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NEW YORK STATE BAR ASSOCIATION TAX SECTION

REPORT ON PROPOSED FOREIGN CURRENCY HEDGING REGULATIONS

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I. INTRODUCTION

This Report[1] (the "**Report**") addresses the request for comments included in REG11914-15 regarding proposed regulations under sections 446, 954 and 988,[2] which the Department of Treasury ("**Treasury**") and the Internal Revenue Service ("**IRS**") issued on December 19, 2017 (collectively, the "**Proposed Regulations**").[3] More particularly, this Report addresses issues raised by the Proposed Regulations that involve the application of the foreign personal holding company income ("**FPHCI**") rules with respect to transactions that hedge foreign currency risk. We applaud Treasury and the IRS for addressing long-standing asymmetries arising from a controlled foreign corporation's ("**CFC**") foreign currency hedging activities.

The preamble to the Proposed Regulations (the **"Preamble"**) identified several aspects of the existing regulatory framework that result in mismatches between the classification (as subpart F income or not subpart F income) and/or the "timing" of related items of foreign currency gain or loss incurred by a CFC, and proposed sensible adjustments to the rules. These adjustments, will help ensure that, to the extent that the statutory framework permits, a U.S. shareholder's economically realized section 988 gain/loss is appropriately reflected in the U.S. shareholder's subpart F inclusion.

The Proposed Regulations were especially timely in that they were released in the same week that the P.L. 115-97 (the "**Act**") was enacted. The new current inclusion regime for non-subpart F income of CFCs increases the need to appropriately measure the subpart F income arising from section 988 transactions. Further, given the rate differential for subpart F inclusions, section 951A inclusions, and dividends eligible for a section 245A deduction, the proper delineation impacts rates, whereas in the pre-Act law it only implicated timing. We also address certain issues relating to the Proposed Regulations that arise under the Act.

In addition, the Proposed Regulations helpfully address the treatment of a CFC's foreign currency hedge of a net investment when it conducts business operations in a currency environment that differs from the CFC's functional currency. In this Report, we offer several comments and suggestions with respect to this complex topic.

Finally, the Preamble describes dates of applicability for the various provisions. These dates of applicability are significant for several reasons, including that some of the sensible new provisions could be viewed as adjustments or clarifications of the rules to conform them to existing taxpayer positions. We believe that Treasury and the IRS should clarify how they intend to treat pre-effective date transactions.

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[1] This Report was written by Peter J. Connors and Isaac MacDonald with the substantial assistance of Joshua Emmett. Significant contributions were made by Jeffrey Maddrey, John McDonald and Jo Lynn Ricks and helpful comments were provided by Robert Cassanos, Robert H. Dilworth, John Lutz, Michael Farber, Lucy Farr, Peter Fucci, Erika Nijenhuis, Carolina Perez, Michael Schler, Karen Gilbreath Sowell, Shun Tosaka and Howard Weiner.

[2] Unless otherwise indicated, all section references are to the Internal Revenue Code of 1986, as amended (the "**Code**") and the Treasury Regulations promulgated thereunder.

[3] Fed. Reg. 60135 (12/19/ 2017).

Part II of this Report provides background regarding the treatment of foreign currency under subpart F. Part III summarizes our recommendations. Part IV contains a detailed analysis of the issues and our recommendations.

II. **BACKGROUND**

A. Treatment of Foreign Currency Under Subpart F

Under the Code, foreign currency gain is a separate category of FPHCI.[4] FPHCI is generally considered passive income for foreign tax credit purposes.[5] In general, these rules provide that this category of FPHCI include only the excess of foreign currency gains over foreign currency losses attributable to a section 988 transaction. Further, losses in foreign currency only offset foreign currency gain and will not generally offset other categories of foreign base company income.[6] Moreover, losses may only offset gains in the year in which they arise – there is no ability to "carry forward" currency losses to a future year as there is in the domestic context under section 172.[7] Specifically, where there is section 988 gain (and therefore subpart F income) in one year and an economically related section 988 loss in a different year, the CFC's lifetime FPHCI is overstated. This puts a premium on ensuring that offsetting currency gains and losses are recognized in the same tax year, a subject this Report addresses further below.

Section 954(c)(1)(D) excludes from FPHCI any foreign currency gain or loss attributable to a transaction directly related to the business needs of the CFC. To qualify for the business needs exclusion, foreign currency gain or loss must, in addition to satisfying other requirements, arise from a transaction entered into, or property used, in the normal course of the CFC's business that does not itself (and could not reasonably be expected to) give rise to subpart F income (other than foreign currency gain or loss). One of the relevant requirements is that the foreign currency gain or loss needs to be clearly determinable from the records of the CFC as being derived from such transaction or property. Foreign currency gain or loss attributable to certain "bona fide hedging transactions" with respect to a transaction or property that qualifies for the business needs exclusion also qualifies for the business needs exclusion.[8] The regulations also provide a framework under which aggregate hedges can qualify as bona fide hedges.

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[4] *See* section 954(c)(1)(D).

[5] Treas. Reg. § 1.904-4(b)(2)(A).

[6] § 954(c)(1)(D); Treas. Reg. § 1.954-2(g)(2)(i). Treas. Reg. §1.954-2(g)(4) provides an election, however, that causes currency gain or loss to be added to (or subtracted from) net FPHCI.

[7] It is possible for a loss to reduce subpart F income via the "current year earnings and profits" limitation in section 952. Nevertheless, if that route is followed, a section 952(c) recapture account is created and non-subpart F income that is subsequently recognized is recast as subpart F income.

[8] Treas. Reg. § 1.954-2(a)(4)(ii). To be a bona fide hedging transaction, the transaction must meet the requirements of Treasury regulations section 1.1221-2((a) through (d), 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. The taxpayer must meet the identification and recordkeeping requirements of Treasury regulations section 1.1221-2(f).

The section 954 rules provide an election to treat all foreign currency gain or loss as FPHCI.[9] They also provide an election that allows taxpayers to characterize foreign currency gain or loss in the same specific category of subpart F income as gain or loss in that category.[10] In some circumstances these elections can mitigate basketing issues. However, these elections are only helpful in some cases, and the current regulations create certain problems when taxpayers attempt to make these elections in practice. We discuss these issues below.

1. In Practice, Currency Hedges Are Often Hedges of Aggregate Risks

As discussed below, most hedging activity is done on an "aggregate hedging basis" under which the taxpayer aggregates risk under several transactions that have occurred or are expected to occur and enters into a hedging contract to offset the risk. [11]

As described in the Preamble, under the section 954 rules, the underlying transaction in a hedging transaction cannot reasonably be expected to give rise to subpart F income (often described as creating a "cliff effect"). That is, if even a de minimis amount of income or gain from the underlying transaction or property is subpart F income, other than foreign currency gain or loss, the entire foreign currency gain or loss from the hedging transaction is included in the FPHCI computation.

These rules are significant because most hedging activity is done on an "aggregate hedging basis" under which the taxpayer aggregates risk under several transactions and enters into a hedging contract to offset the risk. When this occurs, the individual items being hedged could generate subpart F income or non-subpart F income.[12] Thus, the section 954 rules create a whipsaw effect whereby the losses on the underlying transactions do not reduce FPHCI, but the gains on the hedging transactions generate FPHCI. Further, when the hedges produce losses, the losses are not always fully utilizable (*i.e.,* they cannot be carried backward or forward to offset the CFC's hedge gains in a prior or subsequent year).[13]

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[9] Treas. Reg. § 1.954-2(g)(4).

[10] Treas. Reg. § 1.954-2(g)(3).

[11] Treasury regulations section 1.1221-2(c)(3) states that the term "hedging transaction" includes a transaction that manages an aggregate risk of interest rate changes, price changes, and currency fluctuations only if all of the risk, or all but a de minimis amount of the risk, is with respect to ordinary property, ordinary obligations, or borrowings. Treasury regulations section 1.954-2(g)(2)(ii)(B)(2) in turn generally provides that for purposes of the business needs exclusion, a hedging transaction will satisfy the aggregate hedging rules of section 1.1221-2(c)(3) only if all (or all but a de minimis amount) of the aggregate risk being hedged arises in connection with transactions or property that qualifies for the business needs exclusion, and any gain or loss arising from such transactions or property that is attributable to changes in exchange rates is clearly determinable from the records of the CFC as being derived from such transactions or property.

[12] Treasury regulations section 1.1221-2(d)(3) states that the term "hedging transaction" includes a transaction that manages an aggregate risk of interest rate changes, price changes, and currency fluctuations only if all of the risk, or all but a de minimis amount of the risk, is with respect to ordinary property, ordinary obligations, or borrowings.

[13] One potential approach to minimizing the whipsaw for treasury center operations would be to use a foreign entity treated a partnership whose partners are members of a domestic affiliated group that files a consolidated return. Prior to issuance of Treasury regulations section 1.956-4 in 2007, such an entity could realize and recognize currency gain and losses without regard to the inclusion asymmetries arising under section 954(c)(1)(D).

2. The Current Rules May Create Unnecessary Risks for Treasury Centers

In 2013, the Tax Section addressed certain issues relating to a transaction in which a CFC served as a treasury center making loans and borrowing money from affiliates.[14] The activities of a treasury center with related parties are typically not eligible for the exception under subpart F for "regular dealer activities."[15] They are also not eligible for the active financing exception under subpart F.[16] Nevertheless, most treasury centers are considered "dealers" and are required to mark their securities to market under section 475. Normally, this would allow all currency gains and losses to be marked-to-market annually and therefore offset each other from a timing standpoint. In a situation where the long and short positions with respect to the same currency are balanced, the treasury center would have no net gain or loss. However, under the section 475 regulations, liabilities generally are not eligible to be marked-to-market and, therefore, it is not clear whether currency-denominated liabilities (or the foreign currency element of such liabilities) can be marked-to-market.[17] As a result, the treasury center could recognize FPHCI even though its long and short positions in each currency economically offset each other. The 2013 Report proposed a number of solutions to address this concern that could be implemented through regulations. In practice, many taxpayers have treated foreign currency liabilities as short positions in the currency, allowing for mark-to-market treatment.

3. The Current Regulations Have a Special Rule for Interest-Bearing Liabilities

Another provision of concern to taxpayers is the rule under the current regulations that allocates foreign currency gain or loss on interest-bearing liabilities between subpart F and non-subpart F based on the rules for allocating interest expense. There is no corresponding rule for gain or loss generated by transactions that are bona fide hedges with respect to interest bearing liabilities. This is another situation that has the potential for a whipsaw effect.

B. The Current Rules Do Not Adequately Address Hedges of CFCs or of QBUs, Including the Related Section 987 Issues

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[14] *See* New York State Bar Association Tax Section Report No. 1287, *Report on Subpart F Issues Involving Currency Gain and Loss* (June 3, 2013) (the "**2013 Report**"), pages 7-34 (discussing treasury center loan issues).

[15] § 954(c)(2)(C); Treas. Reg. §1.954-2(a)(4)(iv) (defining "regular dealer"), Treas. Reg. §1.954(a)(4)(v) ("dealer property"), Treas. Reg. §1.954-2(a)(4)(ii) ("bona fide hedging transaction").

[16] § 954(h).

[17] Although Treasury regulations section 1.475(c)-2(a)(2) generally excludes from the definition of a security a debt instrument issued by the taxpayer, it does not address borrowings in a nonfunctional currency, and the statute, in section 475(c)(2)(E) expressly includes within the definition of a security, a "short position … in … currency," which is included in a foreign currency borrowing (like a short seller of foreign currency, a borrower of foreign currency incurs a loss upon repayment when the currency increases in value). *See also* section 1092(d)(7) (treating an obligor's interest in a nonfunctional currency debt obligation as a position in the nonfunctional currency). In 2016, Treasury and the IRS included guidance under section 988 in its business plan, thereby acknowledging the possibility of additional regulations that could clarify further the application of the mark-to-market method to foreign currency borrowings. *See* https://www.irs.gov/pub/irs-utl/2016-2017_pgp_initial.pdf at 17.

