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United States Tax Alert
Key tax considerations related to the Argentine economy being classified as highly inflationary under ASC 830

Overview

This alert discusses recent developments related to the classification of Argentina as a highly inflationary economy under US generally accepted accounting principles (US GAAP) for entities whose functional currency has been the Argentine Peso (ARS). As discussed below, for taxpayers that adopt US GAAP principles in determining whether a country is hyperinflationary for US federal income tax purposes (the "Hyperinflationary Currency"), as provided by Treas. Reg. § 1.985-1(b)(2)(ii)(D), such taxpayers' qualified business units (QBUs) (i.e., controlled foreign corporations (CFCs) and section 987 QBUs) with ARS as their functional currency likely will be required to adopt the United States Dollar Approximate Separate Transactions Method (DASTM) for the taxable year beginning in 2019 (the "2019 Taxable Year").[1]

Summary of impacts on taxpayers

Under Treas. Reg. § 1.985-1(b)(2)(ii), taxpayers' QBUs that otherwise would be required to use a Hyperinflationary Currency as their functional currency are required to compute income, loss, or earnings and profits (E&P) using DASTM.[2] The adoption of DASTM involves complicated computations. First, the taxpayer is required to make certain adjustments to prior year income and/or earnings and profits when a QBU transitions to DASTM and to take such adjustments into account in the adoption year. Second, the taxpayer must adopt the DASTM method going forward for its QBUs that would otherwise use the Hyperinflationary Currency as their functional currency until that currency ceases to be hyperinflationary.

Complex transition rules

Treas. Reg. § 1.985-7 requires that taxpayers transition to DASTM by making certain adjustments covering a three-year "look-back" period beginning three taxable years prior to the taxable year of change and ending on the last day prior to the taxable year of change (the "Transition Rules"). Simply put, taxpayers would compute the adjustments by treating the QBU as though it had been on DASTM since the beginning of the three-year look-back period. The adjustments capture the difference between (i) what the gain, loss, income, and expense of the QBU would have been if the QBU had been on DASTM during the look-back period; and (ii) what the QBU actually reported under the profit and loss method using the Hyperinflationary Currency as the QBU's functional currency. For example, if a CFC (with ARS functional currency) is required to adopt DASTM on January 1, 2019, the CFC must compute its adjustments for taxable years 2016, 2017, and 2018 as if the CFC had been on DASTM since January 1, 2016. As discussed below, the adjustments would be taken into account on a prospective basis only.

Further, for a "section 987 QBU" subject to DASTM, the rules would deem the section 987 QBU to be terminated at the end of the taxable year immediately preceding the three-year look-back period, resulting in the recognition of section 987 gain or loss.[3]

Any adjustments related to a CFC's E&P would be taken into account for the CFC's first taxable year during which it is subject to DASTM. Any adjustments related to the subpart F income of a CFC, or to the taxable income or loss and section 987 gain or loss of a section 987 QBU, are taken into account ratably over the four-year period beginning with the first taxable year.

Use of DASTM prospectively for at least three taxable years

Taxpayers must apply DASTM annually beginning on the first day of the taxable year following the calendar year in which the country becomes hyperinflationary under Treas. Reg. § 1.985-1(b)(2)(ii)(D) and until that currency is no longer considered hyperinflationary under Treas. Reg. § 1.985-1(b)(2)(ii)(E). Whether a country is hyperinflationary is determined based on a three-year look-back period, and once a QBU becomes subject to DASTM it must continue to apply DASTM for at least three taxable years. As discussed below, DASTM provides either a simplified methodology for QBUs whose assets have an adjusted basis of USD 10 million or less at the end of the taxable year in which DASTM applies, or a complicated nine-step methodology for all other QBUs.

Year of adoption

The Transition Rules and application of DASTM could have an effect in the taxable year of adoption, including a potential impact for foreign tax credits, global intangible low-tax income (GILTI), subpart F, and foreign branch income. It is important for impacted organizations to carefully analyze these consequences. Note that the transition to DASTM is not expected to affect computations under section 965.

Foreign currency GAAP considerations

For a discussion of the effect of Argentina's highly inflationary economy under US GAAP, see Deloitte's Financial Reporting Alert 18-

8, **Recent Developments Related to the Classification of Argentina as a Highly Inflationary Economy Under U.S. GAAP** ("FRA 18-8").

