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(1) The sum of the amounts of income excluded from foreign base company income under section 954(b)(2) and paragraph (b)(1) of §1.954–1 for all prior taxable years,

(2) The sum of the amounts of previously excluded subpart F income withdrawn from investment in foreign base company shipping operations for all prior taxable years, as determined under section 955(a) and paragraph (b) of §1.955A–1,

(3) The amount withdrawn from investment in foreign base company shipping operations for the taxable year as determined under section 955(a) and paragraph (b) of §1.955A–1, and

(4) If the carryover (as described in §1.955A–1(b)(3)) of amounts relating to investments in less developed country shipping companies (as described in §1.995–5(b)) is applicable, (i) the amount of the corporation's qualified investments (determined under §1.955–2 other than paragraph (b)(5) thereof) in less developed country shipping companies at the close of the last taxable year of the corporation beginning before January 1, 1976, and (ii) the amount of the limitation with respect to previously excluded subpart F income (determined under §1.955–1(b)(1)(i)(*b*)) for the first taxable year of the corporation beginning after December 31, 1975.

(h) *Withdrawal of previously excluded export trade income from investment.* Books or records sufficient to verify the previously excluded export trade income of the controlled foreign corporation withdrawn from investment for the taxable year must establish the United States shareholder's proportionate share of—

(1) The sum of the amounts by which the subpart F income of such corporation was reduced for all prior taxable years under section 970(a) and paragraph (b) of §1.970–1,

(2) The sum of the amounts described in section 970(b)(1)(B),

(3) The sum of the amounts of previously excluded export trade income of such corporation withdrawn from investment under section 970(b) and paragraph (c) of §1.970–1 for all prior taxable years, and

(4) The amount withdrawn from investment under section 970(b) and paragraph (c) of §1.970–1 for the taxable year.

(i) *Increase in earnings invested in United States property.* Books or records sufficient to verify the increase for the taxable year in earnings invested by the controlled foreign corporations in United States property must establish—

(1) The amount of such corporation's earnings invested in United States property (as defined in section 956(b)(1) and paragraph (a) of §1.956–2) at the close of the current and preceding taxable years, as determined under paragraph (b) of §1.956–1,

(2) The amount of excluded property described in section 956(b)(2) and paragraph (b) of §1.956–2 held by such corporation at the close of such years,

(3) The earnings and profits, to which section 959(c)(1) and paragraph (b)(1) of §1.959–3 apply, distributed by such corporation during the preceding taxable year, and

(4) The amount of increase in earnings invested by such corporation in United States property which is excluded from the United States shareholder's gross income for the taxable year under section 959(a)(2) and paragraph (c) of §1.959–1.

[T.D. 6824, 30 FR 6481, May 11, 1965, as amended by T.D. 7211, 37 FR 21436, Oct. 11, 1972; T.D. 7893, 48 FR 22511, May 19, 1983; T.D. 8331, 56 FR 2849, Jan. 25, 1991]

§1.964–5 Effective date of subpart F.

Sections 951 through 964 and §§1.951 through 1.964–4 shall apply with respect to taxable years of foreign corporations beginning after December 31, 1962, and to taxable years of United States shareholders within which or with which such taxable years of such corporations end.

[T.D. 7120, 36 FR 10862, June 4, 1971]

EXPORT TRADE CORPORATIONS

§1.970–1 Export trade corporations.

(a) *In general.* Sections 970 through 972 provide in general that if a controlled foreign corporation is an export trade corporation for any taxable year, the subpart F income of such corporation shall, subject to limitations provided by section 970(a) and paragraph (b) of this section, be reduced by so

much of such corporation's export trade income as constitutes foreign base company income. To the extent subpart F income of an export trade corporation is reduced under section 970 and this section, an amount is required by section 970(b) and paragraph (c) of this section to be included in gross income of United States shareholders of the corporation if there is a subsequent decrease in such corporation's investments in export trade assets. See section 971(a) and paragraph (a) of §1.971–1 for definition of the term ''export trade corporation'', section 971(b) and paragraph (b) of §1.971–1 for definition of the term ''export trade income'', and section 971(c) and paragraph (c) of §1.971–1 for definition of the term ''export trade assets''.

(b) *Amount by which export trade income shall reduce subpart F income*—(1) *Deductible amount.* The subpart F income, determined as provided in section 952 and the regulations thereunder but without regard to section 970 and this paragraph, of a controlled foreign corporation which is an export trade corporation for its taxable year shall be reduced by an amount equal to so much of its export trade income as constitutes foreign base company income for such taxable year, but only to the extent that such amount of export trade income does not exceed the limitation determined under subparagraph (2) of this paragraph for such taxable year. See section 972 and §1.972–1 for rules relating to the consolidation of export trade corporations for purposes of determining the limitations described in subparagraph (2) of this paragraph.

(2) *Limitation on the amount of export trade income deductible from subpart F income.* The amount by which subpart F income of an export trade corporation may be reduced for any taxable year under subparagraph (1) of this paragraph may not exceed whichever of the following limitations is the smallest:

(i) The amount which is equal to 150 percent of the export promotion expenses, as defined in section 971(d) and paragraph (d) of §1.971–1, of the export trade corporation paid or incurred during the taxable year which are properly allocable to the receipt or the production of so much of its export trade income as constitutes foreign base company income for such taxable year;

(ii) The amount which is equal to 10 percent of the gross receipts (other than from commissions, fees, or other compensation for services), plus 10 percent of the gross amount upon the basis of which are computed commissions, fees, or other compensation for services included in gross receipts, of the export trade corporation received or accrued during the taxable year from, or in connection with, the sale, installation, operation, maintenance, or use of property in respect of which such corporation derives export trade income which constitutes foreign base company income for such taxable year; or

(iii) The amount which bears the same ratio to the increase in investments in export trade assets, as defined in section 970(c)(2) and paragraph (d)(2) of this section, of the export trade corporation for its taxable year as the export trade income which constitutes foreign base company income of such corporation for such taxable year bears to the entire export trade income of the corporation for such year.

Under subdivision (ii) of this subparagraph, in the case of minimum or maximum fee arrangements, the determination shall be made on the basis of the actual gross amounts with respect to which such fees are paid, rather than on the basis of the amounts upon which such minimum or maximum fees are computed. All determinations of limitations under this subparagraph shall be made on an aggregate basis and not with respect to separate items or categories of income described in paragraph (b)(1) of §1.971–1.

(3) *Determination of export promotion expense limitation.* For purposes of determining the limitation contained in subparagraph (2)(i) of this paragraph for any taxable year of the export trade corporation, there shall be taken into account with respect to those items or categories of export trade income which constitute foreign base company income the entire amount of those export promotion expenses which are directly related to such items or categories of income and a ratable part of any other export promotion expenses which are indirectly related to such

items or categories of income, except that no export promotion expense shall be allocated to an item or category of income to which it clearly does not apply and no deduction allowable to such corporation under section 882(c) and the regulations thereunder shall be taken into account.

(4) *Application of section 482.* The limitations provided in section 970(a) and subparagraph (2) of this paragraph shall not affect the authority of the district director to apply the provisions of section 482 and the regulations thereunder, relating to allocation of income and deductions among taxpayers.

(5) *Illustrations.* The application of this paragraph may be illustrated by the following examples:

Example 1. Foreign corporation A is a wholly owned subsidiary of domestic corporation M. Both corporations use the calendar year as the taxable year. For 1963, A Corporation's subpart F income determined under section 952 and the regulations thereunder is $35, the total of its gross receipts and gross amounts referred to in subparagraph (2)(ii) of this paragraph is $310, its export promotion expenses properly allocable to its export trade income which constitutes foreign base company income are $18, its increase in investments in export trade assets is $32, and its export trade income is $40, of which $30 constitutes foreign base company income and $10 does not constitute foreign base company income. The subpart F income of A Corporation for 1963 as reduced under section 970(a) is $11, determined as follows:

(i) Subpart F income		$35
(ii) Less: $30 export trade income which constitutes foreign base company income, but deduction not to exceed the smallest of the following limitations (smallest of (*a*), (*b*), or (*c*)):		
(*a*) 150 percent of allocable export promotion expenses referred to in subparagraph (2)(i) of this paragraph (150% of $18)	$27	
(*b*) 10 percent of gross receipts and gross amounts referred to in subparagraph (2)(ii) of this paragraph (10% of $310)	$31	
(*c*) Amount which bears to the increase in investments in export trade assets ($32) the same ratio as the export trade income which constitutes foreign base company income ($30) bears to total export trade income ($40) (75% [$30/$40] of $32)	$24	$24
(iii) Subpart F income as reduced under section 970(a)		11

Example 2. The facts are the same as in example 1, except that A Corporation's export promotion expenses properly allocable to export trade income which constitutes foreign base company income are $14 instead of $18. The applicable limitation on the amount deductible from A Corporation's subpart F income for 1963 is $21 (150% of $14) instead of $24. The subpart F income as reduced under section 970(a) is $14 ($35 less $21).

Example 3. The facts are the same as in example 1, except that the total amount of A Corporation's gross receipts and gross amounts referred to in subparagraph (2)(ii) of this paragraph is $200 instead of $310. The applicable limitation on the amount deductible from A Corporation's subpart F income for 1963 is $20 (10 percent of $200) instead of $24. The subpart F income as reduced under section 970(a) is $15 ($35 less $20).

Example 4. The facts are the same as in example 1, except that A Corporation derives its export trade income which constitutes foreign base company income of $30 in a service arrangement with M Corporation under which it receives as a fee 5 percent of the gross receipts from M Corporation's sales or a minimum fee of $30. Such gross receipts are $220. The gross amounts taken into account in determining the limitation under subparagraph (2)(ii) of this paragraph are $220. The applicable limitation on the amount deductible from A Corporation's subpart F income for 1963 is $22 (10 percent of $220) instead of $24. The subpart F income as reduced under section 970(a) is $13 ($35 minus $22).

Example 5. The facts are the same as in example 1, except that A Corporation derives its export trade income which constitutes foreign base company income of $30 in a service arrangement with M Corporation under which it receives as a fee 9 percent of the gross receipts from M Corporation's sales or a maximum fee of $30. Such gross receipts are $400. In such instance, the limitation under (ii)(*b*) of example 1 is $40 (10 percent of $400) instead of $31. The applicable limitation on the amount deductible from A Corporation's subpart F income for 1963 is $24, the smallest of the three limitations. The subpart F income as reduced under section 970(a) is $11 ($35 less $24).

(c) *Withdrawal of previously excluded export trade income*—(1) *Inclusion of withdrawal in income of United States shareholders.* If—

(i) A controlled foreign corporation was an export trade corporation for any taxable year,

(ii) Such corporation in any such taxable year derived subpart F income which, under the provisions of section 970(a) and paragraph (b) of this section, was reduced, and

(iii) Such corporation has in a subsequent taxable year a decrease in investments in export trade assets,

every person who is a United States shareholder, as defined in section 951(b), of such corporation on the last day of such subsequent taxable year on which such corporation is a controlled foreign corporation shall include in his gross income, under section 951(a)(1)(A)(ii) and the regulations thereunder as an amount to which section 955 (as in effect before the enactment of the Tax Reduction Act of 1975) applies, his pro rata share of the amount of such decrease in investments but only to the extent that such pro rata share does not exceed the limitations determined under subparagraph (2) of this paragraph. A United States shareholder's pro rata share of a controlled foreign corporation's decrease for any taxable year in investments in export trade assets shall be his pro rata share of such corporation's decrease for such year determined under section 970(c)(3) and paragraph (d)(3) of this section.

(2) *Limitations applicable in determining amount includible in income*—(i) *General.* A United States shareholder's pro rata share of a controlled foreign corporation's decrease in investments in export trade assets for any taxable year of such corporation shall, for purposes of determining an amount to be included in the gross income for any taxable year of such shareholder, not exceed the lesser of the limitations determined under (*a*) and (*b*) of this subdivision:

(*a*) Such shareholder's pro rata share of the sum of the controlled foreign corporation's earnings and profits (or deficit in earnings and profits) for the taxable year, computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year, plus his pro rata share of the sum of its earnings and profits (or deficits in earnings and profits) accumulated for prior taxable years beginning after December 31, 1962, or

(*b*)(*1*) Such shareholder's pro rata share of the sum of the amounts by which the subpart F income of such controlled foreign corporation for prior taxable years was reduced under section 970(a) and paragraph (b) of this section, plus

(*2*) Such shareholder's pro rata share of the sum of the amounts which were not included in the subpart F income of such controlled foreign corporation for such prior taxable years by reason of the application of section 972 and §1.972–1, minus

(*3*) Such shareholder's pro rata share of the sum of the amounts which were previously included in his gross income for prior taxable years under section 951(a)(1)(A)(ii) by reason of the application of section 970(b) and this paragraph with respect to such controlled foreign corporation.

The net amount determined under (*b*) of this subdivision with respect to any stock owned by the United States shareholder shall be determined without taking into account any amount attributable to a period prior to the date on which such shareholder acquired such stock. See section 1248 and the regulations thereunder for rules governing the treatment of gain from sales or exchanges of stock in certain foreign corporations.

(ii) *Treatment of earnings and profits.* For purposes of determining earnings and profits of a controlled foreign corporation under subdivision (i) (*a*) of this subparagraph, such earnings and profits shall be considered not to include any amounts which are attributable to—

(*a*) Amounts which are, or have been, included in the gross income of a United States shareholder of such controlled foreign corporation under section 951(a) (other than an amount included in the gross income of a United States shareholder under section 951(a)(1)(A)(ii) or section 951(a)(1)(B) for the taxable year) and have not been distributed, or

(*b*)(*1*) Amounts which for the current taxable year, are included in the gross income of a United States shareholder of such controlled foreign corporation under section 551(b) or would be so included under such section but for the fact that such amounts were distributed to such shareholder during the taxable year, or

(*2*) Amounts which, for any prior taxable year, have been included in the

gross income of a United States shareholder of such controlled foreign corporation under section 551(b) and have not been distributed.

The rules of this subdivision apply only in determining the limitation on a United States shareholder's pro rata share of a controlled foreign corporation's decrease in investments in export trade assets. See section 959 and the regulations thereunder for limitations on the exclusion of previously taxed earnings and profits.

(iii) *Rules of application.* The determinations made under subdivision (i) of this subparagraph for purposes of determining the United States shareholder's pro rata share of a controlled foreign corporation's decrease in investments in export trade assets for any taxable year shall be made on the basis of the stock such shareholder owns, within the meaning of section 958(a) and the regulations thereunder, in the controlled foreign corporation on the last day in the taxable year on which such corporation is a controlled foreign corporation even though such shareholder owned more or less stock in such corporation prior to that date. See section 972 and paragraph (b)(3) of § 1.972–1 for rules relating to the allocation of a decrease in investments in export trade assets of export trade corporations in a consolidated chain of such corporations. See section 951(a)(3) and the regulations thereunder for an additional limitation upon the amount of a United States shareholder's pro rata share determined under this paragraph.

(3) *Illustrations.* The application of this paragraph may be illustrated by the following examples:

Example 1. Foreign corporation A, which has one class of stock outstanding, is a wholly owned subsidiary of domestic corporation M throughout 1963 and 1964. Both corporations use the calendar year as the taxable year. For 1963, A Corporation qualifies as an export trade corporation and its subpart F income, determined in accordance with the provisions of section 952 and the regulations thereunder, is reduced by $20 under the provisions of section 970(a) and paragraph (b) of this section. Section 972 is assumed not to apply to A Corporation. For 1964, A Corporation has a decrease of $8 in investments in export trade assets. For 1963 and 1964, A Corporation has earnings and profits of $30 (determined under the provisions of subparagraph (2) of this paragraph). Corporation M's pro rata share of A Corporation's decrease in investments in export trade assets for 1964 which is includible in M Corporation's gross income for 1964 under section 951(a)(1)(A)(ii) by reason of the application of section 970(b) is $8, determined as follows:

(i) Corporation M's pro rata share of A Corporation's decrease in investments in export trade assets for 1964 (100% of $8)			$8
(ii) Limitation on amount includible in gross income of M Corporation for 1964 (smaller of (*a*) or (*b*)):			
(*a*) Corporation M's pro rata share of A Corporation's earnings and profits for 1963 and 1964 determined under subparagraph (2) of this paragraph (100% of $30)		$30	
(*b*) Corporation M's pro rata share of amounts by which the subpart F income of A Corporation for 1963 was reduced under section 970(a) (100% of $20)	$20		
Plus: Corporation M's pro rata share of amounts which were not included in subpart F income of A Corporation for 1963 by reason of the application of section 972	0		
Total	20		
Less: Corporation M's pro rata share of the sum of amounts which were previously included in gross income of M Corporation under section 951(a)(1)(A)(ii) by reason of the application of section 970(b) with respect to A Corporation	0	20	
(iii) Corporation M's pro rata share includible in gross income for 1964 under section 951(a)(1)(A)(ii) by reason of the application of section 970(b) (smaller of (i) or (ii))			8

Example 2. Assume the same facts as in example 1, except that on February 14, 1965, M Corporation sells 25 percent of its stock in A Corporation to N Corporation. Corporation N is a domestic corporation which also uses the calendar year as a taxable year. For 1965, A Corporation has a decrease of $16 in investments in export trade assets. Corporation A's earnings and profits for 1963 and 1964 (determined under the provisions of subparagraph (2) of this paragraph) are $22 ($30 minus $8). Corporation A's earnings and profits for 1965 are $6 (determined under the provisions of subparagraph (2) of this paragraph). For 1965, M Corporation's pro rata share of A Corporation's decrease in investments in export trade assets which is includible in M Corporation's gross income under section 951(a)(1)(A)(ii) is $9, and N Corporation's pro rata share includible in gross income under such section is $0, determined as follows:

M CORPORATION

(i) Corporation M's pro rata share of A Corporation's decrease in investments in export trade assets for 1965 (75% of $16)	.....	.....	$12
(ii) Limitation on amount includible in gross income of M Corporation for 1965 (smaller of (*a*) or (*b*)):			
(*a*) Corporation M's pro rata share of A Corporation's earnings and profits for 1963, 1964, and 1965 determined under subparagraph (2) of this paragraph (75% of $28)	.....	$21	
(*b*) Corporation M's pro rata share of amounts by which the subpart F income of A Corporation for 1963 was reduced under section 970(a) (75% of $20)	$15		
Plus: Corporation M's pro rata share of amounts which were not included in subpart F income of A Corporation for 1963 and 1964 by reason of the application of section 972	0		
Total	$15		
Less: Corporation M's pro rata share of the sum of amounts which were previously included in gross income of M Corporation under section 951(a)(1)(A)(ii) by reason of the application of section 970(b) with respect to A Corporation (75% of $8)	6	9	
(iii) Corporation M's pro rata share includible in gross income for 1965 under section 951(a)(1)(A)(ii) by reason of the application of section 970(b) (smaller of (i) or (ii))	.....	.....	9

N CORPORATION

(i) Corporation N's pro rata share of A Corporation's decrease in investments in export trade assets for 1965 (25% of $16)	.....	.....	0
(ii) Limitation on amount includible in gross income of N Corporation for 1965 (smaller of (*a*) or (*b*)):			
(*a*) Corporation N's pro rata share of A Corporation's earnings and profits for 1963, 1964, and 1965 determined under subparagraph (2) of this paragraph (25% of $28)	.....	07	
(*b*) Corporation N's pro rata share of amounts by which the subpart F income of A Corporation for 1963 was reduced under section 970(a) (amounts prior to 2/14/65 not being taken into account)	0		
Plus: Corporation N's pro rata share of amounts which were not included in subpart F income of A Corporation for 1963 and 1964 by reason of the application of section 972 (amounts prior to 2/14/65 not being taken into account)	0		
Total	0		
Less: Corporation N's pro rata share of the sum of amounts which were previously included in gross income of N Corporation under section 951(a)(1)(A)(ii) by reason of the application of section 970(b) with respect to A Corporation (amounts prior to 2/14/65 not being taken into account)	0	0	
(iii) Corporation N's pro rata share includible in gross income for 1965 under section 951(a)(1)(A)(ii) by reason of the application of section 970(b) (smaller of (i) or (ii))	.....	.....	0

(d) *Investments in export trade assets*—(1) *Amount of investments.* For purposes of sections 970 through 972 and §§ 1.970–1 to 1.972–1, inclusive, export trade assets shall be taken into account on the following bases:

(i) *Working capital.* Working capital to which section 971(c)(1) applies shall be taken into account at the adjusted basis of current assets, determined as of the applicable determination date, less any current liabilities (except as provided in subdivision (iii) of this subparagraph).

(ii) *Other export trade assets.* Inventory to which section 971(c)(2) applies, facilities to which section 971(c)(3) applies, and evidences of indebtedness to which section 971(c)(4) applies, shall be taken into account at their adjusted bases as of the applicable determination date, reduced by any liabilities (except as provided in subdivision (iii) of this subparagraph) to which such property is subject on such date. To be taken into account under this subparagraph, a liability must constitute a specific charge against the property involved. Thus, a liability evidenced by an open account or a liability secured only by the general credit of the controlled foreign corporation will not be taken into account. On the other hand, if a liability constitutes a specific charge against several items of property and cannot definitely be allocated to any single item of property, the liability shall be apportioned against each of such items of property in that ratio which the adjusted basis of such item on the applicable determination date bears to the adjusted basis of all such items on such date. A liability in excess of the adjusted basis of the property which is subject to such liability will not be taken into account for the purpose of reducing the adjusted basis

of other property which is not subject to such liability. See paragraph (c)(6) of §1.971–1 for treatment of export trade assets which constitute working capital to which section 971(c)(1) applies and which also constitute inventory to which section 971(c)(2) applies or evidences of indebtedness to which section 971(c)(4) applies.

(iii) *Treatment of certain liabilities.* For purposes of subdivisions (i) and (ii) of this subparagraph, a current liability, or a specific charge created with respect to any item of property, principally for the purpose of artificially increasing or decreasing the amount of a controlled foreign corporation's investments in export trade assets shall be taken into account in such a manner as to properly reflect the controlled foreign corporation's investments in export trade assets; whether a specific charge or current liability is created principally for such purpose will depend upon all the facts and circumstances of each case. One of the factors that will be considered in making such a determination with respect to a loan is whether the loan is from a related person, as defined in section 954(d)(3) and paragraph (e) of §1.954–1.

(iv) *Statement required.* If for purposes of this section a United States shareholder of a controlled foreign corporation reduces the adjusted basis of property which constitutes an export trade asset on the ground that such property is subject to a liability, he shall attach to his return a statement setting forth the adjusted basis of the property before the reduction and the amount and nature of the reduction.

(2) *Increase in investments in export trade assets.* For purposes of section 970(a) and paragraph (b) of this section, the amount of increase in investments in export trade assets of a controlled foreign corporation for a taxable year shall be, except as provided in §1.970–2, the amount by which—

(i) The amount of its investments in export trade assets at the close of such taxable year, exceeds

(ii) The amount of its investments in export trade assets at the close of the preceding taxable year.

(3) *Decrease in investments in export trade assets.* For purposes of section 970(b) and paragraph (c) of this section, the amount of the decrease in investments in export trade assets of a controlled foreign corporation for a taxable year shall be, except as provided in §1.970–2, the amount by which—

(i) The amount of its investments in export trade assets at the close of the preceding taxable year, minus

(ii) An amount equal to the excess of recognized losses over recognized gains on sales, exchanges, involuntary conversions, assets or other dispositions, of export trade during the taxable year, exceeds

(iii) The amount of its investments in export trade assets at the close of the taxable year.

For purposes of subdivision (ii) of this subparagraph, recognized losses include a write-down of inventory to lower of cost or market in accordance with a method of inventory valuation established or adopted by or on behalf of such foreign corporation under paragraph (c) of §1.964–1.

[T.D. 6755, 29 FR 12704, Sept. 9, 1964, as amended by T.D. 6795, 30 FR 947, Jan. 29, 1965; T.D. 6892, 31 FR 11144, Aug. 23, 1966; T.D. 7293, 38 FR 32802, Nov. 28, 1973; T.D. 7893, 48 FR 22511, May 19, 1983]

§1.970–2 Elections as to date of determining investments in export trade assets.

(a) *Nature of elections*—(1) *In general.* In lieu of determining the increase under the provisions of paragraph (d)(2) of §1.970–1, or the decrease under the provisions of paragraph (d)(3) of §1.970–1, in a controlled foreign corporation's investments in export trade assets for a taxable year in the manner provided in such provisions, a United States shareholder of such corporation may elect, under the provisions of section 970(c)(4) and this section, to determine such increase or decrease in accordance with the provisions of subparagraph (2) of this paragraph or, in the case of export trade assets which are facilities described in section 971(c)(3), in accordance with the provisions of subparagraph (3) of this paragraph. Separate elections may be made under subparagraph (2) and/or (3) of this paragraph with respect to each controlled foreign corporation with respect to which a person is a United States shareholder, within the meaning of section 951(b).

(2) *Election of 75-day rule.* A United States shareholder of a controlled foreign corporation may elect with respect to a taxable year of such corporation to make the determinations under subparagraphs (2)(i) and (3)(iii) of paragraph (d) of §1.970–1 of the amount of such corporation's investments in export trade assets as of the 75th day after the close of the taxable year referred to in such subparagraphs of paragraph (d) of §1.970–1. The election provided by this subparagraph may be made with respect to export trade assets other than facilities described in section 971(c)(3) or with respect to export trade assets which are facilities or with respect to both types of export trade assets (but the election under this paragraph with respect to export trade assets which are facilities or with respect to both types of export trade assets may be made only if the election provided by subparagraph (3) of this paragraph is not made). If the election provided by this subparagraph is made, the amount of export trade assets with respect to which such election is made at the close of the preceding taxable year which is described in subparagraphs (2)(ii) and (3)(i) of paragraph (d) of §1.970–1 shall be the amount of export trade assets which was considered by application of the 75-day rule to be the amount of export trade assets at the close of such preceding taxable year; except that for the first taxable year of the controlled foreign corporation for which the 75-day rule is elected the amount of investments in export trade assets with respect to which such election is made at the close of such preceding year described in subparagraphs (2)(ii) and (3)(i) of paragraph (d) of §1.970–1 shall be the amount of investments in export trade assets at the actual close of such preceding year. In the case of a taxable year of such corporation beginning after December 31, 1962, and before December 31, 1963, the amount of investments in export trade assets with respect to which such election is made alternatively may be determined by the United States shareholder as of the 75th day after the close of the preceding taxable year referred to in subparagraphs (2)(ii) and (3)(i) of paragraph (d) of §1.970–1 rather than as of the close of such preceding taxable year.

(3) *Election for export trade assets which are facilities.* A United States shareholder of a controlled foreign corporation may elect with respect to a taxable year of such corporation to make the determinations under subparagraphs (2)(i) and (3)(iii) of paragraph (d) of §1.970–1 of the amount of such corporation's investments in export trade assets which are facilities described in section 971(c)(3) as of the close of such corporation's taxable year following the taxable year referred to in such subparagraphs of paragraph (d) of §1.970–1. The election provided by this subparagraph may be made only if the United States shareholder does not elect the 75-day rule of subparagraph (2) of this paragraph with respect to export trade assets which are facilities. If the election provided by this subparagraph is made, the amount of investments in export trade assets which are facilities at the close of the preceding taxable year which is described in subparagraphs (2)(ii) and (3)(i) of paragraph (d) of §1.970–1 shall be the amount of export trade assets which are facilities which was considered, by reason of the application of the following-year rule provided in this subparagraph with respect to such preceding taxable year, to be the amount of export trade assets which are facilities at the close of such preceding taxable year; except that for the first taxable year of the controlled foreign corporation for which such following-year rule is elected the amount of investments in export trade assets which are facilities at the close of the preceding taxable year described in subparagraphs (2)(ii) and (3)(i) of paragraph (d) of §1.970–1 shall be the amount of investments in export trade assets which are facilities at the actual close of such preceding taxable year.

(b) *Time and manner of making elections*—(1) *Without consent.* A United States shareholder may, with respect to any controlled foreign corporation, make one or both of the elections described in paragraph (a)(2) or (3) of this section without the consent of the Commissioner by filing a statement to such effect with his return for his taxable year in which or with which ends

the first taxable year of such corporation in which—

(i) Such shareholder owns, within the meaning of section 958(a), or is considered as owning, by applying the rules of section 958(b), 10 percent or more of the total combined voting power of all classes of stock entitled to vote of such corporation, and

(ii) Such corporation realizes subpart F income which is reduced under section 970(a) and paragraph (b) of §1.970–1.

The statement shall contain the name and address of the controlled foreign corporation, identification of such first taxable year of such corporation, and an indication as to which election or elections described in paragraph (a) of this section the United States shareholder is making. If such return has been filed on or before the 90th day after the date these regulations are published in the FEDERAL REGISTER, such United States shareholder shall file such statement with the district director with which the return was filed on or before such 90th day.

(2) *With consent.* A United States shareholder may make one or both of the elections described in paragraph (a)(2) or (3) of this section with respect to any controlled foreign corporation at any time with the consent of the Commissioner. Consent will not be granted unless the shareholder and the Commissioner agree to the terms, conditions, and adjustments under which the election will be effected. The application for consent to elect shall be made by the shareholder's mailing a letter for such purpose to the Commissioner of Internal Revenue, Washington, DC 20224. The application shall be mailed before the close of the first taxable year of the controlled foreign corporation with respect to which the shareholder desires to determine an exclusion under section 970(a) in accordance with one or both of the elections provided in paragraph (a) of this section. The application shall include the following information:

(i) The name, address, and taxable year of the United States shareholder;

(ii) The name, address, and taxable year of the controlled foreign corporation;

(iii) A statement indicating which of the elections the shareholder desires to make;

(iv) The amount of the foreign corporation's investments in export trade assets (by a category which includes export trade assets other than facilities and a category which includes only export trade assets which are facilities) at the close of its preceding taxable year;

(v) The shareholder's pro rata share of the sum of the amounts by which the subpart F income of the foreign corporation, for all prior taxable years during which such shareholder was a United States shareholder of such corporation, was reduced under section 970(a) and paragraph (b) of §1.970–1;

(vi) The shareholder's pro rata share of the sum of the amounts which were not included in the subpart F income of the foreign corporation, for all prior taxable years during which such shareholder was a United States shareholder of such corporation, by reason of the application of section 972 and §1.972–1; and

(vii) The shareholder's pro rata share of the sum of the amounts which were previously included in his gross income, for all prior taxable years during which such shareholder was a United States shareholder of such corporation, under section 951(a)(1)(A)(ii) by reason of the application of section 970(b) and paragraph (b) of §1.970–1 to the foreign corporation.

(c) *Effect of elections*—(1) *In general.* Except as provided in subparagraphs (3) and (4) of this paragraph, an election made under paragraph (a) of this section with respect to a controlled foreign corporation shall be binding on the United States shareholder and—

(i) In the case of the election described in paragraph (a)(2) of this section, shall apply to all investments in export trade assets with respect to which such election is made acquired, or disposed of, by such corporation during the 75-day period following its taxable year for which subpart F income is first computed under the election and during all succeeding corresponding 75-day periods of such corporation, or

(ii) In the case of the election described in paragraph (a)(3) of this section, shall apply to all investments in

export trade assets which are facilities acquired, or disposed of, by such corporation during the taxable year following its taxable year for which subpart F income is first computed under the election and during all succeeding corresponding taxable years of such corporation.

(2) *Returns.* Any return of a United States shareholder required to be filed before the completion of a period with respect to which determinations are to be made as to a controlled foreign corporation's investments in export trade assets for purposes of computing such shareholder's taxable income shall be filed on the basis of an estimate of the amount of such corporation's investments in export trade assets at the close of the period. If the actual amount of such investments is not the same as the amount of the estimate, the shareholder shall immediately notify the Commissioner. The Commissioner will thereupon redetermine the amount of such shareholder's tax for the year or years with respect to which the incorrect amount was taken into account. The amount of tax, if any, due upon such redetermination shall be paid by the shareholder upon notice and demand by the district director. The amount of tax, if any, shown by such redetermination to have been overpaid shall be credited or refunded to the shareholder in accordance with the provisions of sections 6402 and 6511 and the regulations thereunder.

(3) *Revocation*—(i) *In general*—(*a*) *Consent required.* Upon application by the United States shareholder, an election made under paragraph (a) of this section may, subject to the approval of the Commissioner, be revoked. Approval will not be granted unless the shareholder and the Commissioner agree to the terms, conditions, and adjustments under which the revocation will be effected.

(*b*) *Revocation of 75-day rule.* In the case of the revocation of an election described in paragraph (a)(2) of this section, the change in the controlled foreign corporation's investments in export trade assets with respect to which such election was made for its first taxable year for which subpart F income or a decrease in investments in export trade assets is computed without regard to the election previously made shall, unless the agreement with the Commissioner provides otherwise, be considered to be the amount by which—

(*1*) Such corporation's investments in export trade assets with respect to which such election was made at the close of such taxable year exceeds or, if applicable, is exceeded by

(*2*) Such corporation's investments in export trade assets with respect to which such election was made at the close of the 75th day after the close of the preceding taxable year of such corporation.

(*c*) *Revocation of following-year rule.* In the case of the revocation of an election described in paragraph (a)(3) of this section, the change in the controlled foreign corporation's investments in export trade assets which are facilities for its first taxable year for which subpart F income or a decrease in investments in export trade assets is computed without regard to the election previously made shall, unless the agreement with the Commissioner provides otherwise, be considered to be zero.

(ii) *Time and manner of applying for consent to revocation*—(*a*) *Application to Commissioner.* The application for consent to revocation of an election shall be made by the United States shareholder's mailing a letter for such purpose to the Commissioner of Internal Revenue, Washington, DC, 20224. The application shall be mailed before the close of the first taxable year of the controlled foreign corporation with respect to which the shareholder desires to determine an exclusion under section 970(a) or an inclusion under section 970(b) without regard to such election.

(*b*) *Information required.* The application shall include the following information:

(*1*) The name, address, and taxable year of the United States shareholder;

(*2*) The name, address, and taxable year of the controlled foreign corporation;

(*3*) A statement indicating the election the shareholder desires to revoke under this subparagraph;

(*4*) The information required under subdivisions (iv) through (vii) of paragraph (b)(2) of this section;

(*5*) In the case of an application for consent to revocation of an election made under paragraph (a)(2) of this section, the amount of the foreign corporation's investments in export trade assets with respect to which such election was made at the close of the 75th day after the close of such corporation's taxable year immediately preceding the taxable year of such corporation; and

(*6*) The reasons for the request for consent to revocation.

(4) *Transfer of stock*—(i) *Election of 75-day rule in force.* (*a*) If during any taxable year of a controlled foreign corporation—

(*1*) A United States shareholder who has made the election described in paragraph (a)(2) of this section with respect to such corporation sells, exchanges, or otherwise disposes of all or part of his stock in such corporation, and

(*2*) The foreign corporation is a controlled foreign corporation immediately after the sale, exchange, or other disposition,

then, with respect to the stock so sold, exchanged, or disposed of, the successor in interest shall consider the controlled foreign corporation's change during the first 75 days of such taxable year in investments in export trade assets with respect to which such election is made to be zero.

(*b*) If the United States shareholder's successor in interest makes an election under paragraph (a)(2) of this section in order to determine an exclusion under section 970(a) for the taxable year of such corporation in which the acquires such stock, the amount of the controlled foreign corporation's investments in export trade assets with respect to which such election is made at the close of its preceding taxable year shall be considered, with respect to the stock so acquired, to be the amount of such corporation's investments in export trade assets with respect to which such election is made at the close of the 75th day after the close of such preceding taxable year.

(*c*) If the United States shareholder's successor in interest makes an election under paragraph (a)(2) of this section in order to determine an exclusion under section 970(a) for a taxable year of such corporation subsequent to the taxable year in which he acquired the stock, the amount of the controlled foreign corporation's investments in export trade assets with respect to which such election is made at the close of its taxable year immediately preceding such subsequent taxable year shall, with respect to the stock so acquired, be the amount of such corporation's investments in such assets at the actual close of such preceding taxable year.

(ii) *Election in force with respect to export trade assets which are facilities*—(*a*) If during any taxable year of a controlled foreign corporation—

(*1*) A United States shareholder who has made the election described in paragraph (a)(3) of this section with respect to such corporation sells, exchanges, or otherwise disposes of all or part of his stock in such corporation, and

(*2*) The foreign corporation is a controlled foreign corporation immediately after the sale, exchange or other disposition,

then, with respect to the stock so sold, exchanged, or disposed of, the successor in interest shall consider the controlled foreign corporation's change for such taxable year in investments in export trade assets which are facilities to be zero.

(*b*) If the United States shareholder's successor in interest makes an election under paragraph (a)(3) of this section in order to determine an exclusion under section 970(a) for the taxable year of such corporation in which he acquires such stock, the amount of the controlled foreign corporation's investments in export trade assets which are facilities at the close of its preceding taxable year shall be considered, with respect to the stock so acquired, to be the amount of such corporation's investments in export trade assets which are facilities at the close of the taxable year in which such stock is acquired.

(*c*) If the United States shareholder's successor in interest makes an election under paragraph (a)(3) of this section in order to determine an exclusion under section 970(a) for a taxable year of such corporation subsequent to the taxable

year in which he acquired the stock, the amount of the controlled foreign corporation's investments in export trade assets which are facilities at the close of its taxable year immediately preceding such subsequent taxable year shall, with respect to the stock so acquired, be the amount of such corporation's investments in such assets at the actual close of such preceding taxable year.

(d) *Illustrations.* The principles contained in this section are illustrated by the examples set forth in paragraph (d) of § 1.955.3.

[T.D. 6755, 29 FR 12707, Sept. 9, 1964]

§ 1.970–3 Effective date of subpart G.

Sections 970 through 972 and §§ 1.970–1 through 1.972–1 shall apply with respect to taxable years of foreign corporations beginning after December 31, 1962, and to taxable years of United States shareholders within which or with which such taxable years of such corporations end.

[T.D. 6755, 29 FR 12709, Sept. 9, 1964]

§ 1.971–1 Definitions with respect to export trade corporations.

(a) *Export trade corporations*—(1) *In general.* For purposes of sections 970 through 972 and §§ 1.970–1 to 1.972–1, inclusive, the term ''export trade corporation'' means a controlled foreign corporation which for the period specified in subparagraph (2) of this paragraph satisfies the conditions specified in subparagraph (3) of this paragraph. However, no controlled foreign corporation may qualify as an export trade corporation for any taxable year beginning after October 31, 1971, unless it qualified as an export trade corporation for any taxable year beginning before such date. In addition, if a corporation fails to qualify as an export trade corporation for a period of any 3 consecutive taxable years beginning after October 31, 1971, then for any taxable year beginning after such 3-year period, such corporation shall not be included within the term ''export trade corporation''.

(2) *Three-year period.* The period referred to in subparagraph (1) of this paragraph is the 3-year period ending with the close of the controlled foreign corporation's current taxable year, or such part of such 3-year period as occurs on and after the beginning of the corporation's first taxable year beginning after December 31, 1962, whichever period is shorter.

(3) *Gross income requirements.* The conditions referred to in subparagraph (1) of this paragraph are that the controlled foreign corporation derives—

(i) 90 percent or more of its gross income from sources without the United States, and

(ii)(*a*) 75 percent of more of its gross income from transactions, activities, or interest described in section 971(b) and paragraph (b) of this section, or

(*b*) 50 percent or more of its gross income from transactions, activities, or interest described in section 971(b) and paragraph (b) of this section in respect of agricultural products grown in the United States.

(4) *Determination of sources of gross income.* The sources of gross income of a controlled foreign corporation shall be determined for purposes of subparagraph (3)(i) of this paragraph in accordance with the rules for determining sources of gross income set forth in sections 861 through 864 and the regulations thereunder.

(b) *Export trade income*—(1) *General rule.* For purposes of sections 970 through 972 and §§ 1.970–1 to 1.972–1, inclusive, the term ''export trade income'' means the gross export trade income of a controlled foreign corporation derived from transactions, activities, or interest described in subdivisions (i) through (vii) of this subparagraph, less deductions allowed under subdivision (viii) of this subparagraph.

(i) *Sale of export property.* Gross export trade income of a controlled foreign corporation includes gross income it derives from the sale of export property (as defined in paragraph (e) of this section) which it purchases, if the sale is made to an unrelated person for use, consumption, or disposition outside the United States. See section 971(b)(1). As a general rule, property will be presumed to have been sold for use, consumption, or disposition in the country of destination of the sale. However, if at the time of the sale the controlled foreign corporation knows, or should

have known from the facts and circumstances surrounding the sales transaction, that the property will probably be used, consumed, or disposed of in the United States, such property will be presumed to have been sold for use, consumption, or disposition in the United States unless the controlled foreign corporation establishes that such property was used, consumed, or disposed of outside the United States. For purposes of this subdivision, export property must be sold by a controlled foreign corporation in essentially the same form in which such property is purchased. Whether export property sold is in essentially the same form in which such property is purchased shall be determined on the basis of all the facts and circumstances in each case. Storage, handling, transportation, packaging, or servicing of property will be considered not to alter the form in which property is purchased. However, manufacture or production, within the meaning of paragraph (a)(4) of §1.954–3, will be considered to alter the form in which property is purchased and no part of the gross income from the sale of such property will be treated as export trade income. The application of this subdivision may be illustrated by the following example:

Example. Controlled foreign corporation A, incorporated under the laws of foreign country Y, purchases articles manufactured in the United States from domestic corporation M and sells them in the form in which purchased to foreign corporation B, unrelated to A Corporation, for use in foreign countries, X, Y, and Z. The gross income of A Corporation from the purchase and sale of the articles constitutes gross export trade income.

(ii) *Commissions and other income derived in connection with the sale of export property.* Gross export trade income of a controlled foreign corporation includes gross commissions, fees, compensation, or other income derived by such corporation from the performance for any person of commercial, industrial, financial, technical, scientific, managerial, engineering, architectural, skilled, or other services in respect of a sale by such corporation in a transaction described in subdivision (i) of this subparagraph or in respect of the sale by any other person of export property to a person unrelated to the controlled foreign corporation for use, consumption, or disposition outside the United States. Such gross export trade income includes payments received for surveys made prior to, and in connection with, the sale of such export property (whether or not such sales are ultimately consummated). See section 971(b)(1). The term ''any person'' or ''any other person'' as used in this subdivision includes a related person as defined in section 954(d)(3) and paragraph (e) of §1.954–1. The application of this subdivision may be illustrated by the following examples:

Example 1. Controlled foreign corporation A, incorporated under the laws of foreign country X, receives from M Corporation a commission equal to 6 percent of the gross selling price of all personal property shipped by M Corporation as a result of services performed by A Corporation in soliciting orders in foreign countries X, Y, and Z. In fulfillment of such orders, M Corporation ships products manufactured by it in the United States. Corporation A does not assume title to the property sold. Gross commissions received by A Corporation from M Corporation in connection with the sale of such property to persons unrelated to A Corporation for use, consumption, or disposition outside the United States constitute gross export trade income.

Example 2. Foreign corporation B, incorporated under the laws of foreign country X, is a wholly owned subsidiary of domestic corporation N. Corporation N, is engaged in the business of manufacturing heavy duty electrical equipment in the United States. By contract, N Corporation engages B Corporation for the purpose of conducting engineering, technical, and financial studies required by N Corporation in the preparation of bids to supply foreign country Y with electrical equipment for a construction project to be undertaken by such country. Corporation N pays B Corporation a fee for the services, all of which are performed in country Y, which is based upon the number of hours of work performed without regard to whether a sale is ultimately consummated. Corporation N does not receive a contract from country Y on its bid to supply equipment. Income derived by B Corporation from performance of the service contract constitutes gross export trade income.

(iii) *Commissions and other income derived in connection with the installation or maintenance of export property.* Gross export trade income of a controlled foreign corporation includes gross commissions, fees, compensation, or other

income derived by such corporation from the performance for any person of commercial, industrial, financial, technical, scientific, managerial, engineering, architectural, skilled, or other services in respect of the installation or maintenance of export property which has been sold by such corporation in a transaction described in subdivision (i) of this subparagraph or by any other person to a person unrelated to the controlled foreign corporation for use, consumption, or disposition outside the United States. See section 971(b)(1). The term ''any person'' or ''any other person'' as used in this subdivision includes a related person as defined in section 954(d)(3) and paragraph (e) of §1.954–1.

(iv) *Commissions and other income derived in connection with the use of patents, copyrights, and other like property.* Gross export trade income of a controlled foreign corporation includes gross commissions, fees, compensation, or other income derived by such corporation from the performance for any person of commercial, industrial, financial, technical, scientific, managerial, engineering, architectural, skilled, or other services in connection with the use outside of the United States by an unrelated person of patents, copyrights, secret processes and formulas, goodwill, trademarks, trade brands, franchises, and other like property, including gross income derived from obtaining licensees for patents, but only if the patent, copyright, or other like property is acquired, or developed, and owned by the manufacturer, producer, grower, or extractor of any export property, in respect of which the controlled foreign corporation also derives gross export trade income within the meaning of subdivision (i), (ii), or (iii) of this subparagraph. See section 971(b)(2). The application of this subdivision may be illustrated by the following example:

Example. Foreign corporation A incorporated under the laws of foreign country X, is a wholly owned subsidiary of domestic corporation M. Corporation M, the owner of a patent registered in foreign country X, grants B Corporation, a corporation unrelated to A Corporation, the right to use such patent in foreign country Y in exchange for payment of a royalty. By a separate contract with B Corporation, A Corporation agrees for a gross fee of $100,000 to furnish, by maintaining a staff of technical representatives at the offices of B Corporation, technical services to B Corporation in connection with B Corporation's use of the patent. Corporation A also derives export trade income from the sale of export property which it purchases from M Corporation, the manufacturer of such property, and sells to C Corporation, an unrelated person, for use in country Y by C Corporation. The gross fee of $100,000 received by A Corporation for the furnishing of technical services in connection with B Corporation's use of M Corporation's patent constitutes gross export trade income since the service for which the fee is paid is performed in connection with the use outside the United States by an unrelated person (B Corporation) of a patent owned by a manufacturer (M Corporation) of export property in respect of which the controlled foreign corporation (A Corporation) derives gross export trade income from the sale to an unrelated person (C Corporation) for use outside the United States of export property purchased by it from the manufacturer (M Corporation).

(v) *Income attributable to use of export property by an unrelated person.* Gross export trade income of a controlled foreign corporation includes gross commissions, fees, rents, compensation, or other income which is received by such corporation from an unrelated person and is attributable to the use of export property by such unrelated person. See section 971(b)(3). The application of this subdivision may be illustrated by the following example:

Example. Foreign corporation A, incorporated under the laws of foreign country X, is a wholly owned subsidiary of domestic corporation M. Corporation A acquires by purchase bottling machines manufactured in the United States and leases the machines to B Corporation, a corporation unrelated to A Corporation, for use by B Corporation in foreign country Y. Gross rental income of A Corporation from the lease of the machines to B Corporation constitutes gross export trade income.

(vi) *Income attributable to the use of export property in the rendition of technical, scientific, or engineering services—(a) General.* Gross export trade income of a controlled foreign corporation includes gross commissions, fees, compensation, or other income which is received by such corporation from an unrelated person and is attributable to

the use of export property in the performance of technical, scientific, or engineering services to such unrelated person. See section 971(b)(3).

(*b*) *Rule of apportionment.* If a commission, fee, or other income received by a controlled foreign corporation from an unrelated person under a contract or arrangement for the performance of technical, scientific, or engineering services is not solely attributable to the use of export property in the performance of such services and the amount of the gross income attributable to such use of export property cannot be established by reference to transactions between other unrelated persons, such gross income shall be an amount which bears the same ratio to total gross income from the contract or arrangement as the cost of the export property consumed in the performance of such services, including a reasonable allowance for depreciation with respect to the export property so used, bears to the total costs and expenses attributable to the production of income under the contract or arrangement.

(*c*) *Illustration.* The application of this subdivision may be illustrated by the following example:

Example. Foreign corporation A, incorporated under the laws of foreign country X, is a wholly owned subsidiary of domestic corporation M. Corporation A is engaged in the seismograph service business in foreign country X. In an effort to establish the probable existence of oil in a concession area it owns in foreign country Y, B Corporation which is unrelated to A Corporation enters into a contract with A Corporation whereby A Corporation is required to make seismographic tests of the area in country Y for a fixed fee of $100,000. In performance of the contract, A Corporation hires a skilled crew to carry out the contract and utilizes equipment and supplies (for example, trucks, seismographic equipment, etc.) which constitute export property. Corporation A cannot establish by reference to transactions between other unrelated persons, the income attributable to the use of the export property in the performance of the contract. Corporation A's total costs and expenses (for example, salaries of the crew, administrative expenses, all supplies, total depreciation on property used in performance of the contract, etc.) incurred in performance of the contract are $80,000. The cost of export property consumed in performance of the contract (for example, dynamite, motor oil, and other supplies which were produced in the United States, reasonable depreciation on trucks and seismographic equipment manufactured in the United States and used in performance of the contract, etc.) is $30,000. Corporation A's gross export trade income from the contract is $37,500, that is, the amount which bears the same ratio to total gross income from the contract ($100,000) as the cost of the export property consumed in the rendition of the services ($30,000) bears to total costs and expenses attributable to the contract ($80,000).

(vii) *Interest from export trade assets.* Gross export trade income of a controlled foreign corporation includes interest derived by it from export trade assets described in section 971(c)(4) and paragraph (c)(5) of this section. See section 971(b)(4).

(viii) *Deductions to be taken into account.* Export trade income of a controlled foreign corporation for any taxable year shall be the amount determined by deducting from the items or categories of gross income described in subdivisions (i) through (vii) of this subparagraph the entire amount of those expenses, taxes, and other deductions properly allocable to such items or categories of income. For purposes of this section, expenses, taxes, and other deductions shall first be allocated to items or categories of gross income to which they directly relate; then, expenses, taxes, and other deductions which cannot definitely be allocated to some item or category of gross income shall be ratably apportioned among all items or categories of gross income, except that no expense, tax, or other deduction shall be allocated to an item or category of income to which it clearly does not apply and no deduction allowable to such controlled foreign corporation under section 882(c) and the regulations thereunder shall be taken into account.

(2) *Cross reference.* For rules governing the determination of gross income and taxable income of a foreign corporation, see §1.952–2.

(c) *Export trade assets*—(1) *In general.* For purposes of sections 970 through 972 and §§1.970–1 to 1.972–1, inclusive, the term ''export trade assets'' means—

(i) Working capital reasonably necessary for the production of export trade income,

(ii) Inventory of export property held for use, consumption, or disposition outside the United States,

(iii) Facilities located outside the United States for the storage, handling, transportation, packaging, servicing, sale, or distribution of export property, and

(iv) Evidences of indebtedness executed by unrelated persons in connection with payment for purchases of export property for use, consumption, or disposition outside the United States, or in connection with the payment for services described in section 971(b)(2) or (3) and paragraph (b)(1)(iv), (v), or (vi) of this section.

(2) *Working capital.* For purposes of subparagraph (1)(i) of this paragraph, working capital of a controlled foreign corporation is the excess of its current assets over its current liabilities. Liabilities maturing in one year or less shall be considered current liabilities. A determination of the amount of working capital of a controlled foreign corporation which is reasonably necessary for the production of export trade income will depend upon the nature and volume of the activities of the controlled foreign corporation which produce export trade income as they exist on the applicable determination date. In determining working capital which is reasonably necessary for the production of export trade income, the anticipated future needs of the business will be taken into account to the extent that such needs relate to the year of the controlled foreign corporation following the applicable determination date; anticipated future needs relating to a later period will not be taken into account unless it is clearly established that such needs are reasonably related to the production of export trade income as of the applicable determination date.

(3) *Inventory of export property.* For purposes of subparagraph (1)(ii) of this paragraph, the inclusion of items in inventory shall be determined in accordance with rules applicable to domestic corporations. See §§1.471–1 through 1.471–9. Inventory of export property of a controlled foreign corporation includes export property held for use, consumption, or disposition outside the United States regardless of where it is located on the applicable determination date. Thus, such property may be physically located in the United States on such date. However, for property physically located in the United States to constitute export property, it must have been acquired by the controlled foreign corporation with a clear intent that it would dispose of the property for use, consumption, or disposition outside the United States. As a general rule, if during the year following the applicable determination date export property which was physically located in the United States on such date is actually exported for use, consumption, or disposition outside the United States, such property will be deemed held for such purpose on the applicable determination date. On the other hand, the indefinite warehousing of export property in the United States by the controlled foreign corporation, or the subsequent sale of export property by such corporation for use, consumption, or disposition in the United States, will evidence a lack of intent by such corporation on the applicable determination date to hold such property for use, consumption, or disposition outside the United States.

(4) *Facilities located outside the United States*—(i) *In general.* For purposes of subparagraph (1)(iii) of this paragraph, a facility, as defined in subdivision (ii)(*a*) of this subparagraph, will be considered an export trade asset only—

(*a*) If such facility is located outside the United States, and

(*b*) To the extent that such facility is used, within the meaning of subdivision (ii)(*c*) of this subparagraph, by the controlled foreign corporation for the storage, handling, transportation, packaging, servicing, sale, or distribution of export property in essentially the same form in which such property is acquired by such corporation.

Thus, a facility in which property is manufactured or produced, even though export property is used or consumed in the production or becomes a component part of the manufactured article, will not qualify as an export trade asset.

(ii) *Special rules*—(*a*) *Facility defined.* For purposes of subdivision (i) of this subparagraph, the term ''facility'' includes any asset or group of assets used

for the storage, handling, transportation, packaging, servicing, sale, or distribution of export property. Thus, such term includes warehouse, storage, or sales facilities (for example, sales office equipment), transportation equipment (for example, motor trucks, vessels, etc.), and machinery and equipment (for example, packaging equipment, servicing equipment, cranes, forklift trucks used in warehouses, etc.).

(*b*) *Determination of location of transportation facilities.* A transportation facility shall be considered to be located outside the United States for purposes of subdivision (i)(*a*) of this subparagraph if such property is predominantly located outside the United States. As a general rule, on an applicable determination date a transportation facility will be considered to be predominantly located outside the United States if 70 percent or more of the miles traversed (during the 12-month period immediately preceding such determination date or for such part of such period as such facility is owned by the controlled foreign corporation) in the use of such facility are traversed outside the United States or if such facility is located outside the United States at least 70 percent of the time during such period or such part thereof.

(*c*) *Determination of use.* For purposes of subdivision (i)(*b*) of this subparagraph, the extent to which a facility is used in carrying on the activities described in such subdivision depends on the use made of the facility for the 12-month period immediately preceding the applicable determination date or for such part of such period as such facility is owned by the controlled foreign corporation. The method of measuring such use will depend upon the facts and circumstances in each case. However, such determinations of use will generally be made for a facility as a whole and not on the basis of individual items used in the operation of a facility. Thus, a determination as to the use of a warehouse facility will generally be made with respect to the entire facility and not separately for the items used in such warehouse, such as forklift trucks, storage bins, etc.

(5) *Evidences of indebtedness.* For purposes of subparagraph (1)(iv) of this paragraph, the term ''evidence of indebtedness'' shall mean a note, installment sales contract, a time bill of exchange evidencing a sale on credit, or similar written instrument executed by an unrelated person which evidences the obligation of an unrelated person to pay for export property which an unrelated person purchases for use, consumption, or disposition outside the United States or to pay for services described in section 971(b)(2) or (3) and paragraph (b)(1)(iv), (v), or (vi) of this section which are performed for an unrelated person. Receivables which arise out of the delivery of export property, or the performance of services, which are evidenced by invoices, bills of lading, bills of exchange which do not evidence a sale on credit, sales slips, and similar documents created by the unilateral act of a creditor shall not be considered evidences of indebtedness for purposes of section 971(c)(4).

(6) *Duplication of treatment and priority of application.* No asset which constitutes an export trade asset shall be taken into account more than once in determining the investments in export trade assets of a controlled foreign corporation. Assets which constitute working capital and also constitute inventory to which section 971(c)(2) applies or evidences of indebtedness to which section 971(c)(4) applies shall be taken into account in determining whether the amount of working capital of the controlled foreign corporation is reasonably necessary for the production of export trade income. However, to the extent that the amount of inventory to which section 971(c)(2) applies or evidences of indebtedness to which section 971(c)(4) applies is not included in working capital to which section 971(c)(1) applies on the ground that such amount is not reasonably necessary for the production of export trade income, the amount shall be included under section 971(c)(2) or 971(c)(4), as the case may be, in a controlled foreign corporation's investments in export trade assets.

(d) *Export promotion expenses*—(1) *In general.* For purposes of sections 970 through 972 and §§ 1.970–1 to 1.972–1, inclusive, the term ''export promotion

expenses'' means, subject to the provisions of subparagraph (2) of this paragraph, all the ordinary and necessary expenses paid or incurred during the taxable year by the controlled foreign corporation which are reasonably allocable to the receipt or production of export trade income including—

(i) A reasonable allowance for salaries or other compensation for personal services actually rendered for such purpose,

(ii) Rentals or other payments for the use of property actually used for such purpose, and

(iii) A reasonable allowance for the exhaustion, wear and tear, or obsolescence of property actually used for such purpose.

In determining for purposes of this subparagraph whether expenses are reasonably allocable to the receipt or production of export trade income, consideration shall be given to the facts and circumstances of each case. As a general rule, if export trade income results from the sale of export property, export promotion expenses allocable to such income shall include warehousing, advertising, selling, billing, collection, other administrative, and similar costs properly allocable to the marketing activity, but shall not include cost of goods sold, income or similar tax, any expense which does not advance the distribution or sale of export property for use, consumption, or disposition outside the United States, or any expense for which the controlled foreign corporation is reimbursed. If export trade income results from the rental of export property, export promotion expenses allocable to such income shall include a reasonable allowance for depreciation and servicing of such property, and the administrative and similar costs properly allocable to the rental activity. If export trade income results from the performance of services, export promotion expenses shall include a reasonable allowance for compensation of the persons performing services for the controlled foreign corporation in the execution of the service contract or arrangement and administrative expenses reasonably allocable to the service activity. In no case shall income taxes be included in export promotion expenses.

(2) *Expenses incurred within the United States.* No expense incurred within the United States shall be treated as an export promotion expense for purposes of section 971(d) and subparagraph (1) of this paragraph unless at least—

(i) 90 percent of all salaries and other personal service compensation incurred in the receipt or the production of export trade income,

(ii) 90 percent of rents and other payments for the use of property used in the receipt or the production of export trade income,

(iii) 90 percent of the allowances for the exhaustion, wear and tear, or obsolescence of property used in the receipt or the production of export trade income, and

(iv) 90 percent of all other ordinary and necessary expenses reasonably allocable to the receipt or the production of export trade income,

is incurred outside the United States. For this purpose, personal service compensation will be considered incurred at the place where the service is performed (for example, salaries will be considered incurred at the place where the employee works; payments for art work will be considered incurred at the place where the art work is prepared, etc.); rent, depreciation, and other expenses related to real or personal property will be considered incurred at the place where the property is located; and expenses for media advertising will be considered incurred at the place where the advertising is consumed. For such purpose, newspaper or periodical advertising will be considered consumed where the newspaper or periodical is principally distributed, and television and radio advertising will be considered consumed at the place where the audience is primarily located. Technicalities of contract or payment, for example, the place where a contract is executed or the location of a bank account from which payment is made, shall not be determinative of the place where an expense is incurred.

(e) *Export property.* For purposes of sections 970 through 972 and §§ 1.970–1 to 1.972–1, inclusive, the term ''export property'' means property, or any interest in property, which is manufactured, produced, grown, or extracted in the United States. Whether property

will be considered manufactured or produced in the United States will depend on the facts and circumstances of each case. As a general rule, if—

(1) The property sold, serviced, used, or rented by the controlled foreign corporation is substantially transformed in the United States prior to its export from the United States, or

(2) The operations conducted in the United States with respect to the property sold, serviced, used, or rented by the controlled foreign corporation, whether performed in the United States by one person or a series of persons in a chain of distribution, are substantial in nature and are generally considered to constitute the manufacture or production of property,

then the property sold, serviced, used, or rented will be considered to have been manufactured or produced in the United States. The rules under paragraph (a)(4)(ii) of §1.954–3, relating to the substantial transformation of property, and paragraph (a)(4)(iii) of such section, dealing with a substantive test for determining whether property will be treated as having been manufactured or produced, shall apply for purposes of making determinations under this paragraph.

(f) *Unrelated person.* For purposes of sections 970 through 972 and §§1.970–1 to 1.972–1, inclusive, the term ''unrelated person'' means a person other than a related person as defined in section 954(d)(3) and paragraph (e) of §1.954–1.

[T.D. 6755, 29 FR 12710, Sept. 9, 1964, as amended by T.D. 7293, 38 FR 32802, Nov. 28, 1973; T.D. 7533, 43 FR 6603, Feb. 15, 1978]

§ 1.972–1 Consolidation of group of export trade corporations.

(a) *Election to consolidate*—(1) *In general.* One or more United States shareholders (as defined in section 951(b)) owning (within the meaning of section 958(a)) or who are considered as owning by applying the rules of ownership of section 958(b) more than 50 percent of the total combined voting power of all classes of stock entitled to vote of an export trade corporation, which is the top-tier corporation in a chain (within the meaning of subparagraph (2) of this paragraph) of export trade corporations, may, subject to the provisions of this section, elect to consolidate such chain for purposes of determining—

(i) The limitations, described in section 970(a) and paragraph (b)(2) of §1.970–1, on the amount by which subpart F income of an export trade corporation in such chain shall be reduced as provided in section 970(a) and paragraph (b)(1) of §1.970–1, and

(ii) The amount includible in gross income of such shareholders under section 951(a)(1)(A)(ii) with respect to such a corporation's decrease in investments in export trade assets to which section 970(b) applies as described in paragraph (c) of §1.970–1.

(2) *''Chain'' defined.* A chain of export trade corporations shall include—

(i) The top-tier export trade corporation referred to in subparagraph (1) of this paragraph which is the first export trade corporation in a chain of ownership described in section 958(a);

(ii) All export trade corporations 80 percent or more of the total combined voting power of all classes of stock entitled to vote of which is owned directly by such top-tier export trade corporation on the last day of its taxable year; and

(iii) All export trade corporations 80 percent or more of the total combined voting power of all classes of stock entitled to vote of which is owned directly by the export trade corporations described in subdivision (ii) of this subparagraph on the last day of the taxable year of the export trade corporation described in subdivision (i) of this subparagraph.

For purposes of this section, a reference to a top-tier corporation shall mean an export trade corporation described in subdivision (i) of this subparagraph, a reference to a second-tier corporation shall mean an export trade corporation described in subdivision (ii) of this subparagraph, and a reference to a third-tier corporation shall mean an export trade corporation described in subdivision (iii) of this subparagraph.

(3) *Inclusion requirement.* If an election is made by a United States shareholder under this paragraph with respect to a chain of export trade corporations (as defined in subparagraph (2) of this paragraph), all export trade corporations which are included in the

chain must be included in the consolidation. If such an election is made, the determinations under section 970 shall be made on a consolidated basis with respect to the entire interest which the electing United States shareholder owns in each of the export trade corporations in the chain, including any minority interests owned directly or indirectly by such shareholder in second-tier and third-tier corporations in the chain. A United States shareholder may elect to consolidate his interest in export trade corporations in one chain of such corporations without electing to consolidate his interest in export trade corporations in other chains.

(4) *Conditions for making initial election*—(i) *Without consent.* The initial election to consolidate a chain of export trade corporations may be made without the consent of the Commissioner only if, immediately before the election to consolidate, each of the export trade corporations to be included in the consolidation is using the same taxable year and has the same elections under section 970(c)(4) and §1.970–2 in force, or not in force, as the case may be. The election shall be made by the electing shareholder or shareholders with respect to the taxable year in which or with which ends the first taxable year of the top-tier corporation to which the election to consolidate applies and at the time of filing such shareholders' returns for such taxable year or within 90 days after final regulations under this section are published in the FEDERAL REGISTER, whichever date occurs later. Each United States shareholder making such an election shall attach to his return a statement showing:

(*a*) The name, address, and taxable year of each export trade corporation in the chain of such corporations for which an election is made,

(*b*) The amount and percentage of each class of stock owned by such shareholder (within the meaning of section 958), corporation by corporation, in each of such export trade corporations, and

(*c*) A list of the names and addresses, and a description of the ownership interests, of all other United States shareholders, if any, who are making the same election to consolidate and a statement that such shareholders are also making the election.

(ii) *With consent.* If, immediately before the election to consolidate, each of the export trade corporations in a chain of such corporations does not use the same taxable year or does not have the same elections under section 970(c)(4) and §1.970–2 in force, or not in force, as the case may be, the initial election to consolidate such chain may be exercised by the electing shareholder or shareholders only with the consent of the Commissioner. Consent will not be granted unless each electing United States shareholder and the Commissioner agree to the terms, conditions, and adjustments under which such consolidation is to be effected and unless, subject to such terms, conditions, and adjustments as the Commissioner may prescribe, each of the export trade corporations in the chain adopts a common taxable year and has the same elections under section 970(c)(4) and §1.970–2 in force, or not in force, as the case may be. The application for consent to consolidate shall be made by mailing a letter, signed by each of the electing United States shareholders, to the Commissioner of Internal Revenue, Washington, DC 20224. The application shall be mailed before the close of the first taxable year of the top-tier corporation with respect to which the electing shareholder or shareholders desire to make a consolidation or before the close of the 90th day after final regulations under this section are published in the FEDERAL REGISTER, whichever date occurs later, and shall include the statement described in subdivision (i) of this subparagraph.

(5) *Effect of election.* If an election to consolidate a chain of export trade corporations is made for a taxable year of a United States shareholder, such election shall, except as provided in subparagraph (6) of this paragraph, be binding on such shareholder for such taxable year and for all succeeding taxable years. If, in a subsequent taxable year of the United States shareholder, an export trade corporation for the first time qualifies as a second-tier or third-tier corporation in such chain on the last day of the taxable year of the top-tier corporation which ends in or

with the subsequent taxable year of such shareholder, the shareholder's interest in such export trade corporation shall be included in the consolidation to which the election applies, but only if such export trade corporation as of such last day uses the same taxable year and has the same elections under section 970(c)(4) and §1.970–2 in force, or not in force, as the case may be, as such top-tier corporation. The United States shareholder shall, with respect to such additional export trade corporation, submit with his return for such subsequent taxable year the statement described in subparagraph (4)(i) of this paragraph.

(6) *Termination of election.* An election under this paragraph to consolidate a chain of export trade corporations shall terminate for the first taxable year of the foreign corporation which during the period of consolidation is a top-tier corporation—

(i) At the close of which any foreign corporation which was included in such consolidation for the preceding taxable year ceases to qualify as an export trade corporation or to be eligible under this paragraph for inclusion in such chain,

(ii) At the close of which an export trade corporation for the first time qualifies as a second-tier or third-tier corporation in such chain but does not as of such close of the year use the same taxable year or have the same elections under section 970(c)(4) and §1.970–2 in force, or not in force, as the case may be, as such top-tier corporation, or

(iii)(*a*) In respect of which the Commissioner, upon application made by a United States shareholder who made the election to consolidate, or his successor in interest, consents to a termination of the election. Approval will not be granted unless the United States shareholder and the Commissioner agree to the terms, conditions, and adjustments under which the termination will be effected.

(*b*) The application for consent to termination shall be made by the United States shareholder's mailing a letter for such purpose to the Commissioner of Internal Revenue, Washington, DC 20224. The application shall be mailed before the close of the taxable year of the foreign corporations with respect to which the shareholder desires to terminate the consolidation and shall include the following information:

(*1*) The name, address, and taxable year of each export trade corporation in the chain of such corporations for which the election was made,

(*2*) The amount and percentage of each class of stock owned by such shareholder (within the meaning of section 958), corporation by corporation, in each of such export trade corporations, and

(*3*) A list of the names and addresses, and a description of the ownership interests, of all other United States shareholders, if any, who participated in making the election with such United States shareholder, or their successors in interest, and a statement whether such other persons are or are not terminating the election.

(7) *Election subsequent to initial election.* If a United States shareholder elects under subparagraph (4) of this paragraph to consolidate his interest in a chain of export trade corporations and the election to consolidate such corporations terminates under the provisions of subparagraph (6) of this paragraph, such shareholder may not thereafter elect under this section to consolidate his interest in any corporation which was in that chain of export trade corporations unless he receives the consent of the Commissioner to do so. Application to obtain such consent of the Commissioner shall be made by a letter mailed to the Commissioner of Internal Revenue, Washington, DC, 20224, before the close of the first taxable year of the top-tier corporation of the chain of export trade corporations in which the election to include such interest is to apply. Such application for consent shall include a statement showing:

(i) With respect to such chain, the information required to be shown in the statement described in subparagraph (4)(i) of this paragraph, and

(ii) The United States shareholder's interest in such chain which was previously included in a consolidation, the taxable years of such previous consolidation, and the manner in which such previous consolidation was terminated.

(8) *Illustration.* The application of this paragraph may be illustrated by the following example:

Example. Domestic corporation M owns 60 percent of the only class of stock of foreign corporation A, and 100 percent of the only class of stock of foreign corporation F, respectively. Corporation A owns 80 percent of the only class of stock of foreign corporations B and C, respectively. Corporation M also owns 20 percent of the stock of B Corporation. Corporation B owns 80 percent of the only class of stock of foreign corporation D. Corporations B and C each own 50 percent of the only class of stock of foreign corporation E. Corporation F owns 100 percent of the only class of stock of foreign corporation G, which owns 100 percent of the only class of stock of foreign corporation H. Corporation F also owns 20 percent of the stock of C Corporation. Domestic corporations N and R own 30 percent and 10 percent, respectively, of the stock of A Corporation. All corporations use the calendar year as a taxable year, and all foreign corporations qualify as export trade corporations for 1963. Corporation M may elect for 1963 to consolidate its interest in the chain (the ''A'' chain) of export trade corporations which includes corporations A, B, C, D, and E; and Corporation M need not, but may, elect to consolidate its interest in the chain (the ''F'' chain) of export trade corporations which includes corporations F, G, and H. Consolidation of M Corporation's interest in the ''A'' chain with its interest in the ''F'' chain is not permitted. If M Corporation elects to consolidate the ''A'' chain, M Corporation must include in the consolidation its 20 percent directly owned interest in B Corporation and its 20 percent indirectly owned (through F Corporation) interest in C Corporation. Either N Corporation or R Corporation, or both, may join M Corporation in electing to consolidate their interests in the ''A'' chain. However, neither N Corporation nor R Corporation may elect to consolidate the ''A'' chain unless M Corporation also agrees to so elect, because corporations N and R, neither jointly nor separately, own more than 50 percent of the total combined voting power of all classes of stock entitled to vote of A Corporation. If corporations M, N, and R elect to consolidate the ''A'' chain, the determinations specified in subparagraph (1) of this paragraph will be made on a consolidated basis with respect to such corporations' respective interest in the chain as shown in the following tabulation:

	A %	B %	C %	D %	E %
M Corporation's interest:					
Direct interest	60				
(60% × 80%) + 20% direct interest		68			
(60% × 80%) + 20% indirect interest			68		
(68% × 80%)				54.4	
(68% × 50%) + (68% × 50%)					68
N Corporation's interest:					
Direct interest	30				
(30% × 80%)		24			
(30% × 80%)			24		
(24% × 80%)				19.2	
(24% × 50%) + (24% × 50%)					24
R Corporation's interest:					
Direct interest	10				
(10% × 80%)		8			
(10% × 80%)			8		
(8% × 80%)				6.4	
(8% × 50%) + (8% × 50%)					8
Total interests to which consolidation applies	100	100	100	80	100

(b) *Effect of consolidation*—(1) *Determination of subpart F income, export trade income, etc.* An election under paragraph (a) of this section to consolidate export trade corporations in a chain of such corporations shall have no effect on the determination of the character of income as subpart F income or on the determination of export trade income, export trade income which constitutes foreign base company income, or earnings and profits of the individual export trade corporations in the chain. Thus, the consolidation of export trade corporations under this section shall not have the effect of reducing earnings and profits of such corporations or of changing the characterization of income from that which is, for example, foreign base company income to that which is not. The application of this paragraph may be illustrated by the following example:

Example. Corporation A, incorporated under the laws of foreign country X, and corporation B, incorporated under the laws of foreign country Y, are both wholly owned subsidiaries of domestic corporation M. Corporations A and B both qualify under section 971(a) as export trade corporations. Corporation A purchases personal property produced in the United States from an unrelated person and sells the property to B Corporation for use outside of country X. Corporation B resells the property to an unrelated person for use in foreign country Z. Corporations A and B each derive foreign base company sales income described in §1.954–3 from the purchase and sale transactions. Consolidation of Corporations A and B under this section does not result in the two transactions being

treated as one transaction which is a purchase of property from an unrelated person and a sale of property to an unrelated person or the nonrecognition of gain on the sale of export property by A Corporation to B Corporation.

(2) *Determination of amount by which consolidated subpart F income is reduced*—(i) *In general.* In determining the amount by which the subpart F income of each export trade corporation includible in a consolidation of export trade corporations shall be reduced as provided in section 970(a) and paragraph (b)(1) of §1.970–1 for any taxable year of consolidation, the limitations provided by section 970(a) and paragraph (b)(2) of §1.970–1 on such amount for each such export trade corporation shall be determined on the basis of such corporation's separate share of—

(*a*) Amounts included in the total export promotion expense,

(*b*) The total gross receipts from the sale, installation, operation, maintenance, or use of property in respect of which each such corporation derives such export trade income as is properly allocable to the export trade income which constitutes foreign base company income, and

(*c*) The total increase in investments in export trade assets,

of all export trade corporations to which the consolidation applies for the taxable year.

(ii) *Limitations not effective.* If for any taxable year each of the limitations under paragraph (b)(2) of §1.970–1, determined on a consolidated basis, equals or exceeds the total export trade income which constitutes foreign base company income of all corporations includible in the consolidation of export trade corporations, the subpart F income of each includible corporation shall be reduced under section 970(a) for such year by its separate export trade income which constitutes foreign base company income.

(iii) *Limitation effective.* If for any taxable year one of the limitations under paragraph (b)(2) of §1.970–1, determined on a consolidated basis, is less than the total export trade income which constitutes foreign base company income of all corporations includible in the consolidation of export trade corporations, the amount by which the subpart F income of each includible corporation shall be reduced under section 970(a) for such year shall be an amount which bears the same ratio to the amount by which the subpart F income may be reduced on a consolidated basis as the export trade income which constitutes foreign base company income of each includible corporation bears to the total export trade income which constitutes foreign base company income of all export trade corporations includible in the consolidation of export trade corporations.

(iv) *Illustration.* The application of this subparagraph may be illustrated by the following example:

Example. (a) Domestic corporation M owns 100 percent of the only class of stock of controlled foreign corporation A, which, in turn, owns 100 percent of the only class of stock of controlled foreign corporation B. All corporations use the calendar year as the taxable year, and corporations A and B are export trade corporations throughout the period here involved. Corporation M elects under this section to consolidate corporations A and B for the entire period here involved. Corporation M elects under paragraph (a)(2) of §1.970–2 for 1963 to determine both A Corporation's and B Corporation's investments in export trade assets as of the close of the 75th day after the close of such corporations' taxable year.

(b) The following amounts are applicable to corporations A and B for 1964:

	Corporation A	Corporation B
Subpart F income	$100	$200
Export trade income which constitutes foreign base company income	25	75
Other export trade income	10	15
Export promotion expenses allocable to export trade income which constitutes foreign base company income	10	80
Gross receipts from the sale of property in respect of which export trade income which constitutes foreign base company income is derived	400	600
Increase in investments in export trade assets for period beginning with March 16, 1964, and ending with March 16, 1965	35	120

(c) The amount by which subpart F income of corporations A and B is reduced for 1964 on a separate-company basis without regard to section 972 may be determined as set forth in items (i) through (vii) below, and the results of the consolidation of corporations A and B for 1964 are set forth in items (viii) through (x). Assuming an alternative case in which for 1964 the facts are the same as set forth in

paragraphs (a) and (b) of this example except that B Corporation incurs export promotion expenses of $50 (rather than $80) which are allocable to the export trade income which constitutes foreign base company income, the results of the consolidation of corporations A and B for such year (a case where one of the limitations under paragraph (b)(2) of §1.970–1 is effective) are set forth in items (xi) through (xiii):

	A Corporation (1)	B Corporation (2)	Total (3)
(i) Subpart F income	$100	$200	$300
(ii) Export trade income which constitutes foreign base company income	25	75	100
(iii) Other export trade income	10	15	25
(iv) Total export trade income	35	90	125
(v) Limitations under §1.970–1(b)(2):			
(*a*) Increase in export trade assets limitation:			
($35 × $25/$35)	25		
($120 × $75/$90)		100	
([$35 + $120] × $100/$125)			124
(*b*) Gross receipts limitation:			
(10% of $400)	40		
(10% of $600)		60	
(10% of $1,000)			100
(*c*) Export promotion expenses limitation:			
(150% of $10)	15		
(150% of $80)		120	
(150% of $90)			135
(*d*) Export promotion expenses limitation (alternative case):			
(150% of $10)	15		
(150% of $50)		75	
(150% of $60)			90
(vi) Reduction in subpart F income on a separate company basis determined without regard to section 972 (item (ii), but not to exceed smallest of items (v) (*a*), (*b*), and (*c*), in columns (1) and (2))	15	60	75
(vii) Subpart F income as reduced on a separate company basis (item (i) minus item (vi))	85	140	225
(viii) Reduction in subpart F income on a consolidated basis determined under section 972 (item (ii), but not to exceed smallest of items (v) (*a*), (*b*), and (*c*), in column (3))			100
(ix) Apportionment of reduction in subpart F income (item (ii))	25	75	100
(x) Subpart F income as reduced on a consolidated basis (item (i) minus item (ix))	75	125	200
ALTERNATIVE CASE			
(xi) Reduction in subpart F income on a consolidated basis determined under section 972 (item (ii) but not to exceed smallest of items (v) (*a*), (*b*), and (*d*), in column (3))			9
(xii) Apportionment of reduction in subpart F income (item (xi) times [item (ii) of column (1) over item (ii) of column (3)] and item (xi) times [item (ii) of column (2) over item (ii) of column (3)]); ($90 × $25/$100)	$22.50		
($90 × $75/$100)		$67.50	90
(xiii) Subpart F income as reduced on a consolidated basis (item (i) minus item (xii))	77.50	132.50	210

(3) *Determination of pro rata share of consolidated withdrawal of previously excluded export trade income*—(i) *In general.* If, for any taxable year, there is a decrease in investments in export trade assets under section 970(b) and paragraph (c)(1) of §1.970–1, determined on a consolidated basis, of export trade corporations includible in a consolidated chain of such corporations, each United States shareholder who has elected under paragraph (a) of this section to consolidate his interest in such chain of corporations shall include in his gross income, under section 951(a)(1)(A)(ii) and the regulations thereunder as an amount to which section 955 (as in effect before the enactment of the Tax Reduction Act of 1975) applies, his pro rata share of the amount of such consolidated decrease in investments but only to the extent such pro rata share does not exceed the lesser of the limitations provided by section 970(b) and paragraph (c)(2) of §1.970–1 with respect to such shareholder determined on a consolidated basis. The consolidated decrease in investments and the consolidated limitations shall be determined by aggregating the applicable amounts determined under paragraph (c) of §1.970–1 with respect to such shareholder's interest in each corporation includible in the consolidation.

(ii) *Allocation of pro rata share of consolidated decrease in investments in export trade assets.* For purposes of determining the amount referred to in paragraph (c)(2)(i)(*b*)(*3*) of §1.970–1 for a subsequent taxable year, a United States shareholder's pro rata share of a consolidated decrease in investments determined under subdivision (i) of this subparagraph for the current taxable year shall be allocated to such shareholder's interest in each of the export trade corporations includible in the consolidation in that ratio which—

(*a*) The net amount determined under paragraph (c)(2)(i)(*b*) of §1.970–1 with respect to such shareholder's interest in such corporation for all prior taxable years (whether or not a taxable year occurring during the period of consolidation) bears to

(*b*) The total of the net amounts determined under paragraph (c)(2)(i) (*b*) of §1.970–1 with respect to such shareholder's interests in all export trade corporations includible in such consolidation for all prior taxable years (whether or not a taxable year occurring during the period of consolidation).

(iii) *Illustration.* The application of this subparagraph may be illustrated by the following example:

Example. (a) Domestic corporation M owns 60 percent of the only class of stock of controlled foreign corporation A, which, in turn, owns 100 percent of the only class of stock of controlled foreign corporation B. All corporations use the calendar year as a taxable year, and corporations A and B are export trade corporations throughout the period here involved. Corporation M elects to consolidate corporations A and B for the entire period here involved.

(b) The following amounts are applicable to corporations A and B for 1964:

	A (1)	B (2)	Consolidated (3)
(i) Consolidated decrease in investments in export trade assets (determined before application of §1.970–1(c)(2))	.....	.....	$100
(ii) M Corporation's pro rata share of consolidated decrease (60%)	.....	.....	60
(iii) M Corporation's pro rata share of earnings and profits for 1963 and 1964 (§1.970–1(c) (2)(i)(*a*)	$120	$90	210
(iv) M Corporation's pro rata share of net amount determined under §1.970–1(c)(2)(i)(*b*) for 1963	180	60	240
(v) Amount includible in M Corporation's gross income for 1964 (smallest of items (ii), (iii), and (iv) in column (3))	.....	.....	60

Corporation M must include $60 in its gross income for 1964 under section 951(a)(1)(A)(ii) by reason of the application of section 970(b) as its pro rata share of the consolidated decrease in investments in export trade assets; and, for purposes of determining the amount under paragraph (c)(2)(i)(*b*)(3) of §1.970–1 with respect to M Corporation's interest in each of corporations A and B for a subsequent taxable year, such consolidated decrease for 1964 is allocated as follows: to M Corporation's interest in A Corporation, $45 ($60 times $180/$240); and to its interest in B Corporation, $15 ($60 times $60/$240).

(c) The following amounts are applicable to corporations A and B for 1965:

	A(1)	B(2)	Consolidated (3)
(i) Consolidated decrease in investments in export trade assets (determined before application of §1.970–1(c)(2))	.....	.....	$150
(ii) M Corporation's pro rata share of consolidated decrease (60%)	.....	.....	90
(iii) M Corporation's pro rata share of earnings and profits (and deficits in earnings and profits) for 1963, 1964, and 1965 (§1.970–1(c)(2)(i)(*a*))	$100	($20)	80
(iv) M Corporation's pro rata share of the net amount determined under §1.970–1(c)(2)(i)(*b*) for 1963 and 1964.			
($180 − $45)	135		
($60 − $15)		45	
Total			180
(v) Amount includible in M Corporation's gross income for 1965 (smallest of items (ii), (iii), and (iv) in column (3)).			80

Corporation M must include $80 in its gross income for 1965 under section 951(a)(1)(A)(ii) by reason of the application of section 970(b) as its pro rata share of the consolidated decrease in investments in export trade assets; and, for purposes of determining the amount under paragraph (c)(2)(i)(*b*)(3) of §1.970–1 with respect to M Corporation's interest in each

of corporations A and B for a subsequent taxable year, such consolidated decrease for 1965 is allocated as follows: to M Corporation's interest in A Corporation, $60 ($80 times $135/$180); and to its interest in B Corporation, $20 ($80 times $45/$180).

(d) The following amounts are applicable to corporations A and B for 1966:

	A(1)	B(2)	Consolidated (3)
(i) Consolidated decrease in investments in export trade assets (determined before application of § 1.970–1(c)(2))	.....	.....	$200
(ii) M Corporation's pro rata share of consolidated decrease (60%)	.....	.....	120
(iii) M Corporation's pro rata share of earnings and profits (and deficits in earnings and profits) for 1963, 1964, 1965, and 1966 (§ 1.970–1(c)(2)(i)(*a*))	$120	$50	170
(iv) M Corporation's pro rata share of the net amount determined under § 1.970–1(c)(2)(i)(b) for 1963, 1964, and 1965.			
($180 minus [$45 + $60])	75		
($60 − [$15 + $20])		25	
Total			100
(v) Amount includible in M Corporation's gross income for 1966 (smallest of items (ii), (iii), and (iv) in column (3))	.....	.....	100

Corporation M must include $100 in its gross income for 1966 under section 951(a)(1)(A)(ii) by reason of the application of section 970(b) as its pro rata share of the consolidated decrease in investments in export trade assets; and, for purposes of determining the amount under paragraph (c)(2)(i)(b)(3) of § 1.970–1 with respect to M Corporation's interest in each of corporations A and B for a subsequent taxable year, such consolidated decrease for 1966 is allocated as follows: to M Corporation's interest in A Corporation, $75 ($100 times $75/$100); and to its interest in B Corporation, $25 ($100 times $25/$100).

[T.D. 6754, 29 FR 12714, Sept. 9, 1964, as amended by T.D. 7893, 48 FR 22512, May 19, 1983]

§ 1.981–0 Repeal of section 981; effective dates.

The provisions of section 981 are not effective for taxable years beginning after December 31, 1976. For the treatment of the community income of aliens and their spouses for taxable years beginning after December 31, 1976, see section 879 and the regulations thereunder.

[T.D. 7670, 45 FR 6929, Jan. 31, 1980]

§ 1.981–1 Foreign law community income for taxable years beginning after December 31, 1966, and before January 1, 1977.

(a) *Election for special treatment*—(1) *In general.* An individual citizen of the United States who meets the requirements of section 981(a)(1) and subparagraph (2) of this paragraph for any open taxable year beginning after December 31, 1966, and before January 1, 1977, may make a binding election with his nonresident alien spouse to have section 981(b) and paragraph (b) of this section apply to their income for such year which is treated as community income under the applicable community property laws of a foreign country or countries. Generally, the community property laws of a foreign country operate upon land situated within its jurisdiction and upon personal property owned by spouses domiciled therein. If the election is made for any taxable year, it shall also apply for all subsequent open taxable years of such citizen and his nonresident alien spouse for which all the requirements of section 981(a)(1) and subparagraph (2) of this paragraph are met, unless the Director of International Operations consents, in accordance with paragraph (c)(2) of this section, to a termination of the election. An election under section 981(a) and this section has no effect for any taxable year beginning before January 1, 1967, for which a separate election, if made, must be made under section 981(c)(1) and § 1.981–2. For the definition of ''open taxable year'' see section 981(e)(2) and paragraph (a) of § 1.981–3. If the citizen and his nonresident alien spouse have different taxable years, see paragraph (c) of § 1.981–3. If one of the spouses is deceased, see paragraph (d) of § 1.981–3.

(2) *Requirements to be met.* In order for a U.S. citizen and his nonresident alien spouse to make an election under section 981(a) and this section for any taxable year and in order for the election to apply for any subsequent taxable year it is required under section 981(a)(1) that, for each such taxable year, such citizen be (i) a citizen of the United States, (ii) a bona fide resident of a foreign country or countries during the entire taxable year, and (iii) married at the close of the taxable year

to an individual who is (*a*) a nonresident alien during the entire taxable year and (*b*), in the case of any such subsequent taxable year, the same nonresident alien individual to whom the citizen was married at the close of the earliest of such taxable years. If either spouse dies during a taxable year, the taxable year of the surviving spouse shall be treated, solely for purposes of making the determination under subdivision (iii) of this subparagraph, as ending on the date of such death. A citizen of the United States shall be considered as not married at the close of his taxable year if he is legally separated from his spouse under a decree of divorce or of separate maintenance. However, the mere fact that spouses have not lived together during the course of the taxable year shall not cause them to be considered as not married at the close of the taxable year. A husband and wife who are separated under an interlocutory decree of divorce retain the relationship of husband and wife until the decree becomes final.

(3) *Determination of residence.* The principles of paragraphs (a)(2) and (b)(7) of §1.911–1 (26 CFR 1.911–1 (1978)) shall apply in order to determine for purposes of this paragraph whether a U.S. citizen is a *bona fide* resident of a foreign country or countries during the entire taxable year. The principles of §§1.871.2 through 1.871–5 shall apply in order to determine whether the alien spouse of a U.S. citizen is a nonresident during the entire taxable year.

(4) *Manner of electing.* The election under section 981(a) and this section shall be made in accordance with the applicable rules set forth in paragraph (c) of this section.

(b) *Treatment of community income*—(1) *In general.* Community income for any taxable year to which an election under section 981(a) and this section applies, and the deductions properly allocable to such income, shall be divided between the electing U.S. citizen and nonresident alien spouses in accordance with the rules set forth in section 981(b) and subparagraphs (2) through (6) of this paragraph. Community income for this purpose means all gross income, whether derived from sources within or without the United States, which is treated as community income of the spouses under the community property laws of the foreign country having jurisdiction to determine the legal ownership of the income. A spouse has ownership of the income for this purpose if under the applicable foreign law he has a proprietary vested interest in the income.

(2) *Earned income.* Wages, salaries, or professional fees, and other amounts received as compensation for personal services actually performed, which are community income for the taxable year, shall be treated as the income of the spouse who actually performed the personal services. This subparagraph does not apply, however, to community income (i) derived from any trade or business carried on by the husband or the wife, (ii) attributable to a spouse's distributive share of the income of a partnership to which subparagraph (4) of this paragraph applies, (iii) consisting of compensation for personal services rendered to a corporation which represents a distribution of the earnings and profits of the corporation rather than a reasonable allowance as compensation for the personal services actually performed, or (iv) derived from property which is acquired as consideration for personal services performed.

(3) *Trade or business income.* If any income derived from a trade or business carried on by the husband or wife is community income for the taxable year, all of the gross income, and the deductions attributable to such income, shall be treated as the gross income and deductions of the husband unless the wife exercises substantially all of the management and control of the trade or business, in which case all of the gross income and deductions shall be treated as the gross income and deductions of the wife. This subparagraph does not apply to any income derived from a trade or business carried on by a partnership of which both or one of the spouses is a member. For purposes of this subparagraph, income derived from a trade or business includes any income derived from a trade or business in which both personal services and capital are material income producing factors. The term ''management and control'' means

management and control in fact, not the management and control imputed to the husband under the community property laws of a foreign country. For example, a wife who operates a beauty parlor without any appreciable collaboration on the part of a husband is considered as having substantially all of the management and control of the business despite the provisions of any community property laws of a foreign country vesting in the husband the right of management and control of community property; and the income and deductions attributable to the operation of the beauty parlor are considered the income and deductions of the wife.

(4) *Partnership income.* If any portion of a spouse's distributive share of the income of a partnership of which such spouse is a member is community income for the taxable year, all of that distributive share shall be treated as the income of that spouse and shall not be taken into account in determining the income of the other spouse. If both spouses are members of the same partnership, the distributive share of the income of each spouse which is community income shall be treated as the income of that spouse. A spouse's distributive share of such income of a partnership shall be determined as provided in section 704, and the regulations thereunder.

(5) *Income from separate property.* Any community income for the taxable year, other than income described in section 981(b)(1) or (2) and subparagraph (2), (3), or (4) of this paragraph, which is derived from the separate property of one of the spouses shall be treated as the income of that spouse. The determination of what property is separate property for this purpose shall be made in accordance with the laws of the foreign country which, in accordance with subparagraph (1) of this paragraph, has jurisdiction to determine that the income from such property is community income.

(6) *Other community income.* Any community income for the taxable year, other than income described in section 981(b)(1), (2), or (3), and subparagraph (2), (3), (4), or (5) of this paragraph, shall be treated as the income of that spouse who has a proprietary vested interest in that income under the laws of the foreign country which, in accordance with subparagraph (1) of this paragraph, has jurisdiction to determine that such income is community income. Thus, for example, this subparagraph applies to community income not described in subparagraph (2), (3), (4), or (5) of this paragraph which consists of dividends, interest, rents, royalties, or gains, from community property or of the earnings of unemancipated minor children.

(7) *Illustrations.* The application of this paragraph may be illustrated by the following examples:

Example 1. H, a nonresident alien individual and W, a U.S. citizen, each of whose taxable years is the calendar year, were married throughout 1967. H and W were residents of, and domiciled in, foreign country Z during the entire taxable year. During 1967, H earned $10,000 from the performance of personal services as an employee. H also received $500 in dividend income from stock which under the community property laws of country Z is considered to be the separate property of H. W had no separate income for 1967. Under the community property laws of country Z all income earned by either spouse is considered to be community income, and one-half of such income is considered to belong to the other spouse. In addition, such laws of country Z provide that all income derived from property held separately by either spouse is to be treated as community income and treated as belonging one-half to each spouse. Thus, under the community property laws of country Z, H and W are both considered to have realized income of $5,250 during 1967, even though such laws recognize the stock as the separate property of H. If the election under this section is in effect for 1967, under the rules of subparagraphs (2) and (5) of this paragraph all of the income of $10,500 derived during 1967 shall be treated, for U.S. income tax purposes, as the income of H.

Example 2. The facts are the same as in example 1 except that H is the sole proprietor of a retail merchandising company and such company has a $10,000 profit during 1967. W exercises no management and control over the business. In addition, H is a partner in a wholesale distributing company, and his distributive share of the partnership profit is $5,000. Both of these amounts of income are treated as community income under the community property laws of country Z, and under such laws both H and W are treated as realizing $7,500 of such income. If the election under this section is in effect for 1967, under the rule of subparagraphs (3) and (4) of this paragraph all $15,000 of such income

shall be treated as the income of H for U.S. income tax purposes.

Example 3. The facts are the same as in example 1 except that H also received $1,000 in dividends on stock held separately in his name. Under the community property laws of country Z the stock is considered to be community property; and the dividends, to be community income, one-half of such income being treated as the income of each spouse. If the election under this section is in effect for 1967, under the rule of subparagraph (6) of this paragraph, $500 of the dividend income shall be treated, for U.S. income tax purposes, as the income of each spouse.

