

INTERNAL REVENUE BULLETIN



HIGHLIGHTS OF THIS ISSUE

Bulletin No. 2023-50
December 11, 2023

These synopses are intended only as aids to the reader in identifying the subject matter covered. They may not be relied upon as authoritative interpretations.

INCOME TAX

REG-131756-11, page 1386.

This document contains proposed regulations that would update regulations regarding whether persons are treated as related persons who are subject to certain special rules pertaining to transactions with partnerships. The regulations affect partnerships that enter into transactions with related persons that result in gain or loss on a sale or exchange of property or result in a difference in the time at which income and deductions are recognized because of the persons' different methods of accounting.

REG-132422-17, page 1390.

Taxpayers are required to recognize taxable income or loss and foreign currency gain or loss with respect to a qualified business unit that has a functional currency other than the dollar. The proposed regulations would provide an election to treat all items of a qualified business unit as marked items (subject to a loss suspension rule), an election to recognize all foreign currency gain or loss with respect to a qualified business unit on an annual basis, a new transition rule, and certain other rules. REG-132422-17. Published on November 14, 2023.

The IRS Mission

Provide America's taxpayers top-quality service by helping them understand and meet their tax responsibilities and enforce the law with integrity and fairness to all.

Introduction

The Internal Revenue Bulletin is the authoritative instrument of the Commissioner of Internal Revenue for announcing official rulings and procedures of the Internal Revenue Service and for publishing Treasury Decisions, Executive Orders, Tax Conventions, legislation, court decisions, and other items of general interest. It is published weekly.

It is the policy of the Service to publish in the Bulletin all substantive rulings necessary to promote a uniform application of the tax laws, including all rulings that supersede, revoke, modify, or amend any of those previously published in the Bulletin. All published rulings apply retroactively unless otherwise indicated. Procedures relating solely to matters of internal management are not published; however, statements of internal practices and procedures that affect the rights and duties of taxpayers are published.

Revenue rulings represent the conclusions of the Service on the application of the law to the pivotal facts stated in the revenue ruling. In those based on positions taken in rulings to taxpayers or technical advice to Service field offices, identifying details and information of a confidential nature are deleted to prevent unwarranted invasions of privacy and to comply with statutory requirements.

Rulings and procedures reported in the Bulletin do not have the force and effect of Treasury Department Regulations, but they may be used as precedents. Unpublished rulings will not be relied on, used, or cited as precedents by Service personnel in the disposition of other cases. In applying published rulings and procedures, the effect of subsequent legislation, regulations, court decisions, rulings, and procedures must be considered, and Service personnel and others concerned are cautioned

against reaching the same conclusions in other cases unless the facts and circumstances are substantially the same.

The Bulletin is divided into four parts as follows:

Part I.—1986 Code.

This part includes rulings and decisions based on provisions of the Internal Revenue Code of 1986.

Part II.—Treaties and Tax Legislation.

This part is divided into two subparts as follows: Subpart A, Tax Conventions and Other Related Items, and Subpart B, Legislation and Related Committee Reports.

Part III.—Administrative, Procedural, and Miscellaneous.

To the extent practicable, pertinent cross references to these subjects are contained in the other Parts and Subparts. Also included in this part are Bank Secrecy Act Administrative Rulings. Bank Secrecy Act Administrative Rulings are issued by the Department of the Treasury's Office of the Assistant Secretary (Enforcement).

Part IV.—Items of General Interest.

This part includes notices of proposed rulemakings, disbarment and suspension lists, and announcements.

The last Bulletin for each month includes a cumulative index for the matters published during the preceding months. These monthly indexes are cumulated on a semiannual basis, and are published in the last Bulletin of each semiannual period.

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Part IV

Transactions Between Related Persons and Partnerships

REG-131756-11

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed regulations that would update regulations regarding whether persons are treated as related persons who are subject to certain special rules pertaining to transactions with partnerships. The regulations affect partnerships that enter into transactions with related persons that result in gain or loss on a sale or exchange of property or result in a difference in the time at which income and deductions are recognized because of the persons' different methods of accounting.

DATES: Written or electronic comments and requests for a public hearing must be received by February 26, 2024. Requests for a public hearing must be submitted as prescribed in the "Comments and Requests for a Public Hearing" section.

ADDRESSES: Commenters are strongly encouraged to submit public comments electronically. Submit electronic submissions via the Federal eRulemaking Portal at <https://www.regulations.gov> (indicate IRS and REG-131756-11). Once submitted to the Federal eRulemaking Portal, comments cannot be edited or withdrawn. The Department of Treasury (Treasury Department) and the IRS will publish any comments submitted electronically and comments submitted on paper to the IRS's public docket. *Send paper submissions to:* CC:PA:LPD:PR (REG-131756-11), Room 5203, Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Washington, D.C. 20044.

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations relating to section 267, Livia

Piccolo, (202) 317-7007 (not a toll-free number); concerning the proposed regulation relating to section 707, Charles D. Wien, (202) 317-5279 (not a toll-free number); and concerning the submission of comments and requests for a public hearing, Vivian Hayes, (202) 317-6960 (not a toll-free number) or by sending an email to publichearings@irs.gov (preferred).

SUPPLEMENTARY INFORMATION:

Background

This document contains proposed amendments to the Income Tax Regulations (26 CFR part 1) under sections 267 and 707 of the Internal Revenue Code (Code) relating to the disallowance or deferral of deductions for losses and expenses in certain transactions with partnerships and related persons (proposed regulations). The proposed regulations would remove §1.267(b)-1(b) and amend §1.267(a)-1 to remove the application of Questions and Answers 2 and 3 in §1.267(a)-2T(c) for taxable years ending on or after the date the Treasury decision adopting these regulations as final regulations is published in the *Federal Register*. In addition, the proposed regulations would amend §1.707-1(b).

In general, section 267(a)(1) provides that a taxpayer may not deduct a loss on the sale or exchange of property with a related person as defined in section 267(b). Section 267(a)(2) sets forth a "matching rule" that provides that if because of a payee's method of accounting, an amount is not (unless paid) includible in the payee's gross income, the taxpayer (payor) may not deduct the otherwise deductible amount until the payee includes the amount in gross income if the taxpayer and payee are related persons within the meaning of section 267(b) on the last day of the taxpayer's taxable year in which the amount otherwise would have been deductible.

As part of enacting the Internal Revenue Code of 1954, Public Law 83-591, ch. 736, 68A Stat. 1 (1954), Congress added

section 707(b)(1) to the Code to address the sale or exchange of property between a partnership and a partner owning, directly or indirectly, more than 50 percent of the capital or profit interest in the partnership. 68A Stat. at 243. Given a lack of statutory and regulatory guidance addressing transactions between a partnership and a related person who was not a partner, the Treasury Department and the IRS issued §1.267(b)-1(b) in 1958. *See* TD 6312, 23 FR 7035 (Sep. 11, 1958).

Section 1.267(b)-1(b) applies an aggregate theory of partnerships to provide that any transaction described in section 267(a) between a partnership and a person other than a partner is considered as occurring between the other person and the members of the partnership separately. Specifically, §1.267(b)-1(b) provides that if the other person and a partner are within any of the relationships specified in section 267(b), no deductions with respect to the transaction between the other person and the partnership will be allowed: (i) to the related partner to the extent of the related partner's distributive share of partnership deductions for losses or unpaid expenses or interest resulting from the transactions, and (ii) to the other person to the extent the related partner acquires an interest in any property sold to or exchanged with the partnership by the other person at a loss, or to the extent of the related partner's distributive share of the unpaid expenses or interest payable to the partnership by the other person as a result of the transaction.

The U.S. Tax Court upheld the validity of §1.267(b)-1(b) and its use of the aggregate theory in *Casel v. Commissioner*, 79 T.C. 424 (1982). However, subsequent statutory changes to sections 267 and 707(b) have made §1.267(b)-1(b) inconsistent with the statute.

In 1982, Congress enacted section 3(h)(1) of the Subchapter S Revision Act of 1982, Public Law 97-354, 96 Stat. 1669, 1689 (1982) to add section 267(b)(10) to the Code to disallow a deduction resulting from a transaction between a commonly-controlled partnership and an S corporation. Specifically, section 267(b)(10) provides that an S corporation and a partnership were related persons if the

same persons owned more than 50 percent of the outstanding stock of the S corporation and more than 50 percent of the capital interest or the profits interest in the partnership.

In 1984, Congress enacted section 174(b)(1) of the Tax Reform Act of 1984 (TRA 1984), Public Law 98-369, 98 Stat. 494, 705 (1984), to add section 267(e) to the Code generally to extend the matching rule of section 267(a)(2) to transactions between a partnership and a partner or a person related to a partner (within the meaning of sections 267(b) or 707(b)(1)). Congress also enacted section 174(b)(3) of the TRA 1984, 98 Stat. at 707, to amend section 267(b)(10) to include C corporations as well as S corporations.

In 1985, the Treasury Department and the IRS issued §1.267(a)-2T(c) to provide guidance for transactions between related partnerships. Consistent with the legislative history of the TRA 1984, the regulations generally apply an aggregate theory of partnerships in deferring deductions according to the partners' aggregate interests in the payor partnership. *See* S. Rep. No. 98-169, 98th Cong., 2nd Sess., at 496 and n. 17 (1984); TD 7991, 49 FR 46992 (Nov. 30, 1984).

In the Tax Reform Act of 1986 (TRA 1986), Public Law 99-514, 100 Stat. 2085 (1986), Congress amended section 707(b) in two ways. First, Congress revised sections 707(b)(1)(A) and 707(b)(2)(A) to expand the application of those provisions to a person who is not a partner and modified section 707(b)(2) to reduce the thresholds described in that section from more than 80 percent of profits or capital to more than 50 percent of profits or capital for purposes of treating recognized gain between related persons as ordinary income. As amended by section 1812(c)(3) of the TRA 1986, 100 Stat. at 2834, the loss disallowance rules of section 707(b)(1)(A) and the character of gain rules of section 707(b)(2)(A) apply to transactions between a partnership and any person (a partner or non-partner) who directly or indirectly owns more than 50 percent of the capital or profits interest in the partnership. *See* sections 707(b)(1)(A), (b)(2)(A), and (b)(3).

Second, in enacting section 642(a)(2) of the TRA 1986, 100 Stat. at 2284, Congress amended section 707(b)(1)(B)

to provide that for purposes of the matching rule in section 267(a)(2), two partnerships in which the same persons own, directly or indirectly, more than 50 percent of the capital interests or profits interests are treated as related persons within the meaning of section 267(b). The related committee reports state that the modifications to section 707(b), and in particular to section 707(b)(1)(B), were intended to replace Questions and Answers 2 and 3 of §1.267(a)-2T(c). *See* H. Rept. No. 99-426, 99th Cong., 1st Sess., at 940 and n. 7 (1986), 1986-3 C.B. Vol. 2, at 940 and n. 7; S. Rep. No. 99-313, 99th Cong., 2nd Sess., at 960 and n. 7, 1986-3 C.B. Vol. 3, 959, 960 and n. 7.

Explanation of Provisions

The statutory changes to sections 267 and 707(b) enacted since 1982 indicate that Congress intended for a partnership to be viewed as an entity, rather than as an aggregate of its partners, in applying the rules of sections 267 and 707(b). Therefore, the loss disallowance rules of sections 267(a)(1) and 707(b)(1), the gain recharacterization rules of section 707(b)(2), and the matching rule of section 267(a)(2) similarly should be applied at the partnership level and not the partner level. Accordingly, the rules relating to partnerships in §1.267(b)-1(b) and §1.267(a)-2T(c), Questions and Answers 2 and 3, do not conform to Congress's view of how section 267 should be applied to partnerships.

To conform the regulations under section 267 with the current statute, the proposed regulations propose: (1) to remove §1.267(b)-1(b), (2) to amend §1.267(a)-1 to reflect the rules in Questions and Answers 1 and 4 in §1.267(a)-2T(c) as §1.267(a)-1(d)(2) and (3); and (3) to amend §1.267(a)-1 to terminate the application of Questions and Answers 2 and 3 in §1.267(a)-2T(c). The regulations under §1.267(a)-2T(b), which provide questions and answers applying section 267(a)(2) and (b) generally, would continue to apply. The Treasury Department and IRS are aware that some of the citations in the existing regulations under section 267 may be outdated due to subsequent legislative and regulatory changes. However, the rules in these questions and answers

remain substantively accurate. For example, Question 1 under §1.267(a)-2T(b) refers to the completed contract method under §1.451-3(d). The substance of this answer remains correct; however, the correct citation to the completed contract method is now under §1.460-4(d). Modifications to update incorrect citations in §1.267(a)-2T(b) are outside the scope of these proposed regulations. Finally, these proposed regulations also revise §1.707-1(b) to conform to the statutory changes made to sections 267 and 707(b).

Proposed Applicability Date

These regulations are proposed to apply to taxable years ending on or after the date the Treasury decision adopting these rules as final regulations is published in the *Federal Register*. Thus, §1.267(b)-1(b) would be removed, and the revisions to §1.267(a)-1 would apply to taxable years ending on or after the date the Treasury decision adopting these rules as final regulations is published in the *Federal Register*. Similarly, the revisions to §1.707-1(b) would apply to sales or exchanges of property with respect to controlled partnerships in taxable years ending on or after the date the Treasury decision adopting these rules as final regulations is published in the *Federal Register*.

Special Analyses

I. Regulatory Impact Analysis

Pursuant to the Memorandum of Agreement, Review of Treasury Regulations under Executive Order 12866 (June 9, 2023), tax regulatory actions issued by the IRS are not subject to the requirements of section 6 of Executive Order 12866, as amended. Therefore, a regulatory impact assessment is not required.

II. Paperwork Reduction Act

These proposed regulations do not impose any additional information collection requirements in the form of reporting, recordkeeping requirements, or third-party disclosure statements. However, a taxpayer may continue to be required

to report on Form 1065, *U.S. Return of Partnership Income*, information about partners that own directly or indirectly more than 50 percent of the partnership. Data on the number of affected taxpayers is not available.

For purposes of the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(c)) (PRA), the reporting burden associated with the collection of information for Form 1065 will be reflected in the PRA submission associated with the income tax returns under the OMB control number 1545-0123.

The overall burden estimates associated with the OMB control number 1545-0123 is an aggregate number related to the entire package of forms associated with the applicable OMB control number and will include, but not isolate, the estimated burden of the tax forms that will be created or revised as a result of these proposed regulations. These numbers are therefore not specific to any burden imposed by these proposed regulations. The burdens have been reported for other income tax regulations that rely on the same information collections and the Treasury Department and the IRS urge readers to recognize that these numbers are duplicates and to guard against overcounting the burdens imposed by tax provisions prior to the Act. No burden estimates specific to the forms affected by the proposed regulations are currently available. For the OMB control numbers discussed in this paragraph, the Treasury Department and the IRS estimate PRA burdens on a taxpayer-type-basis rather than a provision-specific basis. Those estimates capture both changes made by the Act and those that arise out of discretionary authority exercised in the proposed regulations (when final) and other regulations that affect the compliance burden for that form.

The Treasury Department and the IRS request comments on all aspects of information collection burdens related to the proposed regulations, including estimates for how much time it would take to comply with the paperwork burdens described above for each relevant form and ways for the IRS to minimize paperwork burden. In addition, when available, drafts of IRS forms are posted for comment at <https://appsirs.gov/app/pickleist/lit/>

[draftTaxForms.htm](https://www.irs.gov/forms-instructions). IRS forms are available at <https://www.irs.gov/forms-instructions>. Forms will not be finalized until after they have been approved by OMB under the PRA.

III. Regulatory Flexibility Act

The Regulatory Flexibility Act (5 U.S.C. 601 *et seq.*) (RFA) imposes certain requirements with respect to Federal rules that are subject to the notice and comment requirements of section 553(b) of the Administrative Procedure Act (5 U.S.C. 551 *et seq.*) and that are likely to have a significant economic impact on a substantial number of small entities. The Treasury Department and the IRS certify that this proposal will not have a significant economic impact on a substantial number of small entities. The proposed regulations would remove certain outdated regulations under section 267 that apply an aggregate theory of partnerships and relocate other regulations that are not intended to be obsoleted. These regulations would preserve the status quo by updating the existing regulations to reflect the currently effective statutory provisions. Accordingly, this proposal is unlikely to have a significant economic impact on any small entities affected. The Treasury Department and the IRS invite comments on the impact on small entities.

Pursuant to section 7805(f) of the Code, this notice of proposed rulemaking has been submitted to the Chief Counsel of the Office of Advocacy of the Small Business Administration for comment on its impact on small business.

IV. Unfunded Mandates Reform Act

Section 202 of the Unfunded Mandates Reform Act of 1995 (UMRA) requires that agencies assess anticipated costs and benefits and take certain other actions before issuing a final rule that includes any Federal mandate that may result in expenditures in any one year by a State, local, or Tribal government, in the aggregate, or by the private sector, of \$100 million in 1995 dollars, updated annually for inflation. This rule does not include any Federal mandate that may result in expenditures by State, local, or Tribal governments, nor

does this rule include any Federal mandate that may exceed the threshold for the private sector.

V. Executive Order 13132: Federalism

Executive Order 13132 (Federalism) prohibits an agency from publishing any rule that has federalism implications if the rule either imposes substantial, direct compliance costs on State and local governments, and is not required by statute, or preempts State law, unless the agency meets the consultation and funding requirements of section 6 of the Executive Order. This proposed rule does not have federalism implications and does not impose substantial, direct compliance costs on State and local governments or preempt State law within the meaning of the Executive Order.

Comments and Requests for a Public Hearing

Consideration will be given to comments that are submitted timely to the IRS as prescribed in the preamble under the “ADDRESSES” section. The Treasury Department and the IRS request comments on all aspects of the proposed regulations. Any electronic and paper comments submitted will be available at <https://www.regulations.gov> or upon request. A public hearing will be scheduled if requested in writing by any person that timely submits written comments. If a public hearing is scheduled, notice of the date, time, and place for the public hearing will be published in the *Federal Register*. Announcement 2023-16, 2023-20 I.R.B. 854 (May 15, 2023), provides that public hearings will be conducted in person, although the IRS will continue to provide a telephonic option for individuals who wish to attend or testify at a hearing by telephone. Any telephonic hearing will be made accessible to people with disabilities.

Drafting Information

The principal author of these proposed regulations is Livia Piccolo of the Office of Associate Chief Counsel (Income Tax and Accounting). However, other personnel from the Treasury Department and the

IRS participated in the development of the regulations.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and record-keeping requirements.

Proposed Amendments to the Regulations

Accordingly, the Treasury Department and the IRS propose to amend 26 CFR part 1 as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *
* * * * *

Par. 2. Section 1.267(a)-1 is amended by adding new paragraphs (d) and (e) to read as follows:

§1.267(a)-1 Deductions disallowed.

* * * * *

(d) *Rules for partnerships under the Tax Reform Act of 1984—(1) In general.* Paragraphs (d)(2) and (d)(3) of this section provide rules under section 267(a) and related provisions, as amended by section 174 of the Tax Reform Act of 1984, Public Law 98-369, 98 Stat. 494, 705 (1984), applicable specifically to partnerships for taxable years ending on or after [DATE OF PUBLICATION OF FINAL RULE IN THE FEDERAL REGISTER]. Section 1.267(a)-2T(c) does not apply to taxable years ending on or after [DATE OF PUBLICATION OF FINAL RULE IN THE FEDERAL REGISTER].

(2) *Application of section 267(a) to disallow losses and defer otherwise deductible amounts at the partnership (entity) level.* If a loss realized by a partnership from a sale or exchange of property is disallowed under section 267(a)(1), that loss does not enter into the computation of the partnership's taxable income. If an amount that otherwise would be deductible by a partnership is deferred by section 267(a)(2), that amount does not enter into the computation of the partnership's taxable income until the taxable year of the partnership in which falls the day

on which the amount is includible in the gross income of the person to whom payment of the amount is made.

(3) *Application of section 267(e)(5)(C)(ii).* The phrase *incurred at an annual rate not in excess of 12 percent* in section 267(e)(5)(C)(ii) refers to interest that accrues but is not includible in the income of the person to whom payment is to be made during the taxable year of the payor. Thus, in determining whether the requirements of section 267(e)(5) (providing an exception to certain provisions of section 267 for certain expenses and interest of partnerships owning low income housing) are met with respect to a transaction, the requirement of section 267(e)(5)(C)(ii) will be satisfied, even though the total interest (both stated and unstated) paid or accrued in any taxable year of the payor taxpayer exceeds 12 percent, if the interest in excess of 12 percent per annum, compounded semi-annually, on the outstanding loan balance (principal and accrued but unpaid interest) is includible in the income of the person to whom payment is to be made no later than the last day of such taxable year of the payor taxpayer.

(e) *Applicability date.* Paragraph (d) of this section applies to taxable years ending on or after [DATE OF PUBLICATION OF FINAL RULE IN THE FEDERAL REGISTER].

Par. 3. Section 1.267(b)-1 is amended by revising paragraph (b) to read as follows:

§ 1.267(b)-1. Relationships.

* * * * *

(b) *Applicability date.* This section applies to taxable years ending on or after [DATE OF PUBLICATION OF FINAL RULE IN THE FEDERAL REGISTER].

Par. 4. Section 1.707-1 is amended by:

1. Removing the language “partner” in paragraph (b)(1)(i) and adding the language “person” in its place;
2. Removing the language “the provisions of subdivision (i) of this subparagraph,” in paragraph (b)(1)(ii) and adding the language “paragraph (b)(1)(i) of this section,” in its place;
3. Adding new paragraph (b)(1)(iii);
4. Removing the language “partner” in paragraph (b)(2) and adding the language “person” in its place;

5. Removing the language “80 percent” in the first and second sentences of paragraph (b)(2) and adding the language “50 percent” in its place; and
6. Revising paragraph (b)(3).

The additions and revision read as follows:

§1.707-1 Transactions between partner and partnership.

* * * * *

(b) * * *

(1) * * *

(iii) For purposes of matching deductions and income in the case of expenses and interest under section 267(a)(2), two partnerships in which the same persons own, directly or indirectly, more than 50 percent of the capital interests or profits interests in each partnership will be treated as persons specified in section 267(b).

* * * * *

(3) *Ownership of a capital or profits interest.* For the purpose of applying section 707(b), the rules for constructive ownership of stock provided in section 267(c)(1), (2), (4), and (5) apply in determining the extent to which a capital interest or profits interest in a partnership is owned, directly or indirectly, by any person, including a person who does not own a partnership interest prior to application of 267(c). For example, where trust T is a partner in the partnership ABT, and AW, A's wife, is the sole beneficiary of the trust, the ownership of a capital and profits interest in the partnership by T will be attributed to AW both for the purpose of further attributing the ownership of such interest to A and for determining whether AW is a constructive owner of an interest in the partnership. See section 267(c) (1), (2), and (5). Accordingly, if A, B, and T are equal partners in ABT, because AW is treated as constructively owning the one-third capital and profits interest in ABT owned by T and AW's ownership is attributed to A, A will be considered as owning a more than 50 percent capital and profits interest in ABT, and a loss sustained by A on a sale or exchange of property with ABT will be disallowed by section 707(b)(1)(A). Similarly, because AW is treated as constructively owning the one-third capital and profits interest in ABT owned by T and is attributed

the ownership of A's capital and profits interest in ABT, AW will be considered as owning a more than 50 percent capital and profits interest in ABT and a loss sustained by AW on a sale or exchange of property with ABT would also be disallowed by section 707(b)(1)(A).

* * * * *

Par. 5. Section 1.707-9 is amended by:

1. Revising the section heading;
2. Redesignating paragraphs (a) and (b) as paragraphs (b) and (c); and
3. Adding new paragraph (a).

The addition and revision read as follows:

§1.707-9. Applicability dates and transitional rules.

(a) *Section 1.707-1.* Paragraphs (b)(1)(i) through (iii), (b)(2), and (b)(3) of §1.707-1 apply to sales or exchanges of property with respect to controlled partnerships in taxable years ending on or after [DATE OF PUBLICATION OF FINAL RULE IN THE FEDERAL REGISTER].

* * * * *

Douglas W. O'Donnell,
Deputy Commissioner for Services and Enforcement.

(Filed by the Office of the Federal Register November 24, 2023, 8:45 a.m., and published in the issue of the Federal Register for November 27, 2023, 88 FR 82792)

Income and Currency Gain or Loss with Respect to a Qualified Business Unit

REG-132422-17

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking and partial withdrawal of notice of proposed rulemaking.

SUMMARY: This document contains proposed regulations relating to the determination of taxable income or loss and foreign currency gain or loss with respect

to a qualified business unit. These proposed regulations include an election to treat all items of a qualified business unit as marked items (subject to a loss suspension rule), an election to recognize all foreign currency gain or loss with respect to a qualified business unit on an annual basis, and a new transition rule.

DATES: Written or electronic comments and requests for a public hearing must be received by February 12, 2024.

ADDRESSES: Commenters are strongly encouraged to submit public comments electronically via the Federal eRulemaking Portal at <https://www.regulations.gov> (indicate IRS and REG-132422-17) by following the online instructions for submitting comments. Requests for a public hearing must be submitted as prescribed in the "Comments and Requests for a Public Hearing" section. Once submitted to the Federal eRulemaking Portal, comments cannot be edited or withdrawn. The Department of the Treasury (Treasury Department) and the IRS will publish for public availability any comments submitted to the IRS's public docket. Send paper submissions to: CC:PA:01:PR (REG-132422-17), Room 5203, Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Washington, DC 20044.

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations generally, Raphael J. Cohen at (202) 317-6938; concerning consolidated groups, Jeremy Aron-Dine at (202) 317-6847; concerning submissions of comments, requests for a public hearing, and access to a public hearing, Vivian Hayes at (202) 317-5306 (not toll-free numbers) or by e-mail to publichearings@irs.gov (preferred).

SUPPLEMENTARY INFORMATION:

Background

I. Overview

This document contains proposed regulations (the "proposed regulations") under section 987 and related provisions under sections 861, 985 through 989, and 1502 of the Internal Revenue Code ("Code").

Section 987 applies to any taxpayer that has a qualified business unit ("QBU") with a functional currency other than the dollar. Section 987(1) and (2) provide rules for determining and translating taxable income or loss ("section 987 taxable income or loss") with respect to the QBU. In addition, foreign currency gain or loss must be determined under section 987(3) ("section 987 gain or loss"), which requires proper adjustments (as prescribed by the Secretary) for transfers of property between QBUs of the taxpayer having different functional currencies. Section 989(c) authorizes the Secretary to prescribe necessary and appropriate regulations, including regulations limiting the recognition of foreign currency loss on certain remittances from QBUs.

II. Regulations Addressing the Application of Section 987

A. 1991 proposed regulations and Notice 2000-20

On September 25, 1991, the Treasury Department and the IRS published in the **Federal Register** proposed regulations under section 987 (56 FR 48457, September 25, 1991) ("1991 proposed regulations"). The 1991 proposed regulations provided that section 987 taxable income or loss is computed in the QBU's functional currency and is translated into the taxpayer's functional currency at the weighted average exchange rate for the taxable year. For purposes of determining section 987 gain or loss, taxpayers were required to maintain an equity pool in the QBU's functional currency and a basis pool in the taxpayer's functional currency. The equity and basis pools were increased by the QBU's earnings and by capital contributed to the QBU, and they were reduced by remittances, losses, and other transfers from the QBU. Taxpayers recognized section 987 gain or loss at the time of a remittance or upon a termination of the QBU. The amount of section 987 gain or loss recognized was equal to the difference between the value of the remittance in the taxpayer's functional currency (translated at the applicable spot rate) and the portion of the basis pool attributable to the remittance. Thus, under the 1991 proposed regulations, section 987 gain or loss

was determined by reference to a taxpayer's entire equity interest in a QBU. The 1991 proposed regulations reserved on the treatment of partnerships.

On April 3, 2000, the Treasury Department and the IRS issued Notice 2000-20, 2000-1 C.B. 851. The Notice expressed concern that the 1991 proposed regulations may not have achieved their goal of providing administrable rules that result in foreign currency gain and loss recognition under the appropriate circumstances. The Notice also identified certain abusive transactions that could inappropriately accelerate recognition of section 987 loss under the 1991 proposed regulations.

B. 2006 proposed regulations

1. Concerns Relating to the 1991 Proposed Regulations

On September 7, 2006, the Treasury Department and the IRS withdrew the 1991 proposed regulations and published in the **Federal Register** new proposed regulations under section 987 (71 FR 52876, September 7, 2006) ("2006 proposed regulations"). The preamble to the 2006 proposed regulations explained that the IRS had identified many cases in which taxpayers inappropriately claimed substantial section 987 losses resulting from the application of the 1991 proposed regulations when a QBU's functional currency depreciated relative to the functional currency of its owner. The 1991 proposed regulations also could create a "trap for the unwary" by requiring recognition of large section 987 gains when a QBU's functional currency appreciated.

These results arose because the 1991 proposed regulations imputed section 987 gain or loss to all assets and liabilities of a QBU, regardless of whether those assets and liabilities were economically exposed to currency fluctuations or had been subject to a realization event, and because the 1991 proposed regulations did not limit the selective recognition of section 987 losses. Consequently, under the 1991 proposed regulations, exchange rate fluctuations that, at most, had only an uncertain and remote effect on the economic results experienced by the owner of a QBU could give rise to substantial section 987 gains and losses that taxpayers could selectively

recognize by strategically timing remittances or causing a termination of the QBU. For example, the 1991 proposed regulations provided taxpayers with substantial flexibility to recognize section 987 losses selectively by causing QBUs with a weak functional currency to make remittances while avoiding remittances from QBUs with a strong functional currency that would give rise to gains.

2. Foreign Exchange Exposure Pool Method

To address the concerns relating to the 1991 proposed regulations, the 2006 proposed regulations provided a new method of applying section 987, referred to as the foreign exchange exposure pool ("FEEP") method. Under the FEEP method, the owner of a QBU that is subject to section 987 ("section 987 QBU") determines all items of income, gain, deduction, and loss attributable to the QBU in the QBU's functional currency, and then translates those items into the owner's functional currency. For this purpose, the basis of certain assets (referred to as "historic assets") is translated at the exchange rate for the date on which the asset was acquired (the "historic rate"). For example, cost recovery deductions, such as depreciation, in respect of historic assets are translated at the historic rate. Other items (including the amount realized on a sale or exchange of a historic asset) are translated into the owner's functional currency at the average exchange rate for the taxable year.

In addition, the owner of a section 987 QBU must determine the pool of unrecognized section 987 gain or loss ("net unrecognized section 987 gain or loss") based on the annual increase or decrease to the section 987 QBU's balance sheet that is attributable to foreign exchange rate fluctuations. The amount of section 987 gain or loss that is added to the pool each year is equal to the increase or decrease in the basis of assets (net of the amount of liabilities) of the section 987 QBU, measured in the owner's functional currency and adjusted for transfers between the section 987 QBU and its owner and section 987 taxable income or loss. See §1.987-4(d) of the 2006 proposed regulations. For this purpose, certain assets and liabilities (referred to as "historic items")

are translated into the owner's functional currency at the historic rate, while others (referred to as "marked items") are translated into the owner's functional currency at the applicable spot rate. As a result, when translated into the owner's functional currency, the balance sheet value of marked items fluctuates when the QBU's functional currency strengthens or weakens, but the balance sheet value of historic items does not.

Marked items and historic items are defined by reference to section 988. A marked item is an asset or liability that would generate gain or loss under section 988 if it were held or entered into directly by the owner of the section 987 QBU but is not a section 988 transaction with respect to the QBU itself. A historic item is an asset or liability that is not a marked item. Thus, under the FEEP method, section 987 gain or loss reflects currency fluctuations with respect to marked items, which would be subject to section 988 in the hands of the QBU's owner. By contrast, section 987 gain or loss is not imputed to historic items that are not subject to section 988.

As a result of the use of a balance sheet approach, together with the use of historic rates for historic items, the FEEP method distinguishes between those items whose value is highly correlated with exchange rates and those items for which exchange rate fluctuations have no effect on value, or only an uncertain or remote effect that is more appropriately recognized upon a realization event with respect to that item. Unlike the 1991 proposed regulations, which imputed section 987 gain or loss to all assets and liabilities of a QBU, section 987 gain or loss under the FEEP method relates to those assets and liabilities that are economically exposed to currency fluctuations. The FEEP method also minimizes a taxpayer's ability to recognize large section 987 losses unrelated to its economic exposure and, thus, the need for a limitation on the selective recognition of such losses.

3. Partnerships

The 2006 proposed regulations applied section 987 to partnerships using an aggregate approach. Under this approach, an individual or corporation that is a partner

in a partnership is treated as an indirect owner of a portion of the assets and liabilities of the partnership for purposes of section 987. If the partner indirectly owns a QBU with a functional currency different from that of the partner, the QBU is a section 987 QBU, and the partner determines and recognizes section 987 gain or loss with respect to the section 987 QBU under the FEEP method. An elective de minimis exception was provided for partners with a less than five percent interest in a partnership.

4. Transition Rules

The 2006 proposed regulations provided two alternative methods for taxpayers to transition from their prior method of applying section 987: the “deferral transition method” and the “fresh start transition method.” Under both transition methods, all the taxpayer’s section 987 QBUs were deemed to terminate on the day before the transition date, and the owner was treated as having transferred each section 987 QBU’s assets and liabilities to a new section 987 QBU on the transition date. The transition date was defined as the first day of the first taxable year to which the 2006 proposed regulations apply to a taxpayer.

Under the deferral transition method, section 987 gain or loss determined on the date of the deemed termination (under the taxpayer’s prior method) was treated as net unrecognized section 987 gain or loss of the new section 987 QBU, which could be recognized on a remittance (or termination) in subsequent taxable years. The assets and liabilities that were deemed transferred to the section 987 QBU on the transition date (including marked assets and liabilities) were translated using historic rates, increased or decreased to take into account any amount treated as net unrecognized section 987 gain or loss determined with respect to the deemed termination. The deferral transition method thus preserved the taxpayer’s section 987 gain or loss computed under its prior method and adjusted the applicable exchange rates to avoid double counting.

Under the fresh start transition method, section 987 gain or loss that would have been recognized under the taxpayer’s prior method as a result of the deemed termination was neither recognized nor

carried forward as net unrecognized section 987 gain or loss. The assets and liabilities that were deemed transferred to the section 987 QBU on the transition date (including marked assets and liabilities) were translated using historic rates without adjustment.

The fresh start transition method was designed to prevent recognition of non-economic section 987 gain or loss that was not recognized before the transition date. Because marked assets and liabilities were translated at historic rates under the fresh start transition method, any section 987 gain or loss inherent in those assets and liabilities would be added to the pool of net unrecognized section 987 gain or loss in the taxable year beginning on the transition date. However, exchange rate fluctuations with respect to historic items would not give rise to section 987 gain or loss. In addition, section 987 gain or loss attributable to items that were no longer reflected on the section 987 QBU’s balance sheet on the transition date (for example, assets that had been sold before the transition date) would never be taken into account.

Only taxpayers that were applying section 987(3) using a reasonable method before the transition date were permitted to use the deferral transition method. A taxpayer whose prior method was unreasonable, or that failed to make required determinations under section 987 in prior years, was required to use the fresh start transition method.

For this purpose, the preamble to the 2006 proposed regulations explained that the method of applying section 987 provided in the 1991 proposed regulations would be treated as a reasonable method. The preamble to the 2006 proposed regulations further stated that the use of an “earnings only” method would be treated as a reasonable method. Under an “earnings only” method, section 987 gain or loss is recognized on a distribution out of a QBU’s earnings, but not on a distribution in excess of earnings (which represents a return of capital).

C. 2016 final regulations

On December 8, 2016, the Treasury Department and the IRS published final regulations (TD 9794) in the **Federal**

Register (81 FR 88806, December 8, 2016) (the “2016 final regulations”). The 2016 final regulations largely adopt the FEEP method contained in the 2006 proposed regulations but modify those regulations to make the FEEP method easier for the IRS to administer and for taxpayers to apply. For example, the 2016 final regulations permit taxpayers to use the yearly average exchange rate as the historic rate applicable to historic items. *See* §1.987-3(c)(3). The 2016 final regulations also modify the computation of net unrecognized section 987 gain or loss for a taxable year by requiring adjustments for nondeductible expenses and tax-exempt income. *See* §1.987-4(d)(7) and (8).

The 2016 final regulations maintain the aggregate approach of the 2006 proposed regulations for partnerships. However, in response to comments relating to the complexity of the aggregate approach, the 2016 final regulations apply only to partnerships that are wholly owned by related persons (“section 987 aggregate partnerships”). The preamble to the 2016 final regulations indicated that the treatment of other partnerships under section 987 would be addressed separately and such partnerships might be subject to a different approach.

The 2016 final regulations require taxpayers to transition using the fresh start transition method. *See* §1.987-10. The Treasury Department and the IRS were concerned that an election between two transition methods (as permitted under the 2006 proposed regulations) would result in a whipsaw to the fisc, because each taxpayer could choose the method that produces more section 987 loss and less section 987 gain (as was noted by comments on the 2006 proposed regulations). The Treasury Department and the IRS were also concerned about administrative difficulties and planning opportunities associated with adjustments to the translation rate under the deferral transition method.

Section 1.987-11(a) provides that the 2016 final regulations generally apply to taxable years beginning on or after one year after the first day of the first taxable year following December 7, 2016. However, taxpayers could choose to apply them to an earlier taxable year under §1.987-11(b).

D. 2016 temporary and proposed regulations

On December 8, 2016, the Treasury Department and the IRS published Treasury Decision 9795 (the “temporary regulations”) in the **Federal Register** (81 FR 88854, December 8, 2016) and published a notice of proposed rulemaking (81 FR 88882, December 8, 2016) (the “2016 proposed regulations”) in the **Federal Register** by cross-reference to the temporary regulations. The temporary regulations (other than §1.987-12T) had the same applicability date as the 2016 final regulations.

The temporary regulations and the 2016 proposed regulations include: (1) rules relating to the recognition and deferral of section 987 gain or loss in connection with certain QBU terminations and certain other transactions involving partnerships; (2) an annual deemed termination election; (3) an elective method, available to taxpayers that make the annual deemed termination election, for translating all items of income or loss with respect to a section 987 QBU at the yearly average exchange rate; (4) rules regarding the treatment of section 988 transactions of a section 987 QBU; (5) rules regarding QBUs with the U.S. dollar as their functional currency; (6) rules regarding combinations and separations of section 987 QBUs; (7) rules regarding the translation of income used to pay creditable foreign income taxes; (8) rules regarding the allocation of assets and liabilities of certain partnerships for purposes of section 987; and (9) rules requiring the deferral of certain section 988 loss that arises with respect to related-party loans.

Under the annual deemed termination election provided in the temporary regulations, a taxpayer could elect to deem all of its section 987 QBUs to terminate on the last day of each taxable year, resulting in the recognition of all net unrecognized section 987 gain or loss on an annual basis. See §1.987-8T(d). The assets and liabilities of a section 987 QBU subject to the election were deemed to be distributed to the owner pursuant to the deemed termination on the last day of each taxable year and recontributed on the first day of the following taxable year. The temporary regulations further provided that a

taxpayer who made an annual deemed termination election could elect to translate all items of section 987 taxable income or loss at the yearly average exchange rate. See §1.987-3T(d).

The temporary regulations (other than those finalized or withdrawn in 2019, as described in part II.E of this Background section) expired on December 6, 2019. The Treasury Department and the IRS intend to remove the temporary regulations from the Federal Register when the proposed regulations are finalized.

The following parts of the 2016 proposed regulations remain outstanding: (1) rules regarding the treatment of section 988 transactions of a section 987 QBU (see §§1.987-1, 1.987-3, and 1.988-1 of the 2016 proposed regulations); (2) rules regarding QBUs with the U.S. dollar as their functional currency (see §§1.987-1 and 1.987-6 of the 2016 proposed regulations); (3) rules regarding the translation of income used to pay creditable foreign income taxes (see §1.987-3 of the 2016 proposed regulations); and (4) rules requiring the deferral of certain section 988 loss that arises with respect to related-party loans (see §1.988-2 of the 2016 proposed regulations). A notice reopening the comment period for the parts of the 2016 proposed regulations that remain outstanding is published in this issue of the **Federal Register**.

E. 2019 final regulations

On May 13, 2019, the Treasury Department and the IRS published Treasury Decision 9857 (84 FR 20790, May 13, 2019) (the “2019 final regulations”) and, collectively with the 2016 final regulations, the “final regulations”) in the **Federal Register**. The 2019 final regulations finalized parts of the 2016 proposed regulations relating to combinations and separations of section 987 QBUs and the recognition and deferral of section 987 gain or loss in connection with certain QBU terminations and certain other transactions involving partnerships. The 2019 final regulations also withdrew §1.987-7T of the temporary regulations, relating to the allocation of assets and liabilities of a section 987 aggregate partnership to its partners for purposes of section 987, in response to comments noting that these rules could cause distortions in the

computation of section 987 gain or loss. The 2019 final regulations (other than §1.987-12) have the same applicability date as the 2016 final regulations.

III. Executive Order 13789 and Interim Report to the President

Executive Order 13789, issued on April 21, 2017, instructs the Secretary of the Treasury (the “Secretary”) to review all significant tax regulations issued on or after January 1, 2016, and to take action to mitigate the burden of regulations that, in relevant part, impose an undue financial burden on U.S. taxpayers or add undue complexity to the Federal tax laws. The Executive order further instructs the Secretary to submit two reports to the President: an interim report that identifies regulations that meet the criteria described in the Executive order; and a report that recommends specific actions to mitigate the burden imposed by regulations identified in the interim report.

In an interim report to the President dated June 22, 2017, the Treasury Department identified eight regulations, including the 2016 final regulations, as meeting at least one of the criteria described in the Executive order. In Notice 2017-38, 2017-30 I.R.B. 147, which was published on July 24, 2017, the Treasury Department and the IRS requested comments on whether the regulations identified in the interim report (including the 2016 final regulations) should be rescinded or modified and, if not rescinded, how the regulations should be modified to reduce the burden and complexity.

The Treasury Department and the IRS received several comments in response to Notice 2017-38. In addition, one comment was submitted in response to Notice 2017-57, 2017-42 I.R.B. 325 (which was the first of the deferral notices described in part V of this Background section). The comments that are relevant to the proposed regulations are discussed in the Explanation of Provisions.

IV. Second Report to the President on Identifying and Reducing Tax Regulatory Burdens

On October 16, 2017, the Secretary published a report (the “Report”) in the

Federal Register (82 FR 48013, October 16, 2017) recommending specific actions to mitigate the burden imposed by the regulations identified in the interim report. The Report stated that the Treasury Department and the IRS intend to propose modifications to the 2016 final regulations and to issue guidance permitting taxpayers to elect to defer the application of §§1.987-1 through 1.987-10.

In particular, the Report stated that, in response to comments, the Treasury Department and the IRS intend to propose rules that would permit taxpayers to elect to adopt a simplified method of calculating section 987 gain or loss and translating section 987 taxable income or loss, subject to certain limitations on the recognition of section 987 loss. One simplified method discussed in the Report would allow a taxpayer to treat all assets and liabilities of a section 987 QBU as marked items and to translate all items of income and expense at the average exchange rate for the taxable year. Under this method, the amount of section 987 gain or loss would generally be consistent with the amount determined under the 1991 proposed regulations and would more closely conform to the applicable financial accounting rules.

