[4830-01-u]

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[TD 8776]

RIN 1545-AW34

Conversion to the Euro

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final and Temporary regulations.

SUMMARY: This document contains temporary Income Tax Regulations relating to U.S. taxpayers operating, investing or otherwise conducting business in the currencies of certain European countries that are replacing their national currencies with a single, multinational currency called the euro. These regulations provide rules relating to adjustments required for qualified business units operating in such currencies and rules relating to the tax effect of holding such currencies or financial instruments or contracts denominated in such currencies. The text of these temporary regulations also serves as the text of proposed regulations published elsewhere in this issue of the **Federal Register.**

DATES: These regulations are effective July 29, 1998.

FOR FURTHER INFORMATION CONTACT: Howard Wiener of the Office of Associate Chief Counsel (International), (202) 622-3870, regarding the change in functional currency rules and Thomas Preston of the Office of Assistant Chief Counsel (Financial

Institutions and Products), (202) 622-3930, regarding section 1001 (not toll free calls).

SUPPLEMENTARY INFORMATION:

Background

On March 9, 1998, the IRS issued Announcement 98-18 (1998-9 IRB 44) requesting comments relating to the tax issues for U.S. taxpayers operating, investing or otherwise conducting business in a currency that is converting to the euro. Numerous comments were received. After consideration of these comments, these regulations are adopted as a temporary Treasury decision to provide immediate guidance to taxpayers.

Explanation of Provisions

I. Background

The Treaty on European Union signed February 7, 1992, (31 I.L.M. 247) (entered into force November 1, 1993), sets forth a plan to replace the national currencies of participating members (legacy currencies) that meet certain economic criteria with a single European currency (euro). Pursuant to directives of the European Council, the process of converting the legacy currencies into the euro will take place in three phases.

On January 1, 1999, the currency of participating member states of the European Union shall be the euro. At that time, the euro will be substituted for the currency of each state at a conversion rate established pursuant to the Treaty on European Union. Thereafter, the bills and coins of each of the legacy currencies will remain in circulation but will cease to have independent value apart from the euro. On January 1, 2002, euro bills and coins will be introduced into circulation. From January 1, 1999, until June 30, 2002 (transition period), the legacy currencies will remain in circulation as subunits of the euro. The transition period is referred to as the "no prohibition, no compulsion" period because during this time amounts may generally be denominated in the legacy currencies and/or the euro at the option of individuals and businesses. Finally, by July 1, 2002, the legacy currencies will no longer be accepted as legal tender.

On May 3, 1998, the European Union announced the eleven countries that would initially participate in the conversion and the expected rates at which the respective currencies would convert to the euro. The eleven countries are Austria, Belgium, Finland, France, Germany, Ireland, Italy, Luxembourg, Netherlands, Portugal, and Spain. Four current members of the European Union (Denmark, Greece, Sweden, and the United Kingdom) will not participate in the initial conversion to the euro. These countries, along with other countries that later join the European Union, however, may convert their currencies to the euro at some future time.

II. Temporary Regulations

1. In General

These temporary regulations provide guidance regarding certain of the federal income tax consequences arising from the introduction of the euro. Consistent with comments received from taxpayers, the regulations generally minimize the tax consequences that arise by reason of the euro conversion. In a limited number of circumstances, however, the Treasury and IRS determined that considerations, such as administrative feasibility, made a different result more appropriate.

The regulations provide guidance with respect to two issues: (i) the circumstances under which the euro conversion creates a realization event with respect to instruments and contracts denominated in a legacy currency, and (ii) the circumstances under which the euro conversion constitutes a change in functional currency for a qualified business unit (QBU) whose functional currency is a legacy currency, and certain consequences thereof.

2. Realization

The temporary regulations provide that the conversion of legacy currencies to the euro does not result in a realization event under section 1001. This rule is broadly applicable to all situations where the rights and obligations of a taxpayer are altered solely by reason of the euro conversion. Thus, conversion to the euro of legacy currency held by a taxpayer and conversion of legacy currency denominated contractual relationships, financial instruments, and other claims or obligations are not realization events solely as a result of the conversion. In addition, as a result of this rule, exchange gains and losses on section 988 transactions denominated in a legacy currency will not be taken into account until a subsequent realization event with respect to the underlying instrument. For example, when the Dutch guilder is converted into the euro, a U.S. dollar functional currency taxpayer will not recognize either market gain or loss or exchange gain or loss on a fixed interest rate Dutch guilder debt instrument.

