference Report language oversimplifies how Section 987 operates with respect to remittances. As discussed throughout this Part, Section 987 gain and loss items are ***not*** treated as currency gain or loss for tax purposes, nor for various reasons do they typically reflect solely and completely the economic exchange gain or loss incurred by the relevant taxpayer or CFC in connection with its QBU's property and transactions. However, the legislative history does summarize what we think is the intended function of Section 987 gain or loss, which is ultimately to reconcile the taxpayer's or CFC's income with its QBU's income by accounting for any "mismatch" between the QBU's income (which again for various reasons identified in this Part may reflect some but not all of the taxpayer's or CFC's economic exchange gain or loss) and the taxpayer's or CFC's income. And while perhaps not perfectly, that reconciliation will largely reflect amounts attributable to economic exchange gain or loss.

[64] H.R. REP. NO. 99-426, at 469.

legislative history also makes it clear that the treatment of remittances by foreign branches under 987 was intended to be consistent with the treatment of distributions by foreign subsidiaries.[65]

Implementing Section 987 has proven to be very difficult. Two sets of proposed regulations have been released under Section 987, the first in 1991 (the "**1991 Proposed Regulations**"),[66] and the second in 2006 (the "**2006 Proposed Regulations**").[67] The Preamble to the 2006 Proposed Regulations indicates that either the 1991 Proposed Regulations or the 2006 Proposed Regulations is a reasonable method of compliance with Section 987, unless the regulations are applied in a manner such that Section 987 gain or loss does not reflect economic gain or loss derived from changes in exchange rates.[68]

Under the 1991 Proposed Regulations, a Section 987 QBU's income or loss for each taxable year is computed in its functional currency and generally translated into the owner's functional currency using the average exchange rate for the applicable taxable year (and that amount of income or loss is reflected in

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[65] The House Report explains: "[B]ecause the profit and loss method would not translate balance sheet gains and losses, some mechanism for recognizing gains and losses inherent in functional currency or other property remitted to the home office must be provided. . . . One of the reasons for the adoption of the pooling approach is to reverse certain present-law consequences that result in the disparate treatment of branch operations and operations conducted through a subsidiary. Similarly, for purposes of determining exchange gain or loss on branch remittances, the committee discerned no policy reasons for applying different rules to remittances from a branch and distributions from a subsidiary." *Id.* at 469-470. The Senate Report contains substantially the same language. S. REP. NO. 99-313, at 455.

[66] 56 Fed. Reg. 48457 (Sept. 25, 1991).

[67] 71 Fed. Reg. 52876 (Sept. 7, 2006), corrected, 71 Fed. Reg. 77654 (Dec. 27, 2006).

[68] 71 Fed. Reg. at 52890 (Sept. 7, 2006).

the owner's income for the year).[69] In addition, upon a remittance from a Section 987 QBU,[70] the owner of the Section 987 QBU recognizes "Section 987 gain or loss" based on an "equity pool method," which entails maintenance of a "basis pool" in the functional currency of the owner and an "equity pool" in the functional currency of the Section 987 QBU.[71]

Applying the 1991 Proposed Regulations to our Example 2, the Euro Branch has €30X of income during the year, and this results in USD CFC recognizing taxable income of $42X (€30X x $1.4:€1). In addition, the "remittance" of €130X by the Euro Branch to USD CFC, which is worth $156X at spot on the date of the transfer, triggers recognition by USD CFC of $16X of Section 987 loss.[72] Note that because USD CFC's income (as opposed to its Section 987 currency gain or loss, arising on remittances) is translated under the 1991 Proposed Regulations using the *average* exchange rate for the year, rather than either the spot rate at the time the income arose (*i.e.*, on sale of the Euro Branch's inventory) or the spot rate at the time the inventory was purchased, that

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[69] Prop. Treas. reg. Section 1.987-1(b)(1) (1991).

[70] Under the 1991 Proposed Regulations, a remittance is a transfer from a 987 QBU to the extent that the aggregate amount of transfers from the 987 QBU does not exceed the year-end balance of the equity pool. Transfers are netted on a daily basis. Prop. Treas. reg. Section 1.987-2(b)(2), (4) (1991).

[71] Prop. Treas. reg. Section 1.987-2(a), (d) (1991). Very generally, the 1991 Proposed Regulations define Section 987 gain or loss with respect to a remittance as the spot value of the remittance on the remittance date minus the portion of the owner's "basis pool" attributable to the remittance. In our simplified example, USD CFC's basis pool is equal to the spot value of the €100X it transferred to the Euro Branch ($130X) plus the spot value of its income from the Euro Branch ($42X, as described in the next sentence in the text), or $172X.

[72] $156X "spot" value on the date of remittance minus $172X "basis pool" attributable to the remittance.

income ($42X) reflects currency exposure that is not equal to the actual economic currency exposure for USD CFC.[73] Relatedly, the Section 987 loss item resulting from the remittance (-$16X) is not equivalent to the economic loss resulting from the depreciation that actually occurred in the value of the euro relative to the U.S. dollar from the time the inventory was purchased until the time it was sold (which was -$13X). It should, however, be noted that the *sum* of USD CFC's "income" ($42X) and its Section 987 loss item (-$16X), or $26X, does reflect its true net economic consequences.[74]

While USD CFC clearly suffered a $13X currency loss from the Inventory Transactions as a result of the decline in value of the euro, which loss was perfectly hedged by the Euro Contract,[75] under the 1991 Proposed Regulations USD CFC will never recognize a $13X "tax item" relating to that loss. Instead,

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[73] While this is the only "cause" of the differential between the Section 987 loss and USD CFC's economic exchange loss in our simplified example, it is not the only possible cause of this phenomenon. For example, if USD CFC had contributed euros to the Euro Branch and the Euro Branch had not immediately invested them in inventory, or if the Euro Branch had delayed remittance of its inventory sales proceeds, the interim changes in the dollar-euro exchange rate would further complicate the analysis. And of course the fact that remittances can be delayed indefinitely means at least a significant portion of the "tax item" arising from USD CFC's economic exchange exposure to the Inventory Transactions may be deferred accordingly. While this is pertinent to how the hedge of those Transactions would be accounted for under Treasury regulations Section 1.446-4, as discussed further below, we do not think it is pertinent to whether subpart F should apply to the items arising from the hedge.

[74] $156X spot value of inventory sales proceeds minus $130X spot value of euros transferred to the Euro Branch.

[75] For avoidance of doubt, that it was perfectly hedged is not essential to our analysis. If USD CFC had merely *expected* the inventory to be sold for €130X and structured the Euro Contract accordingly, but the inventory had been sold for something more or less than €130X, that would not affect the analysis of whether the Euro Contract was a "hedge" of the inventory sale; the requirement for a hedge is that it be intended primarily to manage risk, not that it perfectly succeed. *See* Treas. reg. Sections 1.1221-2(b), (d).

