

Internal Revenue Service

Department of the Treasury
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Person To Contact:
, ID No.

Telephone Number:

Refer Reply To:
CC:INTL:B05
PLR-133668-17
Date:
January 25, 2018

X =
Sub =
Parent =
media production =
Method =

Dear :

We respond to your letter dated X, requesting a ruling on behalf of Sub pursuant to Treas. Reg. §1.988-5(e) regarding the proper U.S. federal income tax treatment of hedges of Sub’s foreign currency exposure with respect to its anticipated foreign currency denominated media production costs.

The rulings contained in this letter are based upon information and representations submitted by Parent and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

Facts

Parent is a U.S. corporation and the common parent of an affiliated group of corporations that includes Sub. Parent and Sub have the U.S. dollar as their functional currencies, as defined in section 985(b)(1) of the Internal Revenue Code of 1986, as amended (the “Code”).

Sub is primarily engaged in media production. Sub owns various entertainment-related rights and generally contracts with affiliates to facilitate the production of media.

Sub has sole and exclusive control of the distribution, marketing, advertising, publicizing, exploitation, sale, or other disposition of the content.

In a typical media production, Sub forms a U.S. production company for nominal value to undertake U.S. production services. A separate foreign company is formed for nominal value in each foreign jurisdiction where production is to take place. Foreign companies often negotiate with the local jurisdiction for financial incentives which reduce the overall production cost. The companies are responsible for the entire media production process, including hiring production staff and talent and directing and editing the media production.

Generally, in the case of media productions produced in foreign countries, the foreign companies contract in the applicable local foreign currency for production costs, which include salaries and wages to be paid to the local production staff and talent and supplies, goods, and services to be provided by local vendors. Sub funds the media production costs of the foreign companies in the local foreign currency. Sub advances funding to the foreign companies during the production period according to actual production needs. Sub retains all rights to the finished product produced by the foreign companies. The foreign companies receive a nominal service fee for their services.

Sub is responsible for determining the media production budgets. The budget for a media production includes fixed costs associated with items such as the cost of local talent, stage fees, supplies, and goods and services to be provided by local vendors. The media production budget includes a breakdown of expected cash outflows by currency and an expected fixed overall U.S. dollar budget amount. In most cases, the foreign currency denominated media production costs and the timing of the receipt of any financial incentives are not contractually fixed as of the budget date.

Because Sub provides its foreign companies with the foreign currency needed to pay for foreign media production costs, Sub has foreign currency risk related to the movement of the U.S. dollar versus the local foreign currency between the budget date and the payment date. Upon determination of the budgeted cash outflows by currency, Sub provides the projected local foreign currency cash outflows to affiliated U.S.-based treasury personnel ("Treasury"). Treasury provides Sub with an estimate of the cost of buying each foreign currency using a series of forward rates (with 30-day forwards being the most common) for the currency in which media production costs are expected to be incurred over the expected term of the media production. These projected rates are approved by Sub and then blended to get a final budget for the media production in U.S. dollars.

Once the media production is approved for production by Sub, Treasury re-prices and locks in foreign currency forward contracts at the projected rate or better to hedge these foreign currency denominated costs. If the average forward rate has moved against the production from the time of providing the indicative rate to the time of

execution, Treasury will recalculate the weighted average rate and, in the event of a material change in rates, seek Sub approval before executing the trades. Treasury executes the trades with third party banks in the name of Sub such that Sub is the counterparty on the hedges. The currencies in which media production costs are expected to be incurred are actively traded on the interbank market and are also traded through regulated futures contracts.

As production of the media production is completed, Treasury, on behalf of Sub, enters into foreign currency forward contracts as necessary to effectively increase or decrease its long position in the foreign currency based upon variances in the estimated versus actual timing and amount of production costs in the foreign currency. Parent represents that through this process, Sub is rarely over-hedged.

From a financial accounting perspective, the hedged items (the foreign currency denominated media production costs) are capitalized during media production. Upon completion of the media production, the capitalized media production costs are amortized based upon the expected timing and amount of the forecasted revenue stream for the media production. Sub structures and implements each of its foreign currency hedges so as to qualify them for cash flow hedge accounting under FASB Accounting Standards Codification No. 815 ("ASC 815"). Accordingly, to the extent the hedges are effective, gains and losses on the hedges are deferred in other comprehensive income and recognized into earnings in the same period or periods during which the hedged item affects earnings. The hedge gains and losses are effectively integrated with the media production costs resulting in a fixed U.S. dollar amount of media production costs.

Hedge effectiveness is assessed by comparing the present value of the cumulative change in expected future cash flows on the forecasted transaction attributable to the hedged risk with changes in fair value of the forward contract attributable to changes in the foreign currency to the U.S. dollar forward rate. Both at inception and on an ongoing basis, this hedging relationship is expected to be highly effective in achieving offsetting changes in cash flows because the basis of the foreign exchange risk for the hedged transaction and that of the forward contract is identical (i.e., the notional amount of the hedge and the expected timing of realization of gain or loss on the hedge matches the amount and expected timing of the anticipated foreign currency expenditure). Where the basis is identical, a foreign exchange hedge is presumed to be effective and no retrospective assessment of hedge effectiveness is performed. Any hedge ineffectiveness will be the result of a forecast variance on the hedged transaction (i.e., the amount and timing of the foreign currency denominated media production costs), and, in general, is not expected to occur given the fact that Sub is rarely over-hedged.

