Drug, and Cosmetic Act and under authority delegated to the Commissioner of Food and Drugs and redelegated to the Center for Veterinary Medicine, 21 CFR Parts 510 and 558 are amended as follows:

PART 510—NEW ANIMAL DRUGS

1. The authority citation for 21 CFR Part 510 continues to read as follows:

Authority: Secs. 512, 701(a) (21 U.S.C. 360b, 371(a)); 21 CFR 5.10 and 5.83.

2. Section 510.600 is amended in the table in paragraph (c)(1) by alphabetically adding a new entry, and in paragraph (c)(2) by numerically adding a new entry to read as follows:

§ 510.600 Names, addresses, and drug labeler codes of sponsors of approved applications.

* * * * *

(c) * * *

(1) * * *

Firm name and address	Drug labeler code
* * * * *	
NutriBasics Co., North Highway 71, P.O. Box 1014, Willmar, MN 56201	053740
* * * * *	

(2) * * *

Drug labeler code	Firm name and address
* * * * *	
053740	NutriBasics Co., North Highway 71, P.O. Box 1014, Willmar, MN 56201
* * * * *	

PART 558—NEW ANIMAL DRUGS FOR USE IN ANIMAL FEEDS

3. The authority citation for 21 CFR part 558 continues to read as follows:

Authority: Sec. 512, 82 Stat. 343–351 (21 U.S.C. 360b); 21 CFR 5.10 and 5.83.

§ 558.625 [Amended]

4. Section 558.625 *Tylosin* is amended in paragraph (b)(38) by removing "011749" and replacing it with "053740."

Dated: September 8, 1989.

Robert C. Livingston,

Deputy Director, Office of New Animal Drug Evaluation Center for Veterinary Medicine.

[FR Doc. 89–22158 Filed 9–19–89; 8:45 am]

BILLING CODE 4160-01-M

DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT

Office of the Assistant Secretary for Housing-Federal Housing Commissioner

24 CFR Parts 203, 213, and 234

[Docket No. R–89–1372; FR–2333]

RIN 2502–AD98

Deregulation of Mortgagor Income Requirements

AGENCY: Office of the Assistant Secretary for Housing-Federal Housing Commissioner, HUD.

ACTION: Final rule.

SUMMARY: Currently HUD, by regulation, establishes the amount of mortgagor income considered "adequate" to meet the periodic payments required in the mortgage loan. This rule changes the method of calculating the percentage of a mortgagor's income which will be used to determine whether a mortgagor qualifies for a HUD-insured mortgage. A provision contained in the earlier proposed rule relaxing other regulatory limitations with respect to loan origination fees, is not contained in this final rule.

EFFECTIVE DATE: October 20, 1989.

FOR FURTHER INFORMATION CONTACT: Stephen A. Martin, Director, Office of Insured Single Family Housing, Room 9266, Department of Housing and Urban Development, 451 Seventh Street, SW., Washington, DC 20410. Telephone (202) 755–3046. (This is not a toll-free number.)

SUPPLEMENTARY INFORMATION: HUD published a proposed rule entitled "Deregulation of Loan Origination Fee and Mortgagor Income Requirements" on April 29, 1988 (53 FR 15408). This rule makes final that proposal with revisions and changes as indicated below.

Origination Fee

Under its current regulations, HUD places specific limits on the amount a mortgagee may collect from a mortgagor to compensate the mortgagee for expenses incurred in originating and closing a loan (see 24 CFR 203.27 and 234.48). Generally, the charge may not exceed one percent of the original principal amount of the mortgage. (For new construction involving construction advances, that charge may be increased to a maximum of two and a half percent of the original principal amount of the mortgage to compensate the mortgagee for necessary inspections and administrative costs connected with making construction advances. For mortgages on properties requiring repair or rehabilitation, mortgagor charges may be assessed at a maximum of two and one half percent of the portion of the mortgage attributable to the repair or rehabilitation, plus 1 percent on the balance of the mortgage.)

The proposed rule would have removed, as a general matter, these specific limitations on the amounts mortgagees may charge for originating and closing a loan. The Commissioner would have, however, continued to set limits on the amount of such fees that could be included in the insured mortgage.

The Department has not included the provisions to deregulate loan origination fees in this final rule. For fixed rate mortgages, data available to the Department suggests that, while the loan origination fee cap may be set below the cost of providing loan origination services, the shortfall is easily recovered by charging higher interest rates. As a consequence, the loan origination fee cap does not appear to cause significant inefficiencies in the fixed rate loan market. The Department, however, will undertake a study of the efficiency consequences of continuing to cap loan origination fees for adjustable rate mortgages. The Department intends to complete this study by June 1990, and, if the loan origination fee cap for adjustable rate mortgages is found to cause economic inefficiency, will finalize the removal of the fee cap for these mortgages.

Public comments both against and in favor of eliminating the loan origination fee cap were received on the proposed rule. Favorable comments suggested the loan origination fee cap was unnecessary in the highly competitive mortgage loan market and should be removed. While the Department cannot disagree with this comment, it also notes that apparently the loan origination fee cap on fixed rate mortgages does not keep mortgagees from recovering loan origination costs and does not appear to cause significant inefficiencies in loan origination, as indicated above. The commenters opposed to the deregulation of the fee cap generally stated the concern that deregulation would lead to higher loan origination costs for mortgagors. The Department's data for fixed rate mortgages, however, suggests otherwise. Since a shortfall in mortgage origination costs can easily be recovered through adjustments to the mortgage loan interest rate, mortgagors are currently bearing loan origination costs (directly through loan origination fees and indirectly through mortgage

interest rates) at the competitive level set in the marketplace. Therefore, the elimination of the loan origination fee cap would be expected to cause no change in the total origination cost for mortgagors.

The proposed origination fee provision is not included in this final rule.

Mortgagor Income

In addition to limiting origination fees, current regulations also provide specific guidelines for determining the adequacy of a mortgagor's income to meet the periodic payments required by the mortgage. The mortgagor's income is considered adequate if the total prospective housing expense does not exceed 35 percent of the mortgagor's "net effective income" and if the total prospective housing expense and other recurring charges do not exceed 50 percent of the mortgagor's net effective income (see 24 CFR 203.33, 213.518 and 234.48). Exceptions to the above guidelines are permitted where certain favorable compensating factors, specified by the FHA Commissioner, are present. (In fact, these 35/50 ratios were increased by administrative directive in April, 1982 to 38/53.)

As originally proposed, the final rule removes these specific guidelines from the regulatory text and provides a more flexible and realistic standard. The new standard (in conformity with general industry practice), would substitute the concept of gross income rather than the artificial concept "net effective income" currently used. This change should not, as a practical matter, have a significant impact on prospective mortgagors.

In reviewing the process of changing to gross income HUD also considered whether it should continue to include anticipated monthly maintenance and repairs and heat and utility costs as part of the housing expense in the analysis. We initially concluded in the proposed rule that monthly estimates for maintenance and repairs often did not reflect the actual amounts expended for these items. And, although heat and utility estimates could be more accurately projected, we opted to use a monthly housing expense which included only the principal, interest, taxes and insurance (PITI) and related costs such as MIP and homeowner or condominium fees where applicable. This is the approach used by conventional lenders.

In response to extensive criticism in the public comments with respect to HUD's proposal to delete heat and utility costs as a criterion determining income eligibility, HUD has revised its policy with respect to this item and will permit the mortgagor qualifying ratios to be increased up to 2 percent for homes considered to be energy efficient. The local HUD Field Offices will determine the energy efficiency standards that must be met to be eligible for an increase in the ratios.

