

# Section 985.—Functional Currency

*26 CFR 1.985-1: Functional currency.*

T.D. 8765

DEPARTMENT OF THE TREASURY  
Internal Revenue Service  
26 CFR Part 1

Change From Dollar  
Approximate Separate  
Transactions Method of  
Accounting (DASTM) to the  
Profit and Loss Method of  
Accounting/Change From the  
Profit and Loss Method to  
DASTM

**AGENCY:** Internal Revenue Service (IRS), Treasury.

**ACTION:** Final Regulations.

**SUMMARY:** This document contains final Income Tax Regulations relating to adjustments required when a qualified business unit (QBU) that used the profit and loss method of accounting (P&L) in a post-1986 year begins to use the dollar approximate separate transaction method of accounting (DASTM) and adjustments required when a QBU that used DASTM begins using P&L. The regulations provide rules for taxpayers to construct an

opening dollar balance sheet for the QBU and require income adjustments in certain cases.

**DATES:** These regulations are effective April 6, 1998.

**FOR FURTHER INFORMATION CONTACT:** Howard Wiener at (202) 622-3870 (not a toll-free number) of the office of Chief Counsel (International) within the Office of Chief Counsel, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC 20224.

#### SUPPLEMENTARY INFORMATION:

##### *Background*

On January 5, 1993 and July 25, 1994, the IRS published proposed amendments to §1.985-7 in the **Federal Register** at 58 F.R. 300 (INTL-0045-92) and §1.985-1 in the **Federal Register** at 59 F.R. 37733 (INTL-0066-92), respectively. No public hearing was held and few comments were received. After consideration of these comments, the regulations are adopted as a Treasury Decision with modifications as described below.

##### *Explanation of Provisions*

#### *I. Proposed Rules for Changing From P&L to DASTM (§1.985-7)*

##### *1. The Proposed Regulations*

The proposed regulations under §1.985-7 set forth transition rules for QBUs changing from the profit and loss method of accounting (P&L) to DASTM in tax years after 1987. Section 1.985-6 provides the translation rules for QBUs using DASTM in 1987. Generally, when a QBU changes its functional currency, two basic issues arise: (1) How should the QBU translate its balance sheet accounts into the new functional currency in a way that preserves any unrecognized currency gain or loss which accrued in the old functional currency; and (2) whether income adjustments need to be made to recognize any currency gain or loss which accrued in the old functional currency that cannot be preserved.

Section 1.985-5 provides rules that generally apply when a QBU changes its functional currency. Under §1.985-5 balance sheet accounts are translated using the spot rate on the last day prior to the

taxable year of change. In addition, §1.985-5 generally requires recognition of unrealized exchange gain or loss on instruments and other accounts that were maintained in the functional currency to which the QBU is changing.

The proposed regulations issued under §1.985-7 were issued in response to taxpayer comments that §1.985-5 resulted in significant distortions when a QBU either elected or was required to use DASTM. Applying the spot rate on the last day prior to the year in which the QBU begins to use DASTM (the “taxable year of change”) to translate fixed assets typically results in a significant loss of basis in dollar terms and does not take into account certain income and expense distortions that occur in the period immediately preceding the taxable year of change.

In response to taxpayers’ comments, the proposed regulations provide for use of the translation rules provided under §1.985-3. These rules generally translate fixed assets at the historical exchange rate and other assets and liabilities at the current exchange rate. To correct for distortions that would result from applying historic exchange rates for fixed assets while applying the current year’s spot rate for other balance sheet accounts, the proposed regulations provide for income adjustments in the case of a controlled foreign corporation (CFC) and a branch that reflect amounts that would have been included in income under DASTM.

