Internal Revenue Service
DEPARTMENT OF THE TREASURY

LB&I International Practice Service
Concept Unit

IPS Level	Number	Title	UIL Code	Number
Shelf	N/A	Crossover IPN	–	–
Volume	18	Foreign Currency	**Level 1 UIL**	9470
Part	18.2	Transactions in a foreign currency - §988	**Level 2 UIL**	9470.02
Chapter	18.2.1	Computation of exchange gain or loss - general	**Level 3 UIL**	9470.02-01
Sub-Chapter	N/A	N/A	–	–

Unit Name	Overview of IRC Section 988 Nonfunctional Currency Transactions

Document Control Number (DCN)	FCU/CU/C_18.2.1_03(2016)
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General Overview

Overview of IRC Section 988 Nonfunctional Currency Transactions

This Concept Unit covers the following:
1) "Functional currency" (FC) and its application,
2) Definition of Section 988 transactions,
3) Computation of foreign currency gain/loss under IRC 988 on receivables/payables denominated in a nonfunctional currency (including US GAAP ASC 830 (formerly FAS 52) differences), and
4) Computation of foreign exchange gain/loss under IRC 988 on debt instruments denominated in a nonfunctional currency.

Except as provided in the code and regulations, a taxpayer's functional currency is the US dollar (USD). A taxpayer or a Qualified Business Unit (QBU) - any separate and clearly identified unit of a taxpayer that maintains separate books and records) may, under certain circumstances, have a non-USD functional currency (see IRC 985(b); Treas. Reg. 1.985-1(b) and (c)). Note that US Corporations must have the USD as their functional currency, although their foreign branches may have non-USD functional currencies (a QBU can have a functional currency that is different from its owner). The functional currency is relevant for taxpayers that have transactions in multiple currencies. Transactions are accounted for in the taxpayer's functional currency. Certain nonfunctional currency transactions, called "Section 988 transactions" generally give rise to functional currency gain or loss.

Transactions that require the use of a currency other then US dollar have dramatically increased as more taxpayers do business globally. Generally, when US resident taxpayers invest and do business transactions in non US currency, all federal tax determinations must be made in USD. Section 988 transactions include debt instruments, payables, receivables, forward contracts, futures contracts, options or similar instruments denominated in any nonfunctional currency. Also when a taxpayer owns or has a position in a nonfunctional currency asset or liability that generates a Section 988 transaction, the US taxpayer must calculate foreign currency gain or loss. (See the above paragraph for a description of the term "functional currency.") Sections 985 to 989 provide rules for making translations and measuring foreign currency gain or losses.

IRC 988 and its regulations generally provide that foreign currency gain or loss with respect to a transaction is (1) recognized at the time of the sale or disposition of nonfunctional currency denominated property, (2) characterized as ordinary gain or loss, and (3) sourced based upon the residence of the holder.

General Overview (cont'd)

Overview of IRC Section 988 Nonfunctional Currency Transactions

IRC Sections 985 to 989 provide rules for translating tax items into a taxpayer's functional currency and measuring foreign currency gain and losses. In general:

- Section 985 - Defines functional currency including hyperinflationary currency
- Section 986 - Addresses the translation into USD of foreign taxes and foreign corporation's earning and profits
- Section 987 - Addresses branch transactions when the QBU has a different functional currency than the taxpayer
- Section 988 - Describes treatment of certain foreign currency transactions
- Section 989 – Defines a qualified business unit (QBU) and appropriate exchange rate

This IPS Unit will focus on the basic functional currency concepts and the treatment of certain nonfunctional currency transactions under IRC 988. For each example listed in the Examples section of this unit, the first line of the diagram description will reflect the entity name and the second line will reflect the functional currency (FC) of the entity:

Entity name → **HoldCo**

Luxembourg ← **Country of Residence**

Functional Currency → FC = USD

Other IPS units for IRC 989, IRC 987 and other foreign currency issues are in the IPS library.

Note: The Internal Revenue Code refers to foreign currency gains and losses while the Treasury Regulations use the term exchange gain or loss.

