Client Alert
January 9, 2017

Treasury Releases Final & Temporary Section 987 Branch Currency Translation Regulations

Subpart J of the Code governs the recognition of currency gains and losses and translation of certain assets from one currency environment to another.[1] Specifically, under Code Section 989, individuals, corporations, and the "qualified business units" or "QBUs" that they own must have a "functional currency" in which he/she/it computes profit or loss. In broad strokes, Subpart J of the Code attempts to address what happens when a taxpayer or its QBU engages in a transaction that is denominated in a currency other than its functional currency (*a.k.a.*, a "non-functional currency"). Subpart J also addresses what happens when assets, liabilities, profit or loss need to be translated from one functional currency environment to another.

> **EXAMPLE:** U.S. Corp is a domestic corporation that owns all of the outstanding shares of a UK private limited company ("UKDRE") that conducts a business and has elected to be treated as a disregarded entity for U.S. tax purposes. UKDRE uses the British pound as its functional currency and UKDRE borrows Euros from an unrelated party bank.

In the foregoing example, Code Section 988 governs the computation of UKDRE's recognition of foreign currency gain or loss on the repayment of the Euro borrowing from the bank. This provision measures UKDRE's transaction-based foreign currency gain or loss in pounds. Yet, USCO owns UKDRE, UKDRE's profit and loss flow up to USCO, and USCO has to file its U.S. Form 1120 in United States dollars. To address the fact that UKDRE's profit and loss need to be translated into U.S. dollars so that it can be reported on USCO's tax return, section 987 provides rules to effect that translation. Section 987 also governs how U.S. tax basis is computed when UKDRE distributes (or "remits") assets to USCO and those assets leave the pound balance sheet and need to be reflected on USCO's U.S. dollar balance sheet.

On December 7, 2016, the United States Treasury and the Internal Revenue Service (collectively, "Treasury") released over 250 pages of regulations under Subpart J. Although the regulations address a number of issues under subpart J, they are primarily focused on the implementation of section 987 and so we sometimes refer to them collectively as the "Section 987 Regulations". Some of the regulations are final ("Final 987 Regulations") and some are temporary ("Temporary 987 Regulations").

The Section 987 Regulations represent a significant departure from existing practice for the vast majority of U.S.-based multinationals. Although the regulations do provide a transition period, taxpayers would be well-advised to start considering any systems changes they will need to make now. This is because the Section 987 Regulations require the taxpayer to maintain

[1] Unless otherwise noted, all Code, section and Treas. Reg. § references are to the United States Internal Revenue Code of 1986, as amended.

information that is not required for U.S. Generally Accepted Accounting Principles ("GAAP") purposes, or for any other purpose. Thus, unless taxpayers can plan their way out of section 987, compliance with these regulations will likely represent a very significant exercise for many taxpayers.

I. History Up to this Point

To understand the significance of the Section 987 Regulations, it is important to understand some history. In the 30 years since the enactment of section 987, there have never been final regulations interpreting section 987. Treasury first issued proposed regulations under section 987 in 1991 (the "1991 Proposed Regulations"). The 1991 Proposed Regulations remained in proposed form until they were withdrawn in 2006 at which time Treasury issued new proposed regulations in 2006 (the "2006 Proposed Regulations"). The 2006 Proposed Regulations had a prospective effective date and applied to taxable years beginning one year after the first day of the first taxable year following the date of publication of a Treasury decision adopting this rule as a final regulation in the Federal Register. However, Treasury said that until final regulations were published, it would consider positions consistent with the 1991 Proposed Regulations or the 2006 Proposed Regulations to be reasonable constructions of the statute. Treasury also considered an "earnings only" approach (in which section 987 exchange gain or loss is only recognized on the earnings of a QBU and not its capital) to be a reasonable interpretation of section 987.

The 1991 Proposed Regulations

Under the 1991 Proposed Regulations, the income or loss of the QBU for the year is calculated in the QBU's functional currency, then that profit or loss amount is translated into the owner's functional currency, to be included in the owner's income for the year, at the average exchange rate for the year. Assuming the owner's functional currency was the U.S. dollar, the owner was required to maintain a "basis pool" equal to its U.S. dollar tax basis in the assets transferred to the QBU plus the U.S. dollar basis in the QBU's earnings. The owner was also required to maintain an "equity pool" that reflected the QBU's balance sheet in its functional currency. The owner only had to calculate a gain or loss when the QBU made a "remittance" of property to the owner or the QBU terminated. The gain or loss was calculated by translating the value of the remittance into the owner's currency at the spot rate, and then comparing that to a pro rata portion of the owner's tax basis pool. The difference was gain or loss. Importantly, if there was a remittance, there was no attempt under the 1991 Proposed Regulations to calculate a "gain" or "loss" that was unique to a specific item of property. Instead, any remittance of any property (even a recently acquired item of inventory) on the QBU's balance sheet could trigger recognition of section 987 gain or loss.

The primary advantage of the 1991 Proposed Regulations was that they were relatively easy to understand and apply. They also relied on information and exchange rates that taxpayers had to assemble anyway for accounting purposes. Specifically, the 1991 Proposed Regulations were "roughly" similar to what taxpayers did for GAAP purposes. When the FASB adopted Financial Accounting Standard ("FAS") 52, it endorsed the "functional currency" approach for determining profit and loss. Under this approach an entity had to choose a functional currency and then compute its profit or loss in its functional currency, whatever that may be. In addition, the relative book values of assets and liabilities are maintained throughout the process, because both monetary and non-monetary assets are translated into U.S. dollars using a single exchange rate – the spot exchange rate as of the balance sheet date. FAS 52 has since been codified as Accounting Standards Classification ("ASC") 830.

In Notice 2000-20, Treasury stated that it was concerned that the 1991 Proposed Regulations were susceptible to abuse. The notice referred to a number of concerns. Yet, in particular, Treasury wanted to prevent taxpayers from claiming what it perceived to be unjustified currency losses on non-monetary assets, like equipment and buildings and oil rigs. Rather than modify the 1991 Proposed Regulations, Treasury chose to go back to the drawing board and re-think some of the underlying principles surrounding foreign currency translation. This led to the promulgation of the 2006 Proposed Regulations, which we discuss below.

The 2006 Proposed Regulations

On September 7, 2006, Treasury issued new proposed regulations that departed from the 1991 Proposed Regulations and adopted a new approach – the "foreign exchange exposure pool method" - for determining section 987 gains or loss. The 2006 Proposed Regulations represented a major shift away from GAAP reporting requirements.

In general, the foreign exchange exposure pool method provides that the income of a Section 987 QBU is determined by reference to the items of income, gain, deduction and loss booked to the Section 987 QBU in its functional currency, adjusted to reflect U.S. tax principles, but then translated into the functional currency of the Owner (defined below) at specified exchange rates. The general rule is that items of income, gain, deduction and loss of a Section 987 QBU are translated into the functional currency of the Owner at the average exchange rate for the year. This general rule is no different from the 1991 Proposed Regulations. There is a very significant exception, however, which essentially swallows the rule. Specifically, income, expense (i.e., depreciation expense), gains and losses on what the regulations referred to as Historic Assets (defined below) were calculated using historic exchange rates determined on the dates the assets were transferred to, or otherwise acquired by, the QBU. The rationale for this exception is that Treasury does not want the Owner to recognize section 987 gain or loss with respect to these assets. It is easiest to illustrate with a simple example.

> **EXAMPLE:** USCO owns all of the stock of a UK disregarded entity ("UKDRE"). UKDRE has the British pound as its functional currency. USCO uses the calendar year for tax purposes. USCO contributes some equipment to UKDRE on December 31, 2018, with a basis of $1,000,000. The average exchange rate for the year is $2:£1. Thus, the equipment gets translated into the UKDRE's functional currency environment at £500,000. The equipment has a 10 year useful life and so UK DRE takes £50,000 of depreciation deductions for the 2019 tax year. UK DRE has no other revenues or expenses. The average exchange rate during 2019 is $1.75:£1. The spot exchange rate at December 31, 2019, is $1.90:£1. At the end of 2019, USCO subtracts the U.S. dollar value of its UKDRE balance sheet at the beginning of the year ($1,000,000)[2] from the U.S. dollar value of

[2] This figure represents £500,000 translated at the historic $2:£1 exchange rate.

the UKDRE balance sheet at the end of the year (increased to reflect the loss during the year) ($1,000,000)[3] to ascertain its potential section 987 gain.

Importantly, given that the only asset on the QBU's balance sheet in the foregoing example is an Historic Asset, there is no change in the U.S. dollar value of the UKDRE's balance sheet.

As the foregoing example implies, the foreign exchange exposure pool method uses a balance sheet approach to determine exchange gain or loss with respect to monetary assets and liabilities denominated in the Section 987 QBU's functional currency, which is then recognized upon a remittance. Use of this approach forces taxpayers to distinguish between those items whose value fluctuates with respect to changes in the functional currency of the Owner and those which do not. Under this method, exchange gain or loss with respect to these Marked items (defined below) is identified annually but is pooled and deferred into an account ("net unrecognized section 987 gain or loss") that the Owner is required to maintain annually until a remittance is made. A Marked Item is generally defined as an asset or liability that is considered a section 988 transaction but denominated in the QBU's functional currency. An Historic Item is an item that is not a Marked Item. Thus, for example, a Euro QBU that has a receivable denominated in Euros and inventory would have a Marked Item (the receivable) and an Historic Item (the inventory).

It is important to note that the Section 987 gain or loss computed under the 2006 Proposed Regulations is an entirely different economic concept than the Section 987 gain or loss computed under the 1991 Proposed Regulations. Under the 1991 Proposed Regulations, the Section 987 gain or loss arose from the change in the value of the Owner's net equity investment in the Section 987 QBU arising as a result of foreign currency fluctuations. Under the 2006 Proposed Regulations, the Section 987 gain or loss arises from a change in value of the Section 987 QBU's net monetary assets or liabilities denominated in the Section 987 QBU's functional currency, which is effectively a surrogate for a subset of Section 988 gains or losses. The difference between these concepts is illustrated in the case of a Section 987 QBU that has positive equity but that has monetary liabilities greater than its monetary assets such as a manufacturing branch that has borrowed to finance its buildings and equipment. Under the 1991 Proposed Regulations, the Owner would have a Section 987 gain as the Section 987 QBU's currency appreciated against the Owner's currency, because the Owner's equity investment in the Section 987 QBU would become more valuable as the local currency appreciated. Under the 2006 Proposed Regulations, the Owner would have a Section 987 **loss** as the Section 987 QBU's currency appreciated against the Owner's currency because the currency gain in the buildings and equipment is not taken into account under the 2006 Proposed Regulations to offset the currency loss on the liability.

The 2006 Proposed Regulations were heavily criticized for their impracticality. For example, when computing the costs of goods sold for inventory, taxpayers would need to reflect multiple historic exchange rates for the different inputs. In addition, accounting software would have to be developed that was capable of tracking such amounts.

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[3] This figure represents the sum of £450,000 and £50,000 translated at the historic $2:£1 exchange rate.

Given the uncertainty and complexity of the different sets of proposed regulations, there is no one method that taxpayers are currently using. Instead, compliance with respect to section 987 varies greatly from taxpayer to taxpayer. Some taxpayers do nothing. Some taxpayers attempt to apply some variant of the Proposed 1991 Regulations that aligns with information they compile for GAAP purposes. Some attempt to comply with the Proposed 1991 Regulations but use an "earnings only approach". Some attempt only to address first tier Section 987 QBUs, whereas others apply section 987 more broadly to all of their section 987 QBUs. Given the limited statutory guidance and absence of final regulations, there has simply not been any single "right" way to address section 987 thus far. The Section 987 Regulations will obviously change that.

II. Companies Affected, Effective Dates and Immediate To Dos

The Section 987 Regulations represent a fundamental shift in the way in which taxpayers previously have been tracking their foreign currency gains and losses for their Section 987 QBUs. Thus, taxpayers are likely to be asking themselves the following questions with respect to the Section 987 Regulations.

