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INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

FROM: Jeff Dorfman
Chief, CC:INTL:BR5

SUBJECT:

This Field Service Advice responds to your memorandum dated June 24, 1998. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be used or cited as precedent.

LEGEND:

US Sub	=
Foreign Parent	=
FSC	=
Country A	=
Country B	=
Country B currency	=
export property z	=
Year 1	=
Year 3	=
Year 7	=

ISSUE:

For purposes of calculating the exempt foreign trade income under section 923(a) of a commission FSC, should losses on the forward sale of foreign currency be allocated to combined gross income of the commission FSC and its related supplier in determining combined taxable income, when the foreign currency forwards were entered into for bona fide hedging purposes?

CONCLUSION:

The losses on the forward sale of foreign currency should be allocated pursuant to §§ 1.925(a)-1T(d)(2)(iii) and 1.925(a)-1T(c)(6)(iii)(D) to combined gross income.

FACTS:

US Sub is a U.S. subsidiary of Foreign Parent, a Country A corporation. US Sub manufactures export property z in the United States, and sells the export property to Country B purchasers through a commission FSC (Taxpayer). The FSC does not take title to the export property it exports; rather, the FSC is paid a commission for its services. Sales receipts for the exported property are denominated in Country B currency.

US Sub's management is evaluated based on dollar denominated results. Therefore, US Sub hedges in order to minimize dollar denominated earnings volatility and to provide greater certainty in anticipating dollar denominated operating results. US Sub reduces the risk of foreign currency fluctuation by selling Country B currency forward in the amount of the net Country B currency denominated cash flow it anticipates receiving in the future. Depending on US Sub's view of the future levels of the Country B currency/dollar, and the differential between Country B and U.S. interest rates, it may hedge its anticipated receivables as far into the future as four years. The forward contracts in issue are not traded on or subject to the rules of a board of trade or commodity exchange.

There is no factual issue that the forward sale of the Country B currency contracts is to hedge the anticipated receivables. Apparently, US Sub does not engage in foreign currency forward transactions other than in order to hedge its anticipated receivables.

The years at issue are Year 1-Year 7. US Sub realized net foreign currency losses on the forward contracts in all years, with the possible exception of Year 3.
US Sub properly included the foreign currency gains and deducted the losses on its federal tax return. Pursuant to section 988(a)(1) and (3) the gains and losses are characterized as U.S. source ordinary gain or loss. The forward transactions are not part of a section 988 hedging transaction under section 988(d) since the anticipated receivables are not executory contracts under § 1.988-5(b)(2)(ii).

The FSC determined its foreign trade income using 23% of the combined taxable income of it and its related supplier. See section 925(a)(2) and (b)(1).

LAW AND ANALYSIS

The FSC's exempt foreign trade income, i.e., 15/23 of its foreign trade income, is treated as foreign source, non effectively connected income. Sections 921(a) and 291(a)(4)(B). The remainder of the FSC's foreign trade income is treated as U.S. source effectively connected income. Section 921(d)(1). Foreign trade income is defined as the gross income of the FSC attributable to foreign trading gross receipts ("FTGR").

The FSC determined its foreign trade income based on the combined taxable income ("CTI") of it and its related supplier, US Sub. Therefore, the amount of CTI determines the amount of the FSC's exempt foreign trade income, and the amount of the commission paid and deducted by US Sub.

Reg. § 1.925(a)-1T(d)(2)(iii) generally defines CTI for purposes of commission FSCs as the amounts of gross receipts that would have been characterized as FTGR had the FSC sold the export property directly, i.e., the receipts from the export property sales, less the total costs of the FSC and its related supplier, other than the commission paid to the FSC. Reg. § 1.925(a)-1T(c)(6)(iii)(D) states that the allocation and apportionment of the expenses, deductions, and losses to gross income should be determined in a manner consistent with the rules of § 1.861-8.

A deduction must be allocated to the class of gross income to which it is definitely related. § 1.861-8(b)(2). A class of gross income may consist of one or more items of gross income enumerated in section 61. § 1.861-8(a)(3). A deduction shall be considered definitely related to a class of gross income and therefore allocable to such class if it is incurred as a result of, or incident to, an activity, or in connection with property, from which such class of gross income is derived. § 1.861-8(b)(2). Where a deduction is incurred as a result of, or incident to, an activity or in connection with property, which activity or property generates, has generated, or could reasonably have been expected to generate gross income, such deduction shall be considered definitely related to such gross income as a class whether or not there is any item of gross income in such class which is received or accrued during the taxable year and whether or not the amount of deductions exceeds the amount of the gross income in such class. Id.

Based on § 1.861-8(b)(2), we believe the losses on the forward sale of the Country B currency contracts should be included in the calculation of CTI. It is undisputed that the forward sale contracts were entered into in order to hedge US Sub's anticipated receipts from the sale of export property, and that the losses would not have been incurred but for US Sub's anticipated sales of export property. Therefore, the loss was incurred as a result of, or incident to, an activity, which activity generates or could be reasonably expected to generate, gross receipts which would have been FTGR, had they been realized by the FSC directly; under § 1.861-8(b)(2), the losses should be allocated to these gross receipts.

Taxpayer asserts that § 1.861-8(b)(2) supports allocating the losses on the Country B currency contracts to the gains on the contracts, whether or not the FSC's related supplier actually realized any gain on the sale of the forward contracts. Reg. § 1.861-8(b)(2) states in part that a deduction shall be allocable to a class of gross income if it is incurred in connection with property from which such class of gross income is derived, or if it is incurred in connection with property which could reasonably have been expected to generate such gross income. The only type of income which the forward sale of Country B currency could in fact produce is foreign currency gains. Therefore, Taxpayer argues that the losses should be allocated to the gains, whether or not the related supplier in fact realized any foreign currency gains on the forward sale of Country B currency in the years in issue.

