

# Code Sec. 988 and the Nonrecognition Provisions— Part I: Transfers of Foreign Currency Loans Receivable

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Code Sec. 988 provides ordinary character and residence-based sourcing for gains and losses arising from financial transactions denominated in a foreign (or “nonfunctional”) currency. The “section 988 transactions” covered by these rules include gains and losses from lending or borrowing in a nonfunctional currency and derivative transactions in nonfunctional currencies. As a general matter, Code Sec. 988 does not provide rules for the time of recognition of such gains and losses, deferring to generally applicable recognition and nonrecognition provisions of the Code. Treasury regulations under Code Sec. 988 do, however, provide some specific recognition rules for section 988 transactions that override more general nonrecognition provisions of the Code. As discussed below, the purpose of these special recognition provisions is to trigger taxation of a section 988 transaction immediately prior to a transaction that would cause the section 988 transaction to cease to be a section 988 transaction. These special recognition provisions thus prevent Code Sec. 988 gains from escaping taxation and preserve the character and sourcing of Code Sec. 988 gains.

Many multinational enterprises have significant amounts of nonfunctional currency borrowings and loans outstanding, including both loans between affiliates and external borrowings. Given the extreme volatility of the foreign currency markets in recent years, the amounts of unrealized foreign currency gains and losses on these loans can be staggering.



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As taxpayers enter into restructurings of their international groups, the restructurings often involve the transfers of foreign currency denominated loans receivable, or the assumption or extinguishment of foreign currency denominated loans payable. When these transfers, assumptions or extinguishments are parts of larger transactions that are intended to qualify for nonrecognition treatment under the principles of subchapter C, taxpayers must carefully review whether these general nonrecognition provisions will apply to prevent the recognition of Code Sec. 988 gains and losses.

The rules governing the application of the corporate nonrecognition provisions to transfers of nonfunctional currency loans receivable are reasonably well understood, although somewhat complex and full of surprises for the unwary. The interaction of the corporate non-recognition provisions with assumptions or extinguishments of nonfunctional currency liabilities, including loans payable, is far less well understood. A key issue is that the non-recognition provisions of subchapter C, by their terms, generally deal with transfers of appreciated assets, rather than liabilities. This article will summarize the application of the corporate nonrecognition provisions to transfers of Code Sec. 988 assets, specifically loans receivable, and the applicable exceptions to nonrecognition treatment. This article will thereby lay the groundwork for a future installment, which will explore the more ambitious topic of assumptions and extinguishments of nonfunctional currency liabilities in what are otherwise nonrecognition transactions.

### **I. Reg. §1.988-2(b)(5).**

Reg. §1.988-2(b)(5) embodies the rule that a holder of a foreign currency denominated debt instrument generally recognizes foreign currency gain or loss on the loan receivable based on the general recognition provisions of the Code:

(5) Exchange gain or loss recognized by the holder of a debt instrument with respect to principal.

The holder of a debt instrument described in paragraph (b)(2)(i) of this section shall realize exchange gain or loss with respect to the principal amount

of such instrument on the date principal (determined under the ordering rules of paragraph (b)(7) of this section) is received from the obligor or the instrument is disposed of (including a deemed disposition under section 1001 that results from a material change in terms of the instrument). For purposes of computing exchange gain or loss, the principal amount of a debt instrument is the holder's purchase price in units of nonfunctional currency. ... If, however, the holder acquired the instrument in a transac-

tion in which exchange gain or loss was realized but not recognized by the transferor, the nonfunctional currency principal amount of the instrument with respect to the holder shall be the same as that of the transferor. Except as otherwise provided in this paragraph (b) (e.g., paragraph (b)(8) of this section), exchange gain or loss realized with respect to such principal amount *shall be recognized in accordance with the applicable recognition provisions of the Internal Revenue Code*. The amount of exchange gain or loss so realized by the holder with respect to principal is determined by—

(i) Translating the units of nonfunctional currency principal at the spot rate on the date payment is received or the instrument is disposed of (or deemed disposed of); and

(ii) Subtracting from such amount the amount computed by translating the units of nonfunctional currency principal at the spot rate on the date the holder (or a transferor from whom the nonfunctional principal amount is carried over) acquired the instrument (is deemed to acquire the instrument).

**Most of the specific rules relating to the recognition of Code Sec. 988 gains and losses are in the nature of “last clear chance” rules. They are designed to override nonrecognition treatment and tax a foreign currency gain where allowing a general nonrecognition provision to operate would allow a Code Sec. 988 gain or loss to escape taxation completely, or allow the character or source of the gain or loss to be changed.**

The holder's realization of gain or loss on receipt of payment of principal is consistent with the treatment under Code Sec. 1271(a)(1) of the receipt of a principal payment as a sale or exchange of the debt. The treatment of a disposition of a foreign currency denominated loan receivable as a realization event is consistent with general Code Sec. 1001 principles. Reg. §1.988-2(a)(5) carefully distinguishes between realization and recognition principles, specifically providing that the time of *recognition* of such realized foreign currency gains and losses will be *in accordance with the applicable recognition provisions of the Internal Revenue Code*. Therefore, as a general matter, if the foreign currency gain or loss is realized on a transfer of the debt receivable in a transaction governed by a nonrecognition provision, recognition of the foreign currency gain or loss will be deferred in accordance with that nonrecognition provision. A transfer of an appreciated foreign currency loan receivable in a transaction that qualifies for nonrecognition treatment under Code Sec. 351, 332 or 361 will therefore qualify for nonrecognition treatment, subject to the application of the specific rules to the contrary discussed below.

## II. Specific 988 Recognition Rules Relating to Section 988 Transactions

Most of the specific rules relating to the recognition of Code Sec. 988 gains and losses are in the nature of “last clear chance” rules. They are designed to override nonrecognition treatment and tax a foreign currency gain where allowing a general nonrecognition provision to operate would allow a Code Sec. 988 gain or loss to escape taxation completely, or allow the character or source of the gain or loss to be changed. The following are the major specific recognition and timing rules that apply to section 988 transactions.

