effect on the economy of less than $100 million; will not cause a major increase in costs or prices for consumers, individual industries, federal, state, or local government agencies, or geographic regions; and will not cause a significant adverse effect on competition, employment, investment, productivity, innovation, or on the ability of United States-based enterprises to compete with foreign-based enterprises in domestic or export markets.

For this action, the Office of Management and Budget has waived the review process required by Executive Order 12291.

Stallions and mares from Switzerland that are older than 731 days must undergo testing and treatment in Switzerland and the United States that is more extensive than is standard during a 3-day quarantine. The extra time required for this additional testing and treatment will delay the horses' importation into this country; it will therefore increase the cost to importers of horses from Switzerland. However, of the approximately 22,000 horses imported into the United States in 1987, only 56 came from Switzerland. We estimate that fewer than half of these would fall into the category of animals affected by this interim rule. We therefore expect this rule to have little or no effect on importers. Those deterred by the cost of testing and quarantining a stallion or mare affected by this interim rule could, instead, import geldings or, for breeding, horses younger than 731 days. Alternatively, they would import horses from any CEM-free country.

Under these circumstances, the Administrator of the Animal and Plant Health Inspection Service has determined that this will not have a significant economic impact on a substantial number of small entities.

Executive Order 12372

This program/activity is listed in the Catalog of Federal Domestic Assistance under No. 10.025 and is subject to Executive Order 12372, which requires intergovernmental consultation with state and local officals. (See 7 CFR Part 3015, Subpart V.)

List of Subjects in 9 CFR Part 92

Animal diseases, Canada, Imports, Livestock and livestock products, Mexico, Poultry and poultry products, Quarantine, Transportation, Wildlife.

Accordingly, 9 CFR Part 92 is amended as follows:

PART 92—IMPORTATION OF CERTAIN ANIMALS AND POULTRY AND CERTAIN ANIMAL AND POULTRY PRODUCTS; INSPECTION AND OTHER REQUIREMENTS FOR CERTAIN MEANS OF CONVEYANCE AND SHIPPING CONTAINERS THEREON

1. The authority citation for Part 92 continues to read as follows:

Authority: 7 U.S.C. 1622; 19 U.S.C. 1306; 21 U.S.C. 102–105, 111, 134a, 134b, 134c, 134d, 134f, and 135; 31 U.S.C. 9701; 7 CFR 2.17, 2.51, and 371.2(d).

§ 92.2 [Amended]

2. Section 92.2, paragraph (i)(1), is amended by adding "Switzerland," immediately after "Sweden,".

Done in Washington, DC, this 27th day of May, 1988.

James W. Glosser.

Administrator, Animal and Plant Health Inspection Service.

[FR Doc. 88-12484 Filed 6-2-88; 8:45 am]

BILLING CODE 3410-34-M

ENVIRONMENTAL PROTECTION AGENCY

21 CFR Parts 193 and 561

[FAP 7H5529/R959; FRL-3391-1]

Pesticide Tolerances for 3-(3,5-Dichlorophenyl)-5-Ethenyl-5-Methyl-2,4-Oxazolidinedione

AGENCY: Environmental Protection Agency (EPA).

ACTION: Final rule.

SUMMARY: This document establishes permanent tolerances for residues of the fungicide 3-(3,5-dichlorophenyl)-5-ethenyl-5-methyl-2,4-oxazolidinedione (hereafter in the preamble called "vinclozolin") and its metabolites containing the 3,5-dichloroaniline moiety in or on certain food and feed items. BASF Wyandotte Corp. petitioned EPA to establish these tolerances.

EFFECTIVE DATE: May 25, 1988.

ADDRESS: Written objections, identified by the document control number [FAP 7H5529/R959], may be submitted to: Hearing Clerk (A-110), Environmental Protection Agency, Rm. 3708, 401 M St., SW., Washington, DC 20460.

FOR FURTHER INFORMATION CONTACT:

By mail: Lois Rossi, Product Manager (PM) 21, Registration Division (TS-767C), Environmental Protection Agency, 401 M St., SW., Washington, DC 20460.

Office location and telephone number: Rm. 227, CM #2, 1921 Jefferson Davis Highway, Arlington, VA 22202, (703) 557-1900.

SUPPLEMENTARY INFORMATION: EPA issued a proposed rule, published in the Federal Register of April 29, 1988 (53 FR 15407), in which it was announced that BASF Wyandotte Corp., Agricultural Chemical Division, 110 Cherry Hill Rd., Parsippany, NJ 07054, had submitted adequate studies to establish permanent tolerances for vinclozolin and its metabolites containing the 3,5-dichloroaniline moiety in or on raisins at 30 parts per million (ppm) and in or on dry grapes at 42 ppm.

This document establishes permanent tolerances for vinclozolin that were originally issued as temporary tolerances in the Federal Register of May 13, 1987 (52 FR 17941).

There were no comments or requests for referral to an advisory committee received in response to the proposed rule.

The data submitted in the petition and all other relevant material have been evaluated and discussed in the proposed rule. Based on the data and information considered, the Agency concludes that the tolerances will protect the public health. Therefore, the tolerances are established as set forth below.

A related final rule [PP 1E2457/R960], that establishes a permanent tolerance for vinclozolin in or on grapes at 6 ppm in 40 CFR 180.380(b) is published elsewhere in this issue of the Federal Register.

Any person adversely affected by this regulation may, within 30 days after publication of this document in the Federal Register, file written objections with the Hearing Clerk, at the address given above. Such objections should specify the provisions of the regulation deemed objectionable and the grounds for the objections. A hearing will be granted if the objections are supported by grounds legally sufficient to justify the relief sought.

The Office of Management and Budget has exempted this rule from the requirements of section 3 of Executive Order 12291.

Pursuant to the requirements of the Regulatory Flexibility Act (Pub. L. 96-354, 94 Stat. 1164, 5 U.S.C. 601-612), the Administrator has determined that regulations establishing new tolerances or raising tolerance levels or establishing exemptions from tolerance requirements do not have a significant economic impact on a substantial number of small entities. A certification statement to this effect was published in the Federal Register of May 4, 1981 (46 FR 24950).

List of Subjects in 40 CFR Parts 193 and 561

Administrative practice and procedure, Agricultural commodities, Pesticides and pests, Reporting and recordkeeping requirements.

Dated: May 25, 1988.

Douglas D. Campt,

Director, Office of Pesticide Programs.

Therefore, Chapter I of Title 21 of the Code of Federal Regulations is amended as follows:

PART 193—[AMENDED]

1. In Part 193:

a. The authority citation for Part 193 continues to read as follows:

Authority: 21 U.S.C. 348.

§ 193.137 [Amended]

b. In § 193.137 *3-(3,5-Dichlorophenyl)-5-ethenyl-5-methyl-2,4-oxazolidinedione,* by amending paragraph (b) in the first sentence by removing the phrase "until May 13, 1988."