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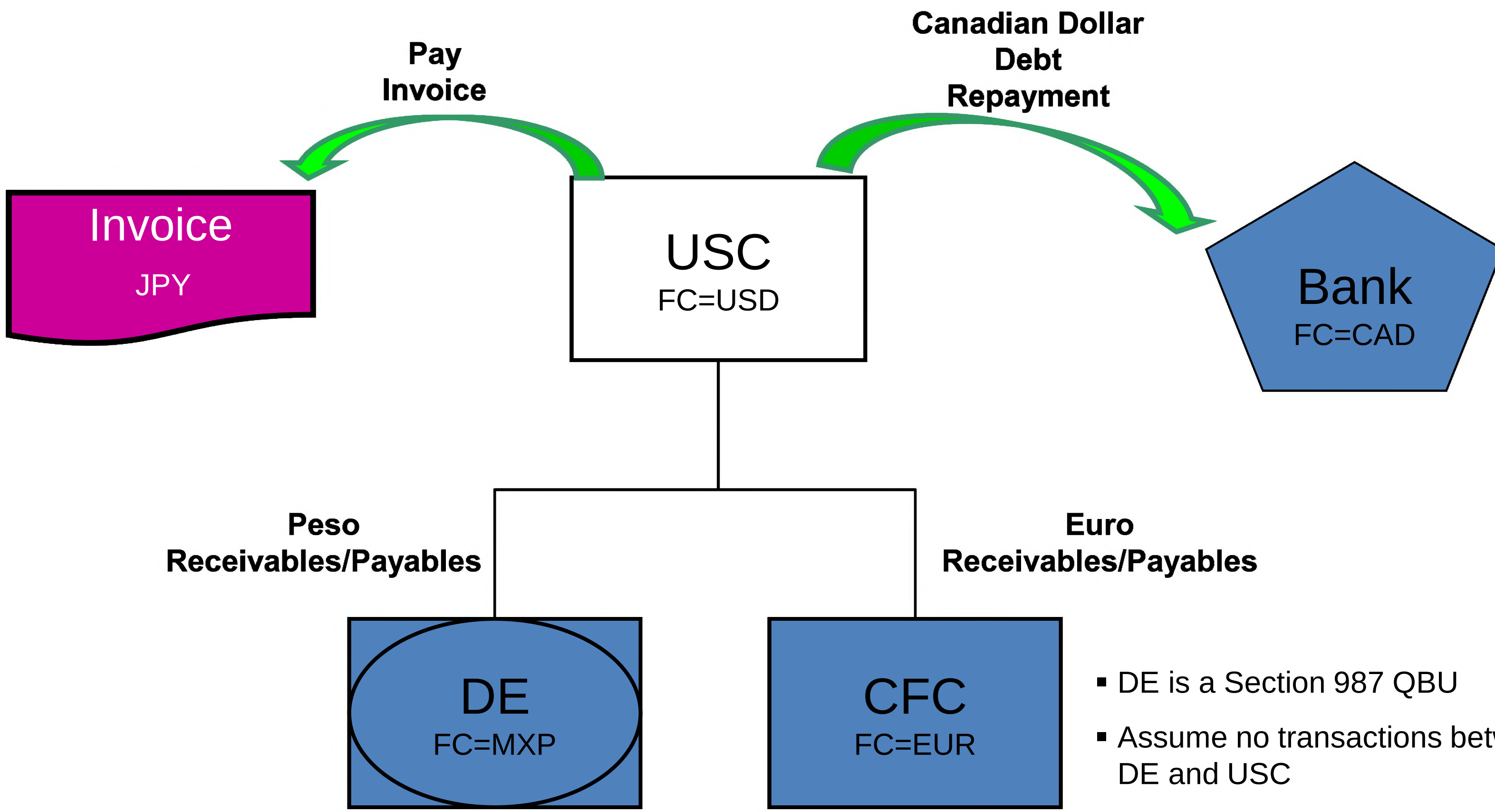
Diagram of Concept

Overview of IRC Section 988 Nonfunctional Currency Transactions

Diagram of Concept



- DE is a Section 987 QBU
- Assume no transactions between DE and USC

Overview of IRC Section 988 Nonfunctional Currency Transactions
Facts of Concept
It is very common that US companies will be transacting in currencies other then the US dollar. Examiners need to understand: ▪ the cash flow of these transactions, ▪ how they are recorded for financial accounting and tax purposes, and ▪ any foreign currency gain or loss that should be reported, as well as the source (US or foreign) and character (ordinary or capital) of the transaction. Nonfunctional currency transaction amounts have to be translated into functional currency. An example of this type of transaction is paying an invoice in a nonfunctional currency. For example, in the Diagram of Concept (prior slide), USC's invoice is payable in Japanese Yen. When the US taxpayer owns foreign currency or has a position in a non-US currency asset or liability, examiners need to be able to measure, translate and establish when foreign currency gains and losses should be determined. For example, in the Diagram of Concept (prior slide), USC has both Euro denominated receivables/payables and a Canadian Dollar debt.