The 2013 Report also addressed the treatment of hedges of disregarded loans made by CFCs to their qualified business units ("**QBUs**"), a common transaction, but it made no recommendation. Such a hedge is generally entered into for Generally Accepted Accounting Principles ("**GAAP**") or International Financial Reporting Standards ("**IFRS**") reasons, and does not exist for U.S. tax purposes. Yet, it also creates a potential whipsaw effect. Specifically, the CFC recognizes hedge gain as subpart F income without any offsetting loss on the underlying transaction. Yet hedged currency losses are not tax-effected.[18]

Foreign currency hedging activities also raise issues under section 987 of the Code. Section 987 requires the recognition of the branch translation gain or loss of a QBU upon certain remittances. Timing and characterization issues arise with respect to gain or loss realized on hedges of assets, liabilities, and income and expense flows that arise from the QBU. These are important issues given that many taxpayers operate through foreign holding companies which, in turn, have operating subsidiaries that have elected to be disregarded entities for U.S. tax purposes. For financial reporting purposes, these operating subsidiaries will use local currencies that may differ from that of the foreign holding company. For example, a U.K. holding company that uses pounds sterling as its functional currency may have subsidiaries in Europe that have elected to be treated as disregarded entities and that use the euro or the Swiss franc as their functional currency. Two sets of regulations potentially govern section 987 transactions: (1) those proposed in 1991 (the "**1991 Proposed Regulations**") and (2) the much more comprehensive, yet controversial, regulations finalized in 2016 (the "**Final 987 Regulations**"). One of the more controversial aspects of these regulations is that they treat some section 987 gain as subpart F income to the extent apportioned to assets that generate subpart F income.[19]

Under the 1991 Proposed Regulations,[20] the income or loss of a section 987 QBU for the year is calculated in the QBU's functional currency, and that amount is translated into its

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[18] Net investment hedges of a "regarded" CFC would not qualify for hedge treatment given that the asset being hedged is a capital asset. An earlier Tax Section report issued in 1990 had addressed the treatment of net investment hedges made by a U.S. parent of its CFC and recommended that an adjustment to the amount of income realized by the taxpayer in respect of actual or deemed distributions from the foreign subsidiary be permitted. New York State Bar Association Tax Section Report No. 656, *Report on Section 988 Temporary Regulations* (May 7, 1990), page 83 (discussing section 988 temporary regulations).

[19] *See* Treas. Reg. § 1.987-6(b). We note that the Tax Section report on the 2006 proposed regulations concluded that there was statutory authority for such treatment. *See* New York State Bar Association Tax Section Report No. 1140, *Report on Proposed Regulations under Section 987* (January 3, 2008), page 70. On June 13, 2018, Treasury and the IRS announced (Notice 2018-57, 2017-42 I.R.B. 324) that they intend to amend the final regulations under section 987, as well as certain related provisions of the temporary regulations under that section, to delay the applicability date of those regulations by one additional year. Treasury and the IRS had previously delayed the application of the Section 987 regulations by one year in Notice 2017-57 — after the regulations were identified in Notice 2017-38 (along with seven other regulations) as significant tax regulations requiring additional review under Executive Order 13789.

[20] A detailed discussion of these regulations, as well as alternative methods patterned on the 1991 Proposed Regulations (including the so called "earnings only method" under which section 987 gain or loss is recognized with respect to earnings but not capital invested in the QBU) is provided in New York State Bar Association Tax Section Report No. 1386, *Report on Notice 2017-57: Alternative Rules for Determining Section 987 Gain or Loss* (January, 2018) pages 7-14 Consistent with the recommendations of that report, where section 987 is relevant, this Report takes an approach to section 987 that is patterned on the 1991 Proposed Regulations. We have noted below instances where we believe that the specific section 987 regime that is applied may impact the analysis in this Report.

owner's functional currency based on the average exchange rate for the year. The owner of the QBU then recognizes section 987 gain or loss upon a remittance from the QBU (or its termination) under an equity pool method. Under this method, an owner of a section 987 QBU is required to maintain a "basis pool" in the owner's functional currency, and a separate "equity pool" in the QBU's functional currency. When an asset is transferred to the section 987 QBU, the basis pool is increased by the adjusted basis of the transferred asset. This amount is then translated into the section 987 QBU's functional currency, based on the spot rate on the date of transfer, and then added to the equity pool of the section 987 QBU. Earnings of the section 987 QBU are added to the basis pool (in the owner's functional currency) and the equity pool (in the section 987 QBU's functional currency). At any given time, the unrealized section 987 gain or loss with respect to the section 987 QBU is equal to the difference between (i) the equity pool translated into the owner's functional currency at the current spot rate and (ii) the basis pool. Upon a remittance from the section 987 QBU to its owner, the amount of section 987 gain or loss realized and recognized is equal to the product of (i) the unrealized section 987 gain or loss at the time of the remittance and (ii) the portion of the section 987 QBU's balance sheet (measured by adjusted basis in the section 987 QBU's functional currency) remitted.

Regulations proposed under section 987 in 2006 described an "earnings only" variation of the 1991 Proposed Regulations as a "reasonable method" of complying with section 987.[21] Under an "earnings only" method, the general equity pool method described in the 1991 Proposed Regulations is followed, except that the basis and equity pools are only increased as a result of earnings of the section 987 QBU. Remittances would be allocated between earnings and capital (either first to earnings until all earnings are remitted or pro-rata between earnings and capital). Importantly, under an "earnings only" method, a change in the value of contributed assets that arises because of a fluctuation in exchange rates is not reflected in section 987 gain or loss (including upon a remittance or termination of the section 987 QBU).

The basic operation of the 1991 Proposed Regulations and the "earnings only" method can be illustrated by the following example. Suppose that a CFC whose functional currency is the U.S. dollar wholly owns a section 987 QBU whose functional currency is the euro ("**Euro QBU**"). At the beginning of year 1, the CFC transfers $100 to the Euro QBU at a time when the exchange rate is $1 to €1. During year 1, Euro QBU has income of €20. The average exchange rate for year 1 is $1 to €1.25. At the beginning of year 2, Euro QBU remits €40 to the CFC at a time when the exchange rate is $1 to €1.5.

Under the 1991 Proposed Regulations, immediately before the CFC remits €40, the CFC has a basis pool of $116 (*i.e.,* $100 + €20 x $1/€1.25) and an equity pool of €120. Accordingly, at that time, Euro QBU has unrealized section 987 loss equal to -$36 (*i.e.,* €120 x $1/€1.5 - $116). The remittance at the beginning of year 2 triggers recognition of section 987 loss equal to -$12 (*i.e.,* -$36 x €40/€120).

Under an "earnings only" method that treats remittances as being sourced first to earnings, immediately before the CFC remits €40, the CFC has a basis pool of $16 (*i.e.,* €20 x

[21] 71 Fed. Reg. 52876 (Sept. 7, 2006), corrected, 71 Fed. Reg. 77654 (Dec. 27, 2006). *See also* Notice 2000-20, 2000-1 C.B. 851 (Mar. 22, 2000) (requesting comments on the potential adoption by Treasury and the IRS of an approach under which section 987 gain or loss is computed only on remittances of earnings of the applicable QBU).

$1/€1.25) and an equity pool of €20. Accordingly, at that time, Euro QBU has unrealized section 987 loss equal to -$2.67 (*i.e.,* €20 x $1/€1.5 - $16). The remittance at the beginning of year 2 triggers recognition of the entirety of the -$2.67 section 987 loss.

Illustration of 1991 Regulations Versus Earnings Only Approach

	1991 Regulations	*Earnings Only*
Beginning of Year 1:		
Contribution by CFC	$100.00	$100.00
Net Income	€20.00	€20.00
Prior to remitting €40 in Year 2:		
Basis Pool	$116.00	$16.00
Equity Pool	€120.00	€20.00
Upon Remittance of €40 in Year 2:		
Unrealized Section 987 Gain (Loss)	($36.00)	($2.67)
Section 987 Gain (Loss) Triggered on Remittance of €40	($12.00)	($2.67)
Beginning Year 1 Exchange Rate	$1 to €1	
Average Year 1 Exchange Rate	$1 to €1.25	
Beginning Year 2 Exchange Rate	$1 to €1.5	

C. Importance of Financial Accounting

Because foreign currency hedging is often driven by financial accounting considerations more than by tax objectives, the development of tax rules for hedging activities needs to be considered in the context of the financial accounting standards.[22] While foreign currency exposure is generally remeasured in preparing a company's income statement, foreign currency exposure related to foreign subsidiaries is not reflected in a company's income statement. Instead, it is reflected in the balance sheet. The balance sheet reflects increases or decreases in the value of (measured in U.S. dollars) equity investments in businesses conducted in non-U.S.-dollar currency environments. These increases or decreases are reflected in the cumulative translation adjustment ("**CTA**") account associated with the investment and are recorded in the U.S. parent's other comprehensive income (**"OCI"**) account. Revenues, expenses, gains, and losses appear in OCI when they have not yet been realized. The OCI account is an equity account and does not impact financial statement income until a realization event occurs. Under GAAP, a realization event occurs only when there is a liquidation of the foreign subsidiary. Given that income statement changes impact earnings per share and changes to the OCI account do not, companies tend to be more concerned about transactional currency gains or losses that are reflected on the income statement and have the potential to create income statement volatility. Nevertheless, some companies that are regulated by or subject to stringent debt covenants may also be concerned about balance-sheet volatility. Whether for income statement

[22] The IRS, in practice, has often deferred to financial accounting. *See, e.g.*, PLR201816009 (hedge treatment permitted, under Treasury regulations section 1.988-5(e), where taxpayer complied with accounting requirements of ACS 815 in connection with hedges of subsidiary's foreign currency exposure with respect to its anticipated foreign currency-denominated media production costs).

purposes or balance-sheet purposes, companies often seek to hedge these currency exposures if they are material. If the hedge gains and losses are reflected on the taxpayer's return but the underlying currency gains and losses are not reflected on the taxpayer's income statement, it creates a problematic disconnect.

D. The Impact of the Act

The Act has changed some of the consequences that result from the determination of whether an item of income is subpart F income or non-subpart F income. The Act included both a significant corporate rate reduction (from 35% to 21%) and the enactment of the Global Intangible Low Taxed Income ("**GILTI**") regime, which generally taxes income at a 10.5% tax rate but significantly reduces the benefits of foreign tax credits associated with such income.[23] Another potentially relevant provision is the new section 267A, which disallows deductions for interest and royalties paid or accrued to a related party pursuant to a "hybrid transaction" or by, or to, a "hybrid entity."

New policy considerations seem to arise under the Act. In this regard, it seems possible to infer that Congress intended that (1) there be no deferral for investment activities and for those activities to be taxed at normal corporate rates and (2) business activities be taxed at a favorable rate.

E. Categorizing Hedging Transactions

In analyzing the different categories of subpart F income that arise from foreign currency hedging transactions, it is useful to consider that seven classes of foreign currency gain or loss seem to emerge:

Category 1 (investments and related hedges). This category includes section 988 gain or loss arising from foreign currency-denominated debt, currency, and foreign currency derivatives that function as hedges where the assets are in the nature of investment assets, not trade or business assets.

Category 2 (foreign currency assets and hedges core to a trade or business). This category includes section 988 gain or loss arising in a trade or business (such as receivables and working capital) and derivatives that hedge this capital.

Category 3 (treasury centers). This includes the section 988 gain or loss of a CFC that aggregates and manages group-wide foreign currency and cash.

Category 4 (hedges of net investment in QBU). This category includes section 988 gain or loss from derivatives that hedge the net investment (both in the form of equity or debt) of an activity that is considered a section 987 QBU of the CFC.

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[23] § 951A. *See* New York State Bar Association Tax Section Report No. 1394, *Report on the GILTI Provisions of the Code* (May 4, 2018).

Category 5 (hedges of net equity investment in CFC). This category includes section 988 gain or loss from derivatives that function as hedges of a CFC's net investment of an equity investment in a CFC.

Category 6 (hedges of debt investment in CFC). This category includes section 988 gain or loss from derivatives that function as hedges of a CFC's investment in foreign currency-denominated debt of a CFC (other than debt of a CFC Treasury center, described in category no. 1 or 2 above).

Category 7 (natural hedges). This category includes section 988 gain or loss from debt and derivatives that function as hedges of the debt.

While Category 1 transactions, which relate to investments and hedging activity, should continue to be treated as FPHCI as there is no policy rationale to justify either tax deferral or a lower rate, the remaining six categories merit symmetrical (favorable) treatment, at least in part, under the present-day subpart F rules. The only exception to the foregoing would be with respect to a hedge of debt investment in a CFC that functions as a treasury center, which may not qualify for deferral under the existing FPHCI rules.

