Fox Horan & Camerini

Tax Update

IRS Issues Proposed Guidance Regarding

Foreign Currency Gains and Losses in CFC Income

The Treasury Department and the Internal Revenue Service (IRS) have proposed modifications and revisions to certain regulations related to Controlled Foreign Corporations (CFCs) and foreign currency transactions. These proposals address issues raised by practitioners regarding the inconsistencies in the procedures for making elections under §1.954-2(g) and the potential for opportunistic tax planning under §1.988-7. This summary will discuss key provisions of the proposed regulations.

I. Proposed Modifications to §1.954-2(g)

Background and Issues Addressed

The §1.954-2(g) regulations govern the treatment of certain income of CFCs and the elections that U.S. shareholders can make regarding this income. Practitioners have raised concerns about the inconsistency of these regulations with other filing requirements related to CFCs. Specifically, the language in §1.954-2(g)(3)(ii) differs from other regulations, which generally require that elections be filed by U.S. shareholders for the taxable year of the CFC that ends within the taxable year of the U.S. shareholders.

Additionally, practitioners noted that the current regulations could lead to inconsistencies in treatment between controlling U.S. shareholders with matching taxable years and those with differing or short taxable years. This discrepancy can prevent certain shareholders from making §1.954-2(g) elections if no year of the controlling U.S. shareholder ends within the CFC's short year.

Proposed Revisions

To address these issues, the proposed regulations would revise §1.954-2(g)(3)(ii) to align with other CFC-related filing requirements. Under the revised rule, controlling U.S. shareholders would make a §1.954-2(g) election by filing a statement with their original income tax returns for the taxable years in which the CFC's taxable year ends. This change ensures that all controlling U.S. shareholders, regardless of their taxable year, can make the election.

Additionally, the proposed regulations withdraw the 2017 proposed versions of §1.954-2(g)(3)(iii) and (g)(4)(iii) and re-propose them with new provisions. These provisions would require controlling U.S. shareholders to file a statement revoking a §1.954-2(g) election for the CFC's taxable year in which the revocation is made. Importantly, the proposed regulations introduce a new restriction: shareholders would be precluded from revoking a §1.954-2(g) election until the sixth taxable year following the election. Similarly, after revoking an election, shareholders would not be able to make a new election until the sixth taxable year following the revocation. This change aims to limit the ability of taxpayers to selectively recognize certain foreign currency losses, thereby preventing opportunistic tax planning.

II. Proposed Amendments to §1.988-7

Background and Issues Addressed

The §1.988-7 regulations pertain to the treatment of foreign currency gains and losses for certain taxpayers. In the view of the IRS and the Treasury Department, the 2017 proposed regulations allowed excessive flexibility in making and revoking elections under §1.988-7. For instance, taxpayers could make an election after the end of the year, allowing them to decide whether the election would be beneficial after knowing the year's foreign currency losses or gains.

Proposed Revisions

The Treasury Department and the IRS have reconsidered the 2017 proposed regulations and, in light of comments received, propose to align §1.988-7 with the rules for making and revoking elections under section 475(e) or (f) (which governs mark-to-market accounting methods for traders and dealers in securities or commodities). The revised rules would require taxpayers to make a §1.988-7 election on the tax return for the year immediately preceding the year to which the election applies, similar to a section 475 election. Once made, the election would apply to all subsequent years, and revocation would require the Commissioner's consent.

These changes are intended to deter selective recognition of losses, ensure consistency in tax reporting, and promote compliance by providing a standardized procedure for making or revoking elections. The proposed regulations would also require that a method of accounting change under §1.988-7 must be approved by the Commissioner.

III. Other Changes

The proposed regulations include several nonsubstantive changes to improve clarity and consistency. For example, the cross-references in §1.954-2(g) are updated to more precisely reference the definition of controlling U.S. shareholders with respect to CFCs. Additionally, the proposed regulations clarify that a §1.954-2(g) election must be made on a timely-filed, original Federal income tax return, aligning this requirement with the proposed §1.988-7 elections.

IV. Applicability Dates

The proposed regulations are intended to apply to taxable years ending on or after the date they are finalized and published in the Federal Register. However, taxpayers may rely on the proposed regulations for earlier taxable years if they consistently apply the provisions to those years.

For §1.954 regulations, taxpayers may rely on the proposed §1.954-2(g)(3)(ii) and the re-proposed §1.954-2(g)(3)(iii) and (g)(4)(iii) for taxable years ending before the finalization date, provided they consistently apply these provisions. Similarly, taxpayers may rely on the proposed §1.988-7(c) and (d) for taxable years ending before the finalization date, subject to consistent application.

Conclusion

The proposed modifications to §1.954-2(g) and §1.988-7 regulations represent an attempt by the Treasury Department and the IRS to improve the consistency and fairness of tax reporting for U.S. shareholders of CFCs and taxpayers engaged in foreign currency transactions, by addressing issues raised by practitioners and aligning the regulations with existing filing requirements. These changes, once finalized, aim to provide clearer guidance to taxpayers and reduce the potential for inconsistent treatment across different taxable years.

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