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 – Section 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	Official versus Free Market Exchange Rate

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General Overview

Official versus Free Market Exchange Rate

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, they 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.

One challenge of reporting total income subject to U.S. federal income tax is computing income earned in non-U.S. locations. Often the books and records of some business enterprises are recorded in multiple currencies and locations. The U.S. federal income tax system for U.S. owned Multinational Enterprises is based on worldwide income in U.S. dollars, so it is necessary to translate amounts that are measured or denominated in different currencies into U.S. dollars. To do so, an appropriate exchange rate must be used to translate the foreign currency amounts. The “appropriate exchange rate” is based on the transaction to be reported on the U.S. federal income tax return. Generally, an item that is recognized as a taxable event at a specific point in time is translated at the foreign currency exchange rate applicable at that specific point in time (e.g., a dividend), also known as the spot rate. However, if the item has occurred over a period of time, it is generally translated at a weighted average foreign currency exchange rate applicable to the period of time.

IRC 989(b) addresses the general rules governing the “appropriate exchange rate” based on the type of transaction to which it is being applied. Treas. Reg. 1.988-1(d) provides a definition of the spot rate and Treas. Reg. 1.989(b)-1 provides a definition of the weighted average exchange rate. Generally, spot rates are utilized in the translation of exchange gains or losses under IRC 988. However, determination of a spot rate in certain environments can be challenging. Most foreign currency exchange rates are established in the open market; however, some governments establish exchange rates that do not reflect a rate that would be supported by the open market in order to artificially stabilize their currency during periods of inflation or economic hardship, such as sanctions.

Official currency spot rates are exchange rates that are either legally established by the specific government or set by the open market when allowed. These rates are reported in online publications cited in this unit (see chart on pages 8 and 9). However , these publications do not provide information regarding any “unofficial exchange rate” information for countries whose official governmental exchange rate does not conform to the free market exchange rate. This IPS Unit discusses the rules and regulations governing the translation of a currency where the official government established rate differs from a free market rate.

Detailed Explanation of the Concept

Official versus Free Market Exchange Rate

The starting point to applying the exchange rate gain or loss tax rules is to determine whether the taxpayer has a qualified business unit (“QBU”) and then determine the taxpayer’s (or QBU’s) “functional currency.” A U.S. corporation will generally have the U.S. dollar as its functional currency.

Analysis	Resources
Qualified Business Units (QBUs): The functional currency determination is made by reference to the “qualified business units” (QBUs) of the taxpayer. The functional currency of a QBU will generally be the currency of the economic environment in which a significant part of its activities are conducted. Transactions in a nonfunctional currency must be translated back into functional currency when determining taxable income or earnings and profits.	For further discussion regarding the identification and determination of a taxpayer’s QBUs, please see IPS Concept Unit “Definition of a QBU”.
Non Functional Currency Transactions: IRC 988 applies to monetary transactions denominated in or determined by reference to a nonfunctional currency, such as buying or selling units of foreign currency, borrowing and lending in functional currency, accruing foreign currency payables and receivables, and transacting in foreign currency derivatives. Under the functional currency / QBU concept, IRC 988 does not apply to any transactions entered into by a QBU of a taxpayer in the QBU’s functional currency. FX gain or loss on those transactions is subject to IRC 987, rather than IRC 988.	IRC 988
Official vs. Free Market Exchange Rate: The Treasury Regulations set forth the general rule that the spot rate shall be determined based on the prices at which the currency freely changes hands. However, in cases which the government rate and free market rate differ, the Regulations provide that the rate which “most clearly reflects income” should be used for the spot rate. Generally, in these cases, the rate that most clearly reflect income is the free market rate. In the current worldwide environment, the countries listed on page 7 have an active free market or black market exchange rates that differ significantly from the government-imposed official rate.	Treas. Reg. 1.988-1(d)(1) and (4)

Detailed Explanation of the Concept (cont'd)

