

# Current Foreign Currency Issues

PLI Taxation of Financial Products 2013

February 16, 2013

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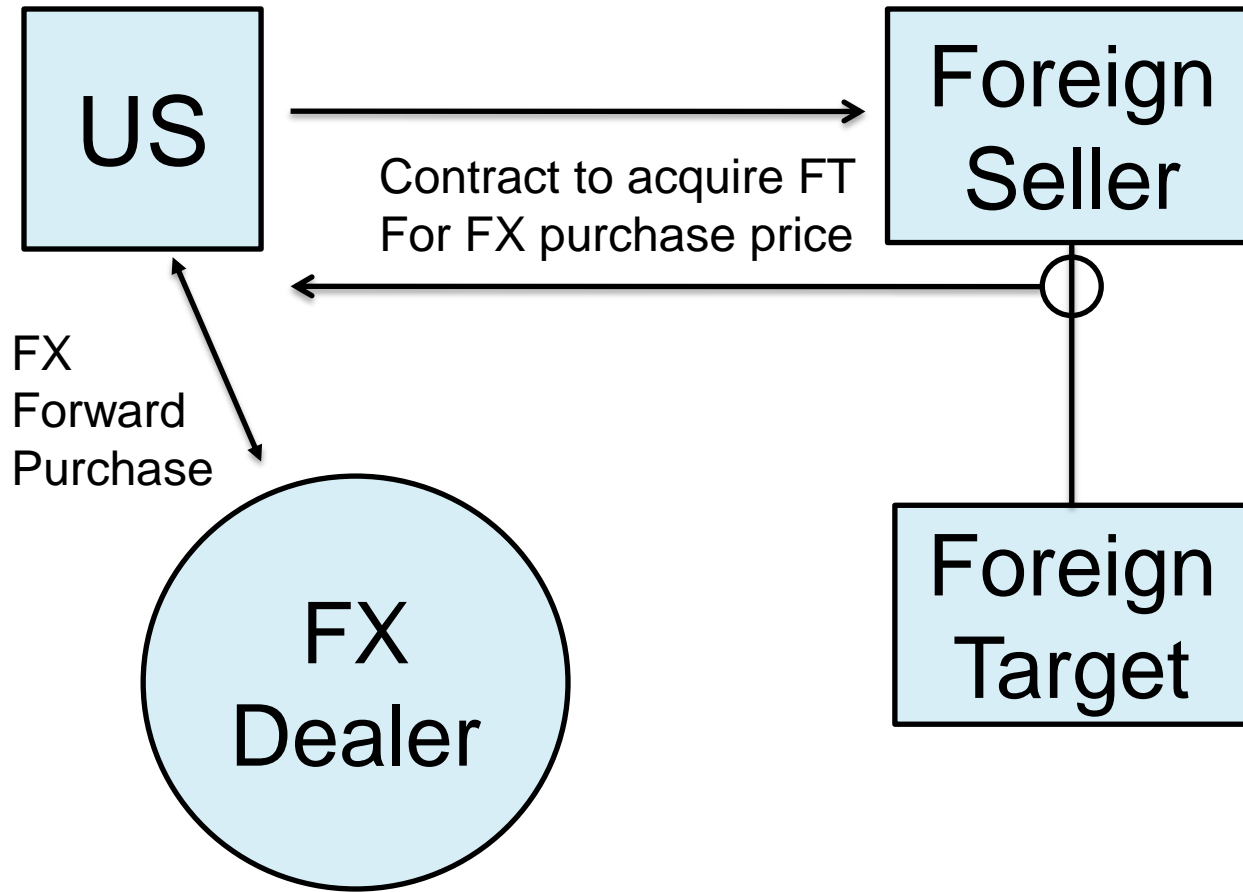
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# Treas. Reg. § 1.988-5(b) Integrated Treatment of Hedged Executory Contracts

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# Treas. Reg. § 1.988-5(b) Integrated Treatment of Hedged Executory Contracts

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## Overview of Reg. § 1.988-5(b)

- Provides integrated treatment of hedge gain or loss
  - Treats as an adjustment to purchase price of shares
  
- Requirements for Integration
  - Executory Contract
  - Hedge
  - Identification of Hedge
    - If Taxpayer does not identify, Commissioner may identify on exam