The Report also noted that the Treasury Department and the IRS were considering limitations on the recognition of section 987 loss that would apply to taxpayers using the simplified method. Two potential limitations were mentioned in the Report: (1) a rule that would allow the electing taxpayer to recognize net section 987 loss only to the extent of net section 987 gain recognized in prior or subsequent years; and (2) a rule that would defer the recognition of all section 987 gain or loss until the earlier of (i) the year that the trade or business conducted by the section 987 QBU ceases to be performed by any member of its controlled group or (ii) the year that substantially all of the assets and activities of the QBU are transferred outside of the controlled group.

Finally, the Report stated that the Treasury Department and the IRS were considering alternative transition rules.

One alternative would allow taxpayers to carry forward unrealized section 987 gains and losses (measured on the transition date with appropriate adjustments), and a second alternative would allow taxpayers to translate all items of the section 987 QBU at the spot rate on the transition date without carrying forward any unrecognized section 987 gain or loss.

V. Deferral Notices

The Treasury Department and the IRS have issued several notices stating that future guidance would defer the applicability dates of the 2016 final regulations, §§1.987-2(c)(9) and 1.987-4(c)(2) and (f) of the 2019 final regulations (the “related 2019 final regulations”), and §§1.987-1T (other than §§1.987-1T(g)(2)(i)(B) and (g)(3)(i)(H)) through 1.987-4T, 1.987-6T, 1.987-7T, 1.988-1T, and 1.988-2T(i) of the temporary regulations. Most recently, on August 22, 2022, Notice 2022-34, 2022-34 I.R.B. 150, announced that future guidance would defer the applicability date of the 2016 final regulations and the related 2019 final regulations by one additional year to taxable years beginning after December 7, 2023. Thus, following the amendments described in that Notice, the 2016 final regulations and the related 2019 final regulations would first apply to the taxable year beginning on January 1, 2024, for calendar year taxpayers. The applicability date of §1.987-12 would not be affected by these amendments.

VI. Financial Accounting Rules

The rules of the final regulations under section 987 differ from the U.S. generally accepted accounting principles (“U.S. GAAP”) relating to foreign currency translation gain or loss.¹ For financial accounting purposes, the consolidated financial statements of a reporting entity may include operations denominated or measured in currencies other than the reporting currency (each such operation, a foreign entity),² resulting in the need to translate those operations into the

reporting currency of the reporting entity. FASB, 2023, ASC par. 830-10-10-1. The assets and liabilities and other elements, such as revenues and expenses, of the financial statements of a foreign entity are translated to the reporting currency using a current exchange rate. FASB, 2023, ASC pars. 830-30-45-3 through 830-30-45-5. For example, assets and liabilities of the foreign entity are translated into the reporting currency using the spot rate on the balance sheet date. Translation adjustments resulting from the process of translating a foreign entity’s financial statements to the reporting currency are not included in determining net income but are reported in the cumulative translation adjustment (CTA), which is part of other comprehensive income, included in the in the equity section of the reporting entity’s consolidated balance sheet. FASB, 2023, ASC par. 830-30-45-12. Upon the sale or liquidation of the investment in the foreign entity, the CTA attributable to that foreign entity is removed from equity and is reported as part of the gain or loss on the sale or liquidation of the investment. FASB, 2023, ASC par. 830-30-40-1.

The treatment of translation gain or loss under FASB, ASC Topic 830, under which translation gain or loss is deferred until a sale or liquidation, differs from the requirements of section 987(3), under which a taxpayer is required to make proper adjustments for the transfer of property between QBUs of a taxpayer by including section 987 gain or loss in income upon a remittance. Further, in contrast to the translation adjustments in the financial accounting rules, which apply to all assets and liabilities of a foreign entity, the FEET method imputes section 987 gain or loss only to marked items of a section 987 QBU and requires the basis of historic assets to be translated at historic rates for purposes of computing section 987 taxable income or loss.

Explanation of Provisions

The proposed regulations retain the basic approach and structure of the final

¹ The relevant U.S. GAAP financial accounting rules are contained in Financial Accounting Standards Board (“FASB”), Accounting Standards Codification (“ASC”), Foreign Currency Matters, Topic 830 (formerly known as FASB Statement No. 52, Foreign Currency Translation).

² A foreign entity is an operation, including a subsidiary, division, and branch, whose financial statements are both (a) prepared in a currency other than the reporting currency of the reporting entity, and (b) combined or consolidated with or accounted for on the equity basis in the financial statements of the reporting entity. FASB, 2023, ASC sec. 830-10-20.

regulations, while adopting a number of the simplifications discussed in the Report and providing additional guidance regarding the determination of section 987 taxable income or loss and section 987 gain or loss.

I. FEET Method

As explained in parts II.B and II.C of the Background section, the final regulations provide that section 987 gain or loss and section 987 taxable income or loss are determined under the FEET method. This method uses a balance sheet approach to determine section 987 gain or loss. In addition, historic items are translated at historic rates (both for purposes of determining section 987 gain or loss and for purposes of translating recovery of basis with respect to historic assets in computing section 987 taxable income or loss). As a result, the FEET method does not impute section 987 gain or loss to historic items, for which exchange rate changes have only an uncertain or remote effect on value that is more appropriately recognized upon a realization event.

Several comments asserted that the FEET method is overly complex and presents significant compliance burdens, primarily related to the treatment of historic items. Comments stated that, because the requirement to use historic rates to translate historic items diverges from financial accounting rules, taxpayers would need to keep a separate set of books with respect to each section 987 QBU and to develop costly reporting systems to maintain information that is not used for any other purpose.

Comments recommended that, to reduce the complexity and administrative burden of the final regulations, taxpayers should be permitted to apply a method similar to that provided in the 1991 proposed regulations. Comments noted that this method could be coupled with rules to prevent the selective recognition of section 987 losses, as discussed in part III of this Explanation of Provisions.

The proposed regulations retain the FEET method of the 2016 final regulations, with modifications discussed in this

Explanation of Provisions, as the default rule for determining section 987 taxable income or loss and net unrecognized section 987 gain or loss. *See* proposed §§1.987-3 and 1.987-4. The FEET method is an appropriate default rule because it generally provides a more precise measure of section 987 gain or loss. Moreover, the enactment of the Tax Cuts and Jobs Act, Public Law 115-97, 131 Stat. 2054 (2017), on December 22, 2017, has made it even more important to accurately calculate taxable income with respect to a section 987 QBU. For example, section 951A, relating to global intangible low-taxed income (“GILTI”), has significantly expanded the scope of taxable income of a controlled foreign corporation (“CFC”) that is subject to current U.S. taxation.³

In addition, because the 2016 final regulations permit the yearly average exchange rate to be used as the historic rate, a taxpayer that knows the year in which an asset was acquired or placed in service can determine the applicable historic rate based on publicly available information. Information relating to the year in which an asset was acquired or placed in service is often tracked for other reasons, including for purposes of computing depreciation and amortization. For example, in computing a CFC’s qualified business asset investment, section 951A(d)(3)(A) now requires the adjusted basis of assets to be determined using the alternative depreciation system under section 168(g).

However, the Treasury Department and the IRS acknowledge that in some cases it may be burdensome to translate the basis of each historic asset using a different historic rate (including for purposes of depreciation) in determining section 987 taxable income or loss. Accordingly, as described in parts II and IV of this Explanation of Provisions, the proposed regulations provide several simplifying elections that permit section 987 to be applied in a way that more closely conforms to the financial accounting rules and reduces the compliance burden. Taxpayers who make these elections would still compute section 987 gain or loss by reference to the year-end balance sheet of the section 987

QBU (though the computation would be modified, as described in part V of this Explanation of Provisions). The proposed regulations do not include an election to use the method prescribed in the 1991 proposed regulations, because the use of fundamentally different computational methods by different taxpayers (or by the same taxpayer in different years) would increase the complexity of the section 987 regulations and make them more difficult to administer.

II. Current Rate Election

As discussed in part I of this Explanation of Provisions section, comments noted that the compliance burden associated with the FEET method relates primarily to the treatment of historic items. Under the 2016 final regulations, taxpayers are required to track the historic rate for historic items and to use the historic rate for purposes of computing section 987 taxable income or loss and section 987 gain or loss.

To alleviate this compliance burden, proposed §1.987-1(d)(2) would provide an election to treat all items that are properly reflected on the books and records of a section 987 QBU as marked items (the “current rate election”). If a current rate election applies, all items of income, gain, deduction, and loss with respect to a section 987 QBU would be translated at the yearly average exchange rate for the current taxable year for purposes of computing section 987 taxable income or loss. *See* proposed §1.987-3(c)(2). In addition, all items of a section 987 QBU would be translated at the year-end spot rate for purposes of computing section 987 gain or loss.

The current rate election is expected to produce an amount of section 987 gain or loss and section 987 taxable income or loss that is similar to the amounts determined under the 1991 proposed regulations. If a current rate election is made, all assets and liabilities of a section 987 QBU would generate section 987 gain or loss, in conformity with the approach used for financial reporting purposes and the 1991 proposed regulations.

³ Previously, section 987 gain or loss recognized by a CFC generally would be taken into account in determining a U.S. shareholder’s taxable income only if a portion of the section 987 gain or loss affected the calculation of subpart F income or when the earnings of the CFC were relevant, such as on a distribution or sale.

In general, a current rate election would increase the pool of net unrecognized section 987 gain or loss with respect to a section 987 QBU (relative to the pool that would be determined without the current rate election). In addition, under a current rate election amounts in the pool may substantially exceed any economic gain or loss attributable to currency fluctuations. The Treasury Department and the IRS are concerned that without appropriate limitation, the current rate election would facilitate the abuses and inappropriate outcomes that occurred under the 1991 proposed regulations, including the potential for taxpayers to choose to recognize significant, and potentially uneconomic, section 987 losses while avoiding or deferring section 987 gains. Accordingly, the proposed regulations include a rule that would suspend the recognition of section 987 loss when a current rate election is in effect. See part III of this Explanation of Provisions.

III. Suspension of Section 987 Loss Under a Current Rate Election

Comments discussed several options for addressing the potential for selective recognition of section 987 losses. First, comments asserted that certain rules provided in the 2016 final regulations (for example, the annual netting of contributions and distributions to determine the amount of a remittance under §1.987-5(c)) would be sufficient to prevent abuse. Alternatively, comments recommended that the recognition of section 987 gain or loss be deferred until a QBU is terminated or its assets are sold to an unrelated party, consistent with the financial accounting rules. Comments also suggested that section 987 loss could be deferred until the owner recognizes an equal or greater amount of section 987 gain from the same QBU. Finally, some comments proposed a “lookback” approach, under which section 987 loss would be deferred only to the extent that the loss exceeded section 987 gain previously recognized with respect to the same section 987 QBU.

The Treasury Department and the IRS are concerned that, notwithstanding the

annual netting rule of §1.987-5(c) and the other rules provided in the 2016 final regulations, taxpayers generally have a significant degree of control over whether and when their section 987 QBUs make remittances and, therefore, could still selectively recognize section 987 losses. In addition, because taxpayers that make a current rate election are expected to have substantial pools of net unrecognized section 987 gain or loss, special rules are needed to prevent the selective recognition of losses.

Accordingly, if a current rate election is in effect, the proposed regulations generally would suspend the recognition of section 987 loss until a taxable year in which an equal or greater amount of section 987 gain is recognized (as described in part III.A of this Explanation of Provisions) or until the occurrence of certain recognition events (as described in part III.B of this Explanation of Provisions).

A. General rules relating to suspended section 987 loss

1. In General

In a taxable year in which a current rate election applies, any section 987 loss that would otherwise be recognized as a result of a remittance (including a deemed remittance resulting from the termination of a section 987 QBU) is treated as suspended section 987 loss. Proposed §1.987-11(c). In general, an owner of a section 987 QBU would recognize suspended section 987 loss in a taxable year in which the owner recognizes section 987 gain that has the same source and character as the suspended section 987 loss (the “loss-to-the-extent-of-gain rule”). Proposed §1.987-11(e). Whether section 987 gain has the same source and character as suspended section 987 loss would be determined on the basis of the initial assignment in proposed §1.987-6(b)(2)(i). See proposed §1.987-11(e)(1) and (f).

The Treasury Department and the IRS considered applying the loss-to-the-extent-of-gain rule at the QBU level, such that suspended section 987 loss with respect to a section 987 QBU would be

recognized only to the extent of section 987 gain recognized with respect to the same section 987 QBU (as was recommended by some comments). However, the Treasury Department and the IRS were concerned that a QBU-level limitation would be overly restrictive. Moreover, if an owner has suspended section 987 loss with respect to one QBU, the concern of selective loss recognition may be mitigated to the extent that the same owner recognizes section 987 gain with respect to another QBU.

Therefore, under the proposed regulations, the loss-to-the-extent-of-gain rule applies at the owner level. An owner of a section 987 QBU recognizes suspended section 987 loss to the extent that it recognizes section 987 gain, regardless of which QBU generates the gain. However, because this rule applies at the owner level, the Treasury Department and the IRS were concerned that an owner might trigger the recognition of section 987 gain that is not subject to residual U.S. tax (or is taxed at a low rate) to release suspended section 987 loss of a different source or character. Accordingly, proposed §1.987-11(e)(1) provides that an owner does not recognize suspended section 987 loss until it recognizes section 987 gain in the same recognition grouping as the suspended section 987 loss.

In general, section 987 gain and suspended section 987 loss are in the same recognition grouping if they are both initially assigned to U.S. source income or to foreign source income in the same section 904 category. Proposed §1.987-11(f)(1). In addition, if the owner of a section 987 QBU is a CFC, in order to be in the same recognition grouping, section 987 gain and suspended section 987 loss must both be initially assigned to the same statutory and residual grouping of subpart F income, tentative tested income, income described in section 952(b) (certain income that is effectively connected with the conduct of a trade or business within the United States (“ECI”) and excluded from subpart F income), or other income.⁴ Proposed §1.987-11(f)(2).

Suspended section 987 loss that is not recognized in a taxable year is recognized

⁴ See part VI of this Explanation of Provisions (requesting comments concerning the treatment of section 987 gain or loss as ECI).

in the next taxable year in which (and to the extent that) the owner recognizes section 987 gain in the same recognition grouping. The Treasury Department and the IRS also considered a lookback rule, under which suspended section 987 loss could be recognized to the extent that section 987 gain was recognized in a prior taxable year. However, a lookback rule would permit taxpayers to selectively trigger section 987 gain in taxable years in which such gain would not give rise to additional U.S. tax (for example, because the gain is offset by losses or because the additional U.S. tax is offset with foreign tax credits). In light of these concerns, the Treasury Department and the IRS request comments regarding, if a lookback rule were to be adopted, how to prevent section 987 gain that has no net effect on U.S. tax from releasing suspended section 987 loss that reduces U.S. tax.

2. Suspension of Section 987 Loss When an Annual Recognition Election Is Made

In general, a taxpayer who makes an annual recognition election will recognize the full amount of net unrecognized section 987 gain or loss that is added to the pool each year. If an annual recognition election and a current rate election are both in effect for a taxable year, section 987 loss generally would not be suspended under proposed §1.987-11(c). See part IV of this Explanation of Provisions.

The Treasury Department and the IRS are concerned that taxpayers who are subject to a current rate election might seek to avoid the application of the loss-to-the-extent-of-gain rule by making an annual recognition election after net unrecognized section 987 loss has accrued. Similarly, the Treasury Department and the IRS are concerned that taxpayers that have not made a current rate election, but which have substantial pools of net unrecognized section 987 loss, might make an annual recognition election to recognize the loss without the need for a remittance. Accordingly, the proposed regulations would treat any net accumulated unrecognized section 987 loss and deferred section 987 loss as suspended section 987 loss in the first year in which an annual recognition election takes effect if either (1) a current rate election was in effect

in the previous year or (2) the owner had more than \$5 million of net section 987 losses. Proposed §1.987-11(d).

3. Recognition of Suspended Section 987 Loss When an Annual Recognition Election Is in Effect

The proposed regulations also contain a special rule relating to the recognition of suspended section 987 loss when a current rate election and an annual recognition election are both in effect. The Treasury Department and the IRS are concerned that, absent a modification to the general loss-to-the-extent-of-gain rule in proposed §1.987-11(e)(1), taxpayers that have suspended section 987 loss would get an unwarranted benefit from making an annual recognition election. Specifically, absent a modification, these taxpayers would be able to recognize suspended section 987 loss even if they had net losses on a cumulative basis for the taxable years to which the annual recognition election applied.

For example, assume that an owner of a section 987 QBU has suspended section 987 loss of \$400 that arose in prior years (for example, under a current rate election). The owner's functional currency is the U.S. dollar, and the section 987 QBU's functional currency is the euro. In year 1, the owner makes an annual recognition election. The euro weakens in year 1 and partially recovers in year 2. As a result of the annual recognition election, the owner recognizes section 987 loss of \$200 in year 1 and recognizes section 987 gain of \$150 in year 2. Under the general loss-to-the-extent-of-gain rule in §1.987-11(e)(1), even though the owner recognized net section 987 loss of \$50 on a cumulative basis (over years 1 and 2), the owner would recognize suspended section 987 loss equal to the section 987 gain in the same recognition grouping that it recognizes in year 2. Assuming all of the section 987 gain or loss is in the same recognition grouping, the owner would recognize \$350 of total section 987 loss (equal to \$200 of section 987 loss recognized under the annual recognition election in year 1 and \$150 of suspended section 987 loss recognized under the loss-to-the-extent-of-gain rule in year 2), even though it recognizes only \$150 of section 987 gain.

Accordingly, if a taxpayer makes both an annual recognition election and a current rate election, the loss-to-the-extent-of-gain rule would apply by reference to the net cumulative amount of section 987 gain in each recognition grouping that is recognized by the taxpayer during the relevant testing period (rather than the gross amount recognized each taxable year). Proposed §1.987-11(e)(2). The testing period generally is the period in which section 987 loss is suspended and both a current rate election and an annual recognition election are in effect. Proposed §1.987-11(e)(2)(iii). The Treasury Department and the IRS request comments on whether any modifications to the limitation in proposed §1.987-11(e)(2) would allow for simplification while preventing inappropriate outcomes.

B. *Suspended section 987 loss recognized or attributed to a successor on termination*

The proposed regulations provide a successor rule that applies when a section 987 QBU with suspended section 987 loss terminates. Under the successor rule, suspended section 987 loss is not recognized in the taxable year of termination, but instead becomes attributable to a successor suspended loss QBU.

For this purpose, an eligible QBU is treated as a successor of a section 987 QBU if it holds a significant portion of the assets of the section 987 QBU following its termination, is engaged in the same trade or business, and is owned by the owner of the section 987 QBU or a member of the owner's controlled group. Proposed §1.987-13(b)(1). For this purpose, any eligible QBU may qualify as a successor, whether or not it is a section 987 QBU (that is, whether or not it has a different functional currency than its owner). Thus, for example, if an owner of a section 987 QBU with suspended section 987 loss contributes the assets of the section 987 QBU to a subsidiary where they are held by an eligible QBU of the subsidiary that uses them in the same trade or business (the "subsidiary QBU"), the subsidiary QBU is a successor suspended loss QBU even if it is not a section 987 QBU. Similar principles apply when a successor terminates. Proposed §1.987-13(c)(1).

If a section 987 QBU (or its successor) terminates without a successor, the original owner of the section 987 QBU recognizes all of its suspended section 987 loss with respect to the section 987 QBU (or its successor). Proposed §1.987-13(b)(2) and (c)(2). Therefore, an owner generally would recognize suspended section 987 loss when it transfers the section 987 QBU's assets to an unrelated party or the section 987 QBU ceases its trade or business (such that there is no successor suspended loss QBU). These events are similar to the events that result in a release of the CTA for financial reporting purposes. Moreover, the Treasury Department and the IRS expect that taxpayers would be less likely to sell or wind up the trade or business of a section 987 QBU for the purpose of selectively recognizing section 987 losses and, accordingly, there is less of a need for continued suspension of section 987 loss after these events occur.

In addition, suspended section 987 loss is recognized if the owner of the successor ceases to be related to the original owner of the suspended loss QBU due to a direct or indirect transfer of interests in the owner of the successor. Proposed §1.987-13(d). If the owner of a successor suspended loss QBU ceases to be related to the original owner of the section 987 QBU for a different reason (for example, due to a transfer of interests in the original owner of the suspended loss QBU), the successor suspended loss QBU is no longer treated as a successor, and suspended section 987 loss can no longer be recognized in connection with a termination (though it can still be recognized under the loss-to-the-extent-of-gain rule). Proposed §1.987-13(e). This rule is intended to prevent taxpayers from transferring the stock of the original owner out of its controlled group for the purpose of selectively recognizing suspended section 987 loss, while leaving behind the assets and activities of the section 987 QBU in the hands of a different controlled group member.

Similarly, suspended section 987 loss is not recognized when the owner of a section 987 QBU liquidates in a transaction described in section 331. Proposed §1.987-13(f). Instead, suspended section 987 loss that is not recognized in the taxable year of the liquidation is eliminated and will never be recognized. This rule

is intended to prevent taxpayers from entering into section 331 transactions in order to trigger the recognition of suspended section 987 loss. For example, a U.S. shareholder could cause an upper-tier CFC that owns a section 987 QBU with suspended section 987 loss to transfer all of its assets and liabilities to a lower-tier CFC in a section 351 contribution, and then cause the upper-tier CFC to liquidate in a transaction described in section 331 in order to recognize the suspended loss. The Treasury Department and the IRS are aware that similar transactions have been used to claim large section 987 losses under current law.

In the case of a combination or separation, the suspended section 987 loss of a combined or separated QBU is determined under rules similar to those applicable to net accumulated unrecognized section 987 gain or loss under proposed §1.987-4(f). Proposed §1.987-11(b)(2) and (3). Therefore, the suspended section 987 loss of a separating QBU is allocated to the separated QBUs in proportion to the assets properly reflected on the books and records of each separated QBU after the separation. Proposed §1.987-11(b)(3)

C. Special rule for inbound liquidations and reorganizations

Under the proposed regulations, if a foreign corporation liquidates or merges into a domestic corporation in a section 381(a) transaction, the domestic corporation does not succeed to or take into account any unused suspended section 987 loss of the foreign corporation. Proposed §1.987-13(g). This rule is intended to prevent the importation of suspended section 987 loss that was generated offshore. Due to differences in how income of a CFC is taxed to its U.S. shareholders, these losses may relate to income subject to tax at a significantly reduced effective rate. For example, a suspended section 987 loss that is allocated and apportioned to the other income grouping under proposed §1.987-6 may effectively reduce only earnings that would typically not be subject to current U.S. tax, and which may be eligible for a dividends received deduction under section 245A upon distribution. As a result, depending on the particular facts, such losses may have little or no impact

on the U.S. tax liability of a CFC's U.S. shareholder when they are recognized and are generally not equivalent to the section 987 gains or losses typical of a domestic corporation.

Furthermore, even if the domestic corporation could, in theory, succeed to the suspended section 987 loss, the loss may have been assigned to an income group, such as the tested income group, that is not relevant to a domestic corporation, in which case, it would be highly unlikely that the suspended section 987 loss could ever be used (absent a subsequent outbound asset transfer by the domestic corporation to a foreign successor) under the loss-to-the-extent-of-gain rule because the domestic corporation would not recognize section 987 gain in the same recognition grouping.

D. Rejection of financial accounting deferral rule

The Treasury Department and the IRS also considered a rule that would defer the recognition of all section 987 gain and loss of a section 987 QBU until a taxable year in which the section 987 QBU's trade or business ceases to be performed by any member of the controlled group or substantially all of the assets and activities of the QBU are transferred outside of the controlled group. This approach would more closely parallel the rules for determining when the CTA is released for financial accounting purposes.

However, the loss limitation rule provided in the proposed regulations is more consistent with the statutory provisions of section 987(3), which contemplates the recognition of section 987 gain or loss at the time of a remittance, and section 989(c)(2), which authorizes regulations limiting the recognition of foreign currency loss on certain remittances. Moreover, the Treasury Department and the IRS are concerned that a rule that defers the recognition of all section 987 gain or loss may be difficult to administer. For example, as a practical matter, taxpayers might not properly track section 987 gain or loss on an annual basis if it is not expected to be recognized in the foreseeable future and the sale or liquidation of a section 987 QBU might occur many years after the accrual of section 987 gain or

loss (at which time the necessary records may no longer be available).

IV. Annual Recognition Election

A. Annual deemed termination election provided in the 2016 temporary and proposed regulations

As explained in part II.D of the Background section, the 2016 temporary and proposed regulations contained an annual deemed termination election. Under this election, a section 987 QBU would be deemed to terminate on the last day of each taxable year, resulting in the remittance of all the gross assets of the section 987 QBU to its owner and the recognition of all net unrecognized section 987 gain or loss on an annual basis. See §§1.987-8T(d) and 1.987-8(e). The assets and liabilities of a section 987 QBU subject to the election would then be deemed to be contributed to the section 987 QBU on the first day of the following taxable year. See §1.987-8T(d).

A comment asserted that it was difficult to apply the rules under the annual deemed termination election. If the election was made, a section 987 QBU's historic assets and the amount of its historic liabilities would be translated at the end of each year into the owner's functional currency using historic rates (due to the deemed termination and remittance); the historic rate would generally be the yearly average exchange rate for the year of the deemed termination. The assets and liabilities would then be retranslated into the section 987 QBU's functional currency at the beginning of the following taxable year at the yearly average exchange rate for the following taxable year (due to the deemed contribution). See §§1.987-2(d)(2) and 1.987-5(f)(3). As a result, the basis of a section 987 QBU's assets and the amount of its liabilities (determined in the section 987 QBU's functional currency) generally would change from one year to the next, which would increase the compliance burden of applying the section 987 regulations.

B. Annual recognition election provided in the proposed regulations

The proposed regulations would replace the annual deemed termination

election with an annual recognition election. Like the annual deemed termination election, an owner that makes the annual recognition election would recognize the full amount of net unrecognized section 987 gain or loss each year. However, the proposed annual recognition election does not result in a deemed termination of a section 987 QBU and a deemed remittance of its assets or a deemed contribution to the section 987 QBU. Instead, the owner of a section 987 QBU simply recognizes the full amount of its net unrecognized section 987 gain or loss on an annual basis. Therefore, the annual recognition election would not alter the functional currency basis of a section 987 QBU's assets, the amount of its liabilities, or their historic exchange rates.

C. Special rules that apply when a current rate election and an annual recognition election are both in effect

The annual recognition election is available to owners whether or not they make a current rate election. If an owner makes both an annual recognition election and a current rate election for a taxable year, the loss suspension rule described in part III of this Explanation of Provisions does not apply to net unrecognized section 987 loss accrued while the election is in effect. Because the annual recognition election requires both gains and losses to be recognized without regard to whether a remittance occurs, selective recognition of losses is not possible and, accordingly, a loss limitation should not be needed. However, see part III.A.3 of this Explanation of Provisions regarding the application of the loss-to-the-extent-of-gain rule when an annual recognition election is in effect.

D. Translation of taxable income under an annual recognition election when a current rate election is not in effect

If an owner of a section 987 QBU makes an annual recognition election, but does not make a current rate election, section 987 taxable income or loss is determined by translating all items at the yearly average exchange rate. Unlike under the 2016 temporary and proposed regulations, this rule is mandatory (rather than elective). Use of the yearly average

exchange rate simplifies the determination of section 987 taxable income or loss without sacrificing accuracy and is consistent with financial accounting principles. Therefore, an election to use historic rates for this purpose should not be needed.

E. Consequences of making an annual recognition election if a current rate election is not in effect

As described in part IV.D of this Explanation of Provisions, if an owner of a section 987 QBU makes an annual recognition election, and does not make a current rate election, the owner would use the yearly average exchange rate for purposes of determining section 987 taxable income or loss. However, the owner would use historic rates to translate historic items for purposes of determining section 987 gain or loss. Thus, the same historic item would be translated at different exchange rates for different purposes. Under the mechanics of the FEET method, if a historic asset is sold or depreciated during the taxable year, the difference between the historic rate basis and the current year average rate basis would be added to the pool of unrecognized section 987 gain or loss (and recognized pursuant to the annual recognition election).

The effect of these rules is that—with respect to historic assets of a section 987 QBU—an owner that does not make a current rate election would recognize the same total amount of taxable income each year regardless of whether it makes an annual recognition election. For example, assume a section 987 QBU has the euro as its functional currency, and its owner is a calendar year taxpayer with the U.S. dollar as its functional currency. At the end of year 1, the section 987 QBU owns a non-depreciable historic asset (Asset A) with a basis of 100 euros, and the historic rate for Asset A is €1=\$1. The yearly average exchange rate in year 2 and the spot rate on December 31, year 2 is €1=\$2. In year 2, the section 987 QBU sells Asset A for 150 euros and holds the 150 euros on its balance sheet until the end of year 2.

If the owner does not make an annual recognition election, the owner will have section 987 taxable income of \$200 for

year 2. This reflects the excess of the amount realized (150 euros, translated at the yearly average exchange rate of €1=\$2 into \$300) over the basis of Asset A (100 euros, translated at the historic rate of €1=\$1 into \$100). The owner will have no unrecognized section 987 gain or loss for the taxable year under §1.987-4(d). A comparison of the year 2 and year 1 year-end balance sheets under §1.987-4(d)(1) will reflect an increase of \$200 (the excess of 150 euros held at the end of year 2, translated at the year 2 year-end spot rate of €1=\$2 into \$300, over the €100 basis of Asset A, which was held at the end of year 1, translated at the historic rate of €1=\$1 into \$100). However, this increase is fully offset by the negative adjustment for taxable income of \$200 under §1.987-4(d)(6).

By contrast, if the owner makes an annual recognition election, the owner will have section 987 taxable income in year 2 of only \$100 (50 euros of taxable income, translated at the yearly average exchange rate of €1=\$2). The owner will also have unrecognized section 987 gain for the taxable year of \$100 under §1.987-4(d), which reflects the balance sheet increase of \$200 (computed under §1.987-4(d)(1) as described in the preceding paragraph) reduced by the negative adjustment for taxable income of \$100. Thus, the difference between Asset A's basis translated at the yearly average exchange rate (which is \$200) and its basis translated at the historic rate (which is \$100) is added to the pool of unrecognized section 987 gain or loss and this amount is recognized in year 2 due to the annual recognition election.

The example illustrates that, whether or not the annual recognition election is made, the owner recognizes the same amount of total income with respect to Asset A (that is, \$200). However, the annual recognition election has the effect of converting a portion of the owner's income into section 987 gain or loss. Because section 987 gain or loss is subject to special source and character rules under proposed §1.987-6, the annual

recognition election can change the source and character of an owner's taxable income.

F. Impact of an annual recognition election on the timing of recognition with respect to marked and historic items

Under an annual recognition election, section 987 gain or loss with respect to marked items would be recognized annually (whereas, in the absence of an annual recognition election, section 987 gain or loss would be deferred until the section 987 QBU makes a remittance). Therefore, with respect to marked items, an annual recognition election would accelerate the recognition of section 987 gain or loss. If a current rate election is in effect, all items of the section 987 QBU will be treated as marked items generating section 987 gain or loss; this gain or loss would be accelerated if an annual recognition election is made.

However, if a current rate election is not in effect, the annual recognition election would not accelerate the recognition of income with respect to historic assets. As explained in part IV.E of this Explanation of Provisions, in the absence of a current rate election, the owner of a section 987 QBU recognizes the same amount of total income with respect to historic assets whether or not an annual recognition election is in effect (though the annual recognition election has the effect of changing the portion of the income that is section 987 gain or loss and the portion that is section 987 taxable income or loss). In addition, as explained in part IV.D of this Explanation of Provisions, an annual recognition election is expected to simplify the computation of section 987 taxable income or loss (because all items would be translated at the yearly average exchange rate). Therefore, for section 987 QBUs that do not have a significant amount of marked assets or liabilities, the election is expected to reduce the compliance burden on taxpayers without materially accelerating the recognition of income.

V. Changes to the Computation of Unrecognized Section 987 Gain or Loss for a Taxable Year

The proposed regulations contain several changes to the computation of unrecognized section 987 gain or loss for a taxable year under §1.987-4(d) (that is, the amount added to the pool of net unrecognized section 987 gain or loss each year).⁵ These modifications are intended to ensure that section 987 gain or loss is attributable only to exchange rate fluctuations. For example, the proposed regulations would modify the adjustments for tax-exempt income and non-deductible expenses to cover all items of income, gain, deduction, or loss that affect the section 987 QBU's balance sheet but are not taken into account in determining section 987 taxable income or loss for the taxable year. Proposed §1.987-4(d)(7) and (8). The proposed regulations would also require an adjustment for items of income, gain, deduction, or loss that are taken into account in determining section 987 taxable income or loss but do not affect the section 987 QBU's balance sheet for the taxable year. Proposed §1.987-4(d)(9).

Thus, the proposed regulations would account for deferred items that are expected to be taken into account in computing taxable income in a subsequent year by taking them into account in the year in which they impact the section 987 QBU's balance sheet and effectively backing them out in the future year when they impact taxable income but do not change the balance sheet. For example, if a section 987 QBU incurs an expense in year 1, but the deduction associated with the expense is deferred until year 5, proposed §1.987-4(d)(7) would treat the expense as a non-deductible expense in year 1, increasing the year 1 unrecognized section 987 gain or loss. In year 5, the deduction would have no net effect on unrecognized section 987 gain or loss, since the deduction would result in a positive adjustment under proposed §1.987-4(d)(6) (because the deduction reduces taxable income, and taxable income is a negative adjustment to unrecognized section 987 gain or loss),

⁵ Proposed §1.987-4(g) contains new examples illustrating the proposed modifications to the computation of unrecognized section 987 gain or loss under proposed §1.987-4(d). The Treasury Department and the IRS intend to make conforming changes to the existing examples in §1.987-4 of the final regulations when the proposed regulations are finalized.

and an offsetting negative adjustment under proposed §1.987-4(d)(9) (since the deduction represents a taxable deduction that does not affect the balance sheet). As a result, the expense would impact the calculation of section 987 gain or loss in the same manner as if it had been deductible in year 1.

In addition, the proposed regulations require an adjustment to unrecognized section 987 gain or loss for any residual increase or decrease to the adjusted balance sheet of the section 987 QBU (determined in the functional currency of the section 987 QBU) that is not accounted for under the other computational steps. Proposed §1.987-4(d)(10). This residual amount is translated into the owner's functional currency at the yearly average exchange rate. The residual increase or decrease is computed by applying the other computational steps described in proposed §1.987-4(d) (steps 1 through 9) in the functional currency of the section 987 QBU. Because these steps must already be performed in the owner's functional currency, determining the residual increase or decrease to the adjusted balance sheet under proposed §1.987-4(d)(10) is not expected to significantly increase the burden of determining net unrecognized section 987 gain or loss.

The application of proposed §1.987-4(d)(10) would ensure that non-currency-related changes to the balance sheet do not artificially increase or decrease the pool of net unrecognized section 987 gain or loss. However, if the computational steps are applied correctly in the functional currency of a section 987 QBU, there should not be any residual increase or decrease to the balance sheet under proposed §1.987-4(d)(10) (unless a current rate election or an annual recognition election is made). Rather, the year-over-year increase (or decrease) to the functional currency balance sheet (step 1) should equal the functional currency amount of net transfers to the section 987 QBU (steps 2 through 5) and income of the section 987 QBU (steps 6 through 8), after backing out items of income that do not impact the balance sheet (step 9). By contrast, when these steps are applied in

owner functional currency, they serve to identify the balance sheet change attributable to currency movements.

For taxpayers that make a current rate election or an annual recognition election, the proposed regulations provide that steps 6 through 9 of the computation (relating to income, gain, deduction, or loss) do not need to be applied. For these taxpayers, all items of income, gain, deduction, or loss would be taken into account as a residual increase or decrease to the section 987 QBU's balance sheet and translated at the yearly average exchange rate. The Treasury Department and the IRS request comments on whether any additional adjustments are needed for section 988 gain or loss of a section 987 QBU that is subject to a current rate election or an annual recognition election. See part XV of this Explanation of Provisions (requesting comments as to whether section 988 gain or loss of a section 987 QBU should be determined in the owner's functional currency or the section 987 QBU's functional currency).

VI. Source and Character of Section 987 Gain or Loss

The final regulations provide that the source and character of section 987 gain or loss is determined in the year of a remittance using the asset method of §§1.861-9(g) and 1.861-9T(g). See §1.987-6(b)(2). For this purpose, only the assets of the section 987 QBU are taken into account. The proposed regulations would generally retain this character and source rule, subject to certain modifications, and would further provide that taxpayers must apply only the tax book value method in characterizing the assets under proposed §§1.861-9(g) and 1.861-9T(g).⁶ See proposed §1.987-6(b)(2)(i)(A).

Proposed §1.987-6(b)(2)(i) would provide special rules for the application of the tax book value method for initially characterizing section 987 gain or loss. Under these proposed regulations, the assets of the section 987 QBU would be initially assigned to statutory and residual groupings under the tax book value method.

However, to prevent circularity, the proportions in which the tax book value of the assets would be initially assigned to the statutory and residual groups are determined without regard to section 987 gain or loss. Proposed §1.987-6(b)(2)(i)(B). The initial assignment would occur after the application of the income attribution rules of §1.904-4(f)(2)(vi) or 1.951A-2(c)(7) (or the principles of these rules), but before expenses are allocated and apportioned to gross income and before the application of provisions that require a net income computation, such as the high-tax exception to passive category income in §1.904-4(c), the high-tax exception to foreign base company income in §1.954-1(d), and the high-tax exclusion from tested income in §1.951A-2(c)(7).

In addition, because, at the time of the initial assignment, a taxpayer may not yet know whether a GILTI high-tax election will be in effect in the taxable year in which the section 987 gain or loss is recognized (since deferred section 987 gain or loss and suspended section 987 loss may be recognized in future year), the proposed regulations would initially assign all of the section 987 gain or loss that would have been assigned to a tested income group if no GILTI high-tax election was in effect to a tentative tested income group. See proposed §1.987-6(b)(2)(i)(D).

The initial assignment would generally be made in the taxable year in which section 987 gain or loss is treated as recognized, deferred, or suspended under proposed §1.987-6(b)(1). Then, in the taxable year in which the section 987 gain or loss is recognized (which may be the same taxable year as the year in which the initial assignment was made or a future taxable year), any section 987 gain or loss that was initially assigned to a tentative tested income group would be reassigned to a tested income group or residual group based on whether the GILTI high-tax election is in effect in that taxable year and, if so, whether the income is high-tax. The initial characterization under proposed §1.987-6(b)(2)(i) would be used for purposes of applying

⁶ The proposed regulations would also make a clarifying change to §1.861-9T(g)(2)(ii)(A)(1) to clarify that the references to beginning-of-year and end-of-year functional currency amounts are to the owner functional currency amounts and to move certain provisions from §1.861-9T to proposed §1.861-9.

the loss-to-the-extent-of-gain rule in proposed §1.987-11(e) and (f), and also applies as the starting point for net income calculations required for other provisions such as the high-tax exception to passive category income under §1.904-4(c) and the GILTI and subpart F high-tax exceptions under §§1.954-1(d) and 1.951A-2(c)(7). Proposed §1.987-6(b)(2)(ii).

Proposed §1.987-6(b)(2)(iii) would also provide that if a GILTI high-tax election is made under §1.951A-2(c)(7)(viii), it applies to all of the section 987 gain or loss in a tentative tested income group that is recognized by the CFC in the taxable year as if the section 987 gain and loss were all assigned to its own separate tested unit of the CFC. In other words, all section 987 gain or loss recognized by the CFC in that taxable year in the same section 904 category would be treated as a single tentative tested income item for purposes of applying the GILTI high-tax exclusion.

For example, if section 987 gain and loss in a section 904 category is initially assigned to a tentative tested income group under proposed §1.987-6(b)(i) and a GILTI high-tax election is in effect in the year in which the section 987 gain or loss is recognized, the section 987 gain or loss in the section 904 category would be treated as its own tentative tested income item for purposes of determining whether it is excluded from tested income under §1.951A-2(c)(7), after which the section 987 gain or loss will be reassigned to a tested income group (if the item is not excluded from tested income) or to the residual category (if the item is excluded from tested income). Because foreign countries generally do not impose tax on section 987 gain, allocation and apportionment of a foreign income tax to section 987 gain under §1.861-20 and proposed §1.987-6(b)(3) will likely be uncommon. As a result, a tentative tested income item consisting of section 987 gain may often have a zero percent effective rate of foreign tax and, therefore, would generally not qualify for the GILTI high-tax exclusion.

As described above, the proposed regulations would provide that, for purposes of determining the source and character of section 987 gain and loss, the initial assignment of suspended section 987

loss and deferred section 987 gain and loss is generally made in the taxable year it becomes suspended or deferred (generally in the year of a remittance or the year the section 987 QBU is transferred to a related party), rather than the taxable year in which it is recognized. Proposed §1.987-6(b)(1). The Treasury Department and the IRS anticipate that making the initial assignment in the year of suspension or deferral, rather than the year the section 987 gain or loss is recognized, will generally result in determining the source and character in a year closer in time to the year in which the section 987 loss originated, and therefore will tend to be more accurate. In addition, making an initial assignment in the taxable year of deferral or suspension means that the source and character are determined by reference to the assets of the section 987 QBU while they are still owned by the owner, rather than after they have been transferred, which would be both administratively difficult and more likely to introduce distortions to the determination.

The Treasury Department and the IRS request comments as to whether it would be appropriate to determine the source and character of unrecognized section 987 gain or loss by making the initial assignment in the taxable year in which the section 987 gain or loss is initially included in unrecognized section 987 gain or loss under §1.987-4(d), rather than in the year of a remittance. Making the initial assignment on an annual basis would require more extensive tracking of section 987 gain or loss in separate categories. However, this approach could avoid distortions that could arise from changes in the bases of a section 987 QBU's assets or shifts in the character of its income or assets between the time unrecognized section 987 gain or loss is added to the pool and the time it is recognized. In addition, this approach could align more closely with the character of income generated by the section 987 QBU's assets at the time of the exchange rate fluctuations that give rise to section 987 gain or loss.

The proposed regulations would not change the rule in the final regulations that section 987 gain or loss that is assigned to a subpart F income group is treated as foreign currency gain or loss attributable to section 988 transactions

not directly related to the business needs of the CFC. *See* proposed §1.987-6(b)(2)(i)(C). The Treasury Department and the IRS request comments as to whether it would be appropriate to eliminate this rule and characterize section 987 gain or loss by reference to subpart F income groups (as defined in §1.960-1(d)(2)(ii)(B)) or whether to retain this rule generally but apply a different rule to taxpayers that make a current rate election (under which section 987 gain or loss can arise with respect to assets that would not generate section 988 gain or loss in the hands of the owner).

