# LB&I Virtual Library
# Concept Unit

| Library Level | Number | Title |
|---|---|---|
| **Shelf** | N/A | Crossover |
| **Volume** | 18 | Foreign Currency |
| **Part** | 18.2 | Transactions in a Foreign Currency – Sec. 988 |
| **Chapter** | 18.2.1 | Computation of Exchange Gain/Loss - General |
| **Subchapter** | N/A | N/A |

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|---|---|---|
| **Unit Name** | Exchange Gains/Losses on Payables and Receivables Denominated in a Nonfunctional Currency | |
| **Primary UIL Code** | 9470.02-01 | Computation of exchange gain or loss - general |

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| **Date of Last Update** | 12/20/16 |

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# General Overview

## Exchange Gains/Losses on Payables and Receivables Denominated in a Nonfunctional Currency

This Concept Unit addresses the following issues related to computing an exchange gain or loss on payables and receivables of a taxpayer:

1. General Rule
2. Booking Date
3. Details
4. Receivables
5. Payables
6. Spot Rate

Except as provided in regulations, a U.S. taxpayer's functional currency is the U.S. dollar (USD). A Qualified Business Unit (QBU - any separate and clearly identified unit of a taxpayer that maintains separate books and records) may have a non USD functional currency if (1) the economic environment in which a significant part of the QBU's activities are conducted is not the USD and (2) the QBU is not keeping its books and records in the USD. See IRC 985(b); Treas. Reg. 1.985-1(b) and (c); note that U.S. Corporations must generally have the USD as their functional currency, although their foreign branches that are QBUs may have non USD functional currencies. A QBU can have a functional currency that is different from its owner. The functional currency is relevant for taxpayers or QBU's that have transactions in multiple currencies. Transactions are generally to be accounted for in the taxpayer's or QBU's functional currency. Certain non-functional currency transactions, called "Section 988 transactions" give rise to functional currency gain or loss.

# General Overview cont'd

| Exchange Gains/Losses on Payables and Receivables Denominated in a Nonfunctional Currency |
| --- |
| Transactions of U.S. corporations that require the use of a currency other then U.S. dollar have dramatically increased as more taxpayers do business globally. Generally, when U.S. resident taxpayers invest and do business transactions in non US currency, all federal tax determinations must be made in USD. Thus, Section 988 transactions, which are certain monetary transactions denominated in (or determined by reference to the value of) a nonfunctional currency, may give rise to foreign exchange gains or losses under Section 988.<br><br>IRC 988 includes accruing, or otherwise taking into account, any item of expense or gross income or receipts which is to be paid or received after the date on which such items is accrued or take into account if the amount the taxpayer is entitled to receive or is required to pay is denominated in terms of a nonfunctional currency or is determined by reference to the value of one or more nonfunctional currencies (e.g. payables and receivables held by a taxpayer or QBU that is denominated in nonfunctional currency.) |

# Relevant Key Factors

## Exchange Gains/Losses on Payables and Receivables Denominated in a Nonfunctional Currency

### Key Factors

IRC 985 to 989 provide rules for determining a taxpayer or QBU's functional currency, determining taxpayer's income in its functional currency and measuring foreign currency gain and losses. In general:

- IRC 985 - Defines functional currency including hyperinflationary currency
- IRC 986 - Addresses the determination of foreign taxes and foreign corporation's earning and profits
- IRC 987 - Addresses Branch transactions when the branch has a different functional currency from its owner
- IRC 988 - Describes treatment of certain foreign currency transactions
- IRC 989 - Defines a qualified business unit (QBU) and other terms

This Concept Unit will focus on the computation of exchange gains or losses on payables and receivables held by a taxpayer or QBU in a currency other than its functional currency. See other concept, transaction, and process units for IRC 989, IRC 987 and other foreign currency issues.

> Note: The Internal Revenue Code (IRC) refers to "foreign currency gains and losses" while the Treasury Regulations use the term "exchange gain or loss".