Are they affected by the Section 987 Regulations? The simple answer is that every individual or "C" corporation taxpayer that operates in a different country through a branch, disregarded entity or maintains a separate set of books and records for a line of business in a currency different than its Owner is affected by the Section 987 Regulations. However, the taxpayers that should care most about the Section 987 Regulations are those taxpayers who have significant numbers of material foreign disregarded entities. Some of these taxpayers may be able to plan their way out of section 987 by choosing to "uncheck" or incorporate their existing Section 987 QBUs. For example, assume that a U.S. corporation has a Section 987 QBU using the Euro as its functional currency that has historically generated losses. That U.S. corporation could choose to incorporate that QBU before the effective date of the Section 987 Regulations to avoid the application of the new rules. This requires a comparison of the costs of incorporation (*i.e.*, section 367(a) branch loss recapture, section 904(f) loss recapture, and dual consolidated loss or "DCL" recapture) against the benefits of avoiding section 987 compliance.

Other companies, however, have "all-checked" structures to avoid subpart F or to facilitate partnership splitter structures. They may have multiple material disregarded entities. These companies may simply not have any choice but to continue owning these disregarded entities in disregarded form. All of these companies should pay particular attention to the Section 987 Regulations.

When do the Section 987 Regulations go into effect? The effective date for the vast majority of the Section 987 Regulations is for the first taxable year beginning after December 6, 2017. Thus, for most taxpayers, the Section 987 Regulations will become effective for tax years beginning on January 1, 2018. However, taxpayers can elect to apply the Section 987 Regulations to taxable years beginning after December 7, 2016. Practically, however, it is unlikely that a taxpayer who is not already on the 2006 Proposed Regulations will be able to elect to apply the Section 987 Regulations early because of the considerable compliance hurdles and information required to apply these rules.

That being said, there are certain portions of the Section 987 Regulations that apply to taxpayers ***now***. Specifically, the Temporary 987 Regulations relating to Deferral Events and Outbound Loss Events entered into with a principal purpose of recognizing section 987 losses went to effect on December 7, 2016. Otherwise, those same rules relating to Deferral Events and Outbound Loss Events go into effect on January 6, 2017, with respect to all transactions whether executed with a principal purpose of avoidance or not.

The chart attached to the end of this alert provides a summary of all the key dates within the Section 987 Regulations.

What do taxpayers need to do to prepare for the Section 987 Regulations and when should they do it? The time to start preparing for Section 987 Regulations is ***now***. While the effective date for the Section 987 Regulations will begin for most taxpayers starting on January 1, 2018, that still might not be enough time for taxpayers to adequately prepare and get their systems ready. The potential compliance issues for taxpayers are massive and daunting, especially with respect to tracking inventoriable costs (*i.e*., interest expense or depreciation expense that has to be capitalized into the cost of inventory).

Most taxpayers are following GAAP and not making significant adjustments for tax. This will have to change. Compliance with the Section 987 Regulations will require "systems" changes either to their accounting software or tax software, as it likely will not be possible for taxpayers to perform all of the computations required in an Excel spreadsheet outside of their accounting software.

PLANNING POINTER: Treasury incorporated two helpful elections into these new regulations to try and ameliorate some of the difficulties of these new regulations. The first is an election to "deem" all Section 987 QBUs to terminate every year and use an average exchange rate to translate certain items. However, taxpayers will need to be prepared to make that election the FIRST year the regulations apply (most likely calendar years beginning January 1, 2018) or else their ability to make the election later will be limited. There are a number of other elections that taxpayers have to consider for the first year in which these elections apply, which are set forth in the timeline at the end of this alert.

In addition, taxpayers would be well advised to take notice that section 987 gain or loss is not just something that impacts the E&P of a CFC. Treasury is taking the position that section 987 gain is subpart F income. Although we believe taxpayers have strong arguments that the Treasury lacks the authority for that position, it is the position Treasury took in the Final 987 Regulations. We elaborate more on this issue below for those taxpayers that may choose to challenge the authority of this portion of the regulations on a go-forward basis.

III. Transition Rules

Regardless of whether the taxpayer waits until the effective date in 2018 or elects to apply the Final 987 Regulations on an earlier date, the same transition rules apply.

As noted above, the vast majority of taxpayers did not apply the 2006 Proposed Regulations after they were released. For those taxpayers, the transition from their existing method (whatever that may be) to the Section 987 Regulations is effected using the "fresh start" transition method. Under this method, all Section

987 QBUs are deemed to terminate (solely for purposes of section 987) and re-form into new Section 987 QBUs. Importantly, even though the Section 987 QBUs are deemed to terminate, Section 987 gain or loss is ***not*** taken into account under the taxpayer's prior method on the deemed termination. Rather, the sole purpose of the termination is to eliminate and eradicate the taxpayer's history of unrecognized section 987 gain or loss with respect to the Section 987 QBU. To compute the balance sheet of the new Section 987 QBU in the owner's functional currency, the taxpayer has to use historic rates (*i.e*., the exchange rate that existed when the asset was transferred to or acquired by the QBU). Note that these historic rates are used for ***all*** assets and liabilities, not just Historic Items. Most taxpayers will not have this information readily available because there was no reason to have maintained it. In that case, the Section 987 Regulations allow taxpayers to make reasonable assumptions about the date when assets were contributed to or acquired by the Section 987 QBU.

The effect of this rule is twofold. First, currency gain or loss on Historic Assets (*e.g*., plant, property, equipment, inventory, intangibles) is never recognized. Second, at the end of the first year to which the Final 987 Regulations apply, the Marked Items, having a historic basis, will generate section 987 gain or loss for the period between the time the asset was acquired by the old Section 987 QBU (not the new Section 987 QBU) to the last day of the first year. This latter amount is not recognized unless or until there is a remittance or a termination of the "new" Section 987 QBU.

The only exception to the foregoing rule is for that small group of taxpayers who already transitioned to the 2006 Proposed Regulations. These taxpayers simply apply the Section 987 Regulations going forward. The Final 987 Regulations do, however, provide rules clarifying how net unrecognized section 987 gain or loss with respect to a Section 987 QBU that was subject to the 2006 Proposed Regulations is determined under the Final 987 Regulations. Also, because the 2006 Proposed Regulations required the use of a spot historic rate whereas the Final 987 Regulations generally require that a yearly average historic rate be used, the Final 987 Regulations permit taxpayers to continue to use their historic rates solely for those assets and liabilities reflected on the Section 987 QBU's balance sheet as of the transition date.

IV. Key Definitions

Like any comprehensive regulation package, the definitions drive the application of the rules. To facilitate understanding, below are some of the Key Definitions provided in the Section 987 Regulations and used throughout this client alert.

QBU: A QBU is any separate and clearly identified unit of a trade or business of a taxpayer provided that separate books and records are maintained. It is important to note that it is the trade or business itself, and not the entity that owns the trade or business, that represents the QBU.

Eligible QBU: An Eligible QBU means a QBU that is not subject to the Dollar Approximate Separate Transactions Method ("DASTM") rules of Treas. Reg. §1.985-3. The DASTM rules apply to QBUs in a hyperinflationary environment.

Section 987 QBU: A Section 987 QBU is an Eligible QBU that has a functional currency (as determined under Treas. Reg. §1.985-1) different from its direct Owner (defined below). A Section 987 QBU also includes the assets and liabilities of an Eligible QBU that are considered to be a Section 987 QBU of a partner in a Section 987 Aggregate Partnership.

The Final 987 Regulations do not apply to "specified entities", which are defined to mean banks, insurance companies, leasing companies, finance coordination centers, regulated investment companies, or real estate investment trusts. Nonetheless, a treasury center that primarily make loans to affiliates could still constitute a Section 987 QBU.

Owner: Only an individual or corporation may be an Owner. So S corporations, trusts, and partnerships (other than Section 987 Aggregate Partnerships) cannot be Owners. An Owner is any individual or corporation having direct or indirect ownership in an Eligible QBU.

An Owner does not include an Eligible QBU. So one Section 987 QBU cannot be the Owner of another Section 987 QBU. This also means that an individual or corporation is considered to "directly" own an Eligible QBU even though that ownership is through another Eligible QBU.

> **EXAMPLE:** USCO is a domestic corporation that owns all of the outstanding shares of a UK private limited company that has elected to be considered a disregarded entity ("UKDRE") that conducts a business and uses the pound as its functional currency. UKDRE, in turn, owns all of the outstanding shares of a Dutch entity ("DUTCH DRE") that conducts a business, uses the Euro as its functional currency, and has elected to be treated as a disregarded entity. USCO is considered to own the assets and liabilities of DUTCH DRE "directly" even though the assets and liabilities are, legally, owned indirectly through UKDRE.

Section 987 Aggregate Partnership: At present, the Section 987 Regulations (not including the Treas. Reg. §1.987-12T anti-abuse rules) only apply to those partnerships that are considered Section 987 Aggregate Partnerships. A partnership is a Section 987 Aggregate Partnership if: (a) all of the interests in partnership capital and profits are owned, directly or indirectly, by persons related to each other[4]; and (b) the partnership owns one or more Eligible QBUs, at least one of which would be a Section 987 QBU with respect to a partner if the partner owned the Eligible QBU directly. The assets and liabilities of an Eligible QBU owned through a Section 987 Aggregate Partnership and allocated to a partner under the principles of §1.987-7(b) are considered to be a Section 987 QBU of such partner if the partner has a functional currency different from that of the Eligible QBU. Stated differently, the Section 987 Regulations treat Section 987 Aggregate Partnerships as "pure" aggregates of their partners. To make this regime work, some transactions that would normally be tax-free under subchapter K (*i.e.*, section 721 contributions) become taxable events under this regime.

> **EXAMPLE:** X owns all of the stock of Y and Z. X, Y and Z are all domestic corporations with the dollar as their functional currency. X and Y each own 50 percent of the equity in P, a partnership. P conducts Business A using the Euro as its functional currency. Z

[4] Relatedness is determined with the meaning of sections 267(b) or 707(b), taking into account constructive ownership rules in section 267(c) except for section 267(c)(3)

> contributes cash to P and, thereby, obtains a 20 percent equity interest in P. P is a Section 987 Aggregate Partnership. Each of X and Y have a Section 987 QBU with respect to their portion of Business A's assets and liabilities which they are considered to own "indirectly". *See e.g.*, Treas. Reg. §1.987-2(c)(10) Example 6.

Normally, Z's acquisition of an equity interest in P would be a tax-free event to X, Y and Z. This is because Subchapter K does not treat X and Y as having "disposed" of its pro rata shares of Business A to Z in exchange for cash. The problem is that the Section 987 Regulations treat P as a complete aggregate of its partners. Thus, before the contribution X and Y each owned 50 percent of the Business A assets. After Z's contribution, however, they only own 40 percent of the Business A assets and they each have 40 percent of Z's contributed cash. Thus, the Section 987 Regulations require the parties to hypothesize that Z transferred a portion of its cash to X and Y for a portion of their Business A assets and then each of X, Y, and Z are deemed to contribute cash (in the case of X and Y) or Business A assets (in the case of Z) to their respective Section 987 QBUs. In order to make this work, the regulations hypothesize that a portion of the Business A assets (the portion that were transferred to Z) are deemed to be remitted to X and Y before being transferred. This can trigger recognition of section 987 gain or loss. As will be noted below in the discussion of the -12T Rules (defined below), those gains and losses may be deferred. The primary takeaway for taxpayers, however, is to understand that the Section 987 Regulations create yet another complex overlay (much like the dual consolidated loss rules or the overall foreign loss rules) that can trump the traditional non-recognition provisions under subchapter C or subchapter K.

The foregoing example can be made much more complicated if the partnership in question does not share profits and losses ratably. In those cases, the partners must determine what their "share" of the partnership's assets and liabilities is. Under the Temporary 987 Regulations, a partner of a Section 987 Aggregate Partnership is treated as owning a share of a Section 987 QBUs assets and liabilities according to the partner's "liquidation value percentage". The Liquidation Value Percentage has recently become Treasury's go-to method for estimating a partner's interest in a partnership (see the recently finalized regulations under Section 956 and the temporary regulations under Section 385). A partner's Liquidation Value Percentage is generally the value of the cash and property a partner would receive in a liquidation of a partnership, as of certain testing dates detailed in the Temporary 987 Regulations.

The issue that makes section 987 particularly tricky is that not all assets and liabilities owned by a partnership are necessarily part of the business that gives rise to the Section 987 QBU. See Treas. Reg. §1.987-2(b)(1) and (4). Only those assets that are owned by the partnership AND reflected on the books and records of the applicable QBU are considered part of the Section 987 QBU.

PLANNING POINTER: One idea for taxpayers to consider is to retain ownership of monetary assets and liabilities at the partnership level outside of, and off of, the Section 987 QBU's balance sheet to thereby minimize the amount of section 987 gain or loss they are creating.

Direct Ownership: An individual or a corporation is a direct Owner of an Eligible QBU if the individual or corporation is the Owner for U.S. Federal income tax purposes of the assets and liabilities of the Eligible QBU. For example, if USCO owns QBU1 which owns QBU2, USCO is considered to own both QBU1 and QBU2 ***directly***. This is a topic the IRS sought comments on back in Notice 2000-20, and they have resolved the issue in favor of the "flat" or "horizontal" view of QBUs.

Indirect Ownership: An individual or corporation that is a partner in a Section 987 Aggregate Partnership and is allocated all or a portion of the assets and liabilities of an Eligible QBU of such partnership is an Indirect Owner of the Eligible QBU.

Grouping Rules: In general, an Owner may elect to treat all directly-owned Section 987 QBUs, with the same functional currency, as a single Section 987 QBU. An Owner may also elect to treat all Section 987 QBUs with the same functional currency owned indirectly through the same Section 987 Aggregate Partnership as a single Section 987 QBU. Contrast these rules with the "separate unit combination rule" in the DCL area where two U.S. consolidated group members can separately own foreign disregarded entities and yet combine them for DCL purposes. *See* Treas. Reg. §1.1503(d)-1(b)(4)(ii). The same two entities are separate for purposes of the Section 987 Regulations.

A grouping election is made by attaching a statement to the Owner's tax return for the first taxable year in which the election is required to be made.

Spot Rate: Subject to certain exceptions, the Spot Rate generally means the fair market rate of exchange based on publicly available information in the free market at the time of the relevant transaction. Use of the Spot Rate will vary depending on the convention chosen for applying the Spot Rate. For example, under a month-to-month convention the Spot Rate may be the average rate for a particular month.

Historic Rate: The Historic Rate generally refers to the yearly average exchange rate for the year in which the asset is acquired. The yearly average exchange rate is, in turn, a rate that represents an average exchange rate for the taxable year (or, if the relevant period is less than a full taxable year, such portion of the taxable year) computed under any reasonable method. Use of an averaging convention that is consistent with the convention used for financial accounting purposes is presumed to be a reasonable method. The Historic Rate for inventory is determined under a different set of rules illustrated in further detail below.

Marked Items: A Marked Item is an asset ("Marked Asset") or a liability ("Marked Liability") that is properly reflected on the books and records of a Section 987 QBU that:

(1) is denominated in, or determined by reference to, the functional currency of the Section 987 QBU, is not a section 988 transaction of the Section 987 QBU, and would be a section 988 transaction if such item were held or entered into directly by the Owner of the Section 987 QBU,

(2) is a prepaid expense or a liability for an advance payment of unearned income, in either case having an original term of one year or less on the date the prepaid expense or liability for an advance payment of unearned income arises, or

(3) gives rise to a Qualified Short-Term Section 988 Transaction of the Section 987 QBU, whether denominated in the functional currency of the Owner or other nonfunctional currency with respect to the Section 987 QBU, for which section 988 gain or loss is determined in, and by reference to, the functional currency of the Section 987 QBU.

This definition may be confusing, but becomes easier to understand if the reader understands what Treasury is trying to do. Remember that Treasury does not want Owners to recognize currency gains or losses in non-financial assets. Hence, they are trying to isolate only those assets on the QBU's books that are financial in nature (*i.e.*, cash, loans receivable, loans payable, and certain derivatives). That is the rationale for the first requirement. At the same time, Treasury does not want Owners to manipulate the rules by having their QBUs enter into financial transactions in a currency other than the QBU's functional currency. That is why they exclude all section 988 transactions from the first paragraph other than very short term transactions that are marked to market and which are described in paragraph (3). Although the preamble does not explain the rationale for this exception, Treasury presumably included it to facilitate compliance and also because there was little abuse potential for transactions with short terms that are marked to market every year.

Specified Owner Functional Currency Transactions: Specified Owner Functional Currency Transactions refer to loans receivable and payable entered into by a Section 987 QBU that are denominated in the Owner's functional currency. These transactions are not treated as section 988 transactions. Thus, no currency gain or loss is recognized by a Section 987 QBU under section 988 with respect to such transactions.

> **EXAMPLE:** USCO is a domestic corporation with the U.S. dollar as its functional currency. USCO owns a Section 987 QBU whose functional currency is the Euro. The QBU owns three (3) assets: (i) a Euro receivable; (ii) a GBP receivable; and (iii) a dollar receivable. The Euro receivable is a Marked Item. The GBP receivable is a section 988 transaction. The dollar receivable is a Specified Owner Functional Currency Transaction.

Historic Items: A Historic Item is an asset (historic asset) or a liability (historic liability) that is properly reflected on the books and records of a Section 987 QBU and that is not a Marked Item. Note that although these items are called "historic" items, these could include some types of section 988 transactions that are denominated in a currency other than the Section 987 QBU's functional currency. So one cannot assume that Historic Items include only those items which one does not ordinarily consider as a financial asset or liability whose value is highly responsive to changes in the functional currency of the Owner.

Owner Functional Currency Net Value ("OFCNV"): This is a fundamental concept used to measure section 987 gain or loss. OFCNV is measured in the Owner's functional currency, not the Section 987 QBU's functional currency. The OFCNV equals the excess of the Section 987 QBU's U.S. tax basis in its assets over its liabilities where Marked Assets and Marked Liabilities are translated using the spot exchange rate at the end of the applicable year and Historic Assets and Historic Liabilities are translated using the applicable Historic Rate.

The rationale of the OFCNV is to capture only those changes in value attributable to changes in currency with respect to Marked Items.

> **EXAMPLE:** USCO is a domestic corporation that establishes a Japanese branch, which has the Yen as its functional currency and is considered a Section 987 QBU of USCO. On the date the branch is formed, USCO transfers it $1,000 cash and land with a $500 U.S. tax basis. On the same day, the Japanese branch borrows ¥10,000. The branch earns ¥10,000 in profit during the remainder of the year. The average exchange rate for the period beginning on the date the branch is formed and ending on December 31st of the first year is $1:¥100 whereas the spot rate on December 31st is $1:¥120. If the Marked Items are translated at the spot rate and the Historic Items (the land) is translated at the Historic Rate, the end of year balance sheet shows:

Closing Balance Sheet		
Asset/Liability	**Measured in Yen**	**Measured in USD**
Cash	¥120,000	$1,000
Land	¥50,000	$500
Bank Loan Payable	(¥10,000)	($83)
Total	¥160,000	$1,417

In the foregoing example, the OFCNV is $1,417 ($1,417 end of year balance sheet minus $0 starting balance sheet). It is important to note that OFCNV is ***not*** synonymous with unrecognized section 987 gain or loss. It is simply the starting point to begin determining net unrecognized section 987 gain or loss. We provide an example below of how unrecognized section 987 gain or loss is recognized.

Qualified Short-Term Section 988 Transactions: The 2006 Proposed Regulations did not contain a concept like the Qualified Short-Term Section 988 Transactions. There is no explanation in the preamble as to why this new concept was added. Yet, presumably, Treasury believes this rule facilitates compliance by respecting certain section 988 transactions as being on the books of the Section 987 QBU while at the same time minimizing the possibility of abuse by limiting the scope of transactions that can qualify as Qualified Short-Term Section 988 Transactions. Specifically, a Qualified Short-Term Section 988 transaction includes any section 988 transaction (including holding cash itself) that occurs in the ordinary course of a Section 987 QBU's business and has an original term of one year or less on the date the transaction is entered into by the Section 987 QBU. The only exception is for transactions denominated in, or determined by reference to, a hyperinflationary currency. The importance of this designation is that the Section 987 Regulations allow the Section 987 QBU to elect to mark the transactions to market. This then allows the taxpayer to just measure the section 988 gain or loss in the Section 987 QBU's functional currency, which is what it would do normally under GAAP.

PLANNING POINTER: Taxpayers should seriously consider making the mark-to-market election for Qualified Short-Term Section 988 Transactions found in Treas. Reg. §1.987-3T(b)(4)(iii)(C). The election is made with the taxpayer's return for the year to which it applies. Helpfully, it can be made on a QBU-by-QBU basis. It is the one rare example where the Section 987 Regulations actually move taxpayers closer to what they were doing anyway for GAAP purposes. Specifically, the assets would normally be "remeasured" for GAAP purposes anyway. So, marking them to market for tax purposes more closely aligns the tax and GAAP treatment.

V. Operating Rules

As we alluded to above, the Section 987 Regulations stress that only businesses can be Eligible QBUs. Entities are not QBUs. This means that only items pertaining to the Section 987 QBU's business may be considered properly reflected on its books and records and dealt with under section 987. This also means that certain assets that cannot be used in the conduct of business are expressly excluded from the books and records (even if owned by the same legal entity that conducts the business). Therefore, corporate stock (other than certain portfolio stock) and partnership interests; the liabilities incurred to acquire same; and the income, gain or loss with respect to same cannot be reflected on the Section 987 QBU's books and records. The Final Regulations also include an anti-abuse rule geared towards preventing Section 987 QBU's from including or excluding items from their books and records, where a principal purpose is tax avoidance.

Assets and liabilities of a Section 987 QBU are reflected on its books in its own functional currency. Therefore, items that an Owner transfers to a Section 987 QBU must be translated from the Owner's functional currency into the Section 987 QBU's functional currency. Items of income, gain, deduction or loss incurred by a Section 987 QBU are incurred in the QBU's functional currency. Those items must then be translated into the functional currency of the Owner. The rules for these translations are described below.

Translating Items that are Transferred to a Section 987 QBU

As a general matter, assets and liabilities are transferred to and from Section 987 QBUs to the extent that they are reflected on or removed from the books and records of the Section 987 QBU. When an asset or liability is transferred by an Owner ***to*** a Section 987 QBU in an otherwise disregarded transaction, the item must be translated into the Section 987 QBU's functional currency. The method for such translation varies depending on whether the item is a Marked Item or a Historic Item. As explained in greater detail below, translation of Marked Items into the Section 987 QBU's functional currency will always use the Spot Rate; whereas, translation of Historic Items will use the average exchange rate for the year, unless the taxpayer elects to use the Spot Rate (the "Spot Rate Election").

Marked Items

Before a Marked Item is transferred to a Section 987 QBU, the basis of the transferred asset or the amount of a transferred liability in the functional currency of the Owner must be determined. When the Marked Item is transferred to the Section 987 QBU, such basis or such liability is translated into the functional currency of the Section 987 QBU using the Spot Rate on the date of the transfer.

EXAMPLE: USCO, a domestic corporation, owns Business A, which has a Euro functional currency. USCO transfers a $500 note receivable and a €500 note receivable to Business A. USCO's basis in the $500 note is $500 and its basis in the €500 note is $435. The Spot Rate to convert U.S. dollars to Euros is €1 to $1.2. The $500 note is not denominated in the functional currency of Business A. Therefore, the $500 note is not a Marked Item. The €500 note is denominated in the functional currency of Business A and is a Marked Item. Therefore, the €500 note's basis in the hands of USCO, $435, is translated to Euros at the Spot Rate ($435 x 1.2), so that Business A will have an €522 basis in the €500 note.

Historic Items

Every asset or liability of a Section 987 QBU that is not a Marked Item is a Historic Item. The adjusted basis of a Historic Asset or the amount of a Historic Liability transferred to a Section 987 QBU is translated using what is referred to as the "Historic Rate." The Historic Rate that is generally applicable for assets is the average annual rate for the year the asset was acquired by the Section 987 QBU. Similarly, for liabilities, the Historic Rate, generally, is the average rate for the year in which the liability was incurred or assumed by the Section 987 QBU. For depreciable and amortizable assets, the average rate for the year the asset was placed into service by the Section 987 QBU may be used instead of the average rate for the year that the asset was acquired.[5]

If a Spot Rate Election is made with respect to a Section 987 QBU, then the Spot Rate is used instead of the average exchange rate. In other words, for assets, generally, the Spot Rate on the date an asset was acquired by the Section 987 QBU is used; for liabilities the Spot Rate on the date a liability was incurred or assumed by the Section 987 QBU is used; and, for depreciable or amortizable assets, there is the option to use the Spot Rate on the date that the asset was placed into service by the Section 987 QBU.

CAUTION: Whether the average yearly rate or the Spot Rate is used, the rule for Historic Assets does not apply to inventory. The rules for determining the Historic Rate for inventory are deeply intertwined with the rules for translating a Section 987 QBU's income, gains, losses and deductions and so are discussed in detail in the section below.

Translating QBU's Profit or Loss Into Owner's Functional Currency

Both the 1991 Proposed Regulations and the 2006 Proposed Regulations required that taxpayer's track their Section 987 QBU's income, gains, deductions and losses in the QBU's functional currency. Thus, the fact that this requirement is now part of the Section 987 Regulations should not come as a surprise to taxpayers. What may be shocking to some taxpayers who did not study the 2006 Proposed Regulations, however, is the fact that the Section 987 Regulations require taxpayers to translate each item of revenue and expense into the Owner's functional currency at different exchange rates ***before*** arriving at net income of the Section 987 QBU. This is a radical departure from both the 1991

[5] Although the Final Regulations give the taxpayer the option to use either the acquisition date or the placed in service date for depreciable and amortizable property, for clarity, we will proceed to discuss the Historic Rate for depreciable/amortizable assets as being their placed in service date.

Proposed Regulations, and more importantly, a radical departure from GAAP. The rationale for this additional complexity is to prevent taxpayers from recognizing section 987 gain or loss with respect to Historic Assets, which is precisely what the drafters did not want to happen.

Revenue and expense items that are denominated in a currency other than a Section 987 QBU's functional currency are translated into the QBU's functional currency first, before applying the rules below. For this translation, the Spot Rate is always used.

> **EXAMPLE:** US Corp is a domestic corporation that owns Business A, which has a euro functional currency. Business A earned $120 of income on February 11, 2016. On February 11, 2016, the Spot Rate to translate U.S. dollars to Euros was €1 to $1.2. The $120 of income is translated into €100. Then, the €100 of income is translated back into U.S. dollars, using the rules below.

Below we expand on the rules relating to the translation of items of income, gain, deductions and losses that give rise to the Section 987 QBU's net income. Treasury set forth a simple General Rule for such translations. It is the exceptions to that General Rule for depreciable and amortizable property, inventory and section 988 transactions that make these rules administratively very difficult.

General Rule

The default translation exchange rate for an item of income, gain, deduction or loss is the average rate for the year that the item was incurred by the Section 987 QBU (the "General Rule"). The 2006 Proposed Regulations had required the use of the Spot Rate, but this requirement was viewed as unnecessarily complex and burdensome. Thus, the ability to use the yearly average exchange rate under the Section 987 Regulations relieves some of the burden, allowing taxpayers to use a single rate applicable to an entire year. However, requiring taxpayers to use the yearly average exchange rate could add compliance complexity if, for example, the taxpayer uses a spot rate convention for GAAP purposes. Taxpayers preferring to use the Spot Rate may still do so by making an election under Treas. Reg. § 1.987-1(c)(1)(iii) (the "Spot Rate Election").[6] All others will use the average rate.

Sale, Depreciation or Amortization of Historical Assets

One of the exceptions to the General Rule applies to the recovery of a Historic Asset's basis through depreciation, amortization or return of cost basis. For Historic Assets that are not subject to depreciation or amortization, their basis

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[6] If a Spot Rate Election is made, the General Rule requires the Spot Rate for the day an item is properly taken into account for tax purposes (under the Owner's method of tax accounting) to be used instead. To make the Spot Rate Election, an Owner must prepare a statement entitled "Section 987 QBU Election to Use Spot Rate in Lieu of Yearly Average Exchange Rates Under §1.987-1(c)(1)(iii)." The statement must include: (i) a description of the convention the Owner will use to determine the Spot Rate and (ii) the name of address of each Section 987 QBU for which the election is being made. The Spot Rate Election is made by attaching the statement to the Owner's timely filed U.S. federal income tax return (or to the tax return of the controlling domestic shareholder, where the Owner is a foreign corporation). The Spot Rate Election must be made for the first year that the rules of Section 987 are relevant to the Section 987 QBU and the election may only be revoked with IRS consent.

generally is recovered when the asset is sold. For assets subject to depreciation or amortization, their basis is generally recovered periodically over their useful lives. Such recovery is not translated using the average rate for the year the basis recovery ***occurs***. Instead, the average rate applicable to the time that the asset was acquired or placed into service is used.

For example, if a Section 987 QBU sells a non-depreciable Historic Asset at a gain, the General Rule provides that the amount realized from the sale is translated into the Owner's functional currency using the average rate for the year of the sale (assuming a Spot Rate Election is not made). However, the basis of the asset sold is translated using the average rate for the year the asset was acquired or placed in service.[7]

Similarly, for a depreciable Historic Asset, depreciation deductions are not translated using the average rate for the years the deductions are taken. Instead, the average rate for the year the asset was placed into service is used.

PLANNING POINTER: By using two different exchange rates for revenue and basis recovery, the government is effectively converting what would have historically been section 987 gain or loss under the 1991 Proposed Regulations into additional ordinary income or loss from operations.

Inventory

Another exception to the General Rule applies to the translation of the cost of good sold ("COGS") with respect to the sale of inventory. A taxpayer may choose one of two methods to translate COGS: (i) the simplified inventory method; or (ii) the historic inventory method. Generally, the simplified inventory method is the default method. The historic inventory method is only available by election. However, if a taxpayer makes a Spot Rate Election with respect to a Section 987 QBU (alluded to above), then taxpayer ***must*** use the historic inventory method for that QBU.

Simplified Inventory Method

Although it is called the "Simplified Inventory Method", it will likely prove challenging for some taxpayers to apply. It involves three (3) distinct steps, each of which is described below.

Step 1: Translate Section 987 QBU's COGS into Owner's Functional Currency

Step 1 of the method begins, simply enough, by translating all of the Section 987 QBU's COGS for the taxable year into the functional currency of the Owner at the average rate for the taxable year. The Final Regulations refer to this amount as the "Translated COGS Amount." However, the regulations then require two additional adjustments to be made to the Translated COGS Amount.

CAUTION: These adjustments are made even when the Translated COGS Amount itself is zero (i.e., because no inventory was sold in a given year).

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[7] Treas. Reg. §1.987-3(e) Example 2.

Step 2: Adjust the Translated COGS Amount Upward or Downward for Inventoriable Costs Included in COGS

Step 2 of the simplified inventory method requires an adjustment to the amount determined in Step 1. This adjustment applies regardless of the Section 987 QBU's method of accounting for inventory. The adjustment is calculated by multiplying: (x) the cost recovery deductions included in inventoriable costs, expressed in the Section 987 QBU's functional currency, by (y) the difference between (i) the average rate for the year that the cost recovered asset was placed into service and (ii) the average rate used to arrive at the translated COGS amount. The product of the calculation is then used to adjust the translated COGS amount upwards or downwards (based on whether (y) is a positive or negative number).

CAUTION: The foregoing calculation will require a lot of information that the taxpayer is unlikely to have. Specifically, while a taxpayer will presumably know how much depreciation it capitalized to inventory in a given year, it likely will not have ready access to the Historic Rate associated with the depreciable asset that generated that depreciation deduction in that year. That information will have to be determined and maintained going forward.

Step 3: Adjust Translated COGS Amount for FIFO or LIFO Inventory Method

Step 3 applies differently depending on whether the Section 987 QBU applies a last-in-first-out ("LIFO") approach to tracking its inventory or a non-LIFO approach. The most common non-LIFO approach is first-in-first-out ("FIFO") and so we refer to FIFO here when referencing any non-LIFO approach.

For inventory accounted for using the LIFO method, the Translated COGS Amount is increased or reduced by the product of: (x) the amount of the LIFO layer liquidated during the taxable year, expressed in the Section 987 QBU's functional currency, and (y) the difference between (i) the average rate for the year that the LIFO layer arose and (ii) the average rate used to arrive at the Translated COGS Amount.

For inventory accounted for using any method other than LIFO, the Translated COGS Amount for the year is increased or reduced by the number that results from multiplying: (x) the ending non-LIFO inventory included on the balance sheet for the preceding year, expressed in the Section 987 QBU's functional currency, by (y) the difference between (i) the average rate for the preceding year and (ii) the average rate used to arrive at the Translated COGS Amount.

Historic Inventory Method

A taxpayer may elect to use the "Historic Inventory Method" (the "Historic Inventory Election") instead of the Simplified Inventory Method. Under the Historic Inventory Method, the Historic Rate of each inventoriable cost is separately translated using the average rate for the year in which it arose (or the Spot Rate on the date it arose, if a Spot Rate Election was made).

The Historic Inventory Election is made automatically for any Section 987 QBU with respect to which the Spot Rate Election is made. Otherwise, the Owner must prepare a statement entitled "Section 987 QBU Election to Use the Historic Inventory Method Under §1.987-3(c)(2)(iv)(B)." The statement must include the name and address of each Section 987 QBU for which the election is being made. The election is made by attaching the statement to the Owner's timely filed U.S. federal income tax return (or to the tax return of the controlling domestic shareholder, where the Owner is a foreign corporation). The election must be made for the first year that the Section 987 rules for accounting for inventory are relevant to the Section 987 QBU. The election may only be revoked with Treasury consent.

Section 988 Transactions

One of the least intuitive aspects of the Section 987 Regulations is the interaction of section 988 transactions with section 987. This is because there can be up to three different currencies that need to be referenced: (1) the Owner's functional currency; (2) the Section 987 QBU's functional currency; or (3) the currency of the underlying item. Therefore, careful attention must be paid to how the translation should occur.

The Temporary 987 Regulations state that whether a transaction is treated as a section 988 transaction is determined by reference to the functional currency of the Section 987 QBU. That is not dissimilar from the 1991 Proposed Regulations.

However, unlike the 1991 Proposed Regulations, the Temporary Section 987 Regulations provide that section 988 gain or loss is measured by reference to the functional currency of the Owner as opposed to the functional currency of the Section 987 QBU.[10] Therefore, the gain or loss with respect to a section 988 transaction of a Section 987 QBU is translated into the Owner's functional currency but it is the Section 987 QBU's functional currency that tells you when you have a section 988 transaction.

It is also important to remember for purposes of discussing section 988 transactions that section 988 transactions of a Section 987 QBU generally are treated as Historic Items. The result of this treatment is that assets and liabilities that give rise to 988 transactions do not give rise to section 987 gain or loss just because the exchange rate between the Owner's functional currency and the QBU's functional currency changes. Thus, the Owner will take into account foreign currency exposure with respect to a section 988 transaction of a Section 988 QBU only to the extent of the Owner's economic exposure to fluctuations of its functional currency relative to the currency in which the section 988 transaction is denominated.

[10] Temp. Treas. Reg. § 1.987-3T(b)(4)(i).

The general rules with respect to section 988 transactions are best explained through the following Example.

> **EXAMPLE:**[11] US Corp owns Business A, which has a euro functional currency. Business A acquires a £100 2-year note for €75 on October 1, 2012 and receives a £100 repayment of principal with respect to the note on December 31, 2021. On October 1, 2012, Business A's €75 purchase price translates into £80 and $95. On December 31, 2021, the £100 principal amount on the note translates into €90 and $130, and £80 translates into $104.

