# Brexit Fallout: US Individual Income Tax Implications Of An Appreciating US Dollar


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## The Impact Of Brexit On Foreign Currency And Asset Values

The unprecedented decision on June 23, 2016 by voters in the UK to exit the EU, known as "Brexit," created an environment of uncertainty for the foreseeable future, and likely for many more years to come.

In the short term, the UK government has appointed Theresa May as the new Prime Minister, who, in turn, has appointed her new cabinet members and a task force to negotiate Britain's exit from the EU. The medium- and long-term impact on the economy are speculative at this juncture and will evolve over time through secession negotiations. It is too early to tell to what extent the UK government will enact new law without regard to existing EU directives, the fundamental freedoms or principles established as controlling precedent under EU authority.

Despite having little, if any, immediate impact to UK direct and indirect taxes, the referendum vote by the UK to leave the EU sent an immediate negative shock to the economy. Most notably, the British Pound (GBP) fell to its lowest value in 30 years and has remained stagnant over the two months following the referendum vote.

There has been a similar impact on the Euro. International stock markets also experienced an immediate impact with the S&P 500, Dow Jones Industrial Average, the London FTSE 100, Germany's DAX and France's CAC 40 all falling in the early morning trading in the wake of Brexit. These changes have interesting consequences for individuals exposed to these currency and asset changes, who are also tied in some way to the US income tax system.

For example, in the case of rules governing US individual income taxation of personal transactions involving foreign currency, there are potential tax consequences connected to personal property acquired using foreign currency when the US dollar has appreciated in value since acquisition. In particular, employees of multinational companies on an international business assignment in the US may incur unexpected US tax costs for conducting personal affairs unrelated to their employment activity.

Many mobile employees are home owners and face decisions about what to do with their residence while going on an international business assignment. Some may decide to maintain their home while on an international assignment abroad; others may rent; and some may decide to sell.

Although there are tax consequences for each scenario; those employees considering selling are more likely to incur an unexpected US tax cost if they fail to consider the US tax rules in light of the current foreign currency market. In a worst-case scenario, such an individual may suffer a non-deductible economic loss on the sale of the property, yet, ironically, be required to pay US income tax on the "foreign currency gain" connected to the payoff of the foreign mortgage secured by the residence.

Although it might be easy to understand the personal, and therefore non-deductible, nature of losses from depreciating asset values, the taxation of currency gains in connection with reducing foreign mortgages may be more difficult to comprehend. In the sections that follow, we will describe the history and application of these rules in more detail.

## History Of US Tax Rules Governing Foreign Currency

The legislative history surrounding US taxation of foreign currency is complicated, so some background is helpful to understanding the mechanics of the rules governing US tax on the disposition of a nonfunctional currency by an individual taxpayer in a personal transaction.

In 1986, Congress codified a set of comprehensive rules governing most foreign currency transactions and foreign currency translation as part of the Tax Reform Act of 1986 (hereafter "1986

Act")[1] by enacting current Subpart J of the Internal Revenue Code of 1986, *as amended* (hereafter "the Code").[2] Prior to the 1986 Act, court decisions and revenue rulings were inconsistent in the application of rules controlling foreign currency transactions (*i.e.,* gain or loss in purchasing power attributed to fluctuations in value from when a foreign currency is acquired relative to when it is disposed) and foreign currency translation (*i.e.,* gain or loss incurred on translating foreign currency into United States Dollar ("USD").

Much of the confusion from the pre-1986 era was the result of a judicially established notion that foreign currency constitutes property for US income tax purposes.[3] Treating foreign currency as property, as opposed to a medium of exchange, requires independent review of a transaction (or series of integrated transactions) involving foreign currency (or property denoted in foreign currency), to determine the governing tax principles applicable to such property transaction(s) and its relevant tax consequences (that is, the timing, amount, character and source of the foreign currency gain or loss) of the transaction.

### Limited Scope Of Section 988 Transactions To Individual Taxpayers

The enactment of Subpart J of the Code offers a consistent statutory framework governing the tax treatment of "foreign currency gain" [4] and "foreign currency loss" [5] of transactions that are business or income producing. However, there is limited statutory guidance applicable to foreign currency transactions of individual taxpayers that are personal in nature. Most personal transactions of individuals involving foreign currency are outside the scope of Subpart J and governed by the laws established before the 1986 Act.[6] Conversely, business or investment transactions of individuals involving foreign currency are within the scope of Subpart J and are generally controlled by Section 988 of the Code.