In place of the rather intricate definitions and concepts which apply under the existing regulations (see HUD Handbook 4155.1 Rev.), the following concepts, now prevalent in the conventional mortgage market, will be used in administrative instructions to implement this new regulatory approach. Unless otherwise indicated, the concepts are the same as those originally set forth in the proposed rule.

Effective Income will mean allowable gross income from all sources. A Federal tax liability calculation will no longer be required.

Total Housing Expense will mean the sum total of principal, interest, real estate taxes, and hazard insurance (PITI). (Note: Monthly MIP and homeowner association/condo fees must be added, when applicable.) Maintenance and repairs will no longer be used in this calculation. Heat and utilities will be treated in a manner different from the proposed rule, as indicated above.

Recurring Charges will continue to mean any debt that does not mature in six months or is classed as continuous, *e.g.*, automobile loans, child support, child care, etc. It will no longer include such things as state and local taxes, retirement or social security.

Fixed Payment will mean the sum total of the housing expense plus the recurring charges.

Residual Income will mean effective income minus fixed payment.

Housing Ratio will mean housing expense divided by effective income. The recommended guideline HUD anticipates using is 29 percent.

Fixed Payment Ratio will mean fixed payment divided by effective income. The recommended guideline HUD anticipates using is 41 percent. This represents an increase from 38 percent in the proposed rule. This increase in the ratio is based upon additional analysis indicating that 38 percent was too low and that 41 percent would make HUD consistent with the Veterans Adminstration.

In essence, the significant change this rule would make in the existing regulation would be to shift from use of a "net effective income" concept to use of a "gross income" concept in determining adequacy of a mortgagor's income. The impact of such a shift on applicant mortgagors would be negligible but the gain in FHA processing efficiency and accuracy could be significant. HUD will retain authority to adjust the guideline income and fixed payment ratios by administrative instructions to meet the demands of the housing market (see Mortgagee Letter (82–10)).

The 29 and 41 percent ratios cited above were arrived at after reprocessing approximately 200 previously processed and approved HUD cases. The former 38 and 53 percent ratios generally equated to these proposed ratios.

Provision is made in the rule that determinations of adequacy of mortgagor income shall be made in a uniform manner without regard to race, color, religion, sex, national origin, familial status, handicap, marital status, source of income of the mortgagor or location of the property.

Public Comments

Thirty three written comments were received from the public on the proposed rule. There were three comments from members of Congress, eight from regional or local trade associations, seven from national trade or other organizations, eight from state or local energy-related governmental agencies, four from individuals and three from individual businesses. The issues raised by the commenters fell into three major catagories.

I. Removal of Current Limits on Loan Origination Fees

For the reasons stated earlier in this preamble, this final rule does not contain the proposal to remove current limits on loan origination fees. The comments received on this proposed rule are indicated in this preamble's earlier discussion of the proposal.

II. Revision of Mortgagor Income Requirements-Qualifying Ratios

Thirteen commenters addressed this issue. Three commenters were opposed to the revision—ten were in favor of it. Many commenters added specific recommendations concerning the qualifying ratios that should be applied.

The rule removes current specific guidelines from the regulatory text and provides a more flexible and realistic standard. The new standard (in conformity with general industry practice), would substitute the concept of gross income rather than the concept of "net effective income" currently used. Guideline income and fixed payment ratios will be set by HUD in administrative instructions.

The following response by a national housing organization is typical of those who oppose the proposal, mainly on the

ground that the qualifying ratios to be used by HUD are improper.

As described in the proposed rule, qualifying ratios would be based on gross income rather than "net-effective" income, and the definition of housing expense would be that used by conventional lenders (principal, interest, taxes and insurances). The measure of total fixed payments would also be adjusted to that used by conventional lenders by dropping social security, and state and local taxes. This approach, while consistent with streamlining efforts we support, does not offer an advantage to homebuyers since the method currently used by FHA to determine housing expense is sensitive to local conditions such as energy costs and taxes.

However, our major objection is to the proposed upper limit ratio of 38 percent. Our analysis of a sample of FHA cases actually approved indicates that a literal application of the proposed 29–38% would have resulted in disapproving almost half of all cases. In all but one case, exceeding the fixed payment ratio would have been the cause. This analysis also indicates that current underwriting ratios (38–53%) were routinely exceeded in order to qualify a buyer. In fact, the fixed payment ratio (53%) is so restrictive that it would, if strictly applied, disqualify most buyers with typical monthly obligations such as a car payment or child support. HUD has had to rely heavily on compensating factors to qualify borrowers under the current ratio system. The implication of this analysis is that unless HUD is prepared to exceed its proposed ratios in a significant number of cases, a large fraction of borrowers who would have been accepted for insurance under current practices will be excluded from participation in the program. It was the [national housing organization's] understanding that HUD's goal was to streamline processing without excluding any borrower who would qualify under current requirements.

A system that is designed to rely on exceptions to make it work reasonably is inefficient and potentially damaging. It would seem more appropriate to set the ratios at a level that permits borrowers to qualify without having to rely routinely on compensating factors, a process that subjects an underwriter to being second guessed in the event a loan goes into default.

We strongly urge the Department to consider a fixed payment ratio of 42 percent. HUD previously concluded that 42 percent was a level which was comparable to HUD's current 53 percent ratio. We see no evidence to suggest that lowering this ratio to 38 percent represents either good policy or sound program administration.

With respect to the fixed payment ratio of 38 percent set forth in the preamble to the proposed rule, this has been increased to 41 percent in this final rule. With respect the earlier comment urging that the "net effective income" concept is more sensitive to local needs, we believe that the special provisions set forth in the Preamble to this final rule with respect to heat and energy costs go a considerable way toward meeting this concern.

III. Proposal not to Include Energy Expenses in Estimates of Monthly Housing Expense

Fourteen commenters, mainly State or local energy offices, or regional associations, objected strongly to this proposal.

The preamble to the proposed rule noted that HUD was reconsidering its policy of including anticipated monthly maintenance and repairs and heat and utility costs as part of its the housing expense analysis. It concluded that monthly estimates for maintenance and repairs often did not reflect the actual amounts expended for these items. Although heat and utility estimates can be more accurately projected, HUD was opting for using a monthly housing expense estimate which included only the principal, interest, taxes and insurance (PITI) and related costs such as MIP and homeowner or condominium fees where applicable. It noted that this is the approach used by conventional lenders and invited the views of the public on this decision, stating that it would give careful consideration to such views in developing a final rule.

Typical of the objections are those raised by a state Energy office.

We feel as though HUD will be doing a disservice to both taxpayers and mortgagors by deleting utility costs as a criterion for determining income eligibility. In Arkansas, it is not uncommon for utility costs to equal or exceed the principal and interests on mortgages. A number of lending institutions have recognized this fact and make efforts to consider the energy efficiency of houses in their income eligibility requirements. The debt-to-income ratio can be adjusted to the benefit of the mortgagor if he/she is purchasing an energy efficient house. Failure to consider energy costs should only serve to increase the number of failed mortgages.

As noted earlier, largely in response to these comments HUD has revised its initial policy to permit the mortgagor qualifying ratios to be increased up to 2 percent for homes considered to be energy efficient. The local HUD Field Offices will determine the energy efficiency standards that must be met to be eligible for an increase in the ratios.

Procedural Requirements

In accordance with 5 U.S.C. 605(b) (the Regulatory Flexibility Act), the Undersigned hereby certifies that this rule does not have a significant economic impact on a substantial number of small entities, since, in general, it would not significantly change mortgagor eligibility or FHA insurance benefits, but instead would increase the efficiency of mortgage insurance application processing.

This rule was listed as item H–18–87 [Sequence Number 953] in the Department's Semiannual Agenda of Regulations published on April 24, 1989 (54 FR 16708, 16728) under Executive Order 12291 and the Regulatory Flexibility Act.

A Finding of No Significant Impact with respect to the environment has been made in accordance with HUD regulations in 24 CFR part 50, which implement section 102(2)(C) of the National Environmental Policy Act of 1969. The Finding of No Significant Impact is available for public inspection during regular business hours (7:30 a.m. to 5:30 p.m. weekdays) in the Office of the Rules Docket Clerk, Office of the General Counsel, Room 10276, Department of Housing and Urban Development, 451 Seventh Street, SW., Washington, DC 20410.

This rule does not constitute a "major rule" as that term is defined in section 1(b) of Executive Order 12291 on Federal Regulation issued by the President on February 17, 1981. Analysis of the proposed rule indicates that it does not: (1) Have an annual effect on the economy of $100 million or more; (2) cause a major increase in costs or prices for consumers, individual industries, Federal, State or local government agencies, or geographic regions; or (3) have a significant adverse effect on competition, employment, investment, productivity, innovation, or the ability of United States-based enterprises in domestic or export markets.

The home mortgage insurance programs affected by the rule are listed in the Catalog of Federal Domestic Assistance under program numbers 14.108 Rehabilitation Mortgage Insurance; 14.117 Mortgage Insurance—Homes; 14.119 Mortgage Insurance—Homes for Disaster Victims; 14.120 Mortgage Insurance— Homes for Low and Moderate Income Families; 14.121 Mortgage Insurance—Homes in Outlying Areas; 14.122 Mortgage Insurance—Homes in Urban Renewal Areas; 14.123 Mortgage Insurance—Housing in Older, Declining Areas; 14.130 Mortgage Insurance—Purchase by Homeowners of Fee Simple Title from Lesssors; 14.133 Mortgage Insurance—Purchase of Units in Condominiums; 14.140 Mortgage Insurance—Special Credit Risks; 14.159 Section 245 Graduated Payment Mortgage Program; 14.161 Single Family Home Mortgage Coinsurance; 14.165 Mortgage Insurance—Homes—Military Impacted Areas; 14.166 Mortgage Insurance—Homes for Members of the Armed Services; 14.172 Mortgage

Insurance—Growing Equity Mortgages; 14.175 Adjustable Rate Mortgages.

Executive Order 12612, Federalism

The General Counsel, as the Designated Official under section 6(a) of Executive Order 12612, *Federalism,* has determined that the policies contained in this rule will not have substantial direct effects on states or their political subdivisions, or the relationship between the Federal government and the States, or on the distribution of power and responsibilities among the various levels of government. As a result, the rule is not subject to review under the Order.

Specifically, the requirements of this rule are directed to mortgagors and lenders and do not impinge upon the relationship between the Federal government and State and local governments.

Executive Order 12606, The Family

The General Counsel, as the Designated Official under Executive Order 12606, *The Family,* has determined that this rule does not have potential for significant impact on family formation, maintenance, and general well-being, and, thus, is not subject to review under the order. The rule involves rationalizing income requirements for mortgage loans insured by the Department. No substantive changes are made in these requirements however, so any effect on the family would likely be indirect and insignificant.

List of Subjects

24 CFR Part 203

Mortgage insurance; Home improvement; Loan programs; Housing and community development; Solar energy.

24 CFR Part 213

Mortgage insurance; Cooperatives.

24 CFR Part 234

Condominiums, mortgage insurance; Homeownership; Projects; Units.

Accordingly, 24 CFR parts 203, 213, and 234 are amended to read as follows:

PART 203—MUTUAL MORTGAGE INSURANCE AND REHABILITATION LOANS

1. The authority citation for 24 CFR part 203 continues to read as follows:

Authority: Secs. 203, 211, National Housing Act (12 U.S.C. 1709, 1715b); sec. 7(d), Department of Housing and Urban Development Act (42 U.S.C. 3535(d)). In addition, subpart C is also issued under sec. 230, National Housing Act (12 U.S.C. 1715(u)).

2. In § 203.33, paragraph (a) is revised and a new paragraph (c) is added, to read as follows:

§ 203.33 Relationship of income to mortgage payments.

(a) Adequacy of mortgagor's gross income. A mortgagor must establish, to the satisfaction of the Secretary, that his or her gross income is and will be adequate to meet (1) the periodic payments required by the mortgage submitted for insurance and (2) other long-term obligations.

* * * * *

(c) Determinations of adequacy of mortgagor income under this section shall be made in a uniform manner without regard to race, color, religion, sex, national origin, familial status, handicap, marital status, source of income of the mortgagor or location of the property.

PART 213—COOPERATIVE HOUSING MORTGAGE INSURANCE

3. The authority citation for 24 CFR part 213 continues to read as follows:

Authority: Secs. 211, 213, National Housing Act (12 U.S.C. 1715b, 1715e); sec. 7(d), Department of Housing and Urban Development Act (42 U.S.C. 3535(d)).

4. In § 213.521, paragraph (a) is revised and a new paragraph (c) is added, to read as follows:

§ 213.521 Relationship of income to mortgage payments.

(a) Adequacy of mortgagor's gross income. A mortgagor must establish, to the satisfaction of the Secretary, that his or her gross income is and will be adequate to meet (1) the periodic payments required by the mortgage submitted for insurance and (2) other long-term obligations.

* * * * *

(c) Determinations of adequacy of mortgagor income under this section shall be made in a uniform manner without regard to race, color, religion, sex, national origin, familial status, handicap, marital status, source of income of the mortgagor or location of the property.

PART 234—CONDOMINIUM OWNERSHIP MORTGAGE INSURANCE

5. The authority citation for 24 CFR part 234 continues to read as follows:

Authority: Secs. 211, 234, National Housing Act (12 U.S.C. 1715b and 1715y); sec. 7(d), Department of Housing and Urban Development Act (42 U.S.C. 3535(d)).

6. Section 234.56 is revised to read as follows:

§ 234.56 Relationship of income to mortgage payments.

(a) A mortgagor must establish, to the satisfaction of the Secretary, that his or her gross income is and will be adequate to meet (1) the periodic payments required by the mortgage submitted for insurance and (2) other long-term obligations.

(b) Determinations of adequacy of mortgagor income under this section shall be made in a uniform manner without regard to race, color, religion, sex, national origin, familial status, handicap, marital status, source of income of the mortgagor or location of the property.

Dated: September 6, 1989.

James E. Schoenberger,

General Deputy Assistant Secretary for Housing—Federal Housing Commissioner.

[FR Doc. 89-22147 Filed 9-19-89; 8:45 am]

BILLING CODE 4210-27-M

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Parts 1 and 602

[T.D. 8263]

RIN 1545-AL24

Definition of Functional Currency

AGENCY: Internal Revenue Service, Treasury.

ACTION: Final and temporary regulations.

SUMMARY: This document contains both final and temporary Income Tax Regulations relating to the definition of functional currency. Under the Tax Reform Act of 1986 all federal income tax determinations are made in a taxpayer's or a qualified business unit's (QBU's) functional currency. These final and temporary regulations are necessary to provide guidance to taxpayers and QBUs which must determine their functional currency in order to determine United States income tax liabilities. The text of the temporary regulations set forth in this document also serves as the text of the proposed regulations cross-referenced in the notice of proposed rulemaking in the Proposed Rules section of this issue of the Federal Register.