A qualified business unit that produces income or loss that is, or is treated as, ECI is required to use the dollar as its functional currency. *See* §1.985-1(b)(1)(v). The 2016 proposed regulations would provide an election under which a qualified business unit with a dollar functional currency may be treated as a section 987 QBU. *See* §1.987-1(b)(6)(iii) of the 2016 proposed regulations. The Treasury Department and the IRS also request comments as to whether, and in what circumstances, section 987 gain or loss should be treated as ECI.

VII. *Expansion of Entities Covered*

In general, the final regulations do not apply to a bank, insurance company, leasing company, finance coordination center, regulated investment company, or real estate investment trust (a "specified entity"), unless it engages in transactions primarily with related persons within the meaning of section 267(b) or section 707(b) that are not themselves specified entities. Additionally, the final regulations do not apply to trusts, estates, S corporations, and partnerships other than section 987 aggregate partnerships. *See* §1.987-1(b)(1)(ii).

The Treasury Department and the IRS are concerned that excluding these entities from the application of the regulations under section 987 would not provide taxpayers with sufficient guidance to ensure these entities are using an appropriate method to calculate their section 987 gain or loss. Furthermore, if these entities are not subject to the regulations under section 987, they may use different methods of applying section 987 that vary in

material ways. Applying a consistent set of rules to all taxpayers facilitates the fair and effective administration of the tax law by treating similarly situated taxpayers similarly as well as eliminating subjectivity and uncertainty.

In addition, the Treasury Department and the IRS anticipate that the new current rate election and annual recognition election described in parts II and IV of this Explanation of Provisions would provide sufficient flexibility to permit the entities excluded under the 2016 final regulations to apply the proposed regulations. As discussed in part VIII of this Explanation of Provisions, the proposed regulations also provide new rules relating to partnerships (other than section 987 aggregate partnerships) and S corporations. See part VIII of this Explanation of Provisions. These rules are expected to significantly reduce the administrative burden and complexity of applying section 987 to partnerships as compared to the aggregate rules. Accordingly, proposed §1.987-1(b)(1)(ii) generally removes the exclusion for entities excluded from the 2016 final regulations, making them subject to the proposed regulations.

The proposed regulations generally continue to exclude foreign non-grantor trusts and foreign estates if the aggregate interests of beneficiaries that are United States persons is less than 10 percent, and foreign partnerships if the aggregate interests of the partners that are United States persons is less than 10 percent of the capital and profits interests. Proposed §1.987-1(b)(1)(ii). The Treasury Department and the IRS are concerned that the shareholders, partners, and beneficiaries of these entities may not be able to obtain the information needed to apply the regulations to these entities, and it would be difficult for the IRS to administer the regulations with respect to these entities. For the same reason, the proposed regulations generally exclude foreign corporations that are not CFCs and foreign corporations that are CFCs but which have no U.S. shareholders (which are not excluded under the final regulations). Foreign individuals are also generally excluded as they are typically not subject to U.S. tax.

The Treasury Department and the IRS request comments on whether any additional rules are needed to facilitate the application of the proposed regulations to the entities that were excluded from the 2016 final regulations. See also part VIII of this Explanation of Provisions, requesting comments on the application of the proposed regulations to partnerships and S corporations.

VIII. *Partnerships*

A. *Background*

As explained in part II.C of the Background section, the 2006 proposed regulations and 2016 final regulations applied aggregate theory to partnerships. As explained in the preamble to the 2006 proposed regulations, the 2006 proposed regulations applied the FEED method directly at the partner level under aggregate theory with the goal of more appropriately preserving the correct amounts of exchange gain or loss as measured from the perspective of the partner. Measuring the currency gain or loss by reference to the partner, rather than the partnership, was considered preferable because the partners would generally bear the economic risk from the exposure.

Comments to the 2006 proposed regulations requested that the Treasury Department and the IRS reconsider the aggregate approach and instead treat a partnership as a separate entity with its own functional currency. The comments indicated that the aggregate approach was overly complex and that minority partners would not have the power to compel a partnership to provide them with the information needed to make the calculations required under the aggregate approach. One comment acknowledged the economic rationale for the aggregate approach but, in light of its complexity, recommended that it apply only in cases in which a partner's interest in partnership capital or profits exceeds a certain threshold, such as 10 percent.

In the preamble to the 2016 final regulations, the Treasury Department and the IRS acknowledged concerns regarding

the complexity of the applying the aggregate approach to partnerships, but determined that it would be feasible to apply an aggregate approach to partnerships that are wholly owned by related persons. Furthermore, the aggregate approach was preserved in order to prevent a group of related parties from holding eligible QBUs through partnerships instead of directly, and thereby altering the section 987 treatment of the eligible QBU without meaningfully altering the group's economic position.

As a result, the 2016 final regulations retained the aggregate approach to partnerships, but applied it only to section 987 aggregate partnerships, as discussed in Part II.C of the Background section. The 2016 final regulations did not address other partnerships.

Under the aggregate approach set forth in the 2016 final regulations, assets and liabilities reflected on the books and records of an eligible QBU of a section 987 aggregate partnership are allocated to each partner, which is considered an indirect owner of the eligible QBU. If the eligible QBU has a different functional currency than its indirect owner, then the assets and liabilities of the eligible QBU that are allocated to the partner are treated as a section 987 QBU of the indirect owner.

B. *Method for determining share of assets and liabilities*

The 2006 proposed regulations provided that a partner's share of assets and liabilities reflected on the books and records of an eligible QBU is determined in a manner consistent with how the partners had agreed to share the economic benefits and burdens corresponding to partnership assets and liabilities, taking into account the rules and principles of subchapter K.⁷

A comment noted that the rules in the 2006 proposed regulations for allocating assets and liabilities to a partner's indirectly owned section 987 QBU were ambiguous and that the rules and principles of subchapter K do not provide sufficient guidance in this regard. The Treasury Department and the IRS acknowledged

⁷A partner's basis in the partnership was adjusted to take into account any section 987 gain or loss that it recognized on any section 987 QBUs owned indirectly through the partnership.

the ambiguity in the preamble to the 2016 final regulations, and the 2016 temporary regulations provided more specific rules for determining a partner's share of the assets and liabilities reflected on the books and records of an eligible QBU owned indirectly through a section 987 aggregate partnership.

In particular, the temporary regulations provided that, in any taxable year, a partner's share of each asset and liability of a section 987 aggregate partnership was proportional to the partner's liquidation value percentage with respect to the aggregate partnership. A partner's liquidation value percentage was defined as the ratio of the liquidation value of the partner's interest in the partnership to the aggregate liquidation value of all the partners' interests in the partnership. The liquidation value of the partner's interest in the partnership was defined as the amount of cash the partner would receive with respect to its interest if, immediately following the applicable determination date, the partnership sold all of its assets for cash equal to the fair market value of such assets (taking into account section 7701(g)), satisfied all of its liabilities (other than those described in §1.752-7), paid an unrelated third party to assume all of its §1.752-7 liabilities in a fully taxable transaction, and then liquidated.

Comments recommended alternative approaches for determining a partner's share of the assets and liabilities of a section 987 aggregate partnership. Some comments recommended that §1.987-7 be withdrawn and replaced with the approach of the 2006 proposed regulations under section 987, which provided that a partner's share of assets and liabilities reflected on the books and records of an eligible QBU held indirectly through the partnership must be determined in a manner consistent with how the partners have agreed to share the economic benefits and burdens corresponding to those partnership assets and liabilities, taking into account the rules and principles of subchapter K. A comment indicated that the liquidation value percentage approach was inconsistent with certain principles of subchapter K, resulting in distortions in the calculation of section 987 gain or loss in certain cases.

The Treasury Department and the IRS determined that, in the absence of a more

comprehensive set of rules for determining a partner's share of assets and liabilities reflected on the books and records of an eligible QBU held indirectly through the partnership that also articulates the interaction of those rules with applicable rules in subchapter K, a more flexible approach was warranted. Moreover, the Treasury Department and the IRS determined that, in certain instances, the liquidation value percentage methodology set forth in the 2016 temporary regulations could be interpreted as applying in a way that inappropriately distorts the computation of section 987 gain or loss. Specifically, under such an interpretation, certain changes in a partner's liquidation value percentage could introduce distortions in the calculation of net unrecognized section 987 gain or loss under §1.987-4, giving rise to net unrecognized section 987 gain or loss that is not attributable to fluctuations in exchange rates. For example, an appreciation or depreciation in property value could result in a change in liquidation value percentage that causes a change in owner functional currency net value for purposes of step 1 of the §1.987-4(d) calculation of unrecognized section 987 gain or loss for a taxable year without creating an offsetting adjustment under step 6 or otherwise that would prevent the change in liquidation value percentage from distorting the calculation of unrecognized section 987 gain or loss. As a result, such unrecognized appreciation or depreciation generally could result in unrecognized section 987 gain or loss for a taxable year being allocated to each partner that indirectly owned a section 987 QBU even when there was no change in exchange rates.

Accordingly, the Treasury Department and the IRS withdrew §1.987-7T in the 2019 final regulations. The preamble to the 2019 final regulations stated that, until new regulations are proposed and finalized, taxpayers may use any reasonable method for determining a partner's share of assets and liabilities reflected on the books and records of an eligible QBU held indirectly through the partnership. For this purpose, taxpayers may rely on subchapter K principles (consistent with the 2006 proposed regulations) or an approach similar to the liquidation value percentage method set forth in §1.987-7T. However, it would not be reasonable to apply the

liquidation value percentage method in §1.987-7T without corresponding adjustments to the determination of net unrecognized section 987 gain or loss. Thus, for example, a taxpayer using the liquidation value percentage method may be required to adjust its determination of net unrecognized section 987 gain or loss of a section 987 QBU that is owned indirectly through a partnership to prevent the determination of unrecognized section 987 gain or loss that is not attributable to fluctuations in exchange rates. These adjustments may include, for example, treating any change in a partner's owner functional currency net value that is attributable to a change in the partner's liquidation value percentage as resulting in a transfer to or from an indirectly owned section 987 QBU.

C. The proposed regulations apply entity theory to non-section 987 aggregate partnerships

As previously discussed in part VIII.A of this Explanation of Provisions, although the final regulations applied the aggregate approach to section 987 aggregate partnerships, the final regulations did not provide rules for applying section 987 to other partnerships. The preamble to the 2016 final regulations stated that section 987 regulations would be developed for these other partnerships in a separate project and indicated that a different approach might be taken. To that end, the preamble requested comments on how an entity approach should work for non-section 987 aggregate partnerships.

Several comments were received asserting that the aggregate approach to partnerships under the 2016 final regulations was overly complex. Comments recommended that a partnership be treated as a separate entity with its own functional currency that can be the owner of a section 987 QBU. Comments also indicated that entity treatment would be more consistent with the principles of subchapter K.

The Treasury Department and the IRS agree that treating non-section 987 aggregate partnerships as an entity and therefore potentially an "owner" of section 987 QBUs would be more administrable than an aggregate approach and would reduce the compliance burden on taxpayers and the IRS. However, the Treasury Department

and the IRS continue to study whether partners might be able to achieve inappropriate outcomes under entity theory. For example, the Treasury Department and the IRS are concerned that if partnerships maintained section 987 gain and loss pools under a “pure” entity theory paradigm, partners would effectively be able to transfer their share of net unrecognized section 987 gain or loss to another partner, thereby avoiding gain recognition or trafficking in losses. To prevent a partner from transferring its share of net unrecognized section 987 gain or loss to another partner, the proposed regulations would generally apply a hybrid approach to entity theory, under which a partnership’s net unrecognized section 987 gain or loss with respect to its section 987 QBUs is allocated to its partners on an annual basis (the “hybrid approach to entity theory”), as described in part VIII.D of this Explanation of Provisions.

The hybrid approach to entity theory may reduce concerns about inappropriate outcomes that might otherwise arise from the transfer of partnership interests under an entity theory approach. However, as described in part VIII.D and E of this Explanation of Provisions, while the Treasury Department and the IRS study whether the hybrid approach to entity theory (or a variation thereof) is suitable for all partnerships, the proposed regulations maintain the aggregate approach to section 987 aggregate partnerships in the final regulations, as modified by the 2019 final regulations, with minimal changes. Special rules are provided in proposed §1.987-7C for partnerships that become (or cease to be) section 987 aggregate partnerships. In addition, for consistency with other transfers of a section 987 QBU, the proposed regulations would treat a change in the form of ownership from direct to indirect as a termination of the section 987 QBU under proposed §1.987-8(b)(6), subject to the deferral rules pursuant to proposed §1.987-12(g)(1)(i)(A). The Treasury Department and the IRS anticipate publishing a subsequent notice of proposed rulemaking that more thoroughly addresses the application of section 987 to partnerships.

D. The hybrid approach to entity theory

Under the proposed regulations, a partnership (other than a section 987

aggregate partnership) would be treated as a qualified business unit having its own functional currency. *See* §1.989(a)-1(b)(2)(i)(C); *see also* §1.985-1(a)(1). If a partnership owns an eligible QBU with a functional currency that is different from the functional currency of the partnership, the eligible QBU would be treated as a section 987 QBU and the partnership (and not the partner) would generally be treated as the owner of the eligible QBU. *See* proposed §§1.987-1(b)(4) through (5) and 1.987-7A(b).

A partnership that owns a section 987 QBU would determine its unrecognized section 987 gain or loss for a taxable year under proposed §1.987-4(d) by reference to the functional currency of the partnership and the section 987 QBU. Proposed §1.987-7A(b). Under the hybrid approach, the partnership would allocate to each partner a share of the unrecognized section 987 gain or loss for the taxable year with respect to each section 987 QBU owned by the partnership on an annual basis. The partnership would determine a partner’s share of the unrecognized section 987 gain or loss for the taxable year for each section 987 QBU based on the partner’s distributive share of profits and losses attributable to that section 987 QBU for the taxable year. At the partner level, each partner would translate its share of the unrecognized section 987 gain or loss into its functional currency at the yearly average exchange rate and calculate its net unrecognized section 987 gain or loss with respect to each section 987 QBU of the partnership based on this share. Proposed §1.987-7A(c)(1).

Section 987 gain or loss attributable to a section 987 QBU owned by a partnership would be recognized and taken into account at the partner level. Notwithstanding that the section 987 gain or loss pools are allocated to the partners and maintained at the partner level, the portion of the net unrecognized section 987 gain or loss that a partner would recognize (or suspend) each year under proposed §1.987-5(a) would be determined by reference to the partnership’s remittance proportion with respect to the section 987 QBU. Proposed §1.987-7A(c)(3). In other words, if the section 987 QBU is treated as remitting 20 percent of its gross assets to its owner, the partnership, in a

taxable year of the partnership, each partner that has net unrecognized section 987 gain or loss with respect to the section 987 QBU would recognize (or suspend) 20 percent of the net unrecognized section 987 gain or loss.

The proposed regulations provide a framework for adjusting a partner’s basis in its partnership interest based on the principles of section 705 when a partner recognizes section 987 gain or loss, defers section 987 gain or loss, or suspends section 987 loss attributable to a partnership. *See* proposed §1.987-7A(d). Similarly, if a partner in an upper-tier partnership (UTP) recognizes section 987 gain or loss, defers section 987 gain or loss, or suspends section 987 loss attributable to a lower-tier partnership (LTP), then the proposed regulations would provide that UTP makes a corresponding basis adjustment to its interest in LTP, with similar rules applying to each successive partnership through which the section 987 gain or loss is attributable. The basis adjustment between UTP and LTP or between LTPs constitutes a basis adjustment solely with respect to the partner that recognizes section 987 gain or loss, defers section 987 gain or loss, or suspends section 987 loss attributable to the partnership. The Treasury Department and the IRS request comments on the coordination of these proposed regulations applicable to partnerships with rules for capital accounts determined and maintained in accordance with §1.704-1(b)(2)(iv). Additionally, the Treasury Department and the IRS request comments on the appropriate currency in which section 743(b) basis adjustments with respect to assets of a section 987 QBU of a partnership should be maintained.

The proposed regulations would also provide rules for applying proposed §§1.987-11 through 1.987-13 (regarding deferred section 987 gain or loss and suspended section 987 loss) to partners and partnerships. Specifically, the application of the loss-to-the-extent-of-gain rule to suspended section 987 loss of the partner is done at the partner level. Proposed §1.987-7A(c)(4). As a result, any section 987 gain recognized by a partner is taken into account in determining the suspended section 987 loss that may be recognized by the partner under proposed §1.987-11(e), without regard to whether the section

987 gain was allocated to the partner from that partnership (or any other partnership) or was attributable to a section 987 QBU owned directly by the partner. Other rules under proposed §§1.987-11 through 1.987-13 would generally apply with respect to a partnership, but may be applied with respect to a partner that ceases to be a partner in the partnership.

In general, the section 987 elections would be made by the partnership. However, if a partner terminates its partnership interest, any annual recognition election in effect with respect to the partner would apply with respect to its deferred section 987 gain or loss or suspended section 987 loss that had been allocated to the partner by the partnership. The partner would also be permitted to make the election to recognize pretransition section 987 gain or loss ratably over the transition period under the transition rules. See proposed §§1.987-7A(c)(5)(ii) and 1.987-10(e)(5)(ii).

The Treasury Department and the IRS are studying the appropriate method for determining the portion of a partner's net unrecognized section 987 gain or loss, deferred section 987 gain or loss, and suspended section 987 loss that should be recognized, deferred, or suspended when a portion of a partner's interest in a partnership is transferred or redeemed (or the partner's interest in the partnership is otherwise reduced) and whether any special rules are needed in respect of a transfer or redemption of a partnership interest to account for the recognition of section 987 gain or loss at the partner level. Accordingly, the proposed regulations reserve on the treatment of transfers and redemptions of a partner's partnership interest. The Treasury Department and the IRS request comments on the appropriate method of determining the partner's interest in the partnership and the reduction to its interest in the partnership, as well as how increases to a partner's partnership interest during the year should be taken into account. In addition, the Treasury Department and the IRS request comments on the appropriate treatment of transfers of a partnership interest between related parties or between member of a consolidated group.

In general, proposed §1.987-6 would provide rules governing the character and

source of section 987 gain or loss. See part VI of this Explanation of Provisions. The proposed regulations reserve on whether any special rules are needed in addition to proposed §1.987-6 for purposes of determining the character and source of section 987 gain or loss of a partner with respect to a section 987 QBU owned by a partnership. Proposed §1.987-7A(e). Comments are requested on whether special rules are needed.

The proposed regulations would treat S corporations in the same manner as partnerships. Proposed §1.987-7A(f). Comments are requested on whether additional guidance is needed with regard to S corporations and whether there are instances in which the rules for S corporations should differ from the rules for partnerships.

The Treasury Department and the IRS also request comments as to whether, under an entity theory of partnerships, section 987 gain or loss could be recognized at the partnership level and then allocated to the partners while preventing the transfer of unrecognized section 987 gain or loss among the partners or between a transferor and transferee partner. Under the hybrid approach in the proposed regulations, a partner's recognition of section 987 gain or loss upon a sale or other disposition of a partnership interest results in the conversion of capital gain or loss to ordinary gain or loss without any remittance from the partnership QBU and without any change in the relationship between the QBU and its owner. Comments are requested on whether special rules are needed to prevent the conversion of capital gain or loss to ordinary gain or loss. In addition, comments are requested on whether the recognition of section 987 gain or loss upon a transfer or redemption of a partnership interest should be limited to the gain or loss that would otherwise be recognized on transfer or redemption, under rules similar to §1.988-2(b)(8).

E. Expanding the application of entity theory

The Treasury Department and the IRS continue to study the application of entity theory and aggregate theory to partnerships in the section 987 context, including whether it would be appropriate to

apply a hybrid approach to entity theory to all partnerships, regardless of whether the partners are related parties. Such an approach would generally result in a partnership generating the same amount of section 987 gain or loss as it would if it were a corporation or an individual.

In connection with these considerations, the Treasury Department and the IRS are studying the concerns expressed in the 2006 proposed regulations and the final regulations that parties could achieve a substantially different section 987 result by owning a section 987 QBU through a partnership, rather than owning the section 987 QBU directly, without meaningfully changing the economic relationship of the parties.

Consider, for example, a domestic corporation that wholly owns two CFCs, each of which use the euro as their functional currency, and which each own fifty percent of an entity treated as a foreign partnership ("P") that operates a British trade or business for which books and records are maintained in pounds. P also has a smaller separate French trade or business that is an eligible QBU that maintains books and records in euros. If just one CFC owned P, then P would be treated as an entity disregarded from its owner, and the CFC would have section 987 gain or loss with respect to its interest in P's pound operations. However, if an election was made to treat P as a corporation under §301.7701-3, P would be treated as a CFC that uses the pound as its functional currency and section 987 gain or loss with respect to P's euro operations would be measured against the pound, rather than against the functional currency of P's partners. Accordingly, it could be argued that, for section 987 purposes, when a partnership is held by CFCs, aggregate theory achieves a result that is more akin to treating P as a disregarded entity and entity theory achieves a result more akin to treating P as a corporation.

However, if instead of being owned by two CFCs, P were owned by two domestic corporations that use the dollar as their functional currency, aggregate theory would achieve a result akin to treating P as a disregarded entity, while entity theory may provide a means of allowing the domestic corporations to avoid the application of section 987 to P's pound trade or

business without needing to contribute the trade or business to a CFC, which might have other tax consequences. *See, e.g.*, section 367(a) and (d). Accordingly, the Treasury Department and the IRS are concerned that if only entity theory is applied to partnerships, there may be instances in which the business of the partnership should be subject to section 987 but is not, such as when two domestic corporations own a partnership doing business in the pound.

When a partner's functional currency differs from that of the partnership, creating a separate layer of currency exposure, the Treasury Department and the IRS are studying whether it might be possible to achieve a result consistent with aggregate theory without the administrative burden of allocating a portion of a partnership's assets and liabilities to each partner and calculating the income and balance sheets of the partnership in the functional currency of each partner. One such approach might determine a partner's section 987 gain or loss with respect to the partnership by reference to the partner's outside basis in the partnership, rather than its share of the inside asset basis and liabilities (the "outside basis approach").

The outside basis approach would be layered on top of the hybrid approach to entity theory taken by the proposed regulations. Under this system, a partnership would first determine its section 987 gain or loss with respect to any section 987 QBUs of the partnership, and allocate the pool to the partners, as described in §1.987-7A of the proposed regulations. If a partner has the same functional currency as the partnership, no additional steps are taken.

If a partner has a different functional currency than the partnership, under one alternative ("alternative 1"), the partner would calculate its section 987 gain or loss with respect to its interest in the partnership (including its interest in the functional currency trade or business of the partnership and its interest in each of the partnership's section 987 QBUs) using a method similar to the calculation of unrecognized section 987 gain or loss for an owner applying the current rate election under proposed §1.987-4(d) (that is, steps 1 through 5 and 10), but by reference to the partner's adjusted basis in its

partnership interest ("outside basis") in the partnership.

Specifically, the partner's annual section 987 gain or loss attributable to its share of the partnership as a whole would be equal to its outside basis determined as of the end of the partnership's taxable year (after taking into account other adjustments prescribed under section 705 but before any adjustments for section 987 gain or loss recognized under the outside basis approach) and translated into the partnership's functional currency reduced by its outside basis determined as of the beginning of the same partnership taxable year and translated into the partnership's functional currency (the "partnership functional currency change in value") (step 1). The partnership functional currency change in value would then be adjusted to subtract the partnership functional currency amounts of contributions to the partnership from the partner and add the partnership functional currency amounts of distributions from the partnership to the partner (steps 2 through 5). The result would then be adjusted to back out the partnership functional currency amount of the partner's allocable share of income, gain, deduction, and loss of the partnership (step 10). The result is the partner's unrecognized section 987 gain or loss attributable to its partnership interest. Under alternative 1, the partner's unrecognized section 987 gain or loss attributable to its partnership interest would be recognized annually and its basis in the partnership would be increased or decreased accordingly. Alternative 1 approximates the result a partner would achieve under aggregate theory if it applied the current rate election and the annual recognition election.

Annual recognition is necessary under alternative 1 to prevent differences in the partnership's adjusted bases in its assets ("inside basis") attributable to fluctuations in the functional currency of the partnership itself or any section 987 QBUs owned by the partnership and the partners' outside bases (an "inside-outside basis disparity"). By adjusting outside basis for these currency fluctuations, the partner's section 987 gain or loss with respect to the partnership will include section 987 gain or loss on the partnership's owner functional currency net value of

the partnership's section 987 QBUs. As a result, the sum of the owner's section 987 gain or loss attributable to its partnership interest under the outside basis approach, plus its allocable share of the partnership's net unrecognized section 987 gain or loss attributable to the partnership's section 987 QBUs should generally be equivalent to the sum of its unrecognized section 987 gain or loss attributable to section 987 QBUs indirectly owned by the partner through the partnership under the aggregate approach (assuming there are no other inside-outside basis disparities).

Alternatively, under another alternative ("alternative 2"), it may not be necessary to require recognition of the partner's section 987 gain or loss annually. Under this approach, the same method is used to determine the partner's section 987 gain or loss with respect to its partnership interest as in alternative 1, except that the partnership functional currency change in value would be determined, not just by reference to the partner's outside basis in the partnership, but to the sum of its outside basis and its net accumulated unrecognized section 987 gain or loss attributable to the partnership and the partnership's section 987 QBUs (that is, the amount that would have been recognized if the partner had been recognizing its section 987 gain and loss attributable to the partnership annually as under alternative 1). Under alternative 2, the partner's unrecognized section 987 gain or loss attributable to its partnership interest might be recognized when it receives a distribution from the partnership or disposes of a portion of its partnership interest.

Both alternative 1 and alternative 2 approximate the result a partner would achieve under aggregate theory if it applied the current rate election to its partnership interest. However, alternative 1, but not alternative 2, requires annual recognition of the partner's net unrecognized section 987 gain or loss. Accordingly, no additional loss limitations may be needed for alternative 1. *See* part IV.C of this Explanation of Provisions. However, it may be appropriate for the partner's net accumulated unrecognized section 987 gain or loss under alternative 2 to be subject to the loss-to-the-extent-of-gain rule in §1.987-11(e) of the proposed regulations.

Under one variation to these alternative approaches, the partner's net accumulated unrecognized section 987 gain or loss attributable to its partnership interest would net with the partner's net unrecognized section 987 gain or loss with respect to the partnership's section 987 QBUs when one amount reflects section 987 gain and the other reflects section 987 loss.

Comments are requested on whether the outside basis approach or a similar system would achieve results consistent with aggregate theory in a more administrable manner. Furthermore, comments are requested on instances in which this system might inappropriately diverge from aggregate theory and how such divergences might be addressed. For example, if inside basis and outside basis are not equivalent (for example, because a partner acquires a partnership interest in a year in which a section 754 election is not in effect), how the resulting mismatch might be minimized or eliminated for purposes of measuring the partner's currency exposure with respect to the partnership. Comments are also requested on whether the outside basis approach or a similar system should apply to partners of (i) all partnerships, (ii) only to those partnerships currently treated as section 987 aggregate partnerships, or (iii) only those partnerships in which the partner owns more than 50 percent of the partnership interest (taking into account constructive ownership).

In addition, comments are also requested on any additional rules that might be necessary to coordinate the outside basis approach or a similar system with the section 987 regulations or with subchapter K, when the functional currency of a partner, the partnership, and the partnership's section 987 QBU differ.

IX. Attribution of Items to the Section 987 QBU

The final regulations provide rules regarding when assets and liabilities, as well as items of income, gain, deduction, and loss are attributable to an eligible QBU, and when a section 987 QBU is treated as making a contribution or distribution to its owner or another eligible QBU of the owner. *See* §1.987-2. In general, the proposed regulations retain the

rules in the final regulations with minor or clarifying revisions. However, in a change from the final regulations, the proposed regulations would treat a change in the form of ownership of a section 987 QBU as a termination, as discussed above.

In general, the final regulations provide that items are attributable to an eligible QBU if they are reflected on the separate set of books and records of the eligible QBU, as defined in §1.989(a)-1(d). §1.987-2(b)(1). The proposed regulations would revise the cross-reference to refer to §1.989(a)-1(d)(1) or (2), as §1.989(a)-1(d)(3) refers back to §1.987-2(b). Proposed §1.987-2(b)(1).

In addition, the final regulations provide that an eligible QBU is not treated as owning stock of a corporation unless the owner of the eligible QBU owns less than 10 percent of the value of the corporation (after taking into account certain attribution rules). §1.987-2(b)(2)(i). In order to generally prevent an eligible QBU from owning stock of a CFC, the proposed regulations would expand the exclusion to cover all stock unless the owner owns less than 10 percent of both the vote and value of the corporation, and to revise the relevant attribution rules. Proposed §1.987-2(b)(2)(i). The proposed regulations also provide that any type of basis that does not affect the income and loss of the eligible QBU, such as section 743(b) basis, would not be treated as included on the books and records of the eligible QBU. Proposed §1.987-2(b)(5).

Similarly, the final regulations provide rules regarding when a transaction or the recording of an asset or liability as on (or not on) the books and records of a section 987 QBU is treated as a disregarded transaction between the section 987 QBU and its owner or another eligible QBU of the owner. §1.987-2(c). The proposed regulations generally retain the substance of these rules but make minor revisions for clarity. *See* proposed §1.987-2(c).

X. Transition Rules

As explained in part II.C of the Background section, the 2016 final regulations require all owners of section 987 QBUs to apply the fresh start transition method. Under this method, unrecognized section 987 gain or loss determined for

years before the transition date generally would not be taken into account under section 987. In addition, for purposes of applying the FEEP method in the first year in which the regulations apply, the assets and liabilities of the section 987 QBU must be translated using historic rates.

Comments stated that the fresh start transition method is difficult to apply because taxpayers did not track historic rates before the transition date and the data needed to determine historic rates for items acquired in prior taxable years is not readily available. In addition, comments asserted that the fresh start transition method imposes an undue financial burden by permanently eliminating unrecognized section 987 losses determined before the transition date.

The Treasury Department and the IRS acknowledge that the fresh start transition method could increase the compliance burden on taxpayers for the initial year in which the regulations apply and would fail to account for section 987 gain or loss that arose before the transition date (to the extent attributable to assets and liabilities that are no longer reflected on the books and records of the section 987 QBU on the transition date). Therefore, the proposed regulations provide a new transition rule that would replace the fresh start transition method.

The new transition rule would account for unrecognized section 987 gain or loss accrued before the transition date. In addition, the new transition rule would not require taxpayers to retrospectively determine historic rates for items acquired before the transition date. As explained in the Applicability Dates section, the fresh start transition method can no longer be applied to any taxable year for which the tax return or information return is filed on or after November 9, 2023.

A. Translation of a section 987 QBU's assets and liabilities at the spot rate

The transition rules under proposed §1.987-10 would apply in the taxable year beginning on the transition date (that is, the first day of the first taxable year in which the regulations apply). For purposes of determining unrecognized section 987 gain or loss in the first taxable year in which the regulations apply, the

assets and liabilities reflected on a section 987 QBU's balance sheet at the end of the previous year would be translated into the owner's functional currency at the spot rate on the day before the transition date. Proposed §1.987-10(d)(1). Similarly, for taxpayers that do not make a current rate election, the historic rate for historic assets and liabilities would generally be the spot rate on the day before the transition date. Proposed §1.987-10(d)(2). These rules are intended to simplify the application of the FEEP method by eliminating the need to determine actual historic rates in the first taxable year in which the regulations apply.

B. *Pretransition gain or loss*

Under the proposed regulations, an owner of a section 987 QBU must determine the amount of section 987 gain or loss that has accrued before the transition date ("pretransition gain or loss"). Proposed §1.987-10(e). By default, in the first taxable year in which the regulations apply, pretransition gain is treated as net unrecognized section 987 gain, and pretransition loss is treated as suspended section 987 loss. Proposed §1.987-10(e)(5)(i). This proposed rule is intended to prevent taxpayers from selectively recognizing pretransition loss (which, like section 987 loss generated under a current rate election, may be computed using a method that results in large section 987 pools) while deferring pretransition gain until a remittance. Alternatively, taxpayers can elect to amortize pretransition gain or loss over a period of ten years beginning on the transition date. Proposed §1.987-10(e)(5)(ii).

In order to prevent owners subject to this election from offshoring pretransition gain or importing pretransition loss, proposed §1.987-10(e)(5)(ii)(B) provides that, immediately before an inbound or outbound transaction described in section 381(a), any unrecognized pretransition gain is recognized and any unrecognized pretransition loss is suspended. As a result, the suspended section 987 loss may be recognized, subject to the loss-to-the-extent-of-gain-rule under §1.987-11(e). In the case of an inbound section 381(a) transaction of a foreign owner with pretransition loss, any suspended section

987 loss that is not recognized before the transaction would not carry over to the domestic acquiring corporation under proposed §1.987-13(g). See part III.C of this Explanation of Provisions.

C. *Computation of pretransition gain or loss*

Under proposed §1.987-10(e)(2), a taxpayer that applied section 987 before the transition date using an "eligible pretransition method" (described in part X.D of this Explanation of Provisions) would use that method to compute pretransition gain or loss. Pretransition gain or loss generally is equal to the amount of section 987 gain or loss that would have been recognized under the eligible pretransition method if the QBU terminated on the day before the transition date. Proposed §1.987-10(e)(2)(i)(A). The amount of pretransition gain or loss must be adjusted to reflect any change to the basis of the section 987 QBU's assets (net of liabilities) that occurs as a result of the transition (for example, where the taxpayer previously used a method that would determine the owner's basis in distributed assets using historic rates). Proposed §1.987-10(e)(2)(i)(B).

A taxpayer that did not apply an eligible pretransition method before the transition date would determine pretransition gain or loss using the method provided in §1.987-10(e)(3). Under this method, pretransition gain or loss is equal to the sum of the annual amounts of unrecognized section 987 gain or loss for each taxable year since the section 987 QBU's inception, reduced by any section 987 gain or loss recognized before the transition date. Proposed §1.987-10(e)(3)(ii).

The amount of unrecognized section 987 gain or loss for each taxable year would be computed using a simplified version of the method provided in §1.987-4(d). Proposed §1.987-10(e)(3)(iii). The only information needed to apply this simplified method is the information reflected in the section 987 QBU's opening and closing balance sheets for each year. Because this method does not require the translation of contributions and distributions at the applicable spot rate, it would only approximate the actual amount of section 987 gain or loss accrued before the transition date.

D. *Eligible pretransition method*

1. In General

An eligible pretransition method includes any reasonable method of applying section 987 before the transition date that fully accounts for foreign currency gain or loss attributable to the assets and liabilities of a section 987 QBU (including foreign currency gain or loss that is recognized in computing taxable income with respect to the section 987 QBU or its owner). The method provided in the 1991 proposed regulations, which determines section 987 gain or loss based on currency fluctuations with respect to the earnings and capital of a section 987 QBU (an "earnings and capital" method) is considered an eligible pretransition method, provided that it is applied in a reasonable manner. Proposed §1.987-10(e)(4)(i). In addition, any other reasonable method of applying section 987 is an eligible pretransition method if it produces the same total amount of income over the life of the owner (taking into account the aggregate of section 987 gain or loss, section 987 taxable income or loss, and gain or loss on the disposition of assets and liabilities transferred by a section 987 QBU to the owner) as a reasonable earnings and capital method. Proposed §1.987-10(e)(4)(ii). However, a method under which the owner does not recognize section 987 gain or loss at the time of a remittance because the recognition of all section 987 gain or loss is deferred until the section 987 QBU terminates is not considered an eligible pretransition method because it is inconsistent with the statutory requirements under section 987(3). Proposed §1.987-10(e)(4)(iv).

2. Earnings Only Method

An earnings only method can qualify as an eligible pretransition method under proposed §1.987-10(e)(4)(ii) if it is applied in a way that produces the same total amount of income as a reasonable earnings and capital method. This can be accomplished by maintaining a separate set of equity and basis pools for the section 987 QBU's capital account and assigning a proportionate amount of the capital basis pool to property distributed

out of capital. *See* proposed §1.987-10(l)(2) (*Example 2*).

The Treasury Department and the IRS are aware that certain taxpayers apply an earnings only method in a manner that creates a permanent difference in their income (as compared to the earnings and capital method). Under this approach, when a section 987 QBU makes a distribution (whether out of earnings or capital), the owner determines its basis in the distributed assets by translating the section 987 QBU's basis into the owner's functional currency at the spot rate applicable on the distribution date ("spot-rate basis"). *See* proposed §1.987-10(l)(3) (*Example 3*). As a result, the owner's basis may be higher or lower than the actual cost of acquiring the assets (in the owner's functional currency) due to exchange rate fluctuations.

When a section 987 QBU makes a distribution out of earnings, which triggers the recognition of section 987 gain or loss under an earnings only method, the use of a spot-rate basis is appropriate. However, when a section 987 QBU makes a distribution out of capital (on which no section 987 gain or loss is recognized under an earnings only method), the use of a spot-rate basis artificially steps up (or steps down) the basis of the distributed assets in the absence of a recognition event. As a result, if a spot-rate basis is used for capital distributions under an earnings only method, the owner would not recognize the same total amount of income as it would under an earnings and capital method.

The Treasury Department and the IRS are concerned that the use of a spot-rate basis for capital distributions under an earnings only method does not accurately measure an owner's economic income with respect to a section 987 QBU. However, the Treasury Department and the IRS acknowledge that the preamble to the 2006 proposed regulations endorsed the use of an earnings only method without explaining how the basis of distributed assets should be determined. Taxpayers may have misunderstood the preamble to suggest that an owner of a section 987 QBU can take a spot-rate basis in all distributed assets under an earnings only method.

Therefore, the proposed regulations provide that an earnings only method that

does not produce the same total amount of income as a reasonable earnings and capital method can qualify as an eligible pretransition method, provided it was first applied on a tax return filed before November 9, 2023 and is consistently applied to all section 987 QBUs of the same owner. Proposed §1.987-10(e)(4)(iii). A taxpayer that begins applying this method on or after November 9, 2023 or fails to apply this method consistently to all of its section 987 QBUs will not be treated as applying an eligible pretransition method.

XI. *Deferral Events and Outbound Loss Events*

A. *Final regulations*

Section 1.987-12 of the final regulations contains rules that defer the recognition of section 987 gain or loss in connection with two categories of related party transactions: deferral events and outbound loss events. A deferral event is defined to include certain transactions in which a section 987 QBU terminates and its assets are reflected on the books and records of a successor QBU after the termination. *See* §1.987-12(b)(2). A successor QBU is a section 987 QBU that is owned by a member of the same controlled group as the original owner (except if the original owner is a U.S. person and the owner of the successor QBU is a foreign person). *See* §1.987-12(b)(4). Section 987 gain or loss that is not recognized in connection with a deferral event ("deferred section 987 gain or loss") is recognized by the original owner of the section 987 QBU when the successor QBU makes a remittance to its owner. *See* §1.987-12(c)(2).

An outbound loss event is defined to include a termination of a section 987 QBU that is owned by a U.S. person and has net unrecognized section 987 loss in connection with a transfer of the section 987 QBU's assets to a related foreign person. *See* §1.987-12(d)(2). If the transfer is a transaction described in section 351 or section 361, any section 987 loss that is not recognized in connection with the outbound loss event ("outbound section 987 loss") is added to the basis of stock received by the owner of the section 987 QBU. *See* §1.987-12(d)(4). Otherwise,

outbound section 987 loss is recognized when the owner of the section 987 QBU and the related foreign person cease to be members of the same controlled group. *See* §1.987-12(d)(5).

B. *Proposed regulations*

1. *Deferral Events*

The proposed regulations generally retain the principles of the final regulations relating to deferral events but modify the rules in several respects. For example, the final regulations provide a de minimis rule pursuant to which §1.987-12 would not apply to a section 987 QBU if the section 987 gain or loss that would not be recognized under §1.987-12 would not exceed \$5 million. §1.987-12(a)(3)(ii). To prevent the de minimis rule from allowing an owner to recognize more than the threshold by transferring multiple section 987 QBUs to members of its controlled group, the proposed regulations would retain the de minimis rule but apply the threshold to the total deferred section 987 gain or loss that would otherwise be recognized by the owner in a single taxable year. Proposed §1.987-12(a)(2)(ii). In addition, because the proposed regulations would apply the suspended section 987 loss rules to outbound loss events, any amount treated as a suspended section 987 loss is not taken into account in determining whether the threshold has been met. *Id.*

The final regulations also provide that, if a deferral event results in multiple successor QBUs, the remittance proportion is determined by treating all the successor QBUs as a single successor QBU. §1.987-12(c)(2)(ii). The Treasury Department and the IRS are concerned that aggregating the contributions and distributions of various successor QBUs in order to treat them as the same successor QBU both increases the administrative burden of determining the remittance proportion and is less precise than determining a remittance proportion for each successor QBU. Therefore, the proposed regulations would apportion an amount of deferred section 987 gain or loss to each successor QBU and recognize (or suspend) a portion of deferred section 987 gain or loss annually with respect to each successor QBU based on the specific successor QBU's remittance proportion

and on whether that successor QBU is subsequently transferred. Proposed §1.987-12(b)(2) and (c).

Although the proposed regulations generally retain the deferral rules of §1.987-12(b) with respect to those circumstances in which they apply under the final regulations, the Treasury Department and the IRS recognize that this can lead to odd results in certain cases, because similar transactions may sometimes be subject to the deferral rules and other times be subject to no limitation or the suspended loss rules.

For example, if a CFC (“CFC1”) with a euro functional currency owns a section 987 QBU (“QBU1”) with a pound functional currency, and CFC1 transfers QBU1 to a wholly owned subsidiary CFC (“CFC2”), the deferral rules would generally apply if CFC2’s functional currency is not the pound. However, if CFC2’s functional currency is the pound, the deferral rules would not apply because QBU1 would cease to be a section 987 QBU upon transfer to CFC2, because it would have the same functional currency as its owner. As a result, if CFC1 does not have a current rate election in effect (or has both a current rate election and an annual recognition election in effect), CFC1 would recognize its net unrecognized section 987 gain or loss with respect to QBU1 on the transfer. However, if CFC1 has a current rate election in effect (and does not have an annual recognition election in effect), CFC1 would recognize net unrecognized section 987 gain on the transfer, but net unrecognized section 987 loss would become suspended section 987 loss.

The Treasury Department and the IRS request comments on whether the deferral rules of proposed §1.987-12 should remain a separate deferral regime or should be modified or combined with the suspended loss rules of proposed §§1.987-11 and 1.987-13.

2. Outbound Loss Events

The proposed regulations generally retain the definition of an outbound loss event contained in the final regulations. However, the proposed regulations provide that outbound section 987 loss is treated as suspended section 987 loss, instead of being added to the basis of

stock or recognized solely when the owner of the section 987 QBU and the related foreign person cease to be related.

This rule is intended to permit the recognition of outbound section 987 loss to the extent the owner recognizes section 987 gain in the same recognition grouping, as described in part III of this Explanation of Provisions. In addition, applying the loss suspension rules to outbound loss events simplifies the proposed regulations by reducing the number of different types of deferral regimes that apply to section 987 losses.

XII. Making and Revoking Elections

The final regulations contain a number of elections relating to section 987. The proposed regulations contain several new elections, including the current rate election, the annual recognition election, and elections under the transition rules.