USD CFC will recognize income of $42X and a Section 987 loss of $16X. Moreover, that Section 987 loss resulting from the "remittance" from the Euro Branch is not treated as currency gain/loss.[76]

We understand that the view has been expressed that this is a critical hurdle to concluding that the Euro Contract is a *bona fide* hedging transaction with respect to a currency exposure – rather, there is a view that the Euro Contract "hedges" a Section 987 "tax attribute" of USD CFC, that the amount of that tax attribute may never match the currency gain or loss realized from the Euro Contract and that the income or loss recognized as a result of that tax attribute is not even treated as currency gain or loss.

The 2006 Proposed Regulations lead to essentially the same phenomenon (although they are considerably more complicated than the 1991 Proposed Regulations).[77] Under the 2006 Proposed Regulations, items of income, gain,

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[76] *See* Section 987(3) (treating Section 987 gain or loss as ordinary income or loss and sourcing that gain or loss by reference to the source of the income giving rise to underlying earnings). *See also* Prop. Treas. reg. Section 1.987-6(b) (2006) (requiring the use of the "asset method" in Treasury regulations Section 1.861-9T(g) to characterize and source Section 987 gain or loss, including for subpart F purposes); Prop. Treas. reg. Section 1.987-2(f) (1991) (to similar effect as the 2006 Proposed Regulations, although allowing either the "asset method" or the "modified gross income method," described in Treasury regulations Section 1.861-9T(j), subject to certain modifications).

[77] A great deal of the complexity of the 2006 Proposed Regulations appears to arise from an attempt to address what the preamble describes as the relative ease of triggering non-economic loss under the 1991 Proposed Regulations. *See* 71 Fed. Reg. at 52879-80 (Sept. 7, 2006). To illustrate this shortcoming, the preamble provides the following example: A taxpayer that conducts mineral extraction in a foreign country forms a foreign corporation that it elects to treat as a disregarded entity ("**DE**"), transfers its mineral extraction equipment to DE and takes the position that DE is a 987 QBU. DE conducts mineral extraction but has no other activities, no employees and minimal financial assets. The taxpayer takes the position that under the 1991 Proposed Regulations, when the functional currency of DE depreciates against the dollar, (…continued)

deduction or loss attributable to a Section 987 QBU are separately translated into the owner's functional currency.[78] The general rule is that those items are translated at the average exchange rate for the taxable year.[79] However, gain or loss from the sale of property is translated differently, and its taxation depends upon whether the property is a "**marked item**" or an "**historic item**."[80] In the case of gain or loss from the sale of an historic item, such as the inventory held by the Euro Branch, generally, the amount realized is translated into the owner's functional currency using the average annual exchange rate, and the adjusted basis is translated into the owner's functional currency using the historic spot rate on the date the asset was transferred to or acquired by the Section 987 QBU.[81]

If there is a remittance during the year (which is generally determined at the end of the year by netting transfers to and from the QBU, treating transfers to the QBU as occurring at spot and generally treating transfers from the QBU as occurring at either spot, in the case of "marked items," or the historic exchange

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(continued…)

termination of the 987 QBU, the assets of which consist almost entirely of mineral extraction equipment, gives rise to exchange loss (which the preamble describes as "non-economic"). *Id.*

[78] Prop. Treas. reg. Section 1.987-3(a)(1) (2006).

[79] Prop. Treas. reg. Section 1.987-3(b)(1) (2006).

[80] A "marked asset" is generally an asset held by a Section 987 QBU that is not a section 988 transaction but that would be a section 988 transaction if entered into or held directly by the owner of the Section 987 QBU (*e.g.*, euros or a euro-denominated debt instrument by the Euro Branch); a "section 987 historic asset" is generally an asset held by a Section 987 QBU that is not a marked item. Prop. Treas. reg. Section 1.987-1(d) (2006).

[81] Prop. Treas. reg. Sections 1.987-3(b)(1), -3(b)(2).

rate, in the case of "historic items"),[82] the owner of the Section 987 QBU recognizes a portion of the "net unrecognized section 987 gain or loss" (a complex formula that very generally determines the change in net value of a QBU by treating "marked items" as having currency gain or loss and "historic items" as not[83]) based on the owner's "remittance proportion,"[84] which is very generally the percentage of the CFC's "basis" in its QBU (as defined) that is being remitted. Because "net unrecognized section 987 gain or loss" reflects only changes in the value of *marked items* attributable to currency fluctuations, remittances relating to sales of "historic assets" will not generally accurately reflect resulting currency gain/loss.

Under the 2006 Proposed Regulations, without regard to the "remittance," USD CFC has taxable income of $52X in respect of Euro Branch,[85] and the remittance appears to result in the recognition of a $26X Section 987 loss.[86]

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[82] Prop. Treas. reg. Section 1.987-5(c) (2006).

[83] Prop. Treas. reg. Section 1.987-4(d) (2006). The preamble to the 2006 Proposed Regulations explains that this "avoids the distortions caused by the 1991 proposed regulations that impute section 987 gain or loss to all assets of a section 987 QBU, even those assets the value of which does not fluctuate with currency movements." 71 Fed. Reg. at 52886 (Sept. 7, 2006).

[84] Prop. Treas. reg. Section 1.987-5(a), (c) (2006). Note that under the 2006 Proposed Regulations, for purposes of determining the amount of the remittance, transfers from the owner to the Section 987 QBU are netted against transfers from the 987 QBU to the owner on an annual basis.

[85] €130X x $1.4:€1 - €100X x $1.3:€1 = $182X - $130X.

[86] Under Proposed Treasury regulations Section 1.987-4(d) (2006), there are seven "steps" necessary to determine the net unrecognized Section 987 gain or loss. Under Step 1, the "change in owner functional currency net value of the QBU" for the year (assuming the QBU terminates upon the remittance, which we have oversimplified to assume is all that exists in the QBU) would be $156X. Under Step 3, that amount is decreased by the spot value of the owner's (…continued)

Thus, as occurs under the 1991 Proposed Regulations, USD CFC recognizes taxable income from the Inventory Transactions ($52X) that is offset by a Section 987 tax item recognized as a result of the remittance (-$26X) to arrive at net income of the correct amount ($26X). But again, there is no recognition of an amount equivalent to USD CFC's economic loss resulting from the depreciation in the value of the euro relative to the dollar ($13X). So again we have the same potential concern as to whether the Euro Contract is a *bona fide* hedging transaction with respect to a currency exposure – does the Euro Contract "hedge" a Section 987 "tax attribute" of USD CFC? Does it matter that the amount of that "tax attribute" may never match the currency gain or loss realized from the Euro Contract, and will in any event not be treated as currency gain or loss?

