Section 985 – Functional Currency Determinations

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Agenda

- Significance of functional currency
- Qualified business units (QBUs)
- Determining functional currency
- Changes in functional currency

Significance of Functional Currency

- A taxpayer or QBU must make all income tax determinations in its functional currency. § 1.985-1(a)(1).
- The adoption of, or election to use, a functional currency is treated as a method of accounting. § 1.985-2(a). Thus, the functional currency must be used for all subsequent years unless permission to change is granted or deemed granted.
- Generally, permission to change functional currencies is not granted unless significant changes in the facts and circumstances of the QBU's economic environment occur. § 1.985-2(b).

Qualified Business Units

- A QBU is a separate and clearly identified unit of a trade or business of a taxpayer provided that separate books and records are maintained. § 1.989-1(b)(1).
- Per se QBUs
  - Corporation. § 1.989-1(b)(2)(i).
  - Partnership. § 1.989-1(b)(2)(i). *But see* Prop. § 1.989(a)-1 (partnership would not be treated as QBU).
  - Trust or estate. § 1.989-1(b)(2)(i).
  - Not a disregarded entity.
- Activities of a taxpayer qualify as a QBU if they constitute a trade or business and a separate set of books and records is maintained for the activities. § 1.989-1(b)(2)(ii).
- Activities that generate income or losses effectively connected with a U.S. trade or business are a QBU, provided the books and records requirement is met. § 1.989-1(b)(3).

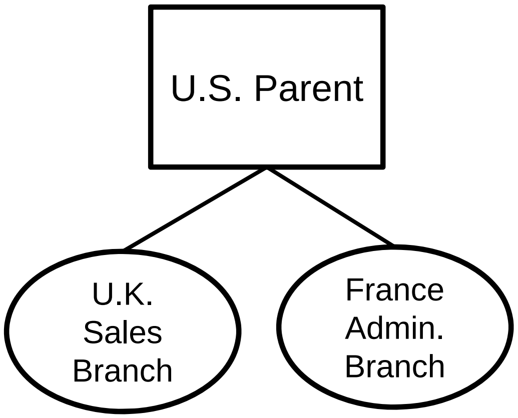
Trade or Business Requirement

- A trade or business generally is a specific unified group of activities that constitutes or could constitute an independent economic enterprise carried on for profit, the expenses related to which are deductible under section 162 or 212. § 1.989-1(c).
- The activities generally must include every operation which forms a part of a process by which an enterprise may earn income or profit, including the collection of income and payment of expenses. § 1.989-1(c).
- The activities need not constitute a separate trade or business from those carried on by other QBUs of the taxpayer. § 1.989-1(c).
- A vertical, functional, or geographic division of a trade or business can be sufficient. § 1.989-1(c).
- Activities of an agent (dependent or independent) can be attributed such that they constitute a QBU of the principal. See, e.g., § 1.989-1(e), Ex. (6) (treating activities of an independent broker conducted on behalf of the taxpayer as a QBU of the taxpayer).
- Ancillary activities are insufficient. § 1.989-1(c). See, e.g., § 1.989-1(e), Ex. (3) (treating the delivery of sales documents to customers by an employee as ancillary and not a QBU).

Books and Records Requirement

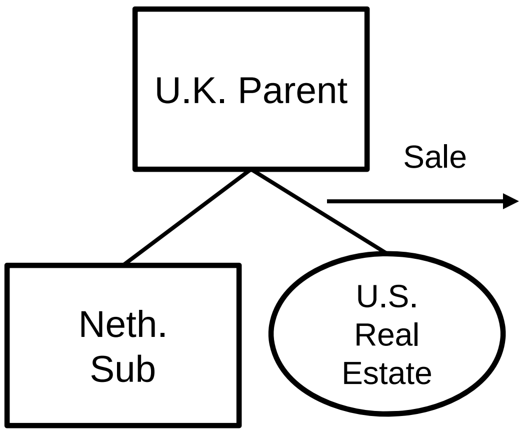
- Books and records include books of original entry and ledger accounts or similar records. § 1.989-1(d)(1).
  - A journal represents a chronological account of transactions entered into for an accounting period.
  - A ledger reflects the impact during an accounting period of transactions entered into on the balance sheet and income statement.
- For a cash method taxpayer, the books of original entry include a cash receipts and disbursements journal. § 1.989-1(d)(1).
- For an accrual method taxpayer, the books of original entry include a journal to record accounts receivable and accounts payable. § 1.989-1(d)(1).

