

## LB&I International Practice Service Concept Unit

IPS Level	Number	Title	UIL Code	Number
Shelf	N/A	Crossover IPN	–	–
Volume	18	Foreign Currency	<b>Level 1 UIL</b>	9470
Part	18.3	Determination of/changes to a functional currency	<b>Level 2 UIL</b>	9470.03
Chapter	18.3.1	Definition of a qualified business unit (QBU)	<b>Level 3 UIL</b>	9470.03.01
Sub-Chapter	N/A	N/A	–	–

<b>Unit Name</b>	Overview of Qualified Business Units (QBUs)
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<b>Document Control Number (DCN)</b>	FCU/CU/C_18.3.1_02(2016)
<b>Date of Last Update</b>	06/01/2016

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# General Overview

## Overview of Qualified Business Units (QBUs)

Fundamental to the taxation of foreign currency are two basic concepts: functional currency (the topic of a separate IPS unit) and Qualified Business Unit (QBU). As explained within this unit, QBUs are subdivisions of taxpayers which separately compute their own income/loss, often in a currency that is different than that of its owner.

The tax provisions applicable to foreign currency are found within Subpart J of the IRC, Sections 985 through 989:

- Section 985 - Functional currency
- Section 986 - Determination of foreign taxes and foreign corporation's earnings and profits
- Section 987 - Branch transactions
- Section 988 - Treatment of certain foreign currency transactions
- Section 989 - Other definitions and special rules

The concept of a QBU derives from the accounting principle found in ASC 830 (FAS 52), and is also found in the international accounting standards. However, the term “QBU” itself is not found in the accounting literature, but is unique to the IRC. A QBU is defined in Section 989 as: “any separate and clearly identified unit of a trade or business of a taxpayer which maintains separate books and records.” QBUs may be of different legal types, both corporate and non-corporate. Several examples of the various types of QBUs are included in this IPS unit. Pertinent factors are included for each example.

A best practice to implement when examining foreign currency gains/losses is to request copies of the organizational chart of the taxpayer prepared under both book and tax bases. A comparison of these charts should be performed as a means to identify the QBUs which have the highest potential for adjustments to occur. In addition, a comparison should be made with the organizational charts of the prior audit cycle to determine new QBUs, QBUs that change their form (via a Form 8832 election), or QBUs that have been terminated.

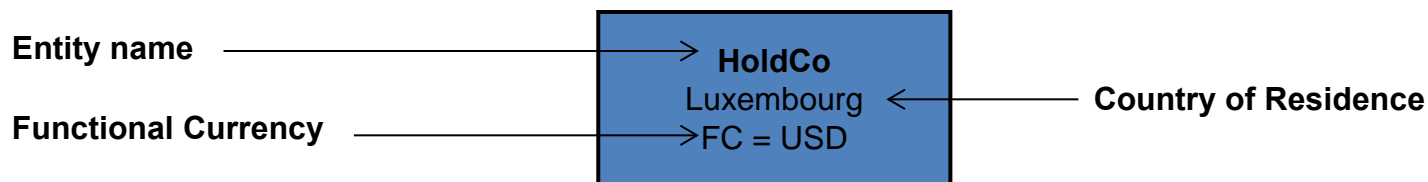
# General Overview (cont'd)

## Overview of Qualified Business Units (QBUs)

Foreign currency gains/losses will likely occur with regard to a QBU that changed its status (from a branch to a corporation or vice versa), was liquidated, or changed its functional currency. In some instances, taxpayers omit recognition of the applicable foreign currency gains. For book purposes, foreign currency gains/losses may be included in Other Comprehensive Income (OCI) instead of book P&L, and such gains/losses may not be added back on the Schedule M-3. Consequently, audit techniques should include a review of items in OCI.

