Chapter 8 Functional Currency

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a. Introduction

For taxable years beginning on or after January 1, 1988, taxpayers may file a combined report on a water's-edge basis. There are multiple types of entities that may be included in the combined report, either 100 percent or partially. (Revenue and Taxation Code (R&TC) §25110.) A detailed discussion of the entities required to be included in the combined report is included in WEM 2.

For some of the entities included in the water's-edge combined report, it may be necessary to convert the income statement and balance sheet from a foreign currency to the U.S. dollar. This will most likely occur for controlled foreign corporations (CFC) with Subpart F income.

This chapter discusses the state and federal rules used to translate the financial results of an entity into dollars.

b. CCR §25106.5-10 - Currency Translations

California Code of Regulations (CCR) §25106.5-10 governs the translation of income and factors of foreign entities. This regulation applies equally to all taxpayers, both worldwide and water's-edge.

CCR §25106.5-10 requires the following:

Net Income:

1. The net income of each branch or corporation will be calculated in the currency in which that branch or corporation's books are regularly maintained, then translated into the currency of the parent.

2. In determining income, depreciation, depletion or amortization is translated for the period in which the cost of the asset was incurred. This is known as the historical rate.
3. All other income items are translated at either the year-end rate or the simple average rate for the taxable year. The rate used for financial reporting purposes is assumed to be correct unless it can be shown that another rate is more appropriate.
4. Currency gains or losses on closed transactions are included in income. Unrealized currency gains or losses will not be included in income.

Apportionment Factors:

1. Fixed assets and inventories are shown at original cost and translated at the exchange rate at date of acquisition.
2. Rents are capitalized using the simple average exchange rate for the reporting period.
3. Financial assets of financial corporations are translated at the year-end rate for the reporting period.
4. The payroll and sales factors are translated at the simple average exchange rate for the reporting period, unless the value of the currency fluctuates substantially. When there is a substantial fluctuation, the exchange rate will either be the average of the month-end rates or a weighted average rate for the reporting period. A 10 percent fluctuation is considered substantial.
5. For taxable years beginning on or after January 1, 2013, pursuant to R&TC §25128.7, only the receipts factor references are applicable to the apportionment factor, unless subdivision (b) of R&TC §25128 applies.

The apportionment factors are computed in the currency of the parent company, unless it can be shown that computing the factor in dollars or any other currency more fairly reflects the taxpayer's activities in California.

c. Entities With 20 Percent or More U.S. Factors

For the purposes of computing total property, payroll, or sales factors within the U.S. to determine if a corporation has 20 percent or more of its factors in the U.S., the rules of each of the individual states in which the corporation has factors will govern.

If a corporation has factors in a state which does not assess tax according to or measured by income, or uses an apportionment formula which does not utilize property, payroll, or sales as factors, these factors will be assigned based on California law and regulations. (R&TC §25110(b)(3).)

After you have determined that the corporation has 20 percent or more of its income and factors in the U.S., follow California rules to determine the amount of its income and factors subject to inclusion in the water's-edge combined report.

d. Controlled Foreign Corporations (CFC)

Any CFC earning Subpart F income will be fully or partially included in the water's-edge combined report. Subpart F income is discussed in detail in WEM 2. The amount that will be included in the water's-edge return is determined by multiplying the CFC's income and factors by a fraction, the numerator of which is the total Subpart F income as defined in IRC §952 and the denominator of which is the earnings and profits (E&P) for the year, determined under IRC §964.

Treasury Regulation (Treas. Reg.) §1.964-1 requires that the E&P of a CFC be computed in the functional currency of the CFC. Functional currency is determined under IRC §985. The numerator, Subpart F income, should be in the same functional currency as the denominator, E&P.

CCR §25106.5-10 governs the translation of the income and factors of the CFCs. The CFCs' inclusion ratio is applied to determine the amount of translated income and factors subject to inclusion in the combined report.

Note that as a practical matter, a foreign entity that has effectively connected income for U.S. tax purposes is required to maintain its U.S. branch books in U.S. dollars, so there will generally be no translation issues for such entities. (See WEM 8(f).)

e. Entities with Income Attributable to U.S. Sources

Entities that have income that is attributable to U.S. sources will be included in the water's-edge combined report using the federal sourcing rules such as those set forth in IRC §861 through §865 and §-897(g) and(h). The comparable California regulation is CCR §25110(d)(2)(F)(2). The U.S. located factors of a bank or corporation that has income attributable to U.S. sources will be determined based on California law and regulations and construed on a basis consistent with the determination of its United States located income. (CCR §25110(d)(2)(F)6.) See WEM 5 for a more detailed discussion.

f. Federal Provisions - Subpart J

The federal rules for foreign currency translations and transactions must be followed when determining the IRC §964 E&P considered in the denominator of the CFC inclusion ratio (e.g., inclusion ratio equals Subpart F income defined in IRC §952 divided by E&P defined in IRC §964). A working knowledge of the federal provisions is needed when calculating the water's-edge inclusion ratio.

