DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Parts 1 and 602

[TD 8556]

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Computation and Characterization of Income and Earnings and Profits Under the Dollar Approximate Separate Transactions Method of Accounting (DASTM)

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final and temporary regulations.

SUMMARY: This document contains final Income Tax Regulations relating to the computation and characterization of income or earnings and profits under the dollar approximate separate transactions method of accounting (DASTM). These regulations are issued under section 985 of the Internal Revenue Code of 1986 (Code), which was added to the Code by the Tax Reform Act of 1986. These regulations provide guidance for taxpayers with a qualified business unit (QBU) operating in a hyperinflationary environment, i.e., a QBU that must use the dollar as its functional currency and determine income or earnings and profits under DASTM because its functional currency otherwise would be a hyperinflationary currency.

DATES: These regulations are effective July 25, 1994.

For dates of applicability, see the *Effective Dates* portion of the preamble under SUPPLEMENTARY INFORMATION.

FOR FURTHER INFORMATION CONTACT: Jacob Feldman or Teresa B. Hughes of the Office of Associate Chief Counsel, Internal Revenue Service, 1111 Constitution Avenue, NW., Washington, DC 20224, Attention: CC:CORP:T:R (INTL-29-91) (202-622-3870, not a toll-free call).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in these 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 varies from 45 minutes to 1¾ hours, depending on individual circumstances, with an estimated average of 1¼ hours.

Comments concerning the accuracy of this burden estimate and suggestions for reducing this burden should be sent to the Internal Revenue Service, Attn: IRS Reports Clearance Officer PC:FP, Washington, DC 20224, and to the Office of Management and Budget, Attention: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503.

Background

On July 17, 1991, proposed amendments to § 1.985-3 were published in the Federal Register at 56 FR 32525. In addition, conforming changes were proposed to §§ 1.904-4, 1.954-2T, 1.985-0, 1.985-1, and 1.985-2. A public hearing was held on September 13, 1991. A number of comments, which are discussed below, were received on issues raised by the proposed regulations. After consideration of these comments, the regulations are adopted as a Treasury decision with the modifications described below.

Explanation of Provisions

Under § 1.985-1(b)(2)(ii)(A), a QBU that would otherwise have a hyperinflationary currency as its functional currency must use the dollar as its functional currency and must compute income or earnings and profits using DASTM for taxable years beginning after August 24, 1994. Any change in a QBU's method of accounting which results from the QBU's adoption of DASTM under these final regulations shall be deemed to have been made with the consent of the Commissioner.

Some commentators objected to the requirement that use of the dollar and DASTM be made mandatory for a QBU operating in a hyperinflationary environment. The suggestion that use of the dollar and DASTM should continue to be elective was not adopted because the use of a hyperinflationary functional currency and the profit and loss method of accounting (P&L method) does not clearly reflect income.

Under the P&L method, income or loss is computed in the hyperinflationary currency and translated into dollars at the appropriate exchange rate for the accounting period. The P&L method distorts income and loss of a QBU with substantial depreciable assets. As the hyperinflationary currency depreciates with respect to the dollar, sales revenues (as measured in the hyperinflationary currency) increase; but depreciation and amortization deductions, which are based on hyperinflationary currency cost bases, remain constant. This results in an overstatement of income. Another distortion occurs with respect to income and expense derived from hyperinflationary financial assets and liabilities. For example, a QBU that borrows in hyperinflationary currency will incur and deduct a very high level of nominal interest expense, reflecting the lender's expectation that payment of interest and repayment of principal will be in devalued currency. However, under the P&L method, the offsetting exchange gain (relative to the dollar) on a QBU's hyperinflationary currency liabilities is deferred, causing the income of net borrowers to be understated.

In light of these distortions, use of a hyperinflationary functional currency and the P&L method by QBUs operating in a hyperinflationary environment is not appropriate. The regulations, therefore, generally require that QBUs operating in a hyperinflationary environment use the dollar and DASTM for future taxable years. Under § 1.985-1(b)(2)(ii)(B)(*2*), however, a taxpayer is not required to use DASTM to compute the income or loss or earnings and profits of a foreign corporation that is not a controlled foreign corporation. This exception is provided because minority shareholders of a foreign corporation may be unable to obtain the information required to apply DASTM. However, where the necessary information can be obtained, § 1.985-1(b)(2)(ii)(B)(*2*) provides that DASTM may be elected by a noncontrolled section 902 corporation under the procedural rules of § 1.985-2(c)(3).

Section 1.985-1(b)(2)(ii)(B)(*1*) clarifies the rule for determining the functional currency of a QBU branch of a foreign corporation when the foreign corporation has a non-dollar functional currency that is not hyperinflationary. If the QBU branch otherwise would have a hyperinflationary currency as its functional currency, the branch's functional currency is the functional currency of the foreign corporation.

The definition of hyperinflationary currency, now found in § 1.985-1(b)(2)(ii)(D), has been revised to clarify that the cumulative inflation rate during the thirty-six month base period is based on compounded inflation rates for the base period, and not on the sum of annual inflation rates. This change conforms the definition of hyperinflationary currency more closely to that applicable under United States generally accepted accounting principles (GAAP).

Section 1.985-3(a) provides that, for all purposes of subtitle A, DASTM must be used to compute gross income, income or loss, or earnings and profits (or deficits in earnings and profits). This provision is intended to clarify that DASTM gain or loss is part of gross income for purposes of the *de minimis* and full inclusion rules of section 954(b)(3) (A) and (B), and that DASTM gain or loss must be taken into account in applying the related party interest rules of section 954(b)(5), among other computations.

Section 1.985-3(a) further provides that, for open taxable years beginning after December 31, 1986, but before the effective date of these regulations, the taxpayer has the option to elect DASTM for any open taxable year (and all subsequent taxable years). Taxpayers previously using the P&L method that wish to elect DASTM for prior open years may do so by amending their tax returns for the applicable years and complying with the applicable election procedures of § 1.985-2, including the conformity requirements of § 1.985-2(d)(3), if applicable. Taxpayers that have elected DASTM and applied the rules under prior § 1.985-3 may elect to apply the rules under this revised § 1.985-3 by amending their tax returns for the applicable years. In either case, the Commissioner is deemed to consent.

If a taxpayer elects for prior years to change the functional currency of a QBU operating in a hyperinflationary environment to the dollar, it must make the adjustments described in § 1.985-5 (or § 1.985-5T, if applicable) if the year of change begins after 1987, or the adjustments described in § 1.985-6 (or § 1.985-6T, if applicable) if the year of change begins in 1987. The adjustments described in § 1.985-5 (or § 1.985-5T, if applicable) must be included in income in the taxable year prior to the year of change unless that prior taxable year is closed. In that case, the adjustments must be included in income in the year of change.

