Section 985.—Functional Currency

26 CFR 1.985–8: Special rules applicable to the European Monetary Union (conversion to euro).

T.D. 8927

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Part 1

Conversion to the Euro

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations and removal of temporary regulations.

SUMMARY: This document contains final Income Tax Regulations relating to U.S. taxpayers operating, investing, or otherwise conducting business in the currencies of certain European countries that replace their national currencies with a single, multinational currency called the euro. These regulations provide rules relating to adjustments required for qualified business units operating in such currencies and rules relating to the tax effect of holding such currencies, or financial instruments or contracts denominated in such currencies.

DATES: *Effective Date*: These regulations are effective January 11, 2001.

Applicability Date: These regulations are applicable for tax years ending after July 29, 1998.

FOR FURTHER INFORMATION CONTACT: John W. Rogers III of the Office of Associate Chief Counsel (International), (202) 622-3870, regarding the change in functional currency rules and Thomas Preston of the Office of Assistant Chief Counsel (Financial Institutions and Products), (202) 622-3930, regarding section 1001 (not toll free calls).

SUPPLEMENTARY INFORMATION:

Background

On March 9, 1998, the IRS issued Announcement 98–18 (1998–1 C.B. 676) requesting comments relating to the tax issues for U.S. taxpayers operating, investing, or otherwise conducting business in a currency that is converting to the euro. Numerous comments were received.

After consideration of the comments, and in order to provide immediate guidance, the Treasury and the IRS published in the **Federal Register** temporary regulations (63 FR 40366) and a notice of proposed rulemaking by cross-reference to the temporary regulations (63 F.R. 40383 [T.D. 8776, 1998–2 C.B. 200]) on July 29, 1998. No public hearing was held in conjunction with the notice of proposed rulemaking because no taxpayers requested to speak at the hearing.

In the notice of proposed rulemaking, the Treasury and The IRS requested comments with respect to certain additional issues. Two comments were received in connection with the request for comments and are discussed in greater detail below.

Explanation of Provisions and Discussion of Comments

The temporary regulations provide rules relating to U.S. taxpayers operating, investing, or otherwise conducting business in the currencies of countries that replace their national currencies (legacy currencies) with a single, multinational currency called the euro. Thus, a legacy currency would include former currencies of the eleven countries that adopted the euro in 1999 as well as the currency of a country after it adopts the euro at some later date. The temporary regulations generally provide guidance relating to the circumstances under which the euro conversion creates a realization event with respect to instruments and contracts denominated in a legacy currency, and the circumstances under which the euro conversion constitutes a change in functional currency for a qualified business unit (QBU or QBUs, as the case may be) whose functional currency is a legacy currency, and certain consequences thereof. The temporary regulations published in the **Federal Register** on July 29, 1998, are finalized substantially as proposed. See the preamble to the temporary regulations for an explanation of the provisions of those regulations.

As noted above, two comments were received in connection with the publication of the temporary regulations and the notice of proposed rulemaking. One comment addressed the effect of the euro conversion to a corporation that has significant numbers of legacy currency transactions but has a non-legacy currency as its functional currency. For example, a corporation may have a non-legacy currency as its functional currency because its economic environment reflected more significant activities denominated in such currency (e.g., the U.S. dollar or the Swiss franc) relative to any single legacy currency. However, given the aggregation of the individual legacy currencies into the euro, the currency of the corporation's economic environment in which a significant part of its activities are conducted is the euro. The commenter suggested that, in such circumstances, the corporation should be allowed to change its functional currency to the euro automatically.

In response to the comment, the regulation provides a new rule in which a QBU that uses a non-legacy currency as its functional currency may change its functional currency to the euro provided that the euro is a currency of the economic environment in which a significant part of the QBU's activities are conducted, the QBU maintains its books and records in the euro after conversion, and the QBU is not required to use the dollar as its functional currency. The change is deemed to be made with the consent of the Commissioner if the change is made within the period set forth in §1.985–8(b)(2). A QBU changing its functional currency under this new rule is required to make the change in method of accounting adjustments under §1.985–5. Treasury and the IRS believe that the rules of §1.985–5 appropriately apply to this circumstance because the change in functional currency is not an involuntary change of the same nature as a QBU whose functional currency is a legacy currency.