In the case of a CFC, the proposed regulations provide for a shareholder level income adjustment to the extent subpart F income realized during the period after 1986 until the taxable year of change differs from subpart F income that would have been realized if the CFC had used DASTM throughout this period. In the case of a branch, the regulations provide that any difference between the branch’s local currency equity translated into dollars at the spot exchange rate on the last day prior to the taxable year of change and the taxpayer’s dollar basis pool on that day is included in income over three taxable years beginning with the taxable year of change. For purposes of translating the balance sheet of noncontrolled section 902 corporations, the proposed regulations apply historic exchange rates for fixed assets. In such case, no shareholder level income adjustments are required.

Recognizing the administrative burden of making income adjustments for all post-1986 tax years in the case of a CFC, the preamble to the proposed regulations requested comments regarding three alternative transition rules as follows: (1) requiring shareholder level adjustments for the three-year base period used to determine the hyperinflationary status of the local currency, (in which case the general rule of §1.985-5 would be applied in preparing the balance sheet for the first year of the base period); (2) treating a portion of retained earnings as subpart F income based on an average historical rate of subpart F income to total earnings and profits, and (3) using the spot rate on the last day prior to the taxable year of change to translate balance sheet items with special rules to allow historical exchange rates to translate fixed assets to the extent of unrealized exchange loss on paid-in capital.

##### *2. Reasons for change*

The IRS is concerned that the approach of the proposed regulations could create a significant administrative burden for shareholders of CFCs. The administrative burden results from the requirement that shareholders recompute subpart F income for all of the CFC’s post 1986 taxable years. If the functional currency of a CFC becomes hyperinflationary in a year that is significantly distant from the CFC’s first post-1986 taxable year, records supporting the required recomputation may be unavailable.

Further, the required recomputation under the proposed regulations is generally inconsistent with the policy of sections 986 and 987 that the income of branches with a functional currency different than that of the taxpayer and the earnings and profits of foreign corporations be computed under a profit and loss method, except in the case of hyperinflation. See S. Rep. No. 99-313, 99th Cong., 2d Sess., 454 (1986). The recomputation under the proposed regulation would put the CFC on DASTM for non-hyperinflationary years. Accordingly, the rules in the proposed regulations have been modified as described below.

#### *II. Final Regulations for Changing From P&L to DASTM (§1.985-7)*

##### *1. General Rule*

The approach employed in the final

regulations has the general effect of treating a QBU as if it had applied §1.985-5 on the last day of the last taxable year prior to the base period for determining whether a currency is hyperinflationary (transition date) and had applied DASTM during the taxable years beginning after the transition date until the taxable year of change (look-back period). This approach addresses the problems of applying §1.985-5 in the taxable year of change for purposes of translating fixed assets by applying the historical exchange rate to the extent fixed assets were acquired during the look-back period. Assets acquired prior to the look-back period are translated by applying the spot rate on the transition date. This approach also corrects distortions in income and expense (generally interest income and expense) that occur during the look-back period.

The final regulations respond to taxpayers' comments and provide an appropriate rule for translating the adjusted basis of fixed assets into dollars by applying an exchange rate in effect prior to the hyperinflationary period. Moreover, this method more accurately reflects Congressional intent for QBUs to apply the profit and loss method except in the case of hyperinflation. In addition, this approach decreases the administrative burden of changing to DASTM.

## 2. Foreign Corporations

In the case of a foreign corporation which is either required or elects to use DASTM, four basic corporate level adjustments are required as follows. (1) The balance sheet is translated by treating the corporation as if it had changed its functional currency to the dollar for the first post-transition date taxable year and had applied the rules of §1.985-5(c) on the transition date. Assets acquired and liabilities incurred in the functional currency during the look-back period are translated by applying the rules of §1.985-3. (2) The unrealized gain or loss on dollar denominated section 988 transactions as determined on the transition date are treated as if recognized on that date (and actual gain or loss recognized on dollar denominated section 988 transactions during the look-back period is reversed). (3) The dollar value of the pre-1987 E&P of the corporation as stated on the transition date in the functional currency is translated

into U.S. dollars at the spot rate in effect on the transition date. (4) The dollar value of the post-1986 E&P is computed by translating the post-1986 E&P as stated on the transition date in the functional currency at the spot rate on such date and adding to it the E&P for the years during the look-back period as computed under DASTM.

