Example 11. The facts are the same as in Example 10, except that A makes no remittance during 1988 but B remits 120 DCs to X on December 31, 1988, which X immediately converts into LCs, and X makes no dividend distribution during 1988. Assume that the appropriate exchange rate for the remittance is 1 LC/3 DCs. B's remittance triggers exchange loss to X. See section 987(3). Under section 987, the exchange loss on the remittance is 20 LCs calculated as follows: 40 LCs, which is the LC value of the 120 DC remittance (120 DCs/3), less 60 LCs, their LC basis (120 DCs/2). This loss is sourced and characterized under section 987 and regulations thereunder.

Example 12. F, a foreign corporation, has gain from the disposition of a United States real property interest (as defined in section 897(c)). The gain is taken into account as if F were engaged in a trade or business within the United States during the taxable year and as if such gain were effectively connected with such trade or business. F's disposition activity shall be treated as a separate QBU with a dollar functional currency because such activity produced income that is treated as effectively connected with a trade or business within the United States. Therefore, F must compute its gain from the disposition by giving the United States real property interest an historic dollar basis.

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

(a) *Background and scope*—(1) *In general.* This section permits an eligible QBU to elect to use the dollar as its functional currency for taxable years beginning on or before August 24, 1994. An election to use a dollar functional currency is not permitted for a QBU other than an eligible QBU. Paragraph (b) of this section defines an eligible QBU. Paragraph (c) of this section describes the time and manner for making the dollar election and paragraph (d) of this section describes the effect of making the election. For the definition of a QBU, see section 989(a). See § 1.985–1(b)(2)(ii) for rules requiring a QBU to use the dollar as its functional currency in taxable years beginning after August 24, 1994.

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

(b) *Eligible QBU*—(1) *In general.* The term ''eligible QBU'' means a QBU that could have used a hyperinflationary currency as its functional currency absent the dollar election. *See* § 1.985–1 for how a QBU determines its functional currency absent the dollar election.

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

(c) *Time and manner for dollar election*—(1) *QBUs that are branches of United States persons*—(i) *Rule.* If an eligible QBU is a branch of a United States person, the dollar election shall be made by attaching a completed Form 8819 to the United States person's timely filed (taking extensions into account) tax return for the first taxable year for which the election is to be effective.

(ii) *Procedure prior to the issuance of Form 8819.* In the absence of Form 8819, the election shall be made in accordance with § 1.985–2T(c)(1). Failure to file an amended return within the time period prescribed in § 1.985–2T(c)(1) shall not invalidate the dollar election if it is established to the satisfaction of the district director that reasonable cause existed for such failure. A subsequent election for 1988 will not prejudice the taxpayer with respect to such reasonable cause determination. Nevertheless, each United States person making an election under the § 1.985–2T(c)(1) must file a Form 8819 in the time and manner provided in the Form's instructions.

(2) *Eligible QBUs that are controlled foreign corporations or branches of controlled foreign corporations*—(i) *Rule.* If an eligible QBU is a controlled foreign corporation (as described in section 957), or a branch of a controlled foreign corporation, the election may be made either by the foreign corporation or by the controlling United States shareholders on behalf of the foreign corporation by—

(A) Filing a completed Form 8819 in the time and manner provided in the Form's instructions, and

(B) Providing the written notice required by paragraph (c)(2)(ii) of this section at the time and in the manner prescribed therein.

The term *controlling United States shareholders* means those United States shareholders (as defined in section 951(b)) who, in the aggregate, own (within the meaning of section 958(a)) greater than 50 percent of the total combined voting power of all classes of stock of the foreign corporation entitled to vote. If the foreign corporation is a controlled foreign corporation (as described in section 957) but the United States shareholders do not, in the aggregate, own the requisite voting power, the term ''controlling United States shareholders'' means all the United States shareholders (as defined in section 951(b)) who own (within the meaning of section 958(a)) stock of the controlled foreign corporation.

(ii) *Notice.* Prior to filing Form 8819, the controlling United States shareholders (or the foreign corporation, if the dollar election is made by the corporation) shall provide written notice that the dollar election will be made to all United States persons known to be shareholders who own (within the meaning of section 958(a)) stock of the foreign corporation. Such notice shall also include all information required in Form 8819.

(iii) *Reasonable cause exception.* Failure of the controlling United States shareholders (or the foreign corporation, if the dollar election is made by the corporation) to timely file Form 8819 or provide written notice to a United States person required to be notified by paragraph (c)(2)(ii) of this section shall not invalidate the dollar election, if it is established to the satisfaction of the district director that reasonable cause existed for such failure.

(iv) *Procedure prior to the issuance of Form 8819.* In the absence of Form 8819, an eligible QBU described in paragraph (c)(2)(i) of this section shall make the dollar election in accordance with §1.985–2T(c)(2). Nevertheless, the person or persons that made such election must file a Form 8819 in the time and manner provided in the Form's instructions.