QBUs – Example 1



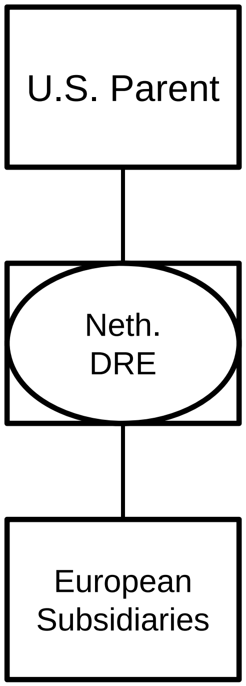
- U.S. Parent is a corporation that manufactures products.
- U.S. Parent has a U.K. sales branch that has its own employees, solicits and processes sales, and maintains a separate set of books and records.
- U.S. Parent also has a branch in France that performs administrative functions (e.g., back-office accounting).
- U.S. Parent, as a corporation, is a per se QBU.
- The U.K. branch is a QBU because its activities constitute a trade or business and separate books and records are maintained. § 1.989(a)-1(e), Ex. (1). The fact that the activities are interrelated with the business activities of U.S. Parent does not preclude them from constituting a QBU.
- The France branch is not a QBU because its activities are ancillary and do not constitute a trade or business. Cf. § 1.989(a)-1(e), Ex. (3).

QBUs – Example 2



- U.K. Parent is a corporation.
- U.K. Parent owns a Netherlands subsidiary, Netherlands Sub, that is a corporation. Netherlands Sub is a holding company without its own business activities.
- U.K. Parent also sells U.S. real estate, recognizing gain that constitutes income effectively connected with a U.S. trade or business under FIRPTA. Separate books and records are maintained for the U.S. real estate business.
- U.K. Parent and Netherlands Sub, as corporations, constitute per se QBUs. § 1.989(a)-1(e), Ex. (5).
- U.K. Parent's U.S. real estate sales activity constitutes a QBU because it gives rise to effectively connected income. § 1.989(a)-1(e), Ex. (10).

QBUs – Example 3



- U.S. Parent owns a Netherlands entity, Netherlands DRE, that is classified as a disregarded entity. Separate books and records are maintained for Netherlands DRE.
- Netherlands DRE acts as a holding company with respect to U.S. Parent's European subsidiaries.
- Netherlands DRE does not itself constitute a QBU.
- Do the activities of Netherlands DRE constitute a QBU? See Prop. § 1.987-1(b)(7), Ex. (1) (concluding that holding stock and servicing a liability does not constitute a trade or business).
- What if Netherlands DRE acts as a treasury center for the European subsidiaries as well?

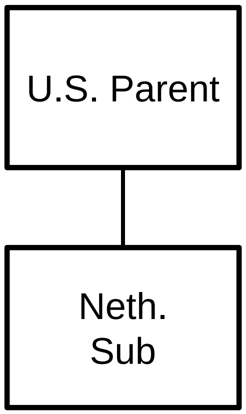
Mandatory Use of USD as Functional Currency

- Certain taxpayers and QBUs are required to use the USD as their functional currencies. § 1.985-1(b)(1).
  - A taxpayer that is not a QBU (e.g., an individual)
  - A QBU that conducts its activities primarily in USD, if the primary currency of the economic environment in which it conducts its activities is the USD
  - A QBU that has the United States as its residence (as defined in § 988(a)(3)(B)) (e.g., a domestic corporation, domestic partnership, or QBU with its principal place of business in the United States)
  - A QBU that does not keep books and records in a currency of any economic environment in which a significant part of its activities is conducted
  - A QBU that produces income or losses effectively connected with a U.S. trade or business
  - A QBU that otherwise would be required to use a hyperinflationary currency as its functional currency, subject to exceptions

Special Residence Rules

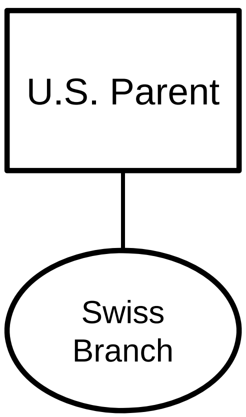
- Residence of individual
  - Generally, the individual’s tax home. § 988(a)(3)(B)(i)(I).
  - If an individual does not have a tax home, (i) the United States if the individual is a U.S. citizen or resident alien and (ii) a country other than the United States if the individual is a nonresident alien. § 988(a)(3)(B).
- Residence of corporation, partnership, trust, or estate
  - For a domestic corporation, partnership, trust, or estate, the United States. § 988(a)(3)(B)(i)(II).
  - For a foreign corporation, partnership, trust, or estate, a country other than the United States. § 988(a)(3)(B)(i)(III).
- Residence of a QBU of a taxpayer is based on the QBU’s principal place of business. § 988(a)(3)(B)(ii).

Mandatory Use of USD – Example 1



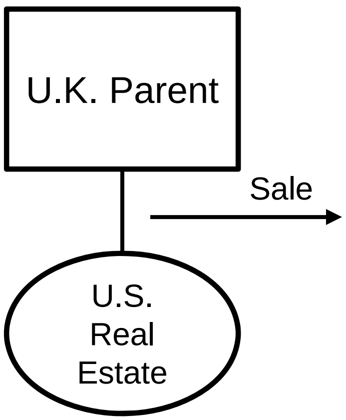
- U.S. Parent, a domestic corporation, owns a Netherlands subsidiary that is classified as a corporation.
- Netherlands Sub is required to keep its books and records in EUR under local law.
- Netherlands Sub's only activities are financing U.S. Parent and other domestic affiliates. Virtually all of Netherlands Sub's borrowing and lending transactions are conducted in USD.
- U.S. Parent is required to use the USD as its functional currency because its residence is in the United States. See § 1.985-1(f), Ex. (1).
- Netherlands Sub is required to use the USD as its functional currency, despite the fact that it maintains its books and records in EUR, because its activities are primarily conducted in USD. See § 1.985-1(f), Exs. (3) and (4).

Mandatory Use of USD – Example 2



- U.S. Parent, a domestic corporation, owns a Swiss branch, the activities of which constitute a QBU.
- The Swiss branch keeps its books and records in CHF but does not conduct a significant part of its activities using CHF. Rather, virtually all of its activities are conducted using EUR.
- The Swiss branch QBU is required to use the USD as its functional currency because it does not keep books and records in a currency of any economic environment in which a significant part of its activities is conducted. Cf. § 1.985-1(c)(3) (regarding presumptions with respect to the books and records requirement).

Mandatory Use of USD – Example 3



- U.K. Parent is a corporation that sells U.S. real estate, recognizing gain that constitutes income effectively connected with a U.S. trade or business under FIRPTA. Separate books and records are maintained for the U.S. real estate business.
- U.K. Parent's U.S. real estate sales activity constitutes a QBU because it gives rise to effectively connected income, and the QBU is required to use the USD as its functional currency for the same reason. See § 1.985-1(f), Ex. (12).