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Detailed Explanation of the Concept

Overview of IRC Section 988 Nonfunctional Currency Transactions
What is a Section 988 transaction? Generally, it is a transaction where the amount that the taxpayer is entitled to receive or required to pay is determined in a currency other than the functional currency of the taxpayer or is determined in reference to the value of one or more nonfunctional currencies. These transactions are described in greater detail below.

Analysis	Resources
Subject to certain statutory exceptions, transactions include: ▪ (i) the acquisition of a debt instrument or becoming the obligor under a debt instrument; ▪ (ii) accruing (or otherwise taking into account) any items of expense or gross income or receipts which is to be paid or received after the date on which so accrued or taken into account (i.e., payable and receivables, provided that for tax purposes, the accrual and payment dated are distinct); and ▪ (iii) entering into or acquiring any forward contract, futures contract, option, or similar financial instrument.	▪ IRC 988(c)(1)(B) and Treas. Reg. 1.988-1(a)(2)
The disposition of any nonfunctional currency is also treated as a Section 988 transaction and any gain or loss arising from such transaction is treated as a foreign currency gain or loss.	▪ IRC 988(c)(1)(C) and Treas. Reg. 1.988-2(a)(1)(i)
Section 988 transactions includes certain financial derivatives. Financial derivatives such as forwards, futures, options contracts, etc. are used by taxpayers to reduce exposure to underlying currency and asset transfer risks. The Internal Revenue Code establishes different tax rules governing how and when foreign currency gains and losses are taxed for different financial instruments. **CONSULTATION:** When a transaction includes complex financial derivatives, the Examiner should consult with a Financial Products Examiner.	▪ IRC 988(c)(1)(D) – (E) and 988(d) ▪ See IPS Concept Unit Overview of Foreign Currency Hedging Transactions DCN FCU/CU/C_18.2.3_14

Detailed Explanation of the Concept (cont'd)

Overview of IRC Section 988 Nonfunctional Currency Transactions
How are Section 988 transactions treated for tax purposes? While the transactions are generally treated as ordinary income, certain exceptions, rules and elections exist that treat these transactions as capital in nature. Likewise, these transactions are generally sourced based on the residence of the taxpayer; however there are exceptions to this rule.

Analysis	Resources
Foreign currency gain or loss attributable to a section 988 transaction is computed separately and generally treated as ordinary.	▪ IRC 988(a)(1)(A) and Treas. Reg. 1.988-3(a)
However, a taxpayer or QBU may elect to treat gain or loss on certain forwards, futures, and options as capital gain or loss.	▪ IRC 988(a)(1)(B) and Treas. Reg. 1.988-3(b) ▪ See IPS Concept Unit on Character of Exchange Gain or Loss on Currency Transactions, DCN FCU/CU/C-18.2.1_04 for further discussion
Generally, the source of foreign currency gain or loss is determined by reference to the residence of the taxpayer or QBU.	▪ IRC 988(a)(3) and Treas. Reg. 1.988-4 ▪ See IPS Concept Unit on Sourcing of Exchange Gains or Losses, DCN FCU/CU/C-18.2.1_17 for further discussion

Detailed Explanation of the Concept (cont'd)

Overview of IRC Section 988 Nonfunctional Currency Transactions
What about other transactions denominated in nonfunctional currency? IRC Section 988 clearly defines transactions covered under this subchapter. Therefore, while other transactions may have foreign currency components as discussed below, the character and sourcing of these transactions are not governed by IRC Section 988 and are therefore both sourced and characterized by separate Code sections.