(3) *Eligible QBUs that are noncontrolled foreign corporations or branches of noncontrolled foreign corporations*—(i) *Rule.* If an eligible QBU is a noncontrolled foreign corporation (a foreign corporation not described in section 957), or a branch of a noncontrolled foreign corporation, the dollar election must be made by the corporation or the majority domestic corporate shareholders on behalf of the corporation by applying the rules provided in paragraph (c)(2)(i)(A) and (B), (ii), (iii), and (iv) of this section substituting ''majority domestic corporate shareholders'' for ''controlling United States shareholders'' wherever it appears therein. The term ''majority domestic corporate shareholders'' means those domestic corporate shareholders (as described in section 902(a)) who, in the aggregate, own (within the meaning of section 958(a)) greater than 50 percent of the total combined voting stock of all classes of stock of the noncontrolled foreign corporation entitled to vote that is owned (within the meaning of section 958(a)) by all the domestic corporate shareholders.

(ii) *Procedure prior to the issuance of Form 8819.* In the absence of Form 8819, an eligible QBU described in paragraph (c)(3)(i) of this section shall make the dollar election in accordance with §1.985–2T(c)(3). Nevertheless, the person or persons that made such election must file a Form 8819 in the time and manner provided in the Form's instructions.

(4) *Others.* Any other person making a dollar election under this section shall elect by filing Form 8819 and fulfilling any other notice requirements that may be required by the Commissioner.

(d) *Effect of dollar election*—(1) *General rule.* If a dollar election is made (or considered made under paragraph (d)(3) of this section) by or on behalf of an eligible QBU, the QBU shall be deemed to have the dollar as its functional currency. Each United States person that owns (within the meaning of section 958(a)) stock of a foreign corporation which has the dollar as its functional currency under §1.985–2 must make all of its federal income tax calculations with respect to the foreign corporation using the dollar as the corporation's functional currency (regardless of when ownership was acquired or whether the United States person received the written notice required by paragraph (c)(2)(i)(B) of this section).

(2) *Computation*—(i) *In general.* Except as provided in paragraph (d)(2)(ii) of this section, any eligible QBU that pursuant to this §1.985–2 has a dollar functional currency must compute income or loss or earnings and profits (or deficit in earnings and profits) in dollars using the dollar approximate separate transactions method described in §1.985–3.

(ii) *Alternative method.* An eligible QBU that has a dollar functional currency pursuant to this §1.985–2 may use a method other than the dollar approximate separate transactions method described in §1.985–3 only if the QBU demonstrates to the satisfaction of the Commissioner that it can properly employ such method. Generally, the QBU must show that it could compute foreign currency gain or loss under the principles of section 988 with respect to each of its section 988 transactions. If subsequently the QBU can no longer demonstrate to the satisfaction of the district director that it can properly employ such an alternative method, then the QBU will be deemed to have changed its method of accounting to the dollar approximate separate transactions method described in §1.985–3. This change in accounting will be treated as having been made with the consent of the Commissioner. No adjustments under either §1.985–5T (or any succeeding final regulation) or section 481(a) shall be required solely because of the change. Rather the QBU shall begin accounting for its operations under §1.985–3 based on its dollar books and records as of the time of the change.

(3) *Conformity*—(i) *General rule.* If a dollar election is made under this §1.985–2 for an eligible QBU (''electing QBU''), then the dollar shall be the functional currency of any related person (regardless of when such person became related to the electing QBU) that is an eligible QBU, or any branch of any such related person that is an eligible QBU. For purposes of the preceding sentence, the term ''related person'' means any person with a relationship defined in section 267 (b) to the electing QBU (or to the United States or foreign person of which the electing QBU is a part). In determining whether two or more corporations are members of the same controlled group under section 267(b)(3), a person is considered to own stock owned directly by such person, stock owned with the application of section 1563(e)(1), and stock owned with the application of section 267(c).

(ii) *Branches of United States and foreign persons.* If a dollar election is made for a QBU branch of any person, each eligible QBU branch of such person shall have the dollar as its functional currency.

(4) *Required adjustments.* If an eligible QBU's functional currency changes due to a dollar election, or due to the conformity requirements of paragraph (d)(3) of this section, such change shall be deemed for purposes of §1.9B5–4 to be consented to by the Commissioner. No adjustments under section 481(a) shall be required solely because of the change. However, the QBU must make those adjustments required by §1.985–5T (or any succeeding final regulation).

(5) *Taxable year conformity required.* Generally, the adjustments required by paragraph (d)(4) of this section shall be made for a related person's taxable year—

(i) That includes the date in which the electing QBU made the dollar election if the person was related to such electing QBU at any time during the QBU's taxable year that includes such date, or

(ii) During which the person first becomes related to any electing QBU, in all other cases.

