

(2) *Exception.* In the case of a qualified business unit of any taxpayer (including an individual), the residence of such unit shall be the country in which the principal place of business of such qualified business unit is located.

(3) *Partner in a partnership not engaged in a U.S. trade or business under section 864(b)(2).* The determination of residence shall be made at the partner level (without regard to whether the partnership is a qualified business unit of the partners) in the case of partners in a partnership that are not engaged in a U.S. trade or business by reason of section 864(b)(2).

(e) *Special rule for certain related party loans—(1) In general.* In the case of a loan by a United States person or a related person to a 10 percent owned foreign corporation, or a corporation that meets the 80 percent foreign business requirements test of section 861(c)(1), other than a corporation subject to § 1.861-11T(e)(2)(i), which is denominated in, or determined by reference to, a currency other than the U.S. dollar and bears interest at a rate at least 10 percentage points higher than the Federal mid-term rate (as determined under section 1274(d)) at the time such loan is entered into, the following rules shall apply—

(i) For purposes of section 904 only, such loan shall be marked to market annually on the earlier of the last business day of the United States person's (or related person's) taxable year or the date the loan matures; and

(ii) Any interest income earned with respect to such loan for the taxable year shall be treated as income from sources within the United States to the extent of any notional loss attributable to such loan under paragraph (d)(1)(i) of this section.

(2) *United States person.* For purposes of this paragraph (e), the term "United States person" means a person described in section 7701(a)(30).

(3) *Loans by related foreign persons—(i) In general.* [Reserved]

(ii) *Definition of related person.* For purposes of this paragraph (e), the term "related person" has the meaning given such term by section 954(d)(3) except that such section shall be applied by substituting "United States person"

for "controlled foreign corporation" each place such term appears.

(4) *10 percent owned foreign corporation.* For purposes of this paragraph (e), the term "10 percent owned foreign corporation" means any foreign corporation in which the United States person owns directly or indirectly (within the meaning of section 318(a)) at least 10 percent of the voting stock.

(f) *Exchange gain or loss treated as interest under § 1.988-3.* Notwithstanding the provisions of this section, any gain or loss realized on a section 988 transaction that is treated as interest income or expense under § 1.988-3(c)(1) shall be sourced or allocated and apportioned pursuant to section 861(a)(1), 862(a)(1), or 864(e) as the case may be.

(g) *Exchange gain or loss allocated in the same manner as interest under § 1.861-9T.* The allocation and apportionment of exchange gain or loss under § 1.861-9T shall not affect the source of exchange gain or loss for purposes of sections 871(a), 881, 1441, 1442 and 6049.

(h) *Effective date.* This section shall be effective for taxable years beginning after December 31, 1986. Thus, 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.

[T.D. 8400, 57 FR 9199, Mar. 17, 1992]

§ 1.988-5 Section 988(d) hedging transactions.

(a) *Integration of a nonfunctional currency debt instrument and a § 1.988-5(a) hedge—(1) In general.* This paragraph (a) applies to a qualified hedging transaction as defined in this paragraph (a)(1). A qualified hedging transaction is an integrated economic transaction, as provided in paragraph (a)(5) of this section, consisting of a qualifying debt instrument as defined in paragraph (a)(3) of this section and a § 1.988-5(a) hedge as defined in paragraph (a)(4) of this section. If a taxpayer enters into a transaction that is a qualified hedging transaction, no exchange gain or loss is recognized by the taxpayer on the qualifying debt instrument or on the § 1.988-5(a) hedge for the period that either is part of a qualified hedging transaction, and the transactions shall be integrated as provided in paragraph (a)(9) of this section. However, if the

qualified hedging transaction results in a synthetic nonfunctional currency denominated debt instrument, such instrument shall be subject to the rules of § 1.988-2(b).

(2) *Exception.* This paragraph (a) does not apply with respect to a qualified hedging transaction that creates a synthetic asset or liability denominated in, or determined by reference to, a currency other than the U.S. dollar if the rate that approximates the Federal short-term rate in such currency is at least 20 percentage points higher than the Federal short term rate (determined under section 1274(d)) on the date the taxpayer identifies the transaction as a qualified hedging transaction.

(3) *Qualifying debt instrument—(i) In general.* A qualifying debt instrument is a debt instrument described in § 1.988-1(a)(2)(i), regardless of whether denominated in, or determined by reference to, nonfunctional currency (including dual currency debt instruments, multi-currency debt instruments and contingent payment debt instruments). A qualifying debt instrument does not include accounts payable, accounts receivable or similar items of expense or income.

(ii) *Special rule for debt instrument of which all payments are proportionately hedged.* If a debt instrument satisfies the requirements of paragraph (a)(3)(i) of this section, and all principal and interest payments under the instrument are hedged in the same proportion, then for purposes of this paragraph (a), that portion of the instrument that is hedged is eligible to be treated as a qualifying debt instrument, and the rules of this paragraph (a) shall apply separately to such qualifying debt instrument. See Example 8 in paragraph (a)(9)(iv) of this section.

(4) *Section 1.988-5(a) hedge—(i) In general.* A § 1.988-5(a) hedge (hereinafter referred to in this paragraph (a) as a “hedge”) is a spot contract, futures contract, forward contract, option contract, notional principal contract, currency swap contract, similar financial instrument, or series or combination thereof, that when integrated with a qualifying debt instrument permits the calculation of a yield to maturity (under principles of section 1272) in the

currency in which the synthetic debt instrument is denominated (as determined under paragraph (a)(9)(ii)(A) of this section).

(ii) *Retroactive application of definition of currency swap contract.* A taxpayer may apply the definition of currency swap contract set forth in § 1.988-2(e)(2)(ii) in lieu of the definition of swap agreement in section 2(e)(5) of Notice 87-11, 1987-1 C.B. 423 to transactions entered into after December 31, 1986 and before September 21, 1989.

(5) *Definition of integrated economic transaction.* A qualifying debt instrument and a hedge are an integrated economic transaction if all of the following requirements are satisfied—

(i) All payments to be made or received under the qualifying debt instrument (or amounts determined by reference to a nonfunctional currency) are fully hedged on the date the taxpayer identifies the transaction under paragraph (a) of this section as a qualified hedging transaction such that a yield to maturity (under principles of section 1272) in the currency in which the synthetic debt instrument is denominated (as determined under paragraph (a)(9)(ii)(A) of this section) can be calculated. Any contingent payment features of the qualifying debt instrument must be fully offset by the hedge such that the synthetic debt instrument is not classified as a contingent payment debt instrument. See Examples 6 and 7 of paragraph (a)(9)(iv) of this section.

(ii) The hedge is identified in accordance with paragraph (a)(8) of this section on or before the date the acquisition of the financial instrument (or instruments) constituting the hedge is settled or closed.

(iii) None of the parties to the hedge are related. The term “related” means the relationships defined in section 267(b) or section 707(b).

(iv) In the case of a qualified business unit with a residence, as defined in section 988(a)(3)(B), outside of the United States, both the qualifying debt instrument and the hedge are properly reflected on the books of such qualified business unit throughout the term of the qualified hedging transaction.

(v) Subject to the limitations of paragraph (a)(5) of this section, both

the qualifying debt instrument and the hedge are entered into by the same individual, partnership, trust, estate, or corporation. With respect to a corporation, the same corporation must enter into both the qualifying debt instrument and the hedge whether or not such corporation is a member of an affiliated group of corporations that files a consolidated return.

(vi) With respect to a foreign person engaged in a U.S. trade or business that enters into a qualifying debt instrument or hedge through such trade or business, all items of income and expense associated with the qualifying debt instrument and the hedge (other than interest expense that is subject to § 1.882-5), would have been effectively connected with such U.S. trade or business throughout the term of the qualified hedging transaction had this paragraph (a) not applied.

(6) *Special rules for legging in and legging out of integrated treatment*—(i) *Legging in*. “Legging in” to integrated treatment under this paragraph (a) means that a hedge is entered into after the date the qualifying debt instrument is entered into or acquired, and the requirements of this paragraph (a) are satisfied on the date the hedge is entered into (“leg in date”). If a taxpayer legs into integrated treatment, the following rules shall apply—

(A) Exchange gain or loss shall be realized with respect to the qualifying debt instrument determined solely by reference to changes in exchange rates between—

(1) The date the instrument was acquired by the holder, or the date the obligor assumed the obligation to make payments under the instrument; and

(2) The leg in date.

(B) The recognition of such gain or loss will be deferred until the date the qualifying debt instrument matures or is otherwise disposed of.

(C) The source and character of such gain or loss shall be determined on the leg in date as if the qualifying debt instrument was actually sold or otherwise terminated by the taxpayer.

(ii) *Legging out*. With respect to a qualifying debt instrument and hedge that are properly identified as a qualified hedging transaction, “legging out”

of integrated treatment under this paragraph (a) means that the taxpayer disposes of or otherwise terminates all or a part of the qualifying debt instrument or hedge prior to maturity of the qualified hedging transaction, or the taxpayer changes a material term of the qualifying debt instrument (*e.g.*, exercises an option to change the interest rate or index, or the maturity date) or hedge (*e.g.*, changes the interest or exchange rates underlying the hedge, or the expiration date) prior to maturity of the qualified hedging transaction. A taxpayer that disposes of or terminates a qualified hedging transaction (*i.e.*, disposes of or terminates both the qualifying transaction and the hedge on the same day) shall be considered to have disposed of or otherwise terminated the synthetic debt instrument rather than as legging out. If a taxpayer legs out of integrated treatment, the following rules shall apply—

(A) The transaction will be treated as a qualified hedging transaction during the time the requirements of this paragraph (a) were satisfied.

