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Global Tax Alert

Argentina's hyperinflation has tax implications for regulated investment companies that invest in certain Argentine debt and financial products

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Following determinations that the Argentine peso is hyperinflationary for United States (US) GAAP[1] and IFRS[2] purposes, EY determined that the Argentine peso also should be treated as hyperinflationary for US federal income tax purposes. As discussed in the following question and answer format, this determination will affect the tax treatment of certain Argentine debt, as well as certain options, forwards, futures and swaps on the Argentine peso.

What is a hyperinflationary currency?

A hyperinflationary currency is a currency of a country in which there is cumulative inflation during a "Base Period" of at least 100%, as determined by reference to a consumer price index (CPI) of the country.

Does the Internal Revenue Service announce that a currency is hyperinflationary?

No. It's up to taxpayers to make the determination. Although the test appears to be mechanical, it can involve subjectivity in situations such as Argentina's in which there currently is a lack of good data on inflation.

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So how do you determine if a currency is hyperinflationary?

For US tax purposes, the determination of whether a currency is hyperinflationary generally is made on a calendar-year basis (e.g., as of 1 January 2019), based on changes in the CPI as reported in the monthly issues of the "International Financial Statistics" or a successor publication of the International Monetary Fund (IMF) for the 36-calendar months immediately preceding the first day of the calendar year (the Base Period).

If a country's currency is not listed in the monthly issues of "International Financial Statistics," Treasury regulations permit a taxpayer to use any other reasonable method consistently applied for determining the country's consumer price index. For example, the US GAAP determination regarding hyperinflation may be used in determining whether a currency is hyperinflationary for US federal income tax purposes, although this approach is not mandatory if a taxpayer has not used it historically.

Has EY determined that the Argentine peso is a hyperinflationary currency?

Although it is not completely clear, EY's view is the better answer is that the Argentine peso is hyperinflationary.

The following questions and answers will apply if the Argentine peso is considered a hyperinflationary currency for US federal income tax purposes as of 31 December 2018:

How is this relevant to regulated investment companies (RICs)?

RICs that hold bonds denominated in, and/or certain derivative contracts on, the Argentine peso will be subject to a mark-to-market regime on these instruments described in more detail later.

Does the mark-to-market regime apply to Argentine bonds and other financial instruments that are US-dollar denominated?

No.

When will this mark-to-market regime start to apply to RICs?

The mark-to-market regime will apply to RIC tax years beginning after 31 December 2018.

Will the mark-to-market regime apply only to newly acquired instruments or to existing holdings as well?

For Argentine bonds and cash deposits, the mark-to-market regime generally will apply only to newly acquired bonds (that is, bonds acquired during or after a RIC's first tax year to which the mark-to-market regime applies). The mark-to-market regime, however, will apply to existing holdings for a bond or cash deposit whose terms provide for the adjustment of principal or interest payments in a manner that reflects hyperinflation. For example, a debt instrument providing for a variable interest rate based on local conditions and generally responding to changes in the local consumer price index will reflect hyperinflation.

For options, forwards and futures that have payments to be made or received that are denominated in (or determined by reference to) a hyperinflationary currency of the taxpayer, the mark-to-market regime will apply only to newly acquired contracts.

For hyperinflationary currency swaps (a special type of swap that, among other characteristics, requires an exchange of principal payments at maturity), the mark-to-market regime generally will apply only to newly acquired contracts. The mark-to-market regime will apply, however, to existing holdings for a swap with payments that are adjusted to take into account the fact that the currency is hyperinflationary during the current tax year. A currency swap contract that provides for periodic payments determined by reference to a variable interest rate based on local conditions and generally responding to changes in the local consumer price index is an example of this latter type of currency swap contract. Other swaps are not subject to the mark-to-market regime.

How does the mark-to-market regime work for hyperinflationary bonds?

A bondholder marks only the currency component of a bond to market and realizes currency gain or loss based on the change in exchange rates between: (i) the later of the first day of the tax year or the date the instrument was entered into; and (ii) the earlier of the last day of the tax year, or the date the instrument is disposed of or otherwise terminated. For bonds and swaps subject to the "existing holding" rule, the fact that the mark-to-market starts with the later of the two dates means that built-in gain/loss in these instruments from non-hyperinflationary years remains unrealized and must be carried forward until the bond is disposed of.

If a bondholder has a loss on the mark-to-market, that loss reduces the amount of interest income paid or accrued on the bond for the year. Any mark-to-market loss exceeding the interest income on that bond is characterized and sourced under standard Internal Revenue Code (IRC) Section 988 rules. For example, if a taxpayer accrues 100 Argentine pesos of interest on a bond in 2019 and has a 150 Argentine peso loss on the mark-to-market, the taxpayer includes no interest on the bond and has a currency loss of 50 pesos.

If a bondholder has a currency gain on the mark-to-market, that gain is characterized and sourced under the standard IRC Section 988 rules for foreign currency transactions.

The same rules apply to cash deposits.

How does the mark-to-market regime work for hyperinflationary contracts?

Under Treas. Reg. 1.988-2(d)(5), the holder of an option, forward or futures contract on a hyperinflationary currency marks the contract to market and realizes currency gain or loss based on the change in exchange rates between: "(A) the later of the first day of the tax year or the date the instrument was entered into; and (B) the earlier of the last day of the tax year, or the date the instrument is disposed of or otherwise terminated."

How does the mark-to-market regime work for hyperinflationary currency swaps?

Under Treas. Reg. 1.988-2(e)(7), the holder of a hyperinflationary currency swap marks the swap to market and realizes currency gain or loss based on the change in exchange rates between: "(A) the later of the first day of the tax year or the date the instrument was entered into; and (B) the earlier of the last day of the tax year, or the date the instrument is disposed of or otherwise terminated."

Is the 988(a)(1)(B) election available for hyperinflationary contracts?

Nothing would appear to prevent making the election.

Is the 1.988-7 election available for IRC Section 988 transactions involving hyperinflationary instruments?

No.

Conclusion

Implementing the tax rules for hyperinflationary currency may raise novel operational issues. Accordingly, RIC complexes should evaluate these rules and understand their implications even if they will not affect their RICs for several months (depending on a RIC's tax year).

Endnotes

1. Generally accepted accounting principles (GAAP).
2. International Financial Reporting Standards (IFRS).

For additional information with respect to this Alert, please contact the following:

Ernst & Young LLP, Financial Services Organizations, US

- Stephen Fisher, *Boston* stephen.fisher@ey.com
- David Mangefrida, *Chicago* david.mangefrida@ey.com
- Robert Meiner, *Hoboken* robert.meiner@ey.com

Ernst & Young LLP, International Tax Services – Capital Markets, US

- Doug Chestnut, *Washington, DC* douglas.chestnut@ey.com
- Karla Johnsen, *New York* karla.johnsen@ey.com

International Tax Services

Global ITS Leader, **Jeffrey Michalak,** *Detroit*

ITS Director, Americas, **Craig Hillier,** *Boston*

ITS Markets Leader, Americas, **Stephen O'Neil,** *New York*

National ITS Leader, **Jose Murillo,** *Washington*

ITS Regional Contacts, Ernst & Young LLP (US)

Central
Colleen Warner, *Chicago*

Northeast
Jonny Lindroos, *McLean, VA*

Southeast
Scott Shell, *Charlotte, NC*

Southwest
Amy Ritchie, *Austin*

West
Sadler Nelson, *San Jose, CA*

Financial Services
Chris J Housman, *New York*

Canada – Ernst & Young LLP (Canada)
Albert Anelli, *Montreal*

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