

## LB&I Transaction Unit

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|-------------------------|--|--|
| <b>Unit Name</b>        | Computation and Review of IRC 986(c) Gain or Loss - Pre-TCJA |  |
| <b>Primary UIL Code</b> | 9470.04-03   | Determination of Exchange Gain or Loss on Previously Taxed Earnings and Profits – Section 986(c) |

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

|                                      |           |
|--------------------------------------|-----------|
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# Issue and Transaction Overview

## Computation and Review of IRC 986(c) Gain or Loss - Pre-TCJA

When a controlled foreign corporation (CFC) of a U.S. Shareholder makes a distribution to that shareholder, the shareholder must determine whether it has previously taxed earning and profits (PTEP) from that CFC in order to avoid double taxation. Internal Revenue Code (IRC) 959(a)(1) generally provides an exclusion from the gross income of a U.S. shareholder for distributions of earnings and profits (E&P) of a CFC attributable to amounts which have already been included by the U.S. shareholder in its income (for example, a subpart F income inclusions under IRC 951(a)). IRC 959(c) provides ordering rules for which E&P of a CFC is allocated to a given distribution.

Additional challenges arise when the CFC's functional currency is not the U.S. dollar. (For additional information regarding functional currency of a non-U.S. entity, please see Practice Units, *Functional Currency Determination* and *Functional Currency of a QBU*.) For example, any U.S. shareholder inclusion under IRC 951(a) is initially computed in the CFC's functional currency and then translated into U.S. dollars at an appropriate exchange rate, depending on the type of inclusion to be included in its U.S. shareholder's income for U.S. tax purposes. (For additional information regarding an appropriate exchange rate, please see Practice Unit, *Definition of Appropriate Exchange Rate Overview*.) This income inclusion generally becomes PTEP. If the exchange rate on the date of distribution of E&P from the CFC to the U.S. shareholder differs from the exchange rate utilized for recognition of the original inclusion that become PTEP, an exchange gain or loss under IRC 986(c) must be reported on the CFC Form 5471 for inclusion by the U.S. shareholder in its U.S. federal taxable income. (For a general overview of IRC 986(c), please see Practice Unit, *Overview of IRC 986(c) Gain or Loss*.)

While the U.S. dollar amount of the distribution of E&P from a CFC to its U.S. shareholder is determined by multiplying the spot exchange rate on the date of distribution by the amount of the E&P in the functional currency of the CFC being distributed, the determination of the U.S. dollar basis of the PTEP for purposes of determining gain or loss under IRC 986(c) is not as clear. Reasonable methodologies include a last-in, first-out (LIFO) method as suggested under the section 959 regulations and the 2006 proposed regulations (REG-121509-00, 71 Fed. Reg. 51155) or the pooling method under Notice 88-71 and as an election provided in the 2006 proposed regulations.

# Issue and Transaction Overview (cont'd)

## Computation and Review of IRC 986(c) Gain or Loss - Pre-TCJA

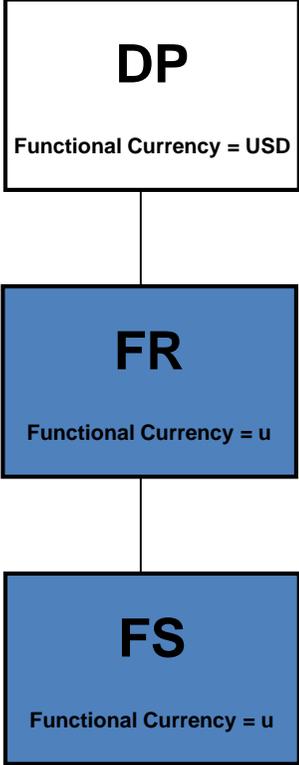
However, the methodologies don't explicitly address circumstances where a distribution of PTEP is made by a lower-tier CFC whose functional currency is not the US dollar to an upper-tier CFC with a different functional currency than the lower-tier CFC, including an upper-tier CFC with a U.S. dollar functional currency. (But, see Treas. Reg. 1.985-5 when a CFC with PTEP changes its functional currency to the U.S. dollar.)