Certain countries with hyperinflation require taxpayers to make adjustments to the balance sheet under a system of monetary correction with respect to fixed assets and capital, with corresponding adjustments to the profit and loss statement. Under U.S. GAAP, these adjustments are reversed. Section 1.985-3(b)(2) and § 1.985-3(d)(2)(ii) have been clarified to require reversal of monetary correction adjustments required by local accounting principles.

Taxpayers suggested that they should be permitted to translate certain financial assets and liabilities at the period-end exchange rate, rather than at the average exchange rate for the last translation period in order to conform the rules under § 1.985-3 to GAAP. To make it clear that the period-end exchange rate may be used, § 1.985-3(c)(6) has been amended to indicate that a spot exchange rate on the last day of the taxable period is a reasonable method, provided that it is consistently and used and conforms to the taxpayer's method of financial accounting.

Taxpayers requested guidance with respect to transactions described in section 988(c)(1) (B) and (C) denominated in a currency other than a QBU's hyperinflationary currency or the dollar (third currency transaction). In order to parallel the financial accounting rules for the administrative ease of taxpayers and the Service, § 1.985-3(c)(9) provides that taxpayers may use any reasonable method of accounting for third currency transactions so long as such method is consistent with their method of financial accounting.

Several commentators requested that the regulations provide a simpler method of allocating and apportioning DASTM gain or loss for small taxpayers. This suggestion has been adopted. Section 1.985-3(e)(2) provides that a taxpayer with a QBU having an adjusted basis in assets of $10 million or less (taking into account assets of related QBUs resident in the same country) may elect to allocate DASTM gain or loss ratably to all items of the QBU's gross income (determined prior to adjustment for DASTM gain or loss). Thus, for purposes of the foreign tax credit, DASTM gain or loss is allocated on the basis of the relative amounts of gross income in each separate category described in section 904(d). Similarly, for purposes of section 952, DASTM gain or loss is allocated to subpart F income in a separate category based on the ratio of gross subpart F income in the separate category to total gross income in that category. Commentators also requested a simpler method for taxpayers with one or two section 904(d) separate categories (or a *de minimis* amount in a second category).

This suggestion was not adopted because the allocation rules in § 1.985-3(e)(3) more accurately reflect the income of large taxpayers.

The prior final regulations under § 1.985-3 provided for the allocation of DASTM gains and losses to section 904(d) separate categories based on foreign source gross income in each category. There was no attempt to identify DASTM gain or loss with specific assets or liabilities. However, in the proposed regulations under § 1.985-3, DASTM gain or loss was identified with specific assets and was directly allocated to specific section 904(d) separate categories based on the income those assets would generate. With respect to liabilities, the proposed regulations provided that DASTM gain or loss should be allocated to the section 904(d) separate categories in the same manner as the allocation and apportionment of interest expense. The proposed regulations applied this method of allocation to all liabilities.

Some comments suggested that DASTM gain or loss on certain non-interest-bearing liabilities, particularly short-term non-interest-bearing trade payables, should be directly allocated to the same section 904(d) separate category as the income produced by the purchased good or service to which the payable relates. The suggested rationale for this approach is that in a hyperinflationary environment the purchase price for deferred payment of goods or services reflects a premium for inflation expected to occur prior to payment. This overstated purchase price is reflected in cost of goods sold, distorting the taxpayer's income in the pertinent section 904(d) separate category. Therefore, in order to compensate for this distortion, commentators recommended adjusting cost of goods sold by the DASTM gain on the trade payable.

In response to this suggestion, § 1.985-3(e) now provides different rules for allocating and apportioning DASTM gain or loss with respect to interest-bearing liabilities (under § 1.985-3(e)(3)(vii)) and non-interest-bearing liabilities (under § 1.985-3(e)(3)(viii)). Section 1.985-3(e)(3)(vii)(A) now provides that the amount of DASTM gain on interest-bearing liabilities reduces interest expense generated by such liabilities; any DASTM gain in excess of interest expense is sourced or otherwise classified in the same manner that interest expense is allocated and apportioned. Any DASTM loss on interest-bearing liabilities is allocated and apportioned in the same manner that interest expense is allocated and apportioned under § 1.861-9T (without regard to the exceptions to fungibility in § 1.861-10T).

Section 1.985-3(e)(3)(vii)(B) provides rules with respect to the allocation of DASTM gain or loss on debt that gives rise to related person interest expense under section 954(b)(5). Section 954(b)(5) requires that related person interest expense must first be allocated to foreign personal holding company income that is passive income to the extent thereof and therefore to the section 904(d)(1)(A) separate category for passive income for purposes of the foreign tax credit limitation. To prevent distortion, any DASTM gain or loss arising from such related person debt must also be allocated for purposes of sections 904 and 952 in the same manner that the related person interest expense of that debt is required to be allocated under the rules of section 954(b)(5).

One commentator suggested that, in applying the modified gross income method under § 1.861-9T(j) to allocate and apportion the interest expense of a controlled foreign corporation, the gross income in each section 904(d) separate category should first be adjusted by the amount of DASTM gain or loss allocated to assets under § 1.985-3(e)(3)(v). Section 1.985-3(e)(3)(vii)(C) of the final regulations adopts this suggestion and requires that, before applying the modified gross income method under § 1.861-9T(j), an adjustment to gross income must be made for DASTM gain or loss attributed to assets under § 1.985-3(e)(3)(v) and DASTM gain or loss on short-term, non-interest-bearing trade payables under § 1.985-3(e)(3)(viii)(A).

In accordance with comments described above, § 1.985-3(e)(3)(viii)(A) provides that DASTM gain or loss on short-term, non-interest-bearing trade payables is allocated to the same category or type of gross income as the cost or expense to which the trade payable relates. For this purpose, a short-term, non-interest-bearing trade payable is a non-interest-bearing liability with a term of 183 days or less that is incurred to purchase property or services to be used by the obligor in an active trade or business. Under § 1.985-3(e)(3)(viii)(B), a similar rule has been provided for excise tax payables.

Under § 1.985-3(e)(3)(viii)(C)(*1*), DASTM gain or loss on other non-interest-bearing liabilities is allocated under § 1.985-3(e)(3)(ix) (i.e., on a gross income basis). However, under § 1.985-3(e)(3)(viii)(C)(*2*), the taxpayer may demonstrate to the satisfaction of the district director, or the district director may determine, that application of the gross income allocation method would result in a substantial distortion of income. In that case, DASTM gain or loss on such liabilities may be attributed to the same section 904(d) separate category or subpart F category as the transaction to which the liability relates.