### A. Reg. §1.988-1(a)(10)(ii)

Reg. §1.988-1(a)(10) requires gain recognition on the transfer of currency or a debt instrument denominated in a nonfunctional currency between different qualified business units of a taxpayer where the transfer results in the currency or debt instrument ceasing to be a section 988 transaction.

(10) Intra-taxpayer transactions

(ii) Certain transfers.

Exchange gain or loss with respect to nonfunctional currency or any item described in paragraph (a)(2) of this section [generally nonfunctional currency debt instruments and derivatives] entered into with another taxpayer shall be realized upon an intra-taxpayer transfer of such currency or item where as the result of the transfer the currency or other such item—

(A) Loses its character as nonfunctional currency or an item described in paragraph (a)(2) of this section; or

(B) Where the source of the exchange gain or loss could be altered absent the application of this paragraph (a)(10)(ii).

Such exchange gain or loss shall be computed in accordance with section 1.988-2 (without regard to section 1.988-2(b)(8)) as if the nonfunctional currency or item described in paragraph (a)(2) of this section had been sold or otherwise transferred at fair market value between unrelated taxpayers. For purposes of the preceding sentence, a taxpayer must use the translation rate that it uses for purposes of computing section 987 gain or loss with respect to the QBU branch that makes the transfer. In the case of a gain or loss incurred in a transaction described in this paragraph (a)(10)(ii) that does not have a significant business purpose, the Commissioner, may defer such gain or loss.

In absence of this rule, a U.S. dollar functional currency taxpayer could, for example, transfer appreciated euros to a euro functional currency branch without gain recognition, because a taxpayer's contribution of property to its own branch is generally not a disposition of such property. The euro branch could then spend or otherwise dispose of the euros without recognizing gain, presumably because a qualified business unit should not recognize gain with respect to its own functional currency. The Treasury and the IRS therefore concluded that it was necessary to provide this rule to tax what would otherwise be a disregarded transfer, because taxing the disregarded transfer was the last chance of preventing the appreciation from forever escaping taxation.

Reg. §1.988-1(a)(10) also applies to transfers of foreign currency debt instruments. If, for example, a U.S. dollar functional taxpayer transfers a euro-denominated loan receivable to its euro functional

currency qualified business unit, the loan would cease to be a nonfunctional currency loan in the hands of the QBU, and would therefore cease to be a section 988 transaction. Reg. §1.988-1(a)(10)(ii) therefore requires recognition of the exchange gain or loss on the note. The QBU takes a euro basis in the note calculated by translating the dollar basis in the note, increased by the gain recognized, into euros at the spot rate for the date of transfer. Marking the foreign currency gain or loss to market and translating the resulting basis into the QBU's functional currency at the spot rate is consistent with the rule under proposed Code Sec. 987 regulations issued in 1991 that a QBU calculates its basis in property contributed to it in kind by translating the home office's basis in the property using the spot rate for the date contribution.<sup>1</sup>

Where Reg. §1.988-1(a)(10) applies to the transfer of a Code Sec. 988 instrument the value of which can change due to variables other than exchange rate fluctuations, such as a loan receivable, the amount of gain to be recognized on the transfer is not entirely clear. The regulation states that "exchange gain or loss shall be recognized in accordance with section 1.988-2," which generally calculates exchange gain or loss on a debt instrument as equal to the change in exchange rates multiplied by the principal amount of the debt. The regulation goes on to state that (1) the gain or loss is calculated as if the debt was sold at its fair market value, but (2) the gain or loss is computed "without regard to § 1.988-2(b)(8)." Reg. §1.988-2(b)(8) limits exchange gain or loss to the total economic gain or loss recognized on a payment or a sale.

Combining these principles, it would appear that where the foreign currency gain on a loan receivable is less than the total gain, only the foreign currency gain would be recognized. For example, if the total appreciation in a note receivable is 100, of which 90 is attributable to currency gain and 10 is attributable to a decline in interest rates, only the 90 would be recognized. This result is due to the regulation providing only that "exchange gain" is recognized.

In the case where the exchange gain is greater than the total gain on the loan receivable, the application

is less clear. Assume, for example, that the exchange gain with respect to a note receivable is 110, but that, due to a rise in interest rates or a fall in the creditworthiness of the issuer, the fair market value of the note has risen by only 100. The instruction in the regulation that gain is calculated without regard to Reg. §1.988-2(b)(8) suggests that the entire 110 of exchange gain must be recognized on the transfer, although this result appears to conflict with the statutory language of Code Sec. 988(b)(1). Assuming that the entire 110 of exchange gain is recognized, it is not clear that the taxpayer gets to recognize an offsetting 10 capital loss to limit its net recognized gain to its economic gain, given that the regulation calls for the recognition of only "exchange gain or loss."

### **B. Reg. §1.985-5**

Reg. §1.985-5 provides another "last clear chance" rule that triggers recognition of gain or loss with respect to a section 988 transaction where that gain or loss would otherwise disappear on a taxpayer's change of functional currency. The taxpayer is required to mark to market exchange gains or losses on section 988 transactions that are denominated in the currency to which the taxpayer is changing.<sup>2</sup> For example, if a controlled foreign corporation, which has been using the U.S. dollar as its

functional currency, changes its functional currency to the euro, it is required to mark to market foreign currency gains and losses on any debt instruments that are denominated in euros. This marking to market occurs on the close of the last day of the tax year ending before the change in functional currency. In the absence of such a rule, those euro denominated debt instruments, now held by a euro functional currency taxpayer, would lose their character as section 988 transactions.

