HOW TO CALCULATE GAIN OR LOSS ON PAYABLES & RECEIVABLES DENOMINATED IN NONFUNCTIONAL CURRENCY

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INTRODUCTION

If all currencies were pegged to one single standard and did not fluctuate in value among themselves, the concept of currency gain and loss would not be needed. To illustrate, if two foreign currency units ("F.C.U.") were to equal one U.S. dollar ("U.S.D."), each time an invoice for F.C.U. 50 would be received and ultimately paid, a U.S. taxpayer would know that the amount set forth in the invoice and the amount of the payment would equal U.S.D. 25. However, major currencies tend to fluctuate. An invoice received for F.C.U. 50 may be worth U.S.D. 25 at the time the invoice is received but worth only U.S.D. 23 at the time the invoice is paid. In this set of circumstances, a uniform method must be applied to identify the amount of the transaction when the books and records of the business are stated in U.S.D. In our example, a U.S. business satisfying an invoice denominated in the amount of F.C.U. 50 could be booked at (i) U.S.D. 25, the value of the foreign currency on the date of receipt, or (ii) at U.S.D. 23, the date of the payment, or (iii) at U.S.D. 25 as a payable satisfied with U.S.D. 23 and U.S.D. 2 as some income or gain.

In an International Practice Unit,[1] the Large Business and International ("LB&I") Division of the I.R.S. provided a broad overview of how currency gains and losses are recognized for U.S. tax purposes. In simple terms, currency gains and losses reflect the movement in value of a transaction between the booking date and the payment date when the transaction is denominated in a foreign currency in relation to the taxpayer.

BASIC CONCEPTS

Transactions generally are accounted for in a taxpayer's functional currency. The functional currency of a U.S. taxpayer, such as a U.S. corporation, generally is U.S.D.

Regardless of its functional currency, a taxpayer's U.S. tax liability must be determined and paid in U.S.D. Thus, when U.S. taxpayers engage in business or investment transactions denominated in foreign currency, foreign currency amounts must be translated into U.S.D. As discussed in detail below, such transactions may give rise to functional currency gain or loss.

A qualified business unit ("Q.B.U.") is a separate and clearly identified unit of a trade or business of a taxpayer which maintains separate books and records. Every corporation, whether domestic or foreign, is a Q.B.U. Further, an activity of a corporation may be a Q.B.U. if it is a trade or business and a separate set of books

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1 Document Control Number ("D.C.N.") FCU/CU/C-18.2.1_04(2016), *Character of Exchange Gain or Loss on Currency Transactions*, as of June 1, 2016.

and records are maintained. For example, the London office of a U.S. corporation may be a Q.B.U. if its activities constitute a trade or business and if separate books are kept for the office.

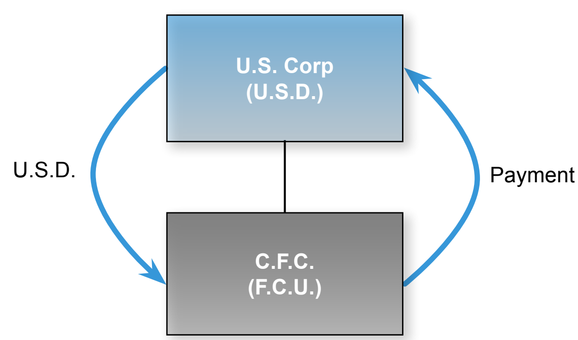
A Q.B.U., as a separate and clearly identified unit of a U.S. taxpayer, may have a functional currency other than U.S.D. if (i) the economic environment in which a significant part of the Q.B.U.'s activities are conducted is not U.S.D. and (ii) the Q.B.U. does not keep its books and records in U.S.D. For example, a foreign branch of a U.S. corporation may have a functional currency that is not U.S.D.

SECTION 988 TRANSACTIONS

Since transactions generally are accounted for in the taxpayer's or Q.B.U.'s functional currency, certain nonfunctional currency transactions, called "Section 988 Transactions" give rise to functional currency gain or loss. Internal Revenue Code ("Code") §988 applies to several types of transactions involving a taxpayer's nonfunctional currency.

Among the Section 988 Transactions are those described as "accruing (or otherwise taking into account) any item of expense or gross income or receipts which is to be paid or received after the date on which so accrued or taken into account."[2] Thus, for example, an account payable or account receivable that is held by a taxpayer and denominated in nonfunctional currency is subject to Code §988. Also, treated as Section 988 Transactions are the acquisition of a debt instrument (or becoming the obligor of a debt instrument); the acquisition of any forward contract, futures contract, option, or similar financial instrument; and the disposition of nonfunctional currency.