The Tax Cuts and Jobs Act (TCJA) significantly changed the number of PTEP categories. Notice 2019-01 (2019-01 I.R.B. 275, January 7, 2019) announced that the Treasury Department and the IRS intend to withdraw the 2006 proposed regulations and to issue new regulations under IRC 959 and 961. The Notice held that forthcoming regulations will provide that PTEP will be comprised of 16 PTEP groups.

While this Unit will reference factual information pertaining to the TCJA, this Practice Unit will focus on the identification, review of the computation, and determination of the circumstances when IRC 986(c) recognition is appropriate in the pre-TCJA environment.

# Transaction and Fact Pattern

## Computation and Review of IRC 986(c) Gain or Loss - Pre-TCJA

| Diagram of Transaction  | Facts  |
|---|--|
|  <p>The diagram illustrates a corporate structure with three entities arranged vertically and connected by lines. At the top is a white box labeled 'DP' with 'Functional Currency = USD' below it. A vertical line connects DP to a blue box labeled 'FR' with 'Functional Currency = u' below it. Another vertical line connects FR to a blue box labeled 'FS' with 'Functional Currency = u' below it.</p> | <ul style="list-style-type: none"> <li>▪ DP, a domestic corporation U.S. shareholder, owns 100% of the only class of stock in FR, a CFC, which, in turn, owns 100% of the only class of stock in FS, a CFC.</li> <li>▪ DP, FR, and FS all use the calendar year as their taxable year.</li> <li>▪ FR and FS both use the u as their functional currency.</li> <li>▪ During 20x1, FR earns 100u of non-subpart F income and invests 100u in U.S. property (IRC 956 amount). DP must include 100u in its gross income for 20x1 under IRC 951(a)(1)(B) with respect to FR.</li> <li>▪ For 20x2, FS has no subpart F income, no IRC 956 amount, or PTEP (but has accumulated E&amp;P of 500u). FS distributes 100u of E&amp;P to FR. The distribution of 100u to FR is subpart F income of FR and DP must include the 100u in its gross income for 20x2 under IRC 951(a)(1)(A). (For the purpose of this example, neither IRC 954(c)(6) nor any other exclusion applies.)</li> <li>▪ Also in 20x2, FR has no IRC 956 amount, but does have non-subpart F income of 100u.</li> <li>▪ The exchange rates at all times in 20x1 and 20x2, respectively, are 1u = \$1 and 1u = \$1.20.</li> <li>▪ During 20x3, neither FR or FS has any subpart F income or IRC 956 amount, but FR distributes 100u on December 31, 20x3, at which time the spot exchange rate is 1u = \$1.30.</li> </ul> |



# Transaction and Fact Pattern (cont'd)

## Computation and Review of IRC 986(c) Gain or Loss - Pre-TCJA

### Facts

|       | Functional Currency = u |               |               |          | US dollar basis |               |               |
|-------|-------------------------|---------------|---------------|----------|-----------------|---------------|---------------|
|       | Inv in US Prop          | Subpart F     | Other E&P     | Exchange | Inv in US Prop  | Subpart F     | Other E&P     |
|       | IRC 959(c)(1)           | IRC 959(c)(2) | IRC 959(c)(3) | Rate     | IRC 959(c)(1)   | IRC 959(c)(2) | IRC 959(c)(3) |
| 20x1  | 100                     |               |               | 1.0      | 100             |               |               |
| 20x2  |                         | 100           | 100           | 1.2      |                 | 120           | 120           |
| Total | 100                     | 100           | 100           |          | 100             | 120           | 120           |

Total Taxed E&P =

200 (d)

220 (a)

12/31/x3 Distribution: 100u (c) x 1.3 = \$ 130 USD amount of distribution (b)

USD basis attributable to

PTI distribution (e) =  $(a) \times (c) / (d)$   
 $220 \times 100 / 200 = 110$

Foreign currency gain

under Section 986(c) =  $(b) - (e)$   
 $\$130 - \$110 = \underline{\$20}$

### Notice 88-71 and Election Under 2006 Proposed Regulations (Dollar Basis Pooling Election):

- The IRC 959(c)(1) earnings and profits are reduced by 100u and the dollar basis of the combined PTEP accounts is reduced by \$110 ( $(100u/200u \times \$220)$ ).
- Since the spot rate at the time of the 100u distribution to DP is  $1u = \$1.30$ , DP recognizes foreign currency gain under IRC 986(c) of \$20 ( $\$130 - \$110$ ).

# Summary of Potential Issues

## Computation and Review of IRC 986(c) Gain or Loss - Pre-TCJA

|                                |  |
|--------------------------------|--|
| <a href="#"><u>Issue 1</u></a> | Did the taxpayer correctly compute an IRC 986(c) exchange gain or loss on the distribution of PTEP to its U.S. parent?   |
| <a href="#"><u>Issue 2</u></a> | Was the distribution of PTEP to the U.S. parent resulting in the IRC 986(c) exchange gain or loss part of a step transaction that should be collapsed, a transaction lacking a business purpose, and/or a transaction that lacks economic substance? |

# All Issues, Step 1: Initial Factual Development

## Computation and Review of IRC 986(c) Gain or Loss - Pre-TCJA

Regardless of the methodology utilized by the taxpayer, certain issues must be determined prior to review of the taxpayer's IRC 986(c) gain or loss computation as discussed below.

| Fact Element   | Resources  |
|--|--|
| <p><u>What Type of Foreign Entity Made the Distribution?</u></p> <ul style="list-style-type: none"> <li>▪ The entity making the distribution of PTEP must be a controlled foreign corporation. A distribution by a foreign disregarded entity (FDE) and foreign disregarded partnership (FDP) to their U.S. parent does not result in a distribution of PTEP.</li> </ul>   | <ul style="list-style-type: none"> <li>▪ Form 5471 (versus Form 8865 or 8858)</li> </ul> |
| <p><u>Did the Taxpayer Have PTEP to Distribute?</u></p> <ul style="list-style-type: none"> <li>▪ If the taxpayer makes a distribution without related PTEP, a Section 986(c) computation is not reported.</li> </ul>   | <ul style="list-style-type: none"> <li>▪ Form 5471, Schedule J</li> </ul>                |
| <p><u>Was the Distribution Part of a Reorganization or Restructuring Plan?</u></p> <ul style="list-style-type: none"> <li>▪ If the distribution was part of a restructuring or reorganization plan, the entire step plan should be reviewed to ascertain the correct computation of the IRC 986(c) adjustment.               <ul style="list-style-type: none"> <li>– IDR Request for:                   <ul style="list-style-type: none"> <li>▪ Step Plan.</li> <li>▪ Journal Entries Detail.</li> <li>▪ Detail of distribution of PTEP from lower tier CFC to U.S. parent if applicable.</li> </ul> </li> </ul> </li> </ul> |  |

# All Issues, Step 1: Initial Factual Development (cont'd)

## Computation and Review of IRC 986(c) Gain or Loss - Pre-TCJA

| Fact Element   | Resources  |
|--|--|
| <p><u>Did the Taxpayer Make a Distribution of PTEP Under IRC 959?</u></p> <ul style="list-style-type: none"> <li>▪ Some distributions do not qualify as a distribution under IRC 959.</li> <li>▪ Distributions under IRC 965(b) should be stated separately in the taxpayer's workpapers for all distributions made after 2017 since an IRC 986(c) exchange gain or loss is not computed on these distributions. Additionally, any gain or loss recognized under IRC 986(c) with respect to distributions of IRC 965(a) PTEP is reduced in the same proportion as the reduction by a IRC 965(c) deduction amount of the IRC 965(a) inclusion amount that gave rise to such IRC 965(a) PTEP.</li> <li>▪ Determine whether the taxpayer made any changes to prior year PTEP in the preparation of their IRC 965(b) distribution that in turn impacts their pre-TCJA computations.</li> </ul> | <ul style="list-style-type: none"> <li>▪ Foreign Currency PN Suggested IDR No. 6</li> <li>▪ IRC 965(b),</li> <li>▪ Prop. Treas. Reg. 1.986(c)-1</li> </ul> |
| <p><u>Was the PTEP Distribution by the CFC Denominated in a Functional Currency Other Than the U.S. Dollar?</u></p> <ul style="list-style-type: none"> <li>▪ The original distribution must have been in a functional currency other than its U.S. parent in order to be a distribution subject to IRC 986(c).</li> <li>▪ # [REDACTED] #</li> </ul>  | <ul style="list-style-type: none"> <li>▪ # [REDACTED] #</li> </ul>   |

