Internal Revenue Service
DEPARTMENT OF THE TREASURY

LB&I Virtual Library
Concept Unit

Library Level	Number	Title
Shelf	N/A	Crossover
Book	18	Foreign Currency
Chapter	18.3	Determination of/changes to a functional currency
Section	18.3.2	Determination of a functional currency (including DASTM)
Subsection	N/A	N/A

Unit Name	Functional Currency Determination	
Primary UIL Code	9470.03-02	Determination of a Functional Currency (Including DASTM)

Document Control Number (DCN)	FCU/C/18_03_02-01 (formerly FCU/C/18_3_2_11(2016))
Date of Last Update	05/12/17

Note: This document is not an official pronouncement of law, and cannot be used, cited or relied upon as such. Further, this document may not contain a comprehensive discussion of all pertinent issues or law or the IRS's interpretation of current law.

Table of Contents

(View this PowerPoint in "Presentation View" to click on the links below)

General Overview

Functional Currency Determination

Multinational businesses that file federal income tax returns in the United States must report any income subject to U.S. federal income tax in U.S. dollars. However, when these businesses operate in different countries, these businesses must adhere to the laws and regulations of each country. Therefore, multinational businesses structure their worldwide operations to operate legally and efficiently for both global accounting and tax purposes.

One challenge of reporting total income subject to U.S. federal income tax is the computation of income earned in non-U.S. locations. Since the U.S. federal income tax system is based on worldwide income of a business enterprise conducting business in the United States, often the books and records of the business enterprise are recorded in multiple currencies and locations. Because it is not possible to combine, add, or subtract measurements expressed in different currencies, it is necessary to translate into a single reporting currency those financial measurements that are measured or denominated in different currencies.

In order to translate the multiple currencies into a single currency, rules were set for both book and tax purposes to determine the functional currency of the separate branches. These rules and issues surrounding them are in this unit. The resources for determining an entity's functional currency are:

▪ Book:
  – US Generally Accepted Accounting Principles (GAAP), ASC 830 (Foreign Currency Matters), or
  – International Financial Reporting Standards (IFRS), IAS 21 (The Effects of Changes in Foreign Exchange Rates)
▪ Tax: IRC 985 (Functional Currency General Rules) and related Treasury Regulations

Please see the diagram on the following page that provides examples of various facts and circumstances to be considered in the determination of an entity's functional currency.
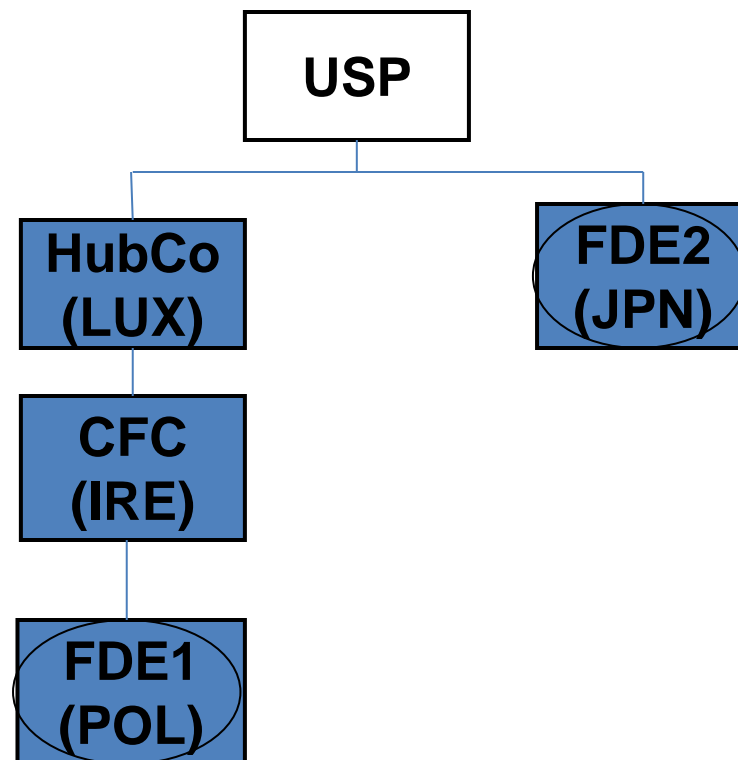
Diagram of Concept

Functional Currency Determination

Diagram of Concept

Consider the example of the legal structure shown at the right:

- USP, located in the United States, would utilize the U.S. dollar as its functional currency but what about the rest of the entities?
- HubCo, a foreign holding company organized in Luxembourg, is vested with centralized functions and centralized control of a portion of its foreign operations. While HubCo might elect to utilize the U.S. dollar as its functional currency for ease of operations, could it also justify utilizing the Euro as its functional currency? A facts and circumstances analysis (described later) would need to performed to determine if the Euro would be a reasonable functional currency for the QBU.
- The CFC (located in Ireland) and the two FDEs (FDE1 located in Poland that Is 100% owned by the CFC and FDE2 located in Japan that is 100% owned by USP) may require additional analysis to determine whether their functional currency should be the currency of the country in which they reside.

