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§ 1.988–6 Nonfunctional Currency Contingent Payment Debt Instruments

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§ 1.988–1 Certain definitions and special rules.

(a) *Section 988 transaction*—(1) *In general.* The term ''section 988 transaction'' means any of the following transactions—

(i) A disposition of nonfunctional currency as defined in paragraph (c) of this section;

(ii) Any transaction described in paragraph (a)(2) of this section if any amount which the taxpayer is entitled to receive or is required to pay by reason of such transaction is denominated

in terms of a nonfunctional currency or is determined by reference to the value of one or more nonfunctional currencies.

A transaction described in this paragraph (a) need not require or permit payment with a nonfunctional currency as long as any amount paid or received is determined by reference to the value of one or more nonfunctional currencies. The acquisition of nonfunctional currency is treated as a section 988 transaction for purposes of establishing the taxpayer's basis in such currency and determining exchange gain or loss thereon.

(2) *Description of transactions.* The following transactions are described in this paragraph (a)(2).

(i) *Debt instruments.* Acquiring a debt instrument or becoming an obligor under a debt instrument. The term ''debt instrument'' means a bond, debenture, note, certificate or other evidence of indebtedness.

(ii) *Payables, receivables, etc.* Accruing, or otherwise taking into account, for purposes of subtitle A of the Internal Revenue Code, 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. A payable relating to cost of goods sold, or a payable or receivable relating to a capital expenditure or receipt, is within the meaning of this paragraph (a)(2)(ii). Generally, a payable relating to foreign taxes (whether or not claimed as a credit under section 901) is within the meaning of this paragraph (a)(2)(ii). However, a payable of a domestic person relating to accrued foreign taxes of its qualified business unit (QBU branch) is not within the meaning of this paragraph (a)(2)(ii) if the QBU branch's functional currency is the U.S. dollar and the foreign taxes are claimed as a credit under section 901.

(iii) *Forward contract, futures contract, option contract, or similar financial instrument.* Except as otherwise provided in this paragraph (a)(2)(iii) and paragraph (a)(4)(i) of this section, entering into or acquiring any forward contract, futures contract, option, warrant, or similar financial instrument.

(A) *Limitation for certain derivative instruments.* A forward contract, futures contract, option, warrant, or similar financial instrument is within this paragraph (a)(2)(iii) only if the underlying property to which the instrument ultimately relates is a nonfunctional currency or is otherwise described in paragraph (a)(1)(ii) of this section. Thus, if the underlying property of an instrument is another financial instrument (*e.g.*, an option on a futures contract), then the underlying property to which such other instrument (*e.g.*, the futures contract) ultimately relates must be a nonfunctional currency. For example, a forward contract to purchase wheat denominated in a nonfunctional currency, an option to enter into a forward contract to purchase wheat denominated in a nonfunctional currency, or a warrant to purchase stock denominated in a nonfunctional currency is not described in this paragraph (a)(2)(iii). On the other hand, a forward contract to purchase a nonfunctional currency, an option to enter into a forward contract to purchase a nonfunctional currency, an option to purchase a bond denominated in or the payments of which are determined by reference to the value of a nonfunctional currency, or a warrant to purchase nonfunctional currency is described in this paragraph (a)(2)(iii).

(B) *Nonfunctional currency notional principal contracts—(1) In general.* The term ''similar financial instrument'' includes a notional principal contract only if the payments required to be made or received under the contract are determined with reference to a nonfunctional currency.

(*2*) *Definition of notional principal contract.* The term ''notional principal contract'' means a contract (*e.g.*, a swap, cap, floor or collar) that provides for the payment of amounts by one party to another at specified intervals calculated by reference to a specified index upon a notional principal amount in exchange for specified consideration or a promise to pay similar amounts. For this purpose, a ''notional principal contract'' shall only include an instrument where the underlying property to which the instrument ultimately relates is money (*e.g.*, functional currency), nonfunctional currency, or property the value of which is determined by reference to an interest rate.

Thus, the term ''notional principal contract'' includes a currency swap as defined in §1.988–2(e)(2)(ii), but does not include a swap referenced to a commodity or equity index.

(C) *Effective date with respect to certain contracts.* This paragraph (a)(2)(iii) does not apply to any forward contract, futures contract, option, warrant, or similar financial instrument entered into or acquired on or before October 21, 1988, if such instrument would have been marked to market under section 1256 if held on the last day of the taxable year.

(3) [Reserved]. For further guidance, see §1.988–1T(a)(3).

(4) *Treatment of assets and liabilities of a section 987 aggregate partnership or DE that are not attributed to an eligible QBU*—(i) *Scope.* This paragraph (a)(4) applies to assets and liabilities of a section 987 aggregate partnership as defined in §1.987–1(b)(5), or of an entity disregarded as an entity separate from its owner for Federal income tax purposes (DE), that are not attributable to an eligible QBU as defined in §1.987–1(b)(3).

(ii) *Section 987 Aggregate Partnerships.* For purposes of applying section 988 and the applicable regulations to transactions involving assets and liabilities described in paragraph (a)(4)(i) of this section that are held by a section 987 aggregate partnership, the owners of the section 987 aggregate partnership (within the meaning of §1.987–1(b)(4)) shall be treated as owning their share of such assets and liabilities. Section 1.987–7(b) shall apply for purposes of determining an owner's share of such assets or liabilities.

