CFC-Level Hedges of Currency Risk—A Review

*By William R. Skinner**

Introduction

Currency risk occurs throughout cross-border business activity, and as a result, currency hedging is a common practice among multinational businesses. If a company's currency risk entails hedges of more than trade payables and receivables, and a significant amount of the risk being hedged is located offshore in one or more controlled foreign corporations (CFCs), there are significant tax issues to be considered in the application of Subpart F's currency rules to common hedging activity.

While the tax issues with a CFC hedging currency risk are not new,[1] they present complex questions that are frequently overlooked by taxpayers. Without proper focus, a taxpayer engaged in hedging currency risk at its CFC can be at risk of paying U.S. tax on significantly more than its economic income from the transaction. This may occur because the subpart F rules, as discussed below, generally tax gains from hedging contracts as currently taxable subpart F income, while losses may be deferred and produce no tax benefit. As a result, an improperly structured hedge or hedge that the taxpayer has failed to contemporaneously identify for tax purpose may give rise to a transaction that converts deferred foreign earnings into currently taxable subpart F income.

To flesh out these issues, this article will consider three common fact patterns. Each fact pattern will involve a CFC that uses the U.S. dollar as its functional currency and enters a forward contract with a bank to hedge its exposure to the euro. First, CFC will borrow in euros from another affiliated CFC. Second, CFC will lend in euros to an affiliated CFC. Third, CFC will hedge its "net investment" in a euro functional currency subsidiary. The subsidiary in this third fact pattern may either be classified as a CFC or a disregarded entity (DRE) of CFC for U.S. tax purposes.

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Subpart F Currency Rules

Subpart F operates on an inclusion or "deemed dividend" basis and causes U.S. shareholders in a CFC to be taxed on their *pro rata* of the subpart F income of the CFC as earned. Subpart F income consists of several categories of income described in Code Sec. 954(c)(1)(A)–Code Secs. 954(c)(1)(H), 954(d) and 954(e) and other more industry-specific categories.

The inclusion with respect to each category of subpart F income is computed separately.[2] If a CFC has net income in one category of subpart F income, but a loss in another category of subpart F income or non-subpart F earnings and profits (E & P), the loss generally does not reduce the shareholder's inclusion except by virtue of the earnings and profits limitation.[3] The earnings and profits limitation only applies where the CFC's overall current E & P is less than its E & P derived from subpart F income.[4] Also, with limited exceptions generally inapplicable to currency, a net loss in one year cannot be carried forward to reduce a subpart F inclusion in a later year.[5]

While the taxpayer may in large measure protect against these risks through careful analysis of the rules and a policy for making appropriate tax hedging identifications, other more structural solutions may also be considered as a means of simplification.

These restrictions on the use of losses, combined with the separate computation of each Code Sec. 954 subpart F income category, mean that currency losses without proper planning may go unutilized. For example, assume that in year 1, CFC has $1,000 of non-subpart F income, a ($50) subpart F currency loss and $100 of passive interest income. The $50 loss does not reduce the $100 subpart F interest income.[6] The U.S. shareholder has a subpart F inclusion of $100. If, in year 2, CFC generates a subpart F currency gain, this will be fully taxable. The year 1 subpart F currency loss has no impact on the calculation of subpart F income because the loss is trapped in CFC's deferred E & P.

The Code Sec. 954 regulations provide several rules and elections to determine whether currency gain or loss is characterized as subpart F income. Generally, under Code Sec. 954(c)(1)(D) and Reg. §1.954-2(g)(1), the excess of the CFC's gains over losses from foreign currency transactions is included in passive basket subpart F income. This general rule is subject to exceptions.

First, subpart F income does not include currency gain or loss directly related to the business needs of the CFC (a "*business needs transaction*"), which meets a four-part test set out in the regulations.[7] Specifically, to directly relate to the business needs of the CFC, the currency gain or loss must, first, arise from a transaction entered into the normal course of a trade or business of the CFC; second, must not arise from a transaction that produces, or could reasonably be expected to produce, subpart F income other than currency gain or loss; third, must not arise from a transaction described in Code Sec. 988(c)(1)(B)(iii), which consists of various foreign currency financial derivatives; and fourth, must be clearly identifiable as such from the CFC's books and records.