In the case of a CFC, there are three shareholder level adjustments as follows: (1) The U.S. shareholders must take into income exchange gain or loss on the deemed recognition of the section 988 transactions as determined at the corporate level to the extent such gain or loss is subpart F income. (2) The U.S. shareholders must recognize foreign currency gain or loss as computed under section 986(c) as if all previously taxed earnings and profits were distributed on the transition date (however, any actual 986(c) gain or loss recognized during the look-back period is reversed). (3) The subpart F income of the CFC is recomputed during the look-back period under DASTM and compared to the subpart F income as computed under the P&L method. The difference (positive or negative) is taken into account in the taxable year of change and spread over four years. Similar rules apply to United States persons who have made an election under section 1295 to treat a passive foreign investment company as a qualified electing fund. In the case of other foreign corporations, no shareholder level income adjustments are necessary.

## 4. Branches

In accord with the general approach articulated above, the regulations treat a branch changing to DASTM as applying the principles of §1.985-5 on the transition date. Thus, the balance sheet is translated by treating the branch as if it had changed its functional currency to the dollar for the first post-transition date taxable year and had applied the rules of §1.985-5(c) on the transition date. Unrealized gain or loss on dollar denominated section 988 transactions as stated on the transition date are treated as if recognized on that date (and any actual gain or loss realized with respect to section 988 transactions during the look-back period is reversed). Further, the regulations require that the taxpayer recognize gain or loss attributable to the branch's equity pool (as stated

on the transition date) under the principles of section 987, computed as if the branch terminated on the transition date. Such gain or loss is reduced by any section 987 gain and increased by any section 987 loss that was recognized by the taxpayer with respect to remittances during the look-back period. Finally, branch income shall be determined under §1.985-3 for each look-back year and compared to the amount that was taken into account for each year. The sum of the difference (positive or negative) is taken into account in the taxable year of change and spread over four years.

## III. Rules for Changing from DASTM to P&L (§1.985-1)

Under the proposed regulation, a QBU that has been required or had elected to use DASTM must change functional currency to the currency of its economic environment in a year in which the currency is no longer hyperinflationary pursuant to the three-year test under §1.985-1(b). These rules provide that when a taxpayer changes from DASTM to the P&L method of accounting, §1.985-5 shall apply for purposes of translating a QBU's balance sheet and for making certain income adjustments. Because these rules generally do not create distortions and are administrable, the final regulations adopt these regulations as proposed.

## IV. Other Changes

Various conforming changes have been made to §§1.985-1 and 1.985-5 to account for the addition of §1.985-7. In addition, the definition of hyperinflation has been liberalized to provide that for purposes of determining whether a currency is hyperinflationary for income tax purposes, United States generally accepted accounting principles will be accepted provided that the determination is based on criteria that is substantially similar to the general rules provided in the regulations, the method of determination is applied consistently from year to year, and the same method is applied to all related persons.

### *Special Analysis*

It has been determined that this Treasury decision is not a significant regulatory action as defined in EO 12866.

Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because the notice of proposed rulemaking preceding the regulations was issued prior to March 29, 1996, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Accordingly, a regulatory flexibility analysis is not required. Pursuant to section 7805(f) of the Code, the notice of proposed rulemaking preceding these regulations was submitted to the Small Business Administration for comment on its impact on small business.

*Drafting Information*

The principal author of these regulations is Howard A. Wiener of the Office of the Associate Chief Counsel (International). Other personnel from the IRS and Treasury Department also participated in their development.

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*Adoption of Amendments to the Regulations*

Accordingly, 26 CFR part 1 is amended as follows:

**PART 1—INCOME TAXES**

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

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

Par. 2. Section 1.985-1 is amended by:

1. Revising paragraph (b)(2)(ii)(C).
2. Adding a sentence to the end of paragraph (b)(2)(ii)(D).
3. Adding paragraph (b)(2)(ii)(E).