Analysis	Resources
Transactions not defined in IRC 988 are not treated as Section 988 transactions. Fluctuations in exchange rates may nonetheless generate foreign currency gains or losses realized by a taxpayer on other transactions.	▪ See IPS Concept Unit on Overview of the Impact of Foreign Currency Exchange Rate Fluctuations" DCN FCU/CU/C-18.2.1_16
For example, purchasing stock in a nonfunctional currency is not a Section 988 transaction because stock is not a Section 988 asset. A taxpayer generally determines its basis in the stock and amount realized upon disposition of the stock using a spot rate. However, the initial acquisition of nonfunctional currency and subsequent disposition of nonfunctional currency to acquire the stock would be a Section 988 transaction if the acquisition and disposition of the currency occurred on separate dates.	▪ IRC 1221 ▪ IRC 988(c)(1)(C)
Example: Assume Dorfman Corp, a taxpayer with USD as its functional currency, purchased a share of stock for LC100 when LC100=USD100. Assume Dorfman Corp holds the stock as capital asset. Further assume that Dorfman Corp sold the stock for LC100 when LC100=USD150. Dorfman Corp had a USD50 gain attributable to the stock. However, because holding stock is not a defined Section 988 transaction, the USD50 gain would not be foreign currency gain. The gain on the stock is a capital gain.	

Examples of the Concept

Overview of IRC Section 988 Nonfunctional Currency Transactions

Examples

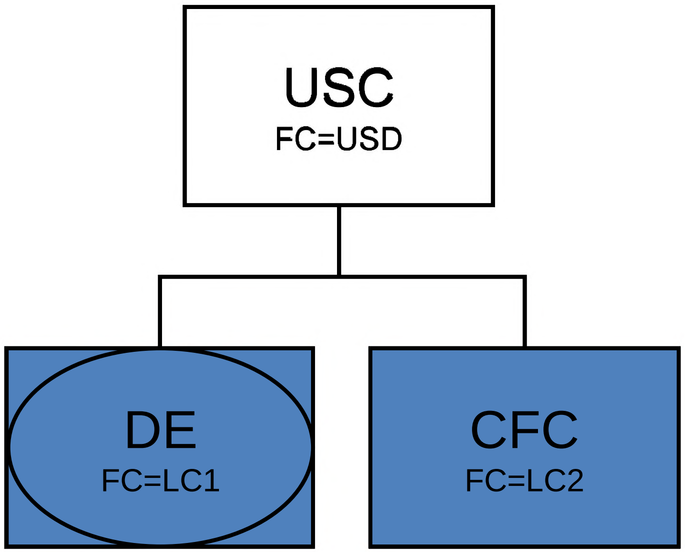

Illustration #1 - Understand the term functional currency (FC), its application, and IRC 988 application

Facts:

- USC owns two foreign entities; DE and CFC.
- DE manufactures in Foreign Country 1 and maintains its own separate books and records using currency LC1. DE is a QBU.
- CFC sells products in Foreign Country 2 and also has its own separate books and records using currency LC2. CFC is a QBU.

Results:

- USC FC is the USD. See Treas. Reg. 1.985-1(b).
- DE is a QBU with FC being LC1. See Treas. Regs. 1.985-1(c) and 1.989(a)-1(b)(1); IRC 987.
- CFC is a QBU with FC being LC2. See Treas. Reg. 1.985-1(c) and 1.989(a)-1(b)(2) (providing that a corporation is a per se QBU).
- DE and CFC's profit and loss at the end of the year is translated to dollars using the average exchange rate for the year after making US GAAP adjustments. The DE profit or loss (P/L) flows into USC's Form 1120; however CFC's P/L is deferred and reported as information on Form 5471. The CFC's gains on an Section 988 transaction (debt/receivable/payable/options etc.) is foreign personal holding company income (FPHCI), unless an exception (e.g., business needs) applies. See IRC 954(c)(1)(D) and Treas. Reg. 1.954-2(g)(2)(ii).

NOTE: For definition of QBU, see *Overview of Qualified Business Units (QBU),* DCN FCU/CU/C_18.3.1_02.

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Examples of the Concept (cont'd)

