



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	Definition of Appropriate Exchange Rate Overview
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Document Control Number (DCN)	FCU/CU/C_18.2.1_01(2015)
Date of Last Update	05/12/2015

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General Overview

Definition of Appropriate Exchange Rate Overview

- 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's 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's generally translated at a weighted average foreign currency exchange rate applicable to the period of time.
- IRC Section 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.

Detailed Explanation of the Concept

Definition of Appropriate Exchange Rate Overview

The starting point to applying the foreign currency tax rules is to determine the Taxpayer's "functional currency." This is the currency in which all of the taxpayer's taxable income and earnings and profits must be computed. Transactions, income and foreign taxes in any other currency then must be translated back into the taxpayer's functional currency under the rules of Sections 986, 987, 988 or 989.

Analysis	Resources
<ul style="list-style-type: none">▪ <u>Qualified Business Units (QBUs)</u>: The functional currency determination is made by reference to the "qualified business units" (QBUs) of the taxpayer.	<ul style="list-style-type: none">▪ For further discussion regarding the identification and determination of a taxpayer's QBUs, please see IPS Concept Unit "Definition of a QBU".
<ul style="list-style-type: none">▪ <u>Non Functional Currency Transactions</u>: Section 988 applies to common foreign currency transactions, such as buying or selling units of foreign currency, borrowing and lending in functional currency, accruing foreign currency payables and receivables, and foreign currency derivatives. Under the functional currency /QBU concept, Section 988 does not apply to any transactions entered into by a branch of a taxpayer in the branch's functional currency. FX gain or loss on those transactions is subject to Section 987, rather than Section 988.	<ul style="list-style-type: none">▪ For further discussion regarding transactions in a QBU's Nonfunctional Currency, please see IPS Practice Unit "Disposition of Nonfunctional Currency".

Detailed Explanation of the Concept (cont'd)

Definition of Appropriate Exchange Rate Overview

The starting point to applying the foreign currency tax rules is to determine the Taxpayer's "functional currency." This is the currency in which all of the taxpayer's taxable income and earnings and profits must be computed. Transactions, income and foreign taxes in any other currency then must be translated back into the taxpayer's functional currency under the rules of Sections 986, 987, 988 or 989.

Analysis	Resources
<ul style="list-style-type: none">▪ <u>Translation Rules for E&P, Subpart F and PTI</u>: E&P is maintained in the foreign corporation's functional currency and translated into U.S. dollars when distributed or deemed distributed to the U.S. shareholder. Actual dividend distributions are translated at the spot rate on the date of the distribution. Income inclusions under subpart F are translated at the average exchange rate for the year. IRC Section 1248 deemed dividends on sale of shares of a CFC are translated at the spot rate on the date of the share sale. In the case of a § 956 investment in U.S. property, the earnings are translated at the spot rate at the end of year.	<ul style="list-style-type: none">▪ For further discussion regarding the these topics, please see IPS Concept Units "Determination of Foreign Corporations E&P and Foreign Taxes", "Earnings and Profits and Distributions", "Previously Taxed Earnings and Profits ("PTI")", and "Determination of Exchange Gain or Loss under IRC Section 986".

Detailed Explanation of the Concept (cont'd)

Definition of Appropriate Exchange Rate Overview

The starting point to applying the foreign currency tax rules is to determine the Taxpayer's "functional currency." This is the currency in which all of the taxpayer's taxable income and earnings and profits must be computed. Transactions, income and foreign taxes in any other currency then must be translated back into the taxpayer's functional currency under the rules of Sections 986, 987, 988 or 989.

Analysis	Resources
<ul style="list-style-type: none"> ▪ <u>Translating Branch Income and Loss</u>: IRC Section 987 provides rules for determining foreign currency translation gain or loss with respect to a separate qualified business unit (QBU) of a taxpayer operating in a different functional currency from that of the taxpayer. The QBU computes its taxable income or loss in its own functional currency which is then translated into the taxpayer's functional currency at the "appropriate" exchange rate (i.e., the average exchange rate for the taxable year). 	<ul style="list-style-type: none"> ▪ For further discussion regarding the application of IRC Section 987, please see IPS Unit "Section 987 Taxable Income Calculation of Translation".
<ul style="list-style-type: none"> ▪ <u>Translation of Foreign Income Taxes</u>: Foreign income taxes are generally are translated into dollars using the average exchange rate for which the year for which such taxes relate. However, there are several exceptions to the rule that foreign income taxes are translated at the exchange rate prevailing at the date of payment. 	<ul style="list-style-type: none"> ▪ For further discussion of these exceptions, please see IPS Unit "Translation of Foreign Income Taxes".
<ul style="list-style-type: none"> ▪ <u>Official vs. Free Market Exchange Rate</u>: Reg. § 1.988-1(d)(1) sets forth the general rule that the spot rate shall be determined based on the prices at which the currency freely changes hands. Reg. § 1.988-1(d)(4) provides that the rate which "most clearly reflects income" should be used for the spot rate in cases in which the government rate and free market rate differ. 	<ul style="list-style-type: none"> ▪ For further discussion of the application of the free market rate versus the official exchange rate, please see IPS Unit "Official versus Free Market Exchange Rate".