Second, currency gains and losses from the hedging contracts themselves may be excluded from subpart F income as "*bona fide hedging transactions*" of a business needs transaction.[8] Under this rule, the taxpayer may treat a hedge of a business needs transaction as not giving rise to subpart F income. However, to qualify for this rule, the underlying transaction must qualify as a business needs transaction, as defined above. In addition, the underlying transaction must be the sort of transaction that is eligible for tax hedge treatment under the subpart F *bona fide* hedging transaction definition. To meet the latter requirement, the risk hedged must relate to certain risks specified in subpart F regulations, which are analogous to the transactions eligible for general tax hedge treatment under the Code Sec. 1221(b)(2) regulations. Namely, the transactions eligible for subpart F *bona fide* hedging treatment include borrowings, ordinary property and ordinary liabilities. In addition, transactions eligible for subpart F *bona fide* hedging treatment also include Code Sec. 988 transactions and Code Sec. 1231 property held by the CFC.[9]

Similar to domestic hedging transactions, the taxpayer must make a contemporaneous identification of the *bona fide* hedging transaction specifically for tax purposes on the date the transaction is entered into.[10] Failure to identify a transaction as a *bona fide* hedge generally results in gains and losses being treated as subpart F income. In addition, if a transaction is improperly identified (*i.e.*, the taxpayer "over-identifies" transactions as *bona fide* hedging transactions), the erroneous identification is binding as to the exclusion of losses from subpart F income,[11] while gains remain included in subpart F income. If the taxpayer has failed to identify the transaction, the primary avenue of relief would be to show that the failure was attributable to an "inadvertent error."[12]

Third, currency gains and losses from interest-bearing liabilities are allocated and apportioned between the CFC's categories of subpart F income and non-subpart F income in the same manner as the CFC allocates interest expense under Code Sec. 861.[13]

Further, two elections are available to the taxpayer for currency gains and losses under subpart F. The first election under Reg. §1.954-2(g)(3) allows a taxpayer to "re-basket" certain currency gains or losses that arise from a transaction that produces another type of subpart F income (*e.g.*, foreign base company sales income) along with the income in that category. The advantage of this election is that it allows currency gains or losses that would otherwise fail the business needs test to be netted against currency gains or losses in that other category. For example, if the CFC generates foreign base company sales income and incurs a currency loss on the underlying accounts receivable, the election under Reg. §1.954-2(g)(3) would allow the currency loss to reduce the foreign base company sales income.[14] Conversely, if the transaction resulted in a currency gain, this election would allow it to be classified as general basket income under Code Sec. 904(d).

The second election, which is made under Reg. §1.954-2(g)(4) (the "*full-inclusion election*"), allows the CFC to include all gains and losses from Code Sec. 988 transactions in foreign personal holding company (FPHC) income. The full-inclusion election waives the business needs exception, but it also assures that all foreign currency losses of the CFC are deductible against its subpart F income in the FPHC category to the extent thereof. By allowing losses to be absorbed, the full inclusion can be beneficial, if used properly. The full-inclusion election is a binding election that cannot be revoked without the IRS,[15] however, and thus must be used carefully.

Lastly, CFCs, like domestic taxpayers, are eligible for integrated treatment of certain currency hedges under Code Sec. 988(d). Under Reg. §1.988-5, transactions eligible for integrated treatment include debt instruments in a nonfunctional currency and executory contracts. Where it applies, Code Sec. 988(d) allows both the hedging transaction and the underlying transaction to be treated as a functional currency borrowing, lending or payable/receivable. Thus, Code Sec. 988 gain and loss, with its attendant subpart F consequences, may be ignored. However, the requirements to obtain integrated treatment, as discussed below, are hard to satisfy in many cases.

CFC Hedges a Nonfunctional Currency Borrowing

In the first hypothetical, a U.S. dollar CFC borrows in a nonfunctional currency and hedges the risk. The Code Sec. 1221 regulations, which are incorporated in relevant part into the subpart F definition of a *bona fide* hedging transaction, specifically identify currency risk with respect to a borrowing as a risk eligible to be hedged.[16] Also, from a subpart F perspective, a borrowing is not expected to produce subpart F income other than currency gain or loss. Thus, it would appear that the CFC could identify the forward contracts as a *bona fide* hedging transaction for subpart F purposes. Tax hedge treatment would allow the hedging gains and losses to qualify for the business needs exception and be excluded from subpart F income. The taxpayer could also identify the contract for a similar exception to the straddle rules.[17] Rather, under the hedge timing rules of Reg. §1.446-4, both hedging gains and losses on the contract would be deferred to match the recognition of currency gain or loss with respect to the debt.[18]

However, certain potential tax traps exist with respect to this transaction. First, despite its importance, the requirement of hedge identification *for tax purposes* can easily be missed. Identification for financial reporting purposes by itself does not satisfy the tax-identification requirement, absent a clear indication in the taxpayer's books and records that the financial statement identification also applies for tax purposes.[19] If no valid tax identification is made, gain from the hedging contracts would be currently includible in subpart F income as recognized, despite the existence of offsetting unrecognized losses with respect to the principal balance of the debt and the allocation of the CFC's interest expense and related currency gain or loss on the borrowing to non-subpart F income. Assuming short-term instruments or bank forward contracts are used to hedge the risk, any currency gain with respect to the hedging activity would be recognized and enter subpart F income on a current basis. This risk underscores the importance of having a clear and effective policy to make tax identifications. Alternatively, if no tax identification is made, the taxpayer's avenue for relief would be to attempt to establish that the failure to identification of the transactions was due to an "inadvertent error."[20]

Second, if CFC earns substantial amounts of subpart F income, then there is an inherent mismatch in characterization of the gain or loss on the hedge and the gain or loss on the underlying debt. Currency gain or loss arising from the borrowing would, under the rule for interest-bearing liabilities cited above, be allocated and apportioned between subpart F income and non-subpart F income in the same manner as interest expense. By contrast, currency gain or loss from a *bona fide* hedging transaction would appear to be entirely excluded from subpart F income. Thus, there is a risk of the economically offsetting positions effectively converting deferred earnings into subpart F income (or *vice versa*), even if the hedging contract is properly and timely identified for tax purposes.[21]

The taxpayer would sidestep these issues entirely if it structured the currency hedge to qualify for integrated treatment under Reg. §1.988-5. This regulation allows currency hedging contracts to be integrated with nonfunctional currency lending or borrowing and treated as a synthetic dollar (or other applicable functional currency) debt instrument. Under Reg. §1.988-5(a), neither the hedging contract nor the nonfunctional currency borrowing would be treated as producing any Code Sec. 988 gain or loss. Integrated treatment would solve any subpart F mismatch issues. The requirements to structure a hedging contract to obtain integration, however, are stringent. Among other things, the hedging contract must be executed directly with an unrelated party (*e.g.*, an investment bank or other broker-dealer), and the contract must have sufficiently long term to allow a yield to maturity to be calculated on the underlying debt.[22]

CFC Hedges a Nonfunctional Currency Loan Receivable

The second fact pattern is also a garden-variety situation, but one that presents potential complexities. It can occur wherever a CFC holding company or financing company lends money to affiliates. If the lender lends in a nonfunctional currency, *e.g.*, so that the lender bears currency risk, the receivable from the affiliate will constitute a Code Sec. 988 transaction.

The loan itself will primarily be held to produce interest income. Under the CFC look-through rules of Code Sec. 954(c)(6), which are now in effect through 2019 under the recent Protecting Americans from Tax Hikes Act (PATH Act),[23] interest will generally be excluded from subpart F income. However, if the borrower generates any subpart F income, part of the lender's interest income could be tainted as subpart F income under the look-through rule.[24]

The loan receivable, as a Code Sec. 988 transaction, is generally the type of transaction eligible to be treated as a *bona fide* hedging transaction.[25] However, the loan receivable must also satisfy the business needs exception, described above, for the hedging gains and losses to be excluded from subpart F income. Two hurdles must be cleared to make this determination.

First, CFC must conclude that the currency gain or loss from the loan arises from a transaction in the "normal course of a trade or business" of CFC. This test can raise potential concern in connection with a loan receivable. For example, if CFC's sole function is that of a holding company or group financing company, is the loan related to, or made in the "normal course of," the CFC's trade or business?

Under Code Sec. 166, an individual taxpayer may be engaged in a trade or business of making loans so that it loans constitute "business bad debts" based on the relevant facts and circumstances, such as the regularity of lending activity and number of loans made.[26] If this analogy were applied to subpart F, the regularity and extent of CFC lending activities would influence the result. The Code Sec. 475 regulations also contemplate that members of an affiliated or related group may be a financing center's "customers,"[27] implying that regular lending to such group members could be a trade or business. On a more basic level, certain case law also holds that the activity of being a holding company is in itself a "trade or business" if conducted through a corporation.[28] Under this line of authority, the formation of a C corporation itself may be indicia of the existence of a trade or business, as the existence of a Code Sec. 162 deduction would seem to pre-suppose a trade or business.

