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of the LC109.3 on December 31, 1992. Calculation of such gain or loss would be governed by the rules of paragraph (d) of this section.

(g) *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.

(h) *Timing of income and deductions from notional principal contracts.* Except as otherwise provided (e.g., in §1.988–5 or §1.446–3(g)), income or loss from a notional principal contract described in §1.988–1(a)(2)(iii)(B) (other than a currency swap) is exchange gain or loss. For the rules governing the timing of income and deductions with respect to notional principal contracts, see §1.446–3. See paragraph (e)(2) of this section with respect to currency swaps.

(i) [Reserved]. For further guidance, see §1.988–2T(i).

[T.D. 8400, 57 FR 9183, Mar. 17, 1992, as amended by T.D. 8491, 58 FR 53135, Oct. 14, 1993; T.D. 8860, 65 FR 2028, Jan. 13, 2000; T.D. 9157, 69 FR 52819, Aug. 30, 2004; T.D. 9795, 81 FR 88879, Dec. 8, 2016]

§1.988–2T Recognition and computation of exchange gain or loss (temporary).

(a) through (b)(15) [Reserved]. For further guidance, see §1.988–2(a) through (b)(15).

(16) *Deferral of loss on certain related-party debt instruments*—(i) *Treatment of creditor.* For rules applicable to a corporation included in a controlled group that is a creditor under a debt instrument see §1.267(f)–1(e).

(ii) *Treatment of debtor*—(A) *In general.* Exchange loss realized under §1.988–2(b)(4) or (b)(6) is deferred if—

(*1*) The loss is realized by a debtor with respect to a loan from a person that has a relationship to the debtor described in section 267(b) or section 707(b); and

(*2*) The transaction resulting in the realization of exchange loss has as a principal purpose the avoidance of Federal income tax.

(B) *Recognition of deferred loss.* Any exchange loss that is deferred under paragraph (b)(16)(ii)(A) of this section is deferred until the end of the term of the loan, determined immediately prior to the transaction.

(17) through (h) [Reserved]. For further guidance, see §1.988–2(b)(17) through (h).

(i) *Special rules for section 988 transactions of a section 987 QBU.* For rules regarding section 988 transactions of a section 987 QBU, see §1.987–3T(b)(4) for section 987 QBUs in general and §1.987–1T(b)(6) for dollar QBUs.

(j) *Effective/applicability date.* Paragraph (b)(16) of this section applies to any exchange loss realized on or after December 7, 2016. Paragraph (i) of 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 paragraph (i) of 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]

§1.988–3 Character of exchange gain or loss.

(a) *In general.* The character of exchange gain or loss recognized on a section 988 transaction is governed by section 988 and this section. Except as otherwise provided in section 988(c)(1)(E), section 1092, §1.988–5 and this section, exchange gain or loss realized with respect to a section 988 transaction (including a section 1256 contract that is also a section 988 transaction) shall be characterized as ordinary gain or loss. Accordingly, unless a valid election is made under paragraph (b) of this section, any section providing special rules for capital gain or loss treatment, such as sections 1233, 1234, 1234A, 1236 and 1256(f)(3), shall not apply.

(b) *Election to characterize exchange gain or loss on certain identified forward contracts, futures contracts and option contracts as capital gain or loss*—(1) *In general.* Except as provided in paragraph (b)(2) of this section, a taxpayer may elect, subject to the requirements

of paragraph (b)(3) of this section, to treat any gain or loss recognized on a contract described in §1.988–2(d)(1) as capital gain or loss, but only if the contract—

(i) Is a capital asset in the hands of the taxpayer;

(ii) Is not part of a straddle within the meaning of section 1092(c) (without regard to subsections (c)(4) or (e)); and

(iii) Is not a regulated futures contract or nonequity option with respect to which an election under section 988(c)(1)(D)(ii) is in effect.

If a valid election under this paragraph (b) is made with respect to a section 1256 contract, section 1256 shall govern the character of any gain or loss recognized on such contract.

(2) *Special rule for contracts that become part of a straddle after an election is made.* If a contract which is the subject of an election under paragraph (b)(1) of this section becomes part of a straddle within the meaning of section 1092(c) (without regard to subsections (c)(4) or (e)) after the date of the election, the election shall be invalid with respect to gains from such contract and the Commissioner, in his sole discretion, may invalidate the election with respect to losses.

(3) *Requirements for making the election.* A taxpayer elects to treat gain or loss on a transaction described in paragraph (b)(1) of this section as capital gain or loss by clearly identifying such transaction on its books and records on the date the transaction is entered into. No specific language or account is necessary for identifying a transaction referred to in the preceding sentence. However, the method of identification must be consistently applied and must clearly identify the pertinent transaction as subject to the section 988(a)(1)(B) election. The Commissioner, in his sole discretion, may invalidate any purported election that does not comply with the preceding sentence.