The gains or losses on such section 988 transactions are recognized without regard to the otherwise applicable rule in Code Sec. 988(b), which limits the amount of foreign currency gain or loss recognized on a section 988 transaction to the total gain or loss on the transaction. If, for example, the controlled foreign corporation changing to the euro had purchased a

Where Reg. §1.988-1(a)(10) applies to the transfer of a Code Sec. 988 instrument the value of which can change due to variables other than exchange rate fluctuations, such as a loan receivable, the amount of gain to be recognized on the transfer is not entirely clear.



€1000 bond for €1000 when €1=\$1, and the spot rate is €1=\$1.50 as of the last day of the taxable year prior to the taxpayer's change in functional currency, the taxpayer would be required to recognize \$500 of gain as of that date. This would be the case even though, as of that date, the bond had a fair market value of €666, so that the controlled foreign corporation had no overall economic gain on the transaction. The controlled foreign corporation should be permitted to increase its dollar basis in the bond to \$1,500, to reflect the recognized foreign currency gain, then translate that \$1,500 basis into euros at the €1=\$1.50 exchange rate in effect at the end of the prior year,<sup>3</sup>

producing a basis of €1000. Although the operative rules of Reg. §1.985-5(b) do not explicitly provide for such a basis adjustment, Example 1 under Reg. §1.985-5(f), which illustrates the basis translation rules, includes such a step up.

### C. Reg. §1.367(b)-2(j)(1)

Reg. §1.367(b)-2(j)(1) meshes with Reg. §1.985-5 by specifically making the rules of Reg. §1.985-5 applicable where a tax-free asset reorganization results in a change in functional currency for a QBU. The regulation applies to Code Sec. 367(b) exchanges described in Code Sec. 381(a) that result in a qualified business unit (or "QBU" as defined in Code Sec. 989(a)) having a different functional currency than it had before the transaction. The QBU is deemed to have automatically changed its functional currency immediately before the transaction, and is required to make the adjustments required by Reg. §1.985-5. A foreign-to-foreign asset reorganization or Code Sec. 332 liquidation, or an inbound asset reorganization or Code Sec. 332 liquidation, can therefore require a QBU experiencing a change in functional currency to mark to market its foreign currency gains and losses with respect to section 988 transactions denominated in its new functional currency. These regulations could apply, for example, where a second-tier controlled foreign corporation with a euro functional currency undergoes a check-the-box Code Sec. 332 liquidation into a first-tier dollar functional currency controlled foreign corporation. If the activities of the second-tier CFC are not treated as continuing to constitute a euro QBU

in the hands of the first-tier CFC, and are instead treated as becoming part of the first-tier CFC's dollar activities, any dollar denominated loans receivable or loans payable of the second-tier CFC would be marked to market immediately prior to the effective date of the liquidation.

Reg. §1.367(b)-2(j)(ii) illustrates the application of these rules with an example involving a merger of two corporations, each of which owns a Code Sec. 987 QBU. The two QBUs are combined into a single QBU, with the acquired QBU's activities taken over by the acquiring QBU with a different functional currency. Because the acquired QBU's

activities are continued in a QBU with a different functional currency, the acquired QBU must make the adjustments required by Reg. §1.985-5 immediately prior to the merger.

Because Reg. §1.985-5 applies to all changes of functional currency by either a taxpayer or a QBU of a taxpayer for whatever reason, Reg. §1.367(b)-2(j) serves mainly as reminder to apply those rules in the context of tax-free reorganizations and liquidations. The one substantive change made in those cases from the normal operation of these rules is that the adjustments required by Reg. §1.985-5 are made immediately prior to the transaction, rather than at the close of the prior tax year.

### D. Reg. §1.988-2(b)(13)

Reg. §1.988-2(b)(13) overrides nonrecognition treatment where a holder of a foreign currency denominated debt instrument exchanges the debt for stock of the issuer, or contributes the debt to the capital of the issuer. Both the holder and the issuer of the debt instrument are required to recognize foreign currency gain or loss under Code Sec. 988, whether the exchange is in accordance with the terms of the debt or is separately negotiated. If, for example, a U.S. parent of a U.K. subsidiary capitalizes a sterling-denominated note of the subsidiary, the U.S. parent must recognize foreign currency gain or loss with respect to the note as of the date of the capitalization. Similarly, if a U.K. parent of a U.S. subsidiary capitalizes a sterling-denominated note of the U.S. subsidiary, the U.S. subsidiary would be required to recognize foreign currency gain or loss.

Is "the transaction" that must be tested for tax avoidance purpose the loan, or the payment or modification that triggered recognition of the loss?

Note that, unlike Reg. §1.985-5(b) and Reg. §1.988-1(a)(10), Reg. §1.988-2(b)(13) requires gain or loss to be recognized only to the extent of the economic gain or loss on the debt obligation. If, for example, a U.S. taxpayer acquired a €1000 bond for \$1000 when €1=\$1, then converts the bond into shares on a date when €1=\$1.50, it would have a \$500 foreign currency gain on the exchange. Reg. §1.988-2(b)(13) would require this gain to be recognized only to the extent of the taxpayer's overall gain on the transaction. If the shares that the bond are converted into are worth only €900 (and the conversion is favorable due to a decline in euro interest rates), the taxpayer's gain recognition would be limited to its overall gain on the transaction, \$350 (*i.e.*, €900 @ €1=\$1.50 minus €1000 @ €1=\$1.00). Reg. §1.988-2(b)(13) is thus consistent with the principle of Code Sec. 988(b).

Reg. §1.988-2(b)(13), by requiring recognition of Code Sec. 988 gains or losses on otherwise tax-free exchanges of debt for stock of the obligor, preserves the Code Sec. 988 character of those gains or losses. The substituted basis rules of Code Sec. 358 would be sufficient to preserve the amount of the unrealized gain or loss for future taxation to the holder of the exchanged debt. In the absence of Reg. §1.988-2(b)(13), however, that future gain or loss would be transmuted into gain or loss on the shares received in the exchange, which would typically be capital in character. Reg. §1.988-2(b)(13), by requiring current recognition, preserves the ordinary character and residence-based sourcing of the gain or loss under Code Sec. 988.

