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Investment management tax alert
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Hyperinflationary Currency and the Argentine Peso: US Tax Implications

Key U.S. tax considerations for taxpayers holding investments denominated in the Argentine Peso (ARS) that are treated as section 988 transactions.

Background

Section 988 provides rules for determining the U.S. tax treatment of foreign exchange gain and loss on certain financial transactions denominated in nonfunctional currency, including debt instruments and foreign currency derivatives ("section 988 transactions"). Special rules are provided for section 988 transactions denominated in or determined by reference to a currency treated as "hyperinflationary currency," as defined in Treas. Reg. § 1.988-1(f) ("hyperinflationary currency"[1]).

This alert discusses recent developments related to the potential classification of the ARS as a hyperinflationary currency for purposes of section 988. As examined below, there are varying U.S. tax implications for taxpayers that hold investments in hyperinflationary currencies depending on the type of financial instrument held.

Determination of Hyperinflationary Status

Hyperinflationary currency refers to the currency of a country in which there is cumulative inflation of at least 100% during the "base period."[2] Inflation rates are determined by reference to the consumer price index ("CPI") of the country listed in monthly issues of the "International Financial Statistics" or a successor publication of the International Monetary Fund (IMF). If a country's currency is not listed, a taxpayer is permitted to use any other reasonable method consistently applied in determining the country's CPI. The cumulative inflation rate for the base period is based on compounded inflation rates. For example, assume that a base period consists of three calendar years, Year 1, Year 2, and Year 3. Assume also that in Year 1, Year 2, and Year 3, a country's annual inflation rates are 6%, 11%, and 90%, respectively. In such case, the cumulative inflation rate is 124% [((1.06 x 1.11 x 1.90) - 1.0 = 1.24) x 100 = 124%].

For purposes of section 988, the "base period" for taxpayers other than RICs and REITs is the thirty-six calendar month period ***ending*** *on the* ***last day*** *of the taxpayer's current* ***taxable*** *year.*[3] For example, assume the taxpayer has a calendar year as its taxable year. To determine whether the currency is hyperinflationary in the taxable year ending on 12/31/19, the base period consists of calendar years 2017, 2018, and 2019 (*i.e.*, the thirty-six calendar months ending on the last day of the current taxable year). Assume, on the other hand, that the taxpayer has a taxable year ending on 11/30/2019. In such case, the base period consists of the thirty-six calendar months beginning on 12/1/2016 and ending on 11/30/2019.

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[1] Unless otherwise stated, the term "hyperinflationary currency" refers to the definition provided specifically for purposes of section 988 in Treas. Reg. § 1.988-1(f). Note that there are separate definitions of the same term for U.S. GAAP purposes as well as for purposes of applying the Dollar Approximate Separate Transactions Method of Accounting (Treas. Reg. § 1.985-1(b)(2)(ii)(D)).
[2] Treas. Reg. § 1.988-1(f)(1) (referencing Treas. Reg. § 1.985-1(b)(2)(ii)(D)). The last sentence of § 1.985-1(b)(2)(ii)(D) does not apply to alter the base period in determining whether a currency is hyperinflationary for purposes of section 988. Accordingly, GAAP principles may not apply to alter the base period. Treas. Reg. § 1.988-1(f)(1)(ii)(B).
[3] Treas. Reg. § 1.988-1(f)(1)(ii)(A).

For RICs and REITs,[4] the "base period" means, with respect to any taxable year, the thirty-six calendar months *immediately **preceding** the **first day** of the current **calendar** year*. For example, assume the taxpayer has a calendar year as its taxable year. To determine whether the currency is hyperinflationary in the taxable year ending on 12/31/19, the base period consists of calendar years 2016, 2017, and 2018 (*i.e.*, the thirty-six calendar months immediately preceding the first day of the current calendar year, which is 2019). Assume, on the other hand, that the taxpayer has a taxable year ending on 11/30/2019. In such case, the base period consists of the calendar years 2015, 2016, and 2017 (*i.e.*, the thirty-six calendar months immediately preceding the first day of the current calendar year, which is 2018[5]).

