

Internal Revenue Service

Department of the Treasury

Washington, DC 20224

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Telephone Number:

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Date:

June 25, 2020

X =
Taxpayer =
Index =

Index Creator =
Trust =
State A =

Dear :

This is in response to your letter, dated X, requesting permission, pursuant to Treas. Reg. § 1.988-5(e), to use the method described below to determine the timing, character, and amount of foreign currency gain or loss on foreign currency denominated bonds and forward contracts entered into for the purpose of hedging the right to receive foreign currencies on such bonds.

FACTS

The Taxpayer will be a series of Trust, a State A statutory trust that is registered with the Securities and Exchange Commission (the "SEC") under the Investment Company Act of 1940, as amended, as an open-end management investment company. The Taxpayer will elect to be, and expects to qualify each year as, a "regulated investment company" under Subchapter M of the Internal Revenue Code of 1986, as amended (the "Code").

As provided in its prospectus and other public offering materials available to investors and in its public filings with the SEC, Taxpayer will seek to track the performance of the Index, which has been created by the Index Creator, a third party who is unrelated to the Taxpayer. The Index measures, in U.S. dollars, the performance of specified foreign currency denominated bonds after applying a foreign currency hedging method. The bonds included in the Index are selected, and the

foreign currency hedging method has been created, by the Index Creator. Under the Index Creator's foreign currency hedging method, the currency return on the foreign currency denominated bonds in the Index is offset (relative to the U.S. dollar) by rolling one-month forward contracts on those currencies. No adjustment is made to the hedge during the month to account for changes in the market value of the constituent bonds in the Index. The forward contracts are reset monthly to adjust the Index's relative positions in the foreign currency denominated bonds and forward contracts, including to account for the intra-month changes in market value of the foreign currency denominated bonds. The Index Creator's foreign currency hedging method is designed to reduce economic exposure to the foreign currency risk associated with the foreign currency denominated payments received on the bonds.

To track the performance of the Index, the Taxpayer will invest in a sampling of foreign currency denominated bonds included in the Index, and will enter into rolling monthly forward contracts to offset the effect of foreign currency rate fluctuations on the values of those foreign currency denominated bonds in the manner prescribed by the Index Creator's foreign currency hedging method. Any deviation from the Index Creator's hedging method will create so-called "tracking error" in the Taxpayer's portfolio returns relative to the Index's returns. The Taxpayer will seek to minimize such tracking error. Therefore, the Taxpayer intends to enter into forward contracts in an amount and manner that tracks the Index Creator's foreign currency hedging method as closely as possible.¹

Consistent with the Index Creator's foreign currency hedging method and in light of the large number of foreign currency denominated bonds in the Index and that are expected to be held by the Taxpayer, the Taxpayer will not execute its currency hedges on a bond-by-bond basis. Rather, in order to determine the appropriate notional amount of forward contracts needed to hedge each relevant currency in its portfolio, the Taxpayer will aggregate the projected market values of all of its bonds that are denominated in that currency. The Taxpayer also will include any foreign currency cash balances held by the Taxpayer as part of the foreign currency exposure being hedged by the monthly forward contracts.

For tax purposes, the Taxpayer will account for the forward contracts and foreign currency components of the foreign currency denominated bonds for each taxable year under its proposed tax accounting method. Under its proposed tax accounting method, the Taxpayer will determine its net realized foreign currency gain and loss in its portfolio by aggregating the foreign currency gain and loss realized in its different holdings during the year, including those generated from (i) foreign currency denominated bonds

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disposed of or with respect to which principal or interest payments were received during the year, (ii) non-U.S. dollar cash positions disposed of during the year and (iii) forward contracts closed or marked to market during the year. Each year, for purposes of determining the amount of realized foreign currency gain and loss:

- 1) The Taxpayer will mark to market all of the forward contracts that are outstanding as of year-end. The Taxpayer will determine gain or loss arising from the foreign currency component of each foreign currency denominated bond sold during the year by limiting such gain or loss to the overall amount of gain or loss on the sale, applying the netting rule of sections 988(b)(1) and (b)(2) of the Code and Treas. Reg. § 1.988-2(b)(8).
- 2) The Taxpayer will determine its net unrealized foreign currency gain and loss in its portfolio by aggregating the unrealized (“built-in”) foreign currency gain and loss in its foreign currency denominated bonds and non-U.S. dollar cash positions held at the end of the year. Each year, for purposes of determining the amount of unrealized foreign currency gain and loss: (a) the Taxpayer will disaggregate the foreign currency component embedded in each foreign currency denominated bond retained at year-end from the bond’s other economic components; and (b) the Taxpayer will not net the unrealized gain or loss arising from the foreign currency component of a foreign currency denominated bond against the unrealized loss or gain arising from the foreign currency denominated bond’s other components. Instead, it will measure the amount of unrealized foreign currency gain or loss on each foreign currency denominated bond on a gross basis.
- 3) The Taxpayer then will compare its net realized foreign currency gain or loss to its net unrealized foreign currency gain or loss, and defer any net realized foreign currency gain or loss to the extent of offsetting net unrealized foreign currency loss or gain. These deferred amounts will be treated as realized on the first day of the following taxable year (and will be included in the realized foreign currency gain and loss amount for purposes of that following year’s netting calculation). The Taxpayer will treat as ordinary income or loss any excess net realized foreign currency gain or loss that is not offset (deferred) under this calculation and will recognize it in the current taxable year.
- 4) If, in a nonrecognition transaction (e.g., under sections 311(a) and 852(b)(6) of the Code), the Taxpayer disposes of a foreign currency denominated bond with unrealized foreign currency gain or loss with respect to which realized foreign currency loss or gain has been (or otherwise would be) deferred under the above mechanisms, the Taxpayer will: (a) terminate the deferral of (and recognize) the realized foreign currency gain or loss to the extent of the corresponding unrealized foreign currency loss or gain in the distributed foreign currency denominated bond; and (b) recognize the corresponding unrealized foreign currency loss or gain in the distributed foreign currency denominated bonds. In calculating the Taxpayer’s net realized and