The second comment suggested that the temporary regulations do not provide clear guidance in the case where, prior to conversion, the functional currency of a taxpayer and one of its QBU branches is the same legacy currency, and either the taxpayer or its QBU branch converts to the euro as its functional currency in a taxable year prior to the conversion of the other. The comment noted that the temporary regulations presume that the taxpayer and its branch have a different functional currency, but do not address instances where they have the same functional currency. The comment recommended that the regulations provide rules that require calculation of section 987 gain or loss during the period in which the taxpayer and its branch have different functional currencies. The recommendation is not adopted because section 987 currency gain or loss should not arise when a taxpayer and its branch use the same legacy currency as their functional currencies even if each adopts the euro as its functional currency in different years.

Finally, the notice of proposed rulemaking requested comments regarding the treatment of section 988 transactions that are held by euro functional currency QBUs and that are denominated in a currency that is replaced by the euro in the future. While no comments were received, Treasury and the IRS believe that rules relating to this issue should be clarified. Accordingly, §1.985–8(d) provides that the principles of §1.985–8(c)(3) apply in this context. Under this rule, legacy currency transactions generally continue to be treated as section 988 transactions and the principles of section 988 apply. Further, the principles provided in §1.985–8(c)(3)(iii) and (iv) continue to apply to currency and accounts payable and receivable, respectively.

Special Analysis

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedures Act (5 U.S.C. chapter 5) does not apply to these regulations, and because the final rule does not impose a collection of information on small entities, the provisions of the Regulatory Flexibility Act do not apply. Pursuant to section 7805(f) of the Internal Revenue Code, these regulations were submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

DRAFTING INFORMATION: The principal authors of these final regulations are John W. Rogers III of the Office of the Associate Chief Counsel (International) and Thomas Preston of the Office of Associate Chief Counsel (Financial Institutions and Products). Other personnel from the IRS and Treasury

Department also participated in their development.

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Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

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

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

§1.985–1 [Amended]

Par. 2. In §1.985–1, paragraph (c)(6), in the last sentence, the reference "§1.985–8T" is removed and "§1.985–8" is added in its place.

§1.985–4 [Amended]

Par. 3. In §1.985–4, paragraph (a), in the last sentence, the reference "§1.985–8T" is removed and "§1.985–8" is added in its place.

Par. 4. Section 1.985–8 is added to read as follows:

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

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

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

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

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

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

(B) In which the QBU begins to maintain its books and records (as described in §1.989(a)–1(d)) in the euro.

(ii) Notwithstanding paragraph (b)(2)(i) of this section, a QBU with a legacy currency as its functional currency is required to change its functional currency to the euro no later than the last taxable year beginning on or before the first day such legacy currency is no longer valid legal tender.

(3) *QBU with a non-legacy currency as its functional currency* — (i) *In general*. A QBU with a non-legacy currency as its functional currency may change its functional currency to the euro pursuant to this §1.985–8 if–

(A) Under the rules set forth in §1.985–1(c), the euro is the currency of the economic environment in which a significant part of the QBU's activities are conducted;

(B) After conversion, the QBU maintains its books and records (as described in §1.989(a)–1(d)) in the euro; and

(C) The QBU is not required to use the dollar as its functional currency under §1.985–1(b).

(ii) *Time period for change*. A QBU with a non-legacy currency as its functional currency may change its functional currency to the euro under this section only if it does so within the period set forth in paragraph (b)(2) of this section as if the functional currency of the QBU was a legacy currency.

(4) *Consent of Commissioner*. A change made pursuant to paragraph (b) of this section shall be deemed to be made with the consent of the Commissioner for purposes of §1.985–4. A QBU changing its functional currency to the euro pursuant to paragraph (b)(2) of this section must make adjustments as provided in paragraph (c) of this section. A QBU changing its functional currency to the euro pursuant to paragraph (b)(3) must make adjustments as provided in §1.985–5.

