deadline for the reasons stated in the Extension Request, the security of our nation's electric grid will continue to be at risk.

However, I understand that Section 403 assigns the Commission the responsibility to take final action on the Proposal within the reasonable time period set forth by me and it is solely within my authority under Section 403 to grant an extension of time for final action. On the assumption that the Commission cannot act on the proposal within the 60-day deadline, I hereby grant the request for an extension of time for the Commission to deliberate and take final action on the Grid Resiliency Pricing Rule for an additional 30 days.[1] The new deadline is Wednesday, January 10, 2018. The Commission is nevertheless authorized to act at any time prior to this deadline and I urge the Commission to act expeditiously. During this additional period, the Department will continue to examine all options within my authority under the *Department of Energy Organization Act, the Federal Power Act,* and any other authorities to take remedial action as necessary to ensure the security of the nation's electric grid.

I continue to believe that urgent action must be taken to ensure the resilience and security of the electric grid, which is so vitally important to the economic and national security of the United States. I look forward to the Commission taking final action in this matter for the benefit of the American people.

Sincerely,

Rick Perry

[FR Doc. 2017–27187 Filed 12–18–17; 8:45 am]

BILLING CODE 6450–01–P

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[REG–119514–15]

RIN 1545–BM80

Exclusion of Foreign Currency Gain or Loss Related to Business Needs From Foreign Personal Holding Company Income; Mark-to-Market Method of Accounting for Section 988 Transactions

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed regulations that provide guidance on the treatment of foreign currency gain or loss of a controlled foreign corporation (CFC) under the business needs exclusion from foreign personal holding company income (FPHCI). The proposed regulations also provide an election for a taxpayer to use a mark-to-market method of accounting for foreign currency gain or loss attributable to section 988 transactions. In addition, the proposed regulations permit the controlling United States shareholders of a CFC to automatically revoke certain elections concerning the treatment of foreign currency gain or loss. The proposed regulations affect taxpayers and United States shareholders of CFCs that engage in transactions giving rise to foreign currency gain or loss under section 988 of the Internal Revenue Code (Code).

DATES: Written or electronic comments and requests for a public hearing must be received by March 19, 2018.

ADDRESSES: Send submissions to CC:PA:LPD:PR (REG–119514–15), Room 5203, Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand-delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to CC:PA:LPD:PR (REG–119514–15), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW, Washington, DC, or sent electronically via the Federal eRulemaking Portal at *http://www.regulations.gov* (IRS REG–119514–15).

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Jeffery G. Mitchell, (202) 317–6934; concerning submissions of comments or requests for a public hearing, Regina Johnson, (202) 317–6901 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collections of information contained in this notice of proposed rulemaking have been submitted to the Office of Management and Budget for review in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)). Comments on the collections of information should be sent to the Office of Management and Budget, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503, with copies to the Internal Revenue Service, Attn: IRS Reports Clearance Officer, SE:W:CAR:MP:T:T:SP, Washington, DC 20224. Comments on the collection of information should be received by February 20, 2018.

Comments are specifically requested concerning:

Whether the proposed collection of information is necessary for the proper performance of the duties of the IRS, including whether the information will have practical utility;

The accuracy of the estimated burden associated with the proposed collection of information;

How the quality, utility, and clarity of the information to be collected may be enhanced;

How the burden of complying with the proposed collection of information may be minimized, including through the application of automated collection techniques or other forms of information technology; and

Estimates of capital or start-up costs and costs of operation, maintenance, and purchases of services to provide information.

The collection of information in these proposed regulations is in proposed §§ 1.954–2(g)(3)(iii) and (4)(iii) and 1.988–7. The information is required to be provided by taxpayers and United States shareholders of CFCs that make an election or revoke an election with respect to the treatment of foreign currency gains and losses. The information provided will be used by the IRS for tax compliance purposes.

Estimated total annual reporting burden: 5,000 hours.

Estimated average annual burden hours per respondent: One hour.

Estimated number of respondents: 5,000.

Estimated annual frequency of responses: One.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a valid control number assigned by the Office of Management and Budget.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

Background

This document contains proposed amendments to 26 CFR part 1 under sections 446, 954(c)(1)(D), and 988 of the Code. Section 446 requires taxpayers to compute taxable income using accounting methods that clearly reflect income. Section 954(c)(1)(D) provides that FPHCI includes the excess of foreign currency gains over foreign currency losses (as defined in section 988(b)) attributable to section 988 transactions, other than transactions directly related to the business needs of the CFC. Section 988 provides rules for determining the source and character of

[1] This extension is granted pursuant to my authority under section 403 of the Department of Energy Organization Act, among other powers and authorities granted to me by law.

gain or loss from certain foreign currency transactions.

A. Business Needs Exclusion

1. In General

Section 954 defines foreign base company income (FBCI), which generally is income earned by a CFC that is taken into account in computing the amount that a United States shareholder of the CFC must include in income under section 951(a)(1)(A). Under section 954(a)(1), FBCI includes FPHCI, which is defined in section 954(c). The excess of foreign currency gains over foreign currency losses from section 988 transactions is generally included in FPHCI pursuant to section 954(c)(1)(D).

Section 988 transactions generally include the following: The accrual of any item of income or expense that is to be paid or received in a nonfunctional currency after the date of accrual; lending or borrowing in a nonfunctional currency; entering into or acquiring a forward, future, option, or similar contract denominated in a nonfunctional currency; and the disposition of nonfunctional currency. *See* section 988(c). Thus, accruals in connection with ordinary business transactions, such as purchases and sales of inventory or the provision of services, are section 988 transactions if the receivable or payable is denominated in, or determined by reference to, a currency other than the taxpayer's functional currency, as determined under § 1.985–1.

Notwithstanding the general rule that includes the excess of foreign currency gains over foreign currency losses from section 988 transactions in FPHCI, section 954(c)(1)(D) excludes from FPHCI any foreign currency gain or loss attributable to a transaction directly related to the business needs of the CFC (business needs exclusion). To qualify for the business needs exclusion, a foreign currency gain or loss must, in addition to satisfying other requirements, arise from a transaction entered into, or property used, in the normal course of the CFC's business that does not itself (and could not reasonably be expected to) give rise to subpart F income (as defined in section 952) other than foreign currency gain or loss. *See* § 1.954–2(g)(2)(ii)(B)(*1*).