EFFECTIVE DATE: Sections 1.985–0 through 1.985–4 of the final regulations and the removal of §§ 1.935–0T through 1.985–4T of the temporary regulations are effective for all taxable years beginning after October 20, 1989. These final regulations may be applied to all

taxable years beginning after December 31, 1986.

Temporary regulation §§ 1.985–5T, 1.985–6T, and 1.989(b)–1T are effective for all taxable years beginning after December 31, 1986.

The amendment to § 602.101 is effective October 20, 1989.

FOR FURTHER INFORMATION CONTACT: Carol Murphy of the Office of Associate Chief Counsel (International), within the Office of Chief Counsel, Internal Revenue Service, 1111 Constitution Avenue, NW., Washington, DC 20224, (Attention: CC:CORP:T:R (INTL–962–86)) (202–566–3160, not a toll-free call).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in this final regulation has been reviewed and approved by the Office of Management and Budget in accordance with the requirements of the Paperwork Reduction Act (44 U.S.C. 3504(h)) under control number 1545–1051. The estimated annual burden per respondent/recordkeeper varies from .75 hours to 1.75 hours, depending on individual circumstances, with an estimated average of 1.25 hours.

These estimates are an approximation of the average time expected to be necessary for a collection of information. They are based on such information as is available to the Internal Revenue Service. Individual respondents/recordkeepers may require greater or less time, depending on their particular circumstances.

Comments concerning the accuracy of this burden estimate and suggestions for reducing this burden should be directed to the Internal Revenue Service, Attn: IRS Reports Clearance Officer T:FP, Washington, DC 20224, and to the Office of Management and Budget, Paperwork Reduction Project (1545–1051), Washington DC 20503.

Background

On June 3, 1988, the **Federal Register** published proposed amendments (53 FR 20308 (1988)) to the Income Tax Regulations (26 CFR part 1) under section 985 of the Internal Revenue Code of 1986, in order to conform the regulations to section 1261 of the Tax Reform Act of 1986 (Pub. L. 99–514, 100 Stat. 2085, 2590). Written comments responding to this notice were received. No public hearing was requested or held. After consideration of all comments regarding the proposed amendments, §§ 1.985–1 through 1.985–4 are adopted by this Treasury Decision with revisions in response to those comments. The comments and revisions are discussed below. In addition, this Treasury Decision also sets forth temporary Income Tax Regulation § 1.985–5T which was previously reserved, to set forth the adjustments necessary on a change in functional currency. Also set forth is temporary Income Tax Regulation § 1.985–6T which provides transition rules for a QBU that uses the dollar approximate separate transactions method for its first taxable year beginning in 1987, and temporary Income Tax Regulation § 1.989(b)–1T which provides the definition of weighted average exchange rate.

Need for Temporary Regulations

Section 1.985–5T is necessary in order to provide taxpayers with immediate guidance as to the adjustments that are necessary when a taxpayer or a QBU changes functional currency, as determined under section 985. Section 1.985–6T is necessary in order to provide taxpayers with immediate guidance as to the transition rules to apply to a QBU that uses the dollar approximate separate transactions method for its first taxable year beginning in 1987. Section 1.989(b)–1T is also necessary in order to provide taxpayers with immediate guidance as to the calculation of the appropriate weighted average exchange rate. Therefore, good cause is found to dispense with the notice and public procedure requirements of 5 U.S.C. 553(b) and the delayed effective date requirement of 5 U.S.C. 553(d).

Explanation of Provisions

Section 1.985–1 Determination of Taxpayer's or Its QBU's Functional Currency

Section 1.985–1(b)(6) has been added to specifically provide that effectively connected income activities will be treated as a separate qualified business unit (QBU) that has the dollar as its functional currency. This rule clarifies that effectively connected income is determined in the United States dollar (dollar).

Several comments were received with respect to the facts and circumstances that are considered in determining the economic environment of a QBU under paragraph (c)(2). In response, an additional factor, the currencies in which pricing and other financial decisions are made, was added to paragraph (c)(2)(i). This provision is illustrated in new Example (6). Like the proposed regulations, the factors listed are not meant to be exclusive nor is any particular weight given to any factor.

In response to questions concerning the effect of the books and records presumption, paragraph (c)(3) has been changed to provide that a QBU may not use the books and records presumption affirmatively. The books and records presumption was adopted to prevent a QBU from effectively electing out of using the currency of its economic environment as its functional currency by simply not keeping books and records. This presumption was not intended to allow QBUs to elect to use a currency as their functional currency where they do not actually keep books and records in the currency.

In response to several comments, paragraph (c)(5) has been changed to make it clear that a QBU's GAAP currency is only relevant where the QBU is not otherwise required to use the dollar under paragraph (b). In this regard, Examples (3), (5), and (6) of the proposed regulations have been removed because of apparent confusion they created on this point.

Several commentators suggested that QBUs should not be required to calculate gain or loss on nonfunctional currency transactions on a strict transaction-by-transaction basis. In response, paragraph (e) has been changed to provide that nonfunctional currency transactions shall be accounted for as provided under section 988.

In response to a comment, Example (2) has been added to paragraph (f) to illustrate that a domestic regulated investment company operating exclusively abroad can have a QBU which has a nondollar functional currency. This example also shows that a functional currency may differ from a GAAP currency, especially where the GAAP currency is determined under facts and circumstances that differ from those listed in paragraph (c)(2).

Section 1.985–2 Election to Use the United States Dollar as the Functional Currency of a QBU

Two commenters suggested that the dollar election should not be limited to QBUs in hyperinflationary economies. This suggestion was not adopted because of a perceived reluctance on the part of taxpayers to use the method on a worldwide basis. Worldwide conformity would lessen the opportunity to select one method over another for tax motivated reasons. However, the Service is interested in receiving comments from taxpayers who would be willing to make the dollar election on a worldwide basis, with appropriate related party conformity rules.

One commenter suggested that all QBUs which use the dollar as their functional currency under § 1.985–1 be

allowed to use the dollar approximate separate transactions method. This suggestion was not adopted since such QBUs presumably must keep dollar books and records in the ordinary course of their business.

It was suggested that a currency should be presumed to be hyperinflationary if it is hyperinflationary for GAAP purposes. This suggestion was not adopted because the conformity rules necessitate a readily available objective standard. If the information that is necessary for making the hyperinflationary determination is not available in the "International Financial Statistics," paragraph (b)(2) now allows the QBU to use any other reasonable method consistently applied for determining the country's consumer price index. In addition, paragraph (b)(2) has been changed to provide that the base period used in calculating whether a currency is hyperinflationary means the thirty-six calendar months immediately preceding the last day of the preceding taxable year.

Under paragraph (c)(2) of the proposed regulations, QBUs electing the dollar were required to file a statement of such election. In order for the Service to better track who is using the dollar method, the election will generally require the filing of a new Form 8819. This form will merely require the same information as the election procedures under the Temporary Regulations. Until Form 8819 is released, the election must continue to be made under the procedures set forth in the Temporary Regulations.

Several commenters requested that the time and manner for making the dollar election for 1987 be extended. The rules were not changed because § 1.9100–1 (relating to time for making certain elections) provides a remedy for late elections. Requests for relief will be considered on a case by case basis. See Rev. Proc. 79–63, 1979–2 C.B. 578. In any event, the dollar election may be made in a later year without the Commissioner's consent.

Paragraph (d)(2)(ii) has been changed to allow a QBU to use a method other than the dollar approximate separate transactions method where the QBU demonstrates that it can compute its currency gain or loss under section 988 with respect to each of its section 988 transactions. However, if in a future year the QBU can no longer demonstrate 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. In such an event the QBU shall simply begin accounting for its operations in accordance with § 1.985–3.