(5) *Statement to file upon change*. With respect to a QBU that changes its functional currency to the euro under paragraph (b) of this section, an affected taxpayer shall attach to its return for the taxable year of change a statement that includes the following: "TAXPAYER CERTIFIES THAT A QBU OF THE TAXPAYER HAS CHANGED ITS FUNCTIONAL CURRENCY TO THE EURO PURSUANT TO TREAS. REG. §1.985–8." For purposes of this paragraph (b)(5), an affected taxpayer shall be in the case where the QBU is: a QBU of an individual U.S. resident (as a result of the activities of such individual), the individual; a QBU branch of a U.S. corporation, the corporation; a controlled foreign corporation (as described in section 957)(or QBU branch thereof), each United States shareholder (as described in section 951(b)); a partnership, each partner separately; a noncontrolled section 902 corporation (as described in section 904(d)(2)(E)) (or branch thereof), each domestic shareholder as described in §1.902–1(a)(1); or a trust or estate, the fiduciary of such trust or estate.

(c) *Adjustments required when a QBU changes its functional currency from a legacy currency to the euro pursuant to paragraph (b)(2) of this section*—(1) *In general*. A QBU that changes its functional currency from a legacy currency to the euro pursuant to paragraph (b)(2) of this section must make the adjustments described in paragraphs (c)(2) through (5) of this section. Section 1.985–5 shall not apply.

(2) *Determining the euro basis of property and the euro amount of liabilities and other relevant items*. The euro basis in property and the euro amount of liabilities and other relevant items shall equal the product of the legacy functional currency adjusted basis or amount of liabilities multiplied by the applicable conversion rate.

(3) *Taking into account exchange gain or loss on legacy currency section 988 transactions*—(i) *In general*. Except as provided in paragraphs (c)(3)(iii) and (iv) of this section, a legacy currency denominated section 988 transaction (determined after applying section 988(d)) outstanding on the last day of the taxable year immediately prior to the year of change shall continue to be treated as a section 988 transaction after the change and the principles of section 988 shall apply.

(ii) *Examples*. The application of this paragraph (c)(3) may be illustrated by the following examples:

Example 1. X, a calendar year QBU on the cash method of accounting, uses the deutschmark as its functional currency. X is not described in section 1281(b). On July 1, 1998, X converts 10,000 deutschmarks (DM) into Dutch guilders(fl) at the spot rate of fl1 = DM1 and loans the 10,000 guilders to Y (an unrelated party) for one year at a rate of 10% with principal and interest to be paid on June 30, 1999. On January 1, 1999, X changes its functional currency to the euro pursuant to this section. Assume that the euro/deutschmark conversion rate is set by the European Council at €1= DM2. Assume further that the euro/guilder conversion rate is set at €1 = fl2.25. Accordingly, under the terms of the note, on June 30, 1999, X will receive € 4444.44 (fl10,000/2.25) of principal and € 444.44 (fl1,000/2.25) of interest. Pursuant to this paragraph (c)(3), X will realize an exchange loss on the principal computed under the principles of §1.988–2(b)(5). For this purpose, the exchange rate used under §1.988–2(b)(5)(i) shall be the guilder/euro conversion rate. The amount under §1.988–2(b)(5)(ii) is determined by translating the fl10,000 at the guilder/deutschmark spot rate on July 1, 1998, and translating that deutschmark amount into euros at the deutschmark/euro conversion rate. Thus, X will compute an exchange loss for 1999 of € 555.56 determined as follows: [€ 4444.44 (fl10,000/2.25) - €5000 ((fl10,000/1)/2) = -€555.56]. Pursuant to this paragraph (c)(3), the character and source of the loss are determined pursuant to section 988 and regulations thereunder. Because X uses the cash method of accounting for the interest on this debt instrument, X does not realize exchange gain or loss on the receipt of that interest.

Example 2. (i) X, a calendar year QBU on the accrual method of accounting, uses the deutschmark as its functional currency. On February 1, 1998, X converts 12,000 deutschmarks into Dutch guilders at the spot rate of fl1 = DM1 and loans the 12,000 guilders to Y (an unrelated party) for one year at a rate of 10% with principal and interest to be paid on January 31, 1999. In addition, assume the average rate (deutschmark/guilder) for the period from February 1, 1998, through December 31, 1998 is fl1.07 = DM1. Pursuant to §1.988–2(b)(2)(ii)(C), X will accrue eleven months of interest on the note and recognize interest income of DM1028.04 (fl1100/1.07) in the 1998 taxable year.