With respect to Argentina, no CPI was published by the Argentinian government or the IMF for certain months during 2015 and 2016.[6] However, CPI for Argentina was published by the IMF for calendar years ending 2017, 2018, and 2019. Based on the published inflation rates, Argentina meets the 100% cumulative inflation requirement during 2017, 2018, and 2019 calendar years (*i.e.*, the thirty-six calendar months period ending on 12/31/2019).[7] As a result, for calendar year non-RIC and non-REIT taxpayers, the ARS is a hyperinflationary currency for purposes of section 988 for taxable years ending on or after 12/31/2019. For calendar year RIC and REIT taxpayers, the ARS is a hyperinflationary currency for purposes of section 988 for taxable years beginning on or after 1/1/2020.[8]

Summary of Tax Implications

Hyperinflationary Debt Instruments and Deposits

Special rules apply to section 988 transactions that are "hyperinflationary debt instruments" and "hyperinflationary deposits."[9]

Subject to an exception described further below, a "hyperinflationary debt instrument" or "hyperinflationary deposit" is a debt instrument or deposit that has payments denominated in or determined by reference to a hyperinflationary currency (hereinafter, the "ARS denominated debt instrument") – *if* the instrument is acquired in the taxable year in which the currency is considered hyperinflationary for the taxpayer.[10] Thus, with respect to a non-ARS functional currency calendar year non-RIC/non-REIT taxpayer, an ARS denominated debt instrument acquired in 2018 is generally not a "hyperinflationary debt instrument," and an ARS denominated debt instrument acquired in 2019 would generally be a "hyperinflationary debt instrument."

If, however, the terms of an ARS denominated debt instrument provide for the adjustment of principal or interest payments in a manner that reflects hyperinflation,[11] such instrument becomes hyperinflationary *in the taxable year* in which the currency becomes hyperinflationary for the taxpayer – even if the

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[4] Treas. Reg. § 1.988-1(f)(1)(i) and (ii)(A). The Service may also, by notice, provide that the rule for RICs and REITs (and not the general rule) applies to any section 988 transaction of an entity with distribution requirements similar to a RIC or REIT.
[5] With respect to a taxable year, the "current calendar year" appears to refer to the calendar year in which the current taxable year begins.
[6] [Reference Deloitte DASTM alert and Deloitte accounting alert.]
[7] In 2017, 2018, and 2019, IMF reported Argentina's annual inflation rates (based on average consumer prices) as 25.7%, 34.3%, and 54.4%, respectively. *See* IMF World Economic Outlook, DataMapper, Inflation rate – average consumer prices (Oct. 2019), *available at* https://www.imf.org/external/datamapper/PCPIPCH@WEO/OEMDC/ARG; *see also* IMF CPI, Country Indexes and Weight, Argentina, *available at* https://data.imf.org/regular.aspx?key=61015892. Based on this data, the cumulative inflation rate is 160.7% [((1.257 x 1.343 x 1.544) - 1.0 = 1.607) x 100 = 160.7%].
[8] Given that CPI was available for some of the months in 2016, it is possible that the 100% inflation rate requirement would be met earlier in 2019. In such case, for fiscal year non-RIC/non-REIT taxpayers, the ARS could be a hyperinflationary currency for purposes of section 988 for taxable years ending on or after such earlier date. On the other hand, for RIC/REIT taxpayers, the ARS would be a hyperinflationary currency for purposes of section 988 for taxable years beginning on or after 1/1/2020 at the earliest.
[9] Treas. Reg. § 1.988-2(b)(15). These rules generally do not apply to debt instruments or deposits that are subject to Treas. Reg. § 1.446-4 or integrated under Treas. Reg. § 1.988-5.
[10] Treas. Reg. § 1.988-2(b)(15)(vi)(A)(1).
[11] For example, an ARS denominated debt instrument with a variable interest rate based on local conditions and generally responding to changes in the local CPI meets this requirement.

instrument were acquired in a prior year.[12] Thus, with respect to a non-ARS functional currency calendar year taxpayer, an ARS denominated debt instrument that meets this exception is a "hyperinflationary debt instrument" for a non-RIC/non-REIT taxpayer in the 2019 taxable year and for a RIC/REIT taxpayer in the 2020 taxable year – even if the instrument was acquired in 2018 or before.