unrealized foreign currency gain and loss, the foreign currency component of each item of the foreign currency denominated bond (whether, for instance, such item is interest, market discount, or gain or loss) will be included in the Taxpayer's realized foreign currency gain or loss amount in the year such item is required to be taken into account under applicable realization provisions of the Code.

LAW

Section 988(d)(1) of the Code provides that, to the extent provided in regulations, if any section 988 transaction is part of a 988 hedging transaction, all transactions which are part of such 988 hedging transaction shall be integrated and treated as a single transaction or otherwise treated consistently for purpose of this subtitle.

Section 988(c)(1)(A) of the Code provides that the term "section 988 transaction" includes the acquisition of a debt instrument if the amount which the taxpayer is entitled to receive or is required to pay by reason of such transaction is denominated in terms of a nonfunctional currency.

Section 988(b)(1) of the Code provides that the term "foreign currency gain" means any gain from a section 988 transaction to the extent such gain does not exceed gain realized by reason of changes in exchange rates on or after the booking date and before the payment date. Section 988(b)(2) of the Code provides that the term "foreign currency loss" means any loss from a section 988 transaction to the extent such loss does not exceed the loss realized by reason of changes in exchange rates on or after the booking date and before the payment date.

Treas. Reg. § 1.988-2(b)(8) provides that when a nonfunctional currency denominated debt instrument is paid or disposed of, pursuant to sections 988(b)(1) and (2) of the Code, 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. The gain or loss realized shall be recognized in accordance with the general principles of the Code.

Section 988(d)(2) of the Code provides that the term "988 hedging transaction" means any transaction entered into by the taxpayer primarily to manage risk of currency fluctuations with respect to property which is held or to be held by the taxpayer, or to manage risk of currency fluctuations with respect to borrowings made or to be made, or obligations incurred or to be incurred, by the taxpayer and is identified by the Secretary or the taxpayer as being a 988 hedging transaction.

Treas. Reg. § 1.988-5(e) provides that in his sole discretion, the Commissioner may issue an advance ruling addressing the income tax consequences of a taxpayer's system of hedging either its net nonfunctional currency exposure or anticipated nonfunctional currency exposure. The ruling may address the character, source, and timing of both the section 988 transaction(s) making up the hedge and the underlying

transactions being hedged. The procedures for obtaining a ruling shall be governed by such pertinent revenue procedures and revenue rulings as the Commissioner may provide. The Commissioner will not issue a ruling regarding hedges of a taxpayer's investment in a foreign subsidiary.

ANALYSIS

As described in its prospectus and other offering materials that are filed publicly with the SEC and/or otherwise made publicly available by the Taxpayer (or its service providers), the Taxpayer will seek to track the performance of the Index as created by Index Creator. Consistent with that objective, the Taxpayer will enter into foreign currency forward contracts in an amount and manner that tracks the Index Creator's foreign currency hedging method as closely as possible. This hedging method is designed to reduce the Taxpayer's economic exposure to the foreign currency risk associated with the foreign currency denominated payments it receives on its bond portfolio.

RULING

Based on the information submitted and the representations made, we rule as follows:

Under the authority provided in Treas. Reg. § 1.988-5(e), we grant the Taxpayer permission to use the proposed tax accounting method described above for determining the timing, character, and amount of foreign currency related gain or loss on foreign currency denominated bonds and the forward contracts entered into for the purpose of hedging the right to receive foreign currency denominated payments on such bonds for the following reasons:

- 1) The investment fund which is being hedged has been designed to track the performance of an index created by an unrelated third party, which incorporates a foreign currency hedging method.
- 2) The underlying assets which are being hedged under the Taxpayer's foreign currency hedging method are bonds which are part of a publicly available investment fund.
- 3) The proposed tax accounting method is a foreign currency hedging method designed for the purpose of reducing economic exposure to the foreign currency risk associated with the foreign currency denominated payments received on the bonds and to track the Index Creator's foreign currency hedging method as closely as possible.

The ruling contained in this letter is based upon information and representations submitted by the Taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material

submitted in support of the request for the ruling, it is subject to verification on examination.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of the Code provides that this ruling may not be used or cited as precedent.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representatives.

Sincerely,

Steven D. Jensen
Senior Counsel, Branch 5
Office of the Associate Chief Counsel
(International)

cc: