

# **Foreign Currency: The Latest Tax and Accounting Considerations**

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# Introduction

- Financial Accounting and Tax Regimes Treat Foreign Currency and Derivatives Transactions Differently.
  - Treasury Decisions Can Have Unexpected Tax Consequences.
  - Parallel Hedge Identification Regime Required for Tax Purposes.
  - Close Cooperation Needed Between the Treasury, Accounting and Tax Functions.
  - SEC Guidance on Critical Terms Match Method.

# Contrast Between GAAP and Tax Hedging Rules

- Overview of GAAP Hedging Principles.
  - Derivatives Marked to Market.
  - GAAP Identification.
    - Sufficient Specificity.
    - Extensive Hedge Documentation at Inception.
    - Precision Demanded!
    - SEC Expound Critical Terms Match Requirements.

# Contrast Between GAAP and Tax Hedging Rules

- SEC Critical Terms Match Requirement.
  - Critical terms match intended to be “Perfectly Match”.
  - If slight mismatch (under limited circumstances), entities required to demonstrate quantitatively that:
    - the hedging relationship is expected to be highly effective.
    - ineffectiveness is expected to be de minimus.
  - In subsequent periods, review documentation and reaffirm that underlying assertions are still appropriate. And if necessary, update prior analysis.
  - Applies to both old and new hedges.

# Contrast Between GAAP and Tax Hedging Rules

- Types of Hedges.
  - Fair Value Hedge.
  - Cash Flow Hedge.
  - Net Investment Hedge.

# Contrast Between GAAP and Tax Hedging Rules

- Fair Value Hedges
  - Generally seen when combined with interest rate hedge, otherwise not prevalent.
  - Basis adjustment recorded to hedged items if qualifies hedge accounting.

# Contrast Between GAAP and Tax Hedging Rules

- Cash Flow Hedges.
  - Commonly seen with forecasted foreign denominated cash inflows or outflows. Allows single hedge designation for forecasted cash flows through settlement.
  - For consolidated group, another member can enter into hedging instrument as long as same FC and no intervening sub with different FC.
  - Special exception for forecasted inter-company transaction.
  - Effective portion of gains/losses of derivatives deferred in OCI if qualifies hedge accounting.

# Contrast Between GAAP and Tax Hedging Rules

- Net Investment Hedges.
  - Hedge FX risk of a net investment in foreign operations.
  - Hedging instrument can be foreign denominated non-derivative.
  - Effective portion of gains/losses of derivatives deferred in CTA if qualifies hedge accounting.

# Contrast Between GAAP and Tax Hedging Rules

- Overview of Tax Hedging Principles:
  - Generally Realization Based Accounting for Derivatives, Except for FX Forward and Futures Contracts.
  - Gains and Losses on Designated Hedges Generally Deferred and Matched With Realization of Underlying.
  - Character of Hedging Gain or Loss Matched with Ordinary Character of Underlying.
  - Separate Tax Hedge Identification Requirement.

# Why Tax Hedge IDs Are Important

- Hedges of Exposures of Controlled Foreign Subsidiaries - Subpart F Whipsaws.
- Tax Straddle Rules - Example of Multiple Offsetting Positions.
- Foreign Tax Credit Limitation - Example of Integrated Hedge.

# Controlled Foreign Corporation Hedging Whipsaws

- General Subpart F Principles:
  - Net Annual FX Gains of a CFC With Respect to Debt Instruments and Derivatives Are Currently Taxed to US Parent.
  - Net Annual FX Losses Produce No Current U.S. Tax Benefit to U.S. Parent.

# Controlled Foreign Corporation Hedging Whipsaws

- Example – CFC has anticipated periodic FX expenses to purchase inventory. CFC hedges anticipated expense 18 months out using forward contracts.
- If no tax hedge ID:
  - FX forward marked to market at year end.
  - A net FX hedging gain for year would be subpart F income taxed to US parent.
  - A net FX hedging loss for the year would produce no current US tax benefit to the US parent.