F. The Proposed Regulations

The Proposed Regulations address the core subpart F classification and timing issues in several ways. First, it addresses the classification issue by expanding the business needs exclusion so that the exception can serve its intended purpose—excluding from FPHCI those items of foreign currency gain or loss that arise from business activities, and not investment activities, of the CFC. Second, it addresses the timing mismatch issue in two ways: (i) it expands the scope of the existing hedge timing rules to clearly cover all bona fide hedging transactions and (ii) it provides an elective mark-to-market regime for items of section 988 gain or loss. The Proposed Regulations also take an important step forward in resolving issues relating to net investment hedges and moving tax treatment of hedges closer to their corresponding GAAP treatment by introducing the concept of a "financial statement hedging transaction."

First, under the Proposed Regulations, the exception for bona fide hedging transactions was modified so that it applies to property that gives rise to both subpart F income (other than foreign currency gain or loss) and non-subpart F income. Under revisions to Treasury regulations section 1.954-2(g), foreign currency gain or loss attributable to a transaction or any property that gives rise to both subpart F income (other than foreign currency gain or loss) and non-subpart F income, or a bona fide hedging transaction with respect to such a transaction or property, and that otherwise satisfies the requirements of the business needs exclusion, is allocated between subpart F income and non-subpart F income in the same proportion as the income from the underlying transaction or property.[24] Second, the rule that allocates foreign currency gain or loss arising from interest-bearing liabilities was modified so that it also applies to foreign currency gain or loss arising from bona fide hedging transactions with respect to such liabilities.[25] Third, the definition of a bona fide hedging transaction was expanded to include the

[24] Prop. Treas. Reg. §1.954-2(g)(2)(ii)(C)(1).

[25] Prop. Treas. Reg. §1.954-2(g)(2)(iii).

acquisition of a debt instrument that has the effect of managing risk with respect to an interest-bearing liability.[26] Fourth, the Proposed Regulations added rules for "financial statement hedging transactions." These are generally hedges by a CFC of its net investment in a QBU. Proposed Treasury regulations section 1.954-2(g)(2)(ii)(C)(2) provides that the qualifying portion of any foreign currency gain or loss that arises from a financial statement hedging transaction with respect to a QBU and that is allocable to non-subpart F income is directly related to the business needs of a CFC.

Changes were also made to both the section 988 and 446 regulations. A new section, proposed Treasury regulations section 1.988-7, was added. It permits taxpayers to elect to use a mark-to-market method of accounting with respect to section 988 transactions, which include becoming an obligor under an interest-bearing liability. Unlike the operation of section 475 or section 1256, the elective mark-to-market treatment considers only changes in the value of the section 988 transaction attributable to exchange rate fluctuations and does not take into account changes in value due to other factors, such as change in market interest or the creditworthiness of the borrower. As discussed below, this is more consistent with the U.S. GAAP accounting rules, which require that non-functional currency assets and liabilities be "remeasured" rather than marked-to-market.

As explained in the Preamble, the Proposed Regulations require appropriate adjustments be made to prevent section 988 gain or loss from being considered again under section 988 or another provision of the Code. The mark is not limited in the case of a debt instrument by the economic gain or loss on the instrument, as provided in Treasury regulations section 1.988-2(b)(8). This election is made by filing a statement with the taxpayer's timely-filed original federal income tax return for the taxable year for which the election is made. Once made, the election may be revoked at any time. However, once the election has been revoked, it may not be made again for six years and then may not be revoked until six years after the subsequent election is made. The addition of the mark-to-market rule specifically addresses the issue that treasury centers had with respect to liabilities. This rule is similar to a provision that was proposed in 1992 and never finalized.[27]

Changes were also made to Treasury regulations section 1.446-4. This section requires gain or loss from a hedging transaction to be taken into account at the same time as the gain or loss from the item being hedged. Under current law, this provision only applies to hedging transactions defined in Treasury regulations section 1.1221-2(b). However, bona fide hedging transactions under section 954 include hedging transactions defined in both Treasury regulations section 1.1221-2(b) and transactions involving section 1231 property and section 988 transactions. Proposed Treasury regulations section 1.446-4 addresses this by providing that bona fide hedging transactions are subject to the hedge timing rules of Treasury regulations section 1.446-4. We note that the expansion of the timing rules to include bona fide hedging transactions did not change the requirement for exemption from the applicable straddle rules that

[26] Prop. Treas. Reg. §1.954-2(a)(4)(ii)(A). The acquisition of a debt instrument generally is not a hedging transaction for purposes of section 1221. *See* Treas. Reg. §1.1221-2(d)(5)(i).

[27] (INTL-0015-91) Prop. Treas. Reg. §1.988-5(f) [March 17, 1992].

the hedged items be ordinary property, ordinary obligations, or borrowings, as discussed further below.

To facilitate a transition into the rules, taxpayers who have made prior elections to eliminate the basketing issues associated with foreign currency gain or loss (*i.e.,* under Treasury regulations sections 1.954-2(g)(3) and (g)(4)) are allowed to revoke these elections without the need to obtain consent.[28]

Taxpayers may rely on the proposed amendments, other than those relating to bona fide hedging transactions, for taxable years ending on or after December 19, 2017, provided the taxpayer consistently applies the proposed amendment for all such taxable years that end before the first taxable year ending on or after the Proposed Regulations are published as final regulations. Taxpayers may rely on the proposed amendments to proposed Treasury regulations sections 1.446-4(a), 1.954-2(a)(4)(ii)(A), 1.954-2(g)(2)(ii)(C)(1) and 1.954-2(g)(2)(iii) with respect to bona fide hedging transactions entered into on or after December 19, 2017, provided the taxpayer consistently applies the proposed amendment to all bona fide hedging transactions entered into on or after such date and prior to the date that the regulations are published as final regulations.

G. The Request for Comments

The Preamble requests comments on three topics. These include: (1) the timing rules of Treasury regulations section 1.446-4; (2) the potential application of the business needs exclusion to a hedge of a CFC's investment in another CFC; and (3) the potential application of the business needs exclusion to transactions that hedge a disregarded transaction between a CFC and its QBU. Below, we address these issues and other issues we have identified while working with the Proposed Regulations.

III. **SUMMARY OF RECOMMENDATIONS**

In response to the request for comments in the Preamble, we make several recommendations. These recommendations are discussed in more detail in Section IV but include the following:

A. Application of the Business Needs Exclusion to Aggregate Hedges

The Proposed Regulations refer to bona fide hedges of a transaction (not transactions) and property (not properties) giving rise to both subpart F and non-subpart F income. This could arguably exclude aggregate hedges of such property (or aggregate hedges of net exposure from assets and liabilities) from the definition of "bona fide hedges" under section 954. We believe that it was an oversight that the Proposed Regulations did not (at least explicitly) address issues relating to aggregate hedges, and recommend that the final regulations address aggregate hedges. In particular, we recommend that taxpayers be able to treat a ratable share of their aggregate

[28] We note that because subpart F income is exempt from the GILTI regime, it is possible that some taxpayers will continue to make the same category election under Treasury regulations section 1.954-2(g)(3) even in light of the adoption of the revised business needs exclusion.

hedges as bona fide hedges if some (but not all) of the underlying transactions generate subpart F income (other than foreign currency gains).

B. Issues Under Proposed Treasury Regulations Section 1.988-7

There is a question as to who can make the election under proposed Treasury regulations section 1.988-7 and whether making the election for one trade or business will affect the ability of another trade or business to choose whether or not to make the election. We recommend Treasury and the IRS consider allowing flexibility in making this election, subject to appropriate constraints to limit the opportunity for "cherry picking." We also recommend clarification of the requirement that appropriate adjustments be made to prevent duplication of section 988 gain or loss from being taken into account again under another provision of the Code or regulations and set forth one approach for doing so. One approach we discuss would involve delaying the adjustment to basis until the asset is disposed of. In addition, we believe that the straddle rules should not apply where offsetting positions in foreign currency are both required to be marked-to-market under proposed Treasury regulations section 1.988-7. Finally, we recommend that Treasury and the IRS confirm that an election under proposed Treasury regulations section 1.988-7 does not require the consent of the IRS or, alternatively, is a change in method of accounting for which the consent is automatically granted, and confirm whether an adjustment under section 481(a) is required.

C. Clarification of the Allocation Rule in the Business Needs Exclusion

Where foreign currency gain or loss arising from a transaction or property gives rise to both subpart F income (other than foreign currency gain or loss) and non-subpart F income, or a bona fide hedging transaction with respect to such a transaction or property, and that otherwise satisfies the requirements of the business needs exclusion, there is a question about how to compute the amount of foreign currency gain or loss that is allocated to non-subpart F income. We recommend that Treasury and the IRS clarify how this allocation should be computed.

D. Incorporation of Risk Management Standard for Purposes of the Business Needs Exclusion

We recommend that Treasury and the IRS confirm that the risk management standard, as opposed to the risk reduction standard, be used in applying the business needs exclusion. Because of the complexity that already exists in QBU-related transactions, it seems appropriate to use the more flexible risk management standard. We believe that such a change would be in the nature of a technical correction.

E. Effective Date Issues

One reading of the Preamble would permit taxpayers to rely on and apply proposed Treasury regulations section 1.988-7 for purposes of tax years ending after December 17, 2017. However, the Preamble could also be read to suggest that proposed Treasury regulations section 1.988-7 cannot be relied on by taxpayers prior to the issuance of final regulations. The question arises as to what taxpayers should do if the Proposed Regulations are not finalized by the date their tax return is due. There have been conflicting public statements by government officials on

this issue. The final regulations or some other guidance should address the issue regarding the applicability date in the Preamble to the Proposed Regulations.

F. Timing of Recognition of Hedging Gains and Losses on Net Investment Hedges in a QBU

Net investment hedges may be entered into with respect to the net assets invested in a QBU or with respect to an equity investment in a CFC. These two situations are addressed separately. The former situation is discussed in the following paragraph. We address the latter situation in the following section.

We recommend several approaches for determining when gain or loss could be recognized on net investment hedges in a QBU. One possibility is that the recognition be matched to the timing of recognition of section 987 gain or loss with respect to the QBU. A second is to defer recognition of items until the termination of the QBU. A third is to defer recognition of items on the QBU Hedge ("**QBU Hedge**") until such items are recognized GAAP purposes. A fourth approach is just to allow ordinary timing rules to control. We recommend the first approach (matching the hedging gain or loss with the section 987 gain or loss on the QBU).

G. Application of the Business Needs Exclusion to Net Investment Hedges

We believe that the business needs exclusion should be broadened to include hedges of a CFC's net investment in a regarded corporate subsidiary ("**CFC Hedge**"). This would be consistent with the legislative history of the business needs exclusion. With respect to the question of how gain or loss with respect to a CFC Hedge should be allocated between subpart F and non-subpart F income, there are multiple approaches. Our principal recommendation is to permit taxpayers to elect to capitalize such gain or loss into the basis of the applicable corporate subsidiary, which would in effect cause the subpart F treatment of such gain or loss to be matched to the subpart F treatment of any gain or loss realized on a disposition of the stock of the subsidiary. If the gain or loss on the CFC Hedge is not capitalized, an assets test (based on fair market value or tax basis) or an income test could be used. We recommend giving taxpayers the option of choosing which test to use. With respect to the timing of the gain or loss, mirroring the timing rules for QBU Hedges with respect to the investment in the CFC may not be appropriate. If taxpayers are permitted to capitalize gain or loss on a CFC Hedge, as we recommend, capitalization will in effect cause the recognition of gain or loss on the CFC Hedge to be matched to recognition of the gain or loss recognized upon a taxable disposition of the stock. As an alternative, we discuss a few possibilities, each with its own advantages and disadvantages. We also believe that hedges of investments in indirect subsidiaries should be eligible for the business needs exclusion.

H. Application of the Business Needs Exclusion to Disregarded Transactions

We believe the business needs exclusion should apply to hedges of disregarded transactions (*e.g.*, disregarded loans) ("**Loan Hedges**"). We also believe it may be helpful to establish a default rule where, in the absence of an affirmative identification of underlying assets, the QBU is treated as hedging a pro rata share of the assets of the applicable QBU. With respect to timing, we suggest, where it is possible, to associate the hedge with particular assets to match

recognition on the hedge to those particular assets. Alternatively, the timing of recognition of the Loan Hedge can be matched with the associated remittance.