FRA 18-8 notes, "Argentina has continued to experience negative economic trends, as evidenced by (i) multiple periods of increasing inflation rates, (ii) devaluation of the peso, and (iii) increasing borrowing rates, requiring the Argentinian government to take mitigating actions." However, as described in FRA 18-8, and based on other publicly available information, no actual consumer price index (CPI) for Argentina was published by the IMF for calendar years ending in 2015 and 2016, and therefore the three-year cumulative CPI data at the end of 2017 was viewed by financial accountants as not completely reliable (due to the source of the data) for purposes of concluding on Argentina's highly inflationary status under ASC 830.[4] Further, due to the lack of reliable CPI data (among other factors), it was concluded for financial reporting purposes that Argentina would not be considered a highly inflationary economy until the second calendar quarter of 2018. Thus, under ASC 830 (as described in FRA 18-8), the rules governing the treatment of highly inflationary economies would start no later than July 1, 2018.

Determination of hyperinflationary currency

For US federal income tax purposes, the term "hyperinflationary currency" means the currency of a country in which there is cumulative inflation during the base period (i.e., the 36 calendar months immediately preceding the first day of the current calendar year) of at least 100% as determined by reference to the CPI of the country listed in the monthly issues of "International Financial Statistics" or a successor publication of the International Monetary Fund (IMF) (see Treas. Reg. § 1.985-1(b)(2)(ii)(D)). If a country's currency is not listed in the monthly issues of "International Financial Statistics," a QBU may use any other reasonable method consistently applied for determining the country's CPI. In making the determination of whether a currency is hyperinflationary, the determination for purposes of US GAAP may be used for income tax purposes, provided (i) the determination is based on criteria that are substantially similar to the tax rule set forth above; (ii) the method of determination is applied consistently from year to year; and (iii) the same method is applied to all related persons, as defined in Treas. Reg. § 1.985-3(e)(2)(vi).

As discussed in FRA 18-8, no CPI was published by the Argentinian government or the IMF for certain months during 2015 and 2016. Considering that fact, combined with the potential unreliability of the three-year cumulative CPI data for calendar year 2017, it seems that following the US GAAP determination, which uses various indices to approximate a reliable CPI, is a reasonable method in determining Argentina's cumulative CPI for US federal income tax purposes. Therefore, for taxpayers who follow the US GAAP methodology in determining hyperinflationary status, it is likely that the ARS would be a hyperinflationary currency as of the 2019 Taxable Year.

Scope and key provisions of DASTM

Affected QBUs

DASTM applies to QBUs as defined under Treas. Reg. § 1.989(a)-1, including CFCs, branches, and partnerships, with certain exceptions. DASTM is not required for foreign corporations and QBUs of such corporations if the foreign corporation does not qualify as a CFC (within the meaning of section 957 or section 953(c)(1)(B)). However, for non-controlled foreign corporations (i.e., foreign corporations in which 10% US shareholders own 50% or less of the stock under section 904(d)(2)(E)) and their QBUs, DASTM may be applied on an elective basis. Treas. Reg. § 1.985-1(b)(2)(ii)(B)(1) provides a special rule for QBU branches of CFCs that do not use the US dollar (USD) as their functional currency.

Transition rules

As noted above, the Transition Rules require a QBU to adjust its income measured in the hyperinflationary currency during the transition period to effectively put the QBU in the same position as if it had applied DASTM for the three taxable years preceding the taxable year of adoption. For a CFC, these adjustments include (i) reduction or increase to the CFC's E&P for certain section 988 transactions denominated in USD that were held by a CFC on the day before the start of the three-year look-back period (the "Transition Date") or entered into and terminated by a CFC during the look-back period; (ii) redetermination of the CFC's opening balance sheets for the taxable year of change; (iii) translation by category of the CFC's post-1986 undistributed E&P; and (iv) potential adjustments at the US shareholder level for subpart F income, a deemed distribution of previously taxed income, and foreign tax credit.

For QBUs to which section 987 applies, these adjustments include (i) recognition of gain or loss for section 988 transactions denominated in USD and outstanding on the Transition Date; (ii) reductions and increases to income for section 988 transactions denominated in USD and terminated during the look-back period; (iii) deemed termination of such QBUs under section 987 on the Transition Date; (iv) adjustments to branch income reported during the look-back period; and (v) redetermination of QBUs' opening balance sheets for the taxable year of change.

Overview of DASTM computation

As the name suggests, DASTM is intended to approximate the results that would be obtained if the QBU had adopted the USD as its functional currency and USD books and records had been maintained. To achieve this result, Treas. Reg. § 1.985-3 provides that the income or loss and E&P (or deficits in E&P) of a QBU are measured first in local currency, and then translated into USD using the following four-step methodology:

(i) Prepare an income or loss statement from the QBU's books and records in the QBU's hyperinflationary currency;

(ii) Adjust the QBU's income or loss statement as necessary to conform the statement to US GAAP and tax accounting principles, including adjustments to reverse the impact of any monetary correction regime required by local accounting principles;

(iii) Translate the adjusted amounts shown in the hyperinflationary currency income or loss statement into USD;

(iv) Adjust the resulting USD income or loss or E&P and, if necessary, particular items of gross income, expense or other amounts, to reflect the amount of "DASTM gain or loss."

According to Treas. Reg. § 1.985-3(c)(1), a QBU is required to use the exchange rate for the translation period to which an item relates when translating each item from the local currency income or loss statement and balance sheet into USD under the methodology described above. As a general rule, Treas. Reg. § 1.985-3(c)(7)(i) provides that a translation period is a month within a QBU's taxable year, although certain other methods are permitted, provided they are applied consistently from year to year.

To determine DASTM gain or loss, as required by step (iv) above, a QBU must first determine its change in net worth for the taxable year measured in USD. The QBU must prepare an opening and closing balance sheet for the taxable year in the hyperinflationary currency, make GAAP and tax adjustments to the balance sheets, and translate the balance sheets into USD using rates that are generally consistent with the profit and loss translations, except that financial assets and liabilities are generally translated into USD using beginning-of-year rates and end-of-year rates, respectively. The QBU's change in USD net worth is calculated by subtracting the aggregate dollar amount of its balance sheet assets and liabilities at the beginning of the year from the aggregate dollar amount of the balance sheet assets and liabilities at year-end. DASTM gain or loss is equal to the change in USD net worth for the year, plus the dollar amount of any items that decreased net worth but did not affect taxable income or E&P (e.g., dividend distributions, nondeductible expenses), minus the dollar amount of any items that increased net worth but did not affect taxable income or E&P (e.g., capital contributions, tax-exempt income), minus any dollar income or E&P as determined above under steps (i) through (iii) above. In essence, DASTM gain or loss is intended to approximate the transactional exchange gain or loss that would be recognized by the QBU if it actually maintained USD books and records and used USD as its functional currency.

Once determined, DASTM gain or loss is allocated to specific items of the QBU's income or expense using one of two methods: (i) a simplified elective method provided for QBUs whose assets have an adjusted basis of USD 10 million or less at the end of the taxable year; or (ii) a complicated nine-step methodology for all other QBUs. In general, under the simplified approach, DASTM gain or loss is allocated ratably to all items of the QBU's gross income based on the gross income determined prior to the DASTM adjustment. A detailed description of the nine-step methodology is beyond the scope of this alert.

Conclusion

For taxpayers that follow the US GAAP methodology in determining whether a currency is hyperinflationary for tax purposes, the ARS may be a hyperinflationary currency for tax purposes as of the taxable year beginning in 2019, and such taxpayers' CFCs and section 987 QBUs with ARS as their functional currency may be required to adopt DASTM at the beginning of such taxable year. Impacted organizations should carefully analyze the potential impact of adopting DASTM.

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[1] For taxpayers not choosing book-tax conformity, it may be possible to adopt DASTM earlier (i.e., for tax years beginning in 2018), or, alternatively, to avoid the adoption of DASTM for the 2019 Taxable Year if the rate of inflation in Argentina were to slow substantially for the second half of calendar year 2018. However, the considerations involved in making such determinations are highly factual and at present are somewhat uncertain, and thus are beyond the scope of this alert.
[2] Note that if the QBU's functional currency is otherwise required to be USD under Treas. Reg. § 1.985-1(b)(1) or (c), DASTM does not apply.
[3] See below for an exception for section 987 QBUs owned by CFCs with functional currencies other than USD.
[4] See **IMF World Economic Outlook, April 2018, Cyclical Upswing, Structural Change** at 217; Center for Audit Quality Discussion Document **"Monitoring Inflation in Certain Countries, May 2018"**; Center for Audit Quality Discussion Document **"Monitoring Inflation in Certain Countries, November 2017."**

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