Internal Revenue Service
DEPARTMENT OF THE TREASURY

LB&I Concept Unit

Unit Name	Overview of IRC 986(c) Gain or Loss Prior to Tax Cuts and Jobs Act of 2017	
Primary UIL Code	9470.04-03	Determination of Exchange Gain or Loss of Previously Taxed Earnings and Profits - Section 986(c)

Library Level	Title
Knowledge Base	International
Shelf	Cross-Over
Book	Foreign Currency
Chapter	Translation of Earnings and Profits and Distributions

Document Control Number (DCN)	INT-C-042 (formerly FCU/C/018_04_03-01)
Date of Last Update	04/23/2020

Table of Contents

(View this PowerPoint in "Presentation View" to click on the links below)

General Overview

Overview of IRC 986(c) Gain or Loss Prior to Tax Cuts and Jobs Act of 2017

Multinational businesses that file federal income tax returns in the United States must report any income subject to U.S. federal income tax in U.S. dollars. However, when these businesses operate in different countries, these businesses must adhere to the laws and regulations of each country. Therefore, multinational businesses structure their worldwide operations to operate legally and efficiently for both global accounting and tax purposes. For U.S. tax purposes, these businesses usually structure their international business operations under entities such as foreign disregarded entities (FDEs), foreign partnerships (FPs), and controlled foreign corporations (CFCs). Foreign currency gain or loss on the distribution of previously taxed income (PTI) by a CFC to the U.S. shareholder will be the focus of this Practice Unit.

IRC 957(a) states that a foreign corporation is a CFC if more than 50 percent of its stock is held by U.S. shareholders at any time during the year. When a foreign corporation meets the definition of a CFC, the U.S. shareholders must include certain income earned by the CFC as well as distributions made by the CFC to the U.S. shareholder in its U.S. federal taxable income. CFC income that must be included by U.S. shareholders in U.S. federal taxable income includes earnings invested in U.S. property under IRC 956 and subpart F Income under IRC 952 (collectively, section 951 inclusions) and the new global intangible low-taxed income (GILTI) under section 951A. (Additionally, see section 965 for the treatment of deferred foreign income as subpart F.)

Potential for double taxation exists when a dividend is received from a CFC by a U.S. shareholder when the shareholder (or a prior U.S shareholder) has already recognized income in their U.S. federal income tax return on the earnings and profits of the CFC from which the dividend was distributed. To avoid this double taxation, IRC 959 allows for an exclusion from U.S. federal income tax for any distribution of previously taxed income by a CFC to its U.S. shareholder.

IRC 986(c) generally applies to these types of distributions. Since the originating deemed distribution under, for example, section 951 is earned and maintained as PTI in the CFC’s functional currency, the distribution of PTI by the CFC must be translated to the U.S. dollar for U.S. federal income tax purposes at the spot rate on the date of actual distribution. If the exchange rate on the date of the actual distribution differs from the exchange rate utilized for the inclusion of the deemed distribution under section 951, 951A or 965, an exchange gain or loss under IRC 986(c) will result. Under section 986(c), a foreign currency gain or loss with respect to distributions of PTI (as described in section 959 or 1293(c)) attributable to movements in exchange rates between the times of the deemed and actual distributions is recognized and treated as ordinary income or loss from the same source as the associated income inclusion.