I. Expansion of the Hedging Rules

To clarify that the hedge timing rules take precedence over the straddle rules for bona fide hedging transactions, we recommend that Treasury and the IRS expand the definition of a hedging transaction in Treasury regulations section 1.1221-2(b) to conform to the definition of a bona fide hedging transaction.

J. Modification of Reportable Transaction Rules

We recommend that the exceptions to the Reportable transaction rules be modified to include transactions that are covered by the election under proposed Treasury regulations section 1.988-7.

K. Issues Relating to the Act

Given the significant changes brought about by the Act, it is reasonable to consider what (if any) impact the new legislation should have on the above-described recommendations. In particular, it is reasonable to consider whether there should be a ‘business needs’ exclusion for the GILTI regime introduced by the Act. As we discuss in more detail below, we do not recommend adding a business needs exclusion to the GILTI regime.

IV. DISCUSSION

A. Application of the Proposed Regulations to Aggregate Hedges

While the Proposed Regulations addressed issues relating to property that could generate both subpart F and non-subpart F income, it is not clear that they fully address aggregate hedges (that is, where a hedge relates to a net exposure arising from multiple assets, some generating subpart F income and some not).

As an example, suppose a CFC with the U.S. dollar as its functional currency sells products in exchange for euros and pays some expenses in euros and, as a result of these transactions, the CFC has exposure to €100 receivables. If more than 10 euros of receivables generate foreign base company sales income, there is a concern that the IRS would argue that the business needs exclusion does not apply. We believe that the final regulations should address this issue. Specifically, if only 10% of the receivables generate foreign base company sales income, then only 10% of the hedge should fail to qualify for the business needs exclusion. In other words, the pro rata approach of the Proposed Regulations should be expanded to cover aggregate hedges and not merely hedges of individual positions.

B. Issues Regarding Proposed Regulation Section 1.988-7

We applaud Treasury and the IRS for considering this common-sense timing rule. Among other things, it will better align the tax rules with the GAAP remeasurement rules.

Nevertheless, proposed Treasury regulations section 1.988-7 raises several questions, which we highlight below.[29]

1. Coordination With Treasury Regulations Section 1.446-6

The first question is how an election under that section coordinates with Treasury regulations section 1.446-4 where the taxpayer is not a section 475 dealer and the relevant section 988 transaction is not a section 1256 contract.[30] Specifically, where a section 988 transaction entered into by an entity that elects to mark section 988 transactions to market under proposed Treasury regulations section 1.988-7 constitutes a hedging transaction under Treasury regulations section 1.1221-2 with respect to an item that is not marked-to-market, a question is presented as to whether the timing rules of Treasury regulations section 1.446-4 or proposed Treasury regulations section 1.988-7 takes precedence. That the specific exceptions[31] to the mark-to-market regime in proposed Treasury regulations section 1.988-7 do not include any reference to Treasury regulations section 1.446-4 supports the view that the 1.988-7 takes precedence as the rules are currently drafted, but that result is not clear. We recommend that the interaction of these rules be expressly addressed in the final regulations. One potential approach to this question would be to permit taxpayers to elect to identify section 988 transactions that are marked-to-market under proposed Treasury regulations section 1.988-7 as hedging transactions and then exempt those transactions from Treasury regulations section 1.446-4, in which case the default rule would be that the section 1.988-7 election controls. This would be helpful if the taxpayer is hedging a position that is marked-to-market under section 475. Another approach would be to provide expressly that Treasury regulations section 1.446-4 supersede the mark-to-market regime under proposed Treasury regulations section 1.988-7. While this latter approach may be more user friendly, as it does not rely on the taxpayer to affirmatively "opt out" of the

[29] Section 988(d) describes the treatment of 988 hedging transactions as including and integrating any section 988 transaction and treating these transactions as a single transaction, or otherwise being treated consistently for purposes of subtitle A (income taxes). This language is consistent with the Conference Report that discusses section 988, which describes an intent for the regulations to address two categories of hedging transactions, one, a "narrow class of fully hedged transactions that are part of an integrated economic package through which the taxpayer … has assured itself of a cash flow that will not vary with movements in exchange rates," and a second category that involves, "transactions that are not entered into as an integrated financial package but are designed to limit a taxpayer's exposure in a particular currency …. Where appropriate, these regulations should provide for consistent treatment with respect to character, source and timing." S. Rep. No. 99-514, at 666–67 (1986) (Conf. Rep.) (emphasis added). There could be a question of whether Prop. Treas. Reg. §1.988-7 (or its predecessor, withdrawn Prop. Treas. Reg. §1.988-5(f)), could pass muster under *State Farm's* "reasoned decisionmaking" understanding of the clause prohibiting "arbitrary" or "capricious" agency action. *See Motor Veh. Mfrs. Ass'n v. State Farm Ins.*, 463 U.S. 29 (1983); Whether or not Prop. Treas. Reg. §1.988-7 would satisfy the *State Farm* standard may purely be an academic exercise as it is unclear who would object to a taxpayer making this election.

[30] A section 988 transaction that is excepted from mark-to-market treatment under section 475 or section 1256 pursuant to an election or identification is not marked-to-market under proposed Treasury regulations section 1.988-7. In such a case, Treasury regulations section 1.446-4 presumably controls the timing on the section 988 transaction if it is a hedging transaction under Treasury regulations section 1.1221-2(b).

[31] Proposed Treasury regulations section 1.988-7(b) generally provides that the mark-to-market election in section 1.988-7(a) does not apply to (i) securities, commodities or section 1256 contracts that are marked-to-market under another provision, (ii) securities commodities or section 1256 contracts that are excepted from mark-to-market treatment under another provision pursuant to an election or identification, (iii) any transaction of a section 987 QBU and (iv) any section 988 transaction that is denominated in or references a hyperinflationary currency.

Treasury regulations section 1.988-7 on a case by case basis, in certain cases the approach may limit the utility and simplicity of the proposed Treasury regulations section 1.988-7 election.[32] Regardless of how these rules are coordinated, we believe it is important to include an express coordination rule to address the interaction of proposed Treasury regulations section 1.988-7 and Treasury regulations section 1.446-4.

2. Application of Appropriate Adjustments Requirement

Another issue relates to the requirement in the Proposed Regulations that "appropriate adjustments" be made to prevent the section 988 gain or loss recognized under the Treasury regulations section 1.988-7 regime from being taken into account again under section 988 or another provision of the Code or the regulations. This issue is complicated by the rule in Treasury regulations section 1.988-2(b)(8) that limits recognition of section 988 gain or loss to overall gain or loss in the context of a debt instrument. Treasury regulations section 1.988-7 contains no such limitation, which is consistent with GAAP's remeasurement process.

We recognize the reason for not incorporating the Treasury regulations section 1.988-2(b)(8) limitation. Nevertheless, it is not altogether clear what "appropriate adjustments" the Proposed Regulations expect taxpayers to make. Section 1256(a)(2), which is referenced in the Proposed Regulation, simply contemplates an "adjustment" to gain or loss subsequently realized on a section 1256 contract that is marked-to-market.[33] This adjustment does not affect the taxpayer's basis in the relevant section 1256 contract but rather affects the *amount* of gain or loss subsequently realized on the Section 1256 contract. Where a section 988 transaction can only give rise to section 988 gain or loss, an adjustment to the amount of gain or loss subsequently realized on the section 988 transaction to account for gain or loss previously recognized under proposed Treasury regulations section 1.988-7(a) is straightforward. Where the section 988 transaction in question can give rise to items that are not section 988 gain or loss (*i.e.,* gains due to rising interest rates or losses due to borrower's creditworthiness), however, there is uncertainty regarding the mechanism for making the adjustment. It is possible that, if marking-to-market results in gain being recognized, there should be an upward adjustment or, if loss is recognized, there should be a downward adjustment. However, this understates the possibility of there being no economic gain or loss on the debt instrument. The result of a subsequent sale in this situation is that a loss or gain would be recognized, resulting in a character mismatch. Gain under section 988 would be ordinary whereas gain or loss on the debt instrument might be capital. For example, assume a taxpayer owned a loan receivable with an inherent foreign currency gain of $100 but (due to the borrower's financial difficulties) the instrument was worth $100 less than when it was issued— yielding a net zero change in value. Under the Treasury regulations section 1.988-7 elective regime, the foreign currency gain would presumably be reflected in basis. The taxpayer's basis would increase by $100. Assuming the currency appreciation and borrower's financial difficulties remain constant and the debt instrument were

[32] For example, some taxpayers may rely on the election to cause foreign currency derivatives entered into with related foreign parties to be marked-to-market for purposes of treating payments on the derivatives as qualified derivative payments under section 59A(h). This may not be possible if Treasury regulations section 1.446-4 overrides proposed Treasury regulations section 1.988-7 in all cases.

[33] The flush language of section 475(a) contemplates similar adjustments with respect to gain or loss realized on securities marked under section 475.

later sold, the taxpayer would recognize a $100 loss. The loss, if the taxpayer is not a dealer, would be capital. The question is whether such a consequence was intended.

While this is a theoretical possibility, if the taxpayer holding the debt instrument is a dealer, gain or loss would generally be ordinary. In the case where the taxpayer is not a dealer, rather than making a basis adjustment, an alternative might be to require the taxpayer to use a memorandum account to record the adjustment and to release the adjustment upon a later disposition. This could be achieved by an adjustment to the previously recognized section 988 gain or loss.[34]

Similar issues arise in the situation in which the election is made, but the taxpayer making the Treasury regulations section 1.988-7 election is the obligor on the debt instrument. In that case, gain or loss (other than that relating to section 988 gain or loss) would also either be ordinary or an adjustment to interest expense similarly resulting in a matching of character. Although there is less practical significance to this situation given the character match, we recommend Treasury and the IRS provide an example illustrating application of the mechanics of the adjustment so that the timing result is clearer.

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[34] As an example, consider the case where section 988 gain is recognized, but the underlying position is disposed of at a loss. In such case, the gain limitation rule should apply to cause a reversal of the previously recognized loss. For example:

> A taxpayer, X, uses the dollar as its functional currency and makes the Treasury regulations section 1.988-7 remeasurement election. At the beginning of year 1, X pays €100,000 for a debt instrument when the spot rate is €1 = $1.00. The issuer will make interest payments of €50 on the last day of year 1, year 2 and year 3 and will repay the €100,000 principal on the last day of year 3. The year 1, year-end rate is equal to €1 = $1.02. X sells the bond on the first day of year 2 for €97,000 after the interest payment when the spot rate is €1 = $1. 02.. At the end of year 1, X recognizes exchange gain on a mark-to-market basis equal to $2,000 (€100,000 x $1.02) – (€100,000 x $1.00). If the value of the debt instrument at the end of year 1 is €98,000, the netting rule will not apply even though X has an overall loss of $40 (€98,000 x $1.02) – (€100,000 x $1.00) since the net rule does not apply when the election is made. The result is that X realizes $2,000 of exchange gain at the end of year 1.
>
> However, when X sells the instrument on the first day of year 2, the netting rule applies. Assuming that there was no basis adjustment and instead, the gain was recorded in a memorandum account, X's exchange gain on the €100,000 of principal is $2,000 (€100,000 x $1.02) – (€100,000 x $1.00), but this is limited to the total gain (loss) on the transaction, ($1,060) (€97,000 x $1.02) – (€100,000 x $1.00). The result is that X should realize $0 of exchange gain and $1,060 market loss with respect to the transaction. X realized $2,000 of exchange gain on the last day of year 1 and, after making proper adjustments, X realized $2,000 of exchange loss and $1,060 of market loss on the first day of year 2 when X sold the debt instrument. X's net exchange gain or loss over the life of the transaction, $0, is equal to the exchange gain or loss that X would have recognized but for the mark-to-market election.

See ICI Seeks Clarification of Proposed Regs on Mark-to-Market Election, Tax Notes (Mar. 20, 2018), https://www.taxnotes.com/tax-notes-today/accounting-periods-and-methods/ici-seeks-clarification-proposed-regs-mark-market-election/2018/05/30/2833f?highlight=2018-22464.

3. Restrictions on Who May Make the Election

Another question is whether the Treasury regulations section 1.988-7 election is taxpayer by taxpayer or whether the election by one member of the consolidated group binds other members of the same consolidated group owned by the taxpayer.[35] A related question is whether the election can be made for one trade or business without being made by another. We note that under section 475(a), which is non-elective, dealer status applies on a taxpayer-by-taxpayer basis. Moreover, a trader election under section 475(f) is made for a trade or business and while not completely analogous, the taxpayer can identify certain securities for which the election does not apply if they are placed in a non-trading account.

In our experience, many U.S.-headed multinational organizations elect to treat significant numbers of foreign subsidiaries as disregarded entities for U.S. tax purposes in order to simplify their U.S. tax structure. These disregarded foreign subsidiaries may include a variety of business models (*e.g.*, limited risk distributor, manufacturer, financial center), and may be in different industries, and thus they may enter into section 988 transactions in a variety of different contexts and manage exposures with respect to those transactions in different ways. In the context of such tax structures, permitting the Treasury regulations section 1.988-7 election to be made on a trade or business basis would provide much needed flexibility. A countervailing consideration arises from the manner in which the election is made and revoked. Specifically, the election is made with the timely filed original tax return for the year in which the election is effective and initially can be made without restrictions, and then may be revoked at any time, which effectively provides a one-time opportunity to "cherry pick" foreign currency losses (*i.e.,* by making an initial election for a particular year after it is known that there are net foreign currency losses on section 988 transactions and then immediately revoking the election). Because of this, permitting the election to be made on a trade or business basis (rather than on a taxpayer-by-taxpayer basis) could be expected to increase the number of opportunities to "cherry pick" foreign currency losses. These opportunities will be limited, to some extent, by the rule in proposed Treasury regulations section 1.988-7(d) that generally precludes a taxpayer from making an election under that section for 5 years following any revocation of the election.

While it is important to allow taxpayers to have significant flexibility in this context, we believe it would be appropriate to constrain this flexibility to some extent to limit cherry picking. Final regulations could potentially require that this election be made on a broader, group-wide basis (*e.g.*, on a consolidated group basis, or on an expanded affiliated group (as defined in section 7874(c)(1)) basis). This would limit opportunities to cherry pick but would likely significantly reduce the utility of this election. Alternatively, final regulations could require that this election be made on a taxpayer-by-taxpayer basis, potentially subject to a requirement that the election be made consistently across different related taxpayers that are engaged in the same trade or business, in which case cherry picking would be limited to a lesser extent but much of the utility of the election would be preserved. Another alternative would be for Treasury and the IRS to permit the election to be made on a trade or business basis but provide a targeted anti-abuse rule with examples of instances in which it would be inappropriate to make the election on

[35] Proposed Treasury regulation 1.988-7(a) states that the election is made for "all section 988 transactions" but the Preamble only states that the election can be made for with respect to "section 988 transactions."

a trade or business basis (*e.g.*, a fact pattern where a taxpayer establishes a small trade or business in order to selectively recognize foreign currency losses).

4. Limitation on Application of Straddle Rules

The straddle rules of section 1092 can create timing mismatches where currency risk is hedged using derivatives that are not disposed of or terminated at the same time as the transaction being hedged. Where the proposed Treasury regulations section 1.988-7 election has been made, since the same timing rules would generally apply to the offsetting currency components of the position being hedged (at least where that position is a section 988 transaction) and the hedging instrument, there generally should be no need for straddle consequences.

As an example, assume a taxpayer has a foreign currency denominated bond that is hedged with derivative contracts. Assume that the derivative contract generates a loss and the foreign currency component of the foreign currency denominated bond generates a gain. Assume that the bond has appreciated in value due to changes in credit quality or interest rate movements. There would be no policy reason to defer the loss on the derivative on the basis of the unrealized gain that is not due to currency movements.

In sum, where the proposed Treasury regulations section 1.988-7 election has been made, it would make sense from a policy perspective for the straddle rules not to apply so long as the offsetting positions in foreign currency are both required to be marked-to-market under proposed Treasury regulations section 1.988-7. The straddle rules could still apply to positions that are outside the election.

5. Transitional Issues

Several transitional issues are raised by the proposed Treasury regulations section 1.988-7. First, the Proposed Regulations do not specify whether it is necessary for taxpayers who make the election under proposed Treasury regulations section 1.988-7 to file a Form 3115 (Application for Change in Accounting Method). The Proposed Regulations state that the election is made by filing a statement that clearly indicates that the election is made with the taxpayer's tax return for the applicable tax year and does not condition the election on approval by the IRS. This suggests that taxpayers are intended to have the freedom to make the election without navigating a significant administrative process, a judgment that we believe is appropriate. Consistent with this apparent intent, we recommend that Treasury confirm that an election under proposed Treasury regulations section 1.988-7 does not require the consent of the IRS or, alternatively, is a change in method of accounting for which the consent is automatically granted. Second, if the election is made, there is a question of whether a section 481(a) adjustment would be required with respect to any outstanding section 988 transactions that were entered into prior to the year for which the election is first effective. The Proposed Regulations do not state that a section 481(a) adjustment is required with respect to such transactions, and it would be simpler from an administrative perspective to simply recognize the full amount of imbedded foreign currency gain or loss with respect to such transactions when they are marked-to-market at the end of the first year for which the election is first effective. On the other hand, by analogy, a section 481(a) adjustment is required to be made in connection with elections

under section 475(e) or (f).[36] We recommend that Treasury and the IRS expressly confirm whether a section 481(a) adjustment is required in connection with an election under proposed Treasury regulations section 1.988-7.

C. Clarification of the Allocation Rule in the Business Needs Exclusion

In the case of foreign currency gain or loss arising from a transaction or property that gives rise to both subpart F income (other than foreign currency gain or loss) and non-subpart F income, or a bona fide hedging transaction with respect to such a transaction or property, and that otherwise satisfies the requirements of the business needs exclusion, the Proposed Regulations provide that the amount of foreign currency gain or loss that is allocable to non-subpart F income is directly related to the business needs of the relevant CFC. Under the Proposed Regulations, the amount of such foreign currency gain or loss that is allocable to non-subpart F income equals, "the product of the total amount of foreign currency gain or loss arising from the transaction or property and the ratio of non-subpart F income (other than foreign currency gain or loss) that the transaction or property gives rise to, or is reasonably expected to give rise to, to the total income that the transaction or property gives rise to, or is reasonably expected to give rise to."[37]

Two questions are raised by this description of the ratio that is used to compute the amount of foreign currency gain or loss that is allocable to non-subpart F income. The first is whether the income described in the numerator and the denominator of the ratio reflects the total expected income over the entire duration of the transaction, or is instead intended to reflect only the expected income for the applicable tax year. The former interpretation appears to be intended, but we recommend that Treasury and the IRS confirm this (*i.e.,* if a CFC's total expected income changes from one year to the next, it would be appropriate to use the expected income of the CFC at the time of testing).

The second question is whether foreign currency gain or loss, which is expressly excluded from the numerator of the ratio, should be excluded from the denominator of the ratio. Read literally, it appears that foreign currency gain or loss is included in the denominator because it is a component of the total economic income of the transaction or property. Inclusion of foreign currency gain or loss in the denominator, however, would result in the percentage of foreign currency gain or loss that is attributable to non-subpart F income varying depending upon the magnitude of the foreign currency gain or loss relative to the other types of income from the transaction or property. For example, assume that a CFC holds a non-functional currency debt instrument that gives rise to $50 of foreign currency gain that would qualify for the business needs exclusion except that the instrument is expected to give rise to $100 of interest income, $50 of which is subpart F income (other than foreign currency gain or loss). If foreign currency gain or loss is included in the denominator (but not the numerator) of the ratio, approximately 33% (or $16.67) of the foreign currency gain would be treated as attributable to non-subpart F income (*i.e.,* $50 x $50/$150). Alternatively, if the amount of foreign currency gain on the same instrument were $25, approximately 40% (or $10) of the foreign currency gain would be treated

[36] Rev. Proc. 99-17, 1999-1 C.B. 503.

[37] Prop. Treas. Reg. §1.954-2(g)(2)(ii)(C).

as attributable to non-subpart F income (*i.e.,* $25 x $50/$125). It is not entirely clear why the relative magnitude of the foreign currency gain or loss should affect the percentage of that gain or loss that is treated as attributable to non-subpart F income. In addition, in the case of a foreign currency loss, inclusion in the denominator could produce peculiar results. For example, assume that a CFC holds a non-functional currency debt instrument that gives rise to $99 of foreign currency loss that would qualify for the business needs exclusion except that the instrument is expected to give rise to $100 of interest income, $50 of which is subpart F income (other than foreign currency gain or loss). If foreign currency gain or loss is included in the denominator (but not the numerator) of the ratio, the amount of foreign currency loss that would be allocable to non-subpart F income would be -$4,950 (*i.e.,* -$99 x $50/($100-$99)), which greatly exceeds the overall amount of the foreign currency loss.

On the other hand, if foreign currency gain or loss is excluded from the denominator (as well as the numerator) of this ratio, the percentage of that gain or loss that is treated as attributable to non-subpart F income would not depend on the relative magnitude of the foreign currency gain or loss, and the absolute value of that amount attributable to non-subpart F income would never exceed the absolute value of the amount of foreign currency gain or loss. We recommend that Treasury and the IRS clarify whether the denominator of this ratio is intended to exclude foreign currency gain or loss.

D. Incorporation of Risk Management Standard for Purposes of the Business Needs Exclusion

Some practitioners have questioned whether the business needs exclusion has incorporated the "risk management" standard that was added to the regulations under section 1221 in 2002. In particular, some have taken the view that because of a statement in the preamble to the Treasury regulations section 1.1221-2, the bona fide hedging transaction definition in Treasury regulations section 1.954-2(a)(4)(ii) implicitly incorporates the former "risk reduction" standard, which is less flexible than the current "risk management" standard reflected in Treasury regulations section 1.1221-2 and in section 475(c)(3).[38] However, the cross reference to Treasury regulations section 1.1221-2 in the bona fide hedging transaction definition could alternatively be interpreted to incorporate the risk management standard. We believe it is appropriate for the risk management standard to apply for purposes of the business needs exclusion, especially in light of the complex issues implicated by QBU-related hedging transactions, and we recommend that Treasury expressly confirm that the risk management standard has been adopted for these purposes. We believe such a change would be in the nature of a technical correction.

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[38] *See* BNA portfolio 6220-1st, IV.C.2 (noting that the preamble to the regulations under section 1221 provided that "subsequent regulations will specify the extent to which the rules that are contained in section 1.1221-2 will be applicable for purposes of [other international] regulations and the related Code provisions" and concluding that the risk reduction standard "apparently [applies] for Subpart F purposes until Treasury affirmatively adopts the new risk management regulations for Subpart F purposes.") (citing T.D. 8985, 67 Fed. Reg. 12863 (3/20/02)); *See also* New York State Bar Association Tax Section Report No. 782, Report on Proposed and Temporary Regulations on Character and Timing of Gains and Losses from Hedging Transactions (March 4, 1994), pages 40-45 (comparing the risk reduction and risk management standards); *cf.* Prop. Treas. Reg. § 1.1221-2, 67 Fed. Reg. 12829, 12863 (Mar. 20, 2002) (withdrawn) (hedging defined to include risk reduction), with Treas. Reg. § 1.1221-2 (as amended in 2007).

E. Effective Date Issues

The final regulations or some other guidance should address questions regarding the applicability date in the Preamble to proposed Treasury regulations section 1.988-7 as there are multiple ways to read the reliance provision. One reading points to the background section of the Preamble, which says "this document contains proposed amendments to 26 CFR part 1 under sections 446, 954(c)(1)(D), and 988 of the Code." The inclusion of section 988 would suggest that the reliance provision would also include proposed Treasury regulations section 1.988-7 and should also be effective for taxable years ending after December 17, 2017. On the other hand, the Preamble can be read to say that only the proposed amendments under sections 446 and 954(c)(1)(D) are amendments and the change under section 988 is the addition of an entirely new provision, proposed Treasury regulations section 1.988-7. This second reading would exclude proposed Treasury regulations section 1.988-7 from the reliance provision. There have been conflicting statements by government officials on this point.[39] We note that because of changes to the corporate tax rate under the Act, whether taxpayers are permitted to apply the regulations to their 2017 tax years is particularly significant.[40]

We recommend that Treasury and IRS allow calendar year taxpayers to apply the regulations to their 2017 tax years.