The temporary regulations under § 1.954-2T have been amended in this Treasury Decision and will be finalized as part of a separate regulation.

An accompanying proposed regulation provides rules that would require a taxpayer to change from DASTM to the P&L method when the currency which otherwise would be its functional currency ceases to be hyperinflationary.

Effective Date

These regulations are effective for taxable years beginning after August 24, 1994. However, a taxpayer may elect to apply § 1.985-3 to any open taxable year beginning after December 31, 1986 (whether or not DASTM has been previously elected for some or all of those years). In order to make this election, the taxpayer must apply § 1.985-3 to that year and all subsequent years. In addition, each person that is related (within the meaning of § 1.985-3(e)(2)(vi)) to the taxpayer on the last day of any taxable year for which the election is effective and that would have been eligible to elect DASTM must also apply § 1.985-3 to that year and all subsequent years.

Special Analyses

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) and the Regulatory Flexibility Act (5 U.S.C. chapter 6) do not apply to these regulations, and, therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue 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 authors of these regulations are Jacob Feldman and Teresa B. Hughes of the Office of Associate Chief Counsel (International) within the Office of Chief Counsel, IRS. However, other personnel from the IRS and Treasury Department participated in their development.

List of Subjects

26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

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:

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. In § 1.904–4, paragraph (j) is revised to read as follows:

§ 1.904–4 Separate application of section 904 with respect to certain categories of income.

* * * * *

(j) *Special rule for DASTM gain or loss.* Any DASTM gain or loss computed under § 1.985–3(d) must be allocated among the categories of income under the rules of § 1.985–3 (e)(2)(iv) or (e)(3). The rules of § 1.985–3(e) apply before the rules of section 904(d)(2)(A)(iii)(III) (the exception from passive income for high-taxed income).

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Par. 3. In § 1.954–2T, paragraph (g)(2)(i) is revised to read as follows:

§ 1.954–2T Foreign personal holding company income; taxable years beginning after December 31, 1986 (temporary).

* * * * *

(g) * * *

(2) * * * (i) *Qualified business units using the dollar approximate separate transactions method.* Any DASTM gain or loss computed under § 1.985–3(d) must be allocated under the rules of § 1.985–3 (e)(2)(iv) or (e)(3).

* * * * *

Par. 4. Section 1.985–0 is amended by revising the table of contents entry for § 1.985–3 to read as follows:

§ 1.985–0 Outline of regulation.

* * * * *

§ 1.985–3 United States dollar approximate separate transactions method.

* * * * *

Par. 5. Section 1.985–1 is amended as follows:

1. Revise the fifth, seventh, and eighth sentences of paragraph (a)(1).

2. Revise paragraph (b).

3. Revise paragraph (c)(6).

4. Add a new sentence to the end of paragraph (d)(1)(ii) and remove the concluding text at the end of paragraph (d)(1).

5. The revisions and additions read as follows:

§ 1.985–1 Functional currency.

(a) * * * (1) * * * Section 1.985–3 sets forth the dollar approximate separate transactions method that certain QBUs must use to compute their income or loss or earnings and profits. * * * Section 1.985–5 provides adjustments that are required to be made upon a change in functional currency. Finally, § 1.985–6 provides transition rules for a QBU that uses the dollar approximate separate transactions method for its first taxable year beginning after December 31, 1986.

* * * * *

(b) *Dollar functional currency*—(1) *In general.* The dollar shall be the functional currency of a taxpayer or QBU described in paragraph (b)(1) (i) through (v) of this section regardless of the currency used in keeping its books and records (as defined in § 1.989(a)–1(d)). The dollar shall be the functional currency of—

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

(ii) 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;

(iii) Except as otherwise provided by ruling or administrative pronouncement, 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));

(iv) 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

(v) A QBU 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.

(2) *QBUs operating in a hyperinflationary environment*—(i) *Taxable years beginning on or before August 24, 1994.* For taxable years beginning on or before August 24, 1994, see § 1.985–2 with respect to a QBU that elects to use, or is otherwise required to use, the dollar as its functional currency.

(ii) *Taxable years beginning after August 24, 1994.*—(A) *In general.* For taxable years beginning after August 24, 1994, except as otherwise provided in paragraph (b)(2)(ii)(B) of this section, any QBU that otherwise would be required to use a hyperinflationary currency as its functional currency must use the dollar as its functional currency and compute income or loss or earnings and profits under the rules of § 1.985–3.

(B) *Exceptions*—(*1*) *Certain QBU branches.* The functional currency of a QBU that otherwise would be required to use a hyperinflationary currency as its functional currency and that is a branch of a foreign corporation having a non-dollar functional currency that is not hyperinflationary shall be the functional currency of the foreign corporation. Such QBU's income or loss or earnings and profits shall be determined under § 1.985–3 by substituting the functional currency of the foreign corporation for the dollar.

(*2*) *Corporation that is not a controlled foreign corporation.* A foreign corporation (or its QBU branch) operating in a hyperinflationary environment is not required to use the dollar as its functional currency pursuant to paragraph (b)(2)(ii)(A) of this section if that foreign corporation is not a controlled foreign corporation as defined in section 957 or 953(c)(1)(B). However, a noncontrolled section 902 corporation, as defined in section 904(d)(2)(E), may elect to use the dollar (or, if appropriate, the currency specified in paragraph (b)(2)(ii)(B)(*1*) of this section) as its (or its QBU branch's) functional currency under the procedures set forth in § 1.985–2(c)(3).

(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 the adjustments described in § 1.985–5 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. The adjustments described in § 1.985–5 must be included in income in the taxable year prior to the year of change unless that prior taxable year is closed. In that case, the adjustments must be included in income in the year of change. No adjustments under section 481 are required solely because of a change in functional currency described in this paragraph (b)(2)(ii)(C).

(D) *Hyperinflationary currency.* For purposes of sections 985 through 989, 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 the "International Financial Statistics" or a successor publication of the International Monetary Fund. If a country's currency is not listed in the monthly issues of "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 first day of the current calendar year. For this purpose, the cumulative inflation rate for the base period is based on compounded inflation rates. Thus, if for 1991, 1992, and 1993, a country's annual inflation rates are 29 percent, 25 percent, and 30 percent, respectively, the cumulative inflation rate for the three-year base period is 110 percent [((1.29 x 1.25 x 1.3) − 1.0 x 1.10)x100=110%] and the currency of the country for the QBU's 1994 year is considered hyperinflationary.