PART 561—[AMENDED]

2. In Part 561:

a. The authority citation for Part 561 continues to read as follows:

Authority: 21 U.S.C. 348.

§ 561.440 [Amended]

b. In § 561.440 *3-(3,5-Dichlorophenyl)-5-ethenyl-5-methyl-2,4-oxazolidinedione,* by amending the introductory text by removing the phrase "until May 13, 1988."

[FR Doc. 88-12527 Filed 6-2-88; 8:45 am]

BILLING CODE 6560-50-M

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Parts 1 and 602

[T.D. 8208]

Income Taxes; Definition of Functional Currency

AGENCY: Internal Revenue Service, Treasury.

ACTION: Temporary regulations.

SUMMARY: This document contains temporary income tax regulations relating to the definition of a taxpayer's functional currency. This action is necessary because of changes to the applicable tax law effected by the Tax Reform Act of 1986. In addition, the temporary regulations set forth in this document also serve as the text of proposed regulations cross-referenced in the notice of proposed rulemaking in the Proposed Rules section of this issue of the **Federal Register.**

EFFECTIVE DATE: These regulations are effective for taxable years beginning after December 31, 1986.

FOR FURTHER INFORMATION CONTACT: David Rosenberg of the Office of Associate Chief Counsel (International), within the Office of Chief Counsel, Internal Revenue Service, 1111 Constitution Avenue, Washington, DC 20224, attention: CC:LR:T (INTL-982-86) (202-634-5406, not a toll-free call).

SUPPLEMENTARY INFORMATION:

Background

This document contains temporary income tax regulations under section 985 of the Internal Revenue Code of 1986. This section was added to the Code by section 1261 of the Tax Reform Act of 1986 (Pub. L. 99-514, 100 Stat. 2085, 2590). Section 985 introduces a new statutory concept that requires all Federal income tax determinations to be made in a taxpayer's functional currency.

Prior Law

Prior to the Act, there were no statutory rules permitting the selection of a currency other than the United States dollar (dollar) as the currency used to determine the amount of income or loss (or earnings and profits) of a foreign operation. However, various methods of translating such amounts into dollars were provided in regulations and revenue rulings.

Statutory Provisions

Section 985(a) requires that, unless otherwise provided in regulations, all determinations for United States income tax pruposes must be made in a taxpayer's functional currency. Section 985(b)(1) provides that a taxpayer's functional currency is either (1) the dollar or, (2) in the case of a qualified business unit (QBU) (as defined in section 989(a)), the currency of the economic environment in which a significant part of the QBU's activities are conducted, provided the books and records are kept in such currency. Section 985(b)(2) provides that the dollar shall be the functional currency of any QBU whose activities are primarily conducted in the dollar. Section 985(b)(3) allows a taxpayer, to the extent provided in regulations, to elect to use the dollar as the functional currency for certain QBUs. The election cannot be revoked without the consent of the Commissioner. Finally, section 985(b)(4) provides that any change in functional currency shall be treated as a change in the taxpayer's method of accounting.

Immediate guidance is needed by taxpayers who must make their income tax determinations in functional currency for taxable years beginning after December 31, 1986. For this reason it is found impracticable to issue this Treasury decision with notice and public procedure under subsection (b) of section 553 of title 5 of the United States Code or subject to the effective date limitation of subsection (d) of that section.

Explanation of Temporary Regulations

Section 1.985-1T(a) provides that a taxpayer and each QBU must make all determinations for United States income tax purposes in their respective functional currency. This section also provides that the regulations set forth in sections 1.985-1T through 5T are effective for taxable years beginning after December 31, 1986.

Section 1.985-1T(b) provides that the dollar shall be the functional currency of the following: (1) Any taxpayer that is not a QBU; a QBU that conducts its activities primarily in dollars; (3) a QBU that has the United States as its residence; (4) a QBU that elects to use, or is otherwise required to use, the dollar as its functional currency under § 1.985-2T; and (5) a QBU that does not keep books and records in the economic environment in which a significant part of its activities are conducted.

Section 1.985-1T(c)(1) provides that the functional currency of a QBU that is not required to use the dollar under § 1.985-1T(b) shall be the currency of the economic environment in which a significant part of the QBU's activities are conducted, provided the QBU keeps (or is presumed to keep under § 1.985-1T(c)(3)) books and records in such currency. Under § 1.985-1T(c)(2), the economic environment in which a significant part of a QBU's activities are conducted is determined by taking into account all the facts and circumstances. These facts and circumstances include, but are not limited to, the following factors: (1) The currency of the country in which the QBU is a resident as determined under section 988(a)(3)(B); (2) the principal currency of the QBU's cash flows: (3) the principal currency in which the QBU generates revenues and incurs expenses; (4) the principal currency in which the borrowing or lending of the QBU is conducted; (5) the currency of the QBU's principal sales market; (6) the duration of the QBU's business operations; and (7) the significance and/or volume of the QBU's

independent activities. The rate of inflation is not a relevant factor.

Section 1.985–1T(c)(3) provides that a QBU shall be presumed to maintain books and records in the currency of the economic environment in which a significant part of its activities are conducted.

Section 1.985–1T(c)(4) provides that if a QBU is not required to have a dollar functional currency and more than one currency could qualify as the QBU's functional currency under the facts and circumstances test of section 1.985–1T(c)(1), the QBU may choose any such currency as its functional currency.

Section 1.985–1T(c)(5) provides that ordinarily the currency that a foreign QBU uses for purposes of United States generally accepted accounting principles (GAAP) will be accepted as the functional currency of the QBU for income tax purposes, if the GAAP determination is based on facts and circumstances substantially similar to those set forth in § 1.985–1T(c)(2).

Various determinations under the Code, such as the determination of subpart F income or the amount of a distribution that constitutes a dividend, require that a foreign corporation must have a single functional currency. Thus, where a foreign corporation has one or more QBUs that do not have the same functional currency § 1.985–1T(d) provides that the single functional currency of the foreign corporation is determined by applying the rules set forth in § 1.985–1T(b) and (c) to the corporation's activities as a whole. Once the foreign corporation determines its functional currency, each QBU branch of the foreign corporation having a different functional currency will apply the principles of section 987 (relating to branch transactions) to translate its income or loss or earnings or profits into the foreign corporation's functional currency. Examples (8), (9), (10), (11), and (12) in § 1.985–1T(f) illustrate these rules.

Section 1.985–1T(e) provides, generally, that all nonfunctional currency transactions shall be translated into the QBUs functional currency on a separate transactions basis. Thus, if a QBU has a functional currency other than the dollar, the QBU must translate dollar or other nonfunctional currency transactions into its functional currency on a transaction-by-transaction basis. The separate transactions method is required in computing nonfunctional currency transactions even in situations where the QBU has no dollar books and records but is required to use the dollar as its functional currency because its economic environment is primarily the dollar. The Service is interested in receiving comments from taxpayers on the efficacy of requiring the use of a separate transactions method in all circumstances where a QBU has the dollar as functional currency under section 985(b) (1) and (2) and section 1.985–1T.