(4) *Verification.* A taxpayer that has made an election under §1.988–3(b)(3) must attach to his income tax return a statement which sets forth the following:

(i) A description and the date of each election made by the taxpayer during the taxpayer's taxable year;

(ii) A statement that each election made during the taxable year was made before the close of the date the transaction was entered into;

(iii) A description of any contract for which an election was in effect and the date such contract expired or was otherwise sold or exchanged during the taxable year;

(iv) A statement that the contract was never part of a straddle as defined in section 1092; and

(v) A statement that all transactions subject to the election are included on the statement attached to the taxpayer's income tax return.

In addition to any penalty that may otherwise apply, the Commissioner, in his sole discretion, may invalidate any or all elections made during the taxable year under §1.988–3(b)(1) if the taxpayer fails to verify each election as provided in this §1.988–3(b)(4). The preceding sentence shall not apply if the taxpayer's failure to verify each election was due to reasonable cause or bona fide mistake. The burden of proof to show reasonable cause or bona fide mistake made in good faith is on the taxpayer.

(5) *Independent verification*—(i) *Effect of independent verification.* If the taxpayer receives independent verification of the election in paragraph (b)(3) of this section, the taxpayer shall be presumed to have satisfied the requirements of paragraphs (b)(3) and (4) of this section. A contract that is a part of a straddle as defined in section 1092 may not be independently verified and shall be subject to the rules of paragraph (b)(2) of this section.

(ii) *Requirements for independent verification.* A taxpayer receives independent verification of the election in paragraph (b)(3) of this section if—

(A) The taxpayer establishes a separate account(s) with an unrelated broker(s) or dealer(s) through which all transactions to be independently verified pursuant to this paragraph (b)(5) are conducted and reported.

(B) Only transactions entered into on or after the date the taxpayer establishes such account may be recorded in the account.

(C) Transactions subject to the election of paragraph (b)(3) of this section are entered into such account on the

date such transactions are entered into.

(D) The broker or dealer provides the taxpayer a statement detailing the transactions conducted through such account and includes on such statement the following: ''Each transaction identified in this account is subject to the election set forth in section 988(a)(1)(B).''

(iii) *Special effective date for independent verification.* The rules of this paragraph (b)(5) shall be effective for transactions entered into after March 17, 1992.

(6) *Effective date.* Except as otherwise provided, this paragraph (b) is effective for taxable years beginning on or after September 21, 1989. For prior taxable years, any reasonable contemporaneous election meeting the requirements of section 988(a)(1)(B) shall satisfy this paragraph (b).

(c) *Exchange gain or loss treated as interest*—(1) *In general.* Except as provided in this paragraph (c)(1), exchange gain or loss realized on a section 988 transaction shall not be treated as interest income or expense. Exchange gain or loss realized on a section 988 transaction shall be treated as interest income or expense as provided in paragraph (c)(2) of this section with regard to tax exempt bonds, §1.988–2(e)(2)(ii)(B), §1.988–5, and in administrative pronouncements. See §1.861–9T(b), providing rules for the allocation of certain items of exchange gain or loss in the same manner as interest expense.

(2) *Exchange loss realized by the holder on nonfunctional currency tax exempt bonds.* Exchange loss realized by the holder of a debt instrument the interest on which is excluded from gross income under section 103(a) or any similar provision of law shall be treated as an offset to and reduce total interest income received or accrued with respect to such instrument. Therefore, to the extent of total interest income, no exchange loss shall be recognized. This paragraph (c)(2) shall be effective with respect to debt instruments acquired on or after June 24, 1987.

(d) *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. Thus, for example, a payment made prior to January 1, 1987, under a forward contract that results in the deferral of a loss under section 1092 to a taxable year beginning after December 31, 1986, is not characterized as an ordinary loss by virtue of paragraph (a) of this section because payment was made prior to January 1, 1987.

[T.D. 8400, 57 FR 9197, Mar. 17, 1992]

§ 1.988–4 Source of gain or loss realized on a section 988 transaction.

(a) *In general.* Except as otherwise provided in §1.988–5 and this section, the source of exchange gain or loss shall be determined by reference to the residence of the taxpayer. This rule applies even if the taxpayer has made an election under §1.988–3(b) to characterize exchange gain or loss as capital gain or loss. This section takes precedence over section 865.

(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.* For purposes of paragraph (b)(1) of this section, the principles of §1.987–2(b) shall apply in determining whether an asset, liability, or item of income or expense is reflected on the books and records of a qualified business unit.

(ii) *Effective/applicability date.* Generally, paragraph (b)(2)(i) of this section shall apply to taxable years beginning on or after 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 paragraph (b)(2)(i) of this section shall apply to taxable years of the taxpayer