### **E. Reg. §1.367(a)-5T(d)**

Reg. §1.367(a)-5T(d) overrides nonrecognition treatment on certain outbound transfers of foreign currency denominated financial instruments subject to Code Sec. 367(a). When a U.S. person transfers a foreign currency denominated financial instrument to a foreign corporation in a Code Sec. 351 exchange or an asset reorganization, the general rule is that gain is recognized. Where foreign currency denominated financial instruments with unrealized losses are transferred, losses are generally not recognized, except that they can offset gains recognized on the transfer of other foreign currency denominated instruments. The foreign currency instruments covered by Reg. §1.367(a)-5T(d) include foreign currency denominated debt obligations, accounts receivable, futures contracts, forward contracts, cash foreign currency,

and "any other obligation entitling the payee to receive payment in a currency other than the U.S. dollar." Therefore, a U.S. person transferring a foreign currency note receivable to a foreign corporation will generally be required to recognize gain, but not loss, on the transfer.

An exception is provided for certain transfers of foreign currency denominated obligations held by a business that is being transferred to the foreign corporation. The obligation must be denominated in the currency of the foreign corporation to which it is being transferred, and must have been "acquired in the ordinary course of the business of the transferor that will be carried on by the transferee foreign corporation." Where a U.S. person conducts an active business through a foreign branch, then contributes the branch business to a local foreign corporation, local currency accounts receivable of the branch can be transferred without gain recognition. Accounts receivable typically qualify for this exception because it is generally easy to establish that they arose in the "ordinary course" of the business being transferred. Transfers of loans receivable and other financial instruments create greater uncertainty, because it is often not clear that such assets were acquired in the "ordinary course" of the business being transferred, unless the business was a lending or financing business.

### **F. Reg. §1.267(f)-1(e)**

Code Sec. 267(f) can operate to defer losses on transactions between commonly controlled corporations, including foreign corporations. Code Sec. 267(f)(3)(C) authorizes regulations to exempt from the operation of this rule foreign currency losses on foreign currency denominated loans made to other members of a controlled group. Reg. §1.267(f)-1(e) provides such an exception. It provides that Code Sec. 267 does not apply to a foreign currency loss realized by a creditor on a nonfunctional currency loan made to another member of a controlled group, provided that the loan is not denominated in a hyperinflationary currency and "the transaction does not have as a significant purpose the avoidance of Federal income tax."

This exception from Code Sec. 267 appears to apply broadly to exempt foreign currency losses to creditors on any type of related-party debt instrument. The main issue that arises with respect to the application of the rule is the requirement that "the transaction" does not have a significant tax avoidance purpose. Circumstances frequently arise where a taxpayer makes a related-party foreign currency denominated

loan entirely for valid business reasons, then chooses to repay, refinance or significantly modify the loan at a particular time to trigger the recognition of a foreign currency loss on the loan. Is “the transaction” that must be tested for tax avoidance purpose the loan, or the payment or modification that triggered recognition of the loss? Although there is no authority on point, the better view appears to be that the relevant “transaction” is the loan. The loan is the transaction giving rise to the foreign currency loss, and a payment or Code Sec. 1001 event with respect to the loan merely relates to the timing of that loss. It is a relatively well established principle of tax law, under precedents including *Cottage Savings Ass’n*<sup>4</sup> that a taxpayer with an unrealized economic loss on a bona fide transaction is free to enter into a transaction for the purpose of causing recognition of that loss. Treating the foreign currency loan as “the transaction” to be tested for tax avoidance purposes under Reg. §1.267(f)-1(e) is consistent with this principle.

Although Reg. §1.988-2(b)(16) reserves on the issue, it is reasonably clear that Code Sec. 267 does not apply to the foreign currency loss of a borrower under a foreign currency denominated debt instrument. Code Sec. 267 applies to a loss on a sale or exchange of property, whereas the foreign currency loss to a borrower under a foreign currency denominated debt instrument is due to the increase in the value of its liability. Although, prior to the Tax Reform Act of 1986, the IRS argued that the loss to a borrower under a foreign currency denominated debt instrument should be characterized as a loss on a short sale of the underlying currency, this characterization was rejected by the courts in *National Standard Co.*<sup>5</sup> and was not adopted by Congress in enacting Code Sec. 988. Because under Code Sec. 988 principles the obligor’s loss is viewed as arising from an increase in the amount of its liability, rather than from a short sale of foreign currency, Code Sec. 267 should not apply to the obligor’s foreign currency loss.<sup>6</sup>

### G. Proposed Reg. §1.988-2(b)(14)

In 1992, the Treasury and the IRS issued Proposed Reg. §1.988-2(b)(14), which would authorize the IRS to defer foreign currency losses on related-party loans where a taxpayer replaces the loan with a new loan denominated in a different currency. The IRS could require the loss on the first loan to be deferred until principal is paid on the replacement loan. The proposed regulation, which would apply to either the borrower or the lender under a related-party loan,

reflects a concern over the ability of taxpayers to control the time of recognition of losses. Somewhat curiously, the proposed regulation would apply only where the entity with the loss on a loan entered into a replacement loan with a related party denominated in a foreign currency that is different than the currency of the original loan. Debt-for-debt exchanges in the same foreign currency would not be covered, although the preamble to the proposed regulations asks for comments on how such exchanges should be addressed. The proposed effective date for the regulation would have it apply retroactively to transactions occurring after May 17, 1992. Given that the regulation has been proposed for 16 years and that its thrust is arguably inconsistent with subsequently issued Reg. §1.1001-3, it appears unlikely that this proposed regulation will be issued in final form, let alone with retroactive effect. Its proposed retroactive application nevertheless needs to be discussed as a qualification to any opinion regarding recognition of foreign currency losses on refinancing of related-party debt.

