Note

U.S. TAX CONSEQUENCES OF THE EURO CONVERSION: IS THE TREASURY'S RESPONSE SUFFICIENT?

I. INTRODUCTION

The Dow Chemical Company is a global science and technology company that develops and manufactures a vast array of chemicals, plastics, and agricultural products for customers in 168 countries.[1] In 1998 and 1999 Dow opened plants in Terneuzen, the Netherlands and Stade, Germany to ease supply shortages and accommodate the company's continued growth in Europe and Asia. These plants conduct business and maintain their accounting records in their respective countries. Because they borrow from each other and from Dow, they hold debt denominated in non-local currencies. The facilities also buy and sell foreign currencies to minimize their exposure to exchange rate fluctuations.

The arrival of the euro on January 1, 1999 presented Dow and other U.S. multinational corporations with a host of serious questions. What would be the implications for existing sales contracts? How would the conversion affect the company's product pricing structure? What changes would be necessary to make existing information systems "euro-friendly"? And, most significantly, would the conversion be a tax-neutral event in the United States?

These questions and concerns were well-founded. On January 1, 1999,[2] the euro became the common currency of eleven member states of the European Union ("EU") as they took another step

1. Factual information about Dow is taken from THE DOW CHEMICAL COMPANY, 1998 ANNUAL REPORT (1999).

2. On this date, participants began the process of replacing their former national currencies with the euro. *See* Council Decision 96/736, 1996 O.J. (L.335) 48. Eleven EU states plan to convert to the euro: Austria, Belgium Finland, France, Germany, Ireland, Italy, Luxembourg, the Netherlands, Portugal, and Spain. Denmark, Sweden, and the United Kingdom elected not to adopt the euro, and Greece did not qualify to join the treaty. However, these countries may enter the agreement within the next few years. *See infra* note 10.

towards fulfilling their obligations under the Maastricht Treaty.[3] The member states of the EU hope and expect that the adoption of a single currency will result in lower interest rates, better integration of national markets, and the reduction or elimination of foreign exchange transaction costs. The euro will affect not only residents of the EU, but also U.S. corporate taxpayers who have multinational operations based in Europe or who engage in cross-border transactions denominated in a currency that is scheduled to be replaced by the euro. Of paramount importance for American taxpayers is the conversion's impact on U.S. taxes. In the absence of statutory guidance, it was an open question as to whether the Internal Revenue Service (IRS) would view the conversion as a realization event, triggering the recognition of foreign currency gains and losses.

In early 1998, the IRS and the Department of the Treasury acknowledged that then-existing law would be inadequate to address the tax issues raised by the euro conversion and requested comments from taxpayers.[4] After receiving submissions from individuals, professional organizations, and multinational corporations,[5] the Treasury issued two temporary regulations that generally treat the euro conversion as a tax-neutral event.[6]

Although the regulations are largely consistent with U.S. tax policy in relation to involuntary conversions, they deviate from existing tax practice when administrative efficacy demands it. More importantly, the regulations leave a number of troubling issues unresolved. The regulations do not address the treatment of euro-related costs, foreign tax credit complications, or implications for currencies that will convert to euros in the future. These issues may have serious tax consequences for the operations of multinationals such as Dow.

This Note will analyze the U.S. tax consequences of the euro conversion for American multinationals in the context of the

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3. Treaty on European Union, Feb. 7, 1992, 31 I.L.M. 247 (entered into force Nov. 1, 1993); *see generally* Jan Meyers & Damien Levie, *The Introduction of the Euro: Overview of the Legal Framework and Selected Legal Issues,* 4 COLUM. J. EUR. L. 321 (1998) (discussing the goals and processes of the EU's economic and monetary union under the Maastricht Treaty).

4. *See* Ann. 98-18, 1998-10 I.R.B. 44. "The Treasury Department and the IRS are studying issues arising from the conversion to the euro to determine the appropriate scope and content of published guidance and invite all interested persons to submit comments . . . ." *Id.*

5. Dow submitted its analysis of the euro conversion in May 1998. *See* Michael Cone & Robert Aukerman, *Writers Outline Principles for Evaluating Tax Consequences of Euro Conversion*, 98 TAX NOTES TODAY 99-40 (1998).

6. *See* Temp. Treas. Reg. §§ 1.985-8T, 1.1001-5T (1998).

temporary regulations issued by the Treasury in July 1998. Having introduced the key issues, Part II briefly describes the origins of the European Monetary Union and the process of European monetary integration. Part III summarizes the euro-related U.S. tax issues for American multinationals, with emphasis on the euro-sensitive provisions of the Internal Revenue Code (the "Code"). Part IV describes the Treasury regulations issued in anticipation of the euro, analyzes their impact, and examines tax planning strategies that minimize conversion costs. Finally, Part V discusses additional tax dilemmas not addressed by the regulations and offers possible resolutions under existing tax law.

II. ORIGINS: THE EUROPEAN MONETARY UNION AND THE EURO

On February 7, 1992, member states of the EU signed the Maastricht Treaty, which committed ratifying states to form an economic and monetary union, the European Monetary Union ("EMU"), by the year 2000.[7] Accordingly, member states that meet pre-determined levels of inflation and standards of fiscal policy will form a full monetary union with a common currency (the euro) and a single monetary policy defined by the European Central Bank.[8]

The first stage[9] of the treaty's implementation occurred on January 1, 1999, when the euro was substituted for the national currencies of the "first wave" of EMU participant states at fixed rates of conversion.[10] During the three-year transition period from 1999 to 2002, businesses can elect to conduct transactions in euros.[11] Local "legacy" currencies[12] will co-exist with the euro, with transactions, bank accounts, financial statements, and other currency-related functions denominated in either currency. Euro notes and coins will

7. *See* Treaty on European Union, *supra* note 3.