2. Whether the Euro Contract can be a Business Needs Hedge

This leads to our second question, which is: In order for the Euro Contract to be a *bona fide* hedging transaction under the Business Needs Hedge rules, does the Euro Contract need to hedge a transaction or property that will produce items recognized by the taxpayer as currency gain or loss? And if so, does Section 987 gain or loss meet that requirement?

Another way of expressing this concern is to focus on the requirement that a *bona fide* hedging transaction must hedge ordinary property, Section 1231

(continued…)

transfers to the QBU, or $130X. Under Step 7, the remaining $26X is decreased by the taxable income of the QBU, which is $52X, for a total of -$26X.

property, a section 988 transaction, a borrowing or an ordinary obligation.[87] Is the Euro Contract merely hedging a "tax attribute," produced by Section 987?[88]

This concern might be illustrated by observing that the Euro Branch itself could ***not*** hedge the "currency exposure" with respect to its inventory or receivables – a taxpayer with a euro functional currency "hedging out" of euros would not be viewed as hedging at all; it would be adding exposure to a nonfunctional currency, which would almost certainly not be viewed as "managing risk." If the USD CFC and the Euro Branch are one person (also a requirement of the Business Needs Exception), then how can it be that one "part" of that person (*i.e.*, USD CFC) can hedge the currency exposure resulting from a transaction but another "part" of the same person can not?

While we acknowledge this concern, we believe that it should not prevent the Euro Contract from qualifying as a *bona fide* hedging transaction.

For U.S. tax purposes, a QBU's income and assets are its owner's income and assets, and all economic income and loss from the QBU's activities, including the owner's exposure to the QBU's functional currency, will ultimately be accounted for by the owner under Section 987 (notwithstanding that any

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[87] *See* Treas. reg. Section 1.954-2(a)(4)(ii)(A).

[88] We note that of course the Euro Contract does not in fact hedge these "tax attributes," or even remittances from the Euro Branch – it hedges USD CFC's exposure to the currency risk associated with (1) its investment in the inventory (€100X) and (2) its expected profit from the QBU's sale of the inventory (€30X). Indeed, as has been noted, under Section 987 some portion of the economic exchange gain or loss of USD CFC is likely to be reflected not in Section 987 items upon "remittances," but in the income or loss USD CFC recognizes "currently," *i.e.*, in our case, when the inventory is sold.

particular tax item arising under Section 987 may not, standing alone, equal the owner's economic currency gain or loss).[89]

Yet, this should not be a problem because there is no requirement that a Business Needs Hedge hedge an asset or transaction that gives rise to an item treated as Section 988 currency gain or loss. Indeed, it is likely that many or most "hedged" transactions that are hedged by a qualifying Business Needs Hedge will ***not*** give rise to Section 988 currency gain or loss.[90] The regulations provide that a "hedged" transaction must meet three criteria:

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[89] Another variant of this concern might be that the Euro Branch's inventory is not eligible for the Business Needs Exception (from which it would follow that the Euro Contract is not eligible, either), because that position – from the Euro Branch's perspective – ***has no*** foreign currency component. Again, and for the same reasons, this strikes us as false logic. From the USD CFC's perspective, the inventory clearly does have a foreign currency component, and that exposure will (ultimately, in the aggregate) be accounted for under Section 987. And nothing in Treasury regulations Section 1.954-2(g)(2)(ii) requires that the property or transaction being hedged be such that it generates foreign currency gain or loss as an income tax matter – indeed, the only pertinent requirement is that the hedged property or transaction ***not*** generate subpart F income ***other than*** foreign currency gain or loss. Treas. reg. Section 1.954-2(g)(2)(ii)(B)(*1*)(*ii*).

[90] The prototypical "hedged" transaction to which Treasury regulations Section 1.954-2(g)(2)(ii)(B)(1) will apply will involve currency exposure relating to a transaction the "ultimate underlier" of which is not a currency. For example, a CFC with a dollar functional currency (and no QBU – *i.e.*, "directly") may enter into a contract to purchase in the future an amount of a commodity, or a component of inventory, for euros. This is not a section 988 transaction. *See* Treasury regulations Section 1.988-1(a)(2)(iii)(A). We have no doubt that the currency component of this contract can be hedged (via a "long" euro forward contract, similar to the Euro Contract in our example, but "reversed") so that any resulting gain (or loss) on the hedge is excluded from the computation of subpart F income under Treasury regulations Section 1.954-2(g)(2)(ii)(B)(2), though there will be no tax item relating to the "underlying" currency exposure.

In this case, the CFC could also potentially "integrate" the hedging contract with the purchase contract, under Treasury regulations Section 1.988-5(b), discussed briefly in note 123, with the consequence of eliminating all currency gain/loss associated with the position. This result is not available (to the taxpayer/CFC) if one but not both of the positions is in a QBU that has a residence outside the United States. Treas. reg. Section 1.988-5(b)(2)(E). We note in any (…continued)

(1) the transaction is entered into in the normal course of the CFC's trade or business, other than trading foreign currency;

(2) the transaction does not itself (and could not reasonably be expected to) give rise to subpart F income other than foreign currency gain or loss; and

(3) the transaction is not a forward contract, futures contract, option or similar instrument described in Section 988(c)(1)(B)(iii).

The only currency-related requirement is that there be a currency exposure in the transaction. And that requirement is met in Example 2. USD CFC has economic exposure to currency value fluctuations as a result of the Inventory Transactions, both before and after taking Section 987 into account.

We think the more appropriate question to focus on is whether the hedge giving rise to the foreign currency gain or loss meets the definition of a *bona fide* hedging transaction,[91] as to which the regulations provide:

> The term *bona fide* hedging transaction means a transaction that meets the requirements of section 1.1221-2(a) through (d) and that is identified in accordance with the requirements of paragraph (a)(4)(ii)(B) of this section,

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(continued…)

event that our fact pattern does not raise this issue, because it does not involve an "executory contract" – that is, we did not assume that when the Euro Contract was entered into on October 1, the QBU had already contracted to sell its inventory on November 30.

[91] The regulations provide that in order for the Business Needs Hedge rules to apply to a CFC's foreign currency gain or loss, "the foreign currency gain or loss [must] arise[] from a *bona fide* hedging transaction, as defined in paragraph [1.954-2](a)(4)(ii)," and certain other conditions must be met. Treasury regulations Section 1.954-2(g)(2)(ii)(B)(*2*).