Foreign currency gain or loss attributable to a bona fide hedging transaction (as defined in § 1.954–2(a)(4)(ii)) with respect to a transaction or property that qualifies for the business needs exclusion also qualifies for the business needs exclusion, provided that any gain or loss with respect to such transaction or property that is attributable to changes in exchange rates is clearly determinable from the records of the CFC as being derived from such property or transaction. *See* § 1.954–2(g)(2)(ii)(B)(*2*). Generally, bona fide hedging transactions are transactions that meet the requirements for a hedging transaction under § 1.1221–2(a) through (d), except that a bona fide hedging transaction also includes a transaction entered into in the normal course of business primarily to manage risk with respect to section 1231 property or a section 988 transaction. Under § 1.1221–2(b), a hedging transaction is defined as a transaction that a taxpayer enters into in the normal course of its trade or business primarily to manage the risk of price changes or currency fluctuations with respect to ordinary property that is held or to be held by the taxpayer, or to manage the risk of interest rate or price changes or currency fluctuations with respect to borrowings made or to be made, or ordinary obligations incurred or to be incurred, by the taxpayer. Transactions that manage risks related to assets that would produce capital gain or loss on disposition (capital assets), or assets owned or liabilities owed by a related party, do not qualify as hedging transactions under § 1.1221–2(b). To qualify as a bona fide hedging transaction, the transaction must be clearly identified as a hedging transaction before the end of the day on which the CFC acquired, originated, or entered into the transaction. *See* §§ 1.1221–2(f) and 1.954–2(a)(4)(ii)(A) and (B).

Section 1.954–2(g)(2)(ii)(C) provides special rules for applying the business needs exclusion to CFCs that are regular dealers as defined in § 1.954–2(a)(4)(iv). Transactions in dealer property (as defined in § 1.954–2(a)(4)(v)) that are entered into by a CFC that is a regular dealer in such property in its capacity as a dealer are treated as directly related to the business needs of the CFC. *See* § 1.954–2(g)(2)(ii)(C)(*1*). In addition, an interest-bearing liability denominated in a nonfunctional currency and incurred by a regular dealer is treated as dealer property if it reduces the CFC's currency risk with respect to dealer property and is identified on the CFC's records as a liability treated as dealer property. *See* § 1.954–2(g)(2)(ii)(C)(*2*). A regular dealer is a CFC that regularly and actively offers to, and in fact does, purchase property from and sell property to unrelated customers in the ordinary course of business, or that regularly and actively offers to, and in fact does, enter into, assume, offset, assign or otherwise terminate positions in property with unrelated customers in the ordinary course of business. *See* § 1.954–2(a)(4)(iv).

2. Use of Net Foreign Currency Losses

Under section 954(c)(1)(D), although a foreign currency loss that does not qualify for the business needs exclusion reduces the amount of foreign currency gain that is included in FPHCI, an excess of foreign currency losses over foreign currency gains from section 988 transactions generally does not reduce FPHCI. Such a net foreign currency loss does, however, reduce earnings and profits for purposes of the current earnings and profits limitation on subpart F income in section 952(c)(1). Additionally, as described in Part D of this Background section, when an election under § 1.954–2(g)(3) or (4) is in effect, a foreign currency loss can reduce FPHCI or, in the case of an election under § 1.954–2(g)(3), another category of subpart F income.

3. Inapplicability of Business Needs Exclusion to Transactions and Property That Give Rise to Both Subpart F Income and Non-Subpart F Income

In order for the business needs exclusion to apply to exclude foreign currency gain and loss from the computation of FPHCI, the foreign currency gain or loss must arise from a transaction or property that does not itself (and could not reasonably be expected to) give rise to any subpart F income other than foreign currency gain or loss. For example, foreign currency gains and losses related to the purchase and sale of inventory are excluded from the computation of FPHCI if none of the income from the purchase and sale is subpart F income under section 952. However, if the transaction or property gives rise to, or could reasonably be expected to give rise to, any amount of subpart F income (other than foreign currency gain or loss), none of the foreign currency gain or loss attributable to the transaction or property would qualify for the business needs exclusion. Thus, there is a cliff effect: If even a de minimis amount of income or gain from the transaction or property is subpart F income, the entire amount of the foreign currency gain or loss from the transaction or property, or from a bona fide hedging transaction with respect to the transaction or property, is included in the FPHCI computation.

4. Transactions That Manage the Risk of Currency Fluctuation in a Qualified Business Unit

A CFC may conduct business through a qualified business unit (as defined in

§ 1.989(a)–1) (QBU) that is not treated as a separate entity for federal income tax purposes, either because it is a branch or division of the CFC or because it is a business entity that is disregarded as separate from its owner. Although the QBU is not treated as a separate entity, it may have a functional currency under § 1.985–1 that is different from that of the CFC owner, with consequences for the determination of foreign currency gain and loss under sections 987 and 988. The QBU's transactions in its own functional currency are not section 988 transactions of the CFC, and accordingly the CFC does not realize foreign currency gain or loss on such transactions. The CFC generally must, however, take into account under section 987 foreign currency gain or loss with respect to the QBU upon remittances from the QBU.

For business and financial accounting reasons, a CFC may enter into transactions to manage the exchange rate risk associated with its net investment in its QBU. Under generally accepted accounting principles in the United States (U.S. GAAP), a majority owner of a business entity (parent corporation) must consolidate the accounts of the majority-owned entity, including a foreign entity, with its own accounts for purposes of financial reporting. Under U.S. GAAP, the income, assets, liabilities, and other financial results of foreign operations that are conducted in a functional currency that differs from the consolidated parent's functional currency must be translated into the functional currency of the consolidated parent. Foreign currency gains or losses arising from the translation are recorded in a ''cumulative translation adjustment'' account and reported as a component of shareholders' equity on the balance sheet. *See generally* Accounting Standards Codification (ASC) 830–30–45. Foreign currency gain or loss from transactions that effectively hedge the risk of currency fluctuations in the net equity investment in foreign operations also are recorded in the cumulative translation adjustment account. *See* ASC 815–35–35. A cumulative translation adjustment is not taken into account in computing the income of the consolidated group until the relevant operations are disposed of or liquidated.

The transactions that a CFC uses to manage its exchange rate risk with respect to its net investment in a QBU are typically section 988 transactions. Thus, foreign currency gains or losses attributable to those transactions are taken into account in computing FPHCI, unless the transactions qualify as bona fide hedging transactions that satisfy the requirements of the business needs exclusion. *See* § 1.954–2(g)(2)(ii)(B)(*2*). Neither the Code nor the section 954 regulations provide specific guidance on whether a transaction entered into to manage exchange rate risk arising from a CFC's net investment in a QBU can qualify as a bona fide hedging transaction eligible for the business needs exclusion. This issue can be consequential because foreign currency gain, but not loss, from a transaction erroneously identified as a bona fide hedging transaction is included in the computation of FPHCI, unless the CFC qualifies for the inadvertent identification exception. *See* § 1.954–2(a)(4)(ii)(C) and (g)(2)(ii)(B)(*2*). Additionally, even if a transaction entered into to manage exchange rate risk arising from a CFC's net investment in a QBU is eligible for treatment as a bona fide hedging transaction, the transaction would not qualify for the business needs exclusion unless the hedged property did not, and could not reasonably be expected to, give rise to any subpart F income.