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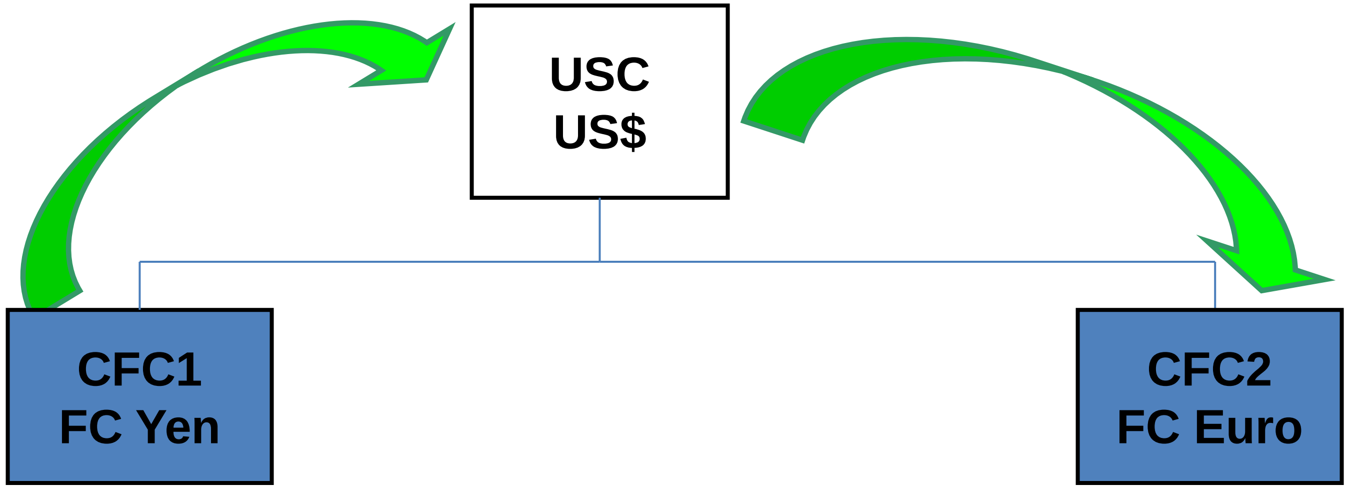
## Exchange Gains/Losses on Payables and Receivables Denominated in a Nonfunctional Currency

**Diagram of Concept**

Transaction #1: CFC1 provides Service to USC resulting in an account payable on USC books in Yen.

Transaction #2: USC sells product to CFC2 on credit in the Euro resulting in an account receivable on USC books in Euro.




Both Transaction #1 and #2 will result in an exchange gain or loss under Section 988. In Transaction #1, USC will recognize an exchange gain or loss on the account payable denominated in the Yen, a nonfunctional currency for USC. In Transaction #2, USC will recognize an exchange gain or loss on the account receivable denominated in the Euro, a nonfunctional currency for USC. CFC1 and CFC2 will not have Section 988 transactions since the transaction is denominated in each CFC's respective functional currency.

# Facts of Concept

## Exchange Gains/Losses on Payables and Receivables Denominated in a Nonfunctional Currency

**Facts of Concept**

- It is very common for U.S. Companies to transact business in currencies other then the US dollar. An examiner needs to understand:
  - the cash flow of these transactions
  - how they are recorded for financial accounting and tax purposes
  - any foreign currency gain or loss that should be reported, as well as the source (US or foreign) and character (ordinary or capital) of the transaction.

- Non-functional currency transaction amounts have to be translated into functional currency. An example of this type of transaction is paying an invoice in a non-functional currency.

- When the US taxpayer owns, or has a position in, a non US currency asset or liability; an examiner should be able to measure, translate and establish when foreign currency gains and losses should be determined. This unit will focus on the exchange gains and losses recognized by a taxpayer or QBU on the receipt or payment of an invoice, recorded on the books of the taxpayer or QBU as an accounts receivable or payable respectively, that is denominated in a nonfunctional currency.