The following diagram illustrates that, in a simple cross-border loan, one party or the other will incur a currency loss or gain in connection with movements in the value of the currency in which the principal is denominated. In the example, the C.F.C. is exposed to currency risk, as the amount owed to its parent, U.S. Corp, will rise and fall with the relative fluctuations in currency.



Note that for financial accounting purposes the gain or loss is realized on an immediate basis.[3] For tax purposes, the gain or loss is deferred until a payment of principal is made.

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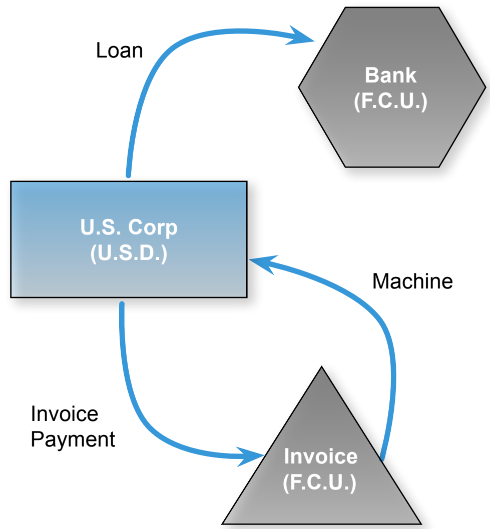
[2] Code §988(c)(1)(B)(ii).

[3] ASC 830-20-35, formerly FAS 52.

The following diagram illustrates that not all movements in the value of a currency result in a foreign currency gain or loss. In the example, U.S. Corp is an accrual basis taxpayer with U.S.D. as its functional currency. It borrows F.C.U. 100 from a bank in 2017. Interest accrues quarterly on the loan. The loan from bank is a five-year note with a face amount of F.C.U. 100.

U.S. Corp separately orders a machine for F.C.U 100. The invoice for the machine is payable at 60 days upon delivery. The value of F.C.U. 100 at the time of delivery is U.S.D. 110. At the time the invoice is paid, the value of F.C.U. 110 is U.S.D 105.



In the foregoing scenario, the tax results of the loan and the purchase are as follows:

- The purchase of the machine is not a Section 988 Transaction. U.S. Corp records an asset for $110 and an account payable of $110 when the machine is received.
- The payment of the F.C.U. account payable is a Section 988 Transaction and gives rise to foreign currency gain or loss. Here, there is ordinary gain of $5. The gain is U.S.-source gain under the residence rule of sourcing.
- The five-year note denominated in terms of F.C.U. gives rise to currency gain or loss at the time of payment of principal. To the extent that accrued interest is paid with currency that has appreciated or depreciated in value between the booked date and the payment date, the gain or loss will be recognized.

THE CALCULATION

As discussed above, a U.S. taxpayer or Q.B.U. must compute its foreign currency gains or losses on its Section 988 Transactions,[4] which include transactions involving the accrual of an expense (such as an account payable) or income (such as an account receivable) that is paid or received after the accrual date and denominated

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[4] The rules of Code §988 may apply to foreign taxpayers, however only in the relatively unusual case of a foreign taxpayer with a U.S. investment or business transaction denominated in a foreign currency.

in a currency other than the taxpayer's or the Q.B.U.'s functional currency.

The exchange gain or loss on an account payable or an account receivable is recognized on the date that the payment of nonfunctional currency is made or received.

The exchange gain or loss on an item of gross income or receipt recorded as an account receivable that is denominated in a nonfunctional currency is computed as follows:

1. Determine the nonfunctional currency accrued as an account receivable.
2. Multiply that amount by the spot rate at the booking date.
3. Determine the nonfunctional currency received as payment on the account receivable.
4. Multiply that amount by the spot rate on the payment date.
5. Subtract 2 from 4.

"The regulations allow a taxpayer or Q.B.U. to utilize a spot rate convention . . . when computing exchange gains or losses on nonfunctional currency accounts receivable and payable."

The exchange gain or loss on an item of expense recorded as account payable that is denominated in a nonfunctional currency is computed in a similar fashion:

1. Determine the nonfunctional currency paid on the account payable.
2. Multiply that amount by the spot rate at the booking date.
3. Determine the nonfunctional currency accrued as an account payable.
4. Multiply that amount by the spot rate on the payment date.
5. Subtract 2 from 4.

Further, the regulations allow a taxpayer or Q.B.U. to utilize a spot rate convention, to be determined at intervals of one quarter year or less, when computing exchange gains or losses on nonfunctional currency accounts receivable and payable. Alternatively, the taxpayer or Q.B.U. may use the spot rate at the actual booking or payment dates. The recognition date is the date on which the payment is made or received.