(c) * * *

(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) or § 1.985–3(a)(2)(ii).

(d) * * *

(1) * * *

(ii) * * * For purposes of this paragraph (d)(1), if a QBU of a foreign corporation has the dollar as its functional currency under paragraph (b)(2) of this section, the QBU's activities shall be considered dollar activities of the corporation.

* * * * *

Par. 6. Section 1.985–2 is amended by revising paragraphs (a) and (b)(2) to read as follows:

§ 1.985–2 Election to use the United States dollar as the functional currency of a QBU.

(a) *Background and scope*—(1) *In general.* This section permits an eligible QBU to elect to use the dollar as its functional currency for taxable years beginning on or before August 24, 1994. 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). See § 1.985–1(b)(2)(ii) for rules requiring a QBU to use the dollar as its functional currency in taxable years beginning after August 24, 1994.

(2) *Exception.* Pursuant to § 1.985–1(b)(2)(ii)(B)(*2*), the rules of paragraph (c)(3) of this section shall apply with respect to the procedure required to be followed by a noncontrolled section 902 corporation as defined in section 904(d)(2)(E) to elect the dollar as its (or its QBU branch's) functional currency and the application of § 1.985–3.

(b) * * *

(2) *Hyperinflationary currency.* See § 1.985–1(b)(2)(ii)(D) for the definition of hyperinflationary currency.

* * * * *

Par. 7. Section 1.985–3 is revised to read as follows:

§ 1.985–3 United States dollar approximate separate transactions method.

(a) *Scope and effective date*—(1) *Scope.* This section describes the United States dollar (dollar) approximate separate transactions method of accounting (DASTM). For all purposes of subtitle A, this method of accounting must be used to compute the gross income, taxable income or loss, or earnings and profits (or deficit in earnings and profits) of a QBU (as defined in section 989(a)) that has the dollar as its functional currency pursuant to § 1.985–1(b)(2).

(2) *Effective date*—(i) *In general.* This section is effective for taxable years beginning after August 24, 1994.

(ii) *DASTM prior-year election.* A taxpayer may elect to apply this section to any open taxable year beginning after December 31, 1986 (whether or not DASTM has been previously elected for some or all of those years). In order to make this election, the taxpayer must apply § 1.985–3 to that year and all subsequent years. In addition, each person that is related (within the meaning of § 1.985–3(e)(2)(vi)) to the taxpayer on the last day of any taxable year for which the election is effective and that would have been eligible to elect DASTM must also apply these rules to that year and all subsequent years. A taxpayer that has not previously elected to apply DASTM to its prior taxable years may make the DASTM election for the pertinent years by filing amended returns and complying with the applicable election procedures of § 1.985–2. Form 8819 shall be attached to the return for the first year for which the election is to be effective. A taxpayer that has elected DASTM for prior taxable years and applied the rules under § 1.985–3 (as contained in the April 1, 1994 edition of 26 CFR part 1 (1.908 to 1.1000)) may amend its returns to apply the rules of this § 1.985–3. In either case, the DASTM election for prior taxable years shall be deemed to be made with the consent of the Commissioner.

(b) *Statement of method.* Under DASTM, income or loss or earnings and profits (or a 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)–1(d)) as recorded in the QBU's hyperinflationary currency (as defined in § 1.985–1(b)(2)(ii)(D));

(2) Making the adjustments necessary to conform such statement to United States generally accepted accounting principles and tax accounting principles (including reversing monetary correction adjustments required by local accounting principles);

(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) and, where necessary, particular items of gross income, deductible expense or other amounts, in accordance with paragraph (e) of this section to reflect the amount of DASTM gain or loss as determined under paragraph (d) of this section.

(c) *Translation into United States dollars*—(1) *In general.* Except as otherwise provided in this paragraph (c), 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 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. However, if the QBU previously changed its functional currency to the dollar, and the rules of § 1.985–5 (or, if applicable,

§ 1.985–5T, as contained in the April 1, 1993 edition of 26 CFR part 1 (1.908 to 1.1000)) applied in translating its balance sheet amounts into dollars, then the spot exchange rate applied under those rules shall be used to translate any amount that would otherwise be translated at a rate determined by reference to a translation period prior to the change in functional currency. For example, depreciation with respect to an asset acquired while the QBU had a nondollar functional currency shall be translated into dollars at the spot rate on the last day of the taxable year before the year of change to a dollar functional currency, rather than at the rate for the period in which the asset was acquired.

(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 closing 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 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 exchange rate for the translation period in which the cost of such items was incurred. However, if amounts representing items included in the 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 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)(3)(iii)(A) of this section may be based upon reasonable approximations and averages, including rates of turnover, provided that the method is used consistently from year to year.

(4) *Depreciation, depletion, and amortization*. Amounts representing allowances for depreciation, depletion, or amortization shall be translated at the exchange rate for the translation period in which the cost of the underlying asset was incurred, except as provided in paragraph (c)(1) of this section.

(5) *Prepaid expenses or income*. Amounts representing expense or income paid or received in a prior taxable year shall be translated at the exchange rate for the translation period during which they were paid or received.

(6) *Exchange rate*. The exchange rate for a translation period may be determined under any reasonable method, provided that the method is consistently applied to all translation periods and conforms to the taxpayer's method of financial accounting. Reasonable methods include the average of beginning and ending exchange rates for the translation period and the spot rate on the last day of the translation period. Once chosen, a method for determining an exchange rate can be changed only with the consent of the district director.

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

(ii) *Exception*. A taxpayer may divide its taxable year into translation periods of equal length (with not more than one short period annually) that are less than one month. Once such a translation period is established, it may not be changed without the consent of the district director.

(8) *Dollar transactions*—(i) *In general*. Except as provided in paragraph (c)(8)(ii) of this section, no DASTM gain or loss is realized 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, the income or loss attributable to any transaction in which the amount that a QBU is entitled to receive (or is required to pay) by reason of such transaction is 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 in dollars (or its LC equivalent), the loan is a dollar transaction. Similarly, this paragraph applies to any transaction that is determined to be a dollar transaction under section 988.

(ii) *Non-dollar functional currency*. If pursuant to § 1.985–1(b)(2)(ii)(B)(*1*), a QBU is required to use a functional currency other than the dollar, then that currency shall be substituted for the dollar in applying paragraph (c)(8)(i) of this section.

