TAX 101:
TRANSACTIONS IN FX: A PRIMER FOR INDIVIDUALS

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In our last issue, we discussed the recent I.R.S. guidance on bitcoins which, in general, stated that transactions in bitcoins should be treated as transactions in property under the general rules of the Internal Revenue Code (the "Code") rather than the special rules applicable to foreign currency. We therefore thought it would be useful to provide a primer on common transactions involving foreign currency (sometimes hereinafter referred to as "FX") with respect to U.S. individuals.

IN GENERAL

The first thing to note about engaging in transactions involving foreign currency is that foreign currency is treated as any other asset. Think stocks, bonds, or real estate. When an individual buys foreign currency, that individual has a basis in the FX (*e.g.*, Euro) similar to any other investment. When the individual sells that foreign currency, that individual will have a realization event, in which case gain or loss may have to be recognized. Whether the character of that gain or loss is ordinary will depend on the specific transaction and the applicability of Code §988, as will be discussed in more detail below.

> **Example 1**
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> Mr. FX Guy, a U.S. citizen individual, buys real property located in the U.K. for 100,000 British pounds (£) on January 1, 2014. In order to effectuate the purchase, Mr. FX Guy uses £100,000 that he purchased for $150,000 on January 1, 2012 when the exchange rate was $1.5 to £1. Assume on January 1, 2014, the exchange rate was $2: £1 as the British pound appreciated against the U.S. dollar. The £100,000 has a basis of $150,000. It was acquired on January 1, 2012 and disposed of on January 1, 2014. The disposition is a sale of an asset (in this case, the FX). The amount realized is the fair market value of the consideration received, or $200,000. Accordingly, the taxpayer has a gain of $50,000 attributable to the foreign currency that must be recognized. The character of the gain, and the applicability of §988, will depend on whether the transaction was a "personal transaction."

The second thing to highlight is the tax treatment of a foreign currency denominated transaction turns on the identity of the taxpayer's functional currency. When dealing with multiple currencies, a rule is required to provide the "default" currency for which transactions are entered into and gain or loss can be measured. Thus, §985(a) generally requires all U.S. Federal income tax determinations to be made

in a taxpayer's functional currency. Subject to one caveat, U.S. individuals are required to use the U.S. dollar as the functional currency.[2] Additionally, U.S. individual taxpayers must measure income or loss from dealings in foreign currency in U.S. dollars, on a transaction-by-transaction basis.

To the extent a taxpayer has a "qualified business unit" ("QBU"), the taxpayer may be permitted to use a foreign currency as its functional currency. In that case, income or loss derived from a QBU is determined in a foreign currency (before translation into U.S. dollars). In general, the use of a foreign currency as the functional currency of a QBU will result in the deferral of exchange gain or loss from transactions conducted in that currency as there will not be a taxable disposition upon exchange of the FX.

QUALIFIED BUSINESS UNIT: FOR INDIVIDUALS

As noted above, a QBU may be permitted to use a foreign currency as its functional currency. A QBU that does not conduct its activities primarily in U.S. dollars may use the currency of the economic environment in which a significant part of the QBU's activities is conducted, provided that the QBU keeps (or is presumed to keep) its books and records in such currency.[3] If a QBU has more than one currency, the QBU may choose any such currency as its functional currency.

A QBU is any separate and clearly identified unit of a trade or business of a taxpayer provided that separate books and records are maintained. The regulations specifically provide that an individual is not a QBU. However, an individual's activities may qualify as a QBU if the activities constitute a trade or business and a separate set of books and records is maintained with respect to the activities. While not ordinarily the case, for these purposes, a trade or business is an independent economic enterprise carried on for profit, the expenses related to which are deductible under §§162 or 212.[4]

Example 1

Mr. FX Guy is an individual resident of the United States and is engaged in a trade or business wholly unrelated to any type of investment activity. Mr. FX Guy also maintains a portfolio of foreign currency-denominated investments through a foreign broker. The broker is responsible for all activities necessary to the management of Mr. FX Guy's investments and maintains separate books and records with respect to all investment activities of the taxpayer. Mr. FX Guy's investment activities qualify as a QBU to the extent the activities generate expenses that are deductible under §212.

[2] See Treas. Reg. §1.985-1(b)(1)(i).
[3] Treas. Reg. §1.985-1(c).
[4] See Treas. Reg. §1.989(a)-1(b), (c).