> except that in applying section 1.1221-2(b)(1), the risk being hedged may be with respect to ordinary property, section 1231 property, or a section 988 transaction."[92]

Under Treasury regulations Section 1.1221-2(b), a hedging transaction is a transaction entered into primarily to "manage risk of price changes or currency fluctuations." A transaction manages risk "if it reduces the risk attributable to [an] asset or liability and if it is reasonably expected to reduce the overall risk of the taxpayer's operations."[93]

The Euro Contract in Example 2 meets this test. The fact that the Section 987 Proposed Regulations do not produce a single tax item that exactly equals the currency gain or loss realized by USD CFC as a result of this economic exposure, or that those items are not treated as Section 988 currency gain or loss, should not, and we believe does not, mean that the Business Needs Exception is not met here.

The conclusion that hedge accounting can apply to transactions that manage economic risk (whether or not the economic risk will be reflected in an isolated recognized tax item) is evident not only in the text of Treasury regulations Section 1.1221-2 but also in the "business hedge" case law, which largely predates the regulation, and on which the regulation was grounded. This

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[92] Treas. reg. Section 1.954-2(a)(4)(ii).

[93] Treas. reg. Section 1.1221-2(d)(1)(ii). Conversely, a transaction "undertaken for speculative purposes" is not a hedging transaction.

case law remains relevant to the factual determination of whether a transaction manages risk even under current law.[94]

Prior to 1999, when the Code was amended to add an explicit rule providing that a "capital asset" did not include a position that was hedging an "ordinary" asset or liability, the scope and nature of this exception from capital asset treatment was determined by decades of case law. Early cases acknowledging that a hedging transaction exclusion from the definition of a capital asset existed cited a General Counsel Memorandum issued in 1936,[95] which noted that hedges "which eliminate speculative risks due to [price fluctuations] and thereby tend to assure ordinary operating profits . . . are generally regarded as a form of insurance" and, notwithstanding the absence of a statutory exclusion or any support for the proposition in the legislative history of

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[94] *See Pine Creek Farms Ltd. v. Comm'r*, T.C.M. 2001-176, 1344 ("Under the regulations, whether or not a transaction reduces the risk of price changes or currency fluctuations is determined 'based on all of the facts and circumstances' surrounding the taxpayer's business and the transaction. In applying this concept, we look to case law to determine whether a transaction reduces a taxpayer's risk.").

The regulations applicable to the tax year at issue in *Pine Creek Farms* generally limited the definition of a "hedging transaction" to certain transactions that *reduced* one of several specified risks of the taxpayer. 59 Fed. Reg. 36356 (July 18, 1994). In 1999, when an explicit exclusion for hedging transactions was added to Code Section 1221(a) and a definition of the term was added to Code Section 1221(b), Congress adopted a broader "risk management" standard. The legislative history of the provision noted that while Congress believed that the approach taken in the relevant Treasury regulations (as they existed at the time) generally should be codified, a risk management standard "better describes modern business hedging practices." S. REP. NO. 106-201, at 21. The preamble to the final Treasury regulations that implemented this change noted that "risk reducing" transactions qualify as one class of hedging transactions that manage risk, confirming that this change only broadened the existing risk reduction standard. 67 Fed. Reg. 12863, 12864 (Mar. 20, 2002).

[95] *See, e.g.*, *Ben Grote v. Comm'r*, 41 B.T.A. 247 (1940); *Comm'r v. Farmers & Ginners Cotton Oil Co.*, 41 B.T.A. 1083 (1940); *Stewart Silk Corp. v. Comm'r*, 9 T.C. 174 (1947), acq., 1948-1 C.B. 3.

the Revenue Act of 1934, concluded that futures contracts entered into only to insure against ordinary risks inherent in the taxpayer's business should be treated as producing ordinary income or loss for tax purposes.[96] These and subsequent cases dealing with business hedges generally did not challenge the existence of a special rule for hedging transactions (even if the line of authorities originating in the *Corn Products*[97] decision and culminating in the *Arkansas Best*[98] decision were perceived to have resulted in changes in its scope[99]), and they have consistently focused on the effect of the transactions at issue on the economic risk borne by the taxpayer.[100]

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[96] G.C.M. 17322 at 155 (1936).

[97] *Corn Products Refining Co. v. Comm'r*, 350 U.S. 46 (1955).

[98] *Arkansas Best Corp. v. Comm'r*, 485 U.S. 212 (1988).

[99] *See* Edward D. Kleinbard & Suzanne F. Greenberg, *Business Hedges After* Arkansas Best, 43 TAX L. REV. 393 (1988).

[100] *See, e.g., Comm'r v. Farmers & Ginners Cotton Oil Co.*, 120 F.2d 772, 774 (5th Cir. 1941) ("A hedge is a form of price insurance; it is resorted to by businessmen to avoid the risk of changes in the market price of a commodity. The basic principle of hedging is the maintenance of an even or balanced market position."); *Stewart Silk Corp. v. Comm'r*, 9 T.C. 174, 178-79 (1947) ("If a manufacturer wishes to hedge against either the purchase of spot goods or actuals already on hand in inventory, the appropriate transaction would be . . . the sale of futures. . . . Thus, loss of inventory value is offset by gain on the futures sales, and conversely loss on the futures sales is offset by rise in inventory value, which will be realized upon the sale of the manufactured product."); *Kurtin v. Comm'r*, 26 T.C. 958 (1956) (holding that butter futures contracts constituted hedges of the taxpayer's long position in cheese because the price of cheese normally fluctuates with that of butter); *Wool Distributing Corp. v. Comm'r*, 34 T.C. 323 (1960) (holding that the taxpayer's short position in pounds sterling and French francs were hedges of its inventory of sterling area and French wools because, in light of the imminent possibility of devaluation of pounds and francs in 1951 and 1952, there was a relationship between the value of the currencies and the dollar price of the inventory).

One business hedge case of particular relevance is *Hoover Co.*,[101] which involved a domestic parent's purported hedge of its net equity in a foreign subsidiary. In that case, the court identified in prior case law two related tests for determining whether a commodity futures contract constitutes a *bona fide* hedge for tax purposes: whether the transaction was used to achieve a "balanced market position," and whether the transaction was used to protect "ordinary operating profits realized in the day-to-day operation of the business enterprise."[102] In determining that the domestic parent's "hedge" of its net equity in a foreign subsidiary did not constitute a hedge under the first test, the court observed that none of the parent's receivables payable in foreign currencies, purchases in foreign currencies, or inventory was hedged.[103] Instead, the parent was seeking to protect the value of its stock in the subsidiary, a capital asset.[104] In considering the application of the second test, the court explained that, "a 'hedge' protects against a true and established risk of loss," and then stated that it did not think that the parent's purported hedge "protected against a real risk of economic loss to it."[105] Conversely, the court implied that if the taxpayer had instead held assets subject to devaluation risk through a foreign branch, rather than through a foreign subsidiary, it would have been able to hedge that risk because it would have held

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[101] *Hoover Co. v. Comm'r*, 72 T.C. 206 (1979).