# Detailed Explanation of the Concept

| Exchange Gains/Losses on Payables and Receivables Denominated in a Nonfunctional Currency |
|---|
| The starting point to applying the foreign currency tax rules is to determine the Taxpayer's or QBU's "functional currency." This is the currency in which all of the taxpayer's or QBU'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 IRC 986, 987, 988 or 989. |

| Analysis | Resources |
|---|---|
| Foreign Currency Gains and Losses (a.k.a. Exchange Gains and Losses):<br>▪ The taxpayer or QBU computes foreign currency gains or losses on certain transactions identified in IRC 988(c)(1)(B) and (C). Included in the listing of these transactions is the accrual of any item of expense or income receipts that is paid or received after the accrual date that is denominated in a currency other than the taxpayer or QBU's functional currency as defined in IRC 988(c)(1)(B)(ii) and Treas. Reg. 1.988(a)(2)(ii). | ▪ The description and computation of exchange gains and losses on other types of transactions discussed in IRC 988(c)(1)(B) are discussed in other IPS units listed at the end of this unit. |
| Recognition Date on Payables and Receivables:<br>▪ The exchange gain or loss on the above identified transaction (accruals of items of expense or income) is recognized on the date that the payment of nonfunctional currency is made or received. Such gain or loss is recognized in accordance with the applicable recognition provisions of the IRC. If a taxpayer's or QBU's right to receive income or pay an expense is transferred or modified in a transaction in which gain or loss would otherwise be recognized, exchange gain or loss is recognized only to the extent of total gain or loss on the transaction. | ▪ See Treas. Reg. 1.988-2(c)(1). |

# Detailed Explanation of the Concept

| Exchange Gains/Losses on Payables and Receivables Denominated in a Nonfunctional Currency |
|---|
| The starting point to applying the foreign currency tax rules is to determine the Taxpayer's or QBU's "functional currency." This is the currency in which all of the taxpayer's or QBU'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 IRC 986, 987, 988 or 989. |

| Analysis | Resources |
|---|---|
| Source of Section 988 gain:<br>▪ The source of foreign currency gain or loss is determined by reference to the residence of the taxpayer or QBU of the taxpayer on whose books the underlying asset, liability, or item of income or expense is properly reflected. Whether an asset, liability, or item of income or expense is properly reflected on the books of a QBU is a question of fact. | ▪ For further discussion regarding the identification and determination of a taxpayer's QBUs, please see IPS Concept Unit "Definition of a QBU".<br>▪ See Treas. Reg. 1.988-4(a) and (b). |
| Computation of Exchange Gain/Loss on Item of Gross Income or Receipt (Accounts Receivable):<br>▪ The exchange gain loss on an item of gross income or receipt (recorded as an account receivable) that is denominated in a nonfunctional currency is computed by subtracting the nonfunctional currency accrued as an account receivable (multiplied by the spot rate at the booking date) from the nonfunctional currency received as payment on the account receivable (multiplied by the spot rate on the payment date). | ▪ See Treas. Reg. 1.988-2(c)(2). |

# Detailed Explanation of the Concept

| Exchange Gains/Losses on Payables and Receivables Denominated in a Nonfunctional Currency |
|---|
| Please see the analysis below for a listing of factors involved in the transactions, the determination and/or computation of the transaction, and the relevant authority. |

| Analysis | Resources |
|---|---|
| Computation of Exchange Gain/Loss on Item of Expense (Accounts Payable):<br>▪ The exchange gain or loss on an item of expense (recorded as an accounts payable) that is denominated in a nonfunctional currency is computed by subtracting the nonfunctional currency paid on the account payable (multiplied by the spot rate at the payment date) from the nonfunctional currency accrued as an account payable (multiplied by the spot rate on the booking date).<br>NOTE: Payment of a payable might result in a separate Section 988 transaction for disposition of nonfunctional currency. | ▪ See Treas. Reg. 1.988-2(c)(3). |
| Spot Rate Option: The Treasury Regulation allows a taxpayer or QBU to utilize a spot rate convention to be determined at intervals of one quarter year or less (versus the spot rate at the actual booking or payment dates) when computing exchange gains and losses on nonfunctional currency accounts receivables and payables. | ▪ See Treas. Reg. 1.988-1(d)(3). |
| Recognition Date: The date that payment is made or received. | ▪ Treas. Reg. 1.988-2(c)(1) |
| Exchange Gain or Loss on item of gross income or receipt (receipt of account receivable): [(Nonfunctional currency received) x (spot rate on payment date)] – [(nonfunctional currency accrued) x (spot rate on booking date)] | ▪ Treas. Reg. 1.988-2(c)(2) |
| Exchange Gain or Loss on item of expense (payment of account payable): [(Nonfunctional currency accrued) x (spot rate on booking date)] – [(nonfunctional currency paid) x (spot rate on payment date)] | ▪ Treas. Reg. 1.988-2(c)(3) |