Overview of IRC Section 988 Nonfunctional Currency Transactions

Examples

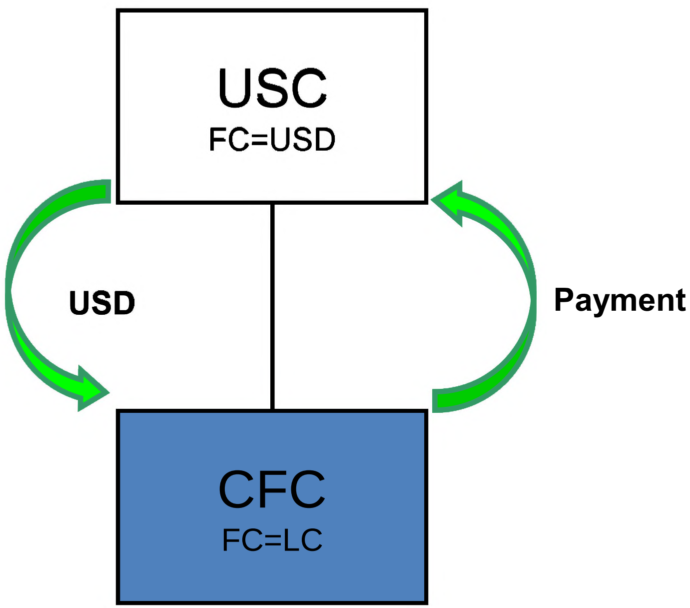

Illustration #2 - Loan denominated in a nonfunctional currency including US GAAP (ASC 830-20-35, formerly FAS 52) differences

Facts:

- USC's functional currency is the US Dollar (USD) and CFC's functional currency is LC. USC advances USD100 to CFC, on 12/01/20X1 when the exchange is USD1:LC1. Rate changes to USD1:LC1.25 on 12/31/20X1 and to USD1:LC1.5 on 03/31/20X2 when the loan is paid.
- CFC's loan payable is a Section 988 transaction.

Results – Accounting:

- Re-measurement is required by US GAAP (ASC 830) for financial accounting purposes. The CFC will record an unrealized financial loss in the P&L at 12/31/X1 and then recognize a realized financial loss on 03/31/X2 as noted below:

Unrealized Loss @ 12/31/20X1 = $100 x (1.25-1.00) = $25 loss

Realized Loss @ 03/31/20X2 = $100 x (1.50 – 1.00) = $50 total loss

Less unrealized loss previously recognized: ($25)

Additional Loss booked on 03/31/20X2: $25 loss in 20X2

! CAUTION: Special Treatment of Intercompany transactions (within consolidated, combined groups or equity accounting) treated as part of the net investment , see ASC 830-20-35-5:

- If an intercompany foreign currency transaction is of a "long-term investment" nature, foreign currency transaction G/L are reported in other comprehensive income (OCI) rather than through the P&L.

Examples of the Concept (cont'd)

Overview of IRC Section 988 Nonfunctional Currency Transactions

Examples

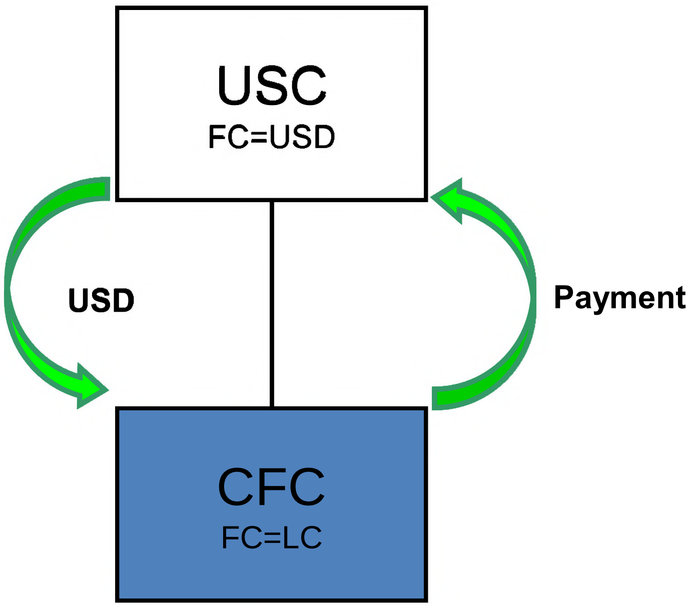

Illustration #2 (cont'd)

Results – Tax:

- Realized gains/losses (G/L) are recognized in the year that the payment is made. See Treas. Reg. 1.988-2(b)(6). CFC recognizes a loss in earnings and profits (E&P) in 03/31/X2 as noted below:

Realized Loss @ 03/31/20X2 = $100 x (1.50 – 1.00) = $50 total loss

Assuming debt treatment for US GAAP

	Financial Accounting P&L	Tax E&P	Sch M-3 E&P Adj
12/31/20X1	(25)	0	25
12/31/20X2	(25)	(50)	(25)

Assuming long-term investment for US GAAP

	Financial Accounting P&L	Tax E&P	Sch M-3 E&P Adj
12/31/20X1	-	0	-
12/31/20X2	-	(50)	(50)

- Unrealized gains / losses (G/L) recorded for financial accounting may be incorrectly reported for tax purposes or not reported when paid for tax purposes in the following year.
- Schedule H of Form 5471 for the CFC should be analyzed to determine the taxpayer's treatment of the transaction and to ascertain whether additional E&P adjustments are required.