Finally, the foreign currency gains/losses reported on the US tax return may be a net of several items – Section 985 (change of accounting adjustment), Section 986, Section 987 and Section 988 amounts, each of which may be net amounts of gains and losses. Consequently, examiners should request an analysis of the foreign currency gains/losses included on the US return. Examiners should then separate the gains/losses in order to apply the tax provisions applicable to them.

This IPS Unit will focus on the definition of a QBU under Section 989. For the example listed in the Diagram of the Concept, the first line of the diagram description will reflect the entity name and the second line will reflect country of residence and the third line will represent the functional currency (FC) of the entity:



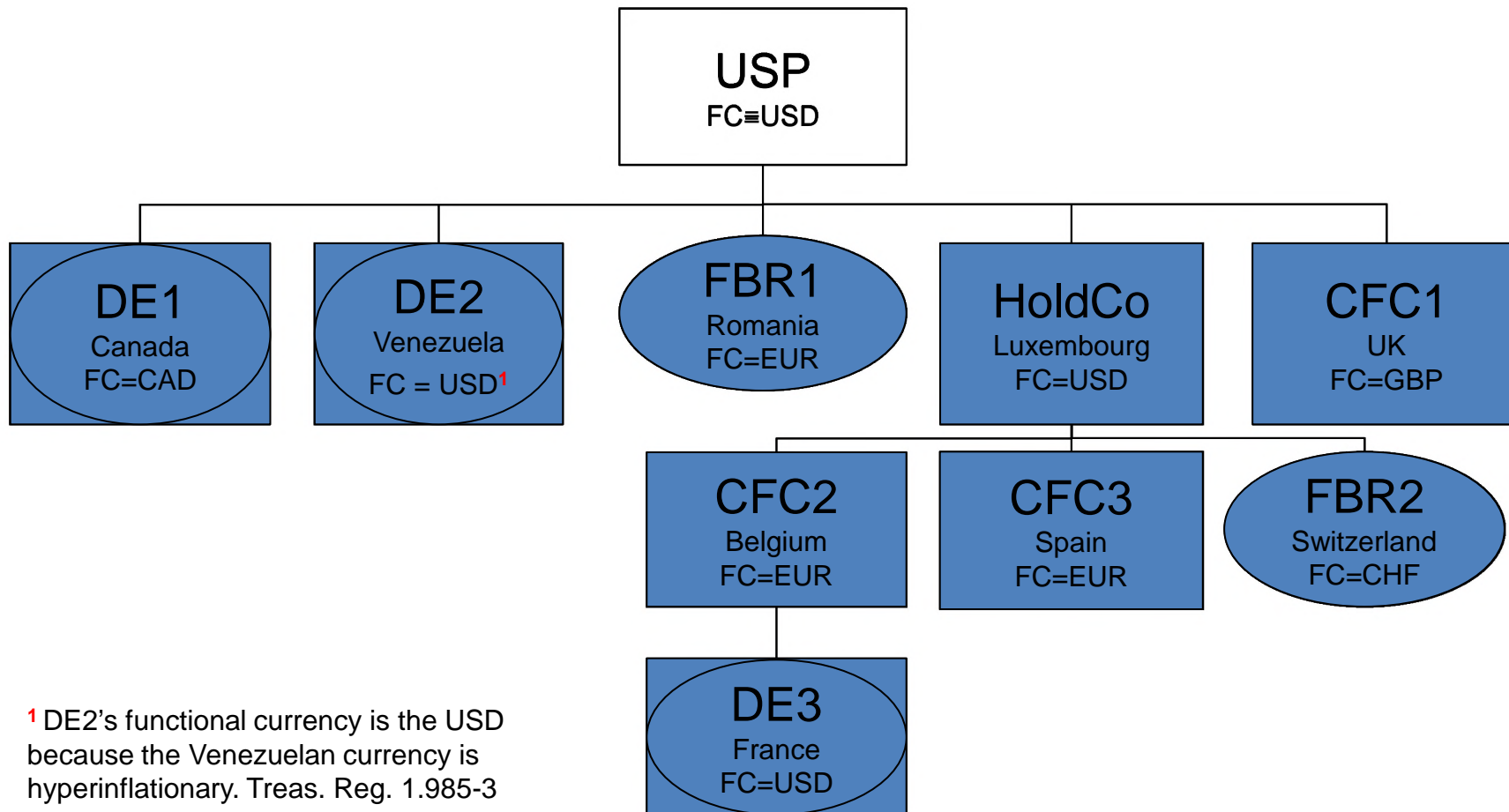
In the Examples of the Concept section, the first line of the diagram will list the entity name and the second line will reflect the type of entity shown.