Other aspects of the euro conversion may result in taxable events. For example, if an unscheduled fractional principal payment is made on a debt instrument in order to facilitate a rounding convention, this payment is accounted for under the rules governing payments on debt instruments (such as §§1.446-2 and 1.1275-2) and under section 988 (in the case of a section 988 transaction). Other changes may or may not constitute realization events depending on the terms of the changes. For example, accrual periods, holiday conventions or indices on a floating rate instrument may be altered. Whether these changes are realization events must be determined under existing law. See, e.g., §1.1001-3.

Limitations that under otherwise applicable principles prevent or defer the recognition of realized gains and losses continue to apply. Thus, for example, recognition of losses between related parties under section 267 and §1.988-1(a)(10) remain subject to the limitations set forth in those sections.

3. Change in Functional Currency

The regulations provide that QBUs with a legacy functional currency will be deemed to have automatically changed their functional currency to the euro at the beginning of the year they are required to make such change. Because of the significant administrative burdens that will be imposed on QBUs when they are required to change their internal systems to accommodate the introduction of the euro, the regulations provide that a QBU that currently uses a legacy functional currency is deemed to automatically change its functional currency to the euro in the year the QBU changes its books and records to the euro. That change, however, must be made no later than the last taxable year beginning on or before the first day such legacy currency is no longer valid legal tender.

The euro conversion implicates the policy concerns underlying §1.985-5, namely, the preservation of built-in exchange gains and losses arising from the fact that positions that had once been denominated in a nonfunctional currency will now be made or received in a QBU’s functional currency.

In the context of the euro conversion, two items are of particular concern in properly accounting for exchange gains and losses: (1) section 988 transactions denominated in a legacy currency other than the QBU’s legacy functional currency, and (2) unremitted earnings of a branch with a legacy functional currency different from the home office’s legacy functional currency. In both these instances, positions that had previously been accounted for in a nonfunctional currency (against which exchange gains and loses would be computed) will, after the conversion, be accounted for in euros (against which exchange gains and losses would not be computed when a QBU’s functional currency is also the euro).

Rather than requiring immediate recognition, as would be required under §1.985-5, the temporary regulations provide special rules for the euro conversion. These rules provide that for affected section 988 transactions (other than transactions in or holdings of nonfunctional currency cash), exchange gains and losses that would have been recognized immediately if the §1.985-5 change in functional currency rules applied will be deferred until otherwise realized. This is accomplished by providing that section 988 transactions continue to be treated as nonfunctional currency transactions under the principles of section 988 even though the remaining payments on the asset or liability will be made in the QBU’s new functional currency (i.e., the euro).

In response to comments by taxpayers, an election is provided for QBUs to realize exchange gain or loss on accounts receivable and payable immediately prior to the year of change. A QBU making this election must realize exchange gains and losses on all of its accounts receivable and payable that are legacy currency denominated section 988 transactions. The election responds to the administrative burdens associated with tracking exchange gains and losses on large quantities of accounts receivable and payable. Taxpayers not making the election will continue to treat these positions as section 988 transactions under the general rule described above.

Exchange gains and losses on transactions in, or holdings of, nonfunctional currency cash are recognized immediately because cash accounts are generally turned over rapidly and the administrative burdens in tracking exchange gains and losses outweigh the benefits of deferral.

The regulations also provide special rules for taking into account exchange gain or loss when the taxpayer and a branch of the taxpayer change their functional currencies to the euro. The rules provide that exchange gains and losses on unremitted earnings of affected branches be recognized ratably over a four-year period beginning in the year of change. Some commentators recommended that the principles of section 987 continue to be applied after the conversion. As in the case with cash, however, the Treasury and IRS believe that the administrative burdens for taxpayers and the government as well as the potential for abuse, outweigh the benefit of extended deferral.

These temporary regulations also provide rules for the proper translation of a QBU's balance sheet accounts in a manner that preserves any accrued but unrecognized currency gain or loss. These rules are consistent with the existing §1.985-5, change in functional currency rules.

III. <u>Other Issues</u>

Finally, these regulations do not address certain issues that taxpayers have commented upon that are not unique to the euro conversion. In particular, these regulations do not address the deductibility of costs associated with the euro conversion and foreign tax credit mismatches that can occur as a result of tax accounting differences between the United States and other countries.