Section 1.985–1T(f) provides examples illustrating the provisions of § 1.985–1T.

In general, section 985(b)(3) provides an election to use the dollar as the functional currency to QBUs whose operations would otherwise require it to use a nondollar functional currency. The election, however, is available only to the extent provided in regulations. Section 1.985–2T(a) provides that only an eligible QBU may elect to use the dollar as its functional currency under section 985(b)(3). Section 1.985–2T(b) defines the term "eligible QBU" to mean a QBU whose functional currency is a hyperinflationary currency absent the dollar election. Generally, the term "hyperinflationary currency" means the currency of any country where there is cumulative inflation of at least 100% for a specified 36 calendar month period.

Section 1.985–2T(c) provides rules concerning the time and manner for making the dollar election. Section 1.985–2T(c)(1) provides that eligible QBUs that are branches of United States persons shall make the election by attaching a statement to the United States person's federal income tax return for the taxable year the election is made.

Section 1.985–2T(c)(2) provides election rules for eligible QBUs that are controlled foreign corporations or branches of controlled foreign corporations. Section 1.985–2T(c)(2)(i) provides that in such a case the election may be made either by the foreign corporation or by the controlling United States shareholder on behalf of the foreign corporation by filing a written statement with the Internal Revenue Service and a written notice to United States shareholders. The written statement requirement and the written notice requirement are set forth in § 1.985–2T(c)(2) (ii) and (iii), respectively.

Section 1.985–2T(c)(3) provides rules for making the election in the case of eligible QBUs that are noncontrolled foreign corporations or branches of noncontrolled foreign corporations. The dollar election must be made by the corporation or the majority domestic corporate United States shareholders on behalf of the corporation. The written statement and the written notice rules applicable to controlled foreign corporations also generally apply.

Section 1.985–2T(d) describes the effect of the dollar election. Section 1.985–2T(d)(1) provides that if a dollar election is made by or on behalf of an eligible QBU, the QBU shall be deemed to have the dollar as its functional currency. One effect of this rule is that each United States person that owns stock of an electing foreign corporation must make all of its federal income tax calculations with respect to the foreign corporation using the dollar as the corporation's functional currency.

Section 1.985–2T(d)(2) provides that, in general, any eligible QBU that elects to have a dollar functional currency must compute profit and loss or earnings and profits in dollars using the dollar approximate separate transaction method described in § 1.985–3T. An eligible QBU that has a dollar functional currency may use a separate transaction method only if the QBU demonstrates to the satisfaction of the Commissioner that it can properly employ such method.

Section 1.985–2T(d)(3) provides that if a dollar election is made then the dollar shall be the functional currency of any related person, or branch of any related person, that is an eligible QBU. The term "related person" means any person with the relationship defined in section 267(b) to the electing QBU (or to the United States or foreign person to which the electing QBU is a part). Further, 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.

Section 1.985–2T(d)(4) provides that in, general, if an eligible QBU's functional currency changes due to a dollar election, such change shall be deemed for purposes of § 1.985–4T (relating to method of accounting) 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 the adjustments, if any, required by § 1.985–5T (relating to adjustments required upon a change in function currency). 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, any subsequent election will require the taxpayer to make adjustments to income and/or earnings and profits that must be accounted for over a specified four-year period. Generally, the adjustments are the differences that occur by recomputing a QBU's functional currency as the dollar. The differences shall retain their character for all purposes as if earned or incurred in the year of recomputation.

Section 1.985–2T(d)(5) provides examples illustrating § 1.985–2T.

Section 1.985–3T sets forth the United States dollar approximate separate transactions method. Section 1.985–3T(a) provides that, in general, the dollar approximate separate transactions method must be used to compute profit and loss or earnings and profits of a QBU that has elected the dollar as its functional currency pursuant to § 1.985–2T.

Section 1.985–3T(b) provides that under the dollar approximate separate transactions method of accounting, profit and loss or earnings and profits of a QBU shall be determined under the following four-step approach: (1) Preparing a profit and loss statement in the QBU's hyperinflationary currency; (2) Making the adjustment necessary to conform this profit and loss statement to United States accounting and tax principles; (3) Translating the amount of hyperinflationary currency as shown on such adjusted statement into dollars in accordance with § 1.985–3T(c); and (4) Adjusting the resulting dollar profit and loss or earnings and profits to reflect the amount of currency gain or loss as determined under § 1.985–3T(3)(d).

Section 1.985–3T(c) provides that, in general, the amounts shown on the profit and loss statement shall be translated into dollars at the average exchange rate for the translation period to which they relate. Special rules are provided for translating items of inventory, cost of good sold, depreciation, depletion, amortization, and prepaid items.

Section 1.985–3T(c)(2) describes the specific rules for translating items of inventory and cost of goods sold. Section 1.985–3T(c)(3) provides that amounts representing allowance for depreciation, depletion, or amortization shall be translated at the average exchange rate for the translation period in which the cost of the underlying asset was incurred. Section 1.985–3T(c)(4) provides that prepaid expenses or income shall be translated at the average rate for the translation period during which they were paid or received.

Section 1.985–3T(c)(5) provides that the average exchange rate for any translation period is the average of the daily exchange rates within the translation period. Section 1.985–3T(c)(6) provides that, in general, a translation period shall be each month within a QBU's taxable year. However, if a QBU computes its profit or loss or earnings and profits using translation periods that are less than a month, the QBU can elect to divide its taxable year into translation periods that are less than a month.

Section 1.985–3T(c)(7)(i) provides that no currency gain or loss is permitted with respect to dollar transactions. Thus, any transaction in which the amount that a QBU is entitled to receive is either denominated in terms of the dollar or is determined by reference to the value of dollar, must be computed in dollars on a separate transaction method. Section 1.985–3T(c)(7)(iii) provides that any transaction involving a third country currency shall be computed in dollars on a separate transactions method. A third country currency is defined as any currency other than either the hyperinflationary currency of the QBU or the dollar.

Section 1.985–3T(c)(8) provides examples illustrating section 1.985–3T.

Section 1.985–3T(d)(1) provides that currency gain or loss determined in accordance with § 1.985–3T(d)(2) shall increase or decrease the amount of dollar profit and loss or earnings and profits as determined pursuant to § 1.985–3T (a), (b), and (c).

In addition, section 1.985–3T(d)(1) provides that the amount of currency gain or loss determined under § 1.985–3T(d)(2) shall be from sources outside the United States.

Regulations under section 904(d) will provide rules allocating the amount of currency gain or loss computed under § 1.985–3T(d)(2). Generally, the amount of an eligible QBU's currency gain or loss will be allocated on a gross to gross basis (before application of its section 904(d)(2)(A)(iii)(III) exception from passive income for high-taxed income) among the foreign source income of the eligible QBU in each section 904(d) separate limitation category.