# Diagram of Concept

## Overview of Qualified Business Units (QBUs)

### Diagram of Concept

Below is a typical organizational structure of a multinational taxpayer. Description of this diagram is found on the following slide.



<sup>1</sup> DE2's functional currency is the USD because the Venezuelan currency is hyperinflationary. Treas. Reg. 1.985-3

# Facts of Concept

## Overview of Qualified Business Units (QBUs)

### Facts of Concept

The following facts relate to the diagram found on the previous slide.

- As defined in Treas. Reg. 1.989(a)-1(b)(2), corporations are per se QBUs. Accordingly USP, HoldCo, CFC 1, CFC 2 and CFC 3 are all QBUs.
- FBR1, FBR2, DE1, DE2 and DE 3 are QBUs if they constitute separate and clearly identified units of a trade or business of a taxpayer and maintain separate books and records. For purposes of this analysis, a foreign DE is effectively treated as a foreign branch.
- The functional currency of a QBU need not be the currency of the country in which the QBU is located. Rather, the functional currency of a QBU will be the currency of the economic environment in which the QBU operates.
- Each of the entities in the diagram (all constitute QBUs), may have foreign currency gains/losses from Section 988 transactions denominated in a nonfunctional currency of the QBU.
- USP may have a foreign currency gain/loss under Section 986.
- The non-corporate (branch and DE) QBUs may have a foreign currency gain/loss under Section 987 whenever remittances are made by the branches to its owner. There will be separate IPS units in Chapter 18.1.2 “Branch Remittances and Branch Terminations” on that topic.
- If any of the entities changed their functional currency under Section 985, they may need to recognize foreign currency gains or losses under Treas. Reg. 1.985-5. There will be separate IPS units in Chapter 18.3.3 “Change in Functional Currency Section 985, Procedural Matters and Calculations” on that topic.

# Facts of Concept (cont'd)

## Overview of Qualified Business Units (QBUs)

### Facts of Concept

- A QBU must meet a two-part test (see Treas. Reg. 1.989(a)-1(b)(1)):
  - It must have activities that constitute a “trade or business”. Generally, a trade or business for purposes of Section 989(a) is a specific unified group of activities that constitutes (or could constitute) an independent economic enterprise carried on for a profit. The determination of whether a trade or business exists depends on an examination of all facts and circumstances.
  - It must maintain a separate set of books and records with respect to such trade or business.
- Under Treas. Reg. 1.989(a)-1(b)(2), a corporation is a QBU. An individual is not a QBU. A partnership, trust, or estate is a QBU of a partner or beneficiary.
- QBUs may compute their profit/loss in a currency other than the US dollar provided that the QBU:
  - Operates in a foreign environment in which the US dollar is not the currency of this economic environment; and,
  - Maintains books and records in the currency of that environment
- Indications of the existence of QBUs with a functional currency other than the US dollar can be found on Forms 5471 (Page 1, Item 1h), 8858 (Page 1, Line 1i) and 8865 (Page 1, Item F8a) attached to the US tax return.
- Income/loss and tax determinations are made in the functional currency of each QBU of a taxpayer. For QBUs with a functional currency other than the US dollar, translation to the US dollar will generally be required when recognition of income/loss (such as from foreign branches, or from foreign corporations remitting dividends), or foreign currency gain/loss (such as remittances from branches under Section 987) is required by a US taxpayer. It should be noted that foreign currency gains/losses from transactions defined in Section 988 may already be included in the taxable income/loss of the QBU from transactions entered into by the QBU which were denominated in a functional currency other than that of the QBU.
- In the case of QBUs of CFCs, the QBU's current E&P is translated into the CFC's functional currency.