Under the final regulations, elections generally are made separately for each section 987 QBU. *See* §1.987-1(g)(1) (i). Elections cannot be revoked without the Commissioner’s consent. *See* §1.987-1(g)(5). Under the 2016 temporary and proposed regulations, an annual deemed termination election generally cannot be made (except in the first taxable year in which the election was relevant) if the aggregate net loss that would be recognized by all owners to which the election applied exceeds \$5 million. *See* §1.987-1T(g)(2)(i)(B). The annual deemed termination election provided in the 2016 temporary and proposed regulations is irrevocable.

The proposed regulations would provide a consistency requirement that applies to both the existing elections under the final regulations and the new elections under the proposed regulations. Under proposed §1.987-1(g), these elections would be required to be made or revoked consistently for all members of the same consolidated group and all CFCs, partnerships, non-grantor trusts, and estates in which the ownership interests or beneficiary interests of the U.S. shareholder (or members of its consolidated group) exceed 50 percent. The consistency requirement is intended to make the application of the proposed rules less complex and more administrable; in most cases,

consistent application of the regulations is also expected to reduce the compliance burden on taxpayers.

The proposed regulations would permit a current rate election or an annual recognition election to be made or revoked without the Commissioner’s consent. The Treasury Department and the IRS recognize that these elections can have important consequences for the substantive application of section 987 and the associated compliance burden, and that taxpayers may wish to change these elections in response to changes in the nature and size of their business operations.

However, the current rate and annual recognition elections are proposed to be subject to timing restrictions and a loss suspension rule. If a current rate election or an annual recognition election is made, it cannot be revoked for five years without the Commissioner’s consent. Similarly, once revoked, these elections cannot be made again for five years without consent. Proposed §1.987-1(g)(3)(ii)(B). These timing requirements are intended to make the proposed regulations easier to administer. In addition, because the Commissioner’s consent is not required to make or revoke these elections, the timing requirements are needed to prevent taxpayers from opportunistically making or revoking elections in response to exchange rate fluctuations.

Proposed §1.987-11(d)(2) provides that, in the first year in which a current rate election is revoked, net accumulated unrecognized section 987 loss is converted into suspended section 987 loss. This rule is needed to prevent net unrecognized section 987 loss generated under a current rate election from being recognized without limitation after the election is revoked.

Similarly, if an annual recognition election is made, and either (1) a current rate election was in effect for the previous year or (2) the aggregate accumulated net unrecognized section 987 loss that would be recognized by the owner as a result of the recognition election exceeds \$5 million, net accumulated unrecognized section 987 loss is converted into suspended section 987 loss. *See* §1.987-11(d)(1). As discussed in part III.A of this Explanation of Provisions, this rule is intended to prevent a taxpayer from using an annual

recognition election to trigger the recognition of net unrecognized section 987 loss that arose in years before the annual recognition election was made.

XIII. *Removal of the Election to Use Spot Rates in Lieu of Yearly Average Exchange Rates*

As explained in part II.C of the Background section, the historic rate under §1.987-1(c)(3) of the 2016 final regulations is equal to the yearly average exchange rate for the year in which a historic asset was acquired or a historic liability was entered into. The 2016 final regulations provide an election under §1.987-1(c)(1)(iii) to use spot rates in lieu of yearly average exchange rates.

The Treasury Department and the IRS understand that this election may not be helpful to taxpayers, as it would increase the compliance burden of applying section 987 due to the need to track historic spot rates for each day in a taxable year on which the section 987 QBU acquires an asset or incurs a liability. In addition, the availability of this election adds to the complexity of the regulations and makes the rules more difficult for the IRS to administer. Accordingly, the proposed regulations remove the election under §1.987-1(c)(1)(iii) to use spot rates in lieu of yearly average exchange rates.

XIV. *Consolidated Groups*

A. *Intercompany transactions*

A section 987 QBU of a member of a consolidated group is a component of that member. Therefore, a transaction between that QBU and a different member of the same group constitutes an intercompany transaction (as defined in §1.1502-13(b)(1)(i)) and is subject to the intercompany transaction regulations in §1.1502-13.

The Treasury Department and the IRS have become aware that achieving single entity treatment under §1.1502-13 may be difficult for certain intercompany transactions involving section 987 QBUs. Accordingly, to facilitate single entity treatment, the proposed regulations would treat a transaction between the section 987 QBU of one member and any other member of the same group (including a

section 987 QBU of that other member) as a combination of (i) an intercompany transaction between the members, and (ii) a transfer between each section 987 QBU and its owner (*see* §1.987-2(c)) as necessary to take into account the effect of the transaction on the assets and liabilities of each section 987 QBU.

The purpose of §1.1502-13 is to provide rules to clearly reflect the taxable income and tax liability of a consolidated group as a whole by preventing intercompany transactions from creating, accelerating, avoiding, or deferring consolidated taxable income (CTI) or consolidated tax liability. *See* §1.1502-13(a)(1). The matching rule in §1.1502-13(c) (Matching Rule) is one of the principal mechanisms for achieving this goal. *See* §1.1502-13(a)(6)(i).

The Matching Rule is a principle-based rule that redetermines the attributes of a selling member's (S) intercompany item and a buying member's (B) corresponding item to produce the effect of transactions between divisions of a single corporation (single entity treatment). *See* §1.1502-13(a)(2). The Matching Rule also can affect the timing of these items so that, whenever possible, the effect of these items on the group's CTI and consolidated tax liability is the same as if S and B were divisions of a single corporation. *See* §1.1502-13(c)(1)(i).

For example, assume that S sells land at a gain to B, which later sells that land at a gain to an unrelated person. To achieve the same result as if S and B were divisions of a single corporation, S does not take into account its gain or loss on the sale until B sells the land to the unrelated person, and S's and B's holding periods for the land are aggregated. *See* §1.1502-13(a)(2), (c)(1)(ii), and (c)(2); *see also Example 1* in §1.1502-13(c)(7)(ii)(A).

The Matching Rule relies on an alignment between S's and B's items that may be unclear in transactions involving section 987 QBUs. For example, assume that Lender (that is, S) and Borrower (that is, B) are members of a consolidated group, and Lender has a section 987 QBU (Lender QBU) whose functional currency is the euro. Lender QBU lends €100 to Borrower. If Borrower and Lender were divisions of a single corporation, the loan would be treated as a transfer from Lender QBU when funded and a transfer

to Lender QBU when repaid (or when interest is paid). These transfers would be taken into account in determining the amount of a remittance from Lender QBU (potentially triggering the recognition of section 987 gain or loss), and the single corporation might recognize section 988 gain or loss when the loan is repaid. *See* §§1.987-5 and 1.988-1(a)(10)(ii)(A).

However, under current law, the foreign currency gain or loss of Lender and Borrower in the foregoing example does not perfectly offset in amount on the group's consolidated return. This is the case because Borrower has foreign currency gain or loss under section 988 when the loan is repaid, whereas Lender's foreign currency gain or loss under section 987 will be taken into account only when Lender QBU makes a remittance. *See* §§1.987-5(a) and 1.988-2(b)(6). Because these amounts are calculated at different times based on different exchange rates, and because section 988 applies to individual transactions while section 987 gain or loss is determined on a pooled basis by reference to the assets and liabilities of a section 987 QBU, achieving single entity treatment under §1.1502-13 may be difficult. In other words, under current law, it may be difficult to "match" Lender's section 987 gain or loss with Borrower's section 988 gain or loss. Similar mismatches would occur with regard to transactions between section 987 QBUs of different consolidated group members.

The proposed regulations would address the matching issue in this example by treating the loan as if it were made directly between Lender and Borrower. *See* proposed §1.1502-13(j)(9). Thus, when the loan is made, Lender QBU would be treated as transferring €100 to Lender, which in turn would be treated as lending €100 to Borrower in an intercompany transaction. The loan would be treated as a section 988 transaction with respect to both Lender and Borrower. When Borrower pays interest on the loan and repays the loan principal, Lender would be treated as transferring the interest or principal amount it receives from Borrower to Lender QBU. Lender's interest income and Borrower's interest expense, and their section 988 gain and loss with respect to principal and interest, would offset each other in amount, producing no net effect on CTI (thereby achieving

single entity treatment). The group would report any foreign currency gain or loss (under section 987 or 988) on the transfers between Lender and Lender QBU (for example, when Lender QBU loans the €100 to Borrower, which is first treated as a remittance of the €100 from Lender QBU to Lender) on the group's consolidated return.

The proposed regulations also would replace Examples 4 and 15 in §1.987-2(c) (10) with new examples in §1.1502-13(j) to illustrate the application of the proposed rule. The new examples make clear that the proposed approach applies to reach single entity treatment for all consolidated groups, regardless of whether the taxpayer had a principal purpose of avoiding tax through the use of section 987. *Cf.* §1.987-2(b)(3) (i) and (c)(10), Example 15 (providing that the IRS may reallocate a receivable from a section 987 QBU to its owner if a principal purpose of avoiding tax through the use of section 987 is present).

B. Separate return limitation years

When a corporation joins a consolidated group, the regulations under section 1502 may limit the group's ability to use the corporation's preexisting tax attributes. For example, §1.1502-21(c) generally restricts the group's ability to use a member's net operating loss (NOL) that arose in a year when the corporation was not a member of the group. In general, §1.1502-21(c) allows the group to use only the portion of the NOL that does not exceed the member's "cumulative register," which reflects the member's items of income, gain, deduction, and loss that have been included in the group's CTI. *See* §1.1502-21(c)(1)(i).

Under the proposed regulations, a corporation that is the owner of a section 987 QBU may have suspended or deferred section 987 losses when it joins a consolidated group. The Treasury Department and the IRS request comments about how rules similar to the rules of §1.1502-21(c) should apply to such losses.

XV. Section 988 Transactions of a Section 987 QBU

The temporary regulations provided special rules relating to section 988

transactions of a section 987 QBU, including transactions denominated in the owner's functional currency. Although the temporary regulations have expired, the corresponding provisions of the 2016 proposed regulations remain outstanding.

In general, under the 2016 proposed regulations, whether a transaction is a section 988 transaction is determined by reference to the section 987 QBU's functional currency, but any section 988 gain or loss is determined in the owner's functional currency. *See* §1.987-3(b)(4) (i) of the 2016 proposed regulations. In addition, certain section 988 transactions of a section 987 QBU that are denominated in, or determined by reference to, the owner's functional currency ("specified owner functional currency transactions") are not treated as section 988 transactions of the section 987 QBU. *See* §1.987-3(b)(4)(ii) of the 2016 proposed regulations.

The 2016 proposed regulations further provide that section 988 gain or loss with respect to certain short-term section 988 transactions of a section 987 QBU ("qualified short-term section 988 transactions") that are accounted for under a mark-to-market method of accounting is determined in the functional currency of the section 987 QBU, and not the functional currency of its owner. *See* §1.987-3(b)(4) (iii) of the 2016 proposed regulations.

Under the final regulations, a transaction denominated in a currency other than the section 987 QBU's functional currency is a historic item. *See* §1.987-1(d) and (e). However, the 2016 proposed regulations provide that a qualified short-term section 988 transaction for which section 988 gain or loss is determined by reference to the functional currency of the section 987 QBU is a marked item. *See* §1.987-1(d)(3) of the 2016 proposed regulations.

The Treasury Department and the IRS understand that the rules of the 2016 proposed regulations relating to nonfunctional currency transactions of a section 987 QBU would increase the compliance burden on taxpayers in certain contexts (for example, where the section 987 QBU operates as a treasury center). This compliance burden could potentially be alleviated by treating all transactions (including specified owner functional currency transactions) denominated in a currency other

than the functional currency of the section 987 QBU as marked items, determining whether those transactions are section 988 transactions by reference to the functional currency of the section 987 QBU, and determining the section 988 gain or loss with respect to those transactions in the functional currency of the section 987 QBU. However, the Treasury Department and the IRS are concerned that, under this approach, transactions denominated in the owner's functional currency would be treated as section 988 transactions of a section 987 QBU. Therefore, these transactions would give rise to offsetting positions in that currency, enabling taxpayers to recognize losses while deferring the offsetting gains. For example, if a section 987 QBU held assets denominated in its owner's functional currency, and the section 987 QBU's functional currency weakened against that of its owner, the section 987 QBU would have section 988 gain and the owner would have an inverse amount of section 987 loss.

The Treasury Department and the IRS request comments as to whether section 988 gain or loss on nonfunctional currency transactions (including specified owner functional currency transactions) of a section 987 QBU should be determined in the functional currency of the section 987 QBU when a current rate election or annual recognition election is in effect and, if so, what limitations should be imposed to prevent abuse. Comments are also requested on whether the definition of qualified short-term section 988 transactions should be expanded or modified, and whether other exceptions or special rules should be provided for section 987 QBUs engaged in certain activities (for example, treasury centers).

XVI. Definition of a Qualified Business Unit and an Eligible QBU

Under section 985(b), the functional currency of a qualified business unit is generally either the dollar or the currency of the economic environment in which a significant part of its activities are conducted and in which its books and records are kept. Section 985(b); §1.985-1(b) through (c). Under section 989, a "qualified business unit" means a "separate and clearly identified unit" of a trade or

business of a taxpayer, provided that the unit maintains separate books and records. Section 989(a). The regulations describe two types of qualified business units. The activities of a person may be a qualified business unit if the activities constitute a trade or business and a separate set of books and records are maintained with respect to the activities. §1.989(a)-1(b)(2)(ii). In addition, the so called “per se” qualified business units include any corporation, partnership (other than a section 987 aggregate partnership), trust, or estate. §1.989(a)-1(b)(2)(i).

A single qualified business unit may only have a single functional currency. Certain qualified business units, such as domestic corporations, are required to use the dollar as their functional currency unless otherwise provided by a ruling or administrative pronouncement. §1.985-1(b)(1)(iii). No rulings or administrative pronouncements have been issued under this provision other than private letter rulings that can be relied on only by the specific taxpayer for whom they were issued. Accordingly, all domestic corporations are required to use the dollar as their functional currency unless they have obtained a private letter ruling specifically allowing that entity to use a different functional currency.

The Treasury Department and the IRS have become aware of uncertainty regarding whether a per se qualified business unit, such as a corporation, that has only a single trade or business for which it keeps a single set of books and records is one qualified business unit (the corporation and its single trade or business) or two qualified business units (the corporation itself being one and its single trade or business being the other). If a domestic corporation with a single trade or business for which it keeps a single set of books and records were a single qualified business unit, that would effectively mean that (absent a ruling) the functional currency of the trade or business would be required to be the dollar, even if the currency of the economic environment of the trade or business was the euro and books and records are maintained in euros; whereas another domestic corporation with an identical trade or business may be permitted to use the euro as the functional currency of the trade or business, as long as

it had at least one other trade or business that uses the dollar.

To clarify that a per se qualified business unit, such as a domestic corporation, is permitted to have a single trade or business that maintains a single set of books and records, and which uses a functional currency other than the dollar, the proposed regulations modify the definition of eligible QBU. The revised definition clarifies that, if a per se QBU has only a single trade or business for which only a single set of books and records are maintained, only the trade or business (and not the entity itself) would be an eligible QBU. Proposed §1.987-1(b)(4). The entity itself would be the owner of the eligible QBU. Proposed §1.987-1(b)(5). As a result, if the eligible QBU has a functional currency other than the functional currency of the owner, the eligible QBU would be a section 987 QBU.

The Treasury Department and the IRS request comments on whether a similar change should be made to §1.989(a)-1(b). Comments should also consider whether additional changes are needed in the regulations under section 985 regarding functional currency or in other provisions that reference the definition of a qualified business unit, such as §1.904-4(f)(3)(vii).

XVII. Other Changes and Revisions

In addition to the provisions described in parts I through XVI of this Explanation of Provisions, the proposed regulations include other wording changes, additions, deletions, and organizational changes to the final regulations and the 2016 proposed regulations for purposes of clarifying, conforming, and making minor revisions.

Applicability Dates

I. Applicability Dates of the Proposed Regulations

Once finalized, the regulations (and the parts of the final regulations that are not replaced or modified by the proposed regulations) would apply to taxable years beginning after December 31, 2024. Proposed §1.987-14(a)(1).

A taxpayer may also choose to apply the final version of the proposed regulations

and the parts of the final regulations that are not replaced or modified by the proposed regulations (the “new final regulations”), once published in the **Federal Register**, for taxable years ending after the date these regulations are published as final in the **Federal Register**. Proposed §1.987-14(b). To choose to apply the new final regulations, the taxpayer and each member of its consolidated group and section 987 electing group must consistently apply the new final regulations in their entirety to the taxable year and all subsequent taxable years beginning on or before December 31, 2024. *Id.*

The Treasury Department and the IRS are concerned that taxpayers may terminate certain QBUs before the general applicability date of the proposed regulations to avoid the application of these rules. Accordingly, the proposed regulations would also provide an earlier applicability date for terminating QBUs to prevent taxpayers from avoiding these rules. Specifically, the new final regulations are proposed to apply to a terminating QBU on the day the section 987 QBU terminates. Proposed §1.987-14(a)(2). The proposed regulations would define a terminating QBU as a section 987 QBU if both (1) the section 987 QBU terminates on or after November 9, 2023, or as a result of an entity classification election filed on or after November 9, 2023 and effective before November 9, 2023, and (2) neither the new final regulations nor the 2016 and 2019 section 987 regulations would apply to the section 987 QBU when it terminates but for the anti-avoidance rule in proposed §1.987-14(a)(2). Proposed §1.987-1(h).

In addition, if the section 987 regulations apply to a taxable year of a partnership and would not otherwise apply to the taxable year of a partner in which or with which the partnership’s taxable year ends, then the section 987 regulations apply to that taxable year of the partner solely with respect to the partner’s interest in the partnership and its section 987 gain or loss attributable to an eligible QBU held by the partnership.

II. Applicability Dates of the 2016 and 2019 Section 987 Regulations

The proposed regulations also provide rules regarding the applicability dates of

the final regulations and temporary regulations. Section 1.987-11(a) of the 2016 final regulations generally provides that the 2016 final regulations apply to taxable years beginning on or after one year after the first day of the first taxable year following December 7, 2016. However, taxpayers could choose to apply them to an earlier taxable year as provided in §1.987-11(b). The 2019 final regulations (other than §1.987-12) have the same applicability date as the 2016 final regulations.

As described in part V of the Background section, following the publication of the 2016 final regulations, the Treasury Department and the IRS have issued several notices stating that future guidance would defer the applicability dates of most provisions of the final regulations and the temporary regulations. Because certain provisions that were originally deferred have since been revoked or expired, those provisions are no longer subject to deferral; other provisions were finalized in 2019 and deferral began at that time. The provisions deferred by the notices (and the respective periods for deferral) are as follows (collectively, the “2016 and 2019 section 987 regulations”):

(i) Sections 1.861-9T(g)(2)(ii)(A)(I) and (g)(2)(vi); 1.985-5; 1.987-1 through 1.987-10; 1.988-1(a)(4), (a)(10)(ii), and (i); 1.988-4(b)(2); and 1.989(a)-1(b)(2) (i), (b)(4), (d)(3), and (d)(4), as contained in 26 CFR in part 1 in effect on April 1, 2017.

(ii) Sections 1.987-2T(c)(9), 1.987-4T(c)(2) and (f), and 1.987-7T, as contained in 26 CFR in part 1 in effect on April 1, 2017 (until they were revoked on May 13, 2019).

(iii) Sections 1.987-2(c)(9) and 1.987-4(c)(2) and (f), as contained in 26 CFR in part 1 in effect on April 1, 2020 (beginning on May 13, 2019).

(iv) Sections 1.987-1T (other than §§1.987-1T(g)(2)(i)(B) and (g)(3)(i)(H)), 1.987-3T, 1.987-6T, 1.988-1T, and 1.988-2T(i), as contained in 26 CFR in part 1 in effect on April 1, 2017 (until they expired on December 6, 2019).

Pursuant to the most recent notice, the 2016 and 2019 section 987 regulations would first apply to taxable years beginning after December 7, 2023. Notice 2022-34, 2022-34 I.R.B. 150. The deferral notices also allow taxpayers to rely on the

provisions of the notices before the section 987 regulations are amended. *See id.*

Because the proposed regulations would replace or modify parts of the final regulations, the final regulations are not expected to become applicable in their current form. However, some taxpayers have chosen to apply the 2016 and 2019 section 987 regulations in accordance with §1.987-11(b) and the deferral notices. The proposed regulations would provide rules for taxpayers who chose to apply the 2016 and 2019 section 987 regulations before the applicability date of those regulations.

Proposed §1.987-14(c)(1) would provide that a taxpayer may choose to apply the 2016 and 2019 section 987 regulations to a taxable year beginning after December 7, 2016, and beginning on or before December 31, 2024, in certain circumstances. Specifically, the taxpayer and each member of its consolidated group and section 987 electing group would be required to first apply the 2016 and 2019 section 987 regulations to a taxable year ending before November 9, 2023. Proposed §1.987-14(c)(1)(i). In addition, the taxpayer and each member of its consolidated group and section 987 electing group would be required to consistently apply the 2016 and 2019 section 987 regulations in their entirety to all section 987 QBUs directly or indirectly owned by the taxpayer and each member of its consolidated group and section 987 electing group on the transition date for the taxable year that includes the transition date and all subsequent taxable years before the taxable year in which the taxpayer and each member of its consolidated group and section 987 electing group rely on the proposed regulations or apply the new final regulations. Proposed §1.987-14(c)(1)(ii). For purposes of proposed §1.987-14(c), the term section 987 electing group does not include foreign partnerships, foreign non-grantor trusts, or foreign estates. Proposed §1.987-14(c)(3)(ii).

If a taxpayer and each member of its consolidated group and section 987 electing group first apply the 2016 and 2019 section 987 regulations on their returns filed on or after November 9, 2023, they would be required to apply proposed §1.987-10 in lieu of §1.987-10 of the final regulations. Proposed §1.987-14(c)(1)(iii)(B). For these taxpayers, proposed

§1.987-14(c)(1)(iii)(B) would provide that a taxpayer and each member of its consolidated group and section 987 electing group must transition from the previous method used to comply with section 987 using the transition rule in proposed §1.987-10. In other words, these taxpayers would not be permitted to apply the fresh start method described in §1.987-10 of the final regulations.

The Treasury Department and the IRS are concerned that, if the new proposed transition rule applied solely with respect to taxable years ending on or after November 9, 2023, taxpayers would effectively have the option to choose between two alternative transition methods. Taxpayers with pretransition loss could apply the transition rule of proposed §1.987-10 (which preserves the pretransition loss), while taxpayers with pretransition gain could choose to apply the 2016 and 2019 section 987 regulations before the applicability date of the proposed regulations to take advantage of the fresh start transition method (which could eliminate the pretransition gain). Therefore, the proposed transition rule would apply to taxpayers who choose to apply the 2016 and 2019 section 987 regulations on their returns filed on or after November 9, 2023 with respect to a taxable year ending before November 9, 2023.

Proposed §1.987-14(c)(2) describes the applicability of the 2016 and 2019 section 987 regulations to section 987 QBUs that were not directly or indirectly owned by the taxpayer on the taxpayer’s transition date. Specifically, a taxpayer that is applying the 2016 and 2019 section 987 regulations to other section 987 QBUs may choose to apply the 2016 and 2019 section 987 regulations to any section 987 QBU that it did not directly or indirectly own on the transition date, provided the taxpayer applies those regulations consistently to that QBU for that taxable year and all subsequent taxable years before the taxable year in which the taxpayer relies on the proposed regulations or applies the new final regulations.

III. Applicability Dates of §1.987-12

Section 1.987-12T was issued as part of the temporary regulations and generally applied to any deferral event (as defined in

§1.987-12T(b)(2)) or outbound loss event (as defined in §1.987-12T(d)(2)) that occurred on or after January 6, 2017. The 2019 final regulations withdrew §1.987-12T and finalized the proposed regulations under §1.987-12 that cross-referenced §1.987-12T. *See* §1.987-12. The deferral notices did not defer the applicability dates of §1.987-12T or §1.987-12, nor would the proposed regulations. Accordingly, all taxpayers to whom section 987(3) applies are currently subject to §1.987-12.

The proposed regulations would replace §1.987-12 with certain deferral provisions generally included in proposed §§1.987-11 through 1.987-13. Accordingly, the proposed regulations would provide that taxpayers continue to apply §1.987-12 until the first taxable year to which they apply the new final regulations.

IV. Reliance on the Proposed Regulations and 2016 Proposed Regulations

Taxpayers may rely on the proposed regulations (and so much of the final regulations as would not be modified by the proposed regulations) for taxable years ending after November 9, 2023, provided the taxpayer and each member of its consolidated group and section 987 electing group consistently follow the proposed regulations in their entirety and in a consistent manner.

In addition, taxpayers may rely on the parts of the 2016 proposed regulations that remain outstanding for taxable years ending after November 9, 2023, provided that both (i) the taxpayer and each member of its consolidated group and section 987 electing group consistently follow these parts in their entirety and in a consistent manner; and (ii) in that taxable year, the taxpayer follows the proposed regulations.

For the avoidance of doubt, any person relying on the proposed regulations is treated as applying them for purposes of any provision that refers to the application of the proposed regulations or any part thereof (for example, for purposes of proposed §1.987-10(b)).

Special Analyses

I. Regulatory Planning and Review – Economic Analysis

Pursuant to the Memorandum of Agreement, Review of Treasury Regulations under Executive Order 12866 (June 9, 2023), tax regulatory actions issued by the IRS are not subject to the requirements of section 6 of Executive Order 12866, as amended. Therefore, a regulatory impact assessment is not required.

II. Paperwork Reduction Act

The collections of information in the proposed regulations with respect to section 987 are in proposed §§1.987-1(g), 1.987-9, and 1.987-10(k). The likely respondents are individuals who file a Form 1040 and businesses that file a Form 1065, 1066, or 1120. Additionally, there is a possibility that a trust or estate that files a Form 1041 could be affected by the requirements of the proposed regulations. The IRS anticipates that the total number of respondents could be 500,⁸ and that less than 1% of the total respondents would be a trust or estate filer.

The collection of information provided by proposed §1.987-1(g) is required only when a taxpayer makes or revokes certain elections for purposes of calculating its section 987 taxable income or loss and section 987 gain or loss with respect to a section 987 QBU. In the first year to which the section 987 regulations apply to the taxpayer, or the taxpayer or a member of its consolidated group or section 987 electing group is the owner of a section 987 QBU, the taxpayer may make any section 987 election. Thereafter, the taxpayer may make or revoke a current rate election or annual recognition election only every five years and may make or revoke other elections only with the consent of the Commissioner, which may be granted with a private letter ruling. When a taxpayer makes or revokes an election, the collection of information is mandatory.

The collection of information required by proposed §1.987-1(g) will be used by the IRS for tax compliance purposes.

Proposed §1.987-9 is intended to specify how a taxpayer satisfies its recordkeeping obligations under section 6001 with respect to section 987. The recordkeeping requirements under proposed §1.987-9 are considered general tax records under §1.6001-1(e). For Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)) (“PRA”) purposes, general tax records are already approved by OMB under 1545-0074 for individuals and under 1545-0123 for business entities, and will be approved under 1545-NEW for trust and estate filers. The IRS intends that the information collection requirements pursuant to proposed §1.987-9 will be satisfied by the taxpayer maintaining permanent books and records that are adequate to verify its section 987 gain or loss and section 987 taxable income or loss with respect to its section 987 QBU. Specifically, with respect to each section 987 QBU, successor deferral QBU, and successor suspended loss QBU for a taxable year, as applicable, proposed §1.987-9 requires taxpayers to maintain books and records related to the amount of the items of income, gain, deduction, or loss attributed to the section 987 QBU in the functional currency of the section 987 QBU and its owner; the adjusted balance sheet of the section 987 QBU in the functional currency of the section 987 QBU and its owner; the exchange rates used to translate items of income, gain, deduction, or loss of the section 987 QBU into the owner’s functional currency and, if a spot rate convention is used, the manner in which the convention is determined; the exchange rates used to translate the assets and liabilities of the section 987 QBU into the owner’s functional currency and, if a spot rate convention is used, the manner in which the convention is determined; the amount of assets and liabilities transferred by the section 987 QBU to the owner determined in the functional currency of the owner; the amount of the unrecognized section 987 gain or loss for the taxable year; the amount of

⁸ The estimated number of respondents is based on the number of taxpayers who filed a Form 8858 in 2021 that showed that the filer: (1) owned at least one disregarded entity or branch with a functional currency different from the functional currency of the owner; and (2) indicated that the disregarded entity was a section 989 QBU. Although these estimates are likely to increase once these proposed regulations are effective, the Treasury Department and the IRS do not have data that would allow for an accurate estimate of these increases.

the net accumulated unrecognized section 987 gain or loss at the close of the taxable year; the amount of a remittance and the remittance proportion for the taxable year; the computations required under proposed §§1.861-9(g) and 1.861-9T(g) for purposes of sourcing and characterizing section 987 gain or loss, deferred section 987 gain or loss, or suspended section 987 loss under proposed §1.987-6; the cumulative suspended section 987 loss in each recognition grouping; the outstanding deferred section 987 gain or loss in each recognition grouping; and the transition information required to be determined under proposed §1.987-10(k). These records are required for the IRS to validate that section 987 gain or loss and section 987 taxable income or loss have been properly determined.

The collection of information in proposed §1.987-10(k) is mandatory. Specifically, proposed §1.987-10(k) would require a taxpayer to file a “Section 987 Transition Information” statement with its return for the taxable year beginning on the transition date (as defined in proposed §1.987-10(c)). The statement would contain information that is necessary for a taxpayer to transition to the proposed section 987 regulations. Specifically, the statement requires a taxpayer to provide information that is relevant to determining the taxpayer’s pretransition gain or loss with respect to its section 987 QBUs. The collection of information required by proposed §1.987-10(k) will be used by the IRS for tax compliance purposes.

The IRS intends that the information described in proposed §1.987-1(g) will be collected by attaching a statement to a taxpayer’s return (such as the appropriate Form 1040, Form 1120, Form 1065, or other appropriate form). With respect to proposed §1.987-10(k), the IRS also intends that the collection of information will be conducted by attaching a “Section 987 Transition Information” statement to a return. For purposes of the PRA, the reporting burden associated with those collections of information with respect to proposed §§1.987-1(g) and 1.987-10(k) will be reflected in the Paperwork Reduction Act Submissions associated with those forms. The OMB Control Numbers for the forms will be approved under 1545-0074 for individuals, under

1545-0123 for business entities, and under 1545-NEW for trust and estate filers.

To the extent that a taxpayer makes or revokes an election by obtaining a private letter ruling, the reporting burden associated with those collections of information will be reflected in the Paperwork Reduction Act Submissions associated with Revenue Procedure 2023-1, IRB 2023-1 (or future revenue procedures governing private letter rulings). The OMB Control Number for the collection of information for Revenue Procedure 2023-1 is control number 1545-1522. The proposed regulation would only require taxpayers to follow the procedures under Revenue Procedure 2023-1 (or future revenue procedure governing private letter rulings) and would not change the collection requirements of the Revenue Procedure.

The attachment to a return used for making elections with respect to these proposed regulations will be used by those taxpayers making or revoking an election for the taxable year. The “Section 987 Transition Information” statement attached to a return will be used by all taxpayers, but generally only with respect to the taxable year in which the taxpayer transitions to these proposed regulations. In certain cases, if the taxpayer owns a QBU that terminates after November 9, 2023 and before the taxable year in which the taxpayer transitions to the proposed regulations, the “Section 987 Transition Information” statement must be filed for that taxable year too, but the statement would only contain information with respect to the terminating QBU. The Treasury Department and the IRS request comments on all aspects of information collection burdens related to these proposed regulations. If the IRS releases a form for the purposes of collecting this information, drafts of IRS forms will be posted for comment at <https://www.irs.gov/draftforms>.

The burden will be accounted for in 1545-0074 for individuals and in 1545-0123 for businesses. The IRS is requesting a new OMB control number to account for trust and estate filers’ burden, as reflected below.

A summary of paperwork burden estimates for the elections as provided in proposed §1.987-1(g) is as follows:

Estimated number of respondents: 5.

Estimated burden per response: 1.95 hours.

Estimated frequency of response: 1 for the first year in which a taxpayer applies these regulations. After the first year, the current rate election and the annual recognition election can generally be changed only once every five years and other elections can be changed with the consent of the Commissioner.

Estimated total burden hours: 9.75 burden hours.

A summary of paperwork burden estimates for the “section 987 transition information” statement as provided in proposed §1.987-10(k) is as follows:

Estimated number of respondents: 5.

Estimated burden per response: 1.95 hours.

Estimated frequency of response: 1 for the initial transition year.

Estimated total burden hours: 9.75 burden hours.

The collections of information contained in this notice of proposed rulemaking have been submitted to the Office of Management and Budget for review in accordance with the Paperwork Reduction Act. Commenters are strongly encouraged to submit public comments electronically. Written comments and recommendations for the proposed information collection should be sent to www.reginfo.gov/public/do/PRAMain, with copies to the Internal Revenue Service. Find this particular information collection by selecting “Currently under Review - Open for Public Comments” then by using the search function. Submit electronic submissions for the proposed information collection to the IRS via email at pra.comments@irs.gov (indicate REG-132422-17 on the subject line). Comments on the collection of information should be received by February 12, 2024.

Comments are specifically requested concerning:

Whether the proposed collection of information is necessary for the proper performance of the duties of the IRS, including whether the information will have practical utility;

The accuracy of the estimated burden associated with the proposed collection of information (including underlying assumptions and methodology);

How the quality, utility, and clarity of the information to be collected may be enhanced;

How the burden of complying with the proposed collection of information may be minimized, including through the application of automated collection techniques or other forms of information technology; and

Estimates of capital or start-up costs and costs of operation, maintenance, and purchases of services to provide information.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a valid control number assigned by the Office of Management and Budget.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

III. *Regulatory Flexibility Act*

Generally, the proposed regulations affect U.S. corporations that have foreign operations. The number of small entities potentially affected by the proposed regulations is unknown; however, it is unlikely to be a substantial number because taxpayers with foreign operations are typically larger businesses. In accordance with the Regulatory Flexibility Act (5 U.S.C. 601 et seq.) the Secretary hereby certifies that these proposed regulations will not have a significant economic impact on a substantial number of small entities.

IV. *Section 7805(f)*

Pursuant to section 7805(f), this proposed regulation will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

V. *Unfunded Mandates Reform Act*

Section 202 of the Unfunded Mandates Reform Act of 1995 requires that agencies assess anticipated costs and benefits and take certain other actions before issuing a

final rule that includes any Federal mandate that may result in expenditures in any one year by a State, local, or Tribal government, in the aggregate, or by the private sector, of \$100 million in 1995 dollars, updated annually for inflation. The proposed regulations do not include any Federal mandate that may result in expenditures by State, local, or Tribal governments, or by the private sector in excess of that threshold.

VI. *Executive Order 13132: Federalism*

Executive Order 13132 (entitled “Federalism”) prohibits an agency from publishing any rule that has federalism implications if the rule either imposes substantial, direct compliance costs on State and local governments, and is not required by statute, or preempts State law, unless the agency meets the consultation and funding requirements of section 6 of the Executive order. The proposed regulations do not have federalism implications and do not impose substantial direct compliance costs on State and local governments or preempt State law within the meaning of the Executive order.

Comments and Request for Public Hearing

Before these proposed amendments to the final regulations are adopted as final regulations, consideration will be given to comments that are submitted timely to the IRS as prescribed in this preamble under the **ADDRESSES** heading. The Treasury Department and the IRS request comments on all aspects of the proposed regulations. Any comments submitted will be made available at <https://www.regulations.gov> or upon request.

A public hearing will be scheduled if requested in writing by any person who timely submits written comments. Requests for a public hearing are also encouraged to be made electronically. If a public hearing is scheduled, notice of the date and time for the public hearing will be published in the **Federal Register**.

Drafting Information

The principal authors of the proposed regulations are Raphael J. Cohen,

D. Peter Merkel, Jack Zhou, and Azeka J. Abramoff of the Office of Associate Chief Counsel (International); and Jeremy Aron-Dine and Julie Wang of the Office of Associate Chief Counsel (Corporate). However, other personnel from the Treasury Department and the IRS participated in their development.

Statement of Availability of IRS Documents

IRS Revenue Procedures, Revenue Rulings, Notices, and other guidance cited in this document are published in the Internal Revenue Bulletin or Cumulative Bulletin and are available from the Superintendent of Documents, U.S. Government Publishing Office, Washington, DC 20402, or by visiting the IRS website at <https://www.irs.gov>.

Partial Withdrawal of Proposed Regulations

Under the authority of 26 U.S.C. 7805, proposed §§1.987-1(g)(2)(i)(B) and (C) and (g)(3)(i)(G) and (H), 1.987-3(d), 1.987-7, and 1.987-8, contained in the notice of proposed rulemaking that was published in the **Federal Register** on December 8, 2016 (81 FR 88882) is withdrawn.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and record-keeping requirements.

Proposed Amendments to the Regulations

Accordingly, the Treasury Department and the IRS propose to amend 26 CFR part 1 as follows:

PART 1—INCOME TAXES

1. The authority citation for part 1 is amended by:

a. Removing the entry for §§1.861-9 and 1.861-9T and §§1.861-8T through 1.861-14T;

b. Adding entries for §§1.861-8T, 1.861-9, 1.861-9T, 1.861-10T, 1.861-11T, 1.861-12T, 1.861-13T, and 1.861-14T in numerical order;

c. Removing the entry for §§1.985-0 through 1.985-5;

d. Adding entries for §§1.985-0 through 1.985-5 in numerical order;

e. Removing the entry for §§1.987-1 through 1.987-5;

f. Adding entries for §§1.987-1 through 1.987-6, 1.987-7A, 1.987-7B, 1.987-7C, and 1.987-8 through 1.987-11 in numerical order;

g. Revising the entry for §1.987-12;

h. Adding entries for §§1.987-13 and 1.987-14 in numerical order;

i. Removing the entry for §§1.988-0 through 1.988-5;

j. Adding entries for §§1.988-0 through 1.988-5 and 1.989(a)-1 in numerical order.

k. Revising the entry for §1.1502-13.

The revisions and additions read as follows:

Authority: 26 U.S.C. 7805 * * *

* * * * *

Section 1.861-8T also issued under 26 U.S.C. 863(a), 864(e), 865(i), and 7701(f).

Section 1.861-9 also issued under 26 U.S.C. 861, 863(a), 864(e), 864(e)(7), 865(i), 987, and 989(c), and 7701(f).

Section 1.861-9T also issued under 26 U.S.C. 861, 863(a), 864(e), 864(e)(7), 865(i), and 7701(f).

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Section 1.861-10T also issued under 26 U.S.C. 863(a), 864(e), 865(i), and 7701(f).

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Section 1.861-11T also issued under 26 U.S.C. 863(a), 864(e), 865(i), and 7701(f).

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Section 1.861-12T also issued under 26 U.S.C. 863(a), 864(e), 865(i), and 7701(f).

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Section 1.861-13T also issued under 26 U.S.C. 863(a), 864(e), 865(i), and 7701(f).

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Section 1.861-14T also issued under 26 U.S.C. 863(a), 864(e), 865(i), and 7701(f).

* * * * *

Section 1.985-0 also issued under 26 U.S.C. 985.

Section 1.985-1 also issued under 26 U.S.C. 985.

Section 1.985-2 also issued under 26 U.S.C. 985.

Section 1.985-3 also issued under 26 U.S.C. 985.

Section 1.985-4 also issued under 26 U.S.C. 985.

Section 1.985-5 also issued under 26 U.S.C. 985, 987, and 989(c).

* * * * *

Section 1.987-1 also issued under 26 U.S.C. 987, 989(c), and 1502.

Section 1.987-2 also issued under 26 U.S.C. 987, 989(c), and 1502.

Section 1.987-3 also issued under 26 U.S.C. 987 and 989(c).

Section 1.987-4 also issued under 26 U.S.C. 987 and 989(c).

Section 1.987-5 also issued under 26 U.S.C. 987 and 989(c).

Section 1.987-6 also issued under 26 U.S.C. 904, 987, and 989(c).

Section 1.987-7A also issued under 26 U.S.C. 987 and 989(c).

Section 1.987-7B also issued under 26 U.S.C. 987 and 989(c).

Section 1.987-7C also issued under 26 U.S.C. 987 and 989(c).

Section 1.987-8 also issued under 26 U.S.C. 987 and 989(c).

Section 1.987-9 also issued under 26 U.S.C. 987, 989(c), and 6001.

Section 1.987-10 also issued under 26 U.S.C. 987, 989(c), and 6001.

Section 1.987-11 also issued under 26 U.S.C. 987, 989(c), and 1502.

Section 1.987-12 also issued under 26 U.S.C. 987 and 989(c).

Section 1.987-13 also issued under 26 U.S.C. 987 and 989(c).

Section 1.987-14 also issued under 26 U.S.C. 987 and 989(c).

Section 1.988-0 also issued under 26 U.S.C. 988.

Section 1.988-1 also issued under 26 U.S.C. 988 and 989(c).

Section 1.988-2 also issued under 26 U.S.C. 988.

Section 1.988-3 also issued under 26 U.S.C. 988.

Section 1.988-4 also issued under 26 U.S.C. 988 and 989(c).

Section 1.988-5 also issued under 26 U.S.C. 988.

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Section 1.989(a)-1 also issued under 26 U.S.C. 989 and 989(c).

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Section 1.1502-13 also issued under 26 U.S.C. 250(c), 987, 989(c), and 1502.

* * * * *

2. Section 1.861-9 is amended by:

a. Revising paragraphs (g)(2)(ii)(A) introductory text, (g)(2)(ii)(A)(I), and (g)(2)(ii)(B).

b. Adding paragraph (g)(2)(v).

The revisions and addition read as follows:

§1.861-9 Allocation and apportionment of interest expense and rules for asset-based apportionment.

* * * * *

(g) * * *

(2) * * *

(ii) * * *

(A) *Tax book value method.* In the case of taxpayers using the tax book value method of apportionment, the following rules apply to determine the value of the assets of a qualified business unit (as defined in section 989(a)) of a domestic corporation with a functional currency other than the dollar.

(1) *Section 987 QBU.* In the case of a section 987 QBU (as defined in §1.987-1(b)(3)), the tax book value is determined by applying the rules of paragraph (g)(2)(i) of this section and §1.861-9T(g)(3) to the beginning-of-year and end-of-year owner functional currency amount of assets. The beginning-of-year owner functional currency amount of assets is determined by reference to the owner functional currency amount of assets computed under §1.987-4(d)(1)(i)(B) and (e) on the last day of the preceding taxable year. The end-of-year owner functional currency amount of assets is determined by reference to the owner functional currency amount of assets computed under §1.987-4(d)(1)(i)(A) and (e) on the last day of the current taxable year. The beginning-of-year and end-of-year owner functional currency amount of assets, as so determined within each grouping, are then averaged as provided in paragraph (g)(2)(i) of this section.

(B) *Fair market value method.* In the case of taxpayers using the fair market value method of apportionment, the beginning-of-year and end-of-year fair market values of branch assets within each grouping is computed in dollars and averaged as provided in this paragraph (g)(2) and §1.861-9T(g)(2).