Regulations under section 954 or 952 will also provide rules for allocating the amount of currency gain or loss computed under § 1.985–3T(d)(2) against subpart F and nonsubpart F income. Generally, this will be accomplished by allocating the currency gain or loss among gross subpart F and gross nonsubpart F income of the eligible QBU in each section 904(d) separate limitation category after such amount has first been allocated for section 904(d) purposes.

Section 1.985–3T(d)(2) provides that the currency gain or loss of an eligible QBU, other than currency gain or loss attributable to third currency transactions, shall be the amount equal to: (1) The retained earnings for the taxable year as determined under § 1.985–3T(d)(4); plus (2) the amount of any distributions made during the taxable year translated at the average rate for the translation period or periods during which such distributions were made, minus (3) the amount representing retained earnings for the preceding taxable year as determined under § 1.985–3T(d)(4), minus (4) the amount of dollar profit (or plus the dollar loss) as determined for the taxable year pursuant to § 1.985–3T(b) (1), (2) and (3). Section 1.985–3T(d)(3) provides that all currency gain or loss computed under § 1.985–3T(d)(2) ordinary income or loss.

Section 1.985–3T(d)(4) provides that retained earnings for any taxable year shall be determined by first: (1) Preparing a balance sheet as of the end of such year from the QBU's books and records as recorded in the QBU's hyperinflationary currency; (2) making those adjustments necessary to conform this balance sheet to United States accounting and tax accounting principles; (3) translating the amount shown on the balance sheet into United States dollars in accordance to § 1.985–3T(d)(5). Retained earnings shall be the dollar amount equal to the excess of the aggregate dollar amount representing assets on the balance sheet (after adjustments and translation) over the aggregate dollar amount representing liabilities, reserves, and paid-in-capital on the balance sheet (after adjustments and translation).

Section 1.985–3T(d)(5) provides rules for translating amounts shown on the balance sheet (as adjusted) into dollars. Rules are provided for translating amounts representing inventory, depreciation and similar reserves, bad debts reserves, paid-in-capital, prepaid income or expenses, hyperinflationary cash, physical assets, long-term liabilities, and other assets and liabilities into dollars on the balance sheet.

Section 1.985–3T(d)(6) provides that dollar transactions shall be reflected as dollars on the balance sheet and third currency transactions shall be translated directly into dollars for purposes of the balance sheet.

Section 1.985–3T(c)(7) provides examples illustrating § 1.985–3T(d).

Section 1.985–4T(a) provides that the adoption of a functional currency is a method of accounting that cannot be changed without the consent of the Commissioner. Section 1.985–4T(b) provides that, generally, permission to change functional currencies will not be granted unless significant changes in the facts and circumstances occur.

Section 1.985–5T pertaining to adjustments required upon change in functional currency is reserved.

Non-applicability of Executive Order 12291

It has been determined that this temporary rule is not a major rule as defined in Executive Order 12291 and that a regulatory impact analysis therefore is not required.

Regulatory Flexibility Analysis

A general notice of proposed rulemaking is not required by 5 U.S.C. 553 for temporary regulations. Accordingly, these temporary regulations do not constitute regulations subject to the Regulatory Flexibility Act (5 U.S.C. chapter 6).

Paperwork Reduction Act

The collection of information requirements contained in this regulation have been sumitted to the Office of the Management and Budget (OMB) in accordance with the requirements of the Paperwork Reduction Act of 1980. These requirements have been approved by OMB under control number 1545–1051.

Drafting Information

The principal authors of these temporary regulations are David Rosenberg and F. Scott Farmer of the Office of Associate Chief Counsel (International) within the Office of Chief Counsel, Internal Revenue Service. However, personnel from other offices of the Internal Revenue Service and the Treasury Department participated in developing the regulations on matters of both substance and style.

List of Subjects in 26 CFR 1.861–1—1.997–1

Income taxes, Aliens, Exports, DISC, Foreign Investments in U.S., Foreign tax credit, FSC, Sources of Income, United States investments abroad.

Adoption of Amendments to the Regulations

Accordingly, 26 CFR Parts 1 and 602 are amended to read as follows:

Income Tax Regulations

PART 602—[AMENDED]

Paragraph 1. The authority for Part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

Par. 2. Section 602.101(c) is amended by inserting in the appropriate places in the table § 1.985–2T . . . 1545–1051.

PART 1—[AMENDED]

Par. 3. The authority for Part 1 is amended by adding the following citation:

Authority: 26 U.S.C. 7805. * * * Sections 1.985–0T through 1.985–5T are also issued under the authority of 26 U.S.C. 985.

Par. 4. New §§ 1.985–0T through 1.985–5T are added immediately after § 1.981–3 to read as follows:

§ 1.985–0T Outline of regulation.

§ 1.985–1T 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.

§ 1.985–2T 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.

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

(a) Scope.
(b) In general.
(c) Translation into United States dollars.
(d) Currency gain or loss.

§ 1.985–4T Method of accounting.

(a) Adoption or election.
(b) Condition for changing functional currencies.
(c) Relationship to certain other income tax sections.

§ 1.985–5T Adjustments required upon change in functional currency. [Reserved]

§ 1.985–1T 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). A taxpayer and each QBU must make all determinations under subtitle A of the Code (relating to income taxes) in their 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 1.985–2T 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 1.985–3T sets forth the accounting method electing QBUs must use to compute their profit and loss or earnings and profits. Section 1.985–4T provides that the adoption of a functional currency is a method of accounting and sets forth conditions for a change in functional currency. Finally, § 1.985–5T provides adjustments that are required to be made upon a change in functional currency.

(2) *Effective date.* The regulations set forth in § 1.985–1T through 5T are effective for taxable years beginning after December 31, 1986.

(b) *Dollar functional currency.* The dollar shall be the functional currency of a taxpayer or QBU described in any subparagraph of this paragraph (b) regardless of the currency used in keeping its books and records (as defined in section 989(a)).

(1) A taxpayer that is not a QBU.

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

(3) A QBU that has the United States as its residence (as defined in section 988(a)(3)(B)).

(4) A QBU that elects to use, or is otherwise required to use, the dollar as its functional currency under § 1.985–2T.

(5) 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.

Regardless of any change in circumstances, a QBU described in any subparagraph of this paragraph (b) may not change its functional currency unless the permission of the Commissioner is granted under § 1.985–4T.

(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 its books and records, 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 principal currency of the QBU's cash flows;

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

(D) The principal currency in which the borrowing or lending of the QBU is conducted;

(E) The currency of the QBU's principal sales market;

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

(G) 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 environnent of its QBUs, *i.e.*, 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.

(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.* If a QBU has its residence outside the United States (as determined under section 988(a)(3)(B)), 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 if the GAAP determination regarding such currency 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 not change the functional currency determined under this section (c) unless the permission of the Commissioner is granted under § 1.985–4T or considered to have been granted under § 1.985–2T(d)(4).