# Detailed Explanation of the Concept

## Overview of Qualified Business Units (QBUs)

**Definition of a QBU:** The definition of a QBU is found in IRC 989(a) and Treas. Reg. 1.989(a)-1(b) as noted below. This definition must be met in order for the entity to utilize a functional currency other than the US dollar. A QBU must include every operation that forms a part of a process of earning income in terms vertical, functional, or geographical divisions of a single trade or business capable of producing income.

### Analysis

### Resources

“For purposes of this subpart, the term ‘qualified business unit’ means any separate and clearly identified unit of a trade or business of a taxpayer which maintains separate books and records.” Accordingly, a two-part analysis must be made to determine if an entity is a QBU.

It should be noted that the definition of a QBU requires that the activities must constitute a trade or business in order to qualify as a QBU under Section 989. A holding company, treated as a corporation, is a QBU even if its activities are not sufficient to be a trade or business. However, holding companies treated as DEs/branches may not constitute QBUs.

The Treasury Regulations contain the rules for determining whether there is a QBU.

A corporation is a QBU.

An individual is not a QBU but may have a QBU with a non-US dollar functional currency. However, an activity that does not generate expenses that are deductible under either related to a trade or business under IRC 162 or the production of income under IRC 212(1) or (2) does not qualify as a QBU.

A partnership, trust, or estate is a QBU of a partner or beneficiary.

Treasury Regulations also state that any activity that produces income/loss that is (or treated as) effectively connected income shall be treated as a separate QBU provided that separate books and records are kept. The QBU must use the USD as FC.

- IRC 989(a)

- Reg. 1.989(a)-1(e) Ex. 5.

- Treas. Reg. 1.989(a)-1(b)(2)

- Treas. Reg. 1.989(a)-1(c)

- Rev. Rul. 90-79 – *Currency gain or loss*

- Treas. Reg. 1.989(a)-1(b)(3)

- Treas. Reg. 1.985-1(b)(6)



# Detailed Explanation of the Concept (cont'd)

## Overview of Qualified Business Units (QBUs)

**Trade or Business Determination:** Treas. Reg. 1.989(a)-1(c) requires that a trade or business “must ordinarily include every operation which forms a part of, or a step in, a process by which an enterprise may earn income or profit,...includ[ing] the collection of income and the payment of expenses.” However, this regulation also states: “merely ancillary” activities are not a trade or business, and activities of an individual as an employee are not considered by themselves to constitute a trade or business.

Analysis	Resources
<p>The determination as to whether activities constitute a trade or business is ultimately dependent upon an examination of all the facts and circumstances. Generally, a trade or business for purposes of Section 989(a) is a specific unified group of activities that constitutes (or could constitute) an independent economic enterprise carried on for profit, the expenses related to which are deductible under Section 162 or 212.</p>	<ul style="list-style-type: none"> <li>▪ Treas. Reg. 1.989(a)-1(c)</li> </ul>
<ul style="list-style-type: none"> <li>▪ To constitute a trade or business, a group of activities must ordinarily include every operation which forms a part of, or a step in, a process by which an enterprise may earn income or profit.</li> </ul>	
<ul style="list-style-type: none"> <li>▪ A group of activities must ordinarily include the collection of income and the payment of expenses.</li> </ul>	
<ul style="list-style-type: none"> <li>▪ It is not necessary that the activities carried out by a QBU constitute a different trade or business from those carried out by other QBUs of the taxpayer.</li> </ul>	
<ul style="list-style-type: none"> <li>▪ A vertical, functional, or geographic division of the same trade or business may be a trade or business for this purpose provided that the activities otherwise qualify as a trade or business.</li> </ul>	
<ul style="list-style-type: none"> <li>▪ Activities that are merely ancillary to a trade or business will not constitute a trade or business. Activities of an individual as an employee are not considered by themselves to constitute a trade or business.</li> </ul>	