The manner in which these principles should apply to the subpart F business needs exception is not explicitly addressed in the Code Sec. 954 regulations. One LTR indicates that, in at least some circumstances, a CFC's lending activity can satisfy the requirement of currency gain or loss arising from the "normal course of a trade or business."[29] Also, the Code Sec. 1221(b)(2) regulations helpfully define a transaction entered into the "normal course" of the taxpayer's trade or business as any transaction "in furtherance of" the trade or business.[30] Thus, if the lender CFC is engaged in some other trade or business (such as making and selling inventory), on some facts, it may be possible to conclude that the lending to the customer CFCs furthers the lender CFC's trade or business even if the lending activities are not themselves a separate trade or business for tax purposes.

Second, to exclude currency gain or loss on the loan receivable and the hedging contract from subpart F income, the CFC must also be able to show the intercompany loan itself does not produce, and will not reasonably be expected to produce, any subpart F income. The five-year extension of Code Sec. 954(c)(6) as part of the PATH Act may help in this regard in making it more likely that the loan will be look-through eligible for the CFC's holding period.

However, as noted above, if the borrower CFC-2 earns subpart F income, part of the interest on the loan will be treated as subpart F income under the look-through rule, as noted above. For example, assume that, under the look-through rules of Notice 2007-9, $10 of CFC's $100 of interest income is tainted as subpart F income. In this case, the business needs exception would not apply to the loan receivable or the related hedge.[31] Unlike the proration rule for borrowing, discussed above, the rule for lending is "all or nothing." Thus, there is a cliff effect if the interest on the loan partially fails to qualify for the look-through rule.

If the loan and hedge failed to qualify for business needs and *bona fide* hedging exceptions, discussed above, foreign currency gain or loss on both the loan and the hedge would be included in subpart F income when realized. In this context, timing issues could present significant problems. As discussed above in the first fact pattern, gains on the hedging contracts could be recognized currently under Code Sec.1001 or 1256, while an unrecognized loss on the loan would be deferred. Losses on the hedging contracts, on the other hand, would likely be deferred under Code Sec. 1092. In either case, the taxpayer could experience a mismatch between the taxpayer's economic currency exposure (zero) and the subpart F inclusions from the CFC.

As in the prior example, integrated treatment of Reg. §1.988-5 is potentially available to avoid these mismatch issues. However, the requirements for integrated treatment may make it difficult to fit within this rule.

CFC Hedges a Net Investment in a CFC Subsidiary

In the third fact pattern, CFC is a U.S. dollar qualified business unit (QBU) that, in addition to its other activities, owns stock of lower-tier euro functional currency QBUs. CFC then enters into a foreign currency contract to hedge the exposure associated with its CFC subsidiary's net balance sheet position (a "*net investment hedge*"). The question for tax purposes is whether the gain or loss on the hedging contracts used to effect the net investment hedge can be excluded from CFC's subpart F income as *bona fide* hedging transactions.

In the case of a net investment hedge with respect to a regarded CFC subsidiary, there is significant precedent on point. In *Hoover Co.*,[32] the Tax Court held a series of net investment hedges did not qualify for tax hedge treatment under the common law rules preceding Code Sec. 1221(b)(2). The court reasoned a CFC's stock is a capital asset and, therefore, outside the scope of ordinary business hedging. The same logic would also seem to apply to the determination of whether a net investment hedge is a *bona fide* hedging transaction.[33] Also, as part of finalizing Reg. §1.988-5, the IRS and the Treasury rejected requests to allow net investment hedges to qualify for integrated treatment. The stated reason was that writing a rule to provide integrated treatment for net investment hedges would be too complex of an undertaking.[34]

Thus, despite the common use of net investment hedges by taxpayers engaged in cross-border business operations, these hedges do not appear to qualify as valid tax hedges. Accordingly, if CFC were to enter the hedging contract for this transaction, adverse tax consequences would result in that gains would be taxed as subpart F income, while losses are deferred and produce no immediate U.S. tax benefit absent other FPHC income of CFC in the currency category recognized in the same tax year.[35]

