

Office of Chief Counsel
Internal Revenue Service

memorandum

CC:LM: [REDACTED]:TL-N-1617-00
[REDACTED]

date:

to: [REDACTED], Team Manager
Attn: [REDACTED], International Examiner

from: Area Counsel
[REDACTED]

subject: **Recognition of Foreign Exchange Loss**
[REDACTED]

This memorandum responds to your request to develop a response to [REDACTED]'s additional submission regarding the [REDACTED] currency loss claimed by [REDACTED] for the year [REDACTED] in the amount of \$ [REDACTED]. This memorandum should not be cited as precedent.

Issue

Whether [REDACTED] is entitled to a \$ [REDACTED] claimed foreign currency loss in [REDACTED], arising from the deconsolidation of [REDACTED] (" [REDACTED]").

Conclusion

Since [REDACTED] elected to use DASTM to determine [REDACTED]'s taxable income for post [REDACTED] tax years, [REDACTED] is not entitled to claim the \$ [REDACTED] currency loss.

Facts

The Examination Division ("Exam") conducted a federal tax audit of [REDACTED] ([REDACTED] for the [REDACTED] through [REDACTED] tax years. During the audit of [REDACTED]'s [REDACTED] through [REDACTED] tax returns Exam issued a Form 5701, Notice of Proposed Adjustment, disallowing [REDACTED]'s claimed foreign currency loss for [REDACTED] relative to the deconsolidation of [REDACTED]. The Form 5701 (attachment 1) details the factual and legal basis supporting the proposed adjustment.

[REDACTED] ([REDACTED]) was incorporated under the laws of Mexico on [REDACTED]. Beginning with [REDACTED]'s [REDACTED] taxable year, [REDACTED] elected under I.R.C. § 1504(d) to treat [REDACTED] as a domestic corporation that is included, as a foreign branch of a U.S. domestic corporation, in [REDACTED]'s consolidated U.S. tax return. For taxable years [REDACTED] - [REDACTED] the net worth method was used to determine [REDACTED]'s taxable income. [REDACTED] elected DASTM to determine [REDACTED] taxable income for post-[REDACTED] taxable years.

On [REDACTED], [REDACTED] issued [REDACTED] shares of its preferred stock to [REDACTED]. The sale of the preferred shares resulted in the deconsolidation of [REDACTED] pursuant to I.R.C. § 1504(d).

Exam, Appeals, and [REDACTED] discussed this issue during the opening conference for the [REDACTED] through [REDACTED] audit cycle on [REDACTED]. Appeals subsequently issued a memorandum dated [REDACTED], outlining a number of follow-up items for various issues, including the [REDACTED] currency loss. Specifically, Appeals noted:

The issue is whether or not a DASTM branch should be treated as an I.R.C. § 987 profit or loss branch. This is not a recurring issue but it does impact E&P, subpart F income, and FTCs arising from Mexico for the current and subsequent year. The RAR amount is \$ [REDACTED] and the protest amount is \$ [REDACTED]. [REDACTED] concedes the difference of \$ [REDACTED] which it stated is attributable to E&P pool adjustments in the DASTM recalculation. [REDACTED] submitted a ruling request on this issue but withdrew it when IRS informed [REDACTED] of an adverse ruling response. The response was released in an FSA format and LMSB Counsel provided a copy to Appeals. [REDACTED] will file a supplemental protest on this issue with Exam by 5/15/01 and Exam agreed to provide a rebuttal by 6/15/01. The Supp. Protest will address remittances as the trigger for exchange loss. This argument was not presented in the ruling request according to t/p. Appeals will review the FSA, supplemental protest, and rebuttal prior to the initial conference with [REDACTED].

Discussion and Analysis

In [REDACTED], [REDACTED] submitted a ruling request relative to the [REDACTED] transaction. [REDACTED] sought a determination that the deconsolidation of [REDACTED] triggered the recognition of built in exchange losses associated with the hyper inflationary local currency (the peso) equity reflected in the basis of [REDACTED]'s

assets.

[REDACTED] argued its ruling request should be granted since:

1. It is appropriate to treat inbound transfers by an I.R.C. § 987 P&L branch and a DASTM branch the same;
2. Built in exchange gains/losses existing in a DASTM branch are measured by the difference in the dollar value of the peso asset basis at acquisition and termination and should be recognized upon branch termination; and
3. I.R.C. § 367 policy considerations require that a branch termination on an outbound reorganization of DASTM branch should have the same tax consequences as an I.R.C. § 987 branch.

National Office notified [REDACTED] that the proposed response to its ruling request was going to be adverse to [REDACTED]'s position. [REDACTED] subsequently withdrew its ruling request. See attachment 1; [REDACTED] FSA LEXIS 330.

National Office's proposed adverse position to [REDACTED]'s ruling request noted that exchange gains or losses are recognized by an I.R.C. § 987 branch upon termination but that exchange gains or losses of a DASTM branch are triggered when assets or liabilities are disposed of in an actual or deemed disposition, an event National Office characterized a market event trigger. National Office noted gain or loss recognition for an I.R.C. § 987 branch upon termination insured that only previously taxed amounts were included in the taxpayer's dollar basis of the remitted assets. However, where a DASTM branch is involved, a dollar basis already exists for the branch assets and no such basis problem is presented.

