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Proposed regulations: CFC's foreign currency gain or loss; election for mark-to-market accounting for section 988 transactions

The U.S. Treasury Department and IRS today released for publication in the Federal Register a notice of proposed rulemaking (REG-119514-15) as guidance for the tax treatment of foreign currency gain or loss of a controlled foreign corporation (CFC) under the "business needs exclusion" from foreign personal holding company income (FPHCI).

The **proposed regulations** [PDF 299 KB] allow an election for a taxpayer to use mark-to-market method of accounting for foreign currency gain or loss attributable to section 988 transactions.

The proposed regulations also permit the controlling U.S. shareholders of a CFC to automatically revoke certain elections concerning the treatment of foreign currency gain or loss.

Proposed regulations – Business needs exclusion

The preamble to these proposed regulations describes the "business needs exclusion" under two areas:

- Transactions and property that give rise to both subpart F income and non-subpart F income
- Hedges of net investment in a qualified business unit (QBU)

As stated in the preamble, the position of the IRS and Treasury is that foreign currency gain or loss arising from a transaction or property—or from a bona hedging transaction with respect to such a transaction or property—is to be eligible for the business needs exclusion to the extent the transaction or property generates non-

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subpart F income. Prop. Reg. section 1.954-2(g)(2)(ii)(C)(1) provides that foreign currency gain or loss attributable to a transaction or property that gives rise to both subpart F income and non-subpart F income, 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. Accordingly, the amount of foreign currency gain or loss allocable to non-subpart F income qualifies for the business needs exclusion, and the amount allocable to subpart F income is taken into account in computing FPHCI.

The proposed regulations (Prop. Reg. section 1.954-2(g)(2)(ii)(C)(1)) provide the entire foreign currency gain or loss arising from property that does not give rise to income (as defined in Reg. section 1.954-2(e)(3)), or from a bona fide hedging transaction with respect to such property, is attributable to subpart F income because any gain upon a disposition of such property would be subpart F income.

Concerning hedges of net investment in a QBU, the preamble sets forth the position of the IRS and Treasury that a transaction that manages exchange rate risk with respect to a CFC's net investment in a QBU that is not treated as a separate entity for federal income tax purposes would qualify for the business needs exclusion to the extent the underlying property of the QBU does not give rise to subpart F income. Prop. Reg. 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.

These proposed regulations define:

- A financial statement hedging transaction as a one that is entered into by a CFC for the purpose of managing exchange rate risk with respect to part or all of that CFC's net investment in a QBU that is included in the consolidated financial statements of a U.S. shareholder of the CFC or a corporation that directly or indirectly owns that U.S. shareholder.
- The qualifying portion as the amount of foreign currency gain or loss arising from a financial statement hedging transaction that is properly accounted for under U.S. GAAP as a cumulative foreign currency translation adjustment to shareholders' equity.

The preamble notes that the qualifying portion of any foreign currency gain or loss arising from a financial statement hedging transaction must be allocated between subpart F income and non-subpart F income using the principles of Reg. section 1.987-6(b). The amount of the qualifying portion allocated to non-subpart F income qualifies for the business needs exclusion.

Foreign currency gain or loss arising from a financial statement hedging transaction is not subject to the hedge timing rules of Reg. section 1.446-4 because such transactions are not included in the definition of bona fide hedging transaction as

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proposed and is taken into account in accordance with the taxpayer's method of accounting.

The preamble explains that in general, a taxpayer's financial statement hedging transaction is a section 988 transaction, and accordingly, to the extent that the taxpayer elects to use a mark-to-market method of accounting for section 988 gain or loss under Prop. Reg. section 1.988-7, and also makes the annual deemed termination election, the taxpayer generally would recognize annually foreign currency gain or loss from both the financial statement hedging transaction and the QBU with respect to which exchange rate risk is managed.

Comments are specifically requested concerning:

- Whether the hedge timing rules of Reg. section 1.446-4 should apply to a financial statement hedging transaction with respect to section 987 QBUs with respect to which no annual deemed termination election is in effect, and, if so, how the appropriate matching would be achieved
- Whether the business needs exclusion should apply to a transaction that is entered into for the purpose of managing the risk of foreign currency fluctuation with respect to a CFC's net investment in a subsidiary CFC
- How the gain or loss on such a transaction could or should be allocated between subpart F and non-subpart F income and whether and how the gain or loss could or should be matched with the foreign currency gain or loss on the "hedged" item
- Whether, taking into account the amendments in the proposed regulations, additional amendments to the business needs exclusion are appropriate to account for foreign currency gain or loss arising from a transaction that is entered into for the purpose of managing the risk of foreign currency fluctuation with respect to disregarded transactions, including disregarded loans, between a CFC and its QBU
- 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 should be recognized

Proposed regulations – Timing of foreign currency gains and losses

The proposed regulations under section 446 would extend the hedge timing rules of Reg. section 1.446-4 to all bona fide hedging transactions (as defined in Reg. section 1.954-2(a)(4)(ii)). According to the preamble, this change would eliminate timing mismatches for gains and losses arising from all bona fide hedging transactions and from the hedged property or transaction.