(B) If the hedge is disposed of or otherwise terminated, the qualifying debt instrument shall be treated as sold for its fair market value on the date the hedge is disposed of or otherwise terminated (the “leg-out date”), and any gain or loss (including gain or loss resulting from factors other than movements in exchange rates) from the identification date to the leg-out date is realized and recognized on the leg-out date. The spot rate on the leg-out date shall be used to determine exchange gain or loss on the debt instrument for the period beginning on the leg-out date and ending on the date such instrument matures or is disposed of or otherwise terminated. Proper adjustment to the principal amount of the debt instrument must be made to reflect any gain or loss taken into account. The netting rule of § 1.988-2(b)(8) shall apply.

(C) If the qualifying debt instrument is disposed of or otherwise terminated, the hedge shall be treated as sold for its fair market value on the date the qualifying debt instrument is disposed of or otherwise terminated (the “leg-out date”), and any gain or loss from the identification date to the leg-out

date is realized and recognized on the leg-out date. The spot rate on the leg-out date shall be used to determine exchange gain or loss on the hedge for the period beginning on the leg-out date and ending on the date such hedge is disposed of or otherwise terminated.

(D) Except as provided in paragraph (a)(8)(iii) of this section (regarding identification by the Commissioner), that part of the qualified hedging transaction that has not been terminated (*i.e.*, the remaining debt instrument in its entirety even if partially hedged, or hedge) cannot be part of a qualified hedging transaction for any period subsequent to the leg out date.

(E) If a taxpayer legs out of a qualified hedging transaction and realizes a gain with respect to the terminated instrument, then paragraph (a)(6)(ii)(B) or (C) of this section, as appropriate, shall not apply if during the period beginning 30 days before the leg-out date and ending 30 days after that date the taxpayer enters into another transaction that hedges at least 50% of the remaining currency flow with respect to the qualifying debt instrument which was part of the qualified hedging transaction (or, if appropriate, an equivalent amount under the §1.988-5 hedge which was part of the qualified hedging transaction).

(7) *Transactions part of a straddle.* At the discretion of the Commissioner, a transaction shall not satisfy the requirements of paragraph (a)(5) of this section if the debt instrument making up the qualified hedging transaction is part of a straddle as defined in section 1092(c) prior to the time the qualified hedging transaction is identified.

(8) *Identification requirements—(i) Identification by the taxpayer.* A taxpayer must establish a record and before the close of the date the hedge is entered into, the taxpayer must enter into the record for each qualified hedging transaction the following information—

(A) The date the qualifying debt instrument and hedge were entered into;

(B) The date the qualifying debt instrument and the hedge are identified as constituting a qualified hedging transaction;

(C) The amount that must be deferred, if any, under paragraph (a)(6) of

this section and the source and character of such deferred amount;

(D) A description of the qualifying debt instrument and the hedge; and

(E) A summary of the cash flow resulting from treating the qualifying debt instrument and the hedge as a qualified hedging transaction.

(ii) *Identification by trustee on behalf of beneficiary.* A trustee of a trust that enters into a qualified hedging transaction may satisfy the identification requirements described in paragraph (a)(8)(i) of this section on behalf of a beneficiary of such trust.

(iii) *Identification by the Commissioner.* If—

(A) A taxpayer enters into a qualifying debt instrument and a hedge but fails to comply with one or more of the requirements of this paragraph (a), and

(B) On the basis of all the facts and circumstances, the Commissioner concludes that the qualifying debt instrument and the hedge are, in substance, a qualified hedging transaction,

then the Commissioner may treat the qualifying debt instrument and the hedge as a qualified hedging transaction. The Commissioner may identify a qualifying debt instrument and a hedge as a qualified hedging transaction regardless of whether the qualifying debt instrument and the hedge are held by the same taxpayer.

(9) *Taxation of qualified hedging transactions—(i) In general—(A) General rule.*

If a transaction constitutes a qualified hedging transaction, the qualifying debt instrument and the hedge are integrated and treated as a single transaction with respect to the taxpayer that has entered into the qualified hedging transaction during the period that the transaction qualifies as a qualified hedging transaction. Neither the qualifying debt instrument nor the hedge that makes up the qualified hedging transaction shall be subject to section 263(g), 1092 or 1256 for the period such transactions are integrated. However, the qualified hedging transaction may be subject to section 263(g) or 1092 if such transaction is part of a straddle.

(B) *Special rule for income or expense of foreign persons effectively connected with a U.S. trade or business.* Interest income of a foreign person resulting from a

qualified hedging transaction entered into by such foreign person that satisfies the requirements of paragraph (a)(5)(vii) of this section shall be treated as effectively connected with a U.S. trade or business. Interest expense of a foreign person resulting from a qualified hedging transaction entered into by such foreign person that satisfies the requirements of paragraph (a)(5)(vii) of this section shall be allocated and apportioned under § 1.882-5 of the regulations.

(C) *Special rule for foreign persons that enter into qualified hedging transactions giving rise to U.S. source income not effectively connected with a U.S. trade or business.* If a foreign person enters into a qualified hedging transaction that gives rise to U.S. source interest income (determined under the source rules for synthetic asset transactions as provided in this section) not effectively connected with a U.S. trade or business of such foreign person, for purposes of sections 871(a), 881, 1441, 1442 and 6049, the provisions of this paragraph (a) shall not apply and such sections of the Internal Revenue Code shall be applied separately to the qualifying debt instrument and the hedge. To the extent relevant to any foreign person, if the requirements of this paragraph (a) are otherwise met, the provisions of this paragraph (a) shall apply for all other purposes of the Internal Revenue Code (*e.g.*, for purposes of calculating the earnings and profits of a controlled foreign corporation that enters into a qualified hedging transaction through a qualified business unit resident outside the United States, income or expense with respect to such qualified hedging transaction shall be calculated under the provisions of this paragraph (a)).

(ii) *Income tax effects of integration.* The effect of integrating and treating a transaction as a single transaction is to create a synthetic debt instrument for income tax purposes, which is subject to the original issue discount provisions of sections 1272 through 1288 and 163(e), the terms of which are determined as follows:

(A) *Denomination of synthetic debt instrument.* In the case where the qualifying debt instrument is a borrowing, the denomination of the synthetic debt

instrument is the same as the currency paid under the terms of the hedge to acquire the currency used to make payments under the qualifying debt instrument. In the case where the qualifying debt instrument is a lending, the denomination of the synthetic debt instrument is the same as the currency received under the terms of the hedge in exchange for amounts received under the qualifying debt instrument. For example, if the hedge is a forward contract to acquire British pounds for dollars, and the qualifying debt instrument is a borrowing denominated in British pounds, the synthetic debt instrument is considered a borrowing in dollars.

(B) *Term and accrual periods.* The term of the synthetic debt instrument shall be the period beginning on the identification date and ending on the date the qualifying debt instrument matures or such earlier date that the qualifying debt instrument or hedge is disposed of or otherwise terminated. Unless otherwise clearly indicated by the payment interval under the hedge, the accrual period shall be a six month period which ends on the dates determined under section 1272(a)(5).

(C) *Issue price.* The issue price of the synthetic debt instrument is the adjusted issue price of the qualifying debt instrument translated into the currency in which the synthetic debt instrument is denominated at the spot rate on the identification date.

(D) *Stated redemption price at maturity.* In the case where the qualifying debt instrument is a borrowing, the stated redemption price at maturity shall be determined under section 1273(a)(2) on the identification date by reference to the amounts to be paid under the hedge to acquire the currency necessary to make interest and principal payments on the qualifying debt instrument. In the case where the qualifying debt instrument is a lending, the stated redemption price at maturity shall be determined under section 1273(a)(2) on the identification date by reference to the amounts to be received under the hedge in exchange for the interest and principal payments received pursuant to the terms of the qualifying debt instrument.

(iii) *Source of interest income and allocation of expense.* Interest income from a synthetic debt instrument described in paragraph (a)(9)(ii) of this section shall be sourced by reference to the source of income under sections 861(a)(1) and 862(a)(1) of the qualifying debt instrument. The character for purposes of section 904 of interest income from a synthetic debt instrument shall be determined by reference to the character of the interest income from qualifying debt instrument. Interest expense from a synthetic debt instrument described in paragraph (a)(9)(ii) of this section shall be allocated and apportioned under §§1.861-8T through 1.861-12T or the successor sections thereof or under §1.882-5.

(iv) *Examples.* The following examples illustrate the application of this paragraph (a)(9).

