INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

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Third Party Communication: None
Date of Communication: Not Applicable

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CASE-MIS No.: TAM-111960-18

Chief, Appeals Office
IRS Appeals

Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No

Year(s) Involved:
Date of Conference:

LEGEND:

Currency A=
Currency B=
Year 1=
Year 2=
Year 3=
Date 1=
Country A=
Country B =
Taxpayer=
Corp A Group=
Seller=
Property=
Brand Name=
Corp B=
X=
Corp C=
Y=

Entity=
Date 2=
Date 3=
Date 4=
Amount 1=
Amount 2=
Amount 3=
Amount 4=
Amount 5=
Amount 6=
Currency C=
Currency D=
Amount 7=
Amount 8=
Amount 9=
Date 5=
Partnership=
Country C=
Corp D=
Corp E=
Date 6=
Asset=
Year 4=
Year 5=
Amount 10=
Amount 11=
Amount 12=
Amount 13=
Amount 14=
Amount 15=

ISSUE(S):

Whether Currency A or Currency B is the correct functional currency to calculate any foreign currency exchange gain or loss under section 988 of the Internal Revenue Code (the “Code”) with respect to payments of principal and interest made on loans during the taxable years that ended on Year 1, Year 2, and Year 3.

CONCLUSION(S):

Currency A is the proper functional currency to use to calculate foreign currency exchange gain or loss under section 988 with respect to payments of principal and interest made on loans during the taxable years that ended on Year 1, Year 2, and Year 3.

FACTS:

Taxpayer is a Country A corporation. On Date 1, Taxpayer entered into an agreement with Seller, a Country B publicly traded company, to buy the Corp A group. The Corp A group owned and operated Property internationally that used the Brand Name. Under the sale agreement, Taxpayer would acquire Corp B, which owned approximately X% of Corp C (the parent company of the Corp A group's Country A consolidated group). Additionally, the agreement provided that Taxpayer would directly acquire the remaining interest of Y% in Corp C from Seller.

Taxpayer formed a new wholly-owned subsidiary, Entity, on Date 2 to serve as a financing and acquisition vehicle. Taxpayer made an election to treat Entity as a disregarded entity for U.S. Federal income tax purposes effective as of Date 3.

On Date 4, Taxpayer paid to Seller a purchase price of Amount 1 for the stock of Corp B and a direct interest in Corp C. Taxpayer financed the cash portion of the purchase price of Amount 2 with cash of Amount 3 and bank debt financing of Amount 4. Of the Amount 4, Entity borrowed the Currency A equivalent of Amount 5, consisting of a term loan of approximately Amount 6 with Currency B, Currency C, and Currency D tranches, a term loan denominated in Currency A of Amount 7, and a revolving line of credit primarily denominated in Currency A of approximately Amount 8. Taxpayer borrowed the remaining Amount 9 of acquisition debt in Currency A from the same revolving line of credit.

After the Corp A group acquisition, Entity held stock in Corp B and Corp C, received distributions from subsidiaries acquired in the Corp A group acquisition, incurred and serviced debt incurred to carry out the Corp A group acquisition, and participated in a single hedging transaction with Corp C.

In Date 5, subsequent to the acquisition of the Corp A group, Taxpayer contributed the stock of Entity to Partnership, a Country C entity that is treated as a partnership for U.S. Federal income tax purposes. Partnership was equally owned by Corp D and Corp E, two subsidiaries of Taxpayer. Corp E was wholly owned by Corp D. Corp D and Corp E had Currency A as their functional currencies.

On Date 6, Corp E converted from a corporation to a U.S. limited liability company ("LLC"). The conversion caused Corp E to be treated as a disregarded entity of Corp D for U.S. Federal income tax purposes. The conversion of Corp E to a LLC caused Partnership to become a single member entity disregarded for U.S. Federal income tax purposes. Due to the conversion, Entity was treated as a disregarded entity owned by Corp D for U.S. tax purposes.

Partnership's sole operating asset was a management agreement for Asset in Country C, and its activities related solely to management of Asset. Prior to Year 4, all of its assets, liabilities, income, and expenses were directly related to those activities. It

also held the equity interest in Entity. The functional currency of Partnership for U.S. GAAP and U.S Federal income tax purposes was Currency B. Partnership and Entity each maintained separate books of original entry and ledger accounts. Entity's assets and liabilities were not recorded on Partnership's books. Additionally, Partnership maintained its foreign exchange exposure pools under the methodology prescribed in 2006 Prop. Treas. Reg. §1.987-4 (REG-208270-86, 71 FR 52876). No portion of Partnership's pool of unrecognized section 987 gain or loss was ever triggered by a remittance.

