

LB&I Transaction Unit Knowledge Base – International

Library Level	Number	Title
Shelf		Crossover
Book	18	Foreign Currency
Chapter	2	Transactions in a Foreign Currency
Section	2.1	Computation of Exchange Gain or Loss - General

Unit Name	Disposition of Nonfunctional Currency	
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Disposition of Nonfunctional Currency

When a taxpayer conducts a transaction in a currency that is not their functional currency, this transaction may result in the recognition of a Section 988 transaction. The timing on the recognition of these transactions often differ from the U.S. Generally Accepted Accounting Principles (GAAP) treatment of the transaction, resulting in a temporary book-tax differences on the U.S. federal income tax return.

Section 988 was included in Subpart J to deal with a select group of transactions (referred to as “Section 988 transactions”) if the amount which the taxpayer is entitled to receive (or is required to pay) is (1) denominated in a nonfunctional currency or (2) determined by reference to the value of 1 or more nonfunctional currencies. IRC 988(c)(1)

IRC 988 provides the following general descriptions of transactions that can result in the computation of a Section 988 recognition transaction under IRC 988(c)(1):

- Either acquiring or becoming the obligor under a debt instrument (such as a loan or a trade account) – See IRC 988(c)(1)(B)(i);
- Accruing (or otherwise taking into account) an item of expense or gross income or receipt which is to be paid or received after the date so accrued or taken into account – See IRC 988(c)(1)(B)(ii);
- Either acquiring or entering into a forward contract, futures contract, options, or similar financial instrument – See IRC 988(c)(1)(B)(iii);
- Disposition of nonfunctional currency – See IRC 988(c)(1)(C).

Examples of disposition of nonfunctional currency include:

- When a U.S. entity (“USE”) with the U.S. dollar as its functional currency buys either a fixed asset or inventory for a price that is not stated in U.S. dollars, USE must first acquire the foreign currency. When the USE actually utilizes the foreign currency to obtain the fixed asset or inventory, this results in an IRC 988 transaction due to the disposal of a nonfunctional currency.
- If the USE sells the fixed asset or inventory and receives monies for the sale that is not in its functional currency and then the USE disposes of the nonfunctional currency for U.S. dollars, this results in an IRC 988 transaction due to the disposal of nonfunctional currency.

Issue and Transaction Overview (cont'd)

Disposition of Nonfunctional Currency

Basic Rules

What is nonfunctional currency? IRC 988(c)(1)(C)(ii) states that the term “nonfunctional currency” includes coin or currency, and nonfunctional currency denominated demand or time deposits or similar instruments issued by a bank or other financial institution.

Bitcoin and other virtual currencies are not currencies that generate foreign currency gain or loss for U.S. federal tax purposes (see Notice 2014-21).

Per Treas. Reg. 1.988-2(a), the recognition of exchange gain or loss upon the sale or other disposition of nonfunctional currency is governed by general recognition principles of the IRC which apply to the sale or disposition of property. Generally, the sourcing of an exchange gain or loss is based on the residence of the taxpayer or taxpayer's Qualified Business Unit (QBU), on whose books the asset, liability, or item of income or expense is properly reflected. See IRC 988(a)(3)(A). Also, the character of the exchange gain or loss from a section 988 transaction is generally ordinary. See IRC 988(a)(1)(A) and 988(c)(1)(A) and (B)(i). Separate Practice Units have been published on these topics.

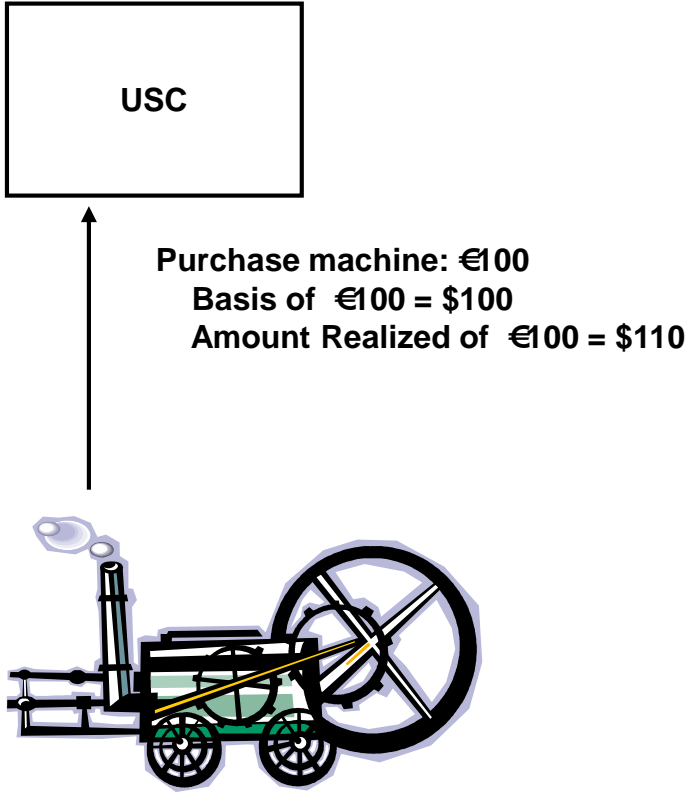
The exchange gain or loss from the disposition of nonfunctional currency is equal to the difference between the amount realized and the adjusted basis (see the “Transaction and Fact Pattern” slides in this Unit). The amount of the exchange gain or loss realized is determined under IRC 1001(b).