* * * * *

(v) *Applicability date.* Generally, paragraph (g)(2)(ii)(A)(I) of this section applies to taxable years beginning after December 31, 2024. However, if pursuant to §1.987-14(b), a taxpayer chooses to apply §§1.987-1 through 1.987-14 to a taxable year before the first taxable year described in §1.987-14(a)(1), then paragraph (g)(2)(ii)(A)(I) of this section applies to that taxable year and subsequent years.

§1.861-9T [Amended]

3. Section 1.861-9T is amended by removing and reserving paragraph (g)(2)(ii) and removing paragraph (g)(2)(vi).

4. Section 1.904-4 is amended by revising paragraph (c)(5)(iii)(B) to read as follows:

§1.904-4 Separate application of section 904 with respect to certain categories of income.

(c) ***

(5) ***

(iii) ***

(B) *Section 987.* For special rules relating to the allocation and apportionment of foreign income taxes to section 987 items, see §1.987-6(b)(3)(iii).

5. Section 1.985-5 is amended by:

a. In paragraph (a) removing the language “§1.987-1(b)(2)” and adding the language “§1.987-1(b)(3)” in its place.

b. In paragraph (d)(1)(i) removing the language “1.987-11” and adding the language “1.987-14” in its place.

c. Revising the last sentence of paragraph (d)(2).

d. Removing the second sentence of paragraph (e)(1).

e. In paragraph (e)(4)(i) removing the language “1.987-11” and adding the language “1.987-14” in its place.

f. In paragraph (e)(4)(i)(C) adding the language “, cumulative suspended section 987 loss determined under §1.987-11(b), and deferred section 987 gain or loss determined under §1.987-12” after “§1.987-4”.

g. In paragraph (e)(4)(ii) removing the language “subsequent years” and adding the language “subsequent taxable years” in its place.

h. Revising the last sentence of paragraph (e)(4)(iii).

i. Revising paragraphs (f) through (g). The revisions read as follows:

§1.985-5 Adjustments required upon change in functional currency.

(d) ***

(2) *** See §§1.987-5, 1.987-8, 1.987-12, and 1.987-13 for the effect of a termination of a section 987 QBU that is subject to §§1.987-1 through 1.987-14.

(e) ***

(4) ***

(iii) *** See §§1.987-5, 1.987-8, 1.987-12, and 1.987-13 for the consequences of a termination of a section 987 QBU that is subject to §§1.987-1 through 1.987-14.

(f) *Example.* The provisions of this section are illustrated by the following example:

(1) *Facts.* FC, a foreign corporation, is wholly owned by DC, a domestic corporation. The Commissioner granted permission to change FC’s functional currency from the British pound to the euro beginning January 1, year 2. The EUR/GBP exchange rate on December 31, year 1, is €1:£0.50.

(2) *Analysis—(i) Determining new functional currency basis of property and liabilities.* The following table shows how FC must convert the items on its balance sheet from the British pound to the euro on December 31, year 1.

Table 1 to paragraph (f)(2)(i)
Conversion of FC’s Balance Sheet Items

	GBP	EUR
Assets:		
Cash on hand	£40,000	€80,000
Accounts Receivable	£10,000	€20,000
Inventory	£100,000	€200,000
€100,000 Euro Bond (£100,000 historical basis)	£50,000	€100,000
Fixed assets:		
Property	£200,000	€400,000
Plant	£500,000	€1,000,000
Accumulated Depreciation	(£200,000)	(€400,000)
Equipment	£1,000,000	€2,000,000
Accumulated Depreciation	(£400,000)	(€800,000)
Total Assets	£1,300,000	€2,600,000
Liabilities and Equity:		
Accounts Payable	£50,000	€100,000
Long-term Liabilities	£400,000	€800,000
Paid-in-Capital	£800,000	€1,600,000
Retained Earnings	£50,000	€100,000
Total Liabilities and Equity	£1,300,000	€2,600,000

(ii) *Exchange gain or loss on section 988 transactions.* Under paragraph (b) of this section, FC will recognize a £50,000 loss (£50,000 current value minus £100,000 historical basis) on the Euro Bond resulting from the change in functional currency because, after the change, the Euro Bond will no longer be an asset denominated in a non-functional currency. The amount of FC's retained earnings on its December 31, year 1, balance sheet reflects the £50,000 loss on the Euro Bond.

(g) *Applicability date.* Generally, this regulation applies to taxable years beginning after December 31, 2024. However, if pursuant to §1.987-14(b), a taxpayer chooses to apply §§1.987-1 through 1.987-14 to a taxable year before the first taxable year described in §1.987-14(a)(1), then this section applies to that taxable year and subsequent years.

6. Section 1.987-1, as proposed to be amended by 81 FR 88882 (December 8, 2016), is further amended by:

- a. Revising paragraph (a);
- b. Revising the paragraph (b) heading, paragraph (b)(1) heading, paragraphs (b)(1)(i) and (ii), (2) through (5) and (7);
- c. Revising paragraphs (c) introductory text, (c)(1)(i) and (c)(1)(ii)(A) and removing paragraph (c)(1)(iii);
- d. Revising paragraphs (c)(2), (c)(3)(i) introductory text, (c)(3)(i)(A) through (D) and adding paragraph (c)(3)(i)(F);
- g. Revising paragraphs (c)(3)(ii) through (iv);
- h. Removing the introductory text in paragraph (d);
- i. Redesignating paragraphs (d)(1) through (3) as paragraphs (d)(1)(i) through (iii);
- j. Adding paragraph (d)(1) introductory text;
- k. Revising newly redesignated paragraphs (d)(1)(i) and (ii);
- l. Adding paragraph (d)(2);
- m. Revising paragraph (e);
- n. Adding paragraph (g) introductory text;
- o. Revising paragraphs (g)(1) and (2);
- p. Revising paragraph (g)(3) heading and adding (g)(3) introductory text;
- q. Revising paragraph (g)(3)(i) heading and introductory text;
- r. Revising paragraphs (g)(3)(i)(A) through (D), (G), and (H);
- s. Adding paragraphs (g)(3)(i)(I) and (J);
- t. Revising paragraph (g)(3)(ii);
- u. Adding paragraph (g)(3)(iii);

v. Revising paragraphs (g)(4) and (5); and

w. Adding paragraph (h).

The revisions and additions read as follows:

§1.987-1 Scope, definitions, and special rules.

(a) *In general.* Sections 1.987-1 through 1.987-14 (the *section 987 regulations*) provide rules for determining the taxable income or loss and earnings and profits of a taxpayer with respect to a section 987 QBU. Further, the section 987 regulations provide rules for determining the timing, amount, character, and source of section 987 gain or loss recognized with respect to a section 987 QBU. This section addresses the scope of the section 987 regulations and provides certain definitions, special rules, and procedures for making elections. Section 1.987-2 provides rules for attributing assets and liabilities and items of income, gain, deduction, and loss to an eligible QBU. It also provides rules regarding the translation of items transferred to a section 987 QBU. Section 1.987-3 provides rules for determining and translating the taxable income or loss of a taxpayer with respect to a section 987 QBU. Section 1.987-4 provides rules for determining net unrecognized section 987 gain or loss. Section 1.987-5 provides rules regarding the recognition of section 987 gain or loss. It also provides rules regarding the translation of items transferred from a section 987 QBU to its owner. Section 1.987-6 provides rules regarding the character and source of section 987 gain or loss. Section 1.987-7A provides rules regarding partnerships (other than section 987 aggregate partnerships) and S corporations that own section 987 QBUs and their partners and shareholders. Section 1.987-7B provides rules regarding section 987 aggregate partnerships. Section 1.987-7C provides transition rules that apply when a partnership becomes, or ceases to be, a section 987 aggregate partnership. Section 1.987-8 provides rules regarding the termination of a section 987 QBU. Section 1.987-9 provides rules regarding the recordkeeping required under section 987. Section 1.987-10 provides transition rules. Section 1.987-11 provides rules relating to

suspended losses in connection with certain elections and the loss-to-the-extent-of-gain rule. Section 1.987-12 provides rules regarding when section 987 gain or loss is deferred, as well as when such amounts are recognized. Section 1.987-13 provides rules relating to suspended section 987 loss of an owner with respect to a section 987 QBU that terminates. Section 1.987-14 provides the applicability date of the section 987 regulations.

(b) *Scope of section 987 and certain rules relating to QBUs—(1) Persons subject to section 987—(i) In general.* Except as provided in paragraphs (b)(1)(ii) and (b)(6) of this section, any person (including an individual, corporation, partnership, S corporation, non-grantor trust, or estate) is subject to the section 987 regulations.

(ii) *Inapplicability to certain entities—(A) In general.* Except as otherwise provided in paragraph (b)(1)(iii) of this section, section 987(3) and the section 987 regulations do not apply to foreign corporations that either are not controlled foreign corporations or that are controlled foreign corporations in which no United States shareholders own (within the meaning of section 958(a)) stock; foreign non-grantor trusts, foreign estates, or foreign partnerships (other than section 987 aggregate partnerships) if the aggregate beneficial interest or partnership interest of all U.S. persons that are beneficiaries or partners in the non-grantor trust, estate, or partnership is de minimis under paragraph (b)(1)(ii)(B) of this section; and individuals who are not United States persons.

(B) *De minimis interest in a foreign non-grantor trust, foreign estate, or foreign partnership—(1) General rules.* The total partnership interests of all U.S. persons that own (within the meaning of section 958(a)) an interest in a partnership is de minimis if their aggregate partnership interests represent less than ten percent of the capital and less than ten percent of the profits of the partnership at all times during the partnership's taxable year. The aggregate beneficial interests of all U.S. persons in a foreign non-grantor trust or foreign estate is de minimis if it constitutes less than ten percent of all of the beneficial interests. For purposes of this paragraph, a partner's interest in a partnership or partnership item and a beneficiary's interest in a non-grantor trust or estate is treated

as including the interests of the partner or beneficiary and any related party (determined under section 267(b) or 707(b)).

(2) *Foreign partnerships.* For purposes of this paragraph (b)(1)(ii)(B), a partner's interest in the profits of a partnership is determined in accordance with the rules and principles of §1.706-1(b)(4)(ii), and a partner's interest in the capital of a partnership is determined in accordance with the rules and principles of §1.706-1(b)(4)(iii).

(3) *Foreign trusts and estates.* For purposes of this paragraph (b)(1)(ii)(B), a person holds a beneficial interest in a foreign trust or in a foreign estate if the person has the right to receive directly or indirectly (for example, through a nominee) a mandatory distribution from the foreign trust or estate, or may receive, directly or indirectly, a discretionary distribution from the foreign trust. For purposes of this section, a mandatory distribution means a distribution that is required to be made pursuant to the terms of the trust's or estate's governing documents. A discretionary distribution means a distribution that is made to a person at the discretion of the trustee or a person with a limited power of appointment of such trust. The aggregate beneficial interests of all U.S. persons in a foreign non-grantor trust or foreign estate will be treated as equaling 10 percent or more of the beneficial interest in a foreign trust or a foreign estate if—

(i) The beneficiaries receive, directly or indirectly, only discretionary distributions from the trust and the fair market value of the currency or other property distributed, directly or indirectly, from the trust to such beneficiaries during the prior calendar year exceeds, in the aggregate, 10 percent of the value of either all of the distributions made by the trust during that year or all of the assets held by the trust at the end of that year;

(ii) The beneficiaries are entitled to receive, directly or indirectly, mandatory distributions from the trust or estate and the value of the beneficiaries' aggregate interest in the trust or estate, as determined under section 7520, exceeds 10 percent of the value of all the assets held by the trust; or

(iii) The beneficiaries are entitled to receive, directly or indirectly, mandatory

distributions and may receive, directly or indirectly, discretionary distributions from the trust, and the value of the beneficiaries' aggregate interest in the trust (determined as the sum of the fair market value of all of the currency or other property distributed from the trust at the discretion of the trustee during the prior calendar year to the beneficiaries and the value of the beneficiaries' interest in the trust as determined under section 7520 at the end of that year) exceeds either 10 percent of the value of all distributions made by such trust during the prior calendar year or 10 percent of the value of all the assets held by the trust at the end of that year.

* * * * *

(2) *Application of the section 987 regulations to earnings and profits—(i) In general.* The rules and principles of the section 987 regulations also apply to the determination of earnings and profits, and any elections that apply pursuant to the section 987 regulations also apply for purposes of determining earnings and profits.

(ii) *Timing.* Earnings and profits are increased when section 987 gain is recognized and decreased when section 987 loss is recognized. As a result, converting net unrecognized section 987 gain or loss to deferred section 987 gain or loss or suspended section 987 loss does not affect earnings and profits because the amounts have not yet been recognized.

(3) *Definition of a section 987 QBU—(i) In general.* For purposes of section 987, a *section 987 QBU* is an eligible QBU that has a functional currency different from its owner. A section 987 QBU also includes the assets and liabilities of an eligible QBU that are considered under paragraph (b)(5)(ii) of this section to be a section 987 QBU of a partner in a section 987 aggregate partnership. A section 987 QBU will continue to be treated as a section 987 QBU of the owner until a sale or other termination of the section 987 QBU as described in §1.987-8(b) and (c). See §1.985-1 for rules determining the functional currency of an eligible QBU.

(ii) *Section 987 QBU grouping election—(A) In general.* Solely for purposes of section 987, an owner may elect to treat all section 987 QBUs with the same functional currency as a single section 987 QBU except to the extent provided in paragraph (b)(2)(ii)(B) of this section.

(B) *Special grouping rules for section 987 QBUs owned indirectly through a section 987 aggregate partnership.* An owner making the section 987 QBU grouping election treats all section 987 QBUs with the same functional currency owned indirectly through a single section 987 aggregate partnership as a single section 987 QBU. However, an owner may not treat section 987 QBUs as a single section 987 QBU if such QBUs are owned indirectly through different section 987 aggregate partnerships. Additionally, an owner may not treat section 987 QBUs that are owned both directly and indirectly through a section 987 aggregate partnership as a single section 987 QBU.

(4) *Definition of an eligible QBU—(i) In general.* For purposes of section 987, an *eligible QBU* means a qualified business unit that is not subject to the United States dollar approximate separate transactions method rules of §1.985-3.

(ii) *Qualified business unit.* For purposes of this paragraph (b)(4), a qualified business unit is defined in §1.989(a)-1(b), except that a corporation, partnership, section 987 aggregate partnership, trust, estate, or DE is not itself a qualified business unit, but the activities of such entity may be a qualified business unit if they meet the requirements of §1.989(a)-1(b)(1) and (b)(2)(ii). For example, if a corporation is solely engaged in activities that constitute a trade or business within the meaning of §1.989(a)-1(b)(2)(ii)(A), and the corporation maintains only one set of books and records, the activities (but not the corporation) are a qualified business unit.

(5) *Definition of an owner.* For purposes of section 987, an *owner* is any person having direct or indirect ownership in an eligible QBU (including ownership through DEs). The term *owner* does not include an eligible QBU. For example, a section 987 QBU (*QBU1*) is not an owner of another section 987 QBU (*QBU2*) even if QBU1 wholly owns the DE that owns QBU2. A person that is not subject to the section 987 regulations under paragraph (b)(1)(ii) of this section can meet the definition of an owner under this paragraph (b)(5) for purposes of applying the section 987 regulations to other persons.

(i) *Direct ownership.* A person is a direct owner of an eligible QBU if the

person is the owner for Federal income tax purposes of the assets and liabilities of the eligible QBU.

(ii) *Indirect ownership.* A person that is a partner in a section 987 aggregate partnership and is allocated, under § 1.987-7B, all or a portion of the assets and liabilities of an eligible QBU of such partnership is an indirect owner of the eligible QBU.

* * * * *

(7) *Examples illustrating paragraph (b) of this section.* The following examples illustrate the principles of this paragraph (b). The following facts are assumed for purposes of the examples. U.S. Corp is a domestic corporation, has the U.S. dollar as its functional currency, and uses the calendar year as its taxable year. Except as otherwise provided: Business A and Business B are eligible QBUs and have the euro and the Japanese yen, respectively, as their functional currencies; and DE1 and DE2 are DEs, have no assets or liabilities, and conduct no activities.

(i) *Example 1—(A) Facts.* U.S. Corp owns Business A and all of the interests in DE1. DE1 maintains a separate set of books and records that are kept in British pounds. DE1 owns pounds and all of the stock of a foreign corporation, FC. DE1 is liable to a lender on a pound-denominated obligation that was incurred to acquire the stock of FC. The FC stock, the pounds, and the liability incurred to acquire the FC stock are recorded on DE1's separate books and records. DE1 has no other assets or liabilities and conducts no activities (other than holding the FC stock and pounds and servicing its liability).

(B) *Analysis—(1)* Pursuant to paragraph (b)(5) of this section, U.S. Corp is the owner of Business A because it has direct ownership of Business A, an eligible QBU. Because Business A is an eligible QBU with a functional currency that is different from the functional currency of its owner, U.S. Corp, Business A is a section 987 QBU under paragraph (b)(3)(i) of this section. As a result, U.S. Corp and its section 987 QBU, Business A, are subject to section 987.

(2) Holding the stock of FC and pounds and servicing a liability does not constitute a trade or business within the meaning of § 1.989(a)-1(c). Because the activities of DE1 do not constitute a trade or business within the meaning of § 1.989(a)-1(c), such activities are not an eligible QBU. In addition, pursuant to paragraph (b)(4)(ii) of this section, DE1 itself is not an eligible QBU. As a result, neither DE1 nor its activities qualify as a section 987 QBU of U.S. Corp. Therefore, neither the activities of DE1 nor DE1 itself is subject to section 987. For the foreign currency treatment of payments on DE1's pound-denominated liability, see § 1.988-2(b).

(ii) *Example 2—(A) Facts.* U.S. Corp owns all of the interests in DE1. DE1 owns Business A and all of the interests in DE2. The only activities of DE1 are Business A activities and holding the interests in DE2. DE2 owns Business B and Business C. For purposes of this example, Business B does

not maintain books and records that are separate from DE2. Instead, the activities of Business B are reflected on the books and records of DE2, which are maintained in Japanese yen. In addition, Business C has the U.S. dollar as its functional currency, maintains books and records that are separate from the books and records of DE2, and is an eligible QBU.

(B) *Analysis—(1)* Pursuant to paragraph (b)(4)(ii) of this section, DE1 and DE2 are not eligible QBUs. Moreover, pursuant to paragraph (b)(5) of this section, DE1 is not the owner of the Business A, Business B, or Business C eligible QBUs, and DE2 is not the owner of the Business B or Business C eligible QBUs. Instead, pursuant to paragraph (b)(5) of this section, U.S. Corp is the owner of the Business A, Business B, and Business C eligible QBUs.

(2) Because Business A and Business B are eligible QBUs with functional currencies that are different than the functional currency of U.S. Corp, Business A and Business B are section 987 QBUs under paragraph (b)(3)(i) of this section.

(3) The Business C eligible QBU has the same functional currency as U.S. Corp, the U.S. dollar. Therefore, the Business C eligible QBU is not a section 987 QBU under paragraph (b)(3)(i) of this section.

(iii) *Example 3—(A) Facts.* U.S. Corp owns all of the interests in DE1. DE1 owns Business A and Business B. For purposes of this example, assume Business B has the euro as its functional currency.

(B) *Analysis—(1)* Pursuant to paragraph (b)(4)(ii) of this section, DE1 is not an eligible QBU. Moreover, pursuant to paragraph (b)(5) of this section, DE1 is not the owner of the Business A or Business B eligible QBUs. Instead, pursuant to paragraph (b)(5) of this section, U.S. Corp is the owner of the Business A and Business B eligible QBUs.

(2) Business A and Business B constitute two separate eligible QBUs, each with the euro as its functional currency. Accordingly, Business A and Business B are section 987 QBUs of U.S. Corp under paragraph (b)(3)(i) of this section. U.S. Corp may elect to treat Business A and Business B as a single section 987 QBU pursuant to paragraph (b)(3)(ii) of this section. If such election is made, pursuant to paragraph (b)(5) of this section, U.S. Corp would be the owner of the Business AB section 987 QBU that would include the activities of both the Business A section 987 QBU and the Business B section 987 QBU. In addition, pursuant to paragraph (b)(5) of this section, DE1 would not be treated as the owner of the Business AB section 987 QBU.

(iv) *Example 4—(A) Facts.* U.S. Corp and FC, an unrelated foreign corporation, are the only partners in P, a foreign partnership with the euro as its functional currency. P owns DE1 and Business A. DE1 owns Business B.

(B) *Analysis—(1)* P is not a section 987 aggregate partnership under paragraph (h) of this section because its partners are not related to each other within the meaning of sections 267(b) and 707(b). Therefore, pursuant to paragraph (b)(5) of this section and § 1.987-7A(b), P is the owner of Business A because it is the owner of the assets and liabilities of Business A. Because Business A is an eligible QBU with the same functional currency as its owner, P (the euro), Business A is not a section 987 QBU under paragraph (b)(3)(i) of this section.

(2) Pursuant to paragraph (b)(4)(ii) of this section, DE1 is not an eligible QBU. Moreover, pursuant to paragraph (b)(5) of this section and § 1.987-7A(b), P (rather than DE1) is the owner of the Business B eligible QBU. The Business B eligible QBU has a different functional currency than P. Therefore, the Business B eligible QBU is a section 987 QBU under paragraph (b)(3)(i) of this section. As a result, P and its section 987 QBU, Business B, are subject to section 987.

(v) *Example 5—(A) Facts.* U.S. Corp owns all of the interests in DE1. DE1 owns Business A and all of the interests in DE2. DE2 owns Business B and all of the interests in DE3, a DE. DE3 owns Business C, which is an eligible QBU with the Mexican peso as its functional currency.

(B) *Analysis.* Pursuant to paragraph (b)(4)(ii) of this section, DE1, DE2, and DE3 are not eligible QBUs. Pursuant to paragraph (b)(5) of this section, an eligible QBU is not an owner of another eligible QBU. Accordingly, the Business A eligible QBU is not the owner of the Business B eligible QBU or the Business C eligible QBU, and the Business B eligible QBU is not the owner of the Business C eligible QBU. Instead, pursuant to paragraph (b)(5) of this section, U.S. Corp is the owner of the Business A, Business B, and Business C eligible QBUs. Because each of the Business A, Business B, and Business C eligible QBUs has a different functional currency than U.S. Corp, such eligible QBUs are section 987 QBUs of U.S. Corp under paragraph (b)(3)(i) of this section.

(c) *Exchange rates.* Solely for purposes of section 987, the spot rate, the yearly average exchange rate, and the historic rate are determined as provided in paragraphs (c)(1) through (3) of this section.

(1) *Spot rate—(i) In general.* Except as otherwise provided in this section, the spot rate means the rate determined under the rules of § 1.988-1(d)(1), (2), and (4) on the relevant date.

(ii) *Election to use a spot rate convention—(A) In general—spot rate convention.* An owner may elect to use a spot rate convention that reasonably approximates the spot rate determined in paragraph (c)(1)(i) of this section. A spot rate convention may be based on the spot rate at the beginning of a reasonable period, the spot rate at the end of a reasonable period, the average of spot rates for a reasonable period, or spot and forward rates for a reasonable period. For this purpose, a reasonable period may not exceed three months. For example, in lieu of the spot rate determined in paragraph (c)(1)(i) of this section, the spot rate for all transactions during a monthly period may be determined pursuant to one of the following conventions: the spot rate at the beginning of the current month or at the end of

the preceding month; the monthly average of daily spot rates for the current or preceding month; or an average of the beginning and ending spot rates for the current or preceding month. Similarly, in lieu of the spot rate determined in paragraph (c)(1)(i) of this section, the spot rate may be determined pursuant to an average of the spot rate and the 30-day forward rate on a day of the preceding month. Use of a spot rate convention that is consistent with the convention used for financial accounting purposes is generally presumed to reasonably approximate the rate in paragraph (c)(1)(i) of this section. However, the Commissioner may prescribe the spot rate as determined in paragraph (c)(1)(i) of this section or an appropriate spot rate pursuant to this paragraph (c)(1)(ii) if the Commissioner determines that the use of the convention would not clearly reflect income based on the facts and circumstances available at the time of the election. The election or revocation of a spot rate convention does not change the spot rate with respect to any day of a taxable year before the election or revocation becomes effective. See paragraph (g) of this section for rules relating to section 987 elections.

* * * * *

(2) *Yearly average exchange rate.* For purposes of section 987, the yearly average exchange rate is a rate that represents an average exchange rate for the taxable year (or, if the section 987 QBU existed for less than the full taxable year, the portion of the year during which the 987 QBU existed) computed under any reasonable method. For example, an owner may determine the yearly average exchange rate based on a daily, monthly, or quarterly averaging convention, whether weighted or unweighted, and may take into account forward rates for a period not to exceed three months. Use of an averaging convention that is consistent with the convention used for financial accounting purposes is generally presumed to be a reasonable method. However, the Commissioner may prescribe an appropriate yearly average exchange rate if the Commissioner determines that the use of the convention would not have been expected to clearly reflect income based on the facts and circumstances available at the time of the election.

(3) *Historic rate—(i) In general.* Except as otherwise provided in the section 987 regulations, the historic rate is determined as described in paragraphs (c)(3)(i)(A) through (F) of this section. In a taxable year in which an annual recognition election is in effect (and a current rate election is not in effect), paragraphs (c)(3)(i)(B) and (C) of this section are applied as if §1.987-3(c)(2)(iv)(A) and (B) were applicable.

(A) *Assets generally.* In the case of an asset other than inventory that is acquired by a section 987 QBU (including through a transfer), the historic rate is the yearly average exchange rate applicable to the year of acquisition.

(B) *Inventory under the simplified inventory method.* In the case of inventory with respect to which a taxpayer uses the simplified inventory method described in §1.987-3(c)(2)(iv)(A), the historic rate for inventory accounted for under the last-in, first-out (*LIFO*) method of accounting is the yearly average exchange rate applicable to the year in which the inventory's LIFO layer arose. The historic rate for all other inventory of such a taxpayer is the yearly average exchange rate for the taxable year for which the determination of the historic rate for such inventory is relevant.

(C) *Inventory under the historic inventory method.* In the case of inventory with respect to which a taxpayer has elected under §1.987-3(c)(2)(iv)(B) to use the historic inventory method, each inventoriable cost with respect to such inventory may have a different historic rate. The historic rate for each inventoriable cost is the exchange rate at which such item would be translated under §1.987-3 if it were not an inventoriable cost.

(D) *Liabilities generally.* In the case of a liability that is incurred or assumed by a section 987 QBU, the historic rate is the yearly average exchange rate applicable to the year the liability is incurred or assumed.

* * * * *

(F) *Determination of historic rates after revocation of current rate election.* Except as provided in paragraph (c)(3)(i)(B) of this section with respect to non-LIFO inventory subject to the simplified inventory method, if a current rate election is revoked or otherwise ceases to be

in effect, the historic rate of all historic items that were properly reflected on the books and records of a section 987 QBU under §1.987-2(b) on the last day of the last taxable year to which the current rate election was in effect is the spot rate applicable to that day.

(ii) [Reserved]

(iii) *Date placed in service for depreciable or amortizable property.* In the case of depreciable or amortizable property, an owner may determine the historic rate by reference to the date such property is placed in service by the section 987 QBU rather than the date the property was acquired, provided that this convention is consistently applied for all such property attributable to that section 987 QBU.

(iv) *Changed functional currency.* In the case of a section 987 QBU or an owner of a section 987 QBU that previously changed its functional currency, §1.985-5(d)(1)(ii)(A) and (e)(4)(i)(A), respectively, are taken into account in determining the historic rate for an item reflected on the balance sheet of the section 987 QBU immediately before the year of change.

(d) *Marked item—(1) In general.* Except as provided in paragraph (d)(2) of this section, a marked item is an asset (*marked asset*) or liability (*marked liability*) that is properly reflected on the books and records of a section 987 QBU under §1.987-2(b) and that—

(i) 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; or

(ii) 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.

* * * * *

(2) *Current rate election.* A taxpayer may elect to treat all assets and liabilities that are properly reflected on the books and records of a section 987 QBU under §1.987-2(b) as marked items (a *current rate election*). See §1.987-11(c) for rules suspending section 987 loss if a current rate election is in effect.

(e) *Historic item.* A historic item is an asset (*historic asset*) or liability (*historic liability*) that is properly reflected on the books and records of a section 987 QBU under §1.987-2(b) and that is not a marked item.

(g) *Elections.* This paragraph (g) provides rules for making and revoking elections under the section 987 regulations (the *section 987 elections*). A section 987 election is made for the owner and for a taxable year and applies to every section 987 QBU owned by the owner while the election is in effect. Once made, a section 987 election remains in effect until revoked.

(1) *Persons making the election.* A section 987 election is made or revoked by the authorized person. The authorized person is described in paragraph (g)(1)(i), (ii), (iii), or (iv) of this section. If there are multiple controlling domestic shareholders, references to “the authorized person” refer to all authorized persons.

(i) *United States persons.* Except as provided in paragraph (g)(1)(iii) or (iv) of this section, if the owner of a section 987 QBU is a United States person, the election is made or revoked by the owner.

(ii) *CFCs and other foreign entities—(A) In general.* Except as provided in paragraph (g)(1)(iv) of this section, if the owner of a section 987 QBU is a controlled foreign corporation or other foreign entity, the election is made or revoked by the controlling domestic shareholders of the controlled foreign corporation or other foreign entity.

(B) *Controlling domestic shareholders.* For purposes of this paragraph (g), the controlling domestic shareholders of a controlled foreign corporation are determined under §1.964-1(c)(5)(i) and the controlling domestic shareholders of a foreign entity other than a controlled foreign corporation are determined by applying the rules and principles of §1.964-1(c)(5)(i) as if the foreign entity were a controlled foreign corporation and, if the entity is a trust or estate, the beneficial interests in the entity were stock.

(iii) *Consolidated groups.* If the owner is a member of a consolidated group, *see* §1.1502-77.

(iv) *Partnerships.* If the owner of a section 987 QBU is a partnership, the

election is made or revoked by the partnership. For a partnership that is not otherwise required to file a partnership return, *see* §1.6031(a)-1(b)(5) for elections that can only be made by a partnership under section 703.

(2) *Consistency rules—(i) Consolidated groups.* A section 987 election is made or revoked by a consolidated group and applies to all members of the group. Therefore, the same section 987 elections will be in effect for all members of a consolidated group at all times. If a corporation becomes a member of a consolidated group, it is deemed to make or revoke any section 987 election as necessary to be consistent with the consolidated group. If a corporation ceases to be a member of a consolidated group and does not join another group, its section 987 elections are unaffected by its departure from the group.

(ii) *United States shareholders, CFCs, foreign partnerships, foreign non-grantor trusts, and foreign estates.* If the authorized person makes or revokes an election on behalf of any person (including the authorized person) described in paragraphs (g)(2)(ii)(A) through (D) of this section (the *section 987 electing group*), then the election must be made or revoked on behalf of all members of the section 987 electing group for the first taxable year of each entity that ends with or within the taxable year of the United States person described in paragraph (g)(2)(ii)(A) of this section in which the election or revocation became effective. If an entity that was not previously a member of the section 987 electing group becomes a member (for example, upon formation or acquisition), it is deemed to make or revoke any section 987 election as necessary to be consistent with the other members (without regard to the requirements of paragraph (g)(3)(ii) of this section). The following persons are described in this paragraph (g)(2)(ii):

(A) A United States person (the *relevant United States person*).

(B) Each controlled foreign corporation in which the relevant United States person owns (within the meaning of section 958(a)) more than fifty percent (by vote or value).

(C) Each foreign partnership in which the relevant United States person owns

(directly or indirectly) more than fifty percent of the capital and profits interest.

(D) Each foreign non-grantor trust or estate in which the relevant United States person’s beneficial interests in the trust or estate exceed fifty percent.

(iii) *Section 381(a) transactions.* If a corporation (*acquiring corporation*) acquires the assets of another corporation in a transaction described in section 381(a), the acquiring corporation’s election status applies to all section 987 QBUs owned by the acquiring corporation after the transaction.

(3) *Manner of making or revoking elections.* The section 987 elections must be made in accordance with this paragraph (g)(3), except as provided in forms and instructions or other guidance as provided by the Secretary.

(i) *Statement must be attached to a return.* An authorized person that makes or revokes a section 987 election in accordance with this paragraph (g) must attach to its return the statement described in this paragraph (g)(3)(i). Each statement must include an identification of the election that is made or revoked; the name, address, and functional currency of each owner (or if the owner is a member of a consolidated group, the common parent of the consolidated group) for which the election is made or revoked; and the name, address, functional currency, and owner of each section 987 QBU owned by each owner.

(A) *Section 987 grouping election.* The election provided in paragraph (b)(3)(ii) of this section is titled “Section 987 Grouping Election Under §1.987-1(b)(3)(ii)” and must provide the name, address, and functional currency of each section 987 QBU of each owner that is being grouped together.

(B) *Election to use a spot rate convention.* An election under paragraph (c)(1)(ii) of this section to use a spot rate convention is titled “Section 987 Election to Use a Spot Rate Convention Under §1.987-1(c)(1)(ii)” and must describe the convention.

(C) [Reserved]

(D) *Election to use the historic inventory method.* An election under §1.987-3(c)(2)(iv)(B) to use the historic inventory method is titled “Section 987 Election to Use the Historic Inventory Method Under §1.987-3(c)(2)(iv)(B).”

(G) *Annual recognition election.* An annual recognition election under §1.987-5(b)(2) is titled “Section 987 Election for Annual Recognition Under §1.987-5(b)(2).”

(H) *Current rate election.* A current rate election under paragraph (d)(2) of this section is titled “Section 987 Election to Use Current Rates Under §1.987-1(d)(2).”

(I) [Reserved]

(J) *Elections related to the transition rules.* The elections provided in §1.987-10 are made by reporting the election on the statement described in §1.987-10(k).

(ii) *Election requirements—(A) Consent required.* Except as provided in paragraph (g)(3)(ii)(B) or (C) of this section, a section 987 election may not be made or revoked without the consent of the Commissioner. A copy of the consent must be attached to the statement described in paragraph (g)(3)(i) of this section. For purposes of this paragraph (g)(3)(ii), the Commissioner’s consent may be obtained only with a ruling or administrative pronouncement. See Revenue Procedure 2023-1, I.R.B. 2023-1 (or superseding guidance).

(B) *Current rate election and annual recognition election.* Except as provided in paragraph (g)(3)(ii)(C) of this section, the authorized person may make a current rate election or an annual recognition election without the Commissioner’s consent by filing the statement prescribed in paragraph (g)(3)(i) of this section with the Internal Revenue Service in accordance with the prescribed form or its instructions (or other guidance) on or before the first day of the taxable year to which the election applies, and attaching a copy of the statement to its return. Once made, a current rate election or annual recognition election may not be revoked without the Commissioner’s consent for any taxable year beginning within 60 months of the first day of the taxable year for which it was made. Once revoked, a new current rate election or annual recognition election may not be made without the Commissioner’s consent for any taxable year beginning within 60 months of the first day of the taxable year for which it was revoked.

(C) *First year to which the section 987 regulations apply.* The authorized person

may make a section 987 election without the consent of the Commissioner on its original, timely filed (including extensions) return for the first taxable year of the owner in which both—

(1) The section 987 regulations apply (other than by applying solely to one or more terminating QBUs pursuant to §1.987-14(a)(2)); and

(2) Either the owner or any member of its consolidated group or section 987 electing group is the owner of a section 987 QBU.

(iii) *Elections made under the 2016 and 2019 section 987 regulations.* Each section 987 election must be made by the authorized person under the rules of this section without regard to whether the election was in effect under the 2016 and 2019 final regulations or under prior §1.987-8T. In the first taxable year in which the section 987 regulations apply, any elections made under the 2016 and 2019 final regulations cease to be effective.

(4) *No change in method of accounting.* An election under section 987 is not governed by the general rules concerning changes in methods of accounting.

(5) *Principles of §1.964-1(c)(3) applicable to section 987 elections.* Except as otherwise provided in this paragraph (g), if the authorized person makes or revokes a section 987 election on behalf of a controlled foreign corporation or other foreign entity, the authorized person must make or revoke the section 987 election in accordance with the rules and principles of §1.964-1(c)(3) (determined by treating the foreign entity as a foreign corporation if it is not one).

(h) *Definitions.* The definitions in this paragraph (h) apply for purposes of the section 987 regulations.

1991 proposed regulations. The term *1991 proposed regulations* means proposed sections 1.987-1 through 1.987-3 as contained in 56 FR 48457-01 (September 25, 1991).

2006 proposed regulations. The term *2006 proposed regulations* means: proposed sections 1.861-9T(g)(2)(ii)(A)(I) and (g)(2)(vi); 1.985-5; 1.987-1 through 1.987-11; 1.988-1(a)(3), (a)(4), (a)(10)(ii), and (i); 1.988-4(b)(2); and 1.989(a)-1(b)(2)(i), and (b)(4) as contained in 71 FR 52876-01 (September 7, 2006).

2016 and 2019 section 987 regulations. The term *2016 and 2019 section*

987 regulations means the following regulations:

(i) Sections 1.861-9T(g)(2)(ii)(A)(I) and (g)(2)(vi); 1.985-5; 1.987-1 through 1.987-10; 1.988-1(a)(4), (a)(10)(ii), and (i); 1.988-4(b)(2); and 1.989(a)-1(b)(2)(i), (b)(4), (d)(3), and (d)(4), as contained in 26 CFR in part 1 in effect on April 1, 2017.

(ii) Sections 1.987-2T(c)(9), 1.987-4T(c)(2) and (f), and 1.987-7T, as contained in 26 CFR in part 1 in effect on April 1, 2017 (until they were revoked on May 13, 2019).

(iii) Sections 1.987-2(c)(9) and 1.987-4(c)(2) and (f), as contained in 26 CFR in part 1 in effect on April 1, 2020 (beginning on May 13, 2019).

(iv) Sections 1.987-1T (other than §§1.987-1T(g)(2)(i)(B) and (g)(3)(i)(H)), 1.987-3T, 1.987-6T, 1.988-1T, and 1.988-2T(i), as contained in 26 CFR in part 1 in effect on April 1, 2017 (until they expired on December 6, 2019).

Adjusted balance sheet. The term *adjusted balance sheet* means a tax basis balance sheet in the functional currency of the eligible QBU, determined by—

(i) Preparing a balance sheet for the relevant date from the eligible QBU’s books and records (within the meaning of §1.989(a)-1(d)) recorded in the eligible QBU’s functional currency and showing all assets and liabilities attributable to the eligible QBU as provided in §1.987-2(b) (the *preliminary balance sheet*); and

(ii) Making adjustments necessary to conform the items reflected on the preliminary balance sheet to United States tax accounting principles.

Annual recognition election. The term *annual recognition election* has the meaning provided in §1.987-5(b)(2).

Authorized person. The term *authorized person* has the meaning provided in paragraph (g)(1) of this section.

Combination. The term *combination* has the meaning provided in §1.987-2(c)(9)(i).

Combined QBU. The term *combined QBU* has the meaning provided in §1.987-2(c)(9)(i).

Combining QBU. The term *combining QBU* has the meaning provided in §1.987-2(c)(9)(i).

Consolidated group. The term *consolidated group* has the meaning provided in §1.1502-1(h).

Controlled group. A *controlled group* means all persons with the relationships to each other specified in sections 267(b) or 707(b).

Controlled foreign corporation. The term *controlled foreign corporation* (or *CFC*) has the meaning provided in section 957.

Cumulative suspended section 987 loss. The term *cumulative suspended section 987 loss* has the meaning provided in §1.987-11(b).

Current rate election. The term *current rate election* has the meaning provided in §1.987-1(d)(2).

Deferral event. The term *deferral event* has the meaning provided in §1.987-12(g)(1).

Deferred section 987 gain or loss. The term *deferred section 987 gain or loss* has the meaning provided in §1.987-12(b)(2).

Disregarded entity. The term *disregarded entity* (or *DE*) means an entity disregarded as an entity separate from its owner for Federal income tax purposes, including an entity described in §301.7701-2(c)(2), a qualified subchapter S subsidiary under section 1361(b)(3), a qualified REIT subsidiary within the meaning of section 856(i)(2), and a wholly-owned grantor trust.

Disregarded transactions. The term *disregarded transactions* has the meaning provided in §1.987-2(c)(2)(ii).

ECI. The term *ECI* means income that is effectively connected with the conduct of a trade or business within the United States.

Eligible pretransition method. The term *eligible pretransition method* has the meaning provided in §1.987-10(e)(4).

Eligible QBU. The term *eligible QBU* has the meaning provided in paragraph (b)(4) of this section.

Historic asset. The term *historic asset* has the meaning provided in paragraph (e) of this section.

Historic item. The term *historic item* has the meaning provided in paragraph (e) of this section.

Historic liability. The term *historic liability* has the meaning provided in paragraph (e) of this section.

Historic rate. The term *historic rate* has the meaning provided in paragraph (c)(3) of this section.

Liability. The term *liability* means the amount of a liability on the adjusted

balance sheet (or the amount that would be on the adjusted balance sheet if an adjusted balance sheet were prepared for that day).

Loss-to-the-extent-of-gain rule. The term *loss-to-the-extent-of-gain rule* has the meaning provided in §1.987-11(e)(1).

Marked asset. The term *marked asset* has the meaning provided in paragraph (d) of this section.

Marked item. The term *marked item* has the meaning provided in paragraph (d) of this section.

Marked liability. The term *marked liability* has the meaning provided in paragraph (d) of this section.

Net accumulated unrecognized section 987 gain or loss. The term *net accumulated unrecognized section 987 gain or loss* has the meaning provided in §1.987-4(c).

Net unrecognized section 987 gain or loss. The term *net unrecognized section 987 gain or loss* has the meaning provided in §1.987-4(b).

Non-grantor trust. The term *non-grantor trust* means a trust (or the portion of a trust) that is not a grantor trust. A *grantor trust* is a trust with respect to which one or more persons are treated as owners of all or a portion of the trust under sections 671 through 679. If only a portion of a trust is treated as owned by a person, that portion is a grantor trust with respect to that person.

Original deferral QBU. The term *original deferral QBU* has the meaning provided in §1.987-12(b).

Original deferral QBU owner. The term *original deferral QBU owner* has the meaning provided in §1.987-12(g)(3).

Original suspended loss QBU owner. The term *original suspended loss QBU owner* has the meaning provided in §1.987-13(l)(1).

Outbound loss event. The term *outbound loss event* has the meaning provided in §1.987-13(h)(2).

Outbound loss QBU. The term *outbound loss QBU* has the meaning provided in §1.987-13(h)(1).

Outbound section 987 loss. The term *outbound section 987 loss* has the meaning provided in §1.987-13(h)(4).

Owner. The term *owner* has the meaning provided in paragraph (b)(5) of this section.

Prior §1.987-1. The term *prior §1.987-1* means §1.987-1, as contained

in 26 CFR in part 1 in effect on April 1, 2017.

Prior §1.987-4. The term *prior §1.987-4* means §1.987-4, as contained in 26 CFR in part 1 in effect on April 1, 2017.

Prior §1.987-5. The term *prior §1.987-5* means §1.987-5, as contained in 26 CFR in part 1 in effect on April 1, 2017.

Prior §1.987-8T. The term *prior §1.987-8T* means §1.987-8T, as contained in 26 CFR in part 1 in effect on April 1, 2017.