CHARACTER OF GAIN OR LOSS

Section 988(a) provides that any foreign currency gain or loss attributable to a "Section 988 transaction" is computed separately and treated as ordinary income or loss.

Thus, the first question is what types of transactions are Section 988 transactions. In general, Section 988 transactions include the following:

- Any disposition of any nonfunctional currency.
  - As previously noted, in the case of U.S. individuals, a nonfunctional currency is any currency other than the U.S. dollar.
  - The acquisition of nonfunctional currency is relevant for determining basis.
  - For these purposes, nonfunctional currency includes coin and nonfunctional currency denominated demand or time deposits or similar instruments issued by a bank or other financial institution.
- Any of the following transactions, if the amount that he taxpayer is entitled to receive (or is required to pay) is: (i) denominated in terms of a nonfunctional currency or (ii) determined by reference to the value of one or more nonfunctional currencies:
  - The acquisition of a debt instrument or becoming the obligor under a debt instrument.
  - Accruing (or otherwise taking into account) for purposes of this subtitle any item of expense or gross income or receipts which is to be paid or received after the date on which so accrued or taken into account.
  - Entering into or acquiring any forward contract, futures contract, option, or similar financial instrument.[5]

However, certain types of transactions are excluded from §988. For example, regulated futures contracts and nonequity options subject to the mark-to-market regime of §1256 are excluded unless the taxpayer elects in. In this case, the election is for all transactions involving regulated futures contracts and nonequity options.[6]

A special rule exists for a forward contract, a futures contract, or option that is held as a capital asset and that is not part of a straddle. The taxpayer may elect to treat exchange gain or loss as capital gain or loss. The election must be made, and the

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5 Code §988(c)(1); see also Treas. Reg. §1.988-1.
6 Code §988(c)(1)(D).

transaction must be identified, on the same day the transaction is entered into by the taxpayer.[7]

Example 2

On January 1, 2014, Mr. FX Guy acquires 10,000 Canadian dollars. On January 15, 2014, Mr. FX Guy converts the 10,000 Canadian dollars to U.S. dollars. The acquisition of the 10,000 Canadian dollars is a Section 988 transaction for purposes of establishing Mr. FX Guy's basis in such Canadian dollars. The conversion of the 10,000 Canadian dollars to U.S. dollars is a Section 988 transaction.

Example 3

On January 1, 2014, Mr. FX Guy purchases at original issue a 3-year bond maturing on December 31, 2017 for £100,000 at a stated redemption price of £100,000. The bond pays 10% interest per annum. The acquisition of the bond is a Section 988 transaction.

Example 4

On January 1, 2014, Mr. FX Guy purchases a one-year note at original issue for its issue price of $1,000. The note pays interest in dollars at the rate of 4% per annum. The amount of principal received by Mr. FX Guy upon maturity is equal to $1,000 plus the equivalent of the excess, if any, of: (a) the Financial Times One Hundred Stock Index (an index of stocks traded on the London Stock Exchange, hereafter referred to as the "FT100") determined and translated into dollars on the last business day prior to the maturity date, over (b) £2.150, the "stated value" of the FT100, which is equal to 110% of the average value of the index for the six months prior to the issue date, translated at the exchange rate of £1 = $1.50. The purchase of this instrument is not a Section 988 transaction because the index used to compute the principal amount received upon maturity is determined with reference to the value of stock and not nonfunctional currency.

Example 5

On January 1, 2014, Mr. FX Guy enters into an interest rate swap that provides for the payment of amounts by Mr. FX Guy to its counterparty based on 4% of a 10,000 yen principal amount in exchange for amounts based on yen LIBOR rates. The yen for yen interest rate swap is a Section 988 transaction.

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[7] Code §988(a)(1); see also Treas. Reg. §1.988-3.

Example 6

On January 1, 2014, Mr. FX Guy enters into an option contract for sale of a group of stocks traded on the Japanese Nikkei exchange. The contract is not a Section 988 transaction because the underlying property to which the option relates is a group of stocks and not nonfunctional currency.

