



Internal Revenue Service

DEPARTMENT OF THE TREASURY

LB&I Concept Unit

Unit Name	Limitation of Exchange Gain or Loss on Payment or Disposition of Debt Instrument	
Primary UIL Code	9470.02-01	Recognition and computation of exchange gain or loss - general

Library Level	Title
Knowledge Base	International
Shelf	Crossover
Book	Foreign Currency
Chapter	Recognition and Computation of Exchange Gain or Loss - General

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General Overview

Limitation of Exchange Gain or Loss on Payment or Disposition of Debt Instrument

The determination of foreign currency (FX) gains and losses under IRC Section 988 is one of the major strategic priorities for the Foreign Currency Practice Network (PN) on the Crossover portion of the International Matrix. In a global economy, many U.S. Multinational Enterprises (MNEs) are doing business in currencies other than the U.S. dollar (USD). These transactions may be one-time transactions (e.g., a loan denominated in an FX), or as part of the ongoing operations of a business unit (e.g., payable and receivable denominated in an FX). To the extent that the transactions are denominated in a currency other than the USD for a U.S. corporation (or are determined by reference to the value of one or more nonfunctional currencies for foreign corporations), MNEs may have FX fluctuation risk. The values of many foreign currencies and the associated exchange rates can change dramatically over a period of years. Depending upon whether the MNE taxpayer has any nonfunctional currency denominated assets or liabilities which are Section 988 covered transactions, there may be gains and/or losses due to the currency fluctuations.

The purpose of this Unit is to cover some basic FX principles related to the currency transactions that MNEs may enter into during the course of its business and show how changes in exchange rates will impact an MNE. Two issues must be considered in the early stages of the examination for planning purposes: (1) whether the MNE has nonfunctional currency denominated transactions that are covered under Section 988; and (2) the direction of the exchange rates for the foreign currencies during the period under examination which determine whether the section 988 transactions will have a gain or loss.

As the value of the currencies in which the transactions are denominated increases or decreases relative to the USD, the MNE will have unrealized exchange gains or losses. When these unrealized exchange gains and losses are eventually recognized for tax purposes, MNE's taxable income will be affected. Certain FX transactions that are denominated in terms of a nonfunctional currency or are determined by reference to the value of one or more nonfunctional currencies, may generate exchange gains or losses which are subject to IRC Section 988 ("section 988 transactions").

General Overview (cont'd)

Limitation of Exchange Gain or Loss on Payment or Disposition of Debt Instrument

For example, if the MNE has a nonfunctional currency denominated loan or note receivable and the exchange rate of the nonfunctional currency rate has appreciated against the USD, then the MNE will have an exchange gain because of the fluctuations in the exchange rate; conversely, if the exchange rate/value of the nonfunctional currency has depreciated against the USD, the MNE will have an exchange loss on the loan or note receivable because of fluctuations in the exchange rate/value. If the MNE has a loan or note payable which is denominated in a nonfunctional currency and the nonfunctional currency appreciates against the USD, it would cost the MNE more in USD to pay off the loan at maturity and therefore result in an exchange loss; any depreciation of the nonfunctional currency against the USD would result in a lower cost to the MNE to pay off the loan at maturity and therefore would result in an exchange gain.

The Practice Units on Qualified Business Units (QBUs), 988 Transactions, and Functional Currency (FC) should also be considered in order to understand the basic terms used in FX transactions. Fluctuations in the FX exchange rate also impact Section 987 covered transactions, which will be covered in a future Practice Unit.


Detailed Explanation of the Concept

Limitation of Exchange Gain or Loss on Payment or Disposition of Debt Instrument

Depending upon whether the MNE has a transaction denominated in an FX which is a Section 988 transaction, changes in the FX exchange rates may result in an exchange gain or loss to the MNE.

Analysis	Resources												
<p>The diagram below is meant to illustrate the potential impact of changes in the exchange rates of FX denominated assets and liabilities. It is intended for general informational purposes, context and risk analysis purposes only. (It should not be interpreted to mean that if one side of a transaction has a gain, the other side will have a loss).</p> <p>GENERAL INFORMATION: Exchange Gain/Loss Chart (for U.S. taxpayer with a nonfunctional currency loan or note):</p> <table style="margin-left: auto; margin-right: auto;"> <tr> <td></td> <td colspan="2" style="text-align: center;"> -----Loan or Note----- </td> </tr> <tr> <td></td> <td style="text-align: center;"><u>Asset</u></td> <td style="text-align: center;"><u>Liability</u></td> </tr> <tr> <td>FX increases in value</td> <td style="text-align: center;">Exchange Gains</td> <td style="text-align: center;">Exchange Losses</td> </tr> <tr> <td>FX decreases in value</td> <td style="text-align: center;">Exchange Losses</td> <td style="text-align: center;">Exchange Gains</td> </tr> </table>		-----Loan or Note-----			<u>Asset</u>	<u>Liability</u>	FX increases in value	Exchange Gains	Exchange Losses	FX decreases in value	Exchange Losses	Exchange Gains	
	-----Loan or Note-----												
	<u>Asset</u>	<u>Liability</u>											
FX increases in value	Exchange Gains	Exchange Losses											
FX decreases in value	Exchange Losses	Exchange Gains											