Paragraph (d)(3) generally provides that if a taxpayer makes a dollar election pursuant to § 1.985–2, and thus uses the dollar approximate separate transactions method or the alternative method described in the preceding paragraph, then each eligible QBU that is related to the taxpayer must use the dollar as its functional currency. Two commenters suggested that the conformity rule found in paragraph (d)(3) be removed or limited to related QBUs having the same functional currency (absent the election). This suggestion was not adopted to prevent a taxpayer from selectively using the dollar approximate separate transactions method only where the taxpayer has a favorable asset/liability mix. No taxpayer suggested that a profit and loss method of accounting accurately reflects income in a hyperinflationary environment.

Paragraph (d)(4) sets forth the adjustments that are necessary when a QBU changes to the dollar as its functional currency under § 1.985–2. Since § 1.985–5T sets forth general rules on the adjustments that are necessary when changing functional currency, paragraph (d)(4)(i) has been changed to provide that if a QBU's functional currency changes to the dollar due to a dollar election or due to the conformity rule of paragraph (d)(3), the QBU must make those adjustments required by § 1.985–5T (or any succeeding final regulation).

Section 1.985–2(d)(5) has been added to clarify which taxable year a related person shall make the adjustments required under paragraph (d)(4).

Section 1.985–2(d)(6) clarifies the rule in the proposed regulations that an election may be made by or on behalf of a QBU in any year in which the QBU is an eligible QBU. If the QBU changes to a dollar functional currency under this paragraph, it must make those adjustments required under § 1.985–5T (or any succeeding final regulation).

Section 1.985–2(d)(7) provides that regardless of any change in circumstances (*e.g.*, a currency ceases to be hyperinflationary), a QBU whose functional currency is the dollar under § 1.985–2 may change its functional currency only as allowed under § 1.985–4.

Section 1.985–3 United States Dollar Approximate Separate Transactions Method

Several commenters suggested that QBUs should be permitted to use GAAP hyperinflationary accounting rather than the dollar approximate separate transactions method (DASTM). This suggestion was not adopted because the DASTM incorporates tax accounting principles not reflected in the GAAP accounting method.

Paragraph (c)(2) has been reorganized in order to clarify how cost of goods sold is computed. The reorganization in no way changes the substantive rules of this paragraph.

One commenter suggested that more flexibility should be allowed in determining the average exchange rate. This suggestion was not adopted because the simple average rate is easily determinable and not subject to manipulation.

In response to a comment, paragraph (c)(7)(ii) of the proposed regulations relating to third currency transactions has been removed. Therefore, no special accounting adjustments are required for third currency transactions. Rather, they are accounted for like any other nondollar transaction. However, in computing the hyperinflationary amount of a third currency asset and liability and the hyperinflationary amount of an eligible QBU's profit and loss or earnings and profits (or deficit in earnings and profits) the principles of section 988 will apply with respect to third currency transactions.

Section 1.985–3(d) provides rules for determining currency gain or loss under the DASTM. Section 1.9B5–3(d)(2) provides that a QBU's currency gain or loss is generally equal to the difference between the QBU's net change in its equity (assets less liabilities) determined under § 1.985–3(d) and the QBU's dollar profit or loss determined under § 1.985–3(c). In making this calculation, however, the QBU must also adjust for certain transactions that affected the QBU's books but should not affect the QBU's net change in its equity. Paragraph (d)(2) has been changed to require that the QBU translate certain adjusting items (*e.g.*, dividends and remittances) into dollars at the spot rate on the relevant date. This change has been made in order to make the DASTM a closer approximation to separate transactions. In addition, capital contributions are now an adjustment in calculating currency gain or loss under this paragraph (d)(2).

Section 1.985–3(d)(4) describes how a QBU calculates its net worth. Net worth is defined as being equal to the dollar amount of the QBU's assets less the dollar amount of its liabilities. This amount is no longer adjusted by prior year's paid-in capital or reserves. This change was made because of certain accounting problems that occurred where a QBU adjusted its net worth for

capital contributions and because it has been determined that there is no need to adjust net worth for any type of reserves. The term "net worth" has been adopted because it is more reflective of the computation than the formerly used term "retained earnings."

Section 1.985–3(d)(5)(vi) has been changed to make it clear that amounts representing long-term liabilities, including any amounts of such liabilities that become short-term during the taxable year, shall be translated at the average exchange rate for the translation period in which the liability was incurred.

Section 1.985–4 Method of Accounting

Section 1.985–4(d) is substantially unchanged. One commenter suggested that a taxpayer have a one time opportunity to change functional currencies without the consent of the Commissioner where under the facts and circumstances the taxpayer thought it was required to use the dollar under § l.985–1T(b)(2). While this suggestion was not adopted, taxpayers have the ability to request a change in functional currencies under § 1.985–4. One factor that may be considered in granting a change is a misapplication of the facts and circumstances test.

Section 1.985–5T Adjustments Required Upon Change in Functional Currency

Section 1.985–5T(a) provides that a QBU changing to a new functional currency must make those adjustments required by the 3-step procedure set forth in § 1.985–5T (b) through (e). These adjustments must be made on the last day of the QBU's taxable year ending prior to the date it changes functional currencies. Except as provided in § 1.985–6T, the principles of § 1.985–5T shall also apply where a QBU's functional currency for its first taxable year beginning in 1987 is different from the currency in which it kept its books and records for United States accounting and tax accounting purposes for its prior taxable year. Thus, for example, it would not apply if a QBU that used the dollar approximate separate transactions method for the QBU's first taxable year beginning in 1987 used a net worth method of accounting for such prior taxable year. *See* § 1.985–6T.

Section 1.985–5T(b) provides that the QBU must first recognize or otherwise take into account any unrealized exchange gain or loss attributable to a section 988 transaction that is denominated in terms of or by reference to the QBU's new functional currency. This gain or loss shall be determined without regard to the market gain or loss on the transaction as a whole.

Section 1.985–5T(c) provides that the QBU must generally then determine the new functional currency adjusted bases of its assets and the new functional currency amounts of its liabilities and any other relevant amounts. All such new amounts shall be determined by translating the old functional currency amounts of such items into new functional currency amounts at the spot rate.

The third step is broken into two parts, § 1.985–5T(d) providing for further adjustments that are necessary when a branch changes functional currency and § 1.985–5T(e) providing for further adjustments that are necessary when a taxpayer changes functional currency.

Section 1.985–5T(d)(1) provides that when a branch changes to a functional currency other than the taxpayer's functional currency, the branch shall make certain adjustments for purposes of section 987. If such a branch's old functional currency was different from the taxpayer's functional currency, § 1.985–5T(d)(1)(i) provides that the branch's new functional currency equity pool shall be determined by translating the branch's old functional currency equity pool into new functional currency at the spot rate. If instead the branch's old functional currency was the same as the taxpayer's functional currency, the branch's equity basis pool shall equal its equity (assets less liabilities) as of the time of the change. The branch's equity pool shall then be determined by translating the equity basis pool into the branch's new functional currency at the spot rate.

Section 1.985–5T(d)(2) provides that if a branch changes to the taxpayer's functional currency, the branch shall be treated as if it terminated and the taxpayer shall realize currency gain or loss under the principles of section 987.

Section 1.985–5T(e)(1) provides that a corporation changing functional currency shall determine the new functional currency amount of earnings and profits and capital by translating the old functional currency amount at the spot rate.