Additionally, deferring DASTM branch gains/losses until the occurrence of a market recognition event reflects transaction gains rather than translation gains. Since DASTM branches are more analogous to dollar separate transactions branches rather than I.R.C. § 987 branches, deferring gain/loss recognition until a market event trigger (as would be the case in a dollar separate transaction branch) is appropriate.

National Office rejected [REDACTED]'s argument that I.R.C. § 367 policy considerations required similar treatment for both DASTM branches and I.R.C. § 987 branches and posited the following example to illustrate the different treatment of economic gains and losses under I.R.C. §§ 987 and 985:

Assume that X, a U.S. corporation, establishes A, a Mexican branch operation, on December 31, 1990, and that A is capitalized at that time with \$ 1,000. The \$ 1,000 is immediately converted by A at the rate of 1:1 into 1,000 pesos, and, on the same day, the pesos are used to buy widgets in the ordinary course of A's business. The widgets were not sold prior to year end, and A had no other income or loss. On December 31, 1991, X transfers the A branch to a wholly-owned CFC.

If A uses the peso as its functional currency as a P&L branch subject to section 987, proposed regulation section 1.987-3 would treat the outbound transfer of A's assets as a deemed termination of the branch. Assuming that the peso-dollar exchange rate on December 31, 1991 was Ps. 2:\$ 1, X would realize an exchange loss of \$ 500 on the deemed termination of the branch attributable to the difference between the current dollar value (2:1) of A's equity pool (Ps. 1,000) and A's basis pool (\$ 1,000). X would take a \$ 500 carryover basis in the 1,000 pesos of widgets acquired from A. If the CFC used the peso as its functional currency, it would translate this carryover basis at the spot rate into 1,000 pesos.

However, if A is a DASTM branch, the deemed termination does not result in recognition of exchange gain or loss to X under section 985. Instead, X (and the CFC) take a \$ 1,000 carryover basis in the assets and will recognize market gain or loss on the sale of the widgets. Exchange loss computed under DASTM would be applied to reduce any profit realized on the widget sales. Thus, if the widgets were sold on January 1, 1992 for 1,000 pesos when the rate was Ps. 2:\$ 1, assuming no other transactions or exchange rate fluctuations during the year, under DASTM, the CFC would recognize a \$ 500 loss equal to the difference between its \$ 1,000 net worth on January 1, 1992 and its \$ 500 net worth on December 31, 1992.

National Office rejected [REDACTED]'s argument that I.R.C. § 987 and DASTM branches be treated the same reasoning that differing treatment is appropriate as a policy matter given that a principal reason for triggering I.R.C. § 987 gain or loss is to assign a dollar basis to the P&L branch's assets and liabilities upon termination or remittance. Because it is not possible to trace asset basis through all historic rates used over time to translate a branch's earnings, a dollar basis is derived by translating the remitted asset's functional currency basis into dollars at the spot rate on the date of termination. An income adjustment (equal to the section I.R.C. § 987 gain or loss) is necessary to ensure that the taxpayer's dollar basis in the remitted assets reflects only previously-taxed amounts. However, in a DASTM branch, a dollar basis already exists for the branch's assets, and therefore this basis problem does not exist. Thus, from a practical standpoint, recognizing I.R.C. § 987-type exchange gains or losses in the DASTM context is unnecessary.

[REDACTED]'s supplemental protest of this issue, filed on [REDACTED], focuses on one aspect of the example noted above, namely the presence of a "market trigger event" not considered in National Office's computation in the above example. See attachment 2. [REDACTED] now argues that the deconsolidation of [REDACTED] operated as a termination of the branch which was equivalent to a "deemed inbound remittance of [REDACTED]'s DASTM branch's net assets to its home office [REDACTED]. [REDACTED] concludes this "deemed inbound remittance" triggers the [REDACTED]'s \$ [REDACTED] built-in currency loss. Applying that rationale to the above example used by National Office, [REDACTED] determines a \$ [REDACTED] loss for the DASTM branch for [REDACTED].

[REDACTED] has cited no new authority for its re-characterization of the [REDACTED] deconsolidation as including a "deemed inbound remittance" which would satisfy the "market trigger event" of a gain/loss recognition for a DASTM branch. The "deemed inbound remittance" is merely a re-characterization of a component of the termination/deconsolidation considered in the ruling request. The analysis applied by National Office in its consideration of [REDACTED]'s ruling request clearly demonstrates the DASTM branch termination is not the triggering event. Consequently we find [REDACTED]'s supplemental protest unpersuasive and concur with National Office's initial analysis of the issue as set forth in the FSA noted above.

Should you have any questions concerning this matter, please contact the undersigned attorney at (313) 237-6426. This advice is subject to National Office Review and should not be relied upon or disseminated for a period of 30 days or upon notification of this office. This writing may contain privileged information.

Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

[REDACTED]
Associate Area Counsel
(Large and Mid-Size Business)

By: _____
[REDACTED]
Attorney (LMSB)

Attachments