8. *See id.* arts. 109j(3), 104c(2), 109e(4).

9. The introduction of the euro is not anticipated to occur suddenly with a "big bang." The popular expectation is that the euro will rapidly replace local currencies in financial markets. Large-scale use of the euro at the individual consumer and retail levels, however, is not predicted to occur until euro notes and coins become widely available. *See* Meyers & Levie, *supra* note 3.

10. At the time the participating countries were announced, the Council also publicized the expected exchange rates at which their currencies would be converted. *See* Alan Winston Granwell, *U.S. Issues Tax Guidance on Euro Conversion,* 430 PUB. L. INSTITUTE/TAX 267, 267 (1998).

11. *See id*. This is known as the "no prohibition, no compulsion" principle.

12. A "legacy" currency is that of a participating EU member state. *See* Temp. Treas. Reg. § 1.985-8T (1998).

also be circulated as legal tender in consumer transactions. The final stage of the conversion to the euro will commence on January 1, 2002, when national currencies will be taken out of circulation. By mid-2002, euro notes and coins are expected to completely replace all local currencies for nations bound by the EMU.

The implementation of a single currency in Europe represents the most significant change in the international monetary system during the last quarter of the 20th century.[13] The conversion will have particular impact on American multinationals because of the strong trade relationship between the United States and Europe and the uncertain future of the euro in the global financial system. As Europe has moved toward integration, investment and trading opportunities for American companies have grown dramatically; Europe is now a dynamic market for American exports and one of its strongest economic partners in the world market.[14] For example, in 1997, the EU was America's second largest trading partner (behind Canada), with merchandise trade exceeding $270 billion. More than half of America's foreign investment—$400 billion—was devoted to Europe.[15] Between 1982 and 1985, American investment in Europe grew by approximately eleven percent per annum, a growth rate far greater than American investment in the rest of the world.[16]

Accordingly, the euro may have a profound impact upon the role of the dollar as an international reserve currency, and it may potentially affect short-term trade and exchange rate developments in Europe.[17] Given its future impact on the world economy, the euro will likely generate many U.S. tax issues.

III. OVERVIEW OF U.S. TAX ISSUES & EURO-SENSITIVE PROVISIONS IN THE CODE

A. U.S. Tax Policy

American tax policy has long recognized that certain involuntary

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13. The EU's conversion to the euro is the most significant monetary change since the breakdown of the Bretton-Woods system in the early 1970s. *See id.* "It truly [created] an event without precedent, either in European history or the history of the world." *Id*.

14. *See* former Deputy Treasury Secretary Lawrence H. Summers, Remarks before the Senate Budget Committee (last modified Oct. 21, 1997) <http://www.ustreas.gov/press/releases/pr1999.htm>. Mr. Summers was sworn in as Secretary of the Treasury on July 2, 1999.

15. *See id*.

16. *See id*.

17. *See id*. But "it is difficult to predict with any certainty what the role of the newly created euro will be." *Id.*

events should not result in the recognition of income.[18] For example, section 1033 of the Code generally defers gains realized upon an involuntary conversion of property.[19] Likewise, section 1081 allows the deferral of gains realized upon certain sales of securities mandated by the Securities and Exchange Commission.[20]

The tax policy considerations implicit in these Code sections, and supported by authoritative jurisprudence,[21] indicate that there should be no realization of gains or losses that result from an involuntary disposition of property. The gain is preserved by adjusting the basis of the property received in the conversion. Furthermore, the Code generally follows a policy of "capital export neutrality"[22] in its attempt to mitigate the role that tax considerations play in the investment decisions of U.S. residents. Since the United States taxes the worldwide income of its citizens, residents, and domestic corporations, double taxation inevitably occurs whenever U.S. taxpayers have earnings sourced in other countries. The foreign tax credit[23] attempts to alleviate double taxation, which occurs when income earned in foreign countries is taxed by both the United States and the country of its source.

The euro conversion raises four primary questions under the U.S. income tax system. First, does the change in currency constitute a "realization event" that requires recognition of foreign exchange gains and losses? Second, does the conversion of a debt instrument into the euro represent a "significant modification" that will be subject to U.S. tax? Third, will the conversion to the euro result in the double taxation of foreign exchange gains, given the conversion's

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18. *See* Cone & Aukerman, *supra* note 5.

19. *See* I.R.C. § 1033 (1994). Section 1033 defers the realization of gain from involuntary conversions of property related to theft, sale pursuant to federal reclamation laws, destruction of livestock by disease, and under certain laws mandated by the Federal Communications Commission. *See id.*

20. *See id.* § 1081. In enacting section 1081(a), Congress decided that "recognition of gain or loss should . . . be postponed until a voluntary realization occurs." S. REP. NO. 75-1567 (1938), *reprinted in* 1939-1 C.B. 779, 785 (1939).

21. In *Gaynor News v. Commissioner*, 22 T.C. 1172 (1954), the Tax Court held that a taxpayer was entitled to defer his gains under section 112 of the 1939 Code (predecessor to the present section 1033) when his property was converted involuntarily and the proceeds were used to acquire a corporation that had title to property similar to the converted property. *See id*. at 1179. In dicta, the court stated that section 112 was enacted as "a relief measure designed to prevent inequitable incidence of taxation, and therefore was to be construed liberally to effectuate its purpose." *Id*. at 1177.

22. H. Onno Ruding, *U.S Tax Policy is Hurting U.S. Multinationals Operating in the EC*, 5 J. INT'L TAX'N 4, 4 (1994).

23. *See* I.R.C. §§ 901-04.

impact on the foreign tax credit? Finally, will the costs of the conversion be currently tax deductible? Given that the conversion to the euro is unprecedented[24] and the manner of its implementation cannot be known entirely in advance, it is not surprising that existing U.S. tax law is not prepared to address the legal and financial issues posed by change to the new currency.

B. A Change in Functional Currency

The Code mandates that if a corporation is created or organized in the United States, its worldwide income is subject to U.S. tax. Worldwide income includes income earned by a corporation's foreign branches, dividends received from foreign subsidiaries, and certain types of income earned by foreign subsidiaries.[25] For U.S. income tax purposes, the income, expenses, gains, and losses of a U.S. corporation must be determined in its "functional currency."[26] The "functional currency" of a corporation is either the U.S. dollar or, in the case of a qualified business unit ("QBU"),[27] the currency of the economic environment in which a significant part of the business' activities are conducted and in which its records are kept.[28] A U.S. corporation operating a foreign QBU initially records the QBU's taxable income in its functional currency and later translates the income into U.S. dollars using the appropriate foreign exchange rate.[29] For example, Dow's facility in Germany would maintain its records in the deutschemark, and, for the purposes of consolidation, Dow in the United States would later translate these records into U.S. dollars.

U.S. corporate taxpayers operating in the EU have a fundamental financial concern: will the Code treat a QBU that converts its functional currency to the euro as having changed its

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24. *See* Myers & Levie *supra* note 3. "The EMU plan is ambitious and far reaching. Nothing on this scale has been done before in recent monetary history." *Id*. at 323.

25. *See* BORIS I. BITTKER & LAWRENCE LOKKEN, FUNDAMENTALS OF INTERNATIONAL TAXATION 65-3 (1998).

26. I.R.C. § 985(a). "Unless otherwise provided in regulations, all determinations under this subtitle shall be made in the taxpayer's functional currency." *Id.*

27. *See id.* § 989(a). A QBU is "any separate and clearly identified unit of a trade or business of a taxpayer which maintains separate books and records." *Id.* QBUs include branches and corporations. *See id*.

28. *See id.* § 985(b). A U.S. corporation's functional currency is generally the dollar, whereas the functional currency of a U.S. corporation's QBU is generally a currency other than the dollar. *See id*.

29. *See id.* § 987. The appropriate exchange rate used is the weighted-average rate for the tax year. *See id.* § 989(b)(4).

currency, and if so, how will the change affect the taxpayer's tax liability? The amount of foreign exchange gain or loss recognized is not at issue, since the rates of exchange between the euro and local currencies will be fixed. Rather, the concerns stem from the timing of the recognition.

Under the Code, when a QBU changes its functional currency it is required to recognize various items of gain or loss, including exchange gain or loss on certain financial assets and liabilities, as if the QBU had changed its method of accounting.[30] If the euro conversion is treated as a change in functional currency, U.S. corporations face a recognition event, requiring compliance with certain administrative procedures and tax adjustments. For example, the regulations require a company to request permission from the IRS to change its method of accounting.[31] More significantly, the regulations require a QBU to recognize any unrealized gain or loss for all foreign exchange ("section 988") transactions[32] on the last day of the tax year prior to the year of change, using the spot exchange rate on that day.[33] Other more complicated tax adjustments are required if the QBU is a branch operation of the U.S. taxpayer corporation.[34] If a QBU maintains dual currency books and records during the transition phase of the conversion to the euro, the regulations suggest that the QBU can choose either currency as its functional currency for tax purposes.[35]

30. *See id.* § 985(b)(4). "Any change in functional currency shall be treated as a change in the taxpayer's method of accounting for purposes of section 481 . . . ." *Id.*

31. *See* Treas. Reg. § 1.985-4(a) (1989). Additionally, under Treas. Reg. § 1.985-4(b), a request to change functional currency will not be granted unless there are significant changes to the facts and circumstances of the QBU's economic environment.

32. *See* I.R.C. § 988(c)(1). Transactions denominated in terms of, or by reference to, the value of one or more nonfunctional currencies, meet the definition of a section 988 transaction if they involve:

(i) issuing or buying a debt security;
(ii) accruing an expense or income or receipt which is to be paid or received after the date on which it is accrued; or
(iii) entering into or acquiring any forward contract, futures contract, option or similar financial instrument.

See id. § 988(c)(1)(B).

33. *See* Treas. Reg. § 1.985-5(a), (c) (as amended in 1998).

34. *See id.* § 1.985-5(d).

35. *See id.* § 1.985-1(c)(1)(4). "If a QBU has more than one currency that satisfies the requirements of [the economic environment of the QBU] the QBU may choose any such currency as its functional currency." *Id.*

C. Conversion of Debt Instruments

One issue is whether the IRS will treat the conversion of a debt instrument, previously denominated in a legacy currency, as an "exchange" of financial instruments. For tax purposes, a debt instrument is "exchanged" when there is a "significant modification" of its terms.[36] The regulations generally require a two-part determination: whether there is a modification, and, if so, whether the modification is "significant."[37]

The euro conversion may modify the terms of a financial instrument in significant ways because monetary policy governing the currency upon which the instruments are based will be set by the European Central Bank, rather than the central bank of any one EC member state.[38] In addition, some financial instruments may have interest rates that are set by reference to an index that will cease to exist after the introduction of the euro. The value of these instruments may also be affected by rounding conventions adopted after the conversion. Furthermore, by altering the terms and conditions of financial instruments that will suddenly be denominated in the new currency, the adoption of the euro could modify the rights and obligations of parties to financial agreements.