Generally, the adjusted basis of nonfunctional currency is determined under the applicable provisions of the Internal Revenue Code (e.g., IRC 1011 – 1023). See Treas. Reg. 1.988-2(a)(2)(iii)(A).

However, Treas. Reg. 1.988-2(a)(2)(iii)(B) addresses the basis of nonfunctional currency withdrawn from an account with a bank or other financial institution. This regulation states that the taxpayer may utilize a reasonable method (e.g., first in first out, last in first out, pro-rata method) that is consistently applied from year to year. The Treasury Regulations also specifically state that a method that consistently results in units of nonfunctional currency with the highest basis being withdrawn first is not a reasonable method.

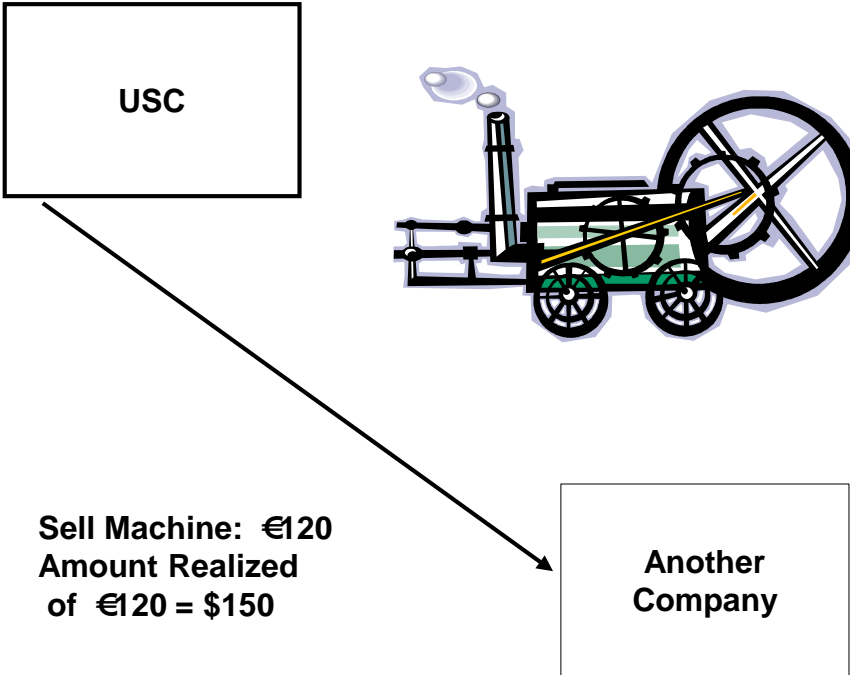
Transaction and Fact Pattern

Disposition of Nonfunctional Currency

Diagram of Transaction	Facts
 <p>USC</p> <p>Purchase machine: €100 Basis of €100 = \$100 Amount Realized of €100 = \$110</p>	<p>Facts: USC, a U.S. corporation with the dollar as its functional currency buys a machine for €100. USC purchased the euros for \$100 six months ago. The euros are worth \$110 on the date the machine is purchased. (Assume the machine is owned by USC and not a QBU of USC)</p> <p>Question: Does the purchase of the machine generate an IRC 988 gain?</p> <p>Answer: Yes, the disposition of the euros is an IRC 988 transaction. The IRC 988 ordinary gain is \$10 (\$110 amount realized less \$100 basis).</p>