In general, any amount of gain (or loss) incurred from a Section 988 transaction is to be computed separately and treated as ordinary income (or loss).[7] The source of any amount treated as ordinary income or loss from a Section 988 transaction is determined by reference to the residence of the taxpayer or the qualified business unit of the taxpayer on whose books the asset, liability, or item of income or expense is properly reflected.[8]

With respect to an individual taxpayer, the scope of Section 988 is limited to business or investment transactions entered into by an individual.[9] Treatment as ordinary income and loss from a Section 988 transaction does not apply to transactions of an individual which are personal in nature.

When dealing with personal transactions of an individual, gain realized on the disposition of a "nonfunctional currency" by an individual in a personal transaction is not recognized if the gain which would otherwise be recognized on the transaction does not exceed USD200.[10] Gain realized in excess of USD200 on the disposition of a nonfunctional currency of an individual in a personal transaction is controlled by the laws established before IRC section 988 was enacted.[11]

## Foreign (Non-US) Currency Transactions Of An Individual Which Are Personal In Nature

For US tax purposes, all taxpayers must make their initial determination of income or loss in its "functional currency." [12] The USD is the functional currency of all individual taxpayers.[13] Nonfunctional currency is the currency of a taxpayer other than its functional currency. Therefore, foreign currency is always the nonfunctional currency of an individual taxpayer.

Because US income tax reporting must be prepared in terms of USD, an individual's cost basis in property acquired using a foreign currency must be converted to USD at the date of acquisition. Any subsequent adjustments to basis made in foreign currency are converted to USD on the date of such adjustment.

When there is a sale or exchange of property purchased using foreign currency, any unrealized foreign currency gain attributed to the USD appreciation in value since the time of acquisition is treated as a separate transaction from the sale of the underlying property.[14] These rules apply universally and irrespective of whether a foreign person has ever had a US tax obligation or income tax reporting requirement.

This universal rule explains why a mobile employee who becomes taxable as a US resident alien may encounter unexpected tax consequences for conducting personal affairs unrelated to his or her international business assignment when the USD appreciates in value relative to their home country currency.

Many mobile employees may own a principal residence before commencing a long-term international business assignment in the US. If the property is secured by a mortgage denoted in a foreign currency, or perhaps funded through a foreign investment vehicle, then a payoff of the loan's principal balance is taxable if it occurs during US residency and the unrealized gain from the appreciation in value of the USD exceeds USD200 at the time of payment.

For example:

*Assume taxpayer B is a UK National who purchased a principal residence in the UK on January 1, 2009 for GBP70,000 (USD90,801) by making a GBP10,000 down payment and financing the remaining balance with a 15-year interest only mortgage. For 2009 US income tax purposes, B is a nonresident alien.*

*On May 1, 2016, B commences a three-year international business assignment in the US and will be taxable as a US resident alien since this date. B sells his UK residence on August 10, 2016, for GBP60,000 and retires the outstanding GBP60,000 loan balance.*

*For US income tax purposes, B realizes a* nondeductible personal loss *on the sale of the residence.*

*However, the unrealized gain from the USD appreciation in value relative to the GBP during the period the loan was obtained through the date of repayment is recognized as ordinary income from a disposition of the taxpayer's nonfunctional currency. As a result, B is subject to tax on USD8,976 of passive interest income from sources within the US.*

| Repayment of foreign mortgage | | |
|---|---|---|
| Date Mortgage was obtained | 1/1/2009 | |
| Ex rate (USD:GBP) | USD1.4493 | GBP1.00 |
| Date mortgage was repaid | 8/10/2016 | |
| Ex rate (USD:GBP) | USD1.2997 | GBP1.00 |
| Mortgage principal repaid | GBP60,000 | |
| Ex rate @ repayment | USD1.2997 | |
| Amount Realized | USD77,982 | USD(77,982) |
| Mortgage principal repaid | GBP60,000 | |
| Ex rate @ repayment | USD1.449 | |
| Cost Basis | USD86,958 | |
| Accumulated Depreciation | N/A | |
| Adjusted Tax Basis | USD86,958 | USD86,958 |
| Gain (Loss) Realized | | **USD8,976** |
| Gain (Loss) Recognized | | **USD8,976** |
| Character | Ordinary-passive (interest) | |
| Source | US (Treas. Reg. §1.8612) | |

## Tax Planning Considerations For Individuals With Mortgages Denoted In Foreign (Non-US) Currency

In the previous example, the simplest approach to avoid triggering gain on the mortgage repayment may be for B to repay the principal balance before establishing US resident tax status, or defer the mortgage repayment until after B terminates status as a US resident. Of course, this may not always be a practical approach for a seller who requires an expedited sale because of a business relocation or another reason beyond their direct control.