Back to Table of Contents

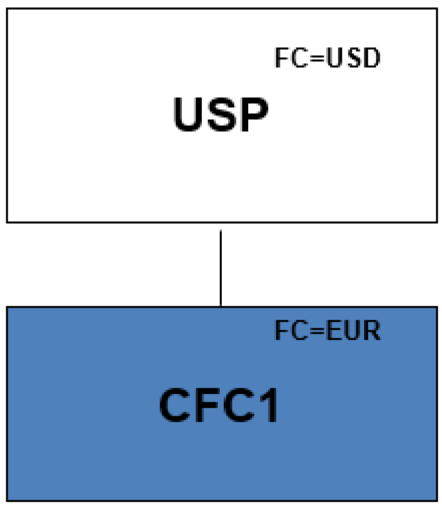
Relevant Key Factors

Overview of IRC 986(c) Gain or Loss Prior to Tax Cuts and Jobs Act of 2017
Key Factors
IRC 959 Under IRC 959, previously taxed income (PTI) are not subject to U.S. tax by the U.S. shareholder when later paid by a CFC to the U.S. shareholder as a distribution. PTI includes Subpart F income (IRC 952), increases in earnings invested in U.S. property (including IRC 956 inclusions), GILTI under section 951A, section 965 inclusions and earnings and profits (E&P) subject to taxation under IRC 1248. Under section 959(c), section 316(a) is applied by applying paragraph (2) and then paragraph (1) first to the aggregate of E&P attributable to section 951(a)(1)(B) inclusions [section 956] and then to E&P attributable to section 951(a)(1)(A) inclusions [subpart F] and lastly to other E&P. Original regulations for IRC 959 were published in 1965, with minor amendments made to the regulations in 1974, 1978, and 1983. No other updates or revisions were made to the IRC 959 regulations until proposed regulations were issued August 29, 2006, along with regulations for related basis adjustments under IRC 961. These proposed regulations have not been finalized. The proposed IRC 959 regulations sought to address relevant statutory changes that had occurred since 1983 while also responding to complexities of IRC 959 in cross-chain stock sales subject to IRC 304(a)(1) and providing guidance for look-through treatment of payments between related CFCs under the foreign personal holding company rules of IRC 954(c). The proposed regulations required the maintenance of PTI accounts and the maintenance of pools of PTI and non-PTI E&P of a CFC. In addition, the proposed regulations required both shareholder-level accounting and corporate-level accounting of PTI and incorporated related foreign currency and foreign tax credit rules. While many comments regarding the proposed regulations were favorable, several requests for additional clarifications were made by public commenters, particularly regarding the applications to transactions under IRC 304, the E&P deficit rules, the basis rules, and general treatment of distributions. Because of these comments and critiques, the IRC 959 regulations were never finalized and different methodologies for the computation of IRC 986(c) exchange gains and losses continue to exist. The next two slides provide a basic example of a computation of an IRC 986(c) exchange gain or loss when CFC income is taxed in one year and a distribution of PTI is made in a subsequent year.

Diagram of Concept

Overview of IRC 986(c) Gain or Loss Prior to Tax Cuts and Jobs Act of 2017

Diagram of Concept



Facts:

- CFC1, a 100% owned foreign subsidiary of USP, a U.S. Corporation, has subpart F income for calendar year (CY) 20x2 in the amount of €100.
- The weighted average exchange rate is Euro Currency (EUR) 1.00 = US Dollar Currency (USD) 1.29. Thus, in 20x2, USP has a subpart F income inclusion of $129 and such amount becomes PTI. (€100 * 1.29)
- CFC1 distributes the €100 of PTI to USP on November 30, 20x4 on which date the spot rate is EUR 1.00 = USD 1.24.

Diagram of Concept (cont'd)

Overview of IRC 986(c) Gain or Loss Prior to Tax Cuts and Jobs Act of 2017

Diagram of Concept

Result

Period	Type	EUR	FX	Rate	USD
CY20x2	Subpart F	€ 100	Yr Avg	1.29	$ 129
11/30/x4	Distribution	€ 100	Spot	1.24	$ 124
					$ (5)

FX = Foreign Currency Exchange

- Amount of distribution of PTI by CFC to USP equals $124 (€100 * 1.24).
- Distribution of PTI is not taxed as a dividend to USP.
- Section 986(c) applies to determine if there is any currency gain or loss (true up of actual distribution to deemed distribution).
- Foreign currency loss $5 ($124 - $129).
  - Ordinary income or loss.
  - Sourced in same manner as Subpart F income.