The additions and revision reads as follows:

*§1.985-1. Functional currency.*

\* \* \* \* \*

- (b) \* \* \*
- (2) \* \* \*
- (ii) \* \* \*

(C) *Change in functional currency.* If a QBU is required to change its functional currency to the dollar under paragraph (b)(2)(ii)(A) of this section, or chooses or is required to change its functional currency to the dollar for any open taxable year (and all subsequent taxable years) under §1.985-3(a)(2)(ii), the change is

considered to be made with the consent of the Commissioner for purposes of §1.985-4. A QBU changing functional currency must make adjustments described in §1.985-7 if the year of change (as defined in §1.481-1(a)(1)) begins after 1987, or the adjustments described in §1.985-6 if the year of change begins in 1987. No adjustments under section 481 are required solely because of a change in functional currency described in this paragraph (b)(2)(ii)(C).

(D) \* \* \* In making the determination whether a currency is hyperinflationary, the determination for purposes of United States generally accepted accounting principles may be used for income tax purposes provided the determination is based on criteria that is substantially similar to the rules previously set forth in this paragraph (b)(2)(ii)(D), the method of determination is applied consistently from year to year, and the same method is applied to all related persons as defined in §1.985-3(e)(2)(vi).

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

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

Par. 3. Section 1.985-5(a) is amended by adding the following sentence to the end of the paragraph:

*§1.985-5 Adjustments required upon change in functional currency.*

(a) \* \* \*

However, a QBU that changes to the dollar pursuant to §1.985-1(b)(2) after 1987 shall apply §1.985-7.

\* \* \* \* \*

Par. 4. Section 1.985-7 is added as follows:

*1.985-7 Adjustments required in connection with a change to DASTM.*

(a) *In general.* If a QBU begins to use the dollar approximate separate transactions method of accounting set forth in §1.985-3 (DASTM) in a taxable year beginning after April 6, 1998, adjustments shall be made as provided by this section. For the rules with respect to foreign corporations, see paragraph (b) of this section. For the rules with respect to adjustments to the income of United States shareholders of controlled foreign corporations, see paragraph (c) of this section. For the rules with respect to adjustments relating to QBU branches, see paragraph (d) of this section. For the effective date of this section, see paragraph (e). For purposes of applying this section, the look-back period shall be the period beginning with the first taxable year after the transition date and ending on the last day prior to the taxable year of change. The term transition date means the later of the last day of the last taxable year ending before the base period as defined in §1.985-1(b)(2)(ii)(D) or the last day of the taxable year in which the QBU last applied DASTM. The taxable year of change shall mean the taxable year of change as defined in §1.481-1(a)(1). The application of this paragraph may be illustrated by the following examples:

*Example 1.* A calendar year QBU that has not previously used DASTM operates in a country in which the functional currency of the country is hyperinflationary as defined under §1.985-1(b)(2)(ii)(D) for the QBU's 1999 tax year. The look-back period is the period from January 1, 1996 through December 31, 1998, the transition date is December 31, 1995, and the taxable year of change is the taxable year beginning January 1, 1999.

*Example 2.* A QBU that has not previously used DASTM with a taxable year ending June 30, operates in a country in which the functional currency of the country is hyperinflationary for the QBU's tax year beginning July 1, 1999 as defined under §1.985-1(b)(2)(ii)(D) (where the base period is the thirty-six calendar months immediately preceding the first day of the current calendar year 1999). The look-back period is the period from July 1, 1995 through June 30, 1999, the transition date is June 30, 1995, and the taxable year of change is the taxable year beginning July 1, 1999.