(c) *Time and manner of making or terminating an election*—(1) *In general.* A citizen of the United States and his nonresident alien spouse shall, for the first taxable year beginning after December 31, 1966, for which an election under section 981(a) and this section is to apply, make the election by filing a return, an amended return, or a claim for refund, whichever is proper, for such taxable year and attaching thereto a statement that the election is being made and that the requirements of paragraph (a)(2) of this section are met for such taxable year. The statement must show the name, address, and account number, if any, of each spouse, the name and address of the executor, administrator, or other person making the election for a deceased spouse, the taxable year to which the election applies, and the name of the foreign country or countries having jurisdiction to determine the ownership of any income being treated in accordance with section 981(b) and paragraph (b) of this section. The statement must be signed by both persons making the election. An election under this section may be made only for a taxable year which, on the date of the election, as defined in paragraph (b) of §1.981–3, is open within the meaning of section 981(e)(2) and paragraph (a) of §1.981–3.

(2) *Termination only with consent of Director of International Operations*—(i) *In general.* An election under this section for any taxable year is binding and may not be revoked. The election shall also remain in effect for all subsequent taxable years of the spouses for which the requirements of paragraph (a)(2) of this section are met and which on the date of the election are open, within the meaning of paragraph (a) of §1.981–3, unless the election is terminated for any such subsequent taxable year or years in accordance with subdivision (ii) of this subparagraph. Any return, amended return, or claim for refund in respect of any such subsequent taxable year for which the election is in effect shall have attached thereto a copy of the statement filed in accordance with subparagraph (1) of this paragraph and an additional signed statement that for such subsequent taxable year the requirements of paragraph (a)(2) of this section are met.

(ii) *Written request to terminate required.* A request to terminate an election under this section for a subsequent taxable year or years shall be made in writing by the persons who made the election and shall be addressed to the Director of International Operations, Internal Revenue Service, Washington, DC 20225. The request must include the name, address, and account number, if any, of each spouse and must be signed by the persons making the request. It must specify the taxable year or years for which the termination is to be effective and the grounds which justify the termination. The request shall be filed not later than 90 days before the close of the period for assessing a deficiency against the U.S. citizen for the earliest taxable year of such citizen for which the termination is to be effective. The Director of International Operations may require such other information as may be necessary in order to determine whether the termination will be permitted. A copy of the consent by the Director of International Operations to terminate must be attached to an amended income tax return for each taxable year for which the termination is effective and for which a return has previously been filed.

(Secs. 913(m) (92 Stat. 3106; 26 U.S.C. 913(m)), and 7805 (68A Stat. 917; 26 U.S.C. 7805), Internal Revenue Code of 1954)

[T.D. 7330, 39 FR 38372, Oct. 31, 1974, as amended by T.D. 7670, 45 FR 6929, Jan. 31, 1980; T.D. 7736, 45 FR 76143, Nov. 18, 1980]

§ 1.981–2 Foreign law community income for taxable years beginning before January 1, 1967.

(a) *Election for special treatment*—(1) *In general.* For all open taxable years beginning before January 1, 1967, for which an individual citizen of the United States meets the requirements of subparagraphs (A) and (C) of section 981(a)(1) and subparagraph (2) of this paragraph, such citizen and his nonresident alien spouse may make a joint election to have section 981(c)(2) and paragraph (b) of this section apply to their income which is treated as community income under the applicable community property laws of a foreign country or countries. However, if the conditions prescribed by section 981(d)(3) and subparagraph (3) of this paragraph are met, the nonresident alien spouse is not required to join in the election and such citizen may make a separate election to have section 981(c)(2) and paragraph (b) of this section apply to such income for such taxable years. An election under section 981(c)(1) and this section shall apply to every open taxable year of such citizen and his nonresident alien spouse beginning before January 1, 1967, for which all the requirements of subparagraphs (A) and (C) of section 981(a)(1) and subparagraph (2) of this paragraph are met. It is immaterial whether such open taxable year is a taxable year subject to the provisions of the 1954 Code, the 1939 Code, or any other internal revenue law in effect before the 1939 Code. An election under section 981(c)(1) and this section has no effect for any taxable year beginning after December 31, 1966. For the definition of ''open taxable year'' see section 981(e)(2) and paragraph (a) of § 1.981–3. If the citizen and his nonresident alien spouse have different taxable years, see paragraph (c) of § 1.981–3. If one of the spouses is deceased, see paragraph (d) of § 1.981–3. An election under section 981(c)(1) and this section is binding and may not be revoked.

(2) *Requirements to be met.* In order for the citizen of the United States to make an election under this section, whether required to be made jointly with his nonresident alien spouse or permitted to be made separately, it is required under section 981(c)(1) that, for each taxable year to which the election applies, the citizen making the election be (i) a citizen of the United States and (ii) married at the close of the taxable year to an individual who is (*a*) a nonresident alien during the entire taxable year and (*b*), in the case of any such taxable years subsequent to the first, the same nonresident alien individual to whom the citizen was married at the close of such first taxable year. The provisions of paragraph (a)(2) of § 1.981–1 apply to determine whether a U.S. citizen making an election under section 981(c)(1) and this section is married at the close of a taxable year to an individual who is a nonresident alien during the entire taxable year.

(3) *Cases where joint election is not required.* A nonresident alien spouse is not required to join in an election under section 981(c)(1) and this section if the Director of International Operations determines in accordance with paragraph (c)(4) of this section—

(i) That an election under section 981(c)(1) and this section would not affect the liability for Federal income tax of the nonresident alien spouse for any taxable year, whether beginning on, before, or after January 1, 1967, or

(ii) That the effect of the election on the liability of the nonresident alien spouse for Federal income tax for any such taxable year cannot be ascertained and that to deny the election to the U.S. citizen spouse would be inequitable and cause undue hardship to the U.S. citizen.

If in accordance with this subparagraph the nonresident alien spouse is not required to join in the election by the U.S. citizen, the provisions of section 981(d)(2) and paragraph (e) of § 1.981–3 shall not apply so as to extend the period for assessing deficiencies or filing a claim for credit or refund for any taxable year of the nonresident alien spouse.

(4) *Manner of electing.* The election under section 981(c)(1) and this section shall be made in accordance with the applicable rules set forth in paragraph (c) of this section.

(b) *Treatment of community income*—(1) *In general.* Community income, as defined in paragraph (b)(1) of § 1.981–1, for

any taxable year beginning before January 1, 1967, to which an election under section 981(c)(1) and this section applies, and the deductions properly allocable to such income, shall be divided between the U.S. citizen and his nonresident alien spouse in accordance with the rules set forth in section 981(c)(2) and subparagraphs (2) and (3) of this paragraph. The income shall be divided in such manner even though the nonresident alien spouse is not required, in accordance with paragraph (a)(3) of this section, to join in the election by the U.S. citizen.

(2) *Earned income, business income, partnership income, and income from separate property.* All community income for any taxable year to which this paragraph applies which is treated as the income of one of the spouses in accordance with section 981(b)(1), (2), or (3) and paragraph (b)(2), (3), (4), or (5) of §1.981–1 shall be treated as the income of that spouse for purposes of this paragraph.

(3) *Other community income.* All community income for any taxable year to which this paragraph applies, other than income described in subparagraph (2) of this paragraph, shall be treated as the income of the spouse who, for such taxable year, has a greater amount of gross income than the other spouse, determined by adding to the amount of gross income which is treated as the gross income of that spouse in accordance with subparagraph (2) of this paragraph the amount of the gross income for the taxable year which is treated as the separate income of that spouse under the community property laws of the foreign country having jurisdiction to determine the legal ownership of the income. If either spouse dies during a taxable year, the taxable year of the surviving spouse shall be treated as ending on the date of such death for the purpose of determining which spouse has the greater amount of gross income for such taxable year. Moreover, if the U.S. citizen and his nonresident alien spouse do not have the same taxable year, as defined in section 441(b) and the regulations thereunder, the periods for which the amounts of gross income are to be compared under this subparagraph are (i) the taxable year of the citizen and (ii) that period falling within the consecutive taxable years of the nonresident alien spouse which coincides with the period covered by such taxable year of the citizen. See paragraph (c) of §1.981–3.

(c) *Time and manner of making election*—(1) *In general.* A citizen of the United States and his nonresident alien spouse or, if subparagraph (4) of this paragraph applies, such citizen alone may make an election under section 981(c)(1) and this section at any time on or after November 13, 1966, for each and every taxable year beginning before January 1, 1967, which on the date of the election, as defined in paragraph (b) of §1.981–3, is open within the meaning of section 981(e)(2) and paragraph (a) of §1.981–3. The election shall be made by filing a return, an amended return, or a claim for refund, whichever is proper, for each taxable year to which the election applies and attaching thereto a statement that the election is being made and that the requirements of paragraph (a)(2) of this section are met for each such taxable year. The statement must also show the information required by subparagraph (2) of this paragraph and must, where applicable, be signed by both persons making the election.

(2) *Information required.* The statement described in subparagraph (1) of this paragraph must show—

(i) The name, address, and account number, if any, of each spouse,

(ii) The name and address of the executor, administrator, or other person making the election for a deceased spouse,

(iii) The taxable years to which the election applies,

(iv) The office of the district director, or the service center, where the return or returns, if any, for such taxable year or years were filed,

(v) The dates on which such return or returns, if any, were filed and on which the tax for such taxable year or years was paid, if the tax has been paid, and

(vi) The name of the foreign country or countries having jurisdiction to determine the ownership of any income being treated in accordance with section 981(c)(2) and paragraph (b) of this section.

(3) *Place for filing.* Any return, amended return, or claim for refund filed under subparagraph (1) of this paragraph in respect of any taxable year shall be filed with the Director of International Operations, Internal Revenue Service, Washington, DC 20225. (See § 1.6091–3.)

(4) *Determination that joint election is not required.* A U.S. citizen spouse entitled to make an election under section 981(c)(1) and this section for open taxable years beginning before January 1, 1967, may apply to the Director of International Operations for a determination under section 981(d)(3) that the nonresident alien spouse is not required to join in the election by such citizen. This application shall be made by filing with the Director of International Operations, Internal Revenue Service, Washington, DC 20225, a statement setting forth the same information required by subparagraph (2) of this paragraph and such other information as is required by the Director of International Operations to justify a claim that the requirements of section 981(d)(3) and paragraph (a)(3) of this section are met. The Director of International Operations shall notify the U.S. citizen by letter of his determination with respect to the application. If the determination is that the nonresident alien spouse is not required to join in the election, a copy of the letter of determination shall be attached to each return, amended return, or claim for refund, to be filed pursuant to subparagraph (1) of this paragraph.

[T.D. 7330, 39 FR 38373, Oct. 31, 1974]

§ 1.981–3 Definitions and other special rules.

(a) *Open taxable years.* (1) For purposes of paragraph (a) of § 1.981–1, and paragraph (a) of § 1.981–2, a taxable year of the U.S. citizen, and the taxable year or years of his nonresident alien spouse ending or beginning within such taxable year of such citizen, shall be treated as open if the period prescribed by section 6501(a) (or section 6501(c)(4) if the period is extended by agreement) for assessing a deficiency against the citizen for his taxable year has not expired before the date of the election, determined under paragraph (b) of this section. Thus, for example, a taxable year of a U.S. citizen beginning before January 1, 1967, is open for purposes of this subparagraph if, before the election under section 981(c)(1) and § 1.981–2, such citizen has never filed a return for such year and a return was required under section 6012 without reference to section 981. For example, if a U.S. citizen spouse on a calendar year basis who has never filed a return for 1960 decides in 1975 that he wishes to make the election under section 981(c)(1) and § 1.981–2 in order to avoid being subject to tax for 1960 on his share of the community income for that year, he may in 1975 elect the benefits of section 981(c)(2) by filing an election in accordance with paragraph (c) of § 1.981–2. In such case, a taxable year or years of the nonresident alien spouse of such citizen ending or beginning within 1960 shall be treated in 1975 as an open taxable year.

(2) Subparagraph (1) of this paragraph shall apply even though the period prescribed by section 6501 for assessing a deficiency against the nonresident alien spouse for his taxable year or years ending or beginning within the taxable year of the U.S. citizen has expired before the election is made.

(3) If either spouse dies during a taxable year to which an election under § 1.981–1 or § 1.981–2 applies, the taxable year of the decedent and the surviving spouse shall be determined under this paragraph without regard to section 981(e)(4), relating to death of spouse during the taxable year. See paragraph (a)(2) of § 1.443–1.

(4) For definition of the term ''taxable year'', see section 441(b) and the regulations thereunder.

(b) *Date of election.* (1) For purposes of § 1.981–1 and this section the date of an election made under section 981(a) and § 1.981–1 is the date on which the return, amended return, or claim for refund required by paragraph (c)(1) of § 1.981–1 is filed.

(2) For purposes of § 1.981–2 and this section the date of an election made under section 981(c)(1) and § 1.981–2 is the date on which the returns, amended returns, or claims for refund, required by paragraph (c)(1) of § 1.981–2 are filed.

(3) For provisions treating timely mailing as timely filing, see section 7502 and the regulations thereunder.

(c) *Spouses with different taxable years.* If the U.S. citizen and his nonresident alien spouse do not have the same taxable year, as defined in section 441(b) and the regulations thereunder, the election under §1.981–1 or §1.981–2 shall apply to each taxable year of such citizen in respect of which the election is made and to that period falling within the consecutive taxable years of the nonresident alien spouse which coincides with the period covered by such taxable year of the citizen.

(d) *Election on behalf of deceased spouse.* Any election, statement, or request, required to be made under paragraph (c) of §1.981–1, or paragraph (c) of §1.981–2, by one of the spouses may, if such spouse is deceased, be made by the executor, administrator, or other person charged with the property of such deceased spouse.

(e) *Extension of period of limitations on assessment or refund*—(1) *Assessment of deficiency.* Except as provided in subparagraph (3) of this paragraph, if an election under section 981(a) and §1.981–1, or under section 981(c)(1) and §1.981–2, is properly made, the period within which a deficiency may be assessed for any taxable year to which the election applies shall, to the extent the deficiency is attributable to the application of such election, not expire before one year after the date of the election, determined under paragraph (b) of this section.

(2) *Refund of tax.* Except as provided in subparagraph (3) of this paragraph, if an election under section 981(a) and §1.981–1, or under section 981(c)(1) and §1.981–2, is properly made, the period within which a claim for credit or refund of an overpayment for any taxable year to which the election applies may be filed shall, to the extent the overpayment is attributable to the application of the election, not expire before one year after the date of the election, determined under paragraph (b) of this section.

(3) *Exception in case of nonelecting alien.* Subparagraphs (1) and (2) of this paragraph shall not apply to any taxable year of a nonresident alien spouse who, in accordance with paragraph (a)(3) of §1.981–2, is not required to join in the election by the U.S. citizen spouse under section 981(c)(1) and §1.981–2.

(f) *Payment of interest for extension period.* To the extent that an overpayment or deficiency for any taxable year is attributable to an election made under §1.981–1 or §1.981–2, no interest shall be allowed or paid for any period ending with the day before the date which is one year after the date of the election, determined under paragraph (b) of this section.

[T.D. 7330, 39 FR 38374, Oct. 31, 1974]

§1.985–0 Outline of regulation.

This section lists the paragraphs contained in §§1.985–1 through 1.985–6.

§1.985–1 Functional currency.

(a) Applicability and effective date.
(b) Dollar functional currency.
(c) Functional currency of a QBU that is not required to use the dollar.
(d) Single functional currency for a foreign corporation.
(e) Translation of nonfunctional currency transactions.
(f) Examples.

§1.985–2 Election to use the United States dollar as the functional currency of a QBU.

(a) Background and scope.
(b) Eligible QBU.
(c) Time and manner for dollar election.
(d) Effect of dollar election.

§1.985–3 United States dollar approximate separate transactions method.

(a) Scope and effective date.
(b) Statement of method.
(c) Translation into United States dollars.
(d) Computation of DASTM gain or loss.
(e) Effect of DASTM gain or loss on gross income, taxable income, or earnings and profits.

§1.985–4 Method of accounting.

(a) Adoption or election.
(b) Condition for changing functional currencies.
(c) Relationship to certain other sections of the Code.

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

(a) In general.
(b) Step 1—Taking into account exchange gain or loss on certain section 988 transactions.

(c) Step 2—Determining the new functional currency basis of property and the new functional currency amount of liabilities and any other relevant items.
(d) Step 3A—Additional adjustments that are necessary when a branch changes functional currency.
(e) Step 3B—Additional adjustments that are necessary when a taxpayer changes functional currency.
(f) Examples.

Section 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.
(b) Certain controlled foreign corporations.
(c) All other foreign corporations.
(d) Pre-1987 section 902 amounts.
(e) Net worth branch.
(f) Profit and loss branch.

[T.D. 8263, 54 FR 38653, Sept. 20, 1989, as amended by T.D. 8464, 58 FR 232, Jan. 5, 1993; T.D. 8556, 59 FR 37672, July 25, 1994]

§ 1.985–1 Functional currency.

(a) *Applicability and effective date*—(1) *Purpose and scope.* These regulations provide guidance with respect to defining the functional currency of a taxpayer and each qualified business unit (QBU), as defined in section 989(a). Generally, a taxpayer and each QBU must make all determinations under subtitle A of the Code (relating to income taxes) in its respective functional currency. This section sets forth rules for determining when the functional currency is the United States dollar (dollar) or a currency other than the dollar. Section 1.985–2 provides an election to use the dollar as the functional currency for certain QBUs that absent the election would have a functional currency that is a hyperinflationary currency, and explains the effect of making the election. Section 1.985–3 sets forth the dollar approximate separate transactions method that certain QBUs must use to compute their income or loss or earnings and profits. Section 1.985–4 provides that the adoption of a functional currency is a method of accounting and sets forth conditions for a change in functional currency. Section 1.985–5 provides adjustments that are required to be made upon a change in functional currency. Finally, §1.985–6 provides transition rules for a QBU that uses the dollar approximate separate transactions method for its first taxable year beginning after December 31, 1986.

(2) *Effective date.* These regulations apply to taxable years beginning after December 31, 1986. However, any taxpayer desiring to apply temporary Income Tax Regulations §1.985–0T through §1.985–4T in lieu of these regulations to all taxable years beginning after December 31, 1986, and on or before October 20, 1989 may (on a consistent basis) so choose. For the text of the temporary regulations, see 53 FR 20308 (1988).

(b) *Dollar functional currency*—(1) *In general.* The dollar shall be the functional currency of a taxpayer or QBU described in paragraph (b)(1)(i) through (v) of this section regardless of the currency used in keeping its books and records (as defined in §1.989(a)–1(d)). The dollar shall be the functional currency of—

(i) A taxpayer that is not a QBU (e.g., an individual);

(ii) A QBU that conducts its activities primarily in dollars. A QBU conducts its activities primarily in dollars if the currency of the economic environment in which the QBU conducts its activities is primarily the dollar. The facts and circumstances test set forth in paragraph (c)(2) of this section shall apply in making this determination;

(iii) Except as otherwise provided by ruling or administrative pronouncement, a QBU that has the United States, or any possession or territory of the United States where the dollar is the standard currency, as its residence (as defined in section 988(a)(3)(B));

(iv) A QBU that does not keep books and records in the currency of any economic environment in which a significant part of its activities is conducted. Whether a QBU keeps such books and records is determined in accordance with paragraph (c)(3) of this section; or

(v) A QBU that produces income or loss that is, or is treated as, effectively connected with the conduct of a trade or business within the United States.

(2) *QBUs operating in a hyperinflationary environment*—(i) *Taxable years beginning on or before August 24, 1994.* For taxable years beginning on or before August 24, 1994, see §1.985–2 with respect to a QBU that elects to

use, or is otherwise required to use, the dollar as its functional currency.

(ii) *Taxable years beginning after August 24, 1994*—(A) *In general.* For taxable years beginning after August 24, 1994, except as otherwise provided in paragraph (b)(2)(ii)(B) of this section, any QBU that otherwise would be required to use a hyperinflationary currency as its functional currency must use the dollar as its functional currency and compute income or loss or earnings and profits under the rules of §1.985–3.

(B) *Exceptions—(1)—Certain QBU branches.* The functional currency of a QBU that otherwise would be required to use a hyperinflationary currency as its functional currency and that is a branch of a foreign corporation having a non-dollar functional currency that is not hyperinflationary shall be the functional currency of the foreign corporation. Such QBU's income or loss or earnings and profits shall be determined under §1.985–3 by substituting the functional currency of the foreign corporation for the dollar.

(*2*) *Corporation that is not a controlled foreign corporation.* A foreign corporation (or its QBU branch) operating in a hyperinflationary environment is not required to use the dollar as its functional currency pursuant to paragraph (b)(2)(ii)(A) of this section if that foreign corporation is not a controlled foreign corporation as defined in section 957 or 953(c)(1)(B). However, a noncontrolled section 902 corporation, as defined in section 904(d)(2)(E), may elect to use the dollar (or, if appropriate, the currency specified in paragraph (b)(2)(ii)(B)(*1*) of this section) as its (or its QBU branch's) functional currency under the procedures set forth in §1.985–2(c)(3).

(C) *Change in functional currency—(1) In general.* If a QBU is required to change its functional currency to the dollar under paragraph (b)(2)(ii)(A) of this section, or chooses or is required to change its functional currency to the dollar for any open taxable year (and all subsequent taxable years) under §1.985–3(a)(2)(ii), the change is considered to be made with the consent of the Commissioner for purposes of §1.985–4. A QBU changing functional currency must make adjustments described in §1.985–7 if the year of change (as defined in §1.481–1(a)(1)) begins after 1987, or the adjustments described in §1.985–6 if the year of change begins in 1987. No adjustments under section 481 are required solely because of a change in functional currency described in this paragraph (b)(2)(ii)(C).

(*2*) *Effective date.* This paragraph (b)(2)(ii)(C) applies to taxable years beginning after April 6, 1998. However, a taxpayer may choose to apply this paragraph (b)(2)(ii)(C) to all open years after December 31, 1986, provided each person, and each QBU branch of a person, that is related (within the meaning of §1.985–2(d)(3)) also applies to this paragraph (b)(2)(ii)(C).

(D) *Hyperinflationary currency.* For purposes of sections 985 through 989, the term hyperinflationary currency means the currency of a country in which there is cumulative inflation during the base period of at least 100 percent as determined by reference to the consumer price index of the country listed in the monthly issues of the ''International Financial Statistics'' or a successor publication of the International Monetary Fund. If a country's currency is not listed in the monthly issues of ''International Financial Statistics,'' a QBU may use any other reasonable method consistently applied for determining the country's consumer price index. Base period means, with respect to any taxable year, the thirty-six calendar months immediately preceding the first day of the current calendar year. For this purpose, the cumulative inflation rate for the base period is based on compounded inflation rates. Thus, if for 1991, 1992, and 1993, a country's annual inflation rates are 29 percent, 25 percent, and 30 percent, respectively, the cumulative inflation rate for the three-year base period is 110 percent [((1.29 × 1.25 × 1.3) − 1.0 × 1.10) × 100 = 110%] and the currency of the country for the QBU's 1994 year is considered hyperinflationary. In making the determination whether a currency is hyperinflationary, the determination for purposes of United States generally accepted accounting principles may be used for income tax purposes provided the determination is based on criteria that is substantially similar to the

rules previously set forth in this paragraph (b)(2)(ii)(D), the method of determination is applied consistently from year to year, and the same method is applied to all related persons as defined in §1.985–3(e)(2)(vi).

(E) *Change in functional currency when currency ceases to be hyperinflationary—(1) In general.* A QBU that has been required to use the dollar as its functional currency under paragraph (b)(2) of this section, or has elected to use the dollar as its functional currency under paragraph (b)(2)(ii)(B)(*2*) of this section or §1.985–2, must change its functional currency as of the first day of the first taxable year that follows three consecutive taxable years in which the currency of its economic environment, determined under paragraph (c)(2) of this section, is not a hyperinflationary currency. The functional currency of the QBU for such year shall be determined in accordance with paragraph (c) of this section. For purposes of §1.985–4, the change is considered to be made with the consent of the Commissioner. See §1.985–5 for adjustments that are required upon a change in functional currency.

(*2*) *Effective Date.* This paragraph (b)(2)(ii)(E) of this section applies to taxable years beginning after April 6, 1998.

(c) *Functional currency of a QBU that is not required to use the dollar*—(1) *General rule.* The functional currency of a QBU that is not required to use the dollar under paragraph (b) of this section shall be the currency of the economic environment in which a significant part of the QBU's activities is conducted, if the QBU keeps, or is presumed under paragraph (c)(3) of this section to keep, its books and records in such currency.

(2) *Economic environment.* For purposes of section 985 and the regulations thereunder, the economic environment in which a significant part of a QBU's activities is conducted shall be determined by taking into account all the facts and circumstances.

(i) *Facts and circumstances.* The facts and circumstances that are considered in determining the economic environment in which a significant part of a QBU's activities is conducted include, but are not limited to, the following:

(A) The currency of the country in which the QBU is a resident as determined under section 988(a)(3)(B);

(B) The currencies of the QBU's cash flows;

(C) The currencies in which the QBU generates revenues and incurs expenses;

(D) The currencies in which the QBU borrows and lends;

(E) The currencies of the QBU's sales markets;

(F) The currencies in which pricing and other financial decisions are made;

(G) The duration of the QBU's business operations; and

(H) The significance and/or volume of the QBU's independent activities.

(ii) *Rate of inflation.* The rate of inflation (regardless of how it is determined) shall not be a factor used to determine a QBU's economic environment.

(iii) *Consistency.* A taxpayer must consistently apply the facts and circumstances test set forth in this paragraph (c)(2) in evaluating the economic environment of its QBUs, *e.g.,* its branches, that engage in the same or similar trades or businesses.

(3) *Books and records presumption.* A QBU shall be presumed to keep books and records in the currency of the economic environment in which a significant part of its activities are conducted. The presumption may be overcome only if the QBU can demonstrate to the satisfaction of the district director that a substantial nontax purpose exists for not keeping any books and records in such currency. A taxpayer may not use this presumption affirmatively in determining a QBU's functional currency.

(4) *Multiple currencies.* If a QBU has more than one currency that satisfies the requirements of paragraph (c)(1) of this section, the QBU may choose any such currency as its functional currency.

(5) *Relationship of United States accounting principles.* In making the functional currency determination under this paragraph (c), the currency of the QBU for purposes of United States generally accepted accounting principles (GAAP) will ordinarily be accepted as

the functional currency of the QBU for income tax purposes, provided that the GAAP determination is based on facts and circumstances substantially similar to those set forth in paragraph (c)(2) of this section.

(6) *Effect of changed circumstances.* Regardless of any change in circumstances, a QBU may change its functional currency determined under this paragraph (c) only if the QBU complies with §1.985–4 or the Commissioner's consent is considered to have been granted under §1.985–2(d)(4) or §1.985–3(a)(2)(ii). For special rules relating to the conversion to the euro, see §1.985–8.

(d) *Single functional currency for a foreign corporation*—(1) *General rule.* This paragraph (d) applies to a foreign corporation that has two or more QBUs that do not have the same functional currency. The foreign corporation shall be treated as having a single functional currency for the corporation as a whole that is different from the functional currency of one or more of its QBUs. The determination of a foreign corporation's functional currency shall be made by first applying paragraph (d)(1)(i) and then paragraph (d)(l)(ii) of this section.

(i) *Step 1.* Each QBU of the foreign corporation determines its functional currency in accordance with the rules set forth in paragraphs (b) and (c) of this section and §1.985–2.

(ii) *Step 2.* The foreign corporation determines its functional currency applying the principles of paragraphs (b) and (c) of this section to the corporation's activities as a whole. Thus, if a foreign corporation has two branches, the corporation shall determine its functional currency by applying the principles of paragraphs (b) and (c) of this section to the combined activities of the corporation and the branches. For purposes of this paragraph (d)(1), if a QBU of a foreign corporation has the dollar as its functional currency under paragraph (b)(2) of this section, the QBU's activities shall be considered dollar activities of the corporation.

(2) *Translation of income or loss of QBUs having different functional currencies than the foreign corporation as a whole.* Where the functional currency of a foreign corporation as a whole differs from the functional currency of one or more of its QBUs, each such QBU shall determine the amount of its income or loss or earnings and profits (or deficit in earnings and profits) in its functional currency under the principles of section 987 (relating to branch transactions). The amount of income or loss or earnings and profits (or deficit in earnings and profits) of each QBU in its functional currency shall then be translated into the foreign corporation's functional currency using the appropriate exchange rate as defined in section 989(b)(4) for purposes of determining the corporation's income or loss or earnings and profits (or deficit in earnings and profits).

(e) *Translation of nonfunctional currency transactions.* Except for a QBU using the dollar approximate separate transactions method described in §1.985–3, *see* section 988 and the regulations thereunder for the treatment of nonfunctional currency transactions.

(f) *Examples.* The provisions of this section are illustrated by the following examples:

Example 1. P, a domestic corporation, operates exclusively through foreign branch X in Country A. X is a QBU within the meaning of section 989(a) and its residence is Country A as determined under section 988 (a)(3)(B). The currency of Country A is the LC. All of X's purchases, sales, and expenses are in the LC. The laws of A require X to keep books and records in the LC. It is determined that the LC is the currency of X under United States generally accepted accounting principles. This determination is based on facts and circumstances substantially similar to those set forth in paragraph (c)(2) of this section. Under these facts, while the functional currency of P is the dollar since its residence is the United States, the functional currency of X is the LC.

Example 2. P, a publicly-held domestic regulated investment company (as defined under section 851), operates exclusively through foreign branch B in Country R. B is a QBU within the meaning of section 989(a) and its residence is Country R as determined under section 988(a)(3)(B). The currency of Country R is the LC. B's principal activities consist of purchasing and selling stock and securities of Country R companies and securities issued by Country R. It is determined that the dollar is the currency of B under United States generally accepted accounting principles. This determination is not based on facts and circumstances substantially similar to those set forth in paragraph (c)(2) of this section. Under these facts, while the

functional currency of P is the dollar since its residence is the United States, B may choose the LC as its functional currency because it has significant activities in the LC provided it keeps books and records in the LC. The fact that the dollar is the currency of B under generally accepted accounting principles is irrelevant for purposes of determining B's functional currency because the GAAP determination was not based on factors similar to those set forth in paragraph (c)(2) of this section.

Example 3. P, a domestic bank, operates through foreign branch X in Country R. X is a QBU within the meaning of section 989(a) and its residence is Country R as determined under section 988(a)(3)(B). The currency of Country R is the LC. The laws of R require X to keep books and records in the LC. The branch customarily loans dollars and LCs. In the case of its LC loans, X ordinarily fixes the terms of the loans by reference to a contemporary London Inter-Bank Offered Rate (LIBOR) on dollar deposits. For instance, the interest on the amount of the outstanding LC loan principal might equal LIBOR plus 2 percent and the amount of the outstanding LC loan principal would be adjusted to reflect changes in the dollar value of the LC. X is primarily funded with dollar-denominated funds borrowed from related and unrelated parties. X's only LC activities are paying local taxes, employee wages, and local expenses such as rent and electricity. Under these facts, X's activities are primarily conducted in dollars. Thus, although X keeps its books and records in LCs, X's functional currency is the dollar.

Example 4. S, a foreign corporation organized in Country U, is wholly-owned by P, a domestic corporation. The currency of Country U is the LC. S's sole function is acting as a financing vehicle for P and domestic corporations that are affiliated with P. All borrowing and lending transactions between S and P and its domestic affiliates are in dollars. Furthermore, primarily all of S's other borrowings are dollar-denominated or based on a dollar index. S's only LC activities are paying local taxes, employee wages, and local expenses such as rent and electricity. S keeps its books and records in the LC. Under these facts, S's activities are primarily conducted in dollars. Thus, although S keeps its books and records in LCs, S's functional currency is the dollar.

Example 5. D is a domestic corporation whose primary activity is the extraction of natural gas and oil through foreign branch X in Country Y. X is a QBU within the meaning of section 989(a) and its residence is Country Y as determined under section 988(a)(3)(B). The currency of Country Y is the LC. X bills a significant amount of its natural gas and oil sales in dollars and a significant amount in LCs. X also incurs significant LC and dollar expenses and liabilities. The laws of Country Y require X to keep its books and records in the LC. It is determined that the LC is the currency of X under United States generally accepted accounting principles. This determination is based on facts and circumstances substantially similar to those set forth in paragraph (c)(2) of this section. Absent other factors indicating that X primarily conducts its activities in the dollar, D could choose either the dollar or the LC as X's functional currency because X has significant activities in both the dollar and the LC, provided the books and records requirement is satisfied. If, instead, X's activities were determined to be primarily in the dollar, then X would have to use the dollar as its functional currency.

Example 6. S, a foreign corporation organized in Country U, is wholly-owned by P, a domestic corporation. The currency of U is the LC. S purchases the products it sells from related and unrelated parties, including P. These purchases are made in the LC. In addition, most of S's gross receipts are generated by transactions denominated in the LC. S attempts to determine its LC price for goods sold in such a manner as to obtain an LC equivalent of a certain dollar amount after reduction for all LC costs. However, local market conditions sometimes result in pricing adjustments. Thus, changes in the LC-dollar exchange rate from period to period generally result in corresponding changes in the LC price of S's products. S pays local taxes, employee wages, and other local expenses in the LC. It is determined that the dollar is the currency of S under United States generally accepted accounting principles. This determination is not based on facts and circumstances substantially similar to those set forth in paragraph (c)(2) of this section. Under these facts, S could choose either the dollar or the LC as its functional currency because S has significant activities in both the dollar and the LC, provided that the books and records requirement is satisfied.

Example 7. S, a foreign corporation organized in Country X, is wholly-owned by P, a domestic corporation. S conducts all of its operations through two branches. Branch A is located in Country F and branch B is located in Country G. S, A, and B are QBUs within the meaning of section 989(a). Branch A's and branch B's residences are Country F and Country G respectively as determined under section 988(a)(3)(B). The currency of Country F is the FC and the currency of Country G is the LC. The functional currencies of S, A, and B are determined in a two step procedure.

Step 1: The functional currency of branches A and B. Branch A and branch B both conduct all activities in their respective local currencies. The FC is the currency of branch A and the LC is the currency of branch B under United States generally accepted accounting

principles. This determination is based on facts and circumstances substantially similar to those set forth in paragraph (c)(2) of this section. Under these facts, the functional currency of branch A is the FC and the functional currency of branch B is the LC.

Step 2: The functional currency of S. S's functional currency is determined by disregarding the fact that A and B are branches. When A's activities and B's activities are viewed as a whole, S determines that it only conducts significant activities in the LC. Therefore, S's functional currency is the LC. See Examples 9, 10, and 11 for how the earnings and profits of a foreign corporation, which has branches with different functional currencies, are determined.

Example 8. Assume the same facts as in Example 7, except that S does not exist and P conducts all of its operations through branch A and branch B. In this instance P's functional currency in Step 2 is the dollar, regardless of the fact that its branches' activities viewed as a whole are in the LC, because P is a taxpayer whose residence is the United States under section 988(a)(3)(B)(i). Therefore, while the functional currency of branch A is the FC and the functional currency of branch B is the LC, the functional currency of P is the dollar because its residence is the United States.

Example 9. The facts are the same as in Example 7. ln addition, assume that in 1987 branch A has earnings of 100 FC and branch B has earnings of 100 LC as determined under section 987. The weighted average exchange rate for the year is 1 FC/2 LC. Branch A's earnings are translated into 200 LC for purposes of computing S's earnings and profits in 1987. Thus, the total earnings and profits of S from branch A and branch B for 1987 is 300 LC.

Example 10. (i) X, a foreign corporation organized in Country W, is wholly-owned by P, a domestic corporation. Both X and P are calendar year taxpayers that began business during 1987. X operates exclusively through two branches, A and B both of which are located outside of Country W. The functional currency of X and A is the LC, while the functional currency of B is the DC as determined under section 985 and §1.985–1. The earnings of B must be computed under section 987, relating to branch transactions. In 1987, A earns 900 LCs of nonsubpart F income and B earns 200 DCs of nonsubpart F income. Under section 904(d)(2), A's income is financial service income and B's income is general limitation income. In order to determine X's earnings and profits, B's income must be translated into LCs (the functional currency of X). The weighted average exchange rate for 1987 is 1 LC/2 DC. Thus, in 1987 X's current earnings and profits (and its post-1986 undistributed earnings) are 1000 LCs consisting of 900 LCs of financial services income earned by A and 100 LCs (200 DC/2) of general limitation income earned by B. Neither A nor B makes any remittances during 1987.

(ii) In 1988, neither A nor B earns any income or generates any loss. On December 31, 1988, A remits 50 LCs directly to P. The remittance to P is considered to be remitted by A to X and then immediately distributed by X as a dividend. The 50 LC remittance does not result in an exchange gain or loss under section 987 to X because the functional currency of X and A is the LC. See section 987(3). Under section 904(d)(3)(D), the 50 LC dividend is treated as income in a separate category to the extent of the dividend's pro rata share of X's earnings and profits in each separate limitation category. Thus, 90 percent, or 45 LCs, is treated as financial services income, and 10 percent, or 5 LCs, is treated as general limitation income. After the dividend distribution, X has 950 LCs of accumulated earnings and profits (and post-1986 undistributed earnings) consisting of 855 LCs of financial service limitation income and 95 LCs of general limitation income.

Example 11. The facts are the same as in Example 10, except that A makes no remittance during 1988 but B remits 120 DCs to X on December 31, 1988, which X immediately converts into LCs, and X makes no dividend distribution during 1988. Assume that the appropriate exchange rate for the remittance is 1 LC/3 DCs. B's remittance triggers exchange loss to X. See section 987(3). Under section 987, the exchange loss on the remittance is 20 LCs calculated as follows: 40 LCs, which is the LC value of the 120 DC remittance (120 DCs/3), less 60 LCs, their LC basis (120 DCs/2). This loss is sourced and characterized under section 987 and regulations thereunder.

Example 12. F, a foreign corporation, has gain from the disposition of a United States real property interest (as defined in section 897(c)). The gain is taken into account as if F were engaged in a trade or business within the United States during the taxable year and as if such gain were effectively connected with such trade or business. F's disposition activity shall be treated as a separate QBU with a dollar functional currency because such activity produced income that is treated as effectively connected with a trade or business within the United States. Therefore, F must compute its gain from the disposition by giving the United States real property interest an historic dollar basis.

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§ 1.985–2 Election to use the United States dollar as the functional currency of a QBU.

(a) *Background and scope*—(1) *In general.* This section permits an eligible QBU to elect to use the dollar as its functional currency for taxable years beginning on or before August 24, 1994. An election to use a dollar functional currency is not permitted for a QBU other than an eligible QBU. Paragraph (b) of this section defines an eligible QBU. Paragraph (c) of this section describes the time and manner for making the dollar election and paragraph (d) of this section describes the effect of making the election. For the definition of a QBU, see section 989(a). See §1.985–1(b)(2)(ii) for rules requiring a QBU to use the dollar as its functional currency in taxable years beginning after August 24, 1994.

(2) *Exception.* Pursuant to §1.985–1(b)(2)(ii)(B)(*2*), the rules of paragraph (c)(3) of this section shall apply with respect to the procedure required to be followed by a noncontrolled section 902 corporation as defined in section 904(d)(2)(E) to elect the dollar as its (or its QBU branch's) functional currency and the application of §1.985–3.

(b) *Eligible QBU*—(1) *In general.* The term ''eligible QBU'' means a QBU that could have used a hyperinflationary currency as its functional currency absent the dollar election. *See* §1.985–1 for how a QBU determines its functional currency absent the dollar election.

(2) *Hyperinflationary currency.* See §1.985–1(b)(2)(ii)(D) for the definition of hyperinflationary currency.

(c) *Time and manner for dollar election*—(1) *QBUs that are branches of United States persons*—(i) *Rule.* If an eligible QBU is a branch of a United States person, the dollar election shall be made by attaching a completed Form 8819 to the United States person's timely filed (taking extensions into account) tax return for the first taxable year for which the election is to be effective.

(ii) *Procedure prior to the issuance of Form 8819.* In the absence of Form 8819, the election shall be made in accordance with §1.985–2T(c)(1). Failure to file an amended return within the time period prescribed in §1.985–2T(c)(1) shall not invalidate the dollar election if it is established to the satisfaction of the district director that reasonable cause existed for such failure. A subsequent election for 1988 will not prejudice the taxpayer with respect to such reasonable cause determination. Nevertheless, each United States person making an election under the §1.985–2T(c)(1) must file a Form 8819 in the time and manner provided in the Form's instructions.

(2) *Eligible QBUs that are controlled foreign corporations or branches of controlled foreign corporations*—(i) *Rule.* If an eligible QBU is a controlled foreign corporation (as described in section 957), or a branch of a controlled foreign corporation, the election may be made either by the foreign corporation or by the controlling United States shareholders on behalf of the foreign corporation by—

(A) Filing a completed Form 8819 in the time and manner provided in the Form's instructions, and

(B) Providing the written notice required by paragraph (c)(2)(ii) of this section at the time and in the manner prescribed therein.

The term *controlling United States shareholders* means those United States shareholders (as defined in section 951(b)) who, in the aggregate, own (within the meaning of section 958(a)) greater than 50 percent of the total combined voting power of all classes of stock of the foreign corporation entitled to vote. If the foreign corporation is a controlled foreign corporation (as described in section 957) but the United States shareholders do not, in the aggregate, own the requisite voting power, the term ''controlling United States shareholders'' means all the United States shareholders (as defined in section 951(b)) who own (within the meaning of section 958(a)) stock of the controlled foreign corporation.

(ii) *Notice.* Prior to filing Form 8819, the controlling United States shareholders (or the foreign corporation, if the dollar election is made by the corporation) shall provide written notice that the dollar election will be made to all United States persons known to be shareholders who own (within the meaning of section 958(a)) stock of the foreign corporation. Such notice shall

also include all information required in Form 8819.

(iii) *Reasonable cause exception.* Failure of the controlling United States shareholders (or the foreign corporation, if the dollar election is made by the corporation) to timely file Form 8819 or provide written notice to a United States person required to be notified by paragraph (c)(2)(ii) of this section shall not invalidate the dollar election, if it is established to the satisfaction of the district director that reasonable cause existed for such failure.

(iv) *Procedure prior to the issuance of Form 8819.* In the absence of Form 8819, an eligible QBU described in paragraph (c)(2)(i) of this section shall make the dollar election in accordance with §1.985–2T(c)(2). Nevertheless, the person or persons that made such election must file a Form 8819 in the time and manner provided in the Form's instructions.

(3) *Eligible QBUs that are noncontrolled foreign corporations or branches of noncontrolled foreign corporations*—(i) *Rule.* If an eligible QBU is a noncontrolled foreign corporation (a foreign corporation not described in section 957), or a branch of a noncontrolled foreign corporation, the dollar election must be made by the corporation or the majority domestic corporate shareholders on behalf of the corporation by applying the rules provided in paragraph (c)(2)(i)(A) and (B), (ii), (iii), and (iv) of this section substituting ''majority domestic corporate shareholders'' for ''controlling United States shareholders'' wherever it appears therein. The term ''majority domestic corporate shareholders'' means those domestic corporate shareholders (as described in section 902(a)) who, in the aggregate, own (within the meaning of section 958(a)) greater than 50 percent of the total combined voting stock of all classes of stock of the noncontrolled foreign corporation entitled to vote that is owned (within the meaning of section 958(a)) by all the domestic corporate shareholders.

(ii) *Procedure prior to the issuance of Form 8819.* In the absence of Form 8819, an eligible QBU described in paragraph (c)(3)(i) of this section shall make the dollar election in accordance with §1.985–2T(c)(3). Nevertheless, the person or persons that made such election must file a Form 8819 in the time and manner provided in the Form's instructions.

(4) *Others.* Any other person making a dollar election under this section shall elect by filing Form 8819 and fulfilling any other notice requirements that may be required by the Commissioner.

(d) *Effect of dollar election*—(1) *General rule.* If a dollar election is made (or considered made under paragraph (d)(3) of this section) by or on behalf of an eligible QBU, the QBU shall be deemed to have the dollar as its functional currency. Each United States person that owns (within the meaning of section 958(a)) stock of a foreign corporation which has the dollar as its functional currency under §1.985–2 must make all of its federal income tax calculations with respect to the foreign corporation using the dollar as the corporation's functional currency (regardless of when ownership was acquired or whether the United States person received the written notice required by paragraph (c)(2)(i)(B) of this section).

(2) *Computation*—(i) *In general.* Except as provided in paragraph (d)(2)(ii) of this section, any eligible QBU that pursuant to this §1.985–2 has a dollar functional currency must compute income or loss or earnings and profits (or deficit in earnings and profits) in dollars using the dollar approximate separate transactions method described in §1.985–3.

(ii) *Alternative method.* An eligible QBU that has a dollar functional currency pursuant to this §1.985–2 may use a method other than the dollar approximate separate transactions method described in §1.985–3 only if the QBU demonstrates to the satisfaction of the Commissioner that it can properly employ such method. Generally, the QBU must show that it could compute foreign currency gain or loss under the principles of section 988 with respect to each of its section 988 transactions. If subsequently the QBU can no longer demonstrate to the satisfaction of the district director that it can properly employ such an alternative method, then the QBU will be deemed to have changed its method of accounting to

the dollar approximate separate transactions method described in §1.985–3. This change in accounting will be treated as having been made with the consent of the Commissioner. No adjustments under either §1.985–5T (or any succeeding final regulation) or section 481(a) shall be required solely because of the change. Rather the QBU shall begin accounting for its operations under §1.985–3 based on its dollar books and records as of the time of the change.

(3) *Conformity*—(i) *General rule.* If a dollar election is made under this §1.985–2 for an eligible QBU (''electing QBU''), then the dollar shall be the functional currency of any related person (regardless of when such person became related to the electing QBU) that is an eligible QBU, or any branch of any such related person that is an eligible QBU. For purposes of the preceding sentence, the term ''related person'' means any person with a relationship defined in section 267 (b) to the electing QBU (or to the United States or foreign person of which the electing QBU is a part). In determining whether two or more corporations are members of the same controlled group under section 267(b)(3), a person is considered to own stock owned directly by such person, stock owned with the application of section 1563(e)(1), and stock owned with the application of section 267(c).

(ii) *Branches of United States and foreign persons.* If a dollar election is made for a QBU branch of any person, each eligible QBU branch of such person shall have the dollar as its functional currency.

(4) *Required adjustments.* If an eligible QBU's functional currency changes due to a dollar election, or due to the conformity requirements of paragraph (d)(3) of this section, such change shall be deemed for purposes of §1.9B5–4 to be consented to by the Commissioner. No adjustments under section 481(a) shall be required solely because of the change. However, the QBU must make those adjustments required by §1.985–5T (or any succeeding final regulation).

(5) *Taxable year conformity required.* Generally, the adjustments required by paragraph (d)(4) of this section shall be made for a related person's taxable year—

(i) That includes the date in which the electing QBU made the dollar election if the person was related to such electing QBU at any time during the QBU's taxable year that includes such date, or

(ii) During which the person first becomes related to any electing QBU, in all other cases.

For purposes of this paragraph (d)(5), the date in which the electing QBU makes the dollar election shall be the last day of the electing QBU's taxable year. The district director may permit the related party to make such adjustments beginning one taxable year later if, in the district director's sole judgment, reasonable cause exists for the related party not being able to make the required adjustments for the earlier year.

(6) *Availability of election.* A dollar election may be made by or on behalf of a QBU, or considered made under the conformity rule of paragraph (d)(3), in any year in which the QBU is an eligible QBU. If a dollar election is not made by or on behalf of a QBU for its first taxable year beginning after December 31, 1986 in which it is an eligible QBU, then any dollar election made by or on behalf of the QBU, or considered made under the conformity rules of paragraph (d)(3) of this section, that results in a change in the QBU's functional currency shall be treated as having been made with the consent of the Commissioner. In such a case, however, the taxpayer must make those adjustments required by §1.985–5T (or any succeeding final regulation).

(7) *Effect of changed circumstances.* Regardless of any change in circumstances (*e.g.*, a currency ceases to qualify as hyperinflationary), a QBU whose functional currency is the dollar under this section may change its functional currency only if the QBU complies with §1.985–4.

(8) *Examples.* The provisions of this section are illustrated by the following examples.

Example 1. X is a calendar year domestic corporation that in 1987 establishes a branch, A, in Country Z. A's functional currency under sections 985(b)(1) and (2) and §1.985–1 is the ''h'', the currency of Country Z. The cumulative inflation in Country Z exceeds 100 percent for the thirty-six months prior to

January 1987, as measured by the consumer price index of Country Z listed in the monthly issues of the ''International Financial Statistics''. Accordingly, A is an eligible QBU in 1987 because the h is a hyperinflationary currency. Thus, X may elect the dollar as the functional currency of A for 1987.

Example 2. The facts are the same as in Example (1). X does not elect the dollar as the functional currency of A for 1987. Rather, X elects the dollar as the functional currency of A for 1991, a year A is an eligible QBU. The election constitutes a change in A's functional currency that is made with the consent of the Commissioner. However, A must make the adjustments required under §1.985–5T (or any succeeding final regulation).

Example 3. X is a domestic corporation that establishes A, an eligible QBU branch. X is wholly owned by domestic corporation Y. Y has an eligible QBU branch, B. Both X and Y are calendar year taxpayers. X makes a dollar election for A in 1987. Thus, A is an electing QBU. X and Y are related persons as defined in section 267(b) (*i.e.*, Y has a relationship under section 267(b)(3) to X, the corporation of which A is a part). Therefore, the dollar election by X for A in 1987 results in B, the eligible QBU branch of Y, also having the dollar as its functional currency for 1987.

Example 4. The facts are the same as in Example 3, except that Y does not have an eligible QBU branch but owns all the stock of C, a calendar year controlled foreign corporation, which is not itself an eligible QBU but which has an eligible QBU branch, D. X and C are related persons as defined in section 267(b) (*i.e.*, C has a relationship under section 267(b)(3) to X, the corporation of which A is a part). Therefore, the dollar election by X for A in 1987 results in D, the eligible QBU branch of C, also having the dollar as its functional currency for 1987.

Example 5. X, whose taxable year ends September 30, is an eligible QBU that does not use the dollar as its functional currency. X is wholly-owned by domestic corporation W. On January 1, 1989, X acquires all the stock of Y, an unrelated eligible QBU that made the dollar election under §1.985–2. Y is a calendar year taxpayer. After the stock purchase, X and Y are related persons as defined in section 267(b). Under §§1.985–2(d)(3) and (5), the dollar shall be the functional currency of X, any person related to X, and any branch of such related person that is an eligible QBU beginning with the taxable year that includes December 31, 1989. Thus, X must change to the dollar for its taxable year beginning October 1, 1988. However, the district director may allow X to change to the dollar for its taxable year beginning October 1, 1989, provided reasonable cause exists. Those QBUs changing to the dollar as their functional currency as the result of the conformity requirements must make the adjustments required under §1.985–5T (or any succeeding final regulation).

Example 6. The facts are the same as in Example 5, except that before X purchased the Y stock, X made the dollar election under §1.985–2 but Y did not use the dollar as its functional currency. Under §§1.985–2(d)(3) and (5) the dollar shall be the functional currency of Y, any person related to Y, and any branch of such related person that is an eligible QBU beginning with the taxable year that includes September 30, 1989. Thus, Y must change to the dollar for its taxable year beginning January 1, 1989. However the district director may allow Y to change to the dollar for its taxable year beginning January 1, 1990, provided reasonable cause exists. Those QBUs changing to the dollar as their functional currency as the result of the conformity requirements must make the adjustments required under §1.985–5T (or any succeeding final regulation).

[T.D. 8263, 54 FR 38656, Sept. 20, 1989, as amended by T.D. 8556, 59 FR 37673, July 25, 1994]

§ 1.985–3 United States dollar approximate separate transactions method.

(a) *Scope and effective date*—(1) *Scope.* This section describes the United States dollar (dollar) approximate separate transactions method of accounting (DASTM). For all purposes of subtitle A, this method of accounting must be used to compute the gross income, taxable income or loss, or earnings and profits (or deficit in earnings and profits) of a QBU (as defined in section 989(a)) that has the dollar as its functional currency pursuant to §1.985–1(b)(2).

(2) *Effective date*—(i) *In general.* This section is effective for taxable years beginning after August 24, 1994.

(ii) *DASTM prior-year election.* A taxpayer may elect to apply this section to any open taxable year beginning after December 31, 1986 (whether or not DASTM has been previously elected for some or all of those years). In order to make this election, the taxpayer must apply §1.985–3 to that year and all subsequent years. In addition, each person that is related (within the meaning of §1.985–3(e)(2)(vi)) to the taxpayer on the last day of any taxable year for which the election is effective and that would have been eligible to elect DASTM must also apply these rules to that year and all subsequent years. A taxpayer that has not previously elected to apply DASTM to its prior taxable

years may make the DASTM election for the pertinent years by filing amended returns and complying with the applicable election procedures of §1.985–2. Form 8819 shall be attached to the return for the first year for which the election is to be effective. A taxpayer that has elected DASTM for prior taxable years and applied the rules under §1.985–3 (as contained in the April 1, 1994 edition of 26 CFR part 1 (1.908 to 1.1000)) may amend its returns to apply the rules of this §1.985–3. In either case, the DASTM election for prior taxable years shall be deemed to be made with the consent of the Commissioner.

(b) *Statement of method.* Under DASTM, income or loss or earnings and profits (or a deficit in earnings and profits) of a QBU for its taxable year shall be determined in dollars by—

(1) Preparing an income or loss statement from the QBU's books and records (within the meaning of §1.989(a)–1(d)) as recorded in the QBU's hyperinflationary currency (as defined in §1.985–1(b)(2)(ii)(D));

(2) Making the adjustments necessary to conform such statement to United States generally accepted accounting principles and tax accounting principles (including reversing monetary correction adjustments required by local accounting principles);

(3) Translating the amounts of hyperinflationary currency as shown on such adjusted statement into dollars in accordance with paragraph (c) of this section; and

(4) Adjusting the resulting dollar income or loss or earnings and profits (or deficit in earnings and profits) and, where necessary, particular items of gross income, deductible expense or other amounts, in accordance with paragraph (e) of this section to reflect the amount of DASTM gain or loss as determined under paragraph (d) of this section.

(c) *Translation into United States dollars*—(1) *In general.* Except as otherwise provided in this paragraph (c), the amounts shown on the income or loss statement, as adjusted under paragraph (b)(2) of this section, shall be translated into dollars at the exchange rate (as defined in paragraph (c)(6) of this section) for the translation period (as defined in paragraph (c)(7) of this section) to which they relate. However, if the QBU previously changed its functional currency to the dollar, and the rules of §1.985–5 (or, if applicable, §1.985–5T, as contained in the April 1, 1993 edition of 26 CFR part 1 (1.908 to 1.1000)) applied in translating its balance sheet amounts into dollars, then the spot exchange rate applied under those rules shall be used to translate any amount that would otherwise be translated at a rate determined by reference to a translation period prior to the change in functional currency. For example, depreciation with respect to an asset acquired while the QBU had a nondollar functional currency shall be translated into dollars at the spot rate on the last day of the taxable year before the year of change to a dollar functional currency, rather than at the rate for the period in which the asset was acquired.

(2) *Cost of goods sold.* The dollar value of cost of goods sold shall equal the sum of the dollar values of beginning inventory and purchases less the dollar value of closing inventory as these amounts are determined under paragraph (c)(3) of this section.

(3) *Beginning inventory, purchases, and closing inventory*—(i) *Beginning inventory.* Amounts representing beginning inventory shall be translated so as to obtain the same amount of dollars which represented such items in the closing inventory balance for the preceding taxable year.

(ii) *Purchases.* Amounts representing items purchased or otherwise first included in inventory during the taxable year shall be translated at the exchange rate for the translation period in which the cost of such items was incurred.

(iii) *Closing inventory*—(A) *In general.* Amounts representing items included in the closing inventory balance shall be translated at the exchange rate for the translation period in which the cost of such items was incurred. However, if amounts representing items included in the closing inventory balance are either valued at market or written down to market value, they shall be translated at the exchange rate existing on the last day of the taxable year. For purposes of determining lower of

cost or market, items of inventory included in the closing inventory balance shall be translated into dollars at the exchange rate for the translation period in which the cost of such items was incurred and compared with market as determined in the QBU's hyperinflationary currency translated into dollars at the exchange rate existing on the last day of the taxable year.

(B) *Determination of translation period.* The method used to determine the translation period of amounts representing items of closing inventory for purposes of paragraph (c)(3)(iii)(A) of this section may be based upon reasonable approximations and averages, including rates of turnover, provided that the method is used consistently from year to year.

(4) *Depreciation, depletion, and amortization.* Amounts representing allowances for depreciation, depletion, or amortization shall be translated at the exchange rate for the translation period in which the cost of the underlying asset was incurred, except as provided in paragraph (c)(1) of this section.

(5) *Prepaid expenses or income.* Amounts representing expense or income paid or received in a prior taxable year shall be translated at the exchange rate for the translation period during which they were paid or received.

(6) *Exchange rate.* The exchange rate for a translation period may be determined under any reasonable method, provided that the method is consistently applied to all translation periods and conforms to the taxpayer's method of financial accounting. Reasonable methods include the average of beginning and ending exchange rates for the translation period and the spot rate on the last day of the translation period. Once chosen, a method for determining an exchange rate can be changed only with the consent of the district director.

(7) *Translation period*—(i) *In general.* Except as provided in paragraphs (c)(3)(iii)(B) and (c)(7)(ii) of this section, a translation period shall be each month within a QBU's taxable year.

(ii) *Exception.* A taxpayer may divide its taxable year into translation periods of equal length (with not more than one short period annually) that are less than one month. Once such a translation period is established, it may not be changed without the consent of the district director.

(8) *Dollar transactions*—(i) *In general.* Except as provided in paragraph (c)(8)(ii) of this section, no DASTM gain or loss is realized with respect to dollar transactions since the dollar is the functional currency of the QBU. Thus, the amount of any payment or receipt of dollars shall be reflected in the income or loss statement by the amount of such dollars. Also, the income or loss attributable to any transaction in which the amount that a QBU is entitled to receive (or is required to pay) by reason of such transaction is denominated in terms of the dollar, or is determined by reference to the value of the dollar, must be computed transaction by transaction. For example, if a foreign corporation lends 20 LC when 20 LC = $20 and is entitled to receive the LC equivalent of $20 at maturity plus a market rate of interest in dollars (or its LC equivalent), the loan is a dollar transaction. Similarly, this paragraph applies to any transaction that is determined to be a dollar transaction under section 988.

(ii) *Non-dollar functional currency.* If pursuant to §1.985–1(b)(2)(ii)(B)(*1*), a QBU is required to use a functional currency other than the dollar, then that currency shall be substituted for the dollar in applying paragraph (c)(8)(i) of this section.

(9) *Third currency transactions.* A taxpayer may use any reasonable method of accounting for transactions described in sections 988(c)(1)(B) and (C) that are denominated in, or determined by reference to, a currency other than the QBU's hyperinflationary currency or the dollar (third currency transactions) so long as such method is consistent with its method of financial accounting.

(10) *Examples.* The provisions of this paragraph (c) are illustrated by the following examples:

Example 1. S is an accrual basis QBU that is required to use the dollar as its functional currency for its first taxable year beginning in 1994. S's hyperinflationary currency is the ''h.'' During 1994, S accrues 100 dollars attributable to dollar-denominated sales. Because

this is a dollar transaction under paragraph (c)(8) of this section, S's income or loss for 1994 shall reflect the 100 dollars (not the hyperinflationary value of such dollars when accrued).

Example 2. (i) S is an accrual basis QBU that is required to use the dollar as its functional currency for its first taxable year beginning in 1994. S's hyperinflationary currency is the ''h.'' During 1994, S's sales amounted to 240,000,000h, its currently deductible expenses were 26,000,000h, and its total inventory purchases amounted to 100,000,000h. During January and February of 1994, S purchased depreciable assets for 80,000,000h and was allowed depreciation of 4,000,000h. At the end of 1994, S's closing inventory was 23,000,000h. No election to use a translation period other than the month is made, S had no transactions described in paragraph (c)(8) or (c)(9) of this section, and S's closing inventory was computed on the first-in, first-out inventory method. S's adjusted income or loss statement for 1994 is translated into dollars as follows:

	Hyperinflationary currency	Exchange rate	United States dollars
Sales			
(Jan.–Feb.)	10,000,000h	[1] 20:1	$500,000
(Mar.–Apr.)	20,000,000	21:1	952,381
(May.–June.)	50,000,000	22:1	2,272,727
(July)	50,000,000	23:1	2,173,913
(August)	20,000,000	26:1	769,231
(Sept.)	20,000,000	28:1	714,286
(Oct.)	20,000,000	29:1	689,655
(Nov.)	20,000,000	30:1	666,667
(Dec.)	30,000,000	31:1	967,742
Total	240,000,000h		9,706,602
Cost of Goods Sold			
Opening Inventory Purchases:	0		0
(Jan.-Feb.)	15,000,000h	20:1	750,000
(Mar.-Apr.)	10,000,000	21:1	476,190
(May-June)	30,000,000	22:1	1,363,636
(July)	20,000,000	23:1	869,565
(August)	10,000,000	26:1	384,615
(Sept.)	5,000,000	28:1	178,571
(Oct.)	5,000,000	29:1	172,414
(Nov.)	2,500,000	30:1	83,333
(Dec.)	2,500,000	31:1	80,645
Less Closing Inventory	(23,000,000)	[2]	(822,655)
	77,000,000h		3,536,314

[1] Where multiple months are indicated, the exchange rate applies for all months.
[2] See paragraph (ii) of this *Example.*

(ii) Since S uses the first-in, first-out inventory method, the closing inventory is assumed to consist of purchases made during the most recent translation period as follows:

	Hyperinflationary currency	Exchange rate	United States dollars
December	2,500,000h	31:1	$80,645
November	2,500,000	30:1	83,333
October	5,000,000	29:1	172,414
September	5,000,000	28:1	178,571
August	8,000,000	26:1	307,692
Total	23,000,000h		822,655
Non-Capitalized Expenses			
(Jan.-Feb.)	4,000,000h	20:1	200,000
(Mar.-Apr.)	2,500,000	21:1	119,048
(May-June)	2,500,000	22:1	113,636
(July)	2,000,000	23:1	86,957
(August)	3,000,000	26:1	115,385
(Sept.)	3,000,000	28:1	107,143
(Oct.)	2,000,000	29:1	68,966
(Nov.)	3,000,000	30:1	100,000

	Hyperinflationary currency	Exchange rate	United States dollars
(Dec.)	4,000,000	31:1	129,032
Total	26,000,000h		1,040,167
Depreciation	4,000,000h	20:1	200,000
Total Cost & Expenses	107,000,000h		4,776,481
Operating Profit	133,000,000h		4,930,121

(d) *Computation of DASTM gain or loss*—(1) *Rule.* DASTM gain or loss of a QBU equals—

(i) The net worth of the QBU (as determined under paragraph (d)(2) of this section) at the end of the taxable year minus the net worth of the QBU at the end of the preceding taxable year; plus

(ii) The dollar amount of the items described in paragraph (d)(3) of this section and minus the dollar amount of the items described in paragraph (d)(4) of this section; minus

(iii) The amount of dollar income or earnings and profits (or plus the amount of any dollar loss or deficit in earnings and profits) as determined for the taxable year pursuant to paragraphs (b)(1) through (b)(3) of this section.

(2) *Net worth.* Net worth of a QBU at the end of any taxable year equals the aggregate dollar amount representing assets on the QBU's balance sheet at the end of the taxable year less the aggregate dollar amount representing liabilities on the balance sheet. Notwithstanding any other provision in this paragraph (d)(2), the district director may adjust the amount of any asset or liability if a purpose for acquiring (or disposing of) the asset or incurring (or discharging) the liability is to manipulate the composition of the balance sheet for any period during the taxable year in order to avoid tax. The taxpayer shall determine net worth by—

(i) Preparing a balance sheet as of the end of the taxable year from the QBU's books and records (within the meaning of §1.989(a)–1(d)) as recorded in the QBU's hyperinflationary currency;

(ii) Making adjustments necessary to conform such balance sheet to United States generally accepted accounting principles and tax accounting principles (including reversing monetary correction adjustments required by local accounting principles); and

(iii) Translating the asset and liability amounts shown on the balance sheet into United States dollars in accordance with paragraph (d)(5) of this section.

(3) *Positive adjustments*—(i) *In general.* The items described in this paragraph (d)(3) are dividend distributions for the taxable year and any items that decrease net worth for the taxable year but that generally do not affect income or loss or earnings and profits (or a deficit in earnings and profits). Such items include a transfer to the home office of a QBU branch and a return of capital.

(ii) *Translation.* Except as provided by ruling or administrative pronouncement, items described in paragraph (d)(3)(i) of this section shall be translated into dollars as follows:

(A) If the item giving rise to the adjustment would be translated under paragraph (d)(5) of this section at the exchange rate for the last translation period of the taxable year if it were shown on the QBU's year-end balance sheet, such item shall be translated at the exchange rate on the date the item is transferred.

(B) If the item giving rise to the adjustment would be translated under paragraph (d)(5) of this section at the exchange rate for the translation period in which the cost of the item was incurred if it were shown on the QBU's year-end balance sheet, such item shall be translated at the same historical rate.

(iii) *Effective date.* Paragraph (d)(3)(ii) of this section is applicable for any transfer, dividend, or distribution that is a return of capital that is made after March 8, 2005, and that gives rise to an adjustment under this paragraph (d)(3).

(4) *Negative adjustments.* The items described in this paragraph (d)(4) are items that increase net worth for the taxable year but that generally do not affect income or loss or earnings and profits (or a deficit in earnings and profits). Such items include a capital contribution or a transfer from a home office to a QBU branch. Except as otherwise provided by ruling or administrative pronouncement, if the contribution or transfer is not in dollars, the amount of a capital contribution or transfer shall be translated into dollars at the exchange rate on the date made.

(5) *Translation of balance sheet.* Asset and liability amounts shown on the balance sheet in hyperinflationary currency (adjusted pursuant to paragraph (d)(2)(ii) of this section) shall be translated into dollars as provided in this paragraph (d)(5). However, if the QBU previously changed its functional currency to the dollar and the rules of §1.985–5 (or, if applicable, §1.985–5T, as contained in the April 1, 1993 edition of 26 CFR part 1 (1.908 to 1.1000)) applied in translating its balance sheet amounts into dollars, then the spot exchange rate applied under those rules shall be used to translate any amount that would otherwise be translated at a rate determined by reference to a translation period prior to the change in functional currency. For example, the basis of real property acquired while the QBU had a nondollar functional currency shall be translated into dollars at the spot rate on the last day of the taxable year before the year of change to a dollar functional currency, rather than at the rate for the period in which the cost was incurred.

(i) *Closing inventory.* Amounts representing items of inventory included in the closing inventory balance shall be translated in accordance with paragraph (c)(3)(iii) of this section.

(ii) *Bad debt reserves.* Amounts representing bad debt reserves shall be translated at the exchange rate for the last translation period for the taxable year.

(iii) *Prepaid income or expense.* Amounts representing expenses or income paid or received in a prior taxable year shall be translated in accordance with paragraph (c)(5) of this section.

(iv) *Hyperinflationary currency.* Amounts of the hyperinflationary currency and hyperinflationary demand deposit balances shall be translated at the exchange rate for the last translation period of the taxable year.

(v) *Certain assets*—(A) *In general.* Amounts representing plant, real property, equipment, goodwill, and patents and other intangibles shall be translated at the exchange rate for the translation period in which the cost of the asset was incurred.

(B) *Adjustment to certain assets.* Amounts representing depreciation, depletion, and amortization reserves shall be translated in accordance with paragraph (c)(4) of this section.

(vi) *Hyperinflationary debt obligations.* Except as provided in paragraph (d)(5)(vii) of this section, amounts representing a hyperinflationary debt obligation (including accounts receivable and payable) shall be translated at the exchange rate for the last translation period for the taxable year.

(vii) *Accrued foreign income taxes.* Amounts representing an accrued but unpaid foreign income tax shall be translated at the exchange rate on the last day of the last translation period of the taxable year of accrual.

(viii) *Certain hyperinflationary financial instruments.* Amounts representing any item described in section 988(c)(1)(B)(iii) (relating to forward contracts, futures contracts, options, or similar financial instruments) denominated in or determined by reference to the hyperinflationary currency shall be translated at the exchange rate for the last translation period for the taxable year.

(ix) *Other assets and liabilities.* Amounts representing assets and liabilities, other than those described in paragraphs (d)(5)(i) through (viii) of this section, shall be translated at the exchange rate for the translation period in which the cost of the asset or the amount of the liability was incurred.

(6) *Dollar transactions.* Notwithstanding any other provisions of this paragraph (d), where the amount representing an item shown on the balance sheet reflects a dollar transaction (described in paragraph (c)(8) of this section), the transaction shall be taken

into account in accordance with that paragraph.

(7) *Third currency transactions.* A taxpayer may use any reasonable method of accounting for transactions described in section 988(c)(1)(B) and (C) that are denominated in, or determined by reference to, a currency other than the QBU's hyperinflationary currency or the dollar (third currency transactions), so long as such method is consistent with its method of financial accounting.

(8) *Character.* The amount of DASTM gain or loss determined under paragraph (d)(1) of this section shall be ordinary income or loss.

(9) *Example.* The provisions of this paragraph (d) are illustrated by the following example:

Example. (i) S, an accrual method calendar year foreign corporation, uses DASTM. S's hyperinflationary currency is the ''h.'' S's net worth at December 31, 1993 was $3,246,495. For 1994, S's operating profit is 81,340,000h, or $2,038,200. S made a 5,000,000h distribution in April and again in December of 1994. S's translation period is the month. None of S's assets or liabilities reflect a dollar or third currency transaction described in paragraph (c)(8) or (c)(9) of this section, respectively. The exchange rate for each month in 1994 is as follows:

January	32h:$1
Feb.-Mar.	33:1
April-May	34:1
June	35:1
July	36:1
Aug.-Sept.	37:1
Oct.	38:1
Nov.	39:1
Dec.	40:1

(ii) At the end of 1994, S's assets and liabilities, as adjusted and translated pursuant to paragraphs (d)(2) and (d)(5) of this section, are as follows:

	Hyperinflationary	Exchange rate	U.S. dollar
Hyperinflationary cash on hand	40,000h	40:1	$1,000
Checking account	400,000	40:1	10,000
Accounts Receivable- 30 Day Accounts	20,000,000	[1] 40:1	500,000
60 Day Accounts	25,000,000	40:1	625,000
Inventory	65,000,000	[2]	2,500,000
Fixed assets—Property	90,000,000	27:1	3,333,333
Plant	190,000,000	[3]	6,785,714
Accumulated Depreciation	(600,000)	[3]	(21,428)
Equipment	10,000,000	[4]	340,000
Accumulated Depreciation	(400,000)	[4]	(13,333)
Common Stock—Stock A	500,000	34:1	14,706
Stock B	400,000	26:1	15,385
Preferred Stock	1,000,000	32:1	31,250
C.D.s	5,000,000	40:1	125,000
Total Assets	406,340,000		14,246,627
Accounts Payable Long-term liabilities:	35,000,000	40:1	875,000
Liability A	150,000,000	40:1	3,750,000
Liability B	80,000,000	40:1	2,000,000
Liability C	30,000,000	40:1	750,000
Total Liabilities	295,000,000h		$7,375,000

[1] S ages its accounts receivable and groups them into two categories—those outstanding for 30 days and those outstanding for 60 days.
[2] Translated the same as closing inventory under paragraph (c)(3)(iii).
[3] The cost of S's plant was incurred in several translation periods. Therefore, the dollar cost and dollar depreciation reflect several translation rates.
[4] S has a variety of equipment. Therefore, S's dollar basis represents the sum of the hyperinflationary cost of each, translated according to the exchange rate for the translation period incurred.

(iii) The DASTM gain of S for 1994 is computed as follows:

Net worth—1994		$6,871,627
Less—Net worth—1993		$3,246,495
Plus—1994 Dividends:.		
April	$149,254	
December	[1] 126,582	275,836
Less Operating Profit—1994		2,038,200
DASTM Gain		$1,862,768

[1] The exchange rates on the date of the April and December dividends were 33.5h:$1 and 39.5h:$1, respectively.

(iv) Thus, total profit = $2,038,200 + $1,862,768 = $3,900,968

(e) *Effect of DASTM gain or loss on gross income, taxable income, or earnings and profits*—(1) *In general.* For all purposes of subtitle A, the amount of DASTM gain or loss of a QBU determined under paragraph (d) of this section is taken into account by the QBU for purposes of determining the

amount of its gross income, taxable income or loss, earnings and profits (or deficit in earnings and profits), and, where necessary, particular items of income, expense or other amounts. DASTM gain or loss is allocated under one of two methods. Certain small QBUs may elect the small QBU DASTM allocation described in paragraph (e)(2) of this section. All other QBUs must use the 9-step procedure described in paragraph (e)(3) of this section.

(2) *Small QBU DASTM allocation*—(i) *Election threshold.* A taxpayer may elect to use the small QBU DASTM allocation described in paragraph (e)(2)(iv) of this section with respect to a QBU that has an adjusted basis in assets (translated as provided in paragraph (d)(5) of this section) of $10 million or less at the end of any taxable year. In calculating the $10 million threshold, a QBU shall be treated as owning all of the assets of each related QBU (as defined in paragraph (e)(2)(vi) of this section) having its residence (as defined in section 988(a)(3)(B)) in the QBU's country of residence (related same- country QBU). For this purpose, appropriate adjustment shall be made to eliminate the double counting of assets created in transactions between related QBUs resident in the same country. For example, assume QBU–1, resident in country X, sells inventory to related QBU–2, also resident in country X, in exchange for an account receivable. For purposes of determining the assets of QBU–1 under this paragraph (e)(2)(i), the taxpayer shall take into account either the inventory shown on the books of QBU–2 or QBU–1's receivable from QBU–2 (but not both).

(ii) *Consent to election.* The election of the small QBU DASTM allocation or subsequent application of the rules of paragraph (e)(3) of this section due to an increase in the adjusted basis of the QBU's assets shall be deemed to have been made with the consent of the Commissioner. Once the election under paragraph (e)(2)(iii) of this section is made, it shall apply for all years in which the adjusted basis of the assets of the QBU (and any related same-country QBU) is $10 million or less, unless revoked with the Commissioner's consent. If the adjusted basis of the assets of the QBU (and any related same-country QBU) exceeds $10 million at the end of any taxable year, the rules of paragraph (e)(3) of this section shall apply to that QBU (and any related same-country QBU) for such year and each subsequent year unless such QBU again qualifies, and applies for and obtains the Commissioner's consent, to use the small QBU DASTM allocation. However, if a QBU acquires assets with a principal purpose of avoiding the application of paragraph (e)(2)(iv) of this section, the Commissioner may disregard the acquisition of such assets.

(iii) *Manner of making election*—(A) *QBUs that are branches of United States persons.* For the first year in which this election is effective, in the case of a QBU branch of a United States person, a statement shall be attached to the United States person's timely filed Federal income tax return (taking extensions into account). The statement shall identify the QBU (or QBUs) for which the election is being made by describing its business and its country of residence, state the adjusted basis of the assets of the QBU (and any related same-country QBUs) to which the election applies, and include a statement that the election is being made pursuant to §1.985–3(e)(2).

(B) *Other QBUs.* In the case of a QBU other than one described in paragraph (e)(2)(iii)(A) of this section, an election must be made in the manner prescribed in §1.964–1. The statement filed with the Internal Revenue Service as required under §1.964–1 must include the information required under paragraph (e)(2)(iii)(A) of this section.

(iv) *Effect of election.* If a taxpayer elects under this paragraph (e)(2) to use the small QBU DASTM allocation, DASTM gain or loss, as determined under paragraph (d) of this section, of a small QBU shall be allocated ratably to all items of the QBU's gross income (determined prior to adjustment for DASTM gain or loss). Therefore, for purposes of the foreign tax credit, DASTM gain or loss shall be allocated on the basis of the relative amounts of gross income in each separate category as defined in §1.904–5(a)(1). In the case of a controlled foreign corporation (within the meaning of section 957 or 953(c)(1)(B)), for purposes of section 952,

DASTM gain or loss shall be allocated to subpart F income in a separate category in the same ratio that the gross subpart F income in that category for the taxable year bears to its total gross income in that category for the taxable year.

(v) *Conformity.* If a person (or a QBU of such person) makes an election under this paragraph (e)(2) to use the small QBU DASTM allocation, then each QBU of any related person (as defined in paragraph (e)(2)(vi) of this section) that satisfies the threshold requirement of paragraph (e)(2)(i) of this section (after application of the aggregation rule of paragraph (e)(2)(i) of this section) shall be deemed to have made the election.

(vi) *Related person.* The term related person means any person with a relationship to the QBU (or to the United States or foreign person of which the electing QBU is a part) that is defined in section 267(b) or section 707(b).

(3) *DASTM 9-step procedure*—(i) *Step 1—prepare balance sheets.* The taxpayer shall prepare an opening and a closing balance sheet for the QBU for each balance sheet period during the taxable year. The balance sheet period is the most frequent period for which balance sheet data are reasonably available (but in no event less frequently than quarterly). The balance sheet period may not be changed without the consent of the district director. The balance sheets must be prepared under the principles of paragraph (d)(2) of this section.

(ii) *Step 2—identify certain assets and liabilities.* The taxpayer shall identify each item on the balance sheet that is described in section 988(c)(1)(B) or (C) and that would have been translated under paragraph (d)(5) of this section into dollars at the exchange rate for the last translation period for the taxable year (or the exchange rate on the last day of the last translation period of the taxable year in the case of an accrued foreign income tax liability).

(iii) *Step 3—characterize the assets.* The taxpayer shall characterize and group the assets identified in paragraph (e)(3)(ii) of this section (Step 2) according to the source and the type of income that they generate, have generated, or may reasonably be expected to generate by applying the principles of §1.861–9T(g)(3) or its successor regulation (relating to characterization of assets for purposes of interest expense allocation). If a purpose for a taxpayer's business practices is to manipulate asset characterization or groupings, the district director may allocate or apportion DASTM gain or loss attributable to the assets. Thus, if a taxpayer that previously did not separately state interest on accounts receivable begins to impose an interest charge and a purpose for the change was to manipulate tax characterizations or groupings, then the district director may require that none of the DASTM gain or loss attributable to those receivables be allocated or apportioned to interest income.

(iv) *Step 4—determine DASTM gain or loss attributable to certain assets*—(A) *General rule.* The taxpayer shall determine the dollar amount of DASTM gain or loss attributable to assets in each group identified in paragraph (e)(3)(iii) of this section (Step 3) as follows:

$$\left[\left(\text{bb}+\text{eb}\right)\div 2\right]\times\left[\text{er}-\text{br}\right]$$

where

bb = the hyperinflationary currency adjusted basis of the assets in the group at the beginning of the balance sheet period.

eb = the hyperinflationary currency adjusted basis of the assets in the group at the end of the balance sheet period.

er = one dollar divided by the number of hyperinflationary currency units that equal one dollar at the end of the balance sheet period.

br = one dollar divided by the number of hyperinflationary currency units that equal one dollar at the beginning of the balance sheet period.

(B) *Weighting to prevent distortion.* If averaging the adjusted basis of assets in a group at the beginning and end of a balance sheet period results in an allocation of DASTM gain or loss that does not clearly reflect income, as might be the case in the event of a purchase or disposition of an asset that is not in the normal course of business, the taxpayer must use a weighting method that reflects the time the assets are held by the QBU during the translation period.

(C) *Example.* The provisions of this paragraph (e)(3)(iv) are illustrated by the following example:

Example. S is a foreign corporation that operates in the hyperinflationary currency ''h'' and computes its income or loss or earnings and profits under DASTM. S's adjusted basis in a group of assets described in section 988(c)(1)(B) or (C) that generate general limitation foreign source income (as characterized under paragraph (e)(3)(iii) of this section) at the beginning of the balance sheet period is 750,000h. S's basis in such assets at the end of the balance sheet period is 1,250,000h. The exchange rate at the beginning of the balance sheet period is $1 = 200h. The exchange rate at the end of the balance sheet period is $1 = 500h. The DASTM loss attributable to the assets described above is $3,000, determined as follows:

[(750,000h + 1,250,000h) ÷ 2] × [($1 ÷ 500h) − ($1 ÷ 200h)] = ($3000)

(v) *Step 5—adjust dollar gross income by DASTM gain or loss from assets.* The taxpayer shall adjust the dollar amount of the QBU's gross income (computed under paragraphs (b)(1) through (b)(3) of this section) generated by each group of assets characterized in paragraph (e)(3)(iii) of this section (Step 3) by the amount of DASTM gain or loss attributable to those assets computed under paragraph (e)(3)(iv) of this section (Step 4). Thus, if a group of assets, such as accounts receivable, generates both a category of income described in section 904(d)(1)(I) (relating to general limitation income) that is not foreign base company income as defined in section 954 and a DASTM loss under paragraph (e)(3)(iv) of this section (Step 4), the amount of the DASTM loss would reduce the amount of the QBU's gross income in that category. Similarly, if a group of assets, such as short-term bank deposits, generates both foreign personal holding company income that is passive income (described in sections 954(c)(1)(A) and 904(d)(1)(A)) and a DASTM loss under paragraph (e)(3)(iv) of this section (Step 4), the amount of the DASTM loss would reduce the amount of the QBU's foreign personal holding company income and passive income. See section 904(f) and the regulations thereunder in the case where that section would apply and DASTM loss attributable to a group of assets exceeds the income generated by such assets.

(vi) *Step 6—determine DASTM gain or loss attributable to liabilities*—(A) *General rule.* The taxpayer shall determine the dollar amount of DASTM gain or loss attributable to liabilities identified in paragraph (e)(3)(ii) of this section (Step 2), and described in paragraph (e)(3)(vi)(B) of this section as follows:

$$\left[\left(\mathrm{bl}+\mathrm{el}\right)\div 2\right]\times\left[\mathrm{br}-\mathrm{er}\right]$$

where

bl = the hyperinflationary currency amount of liabilities at the beginning of the balance sheet period.

el = the hyperinflationary currency amount of liabilities at the end of the balance sheet translation period.

br = one dollar divided by the number of hyperinflationary currency units that equal one dollar at the beginning of the balance sheet period.

er = one dollar divided by the number of hyperinflationary currency units that equal one dollar at the end of the balance sheet period.

(B) *Separate calculation.* The calculation shall be made separately for interest-bearing liabilities described in paragraph (e)(3)(vii) of this section (Step 7) and for each of the classes of non-interest-bearing liabilities described in paragraph (e)(3)(viii) of this section (Step 8).

(C) *Weighting to prevent distortion.* Where a distortion would result from averaging the amount of liabilities at the beginning and end of a balance sheet period, as might be the case where a taxpayer incurs or retires a substantial liability, the taxpayer must use a different method that more clearly reflects the average amount of liabilities weighted to reflect the time the liability was outstanding during the balance sheet period.

(vii) *Step 7—adjust dollar income and expense by DASTM gain or loss from interest-bearing liabilities*—(A) *In general.* The taxpayer shall apply the amount of DASTM gain on interest-bearing liabilities computed under paragraph (e)(3)(vi) of this section (Step 6) to reduce interest expense generated by such liabilities (*e.g.*, prior to the application of §1.861–9T or its successor regulation). To the extent DASTM gain on

such liabilities exceeds interest expense, it shall be sourced or otherwise classified in the same manner that interest expense is allocated and apportioned under §1.861–9T or its successor regulation. The amount of DASTM loss on interest-bearing liabilities computed under paragraph (e)(3)(vi) of this section (Step 6) shall be allocated and apportioned in the same manner that interest expense is allocated and apportioned under §1.861–9T or its successor regulation (without regard to the exceptions to fungibility in §1.861–10T or its successor regulation). For purposes of this section, an interest-bearing liability is a liability that requires payment of periodic interest (whether fixed or variable), has original issue discount, or would have interest imputed under subtitle A.

(B) *Allocation of DASTM gain or loss from interest-bearing liabilities that generate related person interest expense.* DASTM gain or loss from interest-bearing liabilities that generate related person interest expense (as provided in section 954(b)(5)) shall be allocated for purposes of subtitle A (including sections 904 and 952) in the same manner that the related person interest expense of that debt is required to be allocated under the rules of section 954(b)(5) and §1.904–5(c)(2).

(C) *Modified gross income method.* In applying the modified gross income method described in §1.861–9T(j) or its successor regulation, gross income shall be adjusted for any DASTM gain or loss from assets as provided in paragraph (e)(3)(v) of this section (Step 5) and any DASTM gain or loss with respect to short-term, non-interest-bearing trade payables as provided in paragraph (e)(3)(viii)(A) of this section.

(viii) *Step 8—adjust dollar income and expense by DASTM gain or loss from non-interest bearing liabilities*—(A) *Short-term, non-interest-bearing trade payables.* The taxpayer shall allocate DASTM gain or loss on short-term non-interest-bearing trade payables for purposes 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 taxpayer or qualified business unit (QBU) (including a section 987 QBU (as defined in §1.987–1(b)(2)) changing 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. Except as otherwise provided in this section, the adjustments shall be made on the last day of the last 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), (e)(2), and (e)(4)(iii) of this section is not subject to section 481 and, therefore, the full amount of the gain or loss must be included in income on the last day of the last taxable year ending before the year of change.

(b) *Step 1—Taking into account exchange gain or loss on certain section 988 transactions.* The taxpayer or QBU shall recognize or otherwise take into account for all purposes of the Internal Revenue Code the amount of any unrealized exchange gain or loss attributable to a section 988 transaction (as defined in section 988(c)(1)(A) through (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) (that is, 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.* Except as otherwise provided in this section, the new functional currency adjusted basis of property and the new functional currency amount of liabilities and any other relevant items (for example, items described in section 988(c)(1)(B)(iii)) shall equal the product of the old functional currency adjusted basis or liability and the new functional currency/old functional currency spot rate on the last day of the last taxable year ending before the year of change.

(d) *Step 3A—Additional adjustments that are necessary when a QBU changes functional currency*—(1) *QBU changing*

to a functional currency other than the owner's functional currency—(i) *Rule.* If a QBU changes its functional currency, and after the change the QBU is a section 987 QBU that is subject to §§1.987–1 through 1.987–11 pursuant to §1.987–1(b)(1), then the adjustments described in either paragraph (d)(1)(ii) or (d)(1)(iii) of this section shall be taken into account for purposes of section 987.

(ii) *QBU and the owner had different functional currencies prior to the change.* If the QBU and the owner of the QBU had different functional currencies prior to the change and as a result the QBU was a section 987 QBU prior to the change, then the adjustments described in paragraphs (d)(1)(ii)(A) and (d)(1)(ii)(B) of this section shall be taken into account.

(A) *Determining new historic rates.* The historic rate (as defined in §1.987–1(c)(3)) for the year of change and subsequent taxable years with respect to a historic item (as defined in §1.987–1(e)) reflected on the balance sheet of the section 987 QBU immediately prior to the year of change shall be equal to the historic rate prior to the year of change (that is, a rate that translates the section 987 QBU's old functional currency into the owner's functional currency) divided by the spot rate (as defined in §1.987–1(c)(1)) for translating an amount denominated in the section 987 QBU's old functional currency into the section 987 QBU's new functional currency on the last day of the last taxable year ending before the year of change. For example, if a taxpayer with a U.S. dollar (USD) functional currency owns a section 987 QBU that changes from a British pound (GBP) functional currency to a euro (EUR) functional currency, the historic rate for translating a specific historic item of this section 987 QBU from GBP to USD is 1.50, and the spot rate for translating GBP to EUR on the last day of the last taxable year before the change is 1.30, then the new historic rate for translating this historic item from EUR to USD is 1.15 (1.50/1.30).

(B) *Determining the owner functional currency net value of the QBU on the last day of the last taxable year ending before the year of change under §1.987–4(d)(1)(i)(B).* For purposes of determining the owner functional currency net value of the section 987 QBU on the last day of the last taxable year ending before the year of change under §1.987–4(d)(1)(i)(B) and §1.987–4(e), the section 987 QBU's marked items (as defined in §1.987–1(d)) shall be translated from the section 987 QBU's old functional currency into the owner's functional currency using the spot rate on the last day of the last taxable year ending before the year of change.

(iii) *QBU and the taxpayer had the same functional currency prior to the change.* If a QBU that has the same functional currency as a taxpayer changes its functional currency to a new functional currency that is different than the functional currency of the taxpayer, and as a result the taxpayer becomes an owner of a section 987 QBU (see §1.987–1), the taxpayer and section 987 QBU will become subject to section 987 for the year of change and subsequent years.

(2) *QBU changing to the owner's functional currency.* If a section 987 QBU changes its functional currency to the functional currency of its owner, the section 987 QBU shall be treated as if it terminated on the last day of the last taxable year ending before the year of change. See §§1.987–5 and 1.987–8 for the effect of a termination of a section 987 QBU that is subject to §§1.987–1 through 1.987–11.

(e) *Step 3B—Additional adjustments that are necessary when a taxpayer/owner changes functional currency*—(1) *Corporations.* The amount of a corporation's new functional currency earnings and profits and the amount of its new functional currency paid-in capital shall equal the old functional currency amounts of such items multiplied by the spot rate for translating an amount denominated in the corporation's old functional currency into the corporation's new functional currency on the last day of the last taxable year ending before the year of change. 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,

also shall be translated into the new functional currency at the spot rate.

(2) *Collateral consequences to a United States shareholder of a corporation changing to the United States dollar as its functional currency.* A United States shareholder (within the meaning of section 951(b) or section 953(c)(1)(A)) of a controlled foreign corporation (within the meaning of section 957 or section 953(c)(1)(B)) changing its functional currency to the dollar shall recognize foreign currency gain or loss computed under section 986(c) as if all previously taxed earnings and profits, if any, (including amounts attributable to pre-1987 taxable years that were translated from dollars into functional currency in the foreign corporation's first post-1986 taxable year) were distributed immediately prior to the change.

(3) *Taxpayers that are not corporations.* [Reserved]

(4) *Adjustments to a section 987 QBU's balance sheet and net accumulated unrecognized section 987 gain or loss when an owner changes functional currency*—(i) *Owner changing to a functional currency other than the section 987 QBU's functional currency.* If an owner of a section 987 QBU, subject to §§1.987–1 through 1.987–11 pursuant to §1.987–1(b)(1), changes to a functional currency other than the functional currency of the section 987 QBU, the adjustments described in paragraphs (e)(4)(i)(A) through (C) of this section shall be taken into account for purposes of section 987.

(A) *Determining new historic rates.* The historic rate (as defined in §1.987–1(c)(3)) for the year of change and subsequent taxable years with respect to a historic item (as defined in §1.987–1(e)) reflected on the balance sheet of the section 987 QBU immediately prior to the year of change shall be equal to the historic rate prior to the year of change (that is, a rate that translates the section 987 QBU's functional currency into the owner's old functional currency) divided by the spot rate for translating an amount denominated in the owner's new functional currency into the owner's old functional currency on the last day of the last taxable year ending before the year of change. For example, if a taxpayer that owns a section 987 QBU with a British pound functional currency changes from a U.S. dollar functional currency to a euro functional currency, and the historic rate for translating a specific item of the section 987 QBU from GBP to USD is 1.50 and the spot rate for translating EUR to USD on the last day of the last taxable year before the change is 1.10, then the new historic rate for translating this historic item from GBP to EUR is 1.36 (1.50/1.10).

(B) *Determining the owner functional currency net value of the section 987 QBU on the last day of the last taxable year ending before the year of change under §1.987–4(d)(1)(i)(B).* For purposes of determining the change in the owner functional currency net value of the section 987 QBU on the last day of the last taxable year preceding the year of change under §§1.987–4(d)(1)(i)(B) and 1.987–4(e), the section 987 QBU's marked items shall be translated into the owner's new functional currency at the spot rate on the last day of the last taxable year ending before the year of change.

(C) *Translation of net accumulated unrecognized section 987 gain or loss.* Any net accumulated unrecognized section 987 gain or loss determined under §1.987–4 shall be translated from the owner's old functional currency into the owner's new functional currency using the spot rate for translating an amount denominated in the owner's old functional currency into the owner's new functional currency on the last day of the last taxable year ending before the year of change.

(ii) *Taxpayer with the same functional currency as its QBU changing to a different functional currency.* If a taxpayer with the same functional currency as its QBU changes to a new functional currency and as a result the taxpayer becomes an owner of a section 987 QBU (see §1.987–1), the taxpayer and the section 987 QBU shall become subject to section 987 for the year of change and subsequent years.

(iii) *Owner changing to the same functional currency as the section 987 QBU.* If an owner changes its functional currency to the functional currency of its section 987 QBU, the section 987 QBU shall be treated as if it terminated on the last day of the last taxable year ending before the year of change. See

§§1.987–5 and 1.987–8 for the consequences of a termination of a section 987 QBU that is subject to §§1.987–1 through 1.987–11.

(f) *Example.* The provisions of this section are illustrated by the following example:

Example. (i) *Facts.* FC, a foreign corporation, owns all of the stock of DC, a domestic corporation. The Commissioner granted permission to change FC's functional currency from the British pound to the euro beginning January 1, 2020. The EUR/GBP exchange rate on December 31, 2019, is €1:£0.50.

(ii) *Determining new functional currency basis of property and liabilities.* The following table shows how FC must convert the items on its balance sheet from the British pound to the euro on December 31, 2019.

	GBP	EUR
Assets:		
Cash on hand	£40,000	€80,000
Accounts Receivable	10,000	20,000
Inventory	100,000	200,000
€100,000 Euro Bond (£100,000 historical basis)	50,000	100,000
Fixed assets:		
Property	200,000	400,000
Plant	500,000	1,000,000
Accumulated Depreciation	(200,000)	(400,000)
Equipment	1,000,000	2,000,000
Accumulated Depreciation	(400,000)	(800,000)
Total Assets	1,300,000	2,600,000
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

(iii) *Exchange gain or loss on section 988 transactions.* Under paragraph (b) of this section, FC will recognize a £50,000 loss (£50,000 current value minus £100,000 historical basis) on the Euro Bond resulting from the change in functional currency because, after the change, the Euro Bond will no longer be an asset denominated in a non-functional currency. The amount of FC's retained earnings on its December 31, 2019, balance sheet reflects the £50,000 loss on the Euro Bond.