Section 1.985–5T(e)(2) sets forth certain collateral consequences to a United States shareholder of a foreign corporation changing to the dollar as its functional currency. In such a case, the shareholder shall take into account any unrealized foreign currency gain or loss computed under section 986(c) as if any previously taxed earnings and profits were distributed immediately prior to the change. In addition, the shareholder will also recognize gain or loss attributable to the corporation's paid-in capital to the extent provided, if any, in future regulations under section 367(b) or 985.

Section 1.985–5T(e)(3) relating to taxpayers that are not corporations has been reserved.

Section 1.985–5T(e)(4) sets forth adjustments that are necessary for a branch of a taxpayer that changes functional currencies. These adjustments are the same as those required under §§ 1.985–5T(d) (1) and (2).

Section 1.985–5T(f) provides examples illustrating the provisions of § 1.985–5T.

Section 1.985–6T Transition Rules for a QBU That Uses the Dollar Approximate Separate Transactions Method for Its First Taxable Year Beginning After December 31, 1986.

This section incorporates transition rules that were previously issued under Notice 88–101, 1988–2 C.B. 441. These rules are now set forth in § 1.985–6T (a) through (d). In addition, § 1.985–6T(e) provides transition rules for a branch that previously used a profit and loss method of accounting and changes to the DASTM for its first taxable year beginning in 1987. Such branches must first apply the transition rules of § 1.987–1T or its successor provision and then make any adjustments set forth in § 1.985–5T (or any succeeding final regulation).

Section 1.989(b)–1T Definition of Weighted Average Exchange Rate

This Treasury Decision also provides temporary regulations relating to the definition of weighted average exchange rate under section 989(b). The regulation generally adopts the definition which was set forth in Notice 88–102, 1988–2 C.B. 442. In response to commenters, the daily average exchange rate shall be computed on the basis of business days.

Special Analyses

It has been determined that these rules are not major rules as defined in Executive Order 12291. Therefore, a Regulatory Impact Analysis is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. Chapter 5) and the Regulatory Flexibility Act (5 U.S.C. Chapter 6) do not apply to these regulations, and, therefore, a final Regulatory Flexibility Analysis is not required.

Drafting Information

The principal author of these final regulations is David Rosenberg of the Office of Associate Chief Counsel (International) within the Office of Chief

Counsel, Internal Revenue Service. Other personnel from the Internal Revenue Service and the Treasury Department participated in developing the regulations.

List of Subjects

26 CFR 1.861–1 through 1.997–1

Income taxes, Corporate deductions, Aliens, Exports, DISC, Foreign Investments in U.S., Foreign tax credit, FSC, Sources of income, U.S. investments abroad.

26 CFR Part 602

Reporting and recordkeeping requirements.

Adoption of Amendments to the Regulations

Accordingly, 26 CFR parts 1 and 602 are amended as follows:

Income Tax Regulations

PART 1—[AMENDED]

Paragraph 1. The authority for part 1 continues to read in part:

Authority: 26 U.S.C. 7805. * * *

§§ 1.985–0T through 1.985–4T

Par. 2. Sections 1.985–0T through 1.985–4T are removed.

Par. 3. New §§ 1.985–0 through 1.985–4 and 1.985–6T are added at the appropriate places and § 1.985–5T is revised to read as follows:

§ 1.985–0 Outline of regulation.

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

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

§ 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.

§ 1.985–5T Adjustments required upon change in functional currency (Temporary regulation).

(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.

§ 1.985–6T 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) Net worth branch.
(e) Profit and loss branch.

§ 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 accounting method electing 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 1.985–5T provides adjustments that are required to be made upon a change in functional currency. Finally, § 1.985–6T 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.* The dollar shall be the functional currency of a taxpayer or QBU described in any of the following regardless of the currency used in keeping its books and records (as defined in § 1.989(a)–1T(d) or any succeeding Final Regulations):

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

(2) 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;

(3) Except as otherwise provided, 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));

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

(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; or

(6) 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 with a dollar functional currency.

Regardless of any change in circumstances, a QBU described in this paragraph (b) may change its functional currency only if the QBU complies with § 1.985–4.

(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).

(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 § 1.985–2, 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). In 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.

§ 1.985–2 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 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.* 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. If a country is not listed in the "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 last day of the preceding taxable year.

(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 section 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).

§ 1.985–3 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 § 1.985–2(d)(2)(ii), this method of accounting must be used to compute income or loss or earnings and profits (or deficit in 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 § 1.985–2.

(b) *In general.* Under the dollar approximate separate transactions method of accounting, income or loss or earnings and profits (or 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)–1T(d) or its successor) as recorded in the QBU's hyperinflationary currency (as described in § 1.985–2(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 sections 987 and 988 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 income or loss or earnings and profits (or deficit 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), (4), (5), and (8) of this section, 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 average 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.

(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 ending 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 average 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 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.

(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)(2)(iii)(A) of this section may be based upon reasonable approximations and averages, including rates of turnover, provided the method is consistently used from year to year.

(4) *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.

(5) *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.

(6) *Average exchange rate.* The average exchange rate for any translation period is the average of the daily exchange rates (determined by reference to a qualified source of exchange rates within the meaning of § 1.964–1(d)(5)), excluding weekends, holidays and any other nonbusiness days within the translation period, or if these rates are unavailable any other reasonable rate consistently applied that clearly reflects income.

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

(ii) *Election.* A QBU may elect to divide its taxable year into translation periods that are less than a month. The election is made if the QBU computes its income or loss or earnings and profits (or deficit in 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.

(8) *Dollar transactions.* Notwithstanding any other provisions of this section, 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 income or 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 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, the loan is a dollar transaction. Similarly, this paragraph applies to any transaction that is determined to be a dollar transaction under section 988.

(9) *Examples.* 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". During 1987 S received 100 dollars attributable to sales. Because this is a dollar transaction under paragraph (c)(8) of this section, S's income or loss for 1987 shall reflect the 100 dollars (not the hyperinflationary value of such dollars when accrued). If 120 British pounds were received rather than 100 dollars, S's income or loss would reflect the "h" amount (as determined under section 988) of the 120 British pounds translated into dollars at the average rate for the appropriate translation period.

Example (2). S is an accrual basis eligible QBU that makes the dollar election for its first taxable year beginning in 1987. S's hyperinflationary currency is the "h". 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 and was allowed depreciation of 4,000,000h. 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)(8) 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 1987 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	[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 Purchases:			
(Jan–Feb)	15,000,000h	[1]20:1	$750,000
(Mar–Apr)	10,000,000	[1]21:1	476,190
(May–June)	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)
Total	77,000,000h		$3,536,314
Non-Capitalized Exp.:			
(Jan–Feb)	4,000,000h	[1]20:1	$200,000
(Mar–Apr)	2,500,000	[1]21:1	119,048
(May–June)	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.

[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

	Hyperinflationary Currency	Exchange Rate	United States Dollars
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

(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 income or loss or earnings and profits (or deficit in 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* § 1.954–2T(g)(2) or its successor. For the manner in which the currency gain or loss is treated under section 904(d), *see* § 1.904–4(j).