(d) *Single functional currency for a foreign corporation*—(1) *General rule.* This paragraph (d) applies to foreign corporations that have two or more QBUs all of which 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 may be 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)(1)(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 § 1.985–2T.

(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 § 1.985–2T (relating to the dollar election), 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 earnings and profits.

(e) *Translation of nonfunctional currency transactions.* Except for a QBU using the dollar approximate separate transactions method described in § 1.985–3T, each QBU shall translate each of its nonfunctional currency transactions using the separate transactions method—that is, gain or loss must be computed relative to a QBU's functional currency on a transaction-by-transaction basis.

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

Example (1). P, a domestic corporation, operates a branch, X, in foreign Country A. X is a QBU within the meaning of section 989(a). 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, the functional currency of X is the LC.

Example (2). P, a domestic bank, operates in branch form in foreign Country R. The branch is a QBU within the meaning of section 989(a). The currency of Country R is the LC. The laws of R require the branch to keep books and records in the LC. The branch customarily loans dollars and LCs. In the case of a LC loan, the branch fixes the terms of the loan 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. The branch is typically funded with dollar-denominated funds borrowed from related and unrelated parties. Under these facts, the branch's activities are primarily conducted in dollars. Thus, although the branch keeps its books and records in LCs, the branch's functional currency is the dollar.

Example (3). S, a foreign corporation organized in T, is wholly-owned by P, a domestic corporation. The currency of T is the LC. S's books and records are maintained in the LC. S purchases most of the products it sells from P. These purchases are made in dollars. In addition, most of S's gross receipts are generated by transactions denominated in dollars. S's only LC activities are paying local taxes, employee wages, and local expenses such as rent and electricity. It is determined that the LC is the currency of S 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, S's activities are primarily conducted in

dollars. Thus, although S maintains books and records in LCs and uses the LC as its currency under United States generally accepted accounting principles, S's functional currency is the dollar.

Example (4). S, a foreign corporation organized in U, is wholly-owned by P, a domestic corporation. The currency of 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 between S and P and its domestic affiliates are in dollars. Furthermore, primarily all of S's other borrowings are dollar denominated. 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). S, a foreign corporation organized in A, is wholly owned by P, a domestic corporation. The currency of A is the LC. S's sole function is holding portfolio stock of Country A corporations and debt instruments denominated in LCs. The stock and the debt instruments could readily be held by P. S funds these investments primarily with contributions made by P. All dividends and interest paid to S are currently remitted to P. S performs no significant activities in A, has no employees, and no office or other fixed place of business. S's only other LC activity is paying local taxes. 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 because its activities are primarily in the dollar. The result in this example would be the same if rather than holding portfolio stock of Country A corporations and debt instruments denominated in LCs, S's sole function was holding stock in domestic corporations and debt instruments denominated in dollars that could readily be held by P.

Example (6). S, a foreign corporation organized in A, is wholly-owned by P, a domestic corporation. The currency of A is the LC. S invests in a wide variety of stock and securities for its own account. S has a fixed place of business in A, employs portfolio managers, and has the independent authority to invest its earnings, finance its transactions, and manage its portfolio. S's activities are primarily funded through its earnings and third party loans. S conducts most of its borrowing and investment activity in the LC. S maintains its books and records in the LC. It is determined that the LC is the currency of S 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, S's functional currency is the LC.

Example (7). D is a domestic corporation whose primary activity is the extraction of natural gas and oil through a branch operation in foreign country Y. The branch is a QBU within the meaning of section 989(a). The currency of Y is the LC. The branch bills a significant amount of its natural gas and oil sales in dollars and a significant amount in LCs. The branch also incurs significant LC and dollar expenses and liabilities. The laws of country Y require the branch to keep its books and records in the LC. It is determined that the dollar is the currency of the branch 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 the branch primarily conducts its activities in the dollar, D could choose either the dollar or the LC as the branch's functional currency because it has significant activities in both the dollar and the LC, provided the branch maintains books and records in both currencies.

Example (8). 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). 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 (10), (11), and (12) for examples of how the earnings and profits of a foreign corporation, which has branches with different functional currencies, are determined.

Example (9). Assume the same facts as in example (8), 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 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 (10). The facts are the same as in example (8). In addition, assume that in 1987 branch A has income of 100 FC and branch B has income of 100 LC as determined under section 987. The weighted average exchange rate for the year is 1 FC/2 LC. Branch A's income is translated into 200 LC for purposes of computing S's income and 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 (11). 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. The income 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 LC's of financial services income earned by A and 100 LCs (200 DC/2) of general limitation income earned by B. Neither A nor B make any remittances during 1987.

In 1988, neither A nor B earns any income or generate 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 5 percent, or 5 LCs, is treated as general limitation income. After the dividend distribution, X has 950 LCs of accumulated earnings and profits consisting of 855 LCs of financial service limitation income and 95 LCs of general limitation income.

Example (12). The facts are the same as in example (11) 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 LC, their LC basis (120 DCs/2). Under section 987(3)(B), the 20 LC loss is allocated solely to X's general limitation income. At the end of 1988, X's accumulated earnings and profits (and post-1986 undistributed earnings) are 980 LCs (1000 LCs − 20 LCs). The 980 LCs consist of 900 LCs of financial services income and 80 LCs (100 LCs − 20 LCs) of general limitation income.

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

(a) *Background and scope.* Section 985(b)(3) of the Code provides that a qualified business unit ("QBU") with a functional currency other than the United States dollar (the "dollar") under section 985(b) (1) and (2) may, to the extent provided in regulations, elect to use the dollar as its functional currency. Pursuant to the regulatory authority provided by section 985(b)(3), this section permits an eligible QBU to elect to use the dollar as its functional currency. 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).

(b) *Eligible QBU*—(1) *In general.* The term "eligible QBU" means a QBU whose functional currency is a hyperinflationary currency absent the dollar election. See § 1.985–1T to determine the functional currency of a QBU absent the dollar election.

(2) *Hyperinflationary currency.* 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 "International Financial Statistics" or a successor publication of the International Monetary Fund. Base period means, with respect to any taxable year, the thirty-six calendar months immediately preceding the last day of such taxable year.

(c) *Time and manner for dollar election*—(1) *QBUs that are branches of United States persons.* If an eligible QBU is a branch of a United States person, the dollar election shall be made by attaching a statement to the United States person's—

(i) Timely filed federal income tax return (including extensions) for the taxable year the election is made, or

(ii) Amended return for the first taxable year beginning in 1987 filed within 180 days after the date this Temporary Regulation is promulgated in the **Federal Register**, in the case of an election for the person's first taxable year beginning in 1987.

The statement shall identify the election as a "Dollar Election" and describe the country where the principal place of business of the eligible QBU is located.