During the tax year that ended on Year 1, and tax periods that ended on Year 2 and Year 3, Entity made principal and interest payments on the various loans. Taxpayer used Currency A as the functional currency to calculate the section 988 foreign currency gain or loss on those payments. Taxpayer calculated net foreign exchange losses with respect to Currency B, Currency C, and Currency D, resulting from the payment of principal and interest with respect to the Corp A group acquisition financing in Year 4 and Year 5. However, as a result of a hedging agreement between Entity and Corp C, Corp C reported deductions of Amount 10 and Amount 11 on its Schedule M-3 for tax year ended Year 1 and tax period ended Year 2, respectively, due to the operation of this agreement. Taxpayer reported a deduction of Amount 12 on its Schedule M-3 for the tax period ended Year 3 due to the operation of the agreement.

Exam determined that Entity's assets and liabilities should be attributed to Partnership rather than to Corp D and Corp E for purposes of calculating any section 988 foreign currency gain or loss. Therefore, Exam determined that any section 988 foreign currency gain or loss should be computed using Currency B, which was the functional currency of Partnership. The proposed adjustments by Exam were determined using Currency B, resulting in foreign currency gain with respect to the loan payments in the amounts of Amount 13, Amount 14, and Amount 15 for tax year ended Year 1 and tax periods ended Year 2, and Year 3, respectively.

LAW AND ANALYSIS:

Section 988(b)(1) of the Code provides that the term "foreign currency gain" means any gain from a section 988 transaction to the extent the gain does not exceed gain realized by reason of changes in exchange rates on or after the booking date and before the payment date.

Section 988(b)(2) of the Code provides that the term "foreign currency loss" means any loss from a section 988 transaction to the extent the loss does not exceed the loss realized by reason of changes in exchange rates on or after the booking date and before the payment date.

Section 988(c)(1)(A) of the Code defines the term "section 988 transaction" as any transaction described in section 988(c)(1)(B) if the amount which the taxpayer is required to receive or pay by reason of the transaction is denominated in terms of a

nonfunctional currency or is determined by reference to the value of one or more nonfunctional currencies. The acquisition of a debt instrument or becoming an obligor under a debt instrument are transactions included under section 988(c)(1)(B).

Section 985(b) of the Code defines the term "functional currency" as the dollar or in the case of a qualified business unit ("QBU"), the currency of the economic environment in which a significant part of the QBU's activities are conducted and which is used by the QBU in keeping its books and records.

Under section 989(a) of the Code, the term QBU means any separate and clearly identified unit of a trade or business of a taxpayer that maintains separate books and records.

Former Treas. Reg. §1.989(a)-1 (TD 8279, 55 FR 283-01, effective prior to December 7, 2016) provided, in part, that a partnership is a QBU of a partner.

Section 987 of the Code provides that in the case of a taxpayer having one or more QBUs with a functional currency other than the dollar, the taxable income of the taxpayer is determined by computing the taxable income or loss of the QBU separately in its functional currency and translating the income or loss at the appropriate exchange rate. Section 987 further requires the taxpayer to make proper adjustments (as prescribed by the Secretary) for transfers of property between QBUs having different functional currencies, including treating post-1986 remittances from each QBU as made on a pro rata basis out of post-1986 accumulated earnings, treating section 987 gain or loss as ordinary income or loss, and sourcing the gain or loss by reference to the source of the income giving rise to post-1986 accumulated earnings.

On September 6, 2006, the Treasury Department and the IRS published a notice of proposed rulemaking (REG-208270-86, 71 FR 52876) that proposed new regulations under section 987 (the 2006 proposed section 987 regulations) and withdrew proposed regulations under section 987 published on September 25, 1991 (INTL-965-86, 56 FR 48457) (the 1991 proposed regulations). Final regulations under section 987 were published on December 8, 2017 (TD 9794).

Former Treas. Reg. §1.988-4(b) (TD 8400, 57 FR 9172-01, effective prior to December 7, 2016) provided in part:

> (b) Qualified business unit. (1) In general. The source of exchange gain or loss shall be determined by reference to the residence of the qualified business unit of the taxpayer on whose books the asset, liability, or item of income or expense giving rise to such gain or loss is properly reflected.
> (2) Proper reflection on the books of the taxpayer or qualified business unit. (i) In general. Whether an asset, liability, or item of income is properly reflected on the books of a qualified business unit is a question of fact.

(ii) Presumption if booking practices are inconsistent. It shall be presumed that an asset, liability, or item of income or expense is not properly reflected on the books of the qualified business unit if the taxpayer and its qualified business unit employ inconsistent booking practices with respect to the same or similar assets, liabilities, or items of income or expense. If not properly reflected on the books, the Commissioner may allocate any asset, liability, or item of income or expense between or among the taxpayer and its qualified business units to properly reflect the source (or realization) of exchange gain or loss.