## III. Application to Specific Transactions

The balance of this article examines the application of these specific timing rules relating to section 988 transactions to the transfers or extinguishments of foreign currency denominated loans receivable under the major categories of nonrecognition transactions.

### A. Branch Transfers

**1. Transfer of a Loan Receivable to a Branch with a Functional Currency Different from That of Loan.** A transfer of an asset by a taxpayer to a branch of that taxpayer is generally treated as a contribution to a Code Sec. 987 qualified business unit of the taxpayer rather than as a taxable disposition of the asset. No gain or loss is recognized on the transfer of the asset, and, under the proposed Code Sec. 987 regulations issued in 1991, the branch takes a basis in the asset equal to the taxpayer’s basis, translated into the branch’s functional currency at the spot rate for the date of transfer.<sup>7</sup> If the branch is accounting for its income under the proposed Code Sec. 987 regulations issued in 2006, the branch would translate the taxpayer’s basis into its own functional currency using the spot rate for the date of the transfer, then treat a loan receivable denominated in a nonfunctional currency as an historical asset for purposes of those proposed regulations.<sup>8</sup>



For example, if the home office of a U.S. corporation transfers a euro-denominated loan receivable to its U.K. branch, the U.S. corporation would not recognize gain or loss on the transfer. If the branch accounts for its income using the 1991 proposed Code Sec. 987 regulations, it would translate the home office's dollar basis in the euro-denominated note into a sterling basis amount using the spot exchange rate for the date of the contribution. If the branch accounts for its income under the 2006 proposed Code Sec. 987 regulations, the U.K. branch would translate basis in the same manner and treat the euro-denominated loan receivable as a historical asset.

If a loan receivable is transferred to a branch and the loan receivable is denominated in a currency different than the branch's functional currency, the loan receivable continues to be a section 988 transaction on the branch's balance sheet. Therefore, Reg. §1.988-1(a)(10) does not apply to require recognition of gain or loss on the transfer to the branch.

#### **2. Transfer of a Loan Receivable to a Branch with a Functional Currency the Same As That of the Loan.**

If a loan receivable is transferred to a branch and the loan receivable is denominated in the branch's functional currency, the loan receivable ceases to be a section 988 transaction on the branch's balance sheet. If, for example, a U.S. corporation contributes a sterling denominated loan receivable to a U.K. branch that is a Code Sec. 987 qualified business unit, the sterling loan receivable will cease to be a section 988 transaction because it is denominated in the branch's functional currency. Reg. §1.988-1(a)(10) therefore requires that the full foreign currency gain or loss be recognized on the transfer.

If the branch accounts for its income under the 1991 proposed Code Sec. 987 regulations, it would take a sterling basis in the loan receivable equal to the loan's dollar basis, increased by the realized gain, translated into sterling at the spot rate for the date of transfer. If the branch accounts for its income under the 2006 proposed Code Sec. 987 regulations, it would compute its sterling basis in the sterling loan receivable in the same manner. The dollar value of the sterling loan receivable would then be marked to market on an annual basis under the 2006 proposed regulations and the resulting gain or loss would be added to the branch's unremitted Code Sec. 987 gain or loss pool.<sup>9</sup> Under either set of proposed Code Sec. 987 regulations, the U.S. corporation would be taxed on future changes in the value of the sterling loan receivable through the mechanisms of Code Sec. 987.

## **B. Capitalizations and Code Sec. 351 Contributions**

**1. Capitalization of a Foreign Currency Denominated Loan.** If the holder of a foreign currency denominated note exchanges the note for shares of the issuer, the holder has exchanged a Code Sec. 988 asset for an asset that is not governed by Code Sec. 988. As discussed above, Reg. §1.988-2(b)(13) requires the holder to recognize gain on the exchange to prevent the character conversion. If, for example, a U.S. corporation makes a euro-denominated loan to its French subsidiary then later capitalizes the loan, currency gain or loss arising during the period when the loan was outstanding is recognized on the capitalization. If the loan is denominated in a currency other than the functional currency of the borrower, the borrower also recognizes its exchange gain or loss. Unlike Reg. §1.988-1(a)(10), Reg. §1.988-2(b)(13) specifically limits the gain or loss to be recognized to the total gain or loss on the overall transaction.

#### **2. Code Sec. 351 Contribution of a Foreign Currency Denominated Loan Receivable to a Corporation with the Same Functional Currency As the Transferor.**

Where a foreign currency denominated loan receivable is contributed to a corporation in a Code Sec. 351 exchange, and the transferor and the transferee have the same functional currency, nonrecognition treatment under Code Sec. 351 will generally apply. For example, one U.S. corporation can make a Code Sec. 351 contribution of a yen denominated loan receivable to a second U.S. corporation without recognizing exchange gain. The loan receivable remains a section 988 transaction after the transfer; therefore the source and character of the unrealized gain or loss on the loan receivable will be preserved on future taxation to the transferee. The loan receivable is treated like any other asset transferred in such a Code Sec. 351 exchange. Because the transferor and transferee have the same functional currency, there is no need to translate the transferee's carryover basis into a different currency. On a collection of principal or disposition by the transferee, the portion of the resulting gain or loss that is Code Sec. 988 exchange gain or loss must be calculated. Reg. §1.988-2(b)(5) specifies that where a transferee receives a foreign currency denominated debt receivable in a non-recognition transfer, the transferee uses the historic exchange rate for the date on which the *transferor* acquired the debt to determine the portion of the gain or loss that is exchange gain or loss.