Prior §1.987-10. The term *prior §1.987-10* means §1.987-10, as contained in 26 CFR in part 1 in effect on April 1, 2017.

Prior §1.987-12. The term *prior §1.987-12* means §1.987-12, as contained in 26 CFR in part 1 in effect on April 1, 2020.

Prior §1.987-12T. The term *prior §1.987-12T* means §1.987-12T, as contained in 26 CFR in part 1 in effect on April 1, 2017.

Recognition grouping. The term *recognition grouping* has the meaning provided in §1.987-11(f).

Remittance. The term *remittance* has the meaning provided in §1.987-5(c).

S corporation. The term *S corporation* has the meaning provided in section 1361(a)(1).

Section 904 category. The term *section 904 category* means a separate category of income described in §1.904-5(a)(4)(v).

Section 987 aggregate partnership—
(i) *In general.* The term *section 987 aggregate partnership* means a partnership if both:

(A) All of the interests in partnership capital and profits are owned, directly or indirectly, by persons related to each other within the meaning of sections 267(b) or 707(b). For this purpose, ownership of an interest in partnership capital or profits is determined in accordance with the rules for constructive ownership provided in section 267(c), other than section 267(c)(3).

(B) The partnership has 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.

(ii) *Section 987 QBU of a partner.* The assets and liabilities of an eligible QBU

owned through a section 987 aggregate partnership and allocated to a partner under the principles of §1.987-7B 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.

(iii) *Certain unrelated partners disregarded.* In determining whether a partnership is a section 987 aggregate partnership, the interest of an unrelated partner is disregarded if the acquisition of such interest has as a principal purpose the avoidance of treatment as a section 987 aggregate partnership.

(iv) *Cross-reference.* See §1.987-7A(a)(2) for a rule providing that references to “partnerships” in the section 987 regulations are treated as references to partnerships that are not section 987 aggregate partnerships, except where the context otherwise requires.

Section 987 electing group. The term *section 987 electing group* has the meaning provided in paragraph (g)(2)(ii) of this section.

Section 987 elections. The term *section 987 elections* has the meaning provided in paragraph (g) of this section.

Section 987 QBU. The term *section 987 QBU* has the meaning provided in paragraph (b)(3) of this section.

Section 987 regulations. The term *section 987 regulations* has the meaning provided in paragraph (a) of this section.

Section 987 taxable income or loss. The term *section 987 taxable income or loss* has the meaning provided in §1.987-3(a).

Separated QBU. The term *separated QBU* has the meaning provided in §1.987-2(c)(9)(iii).

Separation. The term *separation* has the meaning provided in §1.987-2(c)(9)(iii).

Separation fraction. In the case of a separated QBU, the term *separation fraction* means a fraction, the numerator of which is the aggregate adjusted basis of the gross assets properly reflected on the books and records of the separated QBU immediately after the separation, and the denominator of which is the aggregate adjusted basis of the gross assets properly reflected on the books and records of all separated QBUs immediately after the separation.

Separating QBU. The term *separating QBU* has the meaning provided in §1.987-2(c)(9)(iii).

Spot rate. The term *spot rate* has the meaning provided in paragraph (c)(1) of this section.

Successor deferral QBU. The term *successor deferral QBU* has the meaning provided in §1.987-12(g)(2).

Successor deferral QBU owner. The term *successor deferral QBU owner* has the meaning provided in §1.987-12(c)(1).

Successor suspended loss QBU. The term *successor suspended loss QBU* has the meaning provided in §1.987-13(l)(2).

Successor suspended loss QBU owner. The term *successor suspended loss QBU owner* has the meaning provided in §1.987-13(l)(3).

Suspended section 987 loss. The term *suspended section 987 loss* means section 987 loss that is subject to the limitations on recognition described in §1.987-11(e). See §§1.987-10(e)(5), 1.987-11(c) and (d), 1.987-12(c), and 1.987-13(h) for rules regarding when net unrecognized section 987 loss or deferred section 987 loss becomes suspended section 987 loss.

Tentative tested income group. The term *tentative tested income group* has the meaning provided in §1.987-6(b)(2)(i)(D)(1).

Terminating QBU. The term *terminating QBU* means a section 987 QBU, if both—(i) The section 987 QBU terminates on any date on or after November 9, 2023, or the section 987 QBU terminates as a result of an entity classification election made under §301.7701-3 that is filed on or after November 9, 2023, and that is effective before November 9, 2023; and

(ii) When the section 987 QBU terminates, neither the section 987 regulations nor the 2016 and 2019 section 987 regulations would apply with respect to the section 987 QBU but for §1.987-14(a)(2).

Termination. With respect to a section 987 QBU, the term *termination* has the meaning provided in §1.987-8(b) and (c). With respect to a successor suspended loss QBU, the term *termination* has the meaning provided in §1.987-13(j).

Transfer. The term *transfer* has the meaning provided in §1.987-2(c).

Transition date. The term *transition date* has the meaning provided in §1.987-10(b).

United States person. The term *United States person* (or *U.S. person*) has the meaning provided in section 7701(a)(30).

United States shareholder. The term *United States shareholder* (or *U.S. shareholder*) has the meaning provided in section 951(b) (or, if applicable, section 953(c)(1)(A)).

Yearly average exchange rate. The term *yearly average exchange rate* has the meaning provided in paragraph (c)(2) of this section.

7. Section 1.987-2 is revised to read as follows:

§1.987-2 Attribution of items to eligible QBUs; definition of a transfer and related rules.

(a) *Scope.* This section provides rules regarding when items are attributed to eligible QBUs and when they are treated as transferred to or from section 987 QBUs. Paragraph (b) of this section provides rules for attributing assets and liabilities, and items of income, gain, deduction, and loss, to an eligible QBU. Paragraph (c) of this section defines a transfer to or from a section 987 QBU. Paragraph (d) of this section provides translation rules for transfers to a section 987 QBU. Paragraph (e) of this section provides a cross-reference relating to the treatment of section 987 QBUs owned by consolidated groups.

(b) *Attribution of items to an eligible QBU—(1) General rules.* Except as provided in paragraphs (b)(2) and (3) of this section, items are attributable to an eligible QBU to the extent they are reflected on the separate set of books and records, as defined in §1.989(a)-1(d)(1) and (2), of the eligible QBU. In the case of a section 987 aggregate partnership, items reflected on the books and records of the partnership and deemed allocated to an eligible QBU of such partnership are considered to be reflected on the books and records of such eligible QBU. For purposes of this section, the term *item* refers to any asset or liability, and any item of income, gain, deduction, or loss. Items that are attributed to an eligible QBU pursuant to this section must be adjusted to conform to Federal income tax principles. Except as provided in §1.989(a)-1(d)(3), these attribution rules apply solely for purposes of section 987. For example, the allocation and apportionment of interest expense under section 864(e) is independent of these rules.

(2) *Exceptions for non-portfolio stock, interests in partnerships, and certain acquisition indebtedness.* The following items are not considered to be on the books and records of an eligible QBU:

(i) Stock of a corporation (whether domestic or foreign), other than stock of a corporation if the owner of the eligible QBU owns less than 10 percent of the total combined voting power of all classes of stock entitled to vote and less than 10 percent of the total value of all classes of stock of such corporation. For this purpose, section 958 (other than section 958(b)(1)) applies in determining ownership of a controlled foreign corporation and section 318(a) applies in determining ownership of other corporations, except that in applying section 318(a)(2)(C), the phrase “10 percent” is used instead of the phrase “50 percent.”

(ii) An interest in a partnership (whether domestic or foreign).

(iii) A liability that was incurred to acquire stock described in paragraph (b) (2)(i) of this section or that was incurred to acquire a partnership interest described in paragraph (b)(2)(ii) of this section.

(iv) Income, gain, deduction, or loss arising from the items described in paragraphs (b)(2)(i) through (iii) of this section. For example, if a dividend is received with respect to stock of a corporation described in paragraph (b)(2)(i) of this section, the dividend is excluded from the income of the eligible QBU. See also paragraph (c)(2)(ii) of this section, treating the payment as received by the owner and contributed to the eligible QBU.

(3) *Adjustments to items reflected on the books and records—(i) General rule.* If a principal purpose of recording (or not recording) an item on the books and records of an eligible QBU is the avoidance of Federal income tax under, or through the use of, section 987, the item must be allocated between or among the eligible QBU, the owner of such eligible QBU, and any other persons, entities (including DEs), or other QBUs within the meaning of §1.989(a)-1(b) (including eligible QBUs) in a manner that reflects the substance of the transaction. For purposes of this paragraph (b)(3)(i), relevant factors for determining whether such Federal income tax avoidance is a principal purpose of recording (or not recording) an

item on the books and records of an eligible QBU include the factors set forth in paragraphs (b)(3)(ii) and (iii) of this section. The presence or absence of any factor or factors is not determinative. The weight given to any factor (whether or not set forth in paragraphs (b)(3)(ii) and (iii) of this section) depends on the facts and circumstances.

(ii) *Factors indicating no tax avoidance.* For purposes of paragraph (b)(3) (i) of this section, factors that may indicate that recording (or not recording) an item on the books and records of an eligible QBU did not have as a principal purpose the avoidance of Federal income tax under, or through the use of, section 987 include the recording (or not recording) of an item:

(A) For a significant and bona fide business purpose;

(B) In a manner that is consistent with the economics of the underlying transaction;

(C) In accordance with generally accepted accounting principles (or similar comprehensive accounting standard);

(D) In a manner that is consistent with the treatment of similar items from year to year;

(E) In accordance with accepted conditions or practices in the particular trade or business of the eligible QBU;

(F) In a manner that is consistent with an explanation of existing internal accounting policies that is evidenced by documentation contemporaneous with the timely filing of a return for the taxable year; and

(G) As a result of a transaction between legal entities (for example, the transfer of an asset or the assumption of a liability), even if such transaction is not regarded for Federal income tax purposes (for example, a transaction between a DE and its owner).

(iii) *Factors indicating tax avoidance.* For purposes of paragraph (b)(3)(i) of this section, factors that may indicate that a principal purpose of recording (or not recording) an item on the books and records of an eligible QBU is the avoidance of Federal income tax under, or through the use of, section 987 include:

(A) The presence or absence of an item on the books and records that is the result of one or more transactions that are

transitory, for example, due to a circular flow of cash or other property;

(B) The presence or absence of an item on the books and records that is the result of one or more transactions that do not have substance; and

(C) The presence or absence of an item on the books and records that results in the taxpayer (or a person related to the taxpayer within the meaning of section 267(b) or section 707(b)) having offsetting positions with respect to the functional currency of a section 987 QBU.

(4) *Assets and liabilities of a section 987 aggregate partnership or DE that are not attributed to an eligible QBU.* Neither a section 987 aggregate partnership nor a DE is an eligible QBU and, thus, neither entity can be a section 987 QBU. See §1.987-1(b)(4). As a result, a section 987 aggregate partnership or DE may have assets and liabilities that are not attributed to an eligible QBU as provided under this paragraph (b) and, therefore, are not subject to section 987. For the foreign currency treatment of such assets or liabilities, see §1.988-1(a)(4).

(5) *Special types of basis.* Any type of basis that does not affect the income or loss of the section 987 QBU is not considered to be on the books and records of the section 987 QBU. Thus, for example, section 743(b) basis is not considered to be on the books and records of the section 987 QBU.

(c) *Transfers to and from section 987 QBUs—(1) In general.* The following rules apply for purposes of determining whether there is a transfer of an asset or a liability from an owner to a section 987 QBU, or from a section 987 QBU to an owner. These rules apply solely for purposes of section 987.

(2) *Disregarded transactions—(i) General rule.* An asset or liability is treated as transferred to a section 987 QBU from its owner if, as a result of a disregarded transaction, such asset or liability is reflected on the books and records of (or attributed to) the section 987 QBU within the meaning of paragraph (b) of this section. Similarly, an asset or liability is treated as transferred from a section 987 QBU to its owner if, as a result of a disregarded transaction, such asset or liability is no longer reflected on the books and records of (or attributed to) the section

987 QBU within the meaning of paragraph (b) of this section.

(ii) *Definition of a disregarded transaction.* For purposes of this section, a disregarded transaction means a transaction that is not regarded for Federal income tax purposes (for example, any transaction between separate section 987 QBUs of the same owner). For purposes of this paragraph (c), a disregarded transaction is treated as including events described in paragraphs (c)(2)(ii)(A) through (E) of this section.

(A) If the recording (or not recording) of an asset or liability on the books and records of a section 987 QBU of an owner is the result of such asset or liability being removed from (or included on) the books and records of the owner or another eligible QBU of the owner, the asset or liability is treated as transferred from (or to) the owner or other eligible QBU to (or from) the section 987 QBU in a disregarded transaction (including through a DE or a section 987 aggregate partnership).

(B) If an asset or liability that was previously treated as being on the books and records of a section 987 QBU of an owner begins to be treated as being on the books and records of the owner or a separate eligible QBU of the owner as a result of the application of paragraph (b) (2) or (3) of this section, the asset or liability is treated as having been transferred from the section 987 QBU to the owner or separate eligible QBU in a disregarded transaction. If an asset or liability that was previously treated as being on the books and records of the owner or a separate eligible QBU of the same owner begins to be treated as being on the books and records of the section 987 QBU as a result of the application of paragraph (b)(2) or (3) of this section, the asset or liability is treated as transferred from the owner or separate eligible QBU to the section 987 QBU in a disregarded transaction.

(C) If an asset or liability that is attributable to a section 987 QBU within the meaning of paragraph (b) of this section is sold or exchanged (including in a nonrecognition transaction, such as an exchange under section 351) for an asset or liability that is not attributable to the section 987 QBU immediately after the sale or exchange, the sold or exchanged asset or liability that was attributable to the section

987 QBU immediately before the transaction is treated as transferred from the section 987 QBU to its owner in a disregarded transaction immediately before the sale or exchange for purposes of section 987 (including for purposes of recognizing section 987 gain or loss under §1.987-5) and subsequently sold or exchanged by the owner.

(D) If an asset or liability of an owner of a section 987 QBU that is not attributable to a section 987 QBU within the meaning of paragraph (b) of this section is sold or exchanged (including in a nonrecognition transaction, such as an exchange under section 351) for an asset or liability that is attributable to the section 987 QBU immediately after the sale or exchange, the asset or liability that is attributable to the section 987 QBU immediately after the transaction is treated as received or assumed by the owner and transferred from the owner to the section 987 QBU in a disregarded transaction immediately after the sale or exchange for purposes of section 987 (including for purposes of recognizing section 987 gain or loss under §1.987-5).

(E) If an asset or liability that is properly attributable to a section 987 QBU was received, assumed, or accrued in a regarded transaction (including the making or receiving of a payment) in which the related item of income, gain, deduction, or loss is not attributable to the section 987 QBU, the asset or liability is treated as though it was received, assumed, or accrued by the owner or another eligible QBU and transferred to the section 987 QBU in a disregarded transaction. Similarly, if an asset or liability that is not properly attributable to a section 987 QBU was received, assumed, or accrued in a regarded transaction (including the making or receiving of a payment) in which the related item of income, gain, deduction, or loss is attributable to the section 987 QBU, the asset or liability is treated as though it was received, assumed, or accrued by the section 987 QBU and transferred to the owner or another eligible QBU in a disregarded transaction. For example, if a section 987 QBU receives a dividend on an interest in stock that would be attributable to the section 987 QBU but for paragraph (b)(2)(i) of this section, or pays interest on a liability that would be

attributable to the section 987 QBU but for paragraph (b)(2)(iii) of this section, the owner would be treated as receiving the dividend and transferring to the section 987 QBU the amount of the dividend, or the section 987 QBU would be treated as transferring to the owner the amount of the interest expense and the owner would be treated as paying the interest expense. See also paragraph (c)(7) of this section (application of general tax law principles).

(iii) *Items derived from disregarded transactions ignored.* For purposes of section 987, disregarded transactions do not give rise to items of income, gain, deduction, or loss that are taken into account in determining section 987 taxable income or loss under §1.987-3.

(3) *Transfers of assets to and from section 987 QBUs owned through section 987 aggregate partnerships*—(i) *Contributions to section 987 aggregate partnerships.* Solely for purposes of section 987, an asset is treated as transferred by an indirect owner to a section 987 QBU of a partner to the extent the indirect owner contributes the asset to the section 987 aggregate partnership that carries on the activities of the section 987 QBU, provided that, immediately before the contribution, the asset is not reflected on the books and records of the section 987 QBU within the meaning of paragraph (b) of this section and the asset is reflected on the books and records of the section 987 QBU immediately after the contribution. For purposes of this paragraph (c)(3)(i), deemed contributions of money described under section 752 are disregarded. See paragraph (c)(4)(ii) of this section for rules governing the assumption by a partner of liabilities of a section 987 aggregate partnership.

(ii) *Distributions from section 987 aggregate partnerships.* Solely for purposes of section 987, an asset is treated as transferred from a section 987 QBU of a partner to its indirect owner to the extent the section 987 aggregate partnership that carries on the activities of the section 987 QBU distributes the asset to the indirect owner, provided that, immediately before the distribution, the asset is reflected on the books and records of the section 987 QBU within the meaning of paragraph (b) of this section, and the asset is not reflected on the books and records

of the section 987 QBU immediately after the distribution. For purposes of this paragraph (c)(3)(ii), deemed distributions of money described under section 752 are disregarded. See paragraph (c)(4)(i) of this section for rules governing the assumption by a section 987 aggregate partnership of liabilities of a partner.

(4) *Transfers of liabilities to and from section 987 QBUs owned through section 987 aggregate partnerships*—(i) *Assumptions of partner liabilities.* Solely for purposes of section 987, a liability of the owner of a section 987 aggregate partnership is treated as transferred to a section 987 QBU of a partner if, and to the extent, the section 987 aggregate partnership assumes the liability, provided that, immediately before the transfer, the liability is not reflected on the books and records of the section 987 QBU within the meaning of paragraph (b) of this section, and the liability is reflected on the books and records of the section 987 QBU immediately after the transfer.

(ii) *Assumptions of section 987 aggregate partnership liabilities.* Solely for purposes of section 987, a liability of a section 987 aggregate partnership is treated as transferred from a section 987 QBU of a partner to its indirect owner if, and to the extent, the indirect owner assumes the liability of the section 987 aggregate partnership, provided that, immediately before the assumption, the liability is reflected on the books and records of the section 987 QBU within the meaning of paragraph (b) of this section, and the liability is not reflected on the books and records of the section 987 QBU immediately after the transfer.

(5) *Acquisitions and dispositions of interests in DEs and section 987 aggregate partnerships.* Solely for purposes of section 987, an asset or liability is treated as transferred to a section 987 QBU from its owner if, as a result of an acquisition (including by contribution) or disposition of an interest in a section 987 aggregate partnership or DE, the asset or liability is reflected on the books and records of the section 987 QBU. Similarly, an asset or liability is treated as transferred from a section 987 QBU to its owner if, as a result of an acquisition or disposition of an interest in a section 987 aggregate partnership or DE, the asset or liability is not

reflected on the books and records of the section 987 QBU. See paragraph (c)(10) (xviii) of this section (*Example 18*) for an illustration of this rule.

(6) *Changes in form of ownership treated as terminations.* See §§1.987-8(b)(6) (treating a change in the form of ownership of an eligible QBU from direct ownership to indirect ownership or from indirect ownership to direct ownership as a termination) and 1.987-12(g)(1)(i)(A) (subjecting the termination to the deferral rules).

(7) *Application of general tax law principles.* General tax law principles, including the circular cash flow, step-transaction, economic substance, and substance-over-form doctrines, apply for purposes of determining whether there is a transfer of an asset or liability under this paragraph (c), including a transfer of an asset or liability pursuant to a disregarded transaction.

(8) *Interaction with §1.988-1(a)(10).* See §1.988-1(a)(10) for rules regarding the treatment of an intra-taxpayer transfer of a section 988 transaction.

(9) *Certain disregarded transactions not treated as transfers*—(i) *Combinations of section 987 QBUs.* The combination (a *combination*) of two or more separate section 987 QBUs (*combining QBUs*) that are directly owned by the same owner, or that are indirectly owned by the same partner through a single section 987 aggregate partnership, into one section 987 QBU (*combined QBU*) does not give rise to a transfer of any combining QBU's assets or liabilities to the owner under §1.987-2(c). In addition, transactions between the combining QBUs occurring in the taxable year of the combination do not result in a transfer of the combining QBUs' assets or liabilities to the owner under §1.987-2(c). For this purpose, a combination occurs when the assets and liabilities that are properly reflected on the books and records of two or more combining QBUs begin to be properly reflected on the books and records of a combined QBU and the separate existence of the combining QBUs ceases. A combination may result from any transaction or series of transactions in which the combining QBUs become a combined QBU. A combination may also result when an owner of two or more section 987 QBUs with the same functional

currency becomes subject to a grouping election under §1.987-1(b)(3)(ii) or when a section 987 QBU of an owner subject to a grouping election changes its functional currency to that of another section 987 QBU of the same owner. For purposes of determining net unrecognized section 987 gain or loss, deferred section 987 gain or loss, and cumulative suspended section 987 loss of a combined QBU, the combining QBUs are treated as having combined immediately before the beginning of the taxable year of combination. See §§1.987-4(f)(1), 1.987-11(b)(2), and 1.987-12(f)(1).

(ii) *Change in functional currency from a combination.* If, following a combination of section 987 QBUs described in paragraph (c)(9)(i) of this section, the combined section 987 QBU has a different functional currency than one or more of the combining section 987 QBUs, any such combining section 987 QBU is treated as changing its functional currency and the owner of the combined section 987 QBU must comply with the regulations under section 985 regarding the change in functional currency. See §§1.985-1(c)(6) and 1.985-5.

(iii) *Separation of section 987 QBUs.* The separation (a *separation*) of a section 987 QBU (*separating QBU*) into two or more section 987 QBUs (*separated QBUs*) that, after the separation, are directly owned by the same owner, or that are indirectly owned by the same partner through a single section 987 aggregate partnership, does not result in a transfer of the separating QBU's assets or liabilities to the owner under §1.987-2(c). Additionally, transactions that occurred between the separating QBUs in the taxable year of the separation before the completion of the separation do not result in transfers for purposes of section 987. For this purpose, a separation occurs when the assets and liabilities that are properly reflected on the books and records of a separating QBU begin to be properly reflected on the books and records of two or more separated QBUs and each of the separated QBUs continues to perform a significant portion of the separating QBU's activities immediately after the separation. A separation may result from any transaction or series of transactions in which a separating QBU becomes two or more separated QBUs described in

the preceding sentence. A separation may also result when a section 987 QBU that is subject to a grouping election under §1.987-1(b)(3)(ii) changes its functional currency or when the grouping election is revoked. For purposes of determining net unrecognized section 987 gain or loss, deferred section 987 gain or loss, or cumulative suspended section 987 loss of a separated QBU, the separating QBU is treated as having separated immediately before the beginning of the taxable year of separation. See §§1.987-4(f)(2), 1.987-11(b)(3), and 1.987-12(f)(2).

(iv) *Special rules for successor suspended loss QBUs.* For purposes of determining whether a combination or separation has occurred with respect to a successor suspended loss QBU, the rules of paragraphs (c)(9)(i) and (iii) of this section are applied without regard to whether any of the combining QBUs, the combined QBU, the separating QBU, or the separated QBUs are section 987 QBUs. A combined QBU is a successor suspended loss QBU if either combining QBU was a successor suspended loss QBU, and a separated QBU is a successor suspended loss QBU if the separating QBU was a successor suspended loss QBU.

(10) *Examples.* The following examples illustrate the principles of this paragraph (c). For purposes of the examples, X and Y are domestic corporations, have the U.S. dollar as their functional currencies, and use the calendar year as their taxable years. Furthermore, except as otherwise provided, Business A and Business B are eligible QBUs that have the euro and the Japanese yen, respectively, as their functional currencies, and DE1 and DE2 are DEs. For purposes of determining whether any of the transfers in these examples result in remittances, see §1.987-5.

(i) *Example 1. Transfer to a directly owned section 987 QBU—(A) Facts.* X owns all of the interests in DE1. DE1 owns Business A, which is a section 987 QBU of X. X owns €100 that are not reflected on the books and records of Business A. Business A is in need of additional capital and, as a result, X lends the €100 to DE1 for use in Business A in exchange for a note.

(B) *Analysis—(1)* The loan from X to DE1 is not regarded for Federal income tax purposes (because it is an interbranch transaction) and therefore is a disregarded transaction (as defined in paragraph (c)(2)(ii) of this section). Because DE1 is a DE, the DE1 note held by X and the liability of DE1 under the note are not taken into account under this section.

(2) As a result of the disregarded transaction, the €100 is reflected on the books and records of Business A. Therefore, X is treated as transferring €100 to its Business A section 987 QBU for purposes of section 987. This transfer is taken into account in determining the amount of any remittance for the taxable year under §1.987-5(c). See §1.988-1(a)(10)(ii) for the application of section 988 to X as a result of the transfer of nonfunctional currency to its section 987 QBU.

(ii) *Example 2. Transfer to a directly owned section 987 QBU—(A) Facts.* X owns Business A and Business B, both of which are section 987 QBUs of X. X owns equipment that is used in Business A and is reflected on the books and records of Business A. Because Business A has excess manufacturing capacity and X intends to expand the manufacturing capacity of Business B, the equipment formerly used in Business A is transferred to Business B for use by Business B. As a result of the transfer, the equipment is removed from the books and records of Business A and is recorded on the books and records of Business B.

(B) *Analysis.* The transfer of the equipment from the books and records of Business A to the books and records of Business B is not regarded for Federal income tax purposes (because it is an interbranch transaction) and therefore is a disregarded transaction (as defined in paragraph (c)(2)(ii) of this section). Therefore, for purposes of section 987, the Business A section 987 QBU is treated as transferring the equipment to X, and X is subsequently treated as transferring the equipment to the Business B section 987 QBU. These transfers are taken into account in determining the amount of any remittance for the taxable year under §1.987-5(c).

(iii) *Example 3. Intracompany sale of property between two section 987 QBUs—(A) Facts.* X owns all of the interests in DE1 and DE2. DE1 and DE2 own Business A and Business B, respectively, both of which are section 987 QBUs of X. DE1 owns equipment that is used in Business A and is reflected on the books and records of Business A. For business reasons, DE1 sells a portion of the equipment used in Business A to DE2 in exchange for a fair market value amount of Japanese yen. The yen used by DE2 to acquire the equipment was generated by Business B and was reflected on Business B's books and records. Following the sale, the yen and the equipment will be used in Business A and Business B, respectively. As a result of such sale, the equipment is removed from the books and records of Business A and is recorded on the books and records of Business B. Similarly, as a result of the sale, the yen is removed from the books and records of Business B and is recorded on the books and records of Business A.

(B) *Analysis—(1)* The sale of equipment between DE1 and DE2 is a transaction that is not regarded for Federal income tax purposes (because it is an interbranch transaction) and therefore the transaction is a disregarded transaction (as defined in paragraph (c)(2)(ii) of this section). Pursuant to paragraph (c)(2)(iii) of this section, the sale does not give rise to an item of income, gain, deduction, or loss for purposes of determining section 987 taxable income or loss under §1.987-3. However, the yen and equipment exchanged by DE1 and DE2 in connection with the sale must be taken into account as a transfer under paragraph (c)(2)(i) of this section.

(2) As a result of the disregarded transaction, the equipment ceases to be reflected on the books and records of Business A and becomes reflected on the books and records of Business B. Therefore, the Business A section 987 QBU is treated as transferring the equipment to X, and X is subsequently treated as transferring the equipment to the Business B section 987 QBU.

(3) Additionally, as a result of the disregarded transaction, the yen currency ceases to be reflected on the books and records of Business B and becomes reflected on the books and records of Business A. Therefore, the Business B section 987 QBU is treated as transferring the yen to X, and X is subsequently treated as transferring the yen from X to the Business A section 987 QBU. The transfers among Business A, Business B and X are taken into account in determining the amount of any remittance for the taxable year under §1.987-5(c).

(iv) through (ix) [Reserved]

(x) *Example 10. Contribution of assets to a corporation—(A) Facts.* X owns Business A. X forms Z, a domestic corporation, contributing 50 percent of its Business A assets and liabilities to Z in exchange for all of the stock of Z. X and Z do not file a consolidated tax return.

(B) *Analysis.* Pursuant to paragraph (b)(2) of this section, the Z stock received in exchange for 50 percent of Business A's assets and liabilities is not reflected on the books and records of, and therefore is not attributable to, Business A for purposes of section 987 immediately after the exchange. As a result, pursuant to paragraphs (c)(2)(i) and (ii) of this section, 50 percent of the assets and liabilities of Business A are treated as transferred from Business A to X in a disregarded transaction immediately before the exchange. See §1.1502-13(j)(9) if X and Z file a consolidated return.

(xi) *Example 11. Circular transfers—(A) Facts.* X owns Business A. On December 30, year 1, Business A purports to transfer €100 to X. On January 2, year 2, X purports to transfer €50 to Business A. On January 4, year 2, X purports to transfer another €50 to Business A. As of the end of year 1, X has an unrecognized section 987 loss with respect to Business A, such that a remittance, if respected, would result in recognition of a foreign currency loss under section 987.

(B) *Analysis.* Because the transfer by Business A to X is offset by the transfers from X to Business A that occurred in close temporal proximity, the Internal Revenue Service may disregard the purported transfers to and from Business A for purposes of section 987 pursuant to general tax principles under paragraph (c)(7) of this section.

(xii) *Example 12. Transfers without substance—(A) Facts.* X owns Business A and Business B. On January 1, year 1, Business A purports to transfer €100 to X. On January 4, year 1, X purports to transfer €100 to Business B. The account in which Business B deposited the €100 is used to pay the operating expenses and other costs of Business A. As of the end of year 1, X has an unrecognized section 987 loss with respect to Business A, such that a remittance, if respected, would result in recognition of a foreign currency loss under section 987.

(B) *Analysis.* Because Business A continues to have use of the transferred property, the IRS may

disregard the €100 purported transfer from Business A to X for purposes of section 987 pursuant to general tax principles under paragraph (c)(7) of this section.

(xiii) *Example 13. Offsetting positions in section 987 QBUs—(A) Facts.* X owns Business A and Business B. Business A and Business B each have the euro as its functional currency. X has not made a grouping election under §1.987-1(b)(3)(ii). On January 1, year 1, X borrows €1,000 from a third-party lender, records the liability with respect to the borrowing on the books and records of Business A, and records the borrowed €1,000 on the books and records of Business B. On December 31, year 2, when Business A has \$100 of net unrecognized section 987 loss and Business B has \$100 of net unrecognized section 987 gain resulting from the change in exchange rates with respect to the liability and the €1,000, X terminates the Business A section 987 QBU.

(B) *Analysis.* Because Business A and Business B have offsetting positions in the euro, the IRS will scrutinize the transaction under paragraph (b)(3) of this section to determine if a principal purpose of recording the euro-denominated liability on the books and records of Business A and the borrowed euros on the books and records of Business B was the avoidance of tax under section 987. If such a principal purpose is present, the items must be reallocated (that is, the euros and the euro-denominated liability) between Business A, Business B, and X, under paragraph (b)(3) of this section to reflect the substance of the transaction.

(xiv) *Example 14. Offsetting positions with respect to a section 987 QBU and a section 988 transaction—(A) Facts.* X owns all of the interests in DE1, and DE1 owns Business A. On January 1, year 1, X borrows €1,000 from a third-party lender and records the liability with respect to the borrowing on its books and records. X contributes the €1,000 loan proceeds to DE1 and the €1,000 are reflected on the books and records of Business A. On December 31, year 2, when Business A has \$100 of net unrecognized section 987 loss resulting from the change in exchange rates with respect to the €1,000 received from the borrowing, and when the euro-denominated borrowing, if repaid, would result in \$100 of gain under section 988, X terminates the Business A section 987 QBU.

(B) *Analysis.* Because X and Business A have offsetting positions in the euro, the IRS will scrutinize the transaction under paragraph (b)(3) of this section to determine whether a principal purpose of recording the borrowed euros on the books and records of Business A, or not recording the corresponding euro-denominated liability on the books and records of Business A, was the avoidance of tax under section 987. If such a principal purpose is present, the items (that is, the euros and the euro-denominated liability) must be reallocated between Business A and X under paragraph (b)(3) of this section to reflect the substance of the transaction.

(xv) *Example 15. Offsetting positions with respect to a section 987 QBU and a section 988 transaction—(A) Facts.* X owns all of the stock of Y and all of the interests in DE1. DE1 owns Business A. X and Y do not file a consolidated return. On January 1, year 1, DE1 lends €1,000 to Y. X records

the receivable with respect to the loan on Business A's books and records. On December 31, year 2, when Business A has \$100 of net unrecognized section 987 gain resulting from the loan, Y repays the €1,000 liability. The repayment of the euro-denominated borrowing results in \$100 of loss to Y under section 988. X claims a \$100 loss on its consolidated return under section 988. Business A does not make any remittances to X in year 2, so the offsetting gain with respect to the loan receivable has not been recognized by X.

(B) *Analysis.* Y, a related party to X, and Business A have offsetting positions in the euro. The IRS will scrutinize the transaction under paragraph (b)(3) of this section to determine whether a principal purpose of recording the euro-denominated receivable on the books and records of Business A, rather than on the books and records of X, was to avoid Federal income tax under, or through the use of, section 987. If such a principal purpose is present, the euro-denominated receivable must be reallocated between Business A and X under paragraph (b)(3) of this section to reflect the substance of the transaction. Other provisions may also apply to defer or disallow the loss. See e.g., §1.1502-13(j)(9) if X and Y file a consolidated return.

(xvi) *Example 16. Loan by section 987 QBU followed by immediate distribution to owner—(A) Facts.* X owns all of the interests in DE1. DE1 owns Business A. On January 1, year 1, Business A borrows €1,000 from a bank. On January 2, year 1, Business A distributes the €1,000 it received from the bank to X. There are no other transfers between X and Business A during the year. At the end of the year, X has net unrecognized section 987 loss with respect to Business A such that a remittance would result in the recognition of foreign currency loss under section 987.

(B) *Analysis.* Because the proceeds from the loan to Business A are immediately transferred to X and the distribution from Business A to X could result in the recognition of section 987 loss, the IRS will scrutinize the transaction under paragraph (b)(3) of this section to determine whether a principal purpose of recording the loan on the books and records of Business A, rather than on the books and records of X, was to avoid Federal income tax under, or through the use of, section 987. If such a principal purpose is present, the items must be reallocated to reflect the substance of the transaction, potentially including by moving the loan onto the books of X, resulting in the transfer not being taken into account for purposes of section 987 under paragraph (b)(3) of this section.

(xvii) *Example 17. Payment of interest by section 987 QBU on obligation of owner—(A) Facts.* X owns all of the interests in DE1. DE1 owns Business A. On January 1, X borrows €1,000 from a bank. On July 1, DE1 pays €20 in interest on X's €1,000 obligation to the bank, which is treated as a payment by Business A.

(B) *Analysis.* Under general tax law principles as provided in paragraph (c)(7) of this section, on July 1, year 1, Business A is treated for purposes of section 987 as making a transfer of €20 to X, and X is treated as making a €20 interest payment to the bank. See also paragraph (c)(2)(ii)(E) for interest payments on loans that are not attributable to a

section 987 QBU pursuant to paragraph (b)(2) or (3) of this section.

(xviii) *Example 18. Sale of the interests in a DE—(A) Facts.* X owns all of the interests in DE1, a disregarded entity. DE1 owns Business A, which is a section 987 QBU of X. X has made a current rate election under §1.987-1(d)(2) but not an annual recognition election under §1.987-5(b)(2). On December 31, year 1, X sells all of the interests in DE1 to FC, an unrelated foreign corporation, for \$150,000, when the exchange rate is €1=\$1.2. At the time of the sale, all of DE1's assets are used in Business A and are reflected on the books and records of Business A. The assets have a basis of €100,000 and Business A has no liabilities. In year 1, X has net unrecognized section 987 gain with respect to Business A of \$20,000.

(B) *Analysis—(1)* Under paragraph (c)(5) of this section, solely for purposes of section 987, an asset or liability is treated as transferred from a section 987 QBU to its owner if, as a result of a disposition of an interest in a DE, the asset or liability is not reflected on the books and records of the section 987 QBU. As a result of the sale of DE1, the assets of Business A are no longer reflected on the books and records of the Business A section 987 QBU. Therefore, the assets of Business A are treated as transferred from the Business A section 987 QBU to X in connection with the sale of X's interests in DE1.

(2) The transfer of all of Business A's assets to X under paragraph (c)(5) of this section results in a termination of the Business A section 987 QBU under §1.987-8(b)(2) (substantially all assets transferred). Under §1.987-5(c)(3) and §1.987-8(e), a termination of a section 987 QBU is treated as a remittance of all the gross assets of the section 987 QBU to the owner on the date of the termination. Therefore, the owner's remittance proportion is one, and X recognizes all of its net unrecognized section 987 gain with respect to Business A, or \$20,000.

(3) Because a current rate election was in effect, all of the assets of Business A are marked items. Therefore, under §1.987-5(f)(2), X's basis in the assets transferred from Business A is determined by translating Business A's functional currency basis in the assets into X's functional currency at the spot rate applicable to the date of the transfer, €1=\$1.2. Consequently, immediately before the sale of the interests in DE1, X's functional currency basis in Business A's assets (which Business A held with a basis of €100,000) is \$120,000. X recognizes \$30,000 of gain under section 1001(a) on the sale of DE1.

(d) *Translation of items transferred to a section 987 QBU—(1) Marked items.* The adjusted basis of a marked asset, or the amount of a marked liability, transferred to a section 987 QBU is translated into the section 987 QBU's functional currency at the spot rate applicable to the date of transfer. If, and to the extent that, exchange gain or loss is recognized on the asset or liability transferred under §1.988-1(a)(10)(ii), the adjusted basis of the marked asset, or the amount of the marked liability, is adjusted to take into account the exchange gain or loss recognized.

(2) *Historic items.* The adjusted basis of a historic asset, or the amount of a historic liability, transferred to a section 987 QBU is translated into the section 987 QBU's

functional currency at the rate provided in §1.987-1(c)(3). If, and to the extent that, exchange gain or loss is recognized on the asset or liability transferred under §1.988-1(a)(10)(ii), the adjusted basis of the historic asset, or the amount of the historic liability, is adjusted to take into account the exchange gain or loss recognized.

(e) *Cross-reference.* See also §1.1502-13(j)(9) regarding the treatment of intercompany transactions involving section 987 QBUs owned by a member of a consolidated group.

8. Section 1.987-3, as proposed to be amended by 81 FR 88882 (December 8, 2016), is further amended by:

a. Revising paragraphs (a), (b)(1), (b)(2)(i), (b)(3) and (c)(1);

b. Adding paragraph (c)(2) introductory text.

c. Revising paragraphs (c)(2)(i), (c)(2)(iii) and (iv), (c)(3), (d) and (e).

The revisions and addition read as follows:

§1.987-3 Determination of section 987 taxable income or loss of an owner of a section 987 QBU.

(a) *In general.* This section provides rules for determining the taxable income or loss of an owner of a section 987 QBU (*section 987 taxable income or loss*). Paragraph (b) of this section provides rules for determining items of income, gain, deduction, and loss, which generally are determined in the section 987 QBU's functional currency. Paragraph (c) of this section provides rules for translating each item determined under paragraph (b) of this section into the functional currency of the owner of the section 987 QBU, if necessary. Paragraph (d) of this section is reserved. Paragraph (e) of this section provides examples illustrating the application of the rules of this section.

(b) * * *

(1) *In general.* Except as otherwise provided in this paragraph (b), a section 987 QBU must determine each item of income, gain, deduction, or loss of such section 987 QBU in its functional currency under Federal income tax principles.

(2) * * *

(i) *In general.* Except as otherwise provided in paragraphs (b)(2)(ii) and (b)

(4) of this section, an item of income, gain, deduction, or loss (or the item's components and related items, such as gross receipts and amount realized) that is denominated in (or determined by reference to) a nonfunctional currency (including the functional currency of the owner) is translated into the section 987 QBU's functional currency at the spot rate on the date such item is properly taken into account, subject to the limitation under §1.987-1(c)(1)(ii)(B) regarding the use of a spot rate convention. Paragraphs (e)(1) and (2) of this section (*Examples 1 and 2*) illustrate the application of this paragraph (b)(2)(i).

* * * * *

(3) *Determination in the case of a section 987 QBU owned through a section 987 aggregate partnership—(i) In general.* Except as otherwise provided in this paragraph (b)(3), the taxable income or loss of a section 987 aggregate partnership, and the distributive share of any owner that is a partner in such partnership, are determined in accordance with the provisions of subchapter K of the Internal Revenue Code.

(ii) *Determination of each item of income, gain, deduction, or loss in the eligible QBU's functional currency.* A section 987 aggregate partnership generally must determine each item of income, gain, deduction, or loss reflected on the books and records of each of its eligible QBUs under §1.987-2(b) in the functional currency of each such QBU.

(iii) *Allocation of items of income, gain, deduction, or loss of an eligible QBU.* A section 987 aggregate partnership must allocate the items of income, gain, deduction, or loss of each eligible QBU among its partners in accordance with each partner's distributive share of such income, gain, deduction, or loss as determined under subchapter K of the Internal Revenue Code.

(iv) *Translation of items into the owner's functional currency.* To the extent the items referred to in paragraph (b)(3)(iii) of this section are allocated to a partner, the partner must adjust the items to conform to Federal income tax principles and translate the items into the partner's functional currency, if necessary, as provided in paragraph (c) of this section.

* * * * *

(c) * * *

(1) *In general.* Except as otherwise provided in this section, the exchange rate to be used by an owner in translating an item of income, gain, deduction, or loss attributable to a section 987 QBU (or the item's components and related items, such as gross receipts, amount realized, basis, and cost of goods sold) into the owner's functional currency, if necessary, is the yearly average exchange rate for the taxable year.

(2) *Exceptions.* This paragraph (c)(2) applies to taxable years for which neither the annual recognition election nor the current rate election is in effect.

(i) *Recovery of basis with respect to historic assets.* Except as otherwise provided in this paragraph (c)(2), the exchange rate to be used by the owner in translating any recovery of basis (whether through a sale or exchange; deemed sale or exchange; cost recovery deduction such as depreciation, depletion or amortization; or otherwise) with respect to a historic asset is the historic rate for the property to which such recovery of basis is attributable.

* * * * *

(iii) [Reserved]

(iv) *Cost of goods sold computation—(A) General rule—simplified inventory method.* Except as otherwise provided in paragraph (c)(2)(iv)(B) of this section, cost of goods sold (COGS) for a taxable year is translated into the functional currency of the owner at the yearly average exchange rate for the taxable year in which the sale occurred (or the COGS was otherwise taken into account in computing taxable income) and adjusted as provided in paragraph (c)(3) of this section.

(B) *Election to use the historic inventory method.* In lieu of using the simplified inventory method described in paragraph (c)(2)(iv)(A) of this section, the owner of a section 987 QBU may elect under this paragraph (c)(2)(iv)(B) to translate inventoriable costs (including current-year inventoriable costs and costs that were capitalized into inventory in prior years) that are included in COGS at the historic rate for each such cost.