Overview of IRC 986(c) Gain or Loss Prior to Tax Cuts and Jobs Act of 2017

Facts of Concept

IRC 986(c) exchange gains or losses on PTI can be triggered on distribution of PTI to the U.S. shareholder, including:

- Actual distributions of PTI to the US
- Section 1248 Sale of CFC stock
- Change of functional currency by a CFC with PTI to USD (see Treas. Reg. 1.985-5(e))
- Section 367(b) inclusion (see Treas. Reg. 1.367-2(j)(2))

Certain circumstances exist when the PTI of a CFC is reduced that does not result in a distribution of PTI (e.g., CFC to CFC transfer of PTI) to its U.S. shareholder. In these circumstances, any exchange gains or losses on the reduction of PTI of a corporation is deferred until the PTI is actually distributed to its U.S. shareholder.

Treasury Regulations for IRC 986 have not been promulgated; therefore guidance for IRC 959 is typically applied to the computation of exchange gains or losses under IRC 986(c). The most common methods of computation of IRC 986(c) exchange gains or losses are based on either Notice 88- 71 or the Proposed Treasury Regulations for IRC 959 issued in 2006.

The methodology described in Notice 88-71 (the pooling method) requires the taxpayer to maintain a pool of all PTI in both functional currency and the U.S. dollar on a cumulative basis (post-86 and pre-87 pools are maintained separately). Any distribution reduces the overall functional currency pool and incrementally recognizes foreign currency gains or losses on each distribution. The actual formula and example of the computation is provided later in this Unit.

The Proposed Treasury Regulations for IRC 959 proposed a different methodology (the layering method) whereby a foreign corporation would maintain layers of PTI by type and year. Any distribution would reduce the layers on a last-in, first-out ordering. The Proposed Regulations also allowed taxpayers to elect a dollar basis pooling election on distributions to continue the methodology described in Notice 88-71 as well as providing examples of the computation of both methods. The actual computation and example of the computation is provided later in this Unit.

Regardless of the methodology chosen, the IRC and Treasury Regulations are clear that the methodology utilized must be consistent on a year to year basis and any change in methodology results in a change of accounting method.

Detailed Explanation of the Concept

Overview of IRC 986(c) Gain or Loss Prior to Tax Cuts and Jobs Act of 2017
The methodologies of computing the IRC 986(c) gain or loss under Notice 88-71 (pooling method) versus Proposed Regulations 1.959-3(b) (layering method) is described below.

Analysis	Resources
Notice 88-71 ▪ Dollar basis attributable to PTI distribution = (a) x (c)/(d) ▪ (a) = Total dollar inclusions under IRC 951(a)(1) for post-1986 taxable years less dollar basis of prior distributions of post-1986 PTI (dollar basis in post-1986 PTI account) ▪ (c) = Units of foreign corporation functional currency PTI distributed in the current year ▪ (d) = Total units of PTI in a foreign corporation's functional currency for post-1986 taxable years less prior distributions out of post-1986 PTI ▪ Foreign currency gain or loss under IRC 986(c) = [Dollar value of PTI distribution] – [Dollar basis attributable to PTI distribution] ▪ See Notice 88-70 for rules related to translation of pre-1987 PTI from dollars into functional currency.	▪ Notice 88-71 ▪ Notice 88-70

Detailed Explanation of the Concept (cont'd)

<table>
<tr><th colspan="2">Overview of IRC 986(c) Gain or Loss Prior to Tax Cuts and Jobs Act of 2017</th></tr>
<tr><th>Analysis</th><th>Resources</th></tr>
<tr><td><u>Prop. Reg. 1.959-3(b)</u>
▪ The shareholder maintains PTI under IRC 959(c)(1) and (c)(2) by each separate year in the functional currency of the foreign corporation as well as the annual dollar basis of each category.
▪ Distributions are considered to be made on a last-in first-out basis under IRC 316(a),
− First from any PTI under IRC 959(c)(1);
− Then from any PTI under IRC 959(c)(2); and
− Finally from non-PTI earnings and profits.
▪ Total dollar basis attributable to the PTI distribution less the distribution in the functional currency multiplied by the spot rate of the distribution results in the foreign currency gain or loss under IRC 986(c).
▪ An election can be made by the taxpayer to continue use of the methodology described under Notice 88-71 by making a dollar basis pooling election.</td><td>▪ Prop. Treas. Reg. 1.959-3(b)(1)