# Detailed Explanation of the Concept (cont'd)

## Overview of Qualified Business Units (QBUs)

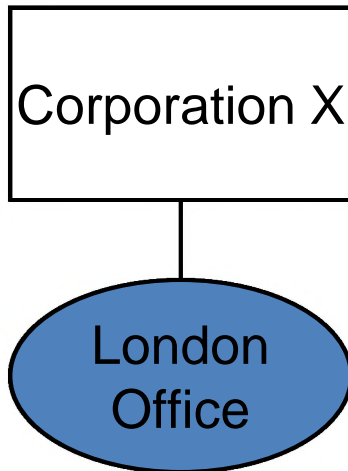
**Books and Records Requirement:** The Treasury Regulations also further define the books and records requirement that must be met for the entity to qualify as a QBU for foreign currency transaction purposes. The regulations state that both books of original entry (journals) and a chronological of impact during the accounting period of specific transactions recorded in the journals impact various accounts on the entity's financial records (ledgers) must be maintained to meet the books and records requirement.

Analysis	Resources
<p>In defining the term “separate books and records,” the Treasury Regulations state: “a separate set of books and records shall include books of original entry and ledger accounts, both general and subsidiary, or similar records.”</p>	<ul style="list-style-type: none"> <li>▪ Treas. Reg. 1.989(a)-1(d)</li> </ul>
<ul style="list-style-type: none"> <li>▪ In the case of a taxpayer using the cash receipts and disbursements method of accounting, the books of original entry include a cash receipts and disbursements journal.</li> </ul>	
<ul style="list-style-type: none"> <li>▪ In the case of a taxpayer using an accrual method of accounting, the books of original entry include journals to record sales (accounts receivable) and journals to record expenses incurred (accounts payable).</li> </ul>	
<ul style="list-style-type: none"> <li>▪ Books and records also include books and records used to determine income or loss that is, or is treated as, effectively connected with the conduct of a trade or business within the United States.</li> </ul>	
<ul style="list-style-type: none"> <li>▪ The books and records of the QBU need not be maintained at the location of the QBU, but may be maintained by its owner.</li> </ul>	

# Examples of the Concept

## Overview of Qualified Business Units (QBUs)

### Example 1



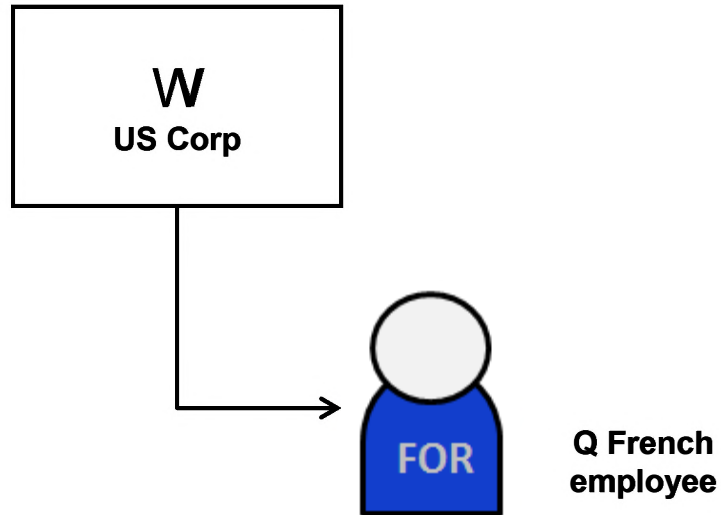
Corporation X is a domestic corporation. Corporation X manufactures widgets in the US for export. Corporation X sells widgets in the UK through a branch office in London. The London office has its own employees and solicits and processes orders. Corporation X maintains in the US a separate set of books and records for all transactions conducted by the London office.

