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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR WILLIAM BOGNER
DEPUTY AREA COUNSEL (SBSE) CHICAGO, AREA 4
Attn: Joseph Ferrick

FROM: Jeffrey Dorfman
Chief, Branch 5 CC:INTL:BR5

SUBJECT:

This Chief Counsel Advice responds to your memorandum dated February 7, 2001. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

LEGEND

Taxpayer =
country X =
currency X =
Month 1 =
Month 2 =
Month 3 =
X Taxable Year =
Y Taxable Year =
Z Taxable Year =

ISSUES

1. Whether and how section 482 applies to inventory purchases by a U.S. subsidiary from its foreign parent where, pursuant to a foreign currency fluctuation agreement ("FCFA"), the prices on the initial invoice reflect a historical foreign exchange rate set annually by the two parties.

2. What is the appropriate exchange rate for determining the basis of inventory where such inventory is purchased for units of currency X, a nonfunctional currency to Taxpayer.

3. Whether section 988 applies to the foreign currency payables arising from the inventory purchases.

CONCLUSIONS

1. Section 482 applies to the taxpayer's controlled transactions. Whether the controlled transactions produce an arm's length result is evaluated using a functional analysis that compares the controlled transactions to comparable uncontrolled transactions. The functional analysis must account for differences in functions performed, risks assumed, and resources employed. Accordingly, appropriate adjustments to the inventory price should be made to reflect the currency risk assumed by the taxpayer if the adjustments are quantifiable and have a material impact on price. We believe that under the facts presented, Taxpayer's method of adjusting for exchange rate risk (which was based on historical exchange rates) was not appropriate.

2. The basis of inventory purchased for units of currency X should be determined by translating the currency X purchase price (adjusted if required under section 482) into U.S. dollars at the spot rate on the accrual date.

3. Section 988 applies to any payable arising out of the sale of inventory if that payable is denominated in, or determined by reference to, a nonfunctional currency.

FACTS

Taxpayer, a U.S. subsidiary of a country X corporation ("Parent"), purchases inventory from its parent on an ongoing basis. These transactions are billed and paid in U.S. dollars but determined as provided below. Beginning in Month 1, Taxpayer and Parent implemented an agreement called the "Foreign Currency Fluctuation Agreement" ("FCFA"). Under the FCFA, purchase prices on the initial invoice were based on a currency X - U.S. dollar exchange rate that was set annually by agreement between Taxpayer and Parent ("standard rate"). The standard rate was generally set in Month A, just prior to the start of a new fiscal year. It consisted of an average of the current standard exchange rate (i.e., the rate used for the preceding year) and the average of spot rates in effect for the previous three months leading up to the rate reset date. The standard rate set at that time was used for the next fiscal year, and this rate was used for that entire fiscal year. Thus, for Y Taxable Year, Taxpayer computed its new standard rate as the following: [(the standard exchange rate in effect for X Taxable Year) plus (the average spot rate for the most recent three months leading up to the date of the rate reset)] divided by 2.[1]

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[1] In years prior to the Z Taxable Year, Taxpayer and Parent also agreed under the FCFA to a subsequent monthly billing, known as the " subsequent billing," in order to adjust for fluctuations between the standard rate and an average rate based on the prior month's average daily spot rates. Parent made a subsequent billing at the end of each month. The FCFA provided that Parent would

For the Z Taxable Year, the year at issue, the examiner translated the inventory purchased by Taxpayer at the spot rate on the purchase date and determined foreign currency gain or loss under §1.988-2(c).

LAW AND ANALYSIS

A. The price of Taxpayer's controlled transactions denominated in currency X must be evaluated under section 482 to determine whether they were at arm's length.

Taxpayer asserts that the pricing method involving the use of a standard rate resulted in an arm's length price. Whether Taxpayer's controlled transactions produce an arm's length result is evaluated by comparing the results of those transactions to results realized by uncontrolled taxpayers engaged in comparable transactions under comparable circumstances. See §1.482-1(d)(1). In determining the comparability between transactions, factors that must be considered include functions performed, contractual terms, risks assumed, economic conditions, and property or services transferred. §§1.482-1(d)(1), 1.482-1(d)(3). Financial risk, including fluctuations in exchange rates, is a relevant risk to consider because such risk could affect prices that would be charged or paid, or the profit that would be earned. §1.482-1(d)(3)(iii)(A). An allocation of risk specified or implied by a taxpayer's contractual terms will generally be respected if it is consistent with the economic substance of the transaction. §1.482-1(d)(3)(iii)(B).

The allocation of currency risk between Taxpayer and Parent, although only one factor, is relevant in determining whether the controlled transactions subject to the FCFA were priced at arm's length. A functional analysis properly takes into account such risk at the time the inventory is purchased not after the results of the currency fluctuation with respect to the payable are known. (Such fluctuations might be

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issue to Taxpayer a debit or credit equal to half of any foreign currency gain or loss computed under the subsequent billing, effectively splitting any exchange gain or loss between Taxpayer and Parent. Each month's subsequent billing only took into account foreign currency movements for initial invoices issued that month, i.e., up to 30 days. The period between the date an invoice was issued and payment was made, however, extended well past 30 days. In fact, inventory purchases had traditional payment terms of 114 days after the end of the month, and depending on when the invoice was issued, the payment period could extend up to 144 days if the invoice was issued on the first of the month. Therefore, the subsequent billing did not account for any foreign currency movements from month-end (when Parent computed the subsequent billing) to the date of payment. Additionally, the subsequent billing applied only to certain transactions which accounted for 50-70 percent of Parent's monthly sales to Taxpayer.