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Overview of IRC Section 988 Nonfunctional Currency Transactions

Examples

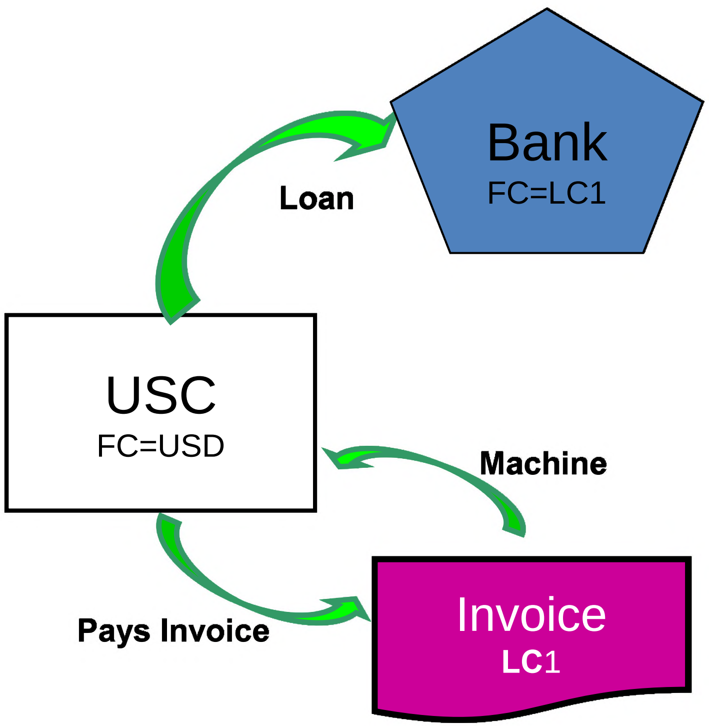

Illustration #3 – IRC 988 computation of realized foreign currency gain or loss on a nonfunctional currency payable

Facts:

- USC, an accrual basis taxpayer with USD FC, borrowed from a bank in 20X2.
- The loan from bank is a 5 year note with a face amount of LC1 100 with interest accruing quarterly.
- USC separately orders a machine for LC1 100. The machine invoice term is 60 day upon delivery. The LC1 is worth $110 US dollars when the machine is received (and the expense accrues) and $105 US dollars when the invoice is paid.

Results:

- Purchase of machine is not an Section 988 transaction. USC records an asset for $110 and an accounts payable of $110 when machine is received. See generally IRC 988.
- Disposition or payment of accounts payable would be an Section 988 transaction and give rise to foreign currency gain or loss – an ordinary gain of $5 US dollars under Treas. Reg. 1.988-3(a) and US source under residence rule of sourcing.
- The five year note denominated in terms of a nonfunctional currency is an Section 988 transaction and gain/loss recognized when paid (see Illustration #4).

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Overview of IRC Section 988 Nonfunctional Currency Transactions

Examples

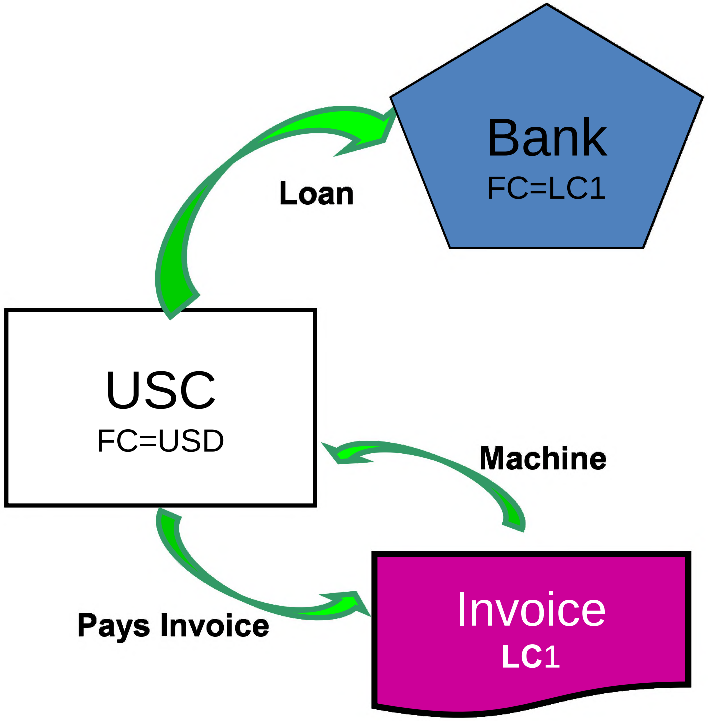

Illustration #4 – IRC 988 nonfunctional currency debt instrument and computation of realized and unrealized foreign currency gains or losses

