Example 2. P, a domestic corporation, operates a foreign branch, S. The Commissioner granted permission to change S’s functional currency from the LC to the FC beginning January 1, 1993. As of December 31, 1992, S’s equity pool was 2,000 LC and its basis pool was $4,000. The LC/FC exchange rate on December 31, 1992 is 1 LC/2 FC. On January 1, 1993, the new functional currency amount of S’s equity pool is 4,000 FC. The basis pool is not affected.

§ 1.985–6 Transition rules for a QBU that uses the dollar approximate separate transactions method for its first taxable year beginning in 1987.

(a) In general. This section sets forth transition rules for a QBU that used the dollar approximate separate transactions method of accounting set forth in §1.985–3 or §1.985–3T (as contained in the April 1, 1989 edition of 26 CFR part 1 (1.908 to 1.1000)) for its first taxable year beginning before January 1, 1987. A DASTM QBU must determine the dollar and hyperinflationary currency basis of its assets and the dollar and hyperinflationary currency amount of its liabilities that were acquired or incurred in taxable years beginning before January 1, 1987. In addition, a DASTM QBU must determine its net worth, including its retained earnings, at the end of the QBU’s last taxable year beginning before January 1, 1987. This section provides rules for controlled foreign corporations (as defined in section 957 or section 953(c)(1)(B)), other foreign corporations, and branches of United States persons that must make these determinations.

(b) Certain controlled foreign corporations. If a DASTM QBU was a controlled foreign corporation for its last taxable year beginning before January 1, 1987, and it had a significant event as described in §1.964–1(c)(6) in a taxable year beginning before January 1, 1987, then the rules of this paragraph (b) shall apply.

(1) Basis in assets and amount of liabilities. The hyperinflationary currency adjusted basis of the QBU’s assets and the hyperinflationary currency amount of the QBU’s liabilities acquired or incurred by the QBU in a taxable year beginning before January 1, 1987, shall be the basis or the amount as determined under §1.964–1(e) prior to translation under §1.964–1(e)(4). The dollar adjusted basis of such assets and the dollar amount of such liabilities shall be the adjusted basis or the amount as determined under the rules of §1.964–1(e) after translation under §1.964–1(e)(4).

(2) Retained earnings. The dollar amount of the QBU’s retained earnings at the end of its last taxable year beginning before January 1, 1987, shall be the dollar amount determined under §1.964–1(e)(3).

(c) All other foreign corporations. If a foreign corporation is a DASTM QBU that is not described in paragraph (b) of this section, then the hyperinflationary currency and dollar adjusted basis in the QBU’s assets acquired in taxable years beginning before January 1, 1987, the hyperinflationary currency and dollar amount of the QBU’s liabilities acquired or incurred in taxable years beginning before January 1, 1987, and the dollar amount of the QBU’s net worth, including its retained earnings, at the end of its last taxable year beginning before January 1, 1987, shall be determined by applying the principles of §1.985–3T or §1.985–3. Thus, for example, the dollar basis of plant and equipment shall be determined using the appropriate historical exchange rate.

(d) Pre-1987 section 902 amounts—(1) Translation of pre-1987 section 902 accumulated profits and taxes into United States dollars. The foreign income taxes and accumulated profits or deficits in accumulated profits of a foreign corporation that were maintained in foreign currency for purposes of section 902 and that are attributable to taxable years of the foreign corporation beginning before January 1, 1987, shall be
translated into dollars at the spot exchange rate on the first day of its first taxable year beginning after December 31, 1986. Once translated into dollars, these accumulated profits and taxes shall (absent a change in functional currency) remain in dollars for all federal income tax purposes.

(2) Carryforward of accumulated deficits in accumulated profits from pre-1987 taxable years to post-1986 taxable years.

For purposes of sections 902 and 960, the post-1986 undistributed earnings of a foreign corporation that is subject to the rules of this section shall be reduced by the dollar amount of the corporation’s deficit in accumulated profits, if any, determined under section 902 and the regulations thereunder, that was accumulated at the end of the corporation’s last taxable year beginning before January 1, 1987. The dollar amount of the accumulated deficit shall be determined by multiplying the foreign currency amount of such deficit by the spot exchange rate on the last day of the corporation’s last taxable year beginning before January 1, 1987, and shall be taken into account on the first day of the corporation’s first taxable year beginning after December 31, 1986. Post-1986 undistributed earnings may not be reduced by the dollar amount of a pre-1987 deficit in retained earnings determined under §1.964–1(e).