# All Issues, Step 1: Initial Factual Development (cont'd)

## Computation and Review of IRC 986(c) Gain or Loss - Pre-TCJA

| Fact Element   | Resources  |
|--|--|
| <p><u>Was the Distribution of PTEP Ultimately Made to the U.S. Parent?</u></p> <ul style="list-style-type: none"> <li>▪ CFC to CFC distributions are not subject to IRC 986(c) unless they are part of a chain distribution to the ultimate U.S. parent.</li> <li>▪ CFC (non-US dollar functional currency) to CFC (US dollar functional currency) should be noted in these step plans to assure that IRC 986(c) exchange gain/loss is recognized when distributed to the U.S. parent.               <ul style="list-style-type: none"> <li>- IDR Request for:                   <ul style="list-style-type: none"> <li>▪ Step Plan describing chain distribution to ultimate U.S. parent.</li> <li>▪ Journal entries supporting distributions among related parties.</li> </ul> </li> </ul> </li> </ul> |  |
| <p><u>Did the Taxpayer Maintain Documentation of PTEP and Prior Year Distributions?</u></p> <ul style="list-style-type: none"> <li>▪ Form 5471, Schedule J should document the taxpayer's PTEP at the beginning of the year in the CFC's functional currency.</li> <li>▪ However, the taxpayer should maintain documentation of any PTEP in both the CFC's functional currency and the U.S. dollar during the year of conversion as well as any distributions that reduced PTEP in prior years.</li> </ul>   | <ul style="list-style-type: none"> <li>▪ Form 5471, Schedule J</li> <li>▪ Foreign Currency PN Suggested IDR No. 6</li> </ul> |

# All Issues, Step 1: Initial Factual Development (cont'd)

## Computation and Review of IRC 986(c) Gain or Loss - Pre-TCJA

| Fact Element   | Resources   |
|--|---|
| <p><u>Did the Taxpayer Report a Change in Functional Currency for This CFC in the Year of Distribution or in a Year Prior to the Distribution?</u></p> <ul style="list-style-type: none"><li>▪ Either of these scenarios could result in changes in the computation for the IRC 986(c) gain or loss.</li><li>▪ If the CFC changed from a non-US functional currency to a US dollar functional currency, this CFC should recognized section 986(c) gain or loss on all of its PTEP under Treas. Reg. 1.985-5.</li></ul> | <ul style="list-style-type: none"><li>▪ Form 3115 (if filed)</li></ul>                |
| <p><u>Did the Taxpayer Have Pre-1987 Earnings and Profits?</u></p> <ul style="list-style-type: none"><li>▪ Specific guidance has been published for treatment and ordering of distributions from pre-1987 E&amp;P and post-1986 E&amp;P when a taxpayer has both types of E&amp;P.</li></ul>   | <ul style="list-style-type: none"><li>▪ Notice 88-70</li><li>▪ Notice 88-71</li></ul> |

# Issue 1, Step 2: Review Potential Issues

## Computation and Review of IRC 986(c) Gain or Loss - Pre-TCJA

### Issue 1

Did the taxpayer correctly compute an IRC 986(c) exchange gain or loss on the distribution of PTEP to its U.S. parent?

| Explanation of Issue   | Resources |
|--|-----------|
| <p><u>Were the Correct Dates Used in the Computation?</u></p> <ul style="list-style-type: none"><li>▪ Review of journal entries requested in IDR.</li><li>▪ The examiner should review the journal entries that support the computation in order to assure that correct dates are used.</li><li>▪ If a planned distribution date and the actual distribution occurred on different dates but the taxpayer's computation does not reflect these differences, an audit adjustment may be required if the difference in the spot rates on these dates differ significantly.</li></ul> |           |
| <p><u>Was the Correct Exchange Rate Used in the Computation?</u></p> <ul style="list-style-type: none"><li>▪ Review of taxpayer's source of exchange rates utilized requested in IDR.</li><li>▪ The examiner should also review the taxpayer's exchange rates in order to assure that the correct exchange rates were used.</li><li>▪ For instance, review of exchange rate tables could show that the taxpayer used an average versus spot rate or the rate utilized could be for the wrong date (see above).</li></ul>   |           |