CFC Hedges a Net Investment in a DRE Subsidiary

Alternatively, the next fact pattern considers a net investment hedge by CFC of its investment in a DRE that constitutes a euro QBU of CFC. In this case, the analysis changes and becomes more complex. Such a DRE would typically be subject to the branch translation rules of Code Sec. 987. Under the check-the-box regulations, however, CFC is treated as directly owning the assets and liabilities of DRE. The assets and liabilities held by CFC would include euro-denominated assets and liabilities, such as cash, accounts receivable and accounts payable that would be Code Sec. 988 transactions if held by CFC through a U.S. dollar QBU. However, due to the fact that the DRE is regarded as a separate entity for Code Sec. 987 purposes, the transactions are no longer accounted for under Code Sec. 988 but rather are included in the DRE's overall Code Sec. 987 calculation.

The *Hoover* case and its progeny do not address net investment hedging of a QBU.[36] Further, the case law rationale that an ordinary hedge cannot be used to protect currency risk with respect to stock does not readily extend to a DRE, since CFC has no "stock" in its DRE. Arguably, the underlying assets and liabilities of the QBU constitute ordinary property of the owner, here, CFC. So long as these assets are ordinary in nature, and the currency gain or loss arising from the QBU does not arise from a transaction that produces or could reasonably be expected to produce subpart F income, CFC's net investment hedge with respect to the DRE arguably is eligible for treatment as a *bona fide* hedging transaction with respect to the underlying assets and liabilities of the QBU. However, there is no guidance from the IRS that specifically addresses this issue.

If the taxpayer takes the approach to analyzing the net investment hedge of a DRE, then as in the lending scenario, the U.S. tax analysis varies if any of the assets or liabilities of the DRE produce subpart F income. Under the business needs exception, as discussed above, the currency gain or loss cannot arise from a transaction that produces subpart F income. If the DRE's assets and liabilities produce subpart F income, there is a "cliff effect" that may taint the entire hedge and disqualify it from satisfying the business needs transaction. As in second fact pattern, the presence of a small amount of subpart F income on the underlying transaction being hedged could cause CFC's entire hedging gain to be treated as producing subpart F income.

Further, under the hedge timing rules applicable for tax purposes,[37] the taxpayer must, in addition to contemporaneously identifying the hedging transaction for tax purposes, maintain in its books and records adequate information to show that its timing of recognition of gain or loss from the hedging contracts clearly reflects income. The taxpayer's satisfaction of this recordkeeping requirement may require some analysis in light of the variable methods that may be employed in calculating the E & P adjustments attributable to a QBU's remittances under Code Sec. 987.[38] Presumably, a clear reflection of CFC's currency gain or loss from the hedging contracts would involve matching the recognition of remittance gains and losses under Code Sec. 987.

Concluding Thoughts

In conclusion, CFC hedging transactions pose risks of noneconomic taxation if not properly analyzed, structured and identified by the taxpayer. There are various issues and potential for mismatches in applying these rules to CFCs with garden-variety currency exposures. While the taxpayer may in large measure protect against these risks through careful analysis of the rules and a policy for making appropriate tax hedging identifications, other more structural solutions may also be considered as a means of simplification.

For example, the full-inclusion election[39] would allow a CFC, at the cost of waiving the business needs exception, to net current-year currency gains and losses in its calculation of FPHC income. *In lieu* of the vagaries of the different subpart F currency rules discussed above, a single CFC would consolidate currency risk within the group and compute a net subpart F income currency inclusion in each year that reflects all gains and losses from Code Sec. 988 transaction. This approach poses its own issues, including ensuring that the full-inclusion CFC has sufficient FPHC income to absorb an annual net currency loss[40] and addressing various uncertainties in the application of mark-to-market accounting under Code Sec. 475.[41] At the price of giving up potential deferral, however, this full-inclusion approach may simplify the subpart F currency analysis.