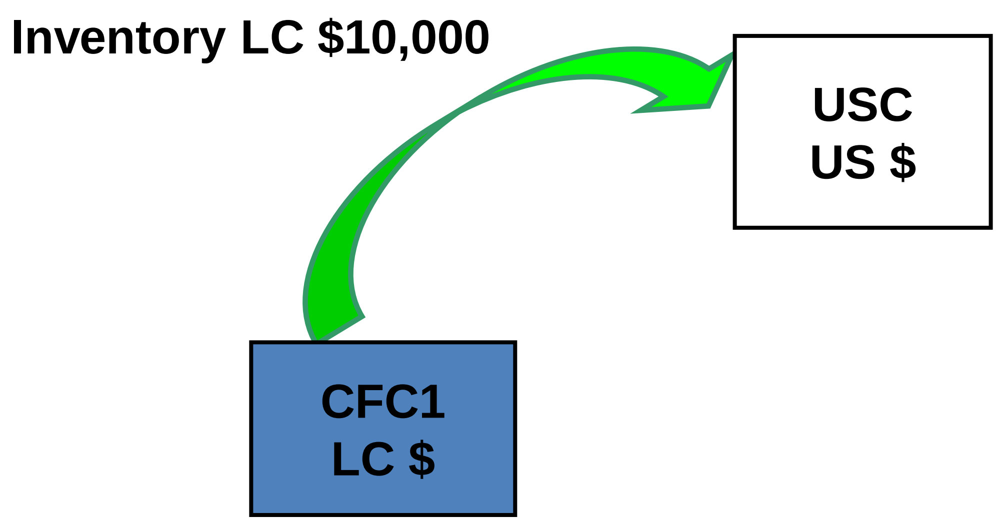
# Examples of the Concept

## Exchange Gains/Losses on Payables and Receivables Denominated in a Nonfunctional Currency

**Example – Exchange Gain/Loss on Payment of an Account Payable in Nonfunctional Currency**

- USC is a calendar year corporation with the USD as its functional currency.
- On 01/15/20x9, USC purchases inventory on account from CFC1 for LC $10,000. The spot rate on 01/15/20x9 is LC $1.00 = US $0.55.
- On 02/23/20x9, when USC makes payment of the LC $10,000 payable, the spot rate is LC $1.00 = US $0.50.
- On 02/23/20x9, USC will realize an exchange gain on the LC $10,000 account payable. USC's gain is computed by multiplying the LC $10,000 by the spot rate on the booking date (LC $10,000 x 0.55 = US $5,500) and subtracting from such amount, the amount computed by multiplying the LC $10,000 by the spot rate on the payment date (LC $10,000 x 0.50 = US $5,000).
- Thus, USC's exchange gain on the transaction is US $500 (US $5,500 – US $5,000). The character of the exchange gain is ordinary.

NOTE: There could be an exchange gain or loss on the disposition of LC by USC depending on when USC acquires LC.

