

§ 1.985-4

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of subtitle A (including sections 904 and 952) to the same category or type of gross income as the cost or expense to which the trade payable relates. For this purpose, a short-term, non-interest-bearing trade payable is a non-interest-bearing liability with a term of 183 days or less that is incurred to purchase property or services to be used by the obligor in an active trade or business.

(B) *Excise tax payables.* The taxpayer shall allocate DASTM gain or loss on excise tax payables for purposes of subtitle A (including sections 904 and 952) to the same category or type of gross income as would be derived from the activity to which the excise tax relates.

(C) *Other non-interest-bearing liabilities—(1) In general.* Except as provided in paragraphs (e)(3)(viii)(A), (e)(3)(viii)(B), and (e)(3)(viii)(C)(2) of this section, DASTM gain or loss on non-interest-bearing liabilities shall be allocated under paragraph (e)(3)(ix) of this section (Step 9).

(2) *Tracing if substantial distortion of income.* DASTM gains and losses on liabilities described in paragraph (e)(3)(viii)(C)(1) of this section may be attributed to the same section 904(d) separate category or subpart F category as the transaction to which the liability relates if the taxpayer demonstrates to the satisfaction of the district director, or it is determined by the district director, that application of paragraph (e)(3)(viii)(C)(1) of this section results in a substantial distortion of income.

(ix) *Step 9—allocate residual DASTM gain or loss.* If there is a difference between the net DASTM gain or loss determined under paragraphs (e)(3)(i) through (viii) of this section (Steps 1 through 8) and the DASTM gain or loss determined under paragraph (d) of this section, the amount of the difference must be allocated for purposes of subtitle A (including sections 904 and 952) to the QBU's gross income (computed under paragraphs (b)(1) through (3) of this section, as adjusted under paragraphs (e)(3)(i) through (viii) of this section (Steps 1 through 8)) on the

basis of the relative amounts of each category or type of gross income.

[T.D. 8556, 59 FR 37673, July 25, 1994, as amended by T.D. 9320, 72 FR 15044, Mar. 30, 2007]

§ 1.985-4 Method of accounting.

(a) *Adoption of election.* The adoption of, or the election to use, a functional currency shall be treated as a method of accounting. The functional currency shall be used for the year of adoption (or election) and for all subsequent taxable years unless permission to change is granted, or considered to be granted under § 1.985-2 or 1.985-8, by the Commissioner.

(b) *Condition for changing functional currencies.* Generally, permission to change functional currencies shall not be granted unless significant changes in the facts and circumstances of the QBU's economic environment occur. If the determination of the functional currency of the QBU for purposes of United States generally accepted accounting principles (GAAP) is based on facts and circumstances substantially similar to those set forth in § 1.985-1(c)(2), then ordinarily the Commissioner will grant a taxpayer's request to change its functional currency (or the functional currency of its branch that is a QBU) to a new functional currency only if the taxpayer (or its QBU) also changes to the new functional currency for purposes of GAAP. However, permission to change will not necessarily be granted merely because the new functional currency will conform to the taxpayer's GAAP functional currency.

(c) *Relationship to certain other sections of the Code.* Nothing in this section shall be construed to override the provisions of any other sections of the Code of regulations that require the use of consistent accounting methods. Such provisions must be independently satisfied separate and apart from the identification of a functional currency. For instance, while separate geographical divisions of a taxpayer's trade or business may have different functional currencies, such geographical divisions may nevertheless

be required to consistently use other methods of accounting.

[T.D. 8263, 54 FR 38661, Sept. 20, 1989, as amended by T.D. 8776, 63 FR 40368, July 29, 1998; T.D. 8927, Jan. 11, 2001]

§ 1.985-5 Adjustments required upon change in functional currency.

(a) *In general.* This section applies in the case of a QBU that changes from one functional currency (old functional currency) to another functional currency (new functional currency). A taxpayer or QBU subject to the rules of this section shall make the adjustments set forth in the 3-step procedure described in paragraphs (b) through (e) of this section. The adjustments shall be made on the last day of the taxable year ending before the year of change as defined in § 1.481-1(a)(1). Gain or loss required to be recognized under paragraphs (b), (d)(2), and (e)(2) of this section is not subject to section 481 and, therefore, the full amount of the gain or loss must be included in income or earnings and profits on the last day of the taxable year ending before the year of change. Except as provided in § 1.985-6, a QBU with a functional currency for its first taxable year beginning in 1987 that is different from the currency in which it had kept its books and records for United States accounting and tax accounting purposes for its prior taxable year shall apply the principles of this § 1.985-5 for purposes of computing the relevant functional currency items, such as earnings and profits, basis of an asset, and amount of a liability, as of the first day of a taxpayer's first taxable year beginning in 1987. However, a QBU that changes to the dollar pursuant to § 1.985-1(b)(2) after 1987 shall apply § 1.985-7.

(b) *Step 1—Taking into account exchange gain or loss on certain section 988 transactions.* The QBU shall recognize or otherwise take into account for all purposes of the Code the amount of any unrealized exchange gain or loss attributable to a section 988 transaction (as defined in section 988(c)(1)(A), (B), and (C)) that, after applying section 988(d), is denominated in terms of or determined by reference to the new functional currency. The amount of such gain or loss shall be determined without regard to the limitations of section

988(b) (*i.e.*, whether any gain or loss would be realized on the transaction as a whole). The character and source of such gain or loss shall be determined under section 988.

(c) *Step 2—Determining the new functional currency basis of property and the new functional currency amount of liabilities and any other relevant items.* The new functional currency adjusted basis of property and the new functional currency amount of liabilities and any other relevant items (*e.g.*, items described in section 988(c)(1)(B)(iii)) shall equal the product of the amount of the old functional currency adjusted basis or amount multiplied by the new functional currency/old functional currency spot exchange rate on the last day of the taxable year ending before the year of change (spot rate).

(d) *Step 3A—Additional adjustments that are necessary when a branch changes functional currency—(1) Branch changing to a functional currency other than the taxpayer's functional currency—*
(i) *Rule.* If a QBU that is a branch of a taxpayer changes to a functional currency other than the taxpayer's functional currency, the branch shall make the adjustments set forth in either paragraph (d)(1)(ii) or (d)(1)(iii) of this section for purposes of section 987. See § 1.987-5(d) for rules for computing the branch's equity pool and basis pool.

(ii) *Where prior to the change the branch and taxpayer had different functional currencies.* If the branch and the taxpayer had different functional currencies prior to the change, the branch's new functional currency equity pool shall equal the product of the old functional currency amount of the equity pool multiplied by the spot rate. No adjustment to the basis pool is necessary.

(iii) *Where prior to the change the branch and taxpayer had the same functional currency.* If the branch and the taxpayer had the same functional currency prior to the change, the branch's basis pool shall equal the difference between the branch's total old functional currency basis of its assets and its total old functional currency amount of its liabilities. The branch's equity pool shall equal the product of the basis pool multiplied by the spot rate.