In this example, the acquisition of the note is a section 988 transaction of Business A. The note is a Historic Item because the note is denominated in pounds and Business A's functional currency is the Euro. To determine its section 987 taxable income or loss with respect to Business A, US Corp must determine Business A's total gain or loss on the disposition of the note in US Corp's dollar functional currency. Consistent with Treas. Reg. §1.988-2(b)(8), US Corp also must determine whether some or all of that gain or loss constitutes section 987 gain or loss described in section 988(b).

The first step is to determine Business A's total gain or loss on the disposition of the note by translating Business A's basis and amount realized in euros to U.S. dollars (*i.e.*, the functional currency of the Owner) as follows:

	Section 987 QBU's Functional Currency	Owner's Functional Currency
Basis in Note (Oct. 1, 2021)	€75	$95
Amount Realized (Dec. 31, 2021)	€90	$130
Total Gain		$35

Next, U.S. Corp must determine whether some or all of the $35 gain with respect to the note constitutes section 988 gain. The amount of section 988 gain realized with respect to the note is determined under Treas. Reg. §1.988-2(b)(5), which requires a comparison of the functional currency value of the principal amount of the note on the booking date and payment date. The principal amount of the note is Business A's purchase price in units of nonfunctional currency, which is £80. Pursuant to Temp. Treas. Reg. §1.987-3T(b)(4)(i), section 988 gain or loss is determined by reference to U.S. Corp's dollar functional currency. Thus, Business A's £80 principal amount with respect to the note is translated at the booking date and payment date spot rates into $95 and $104, respectively. Thus, $9 ($104 less $95) of the $35 total gain taken into account by U.S. Corp as section 987 taxable income with respect to the note is section 988 gain. The remaining $26 of gain, which may be attributable to credit risk or another factor unrelated to currency fluctuations, is considered part of the Euro QBU's section 987 taxable income but is sourced and characterized without regard to section 988.

[11] Temp. Treas. Reg. §1.987-3T(e) Example 11.

CAUTION: The takeaway from the Example above is that essentially two calculations must be performed when there is a section 988 transaction of a Section 987 QBU. The first calculation determines section 987 gain or loss. The second calculation establishes what portion of that amount is attributable section 988. This is not what most taxpayers are doing now. Thus, this is another area where taxpayers will face complexity issues with respect to implementing the Section 987 Regulations.

There is an exception to the foregoing rules for what are referred to as Specified Owner Functional Currency transactions. There is also an exception for certain Qualified Short-Term Section 988 Transactions that may make life easier for those taxpayers who qualify and make the election. We address both exceptions below.

<u>Section 988 Transactions that are Specified Owner Functional Currency Transactions</u>

Specified Owner Functional Currency Transactions occur when the Section 987 QBU does one of the following: (1) acquires or becomes the obligor under a debt instrument denominated in the Owner's functional currency; (2) accrues any item of expense or gross income or receipts denominated in the Owner's functional currency that is to be paid or received after the date on which so accrued or taken into account; or (3) acquires or disposes of any nonfunctional currency denominated in the Owner's functional currency. Interestingly, derivatives (*i.e.*, forwards, options, etc.) described in section 988(c)(1)(B)(iii) denominated in the Owner's functional currency are not included within the definition.

CAUTION: The inclusion of some, but not all, Owner functional currency section 988 transactions will likely prove problematic to the extent a QBU has Specified Owner Functional Currency Transactions and then also enters into derivatives to hedge those transactions. No section 988 gain or loss will be recognized on the former, whereas section 988 gain or loss can be recognized on the latter.

No currency gain or loss is recognized by the Section 987 QBU under section 988 with respect to Specified Owner Functional Currency Transactions.

> **EXAMPLE:**[12] US Corp owns all of the stock of a CFC which uses the pound as its functional currency. CFC conducts Business A, which has a Euro functional currency. Business A acquires a £100 2-year note for €75 on October 1, 2021 and receives a £100 repayment of principal with respect to the note on December 31, 2021. On October 1, 2021, Business A's €75 purchase price translates into £80 and $95. On December 31, 2021, the £100 principal amount on the note translates into €90 and $130, and £80 translates into $104.

The acquisition of the note in this case is a Specified Owner Functional Currency Transaction because the note is denominated in the same currency as CFC1's functional currency. The note is not treated as a section 988 transaction of Business A. The note is treated as a Historic Asset, which causes Business A's €75 basis to be translated into £80 at the historic rate. The £100 amount realized with respect to the note is not translated because it is denominated in the

[12] *See* Temp. Treas. Reg. §1.987-3T(e) Example 12.

Owner's functional currency. Thus, the Owner takes into account £20 (£100 less £80) of section 987 taxable income in 2021 with respect to the note. No portion of the £20 is section 988 gain.

Special Rule for Qualified Short-Term Section 988 Transactions

As a general matter, the Final Section 987 Regulations represent a significant departure from GAAP. As we alluded to above, this makes the regulations exceedingly difficult to apply in practice. One bright spot, however, where the regulations actually move closer to GAAP treatment involves the treatment of short-term section 988 transactions entered into in the ordinary course of business.

Specifically, GAAP requires annual remeasurement of all non-functional currency denominated financial transactions to reflect changes in exchange rates. U.S. tax law only requires certain taxpayers (*i.e.*, dealers or traders subject to section 475) and certain transactions (*i.e.*, section 1256 contracts) to be marked to market annually.

The Temporary Section 987 Regulations provide that taxpayers may elect to apply a foreign currency mark-to-market method for all Qualified Short-Term Section 988 Transactions (defined above) and any related hedges of those transactions. There are two distinct benefits of this election. First, the taxpayer can measure section 988 gain or loss at the QBU level, even if the transaction would otherwise be considered a Specified Owner Functional Currency Transaction. This is more aligned with what the taxpayer will do for GAAP purposes (i.e., measure gain or loss in the QBU's functional currency). Second, the taxpayer can force these transactions to be marked to market every year even though the taxpayer is not a dealer subject to section 475 and the underlying transaction is not described in Code Section 1256.

> **EXAMPLE:**[13] US Corp, a domestic corporation, operates Business A, a Section 987 QBU with the Euro as its functional currency. Business A receives and accrues $100 of income from the provision of services on January 1, 2021. Business A continues to hold the $100 of cash as a dollar demand deposit with a bank through December 31, 2021. US Corp elects to use the foreign currency mark-to-market method for Qualified Short-Term Section 988 Transactions. The Euro to dollar spot rate is €1:$1 on January 1, 2021, and €1:$2 on December 31, 2021. The average exchange rate is €1:$1.50.
>
> The services revenue was denominated in a nonfunctional currency and so must be translated into Business A's functional currency at the Spot Rate into €100. That revenue is then translated into US Corp's functional currency of U.S. dollars at the yearly average exchange rate to $150. The demand deposit is a Qualified Short-Term Section 988 Transaction. Even though it is denominated in the Owner's functional currency, Business A marks the investment to market and recognizes a section 988 loss of €50 (€100 basis in the demand deposit minus $100 translated into 50 Euros at a $2:€1 exchange rate). That €50

[13] *See* Temp. Treas. Reg. §1.987-3T(e) Example 13.

section 988 loss is then translated into a $75 loss at the yearly average exchange rate.

The foregoing is more closely aligned with what the taxpayer would do under GAAP. Under GAAP, Business A would "remeasure" the value of its U.S. dollar deposit at the end of the year, just like in the foregoing example. Moreover, any gain or loss would be translated into the U.S. dollars at the average exchange rate, just like in the foregoing example.

PLANNING POINTER: Taxpayers should seriously consider making the foreign currency mark-to-market election. Unfortunately, it only applies to Qualified Short-Term Section 988 Transactions and not all section 988 transactions.

Translating Foreign Income Taxes Claimed as a Direct Credit Under Section 901

As described above, an item of expense for a Section 987 QBU is typically translated into the Owner's functional currency at the average exchange rate, unless the Owner elects to use the Spot Rate. This is true for foreign taxes that are paid by the Section 987 QBU. However, U.S. Owners are eligible to take credits for foreign taxes that the U.S. Owner is treated as paying. Section 986 generally translates the amount of any foreign income taxes taken as credits into dollars using the average exchange rate for the taxable year to which the taxes relate. In certain circumstances, the foreign taxes are translated at spot rates instead of the average annual rate. Yet, it would be inappropriate to translate all pre-tax earnings using one rate and use a different rate to translate the foreign taxes that are claimed as a credit. Thus, Treas. Reg. § 1.987-3T(c)(2)(v) seeks to coordinate the exchange rates by providing that the Owner must: (1) reduce the Section 987 QBU's income by the creditable tax amount, translated into U.S. dollars using the average exchange rate, and then (2) increase the resulting amount by an equal amount of creditable taxes, translated using the same exchange rate that is used to translate the creditable taxes into U.S. dollars under section 986(a). This approach is designed to prevent a mismatch between the increase in income attributable to the foreign taxes and the credit taken on the foreign taxes. The following example illustrates how the rule operates.

EXAMPLE: US Corp, a domestic corporation, owns Business A. Assume that Business A is a Section 987 QBU using the Euro as its functional currency. It incurs the following revenue and expenses for the year and Country X imposes a 25% tax on Business A's taxable income.

	€ Amounts	Exchange Rates	$ Amounts
Revenue	€100	€1 = $1.50 (average)	$150
General Expenses	(€30)	€1 = $1.50 (average)	($45)
Depreciation	(€10)	€1 = $1 (historic)	($10)
Tentative 987 Taxable Income	€60		$95

> Business A incurs €15 of tax in Country X (25% x €60 pre-tax income). US Corp elects to translate its foreign income taxes at the spot rate on the date paid as opposed to the yearly average. As such, US Corp must first subtract out the €15 of taxes paid at the annual average (€15 x 1.5 = $22.50) and then add back the foreign taxes at the spot rate (€15 x 1.6 = $24.00). Thus, the section 987 taxable income is $96.50 ($95 - $22.50 + $24).

Special Rule for Section 987 Aggregate Partnerships

The items of a Section 987 QBU held by an Aggregate Partnership are allocated to the partnership's partners and then translated into the partners' functional currency. As explained above, an Aggregate Partnership can not be a Section 987 QBU or an Owner of a Section 987 QBU. Instead, the allocations made for subchapter K purposes are used to allocate the Aggregate Partnership's gross items to its partners. Items allocated to a partner's distributive share of the partnership's gross items are then translated into the functional currency of the partner using the methods described above.

VI. Section 987 Gain or Loss Calculation

The amount of section 987 gain or loss that the Owner of a Section 987 QBU must recognize is determined under a two part process. First, the net unrecognized section 987 gain or loss (the "NUGL") of a Section 987 QBU must be calculated at the end of each year. Even though this calculation is made every year, an Owner does not recognize the NUGL until required by Section 987 (i.e., due to a remittance, termination or deemed termination).

CAUTION: Treas. Reg. §1.987-9 requires an annual computation of the NUGL and the components used to arrive at it. It is unclear at the present time whether Treasury will be modifying the Form 8858 or providing another form on which to calculate these amounts. In any event, between now and 2018, taxpayers need to gear up to prepare these calculations. They cannot wait for a remittance to do so.

The second part of the process is used to determine whether any portion of a NUGL must be included in an Owner's income. Generally, an Owner must recognize a portion of a NUGL when the Owner receives a "remittance" from the Section 987 QBU that generated the NUGL. In addition, if a Section 987 QBU is "terminated" during the year, the Owner is then required to recognize the entire NUGL of the terminated Section 987 QBU—although this gain or loss may be deferred in some cases.

Calculating the Net Unrecognized Section 987 Gain or Loss of a Section 987 QBU

The Final 987 Regulations provide a complex procedure for calculating the NUGL of a Section 987 QBU. A NUGL is comprised of two components: (i) the unrecognized section 987 gain or loss that is generated by a Section 987 QBU during the tax year (the "Section 987 UGL") plus (ii) the accumulated unrecognized section 987 gain or loss of the Section 987 QBU from previous tax years. The Final 987 Regulations provide an eight-step procedure to calculate a Section 987 UGL.