[102] *Id.* at 238.

[103] *Id.*

[104] *Id.*

[105] *Id.* at 239.

those assets directly.[106] Throughout, the court was unmistakably focused on the existence (or non-existence) of *economic* risk with respect to an asset held by or transaction entered into by the parent.[107]

Finally, we see no policy or other reason why the question of "hedging" ***should*** turn on anything other than economic risk. In particular, we see no reason why it should turn on the tax treatment of the items being hedged (beyond the requirement, under Treasury regulations Section 1.1221-2, that those items be in all cases ordinary). The rules under Section 987 do not affect the economic risk of the owner of a Section 987 QBU with respect to transactions entered into by or property held by the Section 987 QBU. Accordingly, we see no reason why they should affect the ability of a taxpayer to treat a hedge of currency exposure with respect to its own otherwise eligible transactions or property as such.

Because of the clear focus in the regulations and the case law on economic risk, we do not believe the rules under Section 987 do or should preclude the owner of a Section 987 QBU from hedging currency exposure with respect to otherwise eligible property of the Section 987 QBU in a *bona fide* hedging transaction.

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[106] *Id.* at 236-37 ("Surely, if a corporation decides not to open a foreign branch where ownership of the assets subject to devaluation loss would be direct, but rather sets up a foreign subsidiary for tax advantages present in such form, it ill behooves us to ignore the form that the parent has established.").

[107] The court also observed that the exchange losses reported on the parent's financial statements were not realized or recognized for tax purposes. This could be read to support the notion that only risks of recognized losses can be hedged for tax purposes. However, the court went on to explain that the reporting of these losses "does not reflect corporate reality" and that in its view there was "no real risk of economic loss." *Id.* at 239.

3. *Whether a Section 987 QBU is a related person for purposes of subpart F*

We now turn to the "first" question above, which is whether the Euro Branch could (or should) be considered for this purpose a "related person" with respect to USD CFC, in which case USD CFC could not hedge the Euro Branch's inventory in a *bona fide* hedging transaction. If that is not the case, then the Euro Branch is a part of the same person as USD CFC, in which case the related person prohibition would not apply.

We understand that some are of the view that perhaps the Euro Branch should be treated as a "related person" to USD CFC.[108] For these purposes, the regulations define a "related person" as a person that is an "individual, corporation, partnership, trust or estate" that has a specified relationship with the CFC.[109] The Euro Branch is disregarded as an entity separate from USD CFC and is therefore we think clearly neither a "person" nor a "related person" with respect to USD CFC.[110]

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[108] This view might be bolstered by the fact that the tax treatment of economic currency gain or loss with respect to a transaction or property may differ depending upon whether the transaction is entered into or the property is held by a Section 987 QBU or its owner. For example, a disposition of euros by USD CFC would be treated as a section 988 transaction, and gain or loss therefrom would be treated as foreign currency gain or loss. On the other hand, a disposition of euros by the Euro Branch would ***not*** be treated as a section 988 transaction, and any resulting economic exchange gain or loss (viewed from USD CFC's perspective) would not be treated as currency gain or loss when, if ever, a relevant item is realized by USD CFC. *See* Part IV.C.1.

[109] Section 954(d)(3); Treas. reg. Section 1.954-2(a)(4)(ii)(A).

[110] Treas. reg. Section 301.7701-2(a) ("[I]f the entity is disregarded, its activities are treated in the same manner as a sole proprietorship, branch, or division of the owner."). Further support for the notion that a QBU's risks may be hedged by its owner can be found in the hedging rules, which permit the determination of whether a transaction manages a taxpayer's risk to be (…continued)

Furthermore, if it were true that a disregarded entity was a "related person" to its owner, this would have (potentially significant) implications beyond the scope of this report. It would also contradict our entire understanding of what a disregarded entity is and how it is treated under current law.

This, while we acknowledge the concern, we think that the "related person" prohibition does not apply here, because the Euro Branch is part of USD CFC, not a separate person.

4. "Clearly determinable"

We now address our "third" question above: If the Euro Contract is a hedge with respect to Business Needs Property owned by USD CFC (though its Euro Branch), is the gain or loss (in our example, loss) attributable to a change in exchange rates that arises from the hedged inventory not "clearly determinable" from the records of USD CFC as being derived from the Euro Branch's inventory sales, as a consequence of the Section 987 regime (in which case the Business Needs Exception would not be available)?

Even if a CFC can hedge its currency exposure with respect to a Section 987 QBU's ordinary property in a *bona fide* hedging transaction, in order for gain or loss on the hedge to be excluded from FPHCI, "any gain or loss arising from such [hedged] transaction or property that is attributable to changes in exchange

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(continued…)

made on a business-unit level, provided the business unit is within a single entity or consolidated group. Treas. reg. Section 1.1221-2(c)(4)(i).

rates [must be] clearly determinable from the records of the CFC as being derived from such transaction or property."[111] For the reasons that follow, we do not think that there is any technical impediment to satisfying this prong in connection with a *bona fide* hedging transaction with respect to a Business Needs Transaction or Business Needs Property of a Section 987 QBU.

As a threshold matter, there is a question whether this requirement is not satisfied in our example simply because the property that is being hedged is inventory, which does not give rise to Section 988 currency gain or loss. One important clue that this is not a problem is that the regulation describes this "clearly determinable" prong as relating to "gain or loss . . . that is attributable to changes in exchange rates," which is distinct from "foreign currency gain or loss," the phrase used in Treasury regulations Section 1.954-2 to refer to items of foreign currency gain or loss that are recognized under Section 988, and the history of this provision suggests this difference in phrasing was intended.[112] Thus, this aspect of the Business Needs Hedge rules does not appear to limit its application to hedges of transactions or property that give rise to items of Section 988 gain or loss.

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[111] Treas. reg. Section 1.954-2(g)(2)(ii)(B)(*2*).

[112] In the originally finalized regulation, a *bona fide* hedging transaction with respect to a Business Needs Transaction or Business Needs Property included, through a cross-reference to Treasury regulations Section 1.954-2(g)(2)(ii)(B)(*1*), a requirement that, "foreign currency gain or loss" must be clearly determinable from the records of the CFC. T.D. 8618, 1995-2 C.B. 89, 117. In a 1997 "technical correction," Treasury removed the cross-reference that referred to clearly determinable "foreign currency gain or loss" and added new language requiring that the "gain or loss . . . *attributable to changes in exchange rates*" be clearly determinable from the records of the CFC. T.D. 8704, 1997-1 C.B. 154, 155, 158 (emphasis added).