# Treas. Reg. § 1.988-5(b) Integrated Treatment of Hedged Executory Contracts

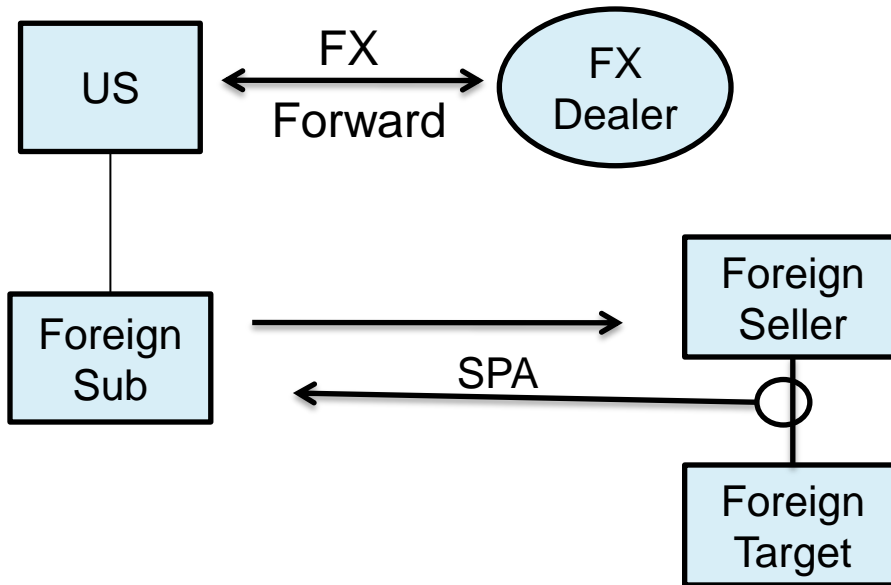
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## Practical and Interpretive Issues

- When does a stock purchase agreement (“SPA”) constitute an “Executory Contract”?
  - Effect of Contingencies
  - Public Tenders
  
- Same person must be party to both the SPA and the hedge

# Treas. Reg. § 1.988-5(b) Integrated Treatment of Hedged Executory Contracts

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- Taxpayer cannot integrate because same person is not party to both SPA and hedge
- IRS has been integrating on exam based on finding that the SPA is “in substance” hedged
- Taxpayer faces serious whipsaw potential because hedging gain will be taxed currently, but IRS has discretion to capitalize any hedging loss

# Subpart F FX Hedging Issues – Foreign exchange gains

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- General Rule - §954(c)(1)(D)
  - Net of FX gains over losses on Section 988 transactions are Subpart F
  
- Business Needs Exception
  - FPHCI does not include FX gains and losses directly related to the business needs of the CFC
    - Transaction in the normal course of the CFC's trade or business
    - A bona fide hedging transaction with respect to an otherwise qualifying transaction

# Subpart F FX Hedging Issues – Bona fide hedging transaction

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- Arises in connection with “Business Needs” transaction
- Bona fide hedge defined at Treas. Reg. §1.954-2(a)(4)(ii)
  - Must satisfy Treas. Reg. §1.1221-2(a) thru (d) hedging requirements
  - Types of “hedgeable” property expanded by Treas. Reg. §1.954-2(a)(4)(ii) to include §1231 property and §988 transactions