The following examples illustrate the calculation of exchange gain on an account payable and exchange loss on an account receivable. In each example, U.S. Corp is a calendar year corporation with U.S.D. as its functional currency. The last example illustrates the spot rate convention option on a monthly basis.

Example 1: Exchange Gain or Loss on Satisfaction of an Account Payable in Nonfunctional Currency

On January 15, 2017, U.S. Corp purchases inventory on account from a wholly-owned foreign subsidiary, C.F.C. 1, for F.C.U. 10,000. The spot rate on that day is F.C.U. 1 = U.S.D. 0.55.

On February 23, 2017, when U.S. Corp makes payment of the F.C.U. 10,000 account payable, the spot rate is F.C.U. 1 = U.S.D. 0.50. Accordingly, U.S. Corp will realize an exchange gain on the F.C.U. 10,000 account payable.

U.S. Corp's gain is computed by first multiplying F.C.U. 10,000 by the spot rate on the booking date:

- F.C.U. 10,000 x U.S.D. 0.55 = U.S.D. 5500

Then, F.C. 10,000 is multiplied by the spot rate on the payment date:

- F.C.U. 10,000 x U.S.D. 0.50 = U.S.D. 5000

Finally, the translated amount booked is subtracted from the translated amount paid:

- U.S.D. 5500 – U.S.D. 5000 = U.S.D. 500

Accordingly, U.S. Corp's exchange gain on the transaction is U.S.D. 500. The character of the exchange gain is ordinary.

Also, note that there could be an exchange gain or loss on the disposition of F.C.U. by U.S. Corp, depending on when U.S. Corp acquired the F.C.U.

Example 2: Exchange Gain or Loss on Receipt of an Account Receivable in Nonfunctional Currency

On January 15, 2017, U.S. Corp sells inventory to a wholly-owned foreign subsidiary, C.F.C. 2, for F.C. 10,000. The spot rate on that day is F.C.U. 1 = U.S.D. 0.55.

On February 23, 2017, when U.S. Corp receives the payment of the F.C.U. 10,000 account receivable from C.F.C. 2, the spot rate is F.C.U.1 = U.S.D. 0.50. Accordingly, on that date, U.S. Corp will realize an exchange loss on the F.C.U. 10,000 account receivable.

U.S. Corp's loss is computed by first multiplying F.C.U. 10,000 by the spot rate on the date the F.C.U. 10,000 are received.

- F.C.U. 10,000 x U.S.D. 0.50 = U.S.D. 5000

Then, F.C.U. 10,000 is multiplied by the spot rate on the booking date:

- F.C.U. 10,000 x U.S.D. 0.55 = U.S.D. 5500

Finally, the translated amount booked is subtracted from the translated amount received:

- U.S.D. 5000 – U.S.D. 5500 = U.S.D. (500)

Accordingly, U.S. Corp's exchange loss on the transaction is U.S.D. 500. The character of the exchange loss is ordinary.

Again, note that there could be an exchange gain or loss on the disposition of F.C.U. by U.S. Corp, depending on when U.S. Corp acquired the F.C.U.

Example 3: Spot Rate Convention Option

U.S. Corp uses a spot rate convention to determine the spot rate as provided under the regulations.

The spot rate determined under the spot rate convention for the month of January is F.C.U. 1.00 = U.S.D. 0.54 and for the month of February is F.C.U. 1.00 = U.S.D. 0.51.

On January 15, 2017, U.S. Corp sells inventory for F.C.U. 10,000. On February 23, 2017, U.S. Corp receives payment for the inventory of F.C. U. 10,000.

As a result, on the last date in February, U.S. Corp will realize exchange loss. The exchange loss is computed by first multiplying the F.C.U. 10,000 by the spot rate convention for the month of February:

- F.C.U. 10,000 x U.S.D. 0.51 = U.S.D. 5100

Then, F.C. 10,000 is multiplied by the spot rate convention for the month of January:

- F.C.U. 10,000 x U.S.D. 0.54 = U.S.D. 5400

Finally, the spot rate translated amount received in February is subtracted from the spot rate translated amount accrued in January:

- U.S.D. 5,100 – U.S.D. 5400 = U.S.D. (300)

Accordingly, U.S. Corp has an exchange loss in the amount of U.S.D. 300.

CONCLUSION

Because the value of currency fluctuates, a cross-border financial transaction that is booked in a nonfunctional currency will likely give rise to currency gain or loss when the transactional value (measured in terms of a functional currency) varies between the date of booking and the date of payment.