Nevertheless, we believe the better view under § 1.861-8(b)(2) is to allocate the foreign currency losses by reference to the activity incident to which the loss is incurred, i.e., in reference to the sale of export property, and to allocate the losses to the income generated as a result of that activity, rather than allocating the loss in reference to the property, i.e., foreign currency contracts.

First, the regulations stress that deductions must be allocated to the class of gross income based on the factual relationship of the deduction to the class. §§ 1.861-8(a)(2); 1.861-8(b)(1). Taxpayer agrees that the foreign currency contracts were entered into solely in order to hedge its anticipated receivables. Therefore, we believe the foreign currency losses are more closely related to the income earned on the export property receivables, rather than to gains on the disposition of the foreign currency forward contracts.

In addition, generally, the tax law recognizes anticipatory hedges as valid hedging transactions. See, e.g., § 1.1221-2(e)(3)(i). Consequently, the tax law generally ties the tax treatment of the hedging transaction to the treatment of the item being hedged. See, e.g., § 1.446-4(b) (taxpayer's method of accounting must match the timing of the income, deduction, gain, or loss from the hedging transaction with the timing of the income, deduction, gain, or loss from the items being hedged); (capital asset does not include property which is part of a hedging transaction). In particular, § 1.1221-2 requires that gain or loss on the hedging transaction should be characterized as ordinary income in the same manner as gain or loss on the property being hedged, rather than as capital gains or a mixture of ordinary income and capital gains under section 1256. § 1.1221-2(a)(1). We note that in the context of this case, section 988(a) characterizes the currency losses as ordinary losses. § 988(a)(1)(A); see also § 1.1221-2(a)(4). Lastly, in a somewhat similar situation, the Tax Court in Trinova Corporation v. Commissioner, T.C. Memo. 1997-100 (1997), held that foreign currency loss on the accrual of swap and interest payables should be allocated to the underlying swap or interest payment, rather than to the class of income consisting of foreign currency gains.

It should be noted that § 1.861-8(e)(7) does not apply in this situation. Section 1.861-8(e)(7) states that the deduction allowed for a loss on the sale, exchange, or other disposition of a capital asset or section 1231(b) property should be allocated to the class of gross income to which the asset ordinarily gives rise in the hands of the taxpayer. However, § 1.861-8(e)(7) does not apply, since the foreign currency sold was a hedging transaction under § 1.1221-2; therefore, the foreign currency is not a capital asset.

Taxpayer also asserts that the foreign currency exchange gain or loss is a class of income under section 61(a)(3) separate and distinct from business income from the sale of the export property, which is a class of income described in section 61(a)(2) (gross income derived from business). Therefore, Taxpayer asserts that the exchange losses should be allocated to the section 61(a)(3) class of gross income, i.e., foreign currency exchange gain, rather than to the section 61(a)(2) class of gross income. Taxpayer is correct that the foreign currency exchange gain is described in section 61(a)(3), and that § 1.861-8(a)(3) cross references the classes of gross income listed in section 61(a). The issue, however, is whether the foreign currency losses in this situation are factually more closely related to the export property receivables which the foreign currency contracts hedged, or the potential gains from the sale of those contracts. For the reasons stated above, we believe the foreign currency losses are more closely related to the income from the export property sales.

Taxpayer also claims that section 988 supports its position that the exchange loss (or gain) should be treated as separate from the underlying sales transaction, and that the exchange loss should not offset FTGR. We disagree. Section 988 merely determines the source and character of the exchange loss as U.S. source, ordinary loss. Congress, by enacting section 988 as part of the Tax Reform Act of 1986, put to rest issues as to the source and character of gain or loss in foreign currency particularly when the gain or loss occurs as part of a larger transaction, e.g., upon repayment of a loan denominated in a foreign currency. Staff of the Joint Committee on Taxation, 100th Cong., 1st Sess., General Explanation of the Tax Reform Act of 1986, at 1068, 1086 (Comm. Print 1987); see also, National-Standard Co. v. Commissioner, 80 T.C. 551 (1983), aff'd, 749 F.2d 369 (6th Cir. 1984). This issue must be decided based on the allocation rules of § 1.861-8. § 1.925(a)-1T(c)(6)(iii)(D). The standard for determining this issue is the requirement that the class of gross income to which the loss is allocated must be determined based on the factual relationship of the loss to the classes of gross income.

Allocating the losses from the forward sale of foreign currency to CTI will not lead to an unfair or inequitable result for the taxpayer, since we believe that any currency gain on the hedging transaction should be treated as FTGR. Section 924(a)(1), to the extent relevant, defines FTGR as the FSC's gross receipts from the sale, exchange or other disposition of export property. Section 927(a)(1) defines export property as property--(A) manufactured, produced, grown, or extracted in the United States by a person other than a FSC, (B) held primarily for sale, lease, or rental, in the ordinary course of trade or business, by, or to, a FSC, for direct use, consumption, or disposition outside the United States, and (C) not more than 50 percent of the fair market value of which is attributable to articles imported into the United States. The forward contracts constitute hedging transactions as defined in §1.1221-2(b). Solely for FSC purposes, the forward contracts should be treated in the same manner as the underlying export property. Cf. § 1.446-4(b); § 1.1221-2(a)(1). In addition, any gains that would arise from the forward contracts would not be excluded from FSC benefits as investment income. <u>See</u> §§ 924(f)(2) and 927(c)(7). Therefore, for the reasons stated above, we believe that currency gains from hedging by forward contracts would constitute FTGR.

If you have any further questions, please call (202) 622-3870.

By: ____________________________

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