(iii) *Disregarded entities.* For purposes of applying section 988 and the applicable regulations to transactions involving assets and liabilities described in paragraph (a)(4)(i) of this section that are held by a DE, the owner of the DE (within the meaning of §1.987–1(b)(4)) shall be treated as owning all such assets and liabilities.

(iv) *Example.* The following example illustrates the application of paragraph (a)(4) of this section:

Example. Liability held through a section 987 aggregate partnership. (i) *Facts.* P, a foreign partnership, has two equal partners, X and Y. X is a domestic corporation with the dollar as its functional currency. Y is a foreign corporation wholly owned by X that has the yen as its functional currency. P is a section 987 aggregate partnership. On January 1, 2021, P borrowed yen and issued a note to the lender that obligated P to pay interest and repay principal to the lender in yen. Also on January 1, 2021, P used the yen it borrowed from the lender to acquire all of the stock of F, a foreign corporation, from an unrelated person. P also holds an eligible QBU (within the meaning of §1.987–1(b)(3)) that has the yen as its functional currency. P maintains one set of books and records. The assets and liabilities of the eligible QBU are reflected on the books and records of P as provided under §1.987–2(b). The F stock held by P, and the yen liability incurred to acquire the F stock, are also recorded on the books and records of P but, pursuant to §1.987–2(b)(2)(i), are not considered to be reflected on the books and records of the eligible QBU for purposes of section 987.

(ii) *Analysis.* X's portion of the assets and liabilities of the eligible QBU owned by P is a section 987 QBU. Y's portion of the assets and liabilities of the eligible QBU owned by P is not a section 987 QBU because Y and the eligible QBU have the same functional currency. Because the F stock and yen-denominated liability incurred to acquire such stock are not considered reflected on the books and records of the eligible QBU, they are not subject to section 987. In addition, because the F stock and the yen-denominated liability incurred to acquire such stock are held by P (but not attributable to P's eligible QBU), X and Y are treated as owning their respective shares of such stock and liability pursuant to §1.988–1(a)(4)(ii) for purposes of applying section 988. As a result, P's becoming the obligor on the portion of the yen-denominated note that is treated as an obligation of X is a section 988 transaction pursuant to paragraphs (a)(1)(ii), (a)(2)(ii) and (a)(3) of this section. Similarly, the dispositions of yen to make payments of interest and principal on the liability, to the extent such yen are treated as owned by X under paragraph (a)(4)(ii) of this section, are section 988 transactions under paragraphs (a)(1)(i) and (a)(3) of this section. To the extent the yen are treated as owned by the eligible QBU, see §1.987–2(c) for the treatment of the payment of yen as a transfer from the eligible QBU to X. P's becoming the obligor on Y's portion of the yen-denominated note, and Y's portion of the yen disposed of in connection with payments on such note, are not section 988 transactions because Y has the yen as its functional currency.

(5) [Reserved]

(6) *Examples.* The following examples illustrate the application of paragraph (a) of this section. The examples assume that X is a U.S. corporation on an

accrual method with the calendar year as its taxable year. Because X is a U.S. corporation the U.S. dollar is its functional currency under section 985. The examples also assume that section 988(d) does not apply.

Example 1. On January 1, 1989, X acquires 10,000 Canadian dollars. On January 15, 1989, X uses the 10,000 Canadian dollars to purchase inventory. The acquisition of the 10,000 Canadian dollars is a section 988 transaction for purposes of establishing X's basis in such Canadian dollars. The disposition of the 10,000 Canadian dollars is a section 988 transaction pursuant to paragraph (a)(1) of this section.

Example 2. On January 1, 1989, X acquires 10,000 Canadian dollars. On January 15, 1989, X 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 X's basis in such Canadian dollars. The conversion of the 10,000 Canadian dollars to U.S. dollars is a section 988 transaction pursuant to paragraph (a)(1) of this section.

Example 3. On January 1, 1989, X borrows 100,000 British pounds (£) for a period of 10 years and issues a note to the lender with a face amount of £100,000. The note provides for payments of interest at an annual rate of 10% paid quarterly in pounds and has a stated redemption price at maturity of £100,000. X's becoming the obligor under the note is a section 988 transaction pursuant to paragraphs (a)(1)(ii) and (2)(i) of this section. Because X is an accrual basis taxpayer, the accrual of interest expense under X's note is a section 988 transaction pursuant to paragraphs (a)(1)(ii) and (2)(ii) of this section. In addition, the acquisition of the British pounds to make payments under the note is a section 988 transaction for purposes of establishing X's basis in such pounds, and the disposition of such pounds is a section 988 transaction under paragraph (a)(1)(i) of this section. See §1.988–2(b) with respect to the translation of accrued interest expense and the determination of exchange gain or loss upon payment of accrued interest expense.

Example 4. On January 1, 1989, X purchases an original issue for 74,621.54 British pounds (£) a 3-year bond maturing on December 31, 1991, at a stated redemption price of £100,000. The bond provides for no stated interest. The bond has a yield to maturity of 10% compounded semiannually and has £25,378.46 of original issue discount. The acquisition of the bond is a section 988 transaction as provided in paragraphs (a)(1)(ii) and (2)(i) of this section. The accrual of original issue discount with respect to the bond is a section 988 transaction under paragraphs (a)(1)(ii) and (2)(ii) of this section. See §1.988–2(b) with respect to the translation of original issue discount and the determination of exchange gain or loss upon receipt of such amounts.