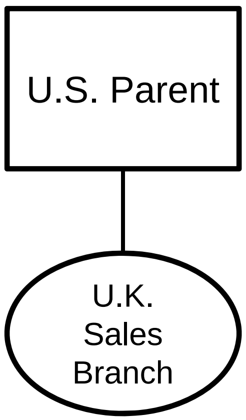
Functional Currency of QBU Not Required to Use USD

- Generally, a QBU's functional currency is the currency of the economic environment in which a significant part of the QBU's activities is conducted, if the QBU keeps its books and records in that currency. § 1.985-1(c)(1).
- The economic environment in which a significant part of the QBU's activities is conducted is determined under all the facts and circumstances. § 1.985-1(c)(2).
- The books and records requirement is presumed satisfied and can be overcome only if the QBU has a substantial non-tax business purpose for not keeping its books and records in the currency of the economic environment in which a significant part of the QBU's activities is conducted. § 1.985-1(c)(3).
- If multiple currencies satisfy these requirements for a QBU, the QBU can choose which of the currencies to use as its functional currency. § 1.985-1(c)(4).
- The functional currency of a QBU for U.S. GAAP ordinarily is accepted for tax purposes, provided the GAAP determination is based on similar factors. § 1.985-1(c)(5).

Functional Currency – Relevant Factors

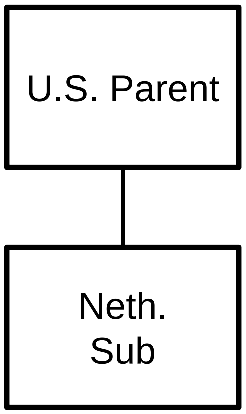
- Currency of country in which the QBU is a resident (within the meaning of § 988(a)(3)(B))
- Currencies in which the QBU generates revenues and incurs expenses
- Currencies in which the QBU borrows and lends
- Currencies of the QBU's sales markets
- Currencies in which pricing and other financial decisions are made
- Duration of the QBU's business operations
- Significance and volume of the QBU's independent activities
- Not relevant: rate of inflation

Non-USD Functional Currency – Example 1



- U.S. Parent, a domestic corporation, owns a U.K. branch, the activities of which constitute a QBU.
- The U.K. branch invoices a significant part of its sales in GBP and a significant part in USD.
- It incurs significant operating expenses in GBP and in USD.
- It keeps its books and records in GBP and in USD.
- Provided that other factors do not establish that the U.K. branch activities are primarily conducted in USD, the U.K. branch can choose to use the GBP as its functional currency. Cf. § 1.985-1(f), Ex. (5).

Non-USD Functional Currency – Example 2

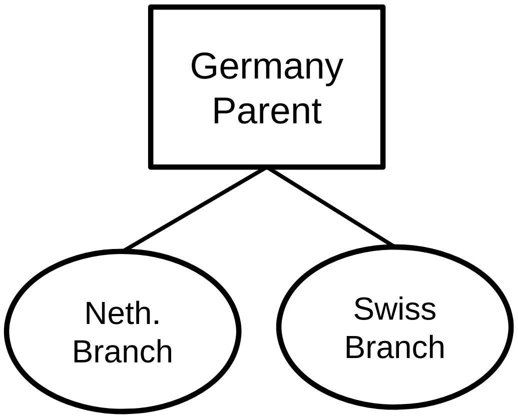


- U.S. Parent, a domestic corporation, owns a Netherlands subsidiary that is classified as a corporation.
- Netherlands Sub purchases products from U.S. Parent in EUR and sells the products to customers in EUR. The sales prices, however, are set to obtain a certain USD amount after reduction for all EUR costs. Netherlands Sub pays its other local expenses in EUR.
- Provided that other factors do not establish that Netherlands Sub's activities are primarily conducted in USD, Netherlands Sub could choose either the USD or the EUR as its functional currency because it has significant activities in both the USD and the EUR, provided the books and records requirement is satisfied. See § 1.985-1(f), Ex. (6).
- What if Netherlands Sub's functional currency is the USD for U.S. GAAP purposes? Does it matter whether the U.S. GAAP functional currency is determined based on similar factors?