There is a further question whether the rules under Section 987 preclude a CFC from satisfying the clearly determinable prong. In particular, one might argue that because the amount of Section 987 gain or loss that is recognized may not be equivalent to the CFC's economic currency gain or loss, it may be difficult or impossible for the amount of economic currency gain or loss to be clearly determined from the CFC's records. Put differently, there might be a concern that if economic currency gain or loss is not treated as Section 988 foreign currency gain or loss, and perhaps is not recognized as a separate item for tax purposes ***at all***, it may not be clearly determinable from the CFC's records. However, the "clearly determinable" prong of the Business Needs Hedge provision does not require that amounts attributable to changes in exchange rates be "recognized" in order for them to be "clearly determinable." The clearly determinable prong simply requires that ***when*** gain or loss from a hedged position is recognized, the portion of that gain or loss that is attributable to a change in exchange rates must be clearly determinable as being derived *from that position* (as opposed to some other position). It seems clear this is requirement is intended only to enable the IRS to establish (in an audit) that what is being claimed to be a hedge of an economic exposure is indeed hedging that exposure, and more importantly to ensure that it is possible to discern which items "match" with the items realized with respect to the hedging position, so that clear reflection of income can be achieved as required by Treasury regulations Section 1.446-4.[113]

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[113] While we are confident it will be difficult to do so in practice, we think it is generally possible to determine what amounts of income and loss under Section 987 are actually attributable to economic currency exchange exposure. How to do so will depend on the version of the Section 987 regime being used and the type of transaction or property involved (*i.e.*, how Section 987 income or loss is being determined and how remittances are being calculated and subjected to tax).

(…continued)

While we believe this to be the case, and while we do not believe that the many difficulties encountered in attempting to make Section 987 operate properly should affect taxpayers' consequences under subpart F, we acknowledge that the potential discrepancy in timing and amount between economic currency gain or loss and recognized Section 987 gain or loss raises a real question whether and how Treasury regulations Section 1.446-4 can operate properly to "clearly reflect income" in the context of a hedge of a nonfunctional-currency QBU's property or transactions.[114] As we have observed, it will often be the case because of the oddities of the Proposed Section 987 Regulations that the tax items from a CFC's currency hedge of its nonfunctional-currency QBU's property or transactions will never perfectly match the tax items relating to currency gain or loss attributable to the hedged positions.

There also may be a concern that under these rules the taxpayer may recognize loss on a hedge with respect to property or transactions of a Section 987

(continued…)

In this regard, we note that our extremely simplified example does not reflect the fact that a CFC will often be funding and hedging multiple exposures of its QBU(s), and it will not always be the case that all such positions will be Business Needs Property or Transactions. We see no reason why this should prevent treatment of the hedging transaction as a Business Needs Hedge to the appropriate extent, assuming appropriate identification and documentation. We note however the limitation on the application of the Business Needs Exception to a hedge of aggregate risk (within the meaning of Treasury regulations Section 1.1221-2(c)(3)) unless all or all but a *de minimis* amount of the risk being hedged arises in connection with Business Needs Property or a Business Needs Transaction. *See* Treas. reg. Section 1.954-2(g)(2)(ii)(B)(*2*).

[114] It should be noted that if the Euro Contract qualifies as a Business Needs Hedge, the consequence is that the resulting income and loss would be exempt from the computation of subpart F income. As a result, how it would be accounted for would affect "only" USD CFC's earnings and profits, and thus how its actual and deemed repatriations (*i.e.*, its *other* subpart F items) to its U.S. shareholder(s) are taxed.

QBU prior to (or to the extent in excess of) the recognition of gain from the QBU's property or transactions that is clearly "attributable" to changes in currency exchange rates (or conversely, that the taxpayer could recognize Section 987 loss upon a remittance from the QBU prior to or in excess of the recognition of gain with respect to the corresponding hedge). In other words, there may be concern that if a QBU Hedge can qualify for the Business Needs Exception, losses might be recognized in advance of associated gains. To the extent that this is perceived to be a concern, we would support a Revenue Ruling or other guidance requiring that in the case of a hedge of property or transactions of a Section 987 QBU, loss should be recognized only to the extent of gain recognized with respect to the hedged (or hedging) position that is clearly attributable to changes in exchange rates. Such guidance would be consistent with Treasury regulations Section 1.446-4. We note also that if it is determined that Section 987 gain or loss from QBU remittances that is otherwise "related" to a QBU hedging transaction that is eligible for the Business Needs Exception is includible in the computation of subpart F income,[115] rules would presumably need to be written to address the matching of items in that event.

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[115] *See supra* note 76. We note that as a technical matter, if a Section 987 item "attributable" to the QBU's hedged position could be treated as subpart F income (that is not foreign currency gain or loss), this could prevent eligibility of the QBU Hedge for the Business Needs Exception. *See* Treas. reg. Section 1.954-2(g)(2)(ii)(B)(*1*)(*ii*) (to be eligible for the Business Needs Exception, the "hedged" transaction or position must not, and must not reasonably be expected to, give rise to subpart F income other than foreign currency gain or loss). However, our view, given the nature of the transactions in question, is that any Section 987 item treated as subpart F income under Section 987 and its regulations should for that reason ***not*** be viewed as "attributable" to the hedged position, which by hypothesis is not otherwise generating (or therefore the source of) FPHCI.

5. Section 988 integration as a possible solution

As discussed above in note 90, a taxpayer (or CFC) is not permitted to integrate an executory contract denominated in a nonfunctional currency with a hedge of the associated currency exposure if one but not both of the positions is on the books of a QBU of the taxpayer (or CFC) that has a residence outside the United States, as is the case in our example (though as noted in note 90, our example does not involve a hedged "executory contract").[116] However, the regulations provide that that the ***Commissioner*** can impose such integration, if it concludes that the executory contract in question is in fact hedged by the currency hedging contract.[117] It is not entirely clear how this forced integration would be reflected for tax purposes. This integration would not appear to be possible at the QBU level; if it were, the QBU would be integrating "out of" its functional currency, which is not within the scope of Treasury regulations section 1.988-5(b).[118] However, if the integrated instrument were treated as being in the CFC, that treatment would appear to necessitate a "deemed remittance" of the inventory sales proceeds (or a deemed remittance of the inventory and a deemed sale by the CFC of the inventory for dollars).

This raises the possibility of making a modest change to the scope of the executory contract integration rules under Treasury regulations Section 1.988-5(b) so as to permit a CFC to treat a hedge of its QBU's executory contract, and the

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[116] The preamble to Treasury regulations Section 1.988-5 indicates that this limitation was imposed as a matter of administrative convenience. 57 Fed. Reg. 9172, 9175 (Mar. 17, 1992).

