applicable to the taxable year, which the number of days in such taxable year which are within the surcharge period and before January 1, 1970, bears to the total number of days in such taxable year.

(2) That portion of the minimum distribution which would be required if the provisions of section 963(b)(2) were applicable to such taxable year, which the number of days in such taxable year which are within the surcharge period and after December 31, 1969, bears to the total number of days in such taxable year, and

(3) That portion of the minimum distribution which would be required if the provisions of section 963(b)(3) were applicable to such taxable year, which the number of days in such taxable year which are not within the surcharge period bears to the total number of days in such taxable year.

(b) *Calendar year 1970.* For calendar year 1970, the required minimum distribution shall be an amount determined in accordance with the following table:

If the effective foreign tax rate is (percentage)—	The required minimum distribution of earnings and profits is (percentage)—
Under 9	84.983562
9 or over but less than 10	82.967123
10 or over but less than 18	80.983562
18 or over but less than 19	79.471233
19 or over but less than 26	77.487671
26 or over but less than 27	73.958904
27 or over but less than 32	70.487671
32 or over but less than 33	67.463014
33 or over but less than 36	63.991781
36 or over but less than 37	57.942466
37 or over but less than 39	51.991781
39 or over but less than 40	44.934247
40 or over but less than 41	37.495890
41 or over but less than 42	31.446575
42 or over but less than 43	19.446575
43 or over but less than 44	12.893151
44 or over but less than 45	6.446575
45 or over	0

(c) *Surcharge period.* For purposes of this section the term ''surcharge period'' means the period beginning January 1, 1968, and ending June 30, 1970.

(d) *Illustration of principles.* The application of the rules set forth in paragraphs (a), (b), and (c) of this section may be illustrated by the following example. It is assumed that all computations are carried to sufficient accuracy:

Example. (a) M, a domestic corporation, and A, its controlled corporation (the one class of stock of which is wholly owned by M), both have a taxable year beginning December 1, 1969, and ending November 30, 1970. For such taxable year M makes a first-tier election with respect to A corporation. The effective foreign tax rate for such year is 30 percent.

(b) Under section 963(b) and paragraph (b) of this section the surcharge period ends June 30, 1970. Therefore, of the 365 days in the taxable year, 153 days are not within the surcharge period. Of the remaining 212 days, 31 are within the surcharge period and before January 1, 1970 and 181 days are within the surcharge period and after December 31, 1969. If section 963(b)(1) were applicable to the entire taxable year, the required minimum distribution of earnings and profits would be 75 percent. If section 963(b)(2) were applicable to the entire taxable year, the required minimum distribution would be 72 percent. If section 963(b)(3) were applicable to the entire taxable year, the required minimum distribution would be 69 percent.

(c) Under section 963(b) and this section the required minimum distribution of earnings and profits is 71 percent, computed as follows:

$$(75\% \times 31 \div 365) + (72\% \times 181 \div 365) + (69\% \times 153 \div 365) = 71\%.$$

[T.D. 7100, 36 FR 5336, Mar. 20, 1971]

§ 1.964–1 Determination of the earnings and profits of a foreign corporation.

(a) *In general.* For purposes of sections 951 through 964, the earnings and profits (or deficit in earnings and profits) of a foreign corporation for its taxable year shall, except as provided in paragraph (f) of this section, be computed substantially as if such corporation were a domestic corporation by—

(1) Preparing a profit and loss statement with respect to such year from the books of account regularly maintained by the corporation for the purpose of accounting to its shareholders;

(2) Making the adjustments necessary to conform such statement to the accounting principles described in paragraph (b) of this section;

(3) Making the further adjustments necessary to conform such statement to the tax accounting standards described in paragraph (c) of this section;

(4) Translating the amounts shown on such adjusted statement into United States dollars in accordance with paragraph (d) of this section, and

(5) Adjusting the amount of profit or loss shown on such translated and adjusted statement in accordance with paragraph (e) of this section to reflect any exchange gain or loss determined thereunder.

The computation described in the preceding sentence may be made by following the procedures described in paragraphs (a)(1) through (5) of this section in an order other than the one listed, as long as the result so obtained would be the same. In determining earnings and profits, or the deficit in earnings and profits, of a foreign corporation under section 964, the amount of any illegal bribe, kickback, or other payment (within the meaning of section 162(c), as amended by section 288 of the Tax Equity and Fiscal Responsibility Act of 1982 in the case of payments made after September 3, 1982, and the regulations thereunder) paid after November 3, 1976, by or on behalf of the corporation during the taxable year of the corporation directly or indirectly to an official, employee, or agent in fact of a government shall not be taken into account to decrease such earnings and profits or to increase such deficit. No adjustment shall be required under subparagraph (2) or (3) of this paragraph unless it is material. Whether an adjustment is material depends on the facts and circumstances of the particular case, including the amount of the adjustment, its size relative to the general level of the corporation's total assets and annual profit or loss, the consistency with which the practice has been applied, and whether the item to which the adjustment relates is of a recurring or merely a nonrecurring nature. For the treatment of earnings and profits whose distribution is prevented by restrictions and limitations imposed by a foreign government, see section 964(b) and the regulations thereunder.

(b) *Accounting adjustments*—(1) *In general.* The accounting principles to be applied in making the adjustments required by paragraph (a)(2) of this section shall be those accounting principles generally accepted in the United States for purposes of reflecting in the financial statements of a domestic corporation the operations of its foreign affiliates, including the following:

(i) *Clear reflection of income.* Any accounting practice designed for purposes other than the clear reflection on a current basis of income and expense for the taxable year shall not be given effect. For example, an adjustment will be required where an allocation is made to an arbitrary reserve out of current income.

(ii) *Physical assets, depreciation, etc.* All physical assets (as defined in paragraph (e)(5)(ii) of this section), including inventory when reflected at cost, shall be taken into account at historical cost computed either for individual assets or groups of similar assets. The historical cost of such an asset shall not reflect any appreciation or depreciation in its value or in the relative value of the currency in which its cost was incurred. Depreciation, depletion, and amortization allowances shall be based on the historical cost of the underlying asset and no effect shall be given to any such allowance determined on the basis of a factor other than historical cost. For special rules for determining historical cost where assets are acquired during a taxable year beginning before January 1, 1950, or a majority interest in the foreign corporation is acquired after December 31, 1949, but before October 27, 1964, see subparagraph (2) of this paragraph.