Special Rules for Certain Foreign Corporations

- If a foreign corporation has two or more QBUs that do not have the same functional currency:
  - First, each QBU of the foreign corporation determines its functional currency under the general rules. § 1.985-1(d)(1)(i).
  - Second, the foreign corporation determines its functional currency under the general rules with respect to its activities as a whole (including those of the QBUs). § 1.985-1(d)(1)(ii).
  - Thus, the foreign corporation will have a single functional currency that is different from the functional currency of one or more of its QBUs. § 1.985-1(d)(1).
- The income or loss of each QBU is determined in the QBU's functional currency and then translated into the functional currency of the foreign corporation using the appropriate exchange rate. § 1.985-1(d)(2).

Functional Currency of Foreign Corporation – Example



- Germany Parent owns a Netherlands branch and a Swiss branch, the activities of each of which constitute a QBU.
- Germany Parent conducts its transactions (other than the transactions conducted by its branches) in EUR.
- The Netherlands Branch conducts its transactions in EUR, and the Swiss branch conducts its transactions in CHF.
- The functional currencies of the Netherlands branch and Swiss branch must be determined first.
- Then the functional currency of Germany Parent as a whole must be determined, taking into account the branch transactions. See § 1.985-1(f), Ex. (7).
- Supposing that the functional currency of Germany Parent and the Netherlands branch is the EUR and the functional currency of the Swiss branch is CHF, for purposes of determining the E&P of Germany Parent, the profit or loss of the Swiss branch must be translated from CHF into EUR under the rules of § 987.

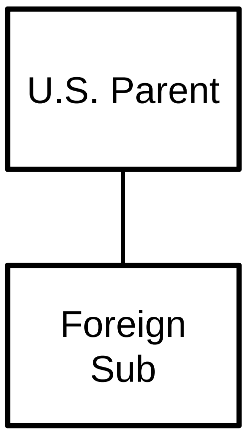
Changes in Functional Currency

- A taxpayer or QBU that changes its functional currency is required to make certain adjustments as of the last day of the taxable year ending before the year of the change. § 1.985-5.
- Step 1 – The taxpayer or QBU must recognize any built-in gain or loss on its section 988 transactions that are denominated in terms of, or by reference to, its new functional currency. § 1.985-5(b). This effectively is a “last chance” rule.
- Step 2 – The taxpayer or QBU must translate its bases in its properties and the amounts of its liabilities from its old functional currency into its new functional currency using the spot exchange rate on the last day of the taxable year ending before the year of the change. § 1.985-5(c).

Changes in Functional Currency, Cont'd

- Step 3A – If a QBU that is a branch of a taxpayer changes to the functional currency of the taxpayer, the branch is treated as if it terminated on the last day of the taxable year ending before the year of change. § 1.985-5(d)(2). This generally will have consequences under section 987.
- Step 3B – If a corporation changes its functional currency:
  - The corporation's earnings and profits are translated into its new functional currency using the spot exchange rate on the last day of the taxable year ending before the year of change. § 1.985-5(e)(1).
  - A U.S. shareholder of a CFC that changes its (the CFC's) functional currency must recognize foreign currency gain or loss under section 986(c) as if all PTI were distributed immediately prior to the change. § 1.985-5(e)(2).
  - Adjustments with respect to section 987 QBUs must be made.

Changes in Functional Currency – Example



E&P	*u*900	*y*1,800

Tax Balance Sheet

Cash	*u*100	*y*200
Property	*u*300	*y*600
Liabilities	*u*50	*y*100

- U.S. Parent owns a foreign corporate subsidiary, Foreign Sub, that uses a calendar taxable year.
- On 6/31/13, Foreign Sub changes its functional currency from *u* to *y*.
- On 12/31/12, the *u*:*y* exchange rate is 1:2.
- Foreign Sub must translate its E&P, basis in its properties, and amount of liabilities from *u* to *y.*
- What if Foreign Sub also holds *y*100 (nonfunctional currency) with built-in gain of *u*35 as of 6/31/13? Foreign Sub must recognize the *u*35 of foreign exchange gain.