The Tax Reform Act of 1986 added Subpart J (§§985 through 989) to the Internal Revenue Code. These provisions are effective for years beginning after December 31, 1986. The reasons for enacting the provisions of Subpart J were twofold:

1. To bring foreign currency translation and transaction results for tax purposes more in line with FASB 52
2. To simplify the rules.

The topics by IRC section are the following:

Section 985	Functional Currency
Section 986	Determination of Foreign Taxes and Foreign Corporation's E&P
Section 987	Branch Transactions
Section 988	Treatment of Certain Foreign Currency Transactions (Adopted by California for years beginning on or after January 1, 1988, R&TC §24905)
Section 989	Other Definitions and Special Rules

IRC §988, regarding classification of foreign currency transactions as ordinary or capital income, was the only section adopted by California. There is no specific authority to use the other sections of Subpart J for California purposes. (See WEM 8(d), above for the exception concerning controlled foreign corporations.)

1. Functional Currency

The term "functional currency" is introduced in IRC §985. The general rule under IRC §985 is that a taxpayer or Qualified Business Unit (QBU) must calculate income using its respective functional currency. The adoption of, or election to use, a functional currency is treated as a method of accounting. (Treas. Reg. §1.985-2(a).) Thus, the functional currency must be used for all subsequent years unless permission to change is granted or deemed granted.

A QBU is defined in IRC §989 as any separate and clearly identified unit of a trade or business that maintains separate books and records. Any activity that produces income or loss that is, or is treated as, effectively connected with the conduct of a trade or business within the U.S. is treated as a separate QBU, provided separate books and records are kept. Under this definition, a corporation is a QBU, as is a branch operation, or possibly even a corporate division. A multinational group could contain any number of QBUs.

2. QBUs Required To Use the Dollar for their Functional Currency

The following taxpayers, or QBUs, must use the U.S. dollar as their functional currency, regardless of the currency used in their books and records under Treas. Reg. §1.985-1(b):

1. An individual taxpayer
2. A QBU that conducts its activities primarily in dollars
3. A QBU that is domiciled in the U.S. or any possession or territory of the U.S. where the dollar is the standard currency
4. A QBU with a hyperinflationary currency that elects or is required to use the dollar as its functional currency under Treas. Reg. §1.985-2
5. A QBU that does not keep books and records in the currency of any economic environment in which a significant part of its activities are conducted
6. Any activity that produces income or loss that is, or is treated as, ECI will be treated as a separate QBU with a dollar functional currency

3. QBUs Not Required To Use the Dollar

For federal purposes, the functional currency of a QBU, that is not required to use the dollar, is the currency of the economic environment in which a significant part of the operations are conducted, provided the books and records are also kept in that currency. (Treas. Reg. §1.985-1(c).)

Two examples of the multiple examples noted in the Treas. Reg. §1.985-1(c) are discussed below:

Example 1

A, a domestic corporation, owns 100% of corporation B located in country X. The currency of country X is the SS. All of B's purchases, sales, and expenses are made in the SS. Country X requires B to keep its books and records in the SS. Under these facts, the functional currency of A would be the dollar and the functional currency of B would be the SS.

Example 2

A, a domestic bank, operates in foreign country X through branch B. B qualifies as a QBU. The currency of country X is the SS. The laws of country X requires B to keep its books and records in SS. B makes loans in both the dollar and SS. The SS loans are tied to the dollar. B is funded primarily in dollars but pays its local expenses such as local taxes, wages, rent, and utilities in the SS. Under these facts, the activities of B would be considered to be conducted primarily in the dollar since its loans are made either in the dollar, or are tied to the dollar. As such, the functional currency of B would be the dollar.

4. If a Foreign Corporation Has Two or More QBUs That do not Have the Same Functional Currency:

a) Each QBU of the foreign corporation determines its functional currency under the general rules. (Treas. Reg. §1.985-1(d)(1)(i).)
b) The foreign corporation determines its functional currency under the general rules with respect to its activities as a whole (including the activities of the QBUs). (Treas. Reg. §1.985-1(d)(1)(ii).)
c) The foreign corporation will then have a single functional currency that is different from the functional currency of one or more of its QBUs. (Treas. Reg. §1.985-1(d)(1).)
d) The income or loss of each QBU would be determined in the QBU's functional currency and then translated into the functional currency of the foreign corporation using the appropriate exchange rate. (Treas. Reg. §1.985-1(d)(2).)

5. DASTM - Dollar Approximate Separate Transactions Method

Treas. Reg. §1.985-2 provides for the use of the dollar as a QBU's functional currency if certain requirements are met. The primary requirement is that the QBU would otherwise use a "hyperinflationary currency" as its functional currency. A hyperinflationary currency is one which experiences at least 100 percent inflation over a 36-month period.

A QBU which uses the dollar as its functional currency pursuant to Treas. Reg. §1.985-2 must calculate its income, loss, and E&P using an accounting method described as the "dollar approximate separate transactions method" (DASTM). This method consists of translating the QBU's income statement into dollars and then adjusting for currency gains or losses. Treas. Reg.

§1.985-3 describes the DASTM. (This method is similar to CCR §25106.5-10 except for the treatment of currency gains/losses under Treas. Reg. §1.985-3(d)).