F. Modification of the Hedge Timing Rules

The Proposed Regulations seeks comments relating to the timing of gain or loss on hedges with respect to section 987 QBUs. The specific question is whether the hedge timing rules should be expanded with respect to section 987 QBUs when no annual deemed termination is in effect, and if so, how the appropriate matching should be achieved. While the issue is posed in the context of the Final 987 Regulations, a similar issue arises under the 1991 Proposed Regulations.

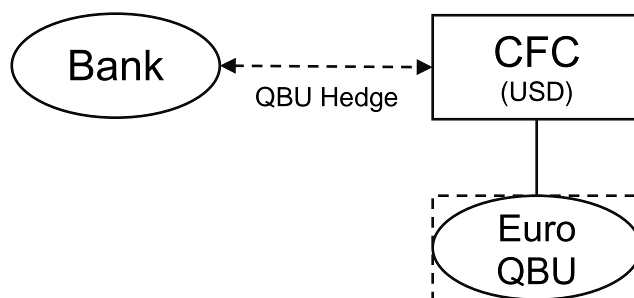
Example 1:

Assume a CFC with a functional currency of the U.S. dollar enters into a QBU Hedge with respect to its net investment in a QBU that has the euro as its functional currency ("**Euro QBU**"). The hedge constitutes a financial statement hedging transaction under proposed Treasury regulations section 1.954-2(g)(2)(ii)(C)(2). The CFC enters into the QBU Hedge when the U.S. dollar euro exchange rate is $1 to €1. Assume further than that the QBU Hedge consists

[39]Tax Notes, IRS Official Settles Confusion on Proposed MTM Election, May 11, 2018, available at: https://www.taxnotes.com/worldwide-tax-daily/accounting-periods-and-methods/irs-official-settles-confusion-proposed-mtm-election/2018/05/14/281lm ("Erwin said in January that taxpayers could rely on the new section 988 mark-to-market election and make the election for 2017 returns….But in February, a Treasury official contradicted Erwin and said he didn't believe the new mark-to-market rule could be relied on yet.").

[40] In Notice 2018-26, Treasury and the IRS announced their intent to issue regulations under which a change in method of accounting for a tax year of a specified foreign corporation that ends in 2017 or 2018 is generally disregarded for purposes of determining transition tax liability under section 965 unless an application for a change in accounting method was filed before November 2, 2017. Under this rule, it appears that an election under proposed Treasury regulations section 1.988-7 for the 2017 tax year would not have the effect of reducing transition tax liability.

of a forward contract to sell €100 for $100 at the end of a two-year period and that at the end of year two, the USD euro exchange rate is $1 to €1.5. Accordingly, at the end of two-year period, the CFC will have realized a cumulative gain of $33.33 on the QBU Hedge. Finally, assume that at the end of year two, Euro QBU distributes €20 (10% of the Euro QBU's equity pool) to the CFC, immediately prior to which, under the 1991 Proposed Regulations the CFC has a basis pool equal to $200 and an equity pool equal to €200 (with an unrealized loss of $66.67, *i.e.,* €200 x $1/€1.5 - $200) with respect to Euro QBU, triggering $6.66 of section 987 loss under the 1991 Proposed Regulations.[41]



Under proposed Treasury regulations section 1.954-2(g)(2)(ii)(C)(2), the qualifying portion of the $33.33 of gain realized on the QBU Hedge that is allocable to non-subpart F income is directly related to the business needs of a CFC. The issue is when the gain on the QBU Hedge should be recognized. We outline several possible approaches below.

One possibility (and the approach we recommend) is that the timing of recognition of gain or loss on the QBU Hedge could be matched to the timing of recognition of section 987 gain or loss with respect to the Euro QBU. This could be accomplished by simply adding the gain or loss on the hedge to the unrecognized section 987 gain or loss associated with the QBU.[42] For example, upon a remittance from the Euro QBU, a percentage of the gain or loss realized on the QBU Hedge equal to the percentage of the unrecognized section 987 gain or loss that is recognized as a result of the remittance could be recognized. On the facts described above, such a rule would mean that at the end of year two, when $6.66 of section 987 loss is recognized, which represents 10% of the unrecognized section 987 loss with respect to Euro QBU that exists at that time, $3.33 of the gain realized on the QBU Hedge (*i.e.,* 10% of the realized gain) would be recognized.[43] This approach has some conceptual appeal because it ties the timing of items

[41] €20 x $1/€1.5 - €20/€200 x $200.

[42] How that occurs mechanically depends on what approach Treasury and the IRS decide to take under the section 987 regulations. Under the Final 987 Regulations, the gain or loss could simply be added to the "net unrecognized section 987 gain or loss" account. In this regard, if Treasury and the IRS decide to retain the distinction between "historic" and "marked" assets then the rules would presumably need to first bifurcate the gain or loss on the hedge into the portion that relates to "historic" assets and the portion that relates to "marked" assets. Only the portion that relates to "marked" assets would be added to the "net unrecognized section 987 gain or loss". The portion relating to "historic" assets would have to be added to or subtracted from the CFC's basis in those assets using some method. Under the 1991 Proposed Regulations, the same result could be achieved by reflecting the gain or loss in the basis pool, without any bifurcation of the gain or loss.

[43] Under current law, it appears that the straddle rules could potentially apply to any loss recognized on a QBU Hedge. Pursuant to section 1092(e), the straddle rules do not apply to properly identified hedging transactions described in section 1221(b)(2)(A). In many cases, however, it may be difficult to conclude that a QBU Hedge is a

on the QBU Hedge to the timing of recognition of section 987 gain or loss, which in a very general sense reflects the economic exposure that is being hedged by the QBU Hedge. We note, however, that if an "earnings only" approach to complying with section 987 is followed, section 987 gain or loss may not correspond fully to the economic exposure that is being hedged, in which case we would recommend that the matching rule not apply to the QBU Hedge.[44] In addition, in some cases it may be complicated to match items on the QBU Hedge to the "right" section 987 gain or loss if less than all of the unrecognized section 987 gain or loss of the Euro QBU is recognized after the QBU Hedge terminates.[45] An alternative way of matching the timing or gain or loss realized on the QBU Hedge to recognition of section 987 gain or loss with respect to the Euro QBU would be to require the CFC to recognize gain or loss realized on the QBU Hedge to the extent that section 987 loss or gain is recognized, respectively. On the facts described above, such a rule would mean that at the end of year two, when $6.66 of section 987 loss is recognized, $6.66 of the gain realized on the QBU Hedge would be recognized. This alternative would simplify application of the rule but would tend to cause items on the QBU Hedge to be recognized earlier than would be the case under the first possibility, particularly where the QBU Hedge represents a hedge of only a portion of the CFC's net investment in the Euro QBU.

A second possibility would be to defer recognition of items of gain or loss on the QBU Hedge until the termination of the QBU. On the facts described above, such a rule would mean that all of the gain that was realized on the QBU Hedge at the end of year two would be deferred until such time as the Euro QBU is terminated for tax purposes. This rule would be relatively simple to apply and administer, and in some instances, we would expect it to result in a significant degree of matching. However, to the extent that section 987 gain or loss reflects the hedged economic exposure is recognized prior to the termination of the QBU, the rule would result in a timing mismatch. In addition, the rule would introduce a degree of electivity, which could be undesirable if a significant portion of the hedged exposure will not be reflected in section 987 gain or loss that would be triggered by a termination of the QBU.[46]

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hedging transaction within the meaning of 1221(b)(2)(A) (*e.g.*, because the hedged items may not be ordinary property). Specifically, the section 1221 regulations require that a disposition of the underlying property not give rise to income other than ordinary income. Yet, a disposition of the QBU's hedged items may give rise to capital gains/losses, and not just ordinary property. Nevertheless, the hedges in this case are clearly designed to hedge only the "currency exposure" associated with the QBU. That exposure is recognized (under U.S. tax law) under section 987, and the gain or loss is considered "ordinary." The same issue is presented in Example 2 and Example 3 described below. As noted above, we recommend that Treasury and the IRS expressly except bona fide hedging transactions described in Treasury regulations section 1.954-2(a)(4)(ii) from the straddle rules.

[44] If a CFC applies an "earnings only" version of the 1991 Proposed Regulations, the section 987 gain or loss that could potentially be recognized by the CFC (even upon a termination of the QBU) would not reflect the entire economic exposure that would be hedged by a net-investment hedge. This issue would not be presented under the original version of the 1991 Proposed Regulations or under the Final 987 Regulations (so long as, in the case of the Final 987 Regulations, gain or loss on the hedge is bifurcated in the manner described above in note 38. This is an instance where the manner in which section 987 is applied may impact the approach that should be taken to the timing of items on a QBU Hedge.

[45] For example, adjustments might need to be made to account for capital contributions to the QBU and changes in the unrecognized section 987 gain or loss that arises, after the QBU Hedge terminates.

[46] This could occur if, for example, because the CFC applies the "earnings only" version of the 1991 Proposed Regulations or the Final 987 Regulations.

A third possibility would be to defer recognition of items of gain or loss on the QBU Hedge until such items are recognized in the applicable income financial statement for GAAP purposes. This approach would make sense if, for example, Treasury and the IRS decide to: (i) depart from the 1991 Proposed Regulations and the Final Section 987 Regulations; and (ii) better align the section 987 rules for measuring and recognizing section 987 gain or loss with the GAAP rules for measuring and recognizing the CTA account. On the facts described above, such a rule would mean that all of the gain that was realized on the QBU Hedge at the end of year two would be deferred until there was a realization event with respect to the Euro QBU for GAAP purposes. It would also be most consistent with the corporate rationale for undertaking the transaction. This rule would be relatively simple to apply and administer and would not entail significant taxpayer electivity. While the rule could potentially result in timing mismatches (*e.g.*, if Euro QBU was terminated in an internal restructuring transaction that did not result in recognition for GAAP purposes), such mismatches may be preferable to the volatility in subpart F income/GILTI that could arise in the absence of any matching rule. A variation on this alternative would simply be to adjust the equity pool for the relevant gain or loss on the QBU Hedge.

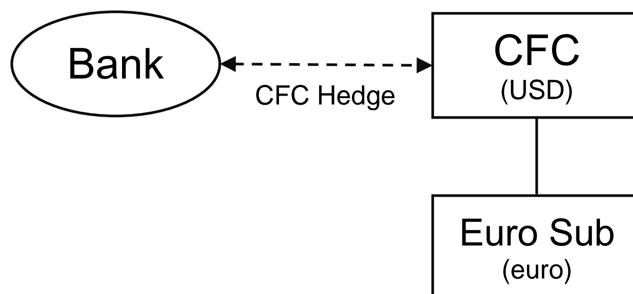
A fourth possibility would be to simply allow ordinary timing rules to control the recognition of items on the QBU Hedge. On the facts described above, such a rule would mean that gain or loss that would be recognized on the QBU Hedge at the end of each of year one and year two under section 1256, which requires that such contracts be marked to market. While this rule would be relatively simple to apply and administer, it would likely result in significant mismatches and volatility in subpart F income/GILTI over time (*i.e.,* as QBU Hedges mature and are rolled over).

G. Expansion of the Business Needs Exclusion for CFC Investment in a CFC

The second question the Preamble raises relates to the application of the business needs exclusion to a transaction that is entered into for the purposes of managing the risk of foreign currency fluctuation with respect to a CFC's net investment in a subsidiary. Such a transaction would not otherwise qualify as a bona fide hedge as the asset being hedged is a capital asset. The question further asks how gain or loss on such a transaction "could or should be" allocated between subpart F income and non-subpart F income and how the currency gain or loss could be matched with the foreign currency gain or loss on the "hedged item."

Example 2:

Assume a CFC with a functional currency of the U.S. dollar enters into a hedging transaction ("**CFC Hedge**") with respect to its net investment in a regarded corporate subsidiary ("**Euro Sub**"), which would constitute a financial statement hedging transaction under proposed Treasury regulations section 1.954-2(g)(2)(ii)(C)(2) if Euro Sub were a section 987 QBU rather than a regarded corporate subsidiary. Assume further that Euro Sub has the euro as its functional currency and that it has €100 of earnings and profits as of the end of year two. Assume the facts are otherwise the same as Example 1.