So what can be done in cases where an individual comes to the US while still maintaining a foreign mortgage?

Consider the US tax principles leading to B's unrealized gain connected to the mortgage. As discussed, pre-1986 rules establish a universal rule that US tax basis in foreign currency or property denoted in foreign currency, is equal to the USD value at acquisition. There is no consideration or relevance afforded to the USD value at the time US resident status is established. Had this been the rule, then unrealized gain would be limited to the increase in value attributed to the period the individual was subject to US resident tax.

Nonetheless, it may be possible for a taxpayer in B's situation to take steps to reduce the foreign currency gain before coming to the US. If B had refinanced the outstanding debt before US residency was established, then B would only be exposed to US tax on the retirement of the debt to the extent of future USD appreciation (although, in light of Brexit and the devaluation of the GBP there may likely be an unrealized gain connected to the debt even with a refinance occurring before B arrives in the US).

Since the GBP devalued to a 30-year low following Brexit, the cost for a taxpayer to refinance their debt to achieve a step-up in basis of the debt before establishing US resident status can be considered as a way to limit the US tax exposure should the individual plan to sell their residence in the foreseeable future once they establish US residency.

## Conclusion

As explained in this article, economic events outside the US (*e.g.,* Brexit), can impact asset and mortgage values for individuals relocating to the US. In the worst scenarios, individuals with a foreign home and mortgage could find themselves with a non-deductible loss from the sale of their home and a taxable gain from the settlement of their mortgage.

Although not discussed in detail in this article, it is even possible for the reverse to occur. That is, individuals might find themselves with a larger gain from the sale of their home after moving to the US if the foreign currency has become stronger. In this case, there will likely be a loss on the pay off of the mortgage, which again is non-deductible due to the personal nature of the loss. So, even though these two transactions (the sale of the home and the retirement of the mortgage) erase much, if not all, of the economic gain to the individual, the different treatment of these items for tax purposes will create additional tax liability.

As a result of these rules, and the inability to net the gains and losses from the two transactions, it is even more important for individuals moving to the US to better plan in advance for the tax consequences of their move. Failing to consider the changes in the global foreign currency market may create an unexpected US tax outlay for the unwary.

## Endnotes

1 Tax Reform Act of 1986, P.L. 99-514.

2 Sections 985-989 of the Code.

3 *See Gillin v. United States*, 191 Ct. Cl. 172, 423 F.2d 309 (1970) (stating "For our legal system, however, foreign currency, which is not established by United States law, has a different status. Account is taken, much more often (if not always), of its fluctuations in value, and it is frequently treated, not as the medium of exchange, but as property or a commodity …")

4 Section 988(b)(1) of the Code. ("The term 'foreign currency gain' means any gain from a section 988 transaction to the extent such gain does not exceed gain realized by reason of changes in exchange rates on or after the booking date and before the payment date.")

5 Section 988(b)(2) of the Code. ("The term 'foreign currency loss' means any loss from a section 988 [IRC Sec. 988] transaction to the extent such loss does not exceed the loss realized by reason of changes in exchange rates on or after the booking date and before the payment date.")

6 *See* Rev. Rul. 90-79, 1990-2 C.B. 187. (Stating "Under the law predating section 988, the borrowing and repayment of the mortgage loan is a separate transaction from the purchase and sale of the personal residence …")

7 Section 988(a)(1)(A) of the Code.

8 Section 988(a)(3)(A) of the Code.

9 Section 988(e)(3)(A) & (3)(B).

10 IRC Section 988(e)(2) *flush language.*

11 *Supra.* Rev. Rul. 90-79.

12 Section 985(a) of the Code.

[13] Section 985(b)(1) of the Code. ***See also*** Section 985(b)(1)(B) – (b)(3). (A unit of a taxpayer's trade or business which constitutes a Qualified Business Unit (QBU) has a functional currency of the economic environment in which it operates and maintains its books and records, unless an election is made by an eligible QBU to have a USD functional currency).

[14] ***Supra,*** Rev. Rul. 90-79.