(g) *Effective/applicability date.* Generally, this regulation shall apply to taxable years beginning on or after one year after the first day of the first taxable year following December 7, 2016. If pursuant to §1.987–11(b) a taxpayer applies §§1.987–1 through 1.987–11 beginning in a taxable year prior to the earliest taxable year described in §1.987–11(a), then this section shall apply to taxable years of the taxpayer beginning on or after the first day of such prior taxable year.

[T.D. 9794, 81 FR 88819, Dec. 8, 2016]

§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 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, 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). The 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)(ii)(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 of change as defined in §1.481–1(a)(1). The application of this paragraph may be illustrated by the following examples:

Example 1. A calendar year QBU that has not previously used DASTM operates in a country in which the functional currency of the country is hyperinflationary as defined under §1.985–1(b)(2)(ii)(D) for the QBU's 1999

tax year. The look-back period is the period from January 1, 1996 through December 31, 1998, the transition date is December 31, 1995, and the taxable year of change is the taxable year beginning January 1, 1999.

Example 2. A QBU that has not previously used DASTM with a taxable year ending June 30, operates in a country in which the functional currency of the country is hyperinflationary for the QBU's tax year beginning July 1, 1999 as defined under §1.985–1(b)(2)(ii)(D) (where the base period is the thirty-six calendar months immediately preceding the first day of the current calendar year 1999). The look-back period is the period from July 1, 1995 through June 30, 1999, the transition date is June 30, 1995, and the taxable year of change is the taxable year beginning July 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 amount of any loss, that was recognized with respect to any dollar denominated section 988 transactions entered into and terminated during the look-back period.

(3) *Opening balance sheet.* The opening balance sheet of a foreign corporation for the taxable year of change shall be determined as if the corporation had changed its functional currency to the dollar by applying §1.985–5(c) on the transition date and had translated its assets and liabilities acquired and incurred during the look-back period under §1.985–3.

(4) *Earnings and profits adjustments*—(i) *Pre-1987 accumulated profits.* The foreign income taxes and accumulated profits or deficits in accumulated profits of a foreign corporation that are attributable to taxable years beginning before January 1, 1987, as stated on the transition date, and that were maintained for purposes of section 902 in the old functional currency, shall be translated into dollars at the spot rate in effect on the transition date. The applicable accumulated profits shall be reduced on a last-in, first-out basis by the aggregate dollar amount (translated from functional currency in accordance with the rules of section 989(b)) attributable to earnings and profits that were distributed (or treated as distributed) during the look-back period to the extent such amounts distributed exceed the earnings and profits calculated under (b)(4)(ii) or (b)(4)(iii), as applicable. See §1.902–1(b)(2)(ii). Once translated into dollars, these pre-1987 taxes and accumulated profits or deficits in accumulated profits shall (absent a change in functional currency) remain in dollars for all federal income tax purposes.

(ii) *Post-1986 undistributed earnings of a CFC.* In the case of a controlled foreign corporation (within the meaning of section 957 or section 953(c)(1)(B))(CFC) or a foreign corporation subject to the rules of §1.904–6(a)(2), the corporation's post-1986 undistributed earnings in each separate category as defined in §1.904–5(a)(1) as of the first day of the taxable year of change (and prior to adjustment under

paragraph (c)(1) of this section) shall equal the sum of—

(A) The corporation's post-1986 undistributed earnings and profits (or deficit in earnings and profits) in each separate category as defined in §1.904–5(a)(1) as stated on the transition date translated into dollars at the spot rate in effect on the transition date; and

(B) The sum of the earnings and profits (or deficit in earnings and profits) in each separate category determined under §1.985–3 for each post-transition date taxable year prior to the taxable year of change.

Such amount shall be reduced by the aggregate dollar amount (translated from functional currency in accordance with the rules of section 989(b)) attributable to earnings and profits that were distributed (or treated as distributed) during the look-back period out of post-1986 earnings and profits in such separate category. For purposes of applying this paragraph (b)(4)(ii)(B), the opening balance sheet for calculating earnings and profits under §1.985–3 for the first post-transition year shall be translated into dollars pursuant to §1.985–5(c).

(iii) *Post-1986 undistributed earnings of other foreign corporations.* In the case of a foreign corporation that is not a CFC or subject to the rules of §1.904–6(a)(2), the corporation's post-1986 undistributed earnings shall equal the sum of—

(A) The corporation's post-1986 undistributed earnings (or deficit) on the transition date translated into dollars at the spot rate in effect on the transition date; and

(B) The sum of the earnings and profits (or deficit in earnings and profits) determined under §1.985–3 for each post-transition date taxable year (or such later year determined under section 902(c)(3)(A)) prior to the taxable year of change.

Such amount shall be reduced by the aggregate dollar amount (translated from functional currency in accordance with the rules of section 989(b)) that was distributed (or treated as distributed) during the look-back period out of post-1986 earnings and profits. For purposes of applying this paragraph (b)(4)(iii)(B), the opening balance sheet for calculating earnings and profits under §1.985–3 for the first post-transition year shall be translated into dollars pursuant to §1.985–5(c).

(c) *United States shareholders of controlled foreign corporations*—(1) *In general.* A United States shareholder (within the meaning of section 951(b) or section 953(c)(1)(B)) of a CFC that changes to DASTM shall make the adjustments set forth in paragraphs (c)(2) through (5) of this section on the first day of the taxable year of change. Adjustments under this section shall be taken into account by the shareholder (or such shareholder s successor in interest) ratably over four taxable years beginning with the taxable year of change. Similar rules shall apply in determining adjustments to income of United States persons who have made an election under section 1295 to treat a passive foreign investment company as a qualified electing fund.

(2) *Treatment under subpart F of income recognized on section 988 transactions.* The character of amounts taken into account under paragraph (b)(2) of this section for purposes of sections 951 through 964, shall be determined on the transition date and to the extent characterized as subpart F income shall be taken into account in accordance with the rules of paragraph (c)(1) of this section. Such amounts shall retain their character for all federal income tax purposes (including sections 902, 959, 960, 961, 1248, and 6038).

(3) *Recognition of foreign currency gain or loss on previously taxed earnings and profits on the transition date.* Gain or loss is recognized under section 986(c) as if all previously taxed earnings and profits as determined on the transition date, if any, were distributed on such date. Such gain or loss shall be reduced by any foreign currency gain and increased by any foreign currency loss that was recognized under section 986(c) with respect to distributions of previously taxed earnings and profits during the look-back period. Such amount shall be characterized in accordance with section 986(c) and taken into account in accordance with the rules of paragraph (c)(1) of this section.

(4) *Subpart F income adjustment.* Subpart F income in a separate category shall be determined under §1.985–3 for each look-back year. For this purpose, the opening DASTM balance sheet

shall be determined under §1.985–5. The sum of the difference (positive or negative) between the amount computed pursuant to §1.985–3 and amount that was included in income for each year shall be taken into account in the taxable year of change pursuant to paragraph (c)(1) of this section. Such amounts shall retain their character for all federal income tax purposes (including sections 902, 959, 960, 961, 1248, and 6038). For rules applicable if an adjustment under this section results in a loss for the taxable year in a separate category, see section 904(f) and the regulations thereunder. The amount of previously taxed earnings and profits as determined under section 959(c)(2) shall be adjusted (positively or negatively) by the amount taken into account under this paragraph (c)(4) as of the first day of the taxable year of change.

(5) *Foreign tax credit.* A United States shareholder of a CFC shall compute an amount of foreign taxes deemed paid under section 960 with respect to any positive adjustments determined under paragraph (c) of this section. The amount of foreign tax deemed paid shall be computed with reference to the full amount of the adjustment and to the post-1986 undistributed earnings determined under paragraph (b)(4) (i) and (ii) of this section and the post-1986 foreign income taxes of the CFC on the first day of the taxable year of change (i.e., without taking into account earnings and taxes for the taxable year of change). For purposes of section 960, the associated taxes in each separate category shall be allocated pro rata among, and deemed paid in, the shareholder's taxable years in which the income is taken into account. (No adjustment to foreign taxes deemed paid in prior years is required solely by reason of a negative adjustment to income under paragraph (c)(1) of this section).

(d) *QBU branches*—(1) *In general.* In the case of a QBU branch, the taxpayer shall make the adjustments set forth in paragraphs (d)(2) through (d)(4) of this section. Adjustments under this section shall be taken into account by the taxpayer ratably over four taxable years beginning with 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 QBU branch shall adjust income 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 QBU branch 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 QBU branch 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 (d)(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 QBU branch shall reduce income by the amount of any gain, and increase income by the amount of any loss, that was recognized with respect to any dollar denominated section 988 transactions entered into and terminated during the look-back period.

(3) *Deemed termination income adjustment.* The taxpayer shall realize gain or loss attributable to the QBU branch's equity pool (as stated on the transition date) under the principles of section 987, computed as if the branch terminated on the transition date. Such amount shall be reduced by section 987 gain and increased by section 987 loss that was recognized by such taxpayer with respect to remittances during the look-back period.

(4) *Branch income adjustment.* Branch income in a separate category shall be determined under §1.985–3 for each look-back year. For this purpose, the opening DASTM balance sheet shall be determined under §1.985–5. The sum of

the difference (positive or negative) between the amount computed pursuant to §1.985–3 and amount taken into account for each year shall be taken into account in the taxable year of change pursuant to paragraph (d)(1) of this section. Such amounts shall retain their character for all federal income tax purposes.

(5) *Opening balance sheet.* The opening balance sheet of a QBU branch for the taxable year of change shall be determined as if the branch had changed its functional currency to the dollar by applying §1.985–5(c) on the transition date and had translated its assets and liabilities acquired and incurred during the look-back period under §1.985–3.

(e) *Effective date.* This section is effective for taxable years beginning after April 6, 1998. However, a taxpayer may choose to apply this section to all open taxable years beginning after December 31, 1986, provided each person, and each QBU branch of a person, that is related (within the meaning of §1.985–2(d)(3)) to the taxpayer also applies this section.

[T.D. 8765, 63 FR 10774, Mar. 5, 1998]

§1.985–8 Special rules applicable to the European Monetary Union (conversion to euro).

(a) *Definitions*—(1) *Legacy currency.* A legacy currency is the former currency of a Member State of the European Community which is substituted for the euro in accordance with the Treaty establishing the European Community signed February 7, 1992. The term legacy currency shall also include the European Currency Unit.

(2) *Conversion rate.* The conversion rate is the rate at which the euro is substituted for a legacy currency.

(b) *Operative rules*—(1) *Initial adoption.* A QBU (as defined in §1.989(a)–1(b)) whose first taxable year begins after the euro has been substituted for a legacy currency may not adopt a legacy currency as its functional currency.

(2) *QBU with a legacy currency as its functional currency*—(i) *Required change.* A QBU with a legacy currency as its functional currency is required to change its functional currency to the euro beginning the first day of the first taxable year—

(A) That begins on or after the day that the euro is substituted for that legacy currency (in accordance with the Treaty on European Union); and

(B) In which the QBU begins to maintain its books and records (as described in §1.989(a)–1(d)) in the euro.

(ii) Notwithstanding paragraph (b)(2)(i) of this section, a QBU with a legacy currency as its functional currency is required to change its functional currency to the euro no later than the last taxable year beginning on or before the first day such legacy currency is no longer valid legal tender.

(3) *QBU with a non-legacy currency as its functional currency*—(i) *In general.* A QBU with a non-legacy currency as its functional currency may change its functional currency to the euro pursuant to this §1.985–8 if—

(A) Under the rules set forth in §1.985–1(c), the euro is the currency of the economic environment in which a significant part of the QBU's activities are conducted;

(B) After conversion, the QBU maintains its books and records (as described in §1.989(a)–1(d)) in the euro; and

(C) The QBU is not required to use the dollar as its functional currency under §1.985–1(b).

(ii) *Time period for change.* A QBU with a non-legacy currency as its functional currency may change its functional currency to the euro under this section only if it does so within the period set forth in paragraph (b)(2) of this section as if the functional currency of the QBU was a legacy currency.

(4) *Consent of Commissioner.* A change made pursuant to paragraph (b) of this section shall be deemed to be made with the consent of the Commissioner for purposes of §1.985–4. A QBU changing its functional currency to the euro pursuant to paragraph (b)(2) of this section must make adjustments as provided in paragraph (c) of this section. A QBU changing its functional currency to the euro pursuant to paragraph (b)(3) must make adjustments as provided in §1.985–5.

(5) *Statement to file upon change.* With respect to a QBU that changes its functional currency to the euro under paragraph (b) of this section, an affected taxpayer shall attach to its return for

the taxable year of change a statement that includes the following: ''TAXPAYER CERTIFIES THAT A QBU OF THE TAXPAYER HAS CHANGED ITS FUNCTIONAL CURRENCY TO THE EURO PURSUANT TO TREAS. REG. §1.985–8.'' For purposes of this paragraph (b)(5), an affected taxpayer shall be in the case where the QBU is: a QBU of an individual U.S. resident (as a result of the activities of such individual), the individual; a QBU branch of a U.S. corporation, the corporation; a controlled foreign corporation (as described in section 957)(or QBU branch thereof), each United States shareholder (as described in section 951(b)); a partnership, each partner separately; a noncontrolled section 902 corporation (as described in section 904(d)(2)(E)) (or branch thereof), each domestic shareholder as described in §1.902–1(a)(1); or a trust or estate, the fiduciary of such trust or estate.

(c) *Adjustments required when a QBU changes its functional currency from a legacy currency to the euro pursuant to paragraph (b)(2) of this section*—(1) *In general.* A QBU that changes its functional currency from a legacy currency to the euro pursuant to paragraph (b)(2) of this section must make the adjustments described in paragraphs (c)(2) through (5) of this section. Section 1.985–5 shall not apply.

(2) *Determining the euro basis of property and the euro amount of liabilities and other relevant items.* The euro basis in property and the euro amount of liabilities and other relevant items shall equal the product of the legacy functional currency adjusted basis or amount of liabilities multiplied by the applicable conversion rate.

(3) *Taking into account exchange gain or loss on legacy currency section 988 transactions*—(i) *In general.* Except as provided in paragraphs (c)(3)(iii) and (iv) of this section, a legacy currency denominated section 988 transaction (determined after applying section 988(d)) outstanding on the last day of the taxable year immediately prior to the year of change shall continue to be treated as a section 988 transaction after the change and the principles of section 988 shall apply.

(ii) *Examples.* The application of this paragraph (c)(3) may be illustrated by the following examples:

Example 1. X, a calendar year QBU on the cash method of accounting, uses the deutschmark as its functional currency. X is not described in section 1281(b). On July 1, 1998, X converts 10,000 deutschmarks (DM) into Dutch guilders (fl) at the spot rate of fl1 = DM1 and loans the 10,000 guilders to Y (an unrelated party) for one year at a rate of 10% with principal and interest to be paid on June 30, 1999. On January 1, 1999, X changes its functional currency to the euro pursuant to this section. Assume that the euro/deutschmark conversion rate is set by the European Council at €1= DM2. Assume further that the euro/guilder conversion rate is set at €1 = fl2.25. Accordingly, under the terms of the note, on June 30, 1999, X will receive €4444.44 (fl10,000/2.25) of principal and €444.44 (fl1,000/2.25) of interest. Pursuant to this paragraph (c)(3), X will realize an exchange loss on the principal computed under the principles of §1.988–2(b)(5). For this purpose, the exchange rate used under §1.988–2(b)(5)(i) shall be the guilder/euro conversion rate. The amount under §1.988–2(b)(5)(ii) is determined by translating the fl10,000 at the guilder/deutschmark spot rate on July 1, 1998, and translating that deutschmark amount into euros at the deutschmark/euro conversion rate. Thus, X will compute an exchange loss for 1999 of €555.56 determined as follows: [€4444.44 (fl10,000/2.25)–5000 ((fl10,000/1)/2) = −€555.56]. Pursuant to this paragraph (c)(3), the character and source of the loss are determined pursuant to section 988 and regulations thereunder. Because X uses the cash method of accounting for the interest on this debt instrument, X does not realize exchange gain or loss on the receipt of that interest.

Example 2. (i) X, a calendar year QBU on the accrual method of accounting, uses the deutschmark as its functional currency. On February 1, 1998, X converts 12,000 deutschmarks into Dutch guilders at the spot rate of fl1 = DM1 and loans the 12,000 guilders to Y (an unrelated party) for one year at a rate of 10% with principal and interest to be paid on January 31, 1999. In addition, assume the average rate (deutschmark/guilder) for the period from February 1, 1998, through December 31, 1998 is fl1.07 = DM1. Pursuant to §1.988–2(b)(2)(ii)(C), X will accrue eleven months of interest on the note and recognize interest income of DM1028.04 (fl1100/1.07) in the 1998 taxable year.

(ii) On January 1, 1999, the euro will replace the deutschmark as the national currency of Germany pursuant to the Treaty on European Union signed February 7, 1992. Assume that on January 1, 1999, X changes its functional currency to the euro pursuant to this section. Assume that the euro/

deutschmark conversion rate is set by the European Council at €1 = DM2. Assume further that the euro/guilder conversion rate is set at €1 = fl2.25. In 1999, X will accrue one month of interest equal to €44.44 (fl100/2.25). On January 31, 1999, pursuant to the note, X will receive interest denominated in euros of €533.33 (fl1200/2.25). Pursuant to this paragraph (c)(3), X will realize an exchange loss in the 1999 taxable year with respect to accrued interest computed under the principles of §1.988–2(b)(3). For this purpose, the exchange rate used under §1.988–2(b)(3)(i) is the guilder/euro conversion rate and the exchange rate used under §1.988–2(b)(3)(ii) is the deutschmark/euro conversion rate. Thus, with respect to the interest accrued in 1998, X will realize exchange loss of €25.13 under §1.988–2(b)(3) as follows: [€488.89 (fl1100/2.25) − €514.02 (DM1028.04/2) = −€25.13]. With respect to the one month of interest accrued in 1999, X will realize no exchange gain or loss since the exchange rate when the interest accrued and the spot rate on the payment date are the same.

(iii) X will realize exchange loss of €666.67 on repayment of the loan principal computed in the same manner as in Example 1 [€5333.33 (fl12,000/2.25) − €6000 fl12,000/1)/2)]. The losses with respect to accrued interest and principal are characterized and sourced under the rules of section 988.

(iii) *Special rule for legacy nonfunctional currency*. The QBU shall realize or otherwise take into account for all purposes of the Internal Revenue Code the amount of any unrealized exchange gain or loss attributable to nonfunctional currency (as described in section 988(c)(1)(C)(ii)) that is denominated in a legacy currency as if the currency were disposed of on the last day of the taxable year immediately prior to the year of change. The character and source of the gain or loss are determined under section 988.

(iv) *Legacy currency denominated accounts receivable and payable*—(A) *In general*. A QBU may elect to realize or otherwise take into account for all purposes of the Internal Revenue Code the amount of any unrealized exchange gain or loss attributable to a legacy currency denominated item described in section 988(c)(1)(B)(ii) as if the item were terminated on the last day of the taxable year ending prior to the year of change.

(B) *Time and manner of election*. With respect to a QBU that makes an election described in paragraph (c)(3)(iv)(A) of this section, an affected taxpayer (as described in paragraph (b)(5) of this section) shall attach a statement to its tax return for the taxable year ending immediately prior to the year of change which includes the following: ''TAXPAYER CERTIFIES THAT A QBU OF THE TAXPAYER HAS ELECTED TO REALIZE CURRENCY GAIN OR LOSS ON LEGACY CURRENCY DENOMINATED ACCOUNTS RECEIVABLE AND PAYABLE UPON CHANGE OF FUNCTIONAL CURRENCY TO THE EURO.'' A QBU making the election must do so for all legacy currency denominated items described in section 988(c)(1)(B)(ii).

(4) *Adjustments when a branch changes its functional currency to the euro*—(i) *Branch changing from a legacy currency to the euro in a taxable year during which taxpayer's functional currency is other than the euro*. If a branch changes its functional currency from a legacy currency to the euro for a taxable year during which the taxpayer's functional currency is other than the euro, the branch's euro equity pool shall equal the product of the legacy currency amount of the equity pool multiplied by the applicable conversion rate. No adjustment to the basis pool is required.

(ii) *Branch changing from a legacy currency to the euro in a taxable year during which taxpayer's functional currency is the euro*. If a branch changes its functional currency from a legacy currency to the euro for a taxable year during which the taxpayer's functional currency is the euro, the taxpayer shall realize gain or loss attributable to the branch's equity pool under the principles of section 987, computed as if the branch terminated on the last day prior to the year of change. Adjustments under this paragraph (c)(4)(ii) shall be taken into account by the taxpayer ratably over four taxable years beginning with the taxable year of change.

(5) *Adjustments to a branch's accounts when a taxpayer changes to the euro*—(i) *Taxpayer changing from a legacy currency to the euro in a taxable year during which a branch's functional currency is other than the euro*. If a taxpayer changes its functional currency to the euro for a taxable year during which the functional currency of a branch of

the taxpayer is other than the euro, the basis pool shall equal the product of the legacy currency amount of the basis pool multiplied by the applicable conversion rate. No adjustment to the equity pool is required.

(ii) *Taxpayer changing from a legacy currency to the euro in a taxable year during which a branch's functional currency is the euro.* If a taxpayer changes its functional currency from a legacy currency to the euro for a taxable year during which the functional currency of a branch of the taxpayer is the euro, the taxpayer shall take into account gain or loss as determined under paragraph (c)(4)(ii) of this section.

(6) *Additional adjustments that are necessary when a corporation changes its functional currency to the euro.* The amount of a corporation's euro currency earnings and profits and the amount of its euro paid-in capital shall equal the product of the legacy currency amounts of these items multiplied by the applicable conversion rate. 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, also shall be translated into the euro at the conversion rate.

(d) *Treatment of legacy currency section 988 transactions with respect to a QBU that has the euro as its functional currency*—(1) *In general.* This §1.985–8(d) applies to a QBU that has the euro as its functional currency and that holds a section 988 transaction denominated in, or determined by reference to, a currency that is substituted by the euro. For example, this paragraph (d) will apply to a German QBU with the euro as its functional currency if the QBU is holding Country X currency or other section 988 transactions denominated in such currency on the day in the year 2005 when the euro is substituted for the Country X currency.

(2) *Principles of paragraph (c)(3) of this section shall apply.* With respect to a QBU described in paragraph (d) of this section, the principles of paragraph (c)(3) of this section shall apply. For example, if a German QBU with the euro as its functional currency is holding a Country X currency denominated debt instrument on the day in the year 2005 when the euro is substituted for the Country X currency, the instrument shall continue to be treated as a section 988 transaction pursuant to the principles of paragraph (c)(3)(i) of this section. However, if such QBU holds Country X currency, the QBU shall take into account any unrealized exchange gain or loss pursuant to the principles of paragraph (c)(3)(iii) of this section as if the currency was disposed of on the day prior to the day the euro is substituted for the Country X currency. Similarly, if the QBU makes an election under the principles of paragraph (c)(3)(iv) of this section, the QBU shall take into account for all purposes of the Internal Revenue Code the amount of any unrealized exchange gain or loss attributable to a legacy currency denominated item described in section 988(c)(1)(B)(ii) as if the item were terminated on the day prior to the day the euro is substituted for the Country X currency.

(e) *Effective date.* This section applies to tax years ending after July 29, 1998.

[T.D. 8927, 66 FR 2216, Jan. 11, 2001; T.D. 8927, 66 FR 21447, Apr. 30, 2001]

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(4) Step 4: Decrease the amount determined in steps 1 through 3 by the amount of liabilities transferred from the section 987 QBU to the owner.
(5) Step 5: Increase the amount determined in steps 1 through 4 by the amount of liabilities transferred from the owner to the section 987 QBU.
(6) Step 6: Decrease or increase the amount determined in steps 1 through 5 by the section 987 taxable income or loss, respectively, of the section 987 QBU for the taxable year.
(7) Step 7: Increase the amount determined in steps 1 through 6 by any expenses that are not deductible in computing the section 987 taxable income or loss of the section 987 QBU for the taxable year.
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§ 1.987–12 Deferral of section 987 gain or loss.

(a) through (h) [Reserved]

[T.D. 9794, 81 FR 88821, Dec. 8, 2016, as amended by T.D. 9795, 81 FR 88867, Dec. 8, 2016]

§ 1.987–1 Scope, definitions, and special rules.

(a) *In general.* These regulations under section 987 (§§ 1.987–1 through 1.987–11) provide rules for determining the taxable income or loss of a taxpayer with respect to a section 987 QBU (as defined in paragraph (b)(2) of this section). Further, these regulations provide rules for determining the timing, amount, character, and source of section 987 gain or loss recognized with respect to a section 987 QBU. This section addresses the scope of these regulations and provides certain definitions, special rules, and the procedures for making the elections provided for in the regulations. Section 1.987–2 provides rules for attributing assets and liabilities and items of income, gain, deduction, and loss to an eligible QBU. It also provides rules regarding the translation of items transferred to a section 987 QBU. Section 1.987–3 provides rules for determining and translating the taxable income or loss of a taxpayer with respect to a section 987 QBU. Section 1.987–4 provides rules for determining net unrecognized section 987 gain or loss. Section 1.987–5 provides rules regarding the recognition of section 987 gain or loss. It also provides rules for determining an owner's basis in assets transferred from a section 987 QBU. Section 1.987–6 provides rules regarding the character and source of section 987 gain or loss. Section 1.987–7 provides rules with respect to section 987 aggregate partnerships. Section 1.987–8 provides rules regarding the termination of a section 987 QBU. Section 1.987–9 provides rules regarding the recordkeeping required under section 987. Section 1.987–10 provides transition rules. Section 1.987–11 provides the effective/applicability date of these regulations.

(b) *Scope of section 987 and definitions*—(1) *Taxpayers subject to section 987*—(i) *In general.* Except as provided in paragraphs (b)(1)(ii) and (b)(6) of this section, an individual or corporation is

subject to these regulations under section 987 if such person is an owner (as defined in paragraph (b)(4) of this section) of an eligible QBU (as defined in paragraph (b)(3) of this section) that is a section 987 QBU (as defined in paragraph (b)(2) of this section).

(ii) *Inapplicability to certain entities.* Except as otherwise provided in paragraph (b)(1)(iii) of this section, these regulations under section 987 do not apply to specified entities described in this paragraph (b)(1)(ii), other than specified entities that engage in transactions primarily with related persons within the meaning of section 267(b) or section 707(b) that are not themselves specified entities. For this purpose, specified entities means banks, insurance companies, leasing companies, finance coordination centers, regulated investment companies, or real estate investment trusts. Further, except as otherwise provided in paragraph (b)(1)(iii) of this section, these regulations do not apply to trusts, estates, S corporations, and partnerships other than section 987 aggregate partnerships (as defined in paragraph (b)(5) of this section).

(iii) [Reserved]. For further guidance, see §1.987–1T(b)(1)(iii).

(2) *Definition of a section 987 QBU*—(i) *In general.* A section 987 QBU is an eligible QBU (as defined in paragraph (b)(3) of this section) that has a functional currency different from its direct owner. A section 987 QBU also includes the assets and liabilities of an eligible QBU that are considered under paragraph (b)(5)(ii) of this section to be a section 987 QBU of a partner in a section 987 aggregate partnership (as defined in paragraph (b)(5) of this section). A section 987 QBU will continue to be treated as a section 987 QBU of the owner until a sale or other termination of the section 987 QBU as described in §1.987–8(b). Except as provided in paragraph (b)(2)(ii) of this section, the functional currency of an eligible QBU shall be determined under §1.985–1.

(ii) *Section 987 QBU grouping election*—(A) *In general.* Except as provided in paragraph (b)(2)(ii)(B) of this section, an owner may elect to treat, solely for purposes of section 987, all section 987 QBUs with the same functional currency that it directly owns as a single section 987 QBU.

(B) *Special grouping rules for section 987 QBUs owned indirectly through a section 987 aggregate partnership.* An owner may elect to treat all section 987 QBUs with the same functional currency owned indirectly through a single section 987 aggregate partnership (as defined in paragraph (b)(5) of this section) as a single section 987 QBU. An owner may not treat section 987 QBUs as a single section 987 QBU if such QBUs are owned indirectly through different section 987 aggregate partnerships. Additionally, an owner may not treat section 987 QBUs that are owned both directly and indirectly through a section 987 aggregate partnership as a single section 987 QBU.

(3) *Definition of an eligible QBU*—(i) *In general.* Eligible QBU means a qualified business unit, as defined in §1.989(a)–1, that is not subject to the Dollar Approximate Separate Transactions Method rules of §1.985–3.

(ii) *Exclusion of certain entities.* A corporation, partnership, trust, estate, or entity disregarded as an entity separate from its owner for Federal income tax purposes as described in §301.7701–2(c)(2) (hereafter referred to as a ''DE'') is not an eligible QBU (even though such an entity may have activities that qualify as an eligible QBU).

(4) *Definition of owner.* For purposes of these regulations under section 987, an owner is any person having direct or indirect ownership in an eligible QBU. Only an individual or corporation may be an owner of an eligible QBU. The term *owner* for section 987 purposes does not include an eligible QBU. For example, a section 987 QBU (QBU1) is not an owner of another section 987 QBU (QBU2) even if QBU1 owns the stock of QBU2.

(i) *Direct ownership.* An individual or a corporation is a direct owner of an eligible QBU if the individual or corporation is the owner for Federal income tax purposes of the assets and liabilities of the eligible QBU.

(ii) *Indirect ownership.* An individual or corporation that is a partner in a section 987 aggregate partnership (as defined in paragraph (b)(5) of this section) and is allocated, under §1.987–7,

all or a portion of the assets and liabilities of an eligible QBU of such partnership is an indirect owner of the eligible QBU.

(5) *Section 987 aggregate partnership*—(i) *In general.* A partnership is a section 987 aggregate partnership if:

(A) All of the interests in partnership capital and profits are owned, directly or indirectly, by persons related to each other within the meaning of sections 267(b) or 707(b). For purposes of this paragraph (b)(5), ownership of an interest in partnership capital or profits is determined in accordance with the rules for constructive ownership provided in section 267(c), other than section 267(c)(3); and

(B) The partnership has one or more eligible QBUs, at least one of which would be a section 987 QBU with respect to a partner if the partner owned the eligible QBU directly.

(ii) *Section 987 QBU of a partner.* The assets and liabilities of an eligible QBU owned through a section 987 aggregate partnership and allocated to a partner under the principles of §1.987–7(b) are considered to be a section 987 QBU of such partner if the partner has a functional currency different from that of the eligible QBU.

(iii) *Certain unrelated partners disregarded.* In determining whether a partnership is a section 987 aggregate partnership, the interest of an unrelated partner shall be disregarded if the acquisition of such interest has as a principal purpose the avoidance of this paragraph (b)(5).

(6) [Reserved]. For further guidance, see §1.987–1T(b)(6).

(7) *Examples illustrating paragraph (b) of this section.* The following examples illustrate the principles of paragraph (b) of this section. U.S. Corp is a domestic corporation, has the U.S. dollar as its functional currency, and uses the calendar year as its taxable year. Except as otherwise provided, (i) Business A and Business B are eligible QBUs and have the euro and the Japanese yen, respectively, as their functional currencies and (ii) DE1 and DE2 are DEs, have no assets or liabilities, and conduct no activities.

Example 1. (i) *Facts.* U.S. Corp owns Business A and all of the interests in DE1. DE1 maintains a separate set of books and records that are kept in British pounds. DE1 owns pounds and all of the stock of a foreign corporation, FC. DE1 is liable to a lender on a pound-denominated obligation that was incurred to acquire the stock of FC. The FC stock, the pounds, and the liability incurred to acquire the FC stock are recorded on DE1's separate books and records. DE1 has no other assets or liabilities and conducts no activities (other than holding the FC stock and servicing its liability).

(ii) *Analysis.* (A) Pursuant to paragraph (b)(4)(i) of this section, U.S. Corp is the direct owner of Business A because it is the owner of the assets and liabilities of Business A. Because Business A is an eligible QBU with a functional currency that is different from the functional currency of its owner, U.S. Corp, Business A is a section 987 QBU (as defined in paragraph (b)(2) of this section). As a result, U.S. Corp and its section 987 QBU, Business A, are subject to section 987.

(B) Holding the stock of FC and pounds and servicing a liability does not constitute a trade or business within the meaning of §1.989(a)–1(c). Because the activities of DE1 do not constitute a trade or business within the meaning of §1.989(a)–1(c), such activities are not an eligible QBU. In addition, pursuant to paragraph (b)(3)(ii) of this section, DE1 itself is not an eligible QBU. As a result, neither DE1 nor its activities qualify as a section 987 QBU of U.S. Corp. Therefore, neither the activities of DE1 nor DE1 itself is subject to section 987. For the foreign currency treatment of payments on DE1's pound-denominated liability, see §1.988–2(b).

Example 2. (i) *Facts.* U.S. Corp owns all of the interests in DE1. DE1 owns Business A and all of the interests in DE2. The only activities of DE1 are Business A activities and holding the interests in DE2. DE2 owns Business B and Business C. For purposes of this example, Business B does not maintain books and records that are separate from its owner, DE2. Instead, the activities of Business B are reflected on the books and records of DE2, which are maintained in Japanese yen. In addition, Business C has the U.S. dollar as its functional currency, maintains books and records that are separate from the books and records of DE2, and is an eligible QBU.

(ii) *Analysis.* (A) Pursuant to paragraph (b)(3)(ii) of this section, DE1 and DE2 are not eligible QBUs. Pursuant to paragraph (b)(3)(i) of this section, the Business B and Business C activities of DE2, and the Business A activities of DE1, are eligible QBUs. Moreover, pursuant to paragraph (b)(4) of this section, DE1 is not the owner of the Business A, Business B, or Business C eligible QBUs, and DE2 is not the owner of the Business B or Business C eligible QBUs. Instead, pursuant to paragraph (b)(4)(i) of this section, U.S. Corp is the direct owner of the

Business A, Business B, and Business C eligible QBUs.

(B) Because Business A and Business B are eligible QBUs with functional currencies that are different than the functional currency of U.S. Corp, Business A and Business B are section 987 QBUs (as defined in paragraph (b)(2) of this section).

(C) The Business C eligible QBU has the same functional currency as U.S. Corp. Therefore, the Business C eligible QBU is not a section 987 QBU.

Example 3. (i) *Facts.* U.S. Corp owns all of the interests in DE1. DE1 owns Business A and Business B. For purposes of this example, assume Business B has the euro as its functional currency.

(ii) *Analysis.* (A) Pursuant to paragraph (b)(3)(ii) of this section, DE1 is not an eligible QBU. Moreover, pursuant to paragraph (b)(4) of this section, DE1 is not the owner of the Business A or Business B eligible QBUs. Instead, pursuant to paragraph (b)(4)(i) of this section, U.S. Corp is the direct owner of the Business A and Business B eligible QBUs.

(B) Business A and Business B constitute two separate eligible QBUs, each with the euro as its functional currency. Accordingly, Business A and Business B are section 987 QBUs of U.S. Corp. U.S. Corp may elect to treat Business A and Business B as a single section 987 QBU pursuant to paragraph (b)(2)(ii)(A) of this section. If such election is made, pursuant to paragraph (b)(4)(i) of this section, U.S. Corp would be the direct owner of the Business AB section 987 QBU that would include the activities of both the Business A section 987 QBU and the Business B section 987 QBU. In addition, pursuant to paragraph (b)(4) of this section, DE1 would not be treated as the owner of the Business AB section 987 QBU.

Example 4. (i) *Facts.* U.S. Corp owns all the stock of Y, a U.S. corporation that is a member of U.S. Corp's consolidated group. U.S. Corp also owns all the stock of CFC, a controlled foreign corporation (as defined in section 957(a)) of U.S. Corp with the Japanese yen as its functional currency. Y and CFC are the only partners in P, a foreign partnership. P owns DE1 and Business A. DE1 owns Business B.

(ii) *Analysis.* (A) Under paragraph (b)(5)(i) of this section, P is a section 987 aggregate partnership because Y and CFC own all the interests in partnership capital and profits, Y and CFC are related within the meaning of section 267(b), and the requirements of §1.987–1(b)(5)(i)(B) are satisfied. Pursuant to paragraph (b)(3)(ii) of this section, P and DE1 are not eligible QBUs. Moreover, pursuant to paragraph (b)(4) of this section, for purposes of section 987, neither P nor DE1 is the owner of the Business B eligible QBU, and P is not the owner of the Business A eligible QBU. Instead, pursuant to paragraph (b)(4)(ii) of this section, Y and CFC are indirect owners of the Business A eligible QBU and the Business B eligible QBU to the extent they are allocated the assets and liabilities of such businesses under §1.987–7.

(B) Because Business A and Business B are eligible QBUs with different functional currencies than Y, the portions of Business A and Business B allocated to Y under §1.987–7 are section 987 QBUs of Y.

(C) Because the Business A eligible QBU has a different functional currency than CFC, the portion of Business A that is allocated to CFC under §1.987–7 is a section 987 QBU, and CFC and its section 987 QBU are subject to section 987. Because the Business B eligible QBU has the same functional currency as CFC, the portion of Business B that is allocated to CFC under §1.987–7 is not a section 987 QBU of CFC.

Example 5. (i) *Facts.* U.S. Corp owns all of the interests in DE1. DE1 owns Business A and all of the interests in DE2. DE2 owns Business B and all of the interests in DE3, an entity disregarded as an entity separate from its owner. DE3 owns Business C, which is an eligible QBU with the Russian ruble as its functional currency.

(ii) *Analysis.* Pursuant to paragraph (b)(3)(ii) of this section, DE1, DE2, and DE3 are not eligible QBUs, and the Business A, Business B, and Business C activities are eligible QBUs. Pursuant to paragraph (b)(4) of this section, an eligible QBU is not an owner of another eligible QBU. Accordingly, the Business A eligible QBU is not the owner of the Business B eligible QBU, and the Business B eligible QBU is not the owner of the Business C eligible QBU. Instead, pursuant to paragraph (b)(4) of this section, U.S. Corp is the direct owner of the Business A, Business B, and Business C eligible QBUs. Because each of the Business A, Business B, and Business C eligible QBUs has a different functional currency than U.S. Corp, such eligible QBUs are section 987 QBUs of U.S. Corp.

(c) *Exchange rates.* Solely for purposes of section 987, the following definitions shall apply.

(1) *Spot rate*—(i) *In general.* Except as otherwise provided in this section, the spot rate means the rate determined under the principles of §1.988–1(d)(1), (2), and (4) on the relevant date.

(ii) *Election to use a spot rate convention*—(A) *In general—spot rate convention.* An owner may elect to use a spot rate convention that reasonably approximates the spot rate determined in paragraph (c)(1)(i) of this section in lieu of such spot rate. A spot rate convention may be determined with respect to a spot rate at the beginning of a reasonable period, the end of a reasonable period, as an average of spot

rates for a reasonable period, or by reference to spot and forward rates for a reasonable period. For this purpose, a reasonable period shall not exceed three months. For example, in lieu of the spot rate determined in paragraph (c)(1)(i) of this section, the spot rate for all transactions during a monthly period can be determined pursuant to one of the following conventions: The spot rate at the beginning of the current month or at the end of the preceding month; the monthly average of daily spot rates for the current or preceding month; or an average of the beginning and ending spot rates for the current or preceding month. Similarly, in lieu of the spot rate determined in paragraph (c)(1)(i) of this section, the spot rate can be determined pursuant to an average of the spot rate and the 30-day forward rate on a day of the preceding month. Use of a spot rate convention that is consistent with the convention used for financial accounting purposes is presumed to reasonably approximate the rate in paragraph (c)(1)(i) of this section. The Commissioner can rebut this presumption if the Commissioner determines that the use of the convention would not clearly reflect income based on the facts and circumstances available at the time of the election.

(B) [Reserved]. For further guidance, see §1.987–1T(c)(1)(ii)(B).

(iii) *Election to use spot rates in lieu of yearly average exchange rates.* A taxpayer may elect under this paragraph (c)(1)(iii) to use spot rates in lieu of yearly average exchange rates (as defined in paragraph (c)(2) of this section) for certain purposes. In particular, a taxpayer that makes this election must use the spot rate for purposes of determining the historic rate, as provided in paragraph (c)(3)(ii) of this section, and for purposes of translating items of income, gain, deduction, or loss of a section 987 QBU into the owner's functional currency, as described in §1.987–3(c)(1). Additionally, a taxpayer that makes this election will be deemed also to elect to use the historic inventory method described in §1.987–3(c)(2)(iv)(B).

(2) *Yearly average exchange rate.* For purposes of section 987, the yearly average exchange rate is a rate that represents an average exchange rate for the taxable year (or, if the relevant period is less than a full taxable year, such portion of the taxable year) computed under any reasonable method. For example, an owner may determine the yearly average exchange rate based on a daily, monthly or quarterly averaging convention, whether weighted or unweighted, and may take into account forward rates for a period not to exceed three months. Use of an averaging convention that is consistent with the convention used for financial accounting purposes is presumed to be a reasonable method. The Commissioner can rebut this presumption if the Commissioner determines that the use of the convention would not have been expected to clearly reflect income based on the facts and circumstances available at the time of the election.

(3) *Historic rate*—(i) *In general.* Except as otherwise provided in these regulations, the historic rate is determined as described in paragraphs (c)(3)(i)(A) through (E) of this section.

(A) *Assets generally.* In the case of an asset other than inventory that is acquired by a section 987 QBU (including through a transfer), the historic rate is the yearly average exchange rate applicable to the year of acquisition.

(B) *Inventory under the simplified inventory method.* In the case of inventory with respect to which a taxpayer uses the simplified inventory method described in §1.987–3(c)(2)(iv)(A), the historic rate for inventory accounted for under the last-in, first-out (LIFO) method of accounting is the yearly average exchange rate applicable to the year in which the inventory's LIFO layer arose. The historic rate for all other inventory of such a taxpayer is the yearly average exchange rate for the taxable year for which the determination of the historic rate for such inventory is relevant.

(C) *Inventory under the historic inventory method.* In the case of inventory with respect to which a taxpayer has elected under §1.987– 3(c)(2)(iv)(B) to use the historic inventory method, each inventoriable cost with respect to such inventory may have a different historic rate. The historic rate for each inventoriable cost is the exchange rate at which such item would be translated

under §1.987–3 if it were not an inventoriable cost.

(D) *Liabilities generally.* In the case of a liability that is incurred or assumed by a section 987 QBU, the historic rate is the yearly average exchange rate applicable to the year the liability is incurred or assumed.

(E) [Reserved]. For further guidance, see §1.987–1T(c)(3)(i)(E).

(ii) *Historic rate when an election to use spot rates in lieu of yearly average exchange rates is in effect.* A taxpayer that has elected under paragraph (c)(1)(iii) of this section to use spot rates in lieu of yearly average exchange rates must determine historic rates under paragraphs (c)(3)(i)(A) and (c)(3)(i)(D) of this section using the spot rate (as defined in paragraph (c)(1) of this section) for the date an asset is acquired by a section 987 QBU or a liability is assumed or incurred by a section 987 QBU in lieu of using the yearly average exchange rate.

(iii) *Date placed in service for depreciable or amortizable property.* In the case of depreciable or amortizable property, an owner may determine the historic rate (whether a yearly average exchange rate or a spot rate, as applicable) by reference to the date such property is placed in service by the section 987 QBU rather than the date the property was acquired, provided that this convention is consistently applied for all such property attributable to that section 987 QBU.

(iv) *Changed functional currency.* In the case of a section 987 QBU or an owner of a section 987 QBU that previously changed its functional currency, §1.985–5(d)(1)(ii)(A) and §1.985–5(e)(4)(i)(A), respectively, shall be taken into account in determining the historic rate for an item reflected on the balance sheet of the section 987 QBU immediately prior to the year of change.

(d) *Marked item.* A marked item is an asset (marked asset) or liability (marked liability) that is properly reflected on the books and records of a section 987 QBU under §1.987–2(b) and that—

(1) Is denominated in, or determined by reference to, the functional currency of the section 987 QBU, is not a section 988 transaction of the section 987 QBU, and would be a section 988 transaction if such item were held or entered into directly by the owner of the section 987 QBU;

(2) Is a prepaid expense or a liability for an advance payment of unearned income, in either case having an original term of one year or less on the date the prepaid expense or liability for an advance payment of unearned income arises; or

(3) [Reserved]. For further guidance, see §1.987–1T(d)(3).

(e) *Historic item.* A historic item is an asset (historic asset) or liability (historic liability) that is properly reflected on the books and records of a section 987 QBU under §1.987–2(b) and that is not a marked item (as defined in paragraph (d) of this section).

(f) [Reserved]. For further guidance, see §1.987–1T(f).

(g) *Elections*—(1) *In general.* This paragraph (g) provides rules for making elections under section 987. Except as otherwise provided in paragraph (g)(2) of this section, such elections—

(i) May be made separately for each section 987 QBU;

(ii) Are made by the owner of the section 987 QBU (as defined in paragraph (b)(4) of this section); and

(iii) Must be made for the first taxable year in which the election is relevant in determining the section 987 taxable income or loss, or section 987 gain or loss, of the section 987 QBU and in which the regulations implementing the election are applicable with respect to the section 987 QBU.

(2) *Exceptions to the general rules*—(i) *Consistency and timeliness requirements for certain elections.* Notwithstanding paragraph (g)(1)(i) of this section, the following consistency and timeliness requirements apply:

(A) *Section 987 grouping election.* Elections made pursuant to paragraph (b)(2)(ii) of this section (regarding the grouping of section 987 QBUs) are binding on all section 987 QBUs that are eligible to be grouped under the particular election (for example, election to group all euro QBUs owned by the same aggregate partnership), regardless of whether the section 987 QBU is established or acquired after the election is made and regardless of whether the section 987 QBU is identified on the

election as required in paragraph (g)(3)(i)(A) of this section.

(B) through (C) [Reserved]. For further guidance, see §1.987–1T(g)(2)(i)(B) through (C).

(ii) *Persons making elections for QBUs owned by foreign corporations.* Notwithstanding paragraph (g)(1)(ii) of this section, if a section 987 QBU is owned by a foreign corporation, elections shall be made in accordance with §1.964–1(c) by the foreign corporation's controlling domestic shareholders, as defined under §1.964–1(c)(5)(i) (dealing with controlled foreign corporations) and §1.964–1(c)(5)(ii) (dealing with noncontrolled section 902 corporations).

(3) *Manner of making elections*—(i) *Election made by attaching statement to a return.* Except as provided in paragraph (g)(3)(ii) of this section, elections shall be made under section 987 for each section 987 QBU by attaching a statement with the information required in this paragraph (g)(3)(i) to the timely filed tax return of the owner or, in the case of a foreign corporation, other applicable person for the first taxable year in which the election is required to be made under paragraph (g)(1)(iii) of this section.

(A) *Section 987 grouping election.* The election provided in paragraph (b)(2)(ii) of this section must be titled ''Section 987 Grouping Election Under §1.987–1(b)(2)(ii)'' and provide the following information:

(*1*) The name, address, and functional currency of each section 987 QBU that the taxpayer is grouping together; and

(*2*) The owner's name and address.

(B) *Election to use a spot rate convention.* An election under paragraph (c)(1)(ii) of this section to use a spot rate convention must be titled ''Section 987 Election to Use a Spot Rate Convention Under §1.987–1(c)(1)(ii)'' and provide the following information:

(*1*) A description of the convention; and

(*2*) The name and address of each section 987 QBU for which the election is being made.

(C) *Election to use spot rates in lieu of yearly average exchange rates.* An election under paragraph (c)(1)(iii) of this section to use spot rates in lieu of yearly average exchange rates must be titled ''Section 987 Election to Use Spot Rates in Lieu of Yearly Average Exchange Rates Under §1.987–1(c)(1)(iii)'' and provide the following information:

(*1*) A description of the convention; and

(*2*) The name and address of each section 987 QBU for which the election is being made.

(D) *Election to use the historic inventory method.* An election under §1.987–3(c)(2)(iv)(B) to use the historic inventory method shall be titled ''Section 987 Election to Use the Historic Inventory Method Under §1.987–3(c)(2)(iv)(B)'' and must provide the name and address of each section 987 QBU for which the election is being made.

(E) through (H) [Reserved]. For further guidance, see §1.987–1T(g)(3)(i)(E) through (H).

(ii) *Election made by filing a dedicated section 987 form.* If the Commissioner publishes a form that provides the manner in which elections are made under section 987, the form shall govern the manner in which elections are made under section 987.

(4) *No change in method of accounting.* An election under section 987 is not governed by the general rules concerning changes in methods of accounting. See also paragraph (g)(5) of this section.

(5) *Revocation of an election.* Elections under section 987 may not be revoked without the consent of the Commissioner or his delegate. The Commissioner or his delegate will consider allowing a revocation of an election if the taxpayer can demonstrate significantly changed circumstances or such other circumstances that clearly demonstrate a substantial non-tax business reason for revoking the election.

[T.D. 9794, 81 FR 88821, Dec. 8, 2016, as amended by T.D. 9795, 81 FR 88867, Dec. 8, 2016]

§1.987–1T Scope, definitions, and special rules (temporary).

(a) through (b)(1)(ii) [Reserved]. For further guidance, see §1.987–1(a) through (b)(1)(ii).

(iii) *Certain provisions applicable to all taxpayers.* Notwithstanding §1.987–1(b)(1)(ii), paragraphs (b)(6) and (g)(3)(i)(E) of this section and §1.987–6T(b)(4) apply to any taxpayer that is

an owner of a dollar QBU (as defined in paragraph (b)(6) of this section), and paragraphs (g)(2)(i)(B) and (g)(3)(i)(H) of this section and §§1.987–8T(d) and 1.987–12T apply to any taxpayer that is an owner of an eligible QBU (determined without regard to §1.987–1(b)(3)(ii)) that is subject to section 987.

(b)(2) through (b)(5) [Reserved]. For further guidance, see §1.987–1(b)(2) through (b)(5).

(6) *Dollar QBUs*—(i) *In general.* Except as provided in paragraphs (b)(1)(iii) and (b)(6)(iii) of this section, section 987 and the regulations thereunder do not apply with respect to an eligible QBU (determined without regard to §1.987–1(b)(3)(ii)) that has the U.S. dollar as its functional currency and that would be subject to section 987 if it had a functional currency other than the dollar (dollar QBU). This paragraph (b)(6) applies to all taxpayers, including entities described in §1.987–1(b)(1)(ii).

(ii) *Application of section 988 to a dollar QBU*—(A) *In general.* Except as provided in paragraphs (b)(6)(ii)(B) and (b)(6)(iii) of this section, a controlled foreign corporation (as defined in section 957(a)) (CFC) that is the owner of a dollar QBU applies section 988 with respect to any item that is properly reflected on the books and records of the dollar QBU and that would give rise to a section 988 transaction if such item were acquired, accrued, or entered into directly by the owner of the dollar QBU. Except as provided in paragraph (b)(6)(ii)(B) of this section, for purposes of determining the amount of section 988 gain or loss of the CFC, any item that is properly reflected on the books and records of the dollar QBU and that would give rise to a section 988 transaction if such item were acquired, accrued, or entered into directly by the owner of the dollar QBU is treated as properly reflected on the books and records of the owner of the dollar QBU, such that the amount of section 988 gain or loss with respect to such item is determined by reference to the owner's functional currency.

(B) *Section 988 gain or loss characterized as effectively connected income.* Solely for the purpose of determining the amount of section 988 gain or loss of a CFC described in paragraph (b)(6)(ii)(A) of this section that is effectively connected with the conduct of a trade or business within the United States (ECI), any section 988 gain or loss that would be determined under section 988 as a result of the acquisition or accrual of any item and treated as ECI under §1.988–4(c) if the item were treated as properly reflected on the books and records of the dollar QBU is determined by treating such item as properly reflected on the books and records of the dollar QBU. Consequently, solely for that purpose, such section 988 gain or loss is determined by reference to the U.S. dollar.

(iii) *Election for a CFC to apply section 987 to a dollar QBU*—(A) *In general.* A CFC that is the owner of a dollar QBU may elect to apply section 987 and the regulations thereunder with respect to the dollar QBU in lieu of applying section 988 pursuant to paragraph (b)(6)(ii) of this section. If the dollar QBU or CFC is described in §1.987–1(b)(1)(ii), however, the CFC must apply section 987 to the dollar QBU using the method it applied to the dollar QBU immediately prior to the effective date of this paragraph (b)(6) as provided in paragraph (h) of this section, provided such method was a reasonable interpretation of section 987, or, if no such method exists, a reasonable method.

(B) *Section 988 gain or loss characterized as effectively connected income.* Solely for the purpose of determining the amount of section 988 gain or loss of a dollar QBU that is the subject of an election described in paragraph (b)(6)(iii)(A) of this section that is ECI, §1.987–3T(b)(4)(i) and (ii) do not apply, and any section 988 gain or loss that would be determined under section 988 as a result of the acquisition or accrual of any item and treated as ECI under §1.988–4(c) if the item were treated as properly reflected on the books and records of the dollar QBU is determined by treating such item as properly reflected on the books and records of the dollar QBU. Consequently, solely for that purpose, such section 988 gain or loss is determined by reference to the U.S. dollar. See §1.987–6T(b)(4) for rules regarding the source of section 987 gain or loss with respect to a dollar QBU for which the CFC owner has made the election described in this paragraph.

(b)(7) through (c)(1)(ii)(A) [Reserved]. For further guidance, see §1.987–1(b)(7) through (c)(1)(ii)(A).

(B) *Election inapplicable with respect to certain amounts.* Except as provided in this paragraph (c)(1)(ii)(B), the election provided in §1.987–1(c)(1)(ii)(A) does not apply for purposes of determining section 987 taxable income or loss (as defined in §1.987–3(a)) with respect to a historic item (as defined in §1.987–1(e)) if acquiring, accruing, or entering into such item gives rise to a section 988 transaction or specified owner functional currency transaction. However, the election provided in §1.987–1(c)(1)(ii)(A) does apply for purposes of determining section 987 taxable income or loss with respect to a payable or receivable described in §1.988–1(d)(3) under the circumstances described in §1.988–1(d)(3).

(c)(2) through (c)(3)(i)(D) [Reserved]. For further guidance, see §1.987–1(c)(2) through (c)(3)(i)(D).

(E) *Section 988 transactions and specified owner functional currency transactions.* If acquiring, accruing, or entering into a historic item gives rise to a section 988 transaction of a section 987 QBU or a specified owner functional currency transaction described in §1.987–3T(b)(4)(ii), the historic rate is the spot rate (as defined in paragraph (c)(1) of this section) on the date such item is acquired, accrued, or entered into. For this purpose, use of a spot rate convention under §1.987–1(c)(1)(ii) is permitted only with respect to a payable or receivable described in §1.988–1(d)(3) and only to the extent provided therein.

(c)(3)(ii) through (d)(2) [Reserved]. For further guidance, see §1.987–1(c)(3)(ii) through (d)(2).

(3) Gives rise to a qualified short-term section 988 transaction (as defined in §1.987–3T(b)(4)(iii)(B)) of the section 987 QBU, whether denominated in the functional currency of the owner or other nonfunctional currency with respect to the section 987 QBU, for which section 988 gain or loss is determined under §1.987–3T(b)(4)(iii)(A) in, and by reference to, the functional currency of the section 987 QBU.

(e) [Reserved]. For further guidance, see §1.987–1(e).

(f) *Examples.* The following examples illustrate the application of §1.987–1(d) and (e).

Example 1. U.S. Corp is a domestic corporation with the U.S. dollar as its functional currency and is the owner of Business A, a section 987 QBU that has the pound as its functional currency. Assume all transactions of Business A are entered into in the ordinary course of its business. U.S. Corp has not made an election under §1.987–3T(b)(4)(iii)(C) to adopt a foreign currency mark-to-market method of accounting for qualified short-term section 988 transactions. Items reflected on Business A's balance sheet include £10,000, $1,000, a building with a basis of £100,000, a light general purpose truck with a basis of £30,000, a computer with a basis of £1,000, a 60-day receivable for ¥15,000, an account payable of £5,000, and a foreign currency contract within the meaning of section 1256(g)(2) that requires Business A to exchange £100 for $125 in 90 days. Under paragraph (d) of this section, the £10,000, the £5,000 account payable and the £/$ section 1256 foreign currency contract are marked items. The other items are historic items under this paragraph (e) of this section.

Example 2. The facts are the same as *Example 1* except that U.S. Corp has elected under §1.987–3T(b)(4)(iii)(C) to adopt the foreign currency mark-to-market method of accounting for qualified short-term section 988 transactions of Business A. Under paragraphs (d) and (e) of this section, the £10,000, the $1,000, the ¥15,000 receivable, the £5,000 account payable, and the £/$ section 1256 foreign currency contract are marked items.

(g)(1) through (g)(2)(i)(A) [Reserved]. For further guidance, see §1.987–1(g)(1) through (g)(2)(i)(A).

(B) *Annual deemed termination election—(1) In general.* Except as provided in paragraph (g)(2)(i)(B)(*2*) of this section, an election under §1.987–8T(d) (annual deemed termination election) applies to all section 987 QBUs owned by the taxpayer, as well as to all section 987 QBUs owned by any person that has a relationship to the taxpayer described in section 267(b) or section 707(b) (substituting ''and the profits interest'' for ''or the profits interest'' in section 707(b)(1)(A) and substituting ''and profits interests'' for ''or profits interests'' in section 707(b)(1)(B)) on the last day of the first taxable year for which the election applies (a related person). If a taxpayer makes the election under §1.987–8T(d), the first taxable year of a related person for which the election applies is the first

taxable year that ends with or within a taxable year of the taxpayer for which the taxpayer's election applies. An election under §1.987–8T(d) may not be revoked.

(*i*) *Fresh start taxpayers.* A taxpayer to which §1.987–10 applies that is required under §1.987–10(a) to apply the fresh start transition method described in §1.987–10(b) (fresh start taxpayer) may make the election under §1.987–8T(d) only if the first taxable year for which the election would apply to the taxpayer is either the first taxable year beginning on or after the transition date (as defined in §1.987–11(c)) in which the election is relevant or a subsequent taxable year in which the taxpayer's controlled group aggregate section 987 loss, if any, does not exceed $5 million. For purposes of this paragraph (g)(2)(i)(B), a taxpayer's controlled group aggregate section 987 loss means the aggregate net amount of section 987 loss that would be recognized pursuant to the election by the taxpayer and all other persons to whom the taxpayer's election would apply in the first taxable year of each person for which the election would apply.

(*ii*) *Other taxpayers.* Other taxpayers, including taxpayers described in §1.987–1(b)(1)(ii) and taxpayers described in §1.987–10(c), must follow the election rules provided in paragraph (g)(2)(i)(B)(*1*)(*i*) of this section if any related party is a fresh start taxpayer. If no related party is a fresh start taxpayer, the election under §1.987–8T(d) may be made only if the first taxable year for which the election would apply to the taxpayer is either the first taxable year beginning on or after December 7, 2016, in which the election is relevant or a subsequent taxable year in which the taxpayer's controlled group aggregate section 987 loss, if any, does not exceed $5 million.

(*2*) *QBU-by-QBU elections in certain circumstances.* Notwithstanding paragraph (g)(2)(i)(B)(*1*) of this section, a taxpayer may make a separate election under §1.987–8T(d) with respect to any section 987 QBU owned by the taxpayer if the first taxable year for which the election would apply to the taxpayer with respect to the section 987 QBU is a taxable year in which there is a section 987 gain recognized with respect to the section 987 QBU pursuant to the election, or is a taxable year in which there is a section 987 loss of $1 million or less that would be recognized with respect to the section 987 QBU pursuant to the election

(C) *Election to translate all items at the yearly average exchange rate.* An election under §1.987–3T(d) (election to translate all items at the yearly average exchange rate) may be made with respect to a section 987 QBU only if the first taxable year for which the election would apply is the first taxable year for which an election under §1.987–8T(d) (annual deemed termination election) applies with respect to the section 987 QBU.

(g)(2)(ii) through (g)(3)(i)(D) [Reserved]. For further guidance, see §1.987–1(g)(2)(ii) through (g)(3)(i)(D).

(E) *Election for a CFC to apply section 987 to a dollar QBU.* An election under §1.987–1T(b)(6)(iii) for a CFC to apply section 987 to a dollar QBU must be titled ''Section 987 Election for a CFC to Apply Section 987 to a Dollar QBU Under §1.987–1T(b)(6)(iii)'' and must provide the name and address of each QBU for which the election is being made.

(F) *Election to apply the foreign currency mark-to-market method of accounting for qualified short-term section 988 transactions.* An election under §1.987–3T(b)(4)(iii)(C) to apply the foreign currency mark-to-market method of accounting for qualified short-term section 988 transactions must be titled ''Section 987 Election to Use Foreign Currency Mark-to-Market Method of Accounting for Qualified Short-Term Section 988 Transactions Under §1.987–3(b)T(4)(iii)(C)'' and must provide the name and address of each section 987 QBU for which the election is being made.

(G) *Election to translate all items at the yearly average exchange rate.* An election under §1.987–3T(d) to translate all items at the yearly average exchange rate must be titled ''Section 987 Election to Translate All Items at the Yearly Average Exchange Rate Under §1.987–3T(d)'' and must provide the name and address of each section 987 QBU for which the election is being made.

(H) *Annual deemed termination election.* An election under §1.987–8T(d) for an owner to deem all of its section 987 QBUs to terminate on the last day of each taxable year must be titled ''Section 987 Annual Deemed Termination Election Under §1.987–8T(d)'' and must provide the name and address of each section 987 QBU to which the election applies, including a section 987 QBU owned by a related person (within the meaning of paragraph (g)(2)(i)(B)(*1*) of this section).

(g)(4) through (6) [Reserved]. For further guidance, see §1.987–1(g)(4) through (6).

(h) *Effective/applicability date.* Paragraphs (g)(2)(i)(B) and (g)(3)(i)(H) of this section apply to the first taxable year beginning on or after December 7, 2016. Paragraphs (b)(1)(iii), (b)(6), (c)(1)(ii)(B), (c)(3)(i)(E), (d)(3), (f), (g)(2)(i)(C), and (g)(3)(i)(E) through (G) of this section apply to taxable years beginning one year after the first day of the first taxable year following December 7, 2016. Notwithstanding the preceding sentence, if a taxpayer makes an election under §1.987–11(b), then paragraphs (b)(1)(iii), (b)(6), (c)(1)(ii)(B), (c)(3)(i)(E), (d)(3), (f), (g)(2)(i)(C), and (g)(3)(i)(E) through (G) of this section apply to taxable years to which §§1.987–1 through 1.987–10 apply as a result of such election.

(i) *Expiration date.* The applicability of this section expires on December 6, 2019.

[T.D. 9795, 81 FR 88868, Dec. 8, 2016]

§ 1.987–2 Attribution of items to eligible QBUs; definition of a transfer and related rules.

(a) *Scope and general principles.* Paragraph (b) of this section provides rules for attributing assets and liabilities, and items of income, gain, deduction, and loss, to an eligible QBU. Assets and liabilities are attributed to a section 987 QBU for purposes of section 987. Items of income, gain, deduction, and loss are attributed to a section 987 QBU for purposes of computing the section 987 taxable income of the section 987 QBU and of its owner. Paragraph (c) of this section defines a transfer to or from a section 987 QBU. Paragraph (d) of this section provides translation rules for transfers to a section 987 QBU.

(b) *Attribution of items to an eligible QBU*—(1) *General rules.* Except as provided in paragraphs (b)(2) and (3) of this section, items are attributable to an eligible QBU to the extent they are reflected on the separate set of books and records, as defined in §1.989(a)–1(d), of the eligible QBU. In the case of a section 987 aggregate partnership, items reflected on the books and records of the partnership and deemed allocated to an eligible QBU of such partnership are considered to be reflected on the books and records of such eligible QBU. For purposes of this section, the term ''item'' refers to any asset or liability, and any item of income, gain, deduction, or loss. Items that are attributed to an eligible QBU pursuant to this section must be adjusted to conform to Federal income tax principles. Except as provided in §1.989(a)–1(d)(3), these attribution rules apply solely for purposes of section 987. For example, the allocation and apportionment of interest expense under section 864(e) is independent of the rules under section 987.

(2) *Exceptions for non-portfolio stock, interests in partnerships, and certain acquisition indebtedness.* The following items shall not be considered to be on the books and records of an eligible QBU:

(i) Stock of a corporation (whether domestic or foreign), other than stock of a corporation reflected on the books and records (within the meaning of paragraph (b)(1) of this section) of an eligible QBU if the owner of the eligible QBU owns less than 10 percent of the total value of all classes of stock of such corporation. For this purpose, section 318(a) applies in determining ownership, except that in applying section 318(a)(2)(C), the phrase ''10 percent'' is used instead of the phrase ''50 percent.''

(ii) An interest in a partnership (whether domestic or foreign).

(iii) A liability that was incurred to acquire stock described in paragraph (b)(2)(i) of this section or that was incurred to acquire a partnership interest described in paragraph (b)(2)(ii) of this section.

(iv) Income, gain, deduction, or loss arising from the items described in paragraphs (b)(2)(i) through (iii) of this

section. For example, a section 951 inclusion with respect to stock of a foreign corporation described in paragraph (b)(2)(i) of this section shall not be considered to be on the books and records of an eligible QBU.

(3) *Adjustments to items reflected on the books and records*—(i) *General rule.* If a principal purpose of recording (or failing to record) an item on the books and records of an eligible QBU is the avoidance of Federal income tax under, or through the use of, section 987, the item must be allocated between or among the eligible QBU, the owner of such eligible QBU, and any other persons, entities (including DEs), or other QBUs within the meaning of §1.989(a)–1(b) (including eligible QBUs) in a manner that reflects the substance of the transaction. For purposes of this paragraph (b)(3)(i), relevant factors for determining whether such Federal income tax avoidance is a principal purpose of recording (or failing to record) an item on the books and records of an eligible QBU shall include, but are not limited to, the factors set forth in paragraphs (b)(3)(ii) and (iii) of this section. The presence or absence of any factor or factors is not determinative. Moreover, the weight given to any factor (whether or not set forth in paragraphs (b)(3)(ii) and (iii) of this section) depends on the particular case.

(ii) *Factors indicating no tax avoidance.* For purposes of paragraph (b)(3)(i) of this section, factors that may indicate that recording (or failing to record) an item on the books and records of an eligible QBU did not have as a principal purpose the avoidance of Federal income tax under, or through the use of, section 987 include the recording (or not recording) of an item:

(A) For a significant and bona fide business purpose;

(B) In a manner that is consistent with the economics of the underlying transaction;

(C) In accordance with generally accepted accounting principles (or similar comprehensive accounting standard);

(D) In a manner that is consistent with the treatment of similar items from year to year;

(E) In accordance with accepted conditions or practices in the particular trade or business of the eligible QBU;

(F) In a manner that is consistent with an explanation of existing internal accounting policies that is evidenced by documentation contemporaneous with the timely filing of a Federal income tax return for the taxable year; and

(G) As a result of a transaction between legal entities (for example, the transfer of an asset or the assumption of a liability), even if such transaction is not regarded for Federal income tax purposes (for example, a transaction between a DE and its owner).

(iii) *Factors indicating tax avoidance.* For purposes of paragraph (b)(3)(i) of this section, factors that may indicate that a principal purpose of recording (or failing to record) an item on the books and records of an eligible QBU is the avoidance of Federal income tax under, or through the use of, section 987 include:

(A) The presence or absence of an item on the books and records that is the result of one or more transactions that are transitory, for example, due to a circular flow of cash or other property;

(B) The presence or absence of an item on the books and records that is the result of one or more transactions that do not have substance;

(C) The presence or absence of an item on the books and records that results in the taxpayer (or a person related to the taxpayer within the meaning of section 267(b) or section 707(b)) having offsetting positions with respect to the functional currency of a section 987 QBU; and

(D) The absence of any or all of the factors listed in paragraph (b)(3)(ii) of this section.

(4) *Assets and liabilities of a section 987 aggregate partnership or DE that are not attributed to an eligible QBU.* Neither a section 987 aggregate partnership nor a DE is an eligible QBU and, thus, neither entity can be a section 987 QBU. See §1.987–1(b)(2) and (3). As a result, a section 987 aggregate partnership or DE may own assets and liabilities that are not attributed to an eligible QBU as provided under this paragraph (b)

and, therefore, are not subject to section 987. For the foreign currency treatment of such assets or liabilities, see §1.988–1(a)(4).

(c) *Transfers to and from section 987 QBUs*—(1) *In general.* The following rules apply for purposes of determining whether there is a transfer of an asset or a liability from an owner to a section 987 QBU, or from a section 987 QBU to an owner. These rules apply solely for purposes of section 987.

(2) *Disregarded transactions*—(i) *General rule.* An asset or liability shall be treated as transferred to a section 987 QBU from its owner (whether direct owner or indirect owner, as defined in §1.987–1(b)(4)) if, as a result of a disregarded transaction (as defined in paragraph (c)(2)(ii) of this section), such asset or liability is reflected on the books and records of the section 987 QBU within the meaning of paragraph (b) of this section. Similarly, an asset or liability shall be treated as transferred from a section 987 QBU to its owner if, as a result of a disregarded transaction, such asset or liability is no longer reflected on the books and records of the section 987 QBU within the meaning of paragraph (b) of this section.

(ii) *Definition of a disregarded transaction.* For purposes of this section, a disregarded transaction means a transaction that is not regarded for Federal income tax purposes (for example, any transaction between separate section 987 QBUs of the same owner). For purposes of this paragraph (c), a disregarded transaction shall be treated as including the recording of an asset or liability on the books and records of an eligible QBU (as defined in §1.987–1(b)(3)) of an owner, if the recording is the result of such asset or liability being removed from the books and records of a separate eligible QBU of the same owner, whether such separate eligible QBU is owned directly or is owned indirectly through the same entity (including through a DE or a section 987 aggregate partnership). Additionally, if an asset or liability that is attributable to a section 987 QBU within the meaning of paragraph (b) of this section is sold or exchanged (including in a nonrecognition transaction, such as an exchange under section 351) for an asset or liability that is not attributable to the section 987 QBU immediately after the sale or exchange, the sold or exchanged asset or liability that was attributable to the section 987 QBU immediately before the transaction shall be treated as transferred from the section 987 QBU to its direct or indirect owner in a disregarded transaction immediately before the sale or exchange for purposes of section 987 (including for purposes of recognizing section 987 gain or loss under §1.987–5) and subsequently sold or exchanged by the owner. The preceding sentence shall not apply with respect to an acquisition or disposition of an interest in a section 987 aggregate partnership or in a DE, as described in paragraph (c)(5) of this section.

(iii) *Items derived from disregarded transactions ignored.* For purposes of section 987, disregarded transactions shall not give rise to items of income, gain, deduction, or loss that are taken into account in determining section 987 taxable income or loss under §1.987–3.

(3) *Transfers of assets to and from section 987 QBUs owned through section 987 aggregate partnerships*—(i) *Contributions to section 987 aggregate partnerships.* Solely for purposes of section 987, an asset shall be treated as transferred by an indirect owner (as defined in §1.987–1(b)(4)(ii)) to a section 987 QBU of a partner (as defined in §1.987–1(b)(5)(ii)) to the extent the indirect owner contributes the asset to the section 987 aggregate partnership that carries on the activities of the section 987 QBU, provided that, immediately prior to the contribution, the asset is not reflected on the books and records of the section 987 QBU within the meaning of paragraph (b) of this section and the asset is reflected on the books and records of the section 987 QBU immediately following such contribution. For purposes of this paragraph (c)(3)(i), deemed contributions of money described under section 752 shall be disregarded. See paragraph (c)(4)(ii) of this section for rules governing the assumption by a partner of liabilities of a section 987 aggregate partnership.

(ii) *Distributions from section 987 aggregate partnerships.* Solely for purposes of section 987, an asset shall be treated as transferred from a section 987 QBU of a

partner to its indirect owner to the extent the section 987 aggregate partnership that carries on the activities of the section 987 QBU distributes the asset to the indirect owner, provided that, immediately prior to such distribution, the asset is reflected on the books and records of the section 987 QBU within the meaning of paragraph (b) of this section, and the asset is not reflected on the books and records of the section 987 QBU immediately after such distribution. For purposes of this paragraph (c)(3)(ii), deemed distributions of money described under section 752 shall be disregarded. See paragraph (c)(4)(i) of this section for rules governing the assumption by a section 987 aggregate partnership of liabilities of a partner.

(4) *Transfers of liabilities to and from section 987 QBUs owned through section 987 aggregate partnerships*—(i) *Assumptions of partner liabilities.* Solely for purposes of section 987, a liability of the owner of a section 987 aggregate partnership shall be treated as transferred to a section 987 QBU of a partner if, and to the extent, the section 987 aggregate partnership assumes such liability, provided that, immediately prior to the transfer, the liability is not reflected on the books and records of the section 987 QBU within the meaning of paragraph (b) of this section, and the liability is reflected on the books and records of the section 987 QBU immediately following the transfer.

(ii) *Assumptions of section 987 aggregate partnership liabilities.* Solely for purposes of section 987, a liability of a section 987 aggregate partnership shall be treated as transferred from a section 987 QBU of a partner to its indirect owner if, and to the extent, the indirect owner assumes such liability of the section 987 aggregate partnership, provided that, immediately prior to such assumption, the liability is reflected on the books and records of the section 987 QBU within the meaning of paragraph (b) of this section, and the liability is not reflected on the books and records of the section 987 QBU immediately following the transfer.

(5) *Acquisitions and dispositions of interests in DEs and section 987 aggregate partnerships.* Solely for purposes of section 987, an asset or liability shall be treated as transferred to a section 987 QBU from its owner if, as a result of an acquisition (including by contribution) or disposition of an interest in a section 987 aggregate partnership or DE, such asset or liability is reflected on the books and records of the section 987 QBU. Similarly, an asset or liability shall be treated as transferred from a section 987 QBU to its owner if, as a result of an acquisition or disposition of an interest in a section 987 aggregate partnership or DE, the asset or liability is not reflected on the books and records of the section 987 QBU.

(6) *Changes in form of ownership.* For purposes of this paragraph (c), mere changes in the form of ownership of an eligible QBU shall not result in a transfer to or from a section 987 QBU. Instead, the determination of whether a transfer has occurred in such case shall be made under paragraph (c)(5) of this section. For example, a transaction that causes a direct owner of an eligible QBU to become an indirect owner of the eligible QBU shall not, except to the extent provided in paragraph (c)(5) of this section, result in a transfer to or from a section 987 QBU. See, for example, Rev. Rul. 99–5 (1999–1 CB 434), Rev. Rul. 99–6 (1999–1 CB 432), §601.601(d)(2) of this chapter, and section 708 and the applicable regulations.

(7) *Application of general tax law principles.* General tax law principles, including the circular cash flow, step-transaction, economic substance, and substance-over-form doctrines, apply for purposes of determining whether there is a transfer of an asset or liability under this paragraph (c), including a transfer of an asset or liability pursuant to a disregarded transaction (as defined in paragraph (c)(2)(ii) of this section).

(8) *Interaction with §1.988–1(a)(10).* See §1.988–1(a)(10) for rules regarding the treatment of an intra-taxpayer transfer of a section 988 transaction.

(9) [Reserved]. For further guidance, see §1.987–2T(c)(9).

(10) *Examples.* The following examples illustrate the principles of this paragraph (c). For purposes of the examples, X and Y are domestic corporations, have the U.S. dollar as their

functional currency, and use the calendar year as their taxable years. Furthermore, except as otherwise provided, Business A and Business B are eligible QBUs that have the euro and the Japanese yen, respectively, as their functional currencies, and DE1 and DE2 are DEs. For purposes of determining whether any of the transfers in these examples result in remittances, see §1.987–5.

Example 1. Transfer to a directly owned section 987 QBU. (i) *Facts.* X owns all of the interests in DE1. DE1 owns Business A, which is a section 987 QBU of X. X owns €100 that are not reflected on the books and records of Business A. Business A is in need of additional capital and, as a result, X lends the €100 to DE1 for use in Business A in exchange for a note.

(ii) *Analysis.* (A) The loan from X to DE1 is not regarded for Federal income tax purposes (because it is an interbranch transaction) and therefore is a disregarded transaction (as defined in paragraph (c)(2)(ii) of this section). As a result, the DE1 note held by X and the liability of DE1 under the note are not taken into account under this section.

(B) As a result of the disregarded transaction, the €100 is reflected on the books and records of Business A. Therefore, X is treated as transferring €100 to its Business A section 987 QBU for purposes of section 987. This transfer is taken into account in determining the amount of any remittance for the taxable year under §1.987–5(c). See §1.988–1(a)(10)(ii) for the application of section 988 to X as a result of the transfer of non-functional currency to its section 987 QBU.

Example 2. Transfer to a directly owned section 987 QBU. (i) *Facts.* X owns Business A and Business B, both of which are section 987 QBUs of X. X owns equipment that is used in Business A and is reflected on the books and records of Business A. Because Business A has excess manufacturing capacity and X intends to expand the manufacturing capacity of Business B, the equipment formerly used in Business A is transferred to Business B for use by Business B. As a result of the transfer, the equipment is removed from the books and records of Business A and is recorded on the books and records of Business B.

(ii) *Analysis.* The transfer of the equipment from the books and records of Business A to the books and records of Business B is not regarded for Federal income tax purposes (because it is an interbranch transaction), and therefore it is a disregarded transaction for purposes of this paragraph (c). Therefore, for purposes of section 987, the Business A section 987 QBU is treated as transferring the equipment to X, and X is subsequently treated as transferring the equipment to the Business B section 987 QBU. These transfers are taken into account in determining the amount of any remittance for the taxable year under §1.987–5(c).

Example 3. Intracompany sale of property between two section 987 QBUs. (i) *Facts.* X owns all of the interests in DE1 and DE2. DE1 and DE2 own Business A and Business B, respectively, both of which are section 987 QBUs of X. DE1 owns equipment that is used in Business A and is reflected on the books and records of Business A. For business reasons, DE1 sells a portion of the equipment used in Business A to DE2 in exchange for a fair market value amount of Japanese yen. The yen used by DE2 to acquire the equipment was generated by Business B and was reflected on Business B's books and records. Following the sale, the yen and the equipment will be used in Business A and Business B, respectively. As a result of such sale, the equipment is removed from the books and records of Business A and is recorded on the books and records of Business B. Similarly, as a result of the sale, the yen is removed from the books and records of Business B and is recorded on the books and records of Business A.

(ii) *Analysis.* (A) The sale of equipment between DE1 and DE2 is a transaction that is not regarded for Federal income tax purposes (because it is an interbranch transaction). Therefore the transaction is a disregarded transaction for purposes of paragraph (c) of this section. As a result, the sale is not taken into account under this section and, pursuant to paragraph (c)(2)(iii) of this section, the sale does not give rise to an item of income, gain, deduction, or loss for purposes of determining section 987 taxable income or loss under §1.987–3. However, the yen and equipment exchanged by DE1 and DE2 in connection with the sale must be taken into account as a disregarded transaction under this paragraph (c).

(B) As a result of the disregarded transaction, the equipment ceases to be reflected on the books and records of Business A and becomes reflected on the books and records of Business B. Therefore, the Business A section 987 QBU is treated as transferring the equipment to X, and X is subsequently treated as transferring such equipment to the Business B section 987 QBU.

(C) Additionally, as a result of the disregarded transaction, the yen currency ceases to be reflected on the books and records of Business B and becomes reflected on the books and records of Business A. Therefore, the Business B section 987 QBU is treated as transferring the yen to X, and X is subsequently treated as transferring such yen from X to the Business A section 987 QBU. The transfers among Business A, Business B and X are taken into account in determining the amount of any remittance for the taxable year under §1.987–5(c).

Example 4. Sale of property by a section 987 QBU to a corporation that is a member of the consolidated group. (i) *Facts.* X owns all of the stock of Y and all of the interests in DE1. DE1 owns Business A. X and Y file a consolidated return. Business A sells property to Y for €100.

(ii) *Analysis.* The sale of property by Business A to Y is not considered a transfer of property to X (and a corresponding transfer from X to Y) under paragraph (c) of this section because the transaction is regarded for Federal income tax purposes. Rather, for purposes of section 987, the transaction is considered to occur between Business A and Y.

Example 5. Transactions of a section 987 QBU owned through an aggregate partnership. (i) *Facts.* (A) X owns all of the stock of Y and a 50 percent interest in the capital and profits of P, a partnership. Y owns the other 50 percent interest in P. P owns 100 percent of the interests in DE1 and DE2. DE1 owns Business A and DE2 owns Business B.

(B) In connection with Business A, DE1 licenses intangible property to both DE2 and X. X enters into the license agreement in a transaction other than in its capacity as a partner of P and, therefore, the license is considered as occurring between P and one who is not a partner within the meaning of section 707(a). X uses the intangible property in its own trade or business in the U.S. DE2 uses the intangible property in Business B. Pursuant to the license agreement, X and DE2 pay a €30 and a €50 royalty, respectively, to DE1.

(ii) *Analysis.* (A) Under §1.987–1(b)(5)(i), P is a section 987 aggregate partnership because X and Y own all the interests in partnership capital and profits, X and Y are related within the meaning of section 267(b), and the requirements of §1.987–1(b)(5)(i)(B) are satisfied. X and Y each have a 50 percent allocable share of the assets and liabilities of Business A and Business B, as determined under §1.987–7. Under §1.987–1(b)(5)(ii), the assets and liabilities of Business A allocated to X are a section 987 QBU of X, and the assets and liabilities of Business A allocated to Y are a section 987 QBU of Y. Likewise, the assets and liabilities of Business B allocated to X are a section 987 QBU of X, and the assets and liabilities of Business B allocated to Y are a section 987 QBU of Y.

(B) The license from DE1 to DE2 is not regarded for Federal income tax purposes (because it is an interbranch agreement) and, as a result, royalty payments under the license are disregarded transactions. Thus, pursuant to paragraph (c)(2)(iii) of this section, DE1's receipt of the royalty pursuant to the license agreement does not give rise to an item of income, gain, deduction, or loss for purposes of determining section 987 taxable income or loss under §1.987–3. However, the €50 that is paid from DE2 to DE1 pursuant to the license agreement must be taken into account under paragraph (c) of this section. Accordingly, €50 ceases to be reflected on the books and records of Business B and becomes reflected on the books and records of Business A. As a result, a 50 percent allocable share of the €50 royalty payment (€25) is treated as transferred from each of the Business B section 987 QBUs of X and Y, to X and Y, respectively. And subsequently, X and Y are treated as transferring their respective receipts of €25 to their respective Business A section 987 QBUs. These transfers are taken into account in determining the amount of any remittance to either of X or Y for the taxable year under §1.987–5(c).

(C) The €30 royalty payment from X to DE1 is regarded for Federal income tax purposes (because it is a payment from a partnership to a separate entity). Accordingly, the royalty payment is not a disregarded transaction for purposes of this paragraph (c) and is therefore not treated as a transfer of an asset from an owner to a section 987 QBU. As a result, the payment is not taken into account in determining the amount of any remittance for the taxable year under §1.987–5(c). Instead, the payment gives rise to an item of income and deduction that must be taken into account in computing section 987 taxable income or loss of Business A pursuant to §1.987–3.

Example 6. Acquisition of an interest in a partnership. (i) *Facts.* (A) X owns all of the stock of Z, a domestic corporation with the dollar as its functional currency. X also owns all of the stock of Y and a 50 percent interest in the capital and profits of P, a partnership. Y owns the other 50 percent interest in P. P owns Business A, and P owns no other assets or liabilities other than those of Business A.

(B) Z contributes cash to P in exchange for a 20 percent interest in the capital and profits of P. The cash Z contributes to P is used in Business A and is reflected on Business A's books and records.

(ii) *Analysis.* (A) Under §1.987–1(b)(5)(i), P is a section 987 aggregate partnership because X and Y own all the interests in partnership capital and profits, X and Y are related within the meaning of section 267(b), and the requirements of §1.987–1(b)(5)(i)(B) are satisfied. Prior to the contribution to P by Z, X and Y each have a 50 percent allocable share of the assets and liabilities of Business A, as determined under §1.987–7. Under §1.987–1(b)(5)(ii), the assets and liabilities of Business A allocated to X are a section 987 QBU of X, and the assets and liabilities of Business A allocated to Y are a section 987 QBU of Y.

(B) Following Z's acquisition of a 20 percent interest in P, P remains a section 987 aggregate partnership because X, Y and Z own all the interests in partnership capital and profits; X, Y, and Z are related within

the meaning of section 267(b); and the requirements of §1.987–1(b)(5)(i)(B) are satisfied. Z acquires a 20 percent allocable share of the assets and liabilities of Business A, as determined under §1.987–7. Under §1.987–1(b)(5)(ii), the assets and liabilities of Business A allocated to Z are a section 987 QBU of Z (because Z becomes an indirect owner of Business A and Z and Business A have different functional currencies).

(C) As a result of Z's contribution of cash to Business A, through its contribution to P, each of X, Y, and Z are allocated a share of that Business A asset. Accordingly, under §1.987–2(c)(5), Z is treated as contributing its allocable share of the cash to its Business A section 987 QBU. In addition, Z is treated as transferring X's and Y's respective allocable shares of the cash to X and Y, and X and Y are subsequently treated as transferring that cash to their respective Business A section 987 QBUs.

(D) In addition, as a result of Z's acquisition of its interest in P and Z's consequent acquisition of a Business A section 987 QBU, Z's allocable portion of the assets and liabilities of Business A (other than the cash) cease being reflected on the books and records of the respective Business A section 987 QBUs of each of X and Y. Those allocable portions of assets and liabilities from the Business A section 987 QBUs of X and Y are treated as if they are transferred from such section 987 QBUs to their respective owners, X and Y. These assets and liabilities are consequently recorded on the books and records of Z's Business A section 987 QBU. Accordingly, X and Y are treated as transferring those assets and liabilities to Z, and Z is treated as contributing those assets and liabilities to its new Business A section 987 QBU.

Example 7. Acquisition of an interest in a partnership. (i) *Facts.* The facts are the same as in *Example 6*, except that the cash that Z contributes to P in exchange for a 20 percent interest in P is not used in Business A and is not reflected on Business A's books and records. Instead, the cash is reflected on P's books and records.

(ii) *Analysis.* (A) Following Z's acquisition of a 20 percent interest in P, P remains a section 987 aggregate partnership because X, Y and Z own all the interests in partnership capital and profits; X, Y, and Z are related within the meaning of section 267(b); and the requirements of §1.987–1(b)(5)(i)(B) are satisfied. Z acquires a 20 percent allocable share of the assets and liabilities of Business A, as determined under §1.987–7. Under §1.987–1(b)(5)(ii), the assets and liabilities of Business A allocated to Z are a section 987 QBU of Z (because Z becomes an indirect owner of Business A and Z and Business A have different functional currencies).

(B) As a result of Z's acquisition of its interest in P and Z's consequent acquisition of a Business A section 987 QBU, Z's allocable portion of the assets and liabilities of Business A cease being reflected on the books and records of the respective Business A section 987 QBUs of each of X and Y. Those allocable portions of assets and liabilities from the Business A section 987 QBUs of X and Y are treated as if they are transferred from such section 987 QBUs to their respective owners, X and Y. These assets and liabilities are consequently recorded on the books and records of Z's Business A section 987 QBU. Accordingly, X and Y are treated as transferring those assets and liabilities to Z, and Z is treated as contributing those assets and liabilities to its new Business A section 987 QBU.

Example 8. Conversion of a DE to a partnership through a sale of an interest. (i) *Facts.* X owns all of the stock of Y and all of the interests in DE1. DE1 owns Business A. Y acquires 50 percent of the DE1 interests from X for cash.

(ii) *Analysis.* (A) DE1 is converted to a partnership when Y purchases the 50 percent interest in DE1. For Federal income tax purposes, Y's purchase of 50 percent of X's interest in DE1 is treated as the direct purchase of 50 percent of the assets of Business A because DE1 is disregarded and Business A is treated as held directly by X. Immediately after the sale of 50 percent of Business A to Y, X and Y are treated as contributing their respective interests in the assets of Business A to a partnership. See Rev. Rul. 99–5 (1999–1 CB 434) (situation 1) and §601.601(d)(2) of this chapter.

(B) For purposes of this paragraph (c), these deemed transactions are disregarded transactions. Under §1.987–1(b)(5)(i), the newly formed partnership is a section 987 aggregate partnership because X and Y own all the interests in partnership capital and profits, X and Y are related within the meaning of section 267(b), and the requirements of §1.987–1(b)(5)(i)(B) are satisfied. Because Y is a partner in a section 987 aggregate partnership that owns Business A and because Y and Business A have different functional currencies, Y's portion of the Business A assets and liabilities constitutes a section 987 QBU of Y.

(C) As a result of the conversion of DE1 to a partnership, Y acquires an allocable share of 50 percent of the assets and liabilities of Business A, as determined under §1.987–7. Accordingly, 50 percent of the assets and liabilities of Business A cease being reflected on the books and records of X's section 987 QBU. Under §1.987–2(b)(5), these amounts are treated as if they are transferred from X's section 987 QBU to X, and X is treated as transferring these assets and liabilities to Y. Accordingly, the assets and liabilities of Business A allocated to Y are treated as transferred by Y to Y's newly formed Business A section 987 QBU.

Example 9. Conversion of a DE to a partnership through a contribution. (i) *Facts.* X owns all of the stock of Y and all of the interests in DE1. DE1 owns Business A. Y contributes property (that is not then attributed to a section 987 QBU of Y) to DE1 in exchange for an interest in DE1. The property transferred by Y to DE1 is used in Business A and is reflected on the books and records of Business A.

(ii) *Analysis.* (A) DE1 is converted to a partnership when Y contributes property to DE1 in exchange for a 50 percent interest in DE1. For Federal income tax purposes, Y's contribution is treated as a contribution to a partnership in exchange for an ownership interest in the partnership. X is treated as contributing all of Business A to the partnership in exchange for a partnership interest. See Rev. Rul. 99–5 (situation 2), (1999–1 CB 434) and §601.601(d)(2) of this chapter.

(B) For purposes of this paragraph (c), these deemed transactions are disregarded transactions. Under §1.987–1(b)(5)(i), the newly formed partnership is a section 987 aggregate partnership because X and Y own all the interests in partnership capital and profits, X and Y are related within the meaning of section 267(b), and the requirements of §1.987–1(b)(5)(i)(B) are satisfied. Because Y is a partner in a section 987 aggregate partnership that owns Business A and because Y and Business A have different functional currencies, Y's portion of the Business A assets and liabilities constitutes a section 987 QBU of Y.

(C) As a result of the conversion of DE1 to a partnership, Y acquires an allocable share of 50 percent of the assets and liabilities of Business A, as determined under §1.987–7. Accordingly, under §1.987–2(c)(5), Y is treated as contributing its allocable share of its contributed property to its Business A section 987 QBU. In addition, Y is treated as transferring X's allocable share of the contributed property to X, and X is subsequently treated as transferring that property to its Business A section 987 QBUs. In addition, Y's allocable share of the original (pre-conversion) assets and liabilities of Business A cease being reflected on the books and records of X's section 987 QBU. Under §1.987–2(b)(5), these amounts are treated as if they are transferred from X's section 987 QBU to X, and X is treated as transferring these assets and liabilities to Y. Y is subsequently treated as transferring these assets and liabilities to Y's Business A section 987 QBU.

Example 10. Contribution of assets to a corporation. (i) *Facts.* X owns Business A. X forms Z, a domestic corporation, contributing 50 percent of its Business A assets and liabilities to Z in exchange for all of the stock of Z. X and Z do not file a consolidated tax return.

(ii) *Analysis.* Pursuant to paragraph (b)(2) of this section, the Z stock received in exchange for 50 percent of Business A's assets and liabilities is not reflected on the books and records of, and therefore is not attributable to, Business A for purposes of section 987 immediately after the exchange. As a result, pursuant to paragraph (c)(2)(i) and (ii) of this section, 50 percent of the assets and liabilities of Business A are treated as transferred from Business A to X in a disregarded transaction immediately before the exchange. The result would be the same even if X and Z filed a consolidated return.

Example 11. Circular transfers. (i) *Facts.* X owns Business A. On December 30, 2021, Business A purports to transfer €100 to X. On January 2, 2022, X purports to transfer €50 to Business A. On January 4, 2022, X purports to transfer another €50 to Business A. As of the end of 2021, X has an unrecognized section 987 loss with respect to Business A, such that a remittance, if respected, would result in recognition of a foreign currency loss under section 987.

(ii) *Analysis.* Because the transfer by Business A to X is offset by the transfers from X to Business A that occurred in close temporal proximity, the Internal Revenue Service (IRS) may disregard the purported transfers to and from Business A for purposes of section 987 pursuant to general tax principles under paragraph (c)(7) of this section.

Example 12. Transfers without substance. (i) *Facts.* X owns Business A and Business B. On January 1, 2021, Business A purports to transfer €100 to X. On January 4, 2021, X purports to transfer €100 to Business B. The account in which Business B deposited the €100 is used to pay the operating expenses and other costs of Business A. As of the end of 2021, X has an unrecognized section 987 loss with respect to Business A, such that a remittance, if respected, would result in recognition of a foreign currency loss under section 987.

(ii) *Analysis.* Because Business A continues to have use of the transferred property, the IRS may disregard the €100 purported transfer from Business A to X for purposes of section 987 pursuant to general tax principles under paragraph (c)(7) of this section.

Example 13. Offsetting positions in section 987 QBUs. (i) *Facts.* X owns Business A and Business B. Each of Business A and Business B has the euro as its functional currency. X has not made a grouping election under §1.987–1(b)(2)(ii). On January 1, 2021, X borrows €1,000 from a third party lender, records the liability with respect to the borrowing on the books and records of Business A, and records the borrowed €1,000 on the books and records of Business B. On December 31, 2022, when Business A has $100 of net unrecognized section 987 loss and Business B has $100 of net unrecognized section 987 gain resulting from the change in exchange rates with respect to the liability and the €1,000, X terminates the Business A section 987 QBU.

(ii) *Analysis.* Because Business A and Business B have offsetting positions in the euro, the IRS will scrutinize the transaction under paragraph (b)(3) of this section to determine if a principal purpose of recording the euro-denominated liability on the books and records of Business A and the borrowed euros on the books and records of Business B was the avoidance of tax under section 987. If such a principal purpose is present, the IRS may reallocate the items (that is, the euros and the euro-denominated liability) between Business A, Business B, and X, under paragraph (c)(7) of this section to reflect the substance of the transaction.