Example 5. On January 1, 1989, X sells and delivers inventory to Y for 10,000,000 Italian lira for payment on April 1, 1989. Under X's method of accounting, January 1, 1989 is the accrual date. Because X is an accrual basis taxpayer, the accrual of a nonfunctional currency denominated item of gross receipts on January 1, 1989, for payment after the date of accrual is a section 988 transaction under paragraphs (a)(1)(ii) and (2)(ii) of this section.

Example 6. On January 1, 1989, X agrees to purchase a machine from Y for delivery on March 1, 1990 for 1,000,000 yen. The agreement calls for X to pay Y for the machine on June 1, 1990. Under X's method of accounting, the expenditure for the machine does not accrue until delivery on March 1, 1990. The agreement to purchase the machine is not a section 988 transaction. In particular, the agreement to purchase the machine is not described in paragraph (a)(2)(ii) of this section because the agreement is not an item of expense taken into account under subtitle A (but rather is an agreement to purchase a capital asset in the future). However, the payable that will arise on the delivery date is a section 988 transaction under paragraphs (a)(1)(ii) and (2)(ii) of this section even though the payable relates to a capital expenditure. In addition, the disposition of yen to satisfy the payable on June 1, 1990, is a section 988 transaction under paragraph (a)(1)(i) of this section.

Example 7. On January 1, 1989, X purchases and takes delivery of inventory for 10,000 French francs with payment to be made on April 1, 1989. Under X's method of accounting, the expense accrues on January 1, 1989. On January 1, 1989, X also enters into a forward contract with a bank to purchase 10,000 French francs for $2,000 on April 1, 1989. Because X is an accrual basis taxpayer, the accrual of a nonfunctional currency denominated item of expense on January 1, 1989, for payment after the date of accrual is a section 988 transaction under paragraphs (a)(1)(ii) and (2)(ii) of this section. Entering into the forward contract to purchase the 10,000 French francs is a section 988 transaction under paragraphs (a)(1)(ii) and (2)(iii) of this section.

Example 8. On January 1, 1989, X acquires 100,000 Norwegian krone. On January 15, 1989, X purchases and takes delivery of 1,000 shares of common stock with the 100,000 krone acquired on January 1, 1989. On August 1, 1989, X sells the 1,000 shares of common stock and receives 120,000 krone in payment. On August 30, 1989, X converts the 120,000 krone to U.S. dollars. The acquisition of the 100,000 krone on January 1, 1989, and the acquisition of the 120,000 krone on August 1, 1989, are section 988 transactions for purposes of establishing the basis of such krone.

The disposition of the 100,000 krone on January 15, 1989, and the 120,000 krone on August 30, 1989, are section 988 transactions as provided in paragraph (a)(1)(i) of this section. Neither the acquisition on January 15, 1989, nor the disposition on August 1, 1989, of the stock is a section 988 transaction.

Example 9. On May 11, 1989, X 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 percent compounded semiannually. The amount of principal received by X 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 by X of the instrument described above 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 10. On April 9, 1989, X enters into an interest rate swap that provides for the payment of amounts by X to its counterparty based on 4% of a 10,000 yen principal amount in exchange for amounts based on yen LIBOR rates. Pursuant to paragraphs (a)(1)(ii) and (2)(iii) of this section, this yen for yen interest rate swap is a section 988 transaction.

Example 11. On August 11, 1989, X 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 within the meaning of §1.988–1(a)(2)(iii) because the underlying property to which the option relates is a group of stocks and not nonfunctional currency.

(7) *Special rules for regulated futures contracts and non-equity options*—(i) *In general.* Except as provided in paragraph (a)(7)(ii) of this section, paragraph (a)(2)(iii) of this section shall not apply to any regulated futures contract or non-equity option which would be marked to market under section 1256 if held on the last day of the taxable year.

(ii) *Election to have paragraph (a)(2)(iii) of this section apply.* Notwithstanding paragraph (a)(7)(i) of this section, a taxpayer may elect to have paragraph (a)(2)(iii) of this section apply to regulated futures contracts and non-equity options as provided in paragraphs (a)(7)(iii) and (iv) of this section.

(iii) *Procedure for making the election.* A taxpayer shall make the election provided in paragraph (a)(7)(ii) of this section by sending to the Internal Revenue Service Center, Examination Branch, Stop Number 92, Kansas City, MO 64999 a statement titled ''Election to Treat Regulated Futures Contracts and Non-Equity Options as Section 988 Transactions Under Section 988 (c)(1)(D)(ii)'' that contains the following:

(A) The taxpayer's name, address, and taxpayer identification number;

(B) The date the notice is mailed or otherwise delivered to the Internal Revenue Service Center;

(C) A statement that the taxpayer (including all members of such person's affiliated group as defined in section 1504 or in the case of an individual all persons filing a joint return with such individual) elects to have section 988(c)(1)(D)(i) and §1.988–1(a)(7)(i) not apply;

(D) The date of the beginning of the taxable year for which the election is being made;

(E) If the election is filed after the first day of the taxable year, a statement regarding whether the taxpayer has previously held a contract described in section 988(c)(1)(D)(i) or §1.988–1(a)(7)(i) during such taxable year, and if so, the first date during the taxable year on which such contract was held; and

(F) The signature of the person making the election (in the case of individuals filing a joint return, the signature of all persons filing such return).