Transaction and Fact Pattern

Disposition of Nonfunctional Currency

Diagram of Transaction	Facts
 <p>USC</p> <p>Sell Machine: €120 Amount Realized of €120 = \$150</p> <p>Another Company</p>	<p>Facts: USC, a U.S. corporation with the dollar as its functional currency, sells the machine two years after the machine is purchased for €120 worth \$150 (assume no depreciation and that the machine is owned directly by USC and not a QBU of USC).</p> <p>Question: Does the sale of the machine generate an IRC 988 gain?</p> <p>Answer: No, the sale of the machine is not an IRC 988 transaction. USC would realize capital gain under IRC 1231 and 1001 of \$40 (\$150 amount realized less \$110 basis).</p> <p>.....BUT: If the USC disposes of the €120 at a later date and exchange rate has changed from the date at the time of the sale, an IRC 988 exchange gain or loss would be recognized at the time of disposal on the difference between the U.S. dollars received (€120 x spot rate on date of disposition) and the \$150 basis that the Euros were worth on the date of the sale of machine/acquisition of euros.</p>

Summary of Potential Issues

Disposition of Nonfunctional Currency

<u>Issue 1</u>	How does an examiner determine whether an IRC 988 gain or loss on the disposition of nonfunctional currency reported on the taxpayer's U.S. federal income tax return (for example, on the acquisition of fixed assets or inventory from a non-U.S. vendor) was correctly computed?
<u>Issue 2</u>	How does an examiner determine whether an IRC 988 gain or loss on the disposition of nonfunctional currency should have been recognized (for example, following the disposition of fixed assets or inventory from a non-U.S. vendor)?

All Issues, Step 1: Initial Factual Development

Disposition of Nonfunctional Currency

Determining whether all IRC 988 transactions due to disposition of nonfunctional currency have been identified by the taxpayer can be difficult. It is based on the individual facts and circumstances of the case.

Fact Element	Resources
<ul style="list-style-type: none">▪ Determine any IRC 988 recognition due to the disposition of nonfunctional currency reported by the taxpayer and confirm that the recognition was computed correctly.<ul style="list-style-type: none">– Review:<ul style="list-style-type: none">▪ Form 1120, line 10 for other income for Foreign Currency Exchange (FX) gains or losses;▪ Form 1120, line 26 for other deductions for FX gains or losses;▪ Form 1120, Schedule M-3, Part II, line 23(g) or 25 and Part III, line 35;▪ Form 926, Part III;▪ Form 8858, Schedule H for detail; and▪ Form 8865, Schedule M-1 for detail.	<ul style="list-style-type: none">▪ Form 1120, line 10▪ Form 1120, line 26▪ Form 1120, Schedule M-3, Part II, line 23(g) or 25 and Part III, line 35▪ Form 926, Part III▪ Form 8858, Schedule H▪ Form 8865, Schedule M-1

All Issues, Step 1: Initial Factual Development (cont'd)

Disposition of Nonfunctional Currency

Fact Element	Resources
<ul style="list-style-type: none">▪ Identify any potential transactions conducted by the taxpayer that could trigger an IRC 988 recognition due to the disposition of nonfunctional currency not reported by the taxpayer.<ul style="list-style-type: none">– Review:<ul style="list-style-type: none">▪ Form 926, Part III;▪ Form 4562;▪ Form 4797;▪ Form 8858, Schedule H for detail;▪ Form 8865, Schedule M-1 for detail; and▪ Form 1120 for disclosures.	<ul style="list-style-type: none">▪ Form 926, Part III▪ Form 4562▪ Form 4797▪ Form 8858, Schedule H▪ Form 8865, Schedule M-1▪ Form 1120

All Issues, Step 1: Initial Factual Development (cont'd)