Changes in Functional Currency – Section 987

- Equity and Basis Pool Method (see former 1991 proposed regulations)
  - If the branch changes to a functional currency other than that of the owner:
    - If the branch and owner previously had different functional currencies, the new functional currency equity pool is determined by translating the old functional currency equity pool by the spot exchange rate on the last day of the taxable year ending before the year of change. § 1.985-5(d)(1)(ii). No adjustment to the basis pool is necessary. § 1.985-5(d)(1)(ii).
    - If the branch and owner previously had the same functional currency, the basis pool equals the difference between the branch's total old functional currency basis of its assets and its total old functional currency amount of its liabilities. § 1.985-5(d)(1)(iii). The equity pool is determined by translating the basis pool by the spot exchange rate on the last day of the taxable year ending before the year of change. § 1.985-5(d)(1)(ii).
  - If the branch changes to the functional currency of the owner, the branch is treated as if it terminated on the last day of the taxable year ending before the year of change. § 1.985-5(d)(2). The owner realizes any gain or loss attributable to the branch's equity pool. § 1.985-5(d)(2).
  - If the owner changes to a functional currency other than that of the branch:
    - If the branch and owner previously had different functional currencies, the new basis pool is determined by translating the old functional currency basis pool by the spot exchange rate on the last day of the taxable year ending before the year of change. § 1.985-5(e)(4)(i).
    - If the branch and owner previously had the same functional currency, the basis pool equals the difference between the branch's functional currency basis of its assets and its functional currency amount of its liabilities. § 1.985-5(e)(4)(i). The equity pool is determined by translating the basis pool by the spot exchange rate on the last day of the taxable year ending before the year of change. § 1.985-5(e)(4)(i).
  - If the owner changes to the functional currency of the branch, the branch is treated as if it terminated on the last day of the taxable year ending before the year of change. § 1.985-5(e)(4)(ii). The owner realizes any gain or loss attributable to the branch's equity pool. § 1.985-5(e)(4)(ii).