Example 14. Offsetting positions with respect to a section 987 QBU and a section 988 transaction. (i) *Facts.* X owns all of the interests in DE1, and DE1 owns Business A. On January 1, 2021, X borrows €1,000 from a third party lender and records the liability with respect to the borrowing on its books and records. X contributes the €1,000 loan proceeds to DE1 and the €1,000 are reflected on the books and records of Business A. On December 31, 2022, when Business A has $100 of net unrecognized section 987 loss resulting from the change in exchange rates with respect to the €1,000 received from the borrowing, and when the euro-denominated borrowing, if repaid, would result in $100 of gain under section 988, X terminates the Business A section 987 QBU.

(ii) *Analysis.* Because X and Business A have offsetting positions in the euro, the IRS will scrutinize the transaction under paragraph (b)(3) of this section to determine whether a principal purpose of recording the borrowed euros on the books and records of Business A, or not recording the corresponding euro-denominated liability on the books and records of Business A, was the avoidance of tax under section 987. If such a principal purpose is present, the Commissioner may reallocate the items (that is, the euros and the euro-denominated liability) between Business A and X under paragraph (c)(7) of this section to reflect the substance of the transaction.

Example 15. Offsetting positions with respect to a section 987 QBU and a section 988 transaction. (i) *Facts.* X owns all of the stock of Y and all of the interests in DE1. DE1 owns Business A. X and Y file a consolidated return. On January 1, 2021, DE1 lends €1,000 to Y. X records the receivable with respect to the loan on Business A's books and records. On December 31, 2022, when Business A has $100 of net unrecognized section 987 gain resulting from the loan, Y repays the €1,000 liability. The repayment of the euro-denominated borrowing results in $100 of loss to Y under section 988. X claims a $100 loss on its consolidated return under section 988. Business A does not make any remittances to X in 2022, so the offsetting gain with respect to the loan receivable has not been recognized by X.

(ii) *Analysis.* Y, a related party to X, and Business A have offsetting positions in the euro. The IRS will scrutinize the transaction under paragraph (b)(3) of this section to determine whether a principal purpose of recording the euro-denominated receivable on the books and records of Business A, rather than on the books and records of X, was to avoid tax through the use of section 987. If such a principal purpose is present, the IRS may reallocate the euro-denominated receivable between Business A and X under paragraph (c)(7) of this section to reflect the substance of the transaction. Other provisions may also apply to defer or disallow the loss.

Example 16. Loan by section 987 QBU followed by immediate distribution to owner. (i) *Facts.* X owns all of the interests in DE1. DE1 owns Business A. On January 1, 2021, Business A borrows €1,000 from a bank. On January 2, 2021, Business A distributes the €1,000 it received from the bank to X. There are no other transfers between X and Business A during the year. At the end of the year, X has net unrecognized section 987 loss with respect to Business A such that a remittance would result in the recognition of foreign currency loss under section 987.

(ii) *Analysis.* Because the proceeds from the loan to Business A are immediately transferred to X and the distribution from Business A to X could result in the recognition of section 987 loss, the IRS may scrutinize the recording of the loan on the books of Business A and move the loan onto the books of X, resulting in the transfer not being taken into account for purposes of section 987 under paragraph (b)(3) of this section.

Example 17. Payment of interest by section 987 QBU on obligation of owner. (i) *Facts.* X owns all of the interests in DE1. DE1 owns business A. On January 1, X borrows €1,000 from a bank. On July 1, Business A pays €20 in interest on X's €1,000 obligation to the bank.

(ii) *Analysis.* Under general tax law principles as provided in paragraph (c)(7) of this section, on July 1, 2021, Business A is treated for purposes of section 987 as making a transfer of €20 to X, and X is treated as making a €20 interest payment to the bank.

(d) *Translation of items transferred to a section 987 QBU*—(1) *Marked items.* The adjusted basis of a marked asset, or the amount of a marked liability, transferred to a section 987 QBU shall be translated into the section 987 QBU's functional currency at the spot rate (as defined in §1.987–1(c)(1)) applicable to the date of transfer. If the asset or liability transferred is denominated in (or determined by reference to) the functional currency of the section 987

QBU (for example, cash or a note denominated in the functional currency of the section 987 QBU), no translation is required. See §1.988–1(a)(10)(ii) for special rules regarding intra-taxpayer transfers.

(2) *Historic items.* The adjusted basis of a historic asset, or the amount of a historic liability, transferred to a section 987 QBU shall be translated into the section 987 QBU's functional currency at the rate provided in §1.987–1(c)(3).

[T.D. 9794, 81 FR 88821, Dec. 8, 2016, as amended by T.D. 9795, 81 FR 88870, Dec. 8, 2016]

§ 1.987–2T Attribution of items to eligible QBUs; definition of a transfer and related rules (temporary).

(a) through (c)(8) [Reserved]. For further guidance, see §1.987–2(a) through (c)(8).

(9) *Certain disregarded transactions not treated as transfers*—(i) *Combinations of section 987 QBUs.* The combination of two or more separate section 987 QBUs (combining QBUs) that are directly owned by the same owner, or that are indirectly owned by the same partner through a single section 987 aggregate partnership, into one section 987 QBU (combined QBU) does not give rise to a transfer of any combining QBU's assets or liabilities to the owner under §1.987–2(c). In addition, transactions between the combining QBUs occurring in the taxable year of the combination do not result in a transfer of the combining QBUs' assets or liabilities to the owner under §1.987–2(c). For this purpose, a combination occurs when the assets and liabilities that are properly reflected on the books and records of two or more combining QBUs begin to be properly reflected on the books and records of a combined QBU and the separate existence of the combining QBUs ceases. A combination may result from any transaction or series of transactions in which the combining QBUs become a combined QBU. For rules regarding the determination of net unrecognized section 987 gain or loss of a combined QBU, see §1.987–4T(f)(1).

(ii) *Change in functional currency from a combination.* If, following a combination of section 987 QBUs described in paragraph (c)(9)(i) of this section, the combined section 987 QBU has a different functional currency than one or more of the combining section 987 QBUs, any such combining section 987 QBU is treated as changing its functional currency and the owner of the combined section 987 QBU must comply with the regulations under section 985 regarding the change in functional currency. See §§1.985–1(c)(6) and 1.985–5.

(iii) *Separation of section 987 QBUs.* The separation of a section 987 QBU (separating QBU) into two or more section 987 QBUs (separated QBUs) that, after the separation, are directly owned by the same owner, or that are indirectly owned by the same partner through a single section 987 aggregate partnership, does not give rise to a transfer of the separating QBU's assets or liabilities to the owner under §1.987–2(c). Additionally, transactions that occurred between the separating QBUs in the taxable year of the separation prior to the completion of the separation do not give rise to transfers for purposes of section 987. For this purpose, a separation occurs when the assets and liabilities that are properly reflected on the books and records of a separating QBU begin to be properly reflected on the books and records of two or more separated QBUs. A separation may result from any transaction or series of transactions in which a separating QBU becomes two or more separated QBUs. A separation may also result when a section 987 QBU that is subject to a grouping election under §1.987–1(b)(2)(ii)(A) changes its functional currency. For rules regarding the determination of net unrecognized section 987 gain or loss of a separated QBU, see §1.987–4T(f)(2).

(c)(10) through (d) [Reserved]. For further guidance see §1.987–2(c)(10) through (d).

(e) *Effective/applicability date.* This section applies to taxable years beginning on or after one year after the first day of the first taxable year following December 7, 2016. Notwithstanding the preceding sentence, if a taxpayer makes an election under §1.987–11(b), then this section applies to taxable years to which §§1.987–1 through 1.987–10 apply as a result of such election.

(f) *Expiration date.* The applicability of this section expires on December 6, 2019.

[T.D. 9795, 81 FR 88870, Dec. 8, 2016]

§ 1.987–3 Determination of section 987 taxable income or loss of an owner of a section 987 QBU.

(a) *In general.* This section provides rules for determining the taxable income or loss, or the earnings and profits, of an owner of a section 987 QBU (hereafter, section 987 taxable income or loss). Paragraph (b) of this section provides rules for determining items of income, gain, deduction, and loss, which generally must be determined in the section 987 QBU's functional currency. Paragraph (c) of this section provides rules for translating each item determined under paragraph (b) of this section into the functional currency of the owner of the section 987 QBU, if necessary. Paragraph (e) of this section provides examples illustrating the application of the rules of this section.

(b) *Determination of each item of income, gain, deduction, or loss in the section 987 QBU's functional currency*—(1) *In general.* Except as otherwise provided in this section, a section 987 QBU shall determine each item of income, gain, deduction, or loss of such section 987 QBU in its functional currency under Federal income tax principles.

(2) *Translation of items of income, gain, deduction, or loss that are denominated in a nonfunctional currency*—(i) *In general.* Except as otherwise provided in paragraphs (b)(2)(ii) and (b)(4) of this section, an item of income, gain, deduction, or loss that is denominated in (or determined by reference to) a nonfunctional currency (including the functional currency of the owner) shall be translated into the section 987 QBU's functional currency at the spot rate (as defined in §1.987–1(c)(1)) on the date such item is properly taken into account, subject to the limitation under §1.987–1(c)(1)(ii)(B) regarding the use of a spot rate convention. Examples 1, 2 and 6 of paragraph (e) of this section illustrate the application of this paragraph (b)(2)(i).

(ii) [Reserved]. For further guidance, see §1.987–3T(b)(2)(ii).

(3) *Determination in the case of a section 987 QBU owned through a section 987 aggregate partnership*—(i) *In general.* Except as otherwise provided in this paragraph (b)(3), the taxable income or loss of a section 987 aggregate partnership, and the distributive share of any owner that is a partner in such partnership, shall be determined in accordance with the provisions of subchapter K of the Internal Revenue Code.

(ii) *Determination of each item of income, gain, deduction, or loss in the eligible QBU's functional currency.* A section 987 aggregate partnership generally shall determine each item of income, gain, deduction, or loss reflected on the books and records of each of its eligible QBUs under §1.987–2(b) in the functional currency of each such QBU.

(iii) *Allocation of items of income, gain, deduction, or loss of an eligible QBU.* A section 987 aggregate partnership shall allocate the items of income, gain, deduction, or loss of each eligible QBU among its partners in accordance with each partner's distributive share of such income, gain, deduction, or loss as determined under subchapter K of the Internal Revenue Code.

(iv) *Translation of items into the owner's functional currency.* To the extent the items referred to in paragraph (b)(3)(iii) of this section are allocated to a partner, the partner shall adjust the items to conform to Federal income tax principles and translate the items into the partner's functional currency as provided in paragraph (c) of this section.

(4) [Reserved]. For further guidance, see §1.987–3T(b)(4).

(c) *Translation of items of income, gain, deduction, or loss of a section 987 QBU into the owner's functional currency*—(1) *In general.* Except as otherwise provided in this section, the exchange rate to be used by an owner in translating an item of income, gain, deduction, or loss attributable to a section 987 QBU into the owner's functional currency, if necessary, shall be the yearly average exchange rate (as defined in §1.987–1(c)(2)) for the taxable year. However, an owner of a section 987 QBU that has elected under §1.987–1(c)(1)(iii) to use spot rates in lieu of yearly average exchange rates must use the spot rate (as defined in §1.987–1(c)(1)) for the date

each item is properly taken into account.

(2) *Exceptions*—(i) *Recovery of basis with respect to historic assets.* Except as otherwise provided in this section, the exchange rate to be used by the owner in translating any recovery of basis (whether through a sale or exchange; deemed sale or exchange; cost recovery deduction such as depreciation, depletion or amortization; or otherwise) with respect to a historic asset (as defined in §1.987–1(e)) shall be the historic rate as determined under §1.987–1(c)(3) for the property to which such recovery of basis is attributable.

(ii) [Reserved]. For further guidance, see §1.987–3T(c)(2)(ii).

(iii) *Gain or loss on the sale, exchange or other disposition of an interest in a section 987 aggregate partnership.* [Reserved]

(iv) *Cost of goods sold computation*—(A) *General rule—simplified inventory method.* Cost of goods sold (COGS) for a taxable year shall be translated into the functional currency of the owner at the yearly average exchange rate (as defined in §1.987–1(c)(2)) for the taxable year and adjusted as provided in paragraph (c)(3) of this section.

(B) *Election to use the historic inventory method.* In lieu of using the simplified inventory method described in paragraph (c)(2)(iv)(A) of this section, the owner of a section 987 QBU may elect under this paragraph (c)(2)(iv)(B) to translate inventoriable costs (including current-year inventoriable costs and costs that were capitalized into inventory in prior years) that are included in COGS at the historic rate as determined under §1.987–1(c)(3) for each such cost. As described in §1.987–1(c)(1)(iii), a taxpayer that elects to use spot rates in lieu of yearly average exchange rates as provided in that section will be deemed to have made the election described in this paragraph (c)(2)(iv)(B).

(v) [Reserved]. For further guidance, see §1.987–3T(c)(2)(v) through (d).

(3) *Adjustments to COGS required under the simplified inventory method*—(i) *In general.* An owner of a section 987 QBU that uses the simplified inventory method described in paragraph (c)(2)(iv)(A) of this section must make the adjustment described in paragraph (c)(3)(ii) of this section. In addition, the owner must make the adjustment described in paragraph (c)(3)(iii) of this section with respect to any inventory for which the section 987 QBU does not use the LIFO inventory method (as described in section 472) and must make the adjustment described in paragraph (c)(3)(iv) of this section with respect to any inventory for which the section 987 QBU uses the LIFO inventory method. An owner of a section 987 QBU that uses the simplified inventory method must make all of the applicable adjustments described in paragraphs (c)(3)(ii) through (iv) with respect to the section 987 QBU even in taxable years in which the amount of COGS is zero.

(ii) *Adjustment for cost recovery deductions included in inventoriable costs.* The translated COGS amount computed under paragraph (c)(2)(iv)(A) of this section must be increased or decreased (as appropriate) to reflect the difference between the historic rates appropriate for translating cost recovery deductions attributable to other historic assets and the exchange rate used to translate COGS under paragraph (c)(2)(iv)(A) of this section, to the extent any such cost recovery deductions are included in inventoriable costs for the taxable year. The adjustment shall be included as an adjustment to translated COGS computed under paragraph (c)(2)(iv)(A) of this section in full in the year to which the adjustment relates and shall not be allocated between COGS and ending inventory. The adjustment for each cost recovery deduction shall be computed as the product of:

(A) The cost recovery deduction, expressed in the functional currency of the section 987 QBU; and

(B) The exchange rate specified in paragraph (c)(2)(i) of this section for translating the cost recovery deduction (that is, the historic rate for the property to which such deduction is attributable) less the exchange rate used to translate COGS under the simplified inventory method described in paragraph (c)(2)(iv)(A) of this section (that is, the yearly average exchange rate for the taxable year).

(iii) *Adjustment to beginning inventory for non-LIFO inventory.* In the case of

inventory with respect to which a section 987 QBU does not use the LIFO inventory method (non-LIFO inventory), the translated COGS amount computed under paragraph (c)(2)(iv)(A) of this section must be increased or decreased (as appropriate) by the product of:

(A) The ending non-LIFO inventory included on the closing balance sheet for the preceding year, expressed in the functional currency of the section 987 QBU; and

(B) The exchange rate described in §§1.987–4(e)(2)(ii) and 1.987–1(c)(3)(i)(C) that is used for translating ending inventory on the closing balance sheet for the preceding year (that is, the yearly average exchange rate for the preceding year) less the exchange rate used to translate COGS under paragraph (c)(2)(iv)(A) of this section (that is, the yearly average exchange rate for the taxable year).

(iv) *Adjustment for year of LIFO liquidation.* In the case of inventory with respect to which a section 987 QBU uses the LIFO inventory method, for each LIFO layer liquidated in whole or in part during the taxable year, the translated COGS amount computed under paragraph (c)(2)(iv)(A) of this section must be increased or decreased (as appropriate) by the product of:

(A) The amount of the LIFO layer liquidated during the taxable year, expressed in the functional currency of the section 987 QBU; and

(B) The exchange rate described in §§1.987–4(e)(2)(ii) and 1.987–1(c)(3)(i)(C) that is used for translating such LIFO layer (that is, the yearly average exchange rate for the year such LIFO layer arose) less the exchange rate used to translate COGS under paragraph (c)(2)(iv)(A) of this section (that is, the yearly average exchange rate for the taxable year).

(d) [Reserved]. For further guidance, see §1.987–3T(c)(2)(v) through (d).

(e) *Examples.* The following examples illustrate the application of this section. For purposes of the examples, U.S. Corp is a domestic corporation that uses the calendar year as its taxable year and has the U.S. dollar as its functional currency. Except as otherwise indicated, U.S. Corp is the owner of Business A, a section 987 QBU with the euro as its functional currency, and elects under paragraph (c)(2)(iv)(B) of this section to use the historic inventory method with respect to Business A but does not make any other elections under section 987. However, where it is specified that U.S. Corp elects to use spot rates in lieu of yearly average exchange rates under §1.987–1(c)(1)(iii), U.S. Corp also elects under §1.987–1(c)(1)(ii) to use a spot rate convention. Under this convention, sales booked during a particular month are translated at the average of the spot rates on the first and last day of the preceding month (the ''convention rate''). Exchange rates used in these examples are selected for the purpose of illustrating the principles of this section. No inference (for example, whether a currency is hyperinflationary or not) is intended by their use. See §1.987–4(g) for an illustration of the simplified inventory method described in paragraphs (c)(2)(iv)(A) and (c)(3) of this section.

Example 1. Business A properly accrues £100 of income from the provision of services. Under paragraph (b)(2)(i) of this section, the £100 is translated into €90 at the spot rate (as defined in §1.987–1(c)(1)) on the date of accrual, without the use of a spot rate convention. In determining U.S. Corp's taxable income, the €90 of income is translated into dollars at the rate provided in paragraph (c)(1) of this section.

Example 2. Business A sells a historic asset consisting of non-inventory property for £100. Under paragraph (b)(2)(i) of this section, the £100 amount realized is translated into €85 at the spot rate (as defined in §1.987–1(c)(1)) on the sale date without the use of a spot rate convention. In determining U.S. Corp's taxable income, the €85 is translated into dollars at the rate provided in paragraph (c)(1) of this section. The euro basis of the property is translated into dollars at the rate provided in paragraph (c)(2)(i) of this section (that is, the historic rate as determined under §1.987–1(c)(3)).

Example 3. (i) Business A uses a first-in, first-out (FIFO) method of accounting for inventory. Business A sells 1,200 units of inventory in 2021 for €3 per unit. Business A's gross sales are translated under paragraph (c)(1) of this section at the yearly average exchange rate for the year of the sale. The yearly average exchange rate is €1 = $1.02 for 2020 and €1 = $1.05 for 2021. Thus, Business A's dollar gross sales will be computed as follows:

GROSS SALES

[2021]

Month	Number of units	Amount in €	€/$ yearly average rate	Amount in $
Jan	100	300	€1 = $1.05	315.00
Feb	200	600	€1 = $1.05	630.00
March	0	0	€1 = $1.05	0
April	200	600	€1 = $1.05	630.00
May	100	300	€1 = $1.05	315.00
June	0	0	€1 = $1.05	0
July	100	300	€1 = $1.05	315.00
Aug	100	300	€1 = $1.05	315.00
Sept	0	0	€1 = $1.05	0
Oct	0	0	€1 = $1.05	0
Nov	100	300	€1 = $1.05	315.00
Dec	300	900	€1 = $1.05	945.00
	1,200			3,780.00

(ii) The purchase price for each inventory unit was €1.50. Under §1.987–1(c)(3)(i) and paragraph (c)(2)(iv)(B) of this section, the basis of each item of inventory is translated into dollars at the yearly average exchange rate for the year the inventory was acquired.

OPENING INVENTORY AND PURCHASES

[2021]

Month	Number of units	Amount in €	€/$ yearly average rate	Amount in $
Opening inventory (purchased in December 2020)	100	150	€1 = $1.02	153.00
Purchases in 2021:				
Jan	300	450	€1 = $1.05	472.50
Feb	0	0	€1 = $1.05	0
March	0	0	€1 = $1.05	0
April	300	450	€1 = $1.05	472.50
May	0	0	€1 = $1.05	0
June	0	0	€1 = $1.05	0
July	300	450	€1 = $1.05	472.50
Aug	0	0	€1 = $1.05	0
Sept	0	0	€1 = $1.05	0
Oct	0	0	€1 = $1.05	0
Nov	300	450	€1 = $1.05	472.50
Dec	0	0	€1 = $1.05	0
	1,200			1,890.00

(iii) Because Business A uses a FIFO method for inventory, Business A is considered to have sold in 2021 the 100 units of opening inventory purchased in 2020 ($153.00), the 300 units purchased in January 2021 ($472.50), the 300 units purchased in April 2021 ($472.50), the 300 units purchased in July 2021 ($472.50), and 200 of the 300 units purchased in November 2021 ($315.00). Accordingly, Business A's translated dollar COGS for 2021 is $1,885.50. Business A's opening inventory for 2022 is 100 units of inventory with a translated dollar basis of $157.50.

(iv) Accordingly, for purposes of section 987 Business A has gross income in dollars of $1,894.50 ($3,780.00—$1,885.50).

Example 4. (i) The facts are the same as in *Example 3* except that U.S. Corp properly elects under paragraph §1.987–1(c)(1)(iii) to use spot rates in lieu of yearly average exchange rates. As a result, under paragraph (c)(3) of this section, U.S. Corp uses the convention rate to translate items of income, gain, deduction, or loss where such rate is appropriate. Thus, Business A's dollar gross sales will be computed as follows:

GROSS SALES

[2021]

Sales	Number of units	Amount in €	€/$ convention rate	Amount in $
Jan	100	300	€1 = $1.00	300
Feb	200	600	€1 = $1.05	630
March	0	0	€1 = $1.03	0
April	200	600	€1 = $1.02	612
May	100	300	€1 = $1.04	312
June	0	0	€1 = $1.05	0
July	100	300	€1 = $1.06	318
Aug	100	300	€1 = $1.05	315
Sept	0	0	€1 = $1.06	0
Oct	0	0	€1 = $1.07	0
Nov	100	300	€1 = $1.08	324
Dec	300	900	€1 = $1.08	972
	1,200	.....	.....	3,783

(ii) As in *Example 3*, the purchase price for each inventory unit was €1.50. Under §1.987–3(c)(2)(iv)(B), U.S. Corp uses the convention rate as the historic rate in determining COGS.

OPENING INVENTORY AND PURCHASES

[2021]

Month	Number of units	Amount in €	€/$ convention rate	Amount in $
Opening inventory (purchased in December 2020)	100	150	€1 = $1.02	153
Purchases in 2021:				
Jan	300	450	€1 = $1.00	450
Feb	0	0	€1 = $1.05	0
March	0	0	€1 = $1.03	0
April	300	450	€1 = $1.02	459
May	0	0	€1 = $1.04	0
June	0	0	€1 = $1.05	0
July	300	450	€1 = $1.06	477
Aug	0	0	€1 = $1.05	0
Sept	0	0	€1 = $1.06	0
Oct	0	0	€1 = $1.07	0
Nov	300	450	€1 = $1.08	486
Dec	0	0	€1 = $1.08	486
	1,200	.....	.....	1,872

(iii) As set forth in (i), Business A's gross sales are $3,783.

(iv) Because Business A uses a FIFO method for inventory, Business A is considered to have sold in 2021 the 100 units of opening inventory purchased in December 2020 ($150), the 300 units purchased in January 2021 ($450), the 300 units purchased in April 2021 ($459), the 300 units purchased in July 2021 ($477), and 200 of the 300 units purchased in November 2021 ($324). Thus, Business A's COGS is $1,860.

(v) Accordingly, Business A has gross income in dollars of $1,923 ($3,783 − $1,860).

Example 5. The facts are the same as in *Example 3* except that during 2021, Business A incurred €100 of depreciation expense with respect to a truck. No portion of the depreciation expense is an inventoriable cost. The truck was purchased on January 15, 2020. The yearly average exchange rate for 2020 was €1 = $1.02. Under paragraph (c)(2)(i) of this section, the €100 of depreciation is translated into dollars at the historic rate. Under §1.987–1(c)(3)(i), the historic rate is the yearly average rate for 2020. Accordingly, U.S. Corp takes into account depreciation of $102 with respect to Business A in 2021.

Example 6. The facts are the same as in *Example 5* except that the €100 of depreciation expense incurred during 2021 with respect to the truck is an inventoriable cost. As a result, the depreciation expense is capitalized into the 1,200 units of inventory purchased by Business A in 2021. Of those 1,200 units, 1,100 units are sold during the year, and 100

units become ending inventory. The portion of depreciation expense capitalized into inventory that is sold during 2021 is reflected in Business A's euro COGS and is translated at the €1 = $1.02 yearly average exchange rate for 2020, the year in which the truck was purchased. The portion of the depreciation expense capitalized into the 100 units of ending inventory is not taken into account in 2021 but, rather, will be taken into account in the year the ending inventory is sold, translated at the €1 = $1.02 yearly average exchange rate for 2020.

Example 7. Business A purchased raw land on October 16, 2020, for €8,000 and sold the land on November 1, 2021, for €10,000. The yearly average exchange rate was €1 = $1.02 for 2020 and €1 = $1.05 for 2021. Under paragraph (c)(1) of this section, the amount realized is translated into dollars at the yearly average exchange rate for 2021 (€10,000 × $1.05 = $10,500). Under paragraph (c)(2)(i) of this section, the basis is determined at the historic rate for 2020, which is the yearly average rate under section §1.987–1(c)(3)(i) for such year (€8,000 × $1.02 = $8,160). Accordingly, the amount of gain reported by U.S. Corp on the sale of the land is $2,340 ($10,500 − $8,160).

Example 8. The facts are the same as in *Example 7* except that Business A properly elects under paragraph §1.987–1(c)(1)(iii) to use spot rates in lieu of yearly average rates. Accordingly, the amount realized will be translated at the convention rate for the date of sale, and the basis will be translated at the convention rate for the date of purchase. The convention rate is €1 = $1.01 for October 2020 and is €1 = $1.08 for November 2021. Under these facts, the amount realized, translated into dollars at the convention rate for November 2021, is $10,800 (€10,000 × $1.08), and the basis, translated at the convention rate for October 2020, is $8,080 (€8,000 × $1.01). The amount of gain reported by U.S. Corp on the sale of the land is $2,720 ($10,800 − $8,080).

Example 9 through Example 14 [Reserved]. For further guidance, see §1.987–3T(e), *Example 9* through *Example 14*.

[T.D. 9794, 81 FR 88821, Dec. 8, 2016, as amended by T.D. 9795, 81 FR 88870, Dec. 8, 2016]

§ 1.987–3T Determination of section 987 taxable income or loss of an owner of a section 987 QBU (temporary).

(a) through (b)(2)(i) [Reserved]. For further guidance, see §1.987–3(a) through (b)(2)(i).

(ii) *No translation of basis or amount realized with respect to a specified owner functional currency transaction treated as a historic asset.* If the acquisition of a historic asset gives rise to a specified owner functional currency transaction described in paragraph (b)(4)(ii) of this section, the basis of the historic asset, and any amount realized on a disposition of the historic asset, is not translated if the amount is denominated in the owner's functional currency.

(3) [Reserved]. For further guidance, see §1.987–3(b)(3).

(4) *Special rule for section 988 transactions*—(i) *In general.* Section 988 and the regulations thereunder apply to section 988 transactions of a section 987 QBU. For this purpose, whether a transaction is a section 988 transaction is determined by reference to the functional currency of the section 987 QBU. (But see paragraph (b)(4)(ii) of this section, providing that specified owner functional currency transactions are not treated as section 988 transactions.) However, except as provided in paragraph (b)(4)(iii)(A) of this section, section 988 gain or loss is determined in, and by reference to, the functional currency of the owner of the section 987 QBU rather than the functional currency of the section 987 QBU. Accordingly, in determining section 988 gain or loss of a section 987 QBU with respect to a section 988 transaction of the section 987 QBU, the amounts required under section 988 and the regulations thereunder to be translated on the applicable booking date or payment date with respect to the section 988 transaction are translated into the owner's functional currency at the rate required under section 988 and the regulations thereunder.

(ii) *Specified owner functional currency transactions not treated as section 988 transactions.* Transactions of a section 987 QBU described in sections 988(c)(1)(B)(i), 988(c)(1)(B)(ii), and 988(c)(1)(C) (including the acquisition of nonfunctional currency as described in §1.988–1(a)(1)), other than transactions described in paragraph (b)(4)(iii)(A) of this section, that are denominated in (or determined by reference to) the owner's functional currency (specified owner functional currency transactions) are not treated as section 988 transactions. Thus, no currency gain or loss is recognized by a section 987 QBU under section 988 with respect to such transactions.

(iii) *Determination of section 988 gain or loss for qualified short-term section 988 transactions*—(A) *Determination by reference to the section 987 QBU's functional currency for certain transactions subject to a mark-to-market method of accounting.* Section 988 gain or loss with respect to section 988 transactions described in paragraph (b)(4)(iii)(B) of this section that are accounted for under a mark-to-market method of accounting for Federal income tax purposes or under the foreign currency mark-to-market method of accounting described in paragraph (b)(4)(iii)(C) of this section, and any hedges entered into to manage risk with respect to such transactions within the meaning of §1.1221–2(c)(4) (related hedges), must be determined in, and by reference to, the functional currency of the section 987 QBU (rather than the functional currency of its owner).

(B) *Qualified short-term section 988 transaction.* A qualified short-term section 988 transaction is a section 988 transaction that occurs in the ordinary course of a section 987 QBU's business and has an original term of one year or less on the date the transaction is entered into by the section 987 QBU. The holding of currency that is nonfunctional currency (within the meaning of section 988(c)(1)(C)(ii)) to the section 987 QBU in the ordinary course of a section 987 QBU's trade or business also is treated as a qualified short-term section 988 transaction. Any transaction that is denominated in, or determined by reference to, a hyperinflationary currency, including the holding of hyperinflationary currency, is not considered a qualified short-term section 988 transaction. See §§1.988–2(b)(15), 1.988–2(d)(5), and 1.988–2(e)(7) for rules relating to transactions denominated in, or determined by reference to, a hyperinflationary currency.

(C) *Election to use a foreign currency mark-to-market method of accounting.* A taxpayer may elect under this paragraph (b)(4)(iii)(C) to apply the foreign currency mark-to-market method of accounting described in this paragraph for all qualified short-term section 988 transactions described in paragraph (b)(4)(iii)(B) of this section, and any related hedges, that are properly attributable to a section 987 QBU on or after the effective date of the election and that are not otherwise accounted for under a mark-to-market method of accounting under section 475 or section 1256. Under the foreign currency mark-to-market method of accounting, the timing of section 988 gain or loss on section 988 transactions is determined under the principles of section 1256(a)(1). Thus, only section 988 gain or loss is taken into account under the foreign currency mark-to-market method of accounting. Appropriate adjustments must be made to prevent the section 988 gain or loss from being taken into account again under section 988 or another provision of the Code or regulations. A section 988 transaction subject to this election is not subject to the ''netting rule'' of section 988(b) and §1.988–2(b)(8), under which exchange gain or loss is limited to overall gain or loss realized in a transaction, in taxable years prior to the taxable year in which section 988 gain or loss would be recognized with respect to such section 988 transaction but for this election.

(iv) *Examples.* Examples 10 through 13 of paragraph (e) of this section illustrate the application of this paragraph (b)(4).

(c)(1) through (c)(2)(i) [Reserved]. For further guidance, see §1.987–3(c)(1) through (c)(2)(i).

(ii) *Amount realized with respect to historic assets that are section 988 transactions.* If the acquisition of a historic asset gave rise to a section 988 transaction described in paragraph (b)(4)(i) of this section, then in computing the total gain or loss on a disposition of the historic asset (some or all of which total gain or loss may be section 988 gain or loss described in section 988(b) and paragraph (b)(4)(i) of this section), the amount realized (determined, if necessary, under §1.987–3(b)(2)(i)) is translated into the owner's functional currency using the spot rate on the date such item is properly taken into account, subject to the limitation under §1.987–1T(c)(1)(ii)(B) regarding the use of a spot rate convention.

(iii) through (iv) [Reserved]. For further guidance, see §1.987–3(c)(2)(iii) through (iv).

(v) *Translation of income to account for certain foreign income tax claimed as a*

credit. The owner of a section 987 QBU claiming a credit under section 901 for foreign income taxes, other than foreign income taxes deemed paid under section 902 or section 960, that are properly reflected on the books and records of the section 987 QBU (the creditable tax amount) must determine section 987 taxable income or loss attributable to the section 987 QBU by reducing the amount of section 987 taxable income or loss that otherwise would be determined under this section by an amount equal to the creditable tax amount, translated into U.S. dollars using the yearly average exchange rate for the taxable year in which the creditable tax is accrued, and by increasing the resulting amount by an amount equal to the creditable tax amount, translated using the same exchange rate that is used to translate the creditable taxes into U.S. dollars under section 986(a). See *Example 14* of paragraph (e) of this section,, for an illustration of this rule.

(d) *Election to translate all items at the yearly average exchange rate.* Notwithstanding §1.987–3(c), a taxpayer that has made the annual deemed termination election described in §1.987–8T(d) may elect under this paragraph (d) to translate all items of income, gain, deduction, and loss with respect to a section 987 QBU determined under §1.987–3(b) in the functional currency of the section 987 QBU into the owner's functional currency, if necessary, at the yearly average exchange rate for the taxable year. *Example 9* of paragraph (e) of this section illustrates the application of this election.

(e) *Example 1* through *Example 8* [Reserved]. For further guidance, see §1.987–3(e), *Example 1* through *Example 8*.

Example 9. The facts are the same as in *Example 7*, except that U.S. Corp properly elects under paragraph (d) of this section to translate all items of income, gain, deduction, and loss with respect to Business A at the yearly average exchange rate. Accordingly, Business A's €2,000 gain on the sale of the land is translated at the yearly average exchange rate for 2021 of €1 = $1.05, and the amount of gain reported by U.S. Corp on the sale of the land is $2,100.

Example 10. Business A acquires £100 on August 27, 2021, for €120 and sells the pounds on November 17, 2021, for €125. The dollar-pound spot rate (without the use of a spot rate convention) is £1 = $1 on August 27, 2021, and £1 = $1.10 on November 17, 2021. The disposition of the pounds is a section 988 transaction of Business A under paragraph (b)(4)(i) of this section, and the pounds are a historic asset under §1.987–1(e). Section 988 gain or loss with respect to the disposition of the pounds is determined under paragraph (b)(4)(i) of this section and §1.988–2(a)(2) by reference to the dollar functional currency of Business A's owner. The dollar amount realized for the pounds is determined under paragraph (c)(2)(ii) of this section by translating £100 into $110 using the dollar-pound spot rate on November 17, 2021, without the use of a spot rate convention. The dollar basis in the pounds is determined under §1.987–3(c)(2)(i) by translating £100 into $100 using the historic rate described in §1.987–1T(c)(3)(i)(E), which is the dollar-pound spot rate on August 27, 2021, without the use of a spot rate convention. Thus, U.S. Corp takes into account $10 of section 988 gain with respect to Business A's disposition of £100.

Example 11. (i) Business A purchases a £100 2-year note for €75 on October 1, 2021, and receives a £100 repayment of principal with respect to the note on December 31, 2021. At the spot rates on October 1, 2021 (as defined in §1.987–1(c)(1)), without the use of a spot rate convention, Business A's €75 purchase price translates into £80 and $95. At the spot rates on December 31, 2021, without the use of a spot rate convention, the £100 principal amount on the note translates into €90 and $130, and £80 translates into $104.

(ii) The acquisition of the note is a section 988 transaction of Business A under paragraph (b)(4)(i) of this section, and the note is a historic asset under §1.987–1(e). To determine its section 987 taxable income or loss with respect to Business A, U.S. Corp must determine Business A's total gain or loss on the disposition of the note in U.S. Corp's dollar functional currency. Consistent with §1.988–2(b)(8), U.S. Corp also must determine whether some or all of that gain or loss constitutes section 987 gain or loss described in section 988(b).

(iii) To determine Business A's total gain or loss on the disposition of the note, Business A's basis and amount realized on the note must be determined in euros under §1.987–3(b), if necessary, and translated into dollars under §1.987–3(c). Business A has a €75 basis in the note that is translated into $95 under §1.987–3(c)(2)(i) at the historic rate described in §1.987–1T(c)(3)(i)(E), which is the spot rate on the date the note was acquired without the use of a spot rate convention. Business A's £100 amount realized on the note is translated into €90 under §1.987–3(b)(2)(i) using the spot rate on December 31, 2021, without the use of a spot rate convention. That €90 amount realized is then translated into $130 under paragraph (c)(2)(ii) of

this section using the spot rate on December 31, 2021, without the use of a spot rate convention. Accordingly, the total gain with respect to the disposition of the note that is included in section 987 taxable income is $35 ($130 less $95).

(iv) U.S. Corp must determine whether some or all of the $35 total gain with respect to the note constitutes section 988 gain. The amount of section 988 gain realized with respect to the note is determined under §1.988–2(b)(5), which requires a comparison of the functional currency value of the principal amount of the note on the booking date and payment date spot rates, respectively, and defines the principal amount of the note as Business A's purchase price in units of nonfunctional currency, which is £80. Under paragraph (b)(4)(i) of this section, section 988 gain or loss with respect to the note is determined by reference to U.S. Corp's dollar functional currency, such that the amounts required under section 988 to be translated on the booking date and payment date are translated into the dollars at the booking date and payment date spot rates. Accordingly, Business A's £80 principal amount with respect to the note is translated at the booking date and payment date spots rates into $95 and $104, respectively. Thus, $9 ($104 less $95) of the $35 total gain taken into account by U.S. Corp as section 987 taxable income with respect to the note is section 988 gain. The remaining $26 of gain, which may be attributable to credit risk or another factor unrelated to currency fluctuations, is sourced and characterized without regard to section 988.

Example 12. The facts are the same as in *Example 11*, except that Business A is owned by a foreign corporation with a pound functional currency. Under paragraph (b)(4)(ii) of this section, the acquisition of the £100 2-year note is a specified owner functional currency transaction that is not treated as a section 988 transaction of Business A. Because the note is a historic asset under §1.987–1(e), Business A's €75 basis in the note translates into £80 at the historic rate described in §1.987–1T(c)(3)(i)(E), which provides that the historic rate is the spot rate for the date the note was acquired without the use of a spot rate convention. (If, instead, Business A had purchased the 5-year note for £80 rather than €75, then pursuant to paragraph (b)(2)(ii) of this section, Business A's basis in the note would have been determined without translating the £80 purchase price because it is denominated in the owner's functional currency.) Under paragraph (b)(2)(ii) of this section, the £100 amount realized with respect to the note is not translated because it is denominated in the owner's functional currency. Thus, the owner takes into account £20 (£100 less £80) of section 987 taxable income in 2021 with respect to the note.

Example 13. (i) Business A receives and accrues $100 of income from the provision of services on January 1, 2021. Business A continues to hold the $100 as a U.S. dollar-denominated demand deposit at a bank on December 31, 2021. U.S. Corp has elected under paragraph (b)(4)(iii)(C) of this section to use the foreign currency mark-to-market method of accounting for qualified short-term section 988 transactions entered into by Business A. The euro-dollar spot rate without the use of a spot rate convention is €1 = $1 on January 1, 2021, and €1 = $2 on December 31, 2021, and the yearly average exchange rate for 2021 is €1 = $1.50.

(ii) Under §1.987–3(b)(2)(i), the $100 earned by Business A is translated into €100 at the spot rate on January 1, 2021, as defined in §1.987–1(c)(1) without the use of a spot rate convention. In determining U.S. Corp's taxable income, the €100 of service income is translated into $150 at the yearly average exchange rate for 2021, as provided in §1.987–3(c)(1).

(iii) The $100 demand deposit constitutes a qualified short-term section 988 transaction under paragraph (b)(4)(iii)(B) of this section because the demand deposit is treated as nonfunctional currency within the meaning of section 988(c)(1)(C)(ii). Because Business A uses the foreign currency mark-to-market method of accounting for qualified short-term section 988 transactions, under paragraph (b)(4)(iii)(A) of this section, section 988 gain or loss for such transactions is determined in, and by reference to, euros, the functional currency of Business A. Accordingly, section 988 gain or loss must be determined on Business A's holding of the $100 demand deposit in, and by reference to, the euro. Under §1.988–2(a)(2), Business A is treated as having an amount realized of €50 when the $100 is marked to market at the end of 2021 under paragraph (b)(4)(iii)(C) of this section. Marking the dollars to market gives rise to a section 988 loss of €50 (€50 amount realized, less Business A's €100 basis in the $100). In determining U.S. Corp's taxable income, that €50 loss is translated into a $75 loss at the yearly average exchange rate for 2021, as provided in §1.987–3(c)(1).

Example 14. (i) *Facts.* Business A earns €100 of revenue from the provision of services and incurs €30 of general expenses and €10 of depreciation expense during 2021. Except as otherwise provided, U.S. Corp uses the yearly average exchange rate described in §1.987–1(c)(2) to translate items of income, gain, deduction, and loss of Business A. Business A is subject to income tax in Country X at a 25 percent rate. U.S. Corp claims a credit with respect to Business A's foreign income taxes and elects under section 986(a)(1)(D) to translate the foreign income taxes at the spot rate on the date the taxes were paid. The yearly average exchange rate for 2021 is €1 = $1.50. The historic rate used to translate the

depreciation expense is €1 = $1.00. The spot rate on the date that Business A paid its foreign income taxes was €1 = $1.60.

(ii) *Analysis.* Because U.S. Corp has elected to translate foreign income taxes at the spot rate on the date such taxes were paid rather than at the yearly average exchange rate, U.S. Corp must make the adjustments described in paragraph (c)(2)(v) of this section. Accordingly, U.S. Corp determines its section 987 taxable income by reducing the section 987 taxable income or loss that otherwise would be determined under this section by €15, translated into U.S. dollars at the yearly average exchange rate (€1 = $1.50), and increasing the resulting amount by €15, translated using the same exchange rate that is used to translate the creditable taxes into U.S. dollars under section 986(a) (€1 = $1.60). Following these adjustments, Business A's section 987 taxable income for 2021 is $96.50, computed as follows:

	Amount in €	Translation rate	Amount in $
Revenue	€100	€1 = $1.50	$150.00
General Expenses	(30)	€1 = $1.50	(45.00)
Depreciation	(10)	€1 = $1.00	(10.00)
Tentative section 987 taxable income	€60		$95.00
Adjustments under paragraph (c)(2)(v) of this section:			
Decrease by €15 tax translated at yearly average exchange rate (€1 = $1.50)			($22.50)
Increase by €15 tax translated at spot rate on payment date (€1 = $1.60)			24.00
Section 987 taxable income			$96.50

(f) *Effective/applicability date.* This section applies to taxable years beginning on or after one year after the first day of the first taxable year following December 7, 2016. Notwithstanding the preceding sentence, if a taxpayer makes an election under §1.987–11(b), then this section applies to taxable years to which §§1.987–1 through 1.987–10 apply as a result of such election.

(g) *Expiration date.* The applicability of this section expires on December 6, 2019.

[T.D. 9795, 81 FR 88870, Dec. 8, 2016]

§ 1.987–4 Determination of net unrecognized section 987 gain or loss of a section 987 QBU.

(a) *In general.* The net unrecognized section 987 gain or loss of a section 987 QBU shall be determined by the owner annually as provided in paragraph (b) of this section in the owner's functional currency. Only assets and liabilities reflected on the books and records of the section 987 QBU under §1.987–2(b) shall be taken into account.

(b) *Calculation of net unrecognized section 987 gain or loss.* Net unrecognized section 987 gain or loss of a section 987 QBU for a taxable year shall equal the sum of:

(1) The section 987 QBU's net accumulated unrecognized section 987 gain or loss for all prior taxable years to which these regulations apply as determined in paragraph (c) of this section, and

(2) The section 987 QBU's unrecognized section 987 gain or loss for the current taxable year as determined in paragraph (d) of this section.

(c) *Net accumulated unrecognized section 987 gain or loss for all prior taxable years*—(1) *In general.* A section 987 QBU's net accumulated unrecognized section 987 gain or loss for all prior taxable years is the aggregate of the amounts determined under §1.987–4(d) for all prior taxable years to which these regulations apply, reduced by the amounts taken into account under §1.987–5 upon remittances for all such prior taxable years.

(2) [Reserved]. For further guidance, see §1.987–4T(c)(2).

(d) *Calculation of unrecognized section 987 gain or loss for a taxable year.* The unrecognized section 987 gain or loss of a section 987 QBU for a taxable year shall be determined under paragraphs (d)(1) through (8) of this section.

(1) *Step 1: Determine the change in the owner functional currency net value of the section 987 QBU for the taxable year*—(i) *In general.* The change in the owner functional currency net value of the section 987 QBU for the taxable year shall equal—

(A) The owner functional currency net value of the section 987 QBU, determined in the functional currency of the owner under paragraph (e) of this section, on the last day of the taxable year; less

(B) The owner functional currency net value of the section 987 QBU, determined in the functional currency of the owner under paragraph (e) of this section, on the last day of the preceding taxable year. This amount shall be zero in the case of the section 987 QBU's first taxable year.

(ii) *Year section 987 QBU is terminated.* If a section 987 QBU is terminated within the meaning of §1.987–8 during an owner's taxable year, the owner functional currency net value of the section 987 QBU as provided in paragraph (d)(1)(i)(A) of this section shall be determined on the date the section 987 QBU is terminated.

(2) *Step 2: Increase the amount determined in step 1 by the amount of assets transferred from the section 987 QBU to the owner*—(i) *In general.* The amount determined in paragraph (d)(1) of this section shall be increased by the total amount of assets described in paragraph (d)(2)(ii) of this section transferred from the section 987 QBU to the owner during the taxable year translated into the owner's functional currency as provided in paragraph (d)(2)(ii) of this section.

(ii) *Assets transferred from the section 987 QBU to the owner during the taxable year.* The assets transferred from the section 987 QBU to the owner for the taxable year shall equal the sum of:

(A) The amount of the section 987 QBU's functional currency and the aggregate adjusted basis of all marked assets (as defined in §1.987–1(d)), after taking into account §1.988–1(a)(10), transferred to the owner during the taxable year determined in the functional currency of the section 987 QBU and translated into the owner's functional currency at the spot rate (as defined in §1.987–1(c)(1)) applicable to the date of transfer; and

(B) The aggregate adjusted basis of all historic assets (as defined in §1.987–1(e)), after taking into account §1.988–1(a)(10), transferred to the owner during the taxable year determined in the functional currency of the section 987 QBU and translated into the owner's functional currency at the historic rate for each such asset (as defined in §1.987–1(c)(3)).

(3) *Step 3: Decrease the amount determined in steps 1 and 2 by the amount of assets transferred from the owner to the section 987 QBU*—(i) *In general.* The aggregate amount determined in paragraphs (d)(1) and (d)(2) of this section shall be decreased by the total amount of assets transferred from the owner to the section 987 QBU during the taxable year determined in the functional currency of the owner as provided in paragraph (d)(3)(ii) of this section.

(ii) *Total of all amounts transferred from the owner to the section 987 QBU during the taxable year.* The total amount of assets transferred from the owner to the section 987 QBU for the taxable year shall equal the aggregate of:

(A) The total amount of functional currency of the owner transferred to the section 987 QBU during the taxable year; and

(B) The adjusted basis, determined in the functional currency of the owner, of any asset transferred to the section 987 QBU during the taxable year (after taking into account §1.988–1(a)(10)).

(4) *Step 4: Decrease the amount determined in steps 1 through 3 by the amount of liabilities transferred from the section 987 QBU to the owner.* The aggregate amount determined in paragraphs (d)(1) through (3) of this section shall be decreased by the aggregate amount of liabilities transferred from the section 987 QBU to the owner during the taxable year. The amount of such liabilities shall be translated into the functional currency of the owner at the spot rate (as defined in §1.987–1(c)(1)) applicable on the date of transfer.

(5) *Step 5: Increase the amount determined in steps 1 through 4 by the amount of liabilities transferred from the owner to the section 987 QBU.* The aggregate amount determined in paragraphs (d)(1) through (4) of this section shall be increased by the aggregate amount of liabilities transferred by the owner to the section 987 QBU during the taxable year. The amount of such liabilities shall be translated into the functional currency of the owner at the spot rate

(as defined in §1.987–1(c)(1)) applicable on the date of transfer.

(6) *Step 6: Decrease or increase the amount determined in steps 1 through 5 by the section 987 taxable income or loss, respectively, of the section 987 QBU for the taxable year.* The aggregate amount determined in paragraphs (d)(1) through (5) of this section shall be decreased or increased by the section 987 taxable income or loss, respectively, computed under §1.987–3 for the taxable year.

(7) *Step 7: Increase the amount determined in steps 1 through 6 by any expenses that are not deductible in computing the section 987 taxable income or loss of the section 987 QBU for the taxable year.* The aggregate amount determined under paragraphs (d)(1) through (6) shall be increased by the amount of any expense or loss attributable to a section 987 QBU for the taxable year that is not deductible in computing the section 987 QBU's taxable income or loss for the year, including any foreign income taxes incurred by the section 987 QBU with respect to which the owner claims a credit (translated at the same rate at which such taxes were translated under section 986(a)).

(8) *Step 8: Decrease the amount determined in steps 1 through 7 by the amount of any tax-exempt income.* The aggregate amount determined under paragraphs (d)(1) through (7) shall be decreased by the amount of any income or gain attributable to a section 987 QBU for the taxable year that is not included in computing the section 987 QBU's taxable income or loss for the year.

(e) *Determination of the owner functional currency net value of a section 987 QBU*—(1) *In general.* The owner functional currency net value of a section 987 QBU on the last day of a taxable year shall equal the aggregate amount of functional currency and the adjusted basis of each asset on the section 987 QBU's balance sheet on that day, less the aggregate amount of each liability on the section 987 QBU's balance sheet on that day, in each case translated into the owner's functional currency as provided in paragraph (e)(2) of this section. Such amount shall be determined by:

(i) Preparing a balance sheet for the relevant date from the section 987 QBU's books and records (within the meaning of §1.989(a)–1(d)), as recorded in the section 987 QBU's functional currency and showing all assets and liabilities reflected on such books and records as provided in §1.987–2(b);

(ii) Making adjustments necessary to conform the items reflected on the balance sheet described in paragraph (e)(1)(i) of this section to United States tax accounting principles; and

(iii) Translating the asset and liability amounts on the adjusted balance sheet described in paragraph (e)(1)(ii) of this section into the functional currency of the owner in accordance with paragraph (e)(2) of this section.

(2) *Translation of balance sheet items into the owner's functional currency.* The amount of the section 987 QBU's functional currency, the basis of an asset, or the amount of a liability shall be translated as follows:

(i) *Marked item.* A marked item (as defined in §1.987–1(d)) shall be translated into the owner's functional currency at the spot rate (as defined in §1.987–1(c)(1)) applicable to the last day of the relevant taxable year.

(ii) *Historic item.* A historic item (as defined in §1.987–1(e)) shall be translated into the owner's functional currency at the historic rate (as defined in §1.987–1(c)(3)).

(f) [Reserved]. For further guidance, see §1.987–4T(f).

(g) *Examples.* The following examples illustrate the provisions of this section. For purposes of the examples, U.S. Corp is a domestic corporation that uses the calendar year as its taxable year and has the dollar as its functional currency. Except as otherwise indicated, U.S. Corp elects under §1.987–3(c)(2)(iv)(B) to use the historic inventory method with respect to all of its section 987 QBUs but does not make other elections under section 987. Exchange rate and tax accounting (for example, depreciation rate) assumptions used in these examples are selected for the purpose of illustrating the principles of this section, and no inference is intended by their use. Additionally, the examples are not intended to demonstrate when activities constitute a trade or business within the meaning of §1.989(a)–1(b)(2)(ii)(A) and §1.989(a)–

1(c) and therefore whether a section 987 QBU is onsidered to exist.

Example 1. (i) On July 1, 2021, U.S. Corp establishes Japan Branch, a section 987 QBU of U.S. Corp that has the yen as its functional currency, and transfers to Japan Branch $1,000 and raw land with a basis of $500. Japan Branch immediately exchanges the $1,000 for ¥100,000. On the same day, Japan Branch borrows ¥10,000. For the taxable year 2021, Japan Branch earns ¥2,000 per month (total of ¥12,000 for the six-month period from July 1, 2021, through December 31, 2021) for providing services and incurs ¥333.33 per month (total of ¥2,000 when rounded for the six-month period from July 1, 2021, through December 31, 2021) of related expenses. Assume that the spot rate on July 1, 2021, is $1 = ¥100; the spot rate on December 31, 2021, is $1 = ¥120; and the average rate for the period of July 1, 2021, to December 31, 2021, is $1 = ¥110. Thus, the ¥12,000 of services revenue when properly translated under §1.987–3(c)(1) at the yearly average exchange rate equals $109.09 (¥12,000 × ($1/¥110)) = $109.09). The ¥2,000 of expenses translated at the same yearly average exchange rate equals $18.18 (¥2,000 × ($1/¥110) = $18.18). Thus, Japan Branch's net income translated into dollars equals $90.91 ($109.09 − $18.18 = $90.91).

(ii) Under paragraph (a) of this section, U.S. Corp must compute the net unrecognized section 987 gain or loss of Japan Branch for 2021. Because this is Japan Branch's first taxable year, the net unrecognized section 987 gain or loss (as defined under paragraph (b) of this section) is the branch's unrecognized section 987 gain or loss for 2021 as determined in paragraph (d) of this section. The calculation under paragraph (d) of this section is made as follows:

(iii) *Step 1.* Under paragraph (d)(1) of this section, U.S. Corp must determine the change in the owner functional currency net value (OFCNV) of Japan Branch for 2021 in dollars. The change in the OFCNV of Japan Branch for 2021 is equal to the OFCNV of Japan Branch determined in dollars on the last day of 2021, less the OFCNV of Japan Branch determined in dollars on the last day of the preceding taxable year.

(A) The OFCNV of Japan Branch determined in dollars on the last day of the current taxable year is determined under paragraph (e) of this section as the sum of the basis of each asset on Japan Branch's balance sheet on December 31, 2021, less the sum of each liability on Japan Branch's balance sheet on that date, translated into dollars as provided in paragraph (e)(2) of this section.

(B) For this purpose, Japan Branch will show the following assets and liabilities on its balance sheet for December 31, 2021:

(1) ¥120,000;

(2) Raw land with a basis of ¥55,000 ($500 translated under §1.987–2(d)(2) at the historic rate of $1 = ¥110); and

(3) Liabilities of ¥10,000.

(C) Under paragraph (e)(2) of this section, U.S. Corp will translate these items as follows. The ¥120,000 is a marked asset and the ¥10,000 liability is a marked liability (as each is defined in §1.987–1(d)). These items are translated into dollars on December 31, 2021, using the spot rate on December 31, 2021, of $1 = ¥120. The raw land is a historic asset (as defined in §1.987–1(e)) and is translated into dollars under paragraph (e)(2)(ii) of this section at the historic rate, which under §1.987–1(c)(3)(1)(A) is the yearly average exchange rate of $1 = ¥110 applicable to the year the land was transferred to the QBU. Thus, the OFCNV of Japan Branch on December 31, 2021, in dollars is $1,416.67 determined as follows:

Assets	Amount in ¥	Translation rate	Amount in $
Yen	120,000	$1 = ¥120 (spot rate—12/31/21)	$1,000.00
Land	55,000	1 = ¥110 (yearly average rate—2021)	500.00
Total assets			1,500.00
Liabilities:			
Bank Loan	10,000	1 = ¥120 (spot rate—12/31/21)	83.33
Total liabilities			83.33
2021 ending OFCNV			1,416.67

(D) Under paragraph (d)(1) of this section, the change in OFCNV of Japan Branch for 2021 is equal to the OFCNV of the branch determined in dollars on December 31, 2021, ($1,416.67) less the OFCNV of the branch determined in dollars on the last day of the preceding taxable year. Because this is the first taxable year of Japan Branch, the OFCNV of Japan Branch determined in dollars on the last day of the preceding taxable year is zero under paragraph (d)(1)(i)(B) of this section. Accordingly, the change in OFCNV of Japan Branch for 2021 is $1,416.67.

(iv) *Step 2.* Under paragraph (d)(2) of this section, the aggregate amount determined in paragraph (d)(1) of this section (step 1) is increased by the total amount of assets described in paragraph (d)(2)(ii) of this section transferred from the section 987 QBU to the owner during the taxable year translated

into the owner's functional currency as provided in paragraph (d)(2)(ii) of this section. Because no such amounts were transferred, there is no change in the $1,416.67 determined in step 1.

(v) *Step 3.* Under paragraph (d)(3) of this section, the aggregate amount determined in paragraphs (d)(1) and (d)(2) of this section (steps 1 and 2) is decreased by the total amount of assets transferred from the owner to the section 987 QBU during the taxable year as determined in paragraph (d)(3)(ii) of this section in dollars. On July 1, 2021, U.S. Corp transferred to Japan Branch $1,000.00 (which Japan Branch immediately converted into ¥100,000) and raw land with a basis of $500.00 (equal to ¥55,000, translated under §1.987–2(d)(2) at the historic rate of $1 = ¥110). Thus, the $1,416.67 determined under steps 1 and 2 is reduced by $1,500.00, resulting in ($83.33).

(vi) *Steps 4 and 5.* Because no liabilities were transferred by U.S. Corp to Japan Branch or by Japan Branch to U.S. Corp during the taxable year, the aggregate amount determined in paragraph (d)(3) of this section (Step 3) is not increased or decreased.

(vii) *Step 6.* Under paragraph (d)(6) of this section, the aggregate amount determined after applying paragraphs (d)(1) through (5) of this section (steps 1 through 5) is decreased by the section 987 taxable income of Japan Branch of $90.91 from ($83.33) to ($174.24).

(viii) *Steps 7 and 8.* Paragraphs (d)(7) and (d)(8) do not apply because Japan Branch does not have any tax-exempt or nondeductible items. Accordingly, the unrecognized section 987 loss of Japan Branch for 2021 is ($174.24), the amount determined after applying step 6.

Example 2. (i) U.S. Corp operates in the United Kingdom through U.K. Branch, a section 987 QBU of U.S. Corp that has the pound as its functional currency. U.S. Corp properly elects under §1.987–1(c)(1)(ii) for U.K. Branch to use a spot rate convention (when permitted). Under the chosen convention, the spot rate (the ''convention rate'') for any transaction occurring during a month is the average of the pound spot rate and the 30-day forward rate for pounds on the next-to-last Thursday of the preceding month. The yearly average exchange rate was £1 = $0.90 for 2020, £1 = $1.00 for 2021, and £1 = $1.10 for 2022. The closing balance sheet of U.K. Branch in 2021 reflected the following assets:

(A) £100;

(B) A sales office purchased in 2020 with an adjusted basis of £1,000;

(C) A delivery truck purchased in 2020 with an adjusted basis of £200;

(D) Inventory of 100 units purchased in 2021 with a basis of £100; and

(E) Stock in ABC Corporation purchased in 2021 with a basis of £150, representing less than 10 percent of the total voting power and value of all classes of stock of ABC Corporation.

The closing balance sheet of U.K. Branch for 2021 reflected one liability, £50 of long-term debt entered into in 2020 with F Bank, an unrelated bank.

The office, truck, stock, and inventory are historic assets (as defined in §1.987–1(e)). The £100 and long-term debt are marked items (as defined in §1.987–1(d)). Assume that U.S. Corp translated U.K. Branch's 2021 closing balance sheet as follows:

Assets	Amount in £	Translation rate	Amount in $
Pounds	100.00	£1 = $1.05 (convention rate—Dec. 2021)	105.00
Office	1,000.00	£1 = $0.90 (historic rate—2020)	900.00
Truck	200.00	£1 = $0.90 (historic rate—2020)	180.00
Stock	50.00	£1 = $1.00 (historic rate—2021)	150.00
Inventory	100.00	£1 = $1.00 (historic rate—2021)	100.00
Total assets			1,435.00
Liabilities:			
Bank Loan	50.00	£1 = $1.05 (convention rate—Dec. 2021)	52.50
Total liabilities			52.50
2021 ending OFCNV			1,382.50

(ii) U.K. Branch uses the first-in, first-out (FIFO) method of accounting for inventory. In 2022, U.K. Branch sold 100 units of inventory for a total of £300 and purchased another 100 units of inventory for £100. There is depreciation of £33 with respect to the office and £40 with respect to the truck, and U.K. Branch incurred £30 of business expenses during 2022. Neither the depreciation nor the business expenses are inventoriable costs. All items of income earned and expenses incurred during 2022 are received and paid, respectively, in pounds. Under §1.987–3, U.K. Branch's section 987 taxable income or loss is determined as follows:

Item	Amount in £	Translation rate	Amount in $
Gross receipts	300.00	£1 = $1.10 (yearly average rate—2022)	330.00
Less:			
COGS	(100.00)	£1 = $1.00 (historic rate—2021)	(100.00)
Gross income			230.00
Dep:			
Office	(33.00)	£1 = $0.90 (historic rate—2020)	(29.70)
Truck	(40.00)	£1 = $0.90 (historic rate—2020)	(36.00)
Other expenses	(30.00)	£1 = $1.10 (yearly average rate—2022)	(33.00)
Total expenses			(98.70)
Section 987 taxable income			131.30

Accordingly, U.K. Branch has $131.30 of section 987 taxable income in 2022.

(iii) In December 2022, U.K. Branch transferred £30 to U.S. Corp, and U.S. Corp transferred a computer with a basis of $10 to U.K. Branch. U.S. Corp's net accumulated unrecognized section 987 gain or loss for all prior taxable years as determined in paragraph (c) of this section is $30.

(iv) The unrecognized section 987 gain or loss of U.K. Branch for 2022 is determined as follows:

(A) *Step 1.* Under paragraph (d)(1) of this section, the change in OFCNV for the taxable year must be determined. This amount is equal to the OFCNV of U.K. Branch determined under paragraph (e) of this section on the last day of 2022, less the OFCNV of U.K. Branch determined on the last day of 2021. The OFCNV of U.K. Branch on December 31, 2022, and the change in OFCNV for 2022, are determined as follows:

Assets	Amount in £	Translation rate	Amount in $
Pounds	240.00	£1 = $1.15 (convention rate—Dec. 2022)	276.00
Office	967.00	1 = $0.90 (historic rate—2020)	870.30
Truck	160.00	£1 = $0.90 (historic rate—2020)	144.00
Inventory	100.00	£1 = $1.10 (historic rate—2022)	110.00
Computer	9.09	£1 = $1.10 (historic rate—2022)	10.00
Stock	150.00	£1 = $1.00 (historic rate—2021)	150.00
Total assets			1,560.30
Liabilities:			
Bank Loan	50.00	£1 = $1.15 (convention rate—Dec. 2022)	57.50
Total liabilities			57.50
2022 ending OFCNV			1,502.80
Less:			
2021 ending OFCNV			(1,382.50)
Change in OFCNV			120.30

(B) *Step 2.* Under paragraph (d)(2) of this section, the aggregate amount determined in step 1 must be increased by the total amount of assets described in paragraph (d)(2)(ii) of this section transferred from U.K. Branch to U.S. Corp during the taxable year, translated into U.S. Corp's functional currency as provided in paragraph (d)(2)(ii) of this section. The amount of assets transferred from U.K. Branch to U.S. Corp during 2022 is determined as follows:

Asset	Amount in £	Translation rate	Amount in $
£30	30.00	£1 = $1.15 (convention rate—Dec. 2022)	34.50

(C) *Step 3: Decrease the aggregate amount described in steps 1 and 2 by the owner's transfers to the section 987 QBU.* Under paragraph (d)(3) of this section, the aggregate amount determined in steps 1 and 2 must be decreased by the total amount of all assets transferred from U.S. Corp to U.K. Branch during the taxable year as determined in paragraph (d)(3)(ii) of this section. The amount of assets transferred from U.S. Corp to U.K. Branch during 2022 is determined as follows:

Asset			Amount in $
Computer			10.00

(D) *Step 4.* Under paragraph (d)(4) of this section, the aggregate amount determined in steps 1 through 3 must be decreased by the aggregate amount of liabilities transferred by U.K. Branch to U.S. Corp. Under these facts, such amount is $0.

(E) *Step 5.* Under paragraph (d)(5) of this section, the aggregate amount determined in steps 1 through 4 must be increased by the aggregate amount of liabilities transferred by U.S. Corp to U.K. Branch. Under these facts, such amount is $0.

(F) *Step 6.* Under paragraph (d)(6) of this section, the aggregate amount determined in steps 1 through 5 is decreased or increased, respectively, by any section 987 taxable income or loss of U.K. Branch computed under §1.987–3 for the taxable year. The amount of U.K. Branch's taxable income, as determined above, is $131.30.

(G) [Reserved]

(H) *Steps 7 and 8:* Paragraphs (d)(7) and (d)(8) do not apply because U.K. Branch does not have any tax-exempt income or nondeductible expense.

(v) *Summary.* Taking steps 1 through 8 into account, the amount of U.S. Corp's unrecognized section 987 gain or loss with respect to U.K. Branch in 2022 is computed as follows:

Step	Amount in $	Balance
1	+ 120.30	$120.30
2	+ 34.50	154.80
3	− 10.00	144.80
4	− 0	144.80
5	+ 0	144.80
6	− 131.30	13.50
7	+ 0	13.50
8	− 0	13.50

Thus, U.S. Corp's unrecognized section 987 gain for 2022 with respect to U.K. Branch is $13.50. As of the end of 2022, before taking into account the recognition of any section 987 gain or loss under §1.987–5, U.S. Corp's net unrecognized section 987 gain is $43.50 (that is, $30.00 accumulated from prior years, plus $13.50 in 2022).

Example 3. (i) *Background.* U.S. Corp is the owner of Business A, a section 987 QBU that has the euro as its functional currency. Business A uses the FIFO method to account for inventory and uses the simplified inventory method described in §1.987–3(c)(2)(iv)(A). On the last day of 2020, U.S. Corp begins Business A by contributing to Business A a building with a basis of $780, a machine with a basis of $300, and $100. On January 1, 2021, Business A converts the $100 into €100. The tax basis of the building and machine is translated into euros using the historic rate, which is the yearly average exchange rate for 2020, the year of the transfer. Accordingly, the building and the machine have a tax basis of €780 and €300, respectively, on December 31, 2020. The building and machine have annual depreciation of €20 and €30, respectively. Business A determines that 50 percent of the building depreciation should be allocated to the cost of goods manufactured (that is, treated as an inventoriable cost) and 50 percent should be allocated to selling, general and administrative (SG&A) expenses. The machine is used exclusively to manufacture inventory. Relevant exchange rates for purposes of this example are as follows:

Year	Yearly average exchange rate	December 31 spot rate
2020	€1 = $1.00	€1 = $1.00
2021	€1 = $1.50	€1 = $2.00
2022	€1 = $2.50	€1 = $3.00

(ii) *Operations in 2021.* During 2021, Business A recognizes €140 of revenue from sales of finished goods. The related COGS is €70. Business A pays €10 in salaries allocable to SG&A. Inventoriable costs in 2021 include €10 of depreciation on the building and €30 of depreciation on the machine. Business A's balance sheet on December 31, 2021, shows no liabilities and the following assets: currency of €160, the building with an adjusted basis of €760, the machine with an adjusted basis of €270, and ending inventory with a FIFO cost basis of €40, comprising raw materials and finished goods.

(A) *Determination of income.* Under the simplified inventory method, Business A's income for 2021 is computed as follows:

Item	Amount in €	Translation rate	Amount in $
Sales revenue	140	€1 = $1.50 (yearly avg. rate—2021)	210
COGS before adjustments	70	€1 = $1.50 (yearly avg. rate—2021)	105
Adjustment for cost recovery deductions (see calculation below).			(20)
Adjustment for beginning inventory (none).			0
Adjusted COGS			85

Item	Amount in €	Translation rate	Amount in $
SG&A:			
Depreciation on building (50%)	10	€1 = $1.00 (historic rate—2020)	10
Salaries	10	€1 = $1.50 (yearly avg. rate—2021)	15
Total SG&A			25
Section 987 net income (revenue less COGS and SG&A).			100

COGS Adjustments.

Adjustment for cost recovery deductions included in inventoriable costs.

Depreciation amount	Historic rate	2021 yearly avg. rate	Difference in translation rates	Adjustment (depreciation × change in rates)
€10 (building)	1.00	1.50	(0.50)	($5)
€30 (machine)	1.00	1.50	(0.50)	(15)
Total adjustment for cost recovery deductions				(20)

(B) *Determination of OFCNV for 2020 and 2021.*

Under the simplified inventory method, the OFCNV of Business A for 2020 and 2021 is determined under paragraph (e) of this section as follows:

OFCNV—END OF 2021

Assets	Amount in €	Translation rate	Amount in $
Euros	160	€1 = $2.00 (year-end spot rate—2021)	320
Building	760	€1 = $1.00 (historic rate—2020)	760
Machine	270	€1 = $1.00 (historic rate—2020)	270
Inventory	40	€1 = $1.50 (yearly average rate—2021)	60
Total assets			1,410
Liabilities:			
Total liabilities			0
2021 ending OFCNV			1,410

OFCNV—END OF 2020

Assets	Amount in €	Translation rate	Amount in $
Euros	100	€1 = $1.00 (year-end spot rate—2020)	100
Building	780	€1 = $1.00 (historic rate—2020)	780
Machine	300	€1 = $1.00 (historic rate—2020)	300
Total assets			1,180
Liabilities:			
Total liabilities			0
2020 ending OFCNV			1,180

(C) *Determination of net unrecognized section 987 gain or loss.* The net unrecognized section 987 gain or loss of Business A is determined under paragraph (d) of this section as follows (relevant steps only):

(*1*) *Step 1.* Under paragraph (d)(1) of this section, the change in OFCNV for the taxable year must be determined. This amount is equal to the OFCNV of Business A determined under paragraph (e) of this section on the last day of 2021, less the OFCNV of Business A determined on the last day of 2020.

2021 ending OFCNV	$1,410
Less: 2020 ending OFCNV	(1,180)
Change in OFCNV	230

(*2*) *Step 6.* Under paragraph (d)(6) of this section, the aggregate amount determined in steps 1 through 5 must be decreased by the

section 987 taxable income of Business A. The amount of Business A's taxable income for 2021, as determined above, is $100.

Change in OFCNV	$230
Less: section 987 taxable income	(100)
Unrecognized section 987 gain	130
Plus: Net accumulated unrecognized section 987 gain or loss from prior years	0
Net unrecognized section 987 gain	130

(iii) *Operations in 2022.* During 2022, Business A recognizes €180 of revenue from sales of finished goods. The related COGS is €96. Business A pays €10 in salaries allocable to SG&A. Inventoriable costs in 2022 include €30 of depreciation on the machine and €10 of depreciation on the building. Business A's balance sheet on December 31, 2022, shows no liabilities and the following assets: currency of €260, the building with an adjusted basis of €740, the machine with an adjusted basis of €240, and ending inventory with a FIFO cost basis of €54, comprising raw materials and finished goods.

(A) *Determination of income.* Under the simplified inventory method, Business A's income for 2022 is computed as follows:

Item	Amount in €	Translation rate	Amount in $
Sales revenue	180	€1 = $2.50 (yearly avg. rate—2022)	450
COGS before adjustments	96	€1 = $2.50 (yearly avg. rate—2022)	240
Adjustment for cost recovery deductions (see calculation below).			(60)
Adjustment for beginning inventory (see calculation below).			(40)
Adjusted COGS			140
SG&A:			
Depreciation on building (50%)	10	€1 = $1.00 (historic rate—2020)	10
Salaries	10	€1 = $2.50 (yearly avg. rate—2022)	25
Total SG&A			35
Section 987 net income (revenue less COGS and SG&A).			275

COGS Adjustments.

Adjustment for cost recovery deductions.

Depreciation amount	Historic rate	2022 yearly avg. rate	Difference in translation rates	Adjustment (depreciation × change in rates)
€10 (building)	1.00	2.50	(1.50)	($15)
€30 (machine)	1.00	2.50	(1.50)	(45)
Total adjustment for cost recovery deductions				(60)

Adjustment for beginning inventory.

Prior year ending inventory	2021 yearly avg. rate	2022 yearly avg. rate	Difference in translation rates	Adjustment (inventory × change in rates)
€40	1.50	2.50	(1.00)	($40)
Total adjustment for beginning inventory				(40)

(B) *Determination of OFCNV.* Under the simplified inventory method, the OFCNV of Business A for 2022 is determined under paragraph (e) of this section as follows:

OFCNV—END OF 2022

Assets	Amount in €	Translation rate	Amount in $
Euros	260	€1 = $3.00 (year-end spot rate—2022)	780
Building	740	€1 = $1.00 (historic rate—2020)	740
Machine	240	€1 = $1.00 (historic rate—2020)	240
Inventory	54	€1 = $2.50 (yearly average rate—2022)	135
Total assets			1,895
Liabilities:			
Total liabilities			0
2022 ending OFCNV			1,895

(C) *Determination of net unrecognized section 987 gain or loss.* The net unrecognized section 987 gain of Business A is determined under paragraph (d) of this section as follows (relevant steps only):

(*1*) *Step 1.* Under paragraph (d)(1) of this section, the change in OFCNV for the taxable year must be determined. This amount is equal to the OFCNV of Business A determined under paragraph (e) of this section on the last day of 2022, less the OFCNV of Business A determined on the last day of 2021.

2022 ending OFCNV	$1,895
Less: 2021 ending OFCNV	(1,410)
Change in OFCNV	485

(*2*) *Step 6.* Under paragraph (d)(6) of this section, the aggregate amount determined in steps 1 through 5 must be decreased by the section 987 taxable income of Business A. The amount of Business A's taxable income for 2022, as determined above, is $275.

Change in OFCNV	$485
Less: Section 987 taxable income	(275)
Unrecognized section 987 gain 2022	210
Plus: Net accumulated unrecognized section 987 gain from prior year	130
Net unrecognized section 987 gain	340

Example 4. (i) *Background.* The background facts about Business A are the same as in *Example 3*, except that Business A uses the dollar-value LIFO method to account for inventory.

(ii) *Operations in 2021.* The facts about Business A's operations in 2021 are the same as in *Example 3*.

(A) *Determination of income.* Under the simplified inventory method, Business A's income for 2021 is computed as follows:

Item	Amount in €	Translation rate	Amount in $
Sales revenue	140	€1 = $1.50 (yearly avg. rate—2021)	210
COGS before adjustments	70	€1 = $1.50 (yearly avg. rate—2021)	105
Adjustment for cost recovery deductions (same as *Example 1*).			(20)
Adjustment for LIFO liquidation (none).			0
Adjusted COGS			85
SG&A:			
Depreciation on building (50%)	10	€1 = $1.00 (historic rate—2020)	10
Salaries	10	€1 = $1.50 (yearly avg. rate—2021)	15
Total SG&A			25
Section 987 net income (revenue less COGS and SG&A).			100

(B) *Determination of OFCNV for 2020 and 2021.* Under the simplified inventory method, the OFCNV of Business A for 2020 and 2021 is determined under paragraph (e) of this section as follows:

OFCNV—END OF 2021

Assets	Amount in €	Translation rate	Amount in $
Euros	160	€1 = $2.00 (year-end spot rate—2021)	320
Building	760	€1 = $1.00 (historic rate—2020)	760

OFCNV—END OF 2021—Continued

Assets	Amount in €	Translation rate	Amount in $
Machine	270	€1 = $1.00 (historic rate—2020)	270
Inventory	40	€1 = $1.50 (historic rate—2021)	60
Total assets			1,410
Liabilities:			
Total liabilities			0
2021 ending OFCNV			1,410

OFCNV—END OF 2020

Assets	Amount in €	Translation rate	Amount in $
Euros	100	€1 = $1.00 (year-end spot rate—2020)	100
Building	780	€1 = $1.00 (historic rate—2020)	780
Machine	300	€1 = $1.00 (historic rate—2020)	300
Total assets			1,180
Liabilities:			
Total liabilities			0
2020 ending OFCNV			1,180

(C) *Determination of net unrecognized section 987 gain or loss.* The net unrecognized section 987 gain or loss of Business A for 2021 is determined under paragraph (d) of this section as follows (relevant steps only):

(*1*) *Step 1.* Under paragraph (d)(1) of this section, the change in OFCNV for the taxable year must be determined. This amount is equal to the OFCNV of Business A determined under paragraph (e) of this section on the last day of 2021, less the OFCNV of Business A determined on the last day of 2020.

2021 ending OFCNV	$1,410
Less: 2020 ending OFCNV	(1,180)
Change in OFCNV	(230)

(*2*) *Step 6.* Under paragraph (d)(6) of this section, the aggregate amount determined in steps 1 through 5 must be decreased by the section 987 taxable income of Business A. The amount of Business A's taxable income for 2021, as determined above, is $100.

Change in OFCNV	$230
Less: section 987 taxable income	(100)
Unrecognized section 987 gain	130
Plus: Net accumulated unrecognized section 987 gain or loss from prior years	0
Net unrecognized section 987 gain	130

(iii) *Operations in 2022.* The facts about Business A's operations in 2022 are the same as in *Example 3*, except that due to Business A's dollar-value LIFO method of inventory accounting, Business A's balance sheet on December 31, 2022, reflects a 2021 layer of inventory with a LIFO cost basis of €40 and a 2022 layer of inventory with a LIFO cost basis of €10.80, and Business A's COGS is €99.20.

(A) *Determination of income.* Business A's income for 2022 is computed as follows:

Item	Amount in €	Translation rate	Amount in $
Sales revenue	180	€1 = $2.50 (yearly avg. rate—2022)	450
COGS before adjustments	99.20	€1 = $2.50 (yearly avg. rate—2022)	248
Adjustment for cost recovery deductions (same as *Example 3*).			(60)
Adjustment for LIFO liquidation (none).			0
Adjusted COGS			188
SG&A:			
Depreciation on building (50%)	10	€1 = $1.00 (historic rate—2020)	10
Salaries	10	€1 = $2.50 (yearly avg. rate—2022)	25
Total SG&A			35
Section 987 net income (revenue less COGS and SG&A).			227

OFCNV—END OF 2022

Assets	Amount in €	Translation rate	Amount in $
Euros	260.00	€1 = $3.00 (year-end spot rate—2022)	780
Building	740.00	€1 = $1.00 (historic rate—2020)	740
Machine	240.00	€1 = $1.00 (historic rate—2020)	240
Inventory	10.80	€1 = $2.50 (historic rate—2022)	27
	40.00	€1 = $1.50 (historic rate—2021)	60
Total assets			1,847
Liabilities:			
Total liabilities			0
2022 ending OFCNV			1,847

(B) *Determination of net unrecognized section 987 gain or loss.* The net unrecognized section 987 gain of Business A for 2022 is determined under paragraph (d) of this section as follows (relevant steps only):

(*1*) *Step 1.* Under paragraph (d)(1) of this section, the change in OFCNV for the taxable year must be determined. This amount is equal to the OFCNV of Business A determined under paragraph (e) of this section on the last day of 2022, less the OFCNV of Business A determined on the last day of 2021.

2022 ending OFCNV	$1,847
Less: 2021 ending OFCNV	(1,410)
Change in OFCNV	437

(*2*) *Step 6—Decrease the aggregate amount determined in steps 1 through 5 by the section 987 taxable income of the section 987 QBU for the taxable year.* Under paragraph (d)(6) of this section, the aggregate amount determined in steps 1 through 5 must be decreased by the section 987 taxable income of Business A. The amount of Business A's taxable income for 2022, as determined above, is $227.

Change in OFCNV	$437
Less: section 987 taxable income	(227)
Unrecognized section 987 gain 2022	210
Plus: net accumulated unrecognized section 987 gain from prior years	130
Net unrecognized section 987 gain	340

(iv) *Operations in 2023.* During 2023, Business A recognizes revenue of €252 from sales of finished goods. The related COGS is €140.80, reflecting a full liquidation of the 2022 inventory layer with a LIFO cost basis of $10.80 and a partial liquidation of inventory from the 2021 layer with a LIFO cost basis of $10.00. Business A pays €10 in salaries allocable to SG&A. Inventoriable costs in 2023 include €10 of depreciation on the building and €30 of depreciation on the machine. Business A's balance sheet on December 31, 2023, shows no liabilities and the following assets: currency of €422, the building with an adjusted basis of €720, the machine with an adjusted basis of €210, and a 2021 layer of ending inventory with a LIFO cost basis of €30, comprising raw materials and finished goods. The yearly average exchange rate for 2023 is €1 = $3.50, and the spot rate on December 31, 2023 is €1 = $4.00.

(A) *Determination of income.* Business A's income for 2023 is computed as follows:

Item	Amount in €	Translation rate	Amount in $
Sales revenue	252	€1 = $3.50 (yearly avg. rate—2023)	882
COGS before adjustments	140.80	€1 = $3.50 (yearly avg. rate—2023)	492.80
Adjustment for cost recovery deductions (see calculation below).			(100.00)
Adjustment for LIFO liquidation (see calculation below).			(30.80)
Adjusted COGS			362.00
SG&A:			
Depreciation on building (50%)	10	€1 = $1.00 (historic rate—2020)	10
Salaries	10	€1 = $3.50 (yearly avg. rate—2023)	35
Total SG&A			45
Section 987 net income			475

COGS Adjustments.
Adjustment for cost recovery deductions.

Depreciation amount	Historic rate	2023 yearly avg. rate	Difference in translation rates	Adjustment (depreciation × change in rates)
€10 (building)	1.00	3.50	(2.50)	($25)
€30 (machine)	1.00	3.50	(2.50)	(75)
Total adjustment for cost recovery deductions				(100)

Adjustment for LIFO liquidation.

LIFO liquidation layer	Historic rate	2023 yearly avg. rate	Difference in translation rates	Adjustment (liquidated layer × change in rates)
€10.80 (2022)	2.50	3.50	(1.00)	($10.80)
€10 (2021)	1.50	3.50	(2.00)	(20.00)
Total adjustment for liquidation of LIFO layers				(30.80)

(B) *Determination of OFCNV.* The OFCNV of Business A for 2023 is determined under paragraph (e) of this section as follows:

OFCNV—END OF 2023

Assets	Amount in €	Translation rate	Amount in $
Euros	422	€1 = $4.00 (year-end spot rate—2023)	1,688
Building	720	€1 = $1.00 (historic rate—2020)	720
Machine	210	€1 = $1.00 (historic rate—2020)	210
Inventory	30	€1 = $1.50 (historic rate—2021)	45
Total assets			2,663
Liabilities:			
Total liabilities			0
2023 ending OFCNV			2,663

(C) *Determination of net unrecognized section 987 gain or loss.* The net unrecognized section 987 gain of Business A is determined under paragraph (d) of this section as follows (relevant steps only):

(*1*) *Step 1.* Under paragraph (d)(1) of this section, the change in OFCNV for the taxable year must be determined. This amount is equal to the OFCNV of Business A determined under paragraph (e) of this section on the last day of 2023, less the OFCNV of Business A determined on the last day of 2022.

2023 ending OFCNV	$2,663
Less: 2022 ending OFCNV	(1,847)
Change in OFCNV	816

(*2*) *Step 6—Decrease the aggregate amount determined in steps 1 through 5 by the section 987 taxable income of the section 987 QBU for the taxable year.* Under paragraph (d)(6) of this section, the aggregate amount determined in steps 1 through 5 must be decreased by the section 987 taxable income of Business A. The amount of Business A's taxable income for 2023, as determined above, is $475.

Change in OFCNV	$816
Less: section 987 taxable income	(475)
Unrecognized section 987 gain 2023	341
Plus: net accumulated unrecognized section 987 gain from prior years	340
Net unrecognized section 987 gain	681

[T.D. 9794, 81 FR 88821, Dec. 8, 2016, as amended by T.D. 9795, 81 FR 88873, Dec. 8, 2016]

§ 1.987–4T Determination of net unrecognized section 987 gain or loss of a section 987 QBU (temporary).

(a) through (c)(1) [Reserved]. For further guidance, see §1.987–4(a) through (c)(1).

(2) *Coordination with §1.987–12T.* For purposes of paragraph (c)(1) of this section, amounts taken into account under §1.987–5 are determined without regard to §1.987–12T.

(d) through (e) [Reserved]. For further guidance, see §1.987–4(d) through (e).

(f) *Combinations and separations*—(1) *Combinations.* The net unrecognized section 987 gain or loss of a combined QBU (as defined in §1.987–2T(c)(9)(i)) for a taxable year is determined under §1.987–4(b) by taking into account the net accumulated unrecognized section 987 gain or loss of each combining QBU (as defined in §1.987–2T(c)(9)(i)) for all prior taxable years to which the regulations under section 987 apply, as determined under §1.987–4(c), and by treating the combining QBUs as having combined immediately prior to the beginning of the taxable year of combination.

(2) *Separations.* The net unrecognized section 987 gain or loss of a separated QBU (as defined in §1.987–2T(c)(9)(iii)) for a taxable year is determined under §1.987–4(b) by taking into account the separated QBU's share of the net accumulated unrecognized section 987 gain or loss of the separating QBU (as defined in §1.987–2T(c)(9)(iii)) for all prior taxable years to which the regulations under section 987 apply, as determined under §1.987–4(c), and by treating the separating QBU as having separated immediately prior to the beginning of the taxable year of separation. A separated QBU's share of the separating QBU's net accumulated unrecognized section 987 gain or loss for all such prior taxable years is determined by apportioning the separating QBU's net accumulated unrecognized section 987 gain or loss for all such prior taxable years to each separated QBU in proportion to the aggregate adjusted basis of the gross assets properly reflected on the books and records of each separated QBU immediately after the separation. For purposes of determining the owner functional currency net value of the separated QBUs on the last day of the taxable year preceding the taxable year of separation under §1.987–5(d)(1)(B) and (e), the balance sheets of the separated QBUs on that day will be deemed to reflect the assets and liabilities reflected on the balance sheet of the separating QBU on that day, apportioned between the separated QBUs in a reasonable manner that takes into account the assets and liabilities reflected on the balance sheets of the separated QBUs immediately after the separation.

(3) *Examples.* The following examples illustrate the rules of paragraphs (f)(1) and (2) of this section.

Example 1. Combination of two section 987 QBUs that have the same owner. (i) *Facts.* DC1, a domestic corporation, owns Entity A, a DE. Entity A conducts a business in France that constitutes a section 987 QBU (French QBU) that has the euro as its functional currency. French QBU has a net accumulated unrecognized section 987 loss from all prior taxable years to which the regulations under section 987 apply of $100. DC1 also owns Entity B, a DE. Entity B conducts a business in Germany that constitutes a section 987 QBU (German QBU) that has the euro as its functional currency. German QBU has a net accumulated unrecognized section 987 gain from all prior taxable years to which the regulations under section 987 apply of $110. During the taxable year, Entity A and Entity B merge under local law. As a result, the books and records of French QBU and German QBU are combined into a new single set of books and records. The combined entity has the euro as its functional currency.

(ii) *Analysis.* Pursuant to §1.987–2T(c)(9)(i), French QBU and German QBU are combining QBUs, and their combination does not give rise to a transfer that is taken into account in determining the amount of a remittance (as defined in §1.987–5(c)). For purposes of computing net unrecognized section 987 gain or loss under §1.987–4 for the year of the combination, the combination is deemed to have occurred on the last day of the owner's prior taxable year, such that the owner functional currency net value of the combined section 987 QBU at the end of that taxable year described under §1.987–4(d)(1)(B) takes into account items reflected on the balance sheets of both French QBU and German QBU at that time. Additionally, any transactions between French QBU and German QBU occurring during the year of the merger will not result in transfers to or from a section 987 QBU. Pursuant to paragraph (f)(1) of this section, the combined QBU will have a net accumulated unrecognized section 987 gain from all prior taxable years of $10 (the $100 loss

from French QBU plus the $110 gain from German QBU).

Example 2. Separation of two section 987 QBUs that have the same owner. (i) *Facts.* DC1, a domestic corporation, owns Entity A, a DE. Entity A conducts a business in the Netherlands that constitutes a section 987 QBU (Dutch QBU) that has the euro as its functional currency. The business of Dutch QBU consists of manufacturing and selling bicycles and scooters and is recorded on a single set of books and records. On the last day of Year 1, the adjusted basis of the gross assets of Dutch QBU is €1,000. In Year 2, the net accumulated unrecognized section 987 loss of Dutch QBU from all prior taxable years is $200. During Year 2, Entity A separates the bicycle and scooter business such that each business begins to have its own books and records and to meet the definition of a section 987 QBU under §1.987–1(b)(2) (hereafter, ''bicycle QBU'' and ''scooter QBU''). There are no transfers between DC1 and Dutch QBU before the separation. After the separation, the aggregate adjusted basis of bicycle QBU's assets is €600 and the aggregate adjusted basis of scooter QBU's assets is €400. Each section 987 QBU continues to have the euro as its functional currency.

(ii) *Analysis.* Pursuant to §1.987–2T(c)(9)(iii), bicycle QBU and scooter QBU are separated QBUs, and the separation of Dutch QBU, a separating QBU, does not give rise to a transfer taken into account in determining the amount of a remittance (as defined in §1.987–5(c)). For purposes of computing net unrecognized section 987 gain or loss under §1.987–4 for Year 2, the separation will be deemed to have occurred on the last day of the owner's prior taxable year, Year 1. Pursuant to paragraph (f)(2) of this section, bicycle QBU will have a net accumulated unrecognized section 987 loss of $120 (€600/€1,000 × $200), and scooter QBU will have a net accumulated unrecognized section 987 loss of $80 (€400/€1,000 × $200).

(g) [Reserved]. For further guidance, see §1.987–4(g).

(h) *Effective/applicability date.* This section applies to taxable years beginning on or after one year after the first day of the first taxable year following December 7, 2016. Notwithstanding the preceding sentence, if a taxpayer makes an election under §1.987–11(b), then this section applies to taxable years to which §§1.987–1 through 1.987–10 apply as a result of such election.

(i) *Expiration date.* The applicability of this section expires on December 6, 2019.

[T.D. 9795, 81 FR 88873, Dec. 8, 2016]

§ 1.987–5 Recognition of section 987 gain or loss.

(a) *Recognition of section 987 gain or loss by the owner of a section 987 QBU.* The taxable income of an owner of a section 987 QBU shall include the owner's section 987 gain or loss recognized with respect to the section 987 QBU for the taxable year. Except as otherwise provided, for any taxable year the owner's section 987 gain or loss recognized with respect to a section 987 QBU shall equal:

(1) The owner's net unrecognized section 987 gain or loss with respect to the section 987 QBU determined under §1.987–4 on the last day of such taxable year (or, if earlier, on the day the section 987 QBU is terminated under §1.987–8); multiplied by

(2) The owner's remittance proportion for the taxable year, as determined under paragraph (b) of this section.

(b) *Remittance proportion.* The owner's remittance proportion with respect to a section 987 QBU for a taxable year shall equal:

(1) The remittance, as determined under paragraph (c) of this section, to the owner from the section 987 QBU for such taxable year; divided by

(2) The sum of

(A) The aggregate adjusted basis of the gross assets of the section 987 QBU as of the end of the taxable year that are reflected on its year-end balance sheet translated into the owner's functional currency as provided in §1.987–4(e)(2) and

(B) The amount of the remittance as determined under paragraph (c) of this section.

(c) *Remittance*—(1) *Definition.* A remittance shall be determined in the owner's functional currency and shall equal the excess, if any, of:

(i) The aggregate of all amounts transferred from the section 987 QBU to the owner during the taxable year, as determined in paragraph (d) of this section; over

(ii) The aggregate of all amounts transferred from the owner to the section 987 QBU during the taxable year, as determined in paragraph (e) of this section.

(2) *Day when a remittance is determined.* An owner's remittance from a

section 987 QBU shall be determined on the last day of the owner's taxable year (or, if earlier, on the day the section 987 QBU is terminated under §1.987–8).

(3) *Termination.* A termination of a section 987 QBU as determined under §1.987–8 is treated as a remittance of all the gross assets of the section 987 QBU to the owner on the date of such termination. See §1.987–8(e). Accordingly, the remittance proportion in the case of a termination is 1.

(d) *Aggregate of all amounts transferred from the section 987 QBU to the owner for the taxable year.* For purposes of paragraph (c)(1)(i) of this section, the aggregate amount transferred from the section 987 QBU to the owner for the taxable year shall be the aggregate amount of functional currency and the aggregate adjusted basis of the assets transferred, as determined in the owner's functional currency under §1.987–4(d)(2). Solely for this purpose, the amount of liabilities transferred from the owner to the section 987 QBU, as determined in the owner's functional currency under §1.987–4(d)(5), shall be treated as a transfer of assets from the section 987 QBU to the owner in an amount equal to the amount of such liabilities.

(e) *Aggregate of all amounts transferred from the owner to the section 987 QBU for the taxable year.* For purposes of paragraph (c)(1)(ii) of this section, the aggregate of all amounts transferred from the owner to the section 987 QBU for the taxable year shall be the aggregate amount of functional currency and the aggregate adjusted basis of the assets transferred, as determined in the owner's functional currency under §1.987–4(d)(3). Solely for this purpose, the amount of liabilities transferred from the section 987 QBU to the owner determined under §1.987–4(d)(4) shall be treated as a transfer of assets from the owner to the section 987 QBU in an amount equal to the amount of such liabilities.

(f) *Determination of owner's adjusted basis in transferred assets*—(1) *In general.* The owner's adjusted basis in an asset received in a transfer from a section 987 QBU (whether or not such transfer is made in connection with a remittance, as defined in paragraph (c) of this section) shall be determined in the owner's functional currency under the rules prescribed in paragraphs (f)(2) and (f)(3) of this section.

(2) *Marked asset.* The basis of a marked asset shall be the amount determined by translating the section 987 QBU's functional currency basis of the asset, after taking into account §1.988–1(a)(10), into the owner's functional currency at the spot rate (as defined in §1.987–1(c)(1)) applicable to the date of transfer.