Also for business and financial accounting reasons, a CFC may enter into transactions to manage the exchange rate risk with respect to its net investment in a subsidiary CFC. A transaction that manages the risk of price or currency fluctuation with respect to a CFC's net investment in a subsidiary CFC is not considered a hedging transaction for federal income tax purposes. In *Hoover Co.* v. *Commissioner,* 72 T.C. 706 (1979), the Tax Court held that transactions entered into to manage the risk of a decline in value of a taxpayer's net investment in a foreign subsidiary that might occur if the value of the subsidiary's functional currency declined relative to the U.S. dollar were not hedging transactions for federal income tax purposes. *See also* § 1.1221–2(b) (providing that a hedging transaction must manage risk with respect to ''ordinary property . . . that is held or to be held by the taxpayer''). Thus, foreign currency gains and losses on transactions that manage the risk of currency fluctuation on a CFC's net investment in a subsidiary CFC are taken into account in computing FPHCI.

B. Timing of Foreign Currency Gains and Losses

1. Hedge Timing Rules of § 1.446–4

Section 1.446–4 generally requires gain or loss from a hedging transaction, as defined in § 1.1221–2(b), to be taken into account at the same time as the gain or loss from the item being hedged. As noted in Part A.1 of this Background section, bona fide hedging transactions under § 1.954–2(a)(4)(ii) include both hedging transactions as defined in § 1.1221–2(b) and transactions that manage the risk of price or currency fluctuation with respect to section 1231 property and section 988 transactions. Thus, § 1.446–4 does not explicitly apply to all bona fide hedging transactions, which has led to some uncertainty about whether gain or loss from a bona fide hedging transaction that is not described in § 1.1221–2(b) is properly taken into account in the same taxable year as gain or loss on the hedged item. The Department of the Treasury (Treasury Department) and the IRS understand that some taxpayers have applied the hedge timing rules of § 1.446–4 to all bona fide hedging transactions, irrespective of whether those transactions are hedging transactions as defined in § 1.1221–2(b).

2. Treasury Center CFCs

It is common for a U.S.-parented multinational group to own one or more CFCs that serve as financing entities for other group members. Such CFCs (treasury center CFCs) may borrow in various currencies from third party lenders or from other members of the group and lend the proceeds to other members of the group. Treasury center CFCs also may be used to centralize the management of currency and other risks of other CFCs within the multinational group. Treasury center CFCs typically qualify as securities dealers under section 475, but if a treasury center CFC transacts primarily or exclusively with related persons, as is often the case, it would not qualify as a regular dealer under § 1.954–2(a)(4)(iv) and thus would not be eligible for the special rules applying the business needs exclusion to certain transactions of regular dealers under § 1.954–2(g)(2)(ii)(C).

When a treasury center CFC borrows nonfunctional currency from related or unrelated parties and makes loans denominated in that nonfunctional currency to a related CFC, the foreign currency gain or loss attributable to the principal amount borrowed by the treasury center CFC will economically offset all or a portion of the foreign currency loss or gain, respectively, attributable to the lending activity. Similarly, the foreign currency gain or loss attributable to the treasury center CFC's accrual of interest income and expense with respect to its lending and borrowing activities, respectively, will offset each other, in whole or in part. Thus, by borrowing and lending in the same nonfunctional currency, a treasury

center CFC is said to be ''naturally hedged.''

Although foreign currency gain and loss attributable to lending and borrowing transactions that are denominated in the same nonfunctional currency will typically partially or fully economically offset, the applicable tax accounting methods may cause the treasury center CFC to recognize a gain and an offsetting loss in different taxable years. If a treasury center CFC qualifies as a dealer under section 475, for example because it regularly purchases debt from related CFCs in the ordinary course of a trade or business, the treasury center CFC generally must use a mark-to-market method of accounting for its securities. *See* section 475 and § 1.475(c)–1(a)(3)(i). However, § 1.475(c)–2(a)(2) provides that a dealer's own issued debt liabilities are not securities for purposes of section 475. Thus, a treasury center CFC that funds its nonfunctional currency lending activities in whole or in part by issuing matching nonfunctional currency debt must mark to market its loan receivables and generally will include any foreign currency gain or loss recognized as a result of the mark to market in the computation of FPHCI each year, but, pursuant to § 1.475(c)–2(a)(2), offsetting foreign currency loss or gain, respectively, on its borrowing transactions generally is not taken into account until principal and interest is paid. Moreover, the rule in § 1.1221–2(d)(5) prohibits taxpayers from treating the purchase or sale of a debt instrument as a hedging transaction, which will generally prevent a treasury center CFC from relying on the § 1.446–4 hedge timing rules to match foreign currency gains and losses on borrowing transactions and loan receivables. The resulting mismatch in the timing of offsetting foreign currency gains and losses may have significant adverse consequences on the computation of the treasury center CFC's subpart F income because, as discussed in Part A.2 of this Background section, a foreign currency loss generally will not reduce the CFC's subpart F income except to the extent there are other foreign currency gains in the year the loss is recognized. Treasury and the IRS understand that some taxpayers have taken the position that the offsetting foreign currency gains and losses on the naturally hedged nonfunctional currency loans and borrowings may be taken into account in the same taxable years.

C. Foreign Currency Gain or Loss on Interest-Bearing Liabilities and Related Hedging Transactions

As explained in Part A.3 of this Background section, the business needs exclusion does not apply to foreign currency gain or loss with respect to a transaction or property if any subpart F income arises, or could reasonably be expected to arise, from the transaction or property. § 1.954–2(g)(2)(ii)(B)(*2*). However, § 1.954–2(g)(2)(iii) provides a special rule for foreign currency gain or loss arising from an interest-bearing liability. Under § 1.954–2(g)(2)(iii), such foreign currency gain or loss generally is characterized as subpart F income and non-subpart F income in the same manner that interest expense associated with the liability would be allocated and apportioned between subpart F income and non-subpart F income under §§ 1.861–9T and 1.861–12T. Section 1.954–2(g) does not provide a corresponding rule for a bona fide hedging transaction with respect to an interest-bearing liability. However, § 1.861–9T(b)(2) and (b)(6) provide rules that allocate foreign currency gain or loss on certain hedging transactions in the same manner as interest expense. A foreign currency gain or loss arising from a transaction that hedges an interest-bearing liability and that is not governed by § 1.861–9T is subject to the general rule of § 1.954–2(g)(2)(ii)(B)(*2*) and its ''cliff effect.'' Consequently, although the foreign currency gain or loss on the hedge of an interest-bearing liability economically offsets the foreign currency loss or gain on that liability, the interaction of the regulations under sections 861 and 954 could result in different allocations of foreign currency gains and losses between subpart F income and non-subpart F income.