(iii) *Valuation of assets and liabilities.* Any accounting practice which results in the systematic undervaluation of assets or overvaluation of liabilities shall not be given effect, even though expressly permitted or required under foreign law, except to the extent allowable under paragraph (c) of this section. For example, an adjustment will be required where inventory is written down below market value. For the definition of market value, see paragraph (a) of § 1.471–4.

(iv) *Income equalization.* Income and expense shall be taken into account without regard to equalization over more than one accounting period; and any equalization reserve or similar provision affecting income or expense shall not be given effect, even though expressly permitted or required under foreign law, except to the extent allowable under paragraph (c) of this section.

(v) *Foreign currency.* If transactions effected in a foreign currency other than that in which the books of the corporation are kept are translated into the foreign currency reflected in the books, such translation shall be made in a manner substantially similar to that prescribed by paragraph (d) of this section for the translation of foreign currency amounts into United States dollars.

(2) *Historical cost.* For purposes of this section, the historical cost of an asset acquired by the foreign corporation during a taxable year beginning before January 1, 1963, shall be determined, if it is so elected by or on behalf of such corporation—

(i) In the event that the foreign corporation became a majority owned subsidiary of a United States person (within the meaning of section 7701(a)(30)) after December 31, 1949, but before October 27, 1964, and the asset was held by such foreign corporation at that time, as though the asset was purchased on the date during such period the foreign corporation first became a majority owned subsidiary at a price equal to its then fair market value, or

(ii) In the event that subdivision (i) of this subparagraph is inapplicable but the asset was acquired by the foreign corporation during a taxable year beginning before January 1, 1950, as though the asset were purchased on the first day of the first taxable year of the foreign corporation beginning after December 31, 1949, at a price equal to the undepreciated cost (cost or other basis minus book depreciation) of that asset as of that date as shown on the books of account of such corporation regularly maintained for the purpose of accounting to its shareholders.

For purposes of this subparagraph, a foreign corporation shall be considered a majority owned subsidiary of a United States person if, taking into account only stock acquired by purchase (as defined in section 334(b)(3)), the United States person owns (within the meaning of section 958(a)) more than 50 percent of the total combined voting power of all classes of stock of the foreign corporation entitled to vote. The election under this subparagraph shall be made for the first taxable year beginning after December 31, 1962, in which the foreign corporation is a controlled foreign corporation (within the meaning of section 957), or for which it is included in a chain or group under section 963(c)(2)(B) or (3)(B) (applied as if section 963 had not been repealed by the Tax Reduction Act of 1975), or has a deficit in earnings and profits sought to be taken into account under section 952(d) or pays a dividend that is included in the foreign base company shipping income of a controlled foreign corporation under §1.954–6(f). Once made, such an election shall be irrevocable. For the time and manner in which an election may be made on behalf of a foreign corporation, see paragraph (c)(3) of this section.

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

Example 1. Corporation M is a controlled foreign corporation which regularly maintains books of account for the purpose of accounting to its shareholders in accordance with the accounting practices prevalent in country X, the country in which it operates. As a consequence of those practices, the profit and loss statement prepared from these books of account reflects an allocation to an arbitrary reserve out of current income and depreciation allowances based on replacement values which are greater than historical cost. Adjustments are necessary to conform such statement to accounting principles generally accepted in the United States. Assuming these adjustments to be material, the unacceptable practices, will have to be eliminated from the statement, an increase in the amount of profit (or a decrease in the amount of loss) thereby resulting.

Example 2. In 1973, Corporation N is a foreign corporation which is not a controlled foreign corporation but which is included in a chain, for minimum distribution purposes, under section 963(c)(2)(B). Corporation N regularly maintains books of account for the purpose of accounting to its shareholders in accordance with the accounting practices of country Y, the country in which it operates. As a consequence of those practices, the profit and loss statement prepared from these books of account reflects the inclusion in income of stock dividends and of corporate distributions representing a return of capital. Adjustments are necessary to conform such statement to accounting principles generally accepted in the United States. Assuming these adjustments to be material, the unacceptable practices will have to be eliminated from the statement, a decrease in the amount of profit (or increase in the amount of loss) thereby resulting.

(c) *Tax adjustments*—(1) *In general.* The tax accounting standards to be applied in making the adjustments required by paragraph (a)(3) of this section shall be the following:

(i) *Accounting methods.* The method of accounting shall reflect the provisions of section 446 and the regulations thereunder.

(ii) *Inventories.* Inventories shall be taken into account in accordance with the provisions of sections 471 and 472 and the regulations thereunder.

(iii) *Depreciation.* Depreciation shall be computed as follows:

(a) For any taxable year beginning before July 1, 1972; depreciation shall be computed in accordance with section 167 and the regulations thereunder.

(b) If, for any taxable year beginning after June 30, 1972, 20 percent or more of the gross income from all sources of the corporation is derived from sources within the United States, then depreciation shall be computed in accordance with the provisions of § 1.312–15.

(c) If, for any taxable year beginning after June 30, 1972, less than 20 percent of the gross income from all sources of the corporation is derived from sources within the United States, then depreciation shall be computed in accordance with section 167 and the regulations thereunder.

(iv) *Elections.* Effect shall be given to any election made in accordance with an applicable provision of the Code and the regulations thereunder and these regulations.

Except as provided in subparagraphs (2) and (3) of this paragraph, any requirements imposed by the Code or applicable regulations with respect to making an election or adopting or changing a method of accounting must be satisfied by or on behalf of the foreign corporation just as though it were a domestic corporation if such election or such adoption or change of method is to be taken into account in the computation of its earnings and profits.

