

April 30, 1998

Internal Revenue Service,  
Attn: CC: DOM: CORP: R  
Announcement 98-18  
Room 5226  
PO Box 7604  
Ben Franklin Station  
Washington DC 20044

**Tax Issues Raised by the European Monetary Union (98-18)**

Dear Sirs:

The International Swaps and Derivatives Association ("ISDA") is pleased to submit this comment letter to the Internal Revenue Service (the "IRS") in response to the IRS' Announcement 98-18, requesting comments on the tax issues raised by European Economic and Monetary Union ("EMU").

ISDA is an international financial trade association whose membership comprises over 340 of the world's largest commercial, merchant and investment banks and other institutions. ISDA's members represent a broad cross section of the institutions that act as end-users of swaps and other privately negotiated derivatives transactions. A recent list of members is attached as Annex A. More information about ISDA and its activities can be found on the ISDA website at **<http://www.isda.org>**

ISDA is grateful to the IRS for its efforts to clarify the implications of EMU for US taxpayers. ISDA has been monitoring closely the impact of EMU on the swaps and derivatives industries. The ISDA EMU Tax, Accounting and Capital Task Force has been working with the Inland Revenue in the United Kingdom to address the tax related issues surrounding the conversion to the single currency.<sup>1</sup> Additionally, ISDA has formed working groups to address

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<sup>1</sup> In 1997, ISDA, in conjunction with the London Investment Banking Association, the British Bankers Association, the International Primary Markets Association, the International Securities Markets Association and the American Banking and Securities Association in London submitted two papers to the Inland Revenue in the UK. The first, dated July 4 1997, sought to address the major tax issues surrounding the EMU. The second, dated October 24 1997, was a Question and Answer paper addressing less-contentious issues arising from the EMU. Copies of these papers are attached as Annex B.

documentation, legislative and regulatory, market practice, and operations issues associated with EMU. The implications of EMU for US taxpayers are of great interest to ISDA and its members.

ISDA believes that the consequences of the transition to the euro for US taxpayers should be minimized and that the conversion itself should be a tax neutral event. To this end, ISDA recommends that the IRS issue guidance that the conversion to the euro is not a change in functional currency under Section 985 of the US Internal Revenue Code (“the Code”) and that the conversion of a national currency of a participating country (a “national currency”) to the euro is not a realization event for a financial instrument denominated in a national currency.

**1. Whether a Qualified Business Unit (“QBU”) with a national functional currency that is converted to the euro will have changed its functional currency under Section 985?**

The issue in the context of the conversion to the euro is whether the conversion to the euro is more properly viewed as (a) a redenomination or (b) a replacement of the national currency by the euro.

ISDA believes that the conversion to the euro is not a change in functional currency under Section 985 of the Code. Instead, ISDA suggests that the most reasonable option is to treat the conversion to the euro as a redenomination of the national currencies to the euro.

Currently, a US taxpayer who operates a QBU in another country must use as its functional currency the currency of the business environment in which a significant part of its business activities are conducted.<sup>2</sup> The concept of a functional currency is important because a US taxpayer is not required to recognize foreign exchange gains or losses with respect to a foreign exchange transaction that is denominated in its own functional currency. If, however, a QBU changes its functional currency, it is required to account for gains or losses that accrued in the old functional currency and that cannot be preserved after the change. That gain or loss is recognized in full on the last day of the taxable year ending before the year in which the new functional currency is adopted.

From January 1, 1999 the exchange rates at which national currencies are converted to euro will go into effect. For a three year period from January 1, 1999 the euro may be used at the option of the individual, however, the national currencies will continue to exist. There will be no euro cash or coins during the transition period; there will only be national currency cash and coins. From January 1 1999, QBUs will have the option of converting existing contracts to the euro. They may continue to conduct all aspects of their business, such as payroll, pricing decisions and the generation of income in their national currency. It is possible, therefore, that a QBU may operate in its national currency for some purposes and in the euro for others.