D. Elections To Treat Foreign Currency Gain or Loss as a Specific Category of Subpart F Income or FBCI or FPHCI

Section 1.954–2 provides two elections with respect to foreign currency gains or losses. Under the first election, the controlling United States shareholders of a CFC may elect to include foreign currency gain or loss that relates to a specific category of subpart F income or, in the case of FBCI, a specific subcategory of FBCI described in § 1.954–1(c)(1)(iii)(A)(*1*) or (*2*), in that category of subpart F income or FBCI, rather than in FPHCI. *See* § 1.954–2(g)(3). Thus, for example, under this election, foreign currency gain or loss on a transaction that hedges currency risk with respect to transactions that result in foreign base company sales income would be included in the foreign base company sales income category for purposes of determining subpart F income. This election associates foreign currency gain or loss that otherwise would be included in the computation of FPHCI with the categories of subpart F income and foreign base company income to which it relates and allows net foreign currency losses with respect to a category to reduce the income in that category. For this treatment to apply, however, the relationship between the foreign currency gain or loss and the category of income must be clearly determinable from the CFC's records. *See* § 1.954–2(g)(3)(i)(A).

Under the second election, the controlling United States shareholders of a CFC may elect to include in the computation of FPHCI all foreign currency gain or loss attributable to any section 988 transaction (except a transaction in which gain or loss is treated as capital gain or loss under section 988(a)(1)(B)) and to certain section 1256 contracts. *See* § 1.954–2(g)(4). When this election is in effect, net foreign currency loss reduces gross income in other categories of FPHCI. Controlling United States shareholders typically make the § 1.954–2(g)(4) election if a CFC has relatively little net foreign currency gain or loss. In those circumstances, the administrative burden of tracing foreign currency gain and loss to specific transactions or property, as is required under the business needs exclusion and the § 1.954–2(g)(3) election, may outweigh the benefit of those provisions. As the CFC's foreign currency gain or loss becomes more significant, the net benefit of the business needs exclusion or the § 1.954–2(g)(3) election may increase and the relative benefit of the § 1.954–2(g)(4) election may decrease.

Explanation of Provisions

A. Business Needs Exclusion

1. Transactions and Property That Give Rise to Both Subpart F Income and Non-Subpart F Income

The Treasury Department and the IRS believe that foreign currency gain or loss arising from a transaction or property, or from a bona hedging transaction with respect to such a transaction or property, should be eligible for the business needs exclusion to the extent the transaction or property generates non-subpart F income. Accordingly, proposed § 1.954–2(g)(2)(ii)(C)(*1*) provides that foreign currency gain or loss attributable to a transaction or property that gives rise to both subpart F income and non-subpart F income, and that otherwise satisfies the

requirements of the business needs exclusion, is allocated between subpart F income and non-subpart F income in the same proportion as the income from the underlying transaction or property. As a result, the amount of foreign currency gain or loss allocable to non-subpart F income qualifies for the business needs exclusion, and the amount allocable to subpart F income is taken into account in computing FPHCI. Under proposed § 1.954–2(g)(2)(ii)(C)(*1*), the entire foreign currency gain or loss arising from property that does not give rise to income (as defined in § 1.954–2(e)(3)), or from a bona fide hedging transaction with respect to such property, is attributable to subpart F income because any gain upon a disposition of such property would be subpart F income.

2. Hedges of Net Investment in a QBU

The Treasury Department and the IRS believe that a transaction that manages exchange rate risk with respect to a CFC's net investment in a QBU that is not treated as a separate entity for federal income tax purposes should qualify for the business needs exclusion to the extent the underlying property of the QBU does not give rise to subpart F income. Accordingly, proposed § 1.954–2(g)(2)(ii)(C)(*2*) provides that the qualifying portion of any foreign currency gain or loss that arises from a ''financial statement hedging transaction'' with respect to a QBU and that is allocable to non-subpart F income is directly related to the business needs of a CFC. A financial statement hedging transaction is defined as a transaction that is entered into by a CFC for the purpose of managing exchange rate risk with respect to part or all of that CFC's net investment in a QBU that is included in the consolidated financial statements of a United States shareholder of the CFC or a corporation that directly or indirectly owns such United States shareholder. The qualifying portion is defined as the amount of foreign currency gain or loss arising from a financial statement hedging transaction that is properly accounted for under U.S. GAAP as a cumulative foreign currency translation adjustment to shareholders' equity. The qualifying portion of any foreign currency gain or loss arising from a financial statement hedging transaction must be allocated between subpart F income and non-subpart F income using the principles of § 1.987–6(b). The amount of the qualifying portion allocated to non-subpart F income qualifies for the business needs exclusion.

The proposed amendment to § 1.446–4(a), discussed in Part B.1 of this Explanation of Provisions section, provides that a bona fide hedging transaction (as defined in § 1.954–2(a)(4)(ii)) is subject to the hedge timing rules of § 1.446–4. Additionally, as noted earlier, proposed § 1.954–2(g)(2)(ii)(C)(*2*) provides that part or all of the qualifying portion of any foreign currency gain or loss arising from a financial statement hedging transaction is eligible for the business needs exclusion. However, financial statement hedging transactions are not included in the definition of bona fide hedging transaction under § 1.954–2(a)(4)(ii), as proposed to be amended pursuant to these proposed regulations. Thus, foreign currency gain or loss arising from a financial statement hedging transaction is not subject to the hedge timing rules of § 1.446–4 and is taken into account in accordance with the taxpayer's method of accounting. Generally, a taxpayer's financial statement hedging transaction is a section 988 transaction with respect to the taxpayer. Accordingly, to the extent that the taxpayer elects to use a mark-to-market method of accounting for section 988 gain or loss under proposed § 1.988–7, and also makes the annual deemed termination election described in § 1.987–8T(d), the taxpayer generally would recognize annually foreign currency gain or loss from both the financial statement hedging transaction and the QBU with respect to which exchange rate risk is managed. The Treasury Department and the IRS request comments regarding whether the hedge timing rules of § 1.446–4 should apply to a financial statement hedging transaction (as defined in proposed § 1.954–2(g)(2)(ii)(C)(*2*)) with respect to section 987 QBUs with respect to which no annual deemed termination election is in effect, and, if so, how the appropriate matching should be achieved.