Special Analysis

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedures Act (5 U.S.C. chapter 5) and the Regulatory Flexibility Act (5 U.S.C. chapter 6) do not apply to these regulations, and therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, these temporary regulations will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

Drafting Information

The principal authors of these regulations are Howard A. Wiener of the Office of the Associate Chief Counsel (International) and Thomas Preston of the Office of Associate Chief Counsel (Domestic). Other personnel from the IRS and Treasury Department also participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1--INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 2. In §1.985-1, paragraph (c)(6) is amended by adding a sentence at the end to read as follows:

<u>§1.985-1 Functional currency.</u>

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(c) * * *

(6) * * * For special rules relating to the conversion to the euro, see §1.985-8T.

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§1.985-4 [Amended]

Par. 3. In §1.985-4, the last sentence of paragraph (a) is amended by removing the reference "§1.985-2" and adding "§1.985-2 or 1.985-8T" in its place.

Par. 4. Section 1.985-8T is added to read as follows:

§1.985-8T Special rules applicable to the European Monetary Union (conversion to the euro)(temporary).

(a) Definitions--(1) Legacy currency. A legacy currency is the national currency of a participating member state of the European Union used prior to the substitution of the euro for the national currency of that state in accordance with the Treaty on European Union signed February 7, 1992. The term legacy currency shall also include the European Currency Unit.

(2) Conversion rate. The conversion rate is the rate at which the euro is substituted for a legacy currency.

(b) Operative rules--(1) Initial adoption. A QBU (as defined in §1.989(a)-1(b)) whose first taxable year begins after the euro has been substituted for a legacy currency may not adopt that legacy currency as its functional currency.

(2) QBU with a legacy functional currency--(i) Required change. A QBU with a legacy currency as its functional currency is required to change its functional currency to the euro beginning the first day of the first taxable year:

(A) That begins on or after the day that the euro is substituted for that legacy currency (in accordance with the Treaty on European Union); and

(B) In which the QBU begins to maintain its books and records (as described in §1.989(a)-1(d)) in the euro.

(ii) Notwithstanding paragraph (b)(2)(i) of this section, a QBU with a legacy currency as its functional currency is required to change its functional currency to the euro no later than the last taxable year beginning on or before the first day such legacy currency is no longer valid legal tender.

(iii) Consent of Commissioner. A change made pursuant to paragraph (b)(2)(i) of this section shall be deemed to be made with the consent of the Commissioner for purposes of §1.985-4. A QBU changing its functional currency to the euro pursuant to this paragraph (b)(2) must make adjustments as provided in paragraph (c) of this section.

(3) Statement to file upon change. With respect to a QBU that changes its functional currency to the euro under paragraph (b)(2) of this section, an affected taxpayer shall attach to its return for the taxable year of change a statement that includes the following: "TAXPAYER CERTIFIES THAT A QBU OF THE TAXPAYER HAS CHANGED ITS FUNCTIONAL CURRENCY TO THE EURO PURSUANT TO TREAS.

REG. §1.985-8T." For purposes of this paragraph (b)(3), an affected taxpayer shall be in the case where the QBU is: a QBU of an individual U.S. resident (as a result of the activities of such individual), the individual; a QBU branch of a U.S. corporation, the corporation; a controlled foreign corporation (as described in section 957)(or QBU branch thereof), each United States shareholder (as described in section 951(b)); a partnership, each partner separately; a noncontrolled section 902 corporation (as described in section 904(d)(2)(E)) (or branch thereof), each domestic shareholder as described in §1.902-1(a)(1); or a trust or estate, the fiduciary of such trust or estate.

(c) Adjustments required--(1) In general. A QBU that changes its functional currency to the euro pursuant to paragraph (b) of this section must make the adjustments described in paragraphs (c)(2) through (5) of this section. Section 1.985-5 shall not apply.

(2) Determining the euro basis of property and the euro amount of liabilities and other relevant items. The euro basis in property and the euro amount of liabilities and other relevant items shall equal the product of the legacy functional currency adjusted basis or amount of liabilities multiplied by the applicable conversion rate.

(3) Taking into account exchange gain or loss on legacy currency section 988 transactions--(i) In general. Except as provided in paragraphs (c)(3)(iii) and (iv) of this section, a legacy currency denominated section 988 transaction (determined after applying section 988(d)) outstanding on the last day of the taxable year immediately prior to the year of change shall continue to be treated as a section 988 transaction after the change and the principles of section 988 shall apply.