(3) *Historic asset.* The basis of a historic asset shall be the amount determined by translating the section 987 QBU's functional currency basis of the asset, after taking into account §1.988–1(a)(10), into the owner's functional currency at the historic rate for the asset (as defined in §1.987–1(c)(3)).

(g) *Example.* The following example illustrates the calculation of section 987 gain or loss under this section:

Example. (i) U.S. Corp, a domestic corporation with the dollar as its functional currency, operates in the United Kingdom through Business A, a section 987 QBU with the pound as its functional currency. During 2021, the following transfers took place between U.S. Corp and Business A. On January 5, 2021, U.S. Corp transferred to Business A $300, which Business A used during the year to purchase services. On March 5, 2021, Business A transferred a machine to U.S. Corp. The pound adjusted basis of the machine when properly translated into dollars as described under §1.987–4(d)(2)(ii)(B) and paragraph (d) of this section is $500. On November 1, 2021, Business A transferred pounds to U.S. Corp. The dollar amount of the pounds when properly translated as described under §1.987–4(d)(2)(ii)(A) and paragraph (d) of this section is $2,300. On December 7, 2021, U.S. Corp transferred a truck to Business A with an adjusted basis of $2,000.

(ii) At the end of 2021, Business A holds assets, properly translated into the owner's functional currency pursuant to §1.987–4(e)(2), consisting of a computer with a pound adjusted basis equivalent to $500, a truck with a pound adjusted basis equivalent to $2,000, and pounds equivalent to $2,850. In addition, Business A has a pound liability entered into in 2020 with Bank A. All such assets and liabilities are reflected on the books and records of Business A. Assume that the net unrecognized section 987 gain for Business A as determined under §1.987–4 as of the last day of 2021 is $80.

(iii) U.S. Corp's section 987 gain with respect to Business A is determined as follows:

(A) *Computation of amount of remittance.* Under paragraphs (c)(1) and (c)(2) of this section, U.S. Corp must determine the amount of the remittance for 2021 in the owner's functional currency (dollars) on the last day of 2021. The amount of the remittance for 2021 is $500, determined as follows:

Transfers from Business A to U.S. Corp in dollars:

Machine	$500
Pounds	2,300
Aggregate transfers from Business A to U.S. Corp	2,800

Transfers from U.S. Corp to Business A in dollars:

U.S. dollars	$300
Truck	2,000
Aggregate transfers from U.S. Corp to Business A	2,300

Computation of amount of remittance:

Aggregate transfers from Business A to U.S. Corp	$2,800
Less: aggregate transfers from U.S. Corp to Business A	(2,300)
Total remittance	500

(B) *Computation of section 987 QBU gross assets plus remittance.* Under paragraph (b)(2) of this section, Business A must determine the aggregate basis of its gross assets that are reflected on its year-end balance sheet translated into the owner's functional currency and must increase this amount by the amount of the remittance.

Computer	$500
Pounds	2,850
Truck	2,000
Aggregate gross assets	5,350
Remittance	500
Aggregate basis of Business A's gross assets at end of 2021, increased by amount of remittance	5,850

(C) *Computation of remittance proportion.* Under paragraph (b) of this section, Business A must compute the remittance proportion by dividing the $500 remittance amount by the $5,850 sum of the aggregate basis of Business A's gross assets and the amount of the remittance. The resulting remittance proportion is 0.085.

(D) *Computation of section 987 gain or loss.* The amount of U.S. Corp's section 987 gain or loss that must be recognized with respect to Business A is determined under paragraph (a) of this section by multiplying the 0.085 remittance proportion by the $80 of net unrecognized section 987 gain. U.S. Corp's resulting recognized section 987 gain for 2021 is $6.80.

[T.D. 9794, 81 FR 88821, Dec. 8, 2016]

§ 1.987–6 Character and source of section 987 gain or loss.

(a) *Ordinary income or loss.* Section 987 gain or loss is ordinary income or loss for Federal income tax purposes.

(b) *Character and source of section 987 gain or loss*—(1) *In general.* With respect to each section 987 QBU, the owner must determine the character and source of section 987 gain or loss in the year of a remittance under the rules of this paragraph (b) for all purposes of the Internal Revenue Code, including sections 904(d), 907, and 954.

(2) *Method required to characterize and source section 987 gain or loss.* The owner must use the asset method set forth in §1.861–9T(g) to characterize and source section 987 gain or loss. In applying the asset method, the owner must take into account only the assets of the section 987 QBU and must consistently determine the value of the assets on the basis of either the tax book value or the fair market value of the assets. The modified gross income method described in §1.861–9T(j) cannot be used.

(3) *Coordination with section 954.* Solely for purposes of determining the excess of foreign currency gains over foreign currency losses characterized as foreign personal holding company income under section 954(c)(1)(D), section 987 gain or loss that is characterized pursuant to paragraph (b)(2) of this section by reference to assets that give rise to subpart F income shall be treated as foreign currency gain or foreign currency loss attributable to section 988 transactions not directly related to the business needs of the controlled foreign corporation.

(4) [Reserved]. For further guidance, see §1.987–6T(b)(4).

(c) *Examples.* The following examples illustrate the application of this section.

Example 1. CFC is a controlled foreign corporation as defined in section 957 with the

Swiss franc (Sf) as its functional currency. CFC is the owner of Business A, a section 987 QBU that has the euro as its functional currency. For the year 2021, CFC recognizes section 987 gain of Sf10,000 under §1.987–5. Applying the rules of this section, Business A has average total assets of Sf1,000,000, which generate income as follows: Sf750,000 of assets that generate foreign source general limitation income under section 904(d)(1)(A), none of which is subpart F income under section 952; and Sf250,000 of assets that generate foreign source passive income under section 904(d)(1)(B), all of which is subpart F income. Under paragraph (b) of this section, Sf7,500 (Sf750,000/Sf1,000,000 × Sf10,000) of the section 987 gain will be characterized as foreign source general limitation income that is not subpart F income under section 952, and Sf2,500 (Sf250,000/Sf1,000,000 × Sf10,000) will be characterized as foreign source passive income that is characterized as foreign personal holding company income under section 954(c)(1)(D). All of the section 987 gain is treated as ordinary income.

Example 2. The facts are the same as in *Example 1* except that: (a) CFC recognizes section 987 loss of Sf40,000, Sf10,000 of which is characterized under paragraph (b) of this section by reference to assets that give rise to subpart F income; and (b) CFC otherwise has Sf12,000 of net foreign currency gain determined under §1.954–2(g) that is taken into account in determining the excess of foreign currency gain over foreign currency losses characterized as foreign personal holding company income under section 954(c)(1)(D). Under paragraph (b)(3) of this section, the Sf10,000 section 987 loss characterized by reference to assets that give rise to subpart F income is treated as foreign currency loss attributable to section 988 transactions not directly related to the business needs of the controlled foreign corporation for purposes of determining the excess of foreign currency gains over foreign currency losses characterized as foreign personal holding company income under section 954(c)(1)(D). Accordingly, CFC will aggregate the Sf10,000 section 987 loss with the Sf12,000 net foreign currency gain and will have Sf2,000 of net foreign currency gain characterized as foreign personal holding company income under section 954(c)(1)(D).

[T.D. 9794, 81 FR 88845, Dec. 8, 2016, as amended by T.D. 9795, 81 FR 88874, Dec. 8, 2016]

§ 1.987–6T Character and source of section 987 gain or loss (temporary).

(a) through (b)(3) [Reserved]. For further guidance, see §1.987–6(a) through (b)(3).

(4) *Source of section 987 gain or loss with respect to a dollar QBU.* The source of section 987 gain or loss with respect to a dollar QBU (as defined in §1.987–1T(b)(6)(i)) for which the CFC owner has elected under §1.987–1T(b)(6)(iii) to apply section 987 is determined by reference to the residence of the CFC owner. This paragraph (b)(4) applies to any CFC that has made the election under §1.987–1T(b)(6)(iii), including a CFC described in §1.987–1(b)(1)(ii).

(c) [Reserved]. For further guidance, see §1.987–6(c).

(d) *Effective/applicability date.* This section applies to taxable years beginning on or after one year after the first day of the first taxable year following December 7, 2016. Notwithstanding the preceding sentence, if a taxpayer makes an election under §1.987–11(b), then this section applies to taxable years to which §§1.987–1 through 1.987–10 apply as a result of such election.

(e) *Expiration date.* The applicability of this section expires on December 6, 2019.

[T.D. 9795, 81 FR 88874, Dec. 8, 2016]

§ 1.987–7 Section 987 aggregate partnerships.

(a) *In general.* This section provides rules for determining an owner's share of the assets and liabilities of an eligible QBU that is owned indirectly, as described in §1.987–1(b)(4)(ii), through a section 987 aggregate partnership.

(b) [Reserved]. For further guidance, see §1.987–7T(b).

(c) *Coordination with subchapter K.* [Reserved]

[T.D. 9794, 81 FR 88845, Dec. 8, 2016, as amended by T.D. 9795, 81 FR 88874, Dec. 8, 2016]

§ 1.987–7T Section 987 aggregate partnerships (temporary).

(a) [Reserved]. For further guidance, see §1.987–7(a).

(b) *Liquidation value percentage methodology*—(1) *In general.* In any taxable year, a partner's share of each asset, including its basis in each asset, and the amount of each liability reflected under §1.987–2(b) on the books and records of an eligible QBU owned indirectly through a section 987 aggregate partnership is proportional to the partner's liquidation value percentage with respect to the aggregate partnership

for that taxable year, as determined under paragraph (b)(2) of this section.

(2) *Liquidation value percentage*—(i) *In general.* For purposes of this paragraph (b), a partner's liquidation value percentage is the ratio (expressed as a percentage) of the liquidation value of the partner's interest in the partnership to the aggregate liquidation value of all of the partners' interests in the partnership. The liquidation value of a partner's interest in a partnership is the amount of cash the partner would receive with respect to the interest if, immediately following the applicable determination date, the partnership sold all of its assets for cash equal to the fair market value of such assets (taking into account section 7701(g)), satisfied all of its liabilities (other than those described in §1.752–7), paid an unrelated third party to assume all of its §1.752–7 liabilities in a fully taxable transaction, and then liquidated.

(ii) *Determination date*—(A) *In general.* Except as provided in paragraph (b)(2)(ii)(B) of this section, the determination date is the date of the most recent event described in §1.704–1(b)(2)(iv)(*f*)(*5*) or §1.704–1(b)(2)(iv)(*s*)(*1*) (a revaluation event), irrespective of whether the capital accounts of the partners are adjusted under §1.704–1(b)(2)(iv)(*f*), or, if there has been no revaluation event, the date of the formation of the partnership.

(B) *Allocations not in accordance with liquidation value percentage.* If a partnership agreement provides for the allocation of any item of income, gain, deduction, or loss from partnership property to a partner other than in accordance with the partner's liquidation value percentage, the determination date is the last day of the partner's taxable year, or, if the partner's section 987 QBU owned indirectly through a section 987 aggregate partnership terminates during the partner's taxable year, the date such section 987 QBU is terminated.

(3) *Example.* The following example illustrates the rule of this paragraph (b).

Example. (i) *Facts.* DC, a domestic corporation, owns all of the stock of FS, a controlled foreign corporation (as defined in section 957(a)) with the U.S. dollar as its functional currency. FS owns a capital and profits interest in FPRS, a foreign partnership. The remaining capital and profits interest in FPRS is owned by DC. FPRS is a section 987 aggregate partnership with the euro as its functional currency. The balance sheet of FPRS reflects one asset (Asset A) with a basis of €60x and a fair market value of €100x, another asset (Asset B) with a basis of €100x and a fair market value of €200x, and a liability (Liability) of €50x. At the end of year 1, the liquidation value percentage, as determined under paragraph (b)(2) of this section, of DC with respect to FPRS is 75 percent, and the liquidation value percentage of FS with respect to FPRS is 25 percent.

(ii) *Result.* Under §1.987–1(b)(4), DC and FS are each treated as indirectly owning an eligible QBU with a balance sheet that reflects their respective shares of any assets and liabilities of FPRS. Under paragraph (b)(1) of this section, DC and FS's shares of FPRS's assets and liabilities are determined in accordance with DC and FS's respective liquidation value percentages. Accordingly, because DC has a liquidation value percentage of 75 percent with respect to FPRS, €75x of Asset A (with a €45x basis), €150x of Asset B (with a €75x basis), and €37.50x of Liability will be attributed to the DC–FPRS QBU. Additionally, because FS has a liquidation value percentage of 25 percent with respect to FPRS, €25x of Asset A (with a €15x basis), €50x of Asset B (with a €25x basis), and €12.50x of Liability will be attributed to the FS–FPRS QBU.

(c) [Reserved]. For further guidance, see §1.987–7(c).

(d) *Effective/applicability date.* This section applies to taxable years beginning on or after one year after the first day of the first taxable year following December 7, 2016. Notwithstanding the preceding sentence, if a taxpayer makes an election under §1.987–11(b), then this section applies to taxable years to which §§1.987–1 through 1.987–10 apply as a result of such election.

(e) *Expiration date.* The applicability of this section expires on December 6, 2019.

[T.D. 9795, 81 FR 88874, Dec. 8, 2016]

§1.987–8 Termination of a section 987 QBU.

(a) *Scope.* This section provides rules regarding the termination of a section 987 QBU. Paragraph (b) of this section provides general rules for determining when a termination occurs. Paragraph (c) of this section provides exceptions to the general termination rules for

certain transactions described in section 381(a). Paragraph (e) of this section describes certain effects of terminations. Paragraph (f) of this section contains examples that illustrate the principles of this section.

(b) *In general.* Except as provided in paragraph (c) of this section, a section 987 QBU terminates if the conditions described in one of paragraphs (b)(1) through (4) is satisfied.

(1) *Trade or business ceases.* A section 987 QBU ceases its trade or business. When a section 987 QBU ceases its trade or business is determined based on all the facts and circumstances, provided that an owner may continue to treat a section 987 QBU as a section 987 QBU for a reasonable period during the winding up of such trade or business, which period may in no event exceed two years from the date on which such QBU ceases its activities carried on for profit.

(2) *Substantially all assets transferred.* The section 987 QBU transfers substantially all (within the meaning of section 368(a)(1)(C)) of its assets to its owner. For purposes of this paragraph (b)(2), the amount of assets transferred from the section 987 QBU to its owner as a result of a transaction shall be reduced by the amount of assets transferred from the owner to the section 987 QBU pursuant to the same transaction. See Examples 2, 5, and 6 in paragraph (f) of this section.

(3) *Owner no longer a CFC.* A foreign corporation that is a controlled foreign corporation (as defined in section 957) that is the owner of a section 987 QBU ceases to be a controlled foreign corporation as a result of a transaction or series of transactions after which persons that were related to the corporation within the meaning of section 267(b) immediately before the transaction or series of transactions collectively own sufficient interests in the corporation such that the corporation would continue to be considered a controlled foreign corporation if such persons were United States shareholders within the meaning of section 951(b).

(4) *Owner ceases to exist.* The owner of the section 987 QBU ceases to exist (including in connection with a transaction described in section 381(a)).

(c) *Transactions described in section 381(a)*—(1) *Liquidations.* Notwithstanding paragraph (b) of this section, a termination does not occur when the owner of a section 987 QBU ceases to exist in a liquidation described in section 332, except in the following cases:

(i) The distributor is a domestic corporation and the distributee is a foreign corporation.

(ii) The distributor is a foreign corporation and the distributee is a domestic corporation.

(iii) The distributor and the distributee are both foreign corporations and the functional currency of the distributee is the same as the functional currency of the distributor's section 987 QBU.

(2) *Reorganizations.* Notwithstanding paragraph (b) of this section, a termination does not occur when the owner of the section 987 QBU ceases to exist in a reorganization described in section 381(a)(2), except in the following cases:

(i) The transferor is a domestic corporation and the acquiring corporation is a foreign corporation.

(ii) The transferor is a foreign corporation and the acquiring corporation is a domestic corporation.

(iii) The transferor is a controlled foreign corporation immediately before the transfer, the acquiring corporation is a foreign corporation that is not a controlled foreign corporation immediately after the transfer, and the acquiring corporation was related to the transferor within the meaning of section 267(b) immediately before the transfer.

(iv) The transferor and the acquiring corporation are foreign corporations and the functional currency of the acquiring corporation is the same as the functional currency of the transferor's section 987 QBU.

(d) [Reserved]. For further guidance, see §1.987–8T(d).

(e) *Effect of terminations.* A termination of a section 987 QBU as determined in this section is treated as a remittance of all the gross assets of the section 987 QBU to its owner immediately before the section 987 QBU terminates. Thus, except as otherwise provided in these regulations under section 987, a termination results in the recognition of any net unrecognized

section 987 gain or loss of the section 987 QBU. See §1.987–5(c)(3).

(f) *Examples.* The following examples illustrate the principles of this section. Except as otherwise provided, U.S. Corp is a domestic corporation that has the U.S. dollar as its functional currency, and Business A is a section 987 QBU.

Example 1. Cessation of operations. (i) *Facts.* U.S. Corp is the owner of Business A, a sales office of U.S. Corp in Country X. Business A ceases sales activities on December 31, 2021. During 2022, Business A sells all of the assets used in its sales activities and winds up its business, settling outstanding accounts.

(ii) *Analysis.* Business A's trade or business ceases on December 31, 2021. The cessation of Business A's trade or business causes a termination of the Business A section 987 QBU under paragraph (b)(1) of this section on December 31, 2021, unless U.S. Corp chooses to continue to treat Business A as a section 987 QBU until completion of the wind-up activities in 2022. If U.S. Corp chooses to continue to treat Business A as a section 987 QBU during the wind-up of Business A, Business A section 987 QBU would terminate under paragraph (b)(1) of this section upon completion of the wind-up in 2022.

Example 2. Transfer of a section 987 QBU to a member of a consolidated group. (i) *Facts.* U.S. Corp, the owner of Business A, transfers all the assets and liabilities of Business A to DS, a domestic corporation all of the stock of which is owned by U.S. Corp, in a transaction qualifying under section 351. U.S. Corp and DS are members of the same consolidated group.

(ii) *Analysis.* Pursuant to §1.987–2(c)(2)(i) and (ii), as a result of the deemed exchange of the assets and liabilities of Business A for DS stock in a section 351 transaction, Business A is treated as transferring its assets and liabilities to U.S. Corp immediately before the transfer by U.S. Corp of the assets and liabilities to DS. Because a section 351 transaction is not a transaction described in section 381(a), the transfer of all of the assets of Business A to U.S. Corp causes a termination of the Business A section 987 QBU under paragraph (b)(2) of this section.

Example 3. Cessation of controlled foreign corporation status. (i) *Facts.* Foreign parent (FP) is a foreign corporation that owns all the stock of U.S. Corp, a domestic corporation. U.S. Corp owns all of the stock of FC, a controlled foreign corporation as defined in section 957. FC is the owner of Business A. FP contributes cash to FC in exchange for FC stock representing 60 percent of the voting power and value of all FC stock. FC no longer constitutes a controlled foreign corporation after the capital contribution.

(ii) *Analysis.* Because FC ceases to qualify as a controlled foreign corporation as a result of a transaction after which persons that were related to FC within the meaning of section 267(b) immediately before the transaction collectively own sufficient interests in FC such that the FC would continue to be considered a controlled foreign corporation if such persons were United States shareholders within the meaning of section 951(b), the Business A section 987 QBU terminates pursuant to paragraph (b)(3) of this section.

Example 4. Section 332 liquidation. (i) *Facts.* U.S. Corp owns all of the stock of FC, a foreign corporation. FC is the owner of Business A. Pursuant to a liquidation described in section 332, FC transfers all of its assets and liabilities to U.S. Corp.

(ii) *Analysis.* FC's liquidation causes a termination of the Business A section 987 QBU as provided in paragraph (b)(4) of this section because FC ceases to exist as a result of the liquidation. The exception for certain section 332 liquidations provided under paragraph (c)(1) of this section does not apply because U.S. Corp is a domestic corporation and FC is a foreign corporation. See paragraph (c)(1)(ii) of this section.

Example 5. Transfers to and from a section 987 QBU pursuant to the same transaction. (i) *Facts.* U.S. Corp owns 100 percent of DC1 and DC2, each a domestic corporation. DC1 owns Entity A, a DE that conducts a business (Business A) in Country X that constitutes a section 987 QBU of DC1. DC2 subsequently contributes property to Entity A in exchange for a 95 percent interest in Entity A. The property DC2 contributes to Entity A is used in the business conducted by Business A and is reflected on its books and records as provided under §1.987–2(b).

(ii) *Analysis.* (A) For general Federal income tax purposes, Entity A is converted to a partnership when DC2 contributes property to Entity A in exchange for a 95 percent interest in Entity A. DC2's contribution is treated as a contribution to a partnership in exchange for an ownership interest in the partnership. DC1 is treated as contributing all of Business A to the partnership in exchange for a partnership interest. See Rev. Rul. 99–5 (situation 2), (1999–1 CB 434) and §601.601(d)(2) of this chapter. For purposes of this section, these deemed transactions are not taken into account. See §1.987–2(c) and §1.987–2(c)(10), Example 9.

(B) Under §1.987–1(b)(5)(i), Entity A is converted to a section 987 aggregate partnership when DC2 contributes property to Entity A in exchange for a 95 percent interest in Entity A because DC1 and DC2 own all the interests in partnership capital and profits, DC1 and DC2 are related within the meaning of section 267(b), and the requirements of §1.987–1(b)(5)(i)(B) are satisfied. Because DC2

is a partner in a section 987 aggregate partnership that owns Business A and because DC2 and Business A have different functional currencies, DC2's portion of the Business A assets constitutes a section 987 QBU of DC2.

(C) As a result of the conversion of Entity A to a partnership, DC2 acquires an allocable share of 95 percent of the assets of Business A, as determined under §1.987–7. Accordingly, under §1.987–2(c)(5), DC2 is treated as contributing 95 percent of its contributed property to its Business A section 987 QBU. In addition, DC2 is treated as transferring 5 percent of the contributed property to DC1, and DC1 is subsequently treated as transferring that property to DC1's Business A section 987 QBU. In addition, 95 percent of the original (pre-conversion) assets of Business A cease being reflected on the books and records of DC1's section 987 QBU. Under §1.987–2(b)(5), these amounts are treated as if they are transferred from DC1's section 987 QBU to DC1, and DC1 is treated as transferring these assets to DC2. DC2 is subsequently treated as transferring these assets to DC2's Business A section 987 QBU. The other 5 percent of the original (pre-conversion) assets are treated as remaining on the books and records of DC1's section 987 QBU and are not deemed to be transferred.

(D) For purposes of determining whether substantially all the assets of Business A were transferred from DC1's section 987 QBU as provided under paragraph (b)(2) of this section, the amount of assets transferred from Business A to DC1 under §1.987–2(c) (95 percent of the assets held by Business A before the contribution by DC2) must be reduced by the 5 percent of the assets contributed by DC2, which were treated as transferred from DC2 to DC1 and subsequently transferred from DC1 to its Business A section 987 QBU, as a result of the formation of the section 987 aggregate partnership. Accordingly, the amount of assets transferred from DC1's section 987 QBU for purposes of paragraph (b)(2) of this section is equal to 95 percent of the original (pre-conversion) assets minus 5 percent of DC2's contributed assets.

Example 6. Deemed transfers to a CFC upon a check-the-box election. (i) *Facts.* In 2021, U.S. Corp forms an entity in a foreign country, Entity A. Entity A owns Business A, which has the pound as its functional currency. Entity A forms Entity B in another foreign country. Entity B owns Business B, a section 987 QBU that has the euro as its functional currency. At the time of formation, Entity A and Entity B elect to be DEs. In 2026, Entity A files an election on Form 8832 to be classified as a corporation under §301.7701–3(g)(1)(iv) and becomes a CFC (FC) owned directly by U.S. Corp. FC has the pound as its functional currency.

(ii) *Analysis.* (A) Under §1.987–1(b)(4)(i), U.S. Corp is the owner of Business A and Business B. In 2026, when Entity A elects to be classified as a corporation, U.S. Corp is deemed to contribute the assets and liabilities of Business A and Business B to FC under section 351 in exchange for FC stock. Pursuant to §1.987–2(c)(2)(i) and (ii), as a result of the deemed exchange of the assets and liabilities of Business A and Business B for FC stock in a section 351 transaction, Business A and Business B are each treated as transferring their assets and liabilities to U.S. Corp immediately before U.S. Corp's transfer of such assets and liabilities to FC. The transfer of assets from Business A and Business B to U.S. Corp causes terminations of those section 987 QBUs under paragraph (b)(2) of this section. The assets and liabilities of Business A and Business B are now owned by FC, but because FC and Business A have the same functional currency, only Business B qualifies as a section 987 QBU to which section 987 applies.

(B) Terminations also would have occurred in 2026 if U.S. Corp had contributed Entity A and Entity B to an existing foreign corporation owned by U.S. Corp or to a newly created foreign corporation owned by U.S. Corp pursuant to a section 351 exchange because the transfer of all of the assets of Business A and Business B would cause terminations of those section 987 QBUs under paragraph (b)(2) of this section.

Example 7. Sale of a section 987 QBU to a member of a consolidated group. (i) *Facts.* U.S. Corp, the owner of Business A, sells all of the assets and liabilities of Business A to DS, a domestic corporation, in exchange for cash. U.S. Corp and DS are members of the same consolidated group. The cash received on the sale is recorded on the books of U.S. Corp.

(ii) *Analysis.* Pursuant to §1.987–2(c)(2)(i) and (ii), Business A is treated as transferring all of its assets and liabilities to U.S. Corp immediately before the sale by U.S. Corp to DS. As a result of this deemed transfer from Business A to U.S. Corp, the Business A section 987 QBU terminates under paragraph (b)(2) of this section.

[T.D. 9794, 81 FR 88845, Dec. 8, 2016, as amended by T.D. 9795, 81 FR 88875, Dec. 8, 2016]

§ 1.987–8T Termination of a section 987 QBU (temporary).

(a) through (c) [Reserved]. For further guidance, see §1.987–8(a) through (c).

(d) *Annual deemed termination election.* A taxpayer, including a taxpayer described in §1.987–1(b)(1)(ii) to which §§1.987–1 through 1.987–11 generally do not apply, may elect under this paragraph (d) to deem all of the section 987 QBUs of which it is an owner to terminate on the last day of each taxable

year for which the election is in effect. See §1.987–8(e) regarding the effect of such a deemed termination. The owner of a section 987 QBU that is deemed to terminate under this paragraph is treated as having transferred all of the assets and liabilities attributable to such section 987 QBU to a new section 987 QBU on the first day of the following taxable year.

(e) through (f) [Reserved]. For further guidance, see §1.987–8(e) through (f).

(g) *Effective/applicability date.* This section applies to taxable years beginning on or after December 7, 2016.

(h) *Expiration date.* The applicability of this section expires on December 6, 2019.

[T.D. 9795, 81 FR 88875, Dec. 8, 2016]

§ 1.987–9 Recordkeeping requirements.

(a) *In general.* A taxpayer that is an owner of a section 987 QBU shall keep a copy of each election made by the taxpayer in accordance with the rules of §1.987–1(g)(3) (if not required to be made on a form published by the Commissioner regarding section 987) and such reasonable records as are sufficient to establish the section 987 QBU's taxable income or loss and section 987 gain or loss.

(b) *Supplemental information.* An owner's obligation to maintain records under section 6001 and paragraph (a) of this section is not satisfied unless the following information is maintained in such records with respect to each section 987 QBU:

(1) The amount of the items of income, gain, deduction, or loss attributed to the section 987 QBU in the functional currency of the section 987 QBU.

(2) The amount of assets and liabilities attributed to the section 987 QBU in the functional currency of the section 987 QBU.

(3) The exchange rates used to translate items of income, gain, deduction, or loss of the section 987 QBU into the owner's functional currency and, if a spot rate convention is used, the manner in which such convention is determined.

(4) The exchange rates used to translate the assets and liabilities of the section 987 QBU into the owner's functional currency and, if a spot rate convention is used, the manner in which such convention is determined.

(5) The amount of the items of income, gain, deduction, or loss attributed to the section 987 QBU translated into the functional currency of the owner.

(6) The amount of assets and liabilities attributed to the section 987 QBU translated into the functional currency of the owner.

(7) The amount of assets and liabilities transferred by the owner to the section 987 QBU determined in the functional currency of the owner.

(8) The amount of assets and liabilities transferred by the section 987 QBU to the owner determined in the functional currency of the owner.

(9) The amount of the unrecognized section 987 gain or loss for the taxable year.

(10) The amount of the net accumulated unrecognized section 987 gain or loss at the close of the taxable year.

(11) If a remittance is made, the computations determined under §1.861–9T(g) for purposes of sourcing and characterizing the remittance under §1.987–5.

(12) The transition information required to be determined under §1.987–10(e).

(c) *Retention of records.* The records required by this section, or records that support the information required on a form published by the Commissioner regarding section 987, must be maintained and kept at all times available for inspection by the Internal Revenue Service for so long as the contents thereof may become relevant in the administration of the Internal Revenue Code.

(d) *Information on a dedicated section 987 form.* The requirements of paragraph (b) of this section shall be satisfied if the taxpayer provides the specific information required on a form published by the Commissioner for this purpose.

[T.D. 9794, 81 FR 88845, Dec. 8, 2016]

§ 1.987–10 Transition rules.

(a) *Scope.* These transition rules shall apply to any taxpayer that is an owner of a section 987 QBU pursuant to §1.987–

1(b)(4) on the transition date (as defined in §1.987–11(c)). Except as provided in paragraph (c) of this section, a taxpayer to which this section applies must transition from the method previously used to comply with section 987 (the ''prior section 987 method'') to the method prescribed by these regulations pursuant to the fresh start transition method set forth in paragraph (b) of this section.

(b) *Fresh start transition method*—(1) *In general.* Pursuant to the fresh start transition method, and solely for purposes of this section, all section 987 QBUs of a taxpayer, other than section 987 QBUs subject to paragraph (c) of this section, are deemed to terminate on the day before the transition date. No section 987 gain or loss is determined or recognized as a result of the deemed termination. The owner of a section 987 QBU that is deemed to terminate under this section is treated as having transferred all of the assets and liabilities attributable to such QBU to a new section 987 QBU on the transition date. This deemed transfer of assets and liabilities is taken into account only for purposes of transitioning to these regulations under section 987 and shall not be taken into account in determining the amounts transferred from the owner to the section 987 QBU during the taxable year for purposes of §1.987–5(c)(1)(ii).

(2) *Application of §1.987–4.* For purposes of applying §1.987–4 with respect to a section 987 QBU described in paragraph (b)(1) of this section for the taxable year beginning on the transition date, the amount of assets and liabilities deemed transferred from the owner to the section 987 QBU on the transition date pursuant to paragraph (b)(1) of this section shall be determined by translating such assets and liabilities (without regard to whether the asset or liability is a marked item or a historic item) at the historic rate as determined under paragraph (b)(3) of this section.

(3) *Determination of historic rate.* For purposes of applying these regulations with respect to a section 987 QBU described in paragraph (b)(1) of this section for taxable years beginning on or after the transition date, the historic rate (as defined in §1.987–1(c)(3)) for an asset or liability deemed transferred under paragraph (b)(1) of this section from an owner to the section 987 QBU on the transition date shall be the historic rate under §1.987–1(c)(3) determined by reference to the date the assets were acquired or liabilities entered into or assumed by the section 987 QBU deemed terminated (that is, without regard to the deemed termination or transfer described in paragraph (b)(1) of this section). However, if the owner is not able to determine reliably the historic rate for a particular asset or liability, then the historic rate must be determined based on reasonable assumptions (for example, assumptions about turnover and aging of accounts receivable), consistently applied.

(4) *Example.* The provisions of this paragraph (b) are illustrated by the following example. Exchange rate assumptions used in the example are selected for the purpose of illustrating the principles of this section, and no inference is intended by their use. Additionally, the effect of depreciation is not taken into account for purposes of this example.

Example. (i) U.S. Corp is a domestic corporation with the dollar as its functional currency. U.S. Corp owns Business A, a U.K. branch with the pound as its functional currency. Business A was formed on January 1, year 1. U.S. Corp uses the method prescribed in the 1991 proposed section 987 regulations to determine the section 987 gain or loss of Business A. U.S. Corp contributed £6,000 to Business A on January 1, year 1. On the same day, Business A bought a truck for £4,000 and a computer for £1,000. Business A had profits determined under §1.987–1(b)(1)(i) through (iii) of the 1991 proposed section 987 regulations of £250 in each of year 1, year 2, and year 3, and the yearly average exchange rate was used in each of those years to translate Business A's profits under the 1991 proposed section 987 regulations. The yearly average exchange rate was £1 = $1.10 in year 1, £1 = $1.20 in year 2, and £1 = $1.30 in year 3. Business A incurred a £50 loss in each of year 4 and year 5. Business A made no remittances to U.S. Corp in any year.

(ii) On January 1, year 5, Business A transitions to the method provided in these regulations pursuant to the fresh start transition method described in paragraph (b) of this section. Pursuant to paragraph (b)(1) of this section, Business A is deemed to terminate on December 31, year 4. However, no section 987 gain or loss is determined or recognized

as a result of the deemed termination. Pursuant to paragraph (b)(2) of this section, for purposes of applying §1.987–4 with respect to Business A for year 5, the amount of assets and liabilities transferred from U.S. Corp to Business A on the transition date shall be determined by translating all of Business A's assets at the historic rates for those assets as determined under §1.987–1(c)(3) and paragraph (b)(3) of this section. Because U.S. Corp is not able to determine reliably the historic rate for the pound currency it is deemed to transfer to Business A, U.S. Corp determines the historic rate for these pounds based on a last-in, first-out cash flow assumption. Thus, it is assumed that the £50 loss in each of year 4 and year 5 first reduces the £250 earned in year 3. Accordingly, for purposes of determining the amount of assets and liabilities deemed transferred from U.S. Corp to Business A on January 1, year 5, U.S. Corp translates Business A's assets and liabilities as follows:

Assets	Amount in £	Translation rate	Amount in $
Pounds	1,000	£1 = $1.10 (yearly average rate—year 1)	1,100
Pounds	250	£1 = $1.10 (yearly average rate—year 1)	275
Pounds	250	£1 = $1.20 (yearly average rate—year 2)	300
Pounds	150	£1 = $1.30 (yearly average rate—year 3)	195
Truck	4,000	£1 = $1.10 (yearly average rate—year 1)	4,400
Computer	1,000	£1 = $1.10 (yearly average rate—year 1)	1,100
Total assets			7,370
Liabilities:			
Total liabilities			0

(c) *Transition of section 987 QBUs that applied the method set forth in the 2006 proposed section 987 regulations*—(1) *In general.* If, with respect to a particular section 987 QBU, a taxpayer's prior section 987 method was based on a reasonable application of the method described in the 2006 proposed section 987 regulations (REG–208270–86, 71 FR 52876), then the taxpayer shall apply these regulations under section 987 with respect to such section 987 QBU without regard to paragraph (b) of this section.

(2) *Application of §1.987–4.* For purposes of applying §1.987–4 with respect to a section 987 QBU described in paragraph (c)(1) for the taxable year beginning on the transition date, the owner functional currency net value of the section 987 QBU on the last day of the preceding taxable year under §1.987–4(d)(1)(B) shall be the amount that was determined under §1.987–4(d)(1)(A) of the 2006 proposed section 987 regulations for the preceding taxable year. Additionally, for purposes of applying §1.987–4 with respect to a section 987 QBU described in paragraph (c)(1) for all taxable years that end after the transition date, the section 987 QBU's net unrecognized section 987 gain or loss for all prior taxable years under §1.987–4(c) shall take into account the aggregate of the amounts determined under §1.987–4(d) of the 2006 proposed section 987 regulations for taxable years for which the taxpayer applied the 2006 proposed section 987 regulations, reduced by the amounts taken into account under §1.987–5 of the 2006 proposed section 987 regulations upon a remittance for all such prior taxable years.

(3) *Use of prior historic rate.* For purposes of applying these regulations under section 987 with respect to historic items (as defined in §1.987–1(e)), other than inventory, that are reflected on the balance sheet of the section 987 QBU on the transition date, a taxpayer may use the same historic exchange rates as were used under the taxpayer's application of the 2006 proposed section 987 regulations in place of the historic rates that otherwise would be determined under §1.987–1(c)(3), provided that, for all taxable years that end after the transition date, the taxpayer does so with respect to all historic items (other than inventory) that are reflected on the balance sheet of the section 987 QBU on the transition date.

(4) *Example.* The provisions of this paragraph (c) are illustrated by the following example. Exchange rate assumptions used in the example are selected for the purpose of illustrating the principles of this section, and no inference is intended by their use. Additionally, the effect of depreciation is

not taken into account for purposes of this example.

Example. (i) U.S. Corp is a domestic corporation with the dollar as its functional currency. U.S. Corp owns Business A, a U.K. branch with the pound as its functional currency. Business A was formed on January 1, year 1. U.S. Corp uses a reasonable application of the method described in the 2006 proposed section 987 regulations to determine the section 987 gain or loss of Business A. On January 1, year 5, Business A transitions to the method provided in these regulations pursuant to the method described in this paragraph (c). Business A's opening balance sheet on January 1, year 5, includes pounds, a truck acquired in year 2, inventory accounted for under the FIFO method, and no liabilities. These assets remain on the balance sheet on December 31, year 5.

(ii) Pursuant to paragraph (c)(3) of this section, U.S. Corp chooses to use the same historic exchange rates as were used under its application of the 2006 proposed regulations in place of the historic rates prescribed under §1.987–1(c)(3) for purposes of applying these regulations with respect to historic items (other than inventory) held on the transition date.

(iii) The pounds are marked items under §1.987–1(d). Because the pounds are marked items, for purposes of determining the owner functional currency net value of Business A on the last day of year 5 pursuant to §1.987–4(e), the pounds are translated into dollars using the spot rate (as defined in §1.987–1(c)(1)) applicable to the last day of year 5.

(iv) The truck held on Business A's balance sheet on January 1, year 5, is a historic item under §1.987–1(e). For purposes of determining the owner functional currency net value of Business A on the last day of year 5 pursuant to §1.987–4(e), the basis of the truck is translated into dollars using the spot rate on the day the truck was acquired in year 2, as determined under §1.987–1(c)(3) of the 2006 proposed section 987 regulations. If U.S. Corp had not chosen pursuant to paragraph (c)(3) of this section to use the same historic exchange rates as were used under its application of the 2006 proposed regulations, the basis of the truck would have been translated into dollars using the historic rate described in §1.987–1(c)(3), which is the yearly average exchange rate for year 5.

(v) The inventory held on Business A's balance sheet on January 1, year 5, is a historic item under §1.987–1(e). For purposes of determining the owner functional currency net value of Business A on the last day of year 5 pursuant to §1.987–4(e), the FIFO cost basis of the inventory is translated into dollars using the historic rate, which pursuant to §1.987–1(c)(3)(i)(B) is the yearly average exchange rate for year 5.

(vi) Pursuant to paragraph (c)(3) of this section, for purposes of applying §1.987–4 with respect to Business A for year 5, the owner functional currency net value of Business A on the last day of year 4 under §1.987–4(d)(1)(B) is the amount that was determined under §1.987–4(d)(1)(A) of the 2006 proposed section 987 regulations for year 4. Additionally, Business A's net unrecognized section 987 gain or loss for all prior years under §1.987–4(c) shall take into account the aggregate of the amounts determined under §1.987–4(d) of the 2006 proposed section 987 regulations for year 1 through year 4, reduced by the amounts taken into account under §1.987–5 of the 2006 proposed section 987 regulations upon a remittance for all such prior taxable years.

(d) *Adjustments to avoid double counting.* If a difference between the treatment of any item under these regulations and the treatment of the item under the taxpayer's prior section 987 method would result in income, gain, deduction or loss being taken into account more than once, then the net unrecognized section 987 gain or loss of the section 987 QBU, as determined under §1.987–4(b) for the first taxable year for which these regulations apply, shall be adjusted to account for the difference.

(e) *Reporting*—(1) *In general.* Except as otherwise provided in this paragraph (e), the taxpayer must attach a statement titled ''Section 987 Transition Information'' to its timely filed return for the first taxable year to which these regulations under section 987 apply providing the following information:

(i) A description of each section 987 QBU to which these rules apply, the section 987 QBU's owner, the section 987 QBU's principal place of business, and a description of the prior section 987 method used by the taxpayer to determine section 987 gain or loss with respect to the section 987 QBU.

(ii) Any assumptions used by the taxpayer for determining the exchange rates used to translate the amount of assets and liabilities transferred to the section 987 QBU on the transition date, as provided in paragraph (b)(3) of this section.

(iii) With respect to each section 987 QBU subject to paragraph (c) of this section, a statement regarding whether historic items (as defined in §1.987–

1(c)(3)) are translated pursuant to paragraph (c)(2) of this section at the same historic rates as were used under the taxpayer's application of the 2006 proposed regulations or at the historic rates determined under §1.987–1(c)(3).

(iv) With respect to each section 987 QBU with respect to which an adjustment is made pursuant to paragraph (d) of this section, a description of the adjustment and the basis for the computation of such adjustments.

(2) *Attachments not required where information is reported on a form.* Paragraph (e) of this section shall not apply to the extent the information described in such paragraph is required to be reported on a form published by the Commissioner.

[T.D. 9794, 81 FR 88845, Dec. 8, 2016]

§ 1.987–11 Effective/applicability date.

(a) *In general.* Except as otherwise provided in this section, §§1.987–1 through 1.987–10 shall apply to taxable years beginning on or after one year after the first day of the first taxable year following December 7, 2016.

(b) *Application of these regulations to taxable years beginning after* December 7, 2016. A taxpayer may apply these regulations under section 987 to taxable years beginning after December 7, 2016, provided the taxpayer consistently applies these regulations to such taxable years with respect to all section 987 QBUs directly or indirectly owned by the taxpayer on the transition date (as defined in paragraph (b)(2) of this section) as well as all section 987 QBUs directly or indirectly owned on the transition date by members that file a consolidated return with the taxpayer or by any controlled foreign corporation, as defined in section 957, in which a member owns more than 50 percent of the voting power or stock value, as determined under section 958(a).

(c) *Transition date.* The transition date is the first day of the first taxable year to which these regulations under section 987 are applicable with respect to a taxpayer under this section.

[T.D. 9794, 81 FR 88845, Dec. 8, 2016]

§ 1.987–12 Deferral of section 987 gain or loss.

(a) through (h) [Reserved]. For further guidance, see §1.987–12T(a) through (h).

[T.D. 9795, 81 FR 88875, Dec. 8, 2016]

§ 1.987–12T Deferral of section 987 gain or loss (temporary).

(a) *In general*—(1) *Overview.* This section provides rules that defer the recognition of section 987 gain or loss that, but for this section, would be recognized in connection with certain QBU terminations and certain other transactions involving partnerships. This paragraph (a) provides an overview of this section and describes the section's scope of application, including with respect to QBUs subject to section 987 but to which §§1.987–1 through 1.987–11 generally do not apply. Paragraph (b) of this section describes the extent to which section 987 gain or loss is recognized under §1.987–5 or similar principles in the taxable year of a deferral event (as defined in paragraph (b)(2) of this section) with respect to a QBU. Paragraph (c) of this section describes the extent to which section 987 gain or loss that, as a result of paragraph (b), is not recognized under §1.987–5 or similar principles is recognized upon the occurrence of subsequent events. Paragraph (d) of this section describes the extent to which section 987 loss is recognized under §1.987–5 or similar principles in the taxable year of an outbound loss event (as defined in paragraph (d)(2) of this section) with respect to a QBU. Paragraph (e) of this section provides rules for determining the source and character of gains and losses that, as a result of this section, are not recognized under §1.987–5 or similar principles in the taxable year of a deferral event or outbound loss event. Paragraph (f) of this section defines controlled group and qualified successor for purposes of this section. Paragraph (g) of this section provides an anti-abuse rule. Paragraph (h) of this section provides examples illustrating the rules described in this section.

(2) *Scope.* This section applies to any foreign currency gain or loss realized under section 987(3), including foreign

currency gain or loss of an entity described in §1.987–1(b)(1)(ii). References in this section to section 987 gain or loss refer to any foreign currency gain or loss realized under section 987(3), references to a section 987 QBU refer to any eligible QBU (as defined in §1.987–1(b)(3)(i), but without regard to §1.987–1(b)(3)(ii)) that is subject to section 987, and references to a section 987 aggregate partnership refer to any partnership for which the acquisition or disposition of a partnership interest could give rise to foreign currency gain or loss realized under section 987(3). Additionally, references to recognition of section 987 gain or loss under §1.987–5 encompass any determination and recognition of gain or loss under section 987(3) that would occur but for this section. Accordingly, the principles of this section apply to a QBU subject to section 987 regardless of whether the QBU otherwise is subject to §§1.987–1 through 1.987–11. An owner of a QBU that is not subject to §1.987–5 must adapt the rules set forth in this section as necessary to recognize section 987 gains or losses that are subject to this section consistent with the principles of this section.

(3) *Exceptions*—(i) *Annual deemed termination elections.* This section does not apply to section 987 gain or loss of a section 987 QBU with respect to which the annual deemed termination election described in §1.987–8T(d) is in effect.

(ii) *De minimis exception.* This section does not apply to a section 987 QBU for a taxable year if the net unrecognized section 987 gain or loss of the section 987 QBU that, as a result of this section, would not be recognized under §1.987–5 in the taxable year does not exceed $5 million.

(b) *Gain and loss recognition in connection with a deferral event*—(1) *In general.* Notwithstanding §1.987–5, the owner of a section 987 QBU with respect to which a deferral event occurs (a deferral QBU) includes in taxable income section 987 gain or loss in connection with the deferral event only to the extent provided in paragraphs (b)(3) and (c) of this section. However, if the deferral event also constitutes an outbound loss event described in paragraph (d) of this section, the amount of loss recognized by the owner may be further limited under that paragraph.

(2) *Deferral event*—(i) *In general.* A deferral event with respect to a section 987 QBU means any transaction or series of transactions that satisfy the conditions described in paragraphs (b)(2)(ii) and (b)(2)(iii) of this section.

(ii) *Transactions.* The transaction or series of transactions include either:

(A) A termination of the section 987 QBU other than any of the following terminations: a termination described in §1.987–8(b)(3), a termination described in §1.987–8(c), or a termination described solely in §1.987–8(b)(1); or

(B) A disposition of part of an interest in a section 987 aggregate partnership or DE through which the section 987 QBU is owned or any contribution by another person to such a partnership or DE of assets that, immediately after the contribution, are not considered to be included on the books and records of an eligible QBU, provided that the contribution gives rise to a deemed transfer from the section 987 QBU to the owner.

(iii) *Assets on books of successor QBU.* Immediately after the transaction or series of transactions, assets of the section 987 QBU are reflected on the books and records of a successor QBU (as defined in paragraph (b)(4) of this section).

(3) *Gain or loss recognized under §1.987–5 in the taxable year of a deferral event.* In the taxable year of a deferral event with respect to a deferral QBU, the owner of the deferral QBU recognizes section 987 gain or loss as determined under §1.987–5, except that, solely for purposes of applying §1.987–5, all assets and liabilities of the deferral QBU that, immediately after the deferral event, are reflected on the books and records of a successor QBU are treated as not having been transferred and therefore as remaining on the books and records of the deferral QBU notwithstanding the deferral event.

(4) *Successor QBU.* For purposes of this section, a section 987 QBU (potential successor QBU) is a successor QBU with respect to a section 987 QBU referred to in paragraph (b)(2)(ii) of this

section if, immediately after the transaction or series of transactions described in that paragraph, the potential successor QBU satisfies all of the conditions described in paragraphs (b)(4)(i) through (b)(4)(iii) of this section.

(i) The books and records of the potential successor QBU reflect assets that, immediately before the transaction or series of transactions described in paragraph (b)(2)(ii) of this section, were reflected on the books and records of the section 987 QBU referred to in that paragraph.

(ii) The owner of the potential successor QBU and the owner of the section 987 QBU referred to in paragraph (b)(2)(ii) of this section immediately before the transaction or series of transactions described in that paragraph are members of the same controlled group.

(iii) In the case of a section 987 QBU referred to in paragraph (b)(2)(ii)(A) of this section, if the owner of the section 987 QBU immediately before the transaction or series of transactions described in that paragraph was a U.S. person, the potential successor QBU is owned by a U.S. person.

(c) *Recognition of deferred section 987 gain or loss in the taxable year of a deferral event and in subsequent taxable years*—(1) *In general*—(i) *Deferred section 987 gain or loss.* A deferral QBU owner (as defined in paragraph (c)(1)(ii) of this section) recognizes section 987 gain or loss attributable to the deferral QBU that, as a result of paragraph (b) of this section, is not recognized in the taxable year of the deferral event under §1.987–5 (deferred section 987 gain or loss) in the taxable year of the deferral event and in subsequent taxable years as provided in paragraphs (c)(2) through (4) of this section.

(ii) *Deferral QBU owner.* For purposes of this paragraph (c), a deferral QBU owner means, with respect to a deferral QBU, the owner of the deferral QBU immediately before the deferral event, or the owner's qualified successor.

(2) *Recognition upon a subsequent remittance*—(i) *In general.* Except as provided in paragraph (c)(3) of this section, a deferral QBU owner recognizes deferred section 987 gain or loss in the taxable year of the deferral event and in subsequent taxable years upon a remittance from a successor QBU to the owner of the successor QBU (successor QBU owner) in the amount described in paragraph (c)(2)(ii) of this section.

(ii) *Amount.* The amount of deferred section 987 gain or loss that is recognized pursuant to this paragraph (c)(2) in a taxable year of the deferral QBU owner is the outstanding deferred section 987 gain or loss (that is, the amount of deferred section 987 gain or loss not previously recognized) multiplied by the remittance proportion of the successor QBU owner with respect to the successor QBU for the taxable year ending with or within the taxable year of the deferral QBU owner, as determined under §1.987–5(b) (and, to the extent relevant, paragraphs (b) and (c)(2)(iii) of this section) without regard to any election under §1.987–8T(d). For purposes of computing this remittance proportion, multiple successor QBUs of the same deferral QBU are treated as a single successor QBU.

(iii) *Deemed remittance when a successor QBU ceases to be owned by a member of the deferral QBU owner's controlled group.* For purposes of this paragraph (c)(2), in a taxable year of the deferral QBU owner in which a successor QBU ceases to be owned by a member of a controlled group that includes the deferral QBU owner, the successor QBU owner is treated as having a remittance proportion of 1. Accordingly, if there is only one successor QBU with respect to a deferral QBU and that successor QBU ceases to be owned by a member of the controlled group that includes the deferral QBU owner, all outstanding deferred section 987 gain or loss with respect to that deferral QBU will be recognized. This paragraph (c)(2)(iii) does not affect the application of §§1.987–1 through 1.987–11 to the successor QBU owner with respect to its ownership of the successor QBU.

(3) *Recognition of deferred section 987 loss in certain outbound successor QBU terminations.* Notwithstanding paragraph (c)(2) of this section, if assets of the successor QBU (transferred assets) are transferred (or deemed transferred) in a transaction that would constitute an outbound loss event if the successor QBU had a net accumulated section 987 loss at the time of the exchange, then

the deferral QBU owner recognizes outstanding deferred section 987 loss, if any, to the extent it would recognize loss under paragraph (d)(1) of this section if (i) the deferral QBU owner owned the successor QBU, (ii) the deferral QBU owner had net unrecognized section 987 loss with respect to the successor QBU equal to its outstanding deferred section 987 loss with respect to the deferral QBU, and (iii) the transferred assets were transferred (or deemed transferred) in an outbound loss event. Any outstanding deferred section 987 loss with respect to the deferral QBU that is not recognized as a result of the preceding sentence is recognized by the deferral QBU owner in the first taxable year in which the deferral QBU owner (including any qualified successor) ceases to be a member of a controlled group that includes the acquirer of the transferred assets or any qualified successor of such acquirer.

(4) *Special rules regarding successor QBUs*—(i) *Successor QBU with respect to a deferral QBU that is a successor QBU.* If a section 987 QBU is a successor QBU with respect to a deferral QBU that is a successor QBU with respect to another deferral QBU, the first-mentioned section 987 QBU is considered a successor QBU with respect to the second-mentioned deferral QBU. For example, if QBU A is a successor QBU with respect to QBU B, and QBU B is a successor QBU with respect to QBU C, then QBU A is a successor QBU with respect to QBU C.

(ii) *Separation of a successor QBU.* If a successor QBU with respect to a deferral QBU separates into two or more separated QBUs (as defined in §1.987–2T(c)(9)(iii)), each separated QBU is considered a successor QBU with respect to the deferral QBU.

(iii) *Combination of a successor QBU.* If a successor QBU with respect to a deferral QBU combines with another section 987 QBU of the same owner, resulting in a combined QBU (as defined in §1.987–2T(c)(9)(i)), the combined QBU is considered a successor QBU with respect to the deferral QBU.

(d) *Loss recognition upon an outbound loss event*—(1) *In general.* Notwithstanding §1.987–5, the owner of a section 987 QBU with respect to which an outbound loss event occurs (an outbound loss QBU) includes in taxable income in the taxable year of an outbound loss event section 987 loss with respect to that section 987 QBU only to the extent provided in paragraph (d)(3) of this section.

(2) *Outbound loss event.* An outbound loss event means, with respect to a section 987 QBU:

(i) Any termination of the section 987 QBU in connection with a transfer by a U.S. person of assets of the section 987 QBU to a foreign person that is a member of the same controlled group as the U.S. transferor immediately before the transaction or, if the transferee did not exist immediately before the transaction, immediately after the transaction (related foreign person), provided that the termination would result in the recognition of section 987 loss with respect to the section 987 QBU under §1.987–5 and paragraph (b) of this section but for this paragraph (d);

(ii) Any transfer by a U.S. person of part of an interest in a section 987 aggregate partnership or DE through which the U.S. person owns the section 987 QBU to a related foreign person that has the same functional currency as the section 987 QBU, or any contribution by such a related foreign person to such a partnership or DE of assets that, immediately after the contribution, are not considered to be included on the books and records of an eligible QBU, provided that the transfer would result in the recognition of section 987 loss with respect to the section 987 QBU under §1.987–5 and paragraph (b) of this section but for this paragraph (d).

(3) *Loss recognized upon an outbound loss event.* In the taxable year of an outbound loss event with respect to an outbound loss QBU, the owner of the outbound loss QBU recognizes section 987 loss as determined under §1.987–5 and paragraphs (b) and (c) of this section, except that, solely for purposes of applying §1.987–5, the following assets and liabilities of the outbound loss QBU are treated as not having been transferred and therefore as remaining on the books and records of the outbound loss QBU notwithstanding the outbound loss event:

(i) In the case of an outbound loss event described in paragraph (d)(2)(i) of this section, assets and liabilities that, immediately after the outbound loss event, are reflected on the books and records of the related foreign person described in that paragraph or of a section 987 QBU owned by such related foreign person; and

(ii) In the case of an outbound loss event described in paragraph (d)(2)(ii) of this section, assets and liabilities that, immediately after the outbound loss event, are reflected on the books and records of the eligible QBU from which the assets and liabilities of the outbound loss QBU are allocated and not on the books and records of a section 987 QBU.

(4) *Adjustment of basis of stock received in certain nonrecognition transactions.* If an outbound loss event results from the transfer of assets of the outbound loss QBU in a transaction described in section 351 or section 361, the basis of the stock that is received in the transaction is increased by an amount equal to the section 987 loss that, as a result of this paragraph (d), is not recognized with respect to the outbound loss QBU in the taxable year of the outbound loss event (outbound section 987 loss).

(5) *Recognition of outbound section 987 loss that is not converted into stock basis.* Outbound section 987 loss attributable to an outbound loss event that is not described in paragraph (d)(4) of this section is recognized by the owner of the outbound loss QBU in the first taxable year in which the owner or any qualified successor of the owner ceases to be a member of a controlled group that includes the related foreign person referred to in paragraph (d)(2)(i) or (ii) of this section, or any qualified successor of such person.

(e) *Source and character*—(1) *Deferred section 987 gain or loss and certain outbound section 987 loss.* The source and character of deferred section 987 gain or loss recognized pursuant to paragraph (c) of this section, and of outbound section 987 loss recognized pursuant to paragraph (d)(5) of this section, is determined under §1.987–6 as if such deferred section 987 gain or loss were recognized pursuant to §1.987–5 without regard to this section on the date of the related deferral event or outbound loss event.

(2) *Outbound section 987 loss reflected in stock basis.* If loss is recognized on the sale or exchange of stock described in paragraph (d)(4) of this section within two years of the outbound loss event described in that paragraph, then, to the extent of the outbound section 987 loss, the source and character of the loss recognized on the sale or exchange is determined under §1.987–6 as if such loss were section 987 loss recognized pursuant to §1.987–5 without regard to this section on the date of the outbound loss event.

(f) *Definitions*—(1) *Controlled group.* For purposes of this section, a controlled group means all persons with the relationships to each other specified in sections 267(b) or 707(b).

(2) *Qualified successor.* For purposes of this section, a qualified successor with respect to a corporation (transferor corporation) means another corporation (acquiring corporation) that acquires the assets of the transferor corporation in a transaction described in section 381(a), but only if (A) the acquiring corporation is a domestic corporation and the transferor corporation was a domestic corporation, or (B) the acquiring corporation is a controlled foreign corporation (as defined in section 957(a)) (CFC) and the transferor corporation was a CFC. A qualified successor of a corporation includes the qualified successor of a qualified successor of the corporation.

(g) *Anti-abuse.* No section 987 loss is recognized under §1.987–5 or this section in connection with a transaction or series of transactions that are undertaken with a principal purpose of avoiding the purposes of this section.

(h) *Examples.* The following examples illustrate the application of this section. For purposes of the examples, DC1 is a domestic corporation that owns all of the stock of DC2, which is also a domestic corporation, and CFC1 and CFC2 are CFCs. In addition, DC1, DC2, CFC1, and CFC2 are members of a controlled group as defined in paragraph (f)(1) of this section, and the de minimis rule of paragraph (a)(3)(ii) of this section is not applicable. Finally, except as otherwise provided, Business A is a section 987 QBU with the euro as its functional

currency, there are no transfers between Business A and its owner, and Business A's assets are not depreciable or amortizable.

Example 1. Contribution of a section 987 QBU to a member of the controlled group. (i) *Facts.* DC1 owns all of the interests in Business A. The balance sheet of Business A reflects assets with an aggregate adjusted basis of €1,000x and no liabilities. DC1 contributes €900x of Business A's assets to DC2 in an exchange to which section 351 applies. Immediately after the contribution, the remaining €100x of Business A's assets are no longer reflected on the books and records of a section 987 QBU. DC2, which has the U.S. dollar as its functional currency, uses the former Business A assets in a business (Business B) that constitutes a section 987 QBU. At the time of the contribution, Business A has net accumulated unrecognized section 987 gain of $100x.

(ii) *Analysis.* (A) Under §1.987–2(c)(2)(ii), DC1's contribution of €900x of Business A's assets to DC2 is treated as a transfer of all of the assets of Business A to DC1, immediately followed by DC1's contribution of €900x of Business A's assets to DC2. The contribution of Business A's assets is a deferral event within the meaning of paragraph (b)(2) of this section because: (1) The transfer from Business A to DC1 is a transfer of substantially all of Business A's assets to DC1, resulting in a termination of Business A under §1.987–8(b)(2); and (2) immediately after the transaction, assets of Business A are reflected on the books and records of Business B, a section 987 QBU owned by a member of DC1's controlled group and a successor QBU within the meaning of paragraph (b)(4) of this section. Accordingly, Business A is a deferral QBU within the meaning of paragraph (b)(1) of this section, and DC1 is a deferral QBU owner of Business A within the meaning of paragraph (c)(1)(ii) of this section.

(B) Under paragraph (b)(3) of this section, DC1's taxable income in the taxable year of the deferral event includes DC1's section 987 gain or loss determined with respect to Business A under §1.987–5, except that, for purposes of applying §1.987–5, all assets and liabilities of Business A that are reflected on the books and records of Business B immediately after Business A's termination are treated as not having been transferred and therefore as though they remained on Business A's books and records (notwithstanding the deemed transfer of those assets under §1.987–8(e)). Accordingly, in the taxable year of the deferral event, DC1 is treated as making a remittance of €100x, corresponding to the assets of Business A that are no longer reflected on the books and records of a section 987 QBU, and is treated as having a remittance proportion with respect to Business A of 0.1, determined by dividing the €100x remittance by the sum of the remittance and the €900x aggregate adjusted basis of the gross assets deemed to remain on Business A's books at the end of the year. Thus, DC1 recognizes $10x of section 987 gain in the taxable year of the deferral event. DC1's deferred section 987 gain equals $90x, which is the amount of section 987 gain that, but for the application of paragraph (b) of this section, DC1 would have recognized under §1.987–5 ($100x), less the amount of section 987 gain recognized by DC1 under §1.987–5 and this section ($10x).

Example 2. Election to be classified as a corporation. (i) *Facts.* DC1 owns all of the interests in Entity A, a DE. Entity A conducts Business A, which has net accumulated unrecognized section 987 gain of $500x. Entity A elects to be classified as a corporation under §301.7701–3(a). As a result of the election and pursuant to §301.7701–3(g)(1)(iv), DC1 is treated as contributing all of the assets and liabilities of Business A to newly-formed CFC1, which has the euro as its functional currency. Immediately after the contribution, the assets and liabilities of Business A are reflected on CFC1's balance sheet.

(ii) *Analysis.* Under §1.987–2(c)(2)(ii), DC1's contribution of all of the assets and liabilities of Business A to CFC1 is treated as a transfer of all of the assets and liabilities of Business A to DC1, followed immediately by DC1's contribution of those assets and liabilities to CFC1. Because the deemed transfer from Business A to DC1 is a transfer of substantially all of Business A's assets to DC1, the Business A QBU terminates under §1.987–8(b)(2). The contribution of Business A's assets is not a deferral event within the meaning of paragraph (b)(2) of this section because, immediately after the transaction, no assets of Business A are reflected on the books and records of a successor QBU within the meaning of paragraph (b)(4) of this section due to the fact that the assets of Business A are not reflected on a section 987 QBU immediately after the termination as well as the fact that the requirement of paragraph (b)(4)(iii) of this section is not met. Accordingly, DC1 recognizes section 987 gain with respect to Business A under §1.987–5 without regard to this section. Because the requirement of paragraph (b)(4)(iii) of this section is not met, the result would be the same even if the assets of Business A were transferred in a section 351 exchange to an existing foreign corporation that had a different functional currency than Business A.

Example 3. Outbound loss event. (i) *Facts.* The facts are the same as in *Example 2*, except that Business A has net accumulated unrecognized section 987 loss of $500x rather than net accumulated unrecognized section 987 gain of $500x.

(ii) *Analysis.* (A) The analysis of the transactions under §§1.987–2(c)(2)(ii), 1.987–8(b)(2), and paragraph (b) of this section is the same

as in *Example 2*. However, the termination of Business A as a result of the transfer of the assets of Business A by a U.S. person (DC1) to a foreign person (CFC1) that is a member of DC1's controlled group is an outbound loss event described in paragraph (d)(2) of this section.

(B) Under paragraphs (d)(1) and (d)(3) of this section, in the taxable year of the outbound loss event, DC1 includes in taxable income section 987 loss recognized with respect to Business A as determined under §1.987–5, except that, for purposes of applying §1.987–5, all assets and liabilities of Business A that are reflected on the books and records of CFC1, a related foreign person described in paragraph (d)(2) of this section, are treated as not having been transferred. Accordingly, DC1's remittance proportion with respect to Business A is 0, and DC1 recognizes no section 987 loss with respect to Business A. DC1's outbound section 987 loss is $500x, which is the amount of section 987 loss that DC1 would have recognized under §1.987–5 ($500x) without regard to paragraph (d) of this section, less the amount of section 987 loss recognized by DC1 under paragraph (d)(3) of this section ($0). Under paragraph (d)(4) of this section, DC1 must increase its basis in its CFC1 shares by the amount of the outbound section 987 loss ($500x).

Example 4. Conversion of a DE to a partnership. (i) *Facts.* DC1 owns all of the interests in Entity A, a DE that conducts Business A. On the last day of Year 1, DC1 sells 50 percent of its interest in Entity A to DC2 (the Entity A sale).

(ii) *Analysis.* (A) For Federal income tax purposes, Entity A is converted to a partnership when DC2 purchases the 50 percent interest in Entity A. DC2's purchase is treated as the purchase of 50 percent of the assets of Entity A (that is, the assets of Business A), which, prior to the purchase, were treated as held directly by DC1 for Federal income tax purposes. Immediately after DC2's deemed purchase of 50 percent of Business A assets, DC1 and DC2 are treated as contributing their respective interests in Business A assets to a partnership. See Rev. Rul. 99–5 (1999–1 CB 434) (situation 1). These deemed transactions are not taken into account for purposes of this section, but the Entity A sale and resulting existence of a partnership have consequences under section 987 and this section, as described in paragraphs (ii)(B) through (D) of this *Example 4*.

(B) Immediately after the Entity A sale, Entity A is a section 987 aggregate partnership within the meaning of §1.987–1(b)(5) because DC1 and DC2 own all the interests in partnership capital and profits, DC1 and DC2 are related within the meaning of section 267(b), and the partnership has an eligible QBU (Business A) that would be a section 987 QBU with respect to a partner if owned by the partner directly. As a result of the Entity A sale, 50 percent of the assets and liabilities of Business A ceased to be reflected on the books and records of DC1's Business A section 987 QBU. As a result, such assets and liabilities are treated as if they were transferred from DC1's Business A section 987 QBU to DC1. Additionally, following DC2's acquisition of 50 percent of the interest in Entity A, DC2 is allocated 50 percent of the assets and liabilities of Business A under §§1.987–2(b), 1.987–7(a), and 1.987–7T(b). Because DC2 and Business A have different functional currencies, DC2's portion of the Business A assets and liabilities constitutes a section 987 QBU. Accordingly, 50 percent of the assets and liabilities of Business A are treated as transferred by DC2 to DC2's Business A section 987 QBU.

(C) The Entity A sale is a deferral event described in paragraph (b)(2) of this section because: (1) The sale constitutes the disposition of part of an interest in a DE; and (2) immediately after the transaction, assets of DC1's Business A section 987 QBU are reflected on the books and records of DC1's Business A section 987 QBU and DC2's Business A section 987 QBU, each of which is a successor QBU with respect to DC1's Business A section 987 QBU within the meaning of paragraph (b)(4) of this section. Accordingly, DC1's Business A section 987 QBU is a deferral QBU within the meaning of paragraph (b)(1) of this section, and DC1 is a deferral QBU owner within the meaning of paragraph (c)(1)(ii) of this section. Under paragraph (b)(1) of this section, DC1 includes in taxable income section 987 gain or loss with respect to Business A in connection with the deferral event to the extent provided in paragraphs (b)(3) and (c) of this section.

(D) Under paragraph (b) of this section, in the taxable year of the Entity A sale, DC1 includes in taxable income section 987 gain or loss with respect to Business A as determined under §1.987–5, except that, for purposes of applying §1.987–5, all assets and liabilities of Business A that, immediately after the Entity A sale, are reflected on the books and records of successor QBUs are treated as though they were not transferred and therefore as remaining on the books and records of DC1's Business A section 987 QBU notwithstanding the Entity A sale. Accordingly, DC1's remittance amount under §1.987–5 is $0, and DC1 recognizes no section 987 gain or loss with respect to Business A.

Example 5. Partial recognition of deferred gain or loss. (i) *Facts.* DC1 owns all of the interests in Entity A, a DE that conducts Business A in Country X. During Year 1, DC1 contributes all of its interests in Entity A to DC2 in an exchange to which section 351 applies. At the time of the contribution, Business A has net accumulated unrecognized section 987 gain of $100x. After the contribution, Entity A continues to conduct business

in Country X (Business B). In Year 3, as a result of a net transfer of property from Business B to DC2, DC2's remittance proportion with respect to Business B, as determined under §1.987–5, is 0.25.

(ii) *Analysis.* (A) For the reasons described in *Example 1*, the contribution of Entity A by DC1 to DC2 results in a termination of Business A and a deferral event with respect to Business A, a deferral QBU; DC1 is a deferral QBU owner within the meaning of paragraph (c)(1)(ii) of this section; Business B is a successor QBU with respect to Business A; DC2 is a successor QBU owner; and the $100x of net accumulated unrecognized section 987 gain with respect to Business A becomes deferred section 987 gain as a result of the deferral event.

(B) Under paragraph (c)(1) of this section, DC1 recognizes deferred section 987 gain with respect to Business A in accordance with paragraphs (c)(2) through (4) of this section. Under paragraph (c)(2)(i) of this section, DC1 recognizes deferred section 987 gain in Year 3 as a result of the remittance from Business B to DC2. Under paragraph (c)(2)(ii) of this section, the amount of deferred section 987 gain that DC1 recognizes is $25x, which is DC1's outstanding deferred section 987 gain or loss ($100x) with respect to Business A multiplied by the remittance proportion (0.25) of DC2 with respect to Business B for the taxable year as determined under §1.987–5(b).

(i) *Coordination with fresh start transition method*—(1) *In general.* If a taxpayer is a deferral QBU owner, or is or was the owner of an outbound loss QBU, and the taxpayer is required under §1.987–10(a) to apply the fresh start transition method described in §1.987–10(b) to the deferral QBU or outbound loss QBU, or would have been so required if the taxpayer had owned the deferral QBU or outbound loss QBU on the transition date (as defined in §1.987–11(c)), the adjustments described in paragraphs (i)(2) and (i)(3) of this section, as applicable, must be made on the transition date.

(2) *Adjustment to deferred section 987 gain or loss.* The amount of any outstanding deferred section 987 gain or loss of a deferral QBU owner with respect to a deferral QBU described in paragraph (i)(1) of this section must be adjusted to equal the amount of outstanding deferred section 987 gain or loss that the deferral QBU owner would have had with respect to the deferral QBU on the transition date if, immediately before the deferral event, the deferral QBU had transitioned to the method prescribed by §§1.987–1 through 1.987–10 pursuant to the fresh start transition method.

(3) *Adjustments in the case of an outbound loss event.* The basis of any stock described in paragraph (d)(4) of this section that was received in connection with the transfer (or deemed transfer) of assets of an outbound loss QBU described in paragraph (i)(1) of this section and that is held on the transition date must be adjusted to equal the basis that such stock would have had on the transition date if, immediately prior to the outbound loss event, the outbound loss QBU had transitioned to the method prescribed by §§1.987–1 through 1.987–10 pursuant to the fresh start transition method. If no such stock was received, the amount of any outbound section 987 loss with respect to the outbound loss QBU that may be recognized on or after the transition date pursuant to paragraph (d)(5) of this section must be adjusted to equal the amount of such loss that would be outstanding and that may be recognized pursuant to that paragraph if, immediately before the outbound loss event, the outbound loss QBU had transitioned to the method prescribed by §§1.987–1 through 1.987–10 pursuant to the fresh start transition method.

(j) *Effective/applicability date*—(1) *In general.* Except as described in paragraph (j)(2) of this section, this section applies to any deferral event or outbound loss event that occurs on or after January 6, 2017.

(2) *Exception.* This section applies to any deferral event or outbound loss event that occurs on or after December 7, 2016, if such deferral event or outbound loss event is undertaken with a principal purpose of recognizing section 987 loss.

(k) *Expiration date.* The applicability of this section expires December 6, 2019.

[T.D. 9795, 81 FR 88875, Dec. 8, 2016]

§1.988–0 Taxation of gain or loss from a section 988 transaction; Table of Contents.

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[T.D. 8400, 57 FR 9177, Mar. 17, 1992, as amended by T.D. 8860, 65 FR 2028, Jan. 13, 2000; T.D. 9157, 69 FR 52818, Aug. 30, 2004; T.D. 9794, 81 FR 88850, Dec. 8, 2016; T.D. 9795, 81 FR 88879, Dec. 8, 2016]

§ 1.988–1 Certain definitions and special rules.

(a) *Section 988 transaction*—(1) *In general.* The term ''section 988 transaction'' means any of the following transactions—

(i) A disposition of nonfunctional currency as defined in paragraph (c) of this section;

(ii) Any transaction described in paragraph (a)(2) of this section if any amount which the taxpayer is entitled to receive or is required to pay by reason of such transaction is denominated

in terms of a nonfunctional currency or is determined by reference to the value of one or more nonfunctional currencies.

A transaction described in this paragraph (a) need not require or permit payment with a nonfunctional currency as long as any amount paid or received is determined by reference to the value of one or more nonfunctional currencies. The acquisition of nonfunctional currency is treated as a section 988 transaction for purposes of establishing the taxpayer's basis in such currency and determining exchange gain or loss thereon.

(2) *Description of transactions.* The following transactions are described in this paragraph (a)(2).

(i) *Debt instruments.* Acquiring a debt instrument or becoming an obligor under a debt instrument. The term ''debt instrument'' means a bond, debenture, note, certificate or other evidence of indebtedness.

(ii) *Payables, receivables, etc.* Accruing, or otherwise taking into account, for purposes of subtitle A of the Internal Revenue Code, any item of expense or gross income or receipts which is to be paid or received after the date on which so accrued or taken into account. A payable relating to cost of goods sold, or a payable or receivable relating to a capital expenditure or receipt, is within the meaning of this paragraph (a)(2)(ii). Generally, a payable relating to foreign taxes (whether or not claimed as a credit under section 901) is within the meaning of this paragraph (a)(2)(ii). However, a payable of a domestic person relating to accrued foreign taxes of its qualified business unit (QBU branch) is not within the meaning of this paragraph (a)(2)(ii) if the QBU branch's functional currency is the U.S. dollar and the foreign taxes are claimed as a credit under section 901.

(iii) *Forward contract, futures contract, option contract, or similar financial instrument.* Except as otherwise provided in this paragraph (a)(2)(iii) and paragraph (a)(4)(i) of this section, entering into or acquiring any forward contract, futures contract, option, warrant, or similar financial instrument.

(A) *Limitation for certain derivative instruments.* A forward contract, futures contract, option, warrant, or similar financial instrument is within this paragraph (a)(2)(iii) only if the underlying property to which the instrument ultimately relates is a nonfunctional currency or is otherwise described in paragraph (a)(1)(ii) of this section. Thus, if the underlying property of an instrument is another financial instrument (*e.g.*, an option on a futures contract), then the underlying property to which such other instrument (*e.g.*, the futures contract) ultimately relates must be a nonfunctional currency. For example, a forward contract to purchase wheat denominated in a nonfunctional currency, an option to enter into a forward contract to purchase wheat denominated in a nonfunctional currency, or a warrant to purchase stock denominated in a nonfunctional currency is not described in this paragraph (a)(2)(iii). On the other hand, a forward contract to purchase a nonfunctional currency, an option to enter into a forward contract to purchase a nonfunctional currency, an option to purchase a bond denominated in or the payments of which are determined by reference to the value of a nonfunctional currency, or a warrant to purchase nonfunctional currency is described in this paragraph (a)(2)(iii).

(B) *Nonfunctional currency notional principal contracts—(1) In general.* The term ''similar financial instrument'' includes a notional principal contract only if the payments required to be made or received under the contract are determined with reference to a nonfunctional currency.

(*2*) *Definition of notional principal contract.* The term ''notional principal contract'' means a contract (*e.g.*, a swap, cap, floor or collar) that provides for the payment of amounts by one party to another at specified intervals calculated by reference to a specified index upon a notional principal amount in exchange for specified consideration or a promise to pay similar amounts. For this purpose, a ''notional principal contract'' shall only include an instrument where the underlying property to which the instrument ultimately relates is money (*e.g.*, functional currency), nonfunctional currency, or property the value of which is determined by reference to an interest rate.

Thus, the term ''notional principal contract'' includes a currency swap as defined in §1.988–2(e)(2)(ii), but does not include a swap referenced to a commodity or equity index.

(C) *Effective date with respect to certain contracts.* This paragraph (a)(2)(iii) does not apply to any forward contract, futures contract, option, warrant, or similar financial instrument entered into or acquired on or before October 21, 1988, if such instrument would have been marked to market under section 1256 if held on the last day of the taxable year.

(3) [Reserved]. For further guidance, see §1.988–1T(a)(3).

(4) *Treatment of assets and liabilities of a section 987 aggregate partnership or DE that are not attributed to an eligible QBU*—(i) *Scope.* This paragraph (a)(4) applies to assets and liabilities of a section 987 aggregate partnership as defined in §1.987–1(b)(5), or of an entity disregarded as an entity separate from its owner for Federal income tax purposes (DE), that are not attributable to an eligible QBU as defined in §1.987–1(b)(3).

(ii) *Section 987 Aggregate Partnerships.* For purposes of applying section 988 and the applicable regulations to transactions involving assets and liabilities described in paragraph (a)(4)(i) of this section that are held by a section 987 aggregate partnership, the owners of the section 987 aggregate partnership (within the meaning of §1.987–1(b)(4)) shall be treated as owning their share of such assets and liabilities. Section 1.987–7(b) shall apply for purposes of determining an owner's share of such assets or liabilities.

(iii) *Disregarded entities.* For purposes of applying section 988 and the applicable regulations to transactions involving assets and liabilities described in paragraph (a)(4)(i) of this section that are held by a DE, the owner of the DE (within the meaning of §1.987–1(b)(4)) shall be treated as owning all such assets and liabilities.

(iv) *Example.* The following example illustrates the application of paragraph (a)(4) of this section:

Example. Liability held through a section 987 aggregate partnership. (i) *Facts.* P, a foreign partnership, has two equal partners, X and Y. X is a domestic corporation with the dollar as its functional currency. Y is a foreign corporation wholly owned by X that has the yen as its functional currency. P is a section 987 aggregate partnership. On January 1, 2021, P borrowed yen and issued a note to the lender that obligated P to pay interest and repay principal to the lender in yen. Also on January 1, 2021, P used the yen it borrowed from the lender to acquire all of the stock of F, a foreign corporation, from an unrelated person. P also holds an eligible QBU (within the meaning of §1.987–1(b)(3)) that has the yen as its functional currency. P maintains one set of books and records. The assets and liabilities of the eligible QBU are reflected on the books and records of P as provided under §1.987–2(b). The F stock held by P, and the yen liability incurred to acquire the F stock, are also recorded on the books and records of P but, pursuant to §1.987–2(b)(2)(i), are not considered to be reflected on the books and records of the eligible QBU for purposes of section 987.

(ii) *Analysis.* X's portion of the assets and liabilities of the eligible QBU owned by P is a section 987 QBU. Y's portion of the assets and liabilities of the eligible QBU owned by P is not a section 987 QBU because Y and the eligible QBU have the same functional currency. Because the F stock and yen-denominated liability incurred to acquire such stock are not considered reflected on the books and records of the eligible QBU, they are not subject to section 987. In addition, because the F stock and the yen-denominated liability incurred to acquire such stock are held by P (but not attributable to P's eligible QBU), X and Y are treated as owning their respective shares of such stock and liability pursuant to §1.988–1(a)(4)(ii) for purposes of applying section 988. As a result, P's becoming the obligor on the portion of the yen-denominated note that is treated as an obligation of X is a section 988 transaction pursuant to paragraphs (a)(1)(ii), (a)(2)(ii) and (a)(3) of this section. Similarly, the dispositions of yen to make payments of interest and principal on the liability, to the extent such yen are treated as owned by X under paragraph (a)(4)(ii) of this section, are section 988 transactions under paragraphs (a)(1)(i) and (a)(3) of this section. To the extent the yen are treated as owned by the eligible QBU, see §1.987–2(c) for the treatment of the payment of yen as a transfer from the eligible QBU to X. P's becoming the obligor on Y's portion of the yen-denominated note, and Y's portion of the yen disposed of in connection with payments on such note, are not section 988 transactions because Y has the yen as its functional currency.

(5) [Reserved]

(6) *Examples.* The following examples illustrate the application of paragraph (a) of this section. The examples assume that X is a U.S. corporation on an

accrual method with the calendar year as its taxable year. Because X is a U.S. corporation the U.S. dollar is its functional currency under section 985. The examples also assume that section 988(d) does not apply.

Example 1. On January 1, 1989, X acquires 10,000 Canadian dollars. On January 15, 1989, X uses the 10,000 Canadian dollars to purchase inventory. The acquisition of the 10,000 Canadian dollars is a section 988 transaction for purposes of establishing X's basis in such Canadian dollars. The disposition of the 10,000 Canadian dollars is a section 988 transaction pursuant to paragraph (a)(1) of this section.

Example 2. On January 1, 1989, X acquires 10,000 Canadian dollars. On January 15, 1989, X converts the 10,000 Canadian dollars to U.S. dollars. The acquisition of the 10,000 Canadian dollars is a section 988 transaction for purposes of establishing X's basis in such Canadian dollars. The conversion of the 10,000 Canadian dollars to U.S. dollars is a section 988 transaction pursuant to paragraph (a)(1) of this section.

Example 3. On January 1, 1989, X borrows 100,000 British pounds (£) for a period of 10 years and issues a note to the lender with a face amount of £100,000. The note provides for payments of interest at an annual rate of 10% paid quarterly in pounds and has a stated redemption price at maturity of £100,000. X's becoming the obligor under the note is a section 988 transaction pursuant to paragraphs (a)(1)(ii) and (2)(i) of this section. Because X is an accrual basis taxpayer, the accrual of interest expense under X's note is a section 988 transaction pursuant to paragraphs (a)(1)(ii) and (2)(ii) of this section. In addition, the acquisition of the British pounds to make payments under the note is a section 988 transaction for purposes of establishing X's basis in such pounds, and the disposition of such pounds is a section 988 transaction under paragraph (a)(1)(i) of this section. See §1.988–2(b) with respect to the translation of accrued interest expense and the determination of exchange gain or loss upon payment of accrued interest expense.

Example 4. On January 1, 1989, X purchases an original issue for 74,621.54 British pounds (£) a 3-year bond maturing on December 31, 1991, at a stated redemption price of £100,000. The bond provides for no stated interest. The bond has a yield to maturity of 10% compounded semiannually and has £25,378.46 of original issue discount. The acquisition of the bond is a section 988 transaction as provided in paragraphs (a)(1)(ii) and (2)(i) of this section. The accrual of original issue discount with respect to the bond is a section 988 transaction under paragraphs (a)(1)(ii) and (2)(ii) of this section. See §1.988–2(b) with respect to the translation of original issue discount and the determination of exchange gain or loss upon receipt of such amounts.

Example 5. On January 1, 1989, X sells and delivers inventory to Y for 10,000,000 Italian lira for payment on April 1, 1989. Under X's method of accounting, January 1, 1989 is the accrual date. Because X is an accrual basis taxpayer, the accrual of a nonfunctional currency denominated item of gross receipts on January 1, 1989, for payment after the date of accrual is a section 988 transaction under paragraphs (a)(1)(ii) and (2)(ii) of this section.

Example 6. On January 1, 1989, X agrees to purchase a machine from Y for delivery on March 1, 1990 for 1,000,000 yen. The agreement calls for X to pay Y for the machine on June 1, 1990. Under X's method of accounting, the expenditure for the machine does not accrue until delivery on March 1, 1990. The agreement to purchase the machine is not a section 988 transaction. In particular, the agreement to purchase the machine is not described in paragraph (a)(2)(ii) of this section because the agreement is not an item of expense taken into account under subtitle A (but rather is an agreement to purchase a capital asset in the future). However, the payable that will arise on the delivery date is a section 988 transaction under paragraphs (a)(1)(ii) and (2)(ii) of this section even though the payable relates to a capital expenditure. In addition, the disposition of yen to satisfy the payable on June 1, 1990, is a section 988 transaction under paragraph (a)(1)(i) of this section.

Example 7. On January 1, 1989, X purchases and takes delivery of inventory for 10,000 French francs with payment to be made on April 1, 1989. Under X's method of accounting, the expense accrues on January 1, 1989. On January 1, 1989, X also enters into a forward contract with a bank to purchase 10,000 French francs for $2,000 on April 1, 1989. Because X is an accrual basis taxpayer, the accrual of a nonfunctional currency denominated item of expense on January 1, 1989, for payment after the date of accrual is a section 988 transaction under paragraphs (a)(1)(ii) and (2)(ii) of this section. Entering into the forward contract to purchase the 10,000 French francs is a section 988 transaction under paragraphs (a)(1)(ii) and (2)(iii) of this section.

Example 8. On January 1, 1989, X acquires 100,000 Norwegian krone. On January 15, 1989, X purchases and takes delivery of 1,000 shares of common stock with the 100,000 krone acquired on January 1, 1989. On August 1, 1989, X sells the 1,000 shares of common stock and receives 120,000 krone in payment. On August 30, 1989, X converts the 120,000 krone to U.S. dollars. The acquisition of the 100,000 krone on January 1, 1989, and the acquisition of the 120,000 krone on August 1, 1989, are section 988 transactions for purposes of establishing the basis of such krone.

The disposition of the 100,000 krone on January 15, 1989, and the 120,000 krone on August 30, 1989, are section 988 transactions as provided in paragraph (a)(1)(i) of this section. Neither the acquisition on January 15, 1989, nor the disposition on August 1, 1989, of the stock is a section 988 transaction.

Example 9. On May 11, 1989, X purchases a one year note at original issue for its issue price of $1,000. The note pays interest in dollars at the rate of 4 percent compounded semiannually. The amount of principal received by X upon maturity is equal to $1,000 plus the equivalent of the excess, if any, of (a) the Financial Times One Hundred Stock Index (an index of stocks traded on the London Stock Exchange hereafter referred to as the FT100) determined and translated into dollars on the last business day prior to the maturity date, over (b) £2,150, the ''stated value'' of the FT100, which is equal to 110% of the average value of the index for the six months prior to the issue date, translated at the exchange rate of £1 = $1.50. The purchase by X of the instrument described above is not a section 988 transaction because the index used to compute the principal amount received upon maturity is determined with reference to the value of stock and not nonfunctional currency.

Example 10. On April 9, 1989, X enters into an interest rate swap that provides for the payment of amounts by X to its counterparty based on 4% of a 10,000 yen principal amount in exchange for amounts based on yen LIBOR rates. Pursuant to paragraphs (a)(1)(ii) and (2)(iii) of this section, this yen for yen interest rate swap is a section 988 transaction.

Example 11. On August 11, 1989, X enters into an option contract for sale of a group of stocks traded on the Japanese Nikkei exchange. The contract is not a section 988 transaction within the meaning of §1.988–1(a)(2)(iii) because the underlying property to which the option relates is a group of stocks and not nonfunctional currency.

(7) *Special rules for regulated futures contracts and non-equity options*—(i) *In general.* Except as provided in paragraph (a)(7)(ii) of this section, paragraph (a)(2)(iii) of this section shall not apply to any regulated futures contract or non-equity option which would be marked to market under section 1256 if held on the last day of the taxable year.

(ii) *Election to have paragraph (a)(2)(iii) of this section apply.* Notwithstanding paragraph (a)(7)(i) of this section, a taxpayer may elect to have paragraph (a)(2)(iii) of this section apply to regulated futures contracts and non-equity options as provided in paragraphs (a)(7)(iii) and (iv) of this section.

(iii) *Procedure for making the election.* A taxpayer shall make the election provided in paragraph (a)(7)(ii) of this section by sending to the Internal Revenue Service Center, Examination Branch, Stop Number 92, Kansas City, MO 64999 a statement titled ''Election to Treat Regulated Futures Contracts and Non-Equity Options as Section 988 Transactions Under Section 988 (c)(1)(D)(ii)'' that contains the following:

(A) The taxpayer's name, address, and taxpayer identification number;

(B) The date the notice is mailed or otherwise delivered to the Internal Revenue Service Center;

(C) A statement that the taxpayer (including all members of such person's affiliated group as defined in section 1504 or in the case of an individual all persons filing a joint return with such individual) elects to have section 988(c)(1)(D)(i) and §1.988–1(a)(7)(i) not apply;

(D) The date of the beginning of the taxable year for which the election is being made;

(E) If the election is filed after the first day of the taxable year, a statement regarding whether the taxpayer has previously held a contract described in section 988(c)(1)(D)(i) or §1.988–1(a)(7)(i) during such taxable year, and if so, the first date during the taxable year on which such contract was held; and

(F) The signature of the person making the election (in the case of individuals filing a joint return, the signature of all persons filing such return).

The election shall be made by the following persons: in the case of an individual, by such individual; in the case of a partnership, by each partner separately; effective for taxable years beginning after March 17, 1992, in the case of tiered partnerships, each ultimate partner; in the case of an S corporation, by each shareholder separately; in the case of a trust (other than a grantor trust) or estate, by the fiduciary of such trust or estate; in the case of any corporation other than an S corporation, by such corporation (in the case of a corporation that is a member of an

affiliated group that files a consolidated return, such election shall be valid and binding only if made by the common parent, as that term is used in §1.1502–77(a)); in the case of a controlled foreign corporation, by its controlling United States shareholders under §1.964–1(c)(3). With respect to a corporation (other than an S corporation), the election, when made by the common parent, shall be binding on all members of such corporation's affiliated group as defined in section 1504 that file a consolidated return. The election shall be binding on any income or loss derived from the partner's share (determined under the principles of section 702(a)) of all contracts described in section 988(c)(1)(D)(i) or paragraph (a)(7)(i) of this section in which the taxpayer holds a direct interest or indirect interest through a partnership or S corporation; however, the election shall not apply to any income or loss of a partnership for any taxable year if such partnership made an election under section 988(c)(1)(E)(iii)(V) for such year or any preceding year. Generally, a copy of the election must be attached to the taxpayer's income tax return for the first year it is effective. It is not required to be attached to subsequent returns. However, in the case of a partner, a copy of the election must be attached to the taxpayer's income tax return for every year during which the taxpayer is a partner in a partnership that engages in a transaction that is subject to the election.

(iv) *Time for making the election*—(A) *In general.* Unless the requirements for making a late election described in paragraph (a)(7)(iv)(B) of this section are satisfied, an election under section 988 (c)(1)(D)(ii) and paragraph (a)(7)(ii) of this section for any taxable year shall be made on or before the first day of the taxable year or, if later, on or before the first day during such taxable year on which the taxpayer holds a contract described in section 988(c)(1)(D)(ii) and paragraph (a)(7)(ii) of this section. The election under section 988(c)(1)(D)(ii) and paragraph (a)(7)(ii) of this section shall apply to contracts entered into or acquired after October 21, 1988, and held on or after the effective date of the election. The election shall be effective as of the beginning of the taxable year and shall be binding with respect to all succeeding taxable years unless revoked with the prior consent of the Commissioner. In determining whether to grant revocation of the election, recapture of the tax benefit derived from the election in previous taxable years will be considered.

(B) *Late elections.* A taxpayer may make an election under section 988(c)(1)(D)(ii) and paragraph (a)(7)(ii) of this section within 30 days after the time prescribed in the first sentence of paragraph (a)(7)(iv)(A) of this section. Such a late election shall be effective as of the beginning of the taxable year; however, any losses recognized during the taxable year with respect to contracts described in section 988(c)(1)(D)(ii) or paragraph (a)(7)(ii) of this section which were entered into or acquired after October 21, 1988, and held on or before the date on which the late election is mailed or otherwise delivered to the Internal Revenue Service Center shall not be treated as derived from a section 988 transaction. A late election must comply with the procedures set forth in paragraph (a)(7)(iii) of this section.

(v) *Transition rule.* An election made prior to September 21, 1989 which satisfied the requirements of Notice 88–124, 1988–51 I.R.B. 6, shall be deemed to satisfy the requirements of paragraphs (a)(7)(iii) and (iv) of this section.

(vi) *General effective date provision.* This paragraph (a)(7) shall apply with respect to futures contracts and options entered into or acquired after October 21, 1988.

(8) *Special rules for qualified funds*—(i) *Definition of qualified fund.* The term ''qualified fund'' means any partnership if—

(A) At all times during the taxable year (and during each preceding taxable year to which an election under section 988(c)(1)(E)(iii)(V) applied) such partnership has at least 20 partners and no single partner owns more than 20 percent of the interests in the capital or profits of the partnership;

(B) The principa1 activity of such partnership for such taxable year (and

each such preceding taxable year) consists of buying and selling options, futures, or forwards with respect to commodities;

(C) At least 90 percent of the gross income of the partnership for the taxable year (and each such preceding year) consists of income or gains described in subparagraph (A), (B), or (G) of section 7704(d)(1) or gain from the sale or disposition of capital assets held for the production of interest or dividends;

(D) No more than a de minimis amount of the gross income of the partnership for the taxable year (and each such preceding taxable year) was derived from buying and selling commodities; and

(E) An election under section 988(c)(1)(E)(iii)(V) as provided in paragraph (a)(8)(iv) of this section applies to the taxable year.

(ii) *Special rules relating to paragraph (a)(8)(i)(A) of this section*—(A) *Certain general partners.* The interest of a general partner in the partnership shall not be treated as failing to meet the 20 percent ownership requirement of paragraph (a)(8)(i)(A) of this section for any taxable year of the partnership if, for the taxable year of the partner in which such partnership's taxable year ends, such partner (and each corporation filing a consolidated return with such partner) had no ordinary income or loss from a section 988 transaction (other than income from the partnership) which is exchange gain or loss (as the case may be).

(B) *Treatment of incentive compensation.* For purposes of paragraph (a)(8)(i)(A) of this section, any income allocable to a general partner as incentive compensation based on profits rather than capital shall not be taken into account in determining such partner's interest in the profits of the partnership.

(C) *Treatment of tax exempt partners.* The interest of a partner in the partnership shall not be treated as failing to meet the 20 percent ownership requirements of paragraph (a)(5)(8)(A) of this section if none of the income of such partner from such partnership is subject to tax under chapter 1 of subtitle A of the Internal Revenue Code (whether directly or through one or more pass-through entities).

(D) *Look-through rule.* In determining whether the 20 percent ownership requirement of paragraph (a)(8)(i)(A) of this section is met with respect to any partnership, any interest in such partnership held by another partnership shall be treated as held proportionately by the partners in such other partnership.

(iii) *Other special rules*—(A) *Related persons.* Interests in the partnership held by persons related to each other (within the meaning of section 267(b) or 707(b)) shall be treated as held by one person.