If the IRS concludes that the change to the euro is a "significant modification," the holder will be deemed to have disposed of the instrument in exchange for its euro equivalent and will be required to recognize a full gain or loss as a result of the exchange.[39] The holder will not only be required to include foreign exchange gains and losses, but any market gain or loss that results from the exchange.

D. The Foreign Tax Credit and Double Taxation

The foreign tax credit is designed to lessen the domestic tax burden on the worldwide income of U.S. residents.[40] However, recognition of this credit may be limited.[41] American taxpayers that

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36. *See id*. § 1.1001-3(b).

37. *See id*. A modification is significant only if, based on all the facts and circumstances, the legal rights or obligations that are altered, and the degree to which they are altered, are economically significant. Significant modifications include changes to the timing of payments and re-designation of a loan from recourse to non-recourse. *See id*. §1.1001-3(c).

38. *See* Meyers & Levie, *supra* note 3, at 328.

39. *See* I.R.C. § 1001.

40. Section 901(a) allows U.S. taxpayers the benefit of a credit for taxes paid to foreign countries and possessions of the United States, subject to certain limitations. *See id*. § 904.

41. *See id*.

have tax credits with limited recognition (also called excess foreign tax credits) may find that in certain circumstances, the euro conversion causes double taxation of currency exchange gains. When income is recognized for U.S. tax purposes in one year and for foreign tax purposes in another year, the foreign tax imposed on the income will not be credited on the U.S. return if the U.S. taxpayer has excess general limitation credits.[42] Such a recognition mismatch would occur if the foreign country immediately recognized exchange gains and losses upon the conversion while the United States deferred recognition. For example, as of February 1998, Belgium was the only country expected to require immediate recognition of exchange gains and losses.[43] Thus, if a Belgian subsidiary of a U.S. multinational had an exchange gain on a French franc loan, the conversion of the loan into euros would trigger recognition of an exchange gain in 1998 for Belgian tax purposes. Assuming that the exchange gain would be recognized for U.S. tax purposes in 1999, the Belgian subsidiary would be unable to use any tax credits to shelter its income from U.S. taxation. The exchange gain would effectively be taxed twice: once in Belgium and once in United States.[44] The majority of member states are expected to enact legislation to defer recognition of exchange gains and losses upon the conversion of their currencies. In dealings with these countries, no mismatch will arise.[45]

E. Deductibility of EMU-Related Costs

American multinationals and domestic corporations are expected to incur substantial costs in preparation for the euro. These costs will include consultancy fees, reprogramming computer systems, and developing and printing price lists in the euro.[46] The Treasury needs

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42. *See id*.

43. *See* Fred F. Murray, *Trade Group Analyzes Tax Consequences of Euro Conversion,* 8 TAX NOTES TODAY app. 58-44 (1998). The European Commission has issued a practical guide to the introduction of the euro, encouraging countries to quickly adopt rules that specify treatment of the EMU for local tax purposes. *See id.*

44. *See id*.

45. *See id*. As of February 1998, Germany, Austria, Luxembourg, and the Netherlands have announced their intention to defer realization of foreign exchange gains or losses until the disposition of the underlying asset or liability. Spain is also expected to adopt this deferral. France and Ireland generally recognize unrealized foreign currency exchange gains or losses annually, and thus their euro conversions are tax neutral events. Italy and Portugal have yet to clarify their positions on this issue. *See id*.

46. Other conversion expenses include the costs of historical data conversion, invoicing and manufacturing systems changes, staff training, and maintaining duplicative systems during the transition period.

to clarify whether these costs can be deducted by the corporate taxpayer immediately or capitalized initially and expensed over time.

Generally, a corporation is allowed to deduct "ordinary and necessary" business expenses for tax purposes.[47] The "ordinary and necessary" criteria has been the source of substantial controversy in the courts and with the IRS. In *INDOPCO v. Commissioner*,[48] the U.S. Supreme Court held that specified professional fees paid by a corporation to facilitate a friendly acquisition of a target company were not "ordinary and necessary."[49] The Court held that because they produced significant benefits beyond the tax year in which they were incurred, the claimed expenses were not deductible.[50] The "significant future value" test elucidated in *INDOPCO* has since been interpreted in IRS guidelines and applied in subsequent jurisprudence.[51]

Although the IRS has stated that the *INDOPCO* decision did not change the legal principles for determining the deductibility of expenditures, "there is guidance reflective of *INDOPCO* on lease termination payments, settlement payments, training, and payments to regulators."[52] The IRS has ruled that, with regard to costs for repairs and maintenance, improvements must be capitalized and repairs deducted.[53]

There is no judicial authority on the extent to which corporations' euro conversion expenses are tax deductible. The IRS has provided guidance, however, in the revenue procedures that govern the treatment of software expenses incurred in an analogous situation: fixing the computer problem generated by the year 2000

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47. *See* I.R.C. § 162(a). "There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business . . . ." *Id.*

48. 503 U.S. 79 (1992).

49. *See id.* at 87. "Although the mere presence of an incidental future benefits—'SOME future aspect'—may not warrant capitalization, a taxpayer's realization of benefits beyond the year in which the expenditure is incurred is undeniably important in determining whether the appropriate tax treatment is immediate deduction or capitalization." *Id.* (emphasis in original).