Disposition of Nonfunctional Currency

Fact Element	Resources
<ul style="list-style-type: none">▪ Identify any potential transactions conducted by the taxpayer that could trigger an IRC 988 recognition due to the disposition of nonfunctional currency not reported by the taxpayer. Dispositions of nonfunctional currency are often intertwined with other IRC 988 transactions but both are generally separately computed. These transactions include, but are not limited to:<ul style="list-style-type: none">– Payment of debt/interest in a nonfunctional currency;– Payment of a liability denominated in a nonfunctional currency;– Payment on forward/future contract denominated in third currency.▪ Request and Review:<ul style="list-style-type: none">– Organization Charts (to assist in identification of domestic entities that might purchase fixed assets or inventory for non-U.S. branches or disregarded entities);– Chart of Accounts (to review accounts in which foreign currency gains and losses are recorded for book purposes);– Account Mapping Detail (to determine where the taxpayer's foreign currency gain and losses accounts are mapped on the U.S. tax returns.– Taxpayer's audited financial statements (review notes to financial statement regarding company funding of purchase of fixed assets and inventory as well as notes regarding any large foreign asset disposal);– Forms 10-K, 10-Q, and 8-K filings (review taxpayer's notes regarding acquisitions and divestitures of foreign entities or assets); and– Financial Account Detail (review specific transactions in the taxpayer's foreign currency gain and losses accounts).	

Issue 1, Step 2: Review Potential Issues

Disposition of Nonfunctional Currency

Issue 1

How does an examiner determine whether an IRC 988 disposition gain or loss reported on the taxpayer's U.S. federal income tax return (for example, on the acquisition of fixed assets or inventory from a non-U.S. vendor) was correctly computed?

Explanation of Issue	Resources
<p>An examiner will need to review the following facts to determine whether the taxpayer correctly computed its reported Section 988 disposition gains or losses on its federal return:</p> <ul style="list-style-type: none"> ▪ Were the correct dates used in the computation? The examiner should review the contracts that support the computation in order to assure that correct dates are used. If the acquisition of the asset and the acquisition of the nonfunctional currency occurred on different dates but the taxpayer's computation does not reflect these differences, an audit adjustment may be required. This is important in determining the correct amount realized and basis in nonfunctional currency. ▪ Did the computation use the correct exchange rates? The examiner should also review the taxpayer's exchange rates in order to assure that the correct exchange rates were used. For instance, review of exchange rate tables could show that the taxpayer used an average versus spot rate, the rate utilized could be for the wrong date, or incorrectly computed based on the contract requirements. This is also important in determining the correct amount realized and basis in nonfunctional currency. ▪ Did the taxpayer treat the disposition as ordinary or capital? In general, a Section 988 disposition gain or loss is an ordinary gain or loss. 	<ul style="list-style-type: none"> ▪ IRC 988(a)(1)(A) ▪ IRC 988(c)(1)(C) ▪ Treas. Reg. 1.988-2(a) ▪ Treas. Reg. 1.988-3

Issue 1, Step 2: Review Potential Issues (cont'd)

Disposition of Nonfunctional Currency

Issue 1

Explanation of Issue	Resources
<p>If necessary, issue additional IDR Requests for:</p> <ul style="list-style-type: none">▪ Section 988 computation workpapers prepared by the taxpayer▪ Source documents utilized for the preparation of the Section 988 disposition including:<ul style="list-style-type: none">– Acquisition or disposition contracts;– Exchange rate methodology utilized; and– General ledger transaction detail supporting treatment for book purposes.	

Issue 1, Step 3: Additional Factual Development

Disposition of Nonfunctional Currency


Issue 1

Fact Element	Resources
<ul style="list-style-type: none">▪ The taxpayer utilizes a different acquisition or disposal date than the date reflected in the related contract.▪ Additional IDR and/or discussion with taxpayer regarding the discrepancy in the utilization of dates.	
<ul style="list-style-type: none">▪ The taxpayer's exchange rate does not generally approximate the rate found by the examiner in the publicly listed resources.▪ Additional IDR and/or discussion with taxpayer regarding the discrepancy in the utilization of exchange rates.	
<ul style="list-style-type: none">▪ The taxpayer treated the Section 988 transaction as a capital gain or loss.▪ Additional IDR and/or discussion with taxpayer regarding the reason for treating the transaction as a capital versus ordinary transaction.	

Issue 1, Step 4: Develop Arguments

Disposition of Nonfunctional Currency

Issue 1

Explanation of Adjustment	Resources
 <p>DECISION POINT: Whether to proceed with this issue is usually based on materiality. An adjustment based on a change in exchange rates may be de minimis and may not require an adjustment.</p> <p>If the responses and/or discussions with the taxpayer indicate that the incorrect information was used to compute the original tax liability, a revised computation should be presented to the taxpayer in a Notice of Proposed Adjustment.</p>	<ul style="list-style-type: none"> ▪ IRC 988(a)(1)(A) - General Rule for Treatment of FX Recognition as Ordinary Income or Loss ▪ IRC 988(c)(1)(C) - Special Rules for Disposition of Nonfunctional Currency ▪ Treas. Reg. 1.988-2(a) - Regulations for Disposition of Nonfunctional Currency ▪ Treas. Reg. 1.988-3 - Character of Exchange Gain or Loss ▪ Treas. Reg. 1.988-4 - Source of Exchange Gain or Loss

Issue 2, Step 2: Review Potential Issues

Disposition of Nonfunctional Currency

Issue 2

How does an examiner determine whether an IRC 988 gain or loss on the disposition of nonfunctional currency should have been recognized (for example, following the disposition of fixed assets or inventory from a non-U.S. vendor)?