Corporation X is a QBU under Treas. Reg. 1.989(a)-1(b)(2)(i) because of its corporation status. The London branch office is a QBU under paragraph Treas. Reg. 1.989(a)-1(b)(2)(ii) because (1) the sale of widgets is a trade or business as defined in Treas. Reg. 1.989(a)-1(c); and (2) a complete and separate set of books and records (as described in Treas. Reg. 1.989(a)-1(d) is maintained with respect to its sales operations. [See Treas. Reg. 1.989(a)-1(e), Example 1]

# Examples of the Concept (cont'd)

## Overview of Qualified Business Units (QBUs)

### Example 2



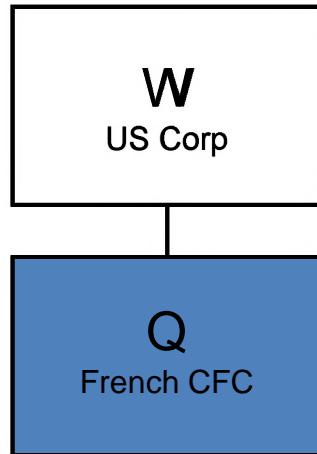
W is a domestic corporation that manufactures product X in the US for sales worldwide. All of W's sales functions are conducted exclusively in the US. W employs individual Q to work in France. Q's sole function is to act as a courier to deliver sales documents to customers in France. With respect to Q's activities in France, a separate set of books and records as described in Treas. Reg. 1.989(a)-1(d) is maintained.

Under Treas. Reg. 1.989(a)-1(c), Q's activities in France do not constitute a QBU since they are merely ancillary to W's manufacturing and selling business. Q is not considered to have a QBU because an individual's activities as an employee are not considered to constitute a trade or business of the individual under Treas. Reg. 1.989(a)-1(c). [See Treas. Reg. 1.989(a)-1(e), Example 3]

# Examples of the Concept (cont'd)

## Overview of Qualified Business Units (QBUs)

### Example 3



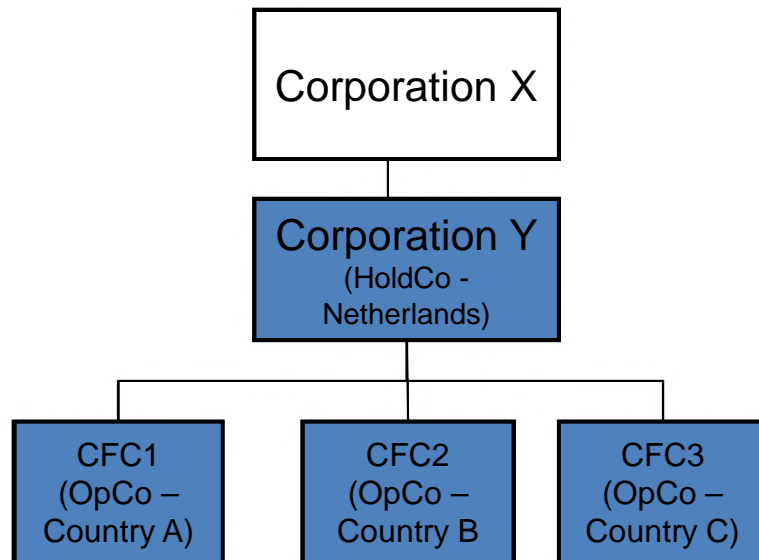
The facts are the same as in the prior slide except the courier function is the sole activity of Q, a wholly-owned French subsidiary of W.