Facts:

- USC, an accrual basis taxpayer with USD as its functional currency, borrowed from bank in 20X2 to purchase a machine.
- Loan from bank is a five year note with a face amount of LC1 100 with quarterly payment of interest only.
  - Note when acquired: USD 101 = LC1 100
  - Note at the end of 20X2 BS measurement date: USD 94 = LC1 100
  - Note paid in full when USD 90 = LC1 100

Results:

- Five year note denominated in terms of a non-FC is a Section 988 transaction and foreign currency gain/loss is recognized for tax purposes when paid.
- Unrealized G/L not recognized while note is outstanding.

For financial purposes, an unrealized foreign currency gain of USD7 will be reported at the end of 20X2.

- FC tax gain of USD11 is recognized when 5 year note paid.
- Accrued interest expense is also an Section 988 item in accordance with Treas. Reg. 1.988-1(a)(1)(ii) and Treas. Reg. 1.988-1(a)(2)(ii), and gain or loss is recognized when accrued payments are made, as determined under Treas. Reg. 1.988-2(b)(3) & (4).

Training and Additional Resources

Chapter 18.2.1 Computation of Exchange Gain or Loss - General		
Type of Resource	**Description(s) and/or Instructions for Accessing**	**References**
Saba Meeting sessions	▪ IBC ONLY – Foreign Currency & Int'l Matrix (Saba – Public Recordings – Event ID JVQ439517) ▪ IBC Common Errors in translating Foreign Currency 44 (Saba – Public Recordings – Event ID PHG711242) ▪ The Building Blocks of Financial Products (Saba – Public Recordings – Search on "Building Blocks of Financial Products)	▪ 2011 Saba – Foreign Currency & Intl Matrix ▪ 2012 Saba –Common Errors in translating Foreign Currency 44 ▪ 2013 Saba – The Building Blocks of Financial Products
Other Training Materials (Saba Meeting sessions)	IE Phase III Hybrid sessions: ▪ IRC 985 and 989 :Foreign Currency Terms and Definitions ▪ Section 986 Translation Rules ▪ Sec 987 – Branch rules and CTB rules ▪ Foreign Currency Section 988 Transactions ▪ Foreign Currency Hedging ▪ Financial Products Basics – Four Major Categories	▪ 2015 Saba – FC 1 Sec 985 (HQL168303) ▪ 2015 Saba – FC 2 986 Transition Rules (FRS408475) ▪ 2015 Saba – FC 3 987 Branch Rules & CTB (LVP748808) ▪ 2015 Saba – FC 4 Sec 988 Transactions (FTS047865) ▪ 2015 Saba – FC 5 Foreign Currency Hedging (HTS256974) ▪ 2015 Saba – Financial Products Basics (JNN441732)

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Training and Additional Resources (cont'd)

Chapter 18.2.1 Computation of Exchange Gain or Loss - General		
Type of Resource	**Description(s) and/or Instructions for Accessing**	**References**
Other Training Materials	▪ IE Phase I, Module E – Lesson 1 Foreign Currency http://lmsb.irs.gov/hq/mf/training/international/phase1/phase_1.asp, Select Module E ▪ IE Phase III, Module D –Interaction of International and Financial Products Issues http://lmsb.irs.gov/hq/mf/training/international/phase3/phase_3.asp, Select Module 5.D., second lesson	
Other Training Materials	▪ FP Phase I, Lesson 9 Foreign Currency ▪ FP Phase I, Download Financial Products Phase One Participant Guide, then proceed to Lesson 9, page 9-1. ▪ FP Phase III, Lesson 4 Foreign Currency ▪ FP Phase III, Download Financial Products Phase Three Participant Guide, then proceed to Lesson 4, page 110.	