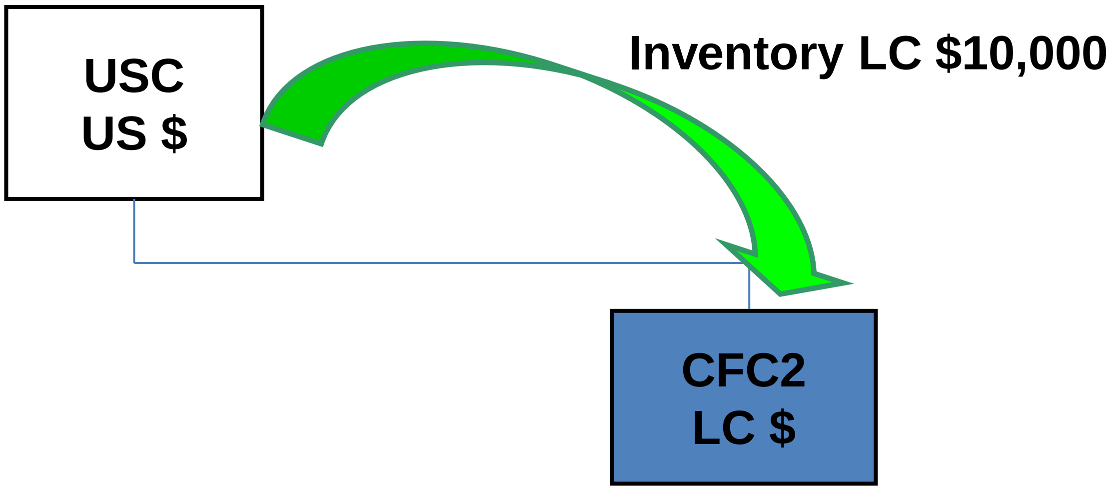


# Examples of the Concept

## Exchange Gains/Losses on Payables and Receivables Denominated in a Nonfunctional Currency

**Example - Exchange Gain/Loss on Receipt of an Accounts Receivable in Nonfunctional Currency**

- USC is a calendar year corporation with the USD as its functional currency.
- On 01/15/20x9, USC sells inventory to CFC2 for LC $10,000. The spot rate on 01/15/20x9 is LC $1.00 = US $0.55.
- On 02/23/20x9, when USC receives payment, of the LC $10,000, the spot rate is LC $1.00 = US $0.50.
- On 02/23/20x9, USC will realize an exchange loss. USC's loss is computed by multiplying the LC $10,000 by the spot rate on the date the LC $10,000 are received (LC $10,000 x 0.50 = US $5,000) and subtracting from such amount, the amount computed by multiplying the LC $10,000 by the spot rate on the booking date (LC $10,000 x 0.55 = US $5,500).
- Thus, USC's exchange loss on the transaction is US $500 (US $5,000 – US $5,500). The character of the exchange loss is ordinary.
- (Source: Treas. Reg. 1.988-2(c)(4), Example 1.)

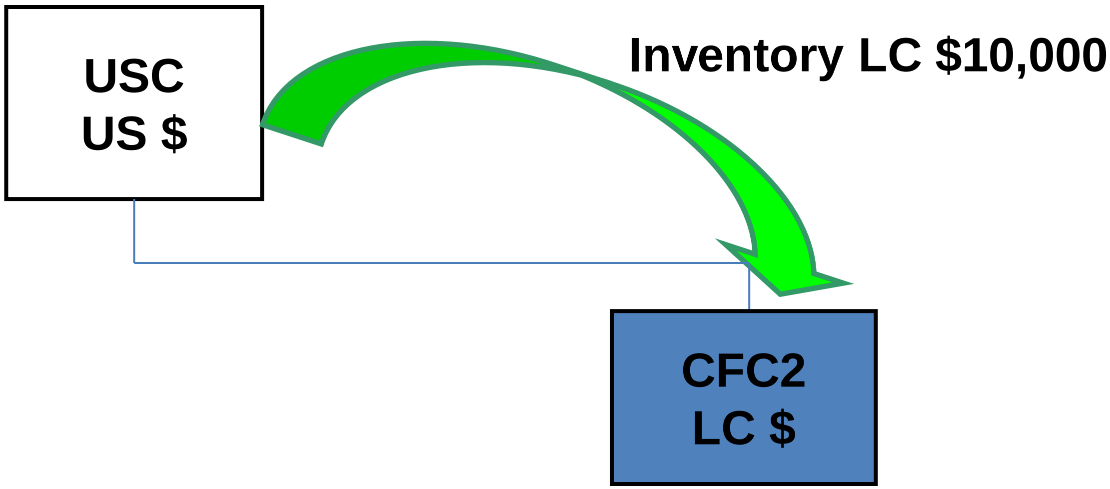


# Examples of the Concept

## Exchange Gains/Losses on Payables and Receivables Denominated in a Nonfunctional Currency

**Example – Spot Rate Convention Option (Monthly Basis)**

- USC is a calendar year corporation with the USD as its functional currency.
- USC uses a spot rate convention to determine the spot rate as provided in Treas. Reg. 1.988-1(d)(3)
- The spot rate determined under the spot rate convention for the month of January is LC $1.00 = US $ 0.54, and for the month of February is LC $1.00 = US $ 0.51.
- On 01/15/20x9, USC sells inventory for LC $10,000. On 02/23/20x9, USC receives payment of the LC $10,000.
- On the last date in February, USC will realize exchange loss. USC's loss is computed by multiplying the LC $10,000 by the spot rate convention for the month of February (LC $10,000 x US $0.51 = US $5,100) and subtracting from such amount, the amount computed by multiplying the LC $10,000 by the spot rate convention for the month of January (LC $10,000 x US $0.54 = US $5,400)
- USC's exchange loss is $300 (US $5,100 – US $ 5,400). (Source: Treas. Reg. 1.988-2(c)(4), Example 2)