Once a debt instrument or deposit becomes a hyperinflationary debt instrument, the rules effectively require the taxpayer to mark to market the exchange gain or loss on such debt instrument or deposit during a certain period.[13] Specifically, a taxpayer with a hyperinflationary debt instrument or deposit realizes exchange gain or loss with respect to such instrument or deposit for its taxable year based on the change in exchange rates between (A) the later of the first day of the taxable year or the date the instrument was acquired (or an amount deposited), and (B) the earlier of the last day of the taxable year, or the date the instrument (or deposit) is disposed of. Such exchange gain or loss is directly allocable to the interest expense or interest income, respectively, from the debt instrument or deposit, and therefore reduces or increases the amount of interest income or interest expense paid or accrued during that year with respect to that instrument or deposit (with the excess exchange gain or loss, if any, characterized and sourced under the normal section 988 rules).[14]

Hyperinflationary Contracts and Swaps

Similar rules apply to section 988 transactions that are "hyperinflationary contracts."[15] Hyperinflationary contracts are defined as currency forward contracts, currency futures contracts, and currency options contracts that provide for payments denominated in or determined by reference to a hyperinflationary currency (hereinafter, the "ARS contract") - *if* the contract is acquired in the taxable year in which the currency is considered hyperinflationary for the taxpayer.[16] Thus, with respect to a non-ARS functional currency calendar year taxpayer, an ARS contract acquired in 2018 is generally not a "hyperinflationary contract," and an ARS contract acquired in 2019 would generally be a "hyperinflationary contract" for a non-RIC/non-REIT taxpayer.

The section 988 rules effectively require the taxpayer to mark to market the exchange gain or loss on such contracts during a certain period.[17] Thus, a taxpayer with a hyperinflationary contract realizes exchange gain or loss with respect to such contract for its taxable year based on the change in exchange rates between A) the later of the first day of the taxable year or the date the contract was acquired, and B) the earlier of the last day of the taxable year or the date the contract is disposed of.

Finally, similar mark-to-market rules also apply to certain currency swap contracts, described in Treas. Reg. § 1.988-2(e)(7), that provide for payments denominated in or determined by reference to a hyperinflationary currency (hereinafter, the "ARS swap") – *if* the swap is acquired in the taxable year in which the currency is considered hyperinflationary for the taxpayer.[18] However, if a currency swap contract provides for payments adjusted to take into account hyperinflation (*e.g.*, provides for periodic payments determined by reference to a variable interest rate based on local conditions and generally responding to changes in the local CPI), the swap becomes hyperinflationary *in the taxable year* in which the currency becomes hyperinflationary for the taxpayer.[19]

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[12] Treas. Reg. § 1.988-2(b)(15)(vi)(A)(2).
[13] Treas. Reg. § 1.988-2(b)(15)(i).
[14] Treas. Reg. § 1.988-2(b)(15)(iv). Additional rules are provided for adjusting the principal amount or basis of the instrument or deposit by the gain or loss. Treas. Reg. § 1.988-2(b)(15)(v).
[15] Treas. Reg. § 1.988-2(d)(5). These rules generally do not apply to contracts that are subject to Treas. Reg. § 1.446-4 or are integrated under Treas. Reg. § 1.988-5.
[16] Treas. Reg. § 1.988-2(d)(5)(ii).
[17] Treas. Reg. § 1.988-2(d)(5)(i).
[18] Treas. Reg. § 1.988-2(e)(7).
[19] Treas. Reg. § 1.988-2(e)(7)(iv)(B).

Observations

Taxpayers should closely evaluate any section 988 transactions denominated in ARS for any potential tax implications. The following table is a summary of potential application of these rules to calendar year taxpayers, as the cumulative inflation rate in Argentina reached 100% for the 36-calendar month period ending on 12/31/2019.[20]

Financial Instrument	RIC/REIT 12/31 YE *Apply rules in Tax Year Ending* ***12/31/20***	Non-RIC/Non-REIT 12/31 YE *Apply rules in Tax Year Ending* ***12/31/19***	Treasury Regulation
ARS denominated debt instruments generally	If acquired on or after 1/1/2020	If acquired on or after 1/1/2019	1.988-2(b)(15)(vi)(A)(*1*)
ARS denominated debt instruments with payments adjusted for hyperinflation	Regardless of when acquired	Regardless of when acquired	1.988-2(b)(15)(vi)(A)(*2*)
ARS contracts generally	If acquired on or after 1/1/2020	If acquired on or after 1/1/2019	1.988-2(d)(5)(ii)
ARS swaps generally	If acquired on or after 1/1/2020	If acquired on or after 1/1/2019	1.988-2(e)(7)(iv)(A)
ARS swaps with payments adjusted for hyperinflation	Regardless of when acquired	Regardless of when acquired	1.988-2(e)(7)(iv)(B)

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[20] The cessation of hyperinflationary status of ARS will be addressed in a separate alert.