As hyperinflationary currency could significantly depreciate against other currencies, including the U.S. dollar, DASTM would be necessary because normal translation rules would not properly reflect the income or loss of the QBU in U.S. dollar terms. DASTM involves preserving the U.S. dollar value and frequent translations of income items from hyperinflationary currency to the U.S. dollar.

Under Treas. Reg. §1.985-3(c)(1), the income statement is translated into dollars at the exchange rate for the translation period to which the amounts relate. Under Treas. Reg. §1.985-3(c)(6), -the exchange rate for a translation period may be determined under any reasonable method, provided that the method is consistently applied to all translation periods and conforms to the taxpayer's method of financial accounting. Reasonable methods include the average of beginning and ending exchange rates for the translation period and the spot rate on the last day of the translation period.

Under Treas. Reg. §1.985-3(c)(4) and (5), depreciation, depletion, and amortization are translated on a historical cost basis for the period in which the cost of the asset was incurred. Prepaid expenses and prepaid income are also translated at the exchange rate for the period in which the expenses or income were paid or received.

Under Treas. Reg. §1.985-3(c)(8), if a QBU uses the dollar as its functional currency, no currency gain or loss will be allowed with respect to *dollar* transactions, since the dollar is the functional currency. For other transactions, the currency gain/loss to be reflected in the income statement and E&P calculation is determined in accordance with Treas. Reg. §1.985-3(d), as follows:

1) Net worth (determined under Treas. Reg. §1.985-3(d)(1)) at the end of the taxable year (in dollars) minus the net worth at the end of the preceding taxable year (In calculating net worth, bad debt reserves are translated at the average rate for the last translation period of the year. Tangible and intangible assets are translated using historical cost.);
2) Plus the U.S. dollar amount of any item that decreased net worth for the taxable year but did not affect income (such as dividends, transfers of cash to the home office, or returns of capital);
3) Minus the U.S. dollar amount of any item that increased net worth for the taxable year but did not affect income (such as capital contributions or transfers of cash from the home office to the QBU branch);

4) Minus the U.S. dollar- amount of income or E&P (or plus the U.S. dollar amount of any loss or deficit in E&P) determined for the taxable year by:

   a) Preparing an income/loss statement from the QBU's books and records as recorded in the QBU's hyperinflationary currency
   b) Making the adjustments necessary to conform such profit and loss statement to U.S. GAAP, and tax accounting principles
   c) Translating the amounts of hyperinflationary currency as shown on such adjusted profit and loss statement into U.S. dollars.

In accordance with Treas. Reg. §1.985-4, once this method is elected, the taxpayer may not change its functional currency without first obtaining permission, since the adoption of a functional currency is treated as a method of accounting. Generally, permission to change functional currencies will not be granted unless significant changes in the QBU's economic environment occur.

DASTM was an election for taxable years beginning prior to August 25, 1994. This method is mandatory for certain entities for taxable years beginning on or after August 25, 1994. There is also a provision in the final federal regulations that allows taxpayers to amend returns back to 1987 using this method.

There are two exceptions to the mandatory use of DASTM. DASTM does not apply to:

1) A foreign corporation that is not a CFC; and
2) An eligible QBU of a foreign corporation when the foreign corporation itself has a non-hyperinflationary functional currency and the eligible QBU uses the same functional currency as the foreign corporation.

The amount of DASTM gain or loss is taken into account by the CFC for purposes of determining the amount of its E&P. Generally for taxable years beginning on or after August 25, 1994, the CFC must use a 9-STEP procedure outlined in Treas. Reg. §1.985-3(e)(3), unless it meets the definition of a "small QBU" under Treas. Reg. §1.985-3(e)(2). Examples of computations can be found in Treas. Reg. §1.985-3(c) and (d).

For California purposes, the DASTM method applies for determining the Subpart F income and the IRC §964 E&P of CFC's with hyperinflationary currency.

6. Transaction Gains and Losses

California formally adopted IRC §988 for years beginning on or after January 1, 1988. Effective January 1, 1993, IRC §988(a)(3), regarding source, does not apply, as noted in R&TC §24905.

Entities not using the DASTM must calculate currency gains or losses pursuant to IRC §988. The primary purpose of this section is to require an entity to report both sides of a foreign currency transaction as a single transaction and to treat the resulting income or loss as ordinary income.

The foreign currency transactions covered by IRC §988 include:
1) The acquisition of or becoming an obligor of a debt instrument;
2) Accruals of income or expenses; and
3) Forward contracts, futures contracts, options, or any other similar financial instrument.

g. Summary

The translation of income or apportionment factors will primarily be an issue for CFCs.

CCR §25106.5-10 will apply to translations of income, expenses, and apportionment factors of entities with 20 percent or more U.S. factors and entities with ECI.

The DASTM will generally be applied for determining the E&P of CFC's with hyperinflationary currency.

Federal law will govern the translation into dollars of the E&P used in the determination of Subpart F to E&P ratio of controlled foreign corporations. Income and factors of the CFC will be determined in accordance with CCR §25106.5-10.