The Treasury Department and the IRS also request comments regarding whether the business needs exclusion should apply to a transaction that is entered into for the purpose of managing the risk of foreign currency fluctuation with respect to a CFC's net investment in a subsidiary CFC. Comments are requested regarding how the gain or loss on such a transaction could or should be allocated between subpart F and non-subpart F income and whether and how the gain or loss could or should be matched with the foreign currency gain or loss on the ''hedged'' item.

The Treasury Department and the IRS are aware that a CFC may enter into a transaction that manages exchange rate risk arising from a disregarded loan to a QBU. The Treasury Department and the IRS understand that, for U.S. GAAP purposes, exchange gain or loss with respect to a transaction that manages exchange rate risk with respect to the disregarded loan generally would not be reflected as a cumulative foreign currency translation adjustment. For federal income tax purposes, the loan would be disregarded, and exchange gain or loss on the hedging transaction potentially could be subpart F income. The Treasury Department and the IRS request comments regarding whether, taking into account the amendments in the proposed regulations, additional amendments to the business needs exclusion are appropriate to account for foreign currency gain or loss arising from a transaction that is entered into for the purpose of managing the risk of foreign currency fluctuation with respect to disregarded transactions, including disregarded loans, between a CFC and its QBU. Specifically, comments are requested regarding how the foreign currency gain or loss on such a hedging transaction could or should be allocated between subpart F and non-subpart F income and when such foreign currency gain or should be recognized.

B. Timing of Foreign Currency Gains and Losses

1. Extension of § 1.446–4 Hedge Timing Rules to Bona Fide Hedging Transactions

The proposed amendment to § 1.446–4(a) extends the hedge timing rules of § 1.446–4 to all bona fide hedging transactions as defined in § 1.954–2(a)(4)(ii). Although this amendment will be particularly useful in connection with foreign currency gains and losses from bona fide hedging transactions of treasury center CFCs, the amendment will eliminate timing mismatches for gains and losses arising from all bona fide hedging transactions and from the hedged property or transaction.

In addition, proposed § 1.954–2(a)(4)(ii) revises the definition of a bona fide hedging transaction to permit the acquisition of a debt instrument by a CFC to be treated as a bona fide hedging transaction with respect to an interest-bearing liability of the CFC, provided that the acquisition of the debt instrument has the effect of managing the CFC's exchange rate risk with respect to the liability within the meaning of § 1.1221–2(c)(4) and (d), determined without regard to § 1.1221–2(d)(5), and otherwise meets the requirements of a bona fide hedging

transaction. If a CFC, including a treasury center CFC, identifies a debt instrument that manages exchange rate risk as a hedge of an interest-bearing liability, the foreign currency gain or loss arising from that debt instrument will be taken into account under § 1.446–4 at the same time as the foreign currency gain or loss arising from the hedged interest-bearing liability.

Treating a debt instrument as a hedge of an interest-bearing liability, rather than treating the interest-bearing liability as a hedge of the debt instrument, is consistent with the principles underlying § 1.861–9T(b)(2), which allocates and apportions foreign currency gain or losses on a transaction that hedges an interest-bearing liability in the same manner as interest expense with respect to the liability is allocated and apportioned. See part C of this Explanation of Provisions section for further discussion of the impact of this rule on the allocation of foreign currency gain or loss on a debt instrument between subpart F income and non-subpart F income.

2. Elective Mark-to-Market Method of Accounting for Foreign Currency Gain and Loss

Proposed § 1.988–7 permits a taxpayer, including a CFC, to elect to use a mark-to-market method of accounting for section 988 gain or loss with respect to section 988 transactions, including becoming an obligor under an interest-bearing liability. This elective mark-to-market method of accounting takes into account only changes in the value of the section 988 transaction attributable to exchange rate fluctuations and does not take into account changes in value due to other factors, such as changes in market interest rates or the creditworthiness of the borrower. The proposed regulations require appropriate adjustments to be made to prevent section 988 gain or loss taken into account under the mark-to-market method of accounting from being taken into account again under section 988 or another provision of the Code.

This election is available to any taxpayer but is expected to be particularly relevant in the case of a treasury center CFC. A treasury center CFC that uses a mark-to-market method for securities under section 475 and that makes the election under proposed § 1.988–7 will be able to match the timing of foreign currency gain or loss with respect to an interest-bearing liability (such as a loan from a related or unrelated party) with economically offsetting foreign currency loss or gain arising from its nonfunctional currency-denominated assets (such as a receivable from a related party). Whether the corresponding foreign currency gains and losses qualify for the business needs exclusion is determined under the rules of § 1.954–2(g)(2), as proposed to be amended pursuant to these proposed regulations. Thus, if the foreign currency gains or losses do not fully offset each other, the difference may increase or decrease the CFC's FPHCI. However, the election under proposed § 1.988–7 does not apply to the following: (1) Any securities that are marked to market under any other provision; (2) any securities that, pursuant to an election or an identification made by the taxpayer, are excepted from mark-to-market treatment under any other provision; (3) any transactions of a QBU that is subject to section 987; or (4) any section 988 transactions denominated in, or determined by reference to, a hyperinflationary currency.

The election applies for the year in which the election is made and all subsequent taxable years unless it is revoked by the Commissioner or the taxpayer or, in the case of a CFC, the controlling domestic shareholders of the CFC. Proposed § 1.988–7(d) permits a taxpayer or CFC to revoke the election to use a mark-to-market method of accounting for foreign currency gains or losses on section 988 transactions at any time. A subsequent election cannot be made until the sixth taxable year following the year of revocation and cannot be revoked until the sixth taxable year following the year of such subsequent election.

C. Hedges of Exchange Rate Risk Arising From an Interest-Bearing Liability

The Treasury Department and the IRS believe that it is appropriate to require foreign currency gain or loss from transactions that have the effect of managing exchange rate risk arising from an interest-bearing liability to be allocated between subpart F income and non-subpart F income in the same manner as the foreign currency gain or loss on the hedged liability. Accordingly, the proposed amendments to § 1.954–2(g)(2)(iii) require foreign currency gains and losses arising from a transaction or property (including debt instruments) that manages exchange rate risk with respect to an interest-bearing liability to be allocated and apportioned between subpart F income and non-subpart F income in the same manner that foreign currency gain or loss from the interest-bearing liability would be allocated and apportioned. As noted in Part B.1 of this Explanation of Provisions, the proposed amendment to § 1.954–2(a)(4)(ii) revises the definition of a bona fide hedging transaction to permit the acquisition of a debt instrument by a CFC to be treated as a bona fide hedging transaction with respect to an interest-bearing liability of the CFC under certain circumstances. As a result of that proposed amendment and the amendment described in this Part C, if a CFC identifies a debt instrument that manages exchange rate risk as a hedge of an interest-bearing liability, the foreign currency gain or loss arising from that debt instrument will be allocated between subpart F income and non-subpart F income in the same manner as the foreign currency gain or loss arising from the hedged interest-bearing liability. Thus, the proposed amendments to the regulations permit a CFC that timely and properly identifies a debt instrument as a hedge of an interest-bearing liability to alleviate the character mismatch that may occur under the existing regulations, as described in Part C of the Background section of this preamble. The proposed amendments to § 1.954–2(g)(2)(iii) also clarify that the special rules in that paragraph apply to foreign currency gain or loss arising from an interest-bearing liability, or from a bona fide hedging transaction with respect to the liability, in lieu of the general rule of the business needs exclusion in § 1.954–2(g)(2)(ii).