(B) *Predecessors.* Reference to any partnership shall include a reference to any predecessor thereof.

(C) *Treatment of certain debt instruments.* Solely for purposes of paragraph (a)(8)(i)(D) of this section, any debt instrument which is described in both paragraphs (a)(1)(ii) and (2)(i) of this section shall be treated as a commodity.

(iv) *Procedure for making the election provided in section 988(c)(1)(E)(iii)(V).* A partnership shall make the election provided in section 988(c)(1)(E)(iii)(V) by sending to the Internal Revenue Service Center, Examination Branch, Stop Number 92, Kansas City, MO 64999 a statement titled ''QUALIFIED FUND ELECTION UNDER SECTION 988(c)(1)(E)(iii)(V)'' that contains the following:

(A) The partnership's name, address, and taxpayer identification number;

(B) The name, address and taxpayer identification number of the general partner making the election on behalf of the partnership;

(C) The date the notice is mailed or otherwise delivered to the Internal Revenue Service Center;

(D) A brief description of the activity of the partnership;

(E) A statement that the partnership is making the election provided in section 988(c)(1)(E)(iii)(V);

(F) The date of the beginning of the taxable year for which the election is being made;

(G) If the election is filed after the first day of the taxable year, then a statement regarding whether the partnership previously held an instrument referred to in section 988(c)(1)(E)(i) during such taxable year and, if so, the

first date during the taxable year on which such contract was held; and

(H) The signature of the general partner making the election.

The election shall be made by a general partner with management responsibility of the partnership's activities and a copy of such election shall be attached to the partnership's income tax return (Form 1065) for the first taxable year it is effective. It is not required to be attached to subsequent returns.

(v) *Time for making the election.* The election under section 988(c)(1)(E)(iii)(V) for any taxable year shall be made on or before the first day of the taxable year or, if later, on or before the first day during such year on which the partnership holds an instrument described in section 988(c)(1)(E)(i). The election under section 988(c)(1)(E)(iii)(V) shall apply to the taxable year for which made and all succeeding taxable years. Such election may only be revoked with the consent of the Commissioner. In determining whether to grant revocation of the election, recapture by the partners of the tax benefit derived from the election in previous taxable years will be considered.

(vi) *Operative rules applicable to qualified funds*—(A) *In general.* In the case of a qualified fund, any bank forward contract or any foreign currency futures contract traded on a foreign exchange which is not otherwise a section 1256 contract shall be treated as a section 1256 contract for purposes of section 1256.

(B) *Gains and losses treated as short-term.* In the case of any instrument treated as a section 1256 contract under paragraph (a)(8)(vi)(A) of this section, subparagraph (A) of section 1256(a)(3) shall be applied by substituting ''100 percent'' for ''40 percent'' (and subparagraph (B) of such section shall not apply).

(vii) *Transition rule.* An election made prior to September 21, 1989, which satisfied the requirements of Notice 88–124, 1988–51 I.R.B. 6, shall be deemed to satisfy the requirements of §1.988–1(a)(8)(iv) and (v).

(viii) *General effective date rules*—(A) The requirements of subclause (IV) of section 988(c)(1)(E)(iii) shall not apply to contracts entered into or acquired on or before October 21, 1988.

(B) In the case of any partner in an existing partnership, the 20 percent ownership requirements of subclause (I) of section 988(c)(1)(E)(iii) shall be treated as met during any period during which such partner does not own a percentage interest in the capital or profits of such partnership greater than 33⅓ percent (or, if lower, the lowest such percentage interest of such partner during any period after October 21, 1988, during which such partnership is in existence). For purposes of the preceding sentence, the term ''existing partnership'' means any partnership if—

(*1*) Such partnership was in existence on October 21, 1988, and principally engaged on such date in buying and selling options, futures, or forwards with respect to commodities; or

(*2*) A registration statement was filed with respect to such partnership with the Securities and Exchange Commission on or before such date and such registration statement indicated that the principal activity of such partnership will consist of buying and selling instruments referred to in paragraph (a)(8)(viii)(B)(*1*) of this section.

(9) *Exception for certain transactions entered into by an individual*—(i) *In general.* A transaction entered into by an individual which otherwise qualifies as a section 988 transaction shall be considered a section 988 transaction only to the extent expenses properly allocable to such transaction meet the requirements of section 162 or 212 (other than the part of section 212 dealing with expenses incurred in connection with taxes).

(ii) *Examples.* The following examples illustrate the application of paragraph (a)(9) of this section.

Example 1. X is a U.S. citizen who therefore has the U.S. dollar as his functional currency. On January 1, 1990, X enters into a spot contract to purchase 10,000 British pounds (£) for $15,000 for delivery on January 3, 1990. Immediately upon delivery, X acquires at original issue a pound denominated bond with an issue price of £10,000. The bond matures on January 3, 1993, pays interest in pounds at a rate of 10% compounded semiannually, and has no original issue discount. Assume that all expenses properly allocable

to these transactions would meet the requirements of section 212. Under §1.988–2(d)(1)(ii), entering into the spot contract on January 1, 1990, is not a section 988 transaction. The acquisition of the pounds on January 3, 1990, under the spot contract is a section 988 transaction for purposes of establishing X's basis in the pounds. The disposition of the pounds and the acquisition of the bond by X are section 988 transactions. These transactions are not excluded from the definition of a section 988 transaction under paragraph (a)(9) of this section because expenses properly allocable to such transactions meet the requirements of section 212.

Example 2. X is a U.S. citizen who therefore has the dollar as his functional currency. In preparation for X's vacation, X purchases 1,000 British pounds (£) from a bank on June 1, 1989. During the period of X's vacation in the United Kingdom beginning June 10, 1989, and ending June 20, 1989, X spends £500 for hotel rooms, £300 for food and £200 for miscellaneous vacation expenses. The expenses properly allocable to such dispositions do not meet the requirements of section 162 or 212. Thus, the disposition of the pounds by X on his vacation are not section 988 transactions.

(10) *Intra-taxpayer transactions*—(i) *In general.* Except as provided in paragraph (a)(10)(ii) of this section, transactions between or among the taxpayer and/or qualified business units of that taxpayer (''intra-taxpayer transactions'') are not section 988 transactions. See section 987 and the regulations thereunder.

(ii) *Certain intra-taxpayer transfers of section 988 transactions that result in the recognition of section 988 gain or loss*—(A) *In general.* Exchange gain or loss with respect to nonfunctional currency or any item described in paragraph (a)(2) of this section entered into with another taxpayer shall be realized upon a transfer (as defined under §1.987–2(c)) of such currency or item from an owner to a section 987 QBU or from a section 987 QBU to an owner if as a result of such transfer—

(*1*) The currency or item loses its character as nonfunctional currency or as an item described in paragraph (a)(2) of this section; or

(*2*) The source of the exchange gain or loss could be altered absent the application of paragraph (a)(10)(ii)(B) of this section.

(B) *Computation of exchange gain or loss.* Exchange gain or loss described in section (a)(10)(ii)(A) of this section shall be computed in accordance with §1.988–2 (without regard to §1.988–2(b)(8)) as if the nonfunctional currency or item described in paragraph (a)(2) of this section had been sold or otherwise transferred at fair market value between unrelated taxpayers. For purposes of the preceding sentence, a taxpayer must use a translation rate that is consistent with the translation conventions of the section 987 QBU to or from which, as the case may be, the item is being transferred. In the case of a gain or loss incurred in a transaction described in this paragraph (a)(10)(ii) that does not have a significant business purpose, the Commissioner may defer such gain or loss.

(iii) *Example.* The following example illustrates the provisions of this paragraph (a)(10).

Example. (A) X, a corporation with the U.S. dollar as its functional currency, operates through foreign branches Y and Z. Y and Z are qualified business units as defined in section 989(a) with the LC as their functional currency. X computes Y's and Z's income under section 987 (relating to branch transactions). On November 12, 1988, Y transfers $25 to the home office of X when the fair market value of such amount equals LC120. Y has a basis of LC100 in the $25. Under paragraph (a)(10)(ii) of this section, Y realizes foreign source exchange gain of LC20 (LC120—LC100) as the result of the $25 transfer. For purposes of determining whether the transfer is a remittance resulting in additional gain or loss, see section 987 and the regulations thereunder.

(B) If instead Y transfers the $25 to Z, exchange gain is not realized because the $25 is nonfunctional currency with respect to Z and if Z were to immediately convert the $25 into LCs, the gain would be foreign source. For purposes of determining whether the transfer is a remittance resulting in additional gain or loss, see section 987 and the regulations thereunder.

(11) *Authority to include or exclude transactions from section 988*—(i) *In general.* The Commissioner may recharacterize a transaction (or series of transactions) in whole or in part as a section 988 transaction if the effect of such transaction (or series of transactions) is to avoid section 988. In addition, the Commissioner may exclude a transaction (or series of transactions) which in form is a section 988 transaction from the provisions of section 988 if the substance of the transaction (or series

of transactions) indicates that it is not properly considered a section 988 transaction.

(ii) *Example.* The following example illustrates the provisions of this paragraph (a)(11).

Example. B is an individual with the U.S. dollar as its functional currency. B holds 500,000 Swiss francs which have a basis of $100,000 and a fair market value of $400,000 as of October 15, 1989. On October 16, 1989, B transfers the 500,000 Swiss francs to a newly formed U.S. corporation, X, with the dollar as its functional currency. On October 16, 1989, B sells the stock of X for $400,000. Assume the transfer to X qualified for nonrecognition under section 351. Because the sale of the stock of X is a substitute for the disposition of an asset subject to section 988, the Commissioner may recharacterize the sale of the stock as a section 988 transaction. The same result would obtain if B transferred the Swiss francs to a partnership and then sold the partnership interest.

(b) *Spot contract.* A spot contract is a contract to buy or sell nonfunctional currency on or before two business days following the date of the execution of the contract. See §1.988–2 (d)(1)(ii) for operative rules regarding spot contracts.

(c) *Nonfunctional currency.* The term ''nonfunctional currency'' means with respect to a taxpayer or a qualified business unit (as defined in section 989 (a)) a currency (including the European Currency Unit) other than the taxpayer's or the qualified business unit's functional currency as defined in section 985 and the regulations thereunder. For rules relating to nonrecognition of exchange gain or loss with respect to certain dispositions of nonfunctional currency, see §1.988–2 (a)(1)(iii).

(d) *Spot rate*—(1) *In general.* Except as otherwise provided in this paragraph, the term ''spot rate'' means a rate demonstrated to the satisfaction of the District Director or the Assistant Commissioner (International) to reflect a fair market rate of exchange available to the public for currency under a spot contract in a free market and involving representative amounts. In the absence of such a demonstration, the District Director or the Assistant Commissioner (International), in his or her sole discretion, shall determine the spot rate from a source of exchange rate information reflecting actual transactions conducted in a free market. For example, the taxpayer or the District Director or the Assistant Commissioner (International) may determine the spot rate by reference to exchange rates published in the pertinent monthly issue of ''International Financial Statistics'' or a successor publication of the International Monetary Fund; exchange rates published by the Board of Governors of the Federal Reserve System pursuant to 31 U.S.C. section 5151; exchange rates published in newspapers, financial journals or other daily financial news sources; or exchange rates quoted by electronic financial news services.

(2) *Consistency required in valuing transactions subject to section 988.* If the use of inconsistent sources of spot rate quotations results in the distortion of income, the District Director or the Assistant Commissioner (International) may determine the appropriate spot rate.

(3) *Use of certain spot rate conventions for payables and receivables denominated in nonfunctional currency.* If consistent with the taxpayer's financial accounting, a taxpayer may utilize a spot rate convention determined at intervals of one quarter year or less for purposes of computing exchange gain or loss with respect to payables and receivables denominated in a nonfunctional currency that are incurred in the ordinary course of business with respect to the acquisition or sale of goods or the obtaining or performance of services. For example, if consistent with the taxpayer's financial accounting, a taxpayer may accrue all payables and receivables incurred during the month of January at the spot rate on December 31 or January 31 (or at an average of any spot rates occurring between these two dates) and record the payment or receipt of amounts in satisfaction of such payables and receivables consistent with such convention. The use of a spot rate convention cannot be changed without the consent of the Commissioner.

(4) *Currency where an official government established rate differs from a free market rate*—(i) *In general.* If a currency has an official government established rate that differs from a free market

rate, the spot rate shall be the rate which most clearly reflects the taxpayer's income. Generally, this shall be the free market rate.

(ii) *Examples.* The following examples illustrate the application of this paragraph (d)(4).

Example 1. X is an accrual method U.S. corporation with the dollar as its functional currency. X owns all the stock of a Country L subsidiary, CFC. CFC has the currency of Country L, the LC, as its functional currency. Country L imposes restrictions on the remittance of dividends. On April 1, 1990, CFC pays a dividend to X in the amount of LC100. Assume that the official governnent established rate is $1 = LC1 and the free market rate, which takes into account the remittance restrictions and which is the rate that most clearly reflects income, is $1 = LC4. On April 1, 1990, X donates the LC100 in a transaction that otherwise qualifies as a charitable contribution under section 170 (c). Both the amount of the dividend income and the deduction under section 170 is $25 (LC100 × the free market rate, $.25).

Example 2. X, a corporation with the U.S. dollar as its functional currency, operates in foreign country L through branch Y. Y is a qualified business unit as defined in section 989 (a). X computes Y's income under the dollar approximate separate transactions method as described in §1.985–3. The currency of L is the LC. X can purchase legally United States dollars ($) in L only from the L government. In order to take advantage of an arbitrage between the official and secondary dollar to LC exchange rates in L:

(i) X purchases LC100 for $60 in L on the secondary market when the official exchange rate is S1 = LC1;

(ii) X transfers the LC100 to Y;

(iii) Y purchases $100 for LC100; and

(iv) Y transfers $65 ($100 less an L tax withheld of $35 on the transfer) to the home office of X.

Under paragraph (a)(7) of this section, the transfer of the LC100 by X to Y is a realization event. X has a basis of $60 in the LC100. Under these facts, the appropriate dollar to LC exchange rate for computing the amount realized by X is the official exchange rate. Therefore, X realizes $40 ($100–$60) of U.S. source gain from the transfer to Y. The same result would obtain if Y rather than X purchased the LC100 on the secondary market in L with $60 supplied by X, because the substance of this transaction is that X is performing the arbitrage.

(e) *Exchange gain or loss.* The term ''exchange gain or loss'' means the amount of gain or loss realized as determined in §1.988–2 with respect to a section 988 transaction. Except as otherwise provided in these regulations (*e.g.*, §1.98B–5), the amount of exchange gain or loss from a section 988 transaction shall be separately computed for each section 988 transaction, and such amount shall not be integrated with gain or loss recognized on another transaction (whether or not such transaction is economically related to the section 988 transaction). See §1.988–2 (b)(8) for a special rule with respect to debt instruments.

(f) *Hyperinflationary currency*—(1) *Definition*—(i) *General rule.* For purposes of section 988, a hyperinflationary currency means a currency described in §1.985–1(b)(2)(ii)(D). Unless otherwise provided, the currency in any example used in §§1.988–1 through 1.988–5 is not a hyperinflationary currency.

(ii) *Special rules for determining base period.* In determining whether a currency is hyperinflationary under §1.985–1(b)(2)(ii)(D) for purposes of this paragraph (f), the following rules will apply:

(A) The base period means the thirty-six calendar month period ending on the last day of the taxpayer's (or qualified business unit's) current taxable year. Thus, for example, if for 1996, 1997, and 1998, a country's annual inflation rates are 6 percent, 11 percent, and 90 percent, respectively, the cumulative inflation rate for the three-year base period is 124% [((1.06 × 1.11 × 1.90) − 1.0 = 1.24) × 100 = 124%]. Accordingly, assuming the QBU has a calendar year as its taxable year, the currency of the country is hyperinflationary for the 1998 taxable year. This change in the §1.985–1(b)(2)(ii)(D) base period shall not apply to any section 988 transaction of an entity described in section 851 (regulated investment company (RIC)) or section 856 (real estate investment trust (REIT)). The Service may, by notice, provide that the foregoing change in the §1.985–1(b)(2)(ii)(D) base period does not apply to any section 988 transaction of an entity with distribution requirements similar to a RIC or REIT.

(B) The last sentence of §1.985–1(b)(2)(ii)(D) shall not apply to alter the base period for purposes of this paragraph (f) in determining whether a

currency is hyperinflationary for purposes of section 988. Accordingly, generally accepted accounting principles may not apply to alter the base period for purposes of this paragraph (f).

(2) *Effective date.* Paragraph (f)(1) of this section shall apply to transactions entered into after February 14, 2000.

(g) *Fair market value.* The fair market value of an item shall, where relevant, reflect an appropriate premium or discount for the time value of money (*e.g.*, the fair market value of a forward contract to buy or sell nonfunctional currency shall reflect the present value of the difference between the units of nonfunctional currency times the market forward rate at the time of valuation and the units of nonfunctional currency times the forward rate set forth in the contract). However, if consistent with the taxpayer's method of financial accounting (and consistently applied from year to year), the preceding sentence shall not apply to a financial instrument that matures within one year from the date of issuance or acquisition. Unless otherwise provided, the fair market value given in any example used in §§ 1.988–1 through 1.988–5 is deemed to reflect appropriately the time value of money. If the use of inconsistent sources of forward or other market rate quotations results in the distortion of income, the District Director or the Assistant Commissioner (International) may determine the appropriate rate.

(h) *Interaction with sections 1092 and 1256.* Unless otherwise provided, it is assumed for purposes of §§ 1.988–1 through 1.988–5 that any contract used in any example is not a section 1256 contract and is not part of a straddle as defined in section 1092. No inference is intended regarding the application of section 1092 or 1256 unless expressly stated.

(i) *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. Generally, the revisions to paragraphs (a)(3), (a)(4), and (a)(10)(ii) of this section shall apply to taxable years beginning one year after the first day of the first taxable year following December 7, 2016. If pursuant to § 1.987–11(b) a taxpayer applies §§ 1.987–1 through 1.987–11 beginning in a taxable year prior to the earliest taxable year described in § 1.987–11(a), then the revisions to paragraphs (a)(3), (a)(4), and (a)(10)(ii) of this section shall apply to taxable years of the taxpayer beginning on or after the first day of such prior taxable year.

[T.D. 8400, 57 FR 9178, Mar. 17, 1992, as amended by T.D. 8914, 66 FR 280, Jan. 3, 2001; T.D. 9794, 81 FR 88850, Dec. 8, 2016; T.D. 9795, 81 FR 88879, Dec. 8, 2016]

§ 1.988–1T Certain definitions and special rules (temporary).

(a)(1) through (a)(2) [Reserved]. For further guidance, see § 1.988–1(a)(1) through (2).

(3) *Specified owner functional currency transactions of a section 987 QBU not treated as section 988 transactions.* Specified owner functional currency transactions, as defined in § 1.987–3T(b)(4)(ii), held by a section 987 QBU are not treated as section 988 transactions. Thus, no currency gain or loss shall be recognized by a section 987 QBU under section 988 with respect to such transactions.

(4) through (i) [Reserved]. For further guidance, see § 1.988–1(a)(4) through (i).

(j) *Effective/applicability date.* This section applies to taxable years beginning on or after one year after the first day of the first taxable year following December 7, 2016. Notwithstanding the preceding sentence, if a taxpayer makes an election under § 1.987–11(b), then this section applies to taxable years to which §§ 1.987–1 through 1.987–10 apply as a result of such election.

(k) *Expiration date.* The applicability of this section expires on December 6, 2019.

[T.D. 9795, 81 FR 88879, Dec. 8, 2016]

§ 1.988–2 Recognition and computation of exchange gain or loss.

(a) *Disposition of nonfunctional currency*—(1) *Recognition of exchange gain or loss*—(i) *In general.* Except as otherwise provided in this section, § 1.988–1(a)(7)(ii), and § 1.988–5, the recognition of exchange gain or loss upon the sale

or other disposition of nonfunctional currency shall be governed by the recognition provisions of the Internal Revenue Code which apply to the sale or disposition of property (*e.g.*, section 1001 or, to the extent provided in regulations, section 1092). The disposition of nonfunctional currency in settlement of a forward contract, futures contract, option contract, or similar financial instrument is considered to be a sale or disposition of the nonfunctional currency for purposes of the preceding sentence.

(ii) *Clarification of section 1031.* An amount of one nonfunctional currency is not ''property of like kind'' with respect to an amount of a different nonfunctional currency.

(iii) *Coordination with section 988(c)(1)(C)(ii).* No exchange gain or loss is recognized with respect to the following transactions—

(A) An exchange of units of nonfunctional currency for different units of the same nonfunctional currency;

(B) The deposit of nonfunctional currency in a demand or time deposit or similar instrument (including a certificate of deposit) issued by a bank or other financial institution if such instrument is denominated in such currency;

(C) The withdrawal of nonfunctional currency from a demand or time deposit or similar instrument issued by a bank or other financial institution if such instrument is denominated in such currency;

(D) The receipt of nonfunctional currency from a bank or other financial institution from which the taxpayer purchased a certificate of deposit or similar instrument denominated in such currency by reason of the maturing or other termination of such instrument; and

(E) The transfer of nonfunctional currency from a demand or time deposit or similar instrument issued by a bank or other financial institution to another demand or time deposit or similar instrument denominated in the same nonfunctional currency issued by a bank or other financial institution.

The taxpayer's basis in the units of nonfunctional currency or other property received in the transaction shall be the adjusted basis of the units of nonfunctional currency or other property transferred. See paragraph (b) of this section with respect to the timing of interest income or expense and the determination of exchange gain or loss thereon.

(iv) *Example.* The following example illustrates the provisions of paragraph (a)(1)(iii) of this section.

Example. X is a corporation on the accrual method of accounting with the U.S. dollar as its functional currency. On January 1, 1989, X acquires 1,500 British pounds (£) for $2,250 (£1 = $1.50). On January 3, 1989, when the spot rate is £1 = $1.49, X deposits the £1,500 with a British financial institution in a non-interest bearing demand account. On February 1, 1989, when the spot rate is £1 = $1.45, X withdraws the £1,500. On February 5, 1989, when the spot rate is £1 = $1.42, X purchases inventory in the amount of £1,500. Pursuant to paragraph (a)(1)(iii) of this section, no exchange loss is realized until February 5, 1989, when X disposes of the £1,500 for inventory. At that time, X realizes exchange loss in the amount of $120 computed under paragraph (a)(2) of this section. The loss is not an adjustment to the cost of the inventory.

(2) *Computation of gain or loss*—(i) *In general.* Exchange gain realized from the sale or other disposition of nonfunctional currency shall be the excess of the amount realized over the adjusted basis of such currency, and exchange loss realized shall be the excess of the adjusted basis of such currency over the amount realized.

(ii) *Amount realized*—(A) *In general.* The amount realized from the disposition of nonfunctional currency shall be determined under section 1001(b). A taxpayer that uses a spot rate convention under §1.988–1(d)(3) to determine exchange gain or loss with respect to a payable shall determine the amount realized upon the disposition of nonfunctional currency paid in satisfaction of the payable in a manner consistent with such convention.

(B) *Exchange of nonfunctional currency for property.* For purpose of paragraph (a)(2) of this section, the exchange of nonfunctional currency for property (other than nonfunctional currency) shall be treated as—

(*1*) An exchange of the units of nonfunctional currency for units of functional currency at the spot rate on the date of the exchange, and

(*2*) The purchase or sale of the property for such units of functional currency.

(C) *Example.* The following example illustrates the provisions of paragraph (a)(2)(ii)(B) of this section.

Example. G is a U.S. corporation with the U.S. dollar as its functional currency. On January 1, 1989, G enters into a contract to purchase a paper manufacturing machine for 10,000,000 British pounds (£) for delivery on January 1, 1991. On January 1, 1991, when G exchanges £10,000,000 (which G purchased for $12,000,000) for the machine, the fair market value of the machine is £17,000,000. On January 1, 1991, the spot exchange rate is £1 = $1.50. Under paragraph (a)(2)(ii)(B) of this section, the transaction is treated as an exchange of £10,000,000 for $15,000,000 and the purchase of the machine for $15,000,000. Accordingly, in computing G's exchange gain of $3,000,000 on the disposition of the £10,000,000, the amount realized is $15,000,000. G's basis in the machine is $15,000,000. No gain is recognized on the bargain purchase of the machine.

(iii) *Adjusted basis*—(A) *In general.* Except as provided in paragraph (a)(2)(iii)(B) of this section, the adjusted basis of nonfunctional currency is determined under the applicable provisions of the Internal Revenue Code (*e.g.*, sections 1011 through 1023). A taxpayer that uses a spot rate convention under §1.988–1 (d)(3) to determine exchange gain or loss with respect to a receivable shall determine the basis of nonfunctional currency received in satisfaction of such receivable in a manner consistent with such convention.

(B) *Determination of the basis of nonfunctional currency withdrawn from an account with a bank or other financial institution—(1) In general.* The basis of nonfunctional currency withdrawn from an account with a bank or other financial institution shall be determined under any reasonable method that is consistently applied from year to year by the taxpayer to all accounts denominated in a nonfunctional currency. For example, a taxpayer may use a first in first out method, a last in first out method, a pro rata method (as illustrated in the example below), or any other reasonable method that is consistently applied. However, a method that consistently results in units of nonfunctional currency with the highest basis being withdrawn first shall not be considered reasonable.

(*2*) *Example.* The following example illustrates the provisions of this paragraph (a)(2)(iii)(B).

Example. (i) X, a cash basis individual with the dollar as his functional currency, opens a demand account with a Swiss bank. Assume expenses associated with the demand account are deductible under section 212. The following chart indicates Swiss franc deposits to the account, Swiss franc interest credited to the account, the dollar basis of each deposit, and the determination of the aggregate dollar basis of all Swiss francs in the account. Assume that the taxpayer has properly translated all the amounts specified in the chart and that all transactions are subject to section 988.

Date	Swiss francs deposited	Interest received	U.S. dollar basis	Aggregate U.S. dollar basis
1/01/89	1000 Sf		$500	$500
3/31/89		50 Sf	25	525
6/30/89		50 Sf	24	549
9/30/89		50 Sf	25	574
12/31/89		50 Sf	26	600

(ii) On January 1, 1990, X withdraws 500 Swiss francs from the account. X may determine his basis in the Swiss francs by multiplying the aggregate U.S. dollar basis of Swiss francs in the account by a fraction the numerator of which is the number of Swiss francs withdrawn from the account and the denominator is the total number of Swiss francs in the account. Under this method, X's basis in the 500 Swiss francs is $250 computed as follows:

$$\frac{500\ \text{Sf}}{1200\ \text{Sf}} \times \$600 = \$250$$

(iii) X's basis in the Swiss francs remaining in the account is $350 ($600 − $250). X must use this method consistently from year to year with respect to withdrawals of nonfunctional currency from all of X's accounts.

(iv) Purchase and sale of stock or securities traded on an established securities market by cash basis taxpayer—

(A) *Amount realized.* If stock or securities traded on an established securities market are sold by a cash basis taxpayer for nonfunctional currency, the amount realized with respect to the stock or securities (as determined on the trade date) shall be computed by translating the units of nonfunctional currency received into functional currency at the spot rate on the settlement date of the sale. This rule applies notwithstanding that the stock or securities are treated as disposed of on a date other than the settlement date under another section of the Code. See section 453(k).

(B) *Basis.* If stock or securities traded on an established securities market are purchased by a cash basis taxpayer for nonfunctional currency, the basis of the stock or securities shall be determined by translating the units of nonfunctional currency paid into functional currency at the spot rate on the settlement date of the purchase.

(C) *Example.* The following example illustrates the provisions of this paragraph (a)(2)(iv).

Example. On November 1, 1989 (the trade date), X, a calendar year cash basis U.S. individual, purchases stock for £100 for settlement on November 5, 1989. On November 1, 1989, the spot value of the £100 is $140. On November 5, 1989, X purchases £100 for $141 which X uses to pay for the stock. X's basis in the stock is $141. On December 30, 1990 (the trade date), X sells the stock for £110 for settlement on January 5, 1991. On December 30, 1990, the spot value of £110 is $165. On January 5, 1991, X transfers the stock and receives £110 which, translated at the spot rate, equal $166. Under section 453(k), the stock is considered disposed of on December 30, 1990. The amount realized with respect to such disposition is the value of the £110 on January 5, 1991 ($166). Accordingly, X's gain realized on December 30, 1990, from the disposition of the stock is $25 ($166 amount realized less $141 basis). X's basis in the £110 received from the sale of the stock is $166.

(v) *Purchase and sale of stock or securities traded on an established securities market by accrual basis taxpayer.* For taxable years beginning after March 17, 1992, an accrual basis taxpayer may elect to apply the rules of paragraph (a)(2)(iv) of this section. The election shall be made by filing a statement with the taxpayer's first return in which the election is effective clearly indicating that the election has been made. A method so elected must be applied consistently from year to year and cannot be changed without the consent of the Commissioner.

(b) *Translation of interest income or expense and determination of exchange gain or loss with respect to debt instruments—*(1) *Translation of interest income received with respect to a nonfunctional currency demand account.* Interest income received with respect to a demand account with a bank or other financial institution which is denominated in (or the payments of which are determined by reference to) a nonfunctional currency shall be translated into functional currency at the spot rate on the date received or accrued or pursuant to any reasonable spot rate convention consistently applied by the taxpayer to all taxable years and to all accounts denominated in nonfunctional currency in the same financial institution. For example, a taxpayer may translate interest income received with respect to a demand account on the last day of each month of the taxable year, on the last day of each quarter of the taxable year, on the last day of each half of the taxable year, or on the last day of the taxable year. No exchange gain or loss is realized upon the receipt or accrual of interest income with respect to a demand account subject to this paragraph (b)(1).

(2) *Translation of nonfunctional currency interest income or expense received or paid with respect to a debt instrument described in § 1.988–1(a)(1)(ii) and (2)(i)—*(i) *Scope—*(A) *In general.* Paragraph (b) of this section only applies to debt instruments described in § 1.988–1(a)(1)(ii) and (2)(i) where all payments are denominated in, or determined with reference to, a single nonfunctional currency. Except as provided in paragraph (b)(2)(i)(B) of this section, this paragraph (b) shall not apply to contingent payment debt instruments.

(B) *Nonfunctional currency contingent payment debt instruments—*(*1*) *Operative rules.* See § 1.988–6 for rules applicable to contingent payment debt instruments for which one or more payments are denominated in, or determined by reference to, a nonfunctional currency.

(*2*) *Certain instruments are not contingent payment debt instruments.* For purposes of sections 163(e) and 1271 through 1275 and the regulations thereunder, a debt instrument does not provide for contingent payments merely because the instrument is denominated

in, or all payments of which are determined with reference to, a single nonfunctional currency. See §1.988–6 for the treatment of nonfunctional currency contingent payment debt instruments.

(ii) *Determination and translation of interest income or expense*—(A) *In general.* Interest income or expense on a debt instrument described in paragraph (b)(2)(i) of this section (including original issue discount determined in accordance with sections 1271 through 1275 and 163(e) as adjusted for acquisition premium under section 1272(a)(7), and acquisition discount determined in accordance with sections 1281 through 1283) shall be determined in units of nonfunctional currency and translated into functional currency as provided in paragraphs (b)(2)(ii)(B) and (C) of this section. For purposes of sections 483, 1273(b)(5) and 1274, the nonfunctional currency in which an instrument is denominated (or by reference to which payments are determined) shall be considered money.

(B) *Translation of interest income or expense that is not required to be accrued prior to receipt or payment.* With respect to an instrument described in paragraph (b)(2)(i) of this section, interest income or expense received or paid that is not required to be accrued by the taxpayer prior to receipt or payment shall be translated at the spot rate on the date of receipt or payment. No exchange gain or loss is realized with respect to the receipt or payment of such interest income or expense (other than the exchange gain or loss that might be realized under paragraph (a) of this section upon the disposition of the nonfunctional currency so received or paid).

(C) *Translation of interest income or expense that is required to be accrued prior to receipt or payment.* With respect to an instrument described in paragraph (b)(2)(i) of this section, interest income or expense that is required to be accrued prior to receipt or payment (*e.g.*, under section 1272, 1281 or 163(e) or because the taxpayer uses an accrual method of accounting) shall be translated at the average rate (or other rate specified in paragraph (b)(2)(iii)(B) of this section) for the interest accrual period or, with respect to an interest accrual period that spans two taxable years, at the average rate (or other rate specified in paragraph (b)(2)(iii)(B) of this section) for the partial period within the taxable year. See paragraphs (b)(3) and (4) of this section for the determination of exchange gain or loss on the receipt or payment of accrued interest income or expense.

(iii) *Determination of average rate or other accrual convention*—(A) *In general.* For purposes of this paragraph (b), the average rate for an accrual period (or partial period) shall be a simple average of the spot exchange rates for each business day of such period or other average exchange rate for the period reasonably derived and consistently applied by the taxpayer.

(B) *Election to use spot accrual convention.* For taxable years beginning after March 17, 1992, a taxpayer may elect to translate interest income and expense at the spot rate on the last day of the interest accrual period (and in the case of a partial accrual period, the spot rate on the last day of the taxable year). If the last day of the interest accrual period is within five business days of the date of receipt or payment, the taxpayer may translate interest income or expense at the spot rate on the date of receipt or payment. The election shall be made by filing a statement with the taxpayer's first return in which the election is effective clearly indicating that the election has been made. A method so elected must be applied consistently to all debt instruments from year to year and cannot be changed without the consent of the Commissioner.

(3) *Exchange gain or loss recognized by the holder with respect to accrued interest income.* The holder of a debt instrument described in paragraph (b)(2)(i) of this section shall realize exchange gain or loss with respect to accrued interest income on the date such accrued interest income is received or the instrument is disposed of (including a deemed disposition under section 1001 that results from a material change in terms of the instrument). Except as otherwise provided in this paragraph (b) (*e.g.*, paragraph (b)(8) of this section), exchange gain or loss realized with respect to accrued interest income shall be recognized in accordance with the

applicable recognition provisions of the Internal Revenue Code. The amount of exchange gain or loss so realized with respect to accrued interest income is determined for each accrual period by—

(i) Translating the units of nonfunctional currency interest income received with respect to such accrual period (as determined under the ordering rules of paragraph (b)(7) of this section) into functional currency at the spot rate on the date the interest income is received or the instrument is disposed of (or deemed disposed of), and

(ii) Subtracting from such amount the amount computed by translating the units of nonfunctional currency interest income accrued with respect to such income received at the average rate (or other rate specified in paragraph (b)(2)(iii)(B) of this section) for the accrual period.

(4) *Exchange gain or loss recognized by the obligor with respect to accrued interest expense.* The obligor under a debt instrument described in paragraph (b)(2)(i) of this section shall realize exchange gain or loss with respect to accrued interest expense on the date such accrued interest expense is paid or the obligation to make payments is transferred or extinguished (including a deemed disposition under section 1001 that results from a material change in terms of the instrument). Except as otherwise provided in this paragraph (b) (*e.g.*, paragraph (b)(8) of this section), exchange gain or loss realized with respect to accrued interest expense shall be recognized in accordance with the applicable recognition provisions of the Internal Revenue Code. The amount of exchange gain or loss so realized with respect to accrued interest expense is determined for each accrual period by—

(i) Translating the units of nonfunctional currency interest expense accrued with respect to the amount of interest paid into functional currency at the average rate (or other rate specified in paragraph (b)(2)(iii)(B) of this section) for such accrual period; and

(ii) Subtracting from such amount the amount computed by translating the units of nonfunctional currency interest paid (or, if the obligation to make payments is extinguished or transferred, the units accrued) with respect to such accrual period (as determined under the ordering rules in paragraph (b)(7) of this section) into functional currency at the spot rate on the date payment is made or the obligation is transferred or extinguished (or deemed extinguished).

(5) *Exchange gain or loss recognized by the holder of a debt instrument with respect to principal.* The holder of a debt instrument described in paragraph (b)(2)(i) of this section shall realize exchange gain or loss with respect to the principal amount of such instrument on the date principal (determined under the ordering rules of paragraph (b)(7) of this section) is received from the obligor or the instrument is disposed of (including a deemed disposition under section 1001 that results from a material change in terms of the instrument). For purposes of computing exchange gain or loss, the principal amount of a debt instrument is the holder's purchase price in units of nonfunctional currency. See paragraph (b)(10) of this section for rules regarding the amortization of that part of the principal amount that represents bond premium and the computation of exchange gain or loss thereon. If, however, the holder acquired the instrument in a transaction in which exchange gain or loss was realized but not recognized by the transferor, the nonfunctional currency principal amount of the instrument with respect to the holder shall be the same as that of the transferor. Except as otherwise provided in this paragraph (b) (*e.g.*, paragraph (b)(8) of this section), exchange gain or loss realized with respect to such principal amount shall be recognized in accordance with the applicable recognition provisions of the Internal Revenue Code. The amount of exchange gain or loss so realized by the holder with respect to principal is determined by—

(i) Translating the units of nonfunctional currency principal at the spot rate on the date payment is received or the instrument is disposed of (or deemed disposed of); and

(ii) Subtracting from such amount the amount computed by translating the units of nonfunctional currency principal at the spot rate on the date

the holder (or a transferor from whom the nonfunctional principal amount is carried over) acquired the instrument (is deemed to acquire the instrument).

(6) *Exchange gain or loss recognized by the obligor of a debt instrument with respect to principal.* The obligor under a debt instrument described in paragraph (b)(2)(i) of this section shall realize exchange gain or loss with respect to the principal amount of such instrument on the date principal (determined under the ordering rules of paragraph (b)(7) of this section) is paid or the obligation to make payments is transferred or extinguished (including a deemed disposition under section 1001 that results from a material change in terms of the instrument). For purposes of computing exchange gain or loss, the principal amount of a debt instrument is the amount received by the obligor for the debt instrument in units of nonfunctional currency. See paragraph (b)(10) of this section for rules regarding the amortization of that part of the principal amount that represents bond premium and the computation of exchange gain or loss thereon. If, however, the obligor became the obligor in a transaction in which exchange gain or loss was realized but not recognized by the transferor, the nonfunctional currency principal amount of the instrument with respect to such obligor shall be the same as that of the transferor. Except as otherwise provided in this paragraph (b) (*e.g.*, paragraph (b)(8) of this section), exchange gain or loss realized with respect to such principal shall be recognized in accordance with the applicable recognition provisions of the Internal Revenue Code. The amount of exchange gain or loss so realized by the obligor is determined by—

(i) Translating the units of nonfunctional currency principal at the spot rate on the date the obligor (or a transferor from whom the principal amount is carried over) became the obligor (or is deemed to have become the obligor); and

(ii) Subtracting from such amount the amount computed by translating the units of nonfunctional currency principal at the spot rate on the date payment is made or the obligation is transferred or extinguished (or deemed extinguished).

(7) *Payment ordering rules*—(i) *Debt instruments subject to the rules of sections 163(e), or 1271 through 1288.* In the case of a debt instrument described in paragraph (b)(2)(i) of this section that is subject to the rules of sections 163(e), or 1272 through 1288, units of nonfunctional currency (or an amount determined with reference to nonfunctional currency) received or paid with respect to such debt instrument shall be treated first as a receipt or payment of periodic interest under the principles of section 1273 and the regulations thereunder, second as a receipt or payment of original issue discount to the extent accrued as of the date of the receipt or payment, and finally as a receipt or payment of principal. Units of nonfunctional currency (or an amount determined with reference to nonfunctional currency) treated as a receipt or payment of original issue discount under the preceding sentence are attributed to the earliest accrual period in which original issue discount has accrued and to which prior receipts or payments have not been attributed. No portion thereof shall be treated as prepaid interest. These rules are illustrated by *Example 10* of paragraph (b)(9) of this section.

(ii) *Other debt instruments.* In the case of a debt instrument described in paragraph (b)(2)(i) of this section that is not subject to the rules of section 163(e) or 1272 through 1288, whether units of nonfunctional currency (or an amount determined with reference to nonfunctional currency) received or paid with respect to such debt instrument are treated as interest or principal shall be determined under section 163 or other applicable section of the Code.

(8) *Limitation of exchange gain or loss on payment or disposition of a debt instrument.* When a debt instrument described in paragraph (b)(2)(i) of this section is paid or disposed of, or when the obligation to make payments thereunder is satisfied by another person, or extinguished or assumed by another person, exchange gain or loss is computed with respect to both principal and any accrued interest (including original issue discount), as provided in paragraph (b)(3) through (7) of

this section. However, pursuant to section 988(b)(1) and (2), the sum of any exchange gain or loss with respect to the principal and interest of any such debt instrument shall be realized only to the extent of the total gain or loss realized on the transaction. The gain or loss realized shall be recognized in accordance with the general principles of the Code. See *Examples 3*, *4* and *6* of paragraph (b)(9) of this section.

(9) *Examples.* The preceding provisions are illustrated in the following examples. The examples assume that any transaction involving an individual is a section 988 transaction.

Example 1. (i) X is an individual on the cash method of accounting with the dollar as his functional currency. On January 1, 1992, X converts $13,000 to 10,000 British pounds (£) at the spot rate of £1 = $1.30 and loans the £10,000 to Y for 3 years. The terms of the loan provide that Y will make interest payments of £1,000 on December 31 of 1992, 1993, and 1994, and will repay X's £10,000 principal on December 31, 1994. Assume the spot rates for the pertinent dates are as follows:

Date	Spot rate (pounds to dollars)
Jan. 1, 1992	£1 = $1.30
Dec. 31, 1992	£1 = $1.35
Dec. 31, 1993	£1 = $1.40
Dec. 31, 1994	£1 = $1.45

(ii) Under paragraph (b)(2)(ii)(B) of this section, X will translate the £1,000 interest payments at the spot rate on the date received. Accordingly, X will have interest income of $1,350 in 1992, $1,400 in 1993, and $1,450 in 1994. Because X is a cash basis taxpayer, X does not realize exchange gain or loss on the receipt of interest income.

(iii) Under paragraph (b)(5) of this section, X will realize exchange gain upon repayment of the £10,000 principal amount determined by translating the £10,000 at the spot rate on the date it is received (£10,000 × $1.45 = $14,500) and subtracting from such amount, the amount determined by translating the £10,000 at the spot rate on the date the loan was made (£10,000 × $1.30 = $13,000). Accordingly, X will realize an exchange gain of $1,500 on the repayment of the loan on December 31, 1994.

Example 2. (i) Assume the same facts as in *Example 1* except that X is an accrual method taxpayer and that average rates are as follows:

Accrual period	Average rate (pounds to dollars)
1992	£1 = $1.32
1993	£1 = $1.37
1994	£1 = $1.42

(ii) Under paragraph (b)(2)(ii)(C) of this section, X will accrue the £1,000 interest payments at the average rate for the accrual period. Accordingly, X will have interest income of $1,320 in 1992, $1,370 in 1993, and $1,420 in 1994. Because X is an accrual basis taxpayer, X determines exchange gain or loss for each interest accrual period by translating the units of nonfunctional currency interest income received with respect to such accrual period at the spot rate on the date received and subtracting the amounts of interest income accrued for such period. Thus, X will realize $90 of exchange gain with respect to interest received under the loan, computed as follows:

Year	Spot value interest received	Accrued interest @ average rate	Exch. gain
1992	$1,350	$1,320	$30
1993	1,400	1,370	30
1994	1,450	1,420	30
Total	.....	.....	$90

(iii) Under paragraph (b)(5) of this section, X will realize exchange gain upon repayment of the £10,000 loan principal determined in the same manner as in *Example 1.* Accordingly, X will realize an exchange gain of $1,500 on the repayment of the loan principal on December 31, 1994.

Example 3. Assume the same facts as in *Example 1* except that X is a calendar year taxpayer on the accrual method of accounting that elects to use a spot rate convention to translate interest income as provided in §1.988–2(b)(2)(iii)(B). Interest income is received by X on the last day of each accrual period. Under paragraph (b)(2)(ii)(C), X will translate the interest income at the spot rate on the last day of each interest accrual period. Accordingly, X will have interest income of $1,350 in 1992, and $1,400 in 1993, $1,450 in 1994. Because the rate at which the interest income is translated is the same as the rate on the day of receipt, X will not realize any exchange gain or loss with respect to the interest income. Under paragraph (b)(5) of this section, X will realize exchange gain upon repayment of the £10,000 loan principal determined in the same manner as in *Example 1.* Accordingly, X will realize an exchange gain of $1,500 on the repayment of the loan principal on December 31, 1994.

Example 4. Assume the same facts as in *Example 1* except that on December 31, 1993, X sells Y's note for 9,821.13 British pounds (£) after the interest payment. Under paragraph

(b)(8) of this section, X will compute exchange gain on the £10,000 principal. The exchange gain is $1,000 [(£10,000 × $1.40) − (£10,000 × $1.30)]. This exchange gain, however, is only realized to the extent of the total gain on the disposition. X's total gain is $749.58 [(£9,821.13 × $1.40) − (£10,000 × $1.30)]. Thus, X will realize $749.58 of exchange gain (and will realize no market loss).

Example 5. (i) The facts are the same as in *Example 1* except that Y becomes insolvent and fails to repay the full £10,000 principal when due. Instead, X and Y agree to compromise the debt for a payment of £8,000 on December 31, 1994. Under paragraph (b)(8) of this section, X will compute exchange gain on the £10,000 originally booked. The exchange gain is $1,500 [(£10,000 × $1.45) − (£10,000 × $1.30) = $1,500]. This exchange gain, however, is only realized to the extent of the total gain on the disposition. X realizes an overall loss on the disposition of $1,400 [(£8,000 × $1.45) − (£10,000 × $1.30) = ($1,400)]. Thus, X will realize no exchange gain (and a $1400 market loss).

(ii) If the exchange rate on December 31, 1994, were £1 = $1.25, rather than £1 = $1.45, X would compute exchange loss under paragraph (b)(8) of this section, on the £10,000 originally booked. The exchange loss would be $500 [(£10,000 × $1.25) − (£10,000 × $1.30) = ($500)]. X's total loss on the disposition would be $3,000 [(£8,000 × $1.25)–(£10,000 × $1.30) = ($3,000)]. Thus, X would realize $500 of exchange loss and a $2,500 market loss on the disposition.

Example 6. (i) X is an individual with the dollar as his functional currency. X is on the cash method of accounting. On January 1, 1989, X borrows 10,000 British pounds (£) from Y, an unrelated person. The terms of the loan provide that X will make interest payments of £1,200 on December 31 of 1989 and 1990 and will repay Y's £10,000 principal on December 31, 1990. The spot rates for the pertinent dates are as follows:

Date	Spot rate [1]
Jan. 1, 1989	1 = $1.50
Dec. 31, 1989	1 = 1.60
Dec. 31, 1990	1 = 1.70

[1] Pounds to dollars.

Assume that the basis of the £1,200 paid as interest by X on December 31, 1989, is $2,000, the basis of the £1,200 paid as interest by X on December 31, 1990, is $2,020 and the basis of the £10,000 principal paid by X on December 31, 1990, is $16,000.

(ii) Under paragraph (b)(2)(ii)(B) of this section, X translates the £1,200 interest payments at the spot rate on the day paid. Thus, X paid $1,920 (£1,200 × $1.60) of interest on December 31, 1989, and $2,040 (£1,200 × $1.70) of interest on December 31, 1990. In addition, X will realize exchange gain or loss on the disposition of the £1,200 on December 31, 1989 and 1990, under paragraph (a) of this section. Pursuant to paragraph (a)(2) of this section, X will realize an exchange loss of $80 [(£1,200 × $1.60) − $2,000] on December 31, 1989, and exchange gain of $20 [(£1,200 × $1.70) − $2,020] on December 31, 1990.

(iii) Under paragraph (b)(6) of this section, X will realize exchange loss on December 31, 1990, upon repayment of the £10,000 principal amount determined by translating the £10,000 received at the spot rate on January 1, 1989 (£10,000 × $1.50 = $15,000) and subtracting from such amount, the amount determined by translating the £10,000 paid at the spot rate on December 31, 1990 (£10,000 × $1.70 = $17,000). Thus, under paragraph (b)(6) of this section, X has an exchange loss with respect to the £10,000 principal of $2,000. Further, under paragraph (a)(2) of this section, X will realize an exchange gain upon disposition of the £10,000 on December 31, 1990. Under paragraph (a)(2) of this section, X will subtract his adjusted basis in the £10,000 ($16,000) from the amount realized upon the disposition of the £10,000 (£10,000 × $1.70 = $17,000) resulting in a gain of $1,000. Accordingly, X's combined exchange gain and loss realized on December 31, 1990, with respect to the repayment of the £10,000 is a $1,000 exchange loss.

Example 7. (i) X is a calendar year corporation on the accrual method of accounting and with the dollar as its functional currency. On January 1, 1989, X purchases at original issue for 82.64 Canadian dollars (C$) M corporation's 2 year note maturing on December 31, 1990, at a stated redemption price of C$100. The yield to maturity in Canadian dollars is 10 percent and the accrual period is the one year period beginning January 1 and ending December 31. The note has C$17.36 of original issue discount. Assume that the spot rates are as follows: C$1 = U.S.$.72 on January 1, 1989; C$1 = U.S.$.80 on January 1, 1990; C$1 = U.S.$ .82 on December 31, 1990. Assume further that the average rate for 1989 is C$1 = U.S.$ .76 and for 1990 is C$1 = U.S. $.81.

(ii) Under paragraph (b)(2)(ii)(A) of this section, X will determine its interest income in Canadian dollars. Accordingly, under section 1272, X must take into account original issue discount in the amount of C$8.26 on December 31, 1989, and C$9.10 on December 31, 1990. Pursuant to paragraph (b)(2)(ii)(C) of this section, X will translate these amounts into U.S. dollars at the average exchange rate for the relevant accrual period. Thus, the amount of interest income taken into account in 1989 is U.S.$6.28 (C$8.26 × U.S.$.76) and in 1990 is U.S.$7.37 (C$9.10 × U.S.$.81). Pursuant to paragraph (b)(3)(ii) of this section, X will realize exchange gain or loss with respect to the accrued interest determined for each accrual period by translating the Canadian dollars received with respect to such accrual period into U.S. dollars at the

spot rate on the date the interest is received and subtracting from that amount the amount accrued in U.S. dollars. Thus, the amount of exchange gain realized on December 31, 1990, is U.S.$.58 (U.S.$.49 from 1989 + U.S.$.09 from 1990). Pursuant to paragraph (b)(5) of this section, X shall realize exchange gain or loss with respect to the principal (C$82.64) on December 31, 1990, computed by translating the C$82.64 at the spot rate on December 31, 1990 (U.S.$67.76) and subtracting the C$82.64 translated at the spot rate on January 1, 1989 (U.S.$59.50) for an exchange gain of U.S.$8.26. Thus, X's combined exchange gain is U.S.$8.84 (U.S.$.49 + U.S.$.09 + U.S.$8.26).

(iii) Assume instead that on January 1, 1990, X sells the note for C$86.95, which it immediately converts to U.S. dollars. X's exchange gain is computed under paragraph (b)(8) of this section with reference to the nonfunctional currency denominated principal amount (C$82.64) and the nonfunctional currency denominated accrued original issue discount (C$8.26). X will compute an exchange gain of U.S.$6.61 with respect to the issue price [(C$82.64 × U.S.$.80) − (C$82.64 × U.S.$.72)] and an exchange gain of U.S.$.33 with respect to the accrued original issue discount [(C$8.26 × U.S.$.80) − (C$8.26 × U.S.$.76)]. Accordingly, prior to the application of paragraph (b)(8) of this section, X's total exchange gain is U.S.$6.94 (U.S.$6.61 + U.S.$.33), and X's market loss is U.S.$3.16 [(C$90.90 − C$86.95) × U.S.$.80]. Pursuant to paragraph (b)(8) of this section, however, X's market loss on the note of U.S.$3.16 is netted against X's exchange gain of U.S.$6.94, resulting in a realized exchange gain of U.S.$3.78 and no market loss.

Example 8. (i) The facts are the same as in *Example 7* (i) except that on January 1, 1990, X contributes the M corporation note to Y, a wholly-owned U.S. subsidiary of X with the dollar as its functional currency, and Y collects C$100 from M corporation at maturity on December 31, 1990, when the spot rate is C$1 = U.S.$.82. The transfer of the note from X to Y qualifies for nonrecognition of gain under section 351(a). On December 31, 1990, Y includes C$9.10 of accrued interest in income which translated at the average exchange rate of C$1 = U.S.$.81 for the year results in U.S.$7.37 of interest income.

(ii) Y's exchange gain is computed under paragraph (b)(3) of this section with respect to accrued interest income and paragraph (b)(5) of this section with respect to the nonfunctional currency principal amount. Under paragraph (b)(3) of this section, Y will realize exchange gain or loss for each accrual period computed by translating the units of nonfunctional currency interest income received with respect to such accrual period at the spot rate on the day received and subtracting the amounts of interest income accrued for such period. Thus, Y will realize $.49 of exchange gain with respect to original issue discount accrued in 1989 [(C$8.26 × U.S.$.82) − (C$8.26 × U.S.$.76) = U.S. $.49] and $.09 of exchange gain with respect to original issue discount accrued in 1990 [(C$9.10 × U.S.$.82) − (C$9.10 × U.S.$.81) = $.09].

(iii) Pursuant to paragraph (b)(5) of this section, the nonfunctional currency principal amount of the M bond in the hands of Y is C$82.64, the amount carried over from X, the transferor. Y's exchange gain with respect to the nonfunctional currency principal amount is $8.26 [(C$82.64 × U.S.$.82) − (C$82.64 × U.S.$.72) = U.S. $8.26]. Accordingly, Y's combined exchange gain is U.S. $8.84 ($.49 + $.09 + $8.26). Because the amount realized in Canadian dollars equals the adjusted issue price (C$100) on retirement of the M note, there is no market loss, and the netting rule of paragraph (b)(8) of this section does not limit realization of the exchange gain.

Example 9. (i) X is a calendar year corporation on the accrual method of accounting and with the dollar as its functional currency. X elects to use the spot rate convention to translate interest income as provided in paragraph (b)(2)(iii)(B) of this section. On January 31, 1992, X loans £1000 to Y, an unrelated person. Under the terms of the loan, Y will pay X interest of £50 on July 31, 1992, and January 31, 1993, and will repay the £1000 principal on January 31, 1993. Assume the following spot exchange rates:

Date	Spot rate [1]
Jan. 31, 1992	£1 = $1.50
July 31, 1992	£1 = 1.55
Dec. 31, 1992	£1 = 1.60
Jan. 31, 1993	£1 = 1.61

[1] Pounds to dollars.

(ii) Under paragraph (b)(2)(ii)(C) of this section, X will translate the interest income at the spot rate on the last day of each interest accrual period (and in the case of a partial accrual period, at the spot rate on the last day of the taxable year). Accordingly, X will have interest income of $77.50 (£50 × $1.55) on July 31, 1992. Assuming under X's method of accounting that interest is accrued daily, X will accrue $66.50 (153 / 184 × £50) × $1.60) of interest income on December 31, 1992. On January 31, 1993, X will have interest income of $13.60 ((31/184 × £50) × $1.61). Because the rate at which the interest income is translated is the same as the rate on the day of receipt, X will not realize any exchange gain or loss with respect to the interest income received on July 31, 1992. However, X will realize exchange gain on the £41.50 (153/184 × £50) of accrued interest income of $.41 [(£41.50 × $1.61) − (£41.50 × $1.60) = $.41].

(iii) Under paragraph (b)(5) of this section, X will realize exchange gain upon repayment of the £100 principal amount determined by translating the £100 at the spot rate on the date it is received (£100 × $1.61 = $161.00) and

subtracting from such amount, the amount determined by translating the £100 at the spot rate on the date the loan was made (£100 × $1.50 = $150.00). Accordingly, X will realize an exchange gain of $11 on the repayment of the loan on January 31, 1993.

Example 10. (i) X, a cash basis taxpayer with the dollar as its functional currency, has the calendar year as its taxable year. On January 1, 1992, X purchases at original issue for 65.88 British pounds (£) M corporation's 5-year bond maturing on December 31, 1996, having a stated redemption price at maturity of £100. The bond provides for annual payments of interest in pounds of 1 pound per year on December 31 of each year. The bond has 34.12 British pounds of original issue discount. The yield to maturity is 10 percent in British pounds and the accrual period is the one year period beginning January 1 and ending December 31 of each calendar year. The amount of original issue discount is determined in pounds for each accrual period by multiplying the adjusted issue price expressed in pounds by the yield and subtracting from such amount the periodic interest payments expressed in pounds for such period. The periodic interest payments are translated at the spot rate on the payment date (December 31 of each year). The original issue discount is translated at the average rate for the accrual period (January 1 through December 31). The following chart describes the determination of interest income with respect to the facts presented and provides other pertinent information.

TABLE 1

Year (Dec. 31)	Periodic interest payments in pounds for the accrual period	Original issue discount in pounds for the accrual period	Issue price or adjusted issue price in pounds	Assumed spot rate on Dec. 31 (pounds to dollars)	Assumed average rate for accrual period (pounds to dollars)	Periodic interest payments in pounds multiplied by spot rate on the date of payment (column 2 times column 5)	Original issue discount in pounds multiplied by the average rate for the accrual period (column 3 times column 6)	Total interest income in dollars (column 7 plus column 8)	Adjusted issue price in dollars
1	2	3	4	5	6	7	8	9	10
Issue Date:			65.88	1 = $1.20	.....	.....	.....	.....	$79.06
1992	1	5.59	71.47	1 = 1.30	1 = $1.25	$1.30	$6.99	$8.29	86.05
1993	1	6.15	77.62	1 = 1.40	1 = 1.35	1.40	8.30	9.70	94.35
1994	1	6.76	84.38	1 = 1.50	1 = 1.45	1.50	9.80	11.30	104.15
1995	1	7.44	91.82	1 = 1.60	1 = 1.55	1.60	11.53	13.13	115.68
1996	1	8.18	100.00	1 = 1.70	1 = 1.65	1.70	13.50	15.20	129.18

(ii) Because X is a cash basis taxpayer, X does not realize exchange gain or loss on the receipt of the £1 periodic interest payments. However, X will realize exchange gain on December 31, 1996 totaling $7.88 with respect to the original issue discount. Exchange gain is determined for each interest accrual period by translating the units of nonfunctional currency interest income received with respect to such accrual period at the spot rate on the date received and subtracting from such amount, the amount computed by translating the units of nonfunctional currency interest income accrued for such period at the average rate for the period. The following chart illustrates this computation:

TABLE 2

Year	OID accrued in pounds for each accrual period	Assumed spot rate on date payment received (pounds to dollars)	Interest received times spot rate on the date received (col. 2 times col. 3)	Assumed average rate for accrual period (pounds to dollars)	IOD in pounds times the average rate for the accrual period (col. 2 times col. 5)	Exchange gain or loss (col. 4 less col. 6)
1	2	3	4	5	6	7
1992	5.59	1 = $1.70	$9.50	1 = $1.25	$6.99	$2.51
1993	6.15	1 = 1.70	10.46	1 = 1.35	8.30	2.16
1994	6.76	1 = 1.70	11.49	1 = 1.45	9.80	1.69
1995	7.44	1 = 1.70	12.65	1 = 1.55	11.53	1.12
1996	8.18	1 = 1.70	13.90	1 = 1.65	13.50	.40
Total	.....	.....	.....	.....	.....	$7.88

(iii) X will also realize exchange gain with respect to the principal of the loan (*i.e.*, the issue price of 65.88 British pounds) on December 31, 1996 computed by translating the units of nonfunctional currency principal received at the spot rate on the date principal is received (65.88 British pounds × $1.70 = $112.00) and subtracting from such amount, the units of nonfunctional currency principal received translated at the spot rate on the date the instrument was acquired (65.88 British pounds × $1.20 = $79.06). Accordingly, X's exchange gain on the principal is $32.94 and X's total exchange gain with respect to the accrued interest and principal is $40.82. It should be noted that, under this fact pattern, the total exchange gain may be determined in an alternative fashion. Exchange gain may be computed by subtracting the adjusted issue price in dollars at maturity ($129.18—see column 10 of Table 1) from the amount computed by multiplying the stated redemption price at maturity in pounds times the spot rate on the maturity date (£100 × $1.70 = $170), which equals $40.82.

Example 11. (i) The facts are the same as in *Example 10* except that X makes an election under paragraph (b)(2)(iii) of this section to translate accrued interest on the last day of the accrual period. Accordingly, columns 8, 9 and 10 in Table 1 would change as follows:

Year (Dec. 31)	Original issue discount in pounds multiplied by the spot rate on last day of accrual period (Dec. 31)	Total interest income in dollars (column 7 plus column 8)	Adjusted issue price in dollars
1	8	9	10
			$79.06
1992	$7.27	$8.57	87.63
1993	8.61	10.01	97.64
1994	10.14	11.64	109.28
1995	11.90	13.50	122.78
1996	13.91	15.61	138.39

(ii) Because X is a cash basis taxpayer, X does not realize exchange gain or loss on the receipt of the £1 periodic interest payments. However, X will realize exchange gain on December 31, 1993 totaling $6.18 with respect to the original issue discount. Exchange gain is determined for each interest accrual period by translating the units of nonfunctional currency interest income received with respect to such accrual period at the spot rate on the date received and subtracting from such amount, the amount computed by translating the units of nonfunctional currency interest income accrued for such period at the spot rate on the last day of the accrual period. Accordingly, columns 5, 6 and 7 of Table 2 would change as follows:

Year	Spot rate on last day of accrual period	OID in pounds times the spot rate on the last day of the accrual period (col 2 times col. 3)	Exchange gain or loss (col. 4 less col. 6)
1	5	6	7
1992	$1.30	$7.27	$2.23
1993	1.40	8.61	1.85
1994	1.50	10.14	1.35
1995	1.60	11.90	0.75
1996	1.70	13.90	0.00
			6.18

(iii) X will realize exchange gain with respect to the principal amount of the loan as provided in the preceding example.

Example 12. (i) C is a corporation that is a calendar year accrual method taxpayer with the dollar as its functional currency. On January 1, 1989, C lends 100 British pounds (£) in exchange for a note under the terms of which C will receive two equal payments of £57.62 on December 31, 1989, and December 31, 1990. Each payment of £57.62 represents the annual payment necessary to amortize the £100 principal amount at a rate of 10% compounded annually over a two year period. The following tables reflect the amounts of principal and interest that compose each payment and assumptions as to the relevant exchange rates:

Date	Principal	Interest
Dec. 31, 1989	£47.62	£10.00
Dec. 12, 1990	£52.38	£5.24

Date	Spot rate £1=	Average rate for year ending
Jan. 1, 1989	$1.30	
Dec. 31, 1989	1.40	1.35
Dec. 31, 1990	1.50	1.45

(ii) Because each interest payment is equal to the product of the outstanding principal balance of the obligation and a single fixed rate of interest, each stated interest payment constitutes periodic interest under the principles of section 1273. Accordingly, there is no original issue discount.

(iii) Because C is an accrual basis taxpayer, C will translate the interest income at the average rate for the annual accrual period pursuant to paragraph (b)(2)(ii)(C) of this section. Thus, C's interest income is $13.50 (£10.00 × $1.35) in 1989, and $7.60 (£5.24 × $1.45) in 1990. C will realize exchange gain or loss upon receipt of accrued interest computed in accordance with paragraph (b)(3) of this section. Thus, C will realize exchange gain in the amount of $.50 [(£10.00 × $1.40) − $13.50] in 1989, and $.26 [(£5.24 × $1.50) − $7.60] in 1990.

(iv) In addition, C will realize exchange gain or loss upon the receipt of principal each year computed under paragraph (b)(5) of this section. Thus, C will realize exchange gain in the amount of $4.76 [(£47.62 × $1.40) − (£47.62 × $1.30)] in 1989, and $10.48 [(£52.38 × $1.50) − (£52.38 × $1.30)] in 1990.

(10) *Treatment of bond premium*—(i) *In general.* Amortizable bond premium on a bond described in paragraph (b)(2)(i) of this section shall be computed in the units of nonfunctional currency in which the bond is denominated (or in which the payments are determined). Amortizable bond premium properly taken into account under section 171 or §1.61–12 (or the successor provision thereof) shall reduce interest income or expense in units of nonfunctional currency. Exchange gain or loss is realized with respect to bond premium described in the preceding sentence by treating the portion of premium amortized with respect to any period as a return of principal. With respect to a holder that does not elect to amortize bond premium under section 171, the amount of bond premium will constitute a market loss when the bond matures. See paragraph (b)(8) of this section. The principles set forth in this paragraph (b)(10) shall apply to determine the treatment of acquisition premium described in section 1272(a)(7).

(ii) *Example.* The following example illustrates the provisions of this paragraph (b)(10).

Example. (A) X is an individual on the cash method of accounting with the dollar as his functional currency. On January 1, 1989, X purchases Y corporation's note for 107.99 British pounds (£) from Z, an unrelated party. The note has an issue price of £100, a stated redemption price at maturity of £100, pays interest in pounds at the rate of 10% compounded annually, and matures on December 31, 1993. X elects to amortize the bond premium of £7.99 under the rules of section 171. Pursuant to paragraph (b)(10)(i) of this section, bond premium is determined and amortized in British pounds. Assume the amortization schedule is as follows:

Year ending 12/31	Bond premium amortized	Unamortized premium plus principal	Interest
		£107.99	
1989	£1.36	£106.63	£8.64
1990	£1.47	£105.16	£8.53
1991	£1.59	£103.57	£8.41
1992	£1.71	£101.86	£8.29
1993	£1.85	£100.00	£8.15

(B) The bond premium reduces X's pound interest income under the note. For example, the £10 stated interest payment made in 1989 is reduced by £1.36 of bond premium, and the resulting £8.64 interest income is translated into dollars at the spot rate on December 31, 1989. Exchange gain or loss is realized on the £1.36 bond premium based on the difference between the spot rates on January 1, 1989, the date the premium is paid to acquire the bond, and December 31, 1989, the date the bond premium is returned as part of the stated interest. The £1.36 bond premium reduces the unamortized premium plus principal to £106.63 (£107.99 − £1.36). On December 31, 1993, when the bond matures and the £7.99 of bond premium has been fully amortized, X will realize exchange gain or loss with respect to the remaining purchase price of £100.

(11) *Market discount*—(i) *In general.* Market discount as defined in section 1278(a)(2) shall be determined in units of nonfunctional currency in which the market discount bond is denominated (or in which the payments are determined). Accrued market discount (other than market discount currently included in income pursuant to section 1278(b)) shall be translated into functional currency at the spot rate on the date the market discount bond is disposed of. No part of such accrued market discount is treated as exchange gain or loss. Accrued market discount currently includible in income pursuant to section 1278(b) shall be translated into functional currency at the average exchange rate for the accrual period. Exchange gain or loss with respect to accrued market discount currently includible in income under section 1278(b) shall be determined in accordance with paragraph (b)(3) of this section relating to accrued interest income.

(ii) *Example.* The following example illustrates the provisions of this paragraph (b)(11).

Example. (A) X is a calendar year corporation with the U.S. dollar as its functional currency. On January 1, 1990, X purchases a bond of M corporation for 96,530 British pounds (£). The bond, which was issued on January 1, 1989, has an issue price of £100,000, a stated redemption price at maturity of

£100,000, and provides for annual pound payments of interest at 8 percent. The bond matures on December 31, 1991. X purchased the bond at a market discount of 3,470 pounds and did not elect to include the market discount currently in income under section 1278(b). X holds the bond to maturity and on December 31, 1991, receives payment of £100,000 (plus £8,000 interest) when the exchange rate is £1 = $1.50.

(B) Pursuant to paragraph (b)(11) of this section, X computes market discount in units of nonfunctional currency. Thus, the market discount as defined under section 1278(a)(2) is £3,470. Accrued market discount (other than market discount currently included in income pursuant to section 1278(b)) is translated at the spot rate on the date the market discount bond is disposed of. Accordingly, X will translate the accrued market discount of £3,470 at the spot rate on December 31, 1991 (£3,470 × $1.50 = $5,205). No exchange gain or loss is realized with respect to the £3,470 of accrued market discount. See paragraphs (b)(3) and (5) of this section for the realization and recognition of exchange gain or loss with respect to accrued interest and principal.

(12) *Tax exempt bonds.* See §1.988–3(c)(2), which characterizes exchange loss realized with respect to a nonfunctional currency tax exempt bond as a reduction of interest income.

(13) *Nonfunctional currency debt exchanged for stock of obligor*—(i) *In general.* Notwithstanding any other section of the Code other than section 267, 1091 or 1092, exchange gain or loss shall be realized and recognized by the holder and the obligor in accordance with the rules of paragraphs (b)(3) through (7) of this section with respect to the principal and accrued interest of a debt instrument described in paragraph (b)(2)(i) of this section that is acquired by the obligor in exchange for its stock, provided however, that such gain or loss shall be recognized only to the extent of the total gain or loss on the exchange (regardless of whether such gain or loss would otherwise be recognized). This rule shall apply whether the debt instrument is converted into stock according to its terms or exchanged pursuant to a separate agreement between the obligor and the holder. A debt instrument that is acquired by the obligor from a shareholder as a contribution to capital shall be treated for purposes of this section as exchanged for stock, whether or not additional stock is issued.

(ii) *Coordination with section 108.* Section 988 and this section shall apply before section 108. Exchange gain realized by the obligor on an exchange described in paragraph (b)(13)(i) of this section shall not be treated as discharge of indebtedness income, but shall be considered to reduce the amount of the liability for purposes of computing the obligor's income on the exchange under section 108(e)(4), section 108(e)(6) or section 108(e)(10).

(iii) *Effective date.* This paragraph (b)(13) shall be effective for exchanges of debt for stock effected after September 21, 1989.

(iv) *Examples.* The following examples illustrate the operation of this paragraph (b)(13). In each such example, assume that sections 267, 1091 and 1092 do not apply.

Example 1. (i) X is a calendar year U.S. corporation with the U.S. dollar as its functional currency. On January 1, 1990 (the issue date), X acquired a convertible bond maturing on December 31, 1998, issued by Y corporation, a U.K. corporation with the British pound (£) as its functional currency. The issue price of the bond is £100,000, the stated redemption price at maturity is £100,000, and the bond provides for annual pound interest payments at the rate of 10%. The terms of the bond also provide that at any time prior to December 31, 1998, the holder may surrender all of his interest in the bond in exchange for 20 shares of Y common stock. On January 1, 1994, X surrenders his interest in the bond for 20 shares of Y common stock. Assume the following: (a) The spot rate on January 1, 1990, is £1 = $1.30, (b) The spot rate on January 1, 1994, is £1 = $1.50, and (c) The 20 shares of Y common stock have a market value of £200,000 on January 1, 1994.

(ii) Pursuant to paragraph (b)(13) of this section, X will realize and recognize exchange gain with respect to the issue price (£100,000) of the bond on January 1, 1994, when the bond is converted to stock. X will compute exchange gain pursuant to paragraph (b)(5) of this section by translating the issue price at the spot rate on the conversion date (£100.000 × $1.50 = $150,000) and subtracting from such amount the issue price translated at the spot rate on the date X acquired the bond (£100,000 × $1.30 = $130,000). Thus, X will realize and recognize $20,000 of exchange gain. X's basis in the 20 shares of Y common stock is $150,000 ($130,000 substituted basis + $20,000 recognized gain).

Example 2. (i) X, a foreign corporation with the British pound (£) as its functional currency, lends £100 at a market rate of interest to Y, its wholly-owned U.S. subsidiary, on

January 1, 1990, on which date the spot exchange rate is £1 = $1. Y's functional currency is the U.S. dollar. On January 1, 1992, when the spot exchange rate is £1 = $.50, X cancels the debt as a contribution to capital. Pursuant to paragraph (b)(13) of this section, Y will realize and recognize exchange gain with respect to the £100 issue price of the debt instrument on January 1, 1992. Y will compute exchange gain pursuant to paragraph (b)(6) of this section by translating the issue price at the spot rate on the date Y became the obligor (£100 × $1 = $100) and subtracting from such amount the issue price translated at the spot rate on the date of extinguishment (£100 × $.50 = $50). Thus, Y will realize and recognize $50 of exchange gain.

(ii) Under section 108(e)(6), on the acquisition of its indebtedness from X as a contribution to capital Y is treated as having satisfied the debt with an amount of money equal to X's adjusted basis in the debt (£100). For purposes of section 108(e)(6), X's adjusted basis is translated into United States dollars at the spot rate on the date Y acquires the debt (£1 = $.50). Therefore, Y is treated as having satisfied the debt for $50. Pursuant to paragraph (b)(13) of this section, for purposes of section 108 the amount of the indebtedness is considered to be reduced by the exchange gain from $100 to $50. Accordingly, Y recognizes $50 of exchange gain and no discharge of indebtedness income on the extinguishment of its debt to X.

(iii) If X were a United States taxpayer with a dollar functional currency and a $100 basis in Y's obligation. X would realize and recognize an exchange loss of $50 under paragraph (b)(5) of this section on the contribution of the debt to Y. The recognized loss would reduce X's adjusted basis in the debt from $100 to $50, so that for purposes of applying section 108(e)(6) Y is treated as having satisfied the debt for $50. Accordingly, under these facts as well Y would recognize $50 of exchange gain and no discharge of indebtedness income.

Example 3. (i) X and Y are unrelated calendar year U.S. corporations with the U.S. dollar as their functional currency. On January 1, 1990 (the issue date), X acquires Y's bond maturing on December 31, 1999. The issue price of the bond is £100,000, the stated redemption price at maturity is £100,000, and the bond provides for annual pound interest payments at the rate of 10%. On January 1, 1994, X and Y agree that Y will redeem its bond from X in exchange for 20 shares of Y common stock. Assume the following:

(a) The spot rate on January 1, 1990, is £1 = $1.00,

(b) The spot rate on January 1, 1994, is £1 = $.50,

(c) Interest rates on equivalent bonds have increased so that as of January 1, 1994, the value of Y's bond has declined to £90,000, and

(d) The 20 shares of Y common stock have a market value of £90,000 as of January 1, 1994.

(ii) Pursuant to paragraph (b)(13) of this section, X will realize and recognize exchange loss with respect to the issue price (£100,000) of the bond on January 1, 1994, when the bond is exchanged for stock. X will compute exchange loss pursuant to paragraph (b)(5) of this section by translating the issue price at the spot rate on the exchange date (£100,000 × $.50 = $50,000) and subtracting from such amount the issue price translated at the spot rate on the date X acquired the bond (£100,000 × $1.00 = $100,000). Thus, X will compute $50,000 of exchange loss, all of which will be realized and recognized because it does not exceed the total $55,000 realized loss on the exchange ($45,000 worth of stock received less $100,000 basis in the exchanged bond).

(iii) Pursuant to paragraph (b)(13) of this section, Y will realize and recognize exchange gain with respect to the issue price, computed under paragraph (b)(6) of this section by translating the issue price at the spot rate on the date Y became the obligor (£100,000 × $1.00 = $100,000) and subtracting from such amount the issue price translated at the spot rate on the exchange date (£100,000 × $.50 = $50,000). Thus, Y will realize and recognize $50,000 of exchange gain. Under section 108(e)(10), on the transfer of stock to X in satisfaction of its indebtedness Y is treated as having satisfied the indebtedness with an amount of money equal to the fair market value of the stock (£90,000 × $.50 = $45,000). Pursuant to paragraph (b)(13) of this section, for purposes of section 108 the amount of the indebtedness is considered to be reduced by the recognized exchange gain from $100,000 to $50,000. Accordingly, Y recognizes an additional $5,000 of discharge of indebtedness income on the exchange.

Example 4. (i) The facts are the same as in *Example 3* except that interest rates on equivalent bonds have declined, rather than increased, so that the value of Y's bond on January 1, 1994, has risen to £112,500; and X and Y agree that Y will redeem its bond from X on that date in exchange for 25 shares of Y common stock worth £112,500. Pursuant to paragraphs (b)(13) and (b)(5) of this section, X will compute $50,000 of exchange loss on the exchange with respect to the £100,000 issue price of the bond. See Example 3. However, because X's total loss on the exchange is only $43,750 ($56,250 worth of stock received less $100,000 basis in the exchanged bond), under the netting rule of paragraph (b)(13) of this section the realized exchange loss is limited to $43,750.

(ii) Pursuant to paragraphs (b)(13) and (b)(6) of this section, Y will compute $50,000 of exchange gain with respect to the issue price. See *Example 3.* Under section 108(e)(10), Y is treated as having satisfied the $100,000

indebtedness with an amount of money equal to the fair market value of the stock (£112,500 × $.50 = $56,250), resulting in a total gain on the exchange of $43,750. Accordingly, under paragraph (b)(13) of this section Y's realized (and recognized) exchange gain on the exchange is limited to $43,750. Also pursuant to paragraph (b)(13) of this section, for purposes of section 108 the amount of the indebtedness is considered to be reduced by the recognized exchange gain from $100,000 to $56,250. Accordingly, Y recognizes no discharge of indebtedness income on the exchange.

(14) [Reserved]

(15) *Debt instruments and deposits denominated in hyperinflationary currencies*—(i) *In general.* If a taxpayer issues, acquires, or otherwise enters into or holds a hyperinflationary debt instrument (as defined in paragraph (b)(15)(vi)(A) of this section) or a hyperinflationary deposit (as defined in paragraph (b)(15)(vi)(B) of this section) on which interest is paid or accrued that is denominated in (or determined by reference to) a nonfunctional currency of the taxpayer, then the taxpayer shall realize exchange gain or loss with respect to such instrument or deposit for its taxable year determined by reference to the change in exchange rates between—

(A) The later of the first day of the taxable year, or the date the instrument was entered into (or an amount deposited); and

(B) The earlier of the last day of the taxable year, or the date the instrument (or deposit) is disposed of or otherwise terminated.

(ii) *Only exchange gain or loss is realized.* No gain or loss is realized under paragraph (b)(15)(i) by reason of factors other than movement in exchange rates, such as the creditworthiness of the debtor.

(iii) *Special rule for synthetic, non-hyperinflationary currency debt instruments*—(A) *General rule.* Paragraph (b)(15)(i) does not apply to a debt instrument that has interest and principal payments that are to be made by reference to a currency or item that does not reflect hyperinflationary conditions in a country (within the meaning of § 1.988–1(f)).

(B) *Example.* Paragraph (b)(15)(iii)(A) is illustrated by the following example:

Example. When the Turkish lira (TL) is a hyperinflationary currency, A, a U.S. corporation with the U.S. dollar as its functional currency, makes a 5 year, 100,000 TL-denominated loan to B, an unrelated corporation, at a 10% interest rate when 1,000 TL equals $1. Under the terms of the debt instrument, B must pay interest annually to A in amount of Turkish lira that is equal to $100. Also under the terms of the debt instrument, B must pay A upon maturity of the debt instrument an amount of Turkish lira that is equal to $1,000. Although the principal and interest are payable in a hyperinflationary currency, the debt instrument is a synthetic dollar debt instrument and is not subject to paragraph (b)(15)(i) of this section.

(iv) *Source and character of gain or loss*—(A) *General rule for hyperinflationary conditions.* The rules of this paragraph (b)(15)(iv)(A) shall apply to any taxpayer that is either an issuer of (or obligor under) a hyperinflationary debt instrument or deposit and has currency gain on such debt instrument or deposit, or a holder of a hyperinflationary debt instrument or deposit and has currency loss on such debt instrument or deposit. For purposes of subtitle A of the Internal Revenue Code, any exchange gain or loss realized under paragraph (b)(15)(i) of this section is directly allocable to the interest expense or interest income, respectively, from the debt instrument or deposit (computed under this paragraph (b)), and therefore reduces or increases the amount of interest income or interest expense paid or accrued during that year with respect to that instrument or deposit. With respect to a debt instrument or deposit during a taxable year, to the extent exchange gain realized under paragraph (b)(15)(i) of this section exceeds interest expense of an issuer, or exchange loss realized under paragraph (b)(15)(i) of this section exceeds interest income of a holder or depositor, the character and source of such excess amount shall be determined under §§ 1.988–3 and 1.988–4.

(B) *Special rule for subsiding hyperinflationary conditions.* If the taxpayer is an issuer of (or obligor under) a hyperinflationary debt instrument or deposit and has currency loss, or if the taxpayer is a holder of a hyperinflationary debt instrument or deposit and has currency gain, then for

purposes of subtitle A of the Internal Revenue Code, the character and source of the currency gain or loss is determined under §§1.988–3 and 1.988–4. Thus, if an issuer has both interest expense and currency loss, the currency loss is sourced and characterized under section 988, and does not affect the determination of interest expense.

(v) *Adjustment to principal or basis.* Any exchange gain or loss realized under paragraph (b)(15)(i) of this section is an adjustment to the functional currency principal amount of the issuer, functional currency basis of the holder, or the functional currency amount of the deposit. This adjusted amount or basis is used in making subsequent computations of exchange gain or loss, computing the basis of assets for purposes of allocating interest under §§1.861–9T through 1.861–12T and 1.882–5, or making other determinations that may be relevant for computing taxable income or loss.

(vi) *Definitions*—(A) *Hyperinflationary debt instrument.* A hyperinflationary debt instrument is a debt instrument that provides for—

(*1*) Payments denominated in or determined by reference to a currency that is hyperinflationary (as defined in §1.988–1(f)) at the time the taxpayer enters into or otherwise acquires the debt instrument; or

(*2*) Payments denominated in or determined by reference to a currency that is hyperinflationary (as defined in §1.988–1(f)) during the taxable year, and the terms of the instrument provide for the adjustment of principal or interest payments in a manner that reflects hyperinflation. For example, a debt instrument providing for a variable interest rate based on local conditions and generally responding to changes in the local consumer price index will reflect hyperinflation.

(B) *Hyperinflationary deposit.* A hyperinflationary deposit is a demand or time deposit or similar instrument issued by a bank or other financial institution that provides for—

(*1*) Payments denominated in or determined by reference to a currency that is hyperinflationary (as defined in §1.988–1(f)) at the time the taxpayer enters into or otherwise acquires the deposit; or

(*2*) Payments denominated in or determined by reference to a currency that is hyperinflationary (as defined in §1.988–1(f)) during the taxable year, and the terms of the deposit provide for the adjustment of the deposit amount or interest payments in a manner that reflects hyperinflation.

(vii) *Interaction with other provisions*—(A) *Interest allocation rules.* In determining the amount of interest expense, this paragraph (b)(15) applies before §§1.861–9T through 1.861–12T, and 1.882–5.

(B) *DASTM.* With respect to a qualified business unit that uses the United States dollar approximate separate transactions method of accounting described in §1.985–3, paragraph (b)(15)(i) of this section does not apply.

(C) *Interaction with section 988(a)(3)(C).* Section 988(a)(3)(C) does not apply to a debt instrument subject to the rules of paragraph (b)(15)(i) of this section.

(D) *Hedging rules.* To the extent §1.446–4 or 1.988–5 apply, the rules of paragraph (b)(15)(i) of this section will not apply. This paragraph (b)(15)(vii)(D) does not apply if the application of §1.988–5 results in hyperinflationary debt instrument or deposit described in paragraph (b)(15)(vi)(A) or (B) of this section.

(viii) *Effective date.* This paragraph (b)(15) applies to transactions entered into after February 14, 2000.

(16) [Reserved]. For further guidance, see §1.988–2T(b)(16).

(17) *Coordination with installment method under section 453.* [Reserved]

(18) *Interaction of section 988 and §1.1275–2(g)*—(i) *In general.* If a principal purpose of structuring a debt instrument subject to section 988 and any related hedges is to achieve a result that is unreasonable in light of the purposes of section 163(e), section 988, sections 1271 through 1275, or any related section of the Internal Revenue Code, the Commissioner can apply or depart from the regulations under the applicable sections as necessary or appropriate to achieve a reasonable result. For example, if this paragraph (b)(18) applies to a multicurrency debt instrument and a hedge or hedges, the Commissioner can

wholly or partially integrate transactions or treat portions of the debt instrument as separate instruments where appropriate. See also §1.1275–2(g).

(ii) *Unreasonable result.* Whether a result is unreasonable is determined based on all the facts and circumstances. In making this determination, a significant fact is whether the treatment of the debt instrument is expected to have a substantial effect on the issuer's or a holder's U.S. tax liability. Another significant fact is whether the result is obtainable without the application of §1.988–6 and any related provisions (*e.g.*, if the debt instrument and the contingency were entered into separately). A result will not be considered unreasonable, however, in the absence of an expected substantial effect on the present value of a taxpayer's tax liability.

(iii) *Effective date.* This paragraph (b)(18) shall apply to debt instruments issued on or after October 29, 2004.

(c) *Item of expense or gross income or receipts which is to be paid or received after the date accrued*—(1) *In general.* Except as provided in §1.988–5, exchange gain or loss with respect to an item described in §1.988–1(a)(1)(ii) and (2)(ii) (other than accrued interest income or expense subject to paragraph (b) of this section) shall be realized on the date payment is made or received. Except as provided in the succeeding sentence, such exchange gain or loss shall be recognized in accordance with the applicable recognition provisions of the Internal Revenue Code. If the taxpayer's right to receive income, or obligation to pay an expense, is transferred or modified in a transaction in which gain or loss would otherwise be recognized, exchange gain or loss shall be realized and recognized only to the extent of the total gain or loss on the transaction.

(2) *Determination of exchange gain or loss with respect to an item of gross income or receipts.* Exchange gain or loss realized on an item of gross income or receipts described in paragraph (c)(1) of this section shall be determined by multiplying the units of nonfunctional currency received by the spot rate on the payment date, and subtracting from such amount the amount determined by multiplying the units of nonfunctional currency received by the spot rate on the booking date. The term ''spot rate on the payment date'' means the spot rate determined under §1.988–1(d) on the date payment is received or otherwise taken into account. Pursuant to §1.988–1(d)(3), a taxpayer may use a spot rate convention for purposes of determining the spot rate on the payment date. The term ''spot rate on the booking date'' means the spot rate determined under §1.988–1(d) on the date the item of gross income or receipts is accrued or otherwise taken into account. Pursuant to §1.988–1(d)(3), a taxpayer may use a spot rate convention for purposes of determining the spot rate on the booking date.

(3) *Determination of exchange gain or loss with respect to an item of expense.* Exchange gain or loss realized on an item of expense described in paragraph (c)(1) of this section shall be determined by multiplying the units of nonfunctional currency paid by the spot rate on the booking date and subtracting from such amount the amount determined by multiplying the units of nonfunctional currency paid by the spot rate on the payment date. The term ''spot rate on the booking date'' means the spot rate determined under §1.988–1(d) on the date the item of expense is accrued or otherwise taken into account. Pursuant to §1.988–1(d)(3), a taxpayer may use a spot rate convention for purposes of determining the spot rate on the booking date. The term ''spot rate on the payment date'' means the spot rate determined under §1.988–1(d) on the date payment is made or otherwise taken into account. Pursuant to §1.988–1(d)(3), a taxpayer may use a spot rate convention for purposes of determining the spot rate on the date.

(4) *Examples.* The following examples illustrate the application of paragraph (c) of this section.

Example 1. X is a calendar year corporation with the dollar as its functional currency. X is on the accrual method of accounting. On January 15, 1989, X sells inventory for 10,000 Canadian dollars (C$). The spot rate on January 15, 1989, is C$1 = U.S. $.55. On February 23, 1989, when X receives payment of the C$10,000, the spot rate is C$1 = U.S. $.50. On February 23, 1989, X will realize exchange loss. X's loss is computed by multiplying the

C$10,000 by the spot rate on the date the C$10,000 are received (C$10,000 × .50 = U.S. $5,000) and subtracting from such amount, the amount computed by multiplying the C$10,000 by the spot rate on the booking date (C$10,000 × .55 = U.S. $5,500). Thus, X's exchange loss on the transaction is U.S. $500 (U.S. $5,000 − U.S. $5,500).

Example 2. The facts are the same as in *Example 1* except that X uses a spot rate convention to determine the spot rate as provided in §1.988–1(d)(3). Pursuant to X's spot rate convention, the spot rate at which a payable or receivable is booked is determined monthly for each nonfunctional currency payable or receivable by adding the spot rate at the beginning of the month and the spot rate at the end of the month and dividing by two. All payables and receivables in a nonfunctional currency booked during the month are translated into functional currency at the rate described in the preceding sentence. Further, the translation of nonfunctional currency paid with respect to a payable, and nonfunctional currency received with respect to a receivable, is also performed pursuant to the spot rate convention. Assume the spot rate determined under the spot rate convention for the month of January is C$1 = U.S. $.54 and for the month of February is C$1 = U.S. $.51. On the last date in February, X will realize exchange loss. X's loss is computed by multiplying the C$10,000 by the spot rate convention for the month of February (C$10,000 × U.S. $.51 = U.S. $5,100) and subtracting from such amount, the amount computed by multiplying the C$10,000 by the spot rate convention for the month of January (C$10,000 × U.S. $.54 = $5,400). Thus, X's exchange loss on the transaction is U.S. $300 (U.S. $5,100–U.S. $5,400). X's basis in the C$10,000 is U.S. $5,400.

Example 3. The facts are the same as in *Example 2* except that X has a standing order with X's bank for the bank to convert any nonfunctional currency received in satisfaction of a receivable into U.S. dollars on the day received and to deposit those U.S. dollars in X's U.S. dollar bank account. X may use its convention to translate the amount booked into U.S. dollars, but must use the U.S. dollar amounts received from the bank with respect to such receivables to determine X's exchange gain or loss. Thus, if X receives payment of the C$10,000 on February 23, 1989, when the spot rate is C$1 = U.S.$ .50, X determines exchange gain or loss by subtracting the amount booked under X's convention (U.S.$5,400) from the amount of U.S. dollars received from the bank under the standing conversion order (assume $5,000). X's exchange loss is U.S.$400.

(d) *Exchange gain or loss with respect to forward contracts, futures contracts and option contracts*—(1) *Scope*—(i) *In general.* This paragraph (d) applies to forward contracts, futures contracts and option contracts described in §1.988–1(a)(1)(ii) and (2)(iii). For rules applicable to currency swaps and notional principal contracts described in §1.988–1(a) (1)(ii) and (2)(iii), see paragraph (e) of this section.

(ii) *Treatment of spot contracts.* Solely for purposes of this paragraph (d), a spot contract as defined in §1.988–1(b) to buy or sell nonfunctional currency is not considered a forward contract or similar transaction described in §1.988–1(a)(2)(iii) unless such spot contract is disposed of (or otherwise terminated) prior to making or taking delivery of the currency. For example, if a taxpayer with the dollar as its functional currency enters into a spot contract to purchase British pounds, and takes delivery of such pounds under the contract, the delivery of the pounds is not a realization event under section 988(c)(5) and paragraph (e)(4)(ii) of this section because the contract is not considered a forward contract or similar transaction described in §1.988–1(a)(2)(iii). However, if the taxpayer sells or otherwise terminates the contract before taking delivery of the pounds, exchange gain or loss shall be realized and recognized in accordance with paragraphs (d)(2) and (3) of this section.

(2) *Realization of exchange gain or loss*—(i) *In general.* Except as provided in §1.988–5, exchange gain or loss on a contract described in §1.988–2(d)(1) shall be realized in accordance with the applicable realization section of the Internal Revenue Code (*e.g.*, sections 1001, 1092, and 1256). See also section 988(c)(5). For purposes of determining the timing of the realization of exchange gain or loss, sections 1092 and 1256 shall take precedence over section 988(c)(5).

(ii) *Realization by offset*—(A) *In general.* Except as provided in paragraphs (d)(2)(ii)(B) and (C) of this section, exchange gain or loss with respect to a transaction described in §1.988–1(a)(1)(ii) and (2)(iii) shall not be realized solely because such transaction is offset by another transaction (or transactions).

(B) *Exception where economic benefit is derived.* If a transaction described in §1.988–1(a)(1)(ii) and (2)(iii) is offset by

another transaction or transactions, exchange gain shall be realized to the extent the taxpayer derives, by pledge or otherwise, an economic benefit (*e.g.*, cash, property or the proceeds from a borrowing) from any gain inherent in such offsetting positions. Proper adjustment shall be made in the amount of any gain or loss subsequently realized for gain taken into account by reason of the preceding sentence. This paragraph (d)(2)(ii)(B) shall apply to transactions creating an offset after September 21, 1989.

(C) *Certain contracts traded on an exchange.* If a transaction described in §1.988–1(a)(1)(ii) and (2)(iii) is traded on an exchange and it is the general practice of the exchange to terminate offsetting contracts, entering into an offsetting contract shall be considered a termination of the contract being offset.

(iii) *Clarification of section 988(c)(5).* If the delivery date of a contract subject to section 988(c)(5) and paragraph (d)(4)(ii) of this section is different than the date the contract expires, then for purposes of determining the date exchange gain or loss is realized, the term delivery date shall mean expiration date.

(iv) *Examples.* The following examples illustrate the rules of this paragraph (d)(1) and (2).

Example 1. On August 1, 1989, X, a calendar year corporation with the dollar as its functional currency, enters into a forward contract with Bank A to buy 100 New Zealand dollars for $80 for delivery on January 31, 1990. (The forward purchase contract is not a section 1256 contract.) On November 1, 1989, the market price for the purchase of 100 New Zealand dollars for delivery on January 31, 1990, is $76. On November 1, 1989, X cancels its obligation under the forward purchase contract and pays Bank A $3.95 (the present value of $4 discounted at 12% for the period) in cancellation of such contract. Under section 1001 (a), X realizes an exchange loss of $3.95 on November 1, 1989, because cancellation of the forward purchase contract for cash results in the termination of X's contract.

Example 2. X is a corporation with the dollar as its functional currency. On January 1, 1989, X enters into a currency swap contract with Bank A under which X is obligated to make a series of Japanese yen payments in exchange for a series of dollar payments. On February 21, 1992, X has a gain of $100,000 inherent in such contract as a result of interest rate and exchange rate movements. Also on February 21, 1992, X enters into an offsetting swap with Bank A to lock in such gain. If on February 21, 1992, X pledges the gain inherent in such offsetting positions as collateral for a loan, X's initial swap contract is treated as being terminated on February 21, 1992, under paragraph (d)(2)(ii)(B) of this section. Proper adjustment is made in the amount of any gain or loss subsequently realized for the gain taken into account by reason of paragraph (d)(2)(ii)(B) of this section.