(ii) On January 1, 1999, the euro will replace the deutschmark as the national currency of Germany pursuant to the Treaty on European Union signed February 7, 1992. Assume that on January 1, 1999, X changes its functional currency to the euro pursuant to this section. Assume that the euro/deutschmark conversion rate is set by the European Council at €1 = DM2. Assume further that the euro/guilder conversion rate is set at €1 = fl2.25. In 1999, X will accrue one month of interest equal to € 44.44 (fl100/2.25). On January 31, 1999, pursuant to the note, X will receive interest denominated in euros of € 533.33 (fl1200/2.25). Pursuant to this paragraph (c)(3), X will realize an exchange loss in the 1999 taxable year with respect to accrued interest computed under the principles of §1.988–2(b)(3). For this purpose, the exchange rate used under §1.988–2(b)(3)(i) is the guilder/euro conversion rate and the exchange rate used under §1.988–2(b)(3)(ii) is the deutschmark/euro conversion rate. Thus, with respect to the interest accrued in 1998, X will realize exchange loss of € 25.13 under §1.988–2(b)(3) as follows: [€ 488.89 (fl1100/2.25)- € 514.02 (DM1028.04/2) = - € 25.13]. With respect to the one month of interest accrued in 1999, X will realize no exchange gain or loss since the exchange rate when the interest accrued and the spot rate on the payment date are the same.

(iii) X will realize exchange loss of € 666.67 on repayment of the loan principal computed in the same manner as in Example 1 [€ 5333.33 (fl12,000/2.25) - € 6000 fl12,000/1)/2)]. The losses with respect to accrued interest and principal are characterized and sourced under the rules of section 988.

(iii) *Special rule for legacy nonfunctional currency*. The QBU shall realize or otherwise take into account for all purposes of the Internal Revenue Code the amount of any unrealized exchange gain or loss attributable to nonfunctional currency (as described in section 988(c)(1)(C)(ii)) that is denominated in a legacy currency as if the currency were disposed of on the last day of the taxable year immediately prior to the year of change. The character and source of the gain or loss are determined under section 988.

(iv) *Legacy currency denominated accounts receivable and payable*—(A) *In general*. A QBU may elect to realize or otherwise take into account for all purposes of the Internal Revenue Code the amount of any unrealized exchange gain or loss attributable to a legacy currency denominated item described in section 988(c)(1)(B)(ii) as if the item were terminated on the last day of the taxable year ending prior to the year of change.

(B) *Time and manner of election*. With respect to a QBU that makes an election described in paragraph (c)(3)(iv)(A) of this section, an affected taxpayer (as described in paragraph (b)(5) of this section) shall attach a statement to its tax return for the taxable year ending immediately prior to the year of change which includes the following: "TAXPAYER CERTIFIES THAT A QBU OF THE TAXPAYER HAS ELECTED TO REALIZE CURRENCY GAIN OR LOSS ON LEGACY CURRENCY DENOMINATED ACCOUNTS RECEIVABLE AND PAYABLE UPON CHANGE OF FUNCTIONAL CURRENCY TO THE EURO." A QBU making the election must do so for all legacy currency denominated items described in section 988(c)(1)(B)(ii).

(4) *Adjustments when a branch changes its functional currency to the euro*—(i) *Branch changing from a legacy currency to the euro in a taxable year during which taxpayer's functional currency is other than the euro*. If a branch changes its functional currency from a legacy currency to the euro for a taxable year during which the taxpayer's functional currency is other than the euro, the branch's euro equity pool shall equal the product of the legacy currency amount of the equity pool multiplied by the applicable conversion rate. No adjustment to the basis pool is required.

(ii) *Branch changing from a legacy currency to the euro in a taxable year during which taxpayer's functional currency is the euro*. If a branch changes its functional currency from a legacy currency to the euro for a taxable year during which the taxpayer's functional currency is the euro, the taxpayer shall realize gain or loss attributable to the branch's equity pool under the principles of section 987, computed as if the branch terminated on the last day prior to the year of change. Adjustments under this paragraph (c)(4)(ii) shall be taken into account by the taxpayer ratably over four taxable years beginning with the taxable year of change.