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<sup>2</sup> Among the factors to consider in determining the functional currency of the QBU are the currency of the country in which the QBU is a resident, the currencies of the QBU’s cash flows, the currencies in which the QBU generates revenues and incurs expenses, the currencies in which the QBU borrows and lends, the currencies of the QBU’s sales markets, and the currencies in which pricing and other financial decisions are made.

During this time, the national currencies and the euro will effectively co-exist as different expressions of one value.<sup>3</sup> This three year period, where the use of the euro is at the option of the individual, is known as the “no compulsion, no prohibition” period. The European Monetary Institute has said that during this time, “private economic agents will be free to use the euro; at the same time they should not be obliged to do so. As far as possible, they should be allowed to develop their own mechanisms of adjustment to the changeover.”<sup>4</sup>

The structure of the transitional period is consistent with the conclusion that conversion to the euro is not a change in functional currency, but a redenomination of the national currency to the euro. During this period, the euro does not completely supersede the national currencies. It is a unit for which another currency may be exchanged. There will be legal equivalence between the euro unit and the national currency whereby monetary debt denominated in a national currency is assigned a fixed value in terms of the euro at the official conversion rate and vice versa. In these circumstances the conversion is properly seen as a redenomination. In the same way that a country that pegs its currency to another source does not change its functional currency, neither does an institution that converts from a national currency to the euro.<sup>5</sup>

Regulation 1.985-5(b) provides that a taxpayer cannot change its functional currency at any time other than the beginning of a taxable year. If the conversion is to be viewed as a change of functional currency under the current US tax code, the change would have to be made as of January 1, 1999. This would mean that all affected QBU’s would have a new functional currency from the beginning of their first taxable year beginning on or after January 1, 1999. This would result in the early triggering of the recognition of gains or losses under these Section 988 and an acceleration of tax liabilities for US taxpayers holding Section 988 instruments denominated in a national-currency.

This outcome would be inconsistent with the “no compulsion, no prohibition” principle that operates during the transition period. It would treat all transactions of a QBU as being denominated in the euro from January 1, 1999, regardless of how the QBU actually chooses to denominate its transactions during the transition period. Not only would this contradict the goal of the EMI to allow parties to develop their own mechanisms of adjustment to the changeover, it would effectively result in an artificial acceleration of recognition of gain or loss, as the gains or losses from the change from one functional currency to another would have to be taxed during the first taxable year beginning on or after January 1, 1999, whether they had been converted or not.

In light of this, ISDA believes that the goals of continuity and consistency are best served by not treating the conversion to the euro as a change in functional currency under Section 985 of the Code. Instead, ISDA recommends that the conversion is treated as a redenomination.

## **2. Whether the conversion of a national currency to the euro creates a realization event for a financial instrument denominated in a national currency and the appropriate time for recognizing gain or loss.**

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<sup>3</sup> The EMI has said that “the changeover will necessarily be characterized by a temporary co-existence of two monetary units.” See European Monetary Institute, *The Changeover to the Single Currency*, 12

<sup>4</sup> *Id.*

<sup>5</sup> See for example the decision by the Argentine Government to peg its currency to the US Dollar.

ISDA believes that the conversion to the euro does not constitute a realization event. Instead, ISDA suggests that any gains or losses from the conversion should be recognized at the disposition of the contract and not at the time of conversion.

The issue arises first in the context of Section 988. A Section 988 transaction includes acquiring or issuing a debt instrument; accruing an item of income or an expense that will be received or paid in the future; or entering into any forward contract, option or similar financial instrument, when the amounts to be received or paid are denominated in or by reference to a non-functional currency. Under regulation 1.985-5(b), when a QBU changes its functional currency, it must recognize gains or losses with respect to any Section 988 transactions denominated in terms of or by reference to the new functional currency. This allows recognition of currency gains or losses that accrued in the old functional currency and which cannot be preserved after the change.

