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by Alessandro-Adelchi Rossi

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U.S. Deferral of Losses From Hedging Transactions Within an Italian Controlled Group

by Alessandro-Adelchi Rossi

Alessandro-Adelchi Rossi is with Funaro & Co. PC in New York.

When a U.S. corporation purchases goods from its Italian parent in one currency and sells in another, it is routinely exposed to currency risk that is likely to affect the profitability of its business enterprise and its transfer pricing policy.

With the dollar falling against the euro, it is not uncommon for such risk to be hedged by the U.S. member of the group in contracts with foreign members of the group. Depending on exchange rate changes, a U.S. subsidiary that enters into such a contract with a foreign affiliate may occasionally realize a loss that is treated for U.S. tax purposes as a loss from the sale of property to a related person.

While the U.S. transfer pricing regulations do not address currency risks in terms of whether allocations are appropriate or, if so, how they would be determined, the IRS suggested that a possible approach is to determine the arm's-length charge for assuming a specific currency or financial risk in light of the ready market that exists for any hedging and related transactions.

In addition to the transfer pricing ramifications, however, and therefore regardless of the arm's-length nature of the related-party transactions, U.S. subsidiaries of Italian corporations should also address the restrictions and limitations imposed under U.S. domestic laws to the deductibility of losses on sales and exchanges of property between related persons.

Section 267(a)(1) of the Internal Revenue Code denies deductions for losses on sales and exchanges of property between related persons. For sales between members of a controlled group of corporations, the disallowance rule of section 267(a)(1) is superseded by section 267(f)(2), which defers the loss until the property is sold or exchanged to someone outside the group.

The application of this rule in a hedging transaction has been recently addressed by the IRS in LTR 200945026, which describes a group of U.S. corporations whose U.S. parent is wholly owned by a foreign public company with subsidiaries worldwide, and where the foreign parent, the foreign affiliates, and the U.S. group constitute a ''controlled group'' within the meaning of section 267(f)(1).

The IRS ruled that a loss realized by a U.S. corporation from a currency contract with a foreign affiliate that is treated as loss from the sale or exchange of property will be deferred under section 267(f)(2) only until the foreign affiliate has taken its corresponding item of income into account under the foreign affiliate's method of accounting, if no currency involved in such contract is hyperinflationary.

Consider an Italian group that engages in currency hedging transactions. Assume that the transactions between U.S. members and Italian members of the group are priced in euros, exposing the U.S. members of the group to currency risk. Such risk may be hedged in contracts with a foreign affiliate, which in turn may consolidate the currency risks of hedging contracts with its affiliates and hedge the net risk with a third party.

Depending on exchange rate fluctuations, a U.S. member of the group that enters into such a contract

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with a foreign subsidiary may from time to time realize a loss that is treated for U.S. tax purposes as a loss from the sale of property to a related person.

Such loss will be deferred, but only until the foreign affiliate has taken its corresponding item of income into account under the foreign affiliate's method of accounting.

Any gains recognized by the foreign entity that enters into a currency contract with a U.S. affiliate would generally not be subject to tax in the United States because they would be from sources without the United States and not effectively connected with the foreign affiliate's conduct of a trade or business within the United States. ◆

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