Under Treas. Reg. 1.989(a)-1(b)(2)(i), the French subsidiary is considered to be a QBU. [See Treas. Reg. 1.989(a)-1(e), Example 4]

# Examples of the Concept (cont'd)

## Overview of Qualified Business Units (QBUs)

### Example 4



Corporation Y incorporated in the Netherlands is a subsidiary of domestic Corporation X and a holding company for the stock of one or more subsidiaries incorporated in other countries. The Netherlands corporation's activities are limited to paying its directors and its administrative expenses, receiving capital contributions from its US parent corporation, contributing capital to its subsidiaries, receiving dividend distributions from its subsidiaries, and distributing dividends to its US parent corporation.

Under Treas. Reg. 1.989(a)-1(b)(2)(ii), the Netherlands corporation is considered to be a QBU. [See Treas. Reg. 1.989(a)-1(e), Example 5]

# Training and Additional Resources

## Chapter 18.3.1 Definition of a Qualified Business Unit (QBU)

Type of Resource	Description(s) and/or Instructions for Accessing	References
Saba Meeting sessions	<ul style="list-style-type: none"> <li>▪ IBC ONLY – Foreign Currency &amp; Int'l Matrix (Saba – Public Recordings – Event ID JVQ439517)</li> <li>▪ IBC Common Errors in translating Foreign Currency 44 (Saba – Public Recordings – Event ID PHG711242)</li> <li>▪ The Building Blocks of Financial Products (Saba – Public Recordings – Search on “Building Blocks of Financial Products)</li> <li>▪ IRC 985 and 989 :Foreign Currency Terms and Definitions</li> </ul>	<ul style="list-style-type: none"> <li>▪ 2011 Saba – Foreign Currency &amp; Intl Matrix</li> <li>▪ 2012 Saba – Common Errors in translating Foreign Currency 44</li> <li>▪ 2013 Saba – The Building Blocks of Financial Products</li> </ul>
Other Training Materials (Saba Meeting sessions)	<p>IE Phase III Hybrid sessions:</p> <ul style="list-style-type: none"> <li>▪ IRC 985 and 989 :Foreign Currency Terms and Definitions</li> <li>▪ Section 986 Translation Rules</li> <li>▪ Sec 987 – Branch rules and CTB rules</li> <li>▪ Foreign Currency Section 988 Transactions</li> <li>▪ Foreign Currency Hedging</li> <li>▪ Financial Products Basics – Four Major Categories</li> </ul>	<ul style="list-style-type: none"> <li>▪ 2015 Saba – FC 1 Sec 985 (HQL168303)</li> <li>▪ 2015 Saba – FC 2 986 Transition Rules (FRS408475)</li> <li>▪ 2015 Saba – FC 3 987 Branch Rules &amp; CTB (LVP748808)</li> <li>▪ 2015 Saba – FC 4 Sec 988 Transactions (FTS047865)</li> <li>▪ 2015 Saba – FC 5 Foreign Currency Hedging (HTS256974)</li> <li>▪ 2015 Saba – Financial Products Basics (JNN441732)</li> </ul>