D. Revocation of Election To Treat Foreign Currency Gain or Loss as a Specific Category of Subpart F Income or as FPHCI

Proposed § 1.954–2(g)(3)(iii) permits a CFC to revoke its election under § 1.954–2(g)(3) (to characterize foreign currency gain or loss that arises from a specific category of subpart F income as gain or loss in that category) at any time without securing the prior consent of the Commissioner. Similarly, proposed § 1.954–2(g)(4)(iii) permits a CFC to revoke its election under § 1.954–2(g)(4) (to treat all foreign currency gain or loss as FPHCI) at any time without securing the prior consent of the Commissioner. The Treasury Department and the IRS remain concerned about CFCs frequently changing these elections without a substantial business reason but also believe that the ability of a taxpayer to automatically revoke these elections would promote sound tax administration. Therefore, the proposed regulations provide that, if an election has been revoked under proposed § 1.954–2(g)(3)(iii) or proposed § 1.954–2(g)(4)(iii), a subsequent election cannot be made until the sixth taxable year following the year of revocation and any subsequent election cannot be revoked

until the sixth year following the year of such subsequent election.

E. Applicability Dates

The proposed amendments generally are proposed to apply to taxable years ending on or after the date the proposed regulations are published as final regulations in the **Federal Register.** However, the proposed amendments to §§ 1.446–4(a), 1.954–2(a)(4)(ii)(A), 1.954–2(g)(2)(ii)(C)(*1*), and 1.954–2(g)(2)(iii) are proposed to apply to bona fide hedging transactions entered into on or after the date the proposed regulations are published as final regulations in the **Federal Register.** A taxpayer may rely on any of the proposed amendments, other than the amendments to §§ 1.446–4(a), 1.954–2(a)(4)(ii)(A), 1.954–2(g)(2)(ii)(C)(*1*), and 1.954–2(g)(2)(iii), insofar as each applies to a bona fide hedging transaction, for taxable years ending on or after December 19, 2017, provided the taxpayer consistently applies the proposed amendment for all such taxable years that end before the first taxable year ending on or after the date the proposed regulations are published as final regulations in the **Federal Register**. A taxpayer may rely on any of the proposed amendments to §§ 1.446–4(a), 1.954–2(a)(4)(ii)(A), 1.954–2(g)(2)(ii)(C)(*1*), and 1.954–2(g)(2)(iii) with respect to a bona fide hedging transaction entered into on or after December 19, 2017 and prior to the applicability date, provided the taxpayer consistently applies the proposed amendment to all bona fide hedging transactions entered into on or after December 19, 2017 and prior to the date that these regulations are published as final regulations in the **Federal Register.**

Special Analyses

Certain IRS regulations, including these, are exempt from the requirements of Executive Order 12866, as supplemented and reaffirmed by Executive Order 13563. Therefore, a regulatory impact assessment is not required. It is hereby certified that the collection of information requirement will not have a significant economic impact on a substantial number of small entities. This certification is based on the fact that these regulations primarily will affect domestic corporations that have foreign operations, which tend to be larger businesses, and that the average burden is minimal. Accordingly, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f), this notice of proposed rulemaking has been submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Requests for Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any comments that are submitted timely to the IRS as prescribed in this preamble under **ADDRESSES**. The Treasury Department and the IRS request comments on all aspects of the proposed rules. All comments will be available at *www.regulations.gov* or upon request. A public hearing will be scheduled if requested in writing by any person that timely submits comments. If a public hearing is scheduled, notice of the date, time, and place for the public hearing will be published in the **Federal Register.**

Drafting Information

The principal author of these regulations is Jeffery G. Mitchell of the Office of Associate Chief Counsel (International). However, other personnel from the IRS and the Treasury Department participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1—INCOME TAXES

■ **Paragraph 1.** The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Section 1.954–2 also issued under 26 U.S.C. 954(b) and (c). * * *

Section 1.988–7 also issued under 26 U.S.C. 446, 988(d), and 989(c). * * *

■ **Par. 2.** Section 1.446–4 is amended by:

■ 1. Revising the first sentence of paragraph (a).

■ 2. Revising the heading of paragraph (g) and adding a sentence at the end of paragraph (g).

■ 3. Removing paragraph (h).

The revisions and addition read as follows:

§ 1.446–4 Hedging transactions.

(a) *In general.* Except as provided in this paragraph (a), a hedging transaction as defined in § 1.1221–2(b) (whether or not the character of gain or loss from the transaction is determined under § 1.1221–2) and a bona fide hedging transaction as defined in § 1.954–2(a)(4)(ii) must be accounted for under the rules of this section. * * *

* * * * *

(g) *Applicability date.* * * * This section applies to a bona fide hedging transaction (as defined in § 1.954–2(a)(4)(ii)) entered into on or after the date that these regulations are published as final regulations in the **Federal Register.**

■ **Par. 3.** Section 1.954–0(b) is amended by:

■ 1. Redesignating the entry for § 1.954–2(g)(2)(ii)(D) as the entry for § 1.954–2(g)(2)(ii)(E).

■ 2. Redesignating the entries for § 1.954–2(g)(2)(ii)(C), (g)(2)(ii)(C)(*1*), (g)(2)(ii)(C)(*2*), (g)(2)(ii)(C)(*2*)(*i*), (g)(2)(ii)(C)(*2*)(*ii*), and (g)(2)(ii)(C)(*2*)t(*iii*) as the entries for § 1.954–2(g)(2)(ii)(D), (g)(2)(ii)(D)(*1*), (g)(2)(ii)(D)(*2*), (g)(2)(ii)(D)(*2*)(*i*), (g)(2)(ii)(D)(*2*)(*ii*), and (g)(2)(ii)(D)(*2*)(*iii*), respectively.

■ 3. Adding new entries for § 1.954–2(g)(2)(ii)(C), (g)(2)(ii)(C)(*1*), and (g)(2)(ii)(C)(*2*).