To ensure that its designated hedging instruments as well as its hedged transactions qualify for hedge accounting under ASC 815, Sub complies with the

procedures and criteria required by ASC 815. Hedge effectiveness is tested by Parent on a quarterly basis and internal controls and procedures have been established to ensure compliance with ASC 815.

Parent requests a ruling pursuant to §1.988-5(e) that Sub be permitted to match the timing of gains and losses from foreign currency derivatives that it enters into to hedge its anticipated foreign currency denominated media production costs with the actual production cost amounts incurred.

Law

Section 988(d)(1) of the Code provides that, to the extent provided in regulations, if any section 988 transaction is part of a 988 hedging transaction, all transactions which are part of such 988 hedging transaction shall be integrated and treated as a single transaction or otherwise treated consistently for purpose of this subtitle.

Section 988(d)(2) of the Code provides that the term “988 hedging transaction” means any transaction—(A) entered into by the taxpayer primarily—(i) to manage risk of currency fluctuations with respect to property which is held or to be held by the taxpayer, or (ii) to manage risk of currency fluctuations with respect to borrowings made or to be made, or obligations incurred or to be incurred, by the taxpayer, and (B) identified by the Secretary or the taxpayer as being a 988 hedging transaction.

Treas. Reg. §1.988-5(b)(1) provides that if the taxpayer enters into a hedged executory contract as defined in paragraph (b)(2), the executory contract and the hedge shall be integrated as provided in paragraph (b)(4) of that section.

Treas. Reg. §1.988-5(b)(2)(i) provides:

A hedged executory contract is an executory contract as defined in paragraph (b)(2)(ii) of this section that is the subject of a hedge as defined in paragraph (b)(2)(iii) of this section, provided that the following requirements are satisfied—(A) The executory contract and the hedge are identified as a hedged executory contract as provided in paragraph (b)(3) of this section. (B) The hedge is entered into (i.e., settled or closed, or in the case of nonfunctional currency deposited in an account with a bank or other financial institution, such currency is acquired and deposited) on or after the date the executory contract is entered into and before the accrual date as defined in paragraph (b)(2)(iv) of this section. (C) The executory contract is hedged in whole or in part throughout the period beginning with the date the hedge is identified in accordance with paragraph (b)(3) of this section and ending on or after the accrual date. (D) None of the parties to the hedge are related. The term related means the relationships defined in section 267(b) and section 707(c)(1). (E) In the case of a qualified

business unit with a residence, as defined in section 988(a)(3)(B), outside of the United States, both the executory contract and the hedge are properly reflected on the books of the same qualified business unit. (F) Subject to the limitations of paragraph (b)(2)(i)(E) of this section, both the executory contract and the hedge are entered into by the same individual, partnership, trust, estate, or corporation. With respect to a corporation, the same corporation must enter into both the executory contract and the hedge whether or not such corporation is a member of an affiliated group of corporations that files a consolidated return. (G) With respect to a foreign person engaged in a U.S. trade or business that enters into an executory contract or hedge through such trade or business, all items of income and expense associated with the executory contract and the hedge would have been effectively connected with such U.S. trade or business throughout the term of the hedged executory contract had this paragraph (b) not applied.

Treas. Reg. § 1.988-5(b)(2)(ii) provides that, except as provided in paragraph (b)(2)(ii)(B), an executory contract is an agreement entered into before the accrual date to pay nonfunctional currency (or an amount determined with reference thereto) in the future with respect to the purchase of property used in the ordinary course of the taxpayer's business, or the acquisition of a service (or services), in the future, or to receive nonfunctional currency (or an amount determined with reference thereto) in the future with respect to the sale of property used or held for sale in the ordinary course of the taxpayer's business, or the performance of a service (or services), in the future.

Treas. Reg. § 1.988-5(b)(2)(iii)(A) provides that the term "hedge" means a deposit of nonfunctional currency in a hedging account (as defined paragraph (b)(3)(iii)(D)), a forward or futures contract described in § 1.988-1(a)(1)(ii) and (2)(iii), or combination thereof, which reduces the risk of exchange rate fluctuations by reference to the taxpayer's functional currency with respect to nonfunctional currency payments made or received under an executory contract.

Treas. Reg. § 1.988-5(b)(2)(iii)(B) provides that a series of hedges as defined in paragraph (b)(3)(iii)(A) shall be considered a hedge if the executory contract is hedged in whole or in part throughout the period beginning with the date the hedge is identified in accordance with paragraph (b)(3)(i) of this section and ending on or after the accrual date. A taxpayer that enters into a series of hedges will be deemed to have satisfied the preceding sentence if the hedge that succeeds a hedge that has been terminated is entered into no later than the business day following such termination.