In general, the Section 987 UGL calculation attempts to approximate the amount by which an Owner's investment in its Section 987 QBU has changed due solely to currency fluctuations. Unfortunately, the method by which the Section 987 UGL is calculated in the Final 987 Regulations is very different from the method by which the Section 987 UGL was calculated under the 1991 Proposed Regulations. More importantly, the Section 987 UGL calculation is almost unrecognizable from its US GAAP counterpart, the Cumulative Translation Adjustment. As a result, the reconciliation process for determining a Section 987 UGL will be very time consuming for tax departments.

To calculate the Section 987 UGL for a Section 987 QBU, the following eight steps as set forth in Treas. Reg. §1.987-4 must be followed:

- **Step 1 – Determine the annual change in the OFCNV of the Section 987 QBU for the taxable year.** The Section 987 UGL calculation begins by determining the amount by which the OFCNV of a Section 987 QBU has changed over the course of the year. Step 1 thus requires the taxpayer to subtract the current year OFCNV of the Section 987 QBU from the previous year OFCNV.

  As described above, the OFCNV uses a modified balance sheet of the Section 987 QBU to approximate the value of the Section 987 QBU's equity. Because the exchange rates for "marked items" on the modified balance sheet will be different for the two OFCNVs, the amount in Step 1 will take into account the change in the value of the Section 987 QBU's marked assets that was caused by currency fluctuations. In addition, the current-year OFCNV will reflect (i) contributions from and distributions to the Owner that were made during the year, (ii) the profit or loss of the Section 987 QBU during the current year, and (iii) certain items that are not taken into account for Federal income tax purposes. Accordingly, Steps 2 through 8 remove these three categories of items in order to calculate the amount by which the Owner's equity in its Section 987 QBU changed due solely to foreign currency fluctuations.

- **Step 2 – Add the amount of assets that are transferred from the Section 987 QBU to the Owner.** It should be noted that the amount of the transferred assets is not based on the fair market value of the assets. Instead, the amount of the transferred assets is equal to: (i) the amount of cash transferred plus (ii) the aggregate adjusted basis of the non-cash assets that are transferred. Thus, when an asset is transferred, the tax basis of the asset—rather than its fair market value—is used to determine the amount that must be added back in Step 2. The basis of each asset that is transferred to the Owner must be converted from the Section 987 QBU's functional currency to the Owner's functional currency at the appropriate exchange rate - Historic Rate or Spot Rate. Accordingly, assets that are Marked Items are converted to the Owner's functional currency at the Spot Rate on the day of the transfer, and assets that are Historic Items are converted to the Owner's functional currency at the Historic Rate.

- **<u>Step 3</u> – Subtract the amount of assets that are transferred from the Owner to the Section 987 QBU.** The amount of the assets transferred in Step 3 is determined in the same manner as in Step 2 (*i.e.*, using the aggregate adjusted basis of the assets rather than their fair market value). However, as the basis of the assets that the Owner is transferring to the Section 987 QBU should already be represented in the Owner's functional currency, no exchange rate adjustments need to be made.

- **<u>Step 4</u> – Subtract the amount of liabilities that are assumed by the Owner from the Section 987 QBU.** The liabilities assumed by the Owner are converted into the Owner's functional currency at the Spot Rate.

- **<u>Step 5</u> – Add the amount of liabilities that are assumed by the Section 987 QBU from the Owner.**

- **<u>Step 6</u> – Subtract the amount of the Section 987 QBU's annual profit, as determined in Treas. Reg. § 1.987-3.** If the Section 987 QBU has a loss for the year, then the loss is added to (rather than subtracted from) the calculation.

- **<u>Step 7</u> – Add any expenses that were not deductible in computing the annual profit or loss of the Section 987 QBU in Treas. Reg. § 1.987-3 (*e.g.*, foreign income taxes).**

- **<u>Step 8</u> – Subtracting any tax-exempt income.**

The example below illustrates the eight-step Section 987 UGL calculation.

> **EXAMPLE:**[14] USCO is a domestic corporation that establishes a Japanese branch, which has the Yen as its functional currency and is considered a Section 987 QBU of USCO. On the date the branch is formed, USCO transfers it $1,000 cash and land with a $500 U.S. tax basis. On the same day, the Japanese branch borrows ¥10,000. The branch's balance sheet immediately after formation is as follows:

Opening Balance Sheet		
Asset/Liability	**Measured in Yen**	**Measured in USD**
Cash	¥110,000	$1,100
Land	¥50,000	$500
Bank Loan Payable	(¥10,000)	($100)
Total	¥150,000	$1,500

[14] This example was taken from Treas. Reg. §1.987-4(g) Example 1.

The branch earns ¥10,000 in profit during the remainder of the year. The average exchange rate for the period beginning on the date the branch is formed and ending on December 31st of the first year is $1:¥110 whereas the spot rate on December 31st is $1:¥120. If the Marked Items are translated at the spot rate and the Historic Items (the land) are translated at the Historic Rate, the end of year balance sheet shows:

Closing Balance Sheet		
Asset/Liability	**Measured in Yen**	**Measured in USD**
Cash	¥120,000	$1,000
Land	¥50,000	$500
Bank Loan Payable	(¥10,000)	($83)
Total	¥150,000	$1,417

To determine the Section 987 UGL, Step One is to measure the OFCNV. In this case the OFCNV is $1,417, which is the end of year balance sheet minus $0 beginning balance sheet before any assets were contributed to the branch. Step Two does not apply because no assets were transferred from the Section 987 QBU to the Owner. Step Three reduces the OFCNV by the value of assets that the Owner contributed to the Section 987 QBU. In this case, the Owner contributed $1,500 of assets to the Japanese Branch. This yields negative $83. Steps Four and Five do not apply because no liabilities were transferred or assumed during the taxable year. In Step Six, the unrecognized gain or loss is reduced by the branch's taxable income measured in U.S. dollars or ¥10,000 / 110 or $91. Steps Seven and Eight do not apply because the branch does not have any nondeductible or tax-exempt items. Thus, the net unrecognized section 987 loss at the end of the year is $174 (-$83 - $91).

CAUTION: The preamble to the Final 987 Regulations and the regulations themselves insist that this calculation be done annually. Thus, an Owner cannot simply wait until there is a remittance or a termination of a Section 987 QBU before computing the latent unrecognized section 987 gain or loss.

Once the Section 987 UGL for the year is determined, the Section 987 UGL then needs to be added to the accumulated section 987 unrecognized gains and losses of the Section 987 QBU from previous years. This combined amount is the NUGL of the Section 987 QBU. The rules discussed below determine the amount of the NUGL that an Owner must recognize upon the remittance by or termination of its Section 987 QBU.

Determining the Amount of Section 987 Gain or Loss the Owner Must Recognize Upon a Remittance from its Section 987 QBU

Much like the 1991 Proposed Regulations, an Owner does not recognize a Section 987 gain or loss until the Section 987 QBU has made a "remittance" to the Owner.[15] Unlike the 1991 Proposed Regulations, however, remittances are not measured on a daily basis. Instead, a remittance only occurs if there is a net movement of assets from the Section 987 QBU to the Owner during the taxable year. Thus, if a Section 987 QBU distributes an asset with a tax basis of 100 on Day 1, and the Owner contributes assets with a tax basis of 110 on Day 4, there will not be a "remittance" because there is no net movement of assets from the QBU to the Owner.

The Final 987 Regulations require an Owner to recognize a section 987 gain or loss that is equal to the NUGL of the Section 987 QBU multiplied by the Owner's "remittance proportion" from the Section 987 QBU. The regulations define the Owner's remittance proportion as a fraction where: (i) the numerator is the net amount of property remitted from the Section 987 QBU, and (ii) the denominator is the sum of the net amount of property remitted plus the aggregate adjusted basis of the gross assets of the of the Section 987 QBU.

$$\text{Section 987 Gain or Loss} = \text{NUGL of the Section 987 QBU} \times \frac{\text{The Amount of the Remittance}}{\text{The Amount of the Remittance} + \text{The Aggregate Adjusted Basis of the Section 987 QBU's Gross Assets at the End of the Year}}$$

We explained above how the NUGL of a Section 987 QBU is determined; the following section will explain how the components of the Owner's remittance proportion is calculated.

Calculating the Components of the Owner's Remittance Proportion

To calculate the Owner's remittance proportion, two amounts must be determined: (i) the amount that a Section 987 QBU has remitted to its Owner during the year and (ii) the aggregate adjusted basis of the Section 987 QBU's gross assets at the end of the year.

The Final 987 Regulations measure the amount of a Section 987 QBU's remittance on an annual basis as the net extent to which distributions exceeded contributions. Thus, the amount of the remittance is equal to the difference between the amount of property that the Section 987 QBU transferred to its Owner during the year minus the amount of property that the Owner transferred to its Section 987 QBU during the year. For purposes of determining the amount of property transferred, the fair market value of the property does not matter. Instead the amount transferred is equal the amount of (i) currency transferred, plus (ii) the aggregate "adjusted basis" of the assets transferred, both of which are determined in the Owner's functional currency.

The exchange rate at which the Section 987 QBU's tax basis in the transferred property must be converted into the Owner's functional currency depends on the type of asset being transferred. If the Section 987 QBU transfers a Marked Item, then the Owner's basis in the asset must be determined based on the Spot Rate.

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[15] As explained below, an Owner also is required to recognize a section 987 gain or loss when its Section 987 QBU terminates.

If the Section 987 QBU transfers a Historic Item, then the Owner's basis in the asset must be determined based on the Historic Rate.

These principles are illustrated by the following example.

> **EXAMPLE:** U.S. Corp, a domestic company with a USD functional currency, operates a Section 987 QBU in Japan. This Japanese branch uses the Yen as its functional currency and has an adjusted gross basis in its assets of ¥50 billion at the end of the year. During the year, the Japanese branch transfers to U.S. Corp (i) ¥1 billion of cash and (ii) a machine that has a fair market value of ¥20 billion and that has an adjusted tax basis of ¥5 billion. During the same year, U.S. Corp transfers to the Japanese branch (i) $25 million of cash and (ii) a machine that has a fair market value of $50 million and that has an adjusted tax basis of $0. Also assume that the current spot rate is $1: ¥100, and both machines (as well as all of the Japanese branch's assets) were acquired when the historic rate was $1: ¥110.

The Japanese branch is treated as transferring a total of $55.5 million to U.S. Corp (*i.e.*, (¥1 billion /100¥/$) + ¥5 billion/110¥/$)). U.S. Corp is treated as transferring $25 million to the Japanese branch because the machine did not have any tax basis. Thus, the amount of the remittance from the Japanese branch to U.S. Corp would be $30.5 million. In addition, the adjusted basis of the Japanese branch's assets in USD would be $454.5 million (*i.e.*, ¥50 billion / 110¥/$). Accordingly, the remittance proportion would be calculated as follows

$$\frac{\text{\$30.5 million (The Amount of the Remittance)}}{\text{\$30.5 million (The Amount of the Remittance)} + \text{(¥50 billion)/(110¥/\$) (The Aggregate Adjusted Basis of the Section 987 QBU's Gross Assets at the End of the Year)}} = 6.29\%$$

The Final 987 Regulations' formula for calculating the remittance proportion avoids one of the situations that concerned Treasury about the 1991 Proposed Regulations—whereby a Section 987 QBU could make a distribution, trigger a section 987 loss, and then the Owner could contribute the same amount of assets (or more) assets to the Section 987 QBU. Treasury believed that many of these losses were triggered solely for U.S. tax purposes and had no independent economic significance. Treasury also addressed this concern by issuing the Temporary 987 Regulations that defer many Section 987 losses.

Source and Character of Section 987 Gain or Loss

Once an Owner is required to recognize a section 987 gain or loss, the section 987 gain or loss has to be characterized and sourced. For this purpose, the Final 987 Regulations provide that all section 987 gain or loss is ordinary income. In addition, the "source" and "basket" of the income is determined using the tax book value or fair market value asset method of apportionment under Treas. Reg. §1.861-9T(g) (*i.e.*, the rules for interest expense apportionment).