[117] Treas. reg. Section 1.988-5(b)(3)(ii).

[118] *See* Treas. reg. Section 1.988-5(b)(2)(ii) (defining an "executory contract" to be one that is among other things nonfunctional-currency-denominated).

hedged contract, as an integrated position on the CFC's (rather than its QBU's) books. This of course would "solve" the subpart F issue associated with the currency component of the transactions, but only in the very limited circumstances in which the CFC's hedge happens to be of an executory contract position in the QBU. It would obviously also require additional guidance involving the transactions that would need to be deemed to occur in order to establish the intended results, but we think this possibility worthy of further consideration.

D. Alternative fact pattern: disregarded loan

A common variation on the example in Figure 2 can be illustrated by the following Example 3: Assume that USD CFC, instead of contributing €100X to the Euro Branch, "lends" €100X to the Euro Branch on October 1, repayable (and repaid) with €1X of interest on November 30. USD CFC also on October 1 enters into a forward contract with a third party to sell €101 euros on November 30. The Euro Branch, as in the above example, uses the loan proceeds to purchase inventory. This Example 3 is illustrated as follows:

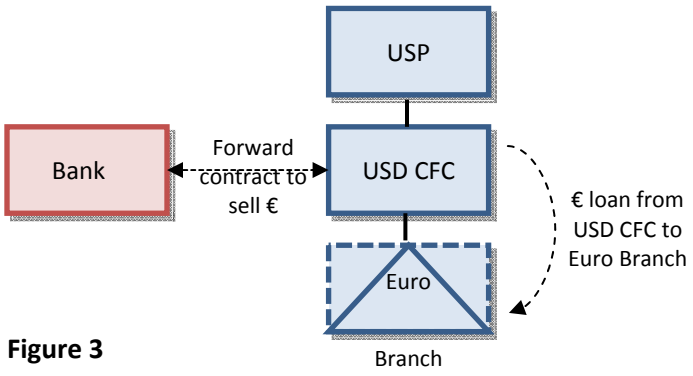

Figure 3

The first observation is that the "loan" between USD CFC and the Euro Branch does not exist for U.S. tax purposes, so it would appear that for U.S. tax purposes, USD CFC has simply provided its QBU with €100X on October 1, just as in Example 2. Otherwise, the U.S. tax analysis is precisely the same as in the Example 2 (except that the USD CFC knows on October 1 that it will receive a "remittance" of €101X from the Euro Branch on November 30, and the Euro Branch is not otherwise remitting to USD CFC the (presumably 29X) remaining euros that it earns on the sale of its inventory on November 30. However, it can be observed that in this variant, the Euro Branch is also likely to be reducing its tax burden in Country Y, in that it is likely to be deducting the €1X of "interest" that it pays (as a Country Y matter) to USD CFC on November 30. We do not believe that this should have any effect on the analysis of whether the currency gain/loss on USD CFC's €101X forward contract should be eligible to be excluded from subpart F under the Business Needs Exception.[119]

It may be worth noting that if it is determined that a CFC cannot hedge its exposure to its nonfunctional-currency QBU's ordinary property or transactions as described above, CFCs may be able to engage in "self-help" to achieve the result, by causing the QBU to become a partnership (*e.g.*, by having a corporate or other non-disregarded subsidiary acquire a small percentage of the interests in the QBU), and then lending nonfunctional currency to the entity, and treating the (now "regarded") loan and hedge as described in Part III (although in this case, the issues would be meaningfully simpler – indeed because the hedge is not itself a borrowing, the loan and hedge might well be eligible for integration, entirely

[119] The difference between the foreign tax treatment and the U.S. tax treatment of the "interest" is a common consequence of our "check the box" regime.

eliminating any currency gain/loss, even if the hedging CFC is not a dealer in securities). If it is the case that a relatively small amount of planning can avoid the issue described in this Part, then the issue is avoidable by those who are sufficiently knowledgeable or well advised, but potentially remains a problem for everyone else.

E. Conclusion and recommendations

For the reasons described above, we believe that a CFC may, in a transaction that qualifies as a Business Needs Hedge, hedge a Business Needs Transaction entered into, or Business Needs Property held or to be held, by a Section 987 QBU owned by the CFC. However, we recognize the difficulties perceived by some in reaching this conclusion, and also the significant uncertainties involved in applying the hedging rules assuming this conclusion is correct. Further, because identification of a transaction as a hedging transaction is generally binding only with respect to losses (*i.e.*, any loss on a transaction misidentified as a hedging transaction will generally be allocated against non-subpart F income, while gain on a misidentified hedging transaction will generally give rise to subpart F income),[120] and because the failure to identify a transaction as a hedging transaction is binding on the taxpayer as to gains (which will therefore generally be treated as subpart F income), while if the transaction is a hedging transaction, losses may be treated as hedging losses and thus potentially not be available to reduce FPHCI attributable to currency gains,[121] there is a

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[120] Treas. reg. Section 1.954-2(a)(4)(ii)(C)(*1*).

[121] Treas. reg. Section 1.954-2(a)(4)(ii)(C)(*5*).

significant risk to taxpayers in taking any position (or no position) on this issue under current law. We therefore recommend that guidance be issued confirming that properly identified hedges of currency exposure to property or transactions of nonfunctional-currency QBUs that are themselves eligible for the Business Needs Exception are eligible to be treated as Business Needs Hedges.

V. HEDGES BY A CFC OF FOREIGN CURRENCY EXPOSURE WITH RESPECT TO NET INVESTMENT IN A SUBSIDIARY CFC

A. Background

In this Part, we address "true" *Hoover* hedges, which are hedges of an entity's currency exposure to its investment in stock of a subsidiary. In fact, a *Hoover* hedge is (or can be) virtually identical to the transactions described in Part IV, except in this case the subsidiary does not check the box to be disregarded as an entity separate from its owner but is a corporation. Accordingly, for the sake of illustration, we will assume the same facts as in Part IV.A, except that the subsidiary is treated as a corporation for U.S. tax purposes. This fact pattern is illustrated as follows:

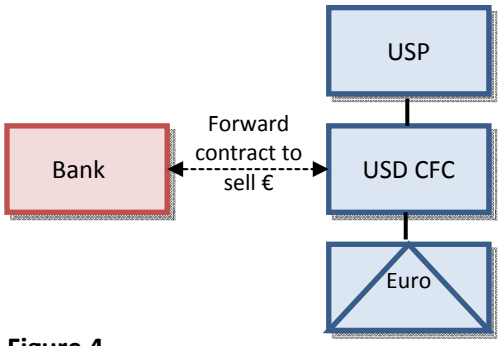

Figure 4

B. Eligibility for the Business Needs Exception

We think it is clear under current law that a *Hoover* hedge is not a "good" Section 1.1221-2 hedging transaction, because (except in very limited circumstances involving members of a consolidated group) a hedge of positions taken by a related party is not a "hedge."[122] And *Hoover* itself rejected the argument that a taxpayer could hedge accounting volatility resulting from its ownership of a subsidiary, or receivables expected from that subsidiary. And it follows that such a hedge is not eligible to be a Business Needs Hedge.