(ii) Example. The application of this paragraph (c)(3) may be illustrated by the following examples:

Example 1. X, a calendar year QBU on the cash method of accounting, uses the deutschmark as its functional currency. X is not described in section 1281(b). On July 1, 1998, X converts 10,000 deutschmarks(DM) into Dutch guilders(fl) at the spot rate of fl1 = DM1 and loans the 10,000 guilders to Y (an unrelated party) for one year at a rate of 10% with principal and interest to be paid on June 30, 1999. On January 1, 1999, X changes its functional currency to the euro pursuant to §1.985-8T. The euro/deutschmark conversion rate is set by the European Council at €1 = DM2. The euro/guilder conversion rate is set at €1 = fl2.25. Accordingly, under the terms of the note, on June 30, 1999, X will receive €4444.44 (fl10,000/2.25) of principal and €444.44 (fl1,000/2.25) of interest. Pursuant to this paragraph (c)(3), X will realize an exchange loss on the principal computed under the principles of §1.988-2(b)(5). For this purpose, the exchange rate used under §1.988-2(b)(5)(i) shall be the guilder/euro conversion rate. The amount under §1.988-2(b)(5)(ii) is determined by translating the fl10,000 at the guilder/deutschmark spot rate on July 1, 1998, and translating that deutschmark amount into euros at the deutschmark/euro conversion rate. Thus, X will compute an exchange loss for 1999 of ®555.56 determined as follows: [®4444.44 (fl10,000/2.25) - ®5000 ((fl10,000/1)/2) = -®555.56]. Pursuant to this paragraph (c)(3), the character and source of the loss are determined pursuant to section 988 and regulations thereunder. Because X uses the cash method of accounting for the interest on this debt instrument, X does not realize exchange gain or loss on the receipt of that interest.

Example 2. (i) X, a calendar year QBU on the accrual method of accounting, uses the deutschmark as its functional currency. On February 1, 1998, X converts 12,000 deutschmarks into Dutch guilders at the spot rate of fl1 = DM1 and loans the 12,000 guilders to Y (an unrelated party) for one year at a rate of 10% with principal and interest to be paid on January 31, 1999. In addition, assume the average rate (deutschmark/guilder) for the period from February 1, 1998, through December 31, 1998 is fl1.07 = DMl. Pursuant to §1.988-2(b)(2)(ii)(C), X will accrue eleven months of interest on the note and recognize interest income of DM1028.04 (fl1100/1.07) in the 1998 taxable year.

(ii) On January 1, 1999, the euro will replace the deutschmark as the national currency of Germany pursuant to the Treaty on European Union signed February 7, 1992. Assume that on January 1, 1999, X changes its functional currency to the euro pursuant to §1.985-8T. The euro/deutschmark conversion rate is set by the European Council at ®1 = DM2. The euro/guilder conversion rate is set at ®1 = fl2.25. In 1999, X will accrue one month of interest equal to ®44.44 (fl100/2.25). On January 31, 1999, pursuant to the note, X will receive interest denominated in euros of ®533.33 (fl1200/2.25). Pursuant to this paragraph (c)(3), X will realize an exchange loss in the 1999 taxable year with respect to accrued interest computed under the principles of §1.988-2(b)(3). For this purpose, the exchange rate used under §1.988-2(b)(3)(i) is the guilder/euro conversion rate and the exchange rate used under §1.988-2(b)(3)(ii) is the deutschmark/euro conversion rate. Thus, with respect to the interest accrued in 1998, X will realize exchange loss of ®25.13 under §1.988-2(b)(3) as follows: [®488.89 (fl1100/2.25) - ®514.02 (DM1028.04/2) = -®25.13]. With respect to the one month of interest accrued in 1999, X will realize no exchange gain or loss since the exchange rate when the interest accrued and the spot rate on the payment date are the same.

(iii) X will realize exchange loss of ®666.67 on repayment of the loan principal computed in the same manner as in Example 1 [®5333.33 (fl12,000/2.25) - ®6000 (fl12,000/1)/2)]. The losses with respect to accrued interest and principal are characterized and sourced under the rules of section 988.

(iii) Special rule for legacy nonfunctional currency. The

QBU shall realize or otherwise take into account for all purposes of the Internal Revenue Code the amount of any unrealized exchange gain or loss attributable to nonfunctional currency (as described in section 988(c)(1)(C)(ii)) that is denominated in a legacy currency as if the currency were disposed of on the last day of the taxable year immediately prior to the year of change. The character and source of the gain or loss are determined under section 988.