Example 1. (i) K is a U.S. corporation with the U.S. dollar as its functional currency. On December 24, 1989, K agrees to close the following transaction on December 31, 1989. K will borrow from an unrelated party on December 31, 1989, 100 British pounds (£) for 3 years at a 10 percent rate of interest, payable annually, with no principal payment due until the final installment. K will also enter into a currency swap contract with an unrelated counterparty under the terms of which—

(a) K will swap, on December 31, 1989, the \$100 obtained from the borrowing for \$100; and

(b) K will exchange dollars for pounds pursuant to the following table in order to obtain the pounds necessary to make payments on the pound borrowing:

Date	U.S. dollars	Pounds
December 31, 1990	8	10
December 31, 1991	8	10
December 31, 1992	108	110

(ii) The interest rate on the borrowing is set and the exchange rates on the swap are fixed on December 24, 1989. On December 31, 1989, K borrows the £100 and swaps such pounds for \$100. Assume x has satisfied the identification requirements of paragraph (a)(8) of this section.

(iii) The pound borrowing (which constitutes a qualifying debt instrument under paragraph (a)(3) of this section) and the currency swap contract (which constitutes a hedge under paragraph (a)(4) of this section) are a qualified hedging transaction as defined in paragraph (a)(1) of this section. Accordingly, the pound borrowing and the swap

are integrated and treated as one transaction with the following consequences:

(A) The integration of the pound borrowing and the swap results in a synthetic dollar borrowing with an issue price of \$100 under section 1273(b)(2).

(B) The total amount of interest and principal of the synthetic dollar borrowing is equal to the dollar payments made by K under the currency swap contract (i.e., \$8 in 1990, \$8 in 1991, and \$108 in 1992).

(C) The stated redemption price at maturity (defined in section 1273(a)(2)) is \$100. Because the stated redemption price equals the issue price, there is no OID on the synthetic dollar borrowing.

(D) K may deduct the annual interest payments of \$8 under section 163(a) (subject to any limitations on deductibility imposed by other provisions of the Code) according to its regular method of accounting. K has also paid \$100 as a return of principal in 1992.

(E) K must allocate and apportion its interest expense with respect to the synthetic dollar borrowing under the rules of §§1.861-8T through 1.861-12T.

Example 2. (i) K, a U.S. corporation, has the U.S. dollar as its functional currency. On December 24, 1989, when the spot rate for Swiss francs (Sf) is Sf1 = \$1, K enters into a forward contract to purchase Sf100 in exchange for \$100.04 for delivery on December 31, 1989. The Sf100 are to be used for the purchase of a franc denominated debt instrument on December 31, 1989. The instrument will have a term of 3 years, an issue price of Sf100, and will bear interest at 6 percent, payable annually, with no repayment of principal until the final installment. On December 24, 1989, K also enters into a series of forward contracts to sell the franc interest and principal payments that will be received under the terms of the franc denominated debt instrument for dollars according to the following schedule:

Date	U.S. dollars	Francs
December 31, 1990	6.12	6
December 31, 1991	6.23	6
December 31, 1992	112.16	106

(ii) On December 31, 1989, K takes delivery of the Sf100 and purchases the franc denominated debt instrument. Assume K satisfies the identification requirements of paragraph (a)(8) of this section. The purchase of the franc debt instrument (which constitutes a qualifying debt instrument under paragraph (a)(3) of this section) and the series of forward contracts (which constitute a hedge under paragraph (a)(4) of this section) are a qualified hedging transaction under paragraph (a)(1) of this section. Accordingly, the franc debt instrument and all the forward contracts are integrated and treated as one transaction with the following consequences:

(A) The integration of the franc debt instrument and the forward contracts results in a synthetic dollar debt instrument in an amount equal to the dollars exchanged under the forward contract to purchase the francs necessary to acquire the franc debt instrument. Accordingly, the issue price is \$100.04 (section 1273(b)(2) of the Code).

(B) The total amount of interest and principal received by K with respect to the synthetic dollar debt instrument is equal to the dollars received under the forward sales contracts (i.e., \$6.12 in 1990, \$6.23 in 1991, and \$112.16 in 1992).

(C) The synthetic dollar debt instrument is an installment obligation and its stated redemption price at maturity is \$106.15 (i.e., \$6.12 of the payments in 1990, 1991, and 1992 are treated as periodic interest payments under the principles of section 1273). Because the stated redemption price at maturity exceeds the issue price, under section 1273(a)(1) the synthetic dollar debt instrument has OID of \$6.11.

(D) The yield to maturity of the synthetic dollar debt instrument is 8.00 percent, compounded annually. Assuming K is a calendar year taxpayer, it must include interest income of \$3.00 in 1990 (of which \$1.88 constitutes OID), \$8.15 in 1991 (of which \$2.03 constitutes OID), and \$8.32 in 1992 (of which \$2.20 constitutes OID). The amount of the final payment received by K in excess of the interest income includible is a return of principal and a payment of previously accrued OID.

(E) The source of the interest income shall be determined by applying sections 861(a)(1) and 862(a)(1) with reference to the franc interest income that would have been received had the transaction not been integrated.

Example 3. (i) K is an accrual method U.S. corporation with the U.S. dollar as its functional currency. On January 1, 1992, K borrows 100 British pounds (£) for 3 years at a 10% rate of interest payable on December 31 of each year with no principal payment due until the final installment. The spot rate on January 1, 1992, is £1 = \$1.50. On January 1, 1993, when the spot rate is £1 = \$1.60, K enters into a currency swap contract with an unrelated counterparty under the terms of which K will exchange dollars for pounds pursuant to the following table in order to obtain the pounds necessary to make the remaining payments on the pound borrowing:

Date	U.S. dollars	Pounds
December 31, 1993	12.80	10
December 31, 1994	12.80	10
December 31, 1994	160.00	100

(ii) Assume that British pound interest rates are still 10% and that K properly identifies the pound borrowing and the currency swap contract as a qualified hedging transaction as provided in paragraph (a)(8) of this

section. Under paragraph (a)(6)(i) of this section, K must realize exchange gain or loss with respect to the pound borrowing determined solely by reference to changes in exchange rates between January 1, 1992 and January 1, 1993. (Thus, gain or loss from other factors such as movements in interest rates or changes in credit quality of K are not taken into account). Recognition of such gain or loss is deferred until K terminates its pound borrowing. Accordingly, K must defer exchange loss in the amount of \$10 [(\$100×1.50)−(£100×1.60)].

(iii) Additionally, the qualified hedging transaction is treated as a synthetic U.S. dollar debt instrument with an issue date of January 1, 1993, and a maturity date of December 31, 1994. The issue price of the synthetic debt instrument is \$160 (£100×1.60, the spot rate on January 1, 1993) and the total amount of interest and principal is \$185.60. The accrual period is the one year period beginning on January 1 and ending December 31 of each year. The stated redemption price at maturity is \$160. Thus, K is treated as paying \$12.80 of interest in 1993, \$12.80 of interest in 1994, and \$160 of principal in 1994. The interest expense from the synthetic instrument is allocated and apportioned in accordance with the rules of §§ 1.861-8T through 1.861-12T. Sections 263(g), 1092, and 1256 do not apply to the positions comprising the synthetic dollar borrowing.

Example 4. (i) K is an accrual method U.S. corporation with the U.S. dollar as its functional currency. On January 1, 1990, K borrows 100 British pounds (£) for 3 years at a 10% rate of interest payable on December 31 of each year with no principal payment due until the final installment. The spot rate on January 1, 1990, is £1 = \$1.50. Also on January 1, 1990, K enters into a currency swap contract with an unrelated counterparty under the terms of which K will exchange dollars for pounds pursuant to the following table in order to obtain the pounds necessary to make the remaining payments on the pound borrowing:

Date	U.S. dollars	Pounds
December 31, 1990	12.00	10
December 31, 1991	12.00	10
December 31, 1992	162.00	110

(ii) Assume that K properly identifies the pound borrowing and the currency swap contract as a qualified hedging transaction as provided in paragraph (a)(1) of this section.

(iii) The pound borrowing (which constitutes a qualifying debt instrument under paragraph (a)(3) of this section) and the currency swap contract (which constitutes a hedge under paragraph (a)(4) of this section) are a qualified hedging transaction as defined in paragraph (a)(1) of this section. Accordingly, the pound borrowing and the swap

Internal Revenue Service, Treasury

§ 1.988-5

are integrated and treated as one transaction with the following consequences:

(A) The integration of the pound borrowing and the swap results in a synthetic dollar borrowing with an issue price of \$150 under section 1273(b)(2).

(B) The total amount of interest and principal of the synthetic dollar borrowing is equal to the dollar payments made by K under the currency swap contract (i.e., \$12 in 1990, \$12 in 1991, and \$162 in 1992).

(C) The stated redemption price at maturity (defined in section 1273(a)(2)) is \$150. Because the stated redemption price equals the issue price, there is no OID on the synthetic dollar borrowing.

(D) K may deduct the annual interest payments of \$12 under section 163(a) (subject to any limitations on deductibility imposed by other provisions of the Code) according to its regular method of accounting. K has also paid \$150 as a return of principal in 1992.

(E) K must allocate and apportion its interest expense from the synthetic instrument under the rules of §§1.861-8T through 1.861-12T.