In Month 2, approximately five years after Month 1, Parent verbally terminated the subsequent billing. The initial billing procedure, however, continued. In other words, the transactions between Taxpayer and Parent continued to be priced in dollars using the standard rate, without a subsequent billing. Taxpayer stated that the reason for terminating the FCFA was that Parent had modified its foreign currency risk management program, linking its internal rate to the actual hedging rate in foreign currency futures contracts between the Parent and banks. This FSA analyzes Taxpayer's use of the standard rate and not the subsequent billing since the latter practice was terminated prior to the Z Taxable Year.

relevant, however, in determining the appropriate compensation for such future risk assumption.)

A functional analysis of Taxpayer's controlled transactions involves a two-step inquiry. First, the inventory purchase price denominated in currency X must be evaluated to determine whether such price was at arm's length. Taxpayer's controlled transactions must be compared to comparable uncontrolled transactions, the price of which are determined on the initial invoice date. Second, in the event the comparable uncontrolled transactions do not reflect an assumption of currency risk by the purchaser, the comparable uncontrolled transactions must be adjusted to account for the difference in financial risks, e.g., currency risk (or denomination), to reflect the presence of additional risk for the purchaser. See Treas Reg § 1.482-1(d)(3)(iii)(A).

It is important to note that only adjustments that are quantifiable and have a material impact on price should be made. Therefore, before adjusting the price of a comparable uncontrolled transaction, the Service should quantify the impact of the assumption of currency risk and determine whether it materially affects the controlled transactions. Treas Reg § 1.482-1(d)(2).[2]

We do not have sufficient facts to determine whether inventory purchased by Taxpayer from its parent was priced at arm's length. We suggest that the examiners undertake the two-step analysis outlined above to determine the appropriate section 482 price. We believe, however, that the use of historical exchange rates, as computed by Taxpayer, is not an appropriate means of adjusting for currency risk (assuming such an adjustment is appropriate).

B. The arm's length price must be translated into U.S. dollars at the spot rate on the accrual date.

After evaluating Taxpayer's controlled transactions and making any necessary adjustments under section 482 to the purchase price of the inventory (including adjustments to reflect the allocation of currency risk), the arm's length price must be translated into U.S. dollars based at the spot rate on the accrual date. See Willard Helburn, Inc. v. Commissioner, 20 T.C. 740 (1953) (inventory is priced at the spot rate on day of purchase), aff'd, 214 F.2d 815 (1st Cir. 1954); Joyce-Koebel Co. v. Commissioner, 6 B.T.A. 403 (1927) (same), acq., 1927-2 C.B. 4; Rev. Rul. 78-281, 1978-2 C.B. 204. The use of historical exchange rates, such as those used by Taxpayer, are not appropriate.

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[2] *See generally* Mitchell J. Tropin, *Currency Fluctuations' Impact on Transfer Pricing Creating Compliance Problems for Taxpayers,* TRANSFER PRICING REPORT (BNA), Feb. 15, 1995, at 721; Toru Nakamura, *Adjusting for Currency Risk in a Transfer Pricing Analysis,* TRANSFER PRICING REPORT (BNA), Mar. 27 1996, at 767; Lawrence Olson*, Transfer Prices and Exchange Rates for Japanese Companies Operating in the United States,* TRANSFER PRICING REPORT (BNA), April 12, 1995, at 886.

C. Section 988 will apply to payables determined by reference to a nonfunctional currency.

Separate and apart from the issue of whether Taxpayer's inventory purchases were priced at arm's length under section 482 is the issue of whether section 988 applies to payables arising from the purchase of inventory by Taxpayer. A section 988 transaction is defined as any transaction described in section 988(c)(1)(B) where the amount a taxpayer receives (or pays) is denominated in a nonfunctional currency or is determined by reference to the value of one or more foreign currencies. Section 988(c)(1); Treas. Reg. §1.988-1(a)(1). A section 988 transaction includes accrual of any item of expense, gross income, or receipt that is to be paid or received on a later date. Section 988(c)(1)(B)(ii); §1.988-1(a)(2)(ii) (nonfunctional currency payables and receivables generally are section 988 transactions). A section 988 transaction does not need to require or permit payment with a nonfunctional currency if any amount paid or received is determined by reference to the value of one or more nonfunctional currencies. §1.988-1(a); S. Rep. No. 99-313, 99th Cong., 2d Sess., (1986) at 460.

To the extent that inventory sold in the Z Taxable Year to Taxpayer gave rise to a payable determined by reference to currency X, such payable is a section 988 transaction. Pursuant to § 1.988-2(c), Taxpayer must take into account foreign currency gain or loss on the payment date.

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John Staples
Associate Chief Counsel
(International)
By: JEFFREY DORFMAN
Chief, Branch 5
Office of Associate Chief Counsel
(International)