Secondly, the taxpayer may opt for the virtue of simplicity and enter the hedging transactions at the U.S. consolidated group and forego using any intercompany transactions to "push down" the contracts to the relevant CFC. Although currency contracts held by the U.S. group would not qualify as tax hedges of a CFC's currency risk,[42] the statutory treatment of Code Sec. 988 transactions as generally producing ordinary income or loss[43] would be helpful in allowing losses on the contracts to be deducted on the U.S. tax return. In this context, however, the application of the straddle rules of Code Sec. 1092 should also be considered as even factually unrelated currency positions of the U.S. group or certain related parties could cause losses to be deferred, to the extent of unrecognized gains in those unrelated positions held by the U.S. group or such related persons. However, subject to these timing and character issues, leaving the contracts as standalone investment positions held by the U.S. group may also smooth the process of obtaining a U.S. tax benefit from losses with respect to foreign currency contracts.

ENDNOTES

* Will thanks James Fuller and David Forst for their review and helpful comments on this article. Any errors and omissions are the author's responsibility.

1 Many other excellent articles have been written on this subject. One initial treatment of this subject, still valid despite the intervening statutory developments, is L.G. "Chip" Harter, *The Subpart F Treatment of Financial Transactions and Hedges Entered into by Controlled Foreign Corporations*, 38 TAX MGMT. MEMO. 6, at 70 (May 1997). A more recent and comprehensive treatment of the subject of foreign currency taxation in general is set out in John D. McDonald, Ira G. Kawaller, L.G. "Chip" Harter & Jeffrey P. Maydew, *The Devil is in the Details: Problems, Solutions and Policy Recommendations with Respect to Currency Translation, Transactions and Hedging*, TAXES, Mar. 2011, at 199.

2 Reg. §1.954-1(c)(1)(ii). Even if subpart F income can be sheltered with an E & P loss, for example, from operating income, the benefit is subject to recapture in a later year when the same category has positive earnings. *See* Code Sec. 952(c)(2).

3 Reg. §1.954-1(c)(1)(iii).

4 Code Sec. 952(c)(1). Moreover, the benefit of a reduction in subpart F income under the earnings limitation is subject to recapture in a later year. *See* Code Sec. 952(c)(2).

5 *See* Code Sec. 952(c)(2) (qualified deficit rule generally does not apply to FPHC income).

6 Reg. §1.954-1(c)(1)(ii).

7 Reg. §1.954-2(g)(2)(ii)(B)(1).

8 Reg. §1.954-2(g)(2)(ii)(B)(2).

9 Reg. §1.954-2(a)(4)(ii)(A). *Compare* Reg. §1.1221-2(b).

10 Reg. §1.954-2(a)(4)(ii)(B).

11 Reg. §1.954-2(a)(4)(ii)(C)(2).

12 Reg. §1.954-2(a)(4)(ii)(C)(4). *Compare* Reg. §1.1221-2(g)(2)(ii).

13 Reg. §1.954-2(g)(2)(iii).

14 Reg. §1.954-2(g)(3)(iv), Example.

15 Reg. §1.954-2(g)(4)(iii).

16 Reg. §§1.1221-2(b)(2) and 1.954-2(a)(4)(ii)(A).

17 *See* Code Secs. 1092(e) and 1256(e).

18 *See* Reg. §1.446-4(e)(4).

19 Reg. §1.1221-2(f)(4)(ii).

20 Reg. §1.954-2(a)(4)(ii)(C)(4).

21 For a discussion of potential arguments to avoid this unfortunate result, and analogize to Reg. §1.861-9T(b)(6) to obtain matched treatment of the currency gain or loss on the hedge

and the underlying liability, *see* Michael J. Feder, *Making CFC Hedging Work: Avoiding Whipsaw in an Ambiguous Environment*, J. TAX'N FINANCIAL PROD., Jan. 1, 2003.

22 Reg. §§1.988-5(a)(5)(i) and 1.988-5(a)(5)(iii).

23 Act Sec. 144, Protecting Americans from Tax Hikes Act of 2015 (P.L. 114-113).

24 Notice 2007-9, 2007-1 CB 401, §5(a).

25 Reg. §1.954-2(a)(4)(ii)(A). Interestingly, the parallel definition in Reg. §1.1221-2(b) does not include a Code Sec. 988 transaction as the type of transaction eligible to be hedged.

26 *See, e.g.*, *A. Serot*, 68 TCM 1015, Dec. 50,199(M), TC Memo. 1994-532; *G. Ruppel*, 53 TCM 829, Dec. 43,917(M), TC Memo. 1987-248. The voluminous case law on this subject is summarized in FSA 199911003 (Nov. 18, 1998).

27 *See* Reg. §1.475(c)-1(a)(3)(i).