**3. Code Sec. 351 Contribution of a Foreign Currency Denominated Loan Receivable Where the Transferee has a Functional Currency Different from Both That of the Transferor and That of the Loan.**

Where the transferor and the transferee in a Code Sec. 351 contribution have different functional currencies, and the loan receivable transferred is denominated in a third currency, nonrecognition treatment under Code Sec. 351 is still generally available. There is a need, however, to translate the transferor's basis, carried over to the transferee under Code Sec. 361, into the transferee's functional currency. Although there appears to be no explicit rule specifying the exchange rate to use, translating the transferor's basis into the transferee's functional currency at the spot cross-exchange rate for the date of the contribution preserves the correct amount of gain for future recognition. On a future sale or collection of the principal by the transferee, it is necessary to determine what portion of the gain or loss is attributable to exchange rate fluctuations and therefore Code Sec. 988 gain or loss. Reg. §1.988-2(b)(5) specifies that where a transferee receives a foreign currency denominated debt receivable in a nonrecognition transfer, the transferee uses the historic exchange rate for the date on which the transferor acquired the debt to determine the portion of the gain or loss that is exchange gain or loss.

**4. Outbound Code Sec. 351 Described in Code Sec. 367(a).** As discussed above, Reg. §1.367(a)-5T(d) generally requires recognition of gains, but not losses, on the outbound transfer of foreign currency denominated financial instruments in transactions described in Code Sec. 367(a). Therefore a U.S. person transferring an appreciated foreign currency denominated loan receivable to a foreign corporation in a Code Sec. 351 exchange, or in an outbound asset reorganization, will generally be required to recognize gain on the transfer. This rule applies regardless of whether the loan receivable remains a section 988 transaction in the hands of the transferee. If the loan receivable is denominated in the currency of the foreign corporation to which it is being transferred, and it was acquired in the ordinary course of the business of the transferor that will be carried on by the transferee foreign corporation, an exception to gain recognition applies. Little guidance exists as to when a loan receivable will be considered acquired in the ordinary course of the transferred business, but the exception could be available if the transferred business is a lending business or the loans arose from a sale in the ordinary course of that business. Loans

receivable transferred other than in connection with the transfer of an entire operating business can never qualify for the exception.

**5. Code Sec. 351 Contribution of a Loan Receivable Denominated in the Transferee's Functional Currency.** Assume that a controlled foreign corporation with a dollar functional currency contributes an appreciated euro-denominated loan receivable to a lower-tier controlled foreign corporation with a euro functional currency in a Code Sec. 351 exchange. Because the euro-denominated loan receivable will be held by a euro functional currency corporation, it will lose its character as a section 988 transaction. The transferor will have exchanged a section 988 asset for equity in the transferee corporation, which is not a Code Sec. 988 asset. The transferee corporation will hold a functional currency loan receivable, which similarly is not a section 988 transaction. In this case, however, none of the specific "last clear chance" rules applies to require recognition of the gain. Provided that the loan receivable is not the obligation of the transferee, Reg. §1.988-2(b)(13) does not apply. Because the exchange is not an "intra-taxpayer transfer," Reg. §1.988-1(a)(10) does not apply. Provided that no qualified business unit is changing its functional currency in connection with the transfer, neither Reg. §1.367(b)-2(j) nor Reg. §1.985-5(b) should apply. Unless some generalized common-law "last clear chance" principle applies, exchange gain or loss should not be recognized on the exchange. Although the IRS has at times asserted, in other contexts, that gain must be recognized whenever necessary to avoid an economic gain permanently escaping taxation,<sup>10</sup> this does not seem to be an accepted principle of law. Where the Code Sec. 988 regime has created a series of specific recognition rules to override the application of nonrecognition provisions, and a transaction is described in none of these specific rules, the better view appears to be that the nonrecognition provisions should be permitted to apply.

If gain is not recognized on such a Code Sec. 351 transfer of a loan receivable to a transferee with the same functional currency as the loan receivable, the transferee must translate the transferor's basis in the loan receivable into the transferee's functional currency. If the spot rate for the date of transfer is used, the transferee would acquire the loan receivable with a basis different from its stated redemption price at maturity, resulting in market discount or acquisition premium as measured in the transferee's functional currency. Although there would be a shift in charac-

ter, the economic gain or loss would be preserved for ultimate taxation to the transferee. In the absence of an explicit rule,<sup>11</sup> however, taxpayers might assert that basis should be translated at the historical rate for the date on which the transferor acquired the loan receivable. The use of such an historical translation rate would cause the unrealized exchange gain or loss to evaporate.

## C. Code Sec. 332 Liquidations

### **1. Code Sec. 332 Liquidation of Subsidiary into a Parent Which Holds Subsidiary's Foreign Currency Denominated Note.**

Where a subsidiary is liquidated into its parent under Code Sec. 332 and the subsidiary is indebted to its parent, Reg. §1.332-7 provides that the distribution of the subsidiary's assets will be deemed to be made first in satisfaction of its debt, and only thereafter with respect to its stock. The regulation goes on to provide that "no gain or loss shall be recognized to the subsidiary upon the transfer of such properties even though some of the properties are transferred in satisfaction of the subsidiary's indebtedness to its parent." It is clear that the parent's receipt of property in satisfaction of the debt it holds results in recognition of gain or loss by the parent with respect to that debt. The regulation gives the example of the parent recognizing gain where the parent had acquired the subsidiary's debt at a discount. It is also clear that the subsidiary does not recognize gain or loss with respect to the *assets* that it transfers in a Code Sec. 332 liquidation in satisfaction of debt held by its parent. The language of Reg. §1.332-7 quoted above is also broad enough to be read to provide that the subsidiary does not recognize gain or loss with respect to the *debt* that it satisfies by the transfer of properties to its parent in a Code Sec. 332 liquidation. It is not entirely clear, however, that the drafters of the regulation were focusing on the possibility of the subsidiary having a gain or loss on the satisfaction of its debt in a Code Sec. 332 liquidation, given that this scenario would not arise except in the case of a foreign currency denominated debt.