# Training and Additional Resources (cont'd)

## Chapter 18.3.1 Definition of a Qualified Business Unit (QBU)

Type of Resource	Description(s) and/or Instructions for Accessing	References
Other Training Materials	<ul style="list-style-type: none"> <li>▪ IE Phase I, Module E – Lesson 1 Foreign Currency <a href="http://lmsb.irs.gov/hq/mf/training/international/phase1/phase_1.asp">http://lmsb.irs.gov/hq/mf/training/international/phase1/phase_1.asp</a>, Select Module E</li> <li>▪ IE Phase III, Module D –Interaction of International and Financial Products Issues <a href="http://lmsb.irs.gov/hq/mf/training/international/phase3/phase_3.asp">http://lmsb.irs.gov/hq/mf/training/international/phase3/phase_3.asp</a>, Select Module 5.D., second lesson</li> </ul>	
Financial Products Training Material	<p><a href="http://lmsb.irs.gov/hq/fs/financial_products/Resources_Information/training_materials.asp">http://lmsb.irs.gov/hq/fs/financial_products/Resources_Information/training_materials.asp</a></p> <ul style="list-style-type: none"> <li>▪ FP Phase I, Lesson 9 Foreign Currency</li> <li>▪ FP Phase I, Download Financial Products Phase One Participant Guide, then proceed to Lesson 9, page 9-1.</li> <li>▪ FP Phase III, Lesson 4 Foreign Currency</li> <li>▪ FP Phase III, Download Financial Products Phase Three Participant Guide, then proceed to Lesson 4, page 110.</li> </ul>	
Bittker & Lokken – Federal Taxation of Income, Estates and Gifts	<ul style="list-style-type: none"> <li>▪ Bittker and Lokken Para 74.2 Functional Currency (Westlaw subscription)</li> </ul>	<ul style="list-style-type: none"> <li>▪ FIXIEG Para 74.2</li> </ul>
BNA Tax Management Portfolio	<ul style="list-style-type: none"> <li>▪ BNA Portfolio 921-2nd Tax Aspects of Foreign Currency (Westlaw subscription)</li> </ul>	<ul style="list-style-type: none"> <li>▪ BNA 921-2nd – TMFEDPORT No 921 s</li> </ul>



# Training and Additional Resources (cont'd)

## Chapter 18.3.1 Definition of a Qualified Business Unit (QBU)

Type of Resource	Description(s) and/or Instructions for Accessing	References
Mertens Law of Federal Income Taxation	<ul style="list-style-type: none"> <li>▪ Mertens Chapter 45C. SOURCING OF INCOME AND EXPENSE, III 45C:63 Functional currency—Qualified business unit (Westlaw subscription)</li> </ul>	
Keyes: Federal Taxation of Financial Instruments and Transactions	<ul style="list-style-type: none"> <li>▪ Keyes Chapter 15. Foreign Currency Denominated Instruments</li> </ul>	
Accounting Standards Codification (Financial Accounting Standards)	<ul style="list-style-type: none"> <li>▪ ASC830 (FAS52) Foreign Currency Matters</li> <li>▪ Available at <a href="https://asc.fasb.org">https://asc.fasb.org</a>. Will need to register for a free “basic view” service.</li> <li>▪ Westlaw subscription: IRS LB&amp;I Tab. Under Financial Accounting, choose RIA FASB Codification Complete Analysis, Table of Contents. ASC 830 is under the Broad Transactions in the Codification section.</li> </ul>	

# Glossary of Terms and Acronyms

Term/Acronym	Definition
ASC	Accounting Standard Codification
CFC	Controlled Foreign Corporation
DE	Disregarded Entity (a foreign legal entity disregarded for US tax purposes under Treas. Reg. 301.7701-3)
DCN	Document Control Number (for Practice Unit)
E&P	Earnings and Profits
FAS	Financial Accounting Standard
FASB	Financial Accounting Standards Board
FBR	A Foreign Branch (a business operation carried on by a person outside their country of residence)
FC	Functional Currency
HoldCo	A Holding Company (Either US or non-US) of a US Parent
IPS	International Practice Service
IRC	Internal Revenue Code
OCI	Other Comprehensive Income
OpCo	Operating Company (Either US or non-US)
P&L	Profit and Loss Statement (Income Statement)
QBU	Qualified Business Unit
USP	US Parent

# Glossary of Terms and Acronyms (cont'd)

Term/Acronym	Definition
Functional Currency	The currency of the primary economic environment in which the entity operates.

# Index of Related Issues

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Integration of Executory Contract and the Currency Hedge	▪ 9470.02	▪ FCU/9470.02_05
Legging into Integrated Treatment	▪ 9470.02	▪ FCU/9470.02_07
Disposition of a Portion of an Integrated Hedge	▪ 9470.02	▪ FCU/9470.02_03
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Issue	Associated UIL(s)	References
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Calculation of IRC 956 Amount	▪ 9414.01	▪ Under Development