For purposes of this paragraph (d)(5), the date in which the electing QBU makes the dollar election shall be the last day of the electing QBU's taxable year. The district director may permit the related party to make such adjustments beginning one taxable year later if, in the district director's sole judgment, reasonable cause exists for the related party not being able to make the required adjustments for the earlier year.

(6) *Availability of election.* A dollar election may be made by or on behalf of a QBU, or considered made under the conformity rule of paragraph (d)(3), in

any year in which the QBU is an eligible QBU. If a dollar election is not made by or on behalf of a QBU for its first taxable year beginning after December 31, 1986 in which it is an eligible QBU, then any dollar election made by or on behalf of the QBU, or considered made under the conformity rules of paragraph (d)(3) of this section, that results in a change in the QBU's functional currency shall be treated as having been made with the consent of the Commissioner. In such a case, however, the taxpayer must make those adjustments required by §1.985–5T (or any succeeding final regulation).

(7) *Effect of changed circumstances.* Regardless of any change in circumstances (*e.g.*, a currency ceases to qualify as hyperinflationary), a QBU whose functional currency is the dollar under this section may change its functional currency only if the QBU complies with §1.985–4.

(8) *Examples.* The provisions of this section are illustrated by the following examples.

Example 1. X is a calendar year domestic corporation that in 1987 establishes a branch, A, in Country Z. A's functional currency under sections 985(b)(1) and (2) and §1.985–1 is the "h", the currency of Country Z. The cumulative inflation in Country Z exceeds 100 percent for the thirty-six months prior to January 1987, as measured by the consumer price index of Country Z listed in the monthly issues of the "International Financial Statistics". Accordingly, A is an eligible QBU in 1987 because the h is a hyperinflationary currency. Thus, X may elect the dollar as the functional currency of A for 1987.

Example 2. The facts are the same as in Example (1). X does not elect the dollar as the functional currency of A for 1987. Rather, X elects the dollar as the functional currency of A for 1991, a year A is an eligible QBU. The election constitutes a change in A's functional currency that is made with the consent of the Commissioner. However, A must make the adjustments required under §1.985–5T (or any succeeding final regulation).

Example 3. X is a domestic corporation that establishes A, an eligible QBU branch. X is wholly owned by domestic corporation Y. Y has an eligible QBU branch, B. Both X and Y are calendar year taxpayers. X makes a dollar election for A in 1987. Thus, A is an electing QBU. X and Y are related persons as defined in section 267(b) (*i.e.*, Y has a relationship under section 267(b)(3) to X, the corporation of which A is a part). Therefore, the dollar election by X for A in 1987 results in B, the eligible QBU branch of Y, also having the dollar as its functional currency for 1987.

Example 4. The facts are the same as in Example 3, except that Y does not have an eligible QBU branch but owns all the stock of C, a calendar year controlled foreign corporation, which is not itself an eligible QBU but which has an eligible QBU branch, D. X and C are related persons as defined in section 267(b) (*i.e.*, C has a relationship under section 267(b)(3) to X, the corporation of which A is a part). Therefore, the dollar election by X for A in 1987 results in D, the eligible QBU branch of C, also having the dollar as its functional currency for 1987.

Example 5. X, whose taxable year ends September 30, is an eligible QBU that does not use the dollar as its functional currency. X is wholly-owned by domestic corporation W. On January 1, 1989, X acquires all the stock of Y, an unrelated eligible QBU that made the dollar election under §1.985–2. Y is a calendar year taxpayer. After the stock purchase, X and Y are related persons as defined in section 267(b). Under §§1.985–2(d)(3) and (5), the dollar shall be the functional currency of X, any person related to X, and any branch of such related person that is an eligible QBU beginning with the taxable year that includes December 31, 1989. Thus, X must change to the dollar for its taxable year beginning October 1, 1988. However, the district director may allow X to change to the dollar for its taxable year beginning October 1, 1989, provided reasonable cause exists. Those QBUs changing to the dollar as their functional currency as the result of the conformity requirements must make the adjustments required under §1.985–5T (or any succeeding final regulation).

Example 6. The facts are the same as in Example 5, except that before X purchased the Y stock, X made the dollar election under §1.985–2 but Y did not use the dollar as its functional currency. Under §§1.985–2(d)(3) and (5) the dollar shall be the functional currency of Y, any person related to Y, and any branch of such related person that is an eligible QBU beginning with the taxable year that includes September 30, 1989. Thus, Y must change to the dollar for its taxable year beginning January 1, 1989. However the district director may allow Y to change to the dollar for its taxable year beginning January 1, 1990, provided reasonable cause exists. Those QBUs changing to the dollar as their functional currency as the result of the conformity requirements must make the adjustments required under §1.985–5T (or any succeeding final regulation).

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