We believe that the business needs exclusion should be broadened to include the CFC Hedge. As is the case with QBU Hedges, CFC Hedges are typically non-speculative transactions entered into in order to hedge financial statement exposures.[47] It would be consistent with the legislative history of the business needs exclusion to include both QBU Hedges and CFC Hedges within the scope of the exception.[48] Moreover, it would appear to be desirable from a policy perspective to treat net investment hedges in a broadly similar way for purposes of the business needs exclusion, regardless of the tax classification of the subsidiary whose equity is hedged. In addition, we believe that it is appropriate to expand the business needs exclusion to include CFC Hedges relating to CFCs that are *indirect* subsidiaries of the CFC.[49] Expansion of the business needs exclusion seems appropriate given that income from a transaction that meets the business needs exclusion will most likely be subject to the GILTI regime, and not escape current taxation.

If the business needs exclusion is broadened to include CFC Hedges, two further questions will need to be addressed.

[47] We note that the Proposed Regulations appear to adequately address the timing and subpart F matching issues that are raised by hedges of nonfunctional currency debt investments in related CFCs. Specifically, under Proposed Regulation section 1.954-2(g)(2)(ii)(C), foreign currency gain or loss on a nonfunctional currency debt instrument that gives rise to subpart F income (other than foreign currency gain or loss) and that is otherwise within the scope of the business needs exception is in effect allocated between subpart F income and non-subpart F income based on the proportion of income from the debt instrument that is treated as subpart F income. Until section 954(c)(6) sunsets, interest paid on a debt instrument issued by a related CFC will generally be allocated between subpart F income and non-subpart F income based on the subpart F income profile of the CFC that issued the debt. Foreign currency gain or loss on a hedge of such a debt instrument will be allocated between subpart F income and non-subpart F income in the same manner, resulting in matched subpart F treatment of foreign currency gain or loss on the hedge and debt instrument.

[48] The legislative history of the business needs exclusion suggests that Congress did not intend for foreign currency gain or loss on non-speculative transactions entered into by a CFC to be subject to current U.S. taxation under subpart F. Congress believed that income from trading in foreign currencies represents the type of income that can easily be routed through a controlled foreign corporation in a tax haven jurisdiction. Therefore, the excess of foreign currency exchange rate gains over foreign currency exchange rate losses should generally be subject to current U.S. taxation under subpart F unless directly related to the business needs of the corporation. Staff of the Joint Committee on Taxation, General Explanation to the Tax Reform Act of 1986, 99th Cong. 2d. Sess. at 966 (Joint Comm. Print 1987). *See also* H.R. REP. NO. 426, 99th Cong., 1st Sess. 391, 392; and S. Rep. No. 313, 99th Cong., 2d Sess. 364.

[49] Net investment hedges may sometimes be centralized in a single CFC that is an indirect parent in order to achieve efficiencies where only a net exposure needs to be hedged. The purpose of such hedges is the same regardless of whether the CFC is the direct or indirect parent of the CFC whose equity is being hedged.

The first question is how gain or loss on a CFC Hedge should be allocated between subpart F income and non-subpart F income in order to best match the subpart F characterization of the hedged exposure. One approach (and the approach that we recommend)[50] would be to permit taxpayers to elect to capitalize gain or loss on the CFC Hedge into the basis of the stock of the CFC.[51] In addition to affecting the timing of the recognition of gain or loss (as discussed below), this approach would in effect cause the subpart F treatment of such gain or loss to be matched to the subpart F treatment of any gain or loss realized on the disposition of the stock of the CFC. To the extent that a CFC Hedge relates to income that will be distributed (and which may generate gain or loss under section 986(c)), capitalization may not result in a matching of items on the CFC Hedge to the hedged item. For this reason, we believe it is important that capitalization be an elective regime.[52] If an elective capitalization regime is adopted, we recommend that Treasury and the IRS consider allowing taxpayers that do not elect to capitalize gain or loss of a CFC Hedge to apply one of the alternative allocation (and timing) rules described below. One alternative approach would be to exclude all gain or loss on a CFC from subpart F income. A rationale for this approach would be that a CFC Hedge is a non-speculative transaction the gain or loss from which should not, as a policy matter, be treated as passive-type gain or loss that is included in the computation of FPHCI. In addition, this would be a very simple approach that may in practice yield acceptable matching of subpart F characterization where the assets that are economically hedged do not give rise to significant amounts of subpart F income. Another alternative approach would be to allocate gain or loss on a CFC Hedge based on the value of the assets of Euro Sub under the principles of section 861. These principles are well understood and could likely be applied without undue difficulty. Either fair market value or tax basis could be used to measure the CFC's assets. Fair market value may be a less arbitrary

[50] Our recommendation of this approach raises a question about whether a similar approach should be taken to the treatment of net investment hedges entered into by U.S. corporations with respect to regarded foreign subsidiaries. While the character issues raised by such hedges are somewhat different from the subpart F and GILTI issues raised by CFC Hedges, the policy considerations are broadly similar – in each case, it is generally desirable from a policy perspective to match the treatment and timing of the underlying items on the hedge and the hedged item (*i.e.*, the equity of the subsidiary). A discussion of potential changes to the treatment of net investment hedges entered into by U.S. corporations is beyond the scope of this Report, but we believe further consideration of this issue would be merited. As noted earlier, the New York State Bar Association Tax Section Report No. 656 issued in 1990 had addressed the treatment of net investment hedges made by a U.S. parent of its CFC and recommended that an adjustment to the amount of income realized by the taxpayer in respect of actual or deemed distributions from the foreign subsidiary be permitted.

[51] If this approach is adopted, however, consideration would have to be given to what would happen if there were a gain realized on the CFC Hedge that exceeded the relevant CFC's basis in the stock of the subsidiary (*i.e.,* such that an adjustment to basis would yield a negative number). For example, assume CFC1 owns CFC2 and CFC1 has a $100 basis in CFC2. If CFC1 realizes a loss with respect to its net investment hedge of CFC2's stock, CFC1 would presumably add that loss to its basis in the stock of CFC2. But if CFC1 realizes a gain of $110, then CFC1 would presumably reduce its basis in CFC2 and consideration would have to be given to what happens to the extra $10. One potential approach would be to require the taxpayer to use a memorandum account to record the extra $10 of gain and release the adjustment upon a later taxable disposition of the stock of CFC 2.

[52] In addition, further consideration to proposed Treasury regulations section 1.988-5(d) may have merit. That regulation, which was proposed in 1992, would general permit the integration of hedges of declared but unpaid nonfunctional currency dividends with the underlying dividends to which they relate. Integration by its nature would result in a matching of timing and subpart F treatment. Finalization of that regulation, in conjunction with adoption of an elective capitalization regime, would provide taxpayers with significant flexibility to address timing and subpart F characterization issues associated with hedges of equity and earnings of CFCs.

metric. Conversely, an allocation based on tax basis may yield somewhat arbitrary results but may be relatively easy to comply with and less susceptible to manipulation by taxpayers. Another alternative approach would be to allocate gain or loss on a CFC Hedge based on the income profile of Euro Sub under, for example, the principles of Treasury regulations section 1.861-9T(j).[53] Which of these approaches best matches the allocation of gain or loss on a CFC Hedge to the subpart F characterization of the hedged exposure may be context-dependent and may depend on the timing of the items. We believe it is worth considering to allow taxpayers flexibility to choose an allocation method subject to a requirement that the chosen allocation method be applied consistently, such that taxpayers are afforded the greatest opportunity to minimize tax volatility arising from CFC Hedges. Given that at the time CFC Hedges are entered into it is unlikely to be known whether any particular CFC Hedge will result in gain or loss, it would seem that such flexibility would afford little opportunity for the government to be whipsawed by taxpayers, provided taxpayers are constrained by a consistency requirement.

The second question is when gain or loss on a CFC Hedge should be recognized. Approaches analogous to those described in the case of a QBU Hedge could potentially be taken in the case of a CFC Hedge. However, the considerations are somewhat different in this context, which may imply that a different approach to timing would be appropriate in the case of a CFC Hedge.

As described above, one possible approach (and the one that we recommend) would be to permit taxpayers to elect to capitalize gain or loss on the CFC Hedge into the basis in the stock of the CFC (*i.e.,* if there is gain on the CFC Hedge, the basis in the stock of the CFC is reduced, and vice versa). The effect would be to match recognition of items of gain or loss on the CFC Hedge to the recognition of gain or loss with respect to the stock of the CFC upon its taxable disposition. Such an approach would be very much like integration which is permitted for hedging transactions under certain fact patterns.[54] On the facts described above, such a rule would mean that all of the gain that was realized on the CFC Hedge at the end of year two would be deferred until such time as the stock of Euro Sub is disposed of in a taxable transaction. Of course, in many instances the disposition of the stock of a CFC may be tax-free (*e.g.*, as a result of a tax-free liquidation) and may not trigger any built-in gain or loss in the assets of the Euro Sub. Moreover, this will tend to increase differences between inside and outside basis. On the other hand, such an approach would be easy to implement.[55]

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[53] P.L. 115-97 amended section 864(e)(2) to prohibit the allocation of interest expense based on the fair market value of assets or gross income. Prior to this amendment, it was permissible to compute a CFC's subpart F income by allocating its interest expense based on the income profile of the CFC under Treasury regulations section 1.861-9T(j). The revision of this rule was likely due to budgetary considerations as the allocation of interest expense is an important issue in the foreign tax credit area. Notwithstanding this change in the permissibility of this method for purposes of interest expense allocation, we believe this allocation method may have merit for purposes of allocating gain or loss on a CFC Hedge. Furthermore, we note that the possibility that any given CFC Hedge will give rise to *gain* or loss distinguishes this allocation question from the question of how interest expense, which only reduces income, should be allocated.

[54] *See* Treas. Reg. §§ 1.1275-6 and 1.988-5.

[55] This approach is suggested in a thoughtful article on foreign currency related issues. *See* John 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 (2011) pages 247 and 265 (discussing net investment hedges

Another possibility would be to match timing of items on the CFC Hedge to distributions by the Euro Sub. For example, upon a distribution of earnings from the Euro Sub to the CFC, a percentage of the gain or loss realized on the QBU Hedge equal to the percentage of the earnings that is distributed could be recognized. On the facts described above, such a rule would mean that at the end of year two, when Euro Sub distributes 20% of its earnings and profits, $6.66 of the gain realized on the CFC Hedge (*i.e.,* 20% of the total gain realized on the CFC hedge) would be recognized. The difficulty with this approach is that in the case of a net investment hedge with respect to a CFC, there may not be a strong connection between the amount of earnings distributed and the hedged exposure.[56] Accordingly, such a rule may result in somewhat arbitrary timing of items on the CFC Hedge.

A third possibility would be to defer recognition of items of gain or loss on the CFC Hedge until such items are recognized in the applicable income statement for GAAP purposes. Unlike the situations described above in connection with Section 987 QBUs, Treasury's adoption of this approach in the context of net investment hedges of CFC shares is not dependent on the path Treasury chooses to go down with respect to section 987 more generally. On the facts described above, such a rule would mean that all of the gain that was realized on the CFC Hedge at the end of year two would be deferred until there was a realization event with respect to Euro Sub for GAAP purposes. This rule would be relatively simple to apply and administer and would not entail significant taxpayer electivity. It would also be most consistent with the corporate rationale for undertaking the transaction. While the rule could potentially result in timing mismatches (*e.g.*, if Euro Sub was terminated in an internal restructuring transaction that did not result in recognition for GAAP purposes), we expect that such mismatches generally would be preferable to the volatility in subpart F income/GILTI that could arise in the absence of any matching rule.

A fourth possibility would be to simply allow ordinary timing rules to control the recognition of items on the CFC Hedge. On the facts described above, such a rule would mean that gain (or loss) would be recognized on the CFC Hedge at the end of each of year one and year two under section 1256, which requires such positions to be marked to market at year-end. While this rule would be relatively simple to apply and administer, it would likely result in significant mismatches and volatility in subpart F income/GILTI over time (*i.e.,* as CFC Hedges mature and are rolled over).