Training and Additional Resources (cont'd)

Chapter 18.2.1 Computation of Exchange Gain or Loss - General		
Type of Resource	**Description(s) and/or Instructions for Accessing**	**References**
Bittker & Lokken – Federal Taxation of Income, Estates and Gifts	▪ Bittker and Lokken Para 74.2 Functional Currency (Westlaw subscription)	▪ FIXIEG Para 74.2
BNA Tax Management Portfolio	▪ BNA Portfolio 921-2nd Tax Aspects of Foreign Currency (Westlaw subscription)	▪ BNA 921-2nd – TMFEDPORT No 921 s
Keyes: Federal Taxation of Financial Instruments and Transactions	▪ Keyes Chapter 15. Foreign Currency Denominated Instruments	
Mertens Law of Federal Income Taxation	▪ Mertens Chapter 45C. SOURCING OF INCOME AND EXPENSE, III 45C:63 Functional currency — Qualified business unit (Westlaw subscription)	
Accounting Standards Codification (Financial Accounting Standards)	▪ ASC830 (FAS52) Foreign Currency Matters ▪ Available at https://asc.fasb.org. Register for free "basic view" service. ▪ Westlaw subscription: IRS LB&I Tab. Under Financial Accounting, choose RIA FASB Codification Complete Analysis, Table of Contents. ASC 830 is under the Broad Transactions in the Codification section.	

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Glossary of Terms and Acronyms

Term/Acronym	Definition
ASC	Accounting Standard Codification
BS	Balance Sheet
CFC	Controlled Foreign Corporation
DE	Disregarded Entity
E&P	Earnings and Profits
FAS	Financial Accounting Standards
FC	Functional currency
FPHC	Foreign Personal Holding Company
FX	Foreign currency or foreign exchange
G/L	Gain or Loss (or Gains/Losses)
GL	General Ledger
OCI	Other Comprehensive Income
P&L	Profit and Loss Statement (Income Statement)
P/L	Profit or Loss
QBU	Qualified Business Unit
US GAAP	US Generally Accepted Accounting Principles
USD	US Dollar

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Glossary of Terms and Acronyms (cont'd)

Term/Acronym	Definition
Forward Contract	A customized contract between two parties to buy or sell an asset at a specified price on a future date.
Functional Currency	The currency of the primary economic environment in which the entity operates.
Futures Contract	A contract between two parties where both parties agree to buy and sell a particular asset of specific quantity and at a predetermined price, at a specified date in the future.
Nonfunctional Currency	A currency utilized by an entity for a transaction that is not the functional currency of the entity.
Option Contract	A contract that allows the holder to buy or sell an underlying security at a specified price.
Section 988 Transaction	Transactions as defined in IRC 988(c)(1)(B)

Index of Related Issues

Issue	Associated UIL(s)	References
Overview of Foreign Currency Hedging Transactions	▪ 9470.02	▪ FCU/CU/C_18.2.3_14
Overview of the Impact of Foreign Currency Exchange Rate Fluctuations	▪ 9470.02	▪ FCU/CU/C-18.2.1_16
Disposition of Nonfunctional Currency	▪ 9470.02	▪ FCU/9470.02_01_04
IRC 988 currency gain or loss determination	▪ 9470.02	▪ FCU/PUO/C_18.2.1_09
Character of Exchange Gain or Loss on Currency Transactions	▪ 9470.02	▪ FCU/CU/C-18.2.1_04
Sourcing of Exchange Gains or Losses	▪ 9470.02	▪ FCU/CU/C-18.2.1_17
Exchange Gain/Loss on Debt Instruments	▪ 9470.02	▪ FCU/CU/C_18.2.1_09
Integration of Executory Contract and the Currency Hedge	▪ 9470.02	▪ FCU/9470.02_05
Legging into Integrated Treatment	▪ 9470.02	▪ FCU/9470.02_07

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Issue	Associated UIL(s)	References
Disposition of a Portion of an Integrated Hedge	▪ 9470.02	▪ FCU/9470.02_03
How to Assess Penalties for Failure to file Form 8886 Disclosing Section 988 Losses	▪ 9470.02	▪ FCU/9470.02_02
Functional Currency of a Qualified Business Unit (QBU)	▪ 9470.03	▪ FCU/PUO/C_18.3.3_08
Overview of Qualified Business Units (QBUs)	▪ 9470.03	▪ FCU/CU/C_18.3.1_02
Computing Foreign Base Company Income	▪ 9412.05	▪ DPL/9412.05_05
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