(2) *Adoption of method.* For the first taxable year beginning after December 31, 1962, in which the foreign corporation is a controlled foreign corporation (within the meaning of section 957), or for which it is included in a chain or group under section 963(c)(2)(B) or (3)(B) (applied as if section 963 had not been repealed by the Tax Reduction Act of 1975), or has a deficit in earnings and profits sought to be taken into account under section 952(d), or pays a dividend that is included in the foreign base company shipping income of a controlled foreign corporation under § 1.954–6(f), there may be adopted or made by such corporation or on its behalf any method of accounting or election allowable under this section notwithstanding that, in previous years, its earnings and profits were computed, or its books or financial statements prepared, on a different basis and notwithstanding that such election is required by the Code or regulations to be made in a prior taxable year. For purposes of determining the amount of a deficit in earnings and profits taken into account pursuant to section 952(c)(1)(B), if a different basis is used in previous years, ratable adjustments shall be made in the earnings and profits attributable to such previous years to prevent any duplication or omission of amounts that would otherwise result from the adoption of such method or the making of such election. See subparagraph (3) of this paragraph for the manner in which a method of accounting or an election may be adopted or made on behalf of the foreign corporation.

(3) *Action on behalf of corporation*—(i) *In general.* An election shall be deemed made, or an adoption or change in method of accounting deemed effectuated, on behalf of the foreign corporation only if its controlling United States shareholders (as defined in subparagraph (5) of this paragraph)—

(a) Satisfy for such corporation any requirements imposed by the Code or applicable regulations with respect to such election or such adoption or change in method, such as the filing of forms, the execution of consents, securing the permission of the Commissioner, or maintaining books and records in a particular manner,

(b) File the written statement described in subdivision (ii) of this subparagraph at the time and in the manner prescribed therein, and

(c) Provide the written notice required by subdivision (iii) of this subparagraph at the time and in the manner prescribed therein.

For purposes of the preceding sentence, the books of the foreign corporation shall be considered to be maintained in a particular manner if the controlling United States shareholders or the foreign corporation regularly keep the records and accounts required by section 964(c) and the regulations thereunder in that manner. Any election required to be made or information required to be filed with a tax return shall be deemed made or furnished on behalf of the foreign corporation if its controlling United States shareholders file the written statement described in subdivision (ii) of this subparagraph with respect to such election within the period specified therein. For a special rule postponing the time for taking action by or on behalf of a foreign corporation until the amount of its earnings and profits becomes significant, see subparagraph (6) of this paragraph.

(ii) *Written statement.* The written statement required by subdivision (i) of this subparagraph shall be jointly executed by the controlling United States shareholders, shall be filed with the Director of the Internal Revenue Service Center, 11601 Roosevelt Blvd., Philadelphia, Pennsylvania 19155, within 180 days after the close of the taxable year of the foreign corporation with respect to which the election is made or the adoption or change of method effected, or before May 1, 1965, whichever is later, and shall set forth the name and country or organization of the foreign corporation, the names, addresses, taxpayer identification numbers (in the case of statements required to be filed after June 20, 1983), and stock interests of the controlling United States shareholders, the nature of the action taken, the names, addresses, and (in the case of statements required to be filed after June 20, 1983) taxpayer identification numbers of all other United States shareholders notified of the election or adoption or change of method, and such other information as the Commissioner may by forms require.

(iii) *Notice.* Prior to the filing of the written statement described in subdivision (ii) of this subparagraph, the controlling United States shareholders shall provide written notice of the election made or the adoption or change of method effected to all other persons known by them to be United States shareholders who own (within the meaning of section 958(a)) stock of the foreign corporation. Such notice shall set forth the name and country of organization of the foreign corporation, the names, addresses, and stock interests of the controlling United States shareholders, the nature of the action taken, and such other information as the Commissioner may by forms require. However, the failure of the controlling United States shareholders to provide such notice to a person required to be notified thereunder shall not invalidate the election made or the adoption or change of method effected, if it is established to the satisfaction of the Commissioner that reasonable cause existed for such failure.

(4) *Effect of action by controlling United States shareholders.* Any action taken by the controlling United States shareholders on behalf of the foreign corporation pursuant to subparagraph (3) of this paragraph shall be reflected in the computation of the earnings and profits of such corporation under this section to the extent that it bears upon the tax liability of a United States shareholder who either—

(i) Was a controlling United States shareholder with respect to the action taken;

(ii) Received the written notice provided by subparagraph (3)(iii) of this paragraph;

(iii) Failed to file any of the returns required by section 6046 and the regulations thereunder within the period prescribed by section 6046(d); or

(iv) Was notified by the Director of the Philadelphia Service Center of the action taken—

(a) Within 61 days after the last day (including extensions of time) prescribed with respect to the taxable year of the foreign corporation by subparagraph (3)(ii) of this paragraph for filing the written statement described in such subparagraph, or

(b) Within 180 days after the close of the first taxable year in which such

shareholder becomes a United States shareholder, whichever is later.

To the extent that the computation of the earnings and profits of the foreign corporation bears upon the tax liability of any United States shareholder other than those enumerated in the preceding sentence, the computation shall reflect the action taken only if such shareholder assents to such treatment. Such assent may be given at any time, but not later than 90 days after the shareholder is first apprised of such action by the Director of the Philadelphia Service Center. The shareholder shall signify his assent by filing a written statement with the Director of the Internal Revenue Service Center, 11601 Roosevelt Blvd., Philadelphia, Pennsylvania, 19155, setting forth the name and country of organization of the foreign corporation, his own name, address, and stock interest in the corporation, the nature of the action being assented to, and such other information as the Commissioner may by forms require.