The following slides present the legal guidance (for book and tax) as well as the facts that must be considered in the determination of functional currency for both book and tax purposes.

```
                USP
                 │
       ┌─────────┴─────────┐
    HubCo                 FDE2
    (LUX)                 (JPN)
      │
     CFC
    (IRE)
      │
    FDE1
    (POL)
```

Facts of Concept

Functional Currency Determination
Facts of Concept
Functional Currency - Book GAAP provision (codified): The Financial Accounting Standards Board codified SFAS 52 (Foreign Currency Translation) into ASC 830 (Foreign Currency Matters) on December 15, 2008. ASC 830-10 provides the overview of this topic and includes a definition of functional currency in ASC 830-10-20. "An entity's functional currency is the currency of the primary economic environment in which the entity operates; normally, that is the currency of the environment in which an entity primarily generates and expends cash." Paragraphs 830-10-45-2 through 830-10-45-6 as well as 830-10-55-3 through 830-10-55-7 provide examples and guidelines for applying this rule. IFRS provision (codified): For entities reporting under IFRS, IAS 21 *The Effects of Changes in Foreign Exchange Rates* defines functional currency in IAS 21.8 as "the currency of the primary economic environment in which the entity operates". The term "functional currency" replaced the term "measurement currency" in the 2003 revision of IAS 21.   Likewise, IAS 21.8 defines a foreign operation as a "subsidiary, associate, joint venture, or branch whose activities are based in a country or currency other than that of the reporting entity".

Functional Currency Determination

Facts of Concept

Functional Currency - Tax

The determination of a functional currency for tax purposes is defined in IRC 985 and the applicable Treasury Regulations.
Outline of IRC 985 and the Treasury Regulations:
- The definition of functional currency is contained in IRC 985(b) – The term functional currency means the dollar, or in the case of a qualified business unit, the currency of the economic environment in which a significant part of the unit's activities are conducted and in which is used by the unit in keeping its books and records.
- Definition of Qualified Business Unit ("QBU") – see IRC 989 and its regulations. - A separate IPS unit has been prepared for this topic.
- The U.S. Dollar must be used as a QBU's functional currency in the following situations:
  - Operations do not rise to the level of a QBU.
  - When operations are primarily conducted in U.S. Dollars.
  - When QBU residence is in the U.S.
  - When the currency of books and records versus currency of economic environments are different. But note that there is a presumption in Treas. Reg. 1.985-1(c)(3) that a QBU is keeping its books and records in the currency of the economic environment in which a significant part of its activities are conducted, unless the QBU can demonstrate that it has a substantial nontax reason for not keeping its books in this currency.
  - When QBU has effectively connected income or loss in U.S.
  - When QBU operates in a hyperinflationary currency environment. See Treas. Reg. 1.985-1(b)(2) and 1.985-3.
- The functional currency of a QBU that is not required to use the dollar must use the currency of the economic environment in which a significant part of its activities are conducted if the QBU keeps, or is presumed to keep, its books and records in this currency.
- Treas. Reg. 1.985-1(c) and (d) lists the factors to be considered in the determination of the functional currency of a QBU. A separate IPS Unit has been prepared for this topic.

Detailed Explanation of the Concept

Functional Currency Determination

How does an auditor determine if the functional currency reported by a QBU is correct? As previously mentioned, this is a facts and circumstances based determination. Referring to the Diagram of the Concept and using the analysis on this and the following page, the factors that could impact the functional currency determination for each QBU include:

Analysis	Resources
▪ QBU Residence: Often the currency of the country of residence for the QBU is the QBU's functional currency. However, other factors as discussed below should also be considered. If the country of residence was the deciding factor in the previous example, then HubCo and CFC's functional currency would be the Euro, FDE1's functional currency would be the Polish Zloty, and FDE2's functional currency would be the Japanese Yen.	▪ Treas. Reg. 1.985-1(c)(2)(i)(A)
▪ QBU's Business Operations: If CFC resides in Ireland for certain legal purposes but its primary customer or supplier resides in Poland, CFC might actually conduct business in Poland, especially if the primary business operations of CFC are being conducted through DE1.	▪ Treas. Reg. 1.985-1(c)(2)(i)(B), (C), and (E)
▪ QBU's Business Management: Likewise, if FDE1 resides in Poland but is managed by its parent (CFC) in Ireland and the parent is its primary customer and/or supplier, then FDE1 might actually conduct business in Ireland.	▪ Treas. Reg. 1.985-1(c)(2)(i)(F) and (H)
▪ QBU's Books and Records: In general, this factor weighs heavily on the functional currency determination of a QBU unless the QBU can show that there is a substantial nontax reason for keeping its records in a different currency.	▪ Treas. Reg. 1.985-1(c)(3)