The election shall be made by the following persons: in the case of an individual, by such individual; in the case of a partnership, by each partner separately; effective for taxable years beginning after March 17, 1992, in the case of tiered partnerships, each ultimate partner; in the case of an S corporation, by each shareholder separately; in the case of a trust (other than a grantor trust) or estate, by the fiduciary of such trust or estate; in the case of any corporation other than an S corporation, by such corporation (in the case of a corporation that is a member of an

affiliated group that files a consolidated return, such election shall be valid and binding only if made by the common parent, as that term is used in §1.1502–77(a)); in the case of a controlled foreign corporation, by its controlling United States shareholders under §1.964–1(c)(3). With respect to a corporation (other than an S corporation), the election, when made by the common parent, shall be binding on all members of such corporation's affiliated group as defined in section 1504 that file a consolidated return. The election shall be binding on any income or loss derived from the partner's share (determined under the principles of section 702(a)) of all contracts described in section 988(c)(1)(D)(i) or paragraph (a)(7)(i) of this section in which the taxpayer holds a direct interest or indirect interest through a partnership or S corporation; however, the election shall not apply to any income or loss of a partnership for any taxable year if such partnership made an election under section 988(c)(1)(E)(iii)(V) for such year or any preceding year. Generally, a copy of the election must be attached to the taxpayer's income tax return for the first year it is effective. It is not required to be attached to subsequent returns. However, in the case of a partner, a copy of the election must be attached to the taxpayer's income tax return for every year during which the taxpayer is a partner in a partnership that engages in a transaction that is subject to the election.

(iv) *Time for making the election*—(A) *In general.* Unless the requirements for making a late election described in paragraph (a)(7)(iv)(B) of this section are satisfied, an election under section 988 (c)(1)(D)(ii) and paragraph (a)(7)(ii) of this section for any taxable year shall be made on or before the first day of the taxable year or, if later, on or before the first day during such taxable year on which the taxpayer holds a contract described in section 988(c)(1)(D)(ii) and paragraph (a)(7)(ii) of this section. The election under section 988(c)(1)(D)(ii) and paragraph (a)(7)(ii) of this section shall apply to contracts entered into or acquired after October 21, 1988, and held on or after the effective date of the election. The election shall be effective as of the beginning of the taxable year and shall be binding with respect to all succeeding taxable years unless revoked with the prior consent of the Commissioner. In determining whether to grant revocation of the election, recapture of the tax benefit derived from the election in previous taxable years will be considered.

(B) *Late elections.* A taxpayer may make an election under section 988(c)(1)(D)(ii) and paragraph (a)(7)(ii) of this section within 30 days after the time prescribed in the first sentence of paragraph (a)(7)(iv)(A) of this section. Such a late election shall be effective as of the beginning of the taxable year; however, any losses recognized during the taxable year with respect to contracts described in section 988(c)(1)(D)(ii) or paragraph (a)(7)(ii) of this section which were entered into or acquired after October 21, 1988, and held on or before the date on which the late election is mailed or otherwise delivered to the Internal Revenue Service Center shall not be treated as derived from a section 988 transaction. A late election must comply with the procedures set forth in paragraph (a)(7)(iii) of this section.

(v) *Transition rule.* An election made prior to September 21, 1989 which satisfied the requirements of Notice 88–124, 1988–51 I.R.B. 6, shall be deemed to satisfy the requirements of paragraphs (a)(7)(iii) and (iv) of this section.

(vi) *General effective date provision.* This paragraph (a)(7) shall apply with respect to futures contracts and options entered into or acquired after October 21, 1988.

(8) *Special rules for qualified funds*—(i) *Definition of qualified fund.* The term ''qualified fund'' means any partnership if—

(A) At all times during the taxable year (and during each preceding taxable year to which an election under section 988(c)(1)(E)(iii)(V) applied) such partnership has at least 20 partners and no single partner owns more than 20 percent of the interests in the capital or profits of the partnership;

(B) The principa1 activity of such partnership for such taxable year (and

each such preceding taxable year) consists of buying and selling options, futures, or forwards with respect to commodities;

(C) At least 90 percent of the gross income of the partnership for the taxable year (and each such preceding year) consists of income or gains described in subparagraph (A), (B), or (G) of section 7704(d)(1) or gain from the sale or disposition of capital assets held for the production of interest or dividends;

(D) No more than a de minimis amount of the gross income of the partnership for the taxable year (and each such preceding taxable year) was derived from buying and selling commodities; and

(E) An election under section 988(c)(1)(E)(iii)(V) as provided in paragraph (a)(8)(iv) of this section applies to the taxable year.

(ii) *Special rules relating to paragraph (a)(8)(i)(A) of this section*—(A) *Certain general partners.* The interest of a general partner in the partnership shall not be treated as failing to meet the 20 percent ownership requirement of paragraph (a)(8)(i)(A) of this section for any taxable year of the partnership if, for the taxable year of the partner in which such partnership's taxable year ends, such partner (and each corporation filing a consolidated return with such partner) had no ordinary income or loss from a section 988 transaction (other than income from the partnership) which is exchange gain or loss (as the case may be).

(B) *Treatment of incentive compensation.* For purposes of paragraph (a)(8)(i)(A) of this section, any income allocable to a general partner as incentive compensation based on profits rather than capital shall not be taken into account in determining such partner's interest in the profits of the partnership.