Detailed Explanation of the Concept (cont'd)

Limitation of Exchange Gain or Loss on Payment or Disposition of Debt Instrument	
Analysis	Resources
 CONSULTATION: Consider consulting with the Financial Institutions & Products (FIP) PN which has substantial experience in debt instruments, derivatives and other financial assets or liabilities that may be involved with transactions covered in this Unit. Also, visit the Financial Institutions & Products Knowledge Base.	<ul style="list-style-type: none">▪ Financial Institutions & Products Knowledge Base - IRS Virtual Library

Examples of the Concept

Limitation of Exchange Gain or Loss on Payment or Disposition of Debt Instrument

Example: Steps in Calculating an Exchange Gain or Loss and Overall Gain or Loss

The following steps should be taken to calculate the exchange gain or loss when a U.S. Taxpayer lends or borrows in a nonfunctional currency, and the exchange rate changes from the origination date of the loan to the repayment date resulting in an exchange gain or loss:

Step 1: Calculate the amount of the exchange gain or loss.

Step 2: Calculate the total overall gain or loss on the transaction.

Step 3: Compare the amount of the exchange gain or loss to the total overall gain or loss on the transaction. An exchange gain or loss on the payment/disposition of debt instruments should be recognized only to the extent of the total overall gain or loss on the transaction.

When a debt instrument is denominated in a nonfunctional currency (as described in Treas. Reg. 1.988-2(b)(2)(i)) and is paid, disposed of, or transferred to another person, the exchange gain or loss realized shall be realized only to the extent of the total gain or loss realized on the transaction. Treas. Reg. 1.988-2(b)(8)

Likewise, if a taxpayer's right to receive income or an obligation to pay an expense is settled, transferred or modified in a transaction in which a gain or loss would otherwise be recognized, an exchange gain or loss shall be realized and recognized only to the extent of the total gain or loss on the transaction. Treas. Reg. 1.988-2(c)(1)

Examples of the Concept (cont'd)

Limitation of Exchange Gain or Loss on Payment or Disposition of Debt Instrument

Examples of a Section 988 Exchange Gain or Loss Calculation

1. [Example of an Exchange Gain Limited by Total Gain](#)
2. [Example of a Market Loss and an Exchange Gain](#)
3. [Example of a Market Loss and an Exchange Loss](#)

Examples of the Concept (cont'd)

Limitation of Exchange Gain or Loss on Payment or Disposition of Debt Instrument

Example of an Exchange Gain Limited by Total Gain

EXAMPLE FACTS

1. The FC of Taxpayer X is the USD.
2. On January 1, 20X2, X loans 10,000 Local Currency (LC).
3. X has a USD basis in the loan of \$13,000 (10,000 LC X \$1.30 spot rate on January 1, 20X2).
4. The terms of the loan provide that Y will repay X's 10,000 LC principal on December 31, 20X4.
5. X sells the loan for 9,821 LC on December 31, 20X3.
6. Assume the spot rates (LC to USDs) for the pertinent dates are as follows:
 - January 1, 20X2, 1 LC = \$1.30
 - December 31, 20X3, 1 LC = \$1.40
 - December 31, 20X4, 1 LC = \$1.45

Examples of the Concept (cont'd)

Limitation of Exchange Gain or Loss on Payment or Disposition of Debt Instrument

Example of an Exchange Gain Limited by Total Gain

Step 1: Isolate Amount of FX Gain or Loss on Sale Date

	<u>Local Currency</u>		<u>FX Rate</u>	=	<u>US Dollars</u>	<u>US Dollars</u>
Spot Value of LC loan - 12/31/20X3	10,000	x	1.40	=	14,000	
Original USD Basis of LC loan	(10,000)	x	1.30	=	<u>(13,000)</u>	
FX gain (loss) on LC loan						1,000

Step 2: Calculation of Overall Gain or Loss

Spot Value of Loan on sale date	9,821	x	1.40	=	13,750	
Original USD Basis	(10,000)	x	1.30	=	<u>(13,000)</u>	
Overall total gain (loss)						750

Step 3: Determine Limitation and Character

FX gain (loss) on LC loan	10,000	x	.010 (*)	=	1,000	
Market Loss on loan (10,000-9,821 LC)	(179)	x	1.40	=	<u>(250)</u>	

Limitation of FX Gain					<u>750</u>	Realize only exchange gain, no market loss.
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(*) change in exchange rate (1.40 – 1.30)

Examples of the Concept (cont'd)

