with its substance. Thus, the January 1, 1990, exchange by X of $100 for LC 100 is treated as a spot purchase of LCs by X and the December 31, 1992, exchange by X at 109.3LC for $133 is treated as a forward sale of LCs by X. Under such treatment there would be no tax consequences to X under paragraph (e)(2) of this section in 1990, 1991, and 1992 with respect to this transaction other than the realization of exchange gain or loss on the sale of the LC109.3 on December 31, 1992. Calculation of such gain or loss would be governed by the rules of paragraph (d) of this section.

(g) *Effective date.* Except as otherwise provided in this section, this section shall be effective for taxable years beginning after December 31, 1986. Thus, except as otherwise provided in this section, any payments made or received with respect to a section 988 transaction in taxable years beginning after December 31, 1986, are subject to this section.

(h) *Timing of income and deductions from notional principal contracts.* Except as otherwise provided (e.g., in §1.988–5 or 1.446–3(g)), income or loss from a notional principal contract described in §1.988–1(a)(2)(iii)(B) (other than a currency swap) is exchange gain or loss. For the rules governing the timing of income and deductions with respect to notional principal contracts, see §1.446–3. See paragraph (e)(2) of this section with respect to currency swaps.

[T.D. 8400, 57 FR 9183, Mar. 17, 1992, as amended by T.D. 8491, 58 FR 53135, Oct. 14, 1993; T.D. 8860, 65 FR 2028, Jan. 13, 2000]

§1.988–3 Character of exchange gain or loss.

(a) *In general.* The character of exchange gain or loss recognized on a section 988 transaction is governed by section 988 and this section. Except as otherwise provided in section 988(c)(1)(E), section 1092, §1.988–5 and this section, exchange gain or loss realized with respect to a section 988 transaction (including a section 1256 contract that is also a section 988 transaction) shall be characterized as ordinary gain or loss. Accordingly, unless a valid election is made under paragraph (b) of this section, any section providing special rules for capital gain or loss treatment, such as sections 1233, 1234, 1234A, 1236 and 1256(f)(3), shall not apply.

(b) *Election to characterize exchange gain or loss on certain identified forward contracts, futures contracts and option contracts as capital gain or loss*—(1) *In general.* Except as provided in paragraph (b)(2) of this section, a taxpayer may elect, subject to the requirements of paragraph (b)(3) of this section, to treat any gain or loss recognized on a contract described in §1.988–2(d)(1) as capital gain or loss, but only if the contract—

(i) Is a capital asset in the hands of the taxpayer;

(ii) Is not part of a straddle within the meaning of section 1092(c) (without regard to subsections (c)(4) or (e)); and

(iii) Is not a regulated futures contract or nonequity option with respect to which an election under section 988(c)(1)(D)(ii) is in effect.

If a valid election under this paragraph (b) is made with respect to a section 1256 contract, section 1256 shall govern the character of any gain or loss recognized on such contract.

(2) *Special rule for contracts that become part of a straddle after an election is made.* If a contract which is the subject of an election under paragraph (b)(1) of this section becomes part of a straddle within the meaning of section 1092(c) (without regard to subsections (c)(4) or (e)) after the date of the election, the election shall be invalid with respect to gains from such contract and the Commissioner, in his sole discretion, may invalidate the election with respect to losses.

(3) *Requirements for making the election.* A taxpayer elects to treat gain or loss on a transaction described in paragraph (b)(1) of this section as capital gain or loss by clearly identifying such transaction on its books and records on the date the transaction is entered into. No specific language or account is necessary for identifying a transaction referred to in the preceding sentence. However, the method of identification must be consistently applied and must clearly identify the pertinent transaction as subject to the section 988(a)(1)(B) election. The Commissioner, in his sole discretion, may invalidate any purported election that does not comply with the preceding sentence.

(4) *Verification.* A taxpayer that has made an election under §1.988–3(b)(3) must attach to his income tax return a statement which sets forth the following:

(i) A description and the date of each election made by the taxpayer during the taxpayer's taxable year;

(ii) A statement that each election made during the taxable year was made before the close of the date the transaction was entered into;

(iii) A description of any contract for which an election was in effect and the date such contract expired or was otherwise sold or exchanged during the taxable year;

(iv) A statement that the contract was never part of a straddle as defined in section 1092; and

(v) A statement that all transactions subject to the election are included on the statement attached to the taxpayer's income tax return.

In addition to any penalty that may otherwise apply, the Commissioner, in his sole discretion, may invalidate any or all elections made during the taxable year under §1.988–3(b)(1) if the taxpayer fails to verify each election as provided in this §1.988–3(b)(4). The preceding sentence shall not apply if the taxpayer's failure to verify each election was due to reasonable cause or bona fide mistake. The burden of proof to show reasonable cause or bona fide mistake made in good faith is on the taxpayer.

(5) *Independent verification*—(i) *Effect of independent verification.* If the taxpayer receives independent verification of the election in paragraph (b)(3) of this section, the taxpayer shall be presumed to have satisfied the requirements of paragraphs (b)(3) and (4) of this section. A contract that is a part of a straddle as defined in section 1092 may not be independently verified and shall be subject to the rules of paragraph (b)(2) of this section.