(5) *Controlling United States shareholders.* For purposes of this paragraph the controlling United States shareholders of a foreign corporation shall be those United States shareholders (as defined in section 951(b)), who, in the aggregate, own (within the meaning of section 958(a)) more than 50 percent of the total combined voting power of all classes of the stock of such corporation entitled to vote and who undertake to act on its behalf. In the event that the foreign corporation is not a controlled foreign corporation but is included in a chain or group under section 963(c)(2)(B) or (3)(B), the controlling United States shareholder with respect to such foreign corporation shall be deemed to be the domestic corporation which elects to receive the minimum distribution from such chain or group. In the event that the foreign corporation is neither a controlled foreign corporation nor included in a chain or group under section 963(c)(2)(B) or (3)(B) but has a deficit in earnings and profits sought to be taken into account under section 952(d), the controlling United States shareholder with respect to such foreign corporation shall be the shareholder seeking to take such deficit into account. In the event that the foreign corporation is a controlled foreign corporation but the United States shareholders (as defined in section 951(b)) do not, in the aggregate, own (within the meaning of section 958(a)) more than 50 percent of the total combined voting power of all classes of the stock of such corporation entitled to vote, the controlling United States shareholders of the foreign corporation shall be all those United States shareholders who own (within the meaning of section 958(a)) stock of such corporation. In the event that a foreign corporation is not a controlled foreign corporation but pays a dividend to a controlled foreign corporation that is attributable to foreign base company shipping income under §1.954–6(f), the controlling United States shareholders (as defined in this subparagraph) of the controlled foreign corporation shall be considered the controlling United States shareholders of the foreign corporation.

(6) *Action not required until significant.* Notwithstanding any other provision of this paragraph, action by or on behalf of a foreign corporation (other than a foreign corporation subject to tax under section 882) to make an election or to adopt a method of accounting shall not be required until 180 days after the close of the first taxable year for which—

(i) An amount is includible in gross income with respect to such corporation under section 951(a);

(ii) It is sought to be established that such corporation is a less developed country corporation (within the meaning of section 955(c), as in effect before the enactment of the Tax Reduction Act of 1975);

(iii) An amount is excluded from Subpart F income (within the meaning of section 952) by section 952(c), section 952(d), or section 970(a);

(iv) Such corporation is the subject of an election to secure an exclusion under section 963 (applied as if section 963 had not been repealed by the Tax Reduction Act of 1975); or

(v) It is sought to be established that the corporation has foreign base company shipping income (within the meaning of section 954(f)).

In the event that action by or on behalf of the foreign corporation is not undertaken by the time specified in the preceding sentence and such failure is shown to the satisfaction of the Commissioner to be due to inadvertence or a reasonable cause, such action may be undertaken during any period of at least 30 days occurring after such showing is made which the Commissioner may specify as appropriate for this purpose. Where the action necessary to make an election or to adopt a method of accounting is undertaken by or on behalf of the foreign corporation in accordance with this subparagraph, such election shall be deemed to have been made, or such adoption of accounting method effected, for the first taxable year of the foreign corporation beginning after December 31, 1962, in which such corporation is a controlled foreign corporation (within the meaning of section 957) or for which it is included in a chain or group under section 963(c)(2)(B) or (3)(B) (applied as if section 963 had not been repealed by the Tax Reduction Act of 1975) or has a deficit in earnings and profits sought to be taken into account under section 952(d) or pays a dividend that is included in the foreign base company shipping income of a controlled foreign corporation under §1.954–6(f). For special rules for computing earnings and profits for purposes of section 1248 or income for purposes of applying an exclusion set forth in section 954(b) where the taxable year of the foreign corporation occurs prior to the making of elections or the adoption of methods of accounting under this subparagraph, see the regulations under section 952 and section 1248.

(7) *Revocation of election.* Notwithstanding any other provision of this section, any election made by or on behalf of a foreign corporation (other than a foreign corporation subject to tax under section 882) may be modified or revoked by or on behalf of such corporation for the taxable year for which made whenever the consent of the Commissioner is secured for such modification or revocation, even though such election would be irrevocable but for this subparagraph.

(8) *Illustrations.* The application of this paragraph may be illustrated by the following examples:

Example 1. X Corporation is a controlled foreign corporation which maintains its books, in accordance with the laws of the country in which it operates, by taking inventoriable items into account under the ''first-in, first-out'' method. A, B, and C, the United States shareholders of X Corporation, own 45 percent, 30 percent, and 25 percent of its voting stock, respectively. For the first taxable year of X Corporation beginning after December 31, 1962, B and C adopt on its behalf the ''last-in, first-out'' inventory method, notifying A of the action taken. Even though A may object to such action, adjustments must be made to reflect the use of the LIFO method of inventorying in the computation of the earnings and profits of X Corporation with respect to him as well as with respect to B and C.

Example 2. Y Corporation is a controlled foreign corporation which maintains its books, in accordance with the laws of the country in which it operates, by employing the straight-line method of depreciation. D and E, the United States shareholders of Y Corporation, own 51 percent and 10 percent of its voting stock, respectively. For the first taxable year of Y Corporation beginning after December 31, 1962, D adopts on its behalf the declining balance method of depreciation. However, not knowing that E is a United States shareholder of the company, D fails to provide him with notice of the action taken. Assuming that E has filed the return required by section 6046 and the regulations thereunder within the period prescribed by section 6046(d), adjustments in the computation of earnings and profits will not be required with respect to him unless the Director of International Operations notifies him of the action taken within 240 days after the close of Y's taxable year. If notice is not provided to E within this period, he will not be compelled to make the adjustments. At his option, however, he may accept the action taken by assenting thereto not later than 90 days after he is first apprised of such action by the Director of International Operations.

(d) *Translation into United States dollars*—(1) *In general*—(i) *General rule.* Except as provided in subdivisions (ii), (iii), and (iv) of this subparagraph, the amounts to be shown on the profit and loss statement, adjusted pursuant to paragraphs (b) and (c) of this section, shall be translated into United States dollars (as required by paragraph (a)(4) of this section) at the appropriate exchange rate for the translation period (as defined in subparagraph (6) of this paragraph) to which they relate.

(ii) *Cost of goods sold.* Amounts representing items of inventory reflected in the cost of goods sold shall be translated—

(a) To the extent that such amounts represent items included in the opening inventory balance, so as to obtain the same amount of United States dollars which represented (after translation and adjustment) such items in the closing inventory balance for the preceding taxable year,

(b) To the extent that such amounts represent items purchased or otherwise first included in inventory during the taxable year, at the appropriate exchange rate for the translation period in which the historical cost of such items was incurred, and

(c) To the extent that such amounts represent items included in the closing inventory balance, at the appropriate exchange rate for the translation period in which the historical cost of such items was incurred, except that, if such amounts are written down to market value, such market value shall be determined at the year-end rate. Notwithstanding the preceding sentence, amounts representing items of inventory included in the closing inventory balance may be translated at the year-end rate even though not written down to market value; however, once such a rate is employed under those circumstances, translation may not be made for subsequent taxable years at the appropriate exchange rate for the translation period in which the historical cost of the items of inventory was incurred unless the permission of the Commissioner is secured.

