

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	Character of Exchange Gain or Loss on Currency Transactions
------------------	---

Document Control Number (DCN)	FCU/CU/C-18.2.1_04(2016)
Date of Last Update	06/01/2016

Table of Contents

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

[General Overview](#)

[Facts of Concept](#)

[Detailed Explanation of the Concept](#)

[Training and Additional Resources](#)

[Glossary of Terms and Acronyms](#)

[Index of Related Issues](#)

General Overview

Character of Exchange Gain or Loss on Currency Transactions

The functional currency of US taxpayers is generally the US dollar. If a US taxpayer engages in a transaction denominated in nonfunctional currency, it will most likely result in a foreign currency exchange gain or loss, separate from the underlying transaction. A foreign currency exchange gain or loss is the gain or loss realized due to the change in exchange rates between the booking date and the payment date of a transaction involving an asset or liability denominated in a nonfunctional currency. The gain or loss from disposing of nonfunctional currency is determined by the change in exchange rates between the date the nonfunctional currency was acquired and the date of disposition.

Prior to the enactment of Internal Revenue Code (IRC) Section 988 under The Tax Reform Act of 1986, the treatment of foreign currency transactions was inconsistent. Determining the timing, amount, character, and source of the gains and losses that resulted from transactions in foreign currencies relied on court decisions and administrative rulings. These decisions were usually based on specific information relative to the transaction at hand.

IRC 988 provides guidelines for the treatment of certain transactions denominated in a nonfunctional currency. These transactions include the acquisition of a debt instrument, or becoming the obligor of a debt instrument, accruing (or otherwise taking into account) any item of expense or income which will be paid or received after the accrual, entering into or acquiring any forward contract, futures contract, option, or similar financial instrument, and the disposition of nonfunctional currency. Definitions of specific transactions subject to IRC 988 will be the subject of a separate IPS unit.

Under IRC 988(a)(1)(A), the foreign currency exchange gain or loss attributable to a Section 988 transaction is generally ordinary income. However, there are special rules, exceptions and elections which change the character of a Section 988 transaction; please see the Detailed Explanation of the Concept for examples of these rules, exceptions and elections. The foreign currency exchange gain or loss is separate from any gain or loss on the underlying Section 988 transaction. IRC 988 is principally a source and character provision.

While IRC 988 addresses the 1) character, 2) source, 3) timing and 4) amount of gains and losses resulting from foreign currency transactions, this IPS unit will address only the character of foreign currency exchange gain or loss resulting from a Section 988 transaction. In general, a Section 988 transaction will result in a foreign currency exchange gain or loss that is ordinary. The remaining items related to gains and losses from transactions in foreign currency will be covered in other IPS units.

Facts of Concept

Character of Exchange Gain or Loss on Currency Transactions

Facts of Concept

In general, the character of a foreign currency exchange gain or loss from any of the following Section 988 transactions, denominated in nonfunctional currency, is ordinary and is determined separately from the underlying transaction.

- The acquisition of a debt instrument or becoming the obligor under a debt instrument.
- Accruing any item of expense or gross income or receipts which will be paid or received after the accrual date.
- Entering into or acquiring any forward contract, futures contract, option or similar financial instrument.
 - There is an exception for regulated futures contract or non-equity options subject to the marked to market rules under IRC 1256. See IRC 988(c)(1)(D)(i). In the case of these contracts, the exchange gain or loss would be subject to character rules under IRC 1256(a), unless an election into the rules of IRC 988 and out of of IRC 988(c)(1)(D)(i) is made.
- The disposition of nonfunctional currency.

These transactions are identified in IRC 988(c)(1)(A), (B), and (C) and Treas. Reg. 1.988-1(a)(1) and (2)(i) – (iii).

The foreign currency exchange gain or loss is determined separately from the underlying transaction and is generally reported as ordinary gain (loss) as a result of undertaking a transaction denominated in a nonfunctional currency under IRC 988.

Although in general, the character rules of IRC 988 provide for ordinary treatment overriding the character rules of IRC 1256, in the case of regulated futures contracts or non-equity options subject to IRC 1256 marked to market rules, IRC 1256(a) character rules (40% short term capital loss and 60% long term capital loss) apply unless the taxpayer elects IRC 988 treatment.