Explanation of Issue	Resources
<p>After the documents in Step 1 have been reviewed, the examiner may identify other transactions for which IRC 988 recognition may be required. If a taxpayer obtains nonfunctional currency and later disposes of the nonfunctional currency to complete another transaction, then the taxpayer will have an IRC 988 recognition event when the nonfunctional currency is no longer held by the taxpayer.</p> <p>These other transactions could include:</p> <ul style="list-style-type: none"> ▪ Purchasing inventory; ▪ Purchasing fixed assets; ▪ Settlement of a financial instrument (such as a debt instrument, forward, future, or option). <p>Section 988 recognition events do not include:</p> <ul style="list-style-type: none"> ▪ Exchanging nonfunctional currency for the same nonfunctional currency; ▪ Depositing the nonfunctional currency in an account in the same currency; ▪ Withdrawal from or transfer to another account in the same currency. <p>NOTE: An amount of one nonfunctional currency is not “property of like kind” under IRC 1031 with respect to an amount of a different nonfunctional currency.</p>	<ul style="list-style-type: none"> ▪ Treas. Reg. 1.988-2(a)(1)(i) - Inclusions of IRC 988 dispositions ▪ Treas. Reg. 1.988-2(a)(1)(ii) and (iii) - Not IRC 988 Dispositions

Issue 2, Step 3: Additional Factual Development

Disposition of Nonfunctional Currency

Issue 2

Fact Element	Resources
<ul style="list-style-type: none">▪ Did the taxpayer purchase inventory with nonfunctional currency it previously acquired?▪ Did the taxpayer purchased fixed assets with nonfunctional currency it previously acquired? <p>In addition to the items requested during the initial factual development, consider requesting and reviewing:</p> <ul style="list-style-type: none">▪ Fixed asset schedules to determine if any assets are owned directly by the taxpayer but reside offshore and may have been acquired with nonfunctional currency;▪ Any IRC 988 gain or loss on accounts payables that were for inventory purchases where the repayments of the payables could also be a disposition of nonfunctional currency;▪ Transactions involving non-U.S. bank accounts held directly by a U.S.-based entity.	

Issue 2, Step 3: Additional Factual Development (cont.)

Disposition of Nonfunctional Currency


Issue 2

Fact Element	Resources
<ul style="list-style-type: none"> ▪ Did the taxpayer settle a financial instrument (such as a debt instrument, forward, future, or option) denominated in a nonfunctional currency? <p>NOTE: Disposition of nonfunctional currency is a separate IRC 988 transaction from the underlying IRC 988 transaction and is generally computed separately.</p> <ul style="list-style-type: none"> – This issue could occur any time a taxpayer invests and settles a financial instrument that is denominated in a nonfunctional currency. In addition to the items requested during the initial factual development, request and review: <ul style="list-style-type: none"> ▪ Loan agreements or other instruments of indebtedness (read and understand the terms of the agreements and the parties to the agreements); ▪ Contract agreements (read and understand the terms of the agreements and the parties to the agreements); ▪ Accounts or interest payable denominated in a nonfunctional currency; ▪ Accounting entries evidencing the debt; ▪ Accounting entries evidencing the financial contract; ▪ Accounting entries recording the settlement of the financial instrument; ▪ Bank statements detailing cash receipts associated with the identified debt; and ▪ Bank statements detailing cash receipts/transfers associated with the identified financial contract and the settlement of the contract. 	

Issue 2, Step 3: Additional Factual Development (cont.)

