DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

OFFICE OF
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR JERRY PAYNE
LMSB DALLAS APPEALS
LM:DAL:AP:JDP

FROM: Jeffrey Dorfman
Chief, CC:INTL:05

SUBJECT:

This Chief Counsel Advice responds to your memorandum November 1, 2001. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

LEGEND

Taxpayer	=
Sub A	=
Country A	=
Investment Bank	=
Date a	=
Date b	=
Date c	=
Date d	=
Date e	=
$X	=
HC	=

ISSUE

Whether the Date a deconsolidation of Sub A through the termination of its section 1504(d) election results in a “transfer” by Sub A’s Country A qualified business unit (hereinafter “QBU”) to Sub A that triggers a foreign currency loss under §1.985-3(d).

CONCLUSION

Under the facts presented, all potential currency gain or loss is recognized under §1.985-3 with respect to the short taxable year ending on the date the section 1504(d) election was terminated. There is no "built-in" currency loss to trigger assuming termination of the section 1504(d) election constituted a "transfer" or "deemed remittance" under §1.985-3(d). Further, termination of the section 1504(d) election does not constitute a "transfer" or "deemed remittance" under §1.985-3(d).

FACTS

Taxpayer incorporated Sub A under the laws of Country A on Date b. Beginning with Taxpayer's Date c taxable year, Taxpayer elected under I.R.C. §1504(d) to treat Sub A as a domestic corporation, included on Taxpayer's consolidated federal tax return, that conducted activities in Country A (these activities are referred to as the Sub A QBU). For the taxable years Date c through Date d, the Sub A QBU used the net worth method to determine its taxable income. For post-Date d taxable years, Taxpayer elected under Treas. Reg. §1.985-2 to use the Dollar Approximate Separate Transactions Method (DASTM) to determine the QBU's taxable income.

Section 1504(d) requires the domestic parent corporation to own 100% of the stock of its foreign subsidiary for the subsidiary's eligibility for inclusion on the parent corporation's consolidated return. On Date a, Sub A issued 2.4 million shares of preferred stock to Investment Bank. Taxpayer represents that the sale of the preferred shares resulted in the section 1504(d) election to terminate, causing the deconsolidation of Sub A[1].

Taxpayer took the position that the deconsolidation of Sub A triggered the recognition of what it claimed to be built-in foreign currency exchange losses associated with the hyperinflationary local currency (the HC) equity reflected in the basis of the Sub A QBU's assets and claimed a $X foreign currency loss.

Taxpayer now argues that the deconsolidation of Sub A operated as a termination of its "branch" equivalent to a "deemed inbound remittance" of the Sub A branch's net assets to the U.S. home office. Taxpayer characterized its "deemed inbound remittance" as a "transfer" for purposes of Treas. Reg. §1.985-3(d)(3) and computed a foreign currency loss under Treas. Reg. §1.985-3(d)(2) by translating Sub A's assets from HC into dollars on Date a, the date Taxpayer issued the preferred stock to terminate the 1504(d) election.

LAW AND ANALYSIS

[1] You have not asked us to analyze whether Taxpayer's issuance of the preferred shares in Sub A caused a valid termination of the section 1504(d) election, and we express no opinion regarding this issue.

I. Differences between the §1.985-3 DASTM method and the proposed section 987 regulations method.

Taxpayer equates the DASTM regulations of §1.985-3 with proposed regulations under section 987 to suggest that in addition to the adjustments for changes in exchange rates allowed annually in computing the income of Sub A under §1.985-3, Taxpayer may deduct currency losses it views as resulting from the termination of Sub A's section 1504(d) election. Taxpayer's position is without merit.

For post-Date d years, Taxpayer elected to use the U.S. dollar as the functional currency of the Sub A QBU under §1.985-2 and to use the DASTM method as prescribed in §1.985-3. §1.985-2(d). Thus, in contrast to the situation addressed under section 987 where a qualified business unit has a functional currency different from that of the home office, the Sub A QBU and Sub A have the same functional currency. The §1.985-3 DASTM regulations use a net worth method of accounting to adjust the QBU's income and expenses for distortions caused by hyperinflation. §1.985-3(b). Three of the principal features of the DASTM method are: (1) the basis of the assets of an entity operating in a hyperinflationary currency is in dollars (§1.985-3(d)(2) and (5)), (2) financial assets and liabilities are translated at the exchange rate for the last translation period for each year resulting in an annual realization of gain or loss (hereafter referred to as an "annual mark") due to movements in exchange rates (§1.985-3(d)(5)), and (3) assets that are not financial assets do not generate gain or loss due to movements in exchange rates (§1.985-3(d)(5)(i) and (v)).

Under the interpretation of section 987 set forth in proposed §§1.987-1 through 3, the methodology for determining exchange gain or loss with respect to a qualified business unit that has a different functional currency from that of the home office is significantly different from the §1.985-3 DASTM regulations. Significant differences include: (1) the proposed section 987 regulations use a profit and loss method (as opposed to a net worth method) of determining income and foreign currency gain or loss (prop. reg. §1.987-1(b)), (2) under the approach of the proposed section 987 regulations, currency gain or loss is determined as the difference between a qualified business unit's basis and equity pools with the result that all assets (not just financial assets) potentially give rise to currency gain or loss (prop. reg. §1.987-2), and (3) currency gain or loss is taken into account upon a remittance (as opposed to an annual mark under the §1.985-3 DASTM regulations) from a qualified business unit to the home office (prop. reg. §1.987-2). At the core of Taxpayer's arguments is the attempt to engraft significant aspects of the proposed section 987 regulations (e.g., the notion that all assets potentially generate foreign currency gain or loss) on to the DASTM methodology of §1.985-3. As more fully set forth below, we believe this is inappropriate given the substantial differences between the proposed section 987 regulations and the §1.985-3 DASTM regulations. Moreover, we note that the section 987 regulations are

proposed and that Notice 2000-20, 2000-1 C.B. 851, indicates that Treasury and the Service plan to review "and possibly replace" such regulations.[2]

2. There is no built-in currency loss in the Sub A QBU's assets at the time of the termination of the section 1504(d) election.