Official versus Free Market Exchange Rate
<u>Interaction and Comparison to the U.S. Dollar Separate Transaction Method (DASTM) under Treas. Reg. 1.985-3</u> : Differences between a country's official foreign currency exchange rate versus a free market exchange rate can result from the following:

Analysis	Resources
Environmental Factors: ▪ High inflation coupled with limited foreign exchange reserves ▪ Controls on foreign currency available to residents ▪ A fixed foreign exchange set by a government (or a government-controlled bank) in an attempt to control inflation ▪ A demand for foreign currency among residents that exceeds its supply (coupled with restrictions on holding foreign currencies)	http://www.investopedia.com/articles/investing/031213/currency-trading-black-market.asp
For U.S. GAAP purposes, a highly inflationary economy is defined as one having a cumulative inflation rate exceeding 100 percent over a three-year period. An economy may also be classified as highly inflationary depending on other economic factors when the cumulative inflation rate is less than 100 percent. IFRS does not specifically define hyperinflation but lists several factors to consider when making that determination.	ASC 830 – *Foreign Currency Matters*, paragraph 10-45-12 IAS29 – *Financial Reporting in Hyperinflationary Economies,* paragraph 3
The SEC staff, through its International Practices Task Force, currently identifies economies that should be treated as highly inflationary for U.S. GAAP purposes. The list currently includes the following countries: Iran (hyperinflationary after 12/31/2013), Malawi (for years starting after 12/31/2014), South Sudan (hyperinflationary after 04/01/2014), Sudan (hyperinflationary after 12/31/2013), and Venezuela (for years starting after 12/31/2009). Belarus was recognized as hyperinflationary through 06/30/2015 and the Democratic Republic of Congo was recognized as hyperinflationary through 2012.	*International Practices Task Force* (IPTF)'s highlights from the 17 November 2015 and 21 May 2014 meetings, available at http://www.thecaq.org/resources/caq-committees/international-practices-task-force/iptf-highlights

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Detailed Explanation of the Concept (cont'd)

Official versus Free Market Exchange Rate

Interaction and Comparison to DASTM (continued): Differences between a country's official foreign currency exchange rate versus a free market exchange rate can result from the following:

Analysis	Resources
The Treasury Regulations define a hyperinflationary currency as the currency of a country whose consumer price index shows at least a 100 percent cumulative increase over three years. This definition is similar to the one used for U.S. GAAP purposes and a GAAP determination of hyperinflation may be used for tax purposes if certain requirements are met. Any company operating in a hyperinflationary economy is required to utilize DASTM to translate its operating income and balance sheet accounts into the U.S. Dollar for U.S. tax purposes.	Treas. Reg. 1.985-1(b)(2)(ii)(D) Treas. Reg. 1.985-3
While similar environmental characteristics are shared by economies with a significant free market currency exchange rate that is different from the official currency exchange rate ("black market currency exchange") and economies in a hyperinflationary environment, the two do not always go together. For instance, Argentina has a healthy black market currency exchange but is not considered a hyperinflationary economy. Likewise, Belarus had a hyperinflationary economy but does not have a flourishing black market currency exchange. However, the environments of both types of economies impact the computation of foreign currency exchange rate tax adjustments.	http://www.investopedia.com/articles/investing/031213/currency-trading-black-market.asp

Detailed Explanation of the Concept (cont'd)

Official versus Free Market Exchange Rate

Some of the countries with active free market, or black market exchange rates, that differ significantly from the government-imposed official rate are listed below with their online exchange rate resources (Source: Steve H. Hanke and Mazin Al-Rayes, The Watch List for the World's Worst Currencies, Cato Institute – Johns Hopkins University. Retrieved on 03/08/2016 from http://www.cato.org/research/troubled-currencies-project-watch-list). Please check this resource regularly for status changes.