RELIEF FOR PERSONAL TRANSACTIONS

Prior to the Tax Reform Act of 1986 ("1986 Act"), many of the rules for determining the U.S. Federal income tax consequences of foreign currency transactions were embodied in a series of court cases and revenue rulings issued by the I.R.S. The legislative history notes that there was some lack of clarity with respect to the pre-1986 law regarding the character, the timing of recognition, and the source of gain or loss due to fluctuations in the exchange rate of foreign currency. Thus, the 1986 Act provided a comprehensive set of rules for the U.S. tax treatment of transactions involving foreign currencies embodied in §988. With respect to individuals, the 1986 Act provided as follows:

> (e) Application to individuals.
>
> This Section shall apply to Section 988 transactions entered into by an individual only to the extent expenses properly allocable to such transactions meet the requirements of Sections 162 or 212 (other than that part of Section 212 dealing with expenses incurred in connection with taxes).

Accordingly, notwithstanding the 1986 Act, pre-1986 law continued to apply to personal transactions. Pre-1986 law provided that crossing in-and-out of currencies required calculation of gain and loss. For example, in Rev. Rul. 74-7, the IRS has ruled that an individual who converts U.S. dollars to a foreign currency for personal use while traveling abroad realizes exchange gain or loss on reconversion of appreciated or depreciated foreign currency and the transaction was not a "like-kind exchange." The ruling further stated that the foreign currency at issue was a capital asset and any gain or loss realized was capital in nature.

In 1997, Congress made a *de minimis* exception to this regime for "personal transactions." Current §988 now provides:

> (e) Application to individuals.
>
> (1) In general.
>
> The preceding provisions of this Section shall not apply to any Section 988 transaction entered into by an individual which is a personal transaction.
>
> (2) Exclusion for certain personal transactions.
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> If—

(A) nonfunctional currency is disposed of by an individual in any transaction, and

(B) such transaction is a personal transaction.

so gain shall be recognized for purposes of this subtitle by reason of changes in exchange rates after such currency was acquired by such individual and before such disposition. The preceding sentence shall not apply if the gain which would otherwise be recognized on the transaction exceeds $200.

(3) Personal transactions.

For purposes of this subsection, the term "personal transaction" means any transaction entered into by an individual, except that such term shall not include any transaction to the extent that expenses properly allocable to such transaction meet the requirements of—

(A) Section 162 (other than traveling expenses described in subsection (a)(2) thereof), or

(B) Section 212 (other than that part of Section 212 dealing with expenses incurred in connection with taxes).

"Thus, if an individual acquires foreign currency and disposes of it in a personal transaction and the exchange rate changes between the acquisition and disposition of such currency, gain is not recognized if it does not exceed $200."

Thus, if an individual acquires foreign currency and disposes of it in a personal transaction and the exchange rate changes between the acquisition and disposition of such currency, gain is not recognized if it does not exceed $200. However, no change is made with respect to losses, which are limited in the case of personal transactions.[8]

As noted above, a personal transaction is any transaction other than a transaction which is a trade or business expense or a §212 expense (*i.e.*, an expense in a for profit activity).

The 1997 legislative history stated the reasons for the change as follows:

An individual who lives or travels abroad generally cannot use U.S. dollars to make all of the purchases incident to daily life. If an individual must treat foreign currency in this instance as property giving rise to U.S.-dollar income or loss every time the individual, in effect, barters the foreign currency for goods or services, the U.S. individual living in or visiting a foreign country will have a significant administrative burden that may bear little or no relation to whether U.S.-dollar measured income has increased or decreased. The Committee believes that individuals should be given relief from the requirement to keep track of exchange gains on a transaction-by-transaction basis in *de minimis* cases.

[8] See Code §165(c).

Although this exception appears to be favorable, for U.S. citizens living abroad or dealing with large sums of foreign currency, the exception is limited. Further, the non-deductibility of losses can be quite disadvantageous to the taxpayer in the case of, *e.g.,* personal mortgages.

Example 8

Assume Mr. FX Guy, a U.S. citizen, exchanges $1,500 for 1000 British pounds (£) on April 1, 2014 for use in a personal vacation in the U.K. when the exchange rate was $1.5 to £1. Assume Mr. FX Guy spent £100 on transportation cost from the airport on April 1, 2014; £200 at a local restaurant on April 5, 2014; £100 on transportation cost to the local airport on his return flight on April 8, 2014; and converted the £600 back to U.S. dollars on April 8, 2014. Assume the exchange rates were $1.5 to £1 on April 1, 2014; $1.75 to £1 on April 5, 2014; and $2 to £1 on April 8, 2014. As a technical matter, Mr. FX Guy must determine his basis in the FX and calculate gain or loss on a <u>per transaction</u> basis. In this case, basis in each £1 is $1.5; gain on each transaction is, respectively, $0; $50; $50; and $300. The first three transactions' gain will not be recognized because they do not exceed $200; the final transaction's gain must be recognized as it exceeds $200.