(iii) *Depreciation, depletion, and amortization.* Amounts representing allowances for depreciation, depletion, or amortization shall be translated at the appropriate exchange rate for the translation period in which the historical cost of the underlying asset was incurred or is deemed to have been incurred. For purposes of this subdivision, if the historical cost of an asset is determined under paragraph (b)(2) of this section, such cost shall be deemed to have been incurred on the date the asset is considered to have been purchased under that paragraph.

(iv) *Prepaid expenses or income.* Amounts representing expenses or income paid or received in a prior taxable year shall be translated at the appropriate exchange rate for the translation period during which they were paid or received. Notwithstanding the preceding sentence, amounts representing such prepaid income or expenses may be translated at the year-end rate; however, once such a rate is employed, translation may not be made for subsequent taxable years at the appropriate exchange rate for the translation period during which such income or expenses were paid or received unless the permission of the Commissioner is secured.

(2) *Appropriate exchange rate*—(i) *In general.* Where the value of the foreign currency relative to the United States dollar does not fluctuate substantially during a translation period, a single exchange rate shall be appropriate for all amounts representing classes of items which relate to such period, such rate to be a simple average determined by dividing the sum of the closing rates for each of the calendar months ending with or within such period by the number of such months. On the other hand, where the value of the foreign currency relative to the United States dollar does fluctuate substantially during a translation period, the exchange rate appropriate to an amount representing a class of items which relates to such period shall be either *(a)* a simple average determined in accordance with the preceding sentence, or *(b)* a weighted average taking into account the volume of transactions (reflected by the amount being translated) for the calendar months ending with or within such period, depending upon which average would produce a result more representative of that which would have been obtained by translating the individual transactions reflected by that amount at the closing rate for the month to which each such transaction relates. Whether the value of the foreign currency relative to the United States dollar fluctuates substantially during the translation period is a question of fact, depending upon, among other things, the extent to which the volume of transactions varies from month to month. In general, however, the degree of fluctuation will be considered substantial if the closing rate

for any calendar month ending with or within the translation period varies by more than 10 percent from the closing rate for any preceding calendar month ending within that period.

(ii) *Monthly rate.* Notwithstanding subdivision (i) of this subparagraph, if it is so elected by or on behalf of the foreign corporation, and if the closing rate for any calendar month ending with or within a translation period does not vary by more than 3 percent from the closing rate for any preceding calendar month ending within that period, the appropriate exchange rate for amounts representing all classes of items relating to such period shall be any exchange rate which is designated in the election and which does not vary by more than 3 percent from the closing rate for any calendar month ending with or within such period. An election under this subdivision may be made with respect to any translation period of any taxable year of the foreign corporation beginning after December 31, 1962. Such election shall be effective only with respect to the translation period for which it is made, and once made shall be irrevocable with respect to that period. See paragraph (c)(3) of this section for the time and manner in which an election may be made on behalf of the foreign corporation.

(iii) *Class of items.* For purposes of this subparagraph, the term ''class of items'' means any category which is reflected separately on books of account or financial statements. For example, sales is a class of items which is reflected separately on the profit and loss statement, and accounts receivable is a class of items which is reflected separately on the balance sheet.

(3) *Closing rate.* The closing rate for any calendar month shall be the exchange rate on the last day of that month determined by reference to a qualified source of exchange rates within the meaning of subparagraph (5) of this paragraph.

(4) *Year-end rate.* The year-end rate shall be the closing rate for the last calendar month of the taxable year.

(5) *Qualified source of exchange rates.* A qualified source of exchange rates shall be any source which is demonstrated to the satisfaction of the district director to reflect actual transactions conducted in a free market and involving representative amounts. In the absence of such a demonstration, the exchange rates taken into account in the computation of the earnings and profits of the foreign corporation shall be determined by reference to the free market rate set forth in the pertinent monthly issue of ''International Financial Statistics'' or a successor publication of the International Monetary Fund, or such other source of exchange rates reflecting actual transactions conducted in a free market and involving representative amounts as the Commissioner may designate as appropriate for this purpose.

(6) *Translation period*—(i) *In general.* Except as provided in subdivision (ii) of this subparagraph, the translation period shall be a taxable year.

(ii) *Currency fluctuations.* If it is so elected by or on behalf of the foreign corporation, the taxable year shall be divided into groups consisting of a calendar month or consecutive calendar months as specified in the election, each such group constituting a separate translation period. Where the value of the foreign currency relative to the United States dollar fluctuates substantially during the taxable year, the use of the weighted average referred to in subparagraph (2)(i) of this paragraph ordinarily may be avoided by dividing the taxable year into translation periods so that the first translation period begins with the first day of such year and each subsequent translation period begins with the first day of the first calendar month thereafter ending with or within such year for which the closing rate varies by more than 10 percent from the closing rate for any month in the preceding translation period. An election under this subdivision may be made with respect to any taxable year of the foreign corporation beginning after December 31, 1962. Such election shall be effective only with respect to the taxable year for which it is made, and once made shall be irrevocable with respect to such year. For the time and manner in which an election may be made on behalf of the foreign corporation, see paragraph (c)(3) of this section.

(7) *Actual transactions.* Notwithstanding any other provisions of this paragraph—

(i) *Dollar transactions.* Any transaction involving the payment or receipt of United States dollars shall be reflected in the profit and loss statement by the amount of United States dollars involved in such transaction.

(ii) *Conversion transactions.* Any transaction involving the conversion of a foreign currency into United States dollars, or the conversion of United States dollars into a foreign currency, shall be reflected in the profit and loss statement by an amount expressed in United States dollars and determined by translation at the exchange rate at which conversion was effected if the foreign corporation knows, or reasonably should know, that exchange rate.

(iii) *Daily rate.* Any transaction other than one described in subdivision (i) or (ii) may be translated into United States dollars at the exchange rate for the day on which that transaction occurred, such rate to be determined by reference to a qualified source of exchange rates within the meaning of subparagraph (5) of this paragraph.