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

(2) *Treatment of certain section 988 transactions*—(i) *Exchange gain or loss from section 988 transactions unrealized as of the transition date.* A foreign corporation shall adjust earnings and profits by the amount of any unrealized exchange gain or loss that was attributable to a section 988 transaction (as defined in sections 988(c)(1)(A), (B), and (C)) that was denominated in terms of (or determined by reference to) the dollar and was held by the corporation on the transition date. Such gain or loss shall be computed as if recognized on the transition date and shall be reduced by any gain and increased by any loss recognized by the corporation with respect to such transaction during the look-back period. The amount of such gain or loss shall be determined without regard to the limitations of section 988(b) (i.e., whether any gain or loss would be realized on the transaction as a whole). The character and source of such gain or loss shall be determined under section 988. Proper adjustments shall be made to account for gain or loss taken into account by reason of this paragraph (b)(2). See §1.985-5(f) *Example 1, footnote 1.*

(ii) *Treatment of a section 988 transaction entered into and terminated during the look-back period.* A foreign corporation shall reduce earnings and profits by the amount of any gain, and increase earnings and profits by the amount of any loss, that was recognized with respect to any dollar denominated section 988 transactions entered into and terminated during the look-back period.

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

(4) *Earnings and profits adjustments*—(i) *Pre-1987 accumulated profits.* The foreign income taxes and accumulated profits or deficits in accumulated

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

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

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

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

Such amount shall be reduced by the aggregate dollar amount (translated from functional currency in accordance with the rules of section 989(b)) attributable to earnings and profits that were distributed (or treated as distributed) during the look-back period out of post-1986 earnings and profits in such separate category. For purposes of applying this paragraph

(b)(4)(ii)(B), the opening balance sheet for calculating earnings and profits under §1.985-3 for the first post-transition year shall be translated into dollars pursuant to §1.985-5(c).

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

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

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

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

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

(2) *Treatment under subpart F of income recognized on section 988 transactions.* The character of amounts taken into account under paragraph (b)(2) of

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

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

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

(5) *Foreign tax credit.* A United States shareholder of a CFC shall compute an amount of foreign taxes deemed paid under section 960 with respect to any positive adjustments determined under para-

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

(d) *QBU branches—(1) In general.* In the case of a QBU branch, the taxpayer shall make the adjustments set forth in paragraphs (d)(2) through (d)(4) of this section. Adjustments under this section shall be taken into account by the taxpayer ratably over four taxable years beginning with the taxable year of change.

(2) *Treatment of certain section 988 transactions—(i) Exchange gain or loss from section 988 transactions unrealized as of the transition date.* A QBU branch shall adjust income by the amount of any unrealized exchange gain or loss that was attributable to a section 988 transaction (as defined in sections 988(c)(1)(A), (B), and (C)) that was denominated in terms of (or determined by reference to) the dollar and was held by the QBU branch on the transition date. Such gain or loss shall be computed as if recognized on the transition date and shall be reduced by any gain and increased by any loss recognized by the QBU branch with respect to such transaction during the look-back period. The amount of such gain or loss shall be determined without regard to the limitations of section 988(b) (i.e., whether any gain or loss would be realized on the transaction as a whole). The character and source of such gain or loss shall be determined under section 988. Proper adjustments shall be made to account for gain or loss taken into account by reason of this paragraph (d)(2). See §1.985-5(f) *Example 1, footnote 1.*

(ii) *Treatment of a section 988 transaction entered into and terminated during*

*the look-back period.* A QBU branch shall reduce income by the amount of any gain, and increase income by the amount of any loss, that was recognized with respect to any dollar denominated section 988 transactions entered into and terminated during the look-back period.

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

(4) *Branch income adjustment.* Branch income in a separate category shall be determined under §1.985-3 for each look-back year. For this purpose, the opening DASTM balance sheet shall be determined under §1.985-5. The sum of the difference (positive or negative) between the amount computed pursuant to §1.985-3 and amount taken into account for each year shall be taken into account in the taxable year of change pursuant to paragraph (d)(1) of this section. Such amounts shall retain their character for all federal income tax purposes.

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

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

Michael P. Dolan,  
Deputy Commissioner of  
Internal Revenue.

Approved February 11, 1998.

Donald C. Lubick,  
Assistant Secretary of  
the Treasury.

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