Example 3. X is a calendar year corporation with the dollar as its functional currency. On October 1, 1989, X enters into a forward contract to buy 100,000 Swiss francs (Sf) for delivery on March 1, 1990, for $51,220. Assume that the contract is a section 1256 contract under section 1256(g)(2) and that section 1256(e) does not apply. Pursuant to section 1256(a)(1), the forward contract is treated as sold for its fair market value on December 31, 1989. Assume that the fair market value of the contract is $1,000 determined under §1.988–1(g). Thus X will realize an exchange gain of $1,000 on December 31, 1989. Such gain is subject to the character rules of §1.988–3 and the source rules of §1.988–4.

(v) *Extension of the maturity date of certain contracts.* An extension of time for making or taking delivery under a contract described in paragraph (d)(1) of this section (*e.g.*, a historical rate rollover as defined in §1.988–5(b)(2)(iii)(C)) shall be considered a sale or exchange of the contract for its fair market value on the date of the extension and the establishment of a new contract on such date. If, under the terms of the extension, the time value of any gain or loss recognized pursuant to the preceding sentence adjusts the price of the currency to be bought or sold under the new contract, the amount attributable to such time value shall be treated as interest income or expense for all purposes of the Code. However, the preceding sentence shall not apply and the amount attributable to the time value of any gain or loss recognized shall be treated as exchange gain or loss if the period beginning on the first date the contract is rolled over and ending on the date payment is ultimately made or received with respect to such contract does not exceed 183 days.

(3) *Recognition of exchange gain or loss.* Except as provided in §1.988–5 (relating to section 988 hedging transactions),

exchange gain or loss realized with respect to a contract described in paragraph (d)(1) of this section shall be recognized in accordance with the applicable recognition provisions of the Internal Revenue Code. For example, a loss realized with respect to a contract described in paragraph (d)(1) of this section which is part of a straddle shall be recognized in accordance with the provisions of section 1092 to the extent such section is applicable.

(4) *Determination of exchange gain or loss*—(i) *In general.* Exchange gain or loss with respect to a contract described in §1.988–2(d)(1) shall be determined by subtracting the amount paid (or deemed paid), if any, for or with respect to the contract (including any amount paid upon termination of the contract) from the amount received (or deemed received), if any, for or with respect to the contract (including any amount received upon termination of the contract). Any gain or loss determined according to the preceding sentence shall be treated as exchange gain or loss.

(ii) *Special rules where taxpayer makes or takes delivery.* If the taxpayer makes or takes delivery in connection with a contract described in paragraph (d)(1) of this section, any gain or loss shall be realized and recognized in the same manner as if the taxpayer sold the contract (or paid another person to assume the contract) on the date on which he took or made delivery for its fair market value on such date. See paragraph (d)(2)(iii) of this section regarding the definition of the term ''delivery date.'' This paragraph (d)(4)(ii) shall not apply in any case in which the taxpayer makes or takes delivery before June 11, 1987.

(iii) *Examples.* The following examples illustrate the application of paragraph (d)(4) of this section.

Example 1. X is a calendar year corporation with the dollar as its functional currency. On October 1, 1989, when the six month forward rate is $.4907, X enters into a forward contract to buy 100,000 New Zealand dollars (NZD) for delivery on March 1, 1990. On March 1, 1990, when X takes delivery of the 100,000 NZD, the spot rate is 1NZD equals $.48. Pursuant to section 988(c)(5) and paragraph (d)(4)(ii) of this section, a taxpayer that takes delivery of nonfunctional currency under a forward contract that is subject to section 988 is treated as if the taxpayer sold the contract for its fair market value on the date delivery is taken. If X sold the contract on March 1, 1990, the transferee would require a payment of $1,070 [($.48 × 100,000NZD) − ($.4907 × 100,000NZD)] to compensate him for the loss in value of the 100,000NZD. Therefore, X realizes an exchange loss of $1,070. X has a basis in the 100,000NZD of $48,000.

Example 2. Assume the same facts as in *Example 1* except that the contract is for Swiss francs and is a section 1256 contract. Assume further that on December 31, 1989, the value to X of the contract as marked to market is $1,000. Pursuant to section 1256(a), X realizes an exchange gain of $1,000. Such gain, however, is characterized as ordinary income under §1.988–3 and will be sourced under §1.988–4.

Example 3. X is a calendar year corporation with the dollar as its functional currency. On May 2, 1989, X enters into an option contract with Bank A to purchase 50,000 Canadian dollars (C$) for U.S. $42,500 (C$1 = U.S. $.85) for delivery on or before September 18, 1989. X pays a $285 premium to Bank A to obtain the option contract. On September 18, 1989, when X exercises the option and takes delivery of the C$50,000, the spot rate is C$1 equals U.S. $.90. Pursuant to section 988(c)(5) and paragraph (d)(4)(ii) of this section, a taxpayer that takes delivery under an option contract that is subject to section 988 is treated as if the taxpayer sold the contract for its fair market value on the date delivery is taken. If X sold the contract for its fair market value on September 18, 1989, X would receive U.S. $2,500 [(C$50,000 × U.S. $.90) − (C$50,000 × U.S. $.85)]. Accordingly, X is deemed to have received U.S. $2,500 on the sale of the contract at its fair market value. X will realize U.S. $2,215 ($2,500 deemed received less $285 paid) of exchange gain with respect to the delivery of Canadian dollars under the option contract. X's basis in the 50,000 Canadian dollars is U.S. $45,000.

(5) *Hyperinflationary contracts*—(i) *In general.* If a taxpayer acquires or otherwise enters into a hyperinflationary contract (as defined in paragraph (d)(5)(ii) of this section) that has payments to be made or received that are denominated in (or determined by reference to) a nonfunctional currency of the taxpayer, then the taxpayer shall realize exchange gain or loss with respect to such contract for its taxable year determined by reference to the change in exchange rates between—

(A) The later of the first day of the taxable year, or the date the contract was acquired or entered into; and

(B) The earlier of the last day of the taxable year, or the date the contract is disposed of or otherwise terminated.

(ii) *Definition of hyperinflationary contract.* A hyperinflationary contract is a contract described in paragraph (d)(1) of this section that provides for payments denominated in or determined by reference to a currency that is hyperinflationary (as defined in §1.988–1(f)) at the time the taxpayer acquires or otherwise enters into the contract.

(iii) *Interaction with other provisions*—(A) *DASTM.* With respect to a qualified business unit that uses the United States dollar approximate separate transactions method of accounting described in §1.985–3, this paragraph (d)(5) does not apply.

(B) *Hedging rules.* To the extent §1.446–4 or 1.988–5 apply, this paragraph (d)(5) does not apply.

(C) *Adjustment for subsequent transactions.* Proper adjustments must be made in the amount of any gain or loss subsequently realized for gain or loss taken into account by reason of this paragraph (d)(5).

(iv) *Effective date.* This paragraph (d)(5) is applicable to transactions acquired or otherwise entered into after February 14, 2000.

(e) *Currency swaps and other notional principal contracts*—(1) *In general.* Except as provided in paragraph (e)(2) of this section or in §1.988–5, the timing of income, deduction and loss with respect to a notional principal contract that is a section 988 transaction shall be governed by section 446 and the regulations thereunder. Such income, deduction and loss is characterized as exchange gain or loss (except as provided in another section of the Internal Revenue Code (or regulations thereunder), §1.988–5, or in paragraph (f) of this section).

(2) *Special rules for currency swaps*—(i) *In general.* Except as provided in paragraph (e)(2)(iii)(B) of this section, the provisions of this paragraph (e)(2) shall apply solely for purposes of determining the realization, recognition and amount of exchange gain or loss with respect to a currency swap contract, and not for purposes of determining the source of such gain or loss, or characterizing such gain or loss as interest. Except as provided in §1.988–3(c), any income or loss realized with respect to a currency swap contract shall be characterized as exchange gain or loss (and not as interest income or expense). Any exchange gain or loss realized in accordance with this paragraph (e)(2) shall be recognized unless otherwise provided in an applicable section of the Code. For purposes of this paragraph (e)(2), a currency swap contract is a contract defined in paragraph (e)(2)(ii) of this section. With respect to a contract which requires the payment of swap principal prior to maturity of such contract, see paragraph (f) of this section. For purposes of this paragraph (e), the rules of paragraph (d)(2)(ii) of this section (regarding realization by offset) apply. See Example 2 of paragraph (d)(2)(iv) of this section.

(ii) *Definition of currency swap contract*—(A) *In general.* A currency swap contract is a contract involving different currencies between two or more parties to—

(*1*) Exchange periodic interim payments, as defined in paragraph (e)(2)(ii)(C) of this section, on or prior to maturity of the contract; and

(*2*) Exchange the swap principal amount upon maturity of the contract.

A currency swap contract may also require an exchange of the swap principal amount upon commencement of the agreement.

(B) *Swap principal amount.* The swap principal amount is an amount of two different currencies which, under the terms of the currency swap contract, is used to determine the periodic interim payments in each currency and which is exchanged upon maturity of the contract. If such amount is not clearly set forth in the contract, the Commissioner may determine the swap principal amount.

(C) *Exchange of periodic interim payments.* An exchange of periodic interim payments is an exchange of one or more payments in one currency specified by the contract for one or more payments in a different currency specified by the contract where the payments in each currency are computed by reference to an interest index applied to the swap principal amount. A currency swap contract must clearly indicate the periodic interim payments, or the interest index used to

compute the periodic interim payments, in each currency.

(iii) *Timing and computation of periodic interim payments*—(A) *In general.* Except as provided in paragraph (e)(2)(iii)(B) of this section and §1.988–5, the timing and computation of the periodic interim payments provided in a currency swap agreement shall be determined by treating—

(*1*) Payments made under the swap as payments made pursuant to a hypothetical borrowing that is denominated in the currency in which payments are required to be made (or are determined with reference to) under the swap, and

(*2*) Payments received under the swap as payments received pursuant to a hypothetical loan that is denominated in the currency in which payments are received (or are determined with reference to) under the swap.

Except as provided in paragraph (e)(2)(v) of this section, the hypothetical issue price of such hypothetical borrowing and loan shall be the swap principal amount. The hypothetical stated redemption price at maturity is the total of all payments (excluding any exchange of the swap principal amount at the inception of the contract) provided under the hypothetical borrowing or loan other than periodic interest payments under the principles of section 1273. For purposes of determining economic accrual under the currency swap, the number of hypothetical interest compounding periods of such hypothetical borrowing and loan shall be determined pursuant to a semiannual compounding convention unless the currency swap contract indicates otherwise. For purposes of determining the timing and amount of the periodic interim payments, the principles regarding the amortization of interest (see generally, sections 1272 through 1275 and 163(e)) shall apply to the hypothetical interest expense and income of such hypothetical borrowing and loan. However, such principles shall not apply to determine the time when principal is deemed to be paid on the hypothetical borrowing and loan. See paragraph (d)(2)(iii) of this section and *Example 2* of paragraph (d)(5) of this section with respect to the time when principal is deemed to be paid. With respect to the translation and computation of exchange gain or loss on any hypothetical interest income or expense, see §1.988–2(b). The amount treated as exchange gain or loss by the taxpayer with respect to the periodic interim payments for the taxable year shall be the amount of hypothetical interest income and exchange gain or loss attributable to such interest income from the hypothetical borrowing and loan for such year less the amount of hypothetical interest expense and exchange gain or loss attributable to the interest expense from such hypothetical borrowing and loan for such year.

(B) *Effect of prepayment for purposes of section 956.* For purposes of section 956, the Commissioner may treat any prepayment of a currency swap as a loan.

(iv) *Timing and determination of exchange gain or loss with respect to the swap principal amount.* Exchange gain or loss with respect to the swap principal amount shall be realized on the day the units of swap principal in each currency are exchanged. (See paragraph (e)(2)(ii)(A)(*2*) of this section which requires that the entire swap principal amount be exchanged upon maturity of the contract.) Such gain or loss shall be determined on the date of the exchange by subtracting the value (on such date) of the units of swap principal paid from the value of the units of swap principal received. This paragraph (e)(2)(iv) does not apply to an equal exchange of the swap principal amount at the commencement of the agreement at a market exchange rate.

(v) *Anti-abuse rules*—(A) *Method of accounting does not clearly reflect income.* If the taxpayer's method of accounting for income, expense, gain or loss attributable to a currency swap does not clearly reflect income, or if the present value of the payments to be made is not equivalent to that of the payments to be received (including the swap premium or discount, as defined in paragraph (e)(3)(ii) of this section) on the day the taxpayer enters into or acquires the contract, the Commissioner may apply principles analogous to those of section 1274 or such other rules as the Commissioner deems appropriate to clearly reflect income. For

example, in order to clearly reflect income the Commissioner may determine the hypothetical issue price, the hypothetical stated redemption price at maturity, and the amounts required to be taken into account within a taxable year. Further, if the present value of the payments to be made is not equivalent to that of the payments to be received (including the swap premium or discount, as defined in paragraph (e)(3)(ii) of this section) on the day the taxpayer enters into or acquires the contract, the Commissioner may integrate the swap with another transaction (or transactions) in order to clearly reflect income.

(B) *Terms must be clearly stated.* If the currency swap contract does not clearly set forth the swap principal amount in each currency, and the periodic interim payments in each currency (or the interest index used to compute the periodic interim payments in each currency), the Commissioner may defer any income, deduction, gain or loss with respect to such contract until termination of the contract.

(3) *Amortization of swap premium or discount in the case of off-market currency swaps*—(i) *In general.* An ''off-market currency swap'' is a currency swap contract under which the present value of the payments to be made is not equal to that of the payments to be received on the day the taxpayer enters into or acquires the contract (absent the swap premium or discount, as defined in paragraph (e)(3)(ii) of this section). Generally, such present values may not be equal if the swap exchange rate (as defined in paragraph (e)(3)(iii) of this section) is not the spot rate, or the interest indices used to compute the periodic interim payments do not reflect current values, on the day the taxpayer enters into or acquires the currency swap.

(ii) *Treatment of taxpayer entering into or acquiring an off-market currency swap.* If a taxpayer that enters into or acquires a currency swap makes a payment (that is, the taxpayer pays a premium, ''swap premium,'' to enter into or acquire the currency swap) or receives a payment (that is, the taxpayer enters into or acquires the currency swap at a discount, ''swap discount'') in order to make the present value of the amounts to be paid equal the amounts to be received, such payment shall be amortized in a manner which places the taxpayer in the same position it would have been in had the taxpayer entered into a currency swap contract under which the present value of the amounts to be paid equal the amounts to be received (absent any swap premium or discount). Thus, swap premium or discount shall be amortized as follows—

(A) The amount of swap premium or discount that is attributable to the difference between the swap exchange rate (as defined in paragraph (e)(3)(iii) of this section) and the spot rate on the date the contract is entered into or acquired shall be taken into account as income or expense on the date the swap principal amounts are taken into account; and

(B) The amount of swap premium or discount attributable to the difference in values of the periodic interim payments shall be amortized in a manner consistent with the principles of economic accrual. *Cf.*, section 171.

Any amount taken into account pursuant to this paragraph (e)(3)(ii) shall be treated as exchange gain or loss.

(iii) *Definition of swap exchange rate.* The swap exchange rate is the single exchange rate set forth in the contract at which the swap principal amounts are determined. If the swap exchange rate is not clearly set forth in the contract, the Commissioner may determine such rate.

(iv) *Coordination with § 1.446–3(g)(4) regarding swaps with significant nonperiodic payments.* The rules of § 1.446–3(g)(4) apply to any currency swap with a significant nonperiodic payment. Section 1.446–3(g)(4) applies before this paragraph (e)(3). Thus, if § 1.446–3(g)(4) applies, currency gain or loss may be realized on the loan. This paragraph (e)(3)(iv) applies to transactions entered into after February 14, 2000.

(4) *Treatment of taxpayer disposing of a currency swap.* Any gain or loss realized on the disposition or the termination of a currency swap is exchange gain or loss.

(5) *Examples.* The following examples illustrate the application of this paragraph (e).

Example 1. (i) C is an accrual method calendar year corporation with the dollar as its functional currency. On January 1, 1989, C enters into a currency swap with J with the following terms:

(1) the principal amount is $150 and 100 British pounds (£) (the equivalent of $150 on the effective date of the contract assuming a spot rate of £1 = $1.50 on January 1, 1989);

(2) C will make payments equal to 10% of the dollar principal amount on December 31, 1989, and December 31, 1990;

(3) J will make payments equal to 12% of the pound principal amount on December 31, 1989, and December 31, 1990; and

(4) on December 31, 1990, C will pay to J the $150 principal amount and J will pay to C the £100 principal amount.

Assume that the spot rate is £1 = $1.50 on January 1, 1989, £1 = $1.40 on December 31, 1989, and £1 = $1.30 on December 31, 1990. Assume further that the average rate for 1989 is £1 = $1.45 and for 1990 is £1 = $1.35.

(ii) Solely for determining the realization of gain or loss in accordance with paragraph (e)(2) of this section (and not for purposes of determining whether any payments are treated as interest), C will treat the dollar payments made by C as payments made pursuant to a dollar borrowing with an issue price of $150, a stated redemption price at maturity of $150, and yield to maturity of 10%. C will treat the pound payments received as payments received pursuant to a pound loan with an issue price of £100, a stated redemption price at maturity of £100, and a yield of 12% to maturity. Pursuant to §1.988–2(b), C is required to compute hypothetical accrued pound interest income at the average rate for the accrual period and then determine exchange gain or loss on the day payment is received with respect to such accrued amount. Accordingly, C will accrue $17.40 (£12 × $1.45) in 1989 and $16.20 (£12 × $1.35) in 1990. C also will compute hypothetical exchange loss of $.60 on December 31, 1989 [(£12 × $1.40) − (£12 × $1.45)] and hypothetical exchange loss of $.60 on December 31, 1990 [(£12 × $1.30) − (£12 × $1.35)]. All such hypothetical interest income and exchange loss are characterized and sourced as exchange gain and loss. Further, C is treated as having paid $15 ($150 × 10%) of hypothetical interest on December 31, 1989, and again on December 31, 1990. Such hypothetical interest expense is characterized and sourced as exchange loss. Thus, C will have a net exchange gain of $1.80 ($17.40 − $.60 − $15.00) with respect to the periodic interim payments in 1989 and a net exchange gain of $.60 ($16.20 − $.60 − $15.00) with respect to the periodic interim payments in 1990. Finally, C will realize an exchange loss on December 31, 1990, with respect to the exchange of the swap principal amount. This loss is determined by subtracting the value of the units of swap principal paid ($150) from the value of the units of swap principal received (£100 × $1.30 = $130) resulting in a $20 exchange loss.

Example 2. (i) C is an accrual method calendar year corporation with the dollar as its functional currency. On January 1, 1989, when the spot rate is £1 = $1.50, C enters into a currency swap contract with J under which C agrees to make and receive the following payments:

Date	C pays	J pays
December 31, 1989	$15.00	£12.00
December 31, 1990	41.04	12.00
December 31, 1991	0.00	12.00
December 31, 1992	150.00	112.00

(ii) Under paragraph (e)(2)(iii) of this section, C must treat the dollar periodic interim payments under the swap as made pursuant to a hypothetical dollar borrowing. The hypothetical issue price is $150 and the stated redemption price at maturity is $206.04. The amount of hypothetical interest expense must be amortized in accordance with economic accrual. Thus J must include and C must deduct periodic interim payment amounts as follows:

	Amount taken into account	Adjusted issue price
December 31, 1989	$15.00	150.00
December 31, 1990	$15.00	123.96
December 31, 1991	$12.40	136.36
December 31, 1992	$13.64	

(iii) Gain or loss with respect to the periodic interim payments of the currency swap is determined under paragraph (e)(2)(iii)(A) of this section with respect to the dollar cash flow amortized as set forth above and the corresponding pound cash flow as stated in the currency swap contract. Gain or loss with respect to the principal payments (*i.e.*, $150 and £100) exchanged on December 31, 1992, is determined under paragraph (e)(2)(iv) of this section on December 31, 1992, notwithstanding that under the principles regarding amortization of interest $26.04 would have been regarded as a payment of principal on December 31, 1990.

Example 3. (i) X is a corporation on the accrual method of accounting with the dollar as its functional currency and the calendar year as its taxable year. On January 1, 1989, X enters into a three year currency swap contract with Y with the following terms. The swap principal amount is $100 and the Swiss franc (Sf) equivalent of such amount

which equals Sf200 translated at the swap exchange rate of $1 = Sf2. There is no initial exchange of the swap principal amount. The interest rates used to compute the periodic interim payments are 10% compounded annually for U.S. dollar payments and 5% compounded annually for Swiss franc payments. Thus, under the currency swap, X agrees to pay Y $10 (10% × $100) on December 31st of 1989, 1990 and 1991 and to pay Y the swap principal amount of $100 on December 31, 1991. Y agrees to pay X Sf10 (5% × Sf200) on December 31st of 1989, 1990 and 1991 and to pay X the swap principal amount of Sf200 on December 31, 1991. Assume that the average rate for 1989 and the spot rate on December 31, 1989, is $1 = Sf2.5.

(ii) Under paragraph (e)(2)(iii) of this section, on December 31, 1989, X will realize an exchange loss of $6 (the sum of $10 of loss by reason of the $10 periodic interim payment paid to Y and $4.00 of gain, the value of Sf10 on December 31, 1989, from the receipt of Sf10 on such date).

(iii) On January 1, 1990, X transfers its rights and obligations under the swap contract to Z, an unrelated corporation. Z has the dollar as its functional currency, is on the accrual method of accounting, and has the calendar year as its taxable year. On January 1, 1990, the exchange rate is $1 = Sf2.50. The relevant dollar interest rate is 8% compounded annually and the relevant Swiss franc interest rate is 5% compounded annually. Because of the movement in exchange and interest rates, the agreement between X and Z to transfer the currency swap requires X to pay Z $23.56 (the swap discount as determined under paragraph (e)(3) of this section).

(iv) Pursuant to paragraph (e)(4) of this section, X may deduct the loss of $23.56 in 1990. The loss is characterized under § 1.988–3 and sourced under § 1.988–4.

(v) Pursuant to paragraph (e)(3)(ii) of this section, Z is required to amortize the $23.56 received as follows. The amount of the $23.56 payment that is attributable to movements in exchange rates ($20) is taken into account on December 31, 1991, the date the swap principal amounts are exchanged, under paragraph (e)(3)(ii)(A) of this section. This amount is the present value (discounted at 10%, the rate under the currency swap contract used to compute the dollar periodic interim payments) of the financial asset required to compensate Z for the loss in value of the hypothetical Swiss franc loan resulting from movements in exchange rates between January 1, 1989, and January 1, 1990. This amount is determined by assuming that interest rates did not change from the date the swap originally was entered into (January 1, 1989), but that the exchange rate is $1 = Sf2.50. Under this assumption, a taxpayer undertaking the obligation to pay dollars under the currency swap on January 1, 1990, would only agree to pay $8 for Sf10 on December 31, 1990, and $88 for Sf210 on December 31, 1991, because the exchange rates have moved from $1 = Sf2 to $1 = Sf2.50. Thus, Z requires $2 on December 31, 1990, and $22 on December 31, 1991, to compensate for the amount of dollar payments Z is required to make in exchange for the Swiss francs received on December 31, 1990 and 1991. The present value of $2 on December 31, 1990, and $22 on December 31, 1991, discounted at the rate for U.S. dollar payments of 10% is $20 ($1.82 + $18.18). This amount is discounted at the rate for U.S. dollar payments (i.e., at the historic rate) because the amount of the $23.56 payment received by Z that is attributable to movements in interest rates is computed and amortized separately as provided in the following paragraph.

(vi) Pursuant to paragraph (e)(3)(ii)(B) of this section, Z is required to amortize the portion of the $23.56 payment attributable to movements in interest rates under principles of economic accrual over the term of the currency swap agreement. The amount of the $23.56 payment that is attributable to movements in interest rates (assuming that exchange rates have not changed) is the present value ($3.56) of the excess ($2.00 in 1990 and $2.00 in 1991) of the periodic interim payments Z is required to pay under the currency swap agreement ($10 in 1990 and $10 in 1991) over the amount Z would be required to pay if the currency swap agreement reflected current interest rates on the day Z acquired the swap contract ($8 in 1990 and $8 in 1991) discounted at the appropriate dollar interest rate on January 1, 1990. Thus, under principles of economic accrual (e.g., see section 171 of the Code), Z will include in income $1.72 on December 31, 1990, the amount that, when added to the interest ($.28) on the $3.56 computed at the 8% rate on the date Z acquired the currency swap contract, will equal the $2.00 needed to compensate Z for the movement in interest rates between January 1, 1989, and January 1, 1990. Z also will include in income $1.85 on December 31, 1991, the amount that, when added to the interest ($.15) on the $1.85 (the remaining balance of the $3.56 payment) computed at the 8% rate on the date Z acquired the currency swap contract, will equal the $2.00 needed to compensate Z for the movement in interest rates between January 1, 1990, and January 1, 1991. This amount is computed assuming exchange rates have not changed because the amount attributable to movements in exchange rates is computed and amortized separately under the preceding paragraph.

(6) *Special effective date for rules regarding currency swaps.* Paragraph (e)(3) of this section regarding amortization of swap premium or discount in the case of off-market currency swaps shall be effective for transactions entered

into after September 21, 1989, unless such swap premium or discount was paid or received pursuant to a binding contract with an unrelated party that was entered into prior to such date. For transactions entered into prior to this date, see Notice 89–21, 1989–8 I.R.B. 23.

(7) *Special rules for currency swap contracts in hyperinflationary currencies*—(i) *In general.* If a taxpayer enters into a hyperinflationary currency swap (as defined in paragraph (e)(7)(iv) of this section), then the taxpayer realizes exchange gain or loss for its taxable year with respect to such instrument determined by reference to the change in exchange rates between—

(A) The later of the first day of the taxable year, or the date the instrument was entered into (by the taxpayer); and

(B) The earlier of the last day of the taxable year, or the date the instrument is disposed of or otherwise terminated.

(ii) *Adjustment to principal or basis.* Proper adjustments are made in the amount of any gain or loss subsequently realized for gain or loss taken into account by reason of this paragraph (e)(7).

(iii) *Interaction with DASTM.* With respect to a qualified business unit that uses the United States dollar approximate separate transactions method of accounting described in §1.985–3, this paragraph (e)(7) does not apply.

(iv) *Definition of hyperinflationary currency swap contract.* A hyperinflationary currency swap contract is a currency swap contract that provides for—

(A) Payments denominated in or determined by reference to a currency that is hyperinflationary (as defined in §1.988–1(f)) at the time the taxpayer enters into or otherwise acquires the currency swap; or

(B) Payments that are adjusted to take into account the fact that the currency is hyperinflationary (as defined in §1.988–1(f)) during the current taxable year. A currency swap contract that provides for periodic payments determined by reference to a variable interest rate based on local conditions and generally responding to changes in the local consumer price index is an example of this latter type of currency swap contract.

(v) *Special effective date for nonfunctional hyperinflationary currency swap contracts.* This paragraph (e)(7) applies to transactions entered into after February 14, 2000.

(f) *Substance over form*—(1) *In general.* If the substance of a transaction described in §1.988–1(a)(1) differs from its form, the timing, source, and character of gains or losses with respect to such transaction may be recharacterized by the Commissioner in accordance with its substance. For example, if a taxpayer enters into a transaction that it designates a ''currency swap contract'' that requires the prepayment of all payments to be made or to be received (but not both), the Commissioner may recharacterize the contract as a loan. In applying the substance over form principle, separate transactions may be integrated where appropriate. See also §1.861–9T(b)(1).

(2) *Example.* The following example illustrates the provisions of this paragraph (f).

Example. (i) On January 1, 1990, X, a U.S. corporation with the dollar as its functional currency, enters into a contract with Y under which X will pay Y $100 and Y will pay X LC100 on January 1, 1990, and X will pay Y LC109.3 and Y will pay X $133 on December 31, 1992. On January 1, 1990, the spot exchange rate is LC1 = $1 and the 3 year forward rate is LC1 = $.8218. X's cash flows are summarized below:

Date	Dollar	LC
1/1/90	(100)	100
12/31/90	0	0
12/31/91	0	0
12/31/92	133	(109.3)

(ii) X and Y designate this contract as a ''currency swap.'' Notwithstanding this designation, for purposes of determining the timing, source, and character with respect to the transaction, the transaction is characterized by the Commissioner in accordance 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.

(i) [Reserved]. For further guidance, see §1.988–2T(i).

[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; T.D. 9157, 69 FR 52819, Aug. 30, 2004; T.D. 9795, 81 FR 88879, Dec. 8, 2016]

§1.988–2T Recognition and computation of exchange gain or loss (temporary).

(a) through (b)(15) [Reserved]. For further guidance, see §1.988–2(a) through (b)(15).

(16) *Deferral of loss on certain related-party debt instruments*—(i) *Treatment of creditor.* For rules applicable to a corporation included in a controlled group that is a creditor under a debt instrument see §1.267(f)–1(e).

(ii) *Treatment of debtor*—(A) *In general.* Exchange loss realized under §1.988–2(b)(4) or (b)(6) is deferred if—

(*1*) The loss is realized by a debtor with respect to a loan from a person that has a relationship to the debtor described in section 267(b) or section 707(b); and

(*2*) The transaction resulting in the realization of exchange loss has as a principal purpose the avoidance of Federal income tax.

(B) *Recognition of deferred loss.* Any exchange loss that is deferred under paragraph (b)(16)(ii)(A) of this section is deferred until the end of the term of the loan, determined immediately prior to the transaction.

(17) through (h) [Reserved]. For further guidance, see §1.988–2(b)(17) through (h).

(i) *Special rules for section 988 transactions of a section 987 QBU.* For rules regarding section 988 transactions of a section 987 QBU, see §1.987–3T(b)(4) for section 987 QBUs in general and §1.987–1T(b)(6) for dollar QBUs.

(j) *Effective/applicability date.* Paragraph (b)(16) of this section applies to any exchange loss realized on or after December 7, 2016. Paragraph (i) of this section applies to taxable years beginning on or after one year after the first day of the first taxable year following December 7, 2016. Notwithstanding the preceding sentence, if a taxpayer makes an election under §1.987–11(b), then paragraph (i) of this section applies to taxable years to which §§1.987–1 through 1.987–10 apply as a result of such election.

(k) *Expiration date.* The applicability of this section expires on December 6, 2019.

[T.D. 9795, 81 FR 88879, Dec. 8, 2016]

§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.* For purposes of paragraph (b)(1) of this section, the principles of §1.987–2(b) shall apply in determining whether an asset, liability, or item of income or expense is reflected on the books and records of a qualified business unit.

(ii) *Effective/applicability date.* Generally, paragraph (b)(2)(i) of this section shall apply to taxable years beginning on or after one year after the first day of the first taxable year following December 7, 2016. If pursuant to §1.987–11(b) a taxpayer applies §§1.987–1 through 1.987–11 beginning in a taxable year prior to the earliest taxable year described in §1.987–11(a), then paragraph (b)(2)(i) of this section shall apply to taxable years of the taxpayer

beginning on or after the first day of such prior taxable year.

(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.

(2) *Exception.* In the case of a qualified business unit of any taxpayer (including an individual), the residence of such unit shall be the country in which the principal place of business of such qualified business unit is located.

(3) *Partner in a partnership not engaged in a U.S. trade or business under section 864(b)(2).* The determination of residence shall be made at the partner level (without regard to whether the partnership is a qualified business unit of the partners) in the case of partners in a partnership that are not engaged in a U.S. trade or business by reason of section 864(b)(2).

(e) *Special rule for certain related party loans*—(1) *In general.* In the case of a loan by a United States person or a related person to a 10 percent owned foreign corporation, or a corporation that meets the 80 percent foreign business requirements test of section 861(c)(1), other than a corporation subject to §1.861–11T(e)(2)(i), which is denominated in, or determined by reference to, a currency other than the U.S. dollar and bears interest at a rate at least 10 percentage points higher than the Federal mid-term rate (as determined under section 1274(d)) at the time such loan is entered into, the following rules shall apply—

(i) For purposes of section 904 only, such loan shall be marked to market annually on the earlier of the last business day of the United States person's (or related person's) taxable year or the date the loan matures; and

(ii) Any interest income earned with respect to such loan for the taxable year shall be treated as income from sources within the United States to the extent of any notional loss attributable to such loan under paragraph (d)(1)(i) of this section.

(2) *United States person.* For purposes of this paragraph (e), the term ''United States person'' means a person described in section 7701(a)(30).

(3) *Loans by related foreign persons*—(i) *In general.* [Reserved]

(ii) *Definition of related person.* For purposes of this paragraph (e), the term ''related person'' has the meaning given such term by section 954(d)(3) except that such section shall be applied by substituting ''United States person'' for ''controlled foreign corporation'' each place such term appears.

(4) *10 percent owned foreign corporation.* For purposes of this paragraph (e), the term ''10 percent owned foreign corporation'' means any foreign corporation in which the United States person owns directly or indirectly

(within the meaning of section 318(a)) at least 10 percent of the voting stock.

(f) *Exchange gain or loss treated as interest under § 1.988–3.* Notwithstanding the provisions of this section, any gain or loss realized on a section 988 transaction that is treated as interest income or expense under § 1.988–3(c)(1) shall be sourced or allocated and apportioned pursuant to section 861(a)(1), 862(a)(1), or 864(e) as the case may be.

(g) *Exchange gain or loss allocated in the same manner as interest under § 1.861–9T.* The allocation and apportionment of exchange gain or loss under § 1.861–9T shall not affect the source of exchange gain or loss for purposes of sections 871(a), 881, 1441, 1442 and 6049.

(h) *Effective date.* This section shall be effective for taxable years beginning after December 31, 1986. Thus, 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.

[T.D. 8400, 57 FR 9199, Mar. 17, 1992, as amended by T.D. 9794, 81 FR 88851, Dec. 8, 2016]

§ 1.988–5 Section 988(d) hedging transactions.

(a) *Integration of a nonfunctional currency debt instrument and a § 1.988–5(a) hedge*—(1) *In general.* This paragraph (a) applies to a qualified hedging transaction as defined in this paragraph (a)(1). A qualified hedging transaction is an integrated economic transaction, as provided in paragraph (a)(5) of this section, consisting of a qualifying debt instrument as defined in paragraph (a)(3) of this section and a § 1.988–5(a) hedge as defined in paragraph (a)(4) of this section. If a taxpayer enters into a transaction that is a qualified hedging transaction, no exchange gain or loss is recognized by the taxpayer on the qualifying debt instrument or on the § 1.988–5(a) hedge for the period that either is part of a qualified hedging transaction, and the transactions shall be integrated as provided in paragraph (a)(9) of this section. However, if the qualified hedging transaction results in a synthetic nonfunctional currency denominated debt instrument, such instrument shall be subject to the rules of § 1.988–2(b).

(2) *Exception.* This paragraph (a) does not apply with respect to a qualified hedging transaction that creates a synthetic asset or liability denominated in, or determined by reference to, a currency other than the U.S. dollar if the rate that approximates the Federal short-term rate in such currency is at least 20 percentage points higher than the Federal short term rate (determined under section 1274(d)) on the date the taxpayer identifies the transaction as a qualified hedging transaction.

(3) *Qualifying debt instrument*—(i) *In general.* A qualifying debt instrument is a debt instrument described in § 1.988–1(a)(2)(i), regardless of whether denominated in, or determined by reference to, nonfunctional currency (including dual currency debt instruments, multi-currency debt instruments and contingent payment debt instruments). A qualifying debt instrument does not include accounts payable, accounts receivable or similar items of expense or income.

(ii) *Special rule for debt instrument of which all payments are proportionately hedged.* If a debt instrument satisfies the requirements of paragraph (a)(3)(i) of this section, and all principal and interest payments under the instrument are hedged in the same proportion, then for purposes of this paragraph (a), that portion of the instrument that is hedged is eligible to be treated as a qualifying debt instrument, and the rules of this paragraph (a) shall apply separately to such qualifying debt instrument. See Example 8 in paragraph (a)(9)(iv) of this section.

(4) *Section 1.988–5(a) hedge*—(i) *In general.* A § 1.988–5(a) hedge (hereinafter referred to in this paragraph (a) as a ''hedge'') is a spot contract, futures contract, forward contract, option contract, notional principal contract, currency swap contract, similar financial instrument, or series or combination thereof, that when integrated with a qualifying debt instrument permits the calculation of a yield to maturity (under principles of section 1272) in the currency in which the synthetic debt instrument is denominated (as determined under paragraph (a)(9)(ii)(A) of this section).

(ii) *Retroactive application of definition of currency swap contract.* A taxpayer may apply the definition of currency swap contract set forth in §1.988–2(e)(2)(ii) in lieu of the definition of swap agreement in section 2(e)(5) of Notice 87–11, 1987–1 C.B. 423 to transactions entered into after December 31, 1986 and before September 21, 1989.

(5) *Definition of integrated economic transaction.* A qualifying debt instrument and a hedge are an integrated economic transaction if all of the following requirements are satisfied—

(i) All payments to be made or received under the qualifying debt instrument (or amounts determined by reference to a nonfunctional currency) are fully hedged on the date the taxpayer identifies the transaction under paragraph (a) of this section as a qualified hedging transaction such that a yield to maturity (under principles of section 1272) in the currency in which the synthetic debt instrument is denominated (as determined under paragraph (a)(9)(ii)(A) of this section) can be calculated. Any contingent payment features of the qualifying debt instrument must be fully offset by the hedge such that the synthetic debt instrument is not classified as a contingent payment debt instrument. See Examples 6 and 7 of paragraph (a)(9)(iv) of this section.

(ii) The hedge is identified in accordance with paragraph (a)(8) of this section on or before the date the acquisition of the financial instrument (or instruments) constituting the hedge is settled or closed.

(iii) None of the parties to the hedge are related. The term ''related'' means the relationships defined in section 267(b) or section 707(b).

(iv) 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 qualifying debt instrument and the hedge are properly reflected on the books of such qualified business unit throughout the term of the qualified hedging transaction.

(v) Subject to the limitations of paragraph (a)(5) of this section, both the qualifying debt instrument 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 qualifying debt instrument and the hedge whether or not such corporation is a member of an affiliated group of corporations that files a consolidated return.

(vi) With respect to a foreign person engaged in a U.S. trade or business that enters into a qualifying debt instrument or hedge through such trade or business, all items of income and expense associated with the qualifying debt instrument and the hedge (other than interest expense that is subject to §1.882–5), would have been effectively connected with such U.S. trade or business throughout the term of the qualified hedging transaction had this paragraph (a) not applied.

(6) *Special rules for legging in and legging out of integrated treatment*—(i) *Legging in.* ''Legging in'' to integrated treatment under this paragraph (a) means that a hedge is entered into after the date the qualifying debt instrument is entered into or acquired, and the requirements of this paragraph (a) are satisfied on the date the hedge is entered into (''leg in date''). If a taxpayer legs into integrated treatment, the following rules shall apply—

(A) Exchange gain or loss shall be realized with respect to the qualifying debt instrument determined solely by reference to changes in exchange rates between—

(*1*) The date the instrument was acquired by the holder, or the date the obligor assumed the obligation to make payments under the instrument; and

(*2*) The leg in date.

(B) The recognition of such gain or loss will be deferred until the date the qualifying debt instrument matures or is otherwise disposed of.

(C) The source and character of such gain or loss shall be determined on the leg in date as if the qualifying debt instrument was actually sold or otherwise terminated by the taxpayer.

(ii) *Legging out.* With respect to a qualifying debt instrument and hedge that are properly identified as a qualified hedging transaction, ''legging out'' of integrated treatment under this paragraph (a) means that the taxpayer disposes of or otherwise terminates all or any portion of the qualifying debt

instrument or the hedge before maturity of the qualified hedging transaction. For purposes of the preceding sentence, if the taxpayer changes a material term of the qualifying debt instrument (for example, exercises an option to change the interest rate or index, or the maturity date) or the hedge (for example, changes the interest or exchange rates underlying the hedge, or the expiration date) before maturity of the qualified hedging transaction, the taxpayer will be deemed to have disposed of or otherwise terminated all or any portion of the qualifying debt instrument or the hedge, as applicable. A taxpayer that disposes of or terminates a qualified hedging transaction (that is, disposes of or terminates both the qualifying debt instrument and the hedge in their entirety on the same day) is considered to have disposed of or otherwise terminated the synthetic debt instrument rather than legging out. See paragraph (a)(9)(iv) of this section, *Example 10* for an illustration of this rule. If a taxpayer legs out of integrated treatment, the following rules apply:

(A) The transaction will be treated as a qualified hedging transaction during the time the requirements of this paragraph (a) were satisfied.

(B) If all of the instruments comprising the hedge (each such instrument, a component) are disposed of or otherwise terminated, the qualifying debt instrument is treated as sold or otherwise terminated by the taxpayer for its fair market value on the date the hedge is disposed of or otherwise terminated (the leg-out date), and any gain or loss (including gain or loss resulting from factors other than movements in exchange rates) from the identification date to the leg-out date is realized and recognized on the leg-out date. The spot rate on the leg-out date is used to determine exchange gain or loss on the debt instrument for the period beginning on the leg-out date and ending on the date such instrument matures or is disposed of or otherwise terminated. Proper adjustment must be made to reflect any gain or loss taken into account. The netting rule of §1.988–2(b)(8) applies. See paragraph (a)(9)(iv) of this section, *Example 4* and *Example 5* for an illustration of this rule.

(C) If a hedge has more than one component (and such components have been properly identified as being part of the qualified hedging transaction) and at least one but not all of the components that comprise the hedge has been disposed of or otherwise terminated, or if part of any component of the hedge has been terminated (whether a hedge consists of a single or multiple components), the date such component (or part thereof) is disposed of or terminated is considered the leg-out date and the qualifying debt instrument is treated as sold or otherwise terminated by the taxpayer for its fair market value in accordance with the rules of paragraph (a)(6)(ii)(B) of this section on such leg-out date. In addition, all of the remaining components (or parts thereof) that have not been disposed of or otherwise terminated are treated as sold by the taxpayer for their fair market value on the leg-out date, and any gain or loss from the identification date to the leg-out date is realized and recognized on the leg-out date. To the extent relevant, the spot rate on the leg-out date is used to determine exchange gain or loss on the remaining components (or parts thereof) for the period beginning on the leg-out date and ending on the date such components (or parts thereof) are disposed of or otherwise terminated. See paragraph (a)(9)(iv) of this section, *Example 11* for an illustration of this rule.

(D) If the qualifying debt instrument is disposed of or otherwise terminated in whole or in part, the date of such disposition or termination is considered the leg-out date. Accordingly, the hedge (including all components making up the hedge in their entirety) that is part of the qualified hedging transaction is treated as sold by the taxpayer for its fair market value on the leg-out date, and any gain or loss from the identification date to the leg-out date is realized and recognized on the leg-out date. To the extent relevant, the spot rate on the leg-out date is used to determine exchange gain or loss on the hedge (including all components thereof) for the period beginning on the leg-out date and ending on the

date such hedge is disposed of or otherwise terminated.

(E) Except as provided in paragraph (a)(8)(iii) of this section (regarding identification by the Commissioner), the part of the qualified hedging transaction that has not been disposed of or otherwise terminated (that is, the remaining debt instrument in its entirety even if partially hedged, or the remaining components of the hedge) cannot be part of a qualified hedging transaction for any period after the leg-out date.

(F) If a taxpayer legs out of a qualified hedging transaction and realizes a net gain with respect to the debt instrument that is disposed of or otherwise terminated, then paragraph (a)(6)(ii)(B), (C), and (D) of this section, as appropriate, will not apply if during the period beginning 30 days before the leg-out date and ending 30 days after that date the taxpayer enters into another transaction that, taken together with any remaining components of the hedge, hedges at least 50 percent of the remaining currency flow with respect to the qualifying debt instrument that was part of the qualified hedging transaction or, if appropriate, an equivalent amount under the hedge (or any remaining components thereof) that was part of the qualified hedging transaction. Similarly, in a case in which a hedge has multiple components that are part of a qualified hedging transaction, if the taxpayer legs out of a qualified hedging transaction by terminating one such component or a part of one or more such components and realizes a net gain with respect to the terminated component, components, or portions thereof, then paragraphs (a)(6)(ii)(B), (C), and (D) of this section, as appropriate, will not apply if the remaining components of the hedge (including parts thereof) by themselves hedge at least 50 percent of the remaining currency flow with respect to the qualifying debt instrument that was part of the qualified hedging transaction. See paragraph (a)(9)(iv) of this section, *Example 11* for an illustration of this rule.

(7) *Transactions part of a straddle.* At the discretion of the Commissioner, a transaction shall not satisfy the requirements of paragraph (a)(5) of this section if the debt instrument making up the qualified hedging transaction is part of a straddle as defined in section 1092(c) prior to the time the qualified hedging transaction is identified.

(8) *Identification requirements*—(i) *Identification by the taxpayer.* 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 for each qualified hedging transaction the following information—

(A) The date the qualifying debt instrument and hedge were entered into;

(B) The date the qualifying debt instrument and the hedge are identified as constituting a qualified hedging transaction;

(C) The amount that must be deferred, if any, under paragraph (a)(6) of this section and the source and character of such deferred amount;

(D) A description of the qualifying debt instrument and the hedge; and

(E) A summary of the cash flow resulting from treating the qualifying debt instrument and the hedge as a qualified hedging transaction.

(ii) *Identification by trustee on behalf of beneficiary.* A trustee of a trust that enters into a qualified hedging transaction may satisfy the identification requirements described in paragraph (a)(8)(i) of this section on behalf of a beneficiary of such trust.

(iii) *Identification by the Commissioner.* If—

(A) A taxpayer enters into a qualifying debt instrument and a hedge but fails to comply with one or more of the requirements of this paragraph (a), and

(B) On the basis of all the facts and circumstances, the Commissioner concludes that the qualifying debt instrument and the hedge are, in substance, a qualified hedging transaction,

then the Commissioner may treat the qualifying debt instrument and the hedge as a qualified hedging transaction. The Commissioner may identify a qualifying debt instrument and a hedge as a qualified hedging transaction regardless of whether the qualifying debt instrument and the hedge are held by the same taxpayer.

(9) *Taxation of qualified hedging transactions*—(i) *In general*—(A) *General rule.* If a transaction constitutes a qualified

hedging transaction, the qualifying debt instrument and the hedge are integrated and treated as a single transaction with respect to the taxpayer that has entered into the qualified hedging transaction during the period that the transaction qualifies as a qualified hedging transaction. Neither the qualifying debt instrument nor the hedge that makes up the qualified hedging transaction shall be subject to section 263(g), 1092 or 1256 for the period such transactions are integrated. However, the qualified hedging transaction may be subject to section 263(g) or 1092 if such transaction is part of a straddle.

(B) *Special rule for income or expense of foreign persons effectively connected with a U.S. trade or business.* Interest income of a foreign person resulting from a qualified hedging transaction entered into by such foreign person that satisfies the requirements of paragraph (a)(5)(vii) of this section shall be treated as effectively connected with a U.S. trade or business. Interest expense of a foreign person resulting from a qualified hedging transaction entered into by such foreign person that satisfies the requirements of paragraph (a)(5)(vii) of this section shall be allocated and apportioned under §1.882–5 of the regulations.

(C) *Special rule for foreign persons that enter into qualified hedging transactions giving rise to U.S. source income not effectively connected with a U.S. trade or business.* If a foreign person enters into a qualified hedging transaction that gives rise to U.S. source interest income (determined under the source rules for synthetic asset transactions as provided in this section) not effectively connected with a U.S. trade or business of such foreign person, for purposes of sections 871(a), 881, 1441, 1442 and 6049, the provisions of this paragraph (a) shall not apply and such sections of the Internal Revenue Code shall be applied separately to the qualifying debt instrument and the hedge. To the extent relevant to any foreign person, if the requirements of this paragraph (a) are otherwise met, the provisions of this paragraph (a) shall apply for all other purposes of the Internal Revenue Code (*e.g.*, for purposes of calculating the earnings and profits of a controlled foreign corporation that enters into a qualified hedging transaction through a qualified business unit resident outside the United States, income or expense with respect to such qualified hedging transaction shall be calculated under the provisions of this paragraph (a)).

(ii) *Income tax effects of integration.* The effect of integrating and treating a transaction as a single transaction is to create a synthetic debt instrument for income tax purposes, which is subject to the original issue discount provisions of sections 1272 through 1288 and 163(e), the terms of which are determined as follows:

(A) *Denomination of synthetic debt instrument.* In the case where the qualifying debt instrument is a borrowing, the denomination of the synthetic debt instrument is the same as the currency paid under the terms of the hedge to acquire the currency used to make payments under the qualifying debt instrument. In the case where the qualifying debt instrument is a lending, the denomination of the synthetic debt instrument is the same as the currency received under the terms of the hedge in exchange for amounts received under the qualifying debt instrument. For example, if the hedge is a forward contract to acquire British pounds for dollars, and the qualifying debt instrument is a borrowing denominated in British pounds, the synthetic debt instrument is considered a borrowing in dollars.

(B) *Term and accrual periods.* The term of the synthetic debt instrument shall be the period beginning on the identification date and ending on the date the qualifying debt instrument matures or such earlier date that the qualifying debt instrument or hedge is disposed of or otherwise terminated. Unless otherwise clearly indicated by the payment interval under the hedge, the accrual period shall be a six month period which ends on the dates determined under section 1272(a)(5).

(C) *Issue price.* The issue price of the synthetic debt instrument is the adjusted issue price of the qualifying debt instrument translated into the currency in which the synthetic debt instrument is denominated at the spot rate on the identification date.

(D) *Stated redemption price at maturity.* In the case where the qualifying debt instrument is a borrowing, the stated redemption price at maturity shall be determined under section 1273(a)(2) on the identification date by reference to the amounts to be paid under the hedge to acquire the currency necessary to make interest and principal payments on the qualifying debt instrument. In the case where the qualifying debt instrument is a lending, the stated redemption price at maturity shall be determined under section 1273(a)(2) on the identification date by reference to the amounts to be received under the hedge in exchange for the interest and principal payments received pursuant to the terms of the qualifying debt instrument.

(iii) *Source of interest income and allocation of expense.* Interest income from a synthetic debt instrument described in paragraph (a)(9)(ii) of this section shall be sourced by reference to the source of income under sections 861(a)(1) and 862(a)(1) of the qualifying debt instrument. The character for purposes of section 904 of interest income from a synthetic debt instrument shall be determined by reference to the character of the interest income from qualifying debt instrument. Interest expense from a synthetic debt instrument described in paragraph (a)(9)(ii) of this section shall be allocated and apportioned under §§1.861–8T through 1.861–12T or the successor sections thereof or under §1.882–5.

(iv) *Examples.* The following examples illustrate the application of this paragraph (a)(9).

Example 1. (i) K is a U.S. corporation with the U.S. dollar as its functional currency. On December 24, 1989, K agrees to close the following transaction on December 31, 1989. K will borrow from an unrelated party on December 31, 1989, 100 British pounds (£) for 3 years at a 10 percent rate of interest, payable annually, with no principal payment due until the final installment. K will also enter into a currency swap contract with an unrelated counterparty under the terms of which—

(a) K will swap, on December 31, 1989, the £100 obtained from the borrowing for $100; and

(b) K will exchange dollars for pounds pursuant to the following table in order to obtain the pounds necessary to make payments on the pound borrowing:

Date	U.S. dollars	Pounds
December 31, 1990	8	10
December 31, 1991	8	10
December 31, 1992	108	110

(ii) The interest rate on the borrowing is set and the exchange rates on the swap are fixed on December 24, 1989. On December 31, 1989, K borrows the £100 and swaps such pounds for $100. Assume x has satisfied the identification requirements of paragraph (a)(8) of this section.

(iii) The pound borrowing (which constitutes a qualifying debt instrument under paragraph (a)(3) of this section) and the currency swap contract (which constitutes a hedge under paragraph (a)(4) of this section) are a qualified hedging transaction as defined in paragraph (a)(1) of this section. Accordingly, the pound borrowing and the swap are integrated and treated as one transaction with the following consequences:

(A) The integration of the pound borrowing and the swap results in a synthetic dollar borrowing with an issue price of $100 under section 1273(b)(2).

(B) The total amount of interest and principal of the synthetic dollar borrowing is equal to the dollar payments made by K under the currency swap contract (i.e., $8 in 1990, $8 in 1991, and $108 in 1992).

(C) The stated redemption price at maturity (defined in section 1273(a)(2)) is $100. Because the stated redemption price equals the issue price, there is no OID on the synthetic dollar borrowing.

(D) K may deduct the annual interest payments of $8 under section 163(a) (subject to any limitations on deductibility imposed by other provisions of the Code) according to its regular method of accounting. K has also paid $100 as a return of principal in 1992.

(E) K must allocate and apportion its interest expense with respect to the synthetic dollar borrowing under the rules of §§1.861–8T through 1.861–12T.

Example 2. (i) K, a U.S. corporation, has the U.S. dollar as its functional currency. On December 24, 1989, when the spot rate for Swiss francs (Sf) is Sf1 = $1, K enters into a forward contract to purchase Sf100 in exchange for $100.04 for delivery on December 31, 1989. The Sf100 are to be used for the purchase of a franc denominated debt instrument on December 31, 1989. The instrument will have a term of 3 years, an issue price of Sf100, and will bear interest at 6 percent, payable annually, with no repayment of principal until the final installment. On December 24, 1989, K also enters into a series of forward contracts to sell the franc interest and principal payments that will be received under the terms of the franc denominated debt instrument for dollars according to the following schedule:

Date	U.S. dollars	Francs
December 31, 1990	6.12	6
December 31, 1991	6.23	6
December 31, 1992	112.16	106

(ii) On December 31, 1989, K takes delivery of the Sf100 and purchases the franc denominated debt instrument. Assume K satisfies the identification requirements of paragraph (a)(8) of this section. The purchase of the franc debt instrument (which constitutes a qualifying debt instrument under paragraph (a)(3) of this section) and the series of forward contracts (which constitute a hedge under paragraph (a)(4) of this section) are a qualified hedging transaction under paragraph (a)(1) of this section. Accordingly, the franc debt instrument and all the forward contracts are integrated and treated as one transaction with the following consequences:

(A) The integration of the franc debt instrument and the forward contracts results in a synthetic dollar debt instrument in an amount equal to the dollars exchanged under the forward contract to purchase the francs necessary to acquire the franc debt instrument. Accordingly, the issue price is $100.04 (section 1273(b)(2) of the Code).

(B) The total amount of interest and principal received by K with respect to the synthetic dollar debt instrument is equal to the dollars received under the forward sales contracts (i.e., $6.12 in 1990, $6.23 in 1991, and $112.16 in 1992).

(C) The synthetic dollar debt instrument is an installment obligation and its stated redemption price at maturity is $106.15 (i.e., $6.12 of the payments in 1990, 1991, and 1992 are treated as periodic interest payments under the principles of section 1273). Because the stated redemption price at maturity exceeds the issue price, under section 1273(a)(1) the synthetic dollar debt instrument has OID of $6.11.

(D) The yield to maturity of the synthetic dollar debt instrument is 8.00 percent, compounded annually. Assuming K is a calendar year taxpayer, it must include interest income of $8.00 in 1990 (of which $1.88 constitutes OID), $8.15 in 1991 (of which $2.03 constitutes OID), and $8.32 in 1992 (of which $2.20 constitutes OID). The amount of the final payment received by K in excess of the interest income includible is a return of principal and a payment of previously accrued OID.

(E) The source of the interest income shall be determined by applying sections 861(a)(1) and 862(a)(1) with reference to the franc interest income that would have been received had the transaction not been integrated.

Example 3. (i) K is an accrual method U.S. corporation with the U.S. dollar as its functional currency. On January 1, 1992, K borrows 100 British pounds (£) for 3 years at a 10% rate of interest payable on December 31 of each year with no principal payment due until the final installment. The spot rate on January 1, 1992, is £1 = $1.50. On January 1, 1993, when the spot rate is £1 = $1.60, K enters into a currency swap contract with an unrelated counterparty under the terms of which K will exchange dollars for pounds pursuant to the following table in order to obtain the pounds necessary to make the remaining payments on the pound borrowing:

Date	U.S. dollars	Pounds
December 31, 1993	12.80	10
December 31, 1994	12.80	10
December 31, 1994	160.00	100

(ii) Assume that British pound interest rates are still 10% and that K properly identifies the pound borrowing and the currency swap contract as a qualified hedging transaction as provided in paragraph (a)(8) of this section. Under paragraph (a)(6)(i) of this section, K must realize exchange gain or loss with respect to the pound borrowing determined solely by reference to changes in exchange rates between January 1, 1992 and January 1, 1993. (Thus, gain or loss from other factors such as movements in interest rates or changes in credit quality of K are not taken into account). Recognition of such gain or loss is deferred until K terminates its pound borrowing. Accordingly, K must defer exchange loss in the amount of $10 [(£100 × 1.50) − (£100 × 1.60)].

(iii) Additionally, the qualified hedging transaction is treated as a synthetic U.S. dollar debt instrument with an issue date of January 1, 1993, and a maturity date of December 31, 1994. The issue price of the synthetic debt instrument is $160 (£100 × 1.60, the spot rate on January 1, 1993) and the total amount of interest and principal is $185.60. The accrual period is the one year period beginning on January 1 and ending December 31 of each year. The stated redemption price at maturity is $160. Thus, K is treated as paying $12.80 of interest in 1993, $12.80 of interest in 1994, and $160 of principal in 1994. The interest expense from the synthetic instrument is allocated and apportioned in accordance with the rules of §§ 1.861–8T through 1.861–12T. Sections 263(g), 1092, and 1256 do not apply to the positions comprising the synthetic dollar borrowing.

Example 4. (i) K is an accrual method U.S. corporation with the U.S. dollar as its functional currency. On January 1, 2013, K borrows 100 British pounds (£) for 3 years at a 10% rate of interest payable on December 31 of each year with no principal payment due until the final installment. The spot rate on January 1, 2013, is £1 = $1.50. Also on January 1, 2013, K enters into a currency swap contract with an unrelated counterparty under the terms of which K will exchange dollars for pounds pursuant to the following table in order to obtain the pounds necessary to

make the remaining payments on the pound borrowing:

Date	U.S. dollars	Pounds
December 31, 2013	12.00	10
December 31, 2014	12.00	10
December 31, 2015	162.00	110

(ii) Assume that K properly identifies the pound borrowing and the currency swap contract as a qualified hedging transaction as provided in paragraph (a)(1) of this section.

(iii) The pound borrowing (which constitutes a qualifying debt instrument under paragraph (a)(3) of this section) and the currency swap contract (which constitutes a hedge under paragraph (a)(4) of this section) are a qualified hedging transaction as defined in paragraph (a)(1) of this section. Accordingly, the pound borrowing and the swap are integrated and treated as one transaction with the following consequences:

(A) The integration of the pound borrowing and the swap results in a synthetic dollar borrowing with an issue price of $150 under section 1273(b)(2).

(B) The total amount of interest and principal of the synthetic dollar borrowing is equal to the dollar payments made by K under the currency swap contract (i.e., $12 in 2013, $12 in 2014, and $162 in 2015).

(C) The stated redemption price at maturity (defined in section 1273(a)(2)) is $150. Because the stated redemption price equals the issue price, there is no OID on the synthetic dollar borrowing.

(D) K may deduct the annual interest payments of $12 under section 163(a) (subject to any limitations on deductibility imposed by other provisions of the Code) according to its regular method of accounting. K has also paid $150 as a return of principal in 2015.

(E) K must allocate and apportion its interest expense from the synthetic instrument under the rules of §§ 1.861–8T through 1.861–12T.

(iv) Assume that on January 1, 2014, the spot exchange rate is £1 = $1.60, interest rates have not changed since January 1, 2013, (accordingly, assume that the market value of K's bond in pounds has not changed) and that K transfers its rights and obligations under the currency swap contract in exchange for $10. Under § 1.988–2(e)(3)(iii), K will include in income as exchange gain $10 on January 1, 2014. Pursuant to paragraph (a)(6)(ii) of this section, the pound borrowing and the currency swap contract are treated as a qualified hedging transaction for 2013. The loss inherent in the pound borrowing from January 1, 2013, to January 1, 2014, is realized and recognized on January 1, 2014. Such loss is exchange loss in the amount of $10.00 [(£100 × $1.50, the spot rate on January 1, 2013) − (£100 × $1.60, the spot rate on January 1, 2014)]. For purposes of determining exchange gain or loss on the £100 principal amount of the debt instrument for the period January 1, 2014, to December 31, 2015, the spot rate on January 1, 2014 is used rather than the spot rate on the issue date. Thus, assuming that the spot rate on December 31, 2015, the maturity date, is £1 = $1.80, K realizes exchange loss in the amount of $20 [(£100 × $1.60) − (£100 × $1.80)]. Except as provided in paragraph (a)(8)(iii) (regarding identification by the Commissioner), the pound borrowing cannot be part of a qualified hedging transaction for any period subsequent to the leg out date.

Example 5. (i) K, a U.S. corporation, has the U.S. dollar as its functional currency. On January 1, 2013, when the spot rate for Swiss francs (Sf) is Sf1 = $.50, K converts $100 to Sf200 and purchases a franc denominated debt instrument. The instrument has a term of 3 years, an adjusted issue price of Sf200, and will bear interest at 5 percent, payable annually, with no repayment of principal until the final installment. The U.S. dollar interest rate on an equivalent instrument is 8% on January 1, 2013, compounded annually. On January 1, 2013, K also enters into a series of forward contracts to sell the franc interest and principal payments that will be received under the terms of the franc denominated debt instrument for dollars according to the following schedule:

Date	U.S. dollars	Francs
December 31, 2013	5.14	10
December 31, 2014	5.29	10
December 31, 2015	114.26	210

(ii) Assume K satisfies the identification requirements of paragraph (a)(8) of this section. Assume further that on January 1, 2014, the spot exchange rate is Sf1 = U.S.$.5143, the U.S. dollar interest rate is 10%, compounded annually, and the Swiss franc interest rate is the same as on January 1, 2013 (5%, compounded annually). On January 1, 2014, K disposes of the forward contracts that were to mature on December 31, 2014, and December 31, 2015 and incurs a loss of $3.62 (the present value of $.10 with respect to the 2014 contract and $4.27 with respect to the 2015 contract).

(iii) The purchase of the franc debt instrument (which constitutes a qualifying debt instrument under paragraph (a)(3) of this section) and the series of forward contracts (which constitute a hedge under paragraph (a)(4) of this section) are a qualified hedging transaction under paragraph (a)(1) of this section. Accordingly, the franc debt instrument and all the forward contracts are integrated for the period beginning January 1, 2013, and ending January 1, 2014.

(A) The integration of the franc debt instrument and the forward contracts results in a synthetic dollar debt instrument with an issue price of $100.

(B) The total amount of interest and principal to be received by K with respect to the synthetic dollar debt instrument is equal to

the dollars to be received under the forward sales contracts (i.e., $5.14 in 2013, $5.29 in 2014, and $114.26 in 2015).

(C) The synthetic dollar debt instrument is an installment obligation and its stated redemption price at maturity is $109.27 (i.e., $5.14 of the payments in 2013, 2014, and 2015 is treated as periodic interest payments under the principles of section 1273). Because the stated redemption price at maturity exceeds the issue price, under section 1273(a)(1) the synthetic dollar debt instrument has OID of $9.27.

(D) The yield to maturity of the synthetic dollar debt instrument is 8.00 percent, compounded annually. Assuming K is a calendar year taxpayer, it must include interest income of $8.00 in 2013 (of which $2.86 constitutes OID).

(E) The source of the interest income is determined by applying sections 861(a)(1) and 862(a)(1) with reference to the franc interest income that would have been received had the transaction not been integrated.

(iv) Because K disposed of the forward contracts on January 1, 2014, the rules of paragraph (a)(6)(ii) of this section shall apply. Accordingly, the $3.62 loss from the disposition of the forward contracts is realized and recognized on January 1, 2014. Additionally, K is deemed to have sold the franc debt instrument for $102.86, its fair market value in dollars on January 1, 2014. K will compute gain or loss with respect to the deemed sale of the franc debt instrument by subtracting its adjusted basis in the instrument ($102.86—the value of the Sf200 issue price at the spot rate on the identification date plus $2.86 of original issue discount accrued on the synthetic dollar debt instrument for 2013) from the amount realized on the deemed sale of $102.86. Thus K realizes and recognizes no gain or loss from the deemed sale of the debt instrument. The dollar amount used to determine exchange gain or loss with respect to the franc debt instrument is the Sf200 issue price on January 1, 2014, translated into dollars at the spot rate on January 1, 2014, of Sf1 = U.S.$.5143. Except as provided in paragraph (a)(8)(iii) of this section (regarding identification by the Commissioner), the franc borrowing cannot be part of a qualified hedging transaction for any period subsequent to the leg out date.

Example 6. (i) K is a U.S. corporation with the dollar as its functional currency. On January 1, 1992, K issues a debt instrument with the following terms: the issue price is $1,000, the instrument pays interest annually at a rate of 8% on the $1,000 principal amount, the instrument matures on December 31, 1996, and the amount paid at maturity is the greater of zero or $2,000 less the U.S. dollar value (determined on December 31, 1996) of 150,000 Japanese yen.

(ii) Also on January 1, 1992, K enters into the following hedges with respect to the instrument described in the preceding paragraph: a forward contract under which K will sell 150,000 yen for $1,000 on December 31, 1996 (note that this forward rate assumes that interest rates in yen and dollars are equal); and an option contract that expires on December 31, 1996, under which K has the right (but not the obligation) to acquire 150,000 yen for $2,000. K will pay for the option by making payments to the writer of the option equal to $5 each December 31 from 1992 through 1996.

(iii) The net economic effect of these transactions is that K has created a liability with a principal amount and amount paid at maturity of $1,000, with an interest cost of 8.5% (8% on debt instrument, 0.5% option price) compounded annually. For example, if on December 31, 1996, the spot exchange rate is $1 = 100 yen, K pays $500 on the bond [$2,000 − (150,000 yen/$100)], and $500 in satisfaction of the forward contract [$1,000 − (150,000 yen/$100)]. If instead the spot exchange rate on December 31, 1996 is $1 = 200 yen, K pays $1,250 on the bond [$2,000 − (150,000 yen/$200)] and K receives $250 in satisfaction of the forward contract [$1,000 − (150,000 yen/$200)]. Finally, if the spot exchange rate on December 31, 1996 is $1 = 50 yen, K pays $0 on the bond [$2,000 − (150,000 yen/$50), but the bond holder is not required under the terms of the instrument to pay additional principal]; K exercises the option to buy 150,000 yen for $2,000; and K then delivers the 150,000 yen as required by the forward contract in exchange for $1,000.

(iv) Assume K satisfies the identification requirements of paragraph (a)(8) of this section. The debt instrument described in paragraph (i) of this *Example 6* (which constitutes a qualifying debt instrument under paragraph (a)(3) of this section) and the forward contract and option contract described in paragraph (ii) of this example (which constitute a hedge under paragraph (a)(4) of this section and are collectively referred to hereafter as ''the contracts'') together are a qualified hedging transaction under paragraph (a)(1) of this section. Accordingly, with respect to K, the debt instrument and the contracts are integrated, resulting in a synthetic dollar debt instrument with an issue price of $1000, a stated redemption price at maturity of $1000 and a yield to maturity of 8.5% compounded annually (with no original issue discount). K must allocate and apportion its annual interest expense of $85 under the rules of §§1.861–8T through 1.861–12T.

Example 7. (i) R is a U.S. corporation with the dollar as its functional currency. On January 1, 1995, R issues a debt instrument with the following terms: the issue price is 504 British pounds (£), the instrument pays interest at a rate of 3.7% (compounded semiannually) on the £504 principal amount, the instrument matures on December 31, 1999,

with a repayment at maturity of the £504 principal plus the proportional gain, if any, in the ''Financial Times'' 100 Stock Exchange (FTSE) index (determined by the excess of the value of the FTSE index on the maturity date over the value of the FTSE on the issue date, divided by the value of the FTSE index on the issue date, multiplied by the number of FTSE index contracts that could be purchased on the issue date for £504).

(ii) Also on January 1, 1995, R enters into a contract with a bank under which on January 1, 1995, R will swap the £504 for $1,000 (at the current spot rate). R will make U.S. dollar payments to the bank equal to 8.15% on the notional principal amount of $1,000 (compounded semi-annually) for the period beginning January 1, 1995 and ending December 31, 1999. R will receive pound payments from the bank equal to 3.7% on the notional principal amount of £504 (compounded semi-annually) for the period beginning January 1, 1995 and ending December 31, 1999. On December 31, 1999, R will swap with the bank $1,000 for £504 plus the proportional gain, if any, in the FTSE index (computed as provided above).

(iii) Economically, both the indexed debt instrument and the hedging contract are hybrid instruments with the following components. The indexed debt instrument is composed of a par pound debt instrument that is assumed to have a 10.85% coupon (compounded semi-annually) plus an embedded FTSE equity index option for which the investor pays a premium of 7.15% (amortized semi-annually) on the pound principal amount. The combined effect is that the premium paid by the investor partially offsets the coupon payments resulting in a return of 3.7% (10.85% − 7.15%). Similarly, the dollar payments under the hedging contract to be made by R are computed by multiplying the dollar notional principal amount by an 8.00% rate (compounded semi-annually) which the facts assume would be the rate paid on a conventional currency swap plus a premium of 0.15% (amortized semi-annually) on the dollar notional principal amount for an embedded FTSE equity index option.

(iv) Assume R satisfies the identification requirements of paragraph (a)(8) of this section. The indexed debt instrument described in paragraph (i) of this *Example 7* constitutes a qualifying debt instrument under paragraph (a)(3) of this section. The hedging contract described in paragraph (ii) of this *Example 7* constitutes a hedge under paragraph (a)(4) of this section. Since both the pound exposure of the indexed debt instrument and the exposure to movements of the FTSE embedded in the indexed debt instrument are hedged such that a yield to maturity can be determined in dollars, the transaction satisfies the requirement of paragraph (a)(5)(i) of this section. Assuming the transactions satisfy the other requirements of paragraph (a)(5) of this section, the indexed debt instrument and hedge are a qualified hedging transaction under paragraph (a)(1) of this section. Accordingly, with respect to R, the debt instrument and the contracts are integrated, resulting in a synthetic dollar debt instrument with an issue price of $1000, a stated redemption price at maturity of $1000 and a yield to maturity of 8.15% compounded semi-annually (with no original issue discount). K must allocate and apportion its interest expense from the synthetic instrument under the rules §§1.861–8T through 1.861–12T.

Example 8. (i) K is a U.S. corporation with the U.S. dollar as its functional currency. On December 24, 1992, K agrees to close the following transaction on December 31, 1992. K will borrow from an unrelated party on December 31, 1992, 200 British pounds (£) for 3 years at a 10 percent rate of interest, payable annually, with no principal payment due until the final installment. K will also enter into a currency swap contract with an unrelated counterparty under the terms of which—

(A) K will swap, on December 31, 1992, £100 obtained from the borrowing for $100; and

(B) K will exchange dollars for pounds pursuant to the following table:

Date	U.S. dollars	Pounds
December 31, 1993	8	10
December 31, 1994	8	10
December 31, 1995	108	110

(ii) The interest rate on the borrowing is set and the exchange rates on the swap are fixed on December 24, 1992. On December 31, 1992, K borrows the £200 and swaps £100 for $100. Assume K has satisfied the identification requirements of paragraph (a)(8) of this section.

(iii) The £200 debt instrument satisfies the requirements of paragraph (a)(3)(i) of this section. Because all principal and interest payments under the instrument are hedged in the same proportion (50% of all interest and principal payments are hedged), 50% of the payments under the £200 instrument (principal amount of £100 and annual interest of £10) are treated as a qualifying debt instrument for purposes of paragraph (a) of this section. Thus, the distinct £100 borrowing and the currency swap contract (which constitutes a hedge under paragraph (a)(4) of this section) are a qualified hedging transaction as defined in paragraph (a)(1) of this section. Accordingly, £100 of the pound borrowing and the swap are integrated and treated as one synthetic dollar transaction with the following consequences:

(A) The integration of £100 of the pound borrowing and the swap results in a synthetic dollar borrowing with an issue price of $100 under section 1273(b)(2).

(B) The total amount of interest and principal of the synthetic dollar borrowing is equal to the dollar payments made by K under the currency swap contract (i.e., $8 in 1993, $8 in 1994, and $108 in 1995).

(C) The stated redemption price at maturity (defined in section 1273(a)(2)) is $100. Because the stated redemption price equals the issue price, there is no OID on the synthetic dollar borrowing.

(D) K may deduct the annual interest payments of $8 under section 163(a) (subject to any limitations on deductibility imposed by other provisions of the Code) according to its regular method of accounting. K has also paid $100 as a return of principal in 1995.

(E) K must allocate and apportion its interest expense from the synthetic instrument under the rules of §§1.861–8T through 1.861–12T.

That portion of the £200 pound debt instrument that is not hedged (*i.e.*, £100) is treated as a separate debt instrument subject to the rules of §1.988–2 (b) and §§1.861–8T through 1.861–12T.

Example 9. (i) K is an accrual method U.S. corporation with the U.S. dollar as its functional currency. On January 1, 1992, K borrows 100 British pounds (£) for 3 years at a 10% rate of interest payable on December 31 of each year with no principal payment due until the final installment. On the same day, K enters into a currency swap agreement with an unrelated bank under which K agrees to the following:

(A) On January 1, 1992, K will exchange the £100 borrowed for $150.

(B) For the period beginning January 1, 1992 and ending December 31, 1994, K will pay at the end of each month an amount determined by multiplying $150 by one month LIBOR less 65 basis points and receive from the bank on December 31st of 1992, 1993, and 1994, £10.

(C) On December 31, 1994, K will exchange $150 for £100.

Assume K satisfies the identification requirements of paragraph (a)(8) of this section.

(ii) The pound borrowing (which constitutes a qualifying debt instrument under paragraph (a)(3) of this section) and the currency swap contract (which constitutes a hedge under paragraph (a)(4) of this section) are a qualified hedging transaction as defined in paragraph (a)(1) of this section. Accordingly, the pound borrowing and the swap are integrated and treated as one transaction with the following consequences:

(A) The integration of the pound borrowing and the swap results in a synthetic dollar borrowing with an issue price of $150 under section 1273(b)(2).

(B) The total amount of interest and principal of the synthetic dollar borrowing is equal to the dollar payments made by K under the currency swap contract.

(C) The stated redemption price at maturity (defined in section 1273(a)(2)) is $150. Because the stated redemption price equals the issue price, there is no OID on the synthetic dollar borrowing.

(D) K may deduct the monthly variable interest payments under section 163(a) (subject to any limitations on deductibility imposed by other provisions of the Code) according to its regular method of accounting. K has also paid $150 as a return of principal in 1994.

(E) K must allocate and apportion its interest expense from the synthetic instrument under the rules of §§1.861–8T through 1.861–12T.

Example 10. (i) K is an accrual method U.S. corporation with the U.S. dollar as its functional currency. On January 1, 1992, K loans 100 British pounds (£) for 3 years at a 10% rate of interest payable on December 31 of each year with no principal payment due until the final installment. The spot rate on January 1, 1992, is £1 = $1.50. Also on January 1, 1992, K enters into a currency swap contract with an unrelated counterparty under the terms of which K will exchange pounds for dollars pursuant to the following table:

Date	Pounds	Dollars
December 31, 1992	10	12
December 31, 1993	10	12
December 31, 1994	110	162

(ii) Assume that K properly identifies the pound borrowing and the currency swap contract as a qualified hedging transaction as provided in paragraph (a)(1) of this section.

(iii) The pound loan (which constitutes a qualifying debt instrument under paragraph (a)(3) of this section) and the currency swap contract (which constitutes a hedge under paragraph (a)(4) of this section) are a qualified hedging transaction as defined in paragraph (a)(1) of this section. Accordingly, the pound loan and the swap are integrated and treated as one transaction with the following consequences:

(A) The integration of the pound loan and the swap results in a synthetic dollar loan with an issue price of $150 under section 1273(b)(2).

(B) The total amount of interest and principal of the synthetic dollar loan is equal to the dollar payments received by K under the currency swap contract (i.e., $12 in 1992, $12 in 1993, and $162 in 1994).

(C) The stated redemption price at maturity (defined in section 1273(a)(2)) is $150. Because the stated redemption price equals the issue price, there is no OID on the synthetic dollar loan.

(D) K must include in income as interest $12 in 1992, 1993, and 1994.

(E) The source of the interest income shall be determined by applying sections 861(a)(1)

and 862(a)(1) with reference to the pound interest income that would have been received had the transaction not been integrated.

(iv) On January 1, 1993, K transfers both the pound loan and the currency swap to B, its wholly owned U.S. subsidiary, in exchange for B stock in a transfer that satisfies the requirements of section 351. Under paragraph (a)(6) of this section, the transfer of both instruments is not ''legging out.'' Rather, K is considered to have transferred the synthetic dollar loan to B in a transaction in which gain or loss is not recognized. B's basis in the loan under section 362 is $100.

Example 11. (i) K is a domestic corporation with the U.S. dollar as its functional currency. On January 1, 2013, K borrows 100 British pounds (£) for two years at a 10% rate of interest payable on December 31 of each year with no principal payment due until maturity on December 31, 2014. Assume that the spot rate on January 1, 2013, is £1=$1. On the same date, K enters into two swap contracts with an unrelated counterparty that economically results in the transformation of the fixed rate £100 borrowing to a floating rate dollar borrowing. The terms of the swaps are as follows:

(A) *Swap #1, Currency swap.* On January 1, 2013, K will exchange £100 for $100.

(*1*) On December 31 of both 2013 and 2014, K will exchange $8 for £10;

(*2*) On December 31, 2014, K will exchange $100 for £100.

(B) *Swap #2, Interest rate swap.* On December 31 of both 2013 and 2014, K will pay LIBOR times a notional principal amount of $100 and will receive 8% times the same $100 notional principal amount.

(ii) Assume that K properly identifies the pound borrowing and the swap contracts as a qualified hedging transaction as provided in paragraph (a)(8)(i) of this section and that the other relevant requirements of paragraph (a) of this section are satisfied.

(iii) On January 1, 2014, the spot exchange rate is £1=$2; the U.S. dollar LIBOR rate of interest is 9%; the market value of K's note in pounds has not changed; and K terminates swap #2. Because interest rates have increased from 8% to 9%, K will incur a loss of ($.92) (the present value of the ($1) difference between the 8% and 9% interest payments discounted at the current interest rate of 9%) with respect to the termination of such swap on January 1, 2014. Pursuant to paragraph (a)(6)(ii)(C) of this section, K must treat swap #1 as having been sold for its fair market value on the leg-out date, which is the date swap #2 is terminated. K must realize and recognize gain of $100.92 (the present value of £110 discounted in pounds to equal £100 × $2 ($200) less the present value of $108 ($99.08)). The loss inherent in the pound borrowing from January 1, 2013 to January 1, 2014 is realized and recognized on January 1, 2014. Such loss is exchange loss in the amount of $100 (the present value of £110 that was to be paid at the end of the year discounted at pound interest rates to equal £100 times the change in exchange rates: (£100 × $1, the spot rate on January 1, 2013) − (£100 × $2, the spot rate on January 1, 2014)). Pursuant to paragraph (a)(6)(ii)(E) of this section, except as provided in paragraph (a)(8)(iii) of this section (regarding identification by the Commissioner), the pound borrowing and currency swap cannot be part of a qualified hedging transaction for any period after the leg-out date.

(iv) Assume the facts are the same as in paragraph (iii) of this *Example* except that on January 1, 2014, the U.S. dollar LIBOR rate of interest is 7% rather than 9%. When K terminates swap #2, K will realize gain of $0.93 (the present value of the ($1) difference between the 8% and 7% interest payments discounted at the current interest rate of 7%) received with respect to the termination on January 1, 2014. Fifty percent or more of the remaining pound cash flow of the pound borrowing remains hedged after the termination of swap #2. Accordingly, under paragraph (a)(6)(ii)(F) of this section, paragraphs (a)(6)(ii)(B) and (C) of this section do not apply, and the gain on swap #1 and the loss on the qualifying debt instrument are not taken into account. Thus, K will include in income $0.93 realized from the termination of swap #2.

(10) *Transition rules and effective dates for certain provisions*—(i) *Coordination with Notice 87–11.* Any transaction entered into prior to September 21, 1989, which satisfied the requirements of Notice 87–11, 1987–1 C.B. 423, shall be deemed to satisfy the requirements of paragraph (a) of this section.

(ii) *Prospective application to contingent payment debt instruments.* In the case of a contingent payment debt instrument, the definition of qualifying debt instrument set forth in paragraph (a)(3)(i) of this section applies to transactions entered into after March 17, 1992.

(iii) *Prospective application of partial hedging rule.* Paragraph (a)(3)(ii) of this section is effective for transactions entered into after March 17, 1992.

(iv) *Effective/applicability dates for legging in and legging out rules.* (A) The rules of paragraph (a)(6)(i) of this section are effective for qualified hedging transactions that are legged into after March 17, 1992.

(B) The rules of paragraph (a)(6)(ii) and *Example 11* of paragraph (a)(9)(iv) of

this section apply to leg-outs that occur on or after September 6, 2012.

(b) *Hedged executory contracts*—(1) *In general.* If the taxpayer enters into a hedged executory contract as defined in paragraph (b)(2) of this section, the executory contract and the hedge shall be integrated as provided in paragraph (b)(4) of this section.

(2) *Definitions*—(i) *Hedged executory contract.* 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.

(ii) *Executory contract*—(A) *In general.* Except as provided in paragraph (b)(2)(ii)(B) of this section, 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. Notwithstanding the preceding sentence, a contract to buy or sell stock shall be considered an executory contract. (Thus, for example, a contract to sell stock of an affiliate is an executory contract for this purpose.) On the accrual date, such agreement ceases to be considered an executory contract and is treated as an account payable or receivable.

(B) *Exceptions.* An executory contract does not include a section 988 transaction. For example, a forward contract to purchase nonfunctional currency is not an executory contract. An executory contract also does not include a transaction described in paragraph (c) of this section.

(C) *Effective date for contracts to buy or sell stock.* That part of paragraph (b)(2)(ii)(A) of this section which provides that a contract to buy or sell stock shall be considered an executory contract applies to contracts to buy or sell stock entered into on or after March 17, 1992.

(iii) *Hedge*—(A) *In general.* For purposes of this paragraph (b), the term hedge means a deposit of nonfunctional

currency in a hedging account (as defined paragraph (b)(3)(iii)(D) of this section), 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. The term hedge also includes an option contract described in §1.988–1(a)(1)(ii) and (2)(iii), but only if the option's expiration date is on or before the accrual date. The premium paid for an option that lapses shall be integrated with the executory contract.

(B) *Special rule for series of hedges.* A series of hedges as defined in paragraph (b)(3)(iii)(A) of this section 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.

(C) *Special rules for historical rate rollovers—(1) Definition.* A historical rate rollover is an extension of the maturity date of a forward contract where the new forward rate is adjusted on the rollover date to reflect the taxpayer's gain or loss on the contract as of the rollover date plus the time value of such gain or loss through the new maturity date.

(*2*) *Certain historical rate rollovers considered a hedge.* A historical rate rollover is considered a hedge if the rollover date is before the accrual date.

(*3*) *Treatment of time value component of certain historical rate rollovers that are hedges.* Interest income or expense determined under §1.988–2(d)(2)(v) with respect to a historical rate rollover shall be considered part of a hedge if the period beginning on the first date a hedging contract is rolled over and ending on the date payment is made or received under the executory contract does not exceed 183 days. Such interest income or expense shall not be recognized and shall be an adjustment to the income from, or expense of, the services performed or received under the executory contract, or to the amount realized or basis of the property sold or purchased under the executory contract. For the treatment of such interest income or expense that is not considered part of a hedge, see §1.988–2(d)(2)(v).

(D) *Special rules regarding deposits of nonfunctional currency in a hedging account.* A hedging account is an account with a bank or other financial institution used exclusively for deposits of nonfunctional currency used to hedge executory contracts. For purposes of determining the basis of units in such account that comprise the hedge, only those units in the account as of the accrual date shall be taken into consideration. A taxpayer may adopt any reasonable convention (consistently applied to all hedging accounts) to determine which units comprise the hedge as of the accrual date and the basis of the units as of such date.

(E) *Interest income on deposit of nonfunctional currency in a hedging account.* Interest income on a deposit of nonfunctional currency in a hedging account may be taken into account for purposes of determining the amount of a hedge if such interest is accrued on or before the accrual date. However, such interest income shall be included in income as provided in section 61. For example, if a taxpayer with the dollar as its functional currency enters into an executory contract for the purchase and delivery of a machine in one year for 100 British pounds (£), and on such date deposits £90.91 in a properly identified bank account that bears interest at the rate of 10%, the interest that accrues prior to the accrual date shall be included in income and may be considered a hedge.

(iv) *Accrual date.* The accrual date is the date when the item of income or expense (including a capital expenditure) that relates to an executory contract is required to be accrued under the taxpayer's method of accounting.

(v) *Payment date.* The payment date is the date when payment is made or received with respect to an executory

contract or the subsequent corresponding account payable or receivable.

(3) *Identification rules*—(i) *Identification by the taxpayer.* 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.

(ii) *Identification by the Commissioner.* If a taxpayer enters into an executory contract and a hedge but fails to satisfy one or more of the requirements of paragraph (b) of this section and, based on the facts and circumstances, the Commissioner concludes that the executory contract in substance is hedged, then the Commissioner may apply the provisions of paragraph (b) of this section as if the taxpayer had satisfied all of the requirements therein, and may make appropriate adjustments. The Commissioner may apply the provisions of paragraph (b) of this section regardless of whether the executory contract and the hedge are held by the same taxpayer.

(4) *Effect of hedged executory contract*—(i) *In general.* If a taxpayer enters into a hedged executory contract, amounts paid or received under the hedge by the taxpayer are treated as paid or received by the taxpayer under the executory contract, or any subsequent account payable or receivable, or that portion to which the hedge relates. Also, the taxpayer recognizes no exchange gain or loss on the hedge. If an executory contract, on the accrual date, becomes an account payable or receivable, the taxpayer recognizes no exchange gain or loss on such payable or receivable for the period covered by the hedge.

(ii) *Partially hedged executory contracts.* The effect of integrating an executory contract and a hedge that partially hedges such contract is to treat the amounts paid or received under the hedge as paid or received under the portion of the executory contract being hedged, or any subsequent account payable or receivable. The income or expense of services performed or received under the executory contract, or the amount realized or basis of property sold or purchased under the executory contract, that is attributable to that portion of the executory contract that is not hedged shall be translated into functional currency on the accrual date. Exchange gain or loss shall be realized when payment is made or received with respect to any payable or receivable arising on the accrual date with respect to such unhedged amount.

(iii) *Disposition of a hedge or executory contract prior to the accrual date*—(A) *In general.* If a taxpayer identifies an executory contract as part of a hedged executory contract as defined in paragraph (b)(2) of this section, and disposes of (or otherwise terminates) the executory contract prior to the accrual date, the hedge shall be treated as sold for its fair market value on the date the executory contract is disposed of and any gain or loss shall be realized and recognized on such date. Such gain or loss shall be an adjustment to the amount received or expended with respect to the disposition or termination, if any. The spot rate on the date the hedge is treated as sold shall be used to determine subsequent exchange gain or loss on the hedge. If a taxpayer identifies a hedge as part of a hedged executory contract as defined in paragraph (b)(2) of this section, and disposes of the hedge prior to the accrual date, any gain or loss realized on such disposition shall not be recognized and shall be an adjustment to the income from, or expense of, the services performed or received under the executory contract, or to the amount realized or basis of the property sold or purchased under the executory contract.

(B) *Certain events in a series of hedges treated as a termination of the hedged executory contract.* If the rules of paragraph (b)(2)(iii)(B) of this section are not satisfied, the hedged executory contract shall be terminated and the provisions of paragraph (b)(4)(iii)(A) of this section shall apply to any gain or loss previously realized with respect to such hedge. Any subsequent hedging contracts entered into to reduce the risk of exchange rate movements with respect to such executory contract shall not be considered a hedge as defined in paragraph (b)(2)(iii) of this section.

(C) *Executory contracts between related persons.* If an executory contract is between related persons as defined in sections 267(b) and 707(b), and the taxpayer disposes of the hedge or terminates the executory contract prior to the accrual date, the Commissioner may redetermine the timing, source, and character of gain or loss from the hedge or the executory contract if he determines that a significant purpose for disposing of the hedge or terminating the executory contract prior to the accrual date was to affect the timing, source, or character of income, gain, expense, or loss for Federal income tax purposes.

(iv) *Disposition of a hedge on or after the accrual date.* If a taxpayer identifies a hedge as part of a hedged executory contract as defined in paragraph (b)(2) of this section, and disposes of the hedge on or after the accrual date, no gain or loss is recognized on the hedge and the booking date as defined in §1.988–2(c)(2) of the payable or receivable for purposes of computing exchange gain or loss shall be the date such hedge is disposed of. See *Example 3* of paragraph (b)(4)(iv) of this section.

(v) *Sections 263(g), 1092, and 1256 do not apply.* Sections 263(g), 1092, and 1256 do not apply with respect to an executory contract or hedge which comprise a hedged executory contract as defined in paragraph (b)(2) of this section. However, sections 263(g), 1092 and 1256 may apply to the hedged executory contract if such transaction is part of a straddle.

(vi) *Examples.* The principles set forth in paragraph (b) of this section are illustrated in the following examples. The examples assume that K is an accrual method, calendar year U.S. corporation with the dollar as its functional currency.

Example 1. (i) On January 1, 1992, K enters into a contract with JPF, a Swiss machine manufacturer, to pay 500,000 Swiss francs for delivery of a machine on June 1, 1993. Also on January 1, 1992, K enters into a foreign currency forward agreement to purchase 500,000 Swiss francs for $250,000 for delivery on June 1, 1993. K properly identifies the executory contract and the hedge in accordance with paragraph (b)(3)(i) of this section. On June 1, 1993, K takes delivery of the 500,000 Swiss francs (in exchange for $250,000) under the forward contract and makes payment of 500,000 Swiss francs to JPF in exchange for the machine. Assume that the accrual date is June 1, 1993.

(ii) Under paragraph (b)(1) of this section, the hedge is integrated with the executory contract. Therefore, K is deemed to have paid $250,000 for the machine and there is no exchange gain or loss on the foreign currency forward contract. K's basis in the machine is $250,000. Section 1256 does not apply to the forward contract.

Example 2. (i) On January 1, 1992, K enters into a contract with S, a Swiss machine manufacturer, to pay 500,000 Swiss francs for delivery of a machine on June 1, 1993. Under the contract, K is not obligated to pay for the machine until September 1, 1993. On February 1, 1992, K enters into a foreign currency forward agreement to purchase 500,000 Swiss francs for $250,000 for delivery on September 1, 1993. K properly identifies the executory contract and the hedge in accordance with paragraph (b)(3) of this section. On June 1, 1993, K takes delivery of machine. Assume that under K's method of accounting the delivery date is the accrual date. On September 1, 1993, K takes delivery of the 500,000 Swiss francs (in exchange for $250,000) under the forward contract and makes payment of 500,000 Swiss francs to S.

(ii) Under paragraph (b)(1) of this section, the hedge is integrated with the executory contract. Therefore K is deemed to have paid $250,000 for the machine and there is no exchange gain or loss on the foreign currency forward contract. Thus K's basis in the machine is $250,000. In addition, no exchange gain or loss is recognized on the payable in existence from June 1, 1993, to September 1, 1993. Section 1256 does not apply to the forward contract.

Example 3. The facts are the same as in *Example 2* except that K disposed of the forward contract on August 1, 1993 for $10,000. Pursuant to paragraph (b)(4)(iv) of this section, K does not recognize the $10,000 gain. K's basis in the machine is $250,000 (the amount fixed by the forward contract), regardless of the amount in dollars that K actually pays to acquire the Sf500,000 when K pays for the machine. K has a payable with a booking date of August 1, 1993, payable on September 1, 1993 for 500,000 Swiss francs. Thus, K will realize exchange gain or loss on the difference between the amount booked on August 1, 1993 and the amount paid on September 1, 1993 under §1.988–2(c).

Example 4. (i) On January 1, 1992, K enters into a contract with S, a Swiss machine repair firm, to pay 500,000 Swiss francs for repairs to be performed on June 1, 1992. Under the contract, K is not obligated to pay for the repairs until September 1, 1992. On February 1, 1992, K enters into a foreign currency forward agreement to purchase 500,000

Swiss francs for $250,000 for delivery on August 1, 1992. K properly identifies the executory contract and the hedge in accordance with paragraph (b)(3) of this section. On June 1, 1992, S performs the repair services. Assume that under K's method of accounting this date is the accrual date. On August 1, 1992, K takes delivery of the 500,000 Swiss francs (in exchange for $250,000) under the forward contract. On the same day, K deposits the Sf500,000 in a separate account with a bank and properly identifies the transaction as a continuation of the hedged executory contract. On September 1, 1992, K makes payment of the Sf500,000 in the account to S.

(ii) Under paragraph (b)(1) of this section, the hedge is integrated with the executory contract. Therefore K is deemed to have paid $250,000 for the services and there is no exchange gain or loss on the foreign currency forward contract or on the disposition of Sf500,000 in the account. Any interest on the Swiss francs in the account is included in income but is not considered part of the hedge (because the amount paid for the services must be set on or before the accrual date). In addition, no exchange gain or loss is recognized on the payable in existence from June 1, 1992, to September 1, 1992. Section 1256 does not apply to the forward contract.

Example 5. (i) On January 1, 1992, K enters into a contract with S, a Swiss machine manufacturer, to pay 500,000 Swiss francs for delivery of a machine on June 1, 1993. Under the contract, K is not obligated to pay for the machine until September 1, 1993. On February 1, 1992, K enters into a foreign currency forward agreement to purchase 250,000 Swiss francs for $125,000 for delivery on September 1, 1993. K properly identifies the executory contract and the hedge in accordance with paragraph (b)(3) of this section. On June 1, 1993, K takes delivery of the machine. Assume that under K's method of accounting the delivery date is the accrual date. Assume further that the exchange rate is Sf1 = $.50 on June 1, 1993. On August 30, 1993, K purchases Sf250,000 for $135,000. On September 1, 1993, K takes delivery of the 250,000 Swiss francs (in exchange for $125,000) under the forward contract and makes payment of 500,000 Swiss francs (the Sf250,000 received under the contract plus the Sf250,000 purchased on August 30, 1993) to S. Assume the spot rate on September 1, 1993, is 1 Sf = $.5420 (Sf250,000 equal $135,500).