28 *See Arkansas Best Co.*, 83 TC 640, 652, Dec. 41,581 (1984), *rev'd on other grounds*, CA-8, 86-2 USTC ¶9671, 800 F2d 215 , *aff'd,* SCt, 88-1 USTC ¶9210, 485 US 212, 108 SCt 971. For a further discussion of this issue in the context of obtaining Code Sec. 1221(b)(2) treatment for a nonfunctional currency loan made by the U.S. parent, *see* L.G. "Chip" Harter & Michael J. Harper, Financing International Operations, *Hedges of Foreign Currency Risk Associated with Debt Instruments Held As Capital Assets*, INT'L TAX., Dec. 1, 2010, at 5.

29 *See* LTR 201235007 (June 4, 2012) (granting Section 9100 relief request to make Reg. §1.954-2(g)(3) election to re-basket currency gain or loss from lending activity as subpart F interest income). In the LTR, it is unstated whether the borrowers were CFCs or unrelated parties.

30 Reg. §1.1221-2(c)(1).

31 Arguably, the hedge of the loan receivable might still qualify, for E & P and timing purposes, as a Code Sec. 1221(b)(2) hedging transaction even if it fails to qualify for the subpart F exclusion. This issue is beyond the scope of this article, however.

32 *Hoover Co., 72* TC 206, Dec. 36,032 (1979).

33 A later district court case also reached the same conclusion as *Hoover*. *See Barnes Group, Inc.*, DC-CT, 88-2 USTC ¶9503, 697 FSupp 591.

34 T.D. 8400, 1992-1 CB 101 (Mar. 16, 1992).

35 For CFC to be able to currently recognize a loss on the contracts, it should also examine whether the straddle rules of Code Sec. 1092 could apply to the FX gain or loss on the contracts. In this regard, the IRS has helpfully concluded in a LTR and two FSAs that a short foreign currency contract and net investment in a subsidiary do not make up a "straddle," because the stock of the subsidiary is not a "position" in "actively traded personal property" under Code Sec. 1092. *See* LTR 9640023 (July 9, 1996); FSA #0420; FSA #001379 (Aug. 23, 1994). However, it would also be important to establish that CFC does not, in this case, own any long euro positions that could be treated as part of the straddle with the hedging instrument.

36 While there is significant and for the most part taxpayer-favorable commentary concerning hedging of a QBU's balance sheet risk, neither the IRS nor the courts have addressed this issue in guidance or as-of-yet updated the Code Sec. 954 regulations in light of the check-the-box. For some additional discussion of this issue, *see* New York State Bar Association (NYSBA) Report (June 2013), *Subpart F Issues Involving Currency Gains and Losses* (hereafter, "*NYSBA 2013 Currency Report*"); L.G. "Chip" Harter, Rebecca Lee & David H. Shapiro, *Inherently Hedgeable: Hedging Foreign Currency Exposure Arising from the Branch Operations of a CFC*, INT'L TAX J. (Oct. 1, 2011); Jeffrey L. Shore, *Subpart F: Hedging Currency Risk in a Branch Context*, INT'L TAX J. (Dec. 1, 2012).

37 Reg. §1.446-4(d).

38 *See* REG-208276-86 (Sept. 7, 2006), Proposed Reg. §1.987-10(d) (illustrating different methods of applying Code Sec. 987 that may be considered "reasonable methods" for purposes of the transition rule).

39 Reg. §1.954-2(g)(4).

40 The full-inclusion election of Reg. §1.954-2(g)(4) treats all currency gains and losses for the year as includible in FPHC income. If the FPHC income category overall is negative for the year, however, the FPHC category loss generally will not offset other categories of subpart F income. *See* Reg. §1.954-1(c)(1)(ii). In addition, a net loss in the FPHC category generally is a not a "qualified deficit" in earnings and profits that is eligible to reduce subpart F inclusions in a later year. *See* Code Sec. 952(c)(1)(B)(iii)(IV) ("qualified activity" producing a qualified deficit in accumulated earnings and profits includes FPHC income only in the case of a "qualified financial institution").

41 The NYSBA 2013 Currency Report provides a good discussion of the issues and potential problems in applying Code Sec. 475 to the foreign currency risk of a CFC engaged in group lending and borrowing activity.

42 See Reg. §1.1221-2(e)(1)(i).

43 Code Sec. 988(a)(1)(A).