(2) *Eligible QBUs that are controlled foreign corporations or branches of controlled foreign corporations*—(i) *In general.* 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 the written statement described in paragraph (c)(2)(ii) of this section at the time and in the manner prescribed therein, and

(B) Providing the written notice required by paragraph (c)(2)(iii) 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) *Written statement.* The written statement required by paragraph (c)(2)(i)(A) of this section shall be jointly executed by the controlling United States shareholders (or by an officer or director of the foreign corporation with the authority to act for the foreign corporation, if the election is made by the corporation). The statement shall be filed with the Director of the Internal Revenue Service Center, 11601 Roosevelt Blvd., Philadelphia, Pennsylvania 19155, within 180 days after the close of the taxable year of the foreign corporation with respect to which the dollar election is made (or 270 days in the case of the foreign corporation's first taxable year beginning in 1987, if the dollar election is made for such year). The statement shall set forth: The name and country of organization of the foreign corporation; the country where the principal place of business of each eligible QBU that is a branch of the foreign corporation is located; the names, addresses, taxpayer identification numbers and stock interest of the controlling United States shareholders (or all the United States persons known by the foreign corporation who own (within the meaning of section 958(a)) stock in the corporation, if the election is made by the foreign corporation); that the dollar election is being made by or for the foreign corporation (or an eligible QBU branch of such corporation); the names, addresses, taxpayer identification numbers of all United States persons notified of the dollar election; and such other information as the Commissioner may by forms or otherwise require.

(iii) *Notice.* Prior to filing the written statement described in paragraph (c)(2)(ii) of this section, the controlling United States shareholders (or the foreign corporation, if the dollar election is made by the corporation) shall provide written notice of the dollar election 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 set forth in the written statement (as described in paragraph (c)(2)(ii) of this section).

(iv) *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 the written statement required by paragraph (c)(2)(i)(A) of this section or to provide written notice to a United States person required to be notified by paragraph (c)(2)(iii) of this section shall not invalidate the dollar election made, if it is established to the satisfaction of the district director that reasonable cause existed for such failure.

(3) *Eligible QBUs that are noncontrolled foreign corporations or branches of noncontrolled foreign corporations.* 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.

(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. Since the use of a dollar functional currency pursuant to this § 1.985–2T is an accounting method of the foreign corporation, each United States person that owns (within the meaning of section 958(a)) stock of the foreign corporation must take 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)(A) 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 § 1.985–2T has a dollar functional currency must compute profit and loss or earnings and profits (or deficits in earnings and profits) in dollars using the dollar approximate separate transactions method described in § 1.985–3T.

(ii) *Separate transactions method.* An eligible QBU that has a dollar functional currency pursuant to this § 1.985–2T may use a separate transactions method only if the QBU demonstrates to the satisfaction of the Commissioner that it can properly employ such method. For the definition of a separate transactions method, see § 1.985–1T(e).

(3) *Conformity*—(i) *General rule.* If a dollar election is made under § 1.985–2T for an eligible QBU ("electing QBU"), then the dollar shall be the functional currency of any related person, or branch of any 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*—(i) *In general.* Except as provided in paragraph (d)(4)(ii) of this section, if an eligible QBU's functional currency changes due to a dollar election, or to the conformity requirements of paragraph (d)(3) of this section, such change shall be deemed for purposes of § 1.985–4T 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 the adjustments, if any, required by § 1.985–5T.

(ii) *Additional adjustments required in certain circumstances*—(A) *In general.* 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 adjustments required by paragraph (d)(4)(ii)(B) of this section.

(B) *Adjustments.* The adjustments required by this paragraph shall be computed for the period beginning with the first taxable year in which the QBU was an eligible QBU and ending with the taxable year prior to the year to which the dollar election is made (whether the QBU is an eligible QBU in the intervening years is irrelevant). The adjustments shall be taken into income and/or earnings and profits ratably in each of the four taxable years beginning with the year of the dollar election. The adjustments are the differences that occur by recomputing the QBU's functional currency as the dollar for each year within the period involved. The differences shall retain their character for all purposes as if earned or incurred in the year of recomputation.

(5) *Illustrations.* The provisions of this section are illustrated by the following examples.

Example (1). X is a calender year domestic corporation that in 1987 establishes a branch, A, in Country Z. A's functional currency under section 985 (b)(1) and (2) and 1.985–1T 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 1988 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) except 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. The h was hyperinflationary currency for 1987, 1988, 1989, 1990, and 1991. The election constitutes a change in A's functional currency that is made with the consent of the Commissioner. However, because A was an eligible QBU in 1987, adjustments under § 1.985–2T (d)(4)(ii)(B) must be made for taxable years 1987 through 1990.

Example (3). The facts are the same as in example (2) except that the h was a hyperinflationary currency in 1987 and 1991 but not for 1988, 1989, and 1990. The results in example (2) are the same since the status of A as an eligible QBU in the intervening years of 1988, 1989 and 1990 is irrelevant.

Example (4). 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 (5). The facts are the same as in example (4), 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(b0(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.

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

(a) *Scope.* This section describes the United States dollar (dollar) approximate separate transactions method of accounting. Except as provided in § 1.985–2T(d)(2)(ii), this method of accounting must be used to compute profit and loss or earnings and profits (or deficits and earnings and profits) of a QBU (as defined in section 989(a) of the Code) that has the dollar as its functional currency pursuant to § 1.985–2T.

(b) *In general.* Under the dollar approximate separate transactions method of accounting, profit and loss or earnings and profits (or deficits in earnings and profits) of a QBU for its taxable year shall be determined in dollars by—

(1) Preparing a profit and loss statement from the QBU's books and records (within the meaning of section 989(a)) as recorded in the QBU's

hyperinflationary currency (as described in § 1.985–2T(b)(1));

(2) Making the adjustments necessary to conform such statement to those United States accounting and tax principles as provided by the appropriate Code section, such as section 987 or sections 986 and 964(a);

(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 profit and loss or earnings and profits (or deficits in earnings and profits) in accordance with paragraph (d) of this section to reflect the amount of currency gain or loss as determined thereunder.

(c) *Translation into United States dollars*—(1) *In general.* Except as provided in paragraphs (c) (2), (3), and (4) of this section, the amounts shown on the profit and loss statement, as adjusted under paragraph (b)(2) of this section, shall be translated into dollars at the average exchange rate (as defined in paragraph (c)(5) of this section) for the translation period (as defined in paragraph (c)(6) of this section) to which they relate.

(2) *Cost of goods sold*—(i) *In general.* Amounts representing items of inventory reflected in the cost of goods sold or in closing inventory shall be translated—

(A) To the extent that such amounts represent items included in the opening inventory balance, so as to obtain the same amount of dollars which represented such items in the closing inventory balance for the preceding taxable year,

(B) To the extent that such amounts represent items purchased or otherwise first included in inventory during the taxable year, at the average exchange rate for the translation period in which the cost of such items was incurred, and

(C) To the extent that such amounts represent items included in the closing inventory balance, at the average exchange rate for the translation period in which the cost of such items was incurred. However, if amounts representing items included in 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 average 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.