Detailed Explanation of the Concept

Character of Exchange Gain or Loss on Currency Transactions

Debt Instruments: In general, the character of the exchange gain or loss will be ordinary. There are special netting rules that may limit the exchange gain or loss on payment or disposition of a debt instrument.

Analysis	Resources
<ul style="list-style-type: none"> ▪ The character of the exchange gain or loss from the acquisition of a debt instrument or becoming an obligor under a debt instrument, denominated in nonfunctional currency, is generally ordinary. 	<ul style="list-style-type: none"> ▪ IRC Section 988(a)(1)(A) and IRC Section 988(c)(1)(A) and (B)(i). Treas. Reg. 1.988-1(a)(2)(i) and Treas. Reg. 1.988-3(a). BNA 921-2nd – TMFEDPORT No. 921 §III Foreign Currency Transactions C.7.e. Character of Exchange Gain or Loss with Respect to Debt Instruments. Refer to Bittker and Lokken Part 9 Chapter 74.8 Debt Instruments.
<ul style="list-style-type: none"> ▪ The realization of an exchange gain or loss from the acquisition of a debt instrument or becoming an obligor under a debt instrument, denominated in nonfunctional currency, is subject to the netting rule. An example of the netting rule would be the taxpayer's capital loss from market fluctuations offsetting the ordinary gain that results from exchange rate fluctuations. 	<ul style="list-style-type: none"> ▪ Treas. Reg. 1.988-2(b)(8) , Limitation of exchange gain or loss on payment or disposition of a debt instrument.
<ul style="list-style-type: none"> ▪ Thus, the sum of any exchange gain or loss with respect to the principal and interest of any such debt instrument shall be realized only to the extent of the total gain or loss realized on the transaction. 	<ul style="list-style-type: none"> ▪ BNA 921- 2nd – TMFEDPORT No. 921 §III Foreign Currency Transactions C.7.d.(1).(d) The Netting Rule for Exchange Gain or Loss on Payment or Disposition of a Debt Instrument.

Detailed Explanation of the Concept (cont'd)

Character of Exchange Gain or Loss on Currency Transactions

Debt Instruments: In general, the character of the exchange gain or loss will be ordinary. There are special netting rules that may limit the exchange gain or loss on payment or disposition of a debt instrument.

Analysis	Resources
<ul style="list-style-type: none">▪ Generally, an exchange gain or loss realized on a Section 988 transaction shall not be treated as interest income or expense. However, exchange gain or loss realized on a Section 988 transaction shall be treated as interest income or expense as provided in IRC 988(c)(2) with regard to tax exempt bonds.	<ul style="list-style-type: none">▪ Treas. Reg. 1.988-3(c) – general rule▪ Treas. Reg. 1.988-3(c)(2) – tax exempt bonds

Detailed Explanation of the Concept (cont'd)

Character of Exchange Gain or Loss on Currency Transactions

Payables and Receivables: In general, the character of the exchange gain or loss will be ordinary. There is an exception to the general rule for accrued foreign taxes of a QBU branch.

Analysis	Resources
<ul style="list-style-type: none"> ▪ If the taxpayer accrues an item of expense or gross income or receipts, denominated in nonfunctional currency, which is later paid or received, the resulting exchange gain or loss is ordinary income. 	<ul style="list-style-type: none"> ▪ IRC 988(a)(1)(A) and IRC 988(c)(1)(A) and (B)(ii). ▪ Treas. Reg. 1.988-1(a)(2)(ii) and Treas. Reg. 1.988-3(a). ▪ BNA 921-2nd – TMFEPOR No. 921 §III Foreign Currency Transactions C.6. <i>Accounts Payable and Accounts Receivable</i>.
<ul style="list-style-type: none"> ▪ There is an exception for the accrued foreign taxes of a QBU branch whose functional currency is the US dollar and the foreign taxes are claimed as a foreign tax credit under IRC 901. Such payables are not Section 988 transactions. QBU branches compute income under IRC 987. 	<ul style="list-style-type: none"> ▪ Treas. Reg. 1.988-1(a)(2)(ii)

Detailed Explanation of the Concept (cont'd)

Character of Exchange Gain or Loss on Currency Transactions

Financial Instruments: In general, the character of the exchange gain or loss will be ordinary. There are special rules and exceptions to the general rule for certain identified forward contracts, futures contracts and option contracts and also for any regulated futures contract or non-equity option which would be marked to market.