■ 4. Revising the entry for § 1.954–2(g)(2)(iii).

The additions and revision read as follows:

§ 1.954–0 Introduction.

* * * * *

(b) * * *

§ 1.954–2 Foreign personal holding company income.

* * * * *

(g) * * *

(2) * * *

(ii) * * *

(C) Foreign currency gains and losses arising from a transaction or property that gives rise to both non-subpart F income and subpart F income or from a bona fide hedging transaction with respect to such a transaction or property.

(*1*) In general.

(*2*) Financial statement hedging transaction with respect to the net investment in a qualified business unit.

* * * * *

(iii) Special rule for foreign currency gain or loss from an interest-bearing liability and bona fide hedges of an interest-bearing liability.

* * * * *

■ **Par. 4.** Section 1.954–2 is amended by:

■ 1. Adding a sentence after the first sentence in paragraph (a)(4)(ii)(A).

■ 2. Redesignating paragraph (g)(2)(ii)(D) as paragraph (g)(2)(ii)(E).

■ 3. Redesignating paragraph (g)(2)(ii)(C) as paragraph (g)(2)(ii)(D).

■ 4. In newly redesignated paragraph (g)(2)(ii)(D)(*2*)(*i*), removing ''paragraph

(g)(2)(ii)(C)'' and adding ''paragraph (g)(2)(ii)(D)'' in its place and removing ''paragraph (g)(2)(ii)(C)(*1*)'' and adding ''paragraph (g)(2)(ii)(D)(*1*)'' in its place.

■ 5. In newly redesignated paragraph (g)(2)(ii)(D)(*2*)(*ii*), removing ''paragraph (g)(2)(ii)(C)(*2*)(*i*)'' and adding ''paragraph (g)(2)(ii)(D)(*2*)(*i*)'' each place it appears.

■ 6. In newly redesignated paragraph (g)(2)(ii)(D)(*2*)(*iii*), removing ''paragraph (g)(2)(ii)(C)(*2*)'' and adding ''paragraph (g)(2)(ii)(D)(*2*)'' in its place.

■ 7. Adding new paragraph (g)(2)(ii)(C).

■ 8. Revising paragraph (g)(2)(iii).

■ 9. Revising paragraph (g)(3)(iii).

■ 10. Revising paragraph (g)(4)(iii).

■ 11. Adding two sentences after the third sentence in paragraph (i)(2).

The additions and revisions read as follows:

§ 1.954–2 Foreign personal holding company income.

(a) * * *

(4) * * *

(ii) * * *

(A) * * * Additionally, the acquisition of a debt instrument by a controlled foreign corporation may be treated as a bona fide hedging transaction with respect to an interest-bearing liability of the controlled foreign corporation, provided that the acquisition of the debt instrument has the effect of managing the controlled foreign corporation's exchange rate risk with respect to the liability within the meaning of § 1.1221–2(c)(4) and (d), determined without regard to § 1.1221–2(d)(5), and otherwise meets the requirements of paragraph (a)(4)(ii) of this section. * * *

* * * * *

(g) * * *

(2) * * *

(ii) * * *

(C) *Foreign currency gains and losses arising from a transaction or property that gives rise to both non-subpart F income and subpart F income or from a bona fide hedging transaction with respect to such a transaction or property*—(*1*) *In general.* If a foreign currency gain or loss would be directly related to the business needs of the controlled foreign corporation pursuant to paragraph (g)(2)(ii)(B)(*1*) or (*2*) of this section except that it arises from a transaction or property that gives rise, or is reasonably expected to give rise, to both non-subpart F income and subpart F income (other than foreign currency gain or loss), or from a bona fide hedging transaction with respect to such a transaction or property, the amount of foreign currency gain or loss that is allocable to non-subpart F income under this paragraph (g)(2)(ii)(C)(*1*) is directly related to the business needs of the controlled foreign corporation. The amount of foreign currency gain or loss arising from a transaction or property described in this paragraph (g)(2)(ii)(C)(*1*), or from a bona fide hedging transaction with respect to such a transaction or property, that is allocable to non-subpart F income equals the product of the total amount of foreign currency gain or loss arising from the transaction or property and the ratio of non-subpart F income (other than foreign currency gain or loss) that the transaction or property gives rise to, or is reasonably expected to give rise to, to the total income that the transaction or property gives rise to, or is reasonably expected to give rise to. However, none of the foreign currency gain or loss arising from property that does not give rise to income (as defined in paragraph (e)(3) of this section), or from a bona fide hedging transaction with respect to such property, is allocable to non-subpart F income.

(*2*) *Financial statement hedging transaction with respect to a qualified business unit.* If foreign currency gain or loss arises from a financial statement hedging transaction (as defined in this paragraph (g)(2)(ii)(C)(*2*)) with respect to a qualified business unit (as defined in § 1.989(a)–1) (QBU) of a controlled foreign corporation that is not treated as an entity separate from the controlled foreign corporation for federal income tax purposes, either because it is a branch or division of the controlled foreign corporation or because it is a business entity that is disregarded as separate from its owner under § 301.7701–3 of this chapter, the amount of the qualifying portion (as determined under this paragraph (g)(2)(ii)(C)(*2*)) of foreign currency gain or loss that is allocable to non-subpart F income under this paragraph (g)(2)(ii)(C)(*2*) is directly related to the business needs of the controlled foreign corporation. Generally, the controlled foreign corporation must allocate the qualifying portion of foreign currency gain or loss arising from the financial statement hedging transaction between subpart F income and non-subpart F income in the same proportion as it would characterize gain or loss determined under section 987 as subpart F income and non-subpart F income under the principles of § 1.987–6(b). A *financial statement hedging transaction* is a transaction that is entered into by a CFC for the purpose of managing exchange rate risk with respect to part or all of that CFC's net investment in a QBU that is included in the consolidated financial statements of a United States shareholder of the CFC (or a corporation that directly or indirectly owns such United States shareholder). The qualifying portion of foreign currency gain or loss is the amount of foreign currency gain or loss arising from a financial statement hedging transaction that is properly accounted for under U.S. generally accepted accounting principles as a cumulative foreign currency translation adjustment to shareholders' equity.