(ii) *Determination of translation period.* The method used to determine the translation period of amounts representing items of inventory reflected in cost of goods sold or closing inventory may be based upon reasonable approximations and averages, including rates of turnover, provided the method is consistently used from year to year.

(3) *Depreciation, depletion, and amortization.* Amounts representing allowances for depreciation, depletion, or amortization shall be translated at the average exchange rate for the translation period in which the cost of the underlying asset was incurred.

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

(5) *Average exchange rate.* The average exchange rate for any translation period is the average of the daily exchange rates within the translation period.

(6) *Translation period*—(i) *In general.* Except as provided in paragraph (c)(6)(ii) of this section, a translation period shall be each month within a QBU's taxable year.

(ii) *Election.* A QBU can elect to divide its taxable year into translation periods that are less than a month. The election is made if the QBU computes its profit or loss or earnings and profits using translation periods that are less than one month. The translation period elected may not be changed without the consent of the district director.

(7) *Dollar and third country currency transactions.* Notwithstanding § 1.985–3T(b)(2) or any other provisions of paragraph (c) of this section, the following rules apply.

(i) *Dollar transactions.* No currency gain or loss is permitted 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 profit and loss statement by the amount of such dollars. Also, any transaction in which the amount that a QBU is entitled to receive (or is required to pay) by reason of such transaction is either denominated in terms of the dollar or is determined by reference to the value of the dollar, must be computed in dollars on a separate transactions method. See § 1.985–1T(e) for the definition of a separate transactions method.

(ii) *Third country currency transactions.* A third country currency is any currency other than either the hyperinflationary currency of the QBU or the dollar. Any transaction involving a third country currency shall be computed in dollars on a separate transactions methods. Thus, any payment or receipt of third country currency shall be reflected in the profit and loss statement in dollars on a separate transactions method. Also, any transaction in which the amount that a QBU is entitled to receive (or is required to pay) by reason of such transaction is either denominated in terms of a third country currency, or is determined by reference to the value of one or more third country currencies, must be computed and reflected in the profit and loss statement in dollars on a separate transactions method.

(8) *Example.* The provisions of this paragraph (c) are illustrated by the following examples.

Example (1). S is an accrual basis eligible QBU that makes a dollar election for its first taxable year beginning in 1987. S's hyperinflationary currency is the "h". At the end of 1987, S has an account receivable for 100 dollars (*i.e.*, the account receivable is payable in dollars). Because this is a dollar transaction under paragraph (c)(7)(i) of this section, S's profit and loss for 1987 shall reflect the 100 dollars (not the hyperinflationary value of such dollars when accrued). If the account receivable were for 120 British pounds, rather than 100 dollars, the account receivable would be a third currency transaction under paragraph (c)(7)(ii) of this section. Therefore, S's profit and loss would reflect the dollar value of the 120 British pounds when accrued.

Example 2. S is an accrual basis eligible QBU that makes the dollar election for its first taxable year beginning in 1987. S has the "h" as its hyperinflationary currency (its functional currency absent the dollar election). During 1987, 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 1987, S purchased depreciable assets for 80,000,000h. At the end of 1987, 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)(7) of this section, and S's closing inventory was computed on the first-in, first-out inventory method. S's adjusted profit and loss statement for 1987 is translated into United States dollars as follows:

Sales	Hyperinflationary currency	Exchange rate	United States dollars
(Jan-Feb)	10,000,000h	[1] 20:1	500,000
(Mar-Apr)	20,000,000	[1] 21:1	952,381
(May-Jun)	50,000,000	[1] 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	0		0
Purchases:			
(Jan-Feb)	15,000,000h	[1] 20:1	750,000
(Mar-Apr)	10,000,000	[1] 21:1	476,190
(May-Jun)	30,000,000	[1] 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] The average exchange rate for each month is the same.
[2] Since S uses the first-in, first-out inventory method, the closing inventory is assumed in normal circumstances 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 Exp.			
(Jan-Feb)	4,000,000h	[1] 20:1	200,000
(Mar-Apr)	2,500,000	[1] 21:1	119,048
(May-Jun)	2,500,000	[1] 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
(Dec.)	4,000,000	31:1	129,032
Total	26,000,000h		1,040,167
Deprec.	4,000,000h	20:1	200,000
Total Cost & Exp.	107,000,000h		4,776,481
Operating Profit	133,000,000h		4,930,121

[1] The average exchange rate for each month is the same.

(d) *Currency gain or loss*—(1) *In general.* Currency gain or loss determined in accordance with paragraph (d)(2) of this section shall increase or decrease the amount of dollar profit and loss or earnings and profits as determined pursuant to paragraphs (a), (b), and (c) of this section. For the manner in which the currency gain or loss is allocated against Subpart F income, see sections 952 and 954 and the regulations thereunder. For the manner in which the currency gain or loss is treated under section 904(d), see section 904(d) and the regulations thereunder. The amount of currency gain or loss determined under paragraph (d)(2) of this section shall be from sources outside the United States.

(2) *Determination of currency gain or loss.* Currency gain or loss of a QBU, other than currency gain or loss attributable to a third currency transaction as described in paragraph (c)(7)(i) of this section, shall be the amount which equals—

(i) The retained earnings for the taxable year as determined under paragraph (d)(4) of this section, plus

(ii) The amount of any distributions (*e.g.*, remittances, dividends, returns of capital, foreign income taxes paid by a QBU branch elected to be credited under section 901 and other non-deductible expenses) made during the taxable year translated at the average exchange rate for the translation period or periods during which such distributions were made (or taken into account in accordance with paragraph

(c)(7) of this section, if applicable), minus

(iii) The amount representing retained earnings for the preceding taxable year as determined under paragraph (d)(4) of this section, minus

(iv) The amount of dollar profit (or plus the amount of any dollar loss) as determined for the taxable year pursuant to paragraph (b) (1) through (3) of this section.

(3) *Character.* The amount of currency gain or loss determined under paragraph (d)(2) of this section shall be ordinary income or loss.

(4) *Retained earnings.* Retained earnings for any taxable year shall be determined by first—

(i) Preparing a balance sheet as of the end of such year from the QBU's books and records (within the meaning of section 989(a)) as recorded in the QBU's hyperinflationary currency;

(ii) Making adjustments necessary to conform such balance sheet to United States accounting and tax principles as provided by the appropriate Code section, such as section 987 or sections 986 and 964(a) (including adjustments for accrued foreign income taxes of a QBU branch if elected to be credited under section 901);

(iii) Translating the amounts shown on the balance sheet (other than the amounts representing retained earnings) into United States dollars in accordance with paragraph (d)(5) of this section. Retained earnings shall be the dollar amount equal to the aggregate amount representing assets on the balance sheet (as adjusted and translated under this paragraph (d)(4) (ii) and (iii)) less the aggregate amount representing liabilities, reserves (other than reserves out of current or accumulated profits and earnings), and paid-in capital on the balance sheet (as adjusted and translated under this paragraph (d)(4) (ii) and (iii)).