* * * * *

(3) *Adjustments to COGS required under the simplified inventory method.*

This paragraph (c)(3) applies to taxable years for which neither the annual recognition election nor the current rate election is in effect.

(i) *In general.* An owner of a section 987 QBU that uses the simplified inventory method described in paragraph (c)(2)(iv)(A) of this section must make the adjustment described in paragraph (c)(3)(ii) of this section. In addition, the owner must make the adjustment described in paragraph (c)(3)(iii) of this section with respect to any inventory for which the section 987 QBU does not use the LIFO inventory method (as described in section 472) and must make the adjustment described in paragraph (c)(3)(iv) of this section with respect to any inventory for which the section 987 QBU uses the LIFO inventory method. An owner of a section 987 QBU that uses the simplified inventory method must make all of the applicable adjustments described in paragraphs (c)(3)(ii) through (iv) of this section with respect to the section 987 QBU even in taxable years in which the amount of COGS is zero.

(ii) *Adjustment for cost recovery deductions included in inventoriable costs.* The translated COGS amount computed under paragraph (c)(2)(iv)(A) of this section is increased or decreased (as appropriate) to reflect the difference between the historic rates appropriate for translating cost recovery deductions attributable to other historic assets and the exchange rate used to translate COGS under paragraph (c)(2)(iv)(A) of this section, to the extent any such cost recovery deductions are included in inventoriable costs for the taxable year. The adjustment is included as an adjustment to translated COGS computed under paragraph (c)(2)(iv)(A) of this section in full in the year to which the adjustment relates and is not allocated between COGS and ending inventory. The adjustment for each cost recovery deduction is computed as the product of:

(A) The cost recovery deduction, expressed in the functional currency of the section 987 QBU; and

(B) The exchange rate specified in paragraph (c)(2)(i) of this section for translating the cost recovery deduction

(that is, the historic rate for the property to which such deduction is attributable) less the exchange rate used to translate COGS under the simplified inventory method described in paragraph (c)(2)(iv)(A) of this section (that is, the yearly average exchange rate for the taxable year).

(iii) *Adjustment to beginning inventory for non-LIFO inventory.* In the case of inventory with respect to which a section 987 QBU does not use the LIFO inventory method (*non-LIFO inventory*), the translated COGS amount computed under paragraph (c)(2)(iv)(A) of this section is increased or decreased (as appropriate) by the product of:

(A) The ending non-LIFO inventory included on the closing balance sheet for the preceding year, expressed in the functional currency of the section 987 QBU; and

(B) The exchange rate described in §§ 1.987-4(e)(2)(ii) and 1.987-1(c)(3)(i)(B) that is used for translating ending inventory on the closing balance sheet for the preceding year (which is generally the yearly average exchange rate for the preceding year) less the exchange rate used to translate COGS under paragraph (c)(2)(iv)(A) of this section (that is, the yearly average exchange rate for the taxable year). For purposes of this paragraph (c)(3)(iii)(B), in the first taxable year in which a current rate election is revoked or otherwise ceases to be in effect, the exchange rate that is used for translating ending inventory on the closing balance sheet for the preceding year is deemed to be equal to the spot rate applicable to the last day of the preceding taxable year.

(iv) *Adjustment for year of LIFO liquidation.* In the case of inventory with respect to which a section 987 QBU uses the LIFO inventory method, for each LIFO layer liquidated in whole or in part during the taxable year, the translated COGS amount computed under paragraph (c)(2)(iv)(A) of this section is increased or decreased (as appropriate) by the product of:

(A) The amount of the LIFO layer liquidated during the taxable year, expressed in the functional currency of the section 987 QBU; and

(B) The exchange rate described in §§ 1.987-4(e)(2)(ii) and 1.987-1(c)(3)(i)(B) or (F) that is used for translating such LIFO layer (which is generally the yearly average exchange rate for the year such LIFO layer arose) less the exchange rate used to translate COGS under paragraph (c)(2)(iv)(A) of this section (that is, the yearly average exchange rate for the taxable year).

(d) [Reserved]

(e) *Examples.* The following examples illustrate the application of this section. For purposes of the examples, U.S. Corp is a domestic corporation that uses the calendar year as its taxable year and has the U.S. dollar as its functional currency. Except as otherwise indicated, U.S. Corp is the owner of Business A, a section 987 QBU with the euro as its functional currency, and elects under paragraph (c)(2)(iv)(B) of this section to use the historic inventory method with respect to Business A but does not make any other elections under section 987. Exchange rates used in these examples are selected for the purpose of illustrating the principles of this section. No inference (for example, whether a currency is hyperinflationary or not) is intended by their use.

(1) *Example 1.* Business A accrues £100 of income from the provision of services. Under paragraph (b)(2)(i) of this section, the £100 is translated into €90 at the spot rate on the date of accrual, without the use of a spot rate convention. In determining U.S. Corp's taxable income, the €90 of income is translated into dollars at the rate provided in paragraph (c)(1) of this section.

(2) *Example 2.* Business A sells a historic asset consisting of non-inventory property for £100. Under paragraph (b)(2)(i) of this section, the £100 amount realized is translated into €85 at the spot rate on the sale date without the use of a spot rate convention. In determining U.S. Corp's taxable income, the €85 is translated into dollars at the rate provided in paragraph (c)(1) of this section. The euro basis of the property is translated into dollars at the rate provided in paragraph (c)(2)(i) of this section (that is, the historic rate).

(3) *Example 3—(i) Facts.* Business A uses a first-in, first-out (*FIFO*) method of accounting for inventory. Business A sells 1,200 units of inventory in year 2 for €3 per unit. Business A's gross sales are translated under paragraph (c)(1) of this section at the yearly average exchange rate for the year of the sale. The yearly average exchange rate is €1 = \$1.02 for year 1 and €1 = \$1.05 for year 2.

(ii) *Analysis—(A)* Business A's dollar gross sales will be computed as follows:

Table 1 to paragraph (e)(3)(ii)(A)

Gross Sales (year 2)

Month	# of units	Amount in €	€/ \$ yearly average rate	Amount in \$
Jan	100	€ 300	€1 = \$1.05	\$315.00
Feb	200	600	€1 = \$1.05	630.00
March	0	0	€1 = \$1.05	0.00
April	200	600	€1 = \$1.05	630.00
May	100	300	€1 = \$1.05	315.00
June	0	0	€1 = \$1.05	0.00
July	100	300	€1 = \$1.05	315.00
Aug	100	300	€1 = \$1.05	315.00
Sept	0	0	€1 = \$1.05	0.00
Oct	0	0	€1 = \$1.05	0.00
Nov	100	300	€1 = \$1.05	315.00
Dec	300	900	€1 = \$1.05	945.00
	1,200			\$3,780.00

(B) The purchase price for each inventory unit was €1.50. Under §1.987-1(c)(3)(i) and paragraph

(c)(2)(iv)(B) of this section, the basis of each item of inventory is translated into dollars at the yearly

average exchange rate for the year the inventory was acquired.

Table 2 to paragraph (e)(3)(ii)(B)

Opening Inventory and Purchases (year 2)

Month	# of units	Amount in €	€/ \$ yearly average rate	Amount in \$
<i>Opening inventory (purchased in Dec. year 1)</i>				
	100	€150	€1 = \$1.02	\$153.00
<i>Purchases in year 2</i>				
Jan	300	€ 450	€1 = \$1.05	\$472.50
Feb	0	0	€1 = \$1.05	0
March	0	0	€1 = \$1.05	0
April	300	450	€1 = \$1.05	472.50
May	0	0	€1 = \$1.05	0
June	0	0	€1 = \$1.05	0
July	300	450	€1 = \$1.05	472.50
Aug	0	0	€1 = \$1.05	0
Sept	0	0	€1 = \$1.05	0
Oct	0	0	€1 = \$1.05	0
Nov	300	450	€1 = \$1.05	472.50
Dec	0	0	€1 = \$1.05	0
	1,200			\$1,890.00

(C) Because Business A uses a FIFO method for inventory, Business A is considered to have sold in year 2 the 100 units of opening inventory purchased in year 1 (\$153.00), the 300 units purchased in January year 2 (\$472.50), the 300 units purchased in April year 2 (\$472.50), the 300 units purchased in July year 2 (\$472.50), and 200 of the 300 units purchased in November year 2 (\$315.00). Accordingly, Business A's translated dollar COGS for year 2 is \$1,885.50. Business A's opening inventory for year 3 is 100 units of inventory with a translated dollar basis of \$157.50.

(D) Accordingly, for purposes of section 987, Business A has gross income in dollars of \$1,894.50 (\$3,780.00 - \$1,885.50) for year 2.

(4) [Reserved]

(5) *Example 5.* The facts are the same as in paragraph (e)(3) of this section (*Example 3*) except that during year 2, Business A incurred €100 of depreciation expense with respect to a truck. No portion of the depreciation expense is an inventoriable cost. The truck was purchased on January 15, year 1. The yearly average exchange rate for year 1 was €1 =

\$1.02. Under paragraph (c)(2)(i) of this section, the €100 of depreciation is translated into dollars at the historic rate. The historic rate is the yearly average exchange rate for year 1. Accordingly, U.S. Corp takes into account depreciation of \$102 with respect to Business A in year 2.

(6) *Example 6.* The facts are the same as in paragraph (e)(5) of this section (*Example 5*) except that the €100 of depreciation expense incurred during year 2 with respect to the truck is an inventoriable cost. As a result, the depreciation expense is

capitalized into the 1,200 units of inventory purchased by Business A in year 2. Of those 1,200 units, 1,100 units are sold during the year, and 100 units become ending inventory. The portion of depreciation expense capitalized into inventory that is sold during year 2 is reflected in Business A's euro COGS and is translated at the €1 = \$1.02 yearly average exchange rate for year 1, the year in which the truck was purchased. The portion of the depreciation expense capitalized into the 100 units of ending inventory is not taken into account in year 2 but rather, will be taken into account in the year the ending inventory is sold, translated at the €1 = \$1.02 yearly average exchange rate for year 1.

(7) *Example 7.* Business A purchased raw land on October 16, year 1, for €8,000 and sold the land on November 1, year 2, for €10,000. The yearly average exchange rate was €1 = \$1.02 for year 1 and €1 = \$1.05 for year 2. Under paragraph (c)(1) of this section, the amount realized is translated into dollars at the yearly average exchange rate for year 2 (€10,000 x \$1.05 = \$10,500). Under paragraph (c)(2)(i) of this section, the basis is determined at the historic rate for year 1, which is the yearly average exchange rate under section §1.987-1(c)(3)(i) for such year (€8,000 x \$1.02 = \$8,160). Accordingly, the amount of gain reported by U.S. Corp on the sale of the land is \$2,340 (\$10,500 - \$8,160).

(8) *Example 8.* The facts are the same as in paragraph (e)(7) of this section (*Example 7*), except that U.S. Corp makes a current rate election under § 1.987-1(d)(2). Under paragraph (c)(2) of this section, none of the exceptions to paragraph (c)(1) of this section apply in a taxable year for which an annual recognition election or a current rate election is in effect. As a result, all items of income, gain, deduction, and loss with respect to Business A are translated into U.S. Corp's functional currency at the yearly average exchange rate under paragraph (c) (1) of this section. Business A's gain on the sale of the land is determined in its functional currency and is equal to €2,000 (amount realized of €10,000 less basis of €8,000). This gain is translated at the yearly average exchange rate for year 2 of €1 = \$1.05, and the amount of gain reported by U.S. Corp on the sale of the land is \$2,100. The result would be the same if U.S. Corp made an annual recognition election under §1.987-5(b)(2).

9. Section 1.987-4 is revised to read as follows:

§1.987-4 Determination of net unrecognized section 987 gain or loss of a section 987 QBU.

(a) *In general.* The net unrecognized section 987 gain or loss of a section 987 QBU is determined by the owner annually as provided in paragraph (b) of this section in the owner's functional currency. Only assets and liabilities reflected on the books and records of the section 987 QBU under §1.987-2(b) are taken into account.

(b) *Calculation of net unrecognized section 987 gain or loss.* Net unrecognized

section 987 gain or loss of a section 987 QBU for a taxable year equals the sum of:

(1) The section 987 QBU's net accumulated unrecognized section 987 gain or loss for all prior taxable years as determined in paragraph (c) of this section; and

(2) The section 987 QBU's unrecognized section 987 gain or loss for the current taxable year as determined in paragraph (d) of this section.

(c) *Net accumulated unrecognized section 987 gain or loss for all prior taxable years—*(1) *In general.* A section 987 QBU's net accumulated unrecognized section 987 gain or loss for all prior taxable years is the aggregate of the amounts determined under §1.987-4(d) for all prior taxable years to which this section applies, reduced (without duplication) by amounts recognized under §1.987-5(a), amounts treated as deferred section 987 gain or loss, and amounts treated as suspended section 987 loss for all prior taxable years to which this section applies.

(2) *Additional adjustments for certain taxable years beginning on or before December 31, 2024.* For any section 987 QBU in existence before the transition date, see §1.987-10(e)(5) and (f)(2) for additional adjustments to the section 987 QBU's net accumulated unrecognized section 987 gain or loss.

(d) *Calculation of unrecognized section 987 gain or loss for a taxable year.* The unrecognized section 987 gain or loss of a section 987 QBU for a taxable year is generally determined under paragraphs (d) (1) through (10) of this section. However, for taxable years in which a current rate election or an annual recognition election is in effect, the unrecognized section 987 gain or loss of a section 987 QBU for a taxable year is determined by only applying paragraphs (d)(1) through (5) and (10) of this section.

(1) *Step 1: Determine the change in the owner functional currency net value of the section 987 QBU for the taxable year—*(i) *In general.* The change in the owner functional currency net value of the section 987 QBU for the taxable year equals—

(A) The owner functional currency net value of the section 987 QBU, determined in the functional currency of the owner under paragraph (e) of this section, on the last day of the taxable year; less

(B) The owner functional currency net value of the section 987 QBU, determined in the functional currency of the owner under paragraph (e) of this section, on the last day of the preceding taxable year.

(ii) *Year section 987 QBU is terminated.* If a section 987 QBU is terminated within the meaning of §1.987-8 during an owner's taxable year, the owner functional currency net value of the section 987 QBU described in paragraph (d)(1)(i)(A) of this section is determined on the date the section 987 QBU is terminated.

(iii) *First taxable year of a section 987 QBU.* If the owner's taxable year is the first taxable year of a section 987 QBU, the owner functional currency net value of the section 987 QBU described in paragraph (d)(1)(i)(B) of this section is zero.

(iv) *First year in which an election is in effect or ceases to be in effect.* Except as otherwise provided, the owner functional currency net value of the section 987 QBU described in paragraph (d)(1)(i)(B) of this section is determined based on the elections that were (or were not) in effect on the last day of the preceding taxable year.

(2) *Step 2: Increase the amount determined in step 1 by the amount of assets transferred from the section 987 QBU to the owner—*(i) *In general.* The amount determined in paragraph (d)(1) of this section is increased by the total amount of assets transferred from the section 987 QBU to the owner during the taxable year translated into the functional currency of the owner as provided in paragraph (d)(2) (ii) of this section.

(ii) *Assets transferred from the section 987 QBU to the owner during the taxable year.* The total amount of assets transferred from the section 987 QBU to the owner for the taxable year translated into the functional currency of the owner equals the sum of:

(A) The amount of the functional currency of the section 987 QBU and the aggregate adjusted basis of all marked assets, after taking into account §1.988-1(a)(10), transferred to the owner during the taxable year determined in the functional currency of the section 987 QBU and translated into the functional currency of the owner at the spot rate applicable to the date of transfer; and

(B) The aggregate adjusted basis of all historic assets, after taking into account

§1.988-1(a)(10), transferred to the owner during the taxable year determined in the functional currency of the section 987 QBU and translated into the functional currency of the owner at the historic rate for each such asset.

(3) *Step 3: Decrease the amount determined in steps 1 and 2 by the amount of assets transferred from the owner to the section 987 QBU—(i) In general.* The aggregate amount determined in paragraphs (d)(1) and (2) of this section is decreased by the total amount of assets transferred from the owner to the section 987 QBU during the taxable year determined in the functional currency of the owner as provided in paragraph (d)(3)(ii) of this section.

(ii) *Assets transferred from the owner to the section 987 QBU during the taxable year.* The total amount of assets transferred from the owner to the section 987 QBU for the taxable year equals the sum of:

(A) The amount of functional currency of the owner transferred to the section 987 QBU during the taxable year; and

(B) The aggregate adjusted basis of all assets, after taking into account §1.988-1(a)(10), transferred to the section 987 QBU during the taxable year determined in the functional currency of the owner immediately before the transfer.

(4) *Step 4: Decrease the amount determined in steps 1 through 3 by the amount of liabilities transferred from the section 987 QBU to the owner—(i) In general.* The aggregate amount determined in paragraphs (d)(1) through (3) of this section is decreased by the total amount of liabilities transferred from the section 987 QBU to the owner during the taxable year translated into the functional currency of the owner as provided in paragraph (d)(4)(ii) of this section.

(ii) *Liabilities transferred from the section 987 QBU to the owner during the taxable year.* The total amount of liabilities transferred from the section 987 QBU to the owner for the taxable year equals the sum of:

(A) The amount of marked liabilities transferred to the owner during the taxable year determined in the functional currency of the section 987 QBU and translated into the functional currency of the owner at the spot rate applicable to the date of transfer; and

(B) The amount of historic liabilities, after taking into account §1.988-1(a)(10), transferred to the owner during the taxable year determined in the functional currency of the section 987 QBU and translated into the functional currency of the owner at the historic rate for each such liability.

(5) *Step 5: Increase the amount determined in steps 1 through 4 by the amount of liabilities transferred from the owner to the section 987 QBU.* The aggregate amount determined in paragraphs (d)(1) through (4) of this section is increased by the total amount of liabilities, after taking into account §1.988-1(a)(10), transferred from the owner to the section 987 QBU during the taxable year determined in the functional currency of the owner immediately before the transfer.

(6) *Step 6: Decrease or increase the amount determined in steps 1 through 5 by the section 987 taxable income or loss, respectively, of the section 987 QBU for the taxable year.* The aggregate amount determined in paragraphs (d)(1) through (5) of this section is decreased or increased by the section 987 taxable income or loss, respectively, computed under §1.987-3 for the taxable year.

(7) *Step 7: Increase the amount determined in steps 1 through 6 by any expenses or losses that are not deductible in computing the section 987 taxable income or loss of the section 987 QBU for the taxable year.* The aggregate amount determined under paragraphs (d)(1) through (6) of this section is increased by the amount of any expense or loss that reduces the basis of assets or increases the amount of liabilities on the adjusted balance sheet of the section 987 QBU for the taxable year but is not deductible in computing the section 987 QBU's taxable income or loss for the taxable year (such as business interest expense that is not deductible under section 163(j)). Items of expense or loss described in the preceding sentence are translated into the functional currency of the owner using the exchange rate that would apply under §1.987-3(c) if they were deductible in computing the section 987 QBU's taxable income or loss for the taxable year. However, any foreign income taxes incurred by the section 987 QBU with respect to which the owner claims a credit are translated at the same rate at which such taxes were translated under section 986(a).

(8) *Step 8: Decrease the amount determined in steps 1 through 7 by the amount of any income or gain that is not included in taxable income in computing the section 987 taxable income or loss of the section 987 QBU for the taxable year.* The aggregate amount determined under paragraphs (d)(1) through (7) of this section is decreased by the amount of any income or gain that increases the basis of assets or reduces the amount of liabilities on the adjusted balance sheet of the section 987 QBU for the taxable year but is not included in taxable income in computing the section 987 QBU's taxable income or loss for the taxable year. Items of income or gain described in the preceding sentence are translated into the functional currency of the owner using the exchange rate that would apply under §1.987-3(c) if they were included in taxable income in computing the section 987 QBU's taxable income or loss for the taxable year.

(9) *Step 9: Increase or decrease the amount determined in steps 1 through 8 by any income or gain, or any deduction or loss, respectively, that does not impact the adjusted balance sheet.* The aggregate amount determined under paragraphs (d)(1) through (8) of this section is increased by any items of income or gain taken into account in step 6 that do not increase the basis of assets or reduce the amount of liabilities on the adjusted balance sheet of the section 987 QBU for the taxable year, and decreased by any items of deduction or loss taken into account in step 6 that do not reduce the basis of assets or increase the amount of liabilities on the adjusted balance sheet of the section 987 QBU for the taxable year. Items of income, gain, deduction, or loss described in the preceding sentence are translated into the functional currency of the owner using the exchange rate that applied under §1.987-3(c) in computing the section 987 QBU's taxable income or loss for the taxable year.

(10) *Step 10: Decrease or increase the amount determined in steps 1 through 9 by any increase or decrease, respectively, to the adjusted balance sheet that is not previously taken into account under steps 2 through 9—(i) In general.* Except as provided in paragraph (d)(10)(iii) of this section, the aggregate amount determined under paragraphs (d)(1) through (9) of this section is—

(A) Decreased by the residual increase to the adjusted balance sheet (as defined in paragraph (d)(10)(ii) of this section), translated into the owner's functional currency at the yearly average exchange rate for the taxable year; or

(B) Increased by the residual decrease to the adjusted balance sheet (as defined in paragraph (d)(10)(ii) of this section), translated into the owner's functional currency at the yearly average exchange rate for the taxable year.

(ii) *Determining the residual increase or decrease to the adjusted balance sheet.* The residual increase to the adjusted balance sheet is the positive amount, if any, that would be determined under paragraphs (d)(1) through (9) of this section in the functional currency of the section 987 QBU if such amounts were determined in the functional currency of the section 987 QBU. The residual decrease to the adjusted balance sheet is the negative amount, if any, that would be determined under paragraphs (d)(1) through (9) of this section in the functional currency of the section 987 QBU if such amounts were determined in the functional currency of the section 987 QBU.

(iii) *Modifications for taxable years to which a current rate election or an annual recognition election applies.* For any taxable year to which a current rate election or an annual recognition election applies, paragraphs (d)(10)(i) and (ii) of this section are applied by replacing "paragraphs (d)(1) through (9)" with "paragraphs (d)(1) through (5)."

(e) *Determination of the owner functional currency net value of a section 987 QBU—(1) In general.* The owner functional currency net value of a section 987 QBU on the last day of a taxable year is equal to the aggregate amount of functional currency and the adjusted basis of each other asset on the section 987 QBU's adjusted balance sheet on that day, less the aggregate amount of each liability on the section 987 QBU's adjusted balance sheet on that day, in each case translated into the owner's functional currency as provided in paragraph (e)(2) of this section.

(2) *Translation of adjusted balance sheet items into the owner's functional currency.* The amount of the section 987 QBU's functional currency, the basis of an

asset, or the amount of a liability is translated as follows:

(i) *Marked item.* A marked item is translated into the owner's functional currency at the spot rate applicable to the last day of the relevant taxable year.

(ii) *Historic item.* A historic item is translated into the owner's functional currency at the historic rate.

(f) *Combinations and separations—(1) Combinations.* The net accumulated unrecognized section 987 gain or loss of a combined QBU for a taxable year is equal to the sum of the combining QBUs' net accumulated unrecognized section 987 gain or loss. See paragraph (f)(3)(i) of this section (*Example 1*) for an illustration of this rule.

(2) *Separations.* The net accumulated unrecognized section 987 gain or loss of a separated QBU for a taxable year is equal to the separating QBU's net accumulated unrecognized section 987 gain or loss multiplied by the separation fraction. For purposes of determining the owner functional currency net value of the separated QBUs on the last day of the taxable year preceding the taxable year of separation under paragraphs (d)(1)(i)(B) and (e) of this section, the balance sheets of the separated QBUs on that day will be deemed to reflect the assets and liabilities reflected on the balance sheet of the separating QBU on that day, apportioned between the separated QBUs in a reasonable manner that takes into account the assets and liabilities reflected on the balance sheets of the separated QBUs immediately after the separation. See paragraph (f)(3)(ii) of this section (*Example 2*) for an illustration of this rule.

(3) *Examples.* The following examples illustrate the rules of paragraphs (f)(1) and (2) of this section. For purposes of these examples, assume that no section 987 elections are in effect.

(i) *Example 1. Combination of two section 987 QBUs that have the same owner—(A) Facts.* DC1, a domestic corporation, owns Entity A, a DE. Entity A conducts a manufacturing business that constitutes a section 987 QBU (*Manufacturing QBU*) that has the euro as its functional currency. Manufacturing QBU has a net accumulated unrecognized section 987 loss of \$100. DC1 also owns Entity B, a DE. Entity B conducts a sales business that constitutes a section 987 QBU (*Sales QBU*) that has the euro as its functional currency. Sales QBU has a net accumulated unrecognized section 987 gain of \$110. During the taxable year, Entity A merges into Entity B under

local law pursuant to which Entity A ceases to exist, Entity B survives, and Entity B acquires all the assets and liabilities of Entity A. As a result, the books and records of Manufacturing QBU and Sales QBU are combined into a new single set of books and records. The combined entity has the euro as its functional currency.

(B) *Analysis.* Pursuant to §1.987-2(c)(9)(i), Manufacturing QBU and Sales QBU are combining QBUs, and their combination does not give rise to a transfer that is taken into account in determining the amount of a remittance (as defined in §1.987-5(c)). For purposes of computing net unrecognized section 987 gain or loss under this section for the year of the combination, the combination is deemed to have occurred on the last day of the owner's prior taxable year, such that the owner functional currency net value of the combined section 987 QBU at the end of that taxable year described under paragraph (d)(1)(i)(B) of this section takes into account items reflected on the balance sheets of both Manufacturing QBU and Sales QBU at that time. Additionally, any transactions between Manufacturing QBU and Sales QBU occurring during the year of the merger will not result in transfers to or from a section 987 QBU. Pursuant to paragraph (f)(1) of this section, the combined QBU will have a net accumulated unrecognized section 987 gain of \$10 (the \$100 loss from Manufacturing QBU plus the \$110 gain from Sales QBU).

(ii) *Example 2. Separation of two section 987 QBUs that have the same owner—(A) Facts.* DC1, a domestic corporation, owns Entity A, a DE. Entity A conducts a business in the Netherlands that constitutes a section 987 QBU (*Dutch QBU*) that has the euro as its functional currency. The business of Dutch QBU consists of manufacturing and selling bicycles and scooters and is recorded on a single set of books and records. On the last day of year 1, the adjusted basis of the gross assets of Dutch QBU is €1,000. In year 2, the net accumulated unrecognized section 987 loss of Dutch QBU from all prior taxable years is \$200. During year 2, Entity A separates the bicycle and scooter business such that each business begins to have its own books and records and to meet the definition of a section 987 QBU under §1.987-1(b)(3) (hereafter, "bicycle QBU" and "scooter QBU"). There are no transfers between DC1 and Dutch QBU before the separation. After the separation, the aggregate adjusted basis of bicycle QBU's assets is €600 and the aggregate adjusted basis of scooter QBU's assets is €400. Each section 987 QBU continues to have the euro as its functional currency.

(B) *Analysis.* Pursuant to §1.987-2(c)(9)(iii), bicycle QBU and scooter QBU are separated QBUs, and the separation of Dutch QBU, a separating QBU, does not give rise to a transfer taken into account in determining the amount of a remittance. For purposes of computing net unrecognized section 987 gain or loss under this section for year 2, the separation will be deemed to have occurred on the last day of the owner's prior taxable year, year 1. Pursuant to paragraph (f)(2) of this section and §1.987-1(h), bicycle QBU will have a separation fraction of €600/€1,000 and net accumulated unrecognized section 987 loss of \$120 (€600/€1,000 x \$200), and scooter QBU will have a separation fraction of €400/€1,000 and net accumulated unrecognized section 987 loss of \$80 (€400/€1,000 x \$200).

(g) *Examples.* The following examples illustrate the provisions of this section. For purposes of the examples, U.S. Corp is a domestic corporation that uses the calendar year as its taxable year and has the dollar as its functional currency. Except as otherwise indicated, no section 987 elections are in effect. Exchange rate assumptions used in these examples are selected for the purpose of illustrating the principles of this section, and no inference is intended by their use. Additionally, the examples are not intended to demonstrate when activities constitute a trade or business within the meaning of §§1.989(a)-1(b)(2)(ii)(A) and 1.989(a)-1(c) and therefore whether a section 987 QBU is considered to exist.

(1) *Example 1—(i) Facts.* On July 1, year 1, U.S. Corp establishes Japan Branch, a section 987 QBU that has the yen as its functional currency, and U.S. Corp transfers to Japan Branch ¥100,000 with a basis of \$1,000 and raw land with a basis of \$500. On the same day, Japan Branch borrows ¥10,000 from a bank. In year 1, Japan Branch earns ¥12,000 for providing services and incurs ¥2,000 of related expenses. Japan Branch thus earns ¥10,000 of net income in year 1. The spot rate on July 1, year 1,

is \$1 = ¥100; the spot rate on December 31, year 1, is \$1 = ¥120; and the average rate for the period of July 1, year 1, to December 31, year 1, is \$1 = ¥110. Thus, the ¥12,000 of services revenue when translated under §1.987-3(c)(1) at the yearly average exchange rate equals \$109.09 (¥12,000 x (\$1 / ¥110)) = \$109.09). The ¥2,000 of expenses translated at the same yearly average exchange rate equals \$18.18 (¥2,000 x (\$1 / ¥110) = \$18.18). Thus, Japan Branch's net income translated into dollars equals \$90.91 (\$109.09 - \$18.18 = \$90.91).

(ii) *Analysis.* Under paragraph (a) of this section, U.S. Corp must compute the net unrecognized section 987 gain or loss of Japan Branch for year 1. Because this is Japan Branch's first taxable year, the net unrecognized section 987 gain or loss (as defined under paragraph (b) of this section) is the branch's unrecognized section 987 gain or loss for year 1 as determined in paragraph (d) of this section. The calculations under paragraph (d) of this section are made as follows:

(A) *Step 1.* Under paragraph (d)(1) of this section (Step 1), U.S. Corp must determine the change in the owner functional currency net value (*OFCNV*) of Japan Branch for year 1 in dollars. The change in the *OFCNV* of Japan Branch for year 1 is equal to the *OFCNV* of Japan Branch determined in dollars on the last day of year 1, less the *OFCNV* of Japan Branch determined in dollars on the last day of the preceding taxable year.

Table 1 to paragraph (g)(1)(ii)(A)(4)

OFCNV—End of Year 1

<i>Assets</i>	<i>Amount in ¥</i>	<i>Translation Rate</i>	<i>Amount in \$</i>
Yen	¥120,000	\$1 = ¥120 (spot rate-12/31/year 1)	\$1,000.00
Land	¥55,000	\$1 = ¥110 (historic rate-yearly average rate-year 1)	\$500.00
Total assets	¥175,000		\$1,500.00
<i>Liabilities</i>			
Bank loan	¥10,000	\$1 = ¥120 (spot rate-12/31/year 1)	\$83.33
Total liabilities	¥10,000		\$83.33
Year 1 ending net value	¥165,000		\$1,416.67

(5) Under paragraph (d)(1) of this section, the change in *OFCNV* of Japan Branch for year 1 is equal to the *OFCNV* of the branch determined in dollars on December 31, year 1, (which is \$1,416.67) less the *OFCNV* of the branch determined in dollars on the last day of the preceding taxable year. Because this is the first taxable year of Japan Branch, the *OFCNV* of Japan Branch determined in dollars on the last day of the preceding taxable year is zero under paragraph (d)(1)(iii) of this section. Accordingly, the change in *OFCNV* of Japan Branch for year 1 is \$1,416.67.

(B) *Step 2 (no adjustment).* No adjustment is made under paragraph (d)(2) of this section (Step 2) because no assets were transferred by Japan Branch to U.S. Corp during the taxable year.

(C) *Step 3.* On July 1, year 1, U.S. Corp transferred to Japan Branch ¥100,000 with a basis of \$1,000.00 and raw land with a basis of \$500.00 (equal to ¥55,000, translated under §1.987-2(d)(2) at the historic rate of \$1 = ¥110). The total amount of

assets transferred from U.S. Corp to Japan Branch in dollars is \$1,500, and the total amount of the transfer in yen is ¥155,000. Therefore, under paragraph (d) (3) of this section (Step 3), the amount determined in previous steps is reduced by \$1,500.00, from \$1,416.67 to negative \$83.33.

(D) *Steps 4 and 5 (no adjustment).* No adjustment is made under paragraphs (d)(4) and (5) of this section (Steps 4 and 5) because no liabilities were transferred by U.S. Corp to Japan Branch or by Japan Branch to U.S. Corp during the taxable year.

(E) *Step 6.* Under paragraph (d)(6) of this section (Step 6), the amount determined in previous steps is decreased by the section 987 taxable income of Japan Branch of \$90.91, from negative \$83.33 to negative \$174.24.

(F) *Steps 7 through 9 (no adjustment).* No adjustment is made under paragraphs (d)(7) through (9) of this section (Steps 7 through 9) because all of Japan Branch's items of income or deduction for

(1) The *OFCNV* of Japan Branch on December 31, year 1 is determined under paragraph (e) of this section as the sum of the basis of each asset on Japan Branch's adjusted balance sheet on December 31, year 1, less the sum of each liability on Japan Branch's adjusted balance sheet on that date, translated into dollars as provided in paragraph (e)(2) of this section.

(2) For this purpose, Japan Branch will show the following assets and liabilities on its adjusted balance sheet for December 31, year 1: cash of ¥120,000; raw land with a basis of ¥55,000 (\$500 translated under §1.987-2(d)(2) at the historic rate of \$1 = ¥110); and liabilities of ¥10,000.

(3) Under paragraph (e)(2) of this section, U.S. Corp will translate these items as follows. The ¥120,000 is a marked asset and the ¥10,000 liability is a marked liability. These items are translated into dollars on December 31, year 1, using the spot rate on December 31, year 1, of \$1 = ¥120. The raw land is a historic asset and is translated into dollars under paragraph (e)(2)(ii) of this section at the historic rate, which under §1.987-1(c)(3)(i)(A) is the yearly average exchange rate of \$1 = ¥110 applicable to the year the land was transferred to the QBU.

(4) The *OFCNV* of Japan Branch on December 31, year 1, in dollars is \$1,416.67, determined below. The *OFCNV* of Japan Branch on December 31, year 1, is shown below in dollars (together with the corresponding amounts in yen).

the taxable year impact the adjusted balance sheet and are taken into account in computing taxable income.

(G) *Step 10 (no adjustment)—(1) Calculation of residual increase or decrease to the adjusted balance sheet.* Under paragraph (d)(10)(ii) of this section, the residual increase (or decrease) to the adjusted balance sheet is the positive (or negative) amount, if any, that would be determined under paragraphs (d)(1) through (9) of this section (Steps 1 through 9) in the functional currency of the section 987 QBU if such amounts were determined in the functional currency of the section 987 QBU. In year 1, the relevant steps that must be applied in the functional currency of Japan Branch (the yen) are paragraphs (d)(1), (3), and (6) of this section (Steps 1, 3, and 6). For purposes of applying paragraph (d) (1) of this section (Step 1) in yen, the change in the net value of Japan Branch is ¥165,000. See paragraph (g)(1)(ii)(A)(4) of this section. For purposes

of applying paragraph (d)(3) of this section (Step 3) in yen, the amount of assets transferred from U.S. Corp to Japan Branch is ¥155,000. See paragraph

(g)(1)(ii)(C) of this section. For purposes of applying paragraph (d)(6) of this section (Step 6) in yen, Japan Branch earned ¥10,000 of net income in year

1. The application of these steps results in no residual increase or decrease to the adjusted balance sheet, as shown below:

Table 2 to paragraph (g)(1)(ii)(G)(I)

Application of Relevant Steps in Yen

Change in net value in yen (Step 1)	¥165,000
Subtract amount determined in yen under Step 3 (transfers from owner to section 987 QBU)	(¥155,000)
Subtract amount determined in yen under Step 6 (section 987 taxable income or loss)	(¥10,000)
Residual increase or decrease to the adjusted balance sheet	¥0

(2) *No residual increase or decrease to the adjusted balance sheet.* As explained in paragraph (g)(1)(ii)(G)(I) of this section, there is no residual increase or decrease to the adjusted balance sheet of Japan Branch in year 1. Therefore, no adjustment is made under paragraph (d)(10) of this section (Step 10). Accordingly, the unrecognized section 987 loss of Japan Branch for year 1 is \$174.24.

(2) *Example 2—(i) Facts.* The facts are the same as in paragraph (g)(1) of this section (*Example 1*), except that U.S. Corp makes a current rate election under §1.987-1(d)(2) for year 1.

(ii) *Analysis.* Because a current rate election is in effect for year 1, the unrecognized section 987 gain or loss for year 1 is determined by applying only paragraphs (d)(1) through (5) and (10) of this

section (Steps 1 through 5 and Step 10). The calculations under paragraph (d) of this section are made as follows:

(A) *Step 1.* The change in the OFCNV of Japan Branch for year 1 is equal to the OFCNV of Japan Branch determined in dollars on the last day of year 1, less the OFCNV of Japan Branch determined in dollars on the last day of the preceding taxable year.

(I) For this purpose, Japan Branch will show the same assets and liabilities on its adjusted balance sheet for December 31, year 1 as are described in paragraph (g)(1)(ii)(A)(2) of this section (*Example 1*), but the land is treated as a marked asset as a result of the current rate election. The adjusted balance sheet reflects cash of ¥120,000, raw land with a basis of ¥50,000 (\$500 translated under §1.987-2(d)(1) at

the July 1, year 1 spot rate of \$1 = ¥100), and liabilities of ¥10,000.

(2) Because of the current rate election, all of Japan Branch's assets and liabilities are treated as marked items. Therefore, under paragraph (e)(2) of this section, these items are translated into dollars on December 31, year 1, using the spot rate on December 31, year 1, of \$1 = ¥120.

(3) The OFCNV of Japan Branch on December 31, year 1, and the change in OFCNV of Japan Branch for year 1, is \$1,333.33, determined below. The OFCNV (and change in OFCNV) of Japan Branch is shown below (together with the corresponding amounts in yen).

Table 3 to paragraph (g)(2)(ii)(A)(3)

OFCNV and Change in OFCNV—Year 1

<i>Assets</i>	<i>Amount in ¥</i>	<i>Translation Rate</i>	<i>Amount in \$</i>
Yen	¥120,000	\$1 = ¥120 (spot rate-12/31/year 1)	\$1,000.00
Land	¥50,000	\$1 = ¥120 (spot rate-12/31/year 1)	\$416.67
Total assets	¥170,000		\$1,416.67
<i>Liabilities</i>			
Bank loan	¥10,000	\$1 = ¥120 (spot rate-12/31/year 1)	\$83.33
Total liabilities	¥10,000		\$83.33
Year 1 ending net value	¥160,000		\$1,333.33
Net value on the last day of the preceding taxable year	¥0		\$0
Change in net value	¥160,000		\$1,333.33

(B) *Step 2 (no adjustment).* No adjustment is made under paragraph (d)(2) of this section (Step 2) because no assets were transferred by Japan Branch to U.S. Corp during the taxable year.

(C) *Step 3.* On July 1, year 1, U.S. Corp transferred to Japan Branch ¥100,000 with a basis of \$1,000.00 and raw land with a basis of \$500.00 (equal to ¥50,000, translated under §1.987-2(d)(1) at the spot rate on July 31, year 1 of \$1 = ¥100). The total amount of assets transferred in dollars is \$1,500.00, and the amount of assets transferred in yen is ¥150,000. Therefore, under paragraph (d)(3) of this section (Step 3), the amount determined in

previous steps is reduced by \$1,500, from \$1,333.33 to negative \$166.67.

(D) *Steps 4 and 5 (no adjustment).* No adjustment is made under paragraphs (d)(4) and (5) of this section (Steps 4 and 5) because no liabilities were transferred by U.S. Corp to Japan Branch or by Japan Branch to U.S. Corp during the taxable year.

(E) *Steps 6 through 9 do not apply.* Under paragraph (d) of this section, paragraphs (d)(6) through (9) of this section (Steps 6 through 9) do not apply because a current rate election is in effect.

(F) *Step 10—(1) Application of relevant steps in Japan Branch's functional currency.* Under

paragraph (d)(10)(iii) of this section, because a current rate election is in effect, the residual increase or decrease to the adjusted balance sheet is determined by applying paragraphs (d)(1) through (5) of this section (Steps 1 through 5) in the functional currency of the section 987 QBU. The relevant steps that must be applied under paragraph (d)(10) of this section in the functional currency of Japan Branch are paragraphs (d)(1) and (3) of this section (Steps 1 and 3). See paragraphs (g)(2)(ii)(A) and (C) of this section for amounts determined in yen. The residual increase to the adjusted balance sheet is determined as follows:

Table 4 to paragraph (g)(2)(ii)(F)(I)

Application of Relevant Steps in Yen

Step 1: Change in net value	¥160,000
Step 3: Subtract amount of transfers from owner to section 987 QBU	(¥150,000)
Residual increase or decrease to the adjusted balance sheet	¥10,000

(2) *Residual increase or decrease to the adjusted balance sheet.* As explained in paragraph (g)(2)(ii)(F)(I) of this section, the residual increase to Japan Branch's adjusted balance sheet in year 1 is ¥10,000. This amount, translated at the yearly average exchange rate of \$1 = ¥110, equals \$90.91. Therefore, the amount determined in previous steps is reduced by \$90.91, from negative \$166.67 to negative \$257.58. Accordingly, the unrecognized section 987 loss of Japan Branch for year 1 is \$257.58.

(3) *Example 3—(i) Facts—(A) Background.* The facts in year 1 are the same as in paragraph (g)(2) of this section (*Example 2*). In year 9, a current rate election remains in effect. U.S. Corp has net unrecognized section 987 loss of \$1,000 with respect to Japan Branch, and Japan Branch does not make a remittance. On December 31, year 9, the adjusted balance sheet of Japan Branch shows the following

assets and liabilities: cash of ¥120,000; raw land with a basis of ¥50,000; and liabilities of ¥10,000. Effective for year 10, U.S. Corp revokes the current rate election.

(B) *Operations in year 10.* In year 10, Japan Branch earns ¥12,000 for providing services and incurs ¥2,000 of related expenses. Japan Branch thus earns ¥10,000 of net income in year 10. On December 31, year 10, the adjusted balance sheet of Japan Branch shows the following assets and liabilities: cash of ¥130,000; raw land with a basis of ¥50,000; and liabilities of ¥10,000. Assume that the spot rate on December 31, year 9, is \$1 = ¥120; the spot rate on December 31, year 10, is \$1 = ¥130; and the yearly average exchange rate for year 10 is \$1 = ¥125. Thus, the ¥12,000 of services revenue when properly translated under §1.987-3(c)(1) at the yearly average exchange rate equals \$96.00 ($¥12,000 \times (\$1/¥125) = \96.00). The ¥2,000 of

expenses translated at the same yearly average exchange rate equals \$16.00 ($¥2,000 \times (\$1/¥125) = \16.00). Thus, Japan Branch's net income translated into dollars equals \$80. There are no transfers of assets or liabilities between U.S. Corp and Japan Branch in year 10.