* * * * *

(iii) *Special rule for foreign currency gain or loss from an interest-bearing liability and bona fide hedges of an interest-bearing liability.* Except as provided in paragraph (g)(2)(ii)(D)(*2*) or (g)(5)(iv) of this section, foreign currency gain or loss arising from an interest-bearing liability is characterized as subpart F income and non-subpart F income in the same manner that interest expense associated with the liability would be allocated and apportioned between subpart F income and non-subpart F income under §§ 1.861–9T and 1.861–12T. Likewise, foreign currency gain or loss arising from a bona fide hedging transaction entered into by the controlled foreign corporation that has the effect of managing exchange rate risk with respect to an interest-bearing liability that is not subject to paragraph (g)(2)(ii)(D)(*2*) (certain interest-bearing liabilities treated as dealer property) or (g)(5)(iv) (gain or loss allocated under § 1.861–9) of this section is characterized as subpart F income and non-subpart F income in the same manner that interest expense associated with the interest-bearing liability would be allocated and apportioned between subpart F income and non-subpart F income under §§ 1.861–9T and 1.861–12T. Paragraph (g)(2)(ii) of this section does not apply to any foreign currency gain or loss described in this paragraph (g)(2)(iii).

(3) * * *

(iii) *Revocation of election.* This election is effective for the taxable year of the controlled foreign corporation for which it is made and all subsequent taxable years of such corporation unless revoked by the Commissioner or the controlling United States shareholders (as defined in § 1.964–1(c)(5)) of the controlled foreign corporation. The controlling United States shareholders of a controlled foreign corporation may revoke such corporation's election at any time. If an election has been revoked under this paragraph (g)(3)(iii), a new election under paragraph (g)(3) of this section cannot be made until the sixth taxable year following the year in which the previous election was

revoked, and such subsequent election cannot be revoked until the sixth taxable year following the year in which the subsequent election was made. The controlling United States shareholders revoke an election on behalf of a controlled foreign corporation by filing a statement that clearly indicates such election has been revoked with their original or amended income tax returns for the taxable year of such United States shareholders ending with or within the taxable year of the controlled foreign corporation for which the election is revoked.

* * * * *

(4) * * *

(iii) *Revocation of election.* This election is effective for the taxable year of the controlled foreign corporation for which it is made and all subsequent taxable years of such corporation unless revoked by the Commissioner or the controlling United States shareholders (as defined in § 1.964–1(c)(5)) of the controlled foreign corporation. The controlling United States shareholders of a controlled foreign corporation may revoke such corporation's election at any time. If an election has been revoked under this paragraph (g)(4)(iii), a new election under paragraph (g)(4) of this section cannot be made until the sixth taxable year following the year in which the previous election was revoked, and such subsequent election cannot be revoked until the sixth taxable year following the year in which the subsequent election was made. The controlling United States shareholders revoke an election on behalf of a controlled foreign corporation by filing a statement that clearly indicates such election has been revoked with their original or amended income tax returns for the taxable year of such United States shareholders ending with or within the taxable year of the controlled foreign corporation for which the election is revoked.

* * * * *

(i) * * *

(2) *Other paragraphs.* * * * The second sentence of paragraph (a)(4)(ii)(A), paragraph (g)(2)(ii)(C)(*1*), and the second sentence of paragraph (g)(2)(iii) apply to a bona fide hedging transaction entered into on or after the date the proposed regulations are published as final regulations in the **Federal Register.** Paragraphs (g)(2)(ii)(C) (other paragraph (g)(2)(ii)(C)(*1*), insofar as it applies to a bona fide hedging transaction), (g)(3)(iii), and (g)(4)(iii) of this section apply to taxable years of controlled foreign corporations ending on or after the date that these regulations are published as final regulations in the **Federal Register.**

■ **Par. 5.** Section 1.988–7 is added to read as follows:

§ 1.988–7 Election to mark-to-market foreign currency gain or loss on section 988 transactions.

(a) *In general.* Except as provided in paragraph (b) of this section, a taxpayer may elect under this section to apply the foreign currency mark-to-market method of accounting described in this section with respect to all section 988 transactions (including the acquisition and holding of nonfunctional currency described in section 988(c)(1)(C)(ii)). Under the foreign currency mark-to-market method of accounting, the timing of section 988 gain or loss on section 988 transactions is determined under the principles of section 1256. Only section 988 gain or loss is taken into account under the foreign currency mark-to-market method of accounting. Consistent with section 1256(a)(2), appropriate adjustments must be made to prevent the section 988 gain or loss from being taken into account again under section 988 or another provision of the Code or regulations. A section 988 transaction subject to this election is not subject to the ''netting rule'' of section 988(b) and § 1.988–2(b)(8), under which exchange gain or loss is limited to overall gain or loss realized in a transaction, in taxable years prior to the taxable year in which section 988 gain or loss would be recognized with respect to such section 988 transaction but for this election.

(b) *Exceptions.* The election described in paragraph (a) of this section does not apply to:

(1) Any security, commodity, or section 1256 contract that is marked to market under any other provision, including section 475 or section 1256;

(2) Any security, commodity, or section 1256 contract that, pursuant to an election or an identification made by the taxpayer, is excepted from mark-to-market treatment under another provision, including section 475 or section 1256;

(3) Any transaction of a qualified business unit (as defined in section 1.989(a)–1(b)) that is subject to section 987; or

(4) Any section 988 transaction denominated in, or determined by reference to, a hyperinflationary currency. See § 1.988–2(b)(15), (d)(5), and (e)(7) for rules relating to such transactions.

(c) *Time and manner of election.* A taxpayer makes the election under paragraph (a) of this section by filing a statement that clearly indicates that such election has been made with the taxpayer's timely-filed original federal income tax return for the taxable year for which the election is made. In the case of a controlled foreign corporation, the controlling United States shareholders (as defined in § 1.964–1(c)(5)) make the election under paragraph (a) of this section on behalf of the controlled foreign corporation by filing a statement that clearly indicates that such election has been made with their timely-filed, original federal income tax returns for the taxable year of such United States shareholders ending with or within the taxable year of the controlled foreign corporation for which the election is made.

(d) *Revocation and subsequent election.* A taxpayer may revoke its election under paragraph (a) of this section at any time. If an election has been revoked under this paragraph (d), a new election under paragraph (a) of this section cannot be made until the sixth taxable year following the year in which the previous election was revoked, and such subsequent election cannot be revoked until the sixth taxable year following the year in which the subsequent election was made. A taxpayer revokes the election by filing a statement that clearly indicates that such election has been revoked with its original or amended federal income tax return for the taxable year for which the election is revoked. In the case of a controlled foreign corporation, the controlling United States shareholders revoke the election on behalf of the controlled foreign corporation by filing a statement that clearly indicates that such election has been revoked with their original or amended federal income tax returns for the taxable year of such United States shareholders ending with or within the taxable year of the controlled foreign corporation for which the election is revoked.

(e) *Applicability dates.* This section applies to taxable years of taxpayers (including controlled foreign corporations) ending on or after the date these regulations are published as final regulations in the **Federal Register.**

Kirsten Wielobob,

Deputy Commissioner for Services and Enforcement.

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