No transaction shall be required to be taken into account under subdivision (i) or (ii) unless the United States dollars involved are material in amount.

(8) *Other methods.* Notwithstanding the other provisions of this paragraph, translation into United States dollars may be made in accordance with a system or method not otherwise described in this paragraph, provided that such system or method (i) was employed by the corporation for purposes of accounting to its shareholders prior to January 1, 1963, and (ii) is shown to the satisfaction of the Commissioner to clearly reflect the earnings and profits of the corporation.

(9) *Illustrations.* The application of this paragraph may be illustrated by the following examples:

Example 1. M Corporation, a controlled foreign corporation organized on January 1, 1963, employs the calendar year as its taxable year and maintains its books of account in abbas, the currency of the country in which it operates. During 1963 M Corporation's monthly sales amounted to 100,000 abbas per month, its total payroll and other expenses for the year amounted to 180,000 abbas, and its total inventory purchases amounted to 1,050,000 abbas. Also during 1963, M Corporation purchased depreciable assets for 1,000,000 abbas. The value of the abba relative to the United States dollar fluctuated only slightly in 1963; the monthly closing rate moved between 19.8 abbas and 20.2 abbas per United States dollar and stood at 19.9 abbas per United States dollar for most of the year and at yearend. An election under subparagraph (2)(ii) of this paragraph is made on behalf of M Corporation to use the par rate of 20 abbas per United States dollar as the exchange rate appropriate for 1963. Assuming that none of the amounts shown therein reflects a transaction described in subparagraph (7) of this paragraph, M Corporation's adjusted profit and loss statement for 1963 would be translated into United States dollars as follows:

	Local currency	Exchange rate	U.S. dollars
Sales	1,200,000	20:1	60,000
Cost of goods sold:			
Purchases	1,050,000	20:1	52,500
Less: Closing inventory	(350,000)	20:1	(17,500)
	700,000		35,000
Wages and other expenses	180,000	20:1	9,000
Depreciation	200,000	20:1	10,000
Total costs and expenses	1,080,000		54,000
Operating profit	120,000		6,000

Example 2. The facts are the same as in example 1 and in addition during 1964 M Corporation had annual sales of 1,470,000 abbas, annual wages and other expenses of 252,000 abbas, and inventory purchases of 910,000 abbas. Also during 1964, M Corporation purchased additional depreciable assets for 430,000 abbas, the bulk of such purchases being made in the last half of the year. The value of the abba relative to the United States dollar gradually declined in 1964, the monthly closing rate moving from 19.9 abbas per United States dollar down to 22 abbas per United States dollar. For most classes of items, the appropriate exchange rate is a simple average of monthly closing rates or 21 abbas per United States dollar. However, since the bulk of the depreciable asset purchases were made in the last half of the year, the rate representative of those transactions is a weighted average of 21.5 abbas per United States dollar. Assuming that none of the amounts shown therein reflects a transaction described in subparagraph (7) of this paragraph and that closing inventory is translated at historical rates, M Corporation's adjusted profit and loss statement for 1964 would be translated into United States dollars as follows:

	Local currency	Exchange rate	U.S. dollars
Sales	1,470,000	21:1	70,000
Cost of goods sold:			
Opening inventory	350,000	20:1	17,500
Purchases	910,000	21:1	43,333
Less: Closing inventory	(418,000)	21:1	(19,905)
	842,000		40,928
Wages and other expenses	252,000	21:1	12,000
Depreciation:			
1963 assets	150,000	20:1	7,500
1964 assets	86,000	21.5:1	4,000
Total costs and expenses	1,330,000		64,428
Operating profit	140,000		5,572

Example 3. The facts are the same as in examples 1 and 2 except that the 1964 sales of M Corporation amounted to 1,260,000 abbas plus $10,500 in United States dollars. Assuming that closing inventory is translated at historical rates, M Corporation's adjusted profit and loss statement for 1964 would be translated as follows:

	Local currency	Exchange rate	U.S. dollars
Sales—Abbas	1,260,000	21:1	60,000
Sales—U.S. dollars	215,250	([1])	10,500
Total sales	1,475,250		70,500
Cost of goods sold:			
Opening inventory	350,000	20:1	17,500
Purchases	910,000	21:1	43,333
Less: Closing inventory	(418,000)	21:1	19,905
	842,000		40,928
Wages and other expenses	252,000	21:1	12,000
Depreciation:			
1963 assets	150,000	20:1	7,500
1964 assets	86,000	21.5:1	4,000
Total costs and expenses	1,330,000		64,428
Operating profit	145,250		6,072

[1] Transaction.

Example 4. The facts are the same as in examples 1 and 2. M Corporation continues to operate during 1965 and the value of the abba relative to the United States dollar declines materially during that year; the monthly closing rate drops from 22 abbas per United States dollar to 26 abbas per United States dollar, a decrease of more than 10 percent. An election under subparagraph (6)(ii) of this paragraph is made on behalf of M Corporation to divide the year into translation periods, the applicable periods being January 1 through July 31 and August 1 through December 31. For most classes of items, the appropriate exchange rate for each of these translation periods is a simple average of monthly closing rates, or 23 abbas and 25 abbas per United States dollar, respectively. However, all of the depreciable asset purchases were made at the end of the first translation period—January 1 through July 31—and, therefore, the rate representative of those transactions is a weighted average of 24 abbas per United States dollar. The classes of items reflecting M Corporation's 1965 financial transactions and the representative rates of exchange for such classes of items are as follows:

	Local currency	Exchange rate
Sales:		
Jan. 1–July 31	1,000,000	23:1
Aug. 1–Dec. 31	500,000	25:1
Inventory purchases:		
Jan. 1–July 31	559,000	23:1
Aug. 1–Dec. 31	361,000	25:1
Expenses:		
Jan. 1–July 31	115,000	23:1
Aug. 1–Dec. 31	145,000	25:1
Fixed asset purchases	216,000	24:1
Closing inventory	430,000	([1])

[1] Historical.