(9) *Third currency transactions*—A taxpayer may use any reasonable method of accounting for transactions described in section 988(c)(1) (B) and (C) that are denominated in, or determined by reference to, a currency other than the QBU's hyperinflationary currency or the dollar (third currency transactions) so long as such method is consistent with its method of financial accounting.

(10) *Examples*. The provisions of this paragraph (c) are illustrated by the following examples:

Example 1. S is an accrual basis QBU that is required to use the dollar as its functional currency for its first taxable year beginning in 1994. S's hyperinflationary currency is the "h." During 1994, S accrues 100 dollars attributable to dollar-denominated sales. Because this is a dollar transaction under paragraph (c)(8) of this section, S's income or loss for 1994 shall reflect the 100 dollars (not the hyperinflationary value of such dollars when accrued).

Example 2. (i) S is an accrual basis QBU that is required to use the dollar as its functional currency for its first taxable year beginning in 1994. S's hyperinflationary currency is the "h." During 1994, 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 1994, S purchased depreciable assets for 80,000,000h and was allowed depreciation of 4,000,000h. At the end of 1994, 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) or (c)(9) 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 1994 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	21:1	952,381
(May.–June.)	50,000,000	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:	0		0
(Jan.–Feb.)	15,000,000h	20:1	750,000
(Mar.–Apr.)	10,000,000	21:1	476,190
(May–June)	30,000,000	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)
	77,000,000h		3,536,314

[1] Where multiple months are indicated, the exchange rate applies for all months.
[2] See paragraph (ii) of this *Example.*

(ii) Since S uses the first-in, first-out inventory method, the closing inventory is assumed 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
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
Non-Capitalized Expenses			
(Jan.–Feb.)	4,000,000h	20:1	200,000
(Mar.–Apr.)	2,500,000	21:1	119,048
(May–June)	2,500,000	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	68,956
(Nov.)	3,000,000	30:1	100,000
(Dec.)	4,000,000	31:1	129,032
Total	26,000,000h		1,040,157
Depreciation	4,000,000h	20:1.	200,000
Total Cost & Expenses	107,000,000h		4,776,481
Operating Profit	133,000,000h		4,930,121

(d) *Computation of DASTM gain or loss*—(1) *Rule.* DASTM gain or loss of a QBU equals—

(i) The net worth of the QBU (as determined under paragraph (d)(2) of this section) at the end of the taxable year minus the net worth of the QBU at the end of the preceding taxable year; plus

(ii) The dollar amount of the items described in paragraph (d)(3) of this section and minus the dollar amount of the items described in paragraph (d)(4) of this section; minus

(iii) 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

	Hyperinflationary currency	Exchange rate	United States dollars
Sales			
(Jan.–Feb.)	10,000,000h	[1] 20:1	$500,000
(Mar.–Apr.)	20,000,000	21:1	952,381
(May.–June.)	50,000,000	22:1	2,272,727
(July)	50,000,000	23:1	2,173,913
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(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:	0		0
(Jan.–Feb.)	15,000,000h	20:1	750,000
(Mar.–Apr.)	10,000,000	21:1	476,190
(May–June)	30,000,000	22:1	1,363,636
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(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)
	77,000,000h		3,536,314

[1] Where multiple months are indicated, the exchange rate applies for all months.
[2] See paragraph (ii) of this *Example*.

(ii) Since S uses the first-in, first-out inventory method, the closing inventory is assumed 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
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Total	23,000,000h		822,655
Non-Capitalized Expenses			
(Jan.–Feb.)	4,000,000h	20:1	200,000
(Mar.–Apr.)	2,500,000	21:1	119,048
(May–June)	2,500,000	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
Depreciation	4,000,000h	20:1	200,000
Total Cost & Expenses	107,000,000h		4,776,481
Operating Profit	133,000,000h		4,930,121

(d) *Computation of DASTM gain or loss*—(1) *Rule*. DASTM gain or loss of a QBU equals—

(i) The net worth of the QBU (as determined under paragraph (d)(2) of this section) at the end of the taxable year minus the net worth of the QBU at the end of the preceding taxable year; plus

(ii) The dollar amount of the items described in paragraph (d)(3) of this section and minus the dollar amount of the items described in paragraph (d)(4) of this section; minus

(iii) 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 paragraphs (b)(1) through (b)(3) of this section.

(2) *Net worth.* Net worth of a QBU at the end of any taxable year equals the aggregate dollar amount representing assets on the QBU's balance sheet at the end of the taxable year less the aggregate dollar amount representing liabilities on the balance sheet. Notwithstanding any other provision in this paragraph (d)(2), the district director may adjust the amount of any asset or liability if a purpose for acquiring (or disposing of) the asset or incurring (or discharging) the liability is to manipulate the composition of the balance sheet for any period during the taxable year in order to avoid tax. The taxpayer shall determine net worth by—

(i) Preparing a balance sheet as of the end of the taxable year from the QBU's books and records (within the meaning of § 1.989(a)–1(d)) as recorded in the QBU's hyperinflationary currency;

(ii) Making adjustments necessary to conform such balance sheet to United States generally accepted accounting principles and tax accounting principles (including reversing monetary correction adjustments required by local accounting principles); 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.

(3) *Positive adjustments.* The items described in this paragraph (d)(3) are dividend distributions for the taxable year and any items that decrease net worth for the taxable year but that generally do not affect income or loss or earnings and profits (or a deficit in earnings and profits). Such items include a transfer to the home office of a QBU branch and a return of capital. Except as otherwise provided by ruling or administrative pronouncement, the amount of a transfer to the home office of a QBU branch, a dividend, or a distribution that is a return of capital shall be translated into dollars at the exchange rate on the date the amount is paid.

(4) *Negative adjustments.* The items described in this paragraph (d)(4) are items that increase net worth for the taxable year but that generally do not affect income or loss or earnings and profits (or a deficit in earnings and profits). Such items include a capital contribution or a transfer from a home office to a QBU branch. Except as otherwise provided by ruling or administrative pronouncement, if the contribution or transfer is not in dollars, the amount of a capital contribution or transfer shall be translated into dollars at the exchange rate on the date made.

(5) *Translation of balance sheet.* Asset and liability amounts shown on the balance sheet in hyperinflationary currency (adjusted pursuant to paragraph (d)(2)(ii) of this section) shall be translated into dollars as provided in this paragraph (d)(5). However, if the QBU previously changed its functional currency to the dollar and the rules of § 1.985–5 (or, if applicable, § 1.985–5T, as contained in the April 1, 1993 edition of 26 CFR part 1 (1.908 to 1.1000)) applied in translating its balance sheet amounts into dollars, then the spot exchange rate applied under those rules shall be used to translate any amount that would otherwise be translated at a rate determined by reference to a translation period prior to the change in functional currency. For example, the basis of real property acquired while the QBU had a nondollar functional currency shall be translated into dollars at the spot rate on the last day of the taxable year before the year of change to a dollar functional currency, rather than at the rate for the period in which the cost was incurred.

