

QBU and the taxpayer must then make the adjustments required by §1.985-5, *e.g.*, the QBU must take into account unrealized exchange gain or loss on dollar-denominated section 988 transactions, the taxpayer must account for the deemed termination of the branch, and the taxpayer must translate the QBU's balance sheet items from hyperinflationary currency into dollars at the spot rate.

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**§ 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

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amount of any loss, that was recognized with respect to any dollar denominated section 988 transactions entered into and terminated during the look-back period.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

(2) *Treatment of certain section 988 transactions*—(i) *Exchange gain or loss from section 988 transactions unrealized*

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

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

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

(4) *Branch income adjustment.* Branch income in a separate category shall be determined under § 1.985-3 for each look-back year. For this purpose, the opening DASTM balance sheet shall be determined under § 1.985-5. The sum of the difference (positive or negative) between the amount computed pursuant to § 1.985-3 and amount taken into account for each year shall be taken into

account in the taxable year of change pursuant to paragraph (d)(1) of this section. Such amounts shall retain their character for all federal income tax purposes.

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

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

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

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

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

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

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

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

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