Country and Current Environment	Free Market Exchange Rate Information and Resources
Argentina: ▪ Not a hyperinflationary economy ▪ Official rate set by government.	www.dolarblue.net
Egypt: ▪ Not a hyperinflationary economy ▪ Official rate set by central bank	www.eshteridollar.com
Iran: ▪ Not a hyperinflationary economy ▪ Official rate set by Iran Central Bank (ICB).	http://www.farsinet.com/toman/exchange.html
Ukraine: ▪ Not a hyperinflationary economy ▪ Official rate set by central bank who also rations foreign currencies to importers.	http://www.minfin.com.ua (NOTE: will need to be translated to English (non-English text)
Venezuela: ▪ Hyperinflationary economy ▪ Official rate set by government. NOTE: Some sites may be restricted by the IRS Internet Usage Policy, to request access complete and submit the Internet Content Filtering Change Request Form.	www.dollar.nu NOTE: It is illegal to publish the black market rate in Venezuela; therefore the use of this rate in tax computations should only be utilized upon approval of IRS counsel based on the facts and circumstances of the transaction.

Detailed Explanation of the Concept (cont'd)

Official versus Free Market Exchange Rate
Official Exchange Rate Resources (with additional description) are listed below. NOTE: Some sites may be restricted by the IRS Internet Usage Policy, to request access complete and submit the Internet Content Filtering Change Request Form.

Source and Description	Link
Bloomberg: ▪ Utilized primarily by large taxpayers ▪ Offers both paid subscription and free currency converter	www.bloomberg.com/markets/currencies/currency-converter
Federal Reserve: ▪ Referenced in Treas. Reg. 1.988-1(d)(1) as acceptable source	http://101currency.com/bank/federal-reserve-system
IMF: ▪ Referenced in Treas. Reg. 1.988-1(d)(1) as acceptable source ▪ Provides rates for last five days for comparison ▪ Limited number of currencies listed	www.imf.org/external/np/fin/data/rms_five.aspx
OANDA: ▪ Utilized by IRS for comparison of rates utilized by taxpayers ▪ Free service with large number of currencies	www.oanda.com/currency/converter
RatesFX: ▪ Free service (primarily used by stock traders)	www.ratesfx.com

Detailed Explanation of the Concept (cont'd)

Official versus Free Market Exchange Rate

Official Exchange Rate Resources (with additional description) are listed below (continued).
NOTE: Some sites may be restricted by the IRS Internet Usage Policy, to request access complete and submit the Internet Content Filtering Change Request Form.

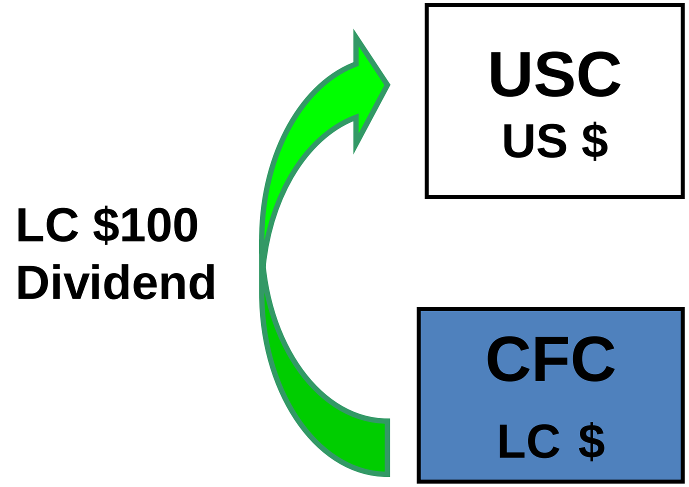
Source and Description	Link
USForex: ▪ Free service that provides a mobile app, customer rates, currency converter, historical rates (interbank rate snapshot, exchange rate seasonality, monthly and yearly average exchange rates), and current spot exchange rates. ▪ Limited number of currencies listed (approximately fifty)	www.usforex.com
XE: ▪ Free service that also acts as foreign currency encyclopedia ▪ Provides multiple live rates in real time ▪ Information for all world currencies	www.xe.com
X-Rates: ▪ Free service with multiple functions including currency calculator, graphs, rates table, monthly average computation and historic rate information ▪ Limited number of currencies listed	www.x-rates.com