(i) *Closing 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 exchange rate for the last translation period for 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 currency.* Amounts of the hyperinflationary currency and hyperinflationary demand deposit balances shall be translated at the exchange rate for the last translation period of the taxable year.

(v) *Certain assets*—(A) *In general.* Amounts representing plant, real property, equipment, goodwill, and patents and other intangibles shall be translated at the 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) *Hyperinflationary debt obligations.* Except as provided in paragraph (d)(5)(vii) of this section, amounts representing a hyperinflationary debt obligation (including accounts receivable and payable) shall be translated at the exchange rate for the last translation period for the taxable year.

(vii) *Accrued foreign income taxes.* Amounts representing an accrued but unpaid foreign income tax shall be translated at the exchange rate on the last day of the last translation period of the taxable year of accrual.

(viii) *Certain hyperinflationary financial instruments.* Amounts representing any item described in section 988(c)(1)(B)(iii) (relating to forward contracts, futures contracts, options, or similar financial instruments) denominated in or determined by reference to the hyperinflationary currency shall be translated at the exchange rate for the last translation period for the taxable year.

(ix) *Other assets and liabilities.* Amounts representing assets and liabilities, other than those described in paragraphs (d)(5)(i) through (viii) of this section, shall be translated at the exchange rate for the translation period in which the cost of the asset or the amount of the liability was incurred.

(6) *Dollar transactions.* Notwithstanding any other provisions of this paragraph (d), where the amount representing an item shown on the balance sheet reflects a dollar transaction (described in paragraph (c)(8) of this section), the transaction shall be taken into account in accordance with that paragraph.

(7) *Third currency transactions.* A taxpayer may use any reasonable method of accounting for transactions described in section 988(c)(1)(B) and (C) that are denominated in, or determined by reference to, a currency other than the QBU's hyperinflationary currency or the dollar (third currency transactions), so long as such method is consistent with its method of financial accounting.

(8) *Character.* The amount of DASTM gain or loss determined under paragraph (d)(1) of this section shall be ordinary income or loss.

(9) *Example.* The provisions of this paragraph (d) are illustrated by the following example:

Example. (i) S, an accrual method calendar year foreign corporation, uses DASTM. S's hyperinflationary currency is the "h." S's net worth at December 31, 1993 was $3,246,495. For 1994, S's operating profit is 81,340,000h, or $2,038,200. S made a 5,000,000h distribution in April and again in December of 1994. S's translation period is the month. None of S's assets or liabilities reflect a dollar or third currency transaction described in paragraph (c)(8) or (c)(9) of this section, respectively. The exchange rate for each month in 1994 is as follows:

January	32h:$1

Feb.–Mar.	33:1	Aug.–Sept.	37:1
April–May	34:1	Oct.	38:1
June	35:1	Nov.	39:1
July	36:1	Dec.	40:1

(ii) At the end of 1994, S's assets and liabilities, as adjusted and translated pursuant to paragraphs (d)(2) and (d)(5) of this section, 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	40:1	625,000
Inventory	65,000,000	(2)	2,500,000
Fixed assets—Property	90,000,000	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	40:1	125,000
Total Assets	406,340,000		14,246,627
Accounts Payable Long-term liabilities:	35,000,000	40:1	875,000
Liability A	150,000,000	40:1	3,750,000
Liability B	80,000,000	40:1	2,000,000
Liability C	30,000,000	40:1	750,000
Total Liabilities	295,000,000h		$7,375,000

[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 and dollar depreciation reflect 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 exchange rate for the translation period incurred.

(iii) The DASTM gain of S for 1994 is computed as follows:

Net worth—1994		$6,871,627
Less—Net worth—1993		$3,246,495
Plus—1994 Dividends:		
April	$149,254	
December	[1] 126,582	275,836
Less Operating Profit—1994		2,038,200
DASTM Gain		$1,862,768

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

(iv) Thus, total profit = $2,038,200 + $1,862,768 = $3,900,968

(e) *Effect of DASTM gain or loss on gross income, taxable income, or earnings and profits*—(1) *In general.* For all purposes of subtitle A, the amount of DASTM gain or loss of a QBU determined under paragraph (d) of this section is taken into account by the QBU for purposes of determining the amount of its gross income, taxable income or loss, earnings and profits (or deficit in earnings and profits), and, where necessary, particular items of income, expense or other amounts. DASTM gain or loss is allocated under one of two methods. Certain small QBUs may elect the small QBU DASTM allocation described in paragraph (e)(2) of this section. All other QBUs must use the 9-step procedure described in paragraph (e)(3) of this section.

(2) *Small QBU DASTM allocation*—(i) *Election threshold.* A taxpayer may elect to use the small QBU DASTM allocation described in paragraph (e)(2)(iv) of this section with respect to a QBU that has an adjusted basis in assets (translated as provided in paragraph (d)(5) of this section) of $10 million or less at the end of any taxable year. In calculating the $10 million threshold, a QBU shall be treated as owning all of the assets of each related QBU (as defined in paragraph (e)(2)(vi) of this section) having its residence (as defined in section 988(a)(3)(B)) in the QBU's country of residence (related same-country QBU). For this purpose, appropriate adjustment shall be made to eliminate the double counting of assets created in transactions between related QBUs resident in the same country. For example, assume QBU–1, resident in country X, sells inventory to related QBU–2, also resident in country X, in exchange for an account receivable. For purposes of determining the assets of QBU–1 under this paragraph (e)(2)(i), the taxpayer shall take into account either the inventory shown on the books of QBU–2 or QBU–1's receivable from QBU–2 (but not both).

(ii) *Consent to election.* The election of the small QBU DASTM allocation or subsequent application of the rules of paragraph (e)(3) of this section due to an increase in the adjusted basis of the QBU's assets shall be deemed to have been made with the consent of the Commissioner. Once the election under paragraph (e)(2)(iii) of this section is made, it shall apply for all years in which the adjusted basis of the assets of the QBU (and any related same-country QBU) is $10 million or less, unless revoked with the Commissioner's consent. If the adjusted basis of the assets of the QBU (and any related same-country QBU) exceeds $10 million at the end of any taxable year, the rules of paragraph (e)(3) of this section shall apply to that QBU (and any related same-country QBU) for such year and each subsequent year unless such QBU again qualifies, and applies for and obtains the Commissioner's consent, to use the small QBU DASTM allocation. However, if a QBU acquires assets with a principal purpose of avoiding the application of paragraph (e)(2)(iv) of this section, the Commissioner may disregard the acquisition of such assets.