(C) *Treatment of tax exempt partners.* The interest of a partner in the partnership shall not be treated as failing to meet the 20 percent ownership requirements of paragraph (a)(5)(8)(A) of this section if none of the income of such partner from such partnership is subject to tax under chapter 1 of subtitle A of the Internal Revenue Code (whether directly or through one or more pass-through entities).

(D) *Look-through rule.* In determining whether the 20 percent ownership requirement of paragraph (a)(8)(i)(A) of this section is met with respect to any partnership, any interest in such partnership held by another partnership shall be treated as held proportionately by the partners in such other partnership.

(iii) *Other special rules*—(A) *Related persons.* Interests in the partnership held by persons related to each other (within the meaning of section 267(b) or 707(b)) shall be treated as held by one person.

(B) *Predecessors.* Reference to any partnership shall include a reference to any predecessor thereof.

(C) *Treatment of certain debt instruments.* Solely for purposes of paragraph (a)(8)(i)(D) of this section, any debt instrument which is described in both paragraphs (a)(1)(ii) and (2)(i) of this section shall be treated as a commodity.

(iv) *Procedure for making the election provided in section 988(c)(1)(E)(iii)(V).* A partnership shall make the election provided in section 988(c)(1)(E)(iii)(V) by sending to the Internal Revenue Service Center, Examination Branch, Stop Number 92, Kansas City, MO 64999 a statement titled ''QUALIFIED FUND ELECTION UNDER SECTION 988(c)(1)(E)(iii)(V)'' that contains the following:

(A) The partnership's name, address, and taxpayer identification number;

(B) The name, address and taxpayer identification number of the general partner making the election on behalf of the partnership;

(C) The date the notice is mailed or otherwise delivered to the Internal Revenue Service Center;

(D) A brief description of the activity of the partnership;

(E) A statement that the partnership is making the election provided in section 988(c)(1)(E)(iii)(V);

(F) The date of the beginning of the taxable year for which the election is being made;

(G) If the election is filed after the first day of the taxable year, then a statement regarding whether the partnership previously held an instrument referred to in section 988(c)(1)(E)(i) during such taxable year and, if so, the

first date during the taxable year on which such contract was held; and

(H) The signature of the general partner making the election.

The election shall be made by a general partner with management responsibility of the partnership's activities and a copy of such election shall be attached to the partnership's income tax return (Form 1065) for the first taxable year it is effective. It is not required to be attached to subsequent returns.

(v) *Time for making the election.* The election under section 988(c)(1)(E)(iii)(V) for any taxable year shall be made on or before the first day of the taxable year or, if later, on or before the first day during such year on which the partnership holds an instrument described in section 988(c)(1)(E)(i). The election under section 988(c)(1)(E)(iii)(V) shall apply to the taxable year for which made and all succeeding taxable years. Such election may only be revoked with the consent of the Commissioner. In determining whether to grant revocation of the election, recapture by the partners of the tax benefit derived from the election in previous taxable years will be considered.

(vi) *Operative rules applicable to qualified funds*—(A) *In general.* In the case of a qualified fund, any bank forward contract or any foreign currency futures contract traded on a foreign exchange which is not otherwise a section 1256 contract shall be treated as a section 1256 contract for purposes of section 1256.

(B) *Gains and losses treated as short-term.* In the case of any instrument treated as a section 1256 contract under paragraph (a)(8)(vi)(A) of this section, subparagraph (A) of section 1256(a)(3) shall be applied by substituting ''100 percent'' for ''40 percent'' (and subparagraph (B) of such section shall not apply).

(vii) *Transition rule.* An election made prior to September 21, 1989, which satisfied the requirements of Notice 88–124, 1988–51 I.R.B. 6, shall be deemed to satisfy the requirements of §1.988–1(a)(8)(iv) and (v).

(viii) *General effective date rules*—(A) The requirements of subclause (IV) of section 988(c)(1)(E)(iii) shall not apply to contracts entered into or acquired on or before October 21, 1988.

(B) In the case of any partner in an existing partnership, the 20 percent ownership requirements of subclause (I) of section 988(c)(1)(E)(iii) shall be treated as met during any period during which such partner does not own a percentage interest in the capital or profits of such partnership greater than 33⅓ percent (or, if lower, the lowest such percentage interest of such partner during any period after October 21, 1988, during which such partnership is in existence). For purposes of the preceding sentence, the term ''existing partnership'' means any partnership if—

(*1*) Such partnership was in existence on October 21, 1988, and principally engaged on such date in buying and selling options, futures, or forwards with respect to commodities; or

(*2*) A registration statement was filed with respect to such partnership with the Securities and Exchange Commission on or before such date and such registration statement indicated that the principal activity of such partnership will consist of buying and selling instruments referred to in paragraph (a)(8)(viii)(B)(*1*) of this section.

(9) *Exception for certain transactions entered into by an individual*—(i) *In general.* A transaction entered into by an individual which otherwise qualifies as a section 988 transaction shall be considered a section 988 transaction only to the extent expenses properly allocable to such transaction meet the requirements of section 162 or 212 (other than the part of section 212 dealing with expenses incurred in connection with taxes).

(ii) *Examples.* The following examples illustrate the application of paragraph (a)(9) of this section.