(ii) Under paragraph (b)(1) of this section, the partial hedge is integrated with the executory contract. K is deemed to have paid $250,000 for the machine [$125,000 on the hedged portion of the Sf500,000 and $125,000 ($.50, the spot rate on June 1, 1993, times Sf250,000) on the unhedged portion of the Sf500,000]. K's basis in the machine therefore is $250,000. K recognizes no exchange gain or loss on the foreign currency forward contract but K will realize exchange gain of $500 on the disposition of the Sf250,000 purchased on August 30, 1993 under §1.988–2(a). In addition, exchange loss is realized on the unhedged portion of the payable in existence from June 1, 1993, to September 1, 1993. Thus, K will realize exchange loss of $10,500 ($125,000 booked less $135,500 paid) under §1.988–2(c) on the payable. Section 1256 does not apply to the forward contract.

Example 6. (i) On January 1, 1990, K enters into a contract with S, a Swiss steel manufacturer, to buy steel for 1,000,000 Swiss francs (Sf) for delivery and payment on December 31, 1990. On January 1, 1990, the spot rate is Sf1 = $.50, the U.S. dollar interest rate is 10% compounded annually, and the Swiss franc rate is 5% compounded annually. Under K's method of accounting, the delivery date is the accrual date.

(ii) Assume that on January 1, 1990, K enters into a foreign currency forward contract to buy Sf1,000,000 for $523,800 for delivery on December 31, 1990. K properly identifies the executory contract and the hedge in accordance with paragraph (b)(3) of this section. Pursuant to paragraph (b)(2)(iii) of this section, the forward contract constitutes a hedge. Assuming that the requirements of paragraph (b)(2)(i) of this section are satisfied, the executory contract to buy steel and the forward contract are integrated under paragraph (b)(1) of this section. Thus, K is deemed to have paid $523,800 for the steel and will have a basis in the steel of $523,800. No gain or loss is realized with respect to the forward contract and section 1256 does not apply to such contract.

(iii) Assume instead that on January 1, 1990, K enters into a foreign currency forward contract to buy Sf1,000,000 for $512,200 for delivery on July 1, 1990. K properly identifies the executory contract and the hedge in accordance with paragraph (b)(3) of this section. On July 1, 1990, when the spot rate is Sf1 = $.53, K cancels the forward contract in exchange for $17,800 ($530,000 − $512,200). On July 1, 1990, K enters into a second forward agreement to buy Sf1,000,000 for $542,900 for delivery on December 31, 1990. K properly identifies the second forward agreement as a hedge in accordance with paragraph (b)(3) of this section. Pursuant to paragraph (b)(2)(iii) of this section, the forward contract entered into on January 1, 1990, and the forward contract entered into on July 1, 1990, constitute a hedge. Assuming that the requirements of paragraph (b)(2)(i) of this section are satisfied, the executory contract to buy steel and the forward agreements are integrated under paragraph (b)(1) of this section. Thus, K is deemed to have paid $525,100 for the steel (the forward price in the second forward agreement of $542,900 less the gain on the first forward agreement of $17,800) and will have a basis in the steel of $525,100. No gain

is realized with respect to the forward contracts and section 1256 does not apply to such contracts.

(iv) Assume instead that on January 1, 1990, K enters into a foreign currency forward contract to buy Sf1,000,000 for $512,200 for delivery on July 1, 1990. K properly identifies the executory contract and the hedge in accordance with paragraph (b)(3) of this section. On July 1, 1990, when the spot rate is Sf1 = $.53, K enters into a historical rate rollover of its $17,800 gain ($530,000 − $512,200) on the forward agreement. Thus, K enters into a second foreign currency forward agreement to buy Sf1,000,000 for $524,210 for delivery on December 31, 1990. (The forward price of $524,210 is the market forward price on July 1, 1990, for the purchase of Sf1,000,000 for delivery on December 31, 1990, of $542,900 less the $17,800 gain on January 1, 1990, contract and less the time value of such gain of $890.) K properly identifies the second forward agreement as a hedge in accordance with paragraph (b)(3) of this section. On December 31, 1990, when the spot rate is Sf1 = $.54, K takes delivery of the Sf1,000,000 (in exchange for $524,210) and purchases the steel for Sf1,000,000. Pursuant to paragraph (b)(2)(iii) of this section, the forward contract entered into on January 1, 1990, and the forward contract entered into on July 1, 1990, which incorporates the rollover of K's gain on the January 1, 1990, contract, constitute a hedge. Assuming that the requirements of paragraph (b)(2)(i) of this section are satisfied, the executory contract to buy steel and the forward agreements are integrated under paragraph (b)(1) of this section. Because the period from the rollover date to the date payment is made under the executory contract does not exceed 183 days, the $890 of interest income is considered part of the hedge and is not recognized. Thus, K is deemed to have paid $524,210 for the steel and will have a basis in the steel of $524,210. No gain is realized with respect to the forward contracts and section 1256 does not apply to such contracts.

(v) Assume instead that on January 1, 1990, K purchases Sf952,380.95 (the present value of Sf1,000,000 to be paid on December 31, 1990) for $476,190.48 and on the same day deposits the Swiss francs in a separate bank account that bears interest at a rate of 5%, compounded annually. K properly identifies the transaction as a hedged executory contract. Over the period beginning January 1, 1990, and ending December 31, 1990, K receives Sf47,619.05 in interest on the account that is included in income and that has a basis of $25,714.29. (Assume that under §1.988–2(b)(1), K uses the spot rate of Sf1 = $.54 to translate the interest income). On December 31, 1990, K makes payment of the Sf1,000,000 principal and accrued interest in the account to S. Pursuant to paragraph (b)(2)(iii) of this section, the principal in the bank account and the interest constitute a hedge. Under paragraph (b)(1) of this section, the hedge is integrated with the executory contract. Therefore K is deemed to have paid $501,904.77 (the basis of the principal deposited plus the basis of the interest) for the steel and there is no exchange gain or loss on the disposition of the Sf1,000,000. K's basis in the steel therefore is $501,904.77.

(5) *References to this paragraph (b).* If the rules of this paragraph (b) are referred to in another paragraph of this section (*e.g.*, paragraph (c) of this section), then the rules of this paragraph (b) shall be applied for purposes of such other paragraph by substituting terms appropriate for such other paragraph. For example, paragraph (c)(2) of this section refers to the identification rules of paragraph (b)(3) of this section. Accordingly, for purposes of paragraph (c)(2), the rules of paragraph (b)(3) will be applied by substituting the term ''stock or security'' for ''executory contract''.

(c) *Hedges of period between trade date and settlement date on purchase or sale of publicly traded stock or security.* If a taxpayer purchases or sells stocks or securities which are traded on an established securities market and—

(1) Hedges all or part of such purchase or sale for any part of the period beginning on the trade date and ending on the settlement date; and

(2) Identifies the hedge and the underlying stock or securities as an integrated transaction under the rules of paragraph (b)(3) of this section;

then any gain or loss on the hedge shall be an adjustment to the amount realized or the adjusted basis of the stock or securities sold or purchased (and shall not be taken into account as exchange gain or loss). The term hedge means a deposit of nonfunctional currency in a hedging account (within the meaning of paragraph (b)(2)(iii)(D) of this section), or 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 for any portion of the period beginning on the trade date and ending on the settlement date. The provisions of paragraphs (b)(2)(i)(D) through (G), and (b)(2)(iii)(D) and (E) of this section shall apply. Sections 263(g), 1092, and 1256 do not apply with

respect to stock or securities and a hedge which are subject to this paragraph (c).

(d) [Reserved]

(e) *Advance rulings regarding net hedging and anticipatory hedging systems.* 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.

(f) [Reserved]

(g) *General effective date.* Except as otherwise provided in this section, the rules of this section shall apply to qualified hedging transactions, hedged executory contracts and transactions described in paragraph (c) of this section entered into on or after September 21, 1989. This section shall apply even if the transaction being hedged (*e.g.*, the debt instrument) was entered into or acquired prior to such date. The effective date regarding advance rulings for net and anticipatory hedging shall be governed by such revenue procedures that the Commissioner may publish.

[T.D. 8400, 57 FR 9199, Mar. 17, 1992, as amended at T.D. 9598, 77 FR 54809, Sept. 6, 2012; T.D. 9736, 80 FR 53733, 53735, Sept. 8, 2015]

§ 1.988–6 Nonfunctional currency contingent payment debt instruments.

(a) *In general*—(1) *Scope.* This section determines the accrual of interest and the amount, timing, source, and character of any gain or loss on nonfunctional currency contingent payment debt instruments described in this paragraph (a)(1) and to which §1.1275–4(a) would otherwise apply if the debt instrument were denominated in the taxpayer's functional currency. Except as provided by the rules in this section, the rules in §1.1275–4 (relating to contingent payment debt instruments) apply to the following instruments—

(i) A debt instrument described in §1.1275–4(b)(1) for which all payments of principal and interest are denominated in, or determined by reference to, a single nonfunctional currency and which has one or more non-currency related contingencies;

(ii) A debt instrument described in §1.1275–4(b)(1) for which payments of principal or interest are denominated in, or determined by reference to, more than one currency and which has no non-currency related contingencies;

(iii) A debt instrument described in §1.1275–4(b)(1) for which payments of principal or interest are denominated in, or determined by reference to, more than one currency and which has one or more non-currency related contingencies; and

(iv) A debt instrument otherwise described in paragraph (a)(1)(i), (ii) or (iii) of this section, except that the debt instrument is described in §1.1275–4(c)(1) rather than §1.1275–4(b)(1) (*e.g.*, the instrument is issued for non-publicly traded property).

(2) *Exception for hyperinflationary currencies*—(i) *In general.* Except as provided in paragraph (a)(2)(ii) of this section, this section shall not apply to an instrument described in paragraph (a)(1) of this section if any payment made under such instrument is determined by reference to a hyperinflationary currency, as defined in §1.985–1(b)(2)(ii)(D). In such case, the amount, timing, source and character of interest, principal, foreign currency gain or loss, and gain or loss relating to a non-currency contingency shall be determined under the method that reflects the instrument's economic substance.

(ii) *Discretion as to method.* If a taxpayer does not account for an instrument described in paragraph (a)(2)(i) of this section in a manner that reflects the instrument's economic substance, the Commissioner may apply the rules of this section to such an instrument or apply the principles of §1.988–2(b)(15), reasonably taking into account the contingent feature or features of the instrument.

(b) *Instruments described in paragraph (a)(1)(i) of this section*—(1) *In general.*

Paragraph (b)(2) of this section provides rules for applying the noncontingent bond method (as set forth in §1.1275–4(b)) in the nonfunctional currency in which a debt instrument described in paragraph (a)(1)(i) of this section is denominated, or by reference to which its payments are determined (the denomination currency). Paragraph (b)(3) of this section describes how amounts determined in paragraph (b)(2) of this section shall be translated from the denomination currency of the instrument into the taxpayer's functional currency. Paragraph (b)(4) of this section describes how gain or loss (other than foreign currency gain or loss) shall be determined and characterized with respect to the instrument. Paragraph (b)(5) of this section describes how foreign currency gain or loss shall be determined with respect to accrued interest and principal on the instrument. Paragraph (b)(6) of this section provides rules for determining the source and character of any gain or loss with respect to the instrument. Paragraph (b)(7) of this section provides rules for subsequent holders of an instrument who purchase the instrument for an amount other than the adjusted issue price of the instrument. Paragraph (c) of this section provides examples of the application of paragraph (b) of this section. See paragraph (d) of this section for the determination of the denomination currency of an instrument described in paragraph (a)(1)(ii) or (iii) of this section. See paragraph (e) of this section for the treatment of an instrument described in paragraph (a)(1)(iv) of this section.

(2) *Application of noncontingent bond method*—(i) *Accrued interest.* Interest accruals on an instrument described in paragraph (a)(1)(i) of this section are initially determined in the denomination currency of the instrument by applying the noncontingent bond method, set forth in §1.1275–4(b), to the instrument in its denomination currency. Accordingly, the comparable yield, projected payment schedule, and comparable fixed rate debt instrument, described in §1.1275–4(b)(4), are determined in the denomination currency. For purposes of applying the noncontingent bond method to instruments described in this paragraph, the applicable Federal rate described in §1.1275–4(b)(4)(i) shall be the rate described in §1.1274–4(d) with respect to the denomination currency.

(ii) *Net positive and negative adjustments.* Positive and negative adjustments, and net positive and net negative adjustments, with respect to an instrument described in paragraph (a)(1)(i) of this section are determined by applying the rules of §1.1275–4(b)(6) (and §1.1275–4(b)(9)(i) and (ii), if applicable) in the denomination currency. Accordingly, a net positive adjustment is treated as additional interest (in the denomination currency) on the instrument. A net negative adjustment first reduces interest that otherwise would be accrued by the taxpayer during the current tax year in the denomination currency. If a net negative adjustment exceeds the interest that would otherwise be accrued by the taxpayer during the current tax year in the denomination currency, the excess is treated as ordinary loss (if the taxpayer is a holder of the instrument) or ordinary income (if the taxpayer is the issuer of the instrument). The amount treated as ordinary loss by a holder with respect to a net negative adjustment is limited, however, to the amount by which the holder's total interest inclusions on the debt instrument (determined in the denomination currency) exceed the total amount of the holder's net negative adjustments treated as ordinary loss on the debt instrument in prior taxable years (determined in the denomination currency). Similarly, the amount treated as ordinary income by an issuer with respect to a net negative adjustment is limited to the amount by which the issuer's total interest deductions on the debt instrument (determined in the denomination currency) exceed the total amount of the issuer's net negative adjustments treated as ordinary income on the debt instrument in prior taxable years (determined in the denomination currency). To the extent a net negative adjustment exceeds the current year's interest accrual and the amount treated as ordinary loss to a holder (or ordinary income to the issuer), the excess is treated as a negative adjustment carryforward, within the meaning of §1.1275–4(b)(6)(iii)(C), in the denomination currency.

(iii) *Adjusted issue price.* The adjusted issue price of an instrument described in paragraph (a)(1)(i) of this section is determined by applying the rules of §1.1275–4(b)(7) in the denomination currency. Accordingly, the adjusted issue price is equal to the debt instrument's issue price in the denomination currency, increased by the interest previously accrued on the debt instrument (determined without regard to any net positive or net negative adjustments on the instrument) and decreased by the amount of any noncontingent payment and the projected amount of any contingent payment previously made on the instrument. All adjustments to the adjusted issue price are calculated in the denomination currency.

(iv) *Adjusted basis.* The adjusted basis of an instrument described in paragraph (a)(1)(i) of this section is determined by applying the rules of §1.1275–4(b)(7) in the taxpayer's functional currency. In accordance with those rules, a holder's basis in the debt instrument is increased by the interest previously accrued on the debt instrument (translated into functional currency), without regard to any net positive or net negative adjustments on the instrument (except as provided in paragraph (b)(7) or (8) of this section, if applicable), and decreased by the amount of any noncontingent payment and the projected amount of any contingent payment previously made on the instrument to the holder (translated into functional currency). See paragraph (b)(3)(iii) of this section for translation rules.

(v) *Amount realized.* The amount realized by a holder and the repurchase price paid by the issuer on the scheduled or unscheduled retirement of a debt instrument described in paragraph (a)(1)(i) of this section are determined by applying the rules of §1.1275–4(b)(7) in the denomination currency. For example, with regard to a scheduled retirement at maturity, the holder is treated as receiving the projected amount of any contingent payment due at maturity, reduced by the amount of any negative adjustment carryforward. For purposes of translating the amount realized by the holder into functional currency, the rules of paragraph (b)(3)(iv) of this section shall apply.

(3) *Treatment and translation of amounts determined under noncontingent bond method*—(i) *Accrued interest.* The amount of accrued interest, determined under paragraph (b)(2)(i) of this section, is translated into the taxpayer's functional currency at the average exchange rate, as described in §1.988–2(b)(2)(iii)(A), or, at the taxpayer's election, at the appropriate spot rate, as described in §1.988–2(b)(2)(iii)(B).

(ii) *Net positive and negative adjustments*—(A) *Net positive adjustments.* A net positive adjustment, as referenced in paragraph (b)(2)(ii) of this section, is translated into the taxpayer's functional currency at the spot rate on the last day of the taxable year in which the adjustment is taken into account under §1.1275–4(b)(6), or, if earlier, the date the instrument is disposed of or otherwise terminated.

(B) *Net negative adjustments.* A net negative adjustment is treated and, where necessary, is translated from the denomination currency into the taxpayer's functional currency under the following rules:

(*1*) The amount of a net negative adjustment determined in the denomination currency that reduces the current year's interest in that currency shall first reduce the current year's accrued but unpaid interest, and then shall reduce the current year's interest which was accrued and paid. No translation is required.

(*2*) The amount of a net negative adjustment treated as ordinary income or loss under §1.1275–4(b)(6)(iii)(B) first is attributable to accrued but unpaid interest accrued in prior taxable years. For this purpose, the net negative adjustment shall be treated as attributable to any unpaid interest accrued in the immediately preceding taxable year, and thereafter to unpaid interest accrued in each preceding taxable year. The amount of the net negative adjustment applied to accrued but unpaid interest is translated into functional currency at the same rate used, in each of the respective prior taxable years, to translate the accrued interest.

(*3*) Any amount of the net negative adjustment remaining after the application of paragraphs (b)(3)(ii)(B)(*1*) and (*2*) of this section is attributable to interest accrued and paid in prior taxable

years. The amount of the net negative adjustment applied to such amounts is translated into functional currency at the spot rate on the date the debt instrument was issued or, if later, acquired.

(*4*) Any amount of the net negative adjustment remaining after application of paragraphs (b)(3)(ii)(B)(*1*), (*2*) and (*3*) of this section is a negative adjustment carryforward, within the meaning of §1.1275–4(b)(6)(iii)(C). A negative adjustment carryforward is carried forward in the denomination currency and is applied to reduce interest accruals in subsequent years. In the year in which the instrument is sold, exchanged or retired, any negative adjustment carryforward not applied to interest reduces the holder's amount realized on the instrument (in the denomination currency). An issuer of a debt instrument described in paragraph (a)(1)(i) of this section who takes into income a negative adjustment carryforward (that is not applied to interest) in the year the instrument is retired, as described in §1.1275–4(b)(6)(iii)(C), translates such income into functional currency at the spot rate on the date the instrument was issued.

(iii) *Adjusted basis*—(A) *In general.* Except as otherwise provided in this paragraph and paragraph (b)(7) or (8) of this section, a holder determines and maintains adjusted basis by translating the denomination currency amounts determined under §1.1275–4(b)(7)(iii) into functional currency as follows:

(*1*) The holder's initial basis in the instrument is determined by translating the amount paid by the holder to acquire the instrument (in the denomination currency) into functional currency at the spot rate on the date the instrument was issued or, if later, acquired.

(*2*) An increase in basis attributable to interest accrued on the instrument is translated at the rate applicable to such interest under paragraph (b)(3)(i) of this section.

(*3*) Any noncontingent payment and the projected amount of any contingent payments determined in the denomination currency that decrease the holder's basis in the instrument under §1.1275–4(b)(7)(iii) are translated as follows:

(*i*) The payment first is attributable to the most recently accrued interest to which prior amounts have not already been attributed. The payment is translated into functional currency at the rate at which the interest was accrued.

(*ii*) Any amount remaining after the application of paragraph (b)(3)(iii)(A)(*3*)(*i*) of this section is attributable to principal. Such amounts are translated into functional currency at the spot rate on the date the instrument was issued or, if later, acquired.

(B) *Exception for interest reduced by a negative adjustment carryforward.* Solely for purposes of this §1.988–6, any amounts of accrued interest income that are reduced as a result of a negative adjustment carryforward shall be treated as principal and translated at the spot rate on the date the instrument was issued or, if later, acquired.

(iv) *Amount realized*—(A) *Instrument held to maturity*—(*1*) *In general.* With respect to an instrument held to maturity, a holder translates the amount realized by separating such amount in the denomination currency into the component parts of interest and principal that make up adjusted basis prior to translation under paragraph (b)(3)(iii) of this section, and translating each of those component parts of the amount realized at the same rate used to translate the respective component parts of basis under paragraph (b)(3)(iii) of this section. The amount realized first shall be translated by reference to the component parts of basis consisting of accrued interest during the taxpayer's holding period as determined under paragraph (b)(3)(iii) of this section and ordering such amounts on a last in first out basis. Any remaining portion of the amount realized shall be translated by reference to the rate used to translate the component of basis consisting of principal as determined under paragraph (b)(3)(iii) of this section.

(*2*) *Subsequent purchases at discount and fixed but deferred contingent payments.* For purposes of this paragraph (b)(3)(iv) of this section, any amount which is required to be added to adjusted basis under paragraph (b)(7) or

(8) of this section shall be treated as additional interest which was accrued on the date the amount was added to adjusted basis. To the extent included in amount realized, such amounts shall be translated into functional currency at the same rates at which they were translated for purposes of determining adjusted basis. See paragraphs (b)(7)(iv) and (b)(8) of this section for rules governing the rates at which the amounts are translated for purposes of determining adjusted basis.

(B) *Sale, exchange, or unscheduled retirement—(1) Holder.* In the case of a sale, exchange, or unscheduled retirement, application of the rule stated in paragraph (b)(3)(iv)(A) of this section shall be as follows. The holder's amount realized first shall be translated by reference to the principal component of basis as determined under paragraph (b)(3)(iii) of this section, and then to the component of basis consisting of accrued interest as determined under paragraph (b)(3)(iii) of this section and ordering such amounts on a first in first out basis. Any gain recognized by the holder (*i.e.*, any excess of the sale price over the holder's basis, both expressed in the denomination currency) is translated into functional currency at the spot rate on the payment date.

(*2*) *Issuer.* In the case of an unscheduled retirement of the debt instrument, any excess of the adjusted issue price of the debt instrument over the amount paid by the issuer (expressed in denomination currency) shall first be attributable to accrued unpaid interest, to the extent the accrued unpaid interest had not been previously offset by a negative adjustment, on a last-in-first-out basis, and then to principal. The accrued unpaid interest shall be translated into functional currency at the rate at which the interest was accrued. The principal shall be translated at the spot rate on the date the debt instrument was issued.

(C) *Effect of negative adjustment carryforward with respect to the issuer.* Any amount of negative adjustment carryforward treated as ordinary income under § 1.1275–4(b)(6)(iii)(C) shall be translated at the exchange rate on the day the debt instrument was issued.

(4) *Determination of gain or loss not attributable to foreign currency.* A holder of a debt instrument described in paragraph (a)(1)(i) of this section shall recognize gain or loss upon sale, exchange, or retirement of the instrument equal to the difference between the amount realized with respect to the instrument, translated into functional currency as described in paragraph (b)(3)(iv) of this section, and the adjusted basis in the instrument, determined and maintained in functional currency as described in paragraph (b)(3)(iii) of this section. The amount of any gain or loss so determined is characterized as provided in § 1.1275–4(b)(8), and sourced as provided in paragraph (b)(6) of this section.

(5) *Determination of foreign currency gain or loss*—(i) *In general.* Other than in a taxable disposition of the debt instrument, foreign currency gain or loss is recognized with respect to a debt instrument described in paragraph (a)(1)(i) of this section only when payments are made or received. No foreign currency gain or loss is recognized with respect to a net positive or negative adjustment, as determined under paragraph (b)(2)(ii) of this section (except with respect to a positive adjustment described in paragraph (b)(8) of this section). As described in this paragraph (b)(5), foreign currency gain or loss is determined in accordance with the rules of § 1.988–2(b).

(ii) *Foreign currency gain or loss attributable to accrued interest.* The amount of foreign currency gain or loss recognized with respect to payments of interest previously accrued on the instrument is determined by translating the amount of interest paid or received into functional currency at the spot rate on the date of payment and subtracting from such amount the amount determined by translating the interest paid or received into functional currency at the rate at which such interest was accrued under the rules of paragraph (b)(3)(i) of this section. For purposes of this paragraph, the amount of any payment that is treated as accrued interest shall be reduced by the amount of any net negative adjustment treated as ordinary loss (to the holder) or ordinary income (to the issuer), as provided in paragraph (b)(2)(ii) of this

section. For purposes of determining whether the payment consists of interest or principal, see the payment ordering rules in paragraph (b)(5)(iv) of this section.

(iii) *Principal.* The amount of foreign currency gain or loss recognized with respect to payment or receipt of principal is determined by translating the amount paid or received into functional currency at the spot rate on the date of payment or receipt and subtracting from such amount the amount determined by translating the principal into functional currency at the spot rate on the date the instrument was issued or, in case of the holder, if later, acquired. For purposes of determining whether the payment consists of interest or principal, see the payment ordering rules in paragraph (b)(5)(iv) of this section.

(iv) *Payment ordering rules*—(A) *In general.* Except as provided in paragraph (b)(5)(iv)(B) of this section, payments with respect to an instrument described in paragraph (a)(1)(i) of this section shall be treated as follows:

(*1*) A payment shall first be attributable to any net positive adjustment on the instrument that has not previously been taken into account.

(*2*) Any amount remaining after applying paragraph (b)(5)(iv)(A)(*1*) of this section shall be attributable to accrued but unpaid interest, remaining after reduction by any net negative adjustment, and shall be attributable to the most recent accrual period to the extent prior amounts have not already been attributed to such period.

(*3*) Any amount remaining after applying paragraphs (b)(5)(iv)(A)(*1*) and (*2*) of this section shall be attributable to principal. Any interest paid in the current year that is reduced by a net negative adjustment shall be considered a payment of principal for purposes of determining foreign currency gain or loss.

(B) *Special rule for sale or exchange or unscheduled retirement.* Payments made or received upon a sale or exchange or unscheduled retirement shall first be applied against the principal of the debt instrument (or in the case of a subsequent purchaser, the purchase price of the instrument in denomination currency) and then against accrued unpaid interest (in the case of a holder, accrued while the holder held the instrument).

(C) *Subsequent purchaser that has a positive adjustment allocated to a daily portion of interest.* A positive adjustment that is allocated to a daily portion of interest pursuant to paragraph (b)(7)(iv) of this section shall be treated as interest for purposes of applying the payment ordering rule of this paragraph (b)(5)(iv).

(6) *Source of gain or loss.* The source of foreign currency gain or loss recognized with respect to an instrument described in paragraph (a)(1)(i) of this section shall be determined pursuant to §1.988–4. Consistent with the rules of §1.1275–4(b)(8), all gain (other than foreign currency gain) on an instrument described in paragraph (a)(1)(i) of this section is treated as interest income for all purposes. The source of an ordinary loss (other than foreign currency loss) with respect to an instrument described in paragraph (a)(1)(i) of this section shall be determined pursuant to §1.1275–4(b)(9)(iv). The source of a capital loss with respect to an instrument described in paragraph (a)(1)(i) of this section shall be determined pursuant to §1.865–1(b)(2).

(7) *Basis different from adjusted issue price*—(i) *In general.* The rules of §1.1275–4(b)(9)(i), except as set forth in this paragraph (b)(7), shall apply to an instrument described in paragraph (a)(1)(i) of this section purchased by a subsequent holder for more or less than the instrument's adjusted issue price.

(ii) *Determination of basis.* If an instrument described in paragraph (a)(1)(i) of this section is purchased by a subsequent holder, the subsequent holder's initial basis in the instrument shall equal the amount paid by the holder to acquire the instrument, translated into functional currency at the spot rate on the date of acquisition.

(iii) *Purchase price greater than adjusted issue price.* If the purchase price of the instrument (determined in the denomination currency) exceeds the adjusted issue price of the instrument, the holder shall, consistent with the rules of §1.1275–4(b)(9)(i)(B), reasonably

allocate such excess to the daily portions of interest accrued on the instrument or to a projected payment on the instrument. To the extent attributable to interest, the excess shall be reasonably allocated over the remaining term of the instrument to the daily portions of interest accrued and shall be a negative adjustment on the dates the daily portions accrue. On the date of such adjustment, the holder's adjusted basis in the instrument is reduced by the amount treated as a negative adjustment under this paragraph (b)(7)(iii), translated into functional currency at the rate used to translate the interest which is offset by the negative adjustment. To the extent related to a projected payment, such excess shall be treated as a negative adjustment on the date the payment is made. On the date of such adjustment, the holder's adjusted basis in the instrument is reduced by the amount treated as a negative adjustment under this paragraph (b)(7)(iii), translated into functional currency at the spot rate on the date the instrument was acquired.

(iv) *Purchase price less than adjusted issue price.* If the purchase price of the instrument (determined in the denomination currency) is less than the adjusted issue price of the instrument, the holder shall, consistent with the rules of §1.1275–4(b)(9)(i)(C), reasonably allocate the difference to the daily portions of interest accrued on the instrument or to a projected payment on the instrument. To the extent attributable to interest, the difference shall be reasonably allocated over the remaining term of the instrument to the daily portions of interest accrued and shall be a positive adjustment on the dates the daily portions accrue. On the date of such adjustment, the holder's adjusted basis in the instrument is increased by the amount treated as a positive adjustment under this paragraph (b)(7)(iv), translated into functional currency at the rate used to translate the interest to which it relates. For purposes of determining adjusted basis under paragraph (b)(3)(iii) of this section, such increase in adjusted basis shall be treated as an additional accrual of interest during the period to which the positive adjustment relates. To the extent related to a projected payment, such difference shall be treated as a positive adjustment on the date the payment is made. On the date of such adjustment, the holder's adjusted basis in the instrument is increased by the amount treated as a positive adjustment under this paragraph (b)(7)(iv), translated into functional currency at the spot rate on the date the adjustment is taken into account. For purposes of determining the amount realized on the instrument in functional currency under paragraph (b)(3)(iv) of this section, amounts attributable to the excess of the adjusted issue price of the instrument over the purchase price of the instrument shall be translated into functional currency at the same rate at which the corresponding adjustments are taken into account under this paragraph (b)(7)(iv) for purposes of determining the adjusted basis of the instrument.

(8) *Fixed but deferred contingent payments.* In the case of an instrument with a contingent payment that becomes fixed as to amount before the payment is due, the rules of §1.1275–4(b)(9)(ii) shall be applied in the denomination currency of the instrument. For this purpose, foreign currency gain or loss shall be recognized on the date payment is made or received with respect to the instrument under the principles of paragraph (b)(5) of this section. Any increase or decrease in basis required under §1.1275–4(b)(9)(ii)(D) shall be taken into account at the same exchange rate as the corresponding net positive or negative adjustment is taken into account.

(c) *Examples.* The provisions of paragraph (b) of this section may be illustrated by the following examples. In each example, assume that the instrument described is a debt instrument for federal income tax purposes. No inference is intended, however, as to whether the instrument is a debt instrument for federal income tax purposes. The examples are as follows:

Example 1. Treatment of net positive adjustment. (i) *Facts.* On December 31, 2004, Z, a calendar year U.S. resident taxpayer whose functional currency is the U.S. dollar, purchases from a foreign corporation, at original issue, a zero-coupon debt instrument with a non-currency contingency for £1000. All payments of principal and interest with respect to the instrument are denominated

in, or determined by reference to, a single nonfunctional currency (the British pound). The debt instrument would be subject to §1.1275–4(b) if it were denominated in dollars. The debt instrument's comparable yield, determined in British pounds under paragraph (b)(2)(i) of this section and §1.1275–4(b), is 10 percent, compounded annually, and the projected payment schedule, as constructed under the rules of §1.1275–4(b), provides for a single payment of £1210 on December 31, 2006 (consisting of a noncontingent payment of £975 and a projected payment of £235). The debt instrument is a capital asset in the hands of Z. Z does not elect to use the spot-rate convention described in §1.988–2(b)(2)(iii)(B). The payment actually made on December 31, 2006, is £1300. The relevant pound/dollar spot rates over the term of the instrument are as follows:

Date	Spot rate (pounds to dollars)
Dec. 31, 2004	£1.00 = $1.00
Dec. 31, 2005	£1.00 = $1.10
Dec. 31, 2006	£1.00 = $1.20

Accrual period	Average rate (pounds to dollars)
2005	£1.00 = $1.05
2006	£1.00 = $1.15

(ii) *Treatment in 2005*—(A) *Determination of accrued interest.* Under paragraph (b)(2)(i) of this section, and based on the comparable yield, Z accrues £100 of interest on the debt instrument for 2005 (issue price of £1000 × 10 percent). Under paragraph (b)(3)(i) of this section, Z translates the £100 at the average exchange rate for the accrual period ($1.05 × £100 = $105). Accordingly, Z has interest income in 2005 of $105.

(B) *Adjusted issue price and basis.* Under paragraphs (b)(2)(iii) and (iv) of this section, the adjusted issue price of the debt instrument determined in pounds and Z's adjusted basis in dollars in the debt instrument are increased by the interest accrued in 2005. Thus, on January 1, 2006, the adjusted issue price of the debt instrument is £1100. For purposes of determining Z's dollar basis in the debt instrument, the $1000 basis ($1.00 × £1000 original cost basis) is increased by the £100 of accrued interest, translated at the rate at which interest was accrued for 2005. See paragraph (b)(3)(iii) of this section. Accordingly, Z's adjusted basis in the debt instrument as of January 1, 2006, is $1105.

(iii) *Treatment in 2006*—(A) *Determination of accrued interest.* Under paragraph (b)(2)(i) of this section, and based on the comparable yield, Z accrues £110 of interest on the debt instrument for 2006 (adjusted issue price of £1100 × 10 percent). Under paragraph (b)(3)(i) of this section, Z translates the £110 at the average exchange rate for the accrual period ($1.15 × £110 = $126.50). Accordingly, Z has interest income in 2006 of $126.50.

(B) *Effect of net positive adjustment.* The payment actually made on December 31, 2006, is £1300, rather than the projected £1210. Under paragraph (b)(2)(ii) of this section, Z has a net positive adjustment of £90 on December 31, 2006, attributable to the difference between the amount of the actual payment and the amount of the projected payment. Under paragraph (b)(3)(ii)(A) of this section, the £90 net positive adjustment is treated as additional interest income and is translated into dollars at the spot rate on the last day of the year ($1.20 × £90 = $108). Accordingly, Z has a net positive adjustment of $108 resulting in a total interest inclusion for 2006 of $234.50 ($126.50 + $108 = $234.50).

(C) *Adjusted issue price and basis.* Based on the projected payment schedule, the adjusted issue price of the debt instrument immediately before the payment at maturity is £1210 (£1100 plus £110 of accrued interest for 2006). Z's adjusted basis in dollars, based only on the noncontingent payment and the projected amount of the contingent payment to be received, is $1231.50 ($1105 plus $126.50 of accrued interest for 2006).

(D) *Amount realized.* Even though Z receives £1300 at maturity, for purposes of determining the amount realized, Z is treated under paragraph (b)(2)(v) of this section as receiving the projected amount of the contingent payment on December 31, 2006. Therefore, Z is treated as receiving £1210 on December 31, 2006. Under paragraph (b)(3)(iv) of this section, Z translates its amount realized into dollars and computes its gain or loss on the instrument (other than foreign currency gain or loss) by breaking the amount realized into its component parts. Accordingly, £100 of the £1210 (representing the interest accrued in 2005) is translated at the rate at which it was accrued (£1 = $1.05), resulting in an amount realized of $105; £110 of the £1210 (representing the interest accrued in 2006) is translated into dollars at the rate at which it was accrued (£1 = $1.15), resulting in an amount realized of $126.50; and £1000 of the £1210 (representing a return of principal) is translated into dollars at the spot rate on the date the instrument was purchased (£1 = $1), resulting in an amount realized of $1000. Z's total amount realized is $1231.50, the same as its basis, and Z recognizes no gain or loss (before consideration of foreign currency gain or loss) on retirement of the instrument.

(E) *Foreign currency gain or loss.* Under paragraph (b)(5) of this section Z recognizes foreign currency gain under section 988 on the instrument with respect to the consideration actually received at maturity (except for the net positive adjustment), £1210. The amount of recognized foreign currency gain

is determined based on the difference between the spot rate on the date the instrument matures and the rates at which the principal and interest were taken into account. With respect to the portion of the payment attributable to interest accrued in 2005, the foreign currency gain is $15 [£100 × ($1.20 − $1.05)]. With respect to interest accrued in 2006, the foreign currency gain equals $5.50 [£110 × ($1.20 − $1.15)]. With respect to principal, the foreign currency gain is $200 [£1000 × ($1.20 − $1.00)]. Thus, Z recognizes a total foreign currency gain on December 31, 2006, of $220.50.

(F) *Source.* Z has interest income of $105 in 2005, interest income of $234.50 in 2006 (attributable to £110 of accrued interest and the £90 net positive adjustment), and a foreign currency gain of $220.50 in 2006. Under paragraph (b)(6) of this section and section 862(a)(1), the interest income is sourced by reference to the residence of the payor and is therefore from sources without the United States. Under paragraph (b)(6) of this section and § 1.988–4, Z's foreign currency gain of $220.50 is sourced by reference to Z's residence and is therefore from sources within the United States.

Example 2. Treatment of net negative adjustment. (i) *Facts.* Assume the same facts as in *Example 1*, except that Z receives £975 at maturity instead of £1300.

(ii) *Treatment in 2005.* The treatment of the debt instrument in 2005 is the same as in *Example 1.* Thus, Z has interest income in 2005 of $105. On January 1, 2006, the adjusted issue price of the debt instrument is £1100, and Z's adjusted basis in the instrument is $1105.

(iii) *Treatment in 2006*—(A) *Determination of accrued interest.* Under paragraph (b)(2)(i) of this section and based on the comparable yield, Z's accrued interest for 2006 is £110 (adjusted issue price of £1100 × 10 percent). Under paragraph (b)(3)(i) of this section, the £110 of accrued interest is translated at the average exchange rate for the accrual period ($1.15 × £110 = $126.50).

(B) *Effect of net negative adjustment.* The payment actually made on December 31, 2006, is £975, rather than the projected £1210. Under paragraph (b)(2)(ii) of this section, Z has a net negative adjustment of £235 on December 31, 2006, attributable to the difference between the amount of the actual payment and the amount of the projected payment. Z's accrued interest income of £110 in 2006 is reduced to zero by the net negative adjustment. Under paragraph (b)(3)(ii)(B)(*1*) of this section the net negative adjustment which reduces the current year's interest is not translated into functional currency. Under paragraph (b)(2)(ii) of this section, Z treats the remaining £125 net negative adjustment as an ordinary loss to the extent of the £100 previously accrued interest in 2005. This £100 ordinary loss is attributable to interest accrued but not paid in the preceding year. Therefore, under paragraph (b)(3)(ii)(B)(*2*) of this section, Z translates the loss into dollars at the average rate for such year (£1 = $1.05). Accordingly, Z has an ordinary loss of $105 in 2006. The remaining £25 of net negative adjustment is a negative adjustment carryforward under paragraph (b)(2)(ii) of this section.

(C) *Adjusted issue price and basis.* Based on the projected payment schedule, the adjusted issue price of the debt instrument immediately before the payment at maturity is £1210 (£1100 plus £110 of accrued interest for 2006). Z's adjusted basis in dollars, based only on the noncontingent payments and the projected amount of the contingent payments to be received, is $1231.50 ($1105 plus $126.50 of accrued interest for 2006).

(D) *Amount realized.* Even though Z receives £975 at maturity, for purposes of determining the amount realized, Z is treated under paragraph (b)(2)(v) of this section as receiving the projected amount of the contingent payment on December 31, 2006, reduced by the amount of Z's negative adjustment carryforward of £25. Therefore, Z is treated as receiving £1185 (£1210 − £25) on December 31, 2006. Under paragraph (b)(3)(iv) of this section, Z translates its amount realized into dollars and computes its gain or loss on the instrument (other than foreign currency gain or loss) by breaking the amount realized into its component parts. Accordingly, £100 of the £1185 (representing the interest accrued in 2005) is translated at the rate at which it was accrued (£1 = $1.05), resulting in an amount realized of $105; £110 of the £1185 (representing the interest accrued in 2006) is translated into dollars at the rate at which it was accrued (£1 = $1.15), resulting in an amount realized of $126.50; and £975 of the £1185 (representing a return of principal) is translated into dollars at the spot rate on the date the instrument was purchased (£1 = $1), resulting in an amount realized of $975. Z's amount realized is $1206.50 ($105 + $126.50 + $975 = $1206.50), and Z recognizes a capital loss (before consideration of foreign currency gain or loss) of $25 on retirement of the instrument ($1206.50 − $1231.50 = − $25).

(E) *Foreign currency gain or loss.* Z recognizes foreign currency gain with respect to the consideration actually received at maturity, £975. Under paragraph (b)(5)(ii) of this section, no foreign currency gain or loss is recognized with respect to unpaid accrued interest reduced to zero by the net negative adjustment resulting in 2006. In addition, no foreign currency gain or loss is recognized with respect to unpaid accrued interest from 2005, also reduced to zero by the ordinary loss. Accordingly, Z recognizes foreign currency gain with respect to principal only. Thus, Z recognizes a total foreign currency gain on December 31, 2006, of $195 [£975 × ($1.20 − $1.00)].

(F) *Source.* In 2006, Z has an ordinary loss of $105, a capital loss of $25, and a foreign currency gain of $195. Under paragraph (b)(6) of this section and §1.1275–4(b)(9)(iv), the $105 ordinary loss generally reduces Z's foreign source passive income under section 904(d) and the regulations thereunder. Under paragraph (b)(6) of this section and §1.865–1(b)(2), the $25 capital loss is sourced by reference to how interest income on the instrument would have been sourced. Therefore, the $25 capital loss generally reduces Z's foreign source passive income under section 904(d) and the regulations thereunder. Under paragraph (b)(6) of this section and §1.988–4, Z's foreign currency gain of $195 is sourced by reference to Z's residence and is therefore from sources within the United States.

Example 3. Negative adjustment and periodic interest payments. (i) *Facts.* On December 31, 2004, Z, a calendar year U.S. resident taxpayer whose functional currency is the U.S. dollar, purchases from a foreign corporation, at original issue, a two-year debt instrument with a non-currency contingency for £1000. All payments of principal and interest with respect to the instrument are denominated in, or determined by reference to, a single nonfunctional currency (the British pound). The debt instrument would be subject to §1.1275–4(b) if it were denominated in dollars. The debt instrument's comparable yield, determined in British pounds under §§1.988–2(b)(2) and 1.1275–4(b), is 10 percent, compounded semiannually. The debt instrument provides for semiannual interest payments of £30 payable each June 30, and December 31, and a contingent payment at maturity on December 31, 2006, which is projected to equal £1086.20 (consisting of a noncontingent payment of £980 and a projected payment of £106.20) in addition to the interest payable at maturity. The debt instrument is a capital asset in the hands of Z. Z does not elect to use the spot-rate convention described in §1.988–2(b)(2)(iii)(B). The payment actually made on December 31, 2006, is £981.00. The relevant pound/dollar spot rates over the term of the instrument are as follows:

Date	Spot rate (pounds to dollars)
Dec. 31, 2004	£1.00 = $1.00
June 30, 2005	£1.00 = $1.20
Dec. 31, 2005	£1.00 = $1.40
June 30, 2006	£1.00 = $1.60
Dec. 31, 2006	£1.00 = $1.80

Accrual period	Average rate (pounds to dollars)
Jan.-June 2005	£1.00 = $1.10
July-Dec. 2005	£1.00 = $1.30
Jan.-June 2006	£1.00 = $1.50
July-Dec. 2006	£1.00 = $1.70

(ii) *Treatment in 2005*—(A) *Determination of accrued interest.* Under paragraph (b)(2)(i) of this section, and based on the comparable yield, Z accrues £50 of interest on the debt instrument for the January-June accrual period (issue price of £1000 × 10 percent/2). Under paragraph (b)(3)(i) of this section, Z translates the £50 at the average exchange rate for the accrual period ($1.10 × £50 = $55.00). Similarly, Z accrues £51 of interest in the July-December accrual period [(£1000 + £50 − £30) × 10 percent/2], which is translated at the average exchange rate for the accrual period ($1.30 × £51 = $66.30). Accordingly, Z accrues $121.30 of interest income in 2005.

(B) *Adjusted issue price and basis—(1) January-June accrual period.* Under paragraphs (b)(2)(iii) and (iv) of this section, the adjusted issue price of the debt instrument determined in pounds and Z's adjusted basis in dollars in the debt instrument are increased by the interest accrued, and decreased by the interest payment made, in the January-June accrual period. Thus, on July 1, 2005, the adjusted issue price of the debt instrument is £1020 (£1000 + £50 − £30 = £1020). For purposes of determining Z's dollar basis in the debt instrument, the $1000 basis is increased by the £50 of accrued interest, translated, under paragraph (b)(3)(iii) of this section, at the rate at which interest was accrued for the January-June accrual period ($1.10 × £50 = $55). The resulting amount is reduced by the £30 payment of interest made during the accrual period, translated, under paragraph (b)(3)(iii) of this section and §1.988–2(b)(7), at the rate applicable to accrued interest ($1.10 × £30 = $33). Accordingly, Z's adjusted basis as of July 1, 2005, is $1022 ($1000 + $55 − $33).

(*2*) *July-December accrual period.* Under paragraphs (b)(2)(iii) and (iv) of this section, the adjusted issue price of the debt instrument determined in pounds and Z's adjusted basis in dollars in the debt instrument are increased by the interest accrued, and decreased by the interest payment made, in the July-December accrual period. Thus, on January 1, 2006, the adjusted issue price of the instrument is £1041 (£1020 + £51 − £30 = £1041). For purposes of determining Z's dollar basis in the debt instrument, the $1022 basis is increased by the £51 of accrued interest, translated, under paragraph (b)(3)(iii) of this section, at the rate at which interest was accrued for the July-December accrual period ($1.30 × £51 = $66.30). The resulting amount is reduced by the £30 payment of interest made during the accrual period, translated, under paragraph (b)(3)(iii) of this section and §1.988–2(b)(7), at the rate applicable to accrued interest ($1.30 × £30 = $39). Accordingly, Z's adjusted basis as of January 1, 2006, is $1049.30 ($1022 + $66.30 − $39).

(C) *Foreign currency gain or loss.* Z will recognize foreign currency gain on the receipt of each £30 payment of interest actually received during 2005. The amount of foreign currency gain in each case is determined, under paragraph (b)(5)(ii) of this section, by

reference to the difference between the spot rate on the date the £30 payment was made and the average exchange rate for the accrual period during which the interest accrued. Accordingly, Z recognizes $3 of foreign currency gain on the January-June interest payment [£30 × ($1.20 − $1.10)], and $3 of foreign currency gain on the July-December interest payment [£30 × ($1.40 − $1.30)]. Z recognizes in 2005 a total of $6 of foreign currency gain.

(D) *Source.* Z has interest income of $121.30 and a foreign currency gain of $6. Under paragraph (b)(6) of this section and section 862(a)(1), the interest income is sourced by reference to the residence of the payor and is therefore from sources without the United States. Under paragraph (b)(6) of this section and §1.988–4, Z's foreign currency gain of $6 is sourced by reference to Z's residence and is therefore from sources within the United States.

(iii) *Treatment in 2006*—(A) *Determination of accrued interest.* Under paragraph (b)(2)(i) of this section, and based on the comparable yield, Z's accrued interest for the January-June accrual period is £52.05 (adjusted issue price of £1041 × 10 percent/2). Under paragraph (b)(3)(i) of this section, Z translates the £52.05 at the average exchange rate for the accrual period ($1.50 × £52.05 = $78.08). Similarly, Z accrues £53.15 of interest in the July-December accrual period [(£1041 + £52.05 − £30) × 10 percent/2], which is translated at the average exchange rate for the accrual period ($1.70 × £53.15 = $90.35). Accordingly, Z accrues £105.20, or $168.43, of interest income in 2006.

(B) *Effect of net negative adjustment.* The payment actually made on December 31, 2006, is £981.00, rather than the projected £1086.20. Under paragraph (b)(2)(ii)(B) of this section, Z has a net negative adjustment of £105.20 on December 31, 2006, attributable to the difference between the amount of the actual payment and the amount of the projected payment. Z's accrued interest income of £105.20 in 2006 is reduced to zero by the net negative adjustment. Elimination of the 2006 accrued interest fully utilizes the net negative adjustment.

(C) *Adjusted issue price and basis*—(1) *January-June accrual period.* Under paragraphs (b)(2)(iii) and (iv) of this section, the adjusted issue price of the debt instrument determined in pounds and Z's adjusted basis in dollars in the debt instrument are increased by the interest accrued, and decreased by the interest payment made, in the January-June accrual period. Thus, on July 1, 2006, the adjusted issue price of the debt instrument is £1063.05 (£1041 + £52.05 − £30 = £1063.05). For purposes of determining Z's dollar basis in the debt instrument, the $1049.30 adjusted basis is increased by the £52.05 of accrued interest, translated, under paragraph (b)(3)(iii) of this section, at the rate at which interest was accrued for the January-June accrual period ($1.50 × £52.05 = $78.08). The resulting amount is reduced by the £30 payment of interest made during the accrual period, translated, under paragraph (b)(3)(iii) of this section and §1.988–2(b)(7), at the rate applicable to accrued interest ($1.50 × £30 = $45). Accordingly, Z's adjusted basis as of July 1, 2006, is $1082.38 ($1049.30 + $78.08 − $45).

(2) *July-December accrual period.* Under paragraphs (b)(2)(iii) and (iv) of this section, the adjusted issue price of the debt instrument determined in pounds and Z's adjusted basis in dollars in the debt instrument are increased by the interest accrued, and decreased by the interest payment made, in the July-December accrual period. Thus, immediately before maturity on December 31, 2006, the adjusted issue price of the instrument is £1086.20 (£1063.05 + £53.15 − £30 = £1086.20). For purposes of determining Z's dollar basis in the debt instrument, the $1082.38 adjusted basis is increased by the £53.15 of accrued interest, translated, under paragraph (b)(3)(iii) of this section, at the rate at which interest was accrued for the July-December accrual period ($1.70 × £53.15 = $90.36). The resulting amount is reduced by the £30 payment of interest made during the accrual period, translated, under paragraph (b)(3)(iii) of this section and §1.988–2(b)(7), at the rate applicable to accrued interest ($1.70 × £30 = $51). Accordingly, Z's adjusted basis on December 31, 2006, immediately prior to maturity is $1121.74 ($1082.38 + $90.36 − $51).

(D) *Amount realized.* Even though Z receives £981.00 at maturity, for purposes of determining the amount realized, Z is treated under paragraph (b)(2)(v) of this section as receiving the projected amount of the contingent payment on December 31, 2006. Therefore, Z is treated as receiving £1086.20 on December 31, 2006. Under paragraph (b)(3)(iv) of this section, Z translates its amount realized into dollars and computes its gain or loss on the instrument (other than foreign currency gain or loss) by breaking the amount realized into its component parts. Accordingly, £20 of the £1086.20 (representing the interest accrued in the January-June 2005 accrual period, less £30 interest paid) is translated into dollars at the rate at which it was accrued (£1 = $1.10), resulting in an amount realized of $22; £21 of the £1086.20 (representing the interest accrued in the July-December 2005 accrual period, less £30 interest paid) is translated into dollars at the rate at which it was accrued (£1 = $1.30), resulting in an amount realized of $27.30; £22.05 of the £1086.20 (representing the interest accrued in the January-June 2006 accrual period, less £30 interest paid) is translated into dollars at the rate at which it was accrued (£1 = $1.50), resulting in an amount realized of $33.08; £23.15 of the £1086.20 (representing the interest accrued in the July 1–December 31, 2006 accrual period, less the £30

interest payment) is translated into dollars at the rate at which it was accrued (£1 = $1.70), resulting in an amount realized of $39.36; and £1000 (representing principal) is translated into dollars at the spot rate on the date the instrument was purchased (£1 = $1), resulting in an amount realized of $1000. Accordingly, Z's total amount realized is $1121.74 ($22 + $27.30 + $33.08 + $39.36 + $1000), the same as its basis, and Z recognizes no gain or loss (before consideration of foreign currency gain or loss) on retirement of the instrument.

(E) *Foreign currency gain or loss.* Z recognizes foreign currency gain with respect to each £30 payment actually received during 2006. These payments, however, are treated as payments of principal for this purpose because all 2006 accrued interest is reduced to zero by the net negative adjustment. See paragraph (b)(5)(iv)(A)(*3*) of this section. The amount of foreign currency gain in each case is determined, under paragraph (b)(5)(iii) of this section, by reference to the difference between the spot rate on the date the £30 payment is made and the spot rate on the date the debt instrument was issued. Accordingly, Z recognizes $18 of foreign currency gain on the January-June 2006 interest payment [£30 × ($1.60 − $1.00)], and $24 of foreign currency gain on the July-December 2006 interest payment [£30 × ($1.80 − $1.00)]. Z separately recognizes foreign currency gain with respect to the consideration actually received at maturity, £981.00. The amount of such gain is determined based on the difference between the spot rate on the date the instrument matures and the rates at which the principal and interest were taken into account. With respect to the portion of the payment attributable to interest accrued in January-June 2005 (other than the £30 payments), the foreign currency gain is $14 [£20 × ($1.80 − $1.10)]. With respect to the portion of the payment attributable to interest accrued in July-December 2005 (other than the £30 payments), the foreign currency gain is $10.50 [£21 × ($1.80 − $1.30)]. With respect to the portion of the payment attributable to interest accrued in 2006 (other than the £30 payments), no foreign currency gain or loss is recognized under paragraph (b)(5)(ii) of this section because such interest was reduced to zero by the net negative adjustment. With respect to the portion of the payment attributable to principal, the foreign currency gain is $752 [£940 × ($1.80 − $1.00)]. Thus, Z recognizes a foreign currency gain of $42 on receipt of the two £30 payments in 2006, and $776.50 ($14 + $10.50 + $752) on receipt of the payment at maturity, for a total 2006 foreign currency gain of $818.50.

(F) *Source.* Under paragraph (b)(6) of this section and §1.988–4, Z's foreign currency gain of $818.50 is sourced by reference to Z's residence and is therefore from sources within the United States.

Example 4. Purchase price greater than adjusted issue price. (i) *Facts.* On July 1, 2005, Z, a calendar year U.S. resident taxpayer whose functional currency is the U.S. dollar, purchases a debt instrument with a non-currency contingency for £1405. All payments of principal and interest with respect to the instrument are denominated in, or determined by reference to, a single nonfunctional currency (the British pound). The debt instrument would be subject to §1.1275–4(b) if it were denominated in dollars. The debt instrument was originally issued by a foreign corporation on December 31, 2003, for an issue price of £1000, and matures on December 31, 2006. The debt instrument's comparable yield, determined in British pounds under §§1.988–2(b)(2) and 1.1275–4(b), is 10.25 percent, compounded semiannually, and the projected payment schedule for the debt instrument (determined as of the issue date under the rules of §1.1275-4(b)) provides for a single payment at maturity of £1349.70 (consisting of a noncontingent payment of £1000 and a projected payment of £349.70). At the time of the purchase, the adjusted issue price of the debt instrument is £1161.76, assuming semiannual accrual periods ending on June 30 and December 31 of each year. The increase in the value of the debt instrument over its adjusted issue price is due to an increase in the expected amount of the contingent payment. The debt instrument is a capital asset in the hands of Z. Z does not elect to use the spot-rate convention described in §1.988–2(b)(2)(iii)(B). The payment actually made on December 31, 2006, is £1400. The relevant pound/dollar spot rates over the term of the instrument are as follows:

Date	Spot rate (pounds to dollars)
July 1, 2005	£1.00 = $1.00
Dec. 31, 2006	£1.00 = $2.00

Accrual period	Average rate (pounds to dollars)
July 1–Dec. 31, 2005	£1.00 = $1.50
Jan. 1–June 30, 2006	£1.00 = $1.50
July 1–Dec. 31, 2006	£1.00 = $1.50

(ii) *Initial basis.* Under paragraph (b)(7)(ii) of this section, Z's initial basis in the debt instrument is $1405, Z's purchase price of £1405, translated into functional currency at the spot rate on the date the debt instrument was purchased (£1 = $1).

(iii) *Allocation of purchase price differential.* Z purchased the debt instrument for £1405 when its adjusted issue price was £1161.76. Under paragraph (b)(7)(iii) of this section, Z allocates the £243.24 excess of purchase price over adjusted issue price to the contingent

payment at maturity. This allocation is reasonable because the excess is due to an increase in the expected amount of the contingent payment and not, for example, to a decrease in prevailing interest rates.

(iv) *Treatment in 2005*—(A) *Determination of accrued interest.* Under paragraph (b)(2)(i) of this section, and based on the comparable yield, Z accrues £59.54 of interest on the debt instrument for the July-December 2005 accrual period (issue price of £1161.76 × 10.25 percent/2). Under paragraph (b)(3)(i) of this section, Z translates the £59.54 of interest at the average exchange rate for the accrual period ($1.50 × £59.54 = $89.31). Accordingly, Z has interest income in 2005 of $89.31.

(B) *Adjusted issue price and basis.* Under paragraphs (b)(2)(iii) and (iv) of this section, the adjusted issue price of the debt instrument determined in pounds and Z's adjusted basis in dollars in the debt instrument are increased by the interest accrued in July-December 2005. Thus, on January 1, 2006, the adjusted issue price of the debt instrument is £1221.30 (£1161.76 + £59.54). For purposes of determining Z's dollar basis in the debt instrument on January 1, 2006, the $1405 basis is increased by the £59.54 of accrued interest, translated at the rate at which interest was accrued for the July-December 2005 accrual period. Paragraph (b)(3)(iii) of this section. Accordingly, Z's adjusted basis in the instrument, as of January 1, 2006, is $1494.31 [$1405 + (£59.54 × $1.50)].

(v) *Treatment in 2006*—(A) *Determination of accrued interest.* Under paragraph (b)(2)(i) of this section, and based on the comparable yield, Z accrues £62.59 of interest on the debt instrument for the January-June 2006 accrual period (issue price of £1221.30 × 10.25 percent/2). Under paragraph (b)(3)(i) of this section, Z translates the £62.59 of accrued interest at the average exchange rate for the accrual period ($1.50 × £62.59 = $93.89). Similarly, Z accrues £65.80 of interest in the July-December 2006 accrual period [(£1221.30 + £62.59) × 10.25 percent/2], which is translated at the average exchange rate for the accrual period ($1.50 × £65.80 = $98.70). Accordingly, Z accrues £128.39, or $192.59, of interest income in 2006.

(B) *Effect of positive and negative adjustments—(1) Offset of positive adjustment.* The payment actually made on December 31, 2006, is £1400, rather than the projected £1349.70. Under paragraph (b)(2)(ii) of this section, Z has a positive adjustment of £50.30 on December 31, 2006, attributable to the difference between the amount of the actual payment and the amount of the projected payment. Under paragraph (b)(7)(iii) of this section, however, Z also has a negative adjustment of £243.24, attributable to the excess of Z's purchase price for the debt instrument over its adjusted issue price. Accordingly, Z will have a net negative adjustment of £192.94 (£50.30 − £243.24 = £192.94) for 2006.

(*2*) *Offset of accrued interest.* Z's accrued interest income of £128.39 in 2006 is reduced to zero by the net negative adjustment. The net negative adjustment which reduces the current year's interest is not translated into functional currency. Under paragraph (b)(2)(ii) of this section, Z treats the remaining £64.55 net negative adjustment as an ordinary loss to the extent of the £59.54 previously accrued interest in 2005. This £59.54 ordinary loss is attributable to interest accrued but not paid in the preceding year. Therefore, under paragraph (b)(3)(ii)(B)(*2*) of this section, Z translates the loss into dollars at the average rate for such year (£1 = $1.50). Accordingly, Z has an ordinary loss of $89.31 in 2006. The remaining £5.01 of net negative adjustment is a negative adjustment carryforward under paragraph (b)(2)(ii) of this section.

(C) *Adjusted issue price and basis—(1) January-June accrual period.* Under paragraph (b)(2)(iii) of this section, the adjusted issue price of the debt instrument on July 1, 2006, is £1283.89 (£1221.30 + £62.59 = £1283.89). Under paragraphs (b)(2)(iv) and (b)(3)(iii) of this section, Z's adjusted basis as of July 1, 2006, is $1588.20 ($1494.31 + $93.89).

(*2*) *July-December accrual period.* Based on the projected payment schedule, the adjusted issue price of the debt instrument immediately before the payment at maturity is £1349.70 (£1283.89 + £65.80 accrued interest for July-December). Z's adjusted basis in dollars, based only on the noncontingent payments and the projected amount of the contingent payments to be received, is $1686.90 ($1588.20 plus $98.70 of accrued interest for July-December).

(*3*) *Adjustment to basis upon contingent payment.* Under paragraph (b)(7)(iii) of this section, Z's adjusted basis in the debt instrument is reduced at maturity by £243.24, the excess of Z's purchase price for the debt instrument over its adjusted issue price. For this purpose, the adjustment is translated into functional currency at the spot rate on the date the instrument was acquired (£1 = $1). Accordingly, Z's adjusted basis in the debt instrument at maturity is $1443.66 ($1686.90 − $243.24).

(D) *Amount realized.* Even though Z receives £1400 at maturity, for purposes of determining the amount realized, Z is treated under paragraph (b)(2)(v) of this section as receiving the projected amount of the contingent payment on December 31, 2006, reduced by the amount of Z's negative adjustment carryforward of £5.01. Therefore, Z is treated as receiving £1344.69 (£1349.70 − £5.01) on December 31, 2006. Under paragraph (b)(3)(iv) of this section, Z translates its amount realized into dollars and computes its gain or loss on the instrument (other than foreign currency gain or loss) by breaking the amount realized into its component

parts. Accordingly, £59.54 of the £1344.69 (representing the interest accrued in 2005) is translated at the rate at which it was accrued (£1 = $1.50), resulting in an amount realized of $89.31; £62.59 of the £1344.69 (representing the interest accrued in January-June 2006) is translated into dollars at the rate at which it was accrued (£1 = $1.50), resulting in an amount realized of $93.89; £65.80 of the £1344.69 (representing the interest accrued in July-December 2006) is translated into dollars at the rate at which it was accrued (£1 = $1.50), resulting in an amount realized of $98.70; and £1156.76 of the £1344.69 (representing a return of principal) is translated into dollars at the spot rate on the date the instrument was purchased (£1 = $1), resulting in an amount realized of $1156.76. Z's amount realized is $1438.66 ($89.31 + $93.89 + $98.70 + $1156.76), and Z recognizes a capital loss (before consideration of foreign currency gain or loss) of $5 on retirement of the instrument ($1438.66 − $1443.66 = −$5).

(E) *Foreign currency gain or loss.* Z recognizes foreign currency gain under section 988 on the instrument with respect to the entire consideration actually received at maturity, £1400. While foreign currency gain or loss ordinarily would not have arisen with respect to £50.30 of the £1400, which was initially treated as a positive adjustment in 2006, the larger negative adjustment in 2006 reduced this positive adjustment to zero. Accordingly, foreign currency gain or loss is recognized with respect to the entire £1400. Under paragraph (b)(5)(ii) of this section, however, no foreign currency gain or loss is recognized with respect to unpaid accrued interest reduced to zero by the net negative adjustment resulting in 2006, and no foreign currency gain or loss is recognized with respect to unpaid accrued interest from 2005, also reduced to zero by the ordinary loss. Therefore, the entire £1400 is treated as a return of principal for the purpose of determining foreign currency gain or loss, and Z recognizes a total foreign currency gain on December 31, 2001, of $1400 [£1400 × ($2.00 − $1.00)].

(F) *Source.* Z has an ordinary loss of $89.31, a capital loss of $5, and a foreign currency gain of $1400. Under paragraph (b)(6) of this section and §1.1275–4(b)(9)(iv), the $89.31 ordinary loss generally reduces Z's foreign source passive income under section 904(d) and the regulations thereunder. Under paragraph (b)(6) of this section and §1.865–1(b)(2), the $5 capital loss is sourced by reference to how interest income on the instrument would have been sourced. Therefore, the $5 capital loss generally reduces Z's foreign source passive income under section 904(d) and the regulations thereunder. Under paragraph (b)(6) of this section and §1.988–4, Z's foreign currency gain of $1400 is sourced by reference to Z's residence and is therefore from sources within the United States.

Example 5. Sale of an instrument with a negative adjustment carryforward. (i) *Facts.* On December 31, 2003, Z, a calendar year U.S. resident taxpayer whose functional currency is the U.S. dollar, purchases at original issue a debt instrument with non-currency contingencies for £1000. All payments of principal and interest with respect to the instrument are denominated in, or determined by reference to, a single nonfunctional currency (the British pound). The debt instrument would be subject to §1.1275–4(b) if it were denominated in dollars. The debt instrument's comparable yield, determined in British poundsunder §§1.988–2(b)(2) and 1.1275–4(b), is 10 percent, compounded annually, and the projected payment schedule for the debt instrument provides for payments of £310 on December 31, 2005 (consisting of a noncontingent payment of £50 and a projected amount of £260) and £990 on December 31, 2006 (consisting of a noncontingent payment of £940 and a projected amount of £50). The debt instrument is a capital asset in the hands of Z. Z does not elect to use the spot-rate convention described in §1.988–2(b)(2)(iii)(B). The payment actually made on December 31, 2005, is £50. On December 30, 2006, Z sells the debt instrument for £940. The relevant pound/dollar spot rates over the term of the instrument are as follows:

Date	Spot rate (pounds to dollars)
Dec. 31, 2003	£1.00 = $1.00
Dec. 31, 2005	£1.00 = $2.00
Dec. 30, 2006	£1.00 = $2.00

Accrual period	Average rate (pounds to dollars)
Jan. 1–Dec. 31, 2004	£1.00 = $2.00
Jan. 1–Dec. 31, 2005	£1.00 = $2.00
Jan. 1–Dec. 31, 2006	£1.00 = $2.00

(ii) *Treatment in 2004*—(A) *Determination of accrued interest.* Under paragraph (b)(2)(i) of this section, and based on the comparable yield, Z accrues £100 of interest on the debt instrument for 2004 (issue price of £1000 × 10 percent). Under paragraph (b)(3)(i) of this section, Z translates the £100 at the average exchange rate for the accrual period ($2.00 × £100 = $200). Accordingly, Z has interest income in 2004 of $200.

(B) *Adjusted issue price and basis.* Under paragraphs (b)(2)(iii) and (iv) of this section, the adjusted issue price of the debt instrument determined in pounds and Z's adjusted basis in dollars in the debt instrument are increased by the interest accrued in 2004. Thus, on January 1, 2005, the adjusted issue price of the debt instrument is £1100. For purposes of determining Z's dollar basis in the debt instrument, the $1000 basis ($1.00 × £1000 original cost basis) is increased by the £100 of accrued interest, translated at the

rate at which interest was accrued for 2004. See paragraph (b)(3)(iii) of this section. Accordingly, Z's adjusted basis in the debt instrument as of January 1, 2005, is $1200 ($1000 + $200).

(iii) *Treatment in 2005*—(A) *Determination of accrued interest.* Under paragraph (b)(2)(i) of this section, and based on the comparable yield, Z's accrued interest for 2005 is £110 (adjusted issue price of £1100 × 10 percent). Under paragraph (b)(3)(i) of this section, the £110 of accrued interest is translated at the average exchange rate for the accrual period ($2.00 × £110 = $220).

(B) *Effect of net negative adjustment.* The payment actually made on December 31, 2005, is £50, rather than the projected £310. Under paragraph (b)(2)(ii) of this section, Z has a net negative adjustment of £260 on December 31, 2005, attributable to the difference between the amount of the actual payment and the amount of the projected payment. Z's accrued interest income of £110 in 2005 is reduced to zero by the net negative adjustment. Under paragraph (b)(3)(ii)(B)(*1*) of this section, the net negative adjustment which reduces the current year's interest is not translated into functional currency. Under paragraph (b)(2)(ii) of this section, Z treats the remaining £150 net negative adjustment as an ordinary loss to the extent of the £100 previously accrued interest in 2004. This £100 ordinary loss is attributable to interest accrued but not paid in the preceding year. Therefore, under paragraph (b)(3)(ii)(B)(*2*) of this section, Z translates the loss into dollars at the average rate for such year (£1 = $2.00). Accordingly, Z has an ordinary loss of $200 in 2005. The remaining £50 of net negative adjustment is a negative adjustment carryforward under paragraph (b)(2)(ii) of this section.

(C) *Adjusted issue price and basis.* Based on the projected payment schedule, the adjusted issue price of the debt instrument on January 1, 2006 is £900, *i.e.*, the adjusted issue price of the debt instrument on January 1, 2005 (£1100), increased by the interest accrued in 2005 (£110), and decreased by the projected amount of the December 31, 2005, payment (£310). See paragraph (b)(2)(iii) of this section. Z's adjusted basis on January 1, 2006 is Z's adjusted basis on January 1, 2005 ($1200), increased by the functional currency amount of interest accrued in 2005 ($220), and decreased by the amount of the payments made in 2005, based solely on the projected payment schedule, (£310). The amount of the projected payment is first attributable to the interest accrued in 2005 (£110), and then to the interest accrued in 2004 (£100), and the remaining amount to principal (£100). The interest component of the projected payment is translated into functional currency at the rates at which it was accrued, and the principal component of the projected payment is translated into functional currency at the spot rate on the date the instrument was issued. See paragraph (b)(3)(iii) of this section. Accordingly, Z's adjusted basis in the debt instrument, following the increase of adjusted basis for interest accrued in 2005 ($1200 + $220 = $1420), is decreased by $520 ($220 + $200 + $100 = $520). Z's adjusted basis on January 1, 2006 is therefore, $900.

(D) *Foreign currency gain or loss.* Z will recognize foreign currency gain on the receipt of the £50 payment actually received on December 31, 2005. Based on paragraph (b)(5)(iv) of this section, the £50 payment is attributable to principal since the accrued unpaid interest was completely eliminated by the net negative adjustment. The amount of foreign currency gain is determined, under paragraph (b)(5)(iii) of this section, by reference to the difference between the spot rate on the date the £50 payment was made and the spot rate on the date the debt instrument was issued. Accordingly, Z recognizes $50 of foreign currency gain on the £50 payment. [($2.00—$1.00) × £50 = $50]. Under paragraph (b)(6) of this section and §1.988–4, Z's foreign currency gain of $50 is sourced by reference to Z's residence and is therefore from sources within the United States.

(iv) *Treatment in 2006*—(A) *Determination of accrued interest.* Under paragraph (b)(2)(i) of this section, and based on the comparable yield, Z accrues £90 of interest on the debt instrument for 2006 (adjusted issue price of £900 × 10 percent). Under paragraph (b)(3)(i) of this section, Z translates the £90 at the average exchange rate for the accrual period ($2.00 × £90 = $180). Accordingly, prior to taking into account the 2005 negative adjustment carryforward, Z has interest income in 2006 of $180.

(B) *Effect of net negative adjustment.* The £50 negative adjustment carryforward from 2005 is a negative adjustment for 2006. Since there are no other positive or negative adjustments, there is a £50 negative adjustment in 2006 which reduces Z's accrued interest income by £50. Accordingly, after giving effect to the £50 negative adjustment carryforward, Z will accrue $80 of interest income. [(£90 − £50) × $2.00 = $80]

(C) *Adjusted issue price.* Under paragraph (b)(2)(iii) of this section, the adjusted issue price of the debt instrument determined in pounds is increased by the interest accrued in 2006 (prior to taking into account the negative adjustment carryforward). Thus, on December 30, 2006, the adjusted issue price of the debt instrument is £990.

(D) *Adjusted basis.* For purposes of determining Z's dollar basis in the debt instrument, Z's $900 adjusted basis on January 1, 2006, is increased by the accrued interest, translated at the rate at which interest was accrued for 2006. See paragraph (b)(3)(iii)(A) of this section. Note, however, that under paragraph (b)(3)(iii)(B) of this section the amount of accrued interest which is reduced

as a result of the negative adjustment carryforward, *i.e.*, £50, is treated for purposes of this section as principal, and is translated at the spot rate on the date the instrument was issued, *i.e.*, £1.00 = $1.00. Accordingly, Z's adjusted basis in the debt instrument as of December 30, 2006, is $1030 ($900 + $50 + $80).

(E) *Amount realized.* Z's amount realized in denomination currency is £940, *i.e.*, the amount of pounds Z received on the sale of the debt instrument. Under paragraph (b)(3)(iv)(B)(*1*) of this section, Z's amount realized is first translated by reference to the principal component of basis (including the amount which is treated as principal under paragraph (b)(3)(iii)(B) of this section) and then the remaining amount realized, if any, is translated by reference to the accrued unpaid interest component of adjusted basis. Thus, £900 of Z's amount realized is translated by reference to the principal component of adjusted basis. The remaining £40 of Z's amount realized is treated as principal under paragraph (b)(3)(iii)(B) of this section, and is also translated by reference to the principal component of adjusted basis. Accordingly, Z's amount realized in functional currency is $940. (No part of Z's amount realized is attributable to the interest accrued on the debt instrument.) Z realizes a loss of $90 on the sale of the debt instrument ($1030 basis − $940 amount realized). Under paragraph (b)(4) of this section and § 1.1275–4(b)(8), $80 of the loss is characterized as ordinary loss, and the remaining $10 of loss is characterized as capital loss. Under §§ 1.988–6(b)(6) and 1.1275–4(b)(9)(iv) the $80 ordinary loss is treated as a deduction that is definitely related to the interest income accrued on the debt instrument. Similarly, under §§ 1.988–6(b)(6) and 1.865–1(b)(2) the $10 capital loss is also allocated to the interest income from the debt instrument.

(F) *Foreign currency gain or loss.* Z recognizes foreign currency gain with respect to the £940 he received on the sale of the debt instrument. Under paragraph (b)(5)(iv) of this section, the £940 Z received is attributable to principal (and the amount which is treated as principal under paragraph (b)(3)(iii)(B) of this section). Thus, Z recognizes foreign currency gain on December 31, 2006, of $940. [($2.00 − $1.00) × £940]. Under paragraph (b)(6) of this section and § 1.988–4, Z's foreign currency gain of $940 is sourced by reference to Z's residence and is therefore from sources within the United States.

(d) *Multicurrency debt instruments*—(1) *In general.* Except as provided in this paragraph (d), a multicurrency debt instrument described in paragraph (a)(1)(ii) or (iii) of this section shall be treated as an instrument described in paragraph (a)(1)(i) of this section and shall be accounted for under the rules of paragraph (b) of this section. Because payments on an instrument described in paragraph (a)(1)(ii) or (iii) of this section are denominated in, or determined by reference to, more than one currency, the issuer and holder or holders of the instrument are required to determine the denomination currency of the instrument under paragraph (d)(2) of this section before applying the rules of paragraph (b) of this section.

(2) *Determination of denomination currency*—(i) *In general.* The denomination currency of an instrument described in paragraph (a)(1)(ii) or (iii) of this section shall be the predominant currency of the instrument. Except as otherwise provided in paragraph (d)(2)(ii) of this section, the predominant currency of the instrument shall be the currency with the greatest value determined by comparing the functional currency value of the noncontingent and projected payments denominated in, or determined by reference to, each currency on the issue date, discounted to present value (in each relevant currency), and translated (if necessary) into functional currency at the spot rate on the issue date. For this purpose, the applicable discount rate may be determined using any method, consistently applied, that reasonably reflects the instrument's economic substance. If a taxpayer does not determine a discount rate using such a method, the Commissioner may choose a method for determining the discount rate that does reflect the instrument's economic substance. The predominant currency is determined as of the issue date and does not change based on subsequent events (*e.g.*, changes in value of one or more currencies).

(ii) *Difference in discount rate of greater than 10 percentage points.* This § 1.988–6(d)(2)(ii) applies if no currency has a value determined under paragraph (d)(2)(i) of this section that is greater than 50% of the total value of all payments. In such a case, if the difference between the discount rate in the denomination currency otherwise determined under (d)(2)(i) of this section and the discount rate determined under paragraph (d)(2)(i) of this section with respect to any other currency in which payments are made (or determined by

reference to) pursuant to the instrument is greater than 10 percentage points, then the Commissioner may determine the predominant currency under any reasonable method.

(3) *Issuer/holder consistency.* The issuer determines the denomination currency under the rules of paragraph (d)(2) of this section and provides this information to the holders of the instrument in a manner consistent with the issuer disclosure rules of §1.1275–2(e). If the issuer does not determine the denomination currency of the instrument, or if the issuer's determination is unreasonable, the holder of the instrument must determine the denomination currency under the rules of paragraph (d)(2) of this section. A holder that determines the denomination currency itself must explicitly disclose this fact on a statement attached to the holder's timely filed federal income tax return for the taxable year that includes the acquisition date of the instrument.

(4) *Treatment of payments in currencies other than the denomination currency.* For purposes of applying the rules of paragraph (b) of this section to debt instruments described in paragraph (a)(1)(ii) or (iii) of this section, payments not denominated in (or determined by reference to) the denomination currency shall be treated as noncurrency-related contingent payments. Accordingly, if the denomination currency of the instrument is determined to be the taxpayer's functional currency, the instrument shall be accounted for under §1.1275–4(b) rather than under this section.

(e) *Instruments issued for nonpublicly traded property*—(1) *Applicability.* This paragraph (e) applies to debt instruments issued for nonpublicly traded property that would be described in paragraph (a)(1)(i), (ii), or (iii) of this section, but for the fact that such instruments are described in §1.1275–4(c)(1) rather than §1.1275–4(b)(1). For example, this paragraph (e) generally applies to a contingent payment debt instrument denominated in a nonfunctional currency that is issued for nonpublicly traded property. Generally the rules of §1.1275–4(c) apply except as set forth by the rules of this paragraph (e).

(2) *Separation into components.* An instrument described in this paragraph (e) is not accounted for using the noncontingent bond method of §1.1275–4(b) and paragraph (b) of this section. Rather, the instrument is separated into its component payments. Each noncontingent payment or group of noncontingent payments which is denominated in a single currency shall be considered a single component treated as a separate debt instrument denominated in the currency of the payment or group of payments. Each contingent payment shall be treated separately as provided in paragraph (e)(4) of this section.

(3) *Treatment of components consisting of one or more noncontingent payments in the same currency.* The issue price of each component treated as a separate debt instrument which consists of one or more noncontingent payments is the sum of the present values of the noncontingent payments contained in the separate instrument. The present value of any noncontingent payment shall be determined under §1.1274–2(c)(2), and the test rate shall be determined under §1.1274–4 with respect to the currency in which each separate instrument is considered denominated. No interest payments on the separate debt instrument are qualified stated interest payments (within the meaning of §1.1273–1(c)) and the *de minimis* rules of section 1273(a)(3) and §1.1273–1(d) do not apply to the separate debt instrument. Interest income or expense is translated, and exchange gain or loss is recognized on the separate debt instrument as provided in §1.988–2(b)(2), if the instrument is denominated in a nonfunctional currency.

(4) *Treatment of components consisting of contingent payments*—(i) *General rule.* A component consisting of a contingent payment shall generally be treated in the manner provided in §1.1275–4(c)(4). However, except as provided in paragraph (e)(4)(ii) of this section, the test rate shall be determined by reference to the U.S. dollar unless the dollar does not reasonably reflect the economic substance of the contingent component. In such case, the test rate shall be determined by reference to the currency which most reasonably reflects the economic substance of the

contingent component. Any amount received in nonfunctional currency from a component consisting of a contingent payment shall be translated into functional currency at the spot rate on the date of receipt. Except in the case when the payment becomes fixed more than six months before the payment is due, no foreign currency gain or loss shall be recognized on a contingent payment component.

(ii) *Certain delayed contingent payments*—(A) *Separate debt instrument relating to the fixed component.* The rules of §1.1275–4(c)(4)(iii) shall apply to a contingent component the payment of which becomes fixed more than 6 months before the payment is due. For this purpose, the denomination currency of the separate debt instrument relating to the fixed payment shall be the currency in which payment is to be made and the test rate for such separate debt instrument shall be determined in the currency of that instrument. If the separate debt instrument relating to the fixed payment is denominated in nonfunctional currency, the rules of §1.988–2(b)(2) shall apply to that instrument for the period beginning on the date the payment is fixed and ending on the payment date.

(B) *Contingent component.* With respect to the contingent component, the issue price considered to have been paid by the issuer to the holder under §1.1275–4(c)(4)(iii)(A) shall be translated, if necessary, into the functional currency of the issuer or holder at the spot rate on the date the payment becomes fixed.

(5) *Basis different from adjusted issue price.* The rules of §1.1275–4(c)(5) shall apply to an instrument subject to this paragraph (e).

(6) *Treatment of a holder on sale, exchange, or retirement.* The rules of §1.1275–4(c)(6) shall apply to an instrument subject to this paragraph (e).

(f) *Rules for nonfunctional currency tax exempt obligations described in §1.1275–4(d)*—(1) *In general.* Except as provided in paragraph (f)(2) of this section, section 1.988–6 shall not apply to a debt instrument the interest on which is excluded from gross income under section 103(a).

(2) *Operative rules.* [Reserved]

(g) *Effective date.* This section shall apply to debt instruments issued on or after October 29, 2004.

[T.D. 9157, 69 FR 52819, Aug. 30, 2004]

§1.989(a)–1 Definition of a qualified business unit.

(a) *Applicability*—(1) *In general.* This section provides rules relating to the definition of the term ''qualified business unit'' (QBU) within the meaning of section 989.

(2) *Effective date.* These rules shall apply to taxable years beginning after December 31, 1986. However, any person may apply on a consistent basis §1.989(a)–1T (c) of the Temporary Income Tax Regulations in lieu of §1.989(a)–1 (c) to all taxable years beginning after December 31, 1986, and on or before February 5, 1990. For the text of the temporary regulation, see 53 FR 20612 (June 8, 1988).

(b) *Definition of a qualified business unit*—(1) *In general.* A QBU is any separate and clearly identified unit of a trade or business of a taxpayer provided that separate books and records are maintained.

(2) *Application of the QBU definition*—(i) *Persons*—(A) *Corporations.* A corporation is a QBU.

(B) *Individuals.* An individual is not a QBU.

(C) *Partnerships.* A partnership, other than a section 987 aggregate partnership as defined in §1.987–1(b)(5), is a QBU.

(D) *Trusts and estates.* A trust or estate is a QBU of a beneficiary.

(ii) *Activities.* Activities of a corporation, partnership, trust, estate, or individual qualify as a QBU if—

(A) The activities constitute a trade or business; and

(B) A separate set of books and records is maintained with respect to the activities.

(3) *Special rule.* Any activity (wherever conducted and regardless of its frequency) that produces income or loss that is, or is treated as, effectively connected with the conduct of a trade or business within the United States shall be treated as a separate QBU, provided the books and records requirement of paragraph (d)(2) of this section is satisfied.

(4) *Effective/applicability date.* Generally, the revisions to paragraph (b)(2)(i) of this section shall apply to taxable years beginning on or after one year after the first day of the first taxable year following December 7, 2016. If pursuant to §1.987–11(b) a taxpayer applies §§1.987–1 through 1.987–11 beginning in a taxable year prior to the earliest taxable year described in §1.987–11(a), then the effective date of the revisions to paragraph (b)(2)(i) of this section with respect to the taxpayer shall apply to taxable years of the taxpayer beginning on or after the first day of such prior taxable year.

(c) *Trade or business.* The determination as to whether activities constitute a trade or business is ultimately dependent upon an examination of all the facts and circumstances. Generally, a trade or business for purposes of section 989(a) is a specific unified group of activities that constitutes (or could constitute) an independent economic enterprise carried on for profit, the expenses related to which are deductible under section 162 or 212 (other than that part of section 212 dealing with expenses incurred in connection with taxes). To constitute a trade or business, a group of activities must ordinarily include every operation which forms a part of, or a step in, a process by which an enterprise may earn income or profit. Such group of activities must ordinarily include the collection of income and the payment of expenses. It is not necessary that the activities carried out by a QBU constitute a different trade or business from those carried out by other QBUs of the taxpayer. A vertical, functional, or geographic division of the same trade or business may be a trade or business for this purpose provided that the activities otherwise qualify as trade or business under this paragraph (c). However, activities that are merely ancillary to a trade or business will not constitute a trade or business under this paragraph (c). Activities of an individual as an employee are not considered by themselves to constitute a trade or business under this paragraph (c).

(d) *Separate books and records*—(1) *General rule.* Except as provided in paragraph (d)(2) of this section, a separate set of books and records shall include books of original entry and ledger accounts, both general and subsidiary, or similar records. For example, in the case of a taxpayer using the cash receipts and disbursements method of accounting, the books of original entry include a cash receipts and disbursements journal where each receipt and each disbursement is recorded. Similarly, in the case of a taxpayer using an accrual method of accounting, the books of original entry include a journal to record sales (accounts receivable) and a journal to record expenses incurred (accounts payable). In general, a journal represents a chronological account of all transactions entered into by an entity for an accounting period. A ledger account, on the other hand, chronicles the impact during an accounting period of the specific transactions recorded in the journal for that period upon the various items shown on the entity's balance sheet (*i.e.,* assets, liabilities, and capital accounts) and income statement (*i.e.,* revenues and expenses).

(2) *Special rule.* For purposes of paragraph (b)(3) of this section, books and records include books and records used to determine income or loss that is, or is treated as, effectively connected with the conduct of a trade or business within the United States.

(3) *Proper reflection on the books of the taxpayer or qualified business unit.* The principles of §1.987–2(b) shall apply in determining whether an asset, liability, or item of income or expense is reflected on the books of a qualified business unit (and therefore is attributable to such unit).

(4) *Effective/applicability date.* Generally, the revisions to paragraph (d)(3) of this section shall apply to taxable years beginning on or after one year after the first day of the first taxable year following December 7, 2016. If pursuant to §1.987–11(b) a taxpayer applies §§1.987–1 through 1.987–11 beginning in a taxable year prior to the earliest taxable year described in §1.987–11(a), then the revisions to paragraph (b)(2)(i) of this section shall apply with respect to taxable years of the taxpayer beginning on or after the first day of such prior taxable year.

(e) *Examples.* The provisions of this section may be illustrated by the following examples:

Example 1. Corporation X is a domestic corporation. Corporation X manufactures widgets in the U.S. for export. Corporation X sells widgets in the United Kingdom through a branch office in London. The London office has its own employees and solicits and processes orders. Corporation X maintains in the U.S. a separate set of books and records for all transactions conducted by the London office. Corporation X is a QBU under paragraph (b)(2)(i) of this section because of its corporate status. The London branch office is a QBU under paragraph (b)(2)(ii) of this section because (1) the sale of widgets is a trade or business as defined in paragraph (c) of this section; and (2) a complete and separate set of books and records (as described in paragraph (d) of this section) is maintained with respect to its sales operations.

Example 2. A domestic corporation incorporates a wholly-owned subsidiary in Switzerland. The domestic corporation is a manufacturer that markets its product abroad primarily through the Swiss subsidiary. To facilitate sales of the parent's product in Europe, the Swiss subsidiary has branch offices in France and West Germany that are responsible for all marketing operations in those countries. Each branch has its own employees, solicits and processes orders, and maintains a separate set of books and records. The domestic corporation and the Swiss subsidiary are both QBUs under paragraph (b)(2)(i) of this section because of their corporate status. The French and West German branches are QBUs of the Swiss subsidiary. They satisfy paragraph (b)(2)(ii) because each constitutes a trade or business (as defined in paragraph (c) of this section) and because separate sets of books and records (as described in paragraph (d) of this section) of their respective operations is maintained. Each branch is considered to have a trade or business although each is a geographical division of the same trade or business.

Example 3. W is a domestic corporation that manufactures product X in the United States for sale worldwide. All of W's sales functions are conducted exclusively in the United States. W employs individual Q to work in France. Q's sole function is to act as a courier to deliver sales documents to customers in France. With respect to Q's activities in France, a separate set of books and records as described in paragraph (d) is maintained. Under paragraph (c) of this section, Q's activities in France do not constitute a QBU since they are merely ancillary to W's manufacturing and selling business. Q is not considered to have a QBU because an individual's activities as an employee are not considered to constitute a trade or business of the individual under paragraph (c).

Example 4. The facts are the same as in example (3) except that the courier function is the sole activity of a wholly-owned French subsidiary of W. Under paragraph (b)(2)(i) of this section, the French subsidiary is considered to be a QBU.

Example 5. A corporation incorporated in the Netherlands is a subsidiary of a domestic corporation and a holding company for the stock of one or more subsidiaries incorporated in other countries. The Dutch corporation's activities are limited to paying its directors and its administrative expenses, receiving capital contributions from its United States parent corporation, contributing capital to its subsidiaries, receiving dividend distributions from its subsidiaries, and distributing dividends to its domestic parent corporation. Under paragraph (b)(2)(i) of this section, the Netherlands corporation is considered to be a QBU.

Example 6. Taxpayer A, an individual resident of the United States, is engaged in a trade or business wholly unrelated to any type of investment activity. A also maintains a portfolio of foreign currency-denominated investments through a foreign broker. The broker is responsible for all activities necessary to the management of A's investments and maintains books and records as described in paragraph (d) of this section, with respect to all investment activities of A. A's investment activities qualify as a QBU under paragraph (b)(2)(ii) of this section to the extent the activities engaged in by A generate expenses that are deductible under section 212 (other than that part of section 212 dealing with expenses incurred in connection with taxes).

Example 7. Taxpayer A, an individual resident of the United States, is the sole shareholder of foreign corporation (FC) whose activities are limited to trading in stocks and securities. FC is a QBU under paragraph (b)(2)(i) of this section.

Example 8. Taxpayer A, an individual resident of the United States, markets and sells in Spain and in the United States various products produced by other United States manufacturers. A has an office and employs a salesman to manage A's activities in Spain, maintains a separate set of books and records with respect to his activities in Spain, and is engaged in a trade or business as defined in paragraph (c) of this section. Therefore, under paragraph (b)(2)(ii) of this section, the activities of A in Spain are considered to be a QBU.

Example 9. Foreign corporation FX is incorporated in Mexico and is wholly owned by a domestic corporation. The domestic corporation elects to treat FX as a domestic corporation under section 1504(d). FX operates entirely in Mexico and maintains a separate set of books and records with respect to its

activities in Mexico. FX is a QBU under paragraph (b)(2)(i) of this section. The activities of FX in Mexico also constitute a QBU under paragraph (b)(2)(ii) of this section.

Example 10. F, a foreign corporation, computes a gain of $100 from the disposition of a United States real property interest (as defined in section 897(c)). The gain is taken into account as if F were engaged in a trade or business in the United States and as if such gain were effectively connected with such trade or business. F is a QBU under paragraph (b)(2)(i) of this section because of its corporate status. F's disposition activity constitutes a separate QBU under paragraph (b)(3) of this section.

[T.D. 8279, 55 FR 284, Jan. 4, 1990, as amended by T.D. 9794, 81 FR 88851, Dec. 8, 2016]

§ 1.989(b)–1 Definition of weighted average exchange rate.

For purposes of section 989(b)(3) and (4), the term ''weighted average exchange rate'' means the simple average of the daily exchange rates (determined by reference to a qualified source of exchange rates described in §1.988–1(d)(1)), excluding weekends, holidays and any other nonbusiness days for the taxable year.

[T.D. 8263, 54 FR 38664, Sept. 20, 1989. Redesignated by T.D. 8367, 56 FR 48437, Sept. 25, 1991; 57 FR 6060, Feb. 18, 1992; T.D. 9452, 74 FR 27890, June 11, 2009]

DOMESTIC INTERNATIONAL SALES CORPORATIONS

§ 1.991–1 Taxation of a domestic international sales corporation.

(a) *In general.* A corporation which is a DISC for a taxable year is not subject to any tax imposed by subtitle A of the Code (sections 1 through 1564) for such taxable year, except for the tax imposed by chapter 5 thereof (sections 1491 through 1494) on certain transfers to avoid tax. Thus, for example, a corporation which is a DISC for a taxable year is not subject for such year to the corporate income tax (section 11), the minimum tax on tax preferences (sections 56 through 58), or the accumulated earnings tax (sections 531 through 537). A DISC is liable for the payment of all taxes payable by corporations under other subtitles of the Code, such as, for example, income taxes withheld at the source and other employment taxes under subtitle C and the interest equalization tax and other miscellaneous excise taxes imposed by subtitle D. In addition, a DISC is subject to the provisions of chapter 3 of subtitle A (including section 1461), relating to withholding of tax on nonresident aliens and foreign corporations and tax-free covenant bonds. See §1.992–1 for the definition of the term ''DISC.''

(b) *Determination of taxable income—*(1) *In general.* Although a DISC is not subject to tax under subtitle A of the Code (other than chapter 5 thereof), a DISC's taxable income shall be determined for each taxable year in order to determine, for example, the amount deemed distributed for that taxable year to its shareholders pursuant to §1.995–2. Except as otherwise provided in the Code and the regulations thereunder, the taxable income of a DISC shall be determined in the same manner as if the DISC were a domestic corporation which had not elected to be treated as a DISC. Thus, for example, a DISC chooses its method of depreciation, inventory method, and annual accounting period in the same manner as if it were a corporation which had not elected to be treated as a DISC. Any elections affecting the determination of taxable income shall be made by the DISC. Thus, as a further example, a DISC which makes an installment sale described in section 453 is able to avail itself of the benefits of section 453: *Provided,* The DISC complies with the election requirements of such section. See §1.995–2(e) and §1.996–8 and the regulations thereunder for rules relating to the application for a taxable year of a DISC of a deduction under section 172 for a net operating loss carryback or carryover or of a capital loss carryback or carryover under section 1212.

(2) *Choice of method of accounting.* A DISC may, generally, choose any method of accounting permissible under section 446(c) and the regulations thereunder. However, if a DISC is a member of a controlled group (as defined in §1.993–1(k)), the DISC may not choose a method of accounting which, when applied to transactions between the DISC and other members of the controlled group, will result in a material distortion of the income of the DISC or any other member of the controlled group. Such a material distortion of income