(iv) Assume that on January 1, 1991, the spot exchange rate is £1 = \$1.60, interest rates have not changed since January 1, 1990, (accordingly, assume that the market value of K's bond in pounds has not changed) and that K transfers its rights and obligations under the currency swap contract in exchange for \$10. Under §1.988-2(e)(3)(iii), K will include in income as exchange gain \$10 on January 1, 1991. Pursuant to paragraph (a)(6)(ii) of this section, the pound borrowing and the currency swap contract are treated as a qualified hedging transaction for 1990. The loss inherent in the pound borrowing from January 1, 1990, to January 1, 1991, is realized and recognized on January 1, 1991. Such loss is exchange loss in the amount of \$10.00 [(\$100×\$1.50, the spot rate on January 1, 1990)—(£100×\$1.60, the spot rate on January 1, 1991)]. For purposes of determining exchange gain or loss on the £100 principal amount of the debt instrument for the period January 1, 1991, to December 31, 1992, the spot rate on January 1, 1991 is used rather than the spot rate on the issue date. Thus, assuming that the spot rate on December 31, 1992, the maturity date, is £1 = \$1.80, K realizes exchange loss in the amount of \$20 [(\$100×\$1.60) - (£100×\$1.80)]. Except as provided in paragraph (a)(8)(iii) (regarding identification by the Commissioner), the pound borrowing cannot be part of a qualified hedging transaction for any period subsequent to the leg out date.

Example 5. (i) K, a U.S. corporation, has the U.S. dollar as its functional currency. On January 1, 1990, when the spot rate for Swiss francs (Sf) is Sf1 = \$.50, K converts \$100 to Sf200 and purchases a franc denominated debt instrument. The instrument has a term of 3 years, an adjusted issue price of Sf200,

and will bear interest at 5 percent, payable annually, with no repayment of principal until the final installment. The U.S. dollar interest rate on an equivalent instrument is 8% on January 1, 1990, compounded annually. On January 1, 1990, K also enters into a series of forward contracts to sell the franc interest and principal payments that will be received under the terms of the franc denominated debt instrument for dollars according to the following schedule:

Date	U.S. dollars	Francs
December 31, 1990	5.14	10
December 31, 1991	5.29	10
December 31, 1992	114.26	210

(i) Assume K satisfies the identification requirements of paragraph (a)(8) of this section. Assume further that on January 1, 1991, the spot exchange rate is Sf1 = U.S.\$143, the U.S. dollar interest rate is 10%, compounded annually, and the Swiss franc interest rate is the same as on January 1, 1990 (5%, compounded annually). On January 1, 1991, K disposes of the forward contracts that were to mature on December 31, 1991, and December 31, 1992 and incurs a loss of \$3.62 (the present value of \$.10 with respect to the 1991 contract and \$4.27 with respect to the 1992 contract).

(iii) The purchase of the franc debt instrument (which constitutes a qualifying debt instrument under paragraph (a)(3) of this section) and the series of forward contracts (which constitute a hedge under paragraph (a)(4) of this section) are a qualified hedging transaction under paragraph (a)(1) of this section. Accordingly, the franc debt instrument and all the forward contracts are integrated for the period beginning January 1, 1990, and ending January 1, 1991.

(A) The integration of the franc debt instrument and the forward contracts results in a synthetic dollar debt instrument with an issue price of \$100.

(B) The total amount of interest and principal to be received by K with respect to the synthetic dollar debt instrument is equal to the dollars to be received under the forward sales contracts (i.e., \$5.14 in 1990, \$5.29 in 1991, and \$114.26 in 1992).

(C) The synthetic dollar debt instrument is an installment obligation and its stated redemption price at maturity is \$109.27 (i.e., \$5.14 of the payments in 1990, 1991, and 1992 is treated as periodic interest payments under the principles of section 1273). Because the stated redemption price at maturity exceeds the issue price, under section 1273(a)(1) the synthetic dollar debt instrument has OID of \$9.27.

(D) The yield to maturity of the synthetic dollar debt instrument is 8.00 percent, compounded annually. Assuming K is a calendar year taxpayer, it must include interest income of \$8.00 in 1990 (of which \$2.86 constitutes OID).

(E) The source of the interest income is determined by applying sections 861(a)(1) and 862(a)(1) with reference to the franc interest income that would have been received had the transaction not been integrated.

(iv) Because K disposed of the forward contracts on January 1, 1991, the rules of paragraph (a)(6)(ii) of this section shall apply. Accordingly, the \$3.62 loss from the disposition of the forward contracts is realized and recognized on January 1, 1991. Additionally, K is deemed to have sold the franc debt instrument for \$102.86, its fair market value in dollars on January 1, 1991. K will compute gain or loss with respect to the deemed sale of the franc debt instrument by subtracting its adjusted basis in the instrument (\$102.86—the value of the \$200 issue price at the spot rate on the identification date plus \$2.86 of original issue discount accrued on the synthetic dollar debt instrument for 1990) from the amount realized on the deemed sale of \$102.86. Thus K realizes and recognizes no gain or loss from the deemed sale of the debt instrument. The dollar amount used to determine exchange gain or loss with respect to the franc debt instrument is the \$200 issue price on January 1, 1991, translated into dollars at the spot rate on January 1, 1991, of \$1 = U.S.\$5143. Except as provided in paragraph (a)(8)(iii) of this section (regarding identification by the Commissioner), the franc borrowing cannot be part of a qualified hedging transaction for any period subsequent to the leg out date.

Example 6. (i) K is a U.S. corporation with the dollar as its functional currency. On January 1, 1992, K issues a debt instrument with the following terms: the issue price is \$1,000, the instrument pays interest annually at a rate of 8% on the \$1,000 principal amount, the instrument matures on December 31, 1996, and the amount paid at maturity is the greater of zero or \$2,000 less the U.S. dollar value (determined on December 31, 1996) of 150,000 Japanese yen.

(ii) Also on January 1, 1992, K enters into the following hedges with respect to the instrument described in the preceding paragraph: a forward contract under which K will sell 150,000 yen for \$1,000 on December 31, 1996 (note that this forward rate assumes that interest rates in yen and dollars are equal); and an option contract that expires on December 31, 1996, under which K has the right (but not the obligation) to acquire 150,000 yen for \$2,000. K will pay for the option by making payments to the writer of the option equal to \$5 each December 31 from 1992 through 1996.

(iii) The net economic effect of these transactions is that K has created a liability with a principal amount and amount paid at maturity of \$1,000, with an interest cost of 8.5% (8% on debt instrument, 0.5% option price) compounded annually. For example, if on December 31, 1996, the spot exchange rate is

\$1 = 100 yen, K pays \$500 on the bond [\$2,000 – (150,000 yen/\$100)], and \$500 in satisfaction of the forward contract [\$1,000 – (150,000 yen/\$100)]. If instead the spot exchange rate on December 31, 1996 is \$1 = 200 yen, K pays \$1,250 on the bond [\$2,000 – (150,000 yen/\$200)] and K receives \$250 in satisfaction of the forward contract [\$1,000 – (150,000 yen/\$200)]. Finally, if the spot exchange rate on December 31, 1996 is \$1 = 50 yen, K pays \$0 on the bond [\$2,000 – (150,000 yen/\$50)], but the bond holder is not required under the terms of the instrument to pay additional principal; K exercises the option to buy 150,000 yen for \$2,000; and K then delivers the 150,000 yen as required by the forward contract in exchange for \$1,000.

(iv) Assume K satisfies the identification requirements of paragraph (a)(8) of this section. The debt instrument described in paragraph (i) of this *Example 6* (which constitutes a qualifying debt instrument under paragraph (a)(3) of this section) and the forward contract and option contract described in paragraph (ii) of this example (which constitute a hedge under paragraph (a)(4) of this section and are collectively referred to hereafter as “the contracts”) together are a qualified hedging transaction under paragraph (a)(1) of this section. Accordingly, with respect to K, the debt instrument and the contracts are integrated, resulting in a synthetic dollar debt instrument with an issue price of \$1000, a stated redemption price at maturity of \$1000 and a yield to maturity of 8.5% compounded annually (with no original issue discount). K must allocate and apportion its annual interest expense of \$85 under the rules of §§ 1.861-8T through 1.861-12T.

Example 7. (i) R is a U.S. corporation with the dollar as its functional currency. On January 1, 1995, R issues a debt instrument with the following terms: the issue price is 504 British pounds (£), the instrument pays interest at a rate of 3.7% (compounded semi-annually) on the £504 principal amount, the instrument matures on December 31, 1999, with a repayment at maturity of the £504 principal plus the proportional gain, if any, in the “Financial Times” 100 Stock Exchange (FTSE) index (determined by the excess of the value of the FTSE index on the maturity date over the value of the FTSE on the issue date, divided by the value of the FTSE index on the issue date, multiplied by the number of FTSE index contracts that could be purchased on the issue date for £504).

(ii) Also on January 1, 1995, R enters into a contract with a bank under which on January 1, 1995, R will swap the £504 for \$1,000 (at the current spot rate). R will make U.S. dollar payments to the bank equal to 8.15% on the notional principal amount of \$1,000 (compounded semi-annually) for the period beginning January 1, 1995 and ending December 31,

1999. R will receive pound payments from the bank equal to 3.7% on the notional principal amount of £504 (compounded semi-annually) for the period beginning January 1, 1995 and ending December 31, 1999. On December 31, 1999, R will swap with the bank \$1,000 for £504 plus the proportional gain, if any, in the FTSE index (computed as provided above).