Functional Currency Determination

How does an auditor determine if the functional currency reported by a QBU is correct? As previously mentioned, this is a facts and circumstances based determination. Referring to the Diagram of the Concept and using the analysis on the previous and this page, the factors that could impact the functional currency determination for each QBU include:

Analysis	Resources
▪ QBU's Business Purpose: The business of a QBU may determine its functional currency. If any of the QBUs in the previous example were a financial institution, the currency(ies) in which the QBU borrows and lends would determine the QBU's functional currency.	▪ Treas. Reg. 1.985-1(c)(2)(i)(D)
▪ Multiple FC: Based on this analysis, a QBU can have more than one currency that could be considered to be its functional currency? If this is the case, the QBU can choose any of these as its functional currency.	▪ Treas. Reg. 1.985-1(c)(4)
▪ Consistency: In general, this is consistent from year to year. However, if the taxpayer changes the functional currency of a QBU, a determination needs to be made as to why the functional currency changed.	▪ Treas. Reg. 1.985-1(c)(6)
▪ Change in Functional Currency: If a change of functional currency did occur, this constitutes a change of accounting method (CAM) for which the provisions of the Treasury Regulations must be followed, including: – the filing of Form 3115, – determination of foreign currency gain/loss; and, – verification of the same change in functional currency made for book purposes.	▪ Treas. Reg. 1.985 -4

Index of Referenced Resources

Functional Currency Determination
Treas. Reg. 1.985-1(c)(2)(i)(A)
Treas. Reg. 1.985-1(c)(2)(i)(B), (C), (D), (E), (F), (H)
Treas. Reg. 1.985-1(c)(3)
Treas. Reg. 1.985-1(c)(4)
Treas. Reg. 1.985-1(c)(6)
Treas. Reg. 1.985 -4

Training and Additional Resources

Functional Currency Determination	
Type of Resource	**Description(s)**
SABA Sessions	- INTL Foreign Currency Issues and IFRS plus Audit Techniques - IBC ONLY – Foreign Currency & Int'l Matrix - IBC Common Errors in translating Foreign Currency - Building Blocks of Financial Products - IE Phase I, Module E – Lesson 1 Foreign Currency - IE Phase III, Module D –Interaction of International and Financial Products Issues - FP Phase I, Lesson 9 Foreign Currency - FP Phase III, Lesson 4 Foreign Currency - Refer to Foreign Currency Practice Network SharePoint Site for a complete listing of Foreign Currency SABA sessions
White Papers / Guidance	- FASB 52/ASC 830 Foreign Currency Matters - IAS 21 The Effects of Changes in Foreign Exchange Rates
Reference Materials – Treaties	BNA Tax Management Portfolio 921-2nd Tax Aspects of Foreign Currency
Other Training Materials	- Bittker & Lokken: Fundamentals of International Taxation, Chapter 74 (Foreign Currency) - Keyes: Federal Taxation of Financial Instruments and Transactions (Chapter 15, Foreign Currency Denominated Instruments

Glossary of Terms and Acronyms

Term/Acronym	Definition
ASC	Accounting Standard Codification
CAM	Change of Accounting Method
CFC	Controlled Foreign Corporation
DASTM	Dollar Approximate Separate Transaction Method
FDE	Foreign Disregarded Entity
GAAP	Generally Accepted Accounting Principles
HUBCO	Holding Company – either Foreign or Domestic
IAS	International Accounting Standards
IFRS	International Financial Reporting Standards
QBU	Qualified Business Unit
USP	US Parent

Index of Related Practice Units

Associated UIL(s)	Related Practice Unit	DCN
9470.02	Foreign Currency Transactions Entered into by an Individual	TBD
9470.02	How to Assess Penalties for Failure to file Form 8886 Disclosing Section 988 Losses	FCU/P/18_02_01-04 (formerly FCU/9470.02_02)
9470.02	Disposition of a Portion of an Integrated Hedge	FCU/T/18_02_03-01 (formerly FCU/9470.02_03)
9470.02	Disposition of Nonfunctional Currency	TBD
9470.02	Integration of Executory Contract and the Currency Hedge	TBD
9470.02	Legging into Integrated Treatment	TBD
9470.02	Legging out of Hedged Executory Contract	TBD
9470.03	Change in Functional Currency – How to Identify Issues	TBD
9412.00	Subpart F Overview	DPL/C/02-01 (formerly DPL/CU/V_2_01)