(iii) *Manner of making election*—(A) *QBUs that are branches of United States persons*. For the first year in which this election is effective, in the case of a QBU branch of a United States person, a statement shall be attached to the United States person's timely filed Federal income tax return (taking extensions into account). The statement shall identify the QBU (or QBUs) for which the election is being made by describing its business and its country of residence, state the adjusted basis of the assets of the QBU (and any related same-country QBUs) to which the election applies, and include a statement that the election is being made pursuant to § 1.985–3(e)(2).

(B) *Other QBUs*. In the case of a QBU other than one described in paragraph (e)(2)(iii)(A) of this section, an election must be made in the manner prescribed in § 1.964–1. The statement filed with the Internal Revenue Service as required under § 1.964–1 must include the information required under paragraph (e)(2)(iii)(A) of this section.

(iv) *Effect of election*. If a taxpayer elects under this paragraph (e)(2) to use the small QBU DASTM allocation, DASTM gain or loss, as determined under paragraph (d) of this section, of a small QBU shall be allocated ratably to all items of the QBU's gross income (determined prior to adjustment for DASTM gain or loss). Therefore, for purposes of the foreign tax credit, DASTM gain or loss shall be allocated on the basis of the relative amounts of gross income in each separate category as defined in § 1.904–5(a)(1). In the case of a controlled foreign corporation (within the meaning of section 957 or 953(c)(1)(B)), for purposes of section 952, DASTM gain or loss shall be allocated to subpart F income in a separate category in the same ratio that the gross subpart F income in that category for the taxable year bears to its total gross income in that category for the taxable year.

(v) *Conformity*. If a person (or a QBU of such person) makes an election under this paragraph (e)(2) to use the small QBU DASTM allocation, then each QBU of any related person (as defined in paragraph (e)(2)(vi) of this section) that satisfies the threshold requirement of paragraph (e)(2)(i) of this section (after application of the aggregation rule of paragraph (e)(2)(i) of this section) shall be deemed to have made the election.

(vi) *Related person*. The term related person means any person with a relationship to the QBU (or to the United States or foreign person of which the electing QBU is a part) that is defined in section 267(b) or section 707(b).

(3) *DASTM 9-step procedure*—(i) *Step 1—prepare balance sheets*. The taxpayer shall prepare an opening and a closing balance sheet for the QBU for each balance sheet period during the taxable year. The balance sheet period is the most frequent period for which balance sheet data are reasonably available (but in no event less frequently than quarterly). The balance sheet period may not be changed without the consent of the district director. The balance sheets must be prepared under the principles of paragraph (d)(2) of this section.

(ii) *Step 2—identify certain assets and liabilities*. The taxpayer shall identify each item on the balance sheet that is described in section 988(c)(1)(B) or (C) and that would have been translated under paragraph (d)(5) of this section into dollars at the exchange rate for the last translation period for the taxable year (or the exchange rate on the last day of the last translation period of the taxable year in the case of an accrued foreign income tax liability).

(iii) *Step 3—characterize the assets*. The taxpayer shall characterize and group the assets identified in paragraph (e)(3)(ii) of this section (Step 2) according to the source and the type of income that they generate, have generated, or may reasonably be expected to generate by applying the principles of § 1.861–9T(g)(3) or its successor regulation (relating to characterization of assets for purposes of interest expense allocation). If a purpose for a taxpayer's business practices is to manipulate asset characterization or groupings, the district director may allocate or apportion DASTM gain or loss attributable to the assets. Thus, if a taxpayer that previously did not separately state interest on accounts receivable begins to impose an interest charge and a purpose for the change was to manipulate tax characterizations or groupings, then the district director may require that none of the DASTM gain or loss attributable to those receivables be allocated or apportioned to interest income.

(iv) *Step 4—determine DASTM gain or loss attributable to certain assets*—(A) *General rule*. The taxpayer shall determine the dollar amount of DASTM gain or loss attributable to assets in each group identified in paragraph (e)(3)(iii) of this section (Step 3) as follows:

$[(bb+eb)\div 2]\times(er-br)$

where

bb = the hyperinflationary currency adjusted basis of the assets in the group at the beginning of the balance sheet period.

eb = the hyperinflationary currency adjusted basis of the assets in the group at the end of the balance sheet period.

er = one dollar divided by the number of hyperinflationary currency units that equal one dollar at the end of the balance sheet period.

br = one dollar divided by the number of hyperinflationary currency units that equal one dollar at the beginning of the balance sheet period.

(B) *Weighting to prevent distortion*. If averaging the adjusted basis of assets in a group at the beginning and end of a balance sheet period results in an allocation of DASTM gain or loss that does not clearly reflect income, as might be the case in the event of a purchase or disposition of an asset that is not in the normal course of business, the taxpayer must use a weighting method that reflects the time the assets are held by the QBU during the translation period.

(C) *Example*. The provisions of this paragraph (e)(3)(iv) are illustrated by the following example:

Example. S is a foreign corporation that operates in the hyperinflationary currency "h" and computes its income or loss or earnings and profits under DASTM. S's adjusted basis in a group of assets described in section 988(c)(1)(B) or (C) that generate general limitation foreign source income (as characterized under paragraph (e)(3)(iii) of this section) at the beginning of the balance sheet period is 750,000h. S's basis in such assets at the end of the balance sheet period is 1,250,000h. The exchange rate at the beginning of the balance sheet period is $1 = 200h. The exchange rate at the end of the balance sheet period is $1 = 500h. The DASTM loss attributable to the assets described above is $3,000, determined as follows:

$$[(750{,}000h+1{,}250{,}000h)\div 2]\times[(\$1\div 500h)-(\$1\div 200h)]=(\$3000)$$

(v) *Step 5—adjust dollar gross income by DASTM gain or loss from assets.* The taxpayer shall adjust the dollar amount of the QBU's gross income (computed under paragraphs (b)(1) through (b)(3) of this section) generated by each group of assets characterized in paragraph (e)(3)(iii) of this section (Step 3) by the amount of DASTM gain or loss attributable to those assets computed under paragraph (e)(3)(iv) of this section (Step 4). Thus, if a group of assets, such as accounts receivable, generates both a category of income described in section 904(d)(1)(I) (relating to general limitation income) that is not foreign base company income as defined in section 954 and a DASTM loss under paragraph (e)(3)(iv) of this section (Step 4), the amount of the DASTM loss would reduce the amount of the QBU's gross income in that category. Similarly, if a group of assets, such as short-term bank deposits, generates both foreign personal holding company income that is passive income (described in sections 954(c)(1)(A) and 904(d)(1)(A)) and a DASTM loss under paragraph (e)(3)(iv) of this section (Step 4), the amount of the DASTM loss would reduce the amount of the QBU's foreign personal holding company income and passive income. See section 904(*f*) and the regulations thereunder in the case where that section would apply and DASTM loss attributable to a group of assets exceeds the income generated by such assets.

