Internal Revenue Service
DEPARTMENT OF THE TREASURY

LB&I International Practice Service Concept Unit

IPS Level	Number	Title	UIL Code	Number
Shelf	N/A	Crossover IPN	–	–
Volume	18	Foreign Currency	**Level 1 UIL**	9470
Part	18.2	Transactions in a Foreign Currency – Section 988	**Level 2 UIL**	9470.02
Chapter	18.2.1	Computation of Exchange Gain or Loss - General	**Level 3 UIL**	9470.02-01
Sub-Chapter	N/A	N/A	–	–

Unit Name	Sourcing of Exchange Gains or Losses in Currency Transactions

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General Overview

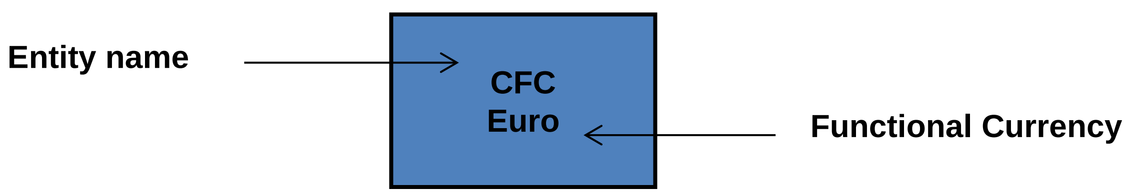
Sourcing of Exchange Gains or Losses in Currency Transactions

Multinational businesses that file federal income tax returns in the United States must report any income subject to U.S. federal income tax in U.S. dollars. However, when these businesses operate in different countries, they must adhere to the laws and regulations of each country. Therefore, multinational businesses structure their worldwide operations to operate legally and efficiently for both global accounting and tax purposes.

One challenge of reporting total income subject to U.S. federal income tax is computing income earned in non-U.S. locations. Often the books and records of some business enterprises are recorded in multiple currencies and locations. The U.S. federal income tax system for U.S.-owned Multinational Enterprises is based on worldwide income in U.S. dollars, so it's necessary to translate amounts that are measured or denominated in different currencies into U.S. dollars. After the worldwide income in U.S. dollars is computed, the net worldwide income must be sourced as U.S.-sourced and foreign-sourced in order to properly compute the foreign tax credit utilized by multinational enterprises to avoid double taxation.

While IRC 861 through 865 (as well as its related Treasury Regulations) provide the general rules for sourcing of worldwide net income for foreign tax credit purposes, IRC 988(a)(3) and the related Treasury Regulations govern the sourcing of certain exchange gains or losses. This IPS Unit will cover the general rule, as well as the exceptions to the general rule, for the sourcing of exchange gains or losses as well as provide examples to apply the general rule and certain exceptions.

This IPS Unit will focus on the sourcing of certain nonfunctional currency transactions under IRC 988. For each example listed, the first line of the diagram description will reflect the entity name and the second line will reflect the functional currency (FC) of the entity:



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Detailed Explanation of the Concept

Sourcing of Exchange Gains or Losses in Currency Transactions
The starting point to applying the foreign currency tax rules is to determine the Taxpayer's "functional currency." This is the currency in which all of the taxpayer'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
Qualified Business Units (QBUs): The sourcing of foreign currency transactions is made by reference to the "qualified business units" (QBUs) of the taxpayer. The residence of a QBU on whose books the underlying financial asset, liability, or item of income or expense is properly reflected is generally its "tax home" as defined in IRC Sect. 911(d)(3).	For further discussion regarding the identification and determination of a taxpayer's QBUs, please see IPS Concept Unit "Definition of a QBU".
General Rule: The code and regulations state that generally the sourcing of an exchange gain or loss is based on the residence of the taxpayer's QBU, or whose books the asset, liability, or item of income or expense is properly reflected.	See IRC 988(a)(3)(A), Treas. Reg. 1.988-4(b), and Treas. Reg. 1.988-4(a)
Effectively Connected Income ("ECI"): The regulations cite an exception to the above rule if the exchange gain or loss results from a transaction that is effectively connected to the conduct of a U.S. trade or business per Treas. Reg. 1.864-4(c). In this instance, the regulations state that this type of gain or loss should also be sourced to the United States.	See Treas. Reg. 1.988-4(c).