50. *See id.*

51. In its post-*INDOPCO* revenue rulings, the IRS confirmed that the following expenses are deductible despite having some incidental future benefit: advertising expenditures (Rev. Rul. 92-80, 1992-2 C.B. 57); payments by a regulated public utility for energy conservation measures (Rev. Rul. 95-32, 1995-1 C.B. 8); and environmental cleanup expenditures (Rev. Rul. 94-38, 1994-1 C.B. 35).

52. *See* Murray, *supra* note 43.

53. *See* Rev. Rul. 94-12, 1994-1 C.B. 36.

("Y2K") bug.[54] In Revenue Procedure 97-50, the IRS determined that costs paid or incurred by a company to enable its computers to recognize dates beginning in the year 2000 may be treated in the same manner as the development, purchase, or lease costs of traditional computer software.[55] Thus, software development costs are deductible if a taxpayer ordinarily treats them as deductible.[56]

Against this backdrop, the Treasury faced the formidable task of analyzing the euro conversion within the framework of U.S. tax policy and existing law.

IV. THE RESPONSE FROM THE TREASURY

On March 9, 1998, the IRS issued Announcement 98-18, inviting comments on the tax issues arising from the conversion to the euro, particularly for U.S. taxpayers operating, investing, or otherwise conducting business in a currency that was to be converted to the euro.[57] In response to the comments received, on July 29, 1998, the Treasury issued temporary regulations.[58] Generally, these regulations minimize the tax consequences that arise from the conversion.[59] In a limited number of circumstances, however, the Treasury determined that considerations such as administrative feasibility or the procedural and record-keeping burdens imposed on taxpayers would warrant a different result.[60]

A. Scope and Operation of the Temporary Regulations

The regulations apply to "U.S. taxpayers operating, investing, or otherwise conducting business in the currencies of certain European countries that are replacing their national currencies with a single, multinational currency called the euro."[61] The regulations do not apply to U.S. taxpayers conducting business in EU member states

54. *See* Rev. Proc. 97-50, 1997-2 C.B. 525.

55. *Id.*

56. Rev Proc 97-50, 1997-45 I.R.B. 8, extended the guidelines set forth in Rev. Proc. 69-21, 1969-2 C.B. 303, to year 2000 software development costs. In Rev. Proc. 69-21, the IRS stated that it will not disturb a taxpayer's treatment of costs incurred in developing software when such costs were consistently treated as deductible expenses and deducted in full in the year incurred or when such costs were consistently capitalized and amortized over the life of the software.

57. *See* 1998-10 I.R.B. 44.

58. *See* Temp. Treas. Reg. § 1.985-8T, § 1.1001-5T (1998).

59. *See* T.D. 8776, 1998-33 I.R.B. 6.

60. *See id.*

61. *Id.*

that did not convert their currencies to the euro on January 1, 1999.[62] Similarly, the regulations do not apply to European countries that are expected to join the EU and the EMU sometime in the future.[63] The regulations also do not mention whether the Treasury will issue additional guidance concerning these events.

Under the temporary regulations, a QBU that currently uses a functional currency is deemed to automatically change its functional currency to the euro in the same year that it changes its books and records to the euro.[64] Generally, the temporary regulations operate so that the conversion to the euro does not give rise to a realization event requiring recognition of foreign exchange gain or loss under section 1001 of the Code.[65] This applies to all situations where the rights and obligations of a taxpayer are altered solely by reason of the conversion to the euro.[66] Thus, contractual relationships, financial instruments, foreign exchange transactions under section 988, and other claims or obligations do not automatically become realization events once they are altered by the euro conversion.[67] Instead, exchange gains or losses will be taken into account only after a subsequent realization event occurs with respect to the underlying instrument or contract; that is, when the underlying instrument is sold or otherwise disposed of.[68]

B. Rationale Underlying the Temporary Regulations

In many material aspects the Treasury's approach is consistent with the existing Code. For example, the temporary regulations conform with the view that the conversion to the euro does not result in a "significant modification" of a debt instrument.[69] Presently, an alteration that "occurs by operation of the terms" of a debt instrument, as opposed to an "alteration of the terms" of the instrument itself, is not a "modification" of the instrument unless the alteration (1) results in a change in the obligor or in the nature of the recourse instrument; (2) converts the debt instrument into something

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62. The EU member States that did not participate in the initial conversion are the United Kingdom, Denmark, Sweden, and Greece. *See* Meyers & Levie, *supra* note 3.

63. Presently, countries that appear to have some prospects of attaining EU membership include Hungary, Poland, the Czech Republic, Estonia, Slovenia, and Cyprus.

64. *See* Temp. Treas. Reg. § 1.985-8T(b)(2) (1998).

65. *See* T.D. 8776, 1998-33 I.R.B. 6.

66. *See id.*

67. *See id.*

68. *See id.*

69. *See* Treas. Reg. § 1.1001-3(b) (1996).

that is not debt, unless pursuant to an option; or (3) results from the exercise of an option.[70] For example, the annual resetting of an instrument's interest rate by reference to a specified index like LIBOR (the London Inter-bank Rate) pursuant to the terms of the instrument, does not constitute a modification under current law. For several reasons, the conversion to the euro is akin to an alteration that "occurs by operation of the terms" of an instrument and thus should not trigger a realized gain or loss.[71] After the conversion, the fundamental obligations of the parties will remain the same. There will be no change in the creditworthiness of 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. Therefore, in the case of debt instruments, the treatment of the conversion under the temporary regulations is consistent with the outcome that should result under the Code.