(iii) Economically, both the indexed debt instrument and the hedging contract are hybrid instruments with the following components. The indexed debt instrument is composed of a par pound debt instrument that is assumed to have a 10.85% coupon (compounded semi-annually) plus an embedded FTSE equity index option for which the investor pays a premium of 7.15% (amortized semi-annually) on the pound principal amount. The combined effect is that the premium paid by the investor partially offsets the coupon payments resulting in a return of 3.7% (10.85% - 7.15%). Similarly, the dollar payments under the hedging contract to be made by R are computed by multiplying the dollar notional principal amount by an 8.00% rate (compounded semi-annually) which the facts assume would be the rate paid on a conventional currency swap plus a premium of 0.15% (amortized semi-annually) on the dollar notional principal amount for an embedded FTSE equity index option.

(iv) Assume R satisfies the identification requirements of paragraph (a)(8) of this section. The indexed debt instrument described in paragraph (i) of this *Example 7* constitutes a qualifying debt instrument under paragraph (a)(3) of this section. The hedging contract described in paragraph (ii) of this *Example 7* constitutes a hedge under paragraph (a)(4) of this section. Since both the pound exposure of the indexed debt instrument and the exposure to movements of the FTSE embedded in the indexed debt instrument are hedged such that a yield to maturity can be determined in dollars, the transaction satisfies the requirement of paragraph (a)(5)(i) of this section. Assuming the transactions satisfy the other requirements of paragraph (a)(5) of this section, the indexed debt instrument and hedge are a qualified hedging transaction under paragraph (a)(1) of this section. Accordingly, with respect to R, the debt instrument and the contracts are integrated, resulting in a synthetic dollar debt instrument with an issue price of \$1000, a stated redemption price at maturity of \$1000 and a yield to maturity of 8.15% compounded semi-annually (with no original issue discount). K must allocate and apportion its interest expense from the synthetic instrument under the rules §§1.861-8T through 1.861-12T.

Example 8. (i) K is a U.S. corporation with the U.S. dollar as its functional currency. On December 24, 1992, K agrees to close the following transaction on December 31, 1992. K will borrow from an unrelated party on De-

ember 31, 1992, 200 British pounds (£) for 3 years at a 10 percent rate of interest, payable annually, with no principal payment due until the final installment. K will also enter into a currency swap contract with an unrelated counterparty under the terms of which—

(A) K will swap, on December 31, 1992, £100 obtained from the borrowing for \$100; and

(B) K will exchange dollars for pounds pursuant to the following table:

Date	U.S. dollars	Pounds
December 31, 1993	8	10
December 31, 1994	8	10
December 31, 1995	108	110

(ii) The interest rate on the borrowing is set and the exchange rates on the swap are fixed on December 24, 1992. On December 31, 1992, K borrows the £200 and swaps £100 for \$100. Assume K has satisfied the identification requirements of paragraph (a)(8) of this section.

(iii) The £200 debt instrument satisfies the requirements of paragraph (a)(3)(i) of this section. Because all principal and interest payments under the instrument are hedged in the same proportion (50% of all interest and principal payments are hedged), 50% of the payments under the £200 instrument (principal amount of £100 and annual interest of £10) are treated as a qualifying debt instrument for purposes of paragraph (a) of this section. Thus, the distinct £100 borrowing and the currency swap contract (which constitutes a hedge under paragraph (a)(4) of this section) are a qualified hedging transaction as defined in paragraph (a)(1) of this section. Accordingly, £100 of the pound borrowing and the swap are integrated and treated as one synthetic dollar transaction with the following consequences:

(A) The integration of £100 of the pound borrowing and the swap results in a synthetic dollar borrowing with an issue price of \$100 under section 1273(b)(2).

(B) The total amount of interest and principal of the synthetic dollar borrowing is equal to the dollar payments made by K under the currency swap contract (i.e., \$8 in 1993, \$8 in 1994, and \$108 in 1995).

(C) The stated redemption price at maturity (defined in section 1273(a)(2)) is \$100. Because the stated redemption price equals the issue price, there is no OID on the synthetic dollar borrowing.

(D) K may deduct the annual interest payments of \$8 under section 163(a) (subject to any limitations on deductibility imposed by other provisions of the Code) according to its regular method of accounting. K has also paid \$100 as a return of principal in 1995.

(E) K must allocate and apportion its interest expense from the synthetic instrument under the rules of §§1.861-8T through 1.861-12T.

§ 1.988-5

26 CFR Ch. I (4-1-02 Edition)

That portion of the £200 pound debt instrument that is not hedged (*i.e.*, £100) is treated as a separate debt instrument subject to the rules of § 1.988-2 (b) and §§ 1.861-8T through 1.861-12T.

Example 9. (i) K is an accrual method U.S. corporation with the U.S. dollar as its functional currency. On January 1, 1992, K borrows 100 British pounds (£) for 3 years at a 10% rate of interest payable on December 31 of each year with no principal payment due until the final installment. On the same day, K enters into a currency swap agreement with an unrelated bank under which K agrees to the following:

(A) On January 1, 1992, K will exchange the £100 borrowed for \$150.

(B) For the period beginning January 1, 1992 and ending December 31, 1994, K will pay at the end of each month an amount determined by multiplying \$150 by one month LIBOR less 65 basis points and receive from the bank on December 31st of 1992, 1993, and 1994, £10.

(C) On December 31, 1994, K will exchange \$150 for £100.

Assume K satisfies the identification requirements of paragraph (a)(8) of this section.

(ii) The pound borrowing (which constitutes a qualifying debt instrument under paragraph (a)(3) of this section) and the currency swap contract (which constitutes a hedge under paragraph (a)(4) of this section) are a qualified hedging transaction as defined in paragraph (a)(1) of this section. Accordingly, the pound borrowing and the swap are integrated and treated as one transaction with the following consequences:

(A) The integration of the pound borrowing and the swap results in a synthetic dollar borrowing with an issue price of \$150 under section 1273(b)(2).

(B) The total amount of interest and principal of the synthetic dollar borrowing is equal to the dollar payments made by K under the currency swap contract.

(C) The stated redemption price at maturity (defined in section 1273(a)(2)) is \$150. Because the stated redemption price equals the issue price, there is no OID on the synthetic dollar borrowing.

(D) K may deduct the monthly variable interest payments under section 163(a) (subject to any limitations on deductibility imposed by other provisions of the Code) according to its regular method of accounting. K has also paid \$150 as a return of principal in 1994.

(E) K must allocate and apportion its interest expense from the synthetic instrument under the rules of §§ 1.861-8T through 1.861-12T.

Example 10. (i) K is an accrual method U.S. corporation with the U.S. dollar as its functional currency. On January 1, 1992, K loans 100 British pounds (£) for 3 years at a 10%

rate of interest payable on December 31 of each year with no principal payment due until the final installment. The spot rate on January 1, 1992, is £1 = \$1.50. Also on January 1, 1992, K enters into a currency swap contract with an unrelated counterparty under the terms of which K will exchange pounds for dollars pursuant to the following table:

Date	Pounds	Dollars
December 31, 1992	10	12
December 31, 1993	10	12
December 31, 1994	110	162

(ii) Assume that K properly identifies the pound borrowing and the currency swap contract as a qualified hedging transaction as provided in paragraph (a)(1) of this section.

(iii) The pound loan (which constitutes a qualifying debt instrument under paragraph (a)(3) of this section) and the currency swap contract (which constitutes a hedge under paragraph (a)(4) of this section) are a qualified hedging transaction as defined in paragraph (a)(1) of this section. Accordingly, the pound loan and the swap are integrated and treated as one transaction with the following consequences:

(A) The integration of the pound loan and the swap results in a synthetic dollar loan with an issue price of \$150 under section 1273(b)(2).

(B) The total amount of interest and principal of the synthetic dollar loan is equal to the dollar payments received by K under the currency swap contract (*i.e.*, \$12 in 1992, \$12 in 1993, and \$162 in 1994).

(C) The stated redemption price at maturity (defined in section 1273(a)(2)) is \$150. Because the stated redemption price equals the issue price, there is no OID on the synthetic dollar loan.

(D) K must include in income as interest \$12 in 1992, 1993, and 1994.

(E) The source of the interest income shall be determined by applying sections 861(a)(1) and 862(a)(1) with reference to the pound interest income that would have been received had the transaction not been integrated.

(iv) On January 1, 1993, K transfers both the pound loan and the currency swap to B, its wholly owned U.S. subsidiary, in exchange for B stock in a transfer that satisfies the requirements of section 351. Under paragraph (a)(6) of this section, the transfer of both instruments is not "legging out." Rather, K is considered to have transferred the synthetic dollar loan to B in a transaction in which gain or loss is not recognized. B's basis in the loan under section 362 is \$100.

(10) *Transition rules and effective dates for certain provisions—(i) Coordination with Notice 87-11.* Any transaction entered into prior to September 21, 1989,

which satisfied the requirements of Notice 87-11, 1987-1 C.B. 423, shall be deemed to satisfy the requirements of paragraph (a) of this section.

(ii) *Prospective application to contingent payment debt instruments.* In the case of a contingent payment debt instrument, the definition of qualifying debt instrument set forth in paragraph (a)(3)(i) of this section applies to transactions entered into after March 17, 1992.