(2) *Determination of currency gain or loss.* Currency gain or loss of a QBU shall be the amount which equals—

(i) The net worth for the taxable year as determined under paragraph (d)(4) of this section; plus

(ii) The dollar amount of any item that decreased net worth for the taxable year but does not generally affect income or loss or earnings and profits (or deficit in earnings and profits) for the taxable year ("additions"), such as remittances, dividends, and returns of capital. Furthermore, foreign income taxes paid by a QBU branch elected to be credited under section 901 shall also be treated as an addition. The amount of a remittance, dividend, return of capital, or foreign tax that is paid by a QBU branch and is elected to be credited under section 901, shall be translated on the date the amount is paid or accrued. The amount of any other additions shall be translated by applying the principles of paragraph (c) of this section; minus

(iii) The net worth for the preceding taxable year as determined under paragraph (d)(4) of this section; minus

(iv) 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 paragraph (b)(1) through (3) of this section; minus

(v) The dollar amount of any item that increased net worth for the taxable year but does not generally affect income or loss or earnings and profits (or deficit in earnings and profits) ("subtractions"), such as capital contributions. The amount of a capital contribution shall be translated on the date the contribution is made. The amount of any other subtractions shall be translated by applying the principles of paragraph (c) 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) *Net worth.* Net worth for any taxable year shall be the dollar amount equal to the aggregate dollar amount representing assets on the balance sheet (as adjusted and translated under this paragraph (d)(4) (ii) and (iii)) less the aggregate dollar amount representing liabilities on the balance sheet (as adjusted and translated under this paragraph (d)(4) (ii) and (iii)). Net worth 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 sections 987 and 988 or sections 986 and 964(a); 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.

(5) *Translation of balance sheet.* Asset and liability amounts shown on the balance sheet as adjusted pursuant to paragraph (d)(4)(ii) of this section 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)(3)(iii) of this section.

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

(v) *Certain assets*—(A) *In general.* Amounts representing plant, real 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 certain assets.* Amounts representing depreciation, depletion, and amortization reserves shall be translated in accordance with paragraph (c)(4) of this section.

(vi) *Long-term liabilities.* Amounts representing long-term liabilities, including any amounts of a long-term liability that become short-term, shall be translated at the average exchange rate for the translation period in which incurred.

(vii) *Accrued taxes.* Amounts representing an accrued tax shall be translated at the average exchange rate for the translation period during which the tax was accrued.

(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 of the taxable year unless the taxpayer establishes to the satisfaction of the district director that any such amounts relate to a different translation period. In such a case, the average exchange rate for that translation period shall apply.

(6) *Dollar 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)(8) of this section, such transaction shall be taken into account in accordance with that paragraph.

(7) *Example.* 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 is the "h". S's net worth at December 31, 1987 was $3,246,495. 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)(8) of this section. The average exchange rate for each month in 1988 is as follows:

January	32h:$1
February–March	33:1
April–May	34:1
June	35:1
July	36:1
August–September	37:1
October	38:1
November	39:1
December	40:1

At the end of 1988, S's assets and liabilities, as adjusted and translated pursuant to this paragraph (d)(4) (ii) and (iii), 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	39:1	641,025
Inventory	65,000,000	([2])	2,500,000
Fixed assets:			
Property	90,000,000	[2] 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	39:1	128,205
Total Assets	406,340,000		14,265,857
Accounts Payable	35,000,000	[5] 40:1	875,000
Long-term liabilities:			
Liability 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
Total Liabilities	295,000,000h		10,022,510

[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 reflects 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 average exchange rate for the translation period incurred.
[5] S has no accounts payable outstanding for greater than 30 days.

The currency loss of S for 1988 is computed as follows:

Net worth—1988	$4,243,347
Plus—1988 Dividends:	
April	[6] $149,254
December	[6] 126,582
Total	275,836
Less—Net worth—1987	$3,246,495
Operating Profit—1988	2,038,200
Total	5,284,695
Exchange Loss	($765,512)

Note: Thus, total profit = $2,038,200 − $765,512 = $1,272,688.

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

§ 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, 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.

§ 1.985–5T Adjustments required upon change in functional currency (Temporary regulations).

(a) *In general.* A QBU that changes from one functional currency (old functional currency) to another functional currency (new functional currency) shall make the adjustments set forth in the 3-step procedure described in paragraphs (b) through (e) of this section. The adjustments shall be made on the last day of the taxable year ending before the year of change as defined in § 1.481–1(a)(1). Except as provided in § 1.985–6T, QBU with a functional currency for its first taxable year beginning in 1987 that is different from the currency in which it had kept its books and records for United States accounting and tax accounting purposes for its prior taxable year shall apply the principles of this § 1.985–5T for purposes of computing the relevant functional currency items, such as earnings and profits, basis of an asset, and amount of a liability, as of the first day of a taxpayer's first taxable year beginning in 1987.

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

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

(d) *Step 3A—Additional adjustments that are necessary when a branch changes functional currency*—(1) *Branch changing to a functional currency other than the taxpayer's functional currency.* If a QBU of a taxpayer (*i.e.* a branch) changes to a functional currency other than the taxpayer's functional currency, the branch shall make the adjustments set forth in either subparagraph (i) or (ii) for purposes of section 987.

(i) *Where prior to the change the branch and taxpayer had different functional currencies.* Where the branch and the taxpayer had different functional currencies prior to the change, the branch's new functional currency equity pool (computed under the principles of § 1.987–1T(b)(1), 53 Fed. Reg. 32384 (1988)) shall equal the product of the old functional currency amount of the equity pool multiplied by the spot new functional currency/old functional currency exchange rate.

(ii) *Where prior to the change the branch and taxpayer had the same functional currency.* Where the branch and the taxpayer had the same functional currency prior to the change, the branch's equity basis pool (computed under the principles of § 1.987–1T(b)(2), 53 FR 32384 (1988)) shall equal the difference between the branch's total old functional currency basis of its assets and its total old functional currency amount of its liabilities. The branch's equity pool shall equal the product of the equity basis pool multiplied by the spot new functional currency/old functional currency exchange rate.

(2) *Branch changing to the taxpayer's functional currency.* If a branch changes to the taxpayer's functional currency, the branch shall be treated as if it terminated. In such a case, the taxpayer shall realize gain or loss attributable to the branch's equity pool under the principles of section 987. This gain or loss is not subject to section 481.

(e) *Step 3B—Additional adjustments that are necessary when a taxpayer 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 product of the old functional currency amounts of such items multiplied by the spot new functional currency/old functional currency exchange 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)) of a controlled foreign corporation (within the meaning of section 957) changing to the United States dollar (dollar) as its functional currency shall recognize foreign currency gain or loss computed under section 986(c) as if all previously taxed earnings and profits, if any, were distributed immediately prior to the change and will also recognize gain or loss attributable to the corporation's paid-in capital to the extent provided, if any, under section 367(b) or future final regulations under section 985. This gain or loss is not subject to section 481.

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

(4) *Adjustments necessary for a branch of a taxpayer changing functional currencies*—(i) *Taxpayer changing to a functional currency other than the branch's functional currency.* If a taxpayer changes to a functional currency other than the functional currency of a branch of the taxpayer, the branch shall make the adjustments set forth in paragraph (d)(1)(i) of this section if the taxpayer's old functional currency was different from the branch's functional currency, or make the adjustments set forth in paragraph (d)(1)(ii) of this section if the taxpayer's old functional currency was the same as the branch's functional currency.

(ii) *Taxpayer changing to the same functional currency as the branch.* If a taxpayer changes to the same functional currency as a branch of the taxpayer, the taxpayer shall realize gain or loss as set forth in paragraph (d)(2) of this section.

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

Example (1). S, a calendar year foreign corporation, is wholly owned by domestic corporation P. The Commissioner granted permission to change S's functional currency from the LC to the FC beginning January 1, 1990. The LC/FC exchange rate on December 31, 1989, is 1 LC/2 FC. The following shows how S must convert the items on its balance sheet from the LC to the FC.