Limitation of Exchange Gain or Loss on Payment or Disposition of Debt Instrument

Example of a Market Loss and an Exchange Gain

EXAMPLE FACTS

1. The FC of Taxpayer X is the US dollar.
2. On January 1, 20X2, X loans 10,000 Local Currency (LC) to Y for 3 years.
3. X has a basis in the 10,000 LC loaned to Y of \$13,000 calculated at the spot rate of 1 LC=\$1.30 on January 1, 20X2.
4. The terms of the loan provide that Y will repay X's 10,000 LC principal on December 31, 20X4.
5. X settles the loan to Y for 8,000 LC on 12/31/20X4.
6. Assume the spot rates (LC to USDs) for the pertinent dates are as follows:
 - January 1, 20X2 1, LC = \$1.30
 - December 31, 20X4, 1 LC = \$1.45

Examples of the Concept (cont'd)

Limitation of Exchange Gain or Loss on Payment or Disposition of Debt Instrument

Example of a Market Loss and an Exchange Gain

Step 1: Isolate Amount of FX Gain or Loss on Settlement

	<u>Local Currency</u>		<u>FX Rate</u>		<u>US Dollars</u>	<u>US Dollars</u>
Spot Value of LC loan - 12/31/2004	10,000	x	1.45	=	14,500	
Original USD Basis of LC loan	(10,000)	x	1.30	=	<u>(13,000)</u>	
FX gain (loss) on LC loan						1,500

Step 2: Calculation of Overall Gain or Loss

Spot value on settlement	8,000	x	1.45	=	11,600	
Original USD Basis	(10,000)	x	1.30	=	<u>(13,000)</u>	
Overall total gain (loss)						(1,400)

Step 3: Determine Limitation and Character

FX gain (loss) on LC loan	10,000	x	0.15 (*)	=	1,500	
Market Loss on loan (\$10,000-8,000)	(2,000)	x	1.45	=	<u>(2,900)</u>	
Limitation of FX Gain						-0-
Market Loss						<u>(1,400)</u>

Realize only market loss, no exchange gain.

(*) Change in exchange rate (1.45 – 1.30)

Examples of the Concept (cont'd)

Limitation of Exchange Gain or Loss on Payment or Disposition of Debt Instrument

Example of a Market Loss and an Exchange Loss

EXAMPLE FACTS

1. The FC of Taxpayer X is the US dollar.
2. On January 1, 20X2, X loans 10,000 Local Currency (LC) to Y for 3 years.
3. X has a basis in the 10,000 LC loaned to Y of \$13,000 calculated at the spot rate of 1 LC=\$1.30 on January 1, 20X2.
4. The terms of the loan provide that Y will repay X's 10,000 LC principal on December 31, 20X4.
5. X settles the loan to Y for 8,000 LC on 12/31/2004.
6. Assume the spot rates (LC to USDs) for the pertinent dates are as follows:
 - January 1, 20X2, 1 LC = \$1.30
 - December 31, 20X4, 1 LC = \$1.25

Examples of the Concept (cont'd)

Limitation of Exchange Gain or Loss on Payment or Disposition of Debt Instrument

Example of a Market Loss and an Exchange Loss

Step 1: Isolate Amount of FX Gain or Loss on Settlement

	Nonfunctional Currency		FX Rate	=	US Dollars	US Dollars
Spot Value of LC loan - 12/31/2004	10,000	x	1.25	=	12,500	
Original USD Basis of LC loan	(10,000)	x	1.30	=	<u>(13,000)</u>	
FX gain (loss) on LC loan						(500)

Step 2: Calculation of Overall Gain or Loss

Spot value on settlement	8,000	x	1.25	=	10,000	
Original USD Basis	(10,000)	x	1.30	=	<u>(13,000)</u>	
Overall total gain (loss)						(3,000)

Step 3: Determine Limitation and Character

FX gain (loss) on LC loan	10,000	x	0.05 (*)	=	(500)	
Market Loss on loan (\$10,000-8,000)	(2,000)	x	1.25	=	<u>(2,500)</u>	
Limitation of FX Loss						(500)
Market Loss						<u>(2,500)</u>

Realize \$500 of exchange loss and \$2,500 of market loss.

(*) Change in exchange rate (1.30 – 1.25)

Index of Referenced Resources

Limitation of Exchange Gain or Loss on Payment or Disposition of Debt Instrument
IRC 987
IRC 988
Treas. Reg. 1.988-2(b)(8)
Treas. Reg. 1.988-2(c)(1)
Financial Institutions & Products Knowledge Base - IRS Virtual Library

Training and Additional Resources

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

Glossary of Terms and Acronyms

Term/Acronym	Definition
FC	Functional Currency
FIP	Financial Institutions & Products
FX	Foreign Currency
LC	Local Currency
MNE	U.S. Multi-national Enterprise
PN	Practice Network
QBU	Qualified Business Unit
USD	United States Dollar

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>
9470	<i>Computation and Review of IRC 986(c) Gain or Loss – Pre-TCJA</i>
9470	<i>Overview of IRC 986(c) Gain or Loss Prior to Tax Cuts and Jobs Act of 2017</i>