Example 1. X is a U.S. citizen who therefore has the U.S. dollar as his functional currency. On January 1, 1990, X enters into a spot contract to purchase 10,000 British pounds (£) for $15,000 for delivery on January 3, 1990. Immediately upon delivery, X acquires at original issue a pound denominated bond with an issue price of £10,000. The bond matures on January 3, 1993, pays interest in pounds at a rate of 10% compounded semiannually, and has no original issue discount. Assume that all expenses properly allocable

to these transactions would meet the requirements of section 212. Under §1.988–2(d)(1)(ii), entering into the spot contract on January 1, 1990, is not a section 988 transaction. The acquisition of the pounds on January 3, 1990, under the spot contract is a section 988 transaction for purposes of establishing X's basis in the pounds. The disposition of the pounds and the acquisition of the bond by X are section 988 transactions. These transactions are not excluded from the definition of a section 988 transaction under paragraph (a)(9) of this section because expenses properly allocable to such transactions meet the requirements of section 212.

Example 2. X is a U.S. citizen who therefore has the dollar as his functional currency. In preparation for X's vacation, X purchases 1,000 British pounds (£) from a bank on June 1, 1989. During the period of X's vacation in the United Kingdom beginning June 10, 1989, and ending June 20, 1989, X spends £500 for hotel rooms, £300 for food and £200 for miscellaneous vacation expenses. The expenses properly allocable to such dispositions do not meet the requirements of section 162 or 212. Thus, the disposition of the pounds by X on his vacation are not section 988 transactions.

(10) *Intra-taxpayer transactions*—(i) *In general.* Except as provided in paragraph (a)(10)(ii) of this section, transactions between or among the taxpayer and/or qualified business units of that taxpayer (''intra-taxpayer transactions'') are not section 988 transactions. See section 987 and the regulations thereunder.

(ii) *Certain intra-taxpayer transfers of section 988 transactions that result in the recognition of section 988 gain or loss*—(A) *In general.* Exchange gain or loss with respect to nonfunctional currency or any item described in paragraph (a)(2) of this section entered into with another taxpayer shall be realized upon a transfer (as defined under §1.987–2(c)) of such currency or item from an owner to a section 987 QBU or from a section 987 QBU to an owner if as a result of such transfer—

(*1*) The currency or item loses its character as nonfunctional currency or as an item described in paragraph (a)(2) of this section; or

(*2*) The source of the exchange gain or loss could be altered absent the application of paragraph (a)(10)(ii)(B) of this section.

(B) *Computation of exchange gain or loss.* Exchange gain or loss described in section (a)(10)(ii)(A) of this section shall be computed in accordance with §1.988–2 (without regard to §1.988–2(b)(8)) as if the nonfunctional currency or item described in paragraph (a)(2) of this section had been sold or otherwise transferred at fair market value between unrelated taxpayers. For purposes of the preceding sentence, a taxpayer must use a translation rate that is consistent with the translation conventions of the section 987 QBU to or from which, as the case may be, the item is being transferred. In the case of a gain or loss incurred in a transaction described in this paragraph (a)(10)(ii) that does not have a significant business purpose, the Commissioner may defer such gain or loss.

(iii) *Example.* The following example illustrates the provisions of this paragraph (a)(10).

Example. (A) X, a corporation with the U.S. dollar as its functional currency, operates through foreign branches Y and Z. Y and Z are qualified business units as defined in section 989(a) with the LC as their functional currency. X computes Y's and Z's income under section 987 (relating to branch transactions). On November 12, 1988, Y transfers $25 to the home office of X when the fair market value of such amount equals LC120. Y has a basis of LC100 in the $25. Under paragraph (a)(10)(ii) of this section, Y realizes foreign source exchange gain of LC20 (LC120—LC100) as the result of the $25 transfer. For purposes of determining whether the transfer is a remittance resulting in additional gain or loss, see section 987 and the regulations thereunder.

(B) If instead Y transfers the $25 to Z, exchange gain is not realized because the $25 is nonfunctional currency with respect to Z and if Z were to immediately convert the $25 into LCs, the gain would be foreign source. For purposes of determining whether the transfer is a remittance resulting in additional gain or loss, see section 987 and the regulations thereunder.

(11) *Authority to include or exclude transactions from section 988*—(i) *In general.* The Commissioner may recharacterize a transaction (or series of transactions) in whole or in part as a section 988 transaction if the effect of such transaction (or series of transactions) is to avoid section 988. In addition, the Commissioner may exclude a transaction (or series of transactions) which in form is a section 988 transaction from the provisions of section 988 if the substance of the transaction (or series

of transactions) indicates that it is not properly considered a section 988 transaction.

(ii) *Example.* The following example illustrates the provisions of this paragraph (a)(11).

Example. B is an individual with the U.S. dollar as its functional currency. B holds 500,000 Swiss francs which have a basis of $100,000 and a fair market value of $400,000 as of October 15, 1989. On October 16, 1989, B transfers the 500,000 Swiss francs to a newly formed U.S. corporation, X, with the dollar as its functional currency. On October 16, 1989, B sells the stock of X for $400,000. Assume the transfer to X qualified for nonrecognition under section 351. Because the sale of the stock of X is a substitute for the disposition of an asset subject to section 988, the Commissioner may recharacterize the sale of the stock as a section 988 transaction. The same result would obtain if B transferred the Swiss francs to a partnership and then sold the partnership interest.