Detailed Explanation of the Concept (cont'd)

Definition of Appropriate Exchange Rate Overview

See the chart below for a listing of types of transactions, the appropriate exchange rate to use, and the relevant authority.

Analysis	Resources
<ul style="list-style-type: none"> Actual distribution of E&P: Spot Rate on date of distribution 	<ul style="list-style-type: none"> IRC Section 989(b)(1)
<ul style="list-style-type: none"> Actual or deemed sale or exchange of stock in a foreign corporation treated as a dividend under section 1248: Spot Rate on date the actual / deemed dividend is included in taxable income 	<ul style="list-style-type: none"> IRC Section 989(b)(2)
<ul style="list-style-type: none"> Subpart F Income or income from Qualifying Electing Funds: Average Exchange Rate for the tax year of the foreign corporation 	<ul style="list-style-type: none"> IRC Section 989(b)(3)
<ul style="list-style-type: none"> Income from QBU of the taxpayer: Average Exchange Rate for the tax year of the QBU (also see Sect. 987 regulations) 	<ul style="list-style-type: none"> IRC Section 989(b)(4)
<ul style="list-style-type: none"> Inclusions relating to investments in U.S. property: Spot Rate on the last day of the tax year 	<ul style="list-style-type: none"> IRC Section 989(b)
<ul style="list-style-type: none"> Currency that has an official government rate different from free market rate: The rate that most clearly reflects the taxpayer's income, usually the free market rate (e.g., Venezuela) 	<ul style="list-style-type: none"> Treas. Reg. 1.988-1(d)(4) (future IPS Unit on topic)
<ul style="list-style-type: none"> Foreign taxes paid or accrued: Average exchange rate for the taxable year to which the taxes relate (General Rule) 	<ul style="list-style-type: none"> IRC Section 986(a)

Detailed Explanation of the Concept (cont'd)

Definition of Appropriate Exchange Rate Overview

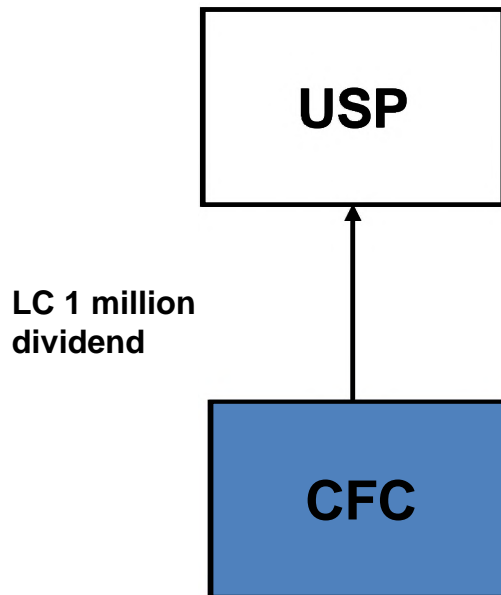
See the chart below for a listing of types of transactions, the appropriate exchange rate to use, and the relevant authority.

