



DEPARTMENT OF THE TREASURY  
INTERNAL REVENUE SERVICE  
WASHINGTON, D.C. 20224

OFFICE OF  
CHIEF COUNSEL

September 21, 1999

Number: **200004006**  
Release Date: 1/28/2000  
CC:INTL:Br5  
WTA-N-104078-99  
JWRogersIII  
UILC: 988.02-03

INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

FROM: Roger M. Brown  
Special Counsel to the Assistant Chief Counsel  
(International - Technical)

SUBJECT:

This Field Service Advice responds to your memoranda dated February 18, 1999, and April 22, 1999. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be used or cited as precedent.

LEGEND:

Business Persons =  
ABC =  
X =  
FX =

U.S. X =

Country 1 =  
Country 1 X =  
Country 1 FX =  
Country 2 =  
Country 2 FX =

Expenses	=
City 1	=
Group 1	=
Group 1 Manager	=
Business 1	=
Business 1 Activity	=
Date 1	=
Date 2	=
Type 1 Income	=
Type 2 Income	=
Type 3 Income	=
AA	=
BB	=
CC	=
DD	=
EE	=
FF	=
Excerpt 1	=

ISSUE:

What is the appropriate exchange rate for translating Expenses attributable to Type 1 Income, as defined under the Closing Agreements?

CONCLUSION:

The spot rate in effect on the date the Expenses are accrued by the Country 1 X(s) is the appropriate exchange rate for translating Expenses.

FACTS:

Our understanding of the facts is as follows. ABC, based in City 1, is an EE where Business 1 Activity is conducted. ABC is not a traditional FF. ABC consists of Business Persons that are organized into Group 1s controlled by Managers. Group 1s accept no AA; rather, a Group 1 provides the means by which a Manager can

accumulate and commit DD to Business 1 AA. Generally, each Business Person belonging to a Group 1 agrees to accept a predetermined percentage of all Business 1 on behalf of a Group 1. Business Persons delegate to Managers authority to select AAs, set BB rates, hold BB and pay CC on their behalf. For each Group 1, ABC maintains separate U.S. dollar, Country 1 FX, and Country 2 FX X. We understand that it is ABC policy to match and manage BB income, Type 2 Income, and payment of CC in the same currency to avoid currency risks.

The U.S. tax consequences of ABC activities are governed by the provisions in two sets of Closing Agreements entered into between ABC Business Persons and the Service on Date 1, and on Date 2 (hereafter, the "Date 1 Closing Agreement" or the "Date 2 Closing Agreement," as the case may be; or collectively, the "Date 1 and Date 2 Closing Agreements"). Under these closing agreements, the Type 1 Income of each Business Person is computed separately for each taxable year and is then Excerpt 1.

The Date 1 and Date 2 Closing Agreements provide that Business Persons shall be entitled to claim a deduction for expenses attributable to Type 1 Income. Generally, the portion of expenses attributable to each taxable year is to be determined by direct allocation, where appropriate. Otherwise, attributable expenses are determined by apportionment by multiplying such expenses by a fraction, the numerator of which is BB included in Type 1 Income for that taxable year and the denominator of which is all BB for that taxable year included in ABC income.

In the vast majority of cases, Expenses are accrued ratably throughout the year and are paid on a continuous basis in Country 1 FX through a Group 1's Country 1 X.<sup>1</sup> For purposes of determining Type 1 Income, the Date 1 and Date 2 Closing Agreements do not specify the rate at which they are to be translated into U.S. dollars or when such expenses are to be accrued. We understand that ABC current practice is to translate Expenses into U.S. dollars at the exchange rate in effect on the last day of each taxable year and to accrue them at that time.

You have asked whether Expenses should be translated into U.S. dollars at the spot rate on the date they were accrued by the Country 1 X rather than at the spot rate at the end of the taxable year. In responding to your question, we note that for

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<sup>1</sup> As agreed, this memorandum specifically does not address those *de minimis* cases where the U.S. X(s) pays Expenses attributable to U.S. dollar business or those situations where an Business Person does not have a Country 1 X that pays Expenses attributable to U.S. dollar business. In other words, this memorandum only addresses those situations where a Business Person has (1) a U.S. business and (2) a Country 1 business.

the purposes of our analysis, we assume that the Country 1 X is not a qualified business unit within the meaning of Subpart J.

#### LAW AND ANALYSIS:

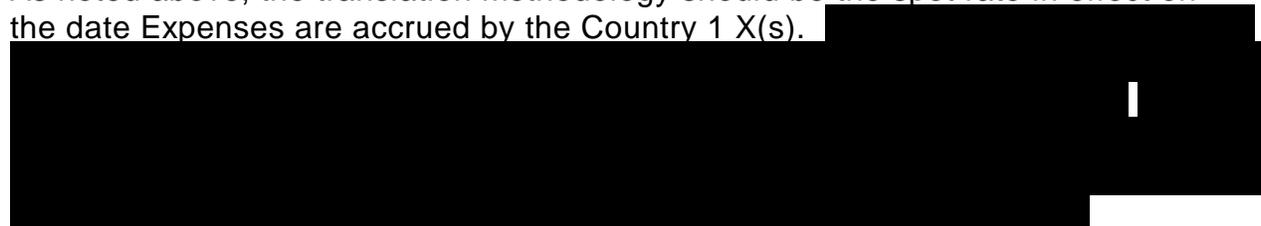
Code section 988(c)(1)(A) defines a “section 988 transaction” as any transaction described in Code section 988(c)(1)(B) if the amount which the taxpayer is required to pay by reason of such transaction is denominated in terms of a nonfunctional currency, or is determined by reference to the value of one or more nonfunctional currencies. Code section 988(c)(1)(B)(ii) describes accruing (or otherwise taking into account) any item of expense which is to be paid after the date on which so accrued or taken into account. Section 988(b) and Treas. Reg. § 1.988-2(c)(3) provide rules to measure exchange gain or loss with respect to an item of expense that is accrued and paid on different dates. These provisions contemplate the use of the spot rate (determined under Treas. Reg. § 1.988-1(d) principles) on the booking date (*i.e.*, the accrual date) to translate an item of expense into U.S. dollars.

Based on the facts developed to date, it appears that section 988 and the regulations thereunder govern. Under these provisions, it is the exchange rate on the booking date that must be used to accrue the relevant expenses rather than the exchange date at the end of the taxable year.

Similarly, under case law, an expense denominated in a foreign currency is generally translated at the spot rate on the day the expense is accrued. *See, e.g., Church’s English Shoes, Ltd. v. Commissioner*, 24 T.C. 56 (1955), *aff’d* 229 F.2d 957 (2d Cir. 1956); *Bennett’s Travel Bureau, Inc. v. Commissioner*, 29 T.C. 350 (1957); *Bernuth Lembcke Company, Inc.* 1 B.T.A. 1051 (1925). Accordingly, the Expenses, which are allocated to Type 1 Income pursuant to the Closing Agreements, should be translated at the spot rate on the date the Expenses are accrued by the Country 1 X.

#### CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

As noted above, the translation methodology should be the spot rate in effect on the date Expenses are accrued by the Country 1 X(s).



Additionally, as noted above, our analysis assumes that the Country 1 X is not a qualified business unit (QBU). If this X is a QBU, then our analysis will likely have to be revised.

If you have any further questions, please call me at (202) 622-3830.

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Counsel (International - Technical)  
CC:INTL