Examples of the Concept

Official versus Free Market Exchange Rate

Example 1: Use of Free Market Exchange Rate

- USC is an accrual method US corporation with the dollar as its functional currency.
- USC owns 100% of the stock of a Country L subsidiary, CFC.
- CFC has the currency of Country L, the LC $ as its functional currency.
- Country L imposes restrictions on the remittance of dividends.
- On April 01, 20X0, CFC pays a dividend to USC in the amount of LC $100. Assume the official government established rate is US $1.00 = LC $1.00 and the free market rate, which takes into account the remittance restrictions and which is the rate that most clearly reflects income, is US $1.00 = LC $4.00.
- On April 01, 20X0, USC donates the LC $100 in a transaction that otherwise qualifies as a charitable contribution under IRC 170.
- Both the amount of the dividend income and the deduction under IRC 170 is US $25 (LC $100 x [1/4] = US $25).
- ¼ = the free market rate
- Source: Treas. Reg. 1.988-1(d)(4)(ii), Example 1.

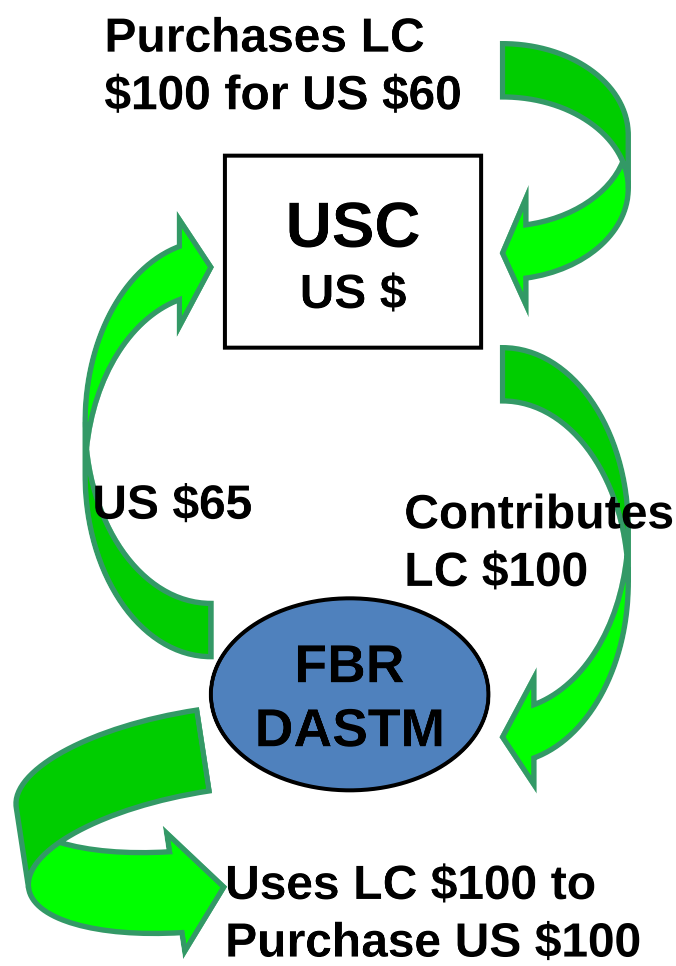


Examples of the Concept (cont'd)