(b) *Spot contract.* A spot contract is a contract to buy or sell nonfunctional currency on or before two business days following the date of the execution of the contract. See §1.988–2 (d)(1)(ii) for operative rules regarding spot contracts.

(c) *Nonfunctional currency.* The term ''nonfunctional currency'' means with respect to a taxpayer or a qualified business unit (as defined in section 989 (a)) a currency (including the European Currency Unit) other than the taxpayer's or the qualified business unit's functional currency as defined in section 985 and the regulations thereunder. For rules relating to nonrecognition of exchange gain or loss with respect to certain dispositions of nonfunctional currency, see §1.988–2 (a)(1)(iii).

(d) *Spot rate*—(1) *In general.* Except as otherwise provided in this paragraph, the term ''spot rate'' means a rate demonstrated to the satisfaction of the District Director or the Assistant Commissioner (International) to reflect a fair market rate of exchange available to the public for currency under a spot contract in a free market and involving representative amounts. In the absence of such a demonstration, the District Director or the Assistant Commissioner (International), in his or her sole discretion, shall determine the spot rate from a source of exchange rate information reflecting actual transactions conducted in a free market. For example, the taxpayer or the District Director or the Assistant Commissioner (International) may determine the spot rate by reference to exchange rates published in the pertinent monthly issue of ''International Financial Statistics'' or a successor publication of the International Monetary Fund; exchange rates published by the Board of Governors of the Federal Reserve System pursuant to 31 U.S.C. section 5151; exchange rates published in newspapers, financial journals or other daily financial news sources; or exchange rates quoted by electronic financial news services.

(2) *Consistency required in valuing transactions subject to section 988.* If the use of inconsistent sources of spot rate quotations results in the distortion of income, the District Director or the Assistant Commissioner (International) may determine the appropriate spot rate.

(3) *Use of certain spot rate conventions for payables and receivables denominated in nonfunctional currency.* If consistent with the taxpayer's financial accounting, a taxpayer may utilize a spot rate convention determined at intervals of one quarter year or less for purposes of computing exchange gain or loss with respect to payables and receivables denominated in a nonfunctional currency that are incurred in the ordinary course of business with respect to the acquisition or sale of goods or the obtaining or performance of services. For example, if consistent with the taxpayer's financial accounting, a taxpayer may accrue all payables and receivables incurred during the month of January at the spot rate on December 31 or January 31 (or at an average of any spot rates occurring between these two dates) and record the payment or receipt of amounts in satisfaction of such payables and receivables consistent with such convention. The use of a spot rate convention cannot be changed without the consent of the Commissioner.

(4) *Currency where an official government established rate differs from a free market rate*—(i) *In general.* If a currency has an official government established rate that differs from a free market

rate, the spot rate shall be the rate which most clearly reflects the taxpayer's income. Generally, this shall be the free market rate.

(ii) *Examples.* The following examples illustrate the application of this paragraph (d)(4).

Example 1. X is an accrual method U.S. corporation with the dollar as its functional currency. X owns all the stock of a Country L subsidiary, CFC. CFC has the currency of Country L, the LC, as its functional currency. Country L imposes restrictions on the remittance of dividends. On April 1, 1990, CFC pays a dividend to X in the amount of LC100. Assume that the official governnent established rate is $1 = LC1 and the free market rate, which takes into account the remittance restrictions and which is the rate that most clearly reflects income, is $1 = LC4. On April 1, 1990, X donates the LC100 in a transaction that otherwise qualifies as a charitable contribution under section 170 (c). Both the amount of the dividend income and the deduction under section 170 is $25 (LC100 × the free market rate, $.25).

Example 2. X, a corporation with the U.S. dollar as its functional currency, operates in foreign country L through branch Y. Y is a qualified business unit as defined in section 989 (a). X computes Y's income under the dollar approximate separate transactions method as described in §1.985–3. The currency of L is the LC. X can purchase legally United States dollars ($) in L only from the L government. In order to take advantage of an arbitrage between the official and secondary dollar to LC exchange rates in L:

(i) X purchases LC100 for $60 in L on the secondary market when the official exchange rate is S1 = LC1;

(ii) X transfers the LC100 to Y;

(iii) Y purchases $100 for LC100; and

(iv) Y transfers $65 ($100 less an L tax withheld of $35 on the transfer) to the home office of X.

Under paragraph (a)(7) of this section, the transfer of the LC100 by X to Y is a realization event. X has a basis of $60 in the LC100. Under these facts, the appropriate dollar to LC exchange rate for computing the amount realized by X is the official exchange rate. Therefore, X realizes $40 ($100–$60) of U.S. source gain from the transfer to Y. The same result would obtain if Y rather than X purchased the LC100 on the secondary market in L with $60 supplied by X, because the substance of this transaction is that X is performing the arbitrage.

(e) *Exchange gain or loss.* The term ''exchange gain or loss'' means the amount of gain or loss realized as determined in §1.988–2 with respect to a section 988 transaction. Except as otherwise provided in these regulations (*e.g.*, §1.98B–5), the amount of exchange gain or loss from a section 988 transaction shall be separately computed for each section 988 transaction, and such amount shall not be integrated with gain or loss recognized on another transaction (whether or not such transaction is economically related to the section 988 transaction). See §1.988–2 (b)(8) for a special rule with respect to debt instruments.