CAUTION: The gross income method of sourcing expenses may **not** be used, **even if** the Owner is a CFC that happens to use the gross income method of apportioning expenses for other purposes.

The Final 987 Regulations unequivocally provide that any portion of a section 987 gain or loss—which is apportioned to assets that generate subpart F income—is considered "currency gain or loss" described in Section 954(c)(1)(D) that is **not** directly related to the business needs of the taxpayer. Thus, if an Owner is a CFC, then a portion of the CFC's section 987 gain could be classified as foreign personal holding company income ("FPHCI"), a type of subpart F income.

By treating section 987 gain or loss as currency income described in section 954(c)(1)(D), the Final 987 Regulations also allow CFCs to offset positive section 988 gains that do not qualify for the business needs exception with section 987 losses for purposes of calculating their section 954(c)(1)(D) category of foreign personal holding company income under Subpart F. This netting rule for section 988 and section 987 income is new to the Final 987 Regulations and can be very beneficial for taxpayers.

PLANNING POINTER: There is a significant open question as to whether Treasury has the statutory authority to classify Section 987 gain as FPHCI, a category of subpart F income. The statutory language of section 954(c)(1)(D) provides that only "foreign currency gains over foreign currency losses (as defined in section 988(b)) attributable to section 988 transactions" is FPHCI. The FPHCI provisions do not mention anything about section 987 gain or loss. Moreover, Congress enacted section 954(c)(1)(D), section 987 and section 988 in the same year, as part of the same tax reform act. No portion of the legislative history suggests that Congress believed that section 987 and 988 gains and losses presented the same potential for abuse that warranted treating section 988 gains as subpart F income. Treasury officials have stated that they are relying on their general authority in sections 987(3) and 989(c)(5) to treat section 987 gain as FPHCI under Section 954(c)(1)(D). Yet, neither those sections nor the legislative history to those sections provides any support for treating section 987 gains as subpart F income. Thus, if taxpayers believe that they will be significantly and negatively impacted by the classification of section 987 gains as subpart F income, they should consider their options for challenging regulations in both a pre- and post-enforcement action.

Determining the Amount of Section 987 Gain or Loss That Must Be Recognized Upon a "Termination"

When a Section 987 QBU "terminates," the Section 987 QBU is treated as transferring all of its assets to the Owner immediately before its termination. As a result of this deemed transfer, the Owner's remittance proportion is deemed to equal "one," and the Owner's section 987 gain or loss will be equal to the entire NUGL of the terminated Section 987 QBU. Under some circumstances, however, the deferral rules in Treas. Reg. § 1.987-12T (discussed below) may require the Owner to defer its section 987 gain or loss.

A Section 987 QBU terminates in the five following circumstances:

(1) **<u>The Section 987 QBU ceases its trade or business</u>.** The regulations incorporate a facts-and-circumstances test and do not discuss when a branch should be treated as ceasing its trade or business. However, the regulations provide that a Section 987 QBU can continue to exist for tax purposes for up to two years after its operations cease.

(2) **<u>The Section 987 QBU transfers "substantially all" its assets to its Owner</u>.** A Section 987 QBU is deemed to terminate when it transfers or is deemed to transfer "substantially all" of its assets (within the meaning of Section 368(a)(1)(C)) to its Owner.[16] The Final 987 Regulations confirm that the incorporation of a branch through a check-the-box election results in a deemed transfer of the Section 987 QBU's assets to the Owner before the assets are transferred to the new corporate entity. Thus, a check-the-box election for a branch will result in a termination of the branch. In addition, the Temporary 987 Regulations provide that certain combinations and separations of Section 987 QBUs do not result in the deemed transfer of property to an Owner. If two Section 987 QBUs are owned by the same Owner and combine together, then this combination does not result in the termination of either Section 987 QBU. Similarly, the separation of a Section 987 QBU into two branches, both of which are owned by the original Owner, should not result in a termination of the original Section 987 QBU.

(3) **<u>The Owner of a Section 987 QBU was a CFC, ceases to be a CFC, but the Owner continues to be owned by persons previously related to the Owner under Section 267(b)</u>.**

(4) **<u>The Owner of a Section 987 QBU ceases to exist</u>.** In general, a Section 987 QBU is deemed to terminate when its Owner ceases to exist. However, the regulations provide that tax-free Section 332 liquidations and section 368(a)(1)(A), (C), (D), (F), and (G) reorganizations do not give rise to a termination event, except under four circumstances. First, a termination will occur if the Owner is a domestic corporation and liquidates (or reorganizes) into a foreign corporation. Second, a termination will occur if the Owner is a foreign corporation and liquidates (or reorganizes) into a domestic corporation. Third, a termination will occur if the Owner is a foreign corporation and liquidates (or reorganizes) into another foreign corporation that has the same functional currency as the Section 987 QBU. Finally, a termination will occur if the Owner is a CFC and the acquiring corporation is related to the Owner but is not a CFC. In practice, transactions in which an Owner ceases to exist are often exempted from the termination rules.

(5) **<u>The Taxpayer has made an election under Treas. Reg. § 1.987-8T(d) for its Section 987 QBUs to be deemed to terminate annually</u>.** If a taxpayer has made this election, then all of its Section 987 QBUs will be deemed to terminate every year. Accordingly, the Owner of each

[16] The substantially all standard is a relatively high one. Historically, the ruling standard in Rev. Proc. 77-37, 1977-2 C.B. 568, § 3.01, required a representation that 90% of net assets and 70% of gross assets were being transferred. *See also* Rev. Proc. 86-42, 1986-2 C.B. 722, § 7.05 (setting forth standard representations for obtaining section 368(a)(1)(C) rulings).

Section 987 QBU will be required to recognize Section 987 gain or loss every year. This election is discussed in more detail below.

If one of these five termination events applies, then the Owner must include the entire NUGL of the Section 987 QBU in the Owner's income. However, the Temporary 987 Regulations provide new rules that may require the Owner to defer its Section 987 gain or loss in certain circumstances. These deferral rules are discussed below.

VII. Deferral and Outbound Loss Events

As illustrated above, a termination can result in the deemed remittance of all the assets of a Section 987 QBU even if the assets continue to be used by a related person in the conduct of the same trade or business. Treasury is concerned that such terminations could facilitate the selective recognition of Section 987 losses. Treasury has similar concerns with respect to transfers of a partnership interest to a related person which results in deemed transfers that cause the recognition of section 987 loss with respect to a Section 987 QBU owned through the partnership, notwithstanding that the trade or business of the Section 987 QBU continues without interruption and remains subject to section 987. Treasury therefore introduced rules under which these losses are to be deferred. At the same time, Treasury recognizes that the rationale for deferring section 987 losses, namely the continuity of ownership of the same Section 987 QBU within a single controlled group, should equally apply to section 987 gains, except where assets of that trade or business are transferred to a related foreign person. Further, Treasury determined that the selective recognition of losses also should not be permitted in the context of certain outbound transfers even when the assets do not remain subject to section 987 in the hands of the transferee.

Accordingly, Temp. Treas. Reg. §1.987-12T applies to two categories of transactions: (1) deferral events, and (2) outbound loss events. The rules for deferral events defer both gains and losses whereas the rules surrounding outbound loss events only defer losses.

PLANNING POINTER: The regulation does not apply, however, to a Section 987 QBU with respect to which the annual deemed termination election described in Temp. Treas. Reg. §1.987-8T(d) is in effect, and any Section 987 QBU if the amount that would otherwise be deferred under Temp. Treas. Reg. §1.987-12T does not exceed $5 million in the taxable year.

Temp. Treas. Reg. §1.987-12T applies to a deferral event or outbound loss event that occurs on or after January 6, 2017. However, the rules also apply to a deferral event or outbound loss event that occurs on or after December 7, 2016 (*i.e.*, immediately upon publication) if the deferral event or outbound loss event is undertaken with a principal purpose of recognizing section 987 loss. The purpose of the rule was to presumably prevent taxpayers that had significant built in section 987 losses under the 1991 Proposed Regulations from triggering those losses once they saw that, under the Final Section 987 Regulations, their losses would likely disappear.

Deferral of Certain Section 987 Gains and Losses

A deferral event is defined as a transaction (or series of transactions) described below if immediately after the transaction (or series of transactions) assets of the Section 987 QBU are reflected on the books and records of a "successor" QBU.

The purpose of requiring the existence of a "successor" QBU is to ensure that the deferral rule only applies when the QBU's assets remain within the same controlled group and within the U.S. or subpart F taxing net. A Section 987 QBU is a "successor" QBU if immediately after the targeted transaction, the potential successor QBU satisfies all of the following conditions: (1) the books and records of the potential successor QBU reflect assets that immediately before the targeted transaction were reflected on the books and records of the targeted QBU; (2) the Owner of the potential successor QBU and the targeted QBU are members of the same controlled group (persons with relationships to each other described in sections 267(b) and 707(b)); and (3) in the case of certain QBU terminations, if the Owner of the targeted QBU was a U.S. person, the potential successor QBU is owned by a U.S. person.

Assuming there is a "successor" QBU, a deferral event encompasses two categories of transactions. The first category includes a termination of a Section 987 QBU except for terminations described in Treas. Reg. §1.987-8(b)(3) (Owner ceases to be a CFC), Treas. Reg. §1.987-8(c) (certain inbound, outbound or foreign-to-foreign reorganizations where it is no longer possible to preserve the built in gain or loss), or Treas. Reg. §1.987-8(b)(1) (trade or business ceases). The second category includes: (1) a disposition of part of an interest in a Section 987 Aggregate Partnership (including, for this purpose, an excluded partnership as provided in Temp. Treas. Reg. §1.987-12T(a)(2)) or a disregarded entity through which the Section 987 QBU is owned; and (2) any contribution by another person to such a partnership or a disregarded entity that, immediately after the contribution, is not considered to be included on the books and records of an Eligible QBU, provided that the contribution gives rise to a deemed transfer from the Section 987 QBU to the Owner. We refer to these transactions as "targeted transactions" and QBUs described above are referred to as "targeted QBUs."

Where there is a deferral event to which Temp. Treas. Reg. §1.987-12T applies, the original Owner of the targeted QBU (also referred to as the "deferral QBU Owner") takes into account section 987 gain or loss of the targeted QBU with respect to: (a) remittances made that are not part of the targeted transaction, and (b) subsequently, when the successor QBU makes remittances to the new Owner of the successor QBU. The subsequent amount is determined by multiplying the deferred section 987 gain or loss by the remittance proportion of the successor QBU that ends with or within the taxable year of the deferral QBU Owner. Further, if the successor QBU ceases to be owned by a member to the controlled group, the remittance proportion is considered to be 1 and all deferred section 987 gain or loss is recognized. There are also a number of special rules regarding successor QBUs.

CAUTION: Although the deferral rule is designed to defer recognition of gains and losses with respect to related party transfers (and so should often be helpful), the sheer record-keeping required to keep track of the portion of gains to be recognized by the original Owner and the new Owner will be very difficult for taxpayers to maintain. Hence, taxpayers should think twice about moving Section 987 QBUs within their control groups.

Outbound Loss Event

An outbound loss event is: (1) any termination of a Section 987 QBU in connection with a transfer by a U.S. person of the assets of a Section 987 QBU to a foreign person that is a member of the controlled group or, if the transferee did not exist immediately before the transaction, is a member of the controlled group immediately after the transaction, provided the termination would result in the recognition of loss with respect to the Section 987 QBU under Treas. Reg. §1.987-5 and Temp Treas. Reg. §1.987-12T(b) but for Temp Treas. Reg. §1.987-12T(d); or (2) any transfer by a U.S. person of part of an interest in a Section 987 Aggregate Partnership or disregarded entity through which the U.S. person owns the Section 987 QBU to a related foreign person that has the same functional currency as the Section 987 QBU, or any contribution by such a related foreign person to such a partnership or disregarded entity of assets that, immediately after the contribution, are not considered to be included on the books and records of an Eligible QBU, provided that the transfer would result in the recognition of section 987 loss with respect to the Section 987 QBU under §1.987-5 and paragraph (b) of that section but for this paragraph (d).