Changes in Functional Currency – Section 987, Cont'd

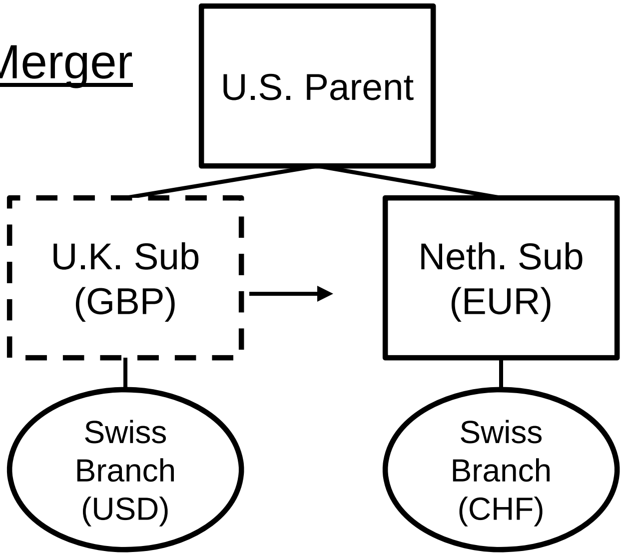
- 2006 Proposed Regulations
  - If the § 987 QBU changes to a functional currency other than that of the owner:
    - ❖ If the § 987 QBU and owner previously had different functional currencies:
      - o For purposes of determining the owner functional currency net value, the historic items are translated from the § 987 QBU's old functional currency into the owner's functional currency at the historic exchange rate and from the owner's functional currency to the § 987 QBU's new functional currency at the spot exchange rate on the last day of the taxable year ending before the year of change. Prop. § 1.985-5(d)(1)(ii)(A). The marked items are translated from the § 987 QBU's old functional currency into its new functional currency directly at the spot exchange rate on the last day of the taxable year ending before the year of change. Prop. § 1.985-5(d)(1)(ii)(A).
      - o No adjustment to the owner's net unrecognized § 987 gain or loss is required. Prop. § 1.985-5(d)(1)(ii)(B).
    - ❖ If the § 987 QBU and owner previously had the same functional currency, the owner and § 987 QBU become subject to section 987 for the year of change and subsequent years. Prop. § 1.985-5(d)(1)(iii).
  - If the § 987 QBU changes to the functional currency of the owner, the § 987 QBU is treated as if it terminated on the last day of the taxable year ending before the year of change. Prop. § 1.985-5(d)(2).
  - If the owner changes to a functional currency other than that of the § 987 QBU:
    - ❖ If the § 987 QBU and owner previously had different functional currencies:
      - o For purposes of determining the owner functional currency net value, the historic items are translated from the § 987 QBU's old functional currency into the owner's old functional currency at the historic exchange rate and from the owner's old functional currency to its new functional currency at the spot exchange rate on the last day of the taxable year ending before the year of change. Prop. § 1.985-5(e)(4)(i)(A)(1). The marked items are translated from the owner's old functional currency into the owner's new functional currency using the spot exchange rate on the last day of the taxable year ending before the year of change. Prop. § 1.985-5(e)(4)(i)(A)(2).
      - o The owner's net unrecognized § 987 gain or loss is translated from the owner's old functional currency to its new functional currency using the spot exchange rate on the last day of the taxable year ending before the year of change. Prop. § 1.985-5(e)(4)(i)(B).
    - ❖ If the § 987 QBU and owner previously had the same functional currency, the owner and § 987 QBU become subject to section 987 for the year of change and subsequent years. Prop. § 1.985-5(e)(4)(ii).
  - If the owner changes to the functional currency of the § 987 QBU, the § 987 QBU is treated as if it terminated on the last day of the taxable year ending before the year of change. Prop. § 1.985-5(e)(4)(iii).

Section 381 Transactions

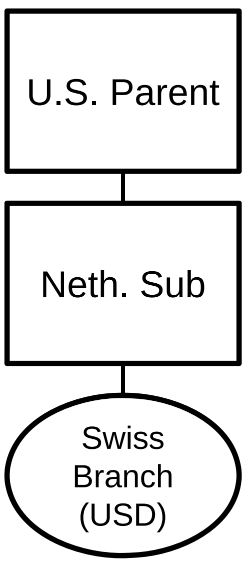
- If as a result of a § 367(b) exchange described in section 381(a) (e.g., a reorganization involving a foreign corporation) a QBU has a different functional currency than it used prior to the transaction, the QBU is treated as having automatically changed its functional currency immediately prior to the transaction. § 1.367(b)-2(j)(1)(i).
- The QBU must make the adjustments required under § 1.985-5.
- The § 367(b) regulations reserve on the possible recognition of exchange gain or loss on paid-in capital in a foreign corporation. See, e.g., § 1.367(b)-3(b)(3)(iii). Cf. § 1.985-5(e)(2) (cross-referencing the paid-in capital rules of § 367(b)).

Section 381 Transaction – Example

Merger



Resulting Structure



- U.S. Parent owns two foreign subsidiaries, U.K. Subsidiary and Netherlands Subsidiary, which use the GBP and EUR as their functional currencies, respectively.
- U.K. Subsidiary and Netherlands Subsidiary each has a Swiss branch, the activities of which constitute a QBU. The Swiss branches have the USD and CHF as their functional currencies, respectively.
- U.K. Subsidiary merges into Netherlands Subsidiary in a transaction described in section 381. The activities of the Swiss branches are combined into a single branch, with the resulting QBU having the USD as its functional currency.
- Netherlands Subsidiary's Swiss branch QBU is treated as changing its functional currency from the CHF to the USD and must make the adjustments required under § 1.985-5. See § 1.367(b)-2(j)(1)(ii), Ex.

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