▪ Prop. Treas. Reg. 1.959-3(b)(2)

▪ Prop. Treas. Reg. 1.959-3(b)(3)(ii)</td></tr>
</table>

Examples of the Concept

Overview of IRC 986(c) Gain or Loss Prior to Tax Cuts and Jobs Act of 2017

Example Facts

Facts:

- CFC, with FC as its functional currency, reported the following Subpart F Income on its Form 5471 for years 20x1 through 20x3.
- USP, with USD as its functional currency, included the Subpart F income in its returns for years 20x1 through 20x3.
- In 20x4, the following distribution was made by CFC to USD with the spot rate noted below.

				Subpart F Inclusion			
Year	Inclusion	E&P General Limitation	FX Rate under §989(b)	FC	Ref	USD	Ref
			Avg Year				
20x1	Subpart F	100	1.00	100		100	
20x2	Subpart F	100	1.20	100		120	
20x3	Subpart F	100	1.40	100		140	
		300		300	(d)	360	(a)
			Spot rate				
20x4	Distribution	150	1.50	150	(c)	225	(b)

Examples of the Concept (cont'd)

Overview of IRC 986(c) Gain or Loss Prior to Tax Cuts and Jobs Act of 2017

Example – Pooling Methodology per Notice 88-71

Year	Inclusion	E&P General Limitation	FX Rate under §989(b)	Subpart F Inclusion FC	Ref	Subpart F Inclusion USD	Ref
			Avg Year				
20x1	Subpart F	100	1.00	100		100	
20x2	Subpart F	100	1.20	100		120	
20x3	Subpart F	100	1.40	100		140	
		300		300	(d)	360	(a)
			Spot rate				
20x4	Distribution	150	1.50	150	(c)	225	(b)

Pooling Method

(1)	USD basis attributable to PTI distribution (e) =	(a) x (c) / (d)
		360 x 150 / 300 = 180 (e)
(2)	Foreign currency gain (loss) under Section 986(c) =	(b) - (e)
		225 - 180 = 45 USD

Pooling Method:

1. Multiply the total inclusion of previously taxed income (in US dollars) (a) by a fraction computed by dividing the distribution (in the functional currency of the CFC) (c) by total previously taxed income (in the functional currency of the CFC) (d) to determine the USD basis attributable to the PTI distribution (e).
2. Subtract the USD basis attributable to the PTI distribution (e) from the distribution multiplied by the spot rate on the date of distribution (b) to determine foreign currency gain or loss under IRC 986(c).

Examples of the Concept (cont'd)

Overview of IRC 986(c) Gain or Loss Prior to Tax Cuts and Jobs Act of 2017

Example – Layering Methodology per Prop. Reg. 1.959-3(b)

				Subpart F Inclusion			
Year	Inclusion	E&P General Limitation	FX Rate under §989(b)	FC	Ref	USD	Ref
			Avg Year				
20x1	Subpart F	100	1.00	100		100	
20x2	Subpart F	100	1.20	100		120	
20x3	Subpart F	100	1.40	100		140	
		300		300	(d)	360	(a)
			Spot rate				
20x4	Distribution	150	1.50	150	(c)	225	(b)

Layer Method (LIFO)

(1)	USD basis attributable to PTI distribution (f)	FC	FX Rate	USD	
	20x3	100	1.4	140	
	20x2	50	1.2	60	
		150		200	(f)

(2) Foreign currency gain (loss) under Section 986(c) = (b) - (f)

225 - 200 = 25 USD

Layering Method:

1. The USD basis attributable to the PTI distribution (last-in, first-out per IRC 316(a)) is the total of all of the 20x3 Subpart F layer plus 50FC of the 20x2 layer of Subpart F to total 150FC, Each layer is multiplied by the average FX rate for such year to compute the USD basis attributable to the PTI distribution (f).
2. Subtract the USD basis attributable to the PTI distribution (f) from the distribution multiplied by the spot rate on the date of distribution (b) to determine foreign currency gain or loss under IRC 986(c).