**2. Transfer of Third-Party, Foreign Currency Denominated Note in a Code Sec. 332 Liquidation—Parent and Subsidiary Have Same Functional Currency.** Where a subsidiary with the same functional currency as its parent is liquidated under Code Sec. 332, a nonfunctional currency, third-party loan receivable can be distributed in the liquidation without recognition of gain or loss. Because no qualified business unit is changing its functional currency,

neither Reg. §1.367(b)-2(j) nor Reg. §1.985-5(b) should apply to require recognition of currency gain. The parent should carry over the subsidiary's basis in the loan receivable under Code Sec. 334(b), subject to the potential application of the loss importation rules of Code Sec. 362(e) in the case of an inbound liquidation. For purposes of measuring the Code Sec. 988 gain or loss on the payment or disposition of the loan, the parent would use the difference between the historical exchange rate on the date that the *subsidiary* acquired the loan receivable and the spot rate on the date of payment or disposition, as provided by Reg. §1.988-2(b)(5). The result is that both the amount and character of the subsidiary's unrealized Code Sec. 988 gain or loss as of the liquidation date are preserved for future taxation to the parent.

### **3. Transfer of Third-Party, Foreign Currency Denominated Note in a Code Sec. 332 Liquidation—Parent and Subsidiary Have Different Functional Currencies.**

Where the parent and subsidiary in the Code Sec. 332 liquidation have different functional currencies, but neither has the currency of the loan receivable as its functional currency, nonrecognition treatment still applies. Even if the subsidiary's operations are carried on in the parent's functional currency, so that there is a change in the functional currency for those operations, neither Reg. §1.367(b)-2(j) nor Reg. §1.985-5(b) should require recognition of the currency gain or loss on the loan receivable, because the loan is not denominated in the parent's functional currency and therefore remains a section 988 transaction. The parent would need to translate the subsidiary's basis in the loan receivable into the parent's functional currency. Although an explicit regulatory rule again appears to be lacking, translating the subsidiary's basis at the spot rate for the date of the liquidation would preserve the correct amount of gain or loss for future taxation. In the case of an inbound liquidation, the loss importation rules of Code Sec. 362(e), could apply, however. For purposes of measuring the Code Sec. 988 gain or loss on the payment or disposition of the loan, the parent would again use the difference between the historical exchange rate on the date that the *subsidiary* acquired the loan receivable and the spot rate on the date of payment or disposition, as provided by Reg. §1.988-2(b)(5).

**4. Transfer of Third-Party, Foreign Currency Denominated Note in a Code Sec. 332 Liquidation—Note Denominated in Parent's Functional Currency.** Where a subsidiary liquidates into its parent under

Code Sec. 332, and the subsidiary's operations are continued and accounted for in the parent's functional currency, the qualified business unit consisting of the subsidiary's operations changes its functional currency. As discussed above, Reg. §1.367(b)-2(j) and Reg. §1.985-5(b) would require the recognition of unrealized foreign currency gain or loss on a loan receivable held by the subsidiary denominated in the parent's functional currency, immediately prior to the liquidation. The subsidiary's functional currency basis in the loan receivable would then be adjusted for the gain or loss recognized, and the adjusted basis would be translated into the parent's functional currency at the spot rate for the date of the liquidation.

If the subsidiary's assets, including the loan receivable, continue to be used in a separate qualified business unit of the parent that maintains the subsidiary's old functional currency, the treatment is less clear. It is arguable that the loan receivable is not deemed distributed to the parent in an intra-taxpayer transaction described in Reg. §1.988-1(a)(10). If the loan receivable is viewed as continuously remaining on the books of the new qualified business unit of the parent, it is arguable that foreign currency gain or loss on the loan receivable is not recognized and that the parent instead establishes basis and equity pools with respect to the qualified business unit for purposes of Code Sec. 987 in the manner described in Reg. §1.988-5(e)(4).

## D. Asset Reorganizations

### **1. Transfer of Third-Party, Foreign Currency Denominated Note in an Asset Reorganization—Transferor and Transferee Have Same Functional Currency.**

Where one corporation transfers a third-party, foreign currency denominated loan receivable in an asset reorganization to a transferee with the same functional currency as the transferor, nonrecognition treatment should generally be available. Because no qualified business unit or taxpayer is changing its functional currency as a result of the reorganization, neither Reg. §1.367(b)-2(j) nor Reg. §1.985-5(b) should require foreign currency gain or loss on the loan receivable to be recognized. The loan receivable remains a section 988 transaction in the hands of the transferee with a basis equal to the transferor's basis and a historical exchange rate dating from the transferor's acquisition of the loan receivable for purposes of measuring Code Sec. 988 gain or loss. Both the amount and the character of the transferor's unrealized Code Sec. 988 gain or loss as of the date

of the reorganization are preserved for future taxation to the transferee.

**2. Transfer of Third-Party, Foreign Currency Denominated Note in an Asset Reorganization—Transferor and Transferee Have Different Functional Currencies.** Where the transferor and the transferee in the asset reorganization have different functional currencies, but neither has the currency of the loan receivable as its functional currency, nonrecognition treatment still applies. Even if the transferor's operations are carried on in the transferee's functional currency, so that there is a change in the functional currency for those operations, neither Reg. §1.367(b)-2(j) nor Reg. §1.985-5(b) should require recognition of the currency gain or loss on the loan receivable, because the loan is not denominated in the transferee's functional currency and therefore remains a section 988 transaction. The transferee must translate the transferor's basis in the loan receivable into the transferee's functional currency. Reg. §1.367(b)-2(j) and Reg. §1.985-5(b) provide for the translation of the transferor's basis at the spot rate for the date of the reorganization to preserve the correct amount of gain or loss for future taxation. In the case of an inbound liquidation, the loss importation rules of Code Sec. 362(e), could apply, however.<sup>12</sup> For purposes of measuring the Code Sec. 988 gain or loss on the payment or disposition of the loan, the transferee would again use the difference between the historical exchange rate on the date that the *transferor* acquired the loan receivable and the spot rate on the date of payment or disposition, as provided by Reg. §1.988-2(b)(5).