Analysis	Resources
<ul style="list-style-type: none">▪ Exceptions to general rule for foreign taxes paid or accrued: Not applicable to foreign taxes paid 2 years after close of tax year or before beginning of tax year to which such taxes relate or taxes denominated in an inflationary currency. Such taxes are translated into dollars using the exchange rate at time paid.	<ul style="list-style-type: none">▪ IRC Section 986(a)(1)(B)▪ IRC Section 986(a)(1)(C)▪ IRC Section 986(a)(2)▪ Treas. Reg. 1.905-3T
<ul style="list-style-type: none">▪ Elective Exception to general rule for foreign taxes paid or accrued: Election available for taxes paid in currency other than its functional currency. Such taxes are translated using the exchange rate at time paid.	<ul style="list-style-type: none">▪ IRC Section 986(a)(1)(D)▪ IRC Section 986(a)(2)▪ Treas. Reg. 1.905-3T

Examples of the Concept

Definition of Appropriate Exchange Rate Overview

Examples

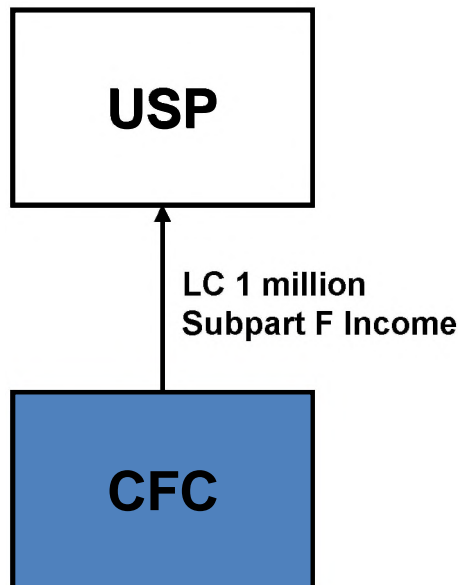


- At 12/31/20x1, a 100% controlled foreign corporation (“CFC”) with LC as its functional currency distributes a Section 301 dividend of LC 1 million to its U.S. Parent (“USP”), whose functional currency is the U.S. dollar. At 12/31/20x1, the spot rate is LC 1.0 = \$1.2
- USP will recognize dividend income of \$1,200,000 (LC 1 million x 1.2 = \$1,200,000) because the appropriate exchange rate is the spot rate on the date of distribution (Section 989(b)(1)).

Examples of the Concept (cont'd)

Definition of Appropriate Exchange Rate Overview

Examples

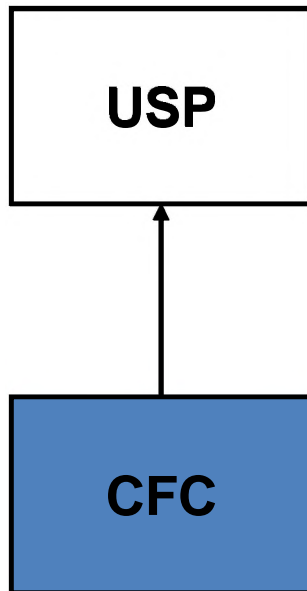


- CFC is a calendar-year 100% controlled foreign corporation of USP, a U.S. corporation with a calendar year and with the U.S. dollar as its functional currency. The functional currency of CFC is LC. CFC has LC 2 million E&P for tax year ending 12/31/20x1. Out of the LC 2 million E&P, LC 1 million was Subpart F income to be included in USP's gross income. The spot rate on 12/31/20x1 was LC 1.0 = \$1.2 and the average exchange rate for calendar year 20x1 is LC 1.0 = \$1.25.
- USP will recognize \$1,250,000 (LC 1 million x 1.25) of Subpart F Income because the appropriate exchange rate for this translation is the average exchange rate for the tax year of the foreign corporation per IRC Section 989(b)(3).

Examples of the Concept (cont'd)

Definition of Appropriate Exchange Rate Overview

Examples



LC 2 million E&P
LC 1 million related to
investment in US
property under Section
956

- CFC is a calendar-year 100% controlled foreign corporation of USP, a U.S. corporation with a calendar year and with the U.S. dollar as its functional currency. The functional currency of CFC is LC. CFC has LC 2 million E&P for tax year ending 12/31/20x1. CFC has an investment in US property and because of this, USP is required to include LC 1 million in income under Section 956. The spot rate on 12/31/20x1 was LC 1.0 = \$1.2 and the average exchange rate for calendar year 20x1 is LC 1.0 = \$1.25.
- USP will recognize \$1,200,000 (LC 1 million x 1.2) because the appropriate exchange rate for this translation is the spot rate on the last day of the tax year per IRC Section 989(b).

Training and Additional Resources

Definition of Appropriate Exchange Rate Overview

Type of Resource	Description(s) and/or Instructions for Accessing	References
CENTRA sessions	<ul style="list-style-type: none"> ▪ INTL Foreign Currency Issues and IFRS plus Audit Techniques (Centra-Public Recordings-Search on 30551) ▪ IBC ONLY – Foreign Currency & Int’l Matrix (Centra – Public Recordings – Event ID JVQ439517) ▪ IBC Common Errors in translating Foreign Currency 44 (Centra – Public Recordings – Event ID PHG711242) ▪ Building Blocks of Financial Products (Centra – Public Recordings – Search on “Building Blocks of Financial Products) 	
Other Training Materials	<ul style="list-style-type: none"> ▪ IE Phase I, Module E – Lesson 1 Foreign Currency ▪ IE Phase I hyperlink: click here , then Select Module E ▪ IE Phase III, Module D –Interaction of International and Financial Products Issues ▪ IE Phase III hyperlink: click here, then Select Module 5.D., second lesson 	

Training and Additional Resources (cont'd)

Definition of Appropriate Exchange Rate Overview		
Type of Resource	Description(s) and/or Instructions for Accessing	References
Other Training Materials	<ul style="list-style-type: none"> ▪ FP Phase I, Lesson 9 Foreign Currency ▪ FP Phase I hyperlink: click here, then select "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 hyperlink: click here, then select "Download Financial Products Phase Three Participant Guide," then proceed to Lesson 4, page 110. 	
Bittker & Lokken: Fundamentals of International Taxation, Chapter 74	<ul style="list-style-type: none"> ▪ Westlaw: Bittker and Lokken Chapter 74. Foreign Currency 	
BNA Tax Management Portfolio	<ul style="list-style-type: none"> ▪ Westlaw: BNA Portfolio 921-2nd Tax Aspects of Foreign Currency 	
Keyes: Federal Taxation of Financial Instruments and Transactions	<ul style="list-style-type: none"> ▪ Westlaw: Keyes Chapter 15. Foreign Currency Denominated Instruments 	
FASB 52/ASC 830 Foreign Currency Matters	<ul style="list-style-type: none"> ▪ Click on title for hyperlink: FASB 52/ASC830 Foreign Currency Matters (you may need to go to https://asc.fasb.org, and register for a "basic view" service, which is free) or sign in to Westlaw and go to the 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
E&P	Earnings and Profits
QBU	Qualified Business Unit
CFC	Controlled Foreign Corporation
DCN	Document Control Number (for Practice Unit)
USP	US Parent
LC	Functional currency of CFC
FP	Financial Products
IE	International Examiner
IBC	International Business Compliance
FASB	Financial Accounting Standards Board
ASC	Accounting Standard Council
PTI	Previously Taxed Income

Index of Related Issues

Issue	Associated UIL(s)	References
How to Assess Penalties for Failure to file Form 8886 Disclosing Section 988 Losses	<ul style="list-style-type: none"> ▪ 9470.02 	<ul style="list-style-type: none"> ▪ Under Development
Overview of Foreign Currency Hedging Transactions	<ul style="list-style-type: none"> ▪ 9470.02 	<ul style="list-style-type: none"> ▪ Under Development
Integration of Executory Contract and the Currency Hedge	<ul style="list-style-type: none"> ▪ 9470.02 	<ul style="list-style-type: none"> ▪ Under Development
Legging into Integrated Treatment	<ul style="list-style-type: none"> ▪ 9470.02 	<ul style="list-style-type: none"> ▪ FCU/9470.02_03(2013)
Disposition of a Portion of an Integrated Hedge	<ul style="list-style-type: none"> ▪ 9470.02 	<ul style="list-style-type: none"> ▪ FCU/9470.02_03(2013)
Disposition of Nonfunctional Currency	<ul style="list-style-type: none"> ▪ 9470.02 	<ul style="list-style-type: none"> ▪ FCU/9470.02-01_03(2014)
Functional Currency of a Qualified Business Unit (QBU)	<ul style="list-style-type: none"> ▪ 9470.03 	<ul style="list-style-type: none"> ▪ FCU/9470.03-02_xx(2014)
Computing Foreign Base Company Income	<ul style="list-style-type: none"> ▪ 9412.05 	<ul style="list-style-type: none"> ▪ DPL/9412.05_05(2013)
Subpart F Overview	<ul style="list-style-type: none"> ▪ 9412.00 	<ul style="list-style-type: none"> ▪ DPL/CBB/V_2_01(2013)
Calculation of IRC §956 Amount	<ul style="list-style-type: none"> ▪ 9414.01 	<ul style="list-style-type: none"> ▪ Under Development