(iii) *Prospective application of partial hedging rule.* Paragraph (a)(3)(ii) of this section is effective for transactions entered into after March 17, 1992.

(iv) *Effective date for paragraph (a)(6)(i) of this section.* The rules of paragraph (a)(6)(i) of this section are effective for qualified hedging transactions that are legged into after March 17, 1992.

(b) *Hedged executory contracts—(1) In general.* If the taxpayer enters into a hedged executory contract as defined in paragraph (b)(2) of this section, the executory contract and the hedge shall be integrated as provided in paragraph (b)(4) of this section.

(2) *Definitions—(i) Hedged executory contract.* A hedged executory contract is an executory contract as defined in paragraph (b)(2)(ii) of this section that is the subject of a hedge as defined in paragraph (b)(2)(iii) of this section, provided that the following requirements are satisfied—

(A) The executory contract and the hedge are identified as a hedged executory contract as provided in paragraph (b)(3) of this section.

(B) The hedge is entered into (*i.e.*, settled or closed, or in the case of nonfunctional currency deposited in an account with a bank or other financial institution, such currency is acquired and deposited) on or after the date the executory contract is entered into and before the accrual date as defined in paragraph (b)(2)(iv) of this section.

(C) The executory contract is hedged in whole or in part throughout the period beginning with the date the hedge is identified in accordance with paragraph (b)(3) of this section and ending on or after the accrual date.

(D) None of the parties to the hedge are related. The term related means

the relationships defined in section 267(b) and section 707(c)(1).

(E) In the case of a qualified business unit with a residence, as defined in section 988(a)(3)(B), outside of the United States, both the executory contract and the hedge are properly reflected on the books of the same qualified business unit.

(F) Subject to the limitations of paragraph (b)(2)(i)(E) of this section, both the executory contract and the hedge are entered into by the same individual, partnership, trust, estate, or corporation. With respect to a corporation, the same corporation must enter into both the executory contract and the hedge whether or not such corporation is a member of an affiliated group of corporations that files a consolidated return.

(G) With respect to a foreign person engaged in a U.S. trade or business that enters into an executory contract or hedge through such trade or business, all items of income and expense associated with the executory contract and the hedge would have been effectively connected with such U.S. trade or business throughout the term of the hedged executory contract had this paragraph (b) not applied.

(ii) *Executory contract—(A) In general.* Except as provided in paragraph (b)(2)(ii)(B) of this section, an executory contract is an agreement entered into before the accrual date to pay nonfunctional currency (or an amount determined with reference thereto) in the future with respect to the purchase of property used in the ordinary course of the taxpayer's business, or the acquisition of a service (or services), in the future, or to receive nonfunctional currency (or an amount determined with reference thereto) in the future with respect to the sale of property used or held for sale in the ordinary course of the taxpayer's business, or the performance of a service (or services), in the future. Notwithstanding the preceding sentence, a contract to buy or sell stock shall be considered an executory contract. (Thus, for example, a contract to sell stock of an affiliate

is an executory contract for this purpose.) On the accrual date, such agreement ceases to be considered an executory contract and is treated as an account payable or receivable.

(B) *Exceptions.* An executory contract does not include a section 988 transaction. For example, a forward contract to purchase nonfunctional currency is not an executory contract. An executory contract also does not include a transaction described in paragraph (c) of this section.

(C) *Effective date for contracts to buy or sell stock.* That part of paragraph (b)(2)(ii)(A) of this section which provides that a contract to buy or sell stock shall be considered an executory contract applies to contracts to buy or sell stock entered into on or after March 17, 1992.

(iii) *Hedge—(A) In general.* For purposes of this paragraph (b), the term hedge means a deposit of nonfunctional currency in a hedging account (as defined paragraph (b)(3)(iii)(D) of this section), a forward or futures contract described in § 1.988-1(a)(1)(ii) and (2)(iii), or combination thereof, which reduces the risk of exchange rate fluctuations by reference to the taxpayer's functional currency with respect to nonfunctional currency payments made or received under an executory contract. The term hedge also includes an option contract described in § 1.988-1(a)(1)(ii) and (2)(iii), but only if the option's expiration date is on or before the accrual date. The premium paid for an option that lapses shall be integrated with the executory contract.

(B) *Special rule for series of hedges.* A series of hedges as defined in paragraph (b)(3)(iii)(A) of this section shall be considered a hedge if the executory contract is hedged in whole or in part throughout the period beginning with the date the hedge is identified in accordance with paragraph (b)(3)(i) of this section and ending on or after the accrual date. A taxpayer that enters into a series of hedges will be deemed to have satisfied the preceding sentence if the hedge that succeeds a hedge that has been terminated is entered into no later than the business day following such termination.

(C) *Special rules for historical rate rollovers—(1) Definition.* A historical rate

rollover is an extension of the maturity date of a forward contract where the new forward rate is adjusted on the rollover date to reflect the taxpayer's gain or loss on the contract as of the rollover date plus the time value of such gain or loss through the new maturity date.

(2) *Certain historical rate rollovers considered a hedge.* A historical rate rollover is considered a hedge if the rollover date is before the accrual date.

(3) *Treatment of time value component of certain historical rate rollovers that are hedges.* Interest income or expense determined under § 1.988-2(d)(2)(v) with respect to a historical rate rollover shall be considered part of a hedge if the period beginning on the first date a hedging contract is rolled over and ending on the date payment is made or received under the executory contract does not exceed 183 days. Such interest income or expense shall not be recognized and shall be an adjustment to the income from, or expense of, the services performed or received under the executory contract, or to the amount realized or basis of the property sold or purchased under the executory contract. For the treatment of such interest income or expense that is not considered part of a hedge, see § 1.988-2(d)(2)(v).

(D) *Special rules regarding deposits of nonfunctional currency in a hedging account.* A hedging account is an account with a bank or other financial institution used exclusively for deposits of nonfunctional currency used to hedge executory contracts. For purposes of determining the basis of units in such account that comprise the hedge, only those units in the account as of the accrual date shall be taken into consideration. A taxpayer may adopt any reasonable convention (consistently applied to all hedging accounts) to determine which units comprise the hedge as of the accrual date and the basis of the units as of such date.

(E) *Interest income on deposit of nonfunctional currency in a hedging account.* Interest income on a deposit of nonfunctional currency in a hedging account may be taken into account for purposes of determining the amount of a hedge if such interest is accrued on or before the accrual date. However,

such interest income shall be included in income as provided in section 61. For example, if a taxpayer with the dollar as its functional currency enters into an executory contract for the purchase and delivery of a machine in one year for 100 British pounds (£), and on such date deposits £90.91 in a properly identified bank account that bears interest at the rate of 10%, the interest that accrues prior to the accrual date shall be included in income and may be considered a hedge.

(iv) *Accrual date.* The accrual date is the date when the item of income or expense (including a capital expenditure) that relates to an executory contract is required to be accrued under the taxpayer's method of accounting.

(v) *Payment date.* The payment date is the date when payment is made or received with respect to an executory contract or the subsequent corresponding account payable or receivable.

(3) *Identification rules—(i) Identification by the taxpayer.* A taxpayer must establish a record and before the close of the date the hedge is entered into, the taxpayer must enter into the record a clear description of the executory contract and the hedge and indicate that the transaction is being identified in accordance with paragraph (b)(3) of this section.

(ii) *Identification by the Commissioner.* If a taxpayer enters into an executory contract and a hedge but fails to satisfy one or more of the requirements of paragraph (b) of this section and, based on the facts and circumstances, the Commissioner concludes that the executory contract in substance is hedged, then the Commissioner may apply the provisions of paragraph (b) of this section as if the taxpayer had satisfied all of the requirements therein, and may make appropriate adjustments. The Commissioner may apply the provisions of paragraph (b) of this section regardless of whether the executory contract and the hedge are held by the same taxpayer.

(4) *Effect of hedged executory contract—(i) In general.* If a taxpayer enters into a hedged executory contract, amounts paid or received under the hedge by the taxpayer are treated as paid or received by the taxpayer under

the executory contract, or any subsequent account payable or receivable, or that portion to which the hedge relates. Also, the taxpayer recognizes no exchange gain or loss on the hedge. If an executory contract, on the accrual date, becomes an account payable or receivable, the taxpayer recognizes no exchange gain or loss on such payable or receivable for the period covered by the hedge.

(ii) *Partially hedged executory contracts.* The effect of integrating an executory contract and a hedge that partially hedges such contract is to treat the amounts paid or received under the hedge as paid or received under the portion of the executory contract being hedged, or any subsequent account payable or receivable. The income or expense of services performed or received under the executory contract, or the amount realized or basis of property sold or purchased under the executory contract, that is attributable to that portion of the executory contract that is not hedged shall be translated into functional currency on the accrual date. Exchange gain or loss shall be realized when payment is made or received with respect to any payable or receivable arising on the accrual date with respect to such unhedged amount.