Example 9

Assume Mr. FX Guy, a U.S. citizen, buys a U.K. home for personal use for 1,000,000 British pounds (£) when the exchange rate was $2 to £1. Assume Mr. FX Guy financed the home with a personal mortgage for £800,000, also converted at $2 = L1. Assume no principal was repaid, and the property was sold for £2,000,000 when the exchange rate was $1.5 to £1, and £800,000 of the purchase price was used to repay the mortgage. In this case, there are two separate transactions: the sale of the real property and the repayment of the mortgage. With respect to the sale of the real property, the taxpayer has a gain of $1,000,000 [current U.S.D. value of $3,000,000 (1.5 x 2,000,000) less initial U.S.D. cost of $2,000,000] a portion of which may be excluded under the principal residence exclusion. With respect to the repayment of the mortgage, the taxpayer has a gain of $400,000, the difference between the U.S.D. value of the amount borrowed ($1,600,000) and the U.S.D. value of the repayment ($1,200,000).

COMMON INVESTMENT ACTIVITIES

As noted above, investment (for profit) activities are Section 988 transactions. Common investments include deposits, debt, equity, and derivatives.

Determining Basis

The basis of nonfunctional currency withdrawn from an account with a bank or other financial institution is determined under any reasonable method that is consistently applied from year to year by the taxpayer to all accounts denominated in a nonfunctional currency. For example, a taxpayer may use a first in first out method, a last in first out method, a pro rata method, or any other reasonable method that is consistently applied. However, a method that consistently results in units of nonfunctional currency with the highest basis being withdrawn first is not considered reasonable.[9] The simplest method is to use a formula represented as follows: (FX withdrawn / total FX in the account) x (total U.S. dollar basis). This method is blessed in an example in the regulations.

Publically Traded Stock

If stock or securities traded on an established securities market are sold for nonfunctional currency by a cash basis taxpayer, the amount realized with respect to the stock or securities (as determined on the trade date) is computed by translating the units of nonfunctional currency received into functional currency at the spot rate on the settlement date of the sale. If a cash basis taxpayer for nonfunctional currency purchases stock or securities traded on an established securities market, the basis of the stock or securities is determined by translating the units of nonfunctional currency paid into functional currency at the spot rate on the settlement date of the purchase. An accrual method taxpayer may also elect to use the same rule.[10]

Example 10

On January 1, 2013 (the trade date), Mr. FX Guy, a calendar year cash basis U.S. individual, purchases stock for 100 British pounds (£) for settlement on January 5, 2013. On January 1, 2014, the spot value of the £100 is $140. On January 5, 2013, Mr. FX Guy purchases £100 for $141, which X uses to pay for the stock. Mr. FX Guy's basis in the stock is $141, or the U.S.D. value on the settlement date.

On December 30, 2013 (the trade date), Mr. FX Guy sells the stock for £110 for settlement on January 5, 2014. On December 30, 2013, the spot value of £110 is $165. On January 5, 2014, Mr. FX Guy transfers the stock and receives £110 which, translated at the spot rate, equals $166. Mr. FX Guy's basis in the £110 received

[9] Treas. Reg. §1.988-2(a)(2)(iii).
[10] Treas. Reg. §1.988-2(a)(4)(iv)(A)-(C).

from the sale of the stock is $166, which is the U.S.D. value on the settlement date.

Special Rules Relating to Certificates of Deposit

As noted above, certificates of deposit can be Section 988 transactions if denominated in a foreign currency or if value is determined by reference to that foreign currency. However, there are special rules with respect to certificates of deposit. In particular, no exchange gain or loss is recognized with respect to the following transactions:

- The deposit of nonfunctional currency in a demand or time deposit or similar instrument (including a certificate of deposit) issued by a bank or other financial institution if such instrument is denominated in such currency;

- Withdrawal of nonfunctional currency from a demand or time deposit or similar instrument issued by a bank or other financial institution if such instrument is denominated in such currency;

- Receipt of nonfunctional currency from a bank or other financial institution from which the taxpayer purchased a certificate of deposit or similar instrument denominated in such currency by reason of the maturing or other termination of such instrument; and

- The transfer of nonfunctional currency from a demand or time deposit or similar instrument issued by a bank or other financial institution to another demand or time deposit or similar instrument denominated in the same nonfunctional currency issued by a bank or other financial institution.