Assuming that M Corporation uses the first-in, first-out method of inventory valuation, the closing inventory is assumed in normal circumstances to consist of purchases made during the most recent translation period as follows:

	Local currency	Exchange rate	U.S. dollars
All of the August-December purchases	361,000	25:1	14,440
Balance from January- July purchases	69,000	23:1	3,000
Total closing inventory	430,000		17,440

Assuming that none of the amounts shown therein reflects a transaction described in subparagraph (7) of this paragraph, and that closing inventory is translated at historical rates, M Corporation's adjusted profit and loss statement for 1965 would be translated into United States dollars as follows:

	Local currency	Exchange rate	U.S. dollars
Sales:			
Jan. 1–July 31	1,000,000	23:1	43,478
Aug. 1–Dec. 31	500,000	25:1	20,000
	1,500,000		63,478
Cost of goods sold:			
Opening inventory purchases	418,000	21:1	19,905
Jan. 1–July 31	559,000	23:1	24,304
Aug. 1–Dec. 31	361,000	25:1	14,440
Less: Closing inventory	(430,000)	([1])	(17,440)
	908,000		41,209

	Local currency	Exchange rate	U.S. dollars
Wages and other expenses:			
Jan. 1–July 31	115,000	23:1	5,000
Aug. 1–Dec. 31	145,000	25:1	5,800
Depreciation:			
1963 assets	120,000	20:1	6,000
1964 assets	64,500	21.5:1	3,000
1965 assets	43,200	24:1	1,800
Total costs and expenses	1,395,700		62,809
Operating profit	104,300		669

[1] Historical.

(e) *Exchange gain or loss*—(1) *In general*. The exchange gain or loss determined in accordance with subparagraph (2) of this paragraph shall be applied against and reduce, or applied to and increase, as the case may be, the amount of profit or loss shown on the profit and loss statement prepared pursuant to paragraph (a)(1) of this section, as adjusted and translated pursuant to paragraph (a)(2), (3), and (4) of this section. For the manner in which the exchange gain or loss is to be allocated to or applied against Subpart F income, see section 952 and the regulations thereunder.

(2) *Determination of exchange gain or loss*. The exchange gain (or loss) for the taxable year shall be the amount which equals—

(i) The retained earnings for the taxable year as determined under subparagraph (3) of this paragraph, plus

(ii) The amount of any distributions made during the taxable year translated at the exchange rate appropriate to the translation period during which such distributions were made (or taken into account) in accordance with paragraph (d)(7) of this section, if applicable, minus

(iii) The amount representing retained earnings for the preceding taxable year as determined under subparagraph (3) of this paragraph, minus

(iv) The amount of profit (or plus the amount of any loss) shown on the profit and loss statement for the taxable year prepared pursuant to paragraph (a)(1) of this section and adjusted and translated pursuant to paragraph (a)(2), (3), and (4) of this section.

(3) *Retained earnings*. The retained earnings for any taxable year shall be determined by first—

(i) Preparing a balance sheet as of the end of such year from the books of account regularly maintained by the foreign corporation for the purpose of accounting to its shareholders;

(ii) Making the adjustments necessary to conform such balance sheet to the accounting principles described in paragraph (b) of this section;

(iii) Making the further adjustments necessary to conform such balance sheet to the tax accounting standards described in paragraph (c) of this section; and

(iv) Translating the amounts shown on the balance sheet (other than amounts representing retained earnings) into United States dollars in accordance with subparagraph (4) of this paragraph.

The retained earnings shall be an amount equal to the excess of the aggregate amount representing assets on the balance sheet (as adjusted and translated under this subparagraph) over the aggregate amount representing liabilities, reserves (other than reserves out of current or accumulated earnings), and paid- in capital on the balance sheet (as adjusted and translated under this subparagraph).

(4) *Translation of balance sheet*. Amounts shown on the balance sheet as adjusted pursuant to subparagraphs (3)(ii) and (iii) of this paragraph (other than amounts representing retained earnings) shall be translated into United States dollars as follows:

(i) *Financial assets*. Amounts representing financial assets shall be translated at the year-end rate.

(ii) *Physical assets*. Amounts representing physical assets (other than inventory) shall be translated at the appropriate exchange rate for the translation period in which the historical cost of the asset was incurred or is deemed to have been incurred. For special rules for determining date on which the historical cost of certain assets acquired during taxable years beginning before January 1, 1950, or owned at the time a majority interest in the corporation was acquired after December 31, 1949, but before October 27, 1964, is deemed to have been incurred, see paragraph (b)(2) of this section.

(iii) *Depreciation and similar reserves.* Amounts representing depreciation, depletion, and amortization reserves shall be translated at the appropriate exchange rate for the translation period in which the historical cost of the underlying asset was incurred or is deemed to have been incurred.

(iv) *Inventory.* Amounts representing items of inventory included in the closing inventory balance shall be translated in accordance with paragraph (d)(1)(ii) of this section.

(v) *Bad debt reserves.* Amounts representing bad debts reserves shall be translated at the year-end rate.

(vi) *Prepaid income or expense.* Amounts representing expenses or income paid or received in a prior taxable year shall be translated in accordance with paragraph (d)(1)(iv) of this section.

(vii) *Short-term liabilities.* Amounts representing short-term liabilities shall be translated at the year-end rate.

(viii) *Long-term liabilities.* Amounts representing long-term liabilities shall be translated at the appropriate exchange rate for the translation period in which such liabilities were incurred.

(ix) *Paid-in capital.* Amounts representing paid-in capital shall be translated at the appropriate exchange rate for the translation period in which such capital was paid in.

Notwithstanding any other provisions of this subparagraph, where the amount representing an item shown on the balance sheet reflects a transaction described in paragraph (d)(7) of this section, such transaction shall be taken into account in accordance with that paragraph.

(5) *Definitions.* For purposes of this paragraph—

(i) *Financial assets.* A financial asset shall be any asset reflecting a fixed amount of foreign currency, such as cash on hand, bank deposits, and loans and accounts receivable. Securities (within the meaning of section 1236(c)) shall be considered physical assets if they have been or are reasonably expected to be held for at least six months; if not they shall be considered financial assets whether or not they reflect a fixed amount of foreign currency. Moreover, advances on open account to any corporation in which the foreign corporation and any related persons (within the meaning of section 954(d)(3) and the regulations thereunder) with respect thereto own at least 10 percent of the combined voting power of all classes of stock entitled to vote shall not be considered financial assets if such advances have remained open for more than one year.