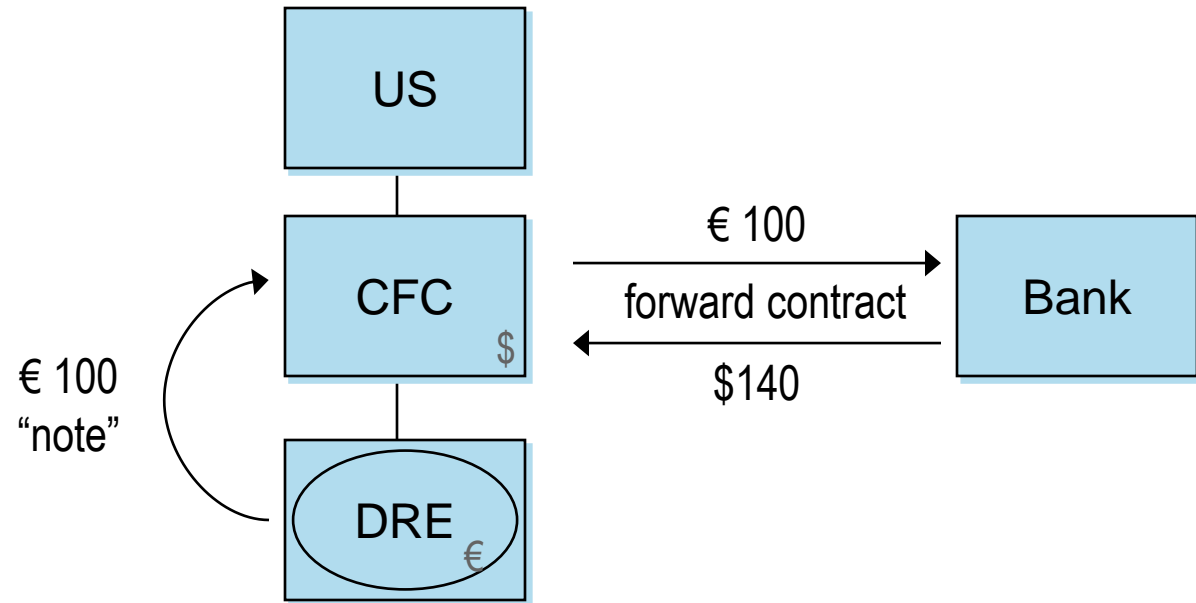
# Subpart F FX Hedging Issues – §1.1221-2(a) thru (d) Hedging Requirements

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- Entered in normal course of business
- Primarily to:
  - *Manage risk* of price changes or currency fluctuations with respect to “ordinary” property held or to be held
    - *or*
  - *Manage risk* of interest rate, price changes or currency fluctuations on borrowings or “ordinary obligations” incurred or to be incurred



# Subpart F FX Hedging Issues – Hedging Disregarded Exposures



- Net FX gains on forward are FPHCI (§954(c)(1)(D))
- Bona fide hedging exception (Reg. §1.954-2(g)(2)(ii))
  - € "note" is not recognized exposure
  - But what about CFC's future disposition of €?
    - §988 transactions (nonfunctional currency) are permitted exposures
    - Anticipatory hedges allowed too

# Hedges of FX Denominated Loans Receivable

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- Integrated Hedges of FX denominated loans receivable are specifically provided for by Treas. Reg. § 1.988-5(a)
  - Where all of the FX cashflows under a debt instrument are perfectly hedged back in to dollars, the taxpayer may treat the combination of the FX debt and the hedge as a synthetic dollar debt
  - Although this tax rule works well, the customized long-term foreign currency swaps required for integration have become expensive and create substantial counterparty risk
    - Corporate treasurers generally prefer to hedge with rolling short-term forward contracts, which do not qualify for integration

# Hedges of FX Denominated Loans Receivable

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Can a hedge of a FX denominated loan receivable qualify as a hedge under I.R.C. § 1221(b)(2)(A) and Treas. Reg. § 1.446-4?

- Hedge defined in I.R.C. § 1221(b)(2)(A) to include “any transaction entered into by a taxpayer in the normal course of its trade or business primarily to manage risk of price change or currency fluctuations with respect to ordinary property which is held to be held by the taxpayer...”
- Qualifying the hedge under I.R.C. § 1221(b)(2)(A) results in the hedge timing rules of Treas. Reg. § 1.446-4 applying and makes the I.R.C. § 1092 straddle rules inapplicable

# Hedges of FX Denominated Loans Receivable

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Can a taxpayer instead designate its hedge as a hedge of the foreign currency it expects to receive in the future in payment of the loan receivable?

- Foreign currency qualifies as “ordinary property”
- The foreign currency to be received in payment is literally “ordinary property which is...to be held by the taxpayer.”
- The rolling forward contracts are an economic hedge of the dollar value of the foreign currency to be received
  - The interest rate risk and credit risk with respect to the loan receivable are not hedged

# Hedges of FX Denominated Loans Receivable

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- Application of matching principle of Treas. Reg. § 1.446-4
  - § 988 gain or loss is recognized on collection of the foreign currency under loan receivable, rather than deferred until currency is disposed of
  - Therefore under Treas. Reg. § 1.446-4 matching principles, one would need to mark to market the hedge when receivable is collected
  - Potential objection that taxpayer is designating the hedge as hedge of foreign currency to be received, but matching hedge gain to timing of payment under loan
    - Inconsistent?

# Contact information

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