Analysis	Resources
<ul style="list-style-type: none">▪ If the taxpayer enters into or acquires any forward contract, futures contract, option, or similar financial instrument, denominated in nonfunctional currency, the resulting foreign currency exchange gain or loss is ordinary.	<ul style="list-style-type: none">▪ IRC 988(a)(1)(A) and IRC 988(c)(1)(A) and (B)(iii)▪ Treas. Reg. 1.988-1(a)(2)(iii) and Treas. Reg. 1.988-3(a)▪ BNA 921-2nd – TMFEDPORT No. 921 §III Foreign Currency Transactions C.9. Forward, Futures, Options and Similar Financial Instruments

Detailed Explanation of the Concept (cont'd)

Character of Exchange Gain or Loss on Currency Transactions

Financial Instruments: In general, the character of the exchange gain or loss will be ordinary. There are special rules and exceptions to the general rule for certain identified forward contracts, futures contracts and option contracts and also for any regulated futures contract or non-equity option which would be marked to market.

Analysis	Resources
<ul style="list-style-type: none">▪ There is a special rule in which the taxpayer can elect to characterize the exchange gain or loss on certain identified forward contracts, futures contracts, and option contracts as capital gain or loss but only if the contract is a capital asset , not part of a straddle and not a regulated futures contract or nonequity option with respect to which an election under section 988(c)(1)(D)(ii) is in effect (see above). If this election is made with respect to a section 1256 contract, section 1256 shall govern the character of any gain or loss recognized on such contract.▪ If a contract which is the subject of an election to characterize the exchange gain as capital gain or loss subsequently becomes part of a straddle under section 1092(c) (but without regard to subsections (c)(4) or (e)), then the election shall be invalid with respect to gains from such contract and the election may be invalidated with respect to losses.	<ul style="list-style-type: none">▪ IRC 988(a)(1)(B) Special rule for forward contracts, etc.▪ Treas. Reg. 1.988-3(b)(1) Election to characterize exchange gain or loss on certain identified forward contracts, futures contracts and option contracts as capital gain or loss▪ Treas. Reg. 1.988-3(b)(2) Special Rule for contracts that become part of a straddle after an election is made

Detailed Explanation of the Concept (cont'd)

Character of Exchange Gain or Loss on Currency Transactions

Financial Instruments: In general, the character of the exchange gain or loss will be ordinary. There are special rules and exceptions to the general rule for certain identified forward contracts, futures contracts and option contracts and also for any regulated futures contract or non-equity option which would be marked to market.

Analysis	Resources
<ul style="list-style-type: none">▪ There is an exception for any regulated futures contract or non-equity option which would be marked to market, in accordance with IRC 1256. The exchange gain or loss, in this case, would be capital, unless the taxpayer makes an election to treat mark to market as ordinary gain or loss.	<ul style="list-style-type: none">▪ IRC 988(c)(1)(D)(i) and Treas. Reg. 1.988-1(a)(7)(i) – exception for certain instruments marked to market.▪ IRC 988(c)(1)(D)(ii) and Treas. Reg. 1.988-1(a)(7)(ii)-(iv) – Election out▪ BNA 921-2nd – TMFEDPORT No. 921 §III Foreign Currency Transactions C.9.f. Special Rules for Regulated Futures Contracts and Nonequity Options.

Detailed Explanation of the Concept (cont'd)

Character of Exchange Gain or Loss on Currency Transactions

Disposition of Nonfunctional Currency: In general, the character of the exchange gain or loss on a disposition of nonfunctional currency will be ordinary. There is an exception to the general rule for individual taxpayers in personal transactions.

Analysis	Resources
<ul style="list-style-type: none">▪ The character of the exchange gain or loss from the disposition of nonfunctional currency is generally ordinary.	<ul style="list-style-type: none">▪ IRC 988(a)(1)(A) and 988(c)(1)(C)▪ Treas. Reg. 1.988-1(a)(i) and 1.988-3(a)▪ BNA 921-2nd – TMFEDPORT No. 921 §III Foreign Currency Transactions C.4 Disposition of Nonfunctional Currency.

Detailed Explanation of the Concept (cont'd)

Character of Exchange Gain or Loss on Currency Transactions

Disposition of Nonfunctional Currency: In general, the character of the exchange gain or loss on a disposition of nonfunctional currency will be ordinary. There is an exception to the general rule for individual taxpayers in personal transactions.

