Part III - Administrative, Procedural, and Miscellaneous

Section 985- Functional Currency

26 CFR 1-985-3(d): United States dollar approximate separate transactions method

Notice 2005-27

SECTION 1. PURPOSE

This Notice provides guidance with respect to, and announces the intention to amend, Treas. Reg. §1.985-3(d) regarding the proper exchange rate for determining dollar approximate separate transactions method ("DASTM") gain or loss when translating current and historical assets upon a transfer from a qualified business unit (a "QBU") to its U.S. home office.

SECTION 2. BACKGROUND

Generally, a taxpayer and each QBU must make all determinations under subtitle A of the Code in its respective functional currency. Treas. Reg. §1.985-1(a)(1). For taxable years beginning after August 24, 1994, a U.S. corporation's QBU that would otherwise be required to use a hyperinflationary currency as its functional currency generally must use the dollar as its functional currency and must compute income or loss under the DASTM method of accounting described in §1.985-3. See Treas. Reg. §1.985-1(b)(2)(ii).

Under the DASTM method of accounting, a QBU's income or loss for a taxable year is computed in U.S. dollars and adjusted to account for its DASTM gain or loss. See Treas. Reg. §1.985-3(b). A QBU's DASTM gain or loss for a taxable year is determined under Treas. Reg. §1.985-3(d) by first computing the QBU's change in net worth from the prior year and then making specified adjustments. The QBU's change in net worth is computed by comparing the year-end balance sheets for the current and preceding taxable years. See Treas. Reg. §1.985-3(d)(1)(i). Special rules provide that some balance-sheet items are translated at the exchange rate for the translation period in which the cost of the item was incurred and so do not give rise to DASTM gain or loss from year to year ("historical items"). See Treas. Reg. §1.985-3(d)(5). Other items are translated at the exchange rate for the last translation period for the taxable year and therefore do give rise to DASTM gain or loss ("current items"). See id. The classification of an item as historical or current generally reflects the extent to which the item's dollar value changes with fluctuations in exchange rates. For example, the value of a financial asset, such as a unit of hyperinflationary local currency, necessarily changes with fluctuations in exchange rates. Accordingly, a financial asset generally is a current item. See Treas. Reg. §1.985-3(d)(5)(iv). By contrast, the value of a nonfinancial asset generally does not change with fluctuations in exchange rates. Accordingly, a nonfinancial asset generally is an historical item. See Treas. Reg. §1.985-3(d)(5)(v). In a hyperinflationary environment, currency exposure with respect to a financial asset typically is expected to give rise to loss.

The computed change in the QBU's net worth is then adjusted to reflect transactions that increase or decrease the QBU's net worth without affecting the QBU's income or loss. For example, an asset transferred from a QBU branch to its home office decreases the QBU's net worth but does not affect the QBU's income or loss and so must be added back to the QBU's net worth for purposes of computing DASTM gain or loss. See Treas. Reg. §1.985-3(d)(3).

A rule is required for translating the amount of any such adjustment into dollars. The DASTM method of accounting provides that adjustments generally shall be translated into dollars at the exchange rate on the date the amount is paid. Treas. Reg. §1.985-3(d)(3). This rule ensures that the QBU branch properly takes into account a current item's change in value due to currency fluctuations while the item was in the QBU branch. However, because historical items do not give rise to DASTM gain or loss, applying the existing translation rule to an adjustment relating to an historical item would inappropriately give rise to DASTM gain or loss.

SECTION 3. GUIDANCE

In view of the potentially anomalous results that may arise due to the application of the existing translation regulation in Treas. Reg. §1.985-3(d)(3), the Treasury Department and the Internal Revenue Service intend to amend that regulation to require as follows. If the item giving rise to the adjustment would be translated under Treas. Reg. §1.985-3(d)(5) at the exchange rate for the last translation period of the year if it were on the QBU's year-end balance sheet, for purposes of Treas. Reg. §1.985-3(d)(3) such item shall be translated at the exchange rate on the date the item is transferred. If the item giving rise to the adjustment would be translated under Treas. Reg. §1.985-3(d)(5) at the exchange rate for the translation period in which the cost of the item was incurred if it were on the QBU's year-end balance sheet, for purposes of Treas. Reg. §1.985-3(d)(3) such item shall be translated at the same historical rate.

SECTION 4. EXAMPLE

The following example illustrates the guidance provided in Section 3 of this notice. C is a U.S. corporation with a foreign branch, B, that constitutes a QBU within the meaning of section 989. C's functional currency is the U.S. dollar. Under Treas. Reg. §1.985-1(b)(2)(ii)(A), B must also use the U.S. dollar as its functional currency which would otherwise be a nondollar local currency that is hyperinflationary within the meaning of Treas. Reg. §1.985-1(b)(2)(ii)(D). On January 1, 2003, B purchases a parcel of undeveloped real property with units of local currency. On March 21, 2005, B transfers to C 100 units of B's local currency and the parcel of undeveloped real property.

Because B is a QBU whose functional currency otherwise would be a hyperinflationary currency, B must compute its income or loss in U.S. dollars using the DASTM method of accounting. Because the transfers from B to C affect B's balance sheet but do not affect its income, B must adjust its year-end balance sheet in accordance with the requirements of Treas. Reg. §1.985-3(d)(3). If the 100 units of hyperinflationary currency had remained on B's year-end balance sheet, then that currency would have been translated at the exchange rate for the last translation period of the taxable year, as required by Treas. Reg. §1.985-3(d)(5)(iv). If the real property had remained on B's year-end balance sheet, then B's basis in that property would have been translated at the exchange rate for the period in which the cost was incurred, as required by Treas. Reg. §1.985-3(d)(5)(v).

In accordance with Section 3 of this notice, for purposes of the adjustments under Treas. Reg. §1.985-3(d) B must translate the 100 units of hyperinflationary local currency transferred to C on March 21, 2005 using the exchange rate on that date and must translate the basis of the real property transferred to C on March 21, 2005 using the exchange rate for the period in which the cost of the property was incurred.

SECTION 5. EFFECTIVE DATE

The amendments to the regulation described in this notice will be effective for any transfer, dividend, or distribution that is a return of capital that is made after March 8, 2005 and that gives rise to an adjustment under §1.985-3(d)(3).

SECTION 6. COMMENTS

Written comments on the issues addressed in this notice may be submitted to the Office of Associate Chief Counsel (International), Attention: Sheila Ramaswamy (Notice 2005-27), room 4566, CC:INTL:Br5, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC 20224. Alternatively, taxpayers may submit comments electronically to Notice 2005-27. Comments@irscounsel.treas.gov. Comments will be available for inspection and copying. Treasury and the IRS request comments by June 6, 2005.

The principal author of this notice is Sheila Ramaswamy of the Office of Associate Chief Counsel (International). For further information regarding this notice contact Sheila Ramaswamy at (202) 622-3870 (not a toll-free call).