It is perhaps possible to attempt to distinguish our facts from those in *Hoover*, which involved a *U.S.* taxpayer hedging its exposure to a foreign subsidiary, on the ground that a CFC can more meaningfully be said to "anticipate" (and therefore more credibly be argued to be hedging) a receivable from its subsidiary than can a U.S. person. This is because a CFC is far less likely to remit cash to its U.S. parent (because that is likely to be a taxable dividend, and because the parent often for accounting reasons takes the position that its offshore earnings are "permanently reinvested," under APB 23) than to its foreign parent (which is far more likely to be eligible for a variant of a "participation exemption"). However, we are not persuaded by this argument, in light of current law.

C. Conclusion

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[122] Treas. reg. Section 1.1221-2(b). *See id.* Section 1.1221-2(e).

If currency gain/loss from a *Hoover* hedge is to be treated as excluded from the computation of subpart F income, we think it will be necessary either to revisit the treatment of *Hoover* hedges generally (which we view as a very significant undertaking) or to modify Treasury regulations Section 1.954-2(g)(2)(ii) to treat gain/loss from *Hoover* hedges (under specified circumstances) as directly related to the reasonable needs of the CFC's business. In this regard, we understand that a primary motivation for *Hoover* hedges is that without them, the exposure that an entity has to its nonfunctional-currency subsidiary produces substantial *accounting* volatility.[123] Thus, it may well be reasonable to conclude that a *Hoover* hedge is a reasonable need of a CFC under these circumstances – although we are not aware of a reason why this is not also the case for U.S. taxpayers that hedge exposures to their CFCs. Of course, the stakes are entirely different; in the case of a CFC, the question is whether currency gain/loss can be excluded from subpart F income (which may be a good or a bad result, depending how the relevant currencies move), whereas in the case of a U.S. taxpayer, the question is the timing of items – if the transaction is a "good" hedge, the taxpayer may be able to defer realized gain on the hedge until the "corresponding" item (the receivable from its subsidiary) is realized (perhaps never) but has the ability to recognize resulting hedge losses by repatriating amounts, if that is efficient/advantageous.[124]

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[123] *See* Part IV.B, *supra*.

[124] We understand that there may have been circumstances where the government has asserted its authority to force hedging or integration treatment upon taxpayers, in cases where the hedge produces losses for the hedging party, presumably on the theory that the hedge in some sense "belongs" with the hedged position, *i.e.*, on the books of the subsidiary. L. Sheppard & A. Elliott, *News Analysis: High Finance and High Fashion: Essential Questions Addressed*, 2013 (…continued)

On the other hand, if the regulations are expanded to bring *Hoover* hedges within the reasonable needs exception, we suspect that many U.S. groups may find it advantageous to ensure that their CFCs are below a dollar-functional holding company, which can then enter into *Hoover* hedges with respect to its investment in its subsidiaries. We are not sure that this is an inappropriate outcome, but it should be considered in determining whether expanding the scope of the regulation is advisable.

A further observation is that the question of *Hoover* hedges is significantly interrelated with the question of QBU hedges, in the following respects: First, if currency gain/loss from a QBU hedge is eligible for exclusion from the computation of subpart F income, a CFC can (all other things being equal, which

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(continued…)

TNT 12-1 (quoting a Treasury employee as saying that clear reflection of income can dictate integration of a parent's hedge with a subsidiary's executory contract position under Treasury regulations Section 1.988-5(b), even though it is clear that taxpayers are not permitted so to treat the positions. *See id.* Section 1.988-5(b)(2)(E); -5(b)(3)(ii) (Commissioner may force integration if one of the criteria in Section 1.988-5(b) is not met)).

We feel strongly that it is not appropriate to impose hedge accounting on a taxpayer in the circumstances described in the text, unless and until it is made clear that the taxpayer is eligible so to treat the transactions itself. As noted above in Part IV.C.2, generally an entity the functional currency of which is not the functional currency of its parent or other group members is ***not*** the appropriate entity to "hedge" its group's exposure to that currency, and indeed almost certainly cannot as a tax matter "hedge" that exposure. It of course does not follow that any other entity in the group can do so, but it does follow that forcing the "hedge" onto the books of the hedged entity is not proper, unless it is being argued that the hedging entity was merely acting as an agent for the hedged entity – which for the reasons mentioned strikes us an extremely unlikely analysis. And as noted in the text accompanying notes 120-121, in circumstances where a taxpayer is not permitted to treat itself as hedging, if the government can do so, the taxpayer is simply in an untenable position – without regard to any actions it can take, it is at risk of receiving the worst of the consequences of treating the relevant position as a hedge (no subpart F reduction for losses) and of not treating it as a hedge (subpart F inclusion for gains).

they very often are not) simply check the box to treat its corporate subsidiary as a branch and rely on the analysis in Part IV. Second, as mentioned in Part IV, a CFC may be able to avoid the *Hoover* hedge problem (at least to some extent) by *lending* an amount of nonfunctional currency to its subsidiary, and hedging that loan (with the issues and consequences described in Part III, or perhaps with an instrument eligible for "integration," eliminating any currency gain/loss).

VI. CONCLUSION

The issues raised by the very simple transactions described in this report are obviously extremely complex, and the relevant regimes clearly lead to results that are at best surprising and at worst simply inappropriate. It is clear to us that a policy decision must be made as to whether and how broadly to clarify and/or expand the Business Needs Exception from subpart F income for currency gain/loss, including perhaps whether to expand the "regular dealer" exception at least as it relates to currency gain/loss, and also whether it might be appropriate to rethink or at least limit the scope of the "special" rule for currency gain/loss attributable to interest-bearing liabilities that are directly related to specific assets or transactions. As we have stated, it is clear to us that Treasury and the IRS have the authority to make these changes to the regime, and it might be noted that further study might be warranted to determine if there are other respects in which the regime fails adequately to address common commercial or financial transactions.

In general, we think it a worthwhile endeavor to attempt to minimize the unpredictability and "tax volatility" associated with back-to-back lending and QBU/*Hoover* hedging in the context of CFCs, for reasons we have set forth, and we support efforts to do so. There are a number of ways to achieve each of those objectives, and we have attempted to set forth the pros and cons of some of the

more obvious ones. We would of course be happy to assist you in further considering all or any of our suggested approaches, if you would like.