Disposition of Nonfunctional Currency


Issue 2

Fact Element	Resources
<ul style="list-style-type: none"> Did the taxpayer settle a financial instrument (such as a debt instrument, forward, future, or option) denominated in a nonfunctional currency? (cont'd) <p> DECISION POINT: It is possible that when additional facts are reviewed that the examiner determines that this is a disposition of a portion of an integrated hedge.</p>	<p>Practice Unit - <i>Disposition of a Portion of an Integrated Hedge</i></p>

Issue 2, Step 4: Develop Arguments

Disposition of Nonfunctional Currency

Issue 2

Explanation of Adjustment	Resources
 DECISION POINT: Whether to proceed with this issue is usually based on materiality. If the change in exchange rates between acquisition of the nonfunctional currency and the disposition is de minimis, an audit adjustment may not be warranted. If the responses and/or discussions with the taxpayer indicate that incorrect information was used to compute the original tax liability, a revised computation should be presented to the taxpayer in a Notice of Proposed Adjustment.	<ul style="list-style-type: none">▪ IRC 988(a)(1)(A) - General Rule for Treatment of FX Recognition as Ordinary Income or Loss▪ IRC 988(c)(1)(C) - Special Rules for Disposition of Nonfunctional Currency▪ Treas. Reg. 1.988-2(a) - Regulations for Disposition of Nonfunctional Currency▪ Treas. Reg. 1.988-3 - Character of Exchange Gain or Loss▪ Treas. Reg. 1.988-4 - Source of Exchange Gain or Loss

Index of Referenced Resources

Disposition of Nonfunctional Currency
IRC 988(a)(1)(A)
IRC 988(c)(1)(C)
IRC 1001(b)
Treas. Reg. 1.988-2(a)
Treas. Reg. 1.988-3
Treas. Reg. 1.988-4
Notice 2014-21
Form 926
Form 1120
Form 1120, Schedule M-3
Form 4562
Form 4797
Form 8858
Form 8865

Training and Additional Resources

Disposition of Nonfunctional Currency	
Type of Resource	Description(s)
Saba Meeting Sessions	<ul style="list-style-type: none"> ▪ <i>FC1 Sec 985 - 2015 Saba Meeting</i> ▪ <i>FC2 986 Transition Rules - 2015 Saba Meeting</i> ▪ <i>FC3 987 Branch Rules & CTB - 2015 Saba Meeting</i> ▪ <i>FC4 Sec 988 Transactions - 2015 Saba Meeting</i> ▪ <i>FC5 Foreign Currency Hedging - 2015 Saba Meeting</i> ▪ <i>Financial Products Basics - 2015 Saba Meeting</i> ▪ <i>IBC Intro to Rules Applic to Recog of Certain Foreign Curre - 2014 Saba Meeting</i>
White Papers / Guidance	<ul style="list-style-type: none"> ▪ <i>ASC 830 - Foreign Currency Matters</i> ▪ <i>IAS 21 - The Effects of Changes in Foreign Exchange Rates</i>
Reference Materials – Treaties	<ul style="list-style-type: none"> ▪ <i>Bittker & Lokken - Fundamentals of International Taxation, Chapter 74</i> ▪ <i>BNA Tax Management Int'l Portfolio 921-2nd (Tax Aspects of Foreign Currency)</i> ▪ <i>Keyes - Federal Taxation of Financial Instruments and Transactions, Chapter 15</i>

Glossary of Terms and Acronyms

Term/Acronym	Definition
Average Rate	An exchange rate computation based on an average of rates over a period of time, generally computed on a monthly or annual basis.
FC	Functional Currency
Forward Contract	A customized contract between two parties to buy or sell an asset at a specified price on a future date.
Functional Currency	The currency of the primary economic environment in which the entity operates.
Futures Contract	A contract between two parties where both parties agree to buy and sell a particular asset of specific quantity and at a predetermined price, at a specified date in the future.
FX	Foreign Currency Exchange
GAAP	Generally Accepted Accounting Principles
IDR	Information Document Request
Nonfunctional Currency	A currency utilized by an entity for a transaction that is not the functional currency of the entity.
Option Contract	A contract that allows the holder to buy or sell an underlying security at a specified price.
QBU	Qualified Business Unit
Spot Rate	An exchange rate computation based on a specific period of time, generally on a daily basis.
USC	U.S. Corporation
USE	U.S. Entity

Index of Related Practice Units

Associated UIL(s)	Related Practice Unit	DCN
9470.02	<i>Disposition of a Portion of an Integrated Hedge</i>	FCU/T/18_02_03-01
9470.02	<i>How to Assess Penalties for Failure to file Form 8886 Disclosing Section 988 Losses</i>	FCU/P/18_02_01-04
9412.00	<i>Subpart F Overview</i>	DPL/C/02-01