For these purposes, the taxpayer's basis in the units of nonfunctional currency or other property received in the transaction is the adjusted basis of the units of nonfunctional currency or other property transferred.[11]

Translating Interest Income and Expense

Demand Accounts

Interest income received, with respect to a demand account with a bank or other financial institution which is denominated in (or the payments of which are determined by reference to) a nonfunctional currency, is translated into functional currency at the spot rate on the date received or accrued or pursuant to any reasonable spot rate convention consistently applied by the taxpayer to all taxable years and to all accounts denominated in nonfunctional currency in the same financial institution. For example, a taxpayer may translate interest income received with respect to a demand account on the last day of each month of the taxable year, on the last day of each quarter of the taxable year, on the last day of each half of the taxable year, or on the last day of the taxable year.[12] However, no

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[11] Treas. Reg. §1.988-2(a)(1)(iii).
[12] Treas. Reg. §1.988-2(b)(1).

exchange gain or loss is realized upon the receipt or accrual of interest income with respect to a demand account.

Debt Denominated or Determined by Reference to a Single Nonfunctional Currency

Interest income or expense received or paid that is not required to be accrued by a taxpayer prior to receipt or payment is translated at the spot rate on the date of receipt or payment. A taxpayer may have to accrue interest income, *e.g.*, if the instrument has original issue discount.[13] In this case, the regulations state that the taxpayer must, in general, translate accrued interest or expense at the average spot rate for the interest accrual period or, with respect to an interest accrual period that spans two taxable years, at the average spot rate for the partial period within the taxable year.[14] However, the taxpayer may elect to use a spot accrual convention, in which case income and expense are translated at the spot rate on the last day of the interest accrual period (and in the case of a partial accrual period, the spot rate on the last day of the taxable year). If the last day of the interest accrual period is within five business days of the date of receipt or payment, the regulations provide that the taxpayer may translate interest income or expense at the spot rate on the date of receipt or payment. The election is made by filing a statement with the taxpayer's first return in which the election is effective.[15]

With respect to exchange gain or loss, the taxpayer must realize exchange gain or loss with respect to accrued interest income on the date such accrued interest income is received or the instrument is disposed of. The amount of exchange gain or loss so realized with respect to accrued interest income is determined for each accrual period by:

- Translating the units of nonfunctional currency interest income received with respect to such accrual period into functional currency at the spot rate on the date the interest income is received or the instrument is disposed of (or deemed disposed of); and

- Subtracting from such amount the amount computed by translating the units of nonfunctional currency interest income accrued with respect to such income received at the average rate for the accrual period.[16]

A similar rule is provided for accrued interest expense.[17]

In general, with respect to principal, the holder of a debt instrument realizes exchange gain or loss on the date principal is received from the obligor or the instrument is disposed of. 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. The amount of exchange gain or loss so realized by the holder with respect to principal is determined by:

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[13] Treas. Reg. §1.988-2(b)(2)(ii)(B).
[14] Treas. Reg. §1.988-2(b)(2)(ii)(C).
[15] Treas. Reg. §1.988-2(b)(2)(iii).
[16] Treas. Reg. §1.988-2(b)(3).
[17] Treas. Reg. §1.988-2(b)(4).

- 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

- 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).

In order to make these calculations for debt instruments issued with original issue discount, a series of ordering rules apply. In general, units of nonfunctional currency received or paid are treated: first as a receipt or payment of periodic interest, second as a receipt or payment of original issue discount to the extent accrued as of the date of the receipt or payment, and finally as a receipt or payment of principal.[18]

Example 11

Mr. FX Guy is an individual on the cash method of accounting with the dollar as his functional currency. On January 1, 2012, Mr. FX Guy converts $13,000 to 10,000 British pounds (£) at the spot rate of £1 = $1.30 and loans the £10,000 to Y for 3 years. The terms of the loan provide that Y will make interest payments of £1,000 on December 31 of 2012, 2013, and 2014, and will repay Mr. FX Guy's £10,000 principal on December 31, 2014. Assume the spot rates for the pertinent dates are as follows:

Date	Spot rate (pounds to dollars)
Jan. 1, 2012	£1 = $1.30
Dec. 31, 2012	£1 = $1.35
Dec. 31, 2013	£1 = $1.40
Dec. 31, 2014	£1 = $1.45

Mr. FX Guy will translate the £1,000 interest payments at the spot rate on the date received. Accordingly, Mr. FX Guy will have interest income of $1,350 in 2012, $1,400 in 2013, and $1,450 in 2014. Because Mr. FX Guy is a cash basis taxpayer, Mr. FX Guy does not realize exchange gain or loss on the receipt of interest income.