### **3. Transfer of Third-Party, Foreign Currency Denominated Note in an Asset Reorganization—Note Denominated in Transferee's Functional Currency.**

Where transferor transfers a foreign currency denominated loan receivable to a transferee in an asset reorganization, and the transferor's operations are continued and accounted for in the transferee's functional currency, the qualified business unit consisting of the transferor's operations changes its functional currency. As discussed above, Reg. §1.367(b)-2(j) and Reg. §1.985-5(b) would require the recognition of unrealized foreign currency gain or loss on the transfer of a loan receivable denominated in the transferee's functional currency, immediately prior to the liquidation. The transferor's functional currency basis in the loan receivable would then be adjusted for the gain or loss recognized, and the adjusted basis would be translated into the transferee's functional currency at the spot rate for the date of the transfer.



If the transferor's assets, including the loan receivable, continue to be held in a separate qualified business unit of the transferee that maintains the transferor's old functional currency, the treatment is again less clear. It is arguable that the loan receivable is not deemed distributed to the transferee's home office in an intra-taxpayer transaction described in Reg. §1.988-1(a)(10). If the loan receivable is viewed as continuously remaining on the books of the new qualified business unit of the transferee, it is arguable that foreign currency gain or loss on the loan receivable is not recognized and that the transferee instead establishes basis and equity pools with respect to its new qualified business unit for purposes of Code Sec. 987 in the manner described in Reg. §1.988-5(e)(4).

**4. Foreign Currency Denominated Note Extinguished in Asset Reorganization.** If the transferor in an asset reorganization transfers a foreign currency denominated loan receivable to the transferee, and the loan is an obligation of the transferee, the loan is treated as extinguished. The transferor is treated as exchanging the loan receivable for stock of the obligor, or in the case of a triangular reorganization, for stock of the obligor's parent. Where the loan receivable is treated as exchanged for stock of the obligor, Reg. §1.988-2(b)(13) would appear to apply, requiring exchange gain or loss to be recognized, as discussed above. In the case of a triangular reorganization, where the transferor is viewed as exchanging the loan receivable for stock of the obligor's parent, Reg. §1.988-2(b)(13) is not applicable. The transferor's exchange of its loan receivable, i.e. property, for stock of the transferee's parent would appear to be literally described in section 361(a) and therefore entitled to nonrecognition treatment. None of the "last

clear change" rules discussed above would apply to override this treatment. This nonrecognition treatment, however, would depend on the satisfaction of the debt being viewed as arising from the transfer of the loan receivable as an asset in the reorganization rather than from a separate satisfaction of the debt by the transferee/obligor delivering stock of its parent outside of the reorganization.

Note, however, that if the *obligor* under the loan is the *transferor* in an asset reorganization and the loan note was held by the transferee, Rev. Rul. 72-464,<sup>13</sup> would apply principles similar to those of Reg. §1.332-7. The transferor/obligor would be deemed to satisfy its obligation under the loan by a transfer of a portion of its assets. The transferee/creditor would therefore be required to recognize gain or loss on a foreign currency denominated loan receivable because it is treated as receiving payment of the loan from the transferor/obligor.

## IV. Conclusion

The interactions of Code Sec. 988 and the corporate nonrecognition provisions as applied to transfers of foreign currency denominated assets, including loans receivable, are complex, but they are the subject of fairly detailed regulatory rules, as discussed above. The interactions of Code Sec. 988 and the nonrecognition provisions in the context of foreign currency denominated liabilities are a much less clear, given that the nonrecognition rules are generally drafted to address gains or losses on assets rather than on liabilities. The next installment of this article will explore the treatment of foreign currency denominated liabilities in the context of corporate nonrecognition transactions.

## ENDNOTES

<sup>1</sup> Proposed Reg. §1.987-2(b)(2) (1991).

<sup>2</sup> Reg. §1.985-5(b) Step 1.

<sup>3</sup> Reg. §1.985-5(b) Step 2.

<sup>4</sup> *Cottage Savings Ass'n*, S Ct, 91-1 USTC ¶10,221, 499 US 554, 111 S Ct 1503.

<sup>5</sup> *National Standard Co.*, 80 TC 551, Dec. 39,969 (1983), *aff'd*, CA-6, 84-2 USTC ¶10,001, 749 F2d 369.

<sup>6</sup> See L.G. Harter & M. Harper, *Can Code Sec. 267(f) Defer an Issuer's Code Sec. 988*

*Loss on the Repayment of its Debt?* J. TAX'N GLOBAL TRANS., Summer 2005, at 12.

<sup>7</sup> Proposed Reg. §1.987-2(b)(2) (1991).

<sup>8</sup> Proposed Reg. §1.987-2(d) (2006).

<sup>9</sup> Proposed Reg. §1.987-4 (2006).

<sup>10</sup> See, e.g., Rev. Rul. 93-7, 1993-1 CB 8; CCA 20040009 (Oct. 6, 2000).

<sup>11</sup> For discussions of the proper exchange rate for translation of basis in inbound nonrecognition transactions, see R. Katcher,

*Back to Basis: Crossing the U.S. Frontier*, TAX NOTES, at 547 (Oct. 28, 2002); R. Doernberg & M. Thompson, *Recognition of Foreign Currency Exchange Gains or Losses on Inbound Event*, TAX NOTES, at 105 (Jan. 6, 2003).

<sup>12</sup> See R. Katcher, *supra*, for argument that use of a spot rate to translate basis in an inbound reorganization may be appropriate.

<sup>13</sup> Rev. Rul. 72-464, 1972-2 CB 214.