Index of Referenced Resources

Overview of IRC 986(c) Gain or Loss Prior to Tax Cuts and Jobs Act of 2017
IRC 304
IRC 316(a)
IRC 951
IRC 951(A)
IRC 952
IRC 954(c)
IRC 957(a)
IRC 965
IRC 959
IRC 961
IRC 965
IRC 986
IRC 1248
IRC 1293(c)
Notice 88-70
Notice 88-71
Treas. Reg. 1.367-2(j)(2)

Index of Referenced Resources (cont’d)

Overview of IRC 986(c) Gain or Loss Prior to Tax Cuts and Jobs Act of 2017
Treas. Reg. 1.985-5(e)
Prop. Treas. Reg. 1.959-3(b)

Training and Additional Resources

Overview of IRC 986(c) Gain or Loss Prior to Tax Cuts and Jobs Act of 2017	
Type of Resource	**Description(s)**
Reference Materials	▪ *BNA Tax Management Int'l Portfolio* 921-2nd ▪ *Bittker and Lokken - Fundamentals of International Taxation* Para 74.2 ▪ *Keyes - Federal Taxation of Financial Instruments and Transactions,* Chapter 15 ▪ *Mertens - Law of Federal Income Taxation,* Chapter 45C
Other Training Materials	▪ IE Phase III: *IRC 985 and 989: Foreign Currency Terms and Definitions* ▪ IE Phase III: *Section 986 Translation Rules* ▪ IE Phase III: *Sec 987 - Branch Rules and CTB Rules* ▪ IE Phase III: *Foreign Currency Section 988 Transactions* ▪ IE Phase III: *Foreign Currency Hedging* ▪ IE Phase III: *Financial Products Basics - Four Major Categories* ▪ IE Phase I: Module E - Lesson 1 *Foreign Currency* ▪ IE Phase III, Module D - *Interaction of International and Financial Products Issues* ▪ FP Phase 1: Lesson 9 - *Foreign Currency* ▪ FP Phase III: Lesson 4 - *Foreign Currency*

Glossary of Terms and Acronyms

Term/Acronym	Definition
CFC	Controlled Foreign Corporation
CY	Calendar Year
E&P	Earnings and Profits
EUR	Euro Currency
FC	Functional Currency
FDE	Foreign Disregarded Entity
FP	Foreign Partnership
FX	Foreign Currency Exchange
GILTI	Global Intangible Low-taxed Income
IRC	Internal Revenue Code
PTI	Previously Taxed Income
USD	US Dollar Currency
USP	U.S. Parent Corporation

Back to Table of Contents

Index of Related Practice Units

Associated UIL(s)	Related Practice Unit
9470.03-03	*Change in Functional Currency Section 985 Procedural Matters and Calculation*
9470.02-01	*Character of Exchange Gain or Loss*
9470.02-01	*Definition of Appropriate Exchange Rate Overview*
9470.02-03	*Disposition of a Portion of an Integrated Hedge*
9470.02-01	*Exchange Gains or Losses on Payables and Receivables*
9470.03-02	*Functional Currency Determination*
9470.02-01	*How to Assess Penalties for Failure to File a Form 8886 Disclosing IRC 988 Losses*
9470.02-01	*Official vs Free Market Exchange Rate*
9470.02-01	*Overview of IRC Section 988 Nonfunctional Currency Transactions*
9470.03-01	*Overview of Qualified Business Units QBUs*
9470.02-01	*Sourcing of Exchange Gains or Losses in Currency Transactions*
9470.03-02	*Functional Currency of a QBU*
9470.02-01	*Disposition of Nonfunctional Currency*