(ii) *Requirements for independent verification.* A taxpayer receives independent verification of the election in paragraph (b)(3) of this section if—

(A) The taxpayer establishes a separate account(s) with an unrelated broker(s) or dealer(s) through which all transactions to be independently verified pursuant to this paragraph (b)(5) are conducted and reported.

(B) Only transactions entered into on or after the date the taxpayer establishes such account may be recorded in the account.

(C) Transactions subject to the election of paragraph (b)(3) of this section are entered into such account on the date such transactions are entered into.

(D) The broker or dealer provides the taxpayer a statement detailing the transactions conducted through such account and includes on such statement the following: ''Each transaction identified in this account is subject to the election set forth in section 988(a)(1)(B).''

(iii) *Special effective date for independent verification.* The rules of this paragraph (b)(5) shall be effective for transactions entered into after March 17, 1992.

(6) *Effective date.* Except as otherwise provided, this paragraph (b) is effective for taxable years beginning on or after September 21, 1989. For prior taxable years, any reasonable contemporaneous election meeting the requirements of section 988(a)(1)(B) shall satisfy this paragraph (b).

(c) *Exchange gain or loss treated as interest*—(1) *In general.* Except as provided in this paragraph (c)(1), exchange gain or loss realized on a section 988 transaction shall not be treated as interest income or expense. Exchange gain or loss realized on a section 988 transaction shall be treated as interest income or expense as provided in paragraph (c)(2) of this section with regard to tax exempt bonds, §1.988–2(e)(2)(ii)(B), §1.988–5, and in administrative pronouncements. See §1.861–9T(b), providing rules for the allocation of certain items of exchange gain or loss in the same manner as interest expense.

(2) *Exchange loss realized by the holder on nonfunctional currency tax exempt bonds.* Exchange loss realized by the holder of a debt instrument the interest on which is excluded from gross income under section 103(a) or any similar provision of law shall be treated as an offset to and reduce total interest income received or accrued with respect to such instrument. Therefore, to

the extent of total interest income, no exchange loss shall be recognized. This paragraph (c)(2) shall be effective with respect to debt instruments acquired on or after June 24, 1987.

(d) *Effective date.* Except as otherwise provided in this section, this section shall be effective for taxable years beginning after December 31, 1986. Thus, except as otherwise provided in this section, any payments made or received with respect to a section 988 transaction in taxable years beginning after December 31, 1986, are subject to this section. Thus, for example, a payment made prior to January 1, 1987, under a forward contract that results in the deferral of a loss under section 1092 to a taxable year beginning after December 31, 1986, is not characterized as an ordinary loss by virtue of paragraph (a) of this section because payment was made prior to January 1, 1987.

[T.D. 8400, 57 FR 9197, Mar. 17, 1992]

§ 1.988–4 Source of gain or loss realized on a section 988 transaction.

(a) *In general.* Except as otherwise provided in §1.988–5 and this section, the source of exchange gain or loss shall be determined by reference to the residence of the taxpayer. This rule applies even if the taxpayer has made an election under §1.988–3(b) to characterize exchange gain or loss as capital gain or loss. This section takes precedence over section 865.

(b) *Qualified business unit*—(1) *In general.* The source of exchange gain or loss shall be determined by reference to the residence of the qualified business unit of the taxpayer on whose books the asset, liability, or item of income or expense giving rise to such gain or loss is properly reflected.

(2) *Proper reflection on the books of the taxpayer or qualified business unit*—(i) *In general.* Whether an asset, liability, or item of income or expense is properly reflected on the books of a qualified business unit is a question of fact.

(ii) *Presumption if booking practices are inconsistent.* It shall be presumed that an asset, liability, or item of income or expense is not properly reflected on the books of the qualified business unit if the taxpayer and its qualified business units employ inconsistent booking practices with respect to the same or similar assets, liabilities, or items of income or expense. If not properly reflected on the books, the Commissioner may allocate any asset, liability, or item of income or expense between or among the taxpayer and its qualified business units to properly reflect the source (or realization) of exchange gain or loss.

(c) *Effectively connected exchange gain or loss.* Notwithstanding paragraphs (a) and (b) of this section, exchange gain or loss that under principles similar to those set forth in §1.864–4(c) arises from the conduct of a United States trade or business shall be sourced in the United States and such gain or loss shall be treated as effectively connected to the conduct of a United States trade or business for purposes of sections 871(b) and 882 (a)(1).

(d) *Residence*—(1) *In general.* Except as otherwise provided in this paragraph (d), for purposes of sections 985 through 989, the residence of any person shall be—

(i) In the case of an individual, the country in which such individual's tax home (as defined in section 911(d)(3)) is located;

(ii) In the case of a corporation, partnership, trust or estate which is a United States person (as defined in section 7701(a)(30)), the United States; and

(iii) In the case of a corporation, partnership, trust or estate which is not a United States person, a country other than the United States.

If an individual does not have a tax home (as defined in section 911(d)(3)), the residence of such individual shall be the United States if such individual is a United States citizen or a resident alien and shall be a country other than the United States if such individual is not a United States citizen or resident alien. If the taxpayer is a U.S. person and has no principal place of business outside the United States, the residence of the taxpayer is the United States. Notwithstanding paragraph (d)(1)(ii) of this section, if a partnership is formed or availed of to avoid tax by altering the source of exchange gain or loss, the source of such gain or loss shall be determined by reference to the residence of the partners rather than the partnership.