Detailed Explanation of the Concept (cont'd)

Sourcing of Exchange Gains or Losses in Currency Transactions
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Analysis	Resources
Related Party Loans: The regulations also cite another exception to the general rule when the exchange gain or loss results from a loan between a U.S. person to a foreign related party that is denominated in a currency other than the U.S. Dollar. When a loan of this type also bears an interest rate that is at least 10% higher than the Federal midterm rate, the loan is required to be marked to market annually on the last day of the U.S. person's taxable year (or the date the loan matures), and the related party interest income is sourced to the United States.	See Treas. Reg. 1.988-4(e).
Foreign Currency Gains or Losses Treated as Interest Income or Expense: Likewise, if an exchange gain or loss on an IRC 988 transaction is required to be treated as interest income or expense per Treas. Reg. 1.988-3(c)(1) (e.g. an exchange gain or loss resulting from a nonfunctional currency tax exempt bond), the gain or loss is sourced or allocated and apportioned pursuant to the foreign tax credit rules (IRC 861(a)(1), 862(a)(1), or 864(e)).	See Treas. Reg. 1.988-4(f).
Partnerships not Engaged in U.S. Trade or Business: If a partnership is formed to avoid tax by altering the source of exchange gain or loss, the residence of a partnership will be determined at the partner level instead of the residence of the partnership, regardless of whether the partnership rises to the level of a QBU for the partners.	See Treas. Reg. 1.988-4(d)(3).

Examples of the Concept

Sourcing of Exchange Gains or Losses in Currency Transactions

Example: General Rule

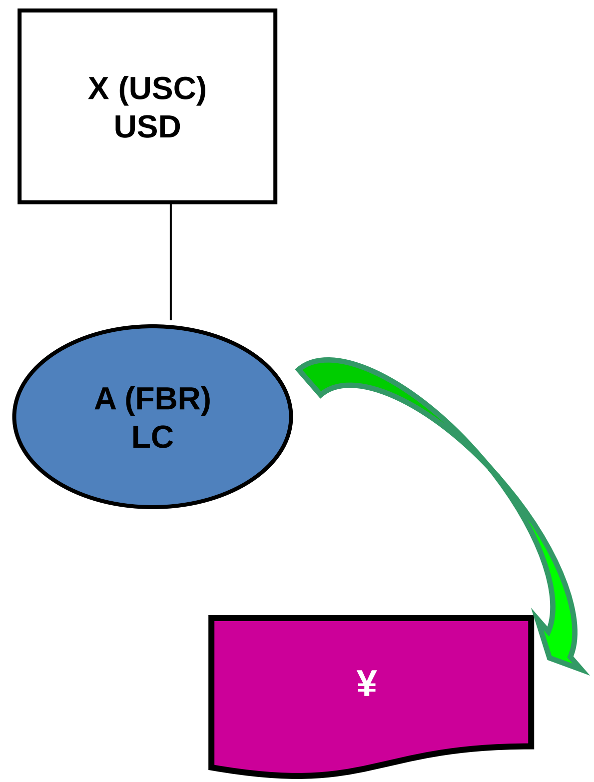
The General Rule for Foreign Currency Transactions is that F/X gains and losses are based on the residence of the taxpayer or Qualified Business Unit ("QBU") of the taxpayer on whose books the asset, liability, or item or expense of item is properly reflected.

Facts:

- Taxpayer X is a US corporation (USC) with the USD as its functional currency.
- A is a foreign branch (FBR) of X and is located and does business in Country C.
- A has the Local Currency ("LC") as its functional currency.
- During 20X2, A disposes of Japanese Yen and recognizes an IRC 988 gain.

Application of IRC 988(a)(3)(A) and Treas. Reg. 1.988-4(b):

Since A (the QBU in this example) resides in Country C, the IRC 988 gain would be sourced to Country C and be foreign source income for foreign tax credit purposes. For rules concerning the residence of a QBU, please see IRC 988(a)(3)(B) and Treas. Reg. 1.988-4(d).



Examples of the Concept (cont'd)

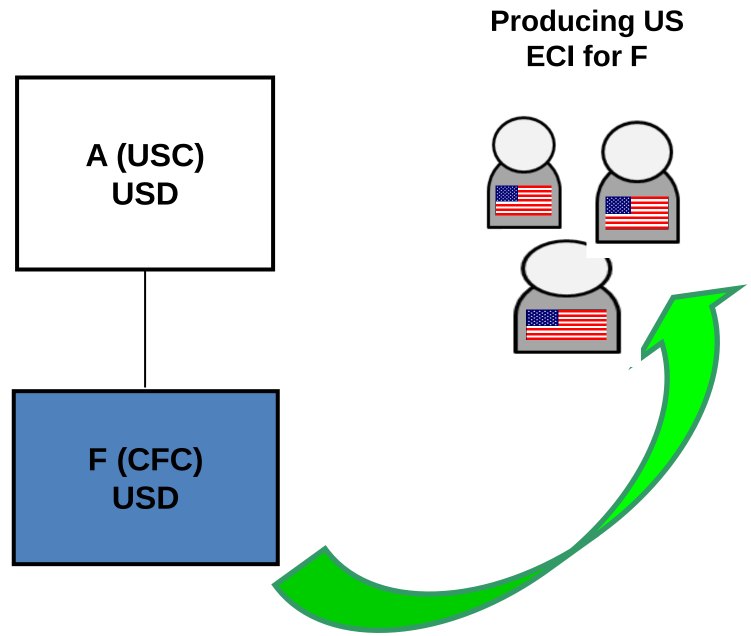
Sourcing of Exchange Gains or Losses in Currency Transactions