Also, Prop. Reg. section 1.954-2(a)(4)(ii)(A) revises the definition of a bona fide hedging transaction to permit the acquisition of a debt instrument by a CFC to be treated as a bona fide hedging transaction with respect to an interest-bearing liability of the CFC, provided that the acquisition of the debt instrument has the effect of managing the CFC's exchange rate risk with respect to the liability within the meaning

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of Reg. section 1.1221-2(c)(4) and (d) (determined without regard to Reg. section 1.1221-2(d)(5)), and otherwise meets the requirements of a bona fide hedging transaction.

Thus, if a CFC—including a treasury center CFC—identifies a debt instrument that manages exchange rate risk as a hedge of an interest-bearing liability, the foreign currency gain or loss arising from that debt instrument will be taken into account under Reg. section 1.446-4 at the same time as the foreign currency gain or loss arising from the hedged interest-bearing liability.

Proposed regulations – Elective mark-to-market method of accounting for foreign currency gain or loss

The proposed regulations would permit a taxpayer, including a CFC, to elect to use a mark-to-market method of accounting for section 988 gain or loss with respect to section 988 transactions, including becoming an obligor under an interest-bearing liability.

The election to use the mark-to-market method of accounting takes into account 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 changes in market interest rates or the creditworthiness of the borrower.

The proposed regulations require that appropriate adjustments are made to prevent section 988 gain or loss taken into account under the mark-to-market method of accounting from being taken into account again under section 988 or another provision of the Code.

The mark-to-market election is available to any taxpayer but, as noted in the preamble, is expected to be "particularly relevant in the case of a treasury center CFC."

The election does not apply to the following:

- Any securities that are marked to market under any other provision
- Any securities that, pursuant to an election or an identification made by the taxpayer, are excepted from mark-to-market treatment under any other provision
- Any transactions of a QBU that is subject to section 987
- Any section 988 transactions denominated in, or determined by reference to, a hyperinflationary currency

The mark-to-market election applies for the year in which the election is made and all subsequent tax years unless it is revoked by the Commissioner or the taxpayer or, in the case of a CFC, the controlling domestic shareholders of the CFC. The election may be revoked by the taxpayer or CFC at any time. However, a subsequent election

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cannot be made until the sixth tax year following the year of revocation and cannot be revoked until the sixth taxable year following the year of such subsequent election.

Proposed regulations – Hedges of exchange rate risk arising from an interest-bearing liability

Proposed changes reflect the IRS and Treasury position that foreign currency gain or loss from transactions that are intended to manage exchange rate risk arising from an interest-bearing liability to be allocated between subpart F and non-subpart F income in the same manner that foreign currency gain or loss from the interest-bearing liability would be allocated and apportioned.

Proposed regulations – Revocation of election to treat foreign currency gain or loss as a specific category of subpart F income or as FPHCI

Provisions in today's proposed regulations permit:

- A CFC to revoke an election to characterize foreign currency gain or loss that arises from a specific category of subpart F income as gain or loss in that category at any time without securing the prior consent of the Commissioner
- A CFC to revoke its election to treat all foreign currency gain or loss as FPHCI at any time without securing the prior consent of the Commissioner

To address a concern of the IRS and Treasury about CFCs frequently changing these elections without a substantial business reason, but in an effort to allow revocation of these elections under sound tax administration, the proposed regulations provide that, if an election has been revoked under one of these provisions, a subsequent election cannot be made until the sixth tax year following the year of revocation and any subsequent election cannot be revoked until the sixth year following the year of such subsequent election.

Effective date

These regulations are generally proposed to apply to tax years ending on or after the date that the proposed regulations are published as final regulations in the Federal Register, although certain provisions (Prop. Reg. sections 1.446-4, 1.954-2(a)(4)(ii)(A), 1.954-2(g)(2)(ii)(C)(1), and 1.954-2(g)(2)(iii)) are proposed to apply to bona fide hedging transactions entered into on or after the proposed regulations are published as final regulations.

Still, the preamble provides that taxpayers may rely on certain measures of the proposed regulations with respect to bona fide hedging transactions for tax years ending on or after December 19, 2017 (the date when the proposed regulations will appear in the Federal Register) and rely on certain other measures of the proposed regulations with respect to bona fide hedging transactions entered into on or after December 19, 2017.

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