(5) *Translation of balance sheet.* Amounts shown on the balance sheet as adjusted pursuant to paragraph (d)(4)(ii) of this section (other than amounts representing retained earnings) shall be translated into dollars as follows:

(i) *Inventory.* Amounts representing items of inventory included in the closing inventory balance shall be translated in accordance with paragraph (c)(2)(i)(C) of this section.

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

(iii) *Paid-in capital.* Amounts representing paid-in capital shall be translated at the average exchange rate for the translation period in which such capital was paid in.

(iv) *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)(4) of this section.

(v) *Hyperinflationary cash.* Amounts representing hyperinflationary cash on hand or in a checking or savings account shall be translated at the average exchange rate for the last translation period of the taxable year.

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

(B) *Adjustment to physical assets.* Amounts representing depreciation, depletion, and amortization reserves shall be translated in accordance with paragraph (c)(3) of this section.

(vii) *Long-term liabilities.* Amounts representing long-term liabilities shall be translated at the average exchange rate for the translation period in which incurred.

(viii) *Other assets and liabilities*—(A) *In general.* Except as provided in paragraph (d)(5)(viii)(B) of this section, amounts representing assets and liabilities other than those specifically described in paragraphs (d)(5) (i) through (vii) of this section shall be translated at the average exchange rate for the translation period in which the cost of the asset was incurred or for the translation period in which the amount of the liability was incurred. For purposes of the preceding sentence, the method used to determine the translation period in which the cost of an asset or amount of a liability was incurred may be based upon reasonable approximations and averages, including rates of turnover and aging of accounts, provided the method is consistently used from year to year.

(B) *Accounts payable.* Amounts representing accounts payable shall be translated at the average rate for the last translation period; except, if the taxpayer establishes to the satisfaction of the district director that any such amounts relate to a different translation period, then the average exchange rate for that translation period shall apply.

(6) *Dollar and third currency transactions.* Notwithstanding any other provisions of this paragraph (d), where the amount representing an item shown on the balance sheet reflects a transaction described in paragraph (c)(7) of this section, such transaction shall be taken into account in accordance with that paragraph.

(7) *Illustration.* The provisions of this paragraph (d) are illustrated by the following example.

Example. S, an accrual method calendar year foreign corporation, makes the dollar election. S's hyperinflationary currency (its functional currency absent the dollar election) is the "h". For 1988, S's operating profit is 81,340,000h, or $2,038,200. S made a 5,000,000h distribution in April and December of 1988. S's translation period is the month. None of S's assets or liabilities reflect a transaction described in paragraph (c)(7) of this section. The average exchange rate for each month in 1988 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

At the end of 1988, S's balance sheet, as adjusted and translated pursuant to this paragraph (d)(4) (ii) and (iii), is 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	39:1	641,025
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

	Hyperinflationary	Exchange rate	U.S. dollar
Preferred Stock	1,000,000	32:1	31,250
C.D.s	5,000,000	39:1,	128,205
Total Assets	406,340,000		14,335,379
Accounts Payable	35,000,000	40:1 [5]	875,000
Long-term liabilities—A	150,000,000	27:1	5,555,556
Liability B	80,000,000	29:1	2,758,621
Liability C	30,000,000	36:1	833,333
Paid-in-Capital	40,000,000	26:1	1,538,462
Retained Earnings	71,340,000		2,774,407
Total Liabilities and Net Worth	406,340,000h		$14,335,379
The exchange gain or loss of S for 1988 is computed as follows:			
Retained Earnings—1988			$2,774,407
Plus—1988 Distributions—April		$147,059	
December		125,000	272,059
Pre-Distribution Earnings			3,046,466
Less—Retained Earnings—1987		$1,708,033	
Operating Profit—1988		2,038,200	3,746,233
Exchange Loss			($699,767)

[1] S ages its account 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)(2)(i)(C).
[3] The cost of S's plant was incurred in several translation periods. Therefore, the dollar cost reflects several translation rates.
[4] S has a variety of equipment. Therefore, S's dollar basis represent the sum of the hyperinflationary cost of each, translated according to the average exchange rate for the translation period incurred.
[5] S has no accounts payable outstanding for greater than 30 days.

§ 1.985-4T Method of accounting.

(a) *Adoption or 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 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 paragraph (d)(2) of this section, then ordinarily the Commissioner will only 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 if the taxpayer (or its QBU) also changes to the new functional currency for purposes of GAAP.

(c) *Relationship to certain other income tax sections.* Nothing in this section shall be construed to override the provisions of any other sections of the Code 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.

§ 1.986-5T Adjustments required upon change in functional currency. [Reserved]

Lawrence B. Gibbs,

Commissioner of Internal Revenue.

Approved April 22, 1988.

O. Donaldson Chapoton,

Assistant Secretary of the Treasury.

[FR Doc. 88-12562 Filed 6-2-88; 8:45 am]

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DEPARTMENT OF TRANSPORTATION

Coast Guard

33 CFR Part 100 and 110

[CGD 05-88-12]

Special Anchorage Areas in Waterside Area of Elizabeth River Between Norfolk and Portsmouth, VA

AGENCY: Coast Guard, DOT.

ACTION: Final rule.

SUMMARY: This rule establishes special anchorage areas to be used during events when the special local regulations in 33 CFR 100.501 are in effect. 33 CFR 100.501 applies to special events held throughout the year in the Waterside Area of the Elizabeth River between Norfolk and Portsmouth, Virginia.

EFFECTIVE DATE: This rule becomes effective on June 3, 1988.

FOR FURTHER INFORMATION CONTACT: Mr. Billy J. Stephenson, Chief, Boating Affairs Branch, Fifth Coast Guard District, 431 Crawford Street, Portsmouth, Virginia 23704-5004 (804) 398-6204.

SUPPLEMENTARY INFORMATION: On March 30, 1988, the Coast Guard issued a notice of proposed rulemaking concerning the establishment of special anchorage areas to be used as spectator anchorage areas during events when the special local regulations 33 CFR 100.501 are in effect, which was published in the **Federal Register** on April 7, 1988 (53 FR 11515). Interested persons were requested to submit comments and no comments were received.

Good cause exists under 5 U.S.C. 553 for making this rule effective in less than 30 days after publication in the **Federal Register.** Delaying the effective date is unnecessary. Without the rule vessels under sixty five feet in length would be required to display anchor lights and shapes while anchored in the spectator anchorages during Harborfest 88.

Drafting Information

The drafters of this rule are Mr. Billy J. Stephenson, project officer, Chief, Boating Affairs Branch, Fifth Coast Guard District, and Commander Robert J. Reining, project attorney, Fifth Coast Guard District Legal Staff.

Discussion of Rule

This rule establishes special anchorage areas to be used as spectator anchorages during events when the special local regulations 33 CFR 100.501 are in effect. These special anchorage areas are required to accommodate spectator craft during the special events