(vi) *Step 6—determine DASTM gain or loss attributable to liabilities*—(A) *General rule.* The taxpayer shall determine the dollar amount of DASTM gain or loss attributable to liabilities identified in paragraph (e)(3)(ii) of this section (Step 2), and described in paragraph (e)(3)(vi)(B) of this section as follows:

$[(bl+el)\div 2]\times[br-er]$

where

bl = the hyperinflationary currency amount of liabilities at the beginning of the balance sheet period.

el = the hyperinflationary currency amount of liabilities at the end of the balance sheet translation period.

br = one dollar divided by the number of hyperinflationary currency units that equal one dollar at the beginning of the balance sheet period.

er = one dollar divided by the number of hyperinflationary currency units that equal one dollar at the end of the balance sheet period.

(B) *Separate calculation.* The calculation shall be made separately for interest-bearing liabilities described in paragraph (e)(3)(vii) of this section (Step 7) and for each of the classes of non-interest-bearing liabilities described in paragraph (e)(3)(viii) of this section (Step 8).

(C) *Weighting to prevent distortion.* Where a distortion would result from averaging the amount of liabilities at the beginning and end of a balance sheet period, as might be the case where a taxpayer incurs or retires a substantial liability, the taxpayer must use a different method that more clearly reflects the average amount of liabilities weighted to reflect the time the liability was outstanding during the balance sheet period.

(vii) *Step 7—adjust dollar income and expense by DASTM gain or loss from interest-bearing liabilities*—(A) *In general.* The taxpayer shall apply the amount of DASTM gain on interest-bearing liabilities computed under paragraph (e)(3)(vi) of this section (Step 6) to reduce interest expense generated by such liabilities (*e.g.*, prior to the application of § 1.861–9T or its successor regulation). To the extent DASTM gain on such liabilities exceeds interest expense, it shall be sourced or otherwise classified in the same manner that interest expense is allocated and apportioned under § 1.861–9T or its successor regulation. The amount of DASTM loss on interest-bearing liabilities computed under paragraph (e)(3)(vi) of this section (Step 6) shall be allocated and apportioned in the same manner that interest expense is allocated and apportioned under § 1.861–9T or its successor regulation (without regard to the exceptions to fungibility in § 1.861–10T or its successor regulation). For purposes of this section, an interest-bearing liability is a liability that requires payment of periodic interest (whether fixed or variable), has original issue discount, or would have interest imputed under subtitle A.

(B) *Allocation of DASTM gain or loss from interest-bearing liabilities that generate related person interest expense.* DASTM gain or loss from interest-bearing liabilities that generate related person interest expense (as provided in section 954(b)(5)) shall be allocated for purposes of subtitle A (including sections 904 and 952) in the same manner that the related person interest expense of that debt is required to be allocated under the rules of section 954(b)(5) and § 1.904–5(c)(2).

(C) *Modified gross income method.* In applying the modified gross income method described in § 1.861–9T(j) or its successor regulation, gross income shall be adjusted for any DASTM gain or loss from assets as provided in paragraph (e)(3)(v) of this section (Step 5) and any DASTM gain or loss with respect to short-term, non-interest-bearing trade payables as provided in paragraph (e)(3)(viii)(A) of this section.

(viii) *Step 8—adjust dollar income and expense by DASTM gain or loss from non-interest bearing liabilities*—(A) *Short-term, non-interest-bearing trade payables.* The taxpayer shall allocate DASTM gain or loss on short-term non-interest-bearing trade payables for purposes of subtitle A (including sections 904 and 952) to the same category or type of gross income as the cost or expense to which the trade payable relates. For this purpose, a short-term, non-interest-bearing trade payable is a non-interest-bearing liability with a term of 183 days or less that is incurred to purchase property or services to be used by the obligor in an active trade or business.

(B) *Excise tax payables.* The taxpayer shall allocate DASTM gain or loss on excise tax payables for purposes of subtitle A (including sections 904 and 952) to the same category or type of gross income as would be derived from the activity to which the excise tax relates.

(C) *Other non-interest-bearing liabilities*—(*1*) *In general.* Except as provided in paragraphs (e)(3)(viii)(A), (e)(3)(viii)(B), and (e)(3)(viii)(C)(*2*) of this section, DASTM gain or loss on non-interest-bearing liabilities shall be allocated under paragraph (e)(3)(ix) of this section (Step 9).

(*2*) *Tracing if substantial distortion of income.* DASTM gains and losses on liabilities described in paragraph (e)(3)(viii)(C)(*1*) of this section may be attributed to the same section 904(d) separate category or subpart F category as the transaction to which the liability relates if the taxpayer demonstrates to the satisfaction of the district director, or it is determined by the district director, that application of paragraph (e)(3)(viii)(C)(*1*) of this section results in a substantial distortion of income.

(ix) *Step 9—allocate residual DASTM gain or loss.* If there is a difference between the net DASTM gain or loss determined under paragraphs (e)(3)(i) through (viii) of this section (Steps 1 through 8) and the DASTM gain or loss determined under paragraph (d) of this section, the amount of the difference must be allocated for purposes of subtitle A (including sections 904 and 952) to the QBU's gross income (computed under paragraphs (b)(1) through (3) of this section, as adjusted under paragraphs (e)(3)(i) through (viii) of this section (Steps 1 through 8)) on the basis of the relative amounts of each category or type of gross income.

PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 8. The authority citation for part 602 continues to read as follows:

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

Par. 9. Section 602.101(c) is amended by adding the following entries to the table in numerical order following to read as follows:

§ 602.101 OMB Control Numbers.

* * * * *

(c) * * *

CFR part or section where identified and described	Current OMB control no.
* * *	* *
1.985–3	1545–1051
* * *	* *

Margaret Milner Richardson,
Commissioner of Internal Revenue.

Approved: June 28, 1994.

Leslie Samuels,
Assistant Secretary of the Treasury.

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