(iii) *Disposition of a hedge or executory contract prior to the accrual date—(A) In general.* If a taxpayer identifies an executory contract as part of a hedged executory contract as defined in paragraph (b)(2) of this section, and disposes of (or otherwise terminates) the executory contract prior to the accrual date, the hedge shall be treated as sold for its fair market value on the date the executory contract is disposed of and any gain or loss shall be realized and recognized on such date. Such gain or loss shall be an adjustment to the amount received or expended with respect to the disposition or termination, if any. The spot rate on the date the hedge is treated as sold shall be used to determine subsequent exchange gain or loss on the hedge. If a taxpayer identifies a hedge as part of a hedged executory contract as defined in paragraph (b)(2) of this section, and disposes of the hedge prior to the accrual date, any gain or loss realized on such disposition shall not be recognized and

shall be an adjustment to the income from, or expense of, the services performed or received under the executory contract, or to the amount realized or basis of the property sold or purchased under the executory contract.

(B) *Certain events in a series of hedges treated as a termination of the hedged executory contract.* If the rules of paragraph (b)(2)(iii)(B) of this section are not satisfied, the hedged executory contract shall be terminated and the provisions of paragraph (b)(4)(iii)(A) of this section shall apply to any gain or loss previously realized with respect to such hedge. Any subsequent hedging contracts entered into to reduce the risk of exchange rate movements with respect to such executory contract shall not be considered a hedge as defined in paragraph (b)(2)(iii) of this section.

(C) *Executory contracts between related persons.* If an executory contract is between related persons as defined in sections 267(b) and 707(b), and the taxpayer disposes of the hedge or terminates the executory contract prior to the accrual date, the Commissioner may redetermine the timing, source, and character of gain or loss from the hedge or the executory contract if he determines that a significant purpose for disposing of the hedge or terminating the executory contract prior to the accrual date was to affect the timing, source, or character of income, gain, expense, or loss for Federal income tax purposes.

(iv) *Disposition of a hedge on or after the accrual date.* If a taxpayer identifies a hedge as part of a hedged executory contract as defined in paragraph (b)(2) of this section, and disposes of the hedge on or after the accrual date, no gain or loss is recognized on the hedge and the booking date as defined in § 1.988-2(c)(2) of the payable or receivable for purposes of computing exchange gain or loss shall be the date such hedge is disposed of. See *Example 3* of paragraph (b)(4)(iv) of this section.

(v) *Sections 263(g), 1092, and 1256 do not apply.* Sections 263(g), 1092, and 1256 do not apply with respect to an executory contract or hedge which comprise a hedged executory contract as defined in paragraph (b)(2) of this section. However, sections 263(g), 1092 and 1256 may

apply to the hedged executory contract if such transaction is part of a straddle.

(vi) *Examples.* The principles set forth in paragraph (b) of this section are illustrated in the following examples. The examples assume that K is an accrual method, calendar year U.S. corporation with the dollar as its functional currency.

Example 1. (i) On January 1, 1992, K enters into a contract with JPF, a Swiss machine manufacturer, to pay 500,000 Swiss francs for delivery of a machine on June 1, 1993. Also on January 1, 1992, K enters into a foreign currency forward agreement to purchase 500,000 Swiss francs for \$250,000 for delivery on June 1, 1993. K properly identifies the executory contract and the hedge in accordance with paragraph (b)(3)(i) of this section. On June 1, 1993, K takes delivery of the 500,000 Swiss francs (in exchange for \$250,000) under the forward contract and makes payment of 500,000 Swiss francs to JPF in exchange for the machine. Assume that the accrual date is June 1, 1993.

(ii) Under paragraph (b)(1) of this section, the hedge is integrated with the executory contract. Therefore, K is deemed to have paid \$250,000 for the machine and there is no exchange gain or loss on the foreign currency forward contract. K's basis in the machine is \$250,000. Section 1256 does not apply to the forward contract.

Example 2. (i) On January 1, 1992, K enters into a contract with S, a Swiss machine manufacturer, to pay 500,000 Swiss francs for delivery of a machine on June 1, 1993. Under the contract, K is not obligated to pay for the machine until September 1, 1993. On February 1, 1992, K enters into a foreign currency forward agreement to purchase 500,000 Swiss francs for \$250,000 for delivery on September 1, 1993. K properly identifies the executory contract and the hedge in accordance with paragraph (b)(3) of this section. On June 1, 1993, K takes delivery of machine. Assume that under K's method of accounting the delivery date is the accrual date. On September 1, 1993, K takes delivery of the 500,000 Swiss francs (in exchange for \$250,000) under the forward contract and makes payment of 500,000 Swiss francs to S.

(ii) Under paragraph (b)(1) of this section, the hedge is integrated with the executory contract. Therefore K is deemed to have paid \$250,000 for the machine and there is no exchange gain or loss on the foreign currency forward contract. Thus K's basis in the machine is \$250,000. In addition, no exchange gain or loss is recognized on the payable in existence from June 1, 1993, to September 1, 1993. Section 1256 does not apply to the forward contract.

Example 3. The facts are the same as in *Example 2* except that K disposed of the forward contract on August 1, 1993 for \$10,000. Pursuant to paragraph (b)(4)(iv) of this section, K does not recognize the \$10,000 gain. K's basis in the machine is \$250,000 (the amount fixed by the forward contract), regardless of the amount in dollars that K actually pays to acquire the Sf500,000 when K pays for the machine. K has a payable with a booking date of August 1, 1993, payable on September 1, 1993 for 500,000 Swiss francs. Thus, K will realize exchange gain or loss on the difference between the amount booked on August 1, 1993 and the amount paid on September 1, 1993 under § 1.988-2(c).

Example 4. (i) On January 1, 1992, K enters into a contract with S, a Swiss machine repair firm, to pay 500,000 Swiss francs for repairs to be performed on June 1, 1992. Under the contract, K is not obligated to pay for the repairs until September 1, 1992. On February 1, 1992, K enters into a foreign currency forward agreement to purchase 500,000 Swiss francs for \$250,000 for delivery on August 1, 1992. K properly identifies the executory contract and the hedge in accordance with paragraph (b)(3) of this section. On June 1, 1992, S performs the repair services. Assume that under K's method of accounting this date is the accrual date. On August 1, 1992, K takes delivery of the 500,000 Swiss francs (in exchange for \$250,000) under the forward contract. On the same day, K deposits the Sf500,000 in a separate account with a bank and properly identifies the transaction as a continuation of the hedged executory contract. On September 1, 1992, K makes payment of the Sf500,000 in the account to S.

(ii) Under paragraph (b)(1) of this section, the hedge is integrated with the executory contract. Therefore K is deemed to have paid \$250,000 for the services and there is no exchange gain or loss on the foreign currency forward contract or on the disposition of Sf500,000 in the account. Any interest on the Swiss francs in the account is included in income but is not considered part of the hedge (because the amount paid for the services must be set on or before the accrual date). In addition, no exchange gain or loss is recognized on the payable in existence from June 1, 1992, to September 1, 1992. Section 1256 does not apply to the forward contract.

Example 5. (i) On January 1, 1992, K enters into a contract with S, a Swiss machine manufacturer, to pay 500,000 Swiss francs for delivery of a machine on June 1, 1993. Under the contract, K is not obligated to pay for the machine until September 1, 1993. On February 1, 1992, K enters into a foreign currency forward agreement to purchase 250,000 Swiss francs for \$125,000 for delivery on September 1, 1993. K properly identifies the executory contract and the hedge in accordance with paragraph (b)(3) of this section. On June 1, 1993, K takes delivery of the machine. As-

sume that under K's method of accounting the delivery date is the accrual date. Assume further that the exchange rate is Sf1 = \$.50 on June 1, 1993. On August 30, 1993, K purchases Sf250,000 for \$135,000. On September 1, 1993, K takes delivery of the 250,000 Swiss francs (in exchange for \$125,000) under the forward contract and makes payment of 500,000 Swiss francs (the Sf250,000 received under the contract plus the Sf250,000 purchased on August 30, 1993) to S. Assume the spot rate on September 1, 1993, is 1 Sf = \$.5420 (Sf250,000 equal \$135,500).

(ii) Under paragraph (b)(1) of this section, the partial hedge is integrated with the executory contract. K is deemed to have paid \$250,000 for the machine [\$125,000 on the hedged portion of the Sf500,000 and \$125,000 (\$.50, the spot rate on June 1, 1993, times Sf250,000) on the unhedged portion of the Sf500,000]. K's basis in the machine therefore is \$250,000. K recognizes no exchange gain or loss on the foreign currency forward contract but K will realize exchange gain of \$500 on the disposition of the Sf250,000 purchased on August 30, 1993 under § 1.988-2(a). In addition, exchange loss is realized on the unhedged portion of the payable in existence from June 1, 1993, to September 1, 1993. Thus, K will realize exchange loss of \$10,500 (\$125,000 booked less \$135,500 paid) under § 1.988-2(c) on the payable. Section 1256 does not apply to the forward contract.

Example 6. (i) On January 1, 1990, K enters into a contract with S, a Swiss steel manufacturer, to buy steel for 1,000,000 Swiss francs (Sf) for delivery and payment on December 31, 1990. On January 1, 1990, the spot rate is Sf1 = \$.50, the U.S. dollar interest rate is 10% compounded annually, and the Swiss franc rate is 5% compounded annually. Under K's method of accounting, the delivery date is the accrual date.