Prop. Reg. §1.987-2 of the 2006 proposed section 987 regulations provided rules for attributing items to a section 987 QBU. This section provided in part:

(b) Attribution of items to an eligible QBU--(1) General rules. Except as provided in paragraphs (b)(2) and (3) of this section, items are attributable to an eligible QBU to the extent they are reflected on the separate set of books and records, as defined in §1.989(a)-1(d), of the eligible QBU. For purposes of this section, the term "item" refers to assets and liabilities, and items of income, gain, deduction, and loss. Items that are attributed to an eligible QBU pursuant to this section must be adjusted to conform to U.S. tax principles as provided in §1.987-4(e). These attribution rules apply solely for purposes of section 987. For example, the allocation and apportionment of interest expense under section 864(e) is independent of the rules under section 987.

(2) Exceptions for non-portfolio stock, interests in partnerships, and certain acquisition indebtedness--(i) General rule. Except as provided in paragraph (b)(2)(ii) of this section, the following shall not be considered to be on the books and records of a an eligible QBU:

(A) Stock of a corporation (whether domestic or foreign).

(B) An interest in a partnership (whether domestic or foreign).

(C) A liability that was incurred to acquire the stock or an interest in a partnership described in paragraphs (b)(2)(i)(A) or (B) of this section, respectively.

(D) Income, gain, deduction, or loss arising from the items described in paragraphs (b)(2)(i)(A) through (C) of this section. For example, a section 951 inclusion with respect to stock of a foreign corporation that is described in paragraph (b)(2)(i)(A) of this section shall not be considered to be on the books and records of the eligible QBU.

(ii) Portfolio stock. Paragraph (b)(2)(i)(A) of this section shall not apply to stock of a corporation (whether domestic or foreign) reflected on the books and records, within the meaning of paragraph (b)(1) of this section, of an eligible QBU provided the owner of the eligible QBU owns less than 10 percent of the total voting power or value of all classes of stock of such corporation. For purposes of this paragraph (b)(2)(ii), section 318(a) shall be applied in determining ownership, except that in applying section 318(a)(2)(C), the phrase "10 percent" is used instead of the phrase "50 percent."

Prop. Reg. §1.988-1(a)(4)(ii) of the 2006 proposed section 987 regulations provided that in the case of partnership assets and liabilities that are not attributable to an eligible QBU, the owners of the partnership are treated as owning their share of the partnership's assets and liabilities. Similarly, Prop. Reg. §1.988-1(a)(4)(iii) of the 2006 proposed section 987 regulations provided that in the case of assets and liabilities owned by a disregarded entity that are not attributable to an eligible QBU, the owner of the disregarded entity is treated as owning all of the disregarded entity's assets and liabilities.

In this particular case, whether Currency A or Currency B is the correct functional currency to calculate any section 988 gain or loss with respect to the payments of principal and interest made on the loans depends upon whether the debt is properly attributed to the books of the Partnership or the books of the partners of the Partnership. If the loans are properly reflected upon Partnership's books, section 988 gain or loss must be computed with respect to Currency B. However, if the loans are properly reflected upon the partners' books, section 988 gain or loss must be computed with respect to Currency A, which is the functional currency of both Corp D and Corp E.

The versions of Treas. Reg. §1.989(a)-1 and Treas. Reg. §1.988-4(b) that were in effect prior to their modification in TD 9794 are applicable to the years at issue. Under former Treas. Reg. §1.989(a)-1, Partnership was a per se QBU of its partners because of its status as a partnership. Under former Treas. Reg. §1.988-4(b), whether an asset, liability, or item of income was properly reflected on the books of a QBU was a question of fact. Partnership's trade or business consisted of managing Asset in Country B. The loans were used to finance the purchase of stock in Corp B and Corp C; therefore, the Corp B stock, Corp C stock, and the associated acquisition debt were not used in the conduct of the trade or business of Partnership. Under the facts of this case, it is not appropriate to attribute the stock and acquisition debt to the books of Partnership.

Under the facts presented, we conclude that the loans, which were used to finance the acquisition of the Corp A group, are properly reflected on the books of Partnership's partners, Corp D and Corp E, rather than on the books of Partnership. This conclusion is also consistent with 2006 Prop. Reg. §1.987-2(b)(2)(i)(C)[1]. Under Prop. Reg. §1.987-2(b)(2)(i)(C), the loans would not be attributed to Partnership because they were liabilities incurred to acquire stock. Under these particular facts, the debt is properly reflected on the books of Corp D and Corp E; therefore, foreign currency gain or loss on the debt is properly computed using Currency A as the functional currency.

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[1] The principles of this rule were finalized in TD 9794 (§1.987-2(b)(2)(iii)).

CAVEAT(S):

A copy of this technical advice memorandum is to be given to the taxpayer(s). Section 6110(k) (3) of the Code provides that it may not be used or cited as precedent.