Where there is an outbound loss event, the Owner of the outbound loss QBU recognizes section 987 loss except in determining the remittance percentage under Treas. Reg. §1.985-5, and the assets and liabilities that are sent outbound are considered to remain on the Section 987 QBU's books and records. Thus, for purposes of determining the amount considered remitted, such items are not taken into account. For example, if a U.S. corporation contributes all the assets and liabilities of a Section 987 QBU to an affiliated CFC in an outbound section 351 transaction where such items do not become part of a Section 987 QBU, the remittance percentage is zero (0) because none of the items are considered transferred.

If the outbound loss event results from the transfer of a Section 987 QBU's assets in a transaction described in section 351 or section 361, the basis of the stock that is received in the transaction is increased by the unrecognized section 987 loss in the year of the outbound loss event. If the outbound loss event is not described in section 351 or section 361, the loss is recognized by the Owner of the outbound loss QBU in the first taxable year in which the Owner or any qualified successor of the Owner ceases to be a member of a controlled group that includes the related foreign person to which the assets and liabilities were transferred, or any qualified successor of such person.

Source and Character of Deferred Section 987 Gain or Loss

The source and character of section 987 gain or loss that is deferred as a result of a deferral event or outbound loss event is determined as if such deferred amount were recognized pursuant to Treas. Reg. §1.987-5 on the date of the related deferral event or outbound loss event without regard to Temp Treas. Reg. §1.987-12T.

If the outbound loss event results in section 987 loss increasing the basis of stock and the stock is sold or exchanged within two years of the outbound loss event, the amount of the section 987 loss built into the basis of the stock is sourced and characterized on the sale or exchange as if the loss were section 987 loss recognized under Treas. Reg. §1.987-5 on the date of the outbound loss event.

VIII. The Helpful Alternative - The Annual Deemed Termination and Yearly Average Exchange Rate Elections

A number of comments to the 2006 Proposed Regulations suggested alternative rules to reduce the complexity and administrative cost of complying with section 987. In particular, one comment proposed allowing taxpayers to elect to deem a Section 987 QBU as having terminated at the end of each year, in response to which Treasury introduced the annual deemed termination election. Treasury considered it desirable to allow taxpayers to make the election also because the election eliminates taxpayers' ability to selectively recognize section 987 losses, obviating the need for the deferral provisions of Temp. Treas. Reg. §1.987-12T. Comments also proposed allowing taxpayers to adopt a "hybrid approach", where section 987 gain or loss would generally be determined under the method of the 2006 Proposed Regulations, but taxable income or loss would be translated into the Owner's functional currency at the yearly average exchange rate as per the 1991 Proposed Regulations. Treasury considered this generally inappropriate because under this approach, exchange rate effects with respect to historic assets would be reflected in section 987 taxable income or loss to the extent of any cost recovery deductions with respect to those assets, but equal and offsetting amounts would be reflected in the foreign exchange exposure pool and would be recognized only upon remittances, thereby resulting in a distortion of section 987 taxable income or loss. Any such distortion would, however, be minimal where taxpayers have made the annual deemed termination election. Thus, Treasury decided to allow taxpayers to translate section 987 taxable income using an average exchange provided the taxpayer ALSO made the annual deemed termination election.

Annual Deemed Termination Election

The Final Section 987 Regulations permit a taxpayer (including specified entities such as banks which are excluded from the application of the Final 987 Regulations) to elect to deem all of the Section 987 QBUs of which it is an Owner as terminated on the last day of each taxable year for which the election is in effect. This creates a fiction that the Owner of a Section 987 QBU that is deemed to terminate is considered to have transferred the assets and liabilities of the terminated Section 987 QBU to a new Section 987 QBU on the first day of the following taxable year. The basis of Marked Items are translated into the functional currency of the Owner at the Spot Rate on the first day of the new taxable year, and the basis of Historic Items are translated into the functional currency of the Owner at the Historic Rate.

CAUTION: The annual deemed termination election generally must be made for all Section 987 QBUs of the taxpayer and all Section 987 QBUs owned by any person that is related to the taxpayer under sections 267(b) and 707(b). Such an election cannot be revoked.

PLANNING POINTER: Taxpayers that transition to the final regulations under the fresh start method can make this election only with respect to: (i) the first taxable year beginning on or after the transition date, or (ii) after the transition date or in a year when the taxpayer's controlled group aggregate section 987 loss, if any, does not exceed $5 million. Thus, taxpayers should not delay their consideration of the annual deemed termination election. Even if they have relatively small Section 987 QBUs today, that fact may change in the future, and so they should seriously consider making this election for their first year (which is 2018 for calendar year taxpayers).

Non-fresh start taxpayers with a related party that is a fresh start taxpayer must follow the rules described above for fresh start taxpayers. All other taxpayers must make the election in the first taxable year in which it is relevant in determining income or section 987 gain or loss, or in a subsequent taxable year in which the aggregate section 987 loss of the controlled group does not exceed $5 million. Note that the Final 987 Regulations are effective for non-fresh start taxpayers for taxable years beginning after December 7, 2016. Thus, this would become relevant for non-fresh start taxpayers soon.

Notwithstanding the conformity rules described above, an election may be made for one or more QBUs (without conformity) if for the first taxable year for which the election would apply, the QBU has a section 987 gain or a loss not exceeding $1 million.

The anti-abuse rules of Temp. Treas. Reg. §1.987-12T do not apply to Section 987 QBUs subject to the annual deemed termination election. At the same time, this election is a condition precedent for electing the "hybrid approach" in Temp. Treas. Reg. §1.987-3T(d).

Yearly Average Exchange Rate Election

Under Temp. Treas. Reg. §1.987-3T(d), a Section 987 QBU that is otherwise subject to the Section 987 Regulations and that has made an annual deemed termination election may elect to translate all income, gain, deduction or loss with respect to a Section 987 QBU (including income related to historic items) into the functional currency of the Owner at the yearly average exchange rate for each taxable year. The election is made on a QBU by QBU basis. This is also referred to as the hybrid approach as explained above.

This election can be made only in conjunction with the annual deemed termination election and only with respect to a Section 987 QBU that is subject to the Final 987 Regulations. This is because the discontinuity derived from translating depreciation and the basis of property at different exchange rates on the section 987 P&L and balance sheet reconciles in a reasonable manner if the income and section 987 gain or loss are taken into account in the same year.

Baker McKenzie
North America Tax

Chicago
+1 312 861 8000

Dallas
+1 214 978 3000

Houston
+1 713 427 5000

Miami
+1 305 789 8900

New York
+1 212 626 4100

Palo Alto
+1 650 856 2400

San Francisco
+1 415 576 3000

Toronto
+1 416 863 1221

Washington, DC
+1 202 452 7000

IX. Key Dates and Elections

The chart at the end of this alert illustrates some key dates on which the Temporary 987 Regulations and the Final 987 Regulations become relevant, and some key dates on which certain elections need to be made if considered desirable, assuming that the taxpayer's taxable year coincides with the calendar year.

Note that although the Section 987 Regulations generally do not apply until after January 1, 2018, Temp Treas. Reg. §1.987-12T, as illustrated above, could apply as soon as December 7, 2016. Taxpayers might also want to consider whether it would be advantageous to elect to apply the Final and Temporary 987 Regulations at an earlier date, in which case certain other elections will also have to be made at an earlier date, if considered desirable. Even if these accelerated deadlines do not apply, taxpayers would nonetheless want to start considering how these rules would apply, as compliance with these rules could require substantial system changes which would likely take time.

X. Conclusion

The Final Section 987 Regulations represent an unfortunate and complex departure from GAAP. Taxpayers should start considering, sooner rather than later, the extent to which they can plan out of the section 987 regulations by "unchecking" various disregarded entities. Taxpayers should start considering potential favorable elections they will want to make in the first year to which section 987 applies such as the election to mark short-term section 988 transactions to market, the annual deemed termination election, and the yearly average exchange rate election. Lastly, they should also consider what their litigation posture should be vis-à-vis Treasury's position that section 987 gains are subpart F income.

Baker McKenzie

www.bakermckenzie.com

For additional information please contact the authors of this Client Alert or any member of Baker McKenzie's North America Tax Practice Group.

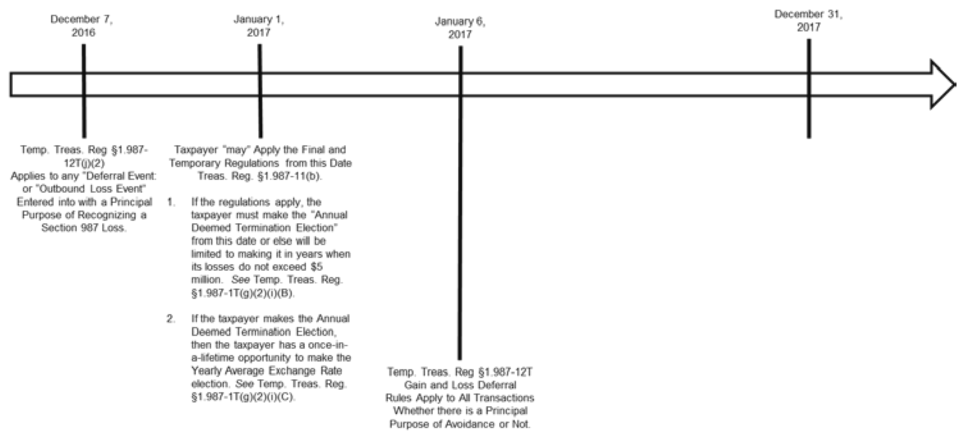
John D. McDonald
+1 312 861 8917
John.McDonald@bakermckenzie.com

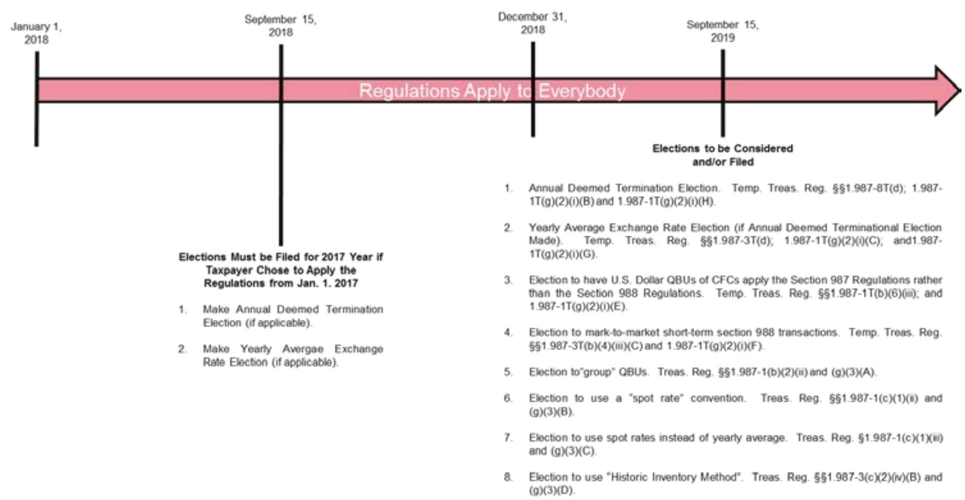
Joshua S. Richardson
+1 312 861 2777
joshua.richardson@bakermckenzie.com

Katie Fung
+1 312-861 6632
katie.fung@bakermckenzie.com

John D. Barlow
+1 202 835 6120
john.barlow@bakermckenzie.com

Samuel Pollack
+1 312 861 8603
samuel.pollack@bakermckenzie.com





Correction: Please note that the original Client Alert, distributed on January 9, contained an error in connection with an example concerning the “Simplified Inventory Method.” This description has been removed from the current version of the Client Alert.

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www.bakermckenzie.com/tax

Baker McKenzie
300 East Randolph Drive
Chicago, Illinois 60601, USA
Tel: +1 312 861 8000
Fax: +1 312 861 2899