Taxpayer argues that there is a "built-in" currency loss resident in the assets making up the equity of the Sub A QBU. As indicated previously, not all assets give rise to currency gain or loss under §1.985-3. Generally, it is financial assets and liabilities that give rise to currency gain or loss under §1.985-3. See, §1.985-3(d). Thus, any argument premised on the notion that fixed assets included in the equity of the Sub A QBU generate currency gain or loss under §1.985-3 is fundamentally incorrect.

When Taxpayer terminates the section 1504(d) election for Sub A, there is a constructive reorganization and transfer of property from Sub A to Foreign Sub A. §1.367(a)-1T(c)(5). At that time, the taxable year of Sub A ends (§1.381(b)-1(a)(1)[3]) and its income is determined under §1.985-3. Accordingly, all currency gain or loss determined to exist under §1.985-3 in the assets and liabilities of Sub A is recognized under §1.985-3 and dollar basis adjustments are taken into account on the balance sheet of the Sub A QBU. That the profit and loss method articulated in the proposed section 987 regulations would determine a different amount of currency gain or loss is irrelevant since the profit and loss method is not the methodology adopted under §1.985-3. (We note again that Treasury and the Service plan to review "and possibly replace" such regulations.)

Taxpayer argues that under §1.985-3(d)(3) that termination of the section 1504(d) election gives rise to a deemed remittance of all of the Sub A QBU's equity to the home office and that such amount is translated into dollars at the spot exchange rate on the date of the deemed remittance giving rise to an exchange loss under §1.985-3. This is not correct. Even if we believed that termination of the section 1504(d) election gave rise to a deemed remittance (which we do not), under these facts, the assets of the Sub A QBU already have a dollar basis and there is nothing to translate.[4] That is, given the short taxable year and the

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[2] Section II-A of Notice 2000-20 indicates that Treasury and the Service are "reevaluating" whether it is appropriate under section 987 to recognize currency gain or loss on the capital of a QBU branch.

[3] See also §1.367(a)-1T(e).

[4] Only items that would be translated at the exchange rate for the last translation period of the taxable year under §1.985-3(d)(5) are subject to re-translation at the spot rate on the date the amount is paid under §1.985-3(d)(3). This is because those items are the items that generate currency gain or loss under the DASTM method of §1.985-3 and re-translation at the spot rate on the date the amount is paid captures such gain or loss for the period during the taxable year that the asset is held. Assets that are translated at a historic exchange rate maintain a constant dollar basis (subject to depreciation) and do

determination of income under §1.985-3, all currency gain or loss that should be recognized under §1.985-3 has been recognized and there are no "built-in" currency gains or losses.

3. Termination of the section 1504(d) election does not give rise to a remittance of the Sub A QBU's equity to the home office.

As stated previously, when Taxpayer terminates the section 1504(d) election for Sub A, there is a constructive reorganization and transfer of property from Sub A to Foreign Sub A. §1.367(a)-1T(c)(5). At that time, the taxable year of Sub A ends (§1.381(b)-1(a)(1)), and its income is determined under §1.985-3 taking into account proper recognition of currency gain of loss as set forth in §1.985-3. Under §1.985-3, this currency gain or loss is recognized under an annual mark, not upon a remittance. Thus, Taxpayer's argument that termination of the section 1504(d) election results in a "deemed remittance" has no place in a system that does not look to remittances to trigger currency gain or loss. There is no "transfer" for purposes of §1.985-3(d)(3)[5] as both the Sub A QBU and Sub A have the dollar as their functional currency and it is not appropriate under §1.985-3 to trigger currency gain or loss on a "deemed remittance" from a dollar QBU to a dollar home office since currency gain or loss is recognized under an annual mark, not upon a remittance.

4. Proper treatment of the termination of the section 1504(d) election.

When Taxpayer terminates the section 1504(d) election for Sub A, there is a constructive reorganization and transfer of property from Sub A to a foreign corporation. §1.367(a)-1T(c)(5)[6]. At that time, the taxable year of Sub A ends (§1.381(b)-1(a)(1)) and its income is determined under §1.985-3. Accordingly, all currency gain or loss determined to exist under §1.985-3 in the assets and liabilities of Sub A is recognized under §1.985-3 and dollar basis adjustments are taken into account on the balance sheet of the Sub A QBU. Under section 362(b), the foreign corporation to which the Sub A QBU assets are deemed to be transferred to in the constructive reorganization will take a transferred dollar basis (subject to any

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not require re-translation.

[5] We note that the positive adjustments described in §1.985-3(d)(3) generally refer to items that decrease the net worth of a QBU during the taxable year. No such decrease occurred in this case.

[6] When there is a constructive reorganization involving the transfer of property by a U.S. person to a foreign corporation in connection with an exchange described in section 332, 351, 354, 355, 356, or 361, to the extent provided in section 367(a)(1) and the regulations thereunder, gain is recognized, but, no loss is recognized. We are not aware as to whether the taxpayer reported the transfer of property from Sub A to Foreign Sub A as required under Section 6038B and the regulations thereunder and recognized the appropriate amount of gain, if any, as required by section 367(a) and the regulations thereunder.

adjustments that may be required under section 367 as a result of the reorganization).

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

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Please call (202) 622-3870 if you have any further questions.

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