Mr. FX Guy will realize exchange gain upon repayment of the £10,000 principal amount determined by translating the £10,000 at

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[18] Treas. Reg. §1.988-2(b)(7).

the spot rate on the date it is received (£10,000 × $1.45 = $14,500) and subtracting from such amount, the amount determined by translating the £10,000 at the spot rate on the date the loan was made (£10,000 × $1.30 = $13,000). Accordingly, Mr. FX Guy will realize an exchange gain of $1,500 on the repayment of the loan on December 31, 2014.

Debt Denominated or Determined by Reference to Multiple Currencies

FX debt subject to contingencies, or determined by reference to multiple currencies, is subject to special rules.[19] In this case, a hypothetical model ("noncontingent bond method") is created that eliminates the contingencies in order to calculate interest income, gain or loss on a per annum basis (to avoid deferral). Appropriate adjustments are made in order to 'true-up' actual interest income, gain or loss. In order to facilitate this model in the case of multicurrency debt, a "predominant" currency must be determined. In general, the predominant currency of the instrument is the currency with the greatest value determined by comparing the functional currency value of the noncontingent and projected payments denominated in, or determined by reference to, each currency on the issue date, discounted to present value (in each relevant currency), and translated (if necessary) into functional currency at the spot rate on the issue date. For this purpose, the applicable discount rate may be determined using any method, consistently applied, that reasonably reflects the instrument's economic substance. The predominant currency is determined as of the issue date and does not change based on subsequent events (*e.g.*, changes in value of one or more currencies). If (i) no currency has a value greater than 50% of the total value of all payments and (ii) the difference between the discount rate in the denomination currency and the discount rate with respect to any other currency in which payments are made (or determined by reference to) pursuant to the instrument is greater than 10%, then the I.R.S. may determine the predominant currency under any reasonable method.[20]

What can be said here is that the rules are incredibly complex, and the taxpayer will need to consult their professional tax advisor to properly report income on the instrument.

Derivatives

As noted above, forward contracts, futures contracts, and option contracts on or referencing foreign currency are Section 988 transactions. With respect to determining exchange gain or loss:

- A spot contract to buy or sell nonfunctional currency is not considered a forward contract or similar transaction unless such spot contract is disposed of (or otherwise terminated) prior to making or taking delivery of the currency.[21] A spot contract is a contract to buy or sell nonfunctional

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[19] See Treas. Reg. §1.988-6.
[20] See Treas. Reg. §1.988-6(d)(1), (2).
[21] Treas. Reg. §1.988-2(d)(1).

currency on or before two business days following the date of the execution of the contract.[22]

- Exchange gain or loss is realized and recognized, in general, upon sale, exchange, or other disposition of the contract.[23]

- Further to point in the preceding sentence, any gain or loss determined is treated as exchange gain or loss. In addition, exchange gain or loss is determined by subtracting the amount paid (or deemed paid), if any, for or with respect to the contract (including any amount paid upon termination of the contract) from the amount received (or deemed received), if any, for or with respect to the contract (including any amount received upon termination of the contract).[24]

- Finally, if the taxpayer makes or takes delivery in connection with the derivative contract, any gain or loss is realized and recognized in the same manner as if the taxpayer sold the contract (or paid another person to assume the contract) *on the date on which he took or made delivery for its fair market value on such date.*[25]

Conclusion

Cross-border investments often result in significant complexity. Transactions in foreign currency are often overlooked. Taxpayers that engage in transactions involving foreign currencies should be prepared to account for significant administrative burdens.

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[22] Treas. Reg. §1.988-1(b).
[23] Treas. Reg. §1.988-2(d)(2), (3).
[24] Treas. Reg. §1.988-2(d)(4)(i).
[25] Treas. Reg. §1.988-2(d)(4)(ii).