# Issue 1, Step 2: Review Potential Issues (cont'd)

## Computation and Review of IRC 986(c) Gain or Loss - Pre-TCJA

### Issue 1

| Explanation of Issue  | Resources   |
|---|---|
| <p><u>Did the Taxpayer Properly Follow the Methodology Outlined in Either Notice 88-71 or the IRC 959 Proposed Regulations?</u></p> <ul style="list-style-type: none"> <li>▪ The two published methodologies provide specific examples regarding lower tier distributions, ordering rules, and treatment of distributions related to mergers and reorganizations.</li> <li>▪ Inconsistencies between the taxpayer's computation and methodology utilized should be questioned further and could result in an audit adjustment.</li> </ul>   | <ul style="list-style-type: none"> <li>▪ Foreign Currency PN Suggested IDR No. 6</li> </ul>                   |
| <p><u>What Methodology Should be Utilized if the Taxpayer has Never Previously Computed an IRC 986(c) Gain or Loss and Should Recognize This in the Current Period?</u></p> <ul style="list-style-type: none"> <li>▪ Review taxpayer's workpapers for IRC 959 distributions to determine methodology.</li> <li>▪ Request information from taxpayer if multiple methodologies are observed.</li> <li>▪ LIFO is default rule in 959 final regulations from the 1960's for distribution of PTEP.</li> <li>▪ The examiner should note the taxpayer's methodology utilized for IRC 959 computations generally.</li> <li>▪ Inconsistencies can occur on methodologies utilized by the taxpayer due to acquisitions of entities historically utilizing a different methodology.</li> <li>▪ Understanding of the taxpayer's historical methodologies for IRC 959 distributions can provide guidance for determining the correct methodology for the computation of an IRC 986(c) gain or loss.</li> </ul> | <ul style="list-style-type: none"> <li>▪ 2006 Proposed IRC 959 Regulations</li> <li>▪ Notice 88-71</li> </ul> |

# Issue 1, Step 3: Additional Factual Development

## Computation and Review of IRC 986(c) Gain or Loss - Pre-TCJA

### [Issue 1](#)

| Fact Element   | Resources |
|--|-----------|
| <p><u>The Taxpayer Utilizes a Different Distribution Date Than the Date Reflected in the Related Computation.</u></p> <ul style="list-style-type: none"><li>▪ This information should be available from the response to Foreign Currency PN Suggested IDR No. 6.</li><li>▪ If not able to determine from IDR response, additional IDR and/or discussion with taxpayer regarding the discrepancy in the utilization of dates may be needed.</li></ul>                               |           |
| <p><u>The Taxpayer's Exchange Rate Does Not Generally Approximate the Rate Found by the Examiner in the Publicly Listed Resources.</u></p> <ul style="list-style-type: none"><li>▪ This information should be available from the response to Foreign Currency PN Suggested IDR No. 6.</li><li>▪ If not able to determine from IDR response, additional IDR and/or discussion with taxpayer regarding the discrepancy in the utilization of exchange rates may be needed.</li></ul> |           |

# Issue 1, Step 3: Additional Factual Development

## Computation and Review of IRC 986(c) Gain or Loss - Pre-TCJA

### [Issue 1](#)

| Fact Element   | Resources |
|--|-----------|
| <p><u>The Taxpayer Utilized Inconsistent Methodology to Compute the IRC 986(c) Exchange Gain or Loss from Prior Years.</u></p> <ul style="list-style-type: none"><li>▪ This information should be available from the response to Foreign Currency PN Suggested IDR No. 6.</li><li>▪ If not able to determine from IDR response, additional IDR and/or discussion with taxpayer regarding the inconsistent methodology may be needed.</li></ul>   |           |
| <p><u>The Taxpayer Failed to Compute an IRC 986(c) Exchange Gain or Loss on the Distribution of PTEP.</u></p> <ul style="list-style-type: none"><li>▪ This information should be available from the response to Foreign Currency PN Suggested IDR No. 6.</li><li>▪ If not able to determine from IDR response, additional IDR and/or discussion with taxpayer regarding the failure to report the exchange gain or loss may be needed.</li></ul> |           |