Treas. Reg. § 1.988-5(b)(3) provides that a taxpayer must establish a record and before the close of the date the hedge is entered into, the taxpayer must enter into the record a clear description of the executory contract and the hedge and indicate that the transaction is being identified in accordance with paragraph (b)(3) of this section.

Section 1256(a)(1) states that each section 1256 contract held by the taxpayer at the close of the taxable year shall be treated as sold for its fair market value on the last business day of such taxable year (and any gain or loss shall be taken into account for the taxable year).

Section 1256(b)(1)(B) provides that the term “section 1256 contract” means any foreign currency contract.

Section 1256(g)(2)(A) defines a foreign currency contract as a contract (i) which requires delivery of, or the settlement of which depends on the value of, a foreign currency which is a currency in which positions are also traded through regulated futures contracts, (ii) which is traded in the interbank market, and (iii) which is entered into at arm’s length at a price determined by reference to the price in the interbank market.

Parent applies Method with respect to its production costs associated with its media productions.

Treas. Reg. §1.988-5(e) provides:

In his sole discretion, the Commissioner may issue an advance ruling addressing the income tax consequences of a taxpayer's system of hedging either its net nonfunctional currency exposure or anticipated nonfunctional currency exposure. The ruling may address the character, source, and timing of both the section 988 transaction(s) making up the hedge and the underlying transactions being hedged. The procedures for obtaining a ruling shall be governed by such pertinent revenue procedures and revenue rulings as the Commissioner may provide. The Commissioner will not issue a ruling regarding hedges of a taxpayer's investment in a foreign subsidiary.

Analysis

The anticipated foreign currency denominated media production costs which Sub hedges are estimates of the probable expected expenditures which Sub will incur in the future as the media production is being made and are not supported by executed purchase orders or similar types of agreements. Thus, an executory contract as defined in §1.988-5(b)(2)(ii) does not exist at the time the hedging transactions are entered into which would qualify for integrated hedging treatment under Treas. Reg. § 1.988-5(b). Absent an advance ruling to the contrary under Treas. Reg. § 1.988-5(e), Sub is required to treat the foreign currency forward contracts it enters into to hedge its underlying foreign currency exposure on its projected media production costs as

separate section 988 transactions that are not integrated with the underlying media production costs. Without an advance ruling, foreign currency gains or losses on foreign currency forward contracts held by Sub would be realized either upon settlement or on a mark-to-market basis under section 1256 while the costs incurred with respect to the media production would be recognized pursuant to Method.

We have determined that Sub should be allowed to apply the principles of Treas. Reg. §1.988-5(b) to integrate its hedges of underlying foreign currency exposure with respect to its anticipated media production costs with the media production costs that it actually incurs for the following reasons:

- (1) Sub must determine and lock in a U.S. dollar budget for an media production in advance of the media production's actual production. Sub will have foreign currency risk related to the movement of the U.S. dollar versus the local foreign currency exchange rate between the budget date and the payment date of the media production costs. Sub must hedge this risk prior to having a binding agreement or contractual obligation to purchase goods or services.
- (2) Sub has a detailed budgeting process to project its funding needs which allows it to determine its total foreign currency exposure and to hedge such exposure according to an expected production schedule.
- (3) Sub has established internal controls and procedures intended to ensure that its hedges are effective and meet the requirements for cash flow hedging under ASC 815.
- (4) Parent routinely re-evaluates each hedge's compliance with these requirements.

Rulings

Based on the information submitted and the representations made, we rule as follows:

Under the authority provided in Treas. Reg. §1.988-5(e), we grant Sub permission to apply the principles of Treas. Reg. § 1.988-5(b) to hedges of anticipated media production costs described in the facts above provided that:

(1) The anticipated production cost being hedged is a foreign currency denominated component of the media production's budget approved by Sub pursuant to its budgeting process and is reasonably related to the media production;

(2) The hedge meets the requirements for cash flow hedge accounting treatment under ASC 815. Parent will test hedge effectiveness on a quarterly basis and continue to maintain adequate internal controls and procedures to ensure compliance with ASC 815; and

(3) If the foreign company does not actually make the hedged anticipated production expenditure or if the hedge fails to continue to meet the criteria for hedge accounting treatment under ASC 815, the hedge is treated as having been sold for its fair market value for federal income tax purposes on the date that such determination is made and any gain or loss on the hedge will be realized and recognized on such date as section 988 gain or loss.

Caveats

We express no opinion on any provisions of the Code or regulations not specifically covered by the above ruling.

Procedural Statements

This ruling is directed only to Parent. Code section 6110(k)(3) provides that it may not be used or cited as precedent.

A copy of this letter must be attached to any income tax return to which it is relevant. Alternatively, taxpayers filing their returns electronically may satisfy this requirement by attaching a statement to their return that provides the date and control number of the letter ruling.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

Sincerely,

Steven D. Jensen
Senior Counsel, Branch 5
Office of Associate Chief Counsel
(International)