The Treasury's position is also consistent with the "continuity of contract" principle that has been adopted by the European Council[72] and by state legislatures in New York and Illinois.[73] The holder of a debt instrument should not expect to realize an economic gain or loss upon the introduction of the euro. Likewise, the lender will have substantially identical legal rights and obligations before and after the exchange. The Treasury's position thus maintains the prevailing principle that there should be no advance recognition of gain or loss at some arbitrary date, but rather that the unrealized foreign exchange gain or loss shall be preserved until the transaction is settled, sold, or exchanged.

Finally, the Treasury's position is consistent with the argument that the euro does not strictly represent a new functional currency, but rather is a redenomination of legacy currencies. At first glance, the conversion to the euro may not appear to fit neatly within the redenomination criteria. For example, the euro conversion involves the conversion of many currencies rather than a single currency. Additionally, the pooling of currency risk and responsibilities (through the European Central Bank) means that the euro will carry

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70. *See id*. § 1.1001-3(c) (1996).

71. *See id.*

72. *See* Council Regulation 1103/97, 1997 O.J. (L 162) 2. "The introduction of the euro shall not have the effect of altering any term of a legal instrument or of discharging or excusing performance . . . ." *Id.* at 3.

73. Illinois and New York legislation provide that the euro is a commercially reasonable substitute for the currencies of all participating countries and the ECU. *See* 815 ILL. COMP. STAT. ANN. 617/10 (West 1997); N.Y. GEN. OBLIG. LAW § 5-1602 (McKinney 1997).

a different interest rate and risk exposure than any single currency. On closer analysis, however, a redenomination and the conversion to the euro share common characteristics: both are involuntary, both provide taxpayers with no economic benefit or detriment, and both involve fixed conversion rates.

C. Taxable Events Under the Temporary Regulations

Although the conversion to the euro will generally not give rise to a taxable event under the temporary regulations, increased tax burdens may accompany other events related to the conversion.

One such event is an unscheduled fractional payment made on a debt instrument to facilitate a rounding convention. To illustrate, assume that Dow's facility in Germany has a loan denominated in French francs. The loan contains a provision that fractional payments will be made to maintain principal payments at 10,000 deutschemarks. If the German facility converts the loan to euros, any fractional payment made pursuant to the loan provision will give rise to a foreign exchange gain or loss that must be recognized. In the alternative, if Dow wishes to retire the loan and issue a replacement debt (so that the principal would be stated in round numbers when denominated in euros), the full amount of any gain for the original debt would have to be recognized.

Additionally, changes in the terms of financial instruments may give rise to realization events, despite the temporary regulations. For example, changes in accrual periods and indices that accompany the instrument's conversion to the euro may be treated as "significant modifications" and trigger tax liability.[74] The temporary regulations do not affect this result. Similarly, the conversion may result in a "significant modification" of a debt instrument when there are unusual contractual obligations between the parties.[75]

D. Explicit Exceptions to Tax Neutrality

Where the administrative burdens clearly outweigh the tax benefits, the temporary regulations make specific exceptions to the general rule of tax neutrality. For example, the regulations provide that a taxpayer may elect to have gains or losses on accounts receivable and may have accounts payable on section 988 transactions

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74. *See* Treas. Reg. § 1.1001-3 (as amended in 1996).

75. *See* H. Bradford Hays, *Pharmaceutical Company Analyzes Tax Consequences of Euro Conversion*, 98 TAX NOTES TODAY 79-38 (1998).

recognized immediately prior to the year of conversion, consistent with the regulations under section 985.[76]

Another exception to the general rule of tax neutrality is in the case of non-functional currencies. The temporary regulations provide for the immediate recognition of exchange gains or losses on holdings of non-functional currency cash.[77] With these provisions, the Treasury aims to ease the administrative burdens of tracking basis in short-term assets and liabilities, which would otherwise be necessary if exchange gains and losses were deferred until the disposal of the underlying assets or liabilities. This exception to tax neutrality is also consistent with arguments in support of the immediate recognition of all exchange gains or losses when such gains or losses are fixed.[78] Once exchange rates between the euro and the local currencies are known, exchange gains or losses will be measurable and should thus be recognized.

Gains or losses on unremitted earnings from branches constitute another exception. The temporary regulations provide that these exchange gains or losses are to be recognized ratably over a four-year period, beginning in the year of conversion.[79] The Treasury's position is consistent with the Code sections that govern changes in accounting methods that provide for a four-year adjustment period.[80]

E. Impact of the Temporary Regulations

The temporary regulations allow for simple strategic tax planning opportunities. In most circumstances, the regulations will not have a significant tax impact, since transactions involving cash, receivables, and payables are typically of short duration. In other instances, a taxpayer may be able to hedge against any foreign currency risks created by the conversion.

As an illustration, suppose that Dow's Netherlands subsidiary entered into a transaction with a French customer, giving rise to a

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76. *See* Temp. Treas. Reg. § 1.985-8T(c)(3) (1998).

77. *See id*. § 1.985-8T(b)(2).

78. This was the underlying premise of the Tax Court's holding in *American Air Filter Company v. CIR*, 81 T.C. 709, 728 (1983), where a taxpayer had borrowed Swiss francs and converted them to U.S. dollars under the terms of the loan agreement. In converting the loan, the taxpayer fixed the amount of its foreign exchange loss, and terminated its foreign exchange risk; the court held the taxpayer liable for the resulting loss. *See id.*

79. *See* Treas. Reg. § 1.985-8T(c)(4) (1998).