(ii) *Analysis—(A) Determination of OFCNV for year 9.* Under paragraph (d)(1)(iv) of this section, the OFCNV of a section 987 QBU on the last day of the preceding taxable year is determined based on the elections that were (or were not) in effect on the last day of that taxable year. In year 9, a current rate election was in effect. Therefore, in determining the OFCNV of Japan Branch for year 9, all assets and liabilities of Japan Branch (including the land) are treated as marked items. The OFCNV of Japan Branch for year 9, is \$1,333.33, determined under paragraph (e) of this section as follows (together with the corresponding amounts in yen):

Table 5 to paragraph (g)(3)(ii)(A)

OFCNV—End of Year 9

<i>Assets</i>	<i>Amount in ¥</i>	<i>Translation Rate</i>	<i>Amount in \$</i>
Yen	¥120,000	\$1 = ¥120 (spot rate-12/31/year 9)	\$1,000.00
Land	¥50,000	\$1 = ¥120 (spot rate-12/31/year 9)	\$416.67
Total assets	¥170,000		\$1,416.67
<i>Liabilities</i>			
Bank loan	¥10,000	\$1 = ¥120 (spot rate-12/31/year 9)	\$83.33
Total liabilities	¥10,000		\$83.33
Year 9 ending net value	¥160,000		\$1,333.33

(B) *Determination of OFCNV for year 10.* In year 10, a current rate election is not in effect. Therefore, in determining the OFCNV of Japan Branch for year 10, the land owned by Japan Branch is treated as a historic item. Under §1.987-1(c)(3)(i)(F), the historic

rate applicable to historic items that were properly reflected on the books and records of Japan Branch on the last day of the last taxable year in which a current rate election was in effect (December 31, year 9) generally is equal to the spot rate applicable to that

day. Therefore, the historic rate applicable to the land is the spot rate on December 31, year 9. The OFCNV of Japan Branch for year 10 is \$1,339.74, determined under paragraph (e) of this section as follows (together with the corresponding amounts in yen):

Table 6 to paragraph (g)(3)(ii)(B)

OFCNV—End of Year 10

<i>Assets</i>	<i>Amount in ¥</i>	<i>Translation Rate</i>	<i>Amount in \$</i>
Yen	¥130,000	\$1 = ¥130 (spot rate-12/31/year 10)	\$1,000.00
Land	¥50,000	\$1 = ¥120 (historic rate-spot rate-12/31/year 9)	\$416.67
Total assets	¥180,000		\$1,416.67
<i>Liabilities</i>			
Bank loan	¥10,000	\$1 = ¥130 (spot rate-12/31/year 10)	\$76.92
Total liabilities	¥10,000		\$76.92
Year 10 ending net value	¥170,000		\$1,339.74

(C) *Determination of unrecognized section 987 gain or loss for year 10.* The unrecognized section 987 gain or loss of Japan Branch for year 10 is determined under paragraph (d) of this section as follows:

(1) *Step 1.* The change in the OFCNV of Japan Branch for year 10 is equal to the OFCNV of Japan Branch determined in dollars on the last day of year 10, less the OFCNV of Japan Branch determined in dollars on the last day of year 9. Therefore, the change in OFCNV is equal to \$6.41 (\$1,339.74 - \$1,333.33).

(2) *Steps 2 through 5 (no adjustment).* No adjustment is made under paragraphs (d)(2) through (5) of this section (Steps 2 through 5) because no assets or liabilities were transferred by U.S. Corp to Japan Branch or by Japan Branch to U.S. Corp during the taxable year.

(3) *Step 6.* Under paragraph (d)(6) of this section (Step 6), the amount determined in previous steps is decreased by the section 987 taxable income of Japan Branch of \$80.00, from \$6.41 to negative \$73.59.

(4) *Steps 7 through 10 (no adjustment).* No adjustment is made under paragraphs (d)(7) through (10) of this section (Steps 7 through 10) because all of Japan Branch's items of income or deduction for the taxable year impact the adjusted balance sheet and are taken into account in computing taxable income. In addition, Japan Branch does not have a residual increase or decrease to the adjusted balance sheet (because the change in net value of ¥10,000 is equal to the amount of Japan Branch's net income in year 10). Accordingly, the unrecognized section 987 loss of Japan Branch for year 10 is negative \$73.59.

(D) *Determination of net unrecognized section 987 gain or loss.* In year 10, Japan Branch has net accumulated section 987 loss of \$1,000. Because U.S. Corp revoked the current rate election for year 10, the net accumulated section 987 loss of \$1,000 becomes suspended section 987 loss under §1.987-11(d)(2) and Japan Branch's net accumulated section 987 loss is reduced to zero. Therefore, in year 10, Japan Branch's net unrecognized section 987 loss is equal to \$73.59, its unrecognized section 987 loss for year 10.

10. Section 1.987-5 is revised to read as follows:

§1.987-5 Recognition of section 987 gain or loss.

(a) *Recognition of section 987 gain or loss by the owner of a section 987 QBU.* The taxable income of an owner of a section 987 QBU includes the owner's section 987 gain or loss recognized with respect to the section 987 QBU for the taxable year. Except as otherwise provided in §1.987-7A(c)(4)(ii), 1.987-11(c), 1.987-12(b) or (e), or 1.987-13(h) or (k), for any taxable year the owner's section 987 gain or loss recognized with respect to a section 987 QBU is equal to:

(1) The owner's net unrecognized section 987 gain or loss with respect to

the section 987 QBU determined under §1.987-4 on the last day of such taxable year (or, if earlier, on the day the section 987 QBU is terminated under §1.987-8); multiplied by

(2) The owner's remittance proportion for the taxable year, as determined under paragraph (b) of this section.

(b) *Remittance proportion*—(1) *In general.* Except as provided in paragraph (b) (2) of this section, the owner's remittance proportion with respect to a section 987 QBU for a taxable year is equal to:

(i) The amount of the remittance, as determined under paragraph (c) of this section, to the owner from the section 987 QBU for such taxable year; divided by

(ii) The sum of:

(A) The aggregate adjusted basis of the gross assets of the section 987 QBU as of the end of the taxable year that are reflected on its year-end balance sheet translated into the owner's functional currency as provided in §1.987-4(e)(2); and

(B) The amount of the remittance, as determined under paragraph (c) of this section.

(2) *Annual recognition election.* A taxpayer may elect to recognize its net unrecognized section 987 gain or loss with respect to the section 987 QBU on an annual basis (*annual recognition election*). For any taxable year in which the annual recognition election is in effect, the owner's remittance proportion with respect to a section 987 QBU is one. See paragraph (g) of this section for an example illustrating this rule. Additionally, for any taxable year of an original deferral QBU owner in which an annual recognition election is in effect, the remittance proportion with respect to any successor deferral QBU is one.

(c) *Remittance*—(1) *Definition.* A remittance is determined in the owner's functional currency and equals the excess, if any, of:

(i) The aggregate of all amounts transferred from the section 987 QBU to the owner during the taxable year, as determined in paragraph (d) of this section; over

(ii) The aggregate of all amounts transferred from the owner to the section 987 QBU during the taxable year, as determined in paragraph (e) of this section.

(2) *Day when a remittance is determined.* An owner's remittance from a

section 987 QBU is determined on the last day of the owner's taxable year (or, if earlier, on the day the section 987 QBU is terminated under §1.987-8).

(3) *Termination.* A termination of a section 987 QBU as determined under §1.987-8 is treated as a remittance of all the gross assets of the section 987 QBU to the owner on the date of such termination. See §1.987-8(e). Accordingly, the remittance proportion in the case of a termination is one.

(d) *Aggregate of all amounts transferred from the section 987 QBU to the owner for the taxable year.* For purposes of paragraph (c)(1)(i) of this section, the aggregate of all amounts transferred from the section 987 QBU to the owner for the taxable year is the aggregate amount of functional currency and the aggregate adjusted basis of the other assets transferred, as determined in the owner's functional currency under §1.987-4(d) (2). Solely for this purpose, the amount of liabilities transferred from the owner to the section 987 QBU, as determined in the owner's functional currency under §1.987-4(d)(5), is treated as a transfer of assets from the section 987 QBU to the owner with an adjusted basis equal to the amount of such liabilities.

(e) *Aggregate of all amounts transferred from the owner to the section 987 QBU for the taxable year.* For purposes of paragraph (c)(1)(ii) of this section, the aggregate of all amounts transferred from the owner to the section 987 QBU for the taxable year is the aggregate amount of functional currency and the aggregate adjusted basis of the assets transferred, as determined in the owner's functional currency under §1.987-4(d)(3). Solely for this purpose, the amount of liabilities transferred from the section 987 QBU to the owner determined under §1.987-4(d) (4) is treated as a transfer of assets from the owner to the section 987 QBU with an adjusted basis equal to the amount of such liabilities.

(f) *Determination of owner's adjusted basis in transferred assets and amount of transferred liabilities*—(1) *In general.* The owner's adjusted basis in an asset or the amount of a liability received in a transfer from a section 987 QBU (whether or not such transfer is made in connection with a remittance) is determined in

the owner's functional currency under the rules prescribed in paragraphs (f)(2) and (3) of this section.

(2) *Marked items.* The basis of a marked asset or amount of a marked liability is the amount determined by translating the section 987 QBU's functional currency basis of the asset or amount of the liability, after taking into account §1.988-1(a)(10), into the owner's functional currency at the spot rate applicable to the date of transfer.

(3) *Historic items.* The basis of a historic asset or amount of a historic liability is the amount determined by translating the section 987 QBU's functional currency basis of the asset or amount of the liability, after taking into account §1.988-1(a)(10), into the owner's functional currency at the historic rate for the asset or liability.

(g) *Example.* The following example illustrates the calculation of section 987 gain or loss under this section. For purposes of this example, except as otherwise indicated, assume that no section 987 elections are in effect.

(1) *Facts*—(i) U.S. Corp, a domestic corporation with the dollar as its functional currency, operates in the United Kingdom through Business A, a section 987 QBU with the pound as its functional currency. During year 2, the following transfers took place between U.S. Corp and Business A. On January 5, year 2, U.S. Corp transferred to Business A \$300, which Business A used during the year to purchase services. On March 5, year 2, Business A transferred a machine to U.S. Corp. The pound adjusted basis of the machine when properly translated into dollars as described under §1.987-4(d)(2)(ii)(B) and paragraph (d) of this section is \$500. On November 1, year 2, Business A transferred pounds to U.S. Corp. The dollar amount of the pounds when properly translated as described under §1.987-4(d)(2)(ii)(A) and paragraph

(d) of this section is \$2,300. On December 7, year 2, U.S. Corp transferred a truck to Business A with an adjusted basis of \$2,000.

(ii) At the end of year 2, Business A holds assets, properly translated into the owner's functional currency pursuant to §1.987-4(e)(2), consisting of a computer with a pound adjusted basis equivalent to \$500, a truck with a pound adjusted basis equivalent to \$2,000, and pounds equivalent to \$2,850. In addition, Business A has a pound liability entered into in year 1 with Bank A. All such assets and liabilities are reflected on the books and records of Business A. Assume that the net unrecognized section 987 gain for Business A as determined under §1.987-4 as of the last day of year 2 is \$80.

(2) *Analysis.* U.S. Corp's section 987 gain with respect to Business A is determined as follows:

(i) *Computation of amount of remittance.* Under paragraphs (c)(1) and (2) of this section, U.S. Corp must determine the amount of the remittance for year 2 in the owner's functional currency (dollars) on the last day of year 2. The amount of the remittance for year 2 is \$500, determined as follows:

Table 1 to paragraph (g)(2)(i)

<i>Transfers from Business A to U.S. Corp in dollars:</i>	
Machine	\$500
Pounds	<u>2,300</u>
Aggregate transfers from Business A to U.S. Corp	\$2,800
<i>Transfers from U.S. Corp to Business A in dollars:</i>	
U.S. dollars	\$300
Truck	<u>2,000</u>
Aggregate transfers from U.S. Corp to Business A	\$2,300
<i>Computation of amount of remittance:</i>	
Aggregate transfers from Business A to U.S. Corp	\$2,800
Less: aggregate transfers from U.S. Corp to Business A	<u>(2,300)</u>
Total remittance	\$500

(ii) *Computation of section 987 QBU gross assets plus remittance.* Under paragraph (b)(1)(ii) of this section, Business A must determine the aggregate

basis of its gross assets that are reflected on its year-end balance sheet translated into the owner's

functional currency and must increase this amount by the amount of the remittance.

Table 2 to paragraph (g)(2)(ii)

Computer	\$500
Pounds	2,850
Truck	<u>2,000</u>
Aggregate gross assets	\$5,350
Remittance	\$500
Aggregate basis of Business A's gross assets at end of year 2, increased by amount of remittance	\$5,850

(iii) *Computation of remittance proportion.* Under paragraph (b) of this section, Business A must compute the remittance proportion by dividing the \$500 remittance amount by the \$5,850 sum of the aggregate basis of Business A's gross assets and the amount of the remittance. The resulting remittance proportion is 0.085.

(iv) *Computation of section 987 gain or loss.* The amount of U.S. Corp's section 987 gain or loss that is recognized with respect to Business A is determined under paragraph (a) of this section by multiplying the 0.085 remittance proportion by the \$80 of net unrecognized section 987 gain. U.S. Corp's resulting recognized section 987 gain for year 2 is \$6.80.

(3) *Annual recognition election.* If an annual recognition election under paragraph (b)(2) of this section were in effect for year 2, U.S. Corp's remittance proportion would be one. Accordingly, U.S. Corp would recognize all \$80 of the net unrecognized section 987 gain with respect to Business A.

11. Section 1.987-6, as proposed to be amended by 81 FR 88882 (December 8, 2016), is further amended by:

- a. Revising paragraph (a).
- b. Adding paragraph (b) introductory text.
- c. Revising paragraphs (b)(1) through (3), and (c).

The revisions and addition read as follows:

§1.987-6 Character and source of section 987 gain or loss.

(a) *Ordinary income or loss.* Section 987 gain or loss is ordinary income or loss for Federal income tax purposes.

(b) *Character and source of section 987 gain or loss.* With respect to each section 987 QBU, the character and source of section 987 gain or loss is determined under this paragraph (b) for all purposes of the Internal Revenue Code, including sections 904(d), 907, and 954. References to an owner in this paragraph (b) include a partner of a partnership (other than a section 987 aggregate partnership) or shareholder of an S corporation that has section 987 gain or loss attributable to a section 987 QBU owned by the partnership or S corporation.

(1) *Timing of character and source determination.* The character and source of section 987 gain or loss is determined based on the initial assignment pursuant to paragraph (b)(2)(i) of this section and may be reassigned in the year in which the section 987 gain or loss is recognized pursuant to paragraph (b)(2)(ii) of this section. The initial assignment is made in the earliest of the taxable years described in paragraphs (b)(1)(i) through (iv) of this section.

(i) The taxable year in which the net unrecognized section 987 gain or loss is recognized.

(ii) The taxable year in which the net unrecognized section 987 loss becomes suspended section 987 loss.

(iii) The taxable year in which the net unrecognized section 987 gain or loss becomes deferred section 987 gain or loss.

(iv) In the case of pretransition gain or loss that is recognized ratably over the transition period pursuant to the election under §1.987-10(e)(5)(ii), the taxable year that includes the transition date.

(2) *Method for determining the character and source of section 987 gain*

or loss—(i) *Initial assignment*—(A) *In general.* In a taxable year of the initial assignment, determined under paragraph (b)(1) of this section, the owner assigns gross section 987 gain or loss to the statutory and residual groupings in the same proportions as the proportions in which the tax book value of the assets of the section 987 QBU are assigned to the groupings under the asset method in §§1.861-9(g) and 1.861-9T(g), as modified by this paragraph (b)(2)(i). For purposes of applying the asset method, the owner takes into account only the assets that are attributed to the section 987 QBU under §1.987-2(b).

(B) *Special rules for applying the asset method to assign section 987 gain or loss.* For purposes of assigning gross section 987 gain or loss to the statutory and residual groupings under paragraph (b)(2)(i)(A) of this section, the proportions in which the tax book value of the assets of the section 987 QBU are assigned to the groupings described in paragraph (b)(2)(i)(A) of this section are determined without regard to section 987 gain or loss. Further, the section 987 gain or loss is assigned after any reattribution of gross income required under §1.904-4(f)(2)(vi) or 1.951A-2(c)(7)(ii)(B)(2) (or the principles thereof, as applicable), but before the allocation and apportionment of expenses or the application of provisions that are based on a net income computation, such as the high-tax exception to passive category income in §1.904-4(c), the high-tax exception to foreign base company income in §1.954-1(d), and the high-tax exclusion from tested income in §1.951A-2(c)(7).

(C) *Section 987 gain or loss that is assigned to subpart F income groups treated as attributable to section 988 transactions.* Section 987 gain or loss assigned under paragraphs (b)(2)(i)(A) and (B) of this section to a grouping described in §1.960-1(d)(2)(ii)(B)(2)(i) through (v) (subpart F income groups) is treated as foreign currency gain or foreign currency loss attributable to section 988 transactions not directly related to the business needs of the controlled foreign corporation and is taken into account for purposes of determining the excess of foreign currency gains over foreign currency losses characterized as foreign personal

holding company income under section 954(c)(1)(D).

(D) *Section 987 gain or loss assigned to tentative tested income rather than tested income*—(1) *In general.* In the case of a controlled foreign corporation, the initial assignment of section 987 gain or loss under paragraphs (b)(2)(i)(A) and (B) of this section is made as though the election described in §1.951A-2(c)(7)(viii) is in effect for the taxable year. As a result, section 987 gain or loss that would have initially been characterized as tested income in a section 904 category if no election under §1.951A-2(c)(7) was in effect is initially characterized as tentative tested income in the section 904 category (a tentative tested income group).

(2) *For purposes of the GILTI high-tax exclusion, section 987 gain or loss is not attributable to any tested unit.* In the case of a controlled foreign corporation, the initial assignment of section 987 gain or loss is made as though the section 987 gain or loss was not attributable to any tested unit for purposes of applying §1.951A-2(c)(7) (GILTI high-tax exclusion). See paragraph (b)(2)(iii) of this section (applying the GILTI high-tax exclusion by treating all section 987 gain or loss in the same tentative tested income group as composing a single tentative tested income item).

(E) *Initial assignment applies for purposes of the loss-to-the-extent-of-gain rule.* See §1.987-11(e) and (f) (grouping of section 987 gain and loss and applying the loss-to-the-extent-of-gain rule on basis of the initial assignment of section 987 gain and loss under this paragraph (b)(2)(i)).

(ii) *Reassignment of section 987 gain or loss.* In the taxable year in which section 987 gain or loss is recognized (determined by taking into account §§1.987-5, 1.987-11(e), 1.987-12(c), and 1.987-13(b) through (d), if applicable), the section 987 gain or loss is sourced and characterized based on the initial determination in paragraph (b)(2)(i)(B) of this section, but with appropriate changes to account for the application of provisions that are based on a net income computation such as the high-tax exception to passive category income in §1.904-4(c), the high-tax exception to foreign base company income in §1.954-1(d), and the high-tax exclusion to tested income in §1.951A-2(c)(7). Thus, for

example, if an election under §1.951A-2(c)(7)(viii) (GILTI high-tax exclusion) is in effect for the taxable year, section 987 gain or loss initially assigned to a tentative tested income group will be reassigned to a tested income group (as defined in §1.960-1(d)(2)(ii)(C)) or to the residual income group (as defined in §1.960-1(d)(2)(ii)(D)). If no election is made under §1.951A-2(c)(7)(viii) for a taxable year, all of the section 987 gain or loss that is recognized in the taxable year that was initially assigned to tentative tested income under paragraph (b)(2)(i) of this section, is reassigned to the appropriate tested income group (as defined in §1.960-1(d)(2)(ii)(C)).

(iii) *Special rule for the application of the GILTI high-tax exclusion to section 987 gain or loss.* Section 987 gain in a tentative tested income group that is recognized by a controlled foreign corporation in a taxable year comprises a single tentative gross tested income item (as if it were allocable to its own tested unit) within the meaning of §1.951A-2(c)(7)(ii), and section 987 loss in a tentative tested income group that is recognized by a controlled foreign corporation in the taxable year is allocated and apportioned to the corresponding tentative gross tested income item for purposes of calculating the tentative tested income item within the meaning of §1.951A-2(c)(7)(iii). Thus, for purposes of applying the high-tax exclusion in §1.951A-2(c)(7), all of the section 987 gain and loss in a tentative tested income group that is recognized by the controlled foreign corporation in a taxable year is a single tentative tested income item.

(3) *Allocation and apportionment of foreign income tax to section 987 items under section 861.* For purposes of applying the definition of a corresponding U.S. item in §1.861-20(b), an item of foreign gross income and an item of section 987 gain or loss are treated as arising from the same transaction or other realization event only if the requirements in both paragraphs (b)(3)(i) and (ii) of this section are satisfied.

(i) *The foreign gross income is an item of foreign currency gain or loss.* The owner of the section 987 QBU, original deferral QBU owner, or original suspended loss QBU owner includes

the foreign gross income under the laws of the foreign country in which it is a tax resident because under that foreign law it is required to recognize foreign currency gain or loss with respect to its interest in the section 987 QBU or with respect to a successor deferral QBU or successor suspended loss QBU.

(ii) *The same event or events give rise to both the foreign gross income and the section 987 gain or loss.* The remittance under §1.987-5(c) that gave rise to the item of section 987 gain or loss comprises one or more of the events that gave rise to the item of foreign gross income described in paragraph (b)(3)(i) of this section.

* * * * *

(c) *Examples.* The following examples illustrate the application of this section. For purposes of the examples, assume that no section 987 elections are in effect.

(1) *Example 1.* CFC is a controlled foreign corporation with the Swiss franc (*Sf*) as its functional currency. CFC is the owner of Business A, a section 987 QBU that has the euro as its functional currency. For year 1, CFC does not have an election described in §1.951A-2(c)(7)(viii) in effect, and CFC recognizes section 987 gain of *Sf*10,000 under §1.987-5. Business A has average total assets of *Sf*1,000,000 in year 1, which generate income (other than section 987 gain) as follows: *Sf*750,000 of assets that produce gross income in the statutory grouping for general category tested income under sections 904(d)(1)(A) and 951A; and *Sf*250,000 of assets that produce foreign source passive gross income in one of the groupings described in §1.960-1(d)(2)(ii)(B)(2)(i) through (v) (subpart F income groups). Under paragraphs (b)(2)(i)(A), (B), and (D) of this section, *Sf*7,500 (*Sf*750,000/*Sf*1,000,000 x *Sf*10,000) of the section 987 gain is initially assigned to the statutory grouping of foreign source general category tentative tested income. Because an election under §1.951A-2(c)(7)(viii) is not in effect for the taxable year in which the section 987 gain is recognized, the section 987 gain is reassigned under paragraph (b)(2)(ii) of this section to foreign source general category tested income. The remaining *Sf*2,500 (*Sf*250,000/*Sf*1,000,000 x *Sf*10,000) is characterized under paragraphs (b)(2)(i)(A) and (B) of this section by reference to assets that give rise to foreign source passive gross income in one of the groupings described in §1.960-1(d)(2)(ii)(B)(2)(i) through (v) (subpart F income groups) and is therefore treated under paragraph (b)(2)(i)(C) of this section as foreign source foreign currency gain taken into account for purpose of determining foreign personal holding company income under section 954(c)(1)(D). All of the section 987 gain is treated as ordinary income.

(2) *Example 2.* The facts are the same as in paragraph (c)(1) of this section (*Example 1*) except that: CFC recognizes section 987 loss of *Sf*40,000, *Sf*10,000 of which is characterized under paragraphs (b)(2)(i)(A) and (B) of this section by reference to assets that give rise to foreign source passive gross

income in one of the groupings described in §1.960-1(d)(2)(ii)(B)(2)(i) through (v) (subpart F income groups); and CFC otherwise has *Sf*12,000 of net foreign currency gain determined under §1.954-2(g) that is taken into account in determining the excess of foreign currency gain over foreign currency losses characterized as foreign personal holding company income under section 954(c)(1)(D). Under paragraph (b)(2)(i)(C) of this section, the *Sf*10,000 section 987 loss characterized by reference to assets that give rise to foreign source passive gross income in one of the groupings described in §1.960-1(d)(2)(ii)(B)(2)(i) through (v) (subpart F income groups) is treated as foreign currency loss taken into account under section 954(c)(1)(D) for purposes of computing foreign personal holding company income. Accordingly, CFC will aggregate the *Sf*10,000 section 987 loss with the *Sf*12,000 net foreign currency gain and will have *Sf*2,000 of net foreign currency gain characterized as passive foreign personal holding company income under section 954(c)(1)(D).

§1.987-7 [Redesignated as §1.987-7B]

12. Section 1.987-7 is redesignated as §1.987-7B.

13. Section 1.987-7A is added to read as follows:

§1.987-7A Partnerships and S corporations that own section 987 QBUs.

(a) *Scope and special rule—(1) In general.* This section provides rules applicable to partnerships (other than section 987 aggregate partnerships) and S corporations that own section 987 QBUs and their partners and shareholders. Paragraph (b) of this section provides the general rule that partnerships are treated as owners of section 987 QBUs. Paragraph (c) of this section provides special rules that apply to section 987 QBUs owned by partnerships and their partners. Paragraph (d) of this section provides rules for adjusting the partner's basis in its partnership interest for its section 987 gain or loss allocated from the partnership. Paragraph (e) of this section is reserved for rules regarding the treatment of section 987 gain or loss when a partner transfers or otherwise reduces its interest in a partnership. Paragraph (f) of this section is reserved for special rules regarding the source and character of section 987 gain and loss of a partner with respect to a section 987 QBU owned by a partnership that would apply in addition to §1.987-6. Paragraph (g) of this section provides that S corporations are treated

in the same manner as partnerships for purposes of the section 987 regulations. Paragraph (h) of this section provides examples.

(2) *References to partnerships are to non-section 987 aggregate partnerships.* For purposes of the section 987 regulations, references to “partnerships” are treated as references to partnerships that are not section 987 aggregate partnerships, except where the context otherwise requires.

(b) *Partnerships treated as owners of section 987 QBUs.* Except as otherwise provided, the section 987 regulations apply to a partnership that is the owner of a section 987 QBU in the same manner as they apply to other owners of section 987 QBUs. See paragraph (c) of this section and §1.987-1(b)(1)(ii) (de minimis rule), providing special rules for partnerships that are owners of a section 987 QBU. Thus, for example, if a partnership owns an eligible QBU with a functional currency that is different from the functional currency of the partnership, the eligible QBU is a section 987 QBU, the partnership is its owner, and the unrecognized section 987 gain or loss of the section 987 QBU for a taxable year is determined under §1.987-4(d) by reference to the functional currency of the partnership and the section 987 QBU.

(c) *Section 987 QBUs owned by partnerships—(1) Annual allocation of a partnership’s unrecognized section 987 gain or loss to its partners—(i) In general.* This paragraph (c)(1) applies to each taxable year of a partnership and with respect to each section 987 QBU of the partnership. A partnership determines its unrecognized section 987 gain or loss for a taxable year under §1.987-4(d) with respect to each section 987 QBU. The partnership allocates to each partner the partner’s share of the unrecognized section 987 gain or loss for a taxable year with respect to each section 987 QBU. The partnership determines each partner’s share of unrecognized section 987 gain or loss for a taxable year under paragraph (c)(1)(ii) of this section. Each partner translates its share of unrecognized section 987 gain or loss for a taxable year into the partner’s functional currency, if necessary, at the yearly average exchange rate for the partnership’s taxable year.

(ii) *Determination of partner’s share of unrecognized section 987 gain or loss.* A partnership determines a partner’s share of any unrecognized section 987 gain or loss for the taxable year with respect to a section 987 QBU based on the partner’s distributive share of profits or losses with respect to the section 987 QBU for the taxable year, as determined by the partnership agreement. The principles of section 706(d) apply to this determination.

(iii) *Partner-level attribute.* Net unrecognized section 987 gain or loss, deferred section 987 gain or loss, and suspended section 987 loss of a partner that are attributable to a partnership are attributes of the partner (not the partnership). As a result, the section 987 gain or loss cannot be used by the partnership or any other partner, including any person that acquires the partner’s partnership interest (other than in a transaction described in section 381(a)).

(2) *Net unrecognized section 987 gain or loss with respect to a section 987 QBU is determined at the partner level.* A partner determines its net unrecognized section 987 gain or loss with respect to a section 987 QBU owned by a partnership under §1.987-4(b) and (c) at the partner level by taking into account the partner’s share of unrecognized section 987 gain or loss with respect to the section 987 QBU owned by a partnership.

(3) *Recognition (or suspension) of net unrecognized section 987 gain or loss upon remittance.* With respect to a section 987 QBU owned by a partnership, a person that is a partner on the last day of the partnership’s taxable year determines the amount of its net unrecognized section 987 gain or loss that is recognized under §1.987-5(a) by reference to its net unrecognized section 987 gain or loss with respect to the section 987 QBU (after taking into account the adjustments under paragraphs (c)(1) and (4) of this section) and the partnership’s remittance proportion, as determined under §1.987-5(a)(2).

(4) *Deferred section 987 gain or loss and suspended section 987 loss—(i) Loss to the extent of gain rule applied at the partner level.* The amount of suspended section 987 loss recognized and taken into account by a partner under §1.987-11(e) (loss to the extent of gain rule) is determined by reference to section 987 gain recognized by the partner, without regard

to whether the section 987 gain is attributable to a section 987 QBU owned by a partnership.

(ii) *Partner- and partnership-level application of §§1.987-11 through 1.987-13—(A) Partner owns an interest in the partnership.* During the time in which a partner or its controlled group owns an interest in a partnership from which it was allocated unrecognized section 987 gain or loss, §§1.987-11 through 1.987-13 are applied by treating the partnership as the owner, original deferral QBU owner, or original suspended loss QBU owner, as appropriate, and treating the partner’s net unrecognized section 987 gain or loss as deferred section 987 gain or loss or suspended section 987 loss, as appropriate.

(B) *Termination of partner’s interest in the partnership.* If the partner ceases to own an interest in a partnership from which it was allocated unrecognized section 987 gain or loss, then each successor deferral QBU or successor suspended loss QBU of the partnership is retested under §1.987-12(b) or 1.987-13(c) and treated as if the partner had transferred the eligible QBU to its actual owner immediately after the partner ceased to own an interest in the partnership. Accordingly, if the owner of the eligible QBU is not a member of the partner’s controlled group, the partner may recognize its deferred section 987 gain or loss or suspended section 987 loss to the extent provided in §1.987-12(b) or 1.987-13(c).

(5) *Section 987 elections—(i) Elections made by the partnership.* Except as provided in paragraph (c)(6)(ii) of this section, section 987 elections are made by the partnership and apply to the partnership and section 987 gain or loss attributable to the partnership. See section 703(b); see also §1.987-1(g) (additional rules regarding section 987 elections).

(ii) *Elections made by partner—(A) Annual recognition election in certain cases.* If a person ceases to be a partner in a partnership and becomes an original deferral QBU owner or original suspended loss QBU owner, that person (and not the partnership) may make the annual recognition election under §1.987-5(b)(2) with respect to its deferred section 987 gain or loss or suspended section 987 loss that was originally attributable to a section 987 QBU of the partnership.

(B) *Election to recognize pretransition section 987 gain or loss ratably.* The election to recognize pretransition section 987 gain or loss ratably over the transition period under §1.987-10(e)(5)(ii) is made by a partner, and not the partnership.

(d) *Basis adjustments—(1) In general.* When, and to the extent that, a partner recognizes section 987 gain or loss, defers section 987 gain or loss, or suspends section 987 loss attributable to the partnership, the partner's adjusted basis in the partnership is adjusted under the principles of section 705 as if the item of income or loss was part of the partner's distributive share of partnership items.

(2) *Tiered-partnership structures.* If a partner (upper-tier partner) that adjusts its basis in a partnership under paragraph (d)(1) of this section owns the partnership indirectly through one or more other partnerships, the partner adjusts its basis in the partnership in which it owns a direct interest, and that partnership adjusts its basis in the partnership in which it owns a direct interest, with similar rules applying to each successive partnership through which the upper-tier partner owns its interest in the lower-tier partnership to which the section 987 gain or loss was attributable. The adjustment with respect to an interest in a lower-tier partnership constitutes a basis adjustment solely with respect to the partner that adjusts its basis in the upper-tier partnership under paragraph (d)(1) of this section.

(e) through (f) [Reserved]

(g) *S corporations treated as partnerships.* For purposes of the section 987 regulations, S corporations are treated in the same manner as partnerships and shareholders of S corporations are treated in the same manner as partners of partnerships. Thus, for example, if an S corporation is the owner of a section 987 QBU, the unrecognized section 987 gain or loss of the section 987 QBU would be allocated annually to its shareholders.

(h) *Examples.* The following examples illustrate the principles of this section. For purposes of these examples, DC1 and DC2 are domestic corporations, FC1 and FC2 are controlled foreign corporations that use the euro as their functional currency, DE1 and DE2 are disregarded entities, Business A is an eligible QBU that has the euro as its functional currency,

and Business B is an eligible QBU that has the pound as its functional currency. Each person is a calendar year taxpayer. Except as otherwise indicated, no section 987 elections are in effect during any of the periods described in the examples. Exchange rates used in these examples are selected for the purpose of illustrating the principles of this section and no inference is intended by their use.

(1) *Example 1—(i) Facts.* DC1 wholly owns FC1 and DC2 wholly owns FC2. FC1 and FC2 are not related within the meaning of section 267(b) or 707(b). FC1 and FC2 each own a 50 percent interest in P, a foreign partnership. P owns 100 percent of DE1, which owns Business A. P also owns 100 percent of DE2, which owns Business B. The partnership agreement provides that FC1 and FC2 will each be allocated 50 percent of the profits and losses from both Business A and Business B. P's functional currency is the euro.

(ii) *Analysis.* Because P's two partners, FC1 and FC2, are not related within the meaning of section 267(b) or 707(b), P is not treated as a section 987 aggregate partnership under §1.987-1(h). As a result, pursuant to §1.987-1(b)(5), P is the owner of Business A and Business B because it has direct ownership of Business A and Business B, each of which is an eligible QBU. Because Business A is an eligible QBU with the same functional currency as its owner, P, Business A is not a section 987 QBU under §1.987-1(b)(3)(i). However, Business B is an eligible QBU with a functional currency that is different from the functional currency of its owner, P. As a result, Business B is a section 987 QBU under §1.987-1(b)(3)(i), and P is its owner under §1.987-1(b)(5) and paragraph (b) of this section.

(2) *Example 2—(i) Facts.* The facts are the same as in paragraph (h)(1) of this section (*Example 1*). In year 1, P has unrecognized section 987 gain (determined under §1.987-4(d)) with respect to Business B of €100. In year 2, P has unrecognized section 987 loss with respect to Business B of €60. In year 3, P has unrecognized section 987 loss with respect to Business B of €120. In year 3, Business B transfers €50 to P on December 31. Following the transfer, its gross assets are €450. There are no other transfers between Business B and P in year 3.

(ii) *Analysis—(A) Partner's net unrecognized section 987 gain or loss.* Pursuant to paragraph (c)(1) of this section, in each of years 1, 2, and 3, P allocates to FC1 and FC2 their respective shares of the unrecognized section 987 gain or loss for the P taxable year with respect to its section 987 QBU, Business B. FC1 and FC2's share of the unrecognized section 987 gain or loss in each taxable year is based on their distributive share of the profits or losses with respect to Business B. Accordingly, in year 1, P allocates unrecognized section 987 gain of €50 to each of FC1 and FC2; in year 2, P allocates unrecognized section 987 loss of €30 to each of FC1 and FC2; and in year 3, P allocates unrecognized section 987 loss of €60 to each of FC1 and FC2. As a result, in year 3, before taking into account any amount recognized under §1.987-5, FC1 and FC2 each have net unrecognized section 987 loss with respect to Business B of €40

(€50 - €30 - €60) under §1.987-4(b) and paragraphs (c)(1) and (2) of this section.

(B) *Recognition of section 987 loss.* Because Business A distributed €50 to P in year 3, P's remittance proportion is 10 percent (€50 over the sum of €450 and €50) under §1.987-5(b). As a result, each partner, FC1 and FC2, recognizes 10 percent of its net unrecognized section 987 loss with respect to Business B under §1.987-5(a) and paragraph (c)(3) of this section. Accordingly, FC1 and FC2 each recognize €4 (€40 x 10 percent) section 987 loss in year 3 and have net accumulated unrecognized section 987 loss of €36 (€40 - €4) in year 4. FC1's adjusted basis in its partnership interest is reduced by €4 and FC2's adjusted basis in its partnership interest is reduced by €4 under the principles of section 705, under paragraph (d)(1) of this section.

(3) *Example 3—(i) The facts are the same as in paragraph (h)(2) of this section (Example 2), except that in years 1 through 3, FC1 has a current rate election in effect and FC2 has an annual recognition election in effect.*

(ii) *Analysis.* The analysis is the same as in paragraph (h)(2) of this section (*Example 2*). Because P does not have a current rate election in effect, FC1 can recognize the section 987 loss of €4 in year 3 without limitation under §1.987-11(e) pursuant to paragraph (c)(5)(i) of this section. Similarly, because P does not have an annual recognition election in effect, while FC2 is a partner in P, FC2 does not recognize its section 987 gain or loss with respect to Business B on an annual basis pursuant to paragraphs (c)(5)(i) and (c)(5)(ii)(A) of this section.

(4) *Example 4—(i) Facts.* The facts are the same as in paragraph (h)(2) of this section (*Example 2*), except that FC2 has the Japanese yen as its functional currency during all relevant time periods. The yearly average exchange rate is €1 = ¥150 in year 1; €1 = ¥175 in year 2; and €1 = ¥125 in year 3.

(ii) *Analysis.* Each year, FC2 converts its share of P's unrecognized section 987 gain or loss into yen at the yearly average exchange rate pursuant to paragraph (c)(1)(i) of this section. As a result, in year 1, FC2's share of the unrecognized section 987 gain with respect to Business B is ¥7,500 (€50 section 987 gain converted to yen at the yearly average exchange rate of €1 = ¥150); in year 2, FC2's share of the unrecognized section 987 loss with respect to Business B is ¥5,250 (€30 section 987 loss converted to yen at the yearly average exchange rate of €1 = ¥175); and in year 3, FC2's share of the unrecognized section 987 loss with respect to Business B is ¥7,500 (€60 section 987 loss converted to yen at the yearly average exchange rate of €1 = ¥125). In year 3, FC2's net unrecognized section 987 loss with respect to Business B is ¥5,250 (¥7,500 - ¥5,250 - ¥7,500). As explained in paragraph (h)(2)(i)(B) of this section (*Example 2*), P's remittance proportion with respect to Business B is 10 percent. Therefore, FC2 recognizes section 987 loss of ¥525 under §1.987-5(a) and paragraph (c)(3) of this section. FC2's net accumulated unrecognized section 987 loss with respect to Business B in year 4 is ¥4,725 (¥5250 - ¥525). FC2's adjusted basis in its partnership interest is reduced by ¥525 under the principles of section 705, under paragraph (d)(1) of this section.

§1.987-7B [Amended]

14. In newly redesignated §1.987-7B amend paragraph (a) by removing the language “§1.987-1(b)(4)(ii)” and adding the language “§1.987-1(b)(5)(ii)” in its place.

15. Section 1.987-7C is added to read as follows:

§1.987-7C Transitioning between partnership and section 987 aggregate partnership treatment.

(a) *In general.* This section provides rules for when a partnership becomes or ceases to be a section 987 aggregate partnership. Paragraph (b) of this section provides transition rules regarding partnerships that cease to be section 987 aggregate partnerships but continue to be partnerships. Paragraph (c) of this section provides transition rules regarding partnerships that were not section 987 aggregate partnerships but become section 987 aggregate partnerships. See §1.987-1(h) for the definition of a section 987 aggregate partnership.

(b) *Partnership ceases to be a section 987 aggregate partnership—(1) In general.* Solely for purposes of section 987, when a partnership ceases to be a section 987 aggregate partnership but continues to be a partnership, each eligible QBU (*pre-termination QBU*) of a partner owned indirectly through the section 987 aggregate partnership is deemed to terminate and transfer all its assets and liabilities to the partnership (the *deemed termination*) and the partnership is then treated as forming each of its eligible QBUs (each, a *post-termination QBU*) and transferring to each post-termination QBU the assets and liabilities of the post-termination QBU (including those assets and liabilities that were assets and liabilities of a pre-termination QBU).

(2) *Section 987 gain or loss with respect to pre-termination QBU.* Notwithstanding the deemed termination described in paragraph (b)(1) of this section, if, immediately before the deemed termination, a partner had any net unrecognized section 987 gain or loss or suspended section 987 loss with respect to a pre-termination QBU that was a section 987 QBU, and after the deemed termination, the assets and liabilities of the pre-termination QBU

are assets and liabilities of a post-termination QBU, then either paragraph (b)(2)(i) or (ii) of this section applies.

(i) *Post-termination QBU is a section 987 QBU.* If the post-termination QBU is a section 987 QBU, then—

(A) Section 1.987-12 (deferral of section 987 gain and loss) does not apply to the deemed termination; and

(B) The partner's net unrecognized section 987 gain or loss or suspended section 987 loss with respect to the pre-termination QBU is not recognized and instead becomes net unrecognized section 987 gain or loss or suspended section 987 loss with respect to the post-termination QBU that is treated as having been allocated to the partner by the partnership.

(ii) *Post-termination QBU is not a section 987 QBU.* If paragraph (b)(2)(i) of this section does not apply, then §1.987-13 (rules relating to suspended section 987 loss upon termination) is applied to the transactions described in paragraph (b)(1) of this section as if the partner had transferred the assets and liabilities of the pre-termination QBU to the partnership. Thus, if the partner had suspended section 987 loss with respect to the pre-termination QBU, §1.987-13(b) may apply to the deemed transfer and the post-termination QBU may be a successor suspended loss QBU. See §§1.987-5, 1.987-8, 1.987-11, and 1.987-13 for rules regarding when section 987 gain or loss is recognized on terminations.

(3) *Successor deferral QBUs and successor suspended loss QBUs.* If a section 987 aggregate partnership ceases to be a section 987 aggregate partnership (the *transition*)—

(i) If any pre-termination QBU was a successor deferral QBU before the transition, the successor deferral QBU is treated as transferring its assets and liabilities to the post-termination QBU that holds the assets and liabilities after the transition for purposes of §§1.987-12 and 1.987-13. See §1.987-12(c)(2).

(ii) If any pre-termination QBU was a successor suspended loss QBU before the transition, the successor suspended loss QBU is treated as transferring its assets and liabilities to the post-termination QBU that hold the assets and liabilities after the transition for purposes of §1.987-13. See §1.987-13(c).

(4) *Timing.* If a partnership ceases to be a section 987 aggregate partnership within the meaning of §1.987-1(h), the partnership continues to be treated as a section 987 aggregate partnership until this paragraph (b) is applied. This paragraph (b) is applied immediately after the transaction (or series of transactions) or event (or series of events) that causes the partnership to cease to be a section 987 aggregate partnership (the *transition*). Thus, for example, if person acquires an interest in a section 987 aggregate partnership from a partner, and the