(e) Net worth branch. If a DASTM QBU is a branch of a United States person and the QBU used a net worth method of accounting for its last taxable year beginning before January 1, 1987, then the rules of this paragraph (e) shall apply. A net worth method of accounting is any method of accounting under which the taxpayer calculates the taxable income of a QBU based on the net change in the dollar value of the QBU’s equity (assets minus liabilities) during the course of a taxable year, taking into account any contributions or remittances made during the year. See, e.g., Rev. Rul. 75–106, 1975–1 C.B. 31. (See §601.601(d)(2)(ii)(b) of this chapter).

(1) Basis in assets and amount of liabilities—(i) Hyperinflationary amounts. For the first taxable year beginning in 1987, the hyperinflationary currency adjusted basis of a QBU’s assets or the hyperinflationary currency amounts of its liabilities acquired or incurred in a taxable year beginning before January 1, 1987 is the hyperinflationary currency basis or amount at the date when acquired or incurred, as adjusted according to United States generally accepted accounting and tax accounting principles. If a hyperinflationary currency basis or amount was not determined at such date, the dollar basis or amount, as adjusted according to United States generally accepted accounting and tax accounting principles, shall be translated into hyperinflationary currency at the spot exchange rate on the date when the asset or liability was acquired or incurred.

(ii) Dollar amounts. For the first taxable year beginning in 1987, the dollar adjusted basis of the QBU’s assets and the amounts of its liabilities shall be those amounts reflected on the QBU’s dollar books and records at the end of the taxpayer’s last taxable year beginning before January 1, 1987, after adjusting the books and records according to United States generally accepted accounting and tax accounting principles.

(2) Ending net worth. The dollar amount of the QBU’s net worth at the end of its last taxable year beginning before January 1, 1987 shall equal the QBU’s net worth at that date as determined under paragraph (e)(1)(ii) of this section.

(f) Profit and loss branch. If a DASTM QBU is a branch of a United States person and the QBU used a profit and loss method of accounting for its last taxable year beginning before January 1, 1987, then the United States person shall first apply the transition rules of §1.987–5 in order to determine the beginning amount and dollar basis of the branch’s EQ pool, the hyperinflationary currency basis of the branch’s assets, and the hyperinflationary currency amounts of its liabilities. A profit and loss method of accounting is any method of accounting under which the taxpayer calculates the profits of a QBU by computing the QBU’s profits in its functional currency and translating the net result into dollars. See, e.g., Rev. Rul. 75–107, 1975–1 C.B. 32. (See §601.601(d)(2)(ii)(b) of this chapter).
QBU and the taxpayer must then make the adjustments required by §1.985–5, e.g., the QBU must take into account unrealized exchange gain or loss on dollar-denominated section 988 transactions, the taxpayer must account for the deemed termination of the branch, and the taxpayer must translate the QBU’s balance sheet items from hyperinflationary currency into dollars at the spot rate.

[T.D. 8464, 58 FR 234, Jan. 5, 1993]

§ 1.985–7 Adjustments required in connection with a change to DASTM.

(a) In general. If a QBU begins to use the dollar approximate separate transactions method of accounting set forth in §1.985–3 (DASTM) in a taxable year beginning after April 6, 1998, adjustments shall be made as provided by this section. For the rules with respect to foreign corporations, see paragraph (b) of this section. For the rules with respect to adjustments to the income of United States shareholders of controlled foreign corporations, see paragraph (c) of this section. For the rules with respect to adjustments relating to QBU branches, see paragraph (d) of this section. For the effective date of this section, see paragraph (e). For purposes of applying this section, the look-back period shall be the period beginning with the first taxable year after the transition date and ending on the last day prior to the taxable year of change. The term transition date means the later of the last day of the last taxable year ending before the base period as defined in §1.985–1(b)(2)(i)(D) or the last day of the taxable year in which the QBU last applied DASTM. The taxable year of change shall mean the taxable year beginning January 1, 1999.

(b) Adjustments to foreign corporations—(1) In general. In the case of a foreign corporation, the corporation shall make the adjustments set forth in paragraphs (b)(2) through (4) of this section. The adjustments shall be made on the first day of the taxable year of change.

(2) Treatment of certain section 988 transactions—(i) Exchange gain or loss from section 988 transactions unrealized as of the transition date. A foreign corporation shall adjust earnings and profits by the amount of any unrealized exchange gain or loss that was attributable to a section 988 transaction (as defined in sections 988(c)(1)(A), (B), and (C)) that was denominated in terms of (or determined by reference to) the dollar and was held by the corporation on the transition date. Such gain or loss shall be computed as if recognized on the transition date and shall be reduced by any gain and increased by any loss recognized by the corporation with respect to such transaction during the look-back period. 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. Proper adjustments shall be made to account for gain or loss taken into account by reason of this paragraph (b)(2). See §1.985–5(f) Example 1, footnote 1.

(ii) Treatment of a section 988 transaction entered into and terminated during the look-back period. A foreign corporation shall reduce earnings and profits by the amount of any gain, and increase earnings and profits by the