80. *See* I.R.C. § 481(a) (1994); Rev. Proc. 97-37, 1997-2 C.B. 455. "In general. . .the section 481(a) adjustment period for positive and negative section 481(a) adjustments is four taxable years." *Id.*

500,000 French franc account receivable, payable on February 1, 2000. The functional currency of the subsidiary is the Dutch guilder. Upon entering into the transaction, the subsidiary has foreign currency exposure. To reduce its risk and lock in its profit margin, the subsidiary enters into a forward contract selling 500,000 francs for 100,000 guilders. The forward contract will mature on February 1, 2000. On January 1, 1999, the European Central Bank established the euro internal exchange rates. The Dow subsidiary opts to convert its books to the euro on February 1, 2000. At that time, the subsidiary will recognize a gain with respect to its receivable balance and an offsetting loss on the forward contract. Thus, under these circumstances, an effective hedge may minimize potentially negative tax consequences from the conversion to the euro.

V. REMAINING QUESTIONS

The temporary regulations fail to address several key issues for U.S. taxpayers affected by the conversion to the euro. The Treasury and the IRS have requested additional comments on a number of these issues.[81] Three of the omitted issues are particularly significant because they affect many taxpayers, involve material amounts of money, and embrace the future of the EMU itself. Because the Treasury and the IRS believed that the issues were not unique to the conversion to the euro and thus could be resolved under existing law, two issues were not addressed in the temporary regulations at the time of drafting:[82] (1) deductibility of costs associated with the conversion; and (2) foreign tax credit mismatches. The third omitted issue concerns the tax implications arising when additional countries decide to adopt the euro, or when an existing participant elects to withdraw from the conversion. Because this matter is unique to the conversion to the euro, the IRS and the Treasury have requested additional comments.

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81. *See* T.D. 8776, 1998-33 I.R.B. 6. Additional comments have been requested on the following issues: (1) the applicability of sections 1092 (straddle rules) and 1259 (constructive sales treatment for appreciated financial positions); (2) re-determination of taxes in post-conversion years under section 905; (3) whether a QBU should be deemed to have automatically changed its functional currency to the euro if its functional currency was a non-converted currency, but should properly be the euro after the conversion; (4) whether the regulations adequately address QBUs with functional currencies of countries that adopt the euro in the future; and (5) whether there needs to be additional clarification of treatment of section 988 transactions that are held by euro functional currency QBUs and denominated in a currency that is later replaced by the euro. *See Temporary and Proposed Regulations on Euro Conversion*, 98 TAX NOTES TODAY 145-14 (1998).

82. *See* T.D. 8776, 1998-33 I.R.B. 6.

A. Deductibility of Conversion-Related Costs

Several arguments support the view that costs incurred in preparation of the conversion to the euro should be immediately deductible under section 162 of the Code.

First, under *INDOPCO's* "significant future value" test, the costs of reprogramming computer systems for the one-time conversion event will not, alone, produce significant benefits beyond the tax year in question[83]—the reprogramming does not improve the taxpayer's systems, but simply enables taxpayers to maintain and continue normal business operations using the euro rather than their local currencies. Any resultant future benefits would be merely ancillary and incidental. Following previous IRS positions, and notwithstanding any ancillary or incidental benefits, costs associated with the conversion to the euro should remain deductible.[84]

Second, the costs associated with the conversion to the euro resemble the costs associated with the Y2K problem, and thus should receive similar tax treatment. In both cases, taxpayers are utilizing a huge amount of resources to address a unique situation.[85] Revenue Procedure 97-50 (addressing tax treatment for Y2K expenses) provides five categories of Y2K expenses.[86] These categories concern expenses incurred to convert existing software; to purchase new software to replace existing software; to purchase software tools to assist in converting existing software; to develop software tools to assist in converting the software; or to lease new software to replace existing software.[87] Costs associated with the conversion to the euro undoubtedly mirror these Y2K expenses, and should be similarly deductible.

By bringing euro conversion costs under the purview of Y2K costs, the IRS would ensure that, in general, costs associated with the conversion are treated consistently with similar costs. For example, under Revenue Procedure 97-50, Y2K costs are treated in the same manner as costs paid or incurred to develop, purchase, or lease

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83. *See supra* text accompanying notes 48-53.

84. *See* Rev. Rul. 94-12, 1994-1 C.B. 36 (repair expenses are generally deductible even though there may be some future benefit obtained); Rev. Rul. 92-80, 1992-2 C.B. 57 (advertising expenses are currently deductible notwithstanding some future effect on business activities).

85. According to one analyst, preparing for the euro may cost five times as much as fixing the Y2K problem. *See* Lynda Radosevich, *Euro Looms Large*, INFO WORLD ELECTRIC, (Oct. 27, 1997) <http://www.infoworld.com/cgi-bin/displayStory.pl?/features/971027euro.htm>.

86. *See* Rev. Proc. 97-50, 1997-2 C.B. 525.

87. *See id*.

computer software.[88] Additionally, Revenue Procedure 69-21, referred to by Revenue Procedure 97-50, provides that software development costs are deductible if a taxpayer ordinarily treats such costs as deductible.