	LC1:2	FC
Assets:		
Cash on hand	40,000	80,000
Accounts receivable	10,000	20,000
Inventory	100,000	200,000
100,000 FC bond (100,000 LC historical basis)	[1] 50,000	100,000

	LC1:2	FC
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)	(8,000,000)
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	[2] 50,000	100,000
Total liabilities and equity	1,300,000	2,600,000

[1] Under § 1.985-5T(b), S will recognize a 50,000 LC loss (100,000 LC basis—50,000 LC value) on the bond resulting from the change in functional currency. Thus, immediately before the change, S's basis in the FC bond (taking into account the loss) is 50,000 LC.
[2] The amount of S's LC retained earnings reflects the 50,000 LC loss on the bond.

Example (2). P, a domestic corporation, operates a foreign branch, S. The Commissioner granted permission to change S's functional currency from the LC to the FC beginning January 1, 1990. As of December 31, 1989, S's equity pool was 2,000 LC and its equity basis pool was $4,000. The LC/FC exchange rate on December 31, 1989 is 1 LC/2 FC. On January 1, 1990, the new functional currency amount of S's equity pool is 4,000 FC. The equity basis pool is not affected.

§ 1.985-6T Transition rules for a QBU that uses the dollar approximate separate transactions method for its first taxable year beginning in 1987 (Temporary regulations).

(a) *In general.* This section sets forth transition rules for those QBUs that use the dollar approximate separate transactions method set forth in § 1.985-3 or § 1.985-3T for their first taxable year beginning in 1987 ("net worth" QBUs). In order for a net worth QBU to apply the dollar approximate separate transactions method of accounting for its first taxable year beginning in 1987, the QBU must determine the United States dollar (dollar) and hyperinflationary currency basis of its assets and the dollar and hyperinflationary currency amount of the QBU's liabilities that were acquired or incurred in taxable years beginning before January 1, 1987. In addition, the QBU must also 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), noncontrolled foreign corporations, and new worth and profit and loss branches of United States persons that must make these determinations.

(b) *Certain controlled foreign corporations.* If a net worth QBU was a controlled foreign corporation for its last taxable year beginning before January 1, 1987, and 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 in 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 in 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 net worth QBU not described in paragraph (b) of this section, then

(1) The hyperinflationary currency and dollar adjusted basis in the QBU's assets acquired in taxable years beginning before January 1, 1987,

(2) The hyperinflationary currency and dollar amount of the QBU's liabilities acquired or incurred in taxable years beginning before January 1, 1987, and

(3) 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.

(d) *Net worth branch.* If a net worth 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 (d) 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 less liabilities) during the course of a taxable year, taking into account any remittances made during the year.

(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 according to United States generally accepted accounting and tax accounting principles. The hyperinflationary currency adjusted basis of an asset or hyperinflationary currency amount of a liability for which a hyperinflationary currency basis or amount was not determined at such date shall be that hyperinflationary currency amount which is determined by using the appropriate spot exchange rate on the date when the asset or amount of the liability was acquired or incurred, as adjusted according to United States generally accepted accounting and tax accounting principles.

(ii) *Dollar amount.* 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 (d)(1)(ii) of this section.

(e) *Profit and loss branch.* If a net worth 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 QBU shall apply the transition rules of § 1.987–1T (as promulgated in 53 FR 32384 (1988)) or its successor provision in order to establish the branch's pre-87 equity and dollar equity and the branch's hyperinflationary currency basis of its assets and 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* § 1.985–5T (or any succeeding final regulation) for the further adjustments that are necessary when a QBU changes functional currencies.

Par. 4. New § 1.989(b)–1T is added at the appropriate place to read as follows:

§ 1.989(b)–1T Definition of weighted average exchange rate (Temporary regulation).

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 within the meaning of § 1.964–1(d)(5)), excluding weekends, holidays and any other nonbusiness days for the taxable year.

OMB Control Numbers Under the Paperwork Reduction Act (26 CFR Part 602)

Par. 5. The authority for part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

§ 602.101 [Amended]

Par. 6. Section 602.101(c) is amended by removing from the table "§ 1.985–2T * * * 1545–1051" and by adding in its place in the table "§ 1.985–2 * * * 1545–1051".

Dated: August 10, 1989.

Fred T. Goldberg,

Commissioner of Internal Revenue.

Approved:

Kenneth W. Gideon,

Assistant Secretary of the Treasury.

[FR Doc. 89–21650 Filed 9–19–89; 8:45 am]

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26 CFR Parts 1 and 602

[T.D. 8264]

RIN 1545–AK26

Temporary Regulations Under Section 383 of the Internal Revenue Code of 1986; Use of Pre-Change Attributes

AGENCY: Internal Revenue Service, Treasury.

ACTION: Temporary regulations.

SUMMARY: This document contains temporary regulations relating to the use of certain corporate tax attributes under section 383 of the Internal Revenue Code of 1986 (the "Code") that are attributable to the period preceding an ownership change of the corporation. Section 383 of the Code was amended by the Tax Reform Act of 1986 (the "1986 Act"). The temporary regulations provide guidance under section 383 relating to the manner and method of absorbing the section 382 limitation with respect to certain capital losses and excess credits after there has been an ownership change of a corporation within the meaning of section 382. The temporary regulations also contain amendments to the temporary regulations under section 382, which was amended by the 1986 Act, the Revenue Act of 1987 (the "1987 Act"), and by the Technical and Miscellaneous Revenue Act of 1988 (the "1988 Act"). The text of the temporary regulations set forth in this document also serves as the text of the proposed regulations cross-referenced in the notice of proposed rulemaking in the Proposed Rules section of this issue of the **Federal Register**

EFFECTIVE DATE: The temporary regulations are effective as of September 19, 1989, and generally are applicable to any ownership change within the meaning of section 382 occurring after December 31, 1986.

FOR FURTHER INFORMATION CONTACT: Lori J. Jones of the Office of Assistant Chief Counsel (Corporate), Office of Chief Counsel, Internal Revenue Service, 1111 Constitution Avenue, NW., Washington, DC 20224 (Attention: CC:CORP:1) or telephone (202) 566–3205 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

These regulations are being issued without prior notice and public procedure pursuant to the Administrative Procedure Act (5 U.S.C. 553). For this reason, the collections of information contained in this regulation have been reviewed and, pending receipt and evaluation of public comments, approved by the Office of Management and Budget (OMB) under control number 1545–0123. The estimated average annual burden associated with the collections of information in these regulations is 18 minutes per respondent.

These estimates are an approximation of the average time expected to be necessary for a collection of information. They are based on such information as is available to the Internal Revenue Service. Individual respondents may require greater or less time, depending on their particular circumstances.

For further information concerning these collections of information, and where to submit comments on these collections of information, the accuracy of the estimated burden, and suggestions for reducing this burden, please refer to the preamble to the cross-reference notice of proposed rulemaking published in the Proposed Rules section of this issue of the **Federal Register.**

Background

This document provides temporary regulations to be added to part 1 of title 26 of the Code of Federal Regulations ("CFR") under sections 382 and 383 of the Code. The temporary regulations provide guidance under sections 382 and 383 relating to the manner and method of absorbing the section 382 limitation with respect to certain capital losses and excess credits after there has been an ownership change of a corporation within the meaning of section 382. Sections 382 and 383 were amended by section 621 of the 1986 Act (Pub. L. No. 99–514; 100 Stat. 2085). Section 382 was further amended by section 10225 of the 1987 Act (Pub. L. No. 100–203; 101 Stat. 1330–413) and by sections 1006, 4012 and 5077 of the 1988 Act (Pub. L. No. 100–647). The temporary regulations also contain amendments to the temporary regulations under section 382. Sections 1.382–1T and 1.382–2T were added to CFR by T.D. 8149, published in the **Federal Register** on August 11, 1987 (52 FR 29668).