If, as ISDA believes, the period of transition to the euro does not lead to a change in functional currency for QBUs, the provisions of Section 988 requiring the recognition of gains and losses are not triggered. If, however, the conversion is viewed as a change in functional currency, ISDA asks that the IRS not require taxpayers to measure the gain or loss as of January 1, 1999, but instead allow them to defer recognition of that gain or loss until the time that it would have been recognized had there been no change in functional currency. Allowing a deferral of recognition would cause the least disturbance to the existing tax position of the QBU and would therefore be the most neutral means of accounting for the involuntary change.

The issue of realization also applies to Section 1001 of the Code. Under Section 1001 of the Code, a taxpayer is required to recognize foreign exchange gains or losses if an existing contract is substantially modified, so that the holder will be deemed to have realized one financial instrument in exchange for another. Reg. 1.1001-3 provides that a modification to a financial instrument is significant if the legal rights and obligations are altered, and the degrees to which they are altered are economically significant.

ISDA believes that the conversion from the national currency to the euro is not a substantial modification that alters the legal rights of the parties to a degree sufficient to bring it within the scope of Section 1001. The fundamental obligations of the parties will remain the same. There will be no change to the creditworthiness of the parties, warranties, representations or covenants made by the parties, the timing of the payments, or the duration of the contract. The only change will be the unit in which the payment obligations are denominated. Because the national currencies and the euro are merely different expressions of the same value, this change should not be viewed as economically significant for the purposes of Section 1001.

This conclusion is consistent with the “continuity of contract” principle that has been adopted by the European Council and by state legislatures in New York and Illinois (with legislation pending in California). The European Council regulations provide that “The introduction of the euro shall not have the effect of altering any term of a legal instrument or of discharging or excusing performance under any legal instrument, nor give a party the right

unilaterally to alter or terminate a legal instrument.”<sup>6</sup> Similarly, the New York and Illinois legislation provides that the euro is a commercially reasonable substitute for the currencies of all participating countries and the ECU. Substantively, the regulations and legislation recognize that the conversion itself is not, and should not be treated as, an event that alters the substantive obligations of the parties.

Further, we believe that the conversion is not a proper time for recognition even in the case of currency swaps and floating for floating cross currency interest rate swaps in which both of the currencies are converting to the euro. For example, if an end-user has entered into a swap in which it pays Lira Libor and receives Deutschemark Libor that swap becomes, in effect, an annuity upon both currencies conversion to the euro. These cash flows should be taken into income under the end user’s normal method of accounting.

### **3. Other issues**

ISDA believes that there are other reasons why the tax implications of the EMU conversion should be minimized. The implementation of EMU will raise major operational issues for all business organizations affected by the conversion. Firms will be implementing costly system-wide changes that will need to be operational by January 1, 1999. The process of accommodating the changeover will continue throughout the transition period. At the same time, businesses worldwide will be coming to terms with the issues associated with planning for the Year 2000. To require recognition of exchange gain or loss at a time when businesses are grappling with these major challenges would complicate an already burdensome and uncertain process. The IRS itself has recognized the extent of these operational burdens in Notice 98-16 which announced an extension of the effective date of the Section 1441 withholding and information reporting regulations.

### **Conclusion**

ISDA commends the IRS in addressing the important issues raised by EMU for US taxpayers. The Request for Comments has identified two of the most important issues raised by the conversion in the US tax context. The cumulative effects of EMU will pose significant challenges to US taxpayers in many aspects of their business. ISDA believes that the IRS should seek to mitigate the tax consequences of the conversion. To this end, ISDA recommends that the Treasury issue guidance that the conversion to the euro is not a change in the functional currency of a QBU and, further, that the conversion to the euro is not a realization event for existing contracts denominated in a national currency.

ISDA appreciates this opportunity to comment on the issues raised by EMU and would welcome any discussion of these or related matters. If you have any questions regarding the matters discussed in this letter, please feel free to contact either of us.

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<sup>6</sup> Article 3 of European Council Article 235 regulation

Sincerely,

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