The immediate deductibility of such euro conversion costs, however, appears to be inconsistent with positions taken by other EU member states. For example, the French tax administration has taken the position that taxpayers cannot deduct reserves accrued to adapt existing assets (such as computer programs) to the euro.[89] Considering that there are many differences between the taxing regimes of different countries, the different treatment of euro conversion costs by other countries does not, by itself, weigh heavily against the deductibility of the conversion costs. More important, however, is the impact of the disparate treatment of conversion costs on the U.S. foreign tax credit: as was the case with the disparate treatment of foreign exchange gains or losses, double taxation may result from the disparate treatment of conversion costs. For example, if Dow's facility in Germany is not permitted to deduct its euro conversion expenses in the year in which they are incurred, the company will be taxed on a higher income than if immediate deductibility were allowed. If the United States permits immediate deductibility, the resultant mismatch of conversion expenses may give rise to double taxation.[90]

B. Foreign Tax Credit Mismatches as a Result of Differences in Tax Accounting Between the United States and Other Countries

As in the case of conversion costs,[91] additional international differences in the tax treatment of events related to the conversion to the euro may create foreign tax credit mismatches that result in the double taxation of U.S. taxpayers' foreign income. For example, the United States' and the EU's disparate treatment of euro-related foreign exchange gains and losses could lead inappropriately to the double taxation of those gains.

In order to prevent this double taxation, the Treasury should adopt the approach taken by the regulations under section 901: either

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88. *See id*.

89. *See* Edouard Milhac & Julien Saiac, *French Tax Developments 1997/98: Corporate Tax Increases, Some Breaks, and Euro Expense Limitations*, 9 J. INT'L TAX'N 12, 15 (1998).

90. See *supra* text accompanying notes 40-45 for discussion of the impact of recognition mismatches upon the foreign tax credit.

91. *See id.*

accelerate income or defer foreign tax credits at the election of the taxpayer.[92] This approach would better match U.S. tax recognition with foreign tax recognition of the same event. Since the existing regulations under section 901 already provide for mismatches that occur as a result of accounting differences,[93] it would be fairly simple for the Treasury to introduce a similar section covering timing differences.

C. Implications for U.S. Taxpayers Holding Currencies of Countries that Adopt the Euro, Withdraw from the EU, or Withdraw from the Conversion

In general, the temporary regulations addressing the conversion to the euro are narrow in scope and applicability. For the most part, they apply only to the conversion of legacy currencies.[94] Thus, several currencies are not included. First, the regulations do not apply to those EU member states that later decide to participate in the euro.[95] Second, the regulations do not consider tax issues that may arise from the use of the currencies of non-participating EU member states, which currently participate in an alternate exchange rate system, where their local currencies are pegged to the euro. Third, the regulations fail to address the ramifications of a participating country withdrawing from the EU and/or the euro.[96] Finally, the temporary regulations have not clarified the tax treatment of currencies of non-participating EU member states that adopt the euro after 2002. At that point, the conversion may be a taxable event.

The exchange rates themselves present another unresolved taxation issue. The temporary regulations provide for conversion at

92. *See* Treas. Reg. §1.901-1 (as amended in 1987).

93. For special rules on the foreign tax credit because of differences in U.S. and foreign tax laws, see Treas. Reg. § 1.904-6(a)(1)(iv) (as amended in 1992).

94. *See* Temp. Treas. Reg. § 1.985-8T.

95. The European Council re-assesses EMU participation every two years, or at a member's request. *See* The Treaty on European Union, *supra* note 3. Current non-participating member states may participate (at their option) in a new exchange rate system with the euro. *See* Meyers & Levie, *supra* note 3, at 333.

96. Incidentally, there is little to no guidance from the EU in this area: "It should be noted that . . . the EC Treaty does not provide any mechanism (other than an amendment of the Treaty) to subsequently correct the initial value relationship between the euro and its constituent national currencies, to allow a Member State to leave the EMU, or to terminate EMU." *See* Meyers & Levie, *supra* note 3, at 328.

the "applicable conversion rate,"[97] but offer no further guidance as to what this rate might be if the euro is permitted to float.

VI. CONCLUSION

On January 1, 1999, eleven EU member states began a three-stage, three-year conversion process to a common currency, thereby taking another step closer to economic and monetary union. The euro brings benefits as well as challenges for U.S. multinationals (like Dow) with operations in EU member states. American companies may be enticed by the benefits that accompany the introduction of a common currency: lower interest rates, a better integration of markets, and an elimination of foreign exchange transaction costs. Conversely, American companies may find that the conversion to the euro has a costly impact on their pricing structures and information systems. In particular, companies risk being saddled by U.S. tax issues raised by the euro conversion, and, if they were subject to immediate recognition of millions of dollars of foreign exchange gains and losses, they could be threatened by massive tax liability.

To allay such fears the IRS and the Treasury issued temporary regulations in early 1998 that address some of the tax issues related to the conversion. These regulations attempt to ease the administrative burdens associated with the conversion and maintain the tax neutrality of the event. In certain aspects, the regulations are consistent with previous tax policies, which treat involuntary events as non-taxable events. In other aspects, the regulations provide for immediate taxation where administratively feasible.

In this regard, U.S. taxpayers like Dow should be aware that the regulations do not achieve one hundred percent tax neutrality. The regulations leave a number of critical issues unresolved, in particular the deductibility of conversion costs, the mismatching of foreign tax credits, and the impact of membership changes within the EU. In the absence of more comprehensive Treasury regulations, Dow and other taxpayers should ensure that their contracts take into account possible euro-related complications.

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97. Temp. Treas. Reg. § 1.985-8T(c)(2) (1998). "The euro basis in property and the euro amount of liabilities and other relevant items shall equal the product of the legacy functional currency adjusted basis or amount of liabilities multiplied by the applicable conversion rate." *Id.*