# Controlled Foreign Corporation Hedging Whipsaws

- Example, cont'd.
- If valid hedging ID made for tax purposes:
  - Forward contracts not marked to market at year end.
  - Timing of gain or loss on forward contracts matched to period of the future expense being hedged.
  - Gains on hedge not subpart F income and therefore not currently taxed to US parent.

# Tax Straddle Rules

- Under Tax Straddle Rules, Deductions for Realized Losses are Deferred to the Extent of Unrealized Gains in “Offsetting Positions.”
- Where a Taxpayer has Multiple Long and Short Positions with respect to a Currency:
  - IRS has ability to determine which long position offsets which short position.
  - “Successor position” rules can result in deferral of realized losses with respect to a currency to the extent that there are offsetting unrealized gains with respect to that currency.
- Straddle Rules Do Not Apply to Identified Hedging Transactions.

# Foreign Tax Credit Limitation Whipsaws

- **General Foreign Tax Credit Limitation Principles:**
  - Foreign taxes creditable against taxpayer's net foreign source income.
  - Foreign currency gains and losses of US corporation are US source.
  - Interest expense of US corporation allocated between US and foreign source income of the corporation.
- **Whipsaw Effect of Borrowing in a Weak Currency:**
  - Greater interest expense allocated in part to foreign source income.
  - Offsetting foreign currency gain entirely US source.
  - Net effect: decreased US source income and FTC limitation.

# Foreign Tax Credit Limitation Whipsaws

- “Integrated Hedge” Designation Avoids FTC Limitation Whipsaws.
- A FX Denominated Debt Instrument and a Perfectly Matched FX Swap Can Be Integrated and Treated as a Synthetic Functional Currency Debt for Tax Purposes.
- A Specific Type of Tax ID is Required to Get Integrated Treatment.

# Differences Between Tax and GAAP Definitions of Hedging Transactions

- For Most Tax Purposes, Hedges of Capital Assets Can Not Qualify as Tax Hedges.
- For Example, a Hedge of Net Equity Investment in a Subsidiary Can Not Qualify as a Hedge for Tax Purposes.
  - As a result, forward contracts used to hedge net investments in subsidiaries do not qualify for the hedging exception from marked-to-market taxation.

# Contrast Between GAAP and Tax Foreign Currency Translation Rules

- Overview of FAS 52 as Applied to Branches.
  - Examples are foreign banking branches, overseas sales office and R&D labs.
  - Remeasurement from local to functional currency included in P&L.
  - Translation from functional to reporting currency included in CTA.
  - Translation adjustment released into P&L only upon sale or substantially complete liquidation.

# Contrast Between GAAP and Tax Foreign Currency Translation Rules

- Tax Translation Regime under 1991 Proposed Regulations:
  - Applies to branches, disregarded entities, and partnerships.
  - Profit and loss method.
  - Similar to FAS 52, except translation gains or losses recognized on remittances.
  - Very large gains or losses potentially triggered on internal restructurings.

# Contrast Between GAAP and Tax Foreign Currency Translation Rules

- New 2006 Proposed Regulations - Potentially Effective 1-1-09.
  - Would essentially eliminate functional currency accounting for branches and disregarded entities.
  - Would require taxable income to be calculated in home office currency.
  - Gains and losses from property calculated using historical exchange rates for basis and amounts realized.
  - Financial assets and liabilities marked to market, with gains or losses taken into income on a remittance basis.

# Contrast Between GAAP and Tax Foreign Currency Translation Rules

- New 2006 Proposed Regulations – Cont'd
  - Would Be Extremely Burdensome to Implement.
    - Complete revision of tax accounting systems would be required.
    - Separate set of US dollar books required for tax purposes.
    - FAS 109 compliance complicated by new book-tax differences.
  - Complex transition rules with both traps and opportunities.

# Conclusion

- As the GAAP and Tax Rules With Respect to Foreign Currency Continue to Diverge, Close Teamwork Between the Treasury, Accounting and Tax Functions Will Be Essential.