# Issue 1, Step 4: Develop Arguments

## Computation and Review of IRC 986(c) Gain or Loss - Pre-TCJA

### [Issue 1](#)

| Explanation of Adjustment  | Resources  |
|--|--|
| <p> <b>DECISION POINT:</b> Whether to proceed with this issue is usually based on materiality. An adjustment based on these changes may be de minimis and may not require an adjustment.</p> <p>If the responses and/or discussions with the taxpayer indicate that the incorrect information or methodology was used to compute the original tax liability (or the computation was not made), a revised computation should be presented to the taxpayer in a Notice of Proposed Adjustment.</p> | <ul style="list-style-type: none"><li>▪ 2006 Proposed IRC 959 Regulations</li><li>▪ Notice 88-71</li></ul> |

# Issue 2, Step 2: Review Potential Issues

## Computation and Review of IRC 986(c) Gain or Loss - Pre-TCJA

### Issue 2

Was the distribution of PTEP to the U.S. parent resulting in the IRC 986(c) exchange gain or loss part of a step transaction that should be collapsed, a transaction lacking a business purpose, and/or a transaction that lacks economic substance?

| Explanation of Issue  | Resources |
|---|-----------|
| <p><u>Did the Distribution Result in Dividend Payments to the U.S. Parent?</u></p> <ul style="list-style-type: none"> <li>▪ IDR Request for:                             <ul style="list-style-type: none"> <li>- Journal entries made by all related parties involved in the transaction.</li> <li>- Documentation for cash payments and receipts (or property distribution if qualified as a dividend) for all parties involved in the transaction.</li> </ul> </li> <li>▪ If the distribution was only recorded for book purposes and no dividend was paid, the distribution may have been recorded to trigger an exchange loss under IRC 986(c) for tax purposes.</li> </ul>  |           |
| <p><u>Was the Cash Payment Part of a Daylight Loan Payment?</u></p> <ul style="list-style-type: none"> <li>▪ IDR Request for:                             <ul style="list-style-type: none"> <li>- Cash account(s) utilized to make the cash payment.</li> <li>- Documentation regarding loans with unrelated third parties utilized to make the cash payments from the CFC to its parent.</li> </ul> </li> <li>▪ Did the CFC have enough cash to make the distribution to the U.S. parent? The distributing CFC's books and records should be reviewed to determine this fact.</li> <li>▪ If a daylight loan was utilized to make the distribution of cash from the CFC to its parent, there may be no intent to make an actual distribution to the parent and instead may be recorded to trigger an exchange loss under IRC 986(c) for tax purposes.</li> </ul> |           |

# Issue 2, Step 2: Review Potential Issues (cont'd)

## Computation and Review of IRC 986(c) Gain or Loss - Pre-TCJA

### [Issue 2](#)

| Explanation of Issue   | Resources |
|--|-----------|
| <p><u>Was the Distributed Cash Utilized as an Investment in the Distributing CFC?</u></p> <ul style="list-style-type: none"> <li>▪ IDR Request for:           <ul style="list-style-type: none"> <li>– General ledger detail for any intercompany transactions between the payor and payee.</li> </ul> </li> <li>▪ If an actual cash distribution was made by the CFC, an examiner should review whether this distribution was later invested by the U.S. parent back into the distributing CFC.</li> <li>▪ If a daylight loan was utilized by the CFC to record the distribution, the U.S. parent would be required to transfer the cash back to the CFC in a short time frame.</li> <li>▪ The examiner should determine whether this reinvestment resulted in an increase of capital in the CFC or whether the reinvestment was treated as a cash infusion resulting in a note payable by the CFC to its U.S. parent.</li> </ul>                               |           |
| <p><u>Was the IRC 986(c) Loss Generated by Using Intercompany Loans to Transfer Funds from a High E&amp;P CFC to a CFC with Built in PTEP and/or IRC 986(c) Losses?</u></p> <ul style="list-style-type: none"> <li>▪ IDR Request for:           <ul style="list-style-type: none"> <li>– General ledger detail for intercompany loans involving distribution payor that provided funds to make distribution.</li> <li>– Loan documents for intercompany loans involving distribution payor that provided funds to make distribution.</li> </ul> </li> <li>▪ If the CFC reporting the IRC 986(c) loss did not have sufficient funds to pay the distribution, an intercompany loan from a high E&amp;P (but low PTEP) CFC to the reporting CFC may be made to fund the distribution.</li> <li>▪ The examiner should review the intercompany loan documents to determine the business purpose of the loan as well as the economic substance of the loan.</li> </ul> |           |