(ii) *Physical assets.* A physical asset shall be any asset other than a financial asset and shall include goodwill, patents, and other intangibles.

(iii) *Short-term liabilities.* A short-term liability shall be any indebtedness of the foreign corporation which is due or overdue as of the date of the balance sheet or which will become due within 1 year thereafter.

(iv) *Long-term liabilities.* A long- term liability is any indebtedness of the foreign corporation other than a short-term liability.

For the definition of ''appropriate exchange rate'', ''year-end rate'', and ''translation period'', see paragraphs (d)(2), (4), and (6), respectively, of this section.

(6) *Illustrations.* The application of this paragraph may be illustrated by the following examples:

Example 1. N Corporation is a controlled foreign corporation which uses the calendar year as its taxable year and which maintains its books in yuccas, the currency of the country in which it operates. For 1963, its operating profit is 140,000 yuccas or $55,720. At the end of the year, its balance sheet, as translated and adjusted pursuant to subparagraph (3) of this paragraph, is as follows:

	Local currency	Exchange rate	U.S. dollars
Cash	77,000	2.20:1	35,000
Accounts receivable	209,000	2.20:1	95,000
Inventory	418,000	(1)	199,050
Fixed assets	1,430,000	(1)	700,000
Less: Accumulated depreciation	(436,000)	(1)	(215,000)
Total assets	1,698,000		814,050
Current liabilities	338,000	2.20:1	153,640
Long-term liabilities	300,000	(1)	150,000
Paid-in capital	800,000	(1)	400,000
Retained earnings	260,000		110,410
Total liabilities and net worth	1,698,000		814,050

[1] Historical.

N Corporation's retained earnings for 1962 are determined on the basis of its balance sheet as of the end of that year, translated as follows:

	Local currency	Exchange rate	U.S. dollars
Cash	70,000	2.00:1	35,000
Accounts receivable	180,000	2.00:1	90,000
Inventory	350,000	(1)	175,000
Fixed assets	1,000,000	(1)	500,000
Less: Accumulated depreciation	(200,000)	(1)	(100,000)
Total assets	1,400,000		700,000
Current liabilities	180,000	2.00:1	90,000
Long-term liabilities	300,000	(1)	150,000
Paid-in capital	800,000	(1)	400,000
Retained earnings	120,000		60,000
Total liabilities and net worth	1,400,000		700,000

[1] Historical.

The exchange gain or loss of N Corporation for 1963 may be computed as follows:

Retained earnings—1963		$110,410
Less:		
Retained earnings—1962	$60,000	
Operating profit—1963	55,720	115,720
Exchange loss		(5,310)

Example 2.

Example 2. Assume the same facts as in example 1. For 1964, N Corporation's operating profit is 104,300 yuccas or $15,740. It pays a dividend of 26,000 yuccas during a translation period when the appropriate exchange rate is 2.60 yuccas per United States dollar. At year-end, its balance sheet, as translated and adjusted pursuant to subparagraph (3) of this paragraph, is as follows:

	Local currency	Exchange rate	U.S. dollars
Cash	91,000	2.60:1	35,000
Accounts receivable	260,000	2.60:1	100,000
Inventory	430,000	(1)	174,400
Fixed assets	1,646,000	(1)	790,000
Less: Accumulated depreciation	(663,700)	(1)	(323,000)
Total assets	1,763,300		776,400
Current liabilities	325,000	2.60:1	125,000
Long-term liabilities	300,000	(1)	150,000
Paid-in capital	800,000	(1)	400,000
Retained earnings	338,300		101,400
Total liabilities and net worth	1,763,300		776,400

[1] Historical.

The exchange gain or loss of N Corporation for 1964 would be computed as follows:

Retained earnings—1964		$101,400
Add:		
Dividends—1964		10,000
Predistribution earnings		111,400
Less:		
Operating profit—1964	15,740	126,150
Exchange loss		(14,750)

(f) *Determination of earnings and profits as if a domestic corporation*—(1) *In general.* If the books of account regularly maintained by a foreign corporation for the purpose of accounting to its shareholders are kept in U.S. dollars and in accordance with accounting principles generally accepted in the United States, and if it is so elected by or on behalf of such corporation, the earnings and profits of the foreign corporation for a taxable year shall, except as otherwise provided in paragraph (f)(2) of this section, be determined in every respect as if it were a domestic corporation. Such election shall be effective only for the taxable year with respect to which the election is made. Once made, such election shall be irrevocable. See paragraph (c)(3) of this section for the time and manner in which an election may be made on behalf of a foreign corporation.

(2) *Illegal payments.* The amount of any illegal bribe, kickback, or other payment (within the meaning of section 162(c), as amended by section 288 of the Tax Equity and Fiscal Responsibility Act of 1982 in the case of payments made after September 3, 1982, and the regulations thereunder) paid after November 3, 1976, by or on behalf of the corporation during the taxable year of the corporation directly or indirectly to an official, employee, or agent in fact of a government shall not be taken into account to decrease earnings and profits or increase the deficit in earnings and profits otherwise determined under paragraph (f)(1) of this section.

[T.D. 6764, 29 FR 14628, Oct. 27, 1964; 29 FR 15204, Nov. 11, 1964, as amended by T.D. 6787, 29 FR 18502, Dec. 29, 1964; T.D. 6995, 34 FR 832, Jan. 18, 1969; T.D. 7221, 37 FR 24747, Nov. 21, 1972; T.D. 7322, 39 FR 30931, Aug. 27, 1974; T.D. 7545, 43 FR 19652, May 8, 1978; T.D. 7862, 47 FR 56491, Dec. 17, 1982; T.D. 7893, 48 FR 22510, May 19, 1983]

§ 1.964–1T Special rules for computing earnings and profits of controlled foreign corporations in taxable years beginning after December 31, 1986 (temporary).

(a)–(f) [Reserved]