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DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

REG-118897-06

RIN 1545-BF67

United States Dollar Approximate Separate Transactions Method

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains a proposed regulation which provides the translation rates that must be used when translating into dollars certain items and amounts transferred by a qualified business unit (QBU) to its home office or parent corporation for purposes of computing dollar approximate separate transactions method (DASTM) gain or loss.

DATES: Written or electronic comments and requests for a public hearing must be received by October 11, 2006.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG-118897-06), room 5203, Internal Revenue Service, PO Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand-delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to CC:PA:LPD:PR (REG-118897-06), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW., Washington, DC, or sent electronically, via the IRS Internet site at www.irs.gov/regs or via the Federal eRulemaking Portal at www.regulations.gov (IRS REG-118897-06).

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Sheila Ramaswamy, at (202) 622-3870; concerning submissions of comments, Richard Hurst@irscounsel.treas.gov, (202) 622-7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

Generally, a taxpayer and each of its qualified business units (QBUs) must make all determinations under subtitle A of the Internal Revenue Code in its respective functional currency. See §1.985-1(a)(1). For taxable years beginning after August 24, 1994, a U.S. corporation's QBU that would otherwise be required to use a hyperinflationary currency as its functional currency generally must use the dollar as its functional currency and must compute income or loss under the DASTM method of accounting described in §1.985-3. See §1.985-1(b)(2)(ii). Section 1.985-3(d)(3) contains a rule for translating into dollars dividends, certain transfers, and returns of capital from the QBU to its home office or parent corporation. On March 8, 2005, Notice 2005-27, 2005-13 IRB 795, (see §601.601(d)(2) of this chapter), announced the intention to amend §1.985-3(d)(3) regarding the proper exchange rate for determining DASTM gain or loss when translating certain current and historical assets upon a transfer from a QBU to its home office or parent corporation, as the case may be.

Explanation of Provisions

Under the DASTM method of accounting, a QBU's income or loss for a taxable year is computed in U.S. dollars and adjusted to account for its DASTM gain or loss. See §1.985-3(b). A QBU's DASTM gain or loss for a taxable year is determined under §1.985-3(d) by first computing the QBU's change in net worth from the prior year and then making specified adjustments. The QBU's change in net worth is computed by comparing the year-end balance sheets for the current and preceding taxable years.

See §1.985-3(d)(1)(i). Special rules provide that some balance-sheet items are translated at the exchange rate for the translation period in which the cost of the item was incurred and so do not give rise to DASTM gain or loss from year to year ("historical items"). See §1.985-3(d)(5). Other items are translated at the exchange rate for the last translation period for the taxable year and therefore do give rise to DASTM gain or loss ("current items"). See §1.985-3(d)(5).

The classification of an item as historical or current generally reflects the extent to which the item's dollar value changes with fluctuations in exchange rates. For example, the dollar value of a financial asset, such as a unit of hyperinflationary local currency, necessarily changes with fluctuations in exchange rates. Accordingly, a financial asset generally is a current item. See §1.985-3(d)(5)(iv). By contrast, the value of a nonfinancial asset generally does not change with fluctuations in exchange rates. Accordingly, a nonfinancial asset generally is an historical item. See §1.985-3(d)(5)(v).

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

The DASTM method of accounting provides that adjustments described in the preceding paragraphs generally shall be translated into dollars at the exchange rate on the date the amount is paid. See §1.985-3(d)(3). This rule ensures that the QBU branch properly takes into account a current item's change in value due to currency fluctuations while the item was in the QBU branch. However, applying this translation rule to historical items could potentially lead to distortions in the calculation of DASTM gain or loss. Because the value of historical items generally does not change with fluctuations in exchange rates, translating adjustments relating to historical items at the exchange rate on the date of distribution or transfer would inappropriately give rise to DASTM gain or loss.

The potentially anomalous results that may arise due to the application of the existing translation rule in §1.985-3(d)(3) can be prevented by modifying the rule to ensure that only the assets whose dollar value changes with fluctuations in exchange rates will give rise to DASTM gain or loss upon a transfer from a QBU to its home office. Accordingly, this proposed regulation amends §1.985-3(d)(3) in accordance with Notice 2005-27 as follows. The proposed regulation provides that if the item giving rise to the adjustment is a current asset which would be translated under §1.985-3(d)(5) at the exchange rate for the last translation period of the taxable year if it were on the QBU's year-end balance sheet, the item will be translated at the exchange rate on the date the item is transferred. However, if the item giving rise to the adjustment is a historical asset which would be translated under §1.985-3(d)(5) at the exchange rate for the translation period in which the cost of the item was incurred if it were on the QBU's year-end balance sheet, the item will be translated at the same historical rate.

Proposed Effective Date

Consistent with Notice 2005-27, this regulation is proposed to be effective for any transfer, dividend, or distribution that is a return of capital that is made after March 8, 2005, and that gives rise to an adjustment under §1.985-3(d)(3).

Special Analyses

It has been determined that this notice of proposed rulemaking 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 Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because these regulations do not impose a collection of information on small entities, the provisions of the Regulatory Flexibility Act (5 U.S.C. chapter 6) do not apply. Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Requests for Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written (a signed original and eight (8) copies) or electronic comments that are submitted timely to the IRS. The IRS and Treasury Department request comments on the clarity of the proposed rules and how they can be made easier to understand. All comments will be available for public inspection and copying. A public hearing will be scheduled if requested in writing by any person that timely submits written comments. If a public hearing is scheduled, notice of the date, time, and place for a public hearing will be published in the **Federal Register.**

Drafting Information

The principal author of these proposed regulations is Sheila Ramaswamy, Office of Associate Chief Counsel (International). However, other personnel from the IRS and Treasury Department participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Proposed Amendment to the Regulations

Accordingly, 26 CFR part 1 is proposed to be 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. Section 1.985-3 is amended by revising paragraph (d)(3) to read as follows:

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

* * * * *

(d) * * *

(3) Positive adjustments--(i) In general. 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.

(ii) Translation. Except as provided by ruling or administrative pronouncement, items described in paragraph (d)(3)(i) of this section shall be translated into dollars as follows:

(A) If the item giving rise to the adjustment would be translated under paragraph (d)(5) of this section at the exchange rate for the last translation period of the taxable year if it were shown on the QBU's year-end balance sheet, such item shall be translated at the exchange rate on the date the item is transferred.

(B) If the item giving rise to the adjustment would be translated under paragraph (d)(5) of this section at the exchange rate for the translation period in which the cost of the item was incurred if it were shown on the QBU's year-end balance sheet, such item shall be translated at the same historical rate.

(iii) Effective date. Paragraph (d)(3)(ii) of this section is applicable for any transfer, dividend, or distribution that is a return of capital that is made after March 8, 2005, and that gives rise to an adjustment under this paragraph (d)(3).

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Deputy Commissioner for Services and Enforcement.