(ii) Assume that on January 1, 1990, K enters into a foreign currency forward contract to buy Sf1,000,000 for \$523,800 for delivery on December 31, 1990. K properly identifies the executory contract and the hedge in accordance with paragraph (b)(3) of this section. Pursuant to paragraph (b)(2)(iii) of this section, the forward contract constitutes a hedge. Assuming that the requirements of paragraph (b)(2)(i) of this section are satisfied, the executory contract to buy steel and the forward contract are integrated under paragraph (b)(1) of this section. Thus, K is deemed to have paid \$523,800 for the steel and will have a basis in the steel of \$523,800. No gain or loss is realized with respect to the forward contract and section 1256 does not apply to such contract.

(iii) Assume instead that on January 1, 1990, K enters into a foreign currency forward contract to buy Sf1,000,000 for \$512,200 for delivery on July 1, 1990. K properly identifies the executory contract and the hedge in accordance with paragraph (b)(3) of this

section. On July 1, 1990, when the spot rate is Sfl = \$.53, K cancels the forward contract in exchange for \$17,800 (\$530,000 - \$512,200). On July 1, 1990, K enters into a second forward agreement to buy Sfl,000,000 for \$542,900 for delivery on December 31, 1990. K properly identifies the second forward agreement as a hedge in accordance with paragraph (b)(3) of this section. Pursuant to paragraph (b)(2)(iii) of this section, the forward contract entered into on January 1, 1990, and the forward contract entered into on July 1, 1990, constitute a hedge. Assuming that the requirements of paragraph (b)(2)(i) of this section are satisfied, the executory contract to buy steel and the forward agreements are integrated under paragraph (b)(1) of this section. Thus, K is deemed to have paid \$525,100 for the steel (the forward price in the second forward agreement of \$542,900 less the gain on the first forward agreement of \$17,800) and will have a basis in the steel of \$525,100. No gain is realized with respect to the forward contracts and section 1256 does not apply to such contracts.

(iv) Assume instead that on January 1, 1990, K enters into a foreign currency forward contract to buy Sfl,000,000 for \$512,200 for delivery on July 1, 1990. K properly identifies the executory contract and the hedge in accordance with paragraph (b)(3) of this section. On July 1, 1990, when the spot rate is Sfl = \$.53, K enters into a historical rate rollover of its \$17,800 gain (\$530,000 - \$512,200) on the forward agreement. Thus, K enters into a second foreign currency forward agreement to buy Sfl,000,000 for \$524,210 for delivery on December 31, 1990. (The forward price of \$524,210 is the market forward price on July 1, 1990, for the purchase of Sfl,000,000 for delivery on December 31, 1990, of \$542,900 less the \$17,800 gain on January 1, 1990, contract and less the time value of such gain of \$890.) K properly identifies the second forward agreement as a hedge in accordance with paragraph (b)(3) of this section. On December 31, 1990, when the spot rate is Sfl = \$.54, K takes delivery of the Sfl,000,000 (in exchange for \$524,210) and purchases the steel for Sfl,000,000. Pursuant to paragraph (b)(2)(iii) of this section, the forward contract entered into on January 1, 1990, and the forward contract entered into on July 1, 1990, which incorporates the rollover of K's gain on the January 1, 1990, contract, constitute a hedge. Assuming that the requirements of paragraph (b)(2)(i) of this section are satisfied, the executory contract to buy steel and the forward agreements are integrated under paragraph (b)(1) of this section. Because the period from the rollover date to the date payment is made under the executory contract does not exceed 183 days, the \$890 of interest income is considered part of the hedge and is not recognized. Thus, K is deemed to have paid \$524,210 for the steel and will have a basis in the steel of \$524,210. No gain is re-

alized with respect to the forward contracts and section 1256 does not apply to such contracts.

(v) Assume instead that on January 1, 1990, K purchases Sf952,380.95 (the present value of Sfl,000,000 to be paid on December 31, 1990) for \$476,190.48 and on the same day deposits the Swiss francs in a separate bank account that bears interest at a rate of 5%, compounded annually. K properly identifies the transaction as a hedged executory contract. Over the period beginning January 1, 1990, and ending December 31, 1990, K receives Sf47,619.05 in interest on the account that is included in income and that has a basis of \$25,714.29. (Assume that under § 1.988-2(b)(1), K uses the spot rate of Sfl = \$.54 to translate the interest income). On December 31, 1990, K makes payment of the Sfl,000,000 principal and accrued interest in the account to S. Pursuant to paragraph (b)(2)(iii) of this section, the principal in the bank account and the interest constitute a hedge. Under paragraph (b)(1) of this section, the hedge is integrated with the executory contract. Therefore K is deemed to have paid \$501,904.77 (the basis of the principal deposited plus the basis of the interest) for the steel and there is no exchange gain or loss on the disposition of the Sfl,000,000. K's basis in the steel therefore is \$501,904.77.

(5) *References to this paragraph (b).* If the rules of this paragraph (b) are referred to in another paragraph of this section (e.g., paragraph (c) of this section), then the rules of this paragraph (b) shall be applied for purposes of such other paragraph by substituting terms appropriate for such other paragraph. For example, paragraph (c)(2) of this section refers to the identification rules of paragraph (b)(3) of this section. Accordingly, for purposes of paragraph (c)(2), the rules of paragraph (b)(3) will be applied by substituting the term "stock or security" for "executory contract".

(c) *Hedges of period between trade date and settlement date on purchase or sale of publicly traded stock or security.* If a taxpayer purchases or sells stocks or securities which are traded on an established securities market and—

(1) Hedges all or part of such purchase or sale for any part of the period beginning on the trade date and ending on the settlement date; and

(2) Identifies the hedge and the underlying stock or securities as an integrated transaction under the rules of paragraph (b)(3) of this section;

then any gain or loss on the hedge shall be an adjustment to the amount realized or the adjusted basis of the stock or securities sold or purchased (and shall not be taken into account as exchange gain or loss). The term hedge means a deposit of nonfunctional currency in a hedging account (within the meaning of paragraph (b)(2)(iii)(D) of this section), or a forward or futures contract described in §1.988-1(a)(1)(ii) and (2)(iii), or combination thereof, which reduces the risk of exchange rate fluctuations for any portion of the period beginning on the trade date and ending on the settlement date. The provisions of paragraphs (b)(2)(i)(D) through (G), and (b)(2)(iii)(D) and (E) of this section shall apply. Sections 263(g), 1092, and 1256 do not apply with respect to stock or securities and a hedge which are subject to this paragraph (c).

(d) [Reserved]

(e) *Advance rulings regarding net hedging and anticipatory hedging systems.* In his sole discretion, the Commissioner may issue an advance ruling addressing the income tax consequences of a taxpayer's system of hedging either its net nonfunctional currency exposure or anticipated nonfunctional currency exposure. The ruling may address the character, source, and timing of both the section 988 transaction(s) making up the hedge and the underlying transactions being hedged. The procedures for obtaining a ruling shall be governed by such pertinent revenue procedures and revenue rulings as the Commissioner may provide. The Commissioner will not issue a ruling regarding hedges of a taxpayer's investment in a foreign subsidiary.

(f) [Reserved]

(g) *General effective date.* Except as otherwise provided in this section, the rules of this section shall apply to qualified hedging transactions, hedged executory contracts and transactions described in paragraph (c) of this section entered into on or after September 21, 1989. This section shall apply even if the transaction being hedged (*e.g.*, the debt instrument) was entered into or acquired prior to such date. The effective date regarding advance rulings for net and anticipatory hedging shall be

governed by such revenue procedures that the Commissioner may publish.

[T.D. 8400, 57 FR 9199, Mar. 17, 1992]

§ 1.989(a)-1 Definition of a qualified business unit.

(a) *Applicability*—(1) *In general.* This section provides rules relating to the definition of the term “qualified business unit” (QBU) within the meaning of section 989.

(2) *Effective date.* These rules shall apply to taxable years beginning after December 31, 1986. However, any person may apply on a consistent basis §1.989(a)-1T (c) of the Temporary Income Tax Regulations in lieu of §1.989(a)-1 (c) to all taxable years beginning after December 31, 1986, and on or before February 5, 1990. For the text of the temporary regulation, see 53 FR 20612 (June 8, 1988).

(b) *Definition of a qualified business unit*—(1) *In general.* A QBU is any separate and clearly identified unit of a trade or business of a taxpayer provided that separate books and records are maintained.

(2) *Application of the QBU definition*—(i) *Persons.* A corporation is QBU. An individual is not a QBU. A partnership, trust, or estate is a QBU of a partner or beneficiary.

(ii) *Activities.* Activities of a corporation, partnership, trust, estate, or individual qualify as a QBU if—

(A) The activities constitute a trade or business; and

(B) A separate set of books and records is maintained with respect to the activities.

(3) *Special rule.* Any activity (whenever conducted and regardless of its frequency) that produces income or loss that is, or is treated as, effectively connected with the conduct of a trade or business within the United States shall be treated as a separate QBU, provided the books and records requirement of paragraph (d)(2) of this section is satisfied.

(c) *Trade or business.* The determination as to whether activities constitute a trade or business is ultimately dependent upon an examination of all the facts and circumstances. Generally, a trade or business for purposes of section 989(a) is a specific unified group of activities that constitutes (or could