(iv) Legacy currency denominated accounts receivable and payable--(A) In general. A QBU may elect to realize or otherwise take into account for all purposes of the Internal Revenue Code the amount of any unrealized exchange gain or loss attributable to a legacy currency denominated item described in section 988(c)(1)(B)(ii) as if the item were terminated on the last day of the taxable year ending prior to the year of change.

(B) Time and manner of election. With respect to a QBU that makes an election described in paragraph (c)(3)(iv)(A) of this section, an affected taxpayer (as described in paragraph (b)(3) of this section) shall attach a statement to its tax return for the taxable year of change which includes the following: "TAXPAYER CERTIFIES THAT A QBU OF THE TAXPAYER HAS ELECTED TO REALIZE CURRENCY GAIN OR LOSS ON LEGACY CURRENCY DENOMINATED ACCOUNTS RECEIVABLE AND PAYABLE UPON CHANGE OF FUNCTIONAL CURRENCY TO THE EURO." A QBU making the election must do so for all legacy currency denominated items described in section 988(c)(1)(B)(ii).

(4) Adjustments when a branch changes its functional

currency to the euro--(i) Branch changing from a legacy currency to the euro in a taxable year during which taxpayer's functional currency is other than the euro. If a branch changes its functional currency from a legacy currency to the euro for a taxable year during which the taxpayer's functional currency is other than the euro, the branch's euro equity pool shall equal the product of the legacy currency amount of the equity pool multiplied by the applicable conversion rate. No adjustment to the basis pool is required.

(ii) Branch changing from a legacy currency to the euro in a taxable year during which taxpayer’s functional currency is the euro. If a branch changes its functional currency from a legacy currency to the euro for a taxable year during which the taxpayer’s functional currency is the euro, the taxpayer shall realize gain or loss attributable to the branch’s equity pool under the principles of section 987, computed as if the branch terminated on the last day prior to the year of change. Adjustments under this paragraph (c)(4)(ii) shall be taken into account by the taxpayer ratably over four taxable years beginning with the taxable year of change.

(5) Adjustments to a branch’s accounts when a taxpayer changes to the euro--(i) Taxpayer changing from a legacy currency to the euro in a taxable year during which a branch's functional currency is other than the euro. If a taxpayer changes its functional currency to the euro for a taxable year during which the functional currency of a branch of the taxpayer is other than the euro, the basis pool shall equal the product of the legacy currency amount of the basis pool multiplied by the applicable conversion rate. No adjustment to the equity pool is required.

(ii) Taxpayer changing from a legacy currency to the euro in a taxable year during which a branch's functional currency is the euro. If a taxpayer changes its functional currency from a legacy currency to the euro for a taxable year during which the functional currency of a branch of the taxpayer is the euro, the taxpayer shall take into account gain or loss as determined under paragraph (c)(4)(ii) of this section.

(6) Additional adjustments that are necessary when a corporation changes its functional currency to the euro. The amount of a corporation's euro currency earnings and profits and the amount of its euro paid-in capital shall equal the product of the legacy currency amounts of these items multiplied by the applicable conversion rate. The foreign income taxes and accumulated profits or deficits in accumulated profits of a foreign corporation that were maintained in foreign currency for purposes of section 902 and that are attributable to taxable years of the foreign corporation beginning before January 1, 1987, also shall be translated into the euro at the conversion rate.

(d) Effective date. This section applies to tax years ending after July 29, 1998.

Par. 5. Section 1.1001-5T is added to read as follows:

§1.1001-5T European Monetary Union (conversion to the euro)(temporary).

(a) Conversion of currencies. For purposes of §1.1001–1(a), the conversion to the euro of legacy currencies (as defined in §1.985–8T(a)(1)) is not the exchange of property for other property differing materially in kind or extent.

(b) Effect of currency conversion on other rights and obligations. For purposes of §1.1001–1(a), if, solely as the result of the conversion of legacy currencies to the euro, rights or obligations denominated in a legacy currency become rights or obligations denominated in the euro, that event is not the exchange of property for other property differing materially in kind or extent. Thus, for example, when a debt instrument that requires payments of amounts denominated in a legacy currency becomes a debt instrument requiring payments of euros, that alteration is not a modification within the meaning of §1.1001–3(c).

(c) Effective date. This section applies to tax years ending after July 29, 1998.

Michael P. Dolan

Deputy Commissioner of Internal Revenue

Approved: July 17, 1998

Donald C. Lubick

Assistant Secretary of the Treasury