H. Expansion of the Business Needs Exclusion for Disregarded Transactions

The third question relates to the consequences of disregarded transactions. In particular, the Preamble asks whether additional amendments to the business needs exclusion are

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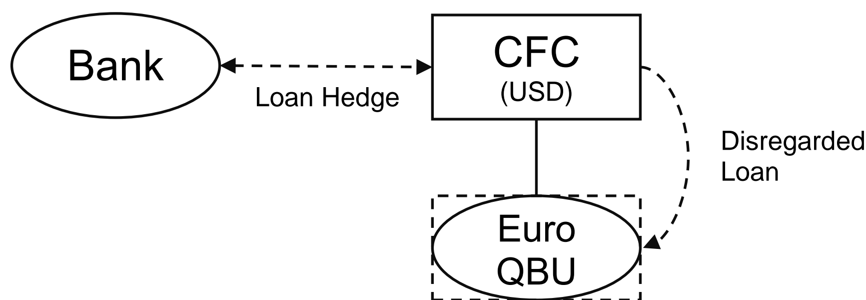
and proposing solutions). The authors suggest an alternative approach under which the hedge would be permitted to be identified solely for purposes of sections 263(g) 1092, 1256 and Treasury regulations section 1.954-2(a)(4)(ii) and the Reportable transaction rules. The same article, adopting the theme of coordinating tax hedging with financial accounting requirements, recommends members of an affiliated group (without the application of section 1504(b)), to hedge other members' risk. *See* page 267 (Problem 12)

[56] By comparison, in the case of a QBU Hedge, even if there is complexity associated with matching items on a QBU Hedge with the recognition of section 987 gain or loss upon a remittance, there can be a relatively strong connection between section 987 gain or loss and the hedged exposure.

appropriate to account for foreign currency gain or loss arising from a transaction that is entered into for the purpose of managing the foreign currency function with respect to disregarded transactions. Specifically, comments are requested regarding how the foreign currency gain or loss on such a hedging transaction "could or should be" allocated between subpart F and non-subpart F income and when such foreign currency gain or loss should be recognized.

Example 3:

Assume CFC makes a euro-denominated loan ("**Disregarded Loan**") to its Euro QBU with a principal amount of €100 at a time when the USD to euro exchange rate is $1 to €1. The loan has a five-year term and calls for annual payments of interest. At the time CFC makes the loan, it enters into the hedging transaction ("**Loan Hedge**") consisting of a forward contract to sell €100 for $100 at the end of a five-year period, and at the end of year five, the USD euro exchange rate is $1 to €0.5. Accordingly, at the end of the five-year period, the CFC will have realized a cumulative loss of $100 on the Loan Hedge. Finally, assume that at the end of year five, Euro QBU repays the principal amount of the €100 loan to the CFC, immediately prior to which, under the 1991 Proposed Regulations, and with respect to Euro QBU, the CFC has a basis pool equal to $200 and an equity pool equal to €200, triggering $100 of section 987 gain under the 1991 Proposed Regulations.[57] It has a corresponding economic gain on the Disregarded Loan of $100.



We believe that the business needs exclusion can and should potentially apply to hedges of disregarded transactions, such as the Disregarded Loan. Hedges of such transactions are not uncommon, and we believe they can be appropriately viewed as akin to net investment hedges, although they may not be treated as such for financial accounting purposes and therefore may not fall within the scope of the proposed exception for financial statement hedging transactions.[58] We understand that, historically, taxpayers taken the position that such hedges can be identified as hedges of the underlying disregarded transaction for financial reporting

[57] At the end of year five, immediately before the remittance, Euro QBU has unrealized section 987 gain equal to $200 (*i.e.,* €200 x $1/€0.5 - $200). The remittance triggers recognition of section 987 gain equal to $100 (*i.e.,* $200 x €100/€200).

[58] *See* 2013 Report, pages 69-71 (discussing hedges of disregarded loans); L.G. "Chip" Harter et al, *Financing International Operations*, 37 Int'l Tax J. 11, 16-17 (Sept. – Oct. 2011) (same).

purposes and identified as hedges of ordinary assets of the QBU or anticipated revenues for purposes of the business needs exclusion. There is potentially some tension, however, between the requirement that such transactions be entered into "primarily" to manage risk with respect to ordinary property (or other specified property) and the fact that such transactions may, in practice, be entered into principally to hedge the relevant disregarded transaction for financial reporting purposes. We note that in the insurance area, the Large Business and International Division ("**LB&I**") has accepted this divergence in identification (LB&I Directive-04-0514-0050(July 17, 2014).[59]

Consistent with this view, we believe it would be appropriate to clarify that the definition of a bona fide hedging transaction in Treasury regulations section 1.954-2(a)(4)(ii) includes a transaction entered into primarily to manage risk with respect to a disregarded transaction entered into with a QBU owned by the applicable CFC—in that case, although the hedging transaction may be entered into for financial reporting purposes, it has the effect of hedging assets or flows of the QBU—and it is evident that the transaction is entered into for non-speculative reasons. It may also be desirable to allow taxpayers to reasonably identify the underlying assets of the QBU that the hedge is intended to relate to for tax purposes. In addition, it may be worthwhile to establish a default rule in the absence of an affirmative identification of underlying assets (or if the identification is ambiguous or, for example, if the identification is in the alternative). For example, a hedge of a disregarded transaction that is not identified for tax purposes as hedging any specific assets of the applicable QBU could be treated by default as hedging a pro rata share of the assets of the applicable QBU. In either case, allocation of gain or loss on the Loan Hedge between subpart F and non-subpart F income should be determined based on the characterization of the assets or income flows to which the Loan Hedge relates.

Assuming the Loan Hedge is included within the scope of the business needs exclusion, there is a question regarding when items on the Loan Hedge should be recognized. Since the Disregarded Loan does not exist for tax purposes, the gain is recognized for GAAP purposes but is not recognized for tax purposes. One possibility would be to match the timing of the items of the Loan Hedge with the associated remittance (*i.e.,* the remittance that arises when the loan is repaid). On the facts described above such a rule could require that $100 of loss would be recognized with respect to the Loan Hedge at the end of year five when the Disregarded Loan is repaid. Such a rule would be consistent with the form of the Loan Hedge but may not result in a matching of the timing of items of the Loan Hedge with items on the economically hedged item. Where the Loan Hedge can be associated with particular assets of the QBU, a better match could potentially be achieved by treating the Loan Hedge as a hedge of those particular assets, in which case items of the Loan Hedge could potentially be matched to items recognized on those particular assets under Treasury regulations section 1.446-4. The same would follow if the Loan Hedge were treated as a hedge of anticipated cash flows.

[59] Here, LB&I accepted as valid hedges, positions held to fund reserve requirements related to equity based variable annuities. One could argue that the hedges were hedges of a capital asset (the equity) since the hedges were also designed to reduce risk with respect to the underlying equity position.

I. Expansion of Hedging Exception

The Proposed Regulations expand the hedge timing rules of Treasury regulation section 1.446-4 to include bona fide hedging transactions, but do not expand the definition of a hedging transaction in Treasury regulation section 1.1221-2(b) to cover all bona fide hedging transactions. The hedging exception to the straddle rules in section 1092(e) (which references the hedge exception in section 1256(e)) requires that the transaction meet the definition of a hedging transaction in section 1221(b)(2)(A). As a result, the Proposed Regulations create uncertainty as to whether the straddle loss deferral rule could still apply to a bona fide hedging transaction that falls outside the section 1221 definition of a hedging transaction, *e.g.*, hedges of the foreign currency risk on the acquisition of or disposition of a section 1231 asset, and hedges of the foreign currency risk with respect to a loan the taxpayer made to a foreign subsidiary. These transactions are common business hedges undertaken in the normal course of a U.S. taxpayer's business. Although the section 1231 asset or the loan receivable may not be ordinary property in the taxpayer's hands, the taxpayer is hedging the foreign currency risk with respect to the anticipated receipt (and disposition) of foreign currency, which qualifies as ordinary property.[60] In order to clarify that the hedge timing rules take precedence over the straddle rules for bona fide hedging transactions, we recommend that Treasury and the IRS expand the definition of a hedging transaction in Treasury regulation section 1.1221-2(b) to conform to the definition of a bona fide hedging transaction. This expanded definition ensures that these common foreign currency hedges qualify as section 1221 tax hedges, resulting in the desired matching of the character and timing of the hedge to the hedged item.[61] In the event that Treasury regulations section 1.1221-2(b) is not broadened to include all categories of transactions that constitute bona fide hedging transaction for purposes of the business needs exception, we recommend that the straddle rules not apply to defer currency loss with respect to positions that constitute bona fide hedging transactions described in Treasury regulations section 1.954-2(a)(4)(ii).[62]

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[60] Treasury regulations section 1.1221-2(c)(2) defines "ordinary property" as property that can never give rise to capital gain or loss if sold or exchanged. The disposition of foreign currency is a section 988 transaction that only gives rise to ordinary gain or loss. Section 988(c)(1)(C).

[61] Where the taxpayer is hedging the foreign currency risk on the sale of a section 1231 asset, there is the potential for a character mismatch as the gain on the disposition of the section 1231 asset is capital, while the loss on the foreign currency hedge may be ordinary. However, this character mismatch may be an acceptable side-effect given the benefits of conforming the definition of a section 1221 hedging transaction to the definition of a bona fide hedging transaction.

[62] As noted previously, in the case of a controlled foreign corporation, to avoid subpart F characterization, identification and recordkeeping requirements must be met. Under the passive foreign investment company ("**PFIC**") rules, passive income includes income of a kind which would be foreign personal holding company income as defined in section 954(c). Section 1297(b)(1). Literally, in the case of a PFIC, the same identification requirements must be met, but a U.S. person often has no mechanism to ensure that these requirements be complied with. We recommend that the identification and recordkeeping requirements for bona fide hedges of foreign currency gain or loss not be applicable in the case of PFICs. The same concern arises in the case of commodity transactions.

J. Modification of the Reportable Transaction Rules

Under Treasury regulations section 1.6011-4, certain categories of transactions are considered "Reportable transactions", reporting is required for corporations or taxpayers claiming losses of $10 million in a single year or $20 million in any combination of years, but in the case of foreign currency losses, reporting is required for individuals and trusts where there is a foreign currency loss is $50,000 or greater.[63] Rev. Proc. 2004-66[64] creates an exception from the reporting rules for transactions that are subject to mark-to-market treatment under section 475(a) or 475(f) or that are properly identified hedges under section 1221(b)(2).

Consistent with the other exceptions contained in Rev. Proc. 2004-66, we recommend that the Reportable transaction rules be modified to exclude transactions that are covered by an election under proposed Treasury regulations section 1.988-7.[65]

K. Issues Raised Under the Act

Assuming the transactions fit within the regime for a bona fide hedging regime and thus do not generate FPHCI, the transactions would seem to fall into the GILTI regime. While avoiding subpart F treatment has historically been the goal of tax planning this area, it is no longer as certain under the GILTI regime due to the foreign tax credit limitations. In high tax jurisdictions, some taxpayers may find subpart F treatment more favorable. In addition, the GILTI regime has significantly increased the importance of the timing of offsetting items that may be excluded from subpart F treatment.

Given the significant changes brought about by the Act, it is reasonable to consider what (if any) impact the new legislation should have on the above-described recommendations. In particular, it is reasonable to consider whether there should be a 'business needs' exclusion for the GILTI regime introduced by the Act. We do not recommend adding a business needs exclusion to the GILTI regime for two reasons. First, the policy rationale of subpart F and GILTI are very different. The subpart F regime specifically targeted certain types of income and is applied to CFCs on a stand-alone basis. The GILTI regime applies to the amount of income (of whatever type) generated by all related CFCs. Second, the problems that the Proposed Regulations seek to resolve by, for example, expanding the application of subpart F's business needs exclusion, do not exist to the same degree in the GILTI regime. Specifically, if a currency loss on a hedge and a gain on an underlying transaction are not realized by the same CFC, in the same year, and in the exact same category of FPHCI, the taxpayer can easily be whipsawed. The gain is taxed as subpart F income while its losses generally cannot be used to offset subpart income that is in a different category of FPHCI. In contrast, currency gains and losses would presumably offset other tested income in computing "tested income" for GILTI purposes, regardless of whether they are generated by the same CFC if earned in the same year. Even if

[63] Treas. Reg. § 1. 6011-4(b)(5)(i)(E).

[64] 2004-50 I.R.B. 966.

[65] *See* McDonald et al, *supra* note 55, at pages 265 to 266, suggesting a broadening of the hedging exception contained in Rev. Proc. 2004-66.

gains and losses were recognized in different years, the loss could still be used to reduce "tested income." Thus, the problems that the Proposed Regulations attempt to address with respect to subpart F income are not present under the GILTI regime.