# Index of Referenced Resources

| Exchange Gains/Losses on Payables and Receivables Denominated in a Nonfunctional Currency |
| --- |
| Treas. Reg. 1.988-2(c)(1). |
| Treas. Reg. 1.988-4(a) and (b) |
| Treas. Reg. 1.988-2(c)(2) |
| Treas. Reg. 1.988-2(c)(3) |
| Treas. Reg. 1.988-1(d)(3) |
| Treas. Reg. 1.988-2(c)(4), Example 1 |
| Treas. Reg. 1.988-2(c)(4), Example 2 |

# Training and Additional Resources

| Exchange Gains/Losses on Payables and Receivables Denominated in a Nonfunctional Currency | |
|---|---|
| **Type of Resource** | **Description(s)** |
| SABA Sessions | ▪ INTL Foreign Currency Issues and IFRS plus Audit Techniques<br>▪ IBC ONLY – Foreign Currency & Int'l Matrix<br>▪ IBC Common Errors in translating Foreign Currency<br>▪ Building Blocks of Financial Products<br>▪ IE Phase I, Module E – Lesson 1 Foreign Currency<br>▪ IE Phase III, Module D –Interaction of International and Financial Products Issues<br>▪ FP Phase I, Lesson 9 Foreign Currency<br>▪ FP Phase III, Lesson 4 Foreign Currency<br>▪ Refer to Foreign Currency PN SharePoint Site for a complete listing of Foreign Currency Centra sessions |
| White Papers / Guidance | ▪ FASB 52/ASC 830 Foreign Currency Matters |
| Reference Materials – Treaties | ▪ Bittker & Lokken: Fundamentals of International Taxation, Chapter 74 (Foreign Currency)<br>▪ BNA Tax Management Portfolio 921-2nd Tax Aspects of Foreign Currency<br>▪ Keyes: Federal Taxation of Financial Instruments and Transactions (Chapter 15, Foreign Currency Denominated Instruments |

# Glossary of Terms and Acronyms

| Term/Acronym | Definition |
|---|---|
| ASC | Accounting Standards Codification |
| CFC | Controlled Foreign Corporation |
| FASB | Financial Accounting Standards Board |
| IFRS | International Financial Reporting Standards |
| INTL | International |
| IRC | Internal Revenue Code |
| LC | Local Currency (generic term for non-U.S. currency) |
| QBU | Qualified Business Unit |
| USC | U.S. Corporation |
| USD | U.S. Dollar |

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# Index of Related Practice Units

| Associated UIL(s) | Related Practice Unit | DCN |
|---|---|---|
| ▪ 9470.02 | How to Assess Penalties for Failure to file Form 8886 Disclosing Section 988 Losses | ▪ FCU/P/18_02_01-04 |
| ▪ 9470.02 | Overview of Foreign Currency Hedging Transactions | ▪ FCU/C/18_02_03-05 |
| ▪ 9470.02 | Integration of Executory Contract and the Currency Hedge | ▪ FCU/T/18_02_03-03 |
| ▪ 9470.02 | Legging into Integrated Treatment | ▪ FCU/T/18_02_03-02 |
| ▪ 9470.02 | Disposition of a Portion of an Integrated Hedge | ▪ FCU/T/18_02_03-01 (Formerly FCU/9470.02_03) |
| ▪ 9470.02 | Disposition of Nonfunctional Currency | ▪ FCU/T/18_02_01-08 |
| ▪ 9470.03 | Functional Currency of a Qualified Business Unit (QBU) | ▪ FCU/C/18_3_3_08 |
| ▪ 9412.05 | Computing Foreign Base Company Income | ▪ DPL/P/02_05_01_01-01 (Formerly DPL/9412.05_05) |
| ▪ 9412.00 | Subpart F Overview | ▪ DPL/C/02-01 (Formerly DPL/CU/V_2_01) |
| ▪ 9414.01 | Calculation of IRC §956 Amount | ▪ RPA/P/04_01_03-01 |