Official versus Free Market Exchange Rate

Example 2: Use Official Exchange Rate

- USC, a corporation with the US $ as its functional currency, operates in foreign country L through branch FBR.
- FBR is a QBU as defined in IRC 989(a).
- USC computes FBR's income under the dollar approximate separate transaction method as described in Treas. Reg. 1.985-3 (DASTM).
- The currency of country L is LC $.
- USC can purchase legally US $ in L only from the L government.
- In order to take advantage of an arbitrage between the official and free market rate to LC $ exchange rates in L, USC purchases LC $100 for US $60 on the free market when the official exchange rate if US $1.00 = LC $1.00.
- USC transfers the LC $100 to FBR and FBR purchases US $100 for LC $100.
- FBR transfers US $65 (US $100 less an L tax withheld of $35 on the transfer) to the home office of USC.
- Under Treas. Reg. 1.988-1(a)(10)(ii)(B), the transfer of the LC $100 by USC to FBR is a realization event. USC has a basis of $60 in the L $100.
- The appropriate US $ to LC $ exchange rate for computing the amount realized by USC is the <u>official exchange rate</u>. Therefore, USC realizes $40 ($100 - $60) of US source gain from the transfer to FBR.
- Source: Treas. Reg. 1.988-1(d)(4)(ii), Example 2



Training and Additional Resources

Official versus Free Market Exchange Rate		
Type of Resource	**Description(s) and/or Instructions for Accessing**	**References**
CENTRA sessions	Refer to Foreign Currency IPN SharePoint Site for a complete listing of Foreign Currency Centra sessions	▪ INTL Foreign Currency Issues and IFRS plus Audit Techniques ▪ IBC ONLY – Foreign Currency & Int'l Matrix ▪ IBC Common Errors in translating Foreign Currency ▪ Building Blocks of Financial Products ▪ IE Phase I, Module E – Lesson 1 Foreign Currency ▪ IE Phase III, Module D –Interaction of International and Financial Products Issues ▪ FP Phase I, Lesson 9 Foreign Currency ▪ FP Phase III, Lesson 4 Foreign Currency

Training and Additional Resources (cont'd)

Official versus Free Market Exchange Rate

Type of Resource	Description(s) and/or Instructions for Accessing	References
White Papers / Guidance	▪ FASB 52/ASC 830 Foreign Currency Matters ▪ IAS29 – Financial Reporting in Hyperinflationary Economies	
Reference Materials - Treatises	Other Reading Material	▪ Bittker & Lokken: Fundamentals of International Taxation, Chapter 74 (Foreign Currency) ▪ BNA Tax Management Portfolio 921-wnd Tax Aspects of Foreign Currency ▪ Keyes: Federal Taxation of Financial Instruments and Transactions (Chapter 15, Foreign Currency Denominated Instruments ▪ Steve H. Hanke and Mazin Al-Rayes, The Watch List for the World's Worst Currencies, Cato Institute – Johns Hopkins University.

Glossary of Terms and Acronyms

Term/Acronym	Definition
ASC	Accounting Standards Codification
CFC	Controlled Foreign Corporation
DASTM	Dollar Approximate Separate Transaction Method
DCN	Document Control Number
EU	European Union
FBR	Foreign Branch
FX	Foreign Currency Exchange
GAAP	Generally Accepted Accounting Principles
ICB	Iran Central Bank
IFRS	International Financial Reporting Standards
IPN	International Practice Network
IPS	International Practice Service
IRC	Internal Revenue Code
LC	Local Currency
QBU	Qualified Business Unit
US	United States
USC	U.S. Corporation

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Disposition of a Portion of an Integrated Hedge	9470.02	FCU/T/18_02_03-01 (Formerly FCU/9470.02_03)
Disposition of Nonfunctional Currency	9470.02	FCU/T/18_02_01-08
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Legging into Integrated Treatment	9470.02	FCU/T/18_02_03-02
Legging out of Hedged Executory Contract	9470.02	FCU/T/18_02_03-04
Change in Functional Currency – How to Identify Issues	9470.03	FCU/P/18_02_03-03
Subpart F Overview	9412.00	DPL/C/02-01 (Formerly DPL/CU/V_2_01)