(f) *Hyperinflationary currency*—(1) *Definition*—(i) *General rule.* For purposes of section 988, a hyperinflationary currency means a currency described in §1.985–1(b)(2)(ii)(D). Unless otherwise provided, the currency in any example used in §§1.988–1 through 1.988–5 is not a hyperinflationary currency.

(ii) *Special rules for determining base period.* In determining whether a currency is hyperinflationary under §1.985–1(b)(2)(ii)(D) for purposes of this paragraph (f), the following rules will apply:

(A) The base period means the thirty-six calendar month period ending on the last day of the taxpayer's (or qualified business unit's) current taxable year. Thus, for example, if for 1996, 1997, and 1998, a country's annual inflation rates are 6 percent, 11 percent, and 90 percent, respectively, the cumulative inflation rate for the three-year base period is 124% [((1.06 × 1.11 × 1.90) − 1.0 = 1.24) × 100 = 124%]. Accordingly, assuming the QBU has a calendar year as its taxable year, the currency of the country is hyperinflationary for the 1998 taxable year. This change in the §1.985–1(b)(2)(ii)(D) base period shall not apply to any section 988 transaction of an entity described in section 851 (regulated investment company (RIC)) or section 856 (real estate investment trust (REIT)). The Service may, by notice, provide that the foregoing change in the §1.985–1(b)(2)(ii)(D) base period does not apply to any section 988 transaction of an entity with distribution requirements similar to a RIC or REIT.

(B) The last sentence of §1.985–1(b)(2)(ii)(D) shall not apply to alter the base period for purposes of this paragraph (f) in determining whether a

currency is hyperinflationary for purposes of section 988. Accordingly, generally accepted accounting principles may not apply to alter the base period for purposes of this paragraph (f).

(2) *Effective date.* Paragraph (f)(1) of this section shall apply to transactions entered into after February 14, 2000.

(g) *Fair market value.* The fair market value of an item shall, where relevant, reflect an appropriate premium or discount for the time value of money (*e.g.*, the fair market value of a forward contract to buy or sell nonfunctional currency shall reflect the present value of the difference between the units of nonfunctional currency times the market forward rate at the time of valuation and the units of nonfunctional currency times the forward rate set forth in the contract). However, if consistent with the taxpayer's method of financial accounting (and consistently applied from year to year), the preceding sentence shall not apply to a financial instrument that matures within one year from the date of issuance or acquisition. Unless otherwise provided, the fair market value given in any example used in §§ 1.988–1 through 1.988–5 is deemed to reflect appropriately the time value of money. If the use of inconsistent sources of forward or other market rate quotations results in the distortion of income, the District Director or the Assistant Commissioner (International) may determine the appropriate rate.

(h) *Interaction with sections 1092 and 1256.* Unless otherwise provided, it is assumed for purposes of §§ 1.988–1 through 1.988–5 that any contract used in any example is not a section 1256 contract and is not part of a straddle as defined in section 1092. No inference is intended regarding the application of section 1092 or 1256 unless expressly stated.

(i) *Effective date.* Except as otherwise provided in this section, this section shall be effective for taxable years beginning after December 31, 1986. Thus, except as otherwise provided in this section, any payments made or received with respect to a section 988 transaction in taxable years beginning after December 31, 1986, are subject to this section. Generally, the revisions to paragraphs (a)(3), (a)(4), and (a)(10)(ii) of this section shall apply to taxable years beginning one year after the first day of the first taxable year following December 7, 2016. If pursuant to § 1.987–11(b) a taxpayer applies §§ 1.987–1 through 1.987–11 beginning in a taxable year prior to the earliest taxable year described in § 1.987–11(a), then the revisions to paragraphs (a)(3), (a)(4), and (a)(10)(ii) of this section shall apply to taxable years of the taxpayer beginning on or after the first day of such prior taxable year.

[T.D. 8400, 57 FR 9178, Mar. 17, 1992, as amended by T.D. 8914, 66 FR 280, Jan. 3, 2001; T.D. 9794, 81 FR 88850, Dec. 8, 2016; T.D. 9795, 81 FR 88879, Dec. 8, 2016]

§ 1.988–1T Certain definitions and special rules (temporary).

(a)(1) through (a)(2) [Reserved]. For further guidance, see § 1.988–1(a)(1) through (2).

(3) *Specified owner functional currency transactions of a section 987 QBU not treated as section 988 transactions.* Specified owner functional currency transactions, as defined in § 1.987–3T(b)(4)(ii), held by a section 987 QBU are not treated as section 988 transactions. Thus, no currency gain or loss shall be recognized by a section 987 QBU under section 988 with respect to such transactions.

(4) through (i) [Reserved]. For further guidance, see § 1.988–1(a)(4) through (i).

(j) *Effective/applicability date.* This section applies to taxable years beginning on or after one year after the first day of the first taxable year following December 7, 2016. Notwithstanding the preceding sentence, if a taxpayer makes an election under § 1.987–11(b), then this section applies to taxable years to which §§ 1.987–1 through 1.987–10 apply as a result of such election.

(k) *Expiration date.* The applicability of this section expires on December 6, 2019.

[T.D. 9795, 81 FR 88879, Dec. 8, 2016]

§ 1.988–2 Recognition and computation of exchange gain or loss.

(a) *Disposition of nonfunctional currency*—(1) *Recognition of exchange gain or loss*—(i) *In general.* Except as otherwise provided in this section, § 1.988–1(a)(7)(ii), and § 1.988–5, the recognition of exchange gain or loss upon the sale