(5) *Adjustments to a branch's accounts when a taxpayer changes to the euro*—(i) *Taxpayer changing from a legacy currency to the euro in a taxable year during which a branch's functional currency is other than the euro*. If a taxpayer changes its functional currency to the euro for a taxable year during which the functional currency of a branch of the taxpayer is other than the euro, the basis pool shall equal the product of the legacy currency amount of the basis pool multiplied by the applicable conversion rate. No adjustment to the equity pool is required.

(ii) *Taxpayer changing from a legacy currency to the euro in a taxable year during which a branch's functional currency is the euro*. If a taxpayer changes its functional currency from a legacy currency to the euro for a taxable year during which the functional currency of a branch of the taxpayer is the euro, the taxpayer shall take into account gain or loss as determined under paragraph (c)(4)(ii) of this section.

(6) *Additional adjustments that are necessary when a corporation changes its functional currency to the euro*. The amount of a corporation's euro currency earnings and profits and the amount of its

euro paid-in capital shall equal the product of the legacy currency amounts of these items multiplied by the applicable conversion rate. The foreign income taxes and accumulated profits or deficits in accumulated profits of a foreign corporation that were maintained in foreign currency for purposes of section 902 and that are attributable to taxable years of the foreign corporation beginning before January 1, 1987, also shall be translated into the euro at the conversion rate.

(d) *Treatment of legacy currency section 988 transactions with respect to a QBU that has the euro as its functional currency*—(1) *In general*. This §1.985–8(d) applies to a QBU that has the euro as its functional currency and that holds a section 988 transaction denominated in, or determined by reference to, a currency that is substituted by the euro. For example, this paragraph (d) will apply to a German QBU with the euro as its functional currency if the QBU is holding Country X currency or other section 988 transactions denominated in such currency on the day in the year 2005 when the euro is substituted for the Country X currency.

(2) *Principles of paragraph (c)(3) of this section shall apply*. With respect to a QBU described in paragraph (d) of this section, the principles of paragraph (c)(3) of this section shall apply. For example, if a German QBU with the euro as its functional currency is holding a Country X currency denominated debt instrument on the day in the year 2005 when the euro is substituted for the Country X currency, the instrument shall continue to be treated as a section 988 transaction pursuant to the principles of paragraph (c)(3)(i) of this section. However, if such QBU holds Country X currency, the QBU shall take into account any unrealized exchange gain or loss pursuant to the principles of paragraph (c)(3)(iii) of this section as if the currency was disposed of on the day prior to the day the euro is substituted for the Country X currency. Similarly, if the QBU makes an election under the principles of paragraph (c)(3)(iv) of this section, the QBU shall take into account for all purposes of the Internal Revenue Code the amount of any unrealized exchange gain or loss attributable to a legacy currency denominated item described in section 988(c)(1)(B)(ii) as if the item were terminated on the day prior to the day the euro is substituted for the Country X currency.

(e) *Effective date*. This section applies to tax years ending after July 29, 1998.

§1.985–8T [Removed]

Par.5. Section 1.985–8T is removed.

Par.6. Section 1.1001–5 is added to read as follows:

§1.1001–5 *European Monetary Union (conversion to the euro).*

(a) *Conversion of currencies*. For purposes of §1.1001–1(a), the conversion to the euro of legacy currencies (as defined in §1.985–8(a)(1)) is not the exchange of property for other property differing materially in kind or extent.

(b) *Effect of currency conversion on other rights and obligations*. For purposes of §1.1001–1(a), if, solely as the result of the conversion of legacy currencies to the euro, rights or obligations denominated in a legacy currency become rights or obligations denominated in the euro, that event is not the exchange of property for other property differing materially in kind or extent. Thus, for example, when a debt instrument that requires payments of amounts denominated in a legacy currency becomes a debt instrument requiring payments of euros, that alteration is not a modification within the meaning of §1.1001–3(c).

(c) *Effective date*. This section applies to tax years ending after July 29, 1998.

§1.1001–5T [Removed]

Par. 7. Section 1.1001–5T is removed.

Robert E. Wenzel,
Deputy Commissioner of Internal Revenue.

Approved December 12, 2000.

Jonathan Talisman,
Acting Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on January 10, 2001, 8:45 a.m., and published in the issue of the Federal Register for January 11, 2001, 66 F.R. 2215)