Analysis	Resources
<ul style="list-style-type: none">▪ There is an exception for individual taxpayers. IRC 988 does not apply if an individual disposes of nonfunctional currency in a personal transaction.	<ul style="list-style-type: none">▪ IRC 988(e) Application to individuals and Treas. Reg. 1.988-1(a)(9) Exceptions for certain transactions entered into by an individual▪ BNA 921-2nd – TMFEDPORT No. 921 §III Foreign Currency Transactions C.11 Special Rules for Foreign Currency Transactions of an Individual▪ Bittker and Lokken Part 9 Chapter 74.12 Nonfunctional Currency Held for Personal Use.▪ See IPS Concept Unit Overview of IRC Section 988 Nonfunctional Currency Transactions DCN FCU/CU/C_18.2.1_03

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	<ul style="list-style-type: none"> ▪ 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) 	<ul style="list-style-type: none"> ▪ 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)	<p>IE Phase III Hybrid sessions:</p> <ul style="list-style-type: none"> ▪ 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 	<ul style="list-style-type: none"> ▪ 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)

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
Other Training Materials	<ul style="list-style-type: none"> ▪ E 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	<ul style="list-style-type: none"> ▪ 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	<ul style="list-style-type: none"> ▪ Bittker and Lokken Chapter 74. Foreign Currency (Westlaw subscription) 	<ul style="list-style-type: none"> ▪ FIXIEG Ch 74
BNA Tax Management Portfolio	<ul style="list-style-type: none"> ▪ BNA Portfolio 921-2nd Tax Aspects of Foreign Currency (Westlaw subscription) 	<ul style="list-style-type: none"> ▪ BNA 921-2nd – TMFEDPORT No 921 s
Keyes: Federal Taxation of Financial Instruments and Transactions	<ul style="list-style-type: none"> ▪ Keyes Chapter 15. Foreign Currency Denominated Instruments (Westlaw subscription) 	
Accounting Standards Codification (Financial Accounting Standards)	<ul style="list-style-type: none"> ▪ ASC830 (FAS52) Foreign Currency Matters ▪ Available at https://asc.fasb.org. Will need to register for a 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. 	

Glossary of Terms and Acronyms

Term/Acronym	Definition
ASC	Accounting Standard Codification
FAS	Financial Accounting Standards
QBU	Qualified Business Unit
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.
Non-Equity Option	A term for option contracts whose underlying securities are instruments other than equities.
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.
Regulated Futures Contract	A specific futures contract, as defined in IRC 1245, that is held by a taxpayer at the end of a tax period but treated as if it was sold for its fair market value, and gains or losses are treated as either short-term or long-term capital gains.
Section 988 Transaction	Transactions as defined in IRC 988(c)(1)(B)

Index of Related Issues

Issue	Associated UIL(s)	References
How to Assess Penalties for Failure to file Form 8886 Disclosing Section 988 Losses	▪ 9470.02	▪ FCU/9470.02_02
Overview of Foreign Currency Hedging Transactions	▪ 9470.02	▪ FCU/CU/C_18.2.3_14
Integration of Executory Contract and the Currency Hedge	▪ 9470.02	▪ FCU/9470.02_05
Legging into Integrated Treatment	▪ 9470.02	▪ FCU/9470.02_07
Disposition of a Portion of an Integrated Hedge	▪ 9470.02	▪ FCU/9470.02_03
Disposition of Nonfunctional Currency	▪ 9470.02	▪ FCU/9470.02_01_04
Functional Currency of a Qualified Business Unit (QBU)	▪ 9470.03	▪ FCU/PUO/C_18.3.3_08
Sourcing of Exchange Gains or Losses	▪ 9470.02	▪ FCU/CU/C-18.2.1_17
Overview of the Impact of Foreign Currency Exchange Rate Fluctuations	▪ 9470.02	▪ FCU/CU/C-18.2.1_16

Index of Related Issues (cont'd)

Issue	Associated UIL(s)	References
Computing Foreign Base Company Income	▪ 9412.05	▪ DPL/9412.05_05
Subpart F Overview	▪ 9412	▪ DPL/CBB/V_2_01
Calculation of IRC §956 Amount	▪ 9414.01	▪ Under Development