Example: ECI of U.S. Trade or Business

When the transaction is Effectively Connected Income ("ECI") of a U.S. trade or business, the exchange gain or loss shall be sourced in the U.S. and the gain shall be treated as ECI.

Facts:

- Taxpayer A is a US corporation with a functional currency of the U.S. Dollar ("USD").
- A owns F, a controlled foreign corporation ("CFC") in Canada.
- F had employees and conducted business in the US that generated ECI of a U.S. Trade or Business under IRC 864.
- F's U.S. trade or business is a QBU with the USD as its functional currency.
- During 20X2, F's U.S. trial balance recognized IRC 988 gains of $10,000 from the disposition of Euros.
- The IRC 988 gain from the disposition of Euros was U.S. Source ECI.



Application of Treas. Reg. 1.988-4(c):

The IRC 988 gain is U.S. Source ECI to the Canadian CFC and taxable on the CFC's Federal Form 1120-F.

Training and Additional Resources

Sourcing of Exchange Gains or Losses in Currency Transactions

Type of Resource	Description(s) and/or Instructions for Accessing	References
CENTRA sessions	Refer to Foreign Currency IPN SharePoint Site for a complete listing of Foreign Currency Centra sessions	▪ INTL Foreign Currency Issues and IFRS plus Audit Techniques ▪ IBC ONLY – Foreign Currency & Int'l Matrix ▪ IBC Common Errors in translating Foreign Currency ▪ Building Blocks of Financial Products ▪ IE Phase I, Module E – Lesson 1 Foreign Currency ▪ IE Phase III, Module D – Interaction of International and Financial Products Issues ▪ FP Phase I, Lesson 9 Foreign Currency ▪ FP Phase III, Lesson 4 Foreign Currency

Training and Additional Resources (cont'd)

Sourcing of Exchange Gains or Losses in Currency Transactions

Type of Resource	Description(s) and/or Instructions for Accessing	References
White Papers / Guidance	▪ FASB 52/ASC 830 Foreign Currency Matters ▪ IAS29 – Financial Reporting in Hyperinflationary Economies	
Reference Materials - Treatises	Other Reading Material	▪ Bittker & Lokken: Fundamentals of International Taxation, Chapter 74 (Foreign Currency) ▪ BNA Tax Management Portfolio 921-2nd Tax Aspects of Foreign Currency ▪ Keyes: Federal Taxation of Financial Instruments and Transactions (Chapter 15, Foreign Currency Denominated Instruments

Glossary of Terms and Acronyms

Acronym	Definition
ASC	Accounting Standard Codification
CFC	Controlled Foreign Corporation
DCN	Document Control Number (for Practice Unit)
ECI	Effectively Connected Income
FASB	Financial Accounting Standards Board
FP	Financial Products
F/X	Foreign Currency Exchange Rate
IBC	International Business Compliance
IFRS	International Financial Reporting Standards
IPN	International Practice Network
IPS	International Practice Service
IRC	Internal Revenue Code
LC	Functional currency of CFC
QBU	Qualified Business Unit
USC	US Corporation
USD	U.S. Dollar

Index of Related Issues

Issue	Associated UIL(s)	References
How to Assess Penalties for Failure to file Form 8886 Disclosing IRC 988 Losses	9470.02	FCU/P/18_02_01-04
Overview of Foreign Currency Hedging Transactions	9470.02	FCU/C/18_02_03-05
Integration of Executory Contract and the Currency Hedge	9470.02	FCU/T/18_02_03-03
Legging into Integrated Treatment	9470.02	FCU/T/18_02_03-02
Disposition of a Portion of an Integrated Hedge	9470.02	FCU/T/18_02_03-01 (Formerly FCU/9470.02_03)
Disposition of Nonfunctional Currency	9470.02	FCU/T/18_02_01-08
Functional Currency of a Qualified Business Unit (QBU)	9470.03	FCU/C/18_03_01-01
Computing Foreign Base Company Income	9412.05	DPL/P/02_05_01_01-01 (Formerly DPL/9412.05_05(2013))
Subpart F Overview	9412	DPL/C/02-01 (Formerly DPL/CU/V_2_01(2013))
Calculation of IRC 956 Amount	9414.01	RPA/T/04_01_03-01

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