Internal Revenue Service, Treasury

§ 1.985–6

The provisions of this section are illustrated by the following examples.

Example 1. S, a calendar year foreign corporation, is wholly owned by domestic corporation P. The Commissioner granted permission to change S's functional currency from the LC to the FC beginning January 1, 1993. The LC/FC exchange rate on December 31, 1992 is 1 LC/2 FC. The following shows how S must convert the items on its balance sheet from the LC to the FC.

<table>
<thead>
<tr>
<th>Assets:</th>
<th>LC</th>
<th>FC</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash on hand</td>
<td>40,000</td>
<td>80,000</td>
</tr>
<tr>
<td>Accounts Receivable</td>
<td>10,000</td>
<td>20,000</td>
</tr>
<tr>
<td>Inventory</td>
<td>100,000</td>
<td>200,000</td>
</tr>
<tr>
<td>100,000 FC Bond (100,000 LC historical basis)</td>
<td>150,000</td>
<td>100,000</td>
</tr>
<tr>
<td>Fixed assets:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Property</td>
<td>200,000</td>
<td>400,000</td>
</tr>
<tr>
<td>Plant</td>
<td>500,000</td>
<td>1,000,000</td>
</tr>
<tr>
<td>Accumulated Depreciation</td>
<td>(200,000)</td>
<td>(400,000)</td>
</tr>
<tr>
<td>Equipment</td>
<td>1,000,000</td>
<td>2,000,000</td>
</tr>
<tr>
<td>Accumulated Depreciation</td>
<td>(400,000)</td>
<td>(800,000)</td>
</tr>
<tr>
<td>Total Assets</td>
<td>1,300,000</td>
<td>2,600,000</td>
</tr>
</tbody>
</table>

| Liabilities:                           |         |         |
| Accounts Payable                       | 50,000  | 100,000 |
| Long-term Liabilities                  | 400,000 | 800,000 |
| Paid-in-Capital                        | 800,000 | 1,600,000 |
| Retained Earnings                      | *50,000* | 100,000 |
| Total Liabilities and Equity           | 1,300,000 | 2,600,000 |

1 Under §1.985–6(b), S will recognize a 50,000 LC loss (100,000 LC basis - 50,000 LC value) on the bond resulting from the change in functional currency. Thus, immediately before the change, S's basis in the FC bond (taking into account the loss) is 50,000 LC.

2 The amount of S's LC retained earnings reflects the 50,000 LC loss on the bond.

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 (1.903 to 1.1000)) for its first taxable year beginning in 1987 (DASTM QBU). 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, 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, and 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

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asset or liability was acquired or in-
curred.

(ii) Dollar amounts. For the first tax-
able 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 taxpaye’s last taxable year begin-
ning before January 1, 1987, after ad-
justing the books and records accord-
ing to United States generally accepted
accounting and tax accounting prin-
ciples.

(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 deter-
mined under paragraph (e)(1)(ii) of this
section.

(f) Profit and loss branch. If a DASTM
QBU is a branch of a United States per-
son and the QBU used a profit and loss
method of accounting for its last tax-
able 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 be-
ginning 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 ac-
counting under which the taxpayer cal-
culates the profits of a QBU by com-
puting the QBU’s profits in its func-
tional 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). The
QBU and the taxpayer must then make
the adjustments required by §1.985–5,
For example, the QBU must take into account unrealized exchange gain or loss on dollar-denominated section 988 trans-
actions, 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. 8454, 58 FR 234, Jan. 5, 1993]