# Issue 2, Step 3: Additional Factual Development

## Computation and Review of IRC 986(c) Gain or Loss - Pre-TCJA

### Issue 2

| Fact Element   | Resources  |
|--|--|
| <p> <b>CONSULTATION:</b> If the payment from the distributing CFC to the U.S. parent was achieved by utilizing a daylight facility or journal entries without the movement of cash, local counsel should be obtained to further determine the facts and circumstances of the transaction and determine whether an audit adjustment should be pursued. The Foreign Currency Practice Network and IRS Local Counsel should also be contacted for assistance in the development of the issue.</p> <p># [REDACTED] #</p> | <ul style="list-style-type: none"> <li>▪ Substance Over Form Doctrine: see <i>Comm’r v. National Alfalfa Dehydrating &amp; Milling Co.</i>- 417 U.S. 134 (1974).</li> <li>▪ Step Transaction Doctrine: see <i>Gregory v Helvering</i> - 293 U.S. 465 (1935).</li> <li>▪ Economic Substance Doctrine: IRC 7701(o).</li> </ul> |
| <p> <b>CONSULTATION:</b> If the payment from the distributing CFC to the U.S. parent was achieved by initiating loans from high E&amp;P CFC(s) to the distributing CFC, local counsel should be obtained to further determine the facts and circumstances of the transaction and determine whether an audit adjustment should be pursued. The Foreign Currency Practice Network and IRS Local Counsel should also be contacted for assistance in the development of the issue.</p> <p># [REDACTED] #</p>            | <ul style="list-style-type: none"> <li>▪ Substance Over Form Doctrine: see <i>Comm’r v. National Alfalfa Dehydrating &amp; Milling Co.</i>- 417 U.S. 134 (1974).</li> <li>▪ Step Transaction Doctrine: see <i>Gregory v Helvering</i> - 293 U.S. 465 (1935).</li> <li>▪ Economic Substance Doctrine: IRC 7701(o).</li> </ul> |

# Issue 2, Step 4: Develop Arguments

## Computation and Review of IRC 986(c) Gain or Loss - Pre-TCJA

### [Issue 2](#)

| Explanation of Adjustment  | Resources |
|--|-----------|
| <p> <b>DECISION POINT:</b> Whether to proceed with this issue is usually based on materiality. An adjustment based on these changes may be de minimis and may not require an adjustment.</p> <p>If the responses and/or discussions with the taxpayer # [REDACTED] # indicate that:</p> <ul style="list-style-type: none"><li>▪ The transaction was part of a step transaction that should be collapsed,</li><li>▪ The transaction lacks a business purpose, and/or</li><li>▪ The transaction lacks economic substance,</li></ul> <p>a revised computation should be presented to the taxpayer in a Notice of Proposed Adjustment.</p> |           |

# Index of Referenced Resources

## Computation and Review of IRC 986(c) Gain or Loss - Pre-TCJA

IRC 959 and related final regulations

2006 Proposed IRC 959 Regulations

IRC 965(b)

IRC 986

Treas. Reg. 1.985-5

Prop. Treas. Reg. 1.986(c)-1

Notice 88-70

Notice 88-71

Foreign Currency PN Suggested IDR No. 6

Form 5471

Form 5471, Schedule J

# [REDACTED] #

*Comm'r v. National Alfalfa Dehydrating & Milling Co.* - 417 U.S. 134 (1974).

*Gregory v. Helvering* - 293 U.S. 465 (1935).

IRC 7701(o)

# Training and Additional Resources

| Computation and Review of IRC 986(c) Gain or Loss - Pre-TCJA |   |
|--|---|
| Type of Resource   | Description(s)  |
| Reference Materials  | <ul style="list-style-type: none"> <li>▪ <i>BNA Tax Management Int'l Portfolio</i> 921-2<sup>nd</sup></li> <li>▪ <i>Bittker and Lokken - Fundamentals of International Taxation</i> Para 74.2</li> <li>▪ <i>Keyes - Federal Taxation of Financial Instruments and Transactions</i>, Chapter 15</li> <li>▪ <i>Mertens - Law of Federal Income Taxation</i>, Chapter 45C</li> </ul>   |
| Other Training Materials                                     | <ul style="list-style-type: none"> <li>▪ IE Phase III: <i>IRC 985 and 989: Foreign Currency Terms and Definitions</i></li> <li>▪ IE Phase III: <i>Section 986 Translation Rules</i></li> <li>▪ IE Phase III: <i>Sec 987 - Branch Rules and CTB Rules</i></li> <li>▪ IE Phase III: <i>Foreign Currency Section 988 Transactions</i></li> <li>▪ IE Phase III: <i>Foreign Currency Hedging</i></li> <li>▪ IE Phase III: <i>Financial Products Basics - Four Major Categories</i></li> <li>▪ IE Phase I: <i>Module E - Lesson 1 Foreign Currency</i></li> <li>▪ IE Phase III, <i>Module D - Interaction of International and Financial Products Issues</i></li> <li>▪ FP Phase 1: <i>Lesson 9 - Foreign Currency</i></li> <li>▪ FP Phase III: <i>Lesson 4 - Foreign Currency</i></li> </ul> |

# Glossary of Terms and Acronyms

| Term/Acronym | Definition  |
|--------------|---|
| CFC          | Controlled Foreign Corporation                          |
| CY           | Calendar Year   |
| E&P          | Earnings and Profits                                    |
| FC           | Functional Currency                                     |
| FDE          | Foreign Disregarded Entity                              |
| FP           | Foreign Partnership                                     |
| FR           | Foreign Parent CFC (1 <sup>st</sup> tier CFC)           |
| FS           | Foreign Subsidiary CFC (2 <sup>nd</sup> tier CFC)       |
| IRC          | Internal Revenue Code                                   |
| LIFO         | Last In, First Out                                      |
| PN           | Practice Network  |
| PTEP         | Previously Taxed Earning and Profits                    |
| TCJA         | Tax Cuts and Jobs Act                                   |
| u            | Generic functional currency that is not the U.S. dollar |
| USD          | US Dollar functional currency                           |
| USP          | U.S. Parent Corporation                                 |

# Index of Related Practice Units

| Associated UIL(s) | Related Practice Unit  |
|-------------------|--|
| 9470              | <i>Change in Functional Currency Section 985 Procedural Matters and Calculation</i>      |
| 9470              | <i>Character of Exchange Gain or Loss</i>  |
| 9470              | <i>Definition of Appropriate Exchange Rate Overview</i>                                  |
| 9470              | <i>Disposition of a Portion of an Integrated Hedge</i>                                   |
| 9470              | <i>Exchange Gains or Losses on Payables and Receivables</i>                              |
| 9470              | <i>Functional Currency Determination</i>   |
| 9470              | <i>How to Assess Penalties for Failure to File a Form 8886 Disclosing IRC 988 Losses</i> |
| 9470              | <i>Official vs Free Market Exchange Rate</i>   |
| 9470              | <i>Overview of IRC Section 988 Nonfunctional Currency Transactions</i>                   |
| 9470              | <i>Overview of Qualified Business Units QBUs</i>   |
| 9470              | <i>Sourcing of Exchange Gains or Losses in Currency Transactions</i>                     |
| 9470              | <i>Functional Currency of a QBU</i>  |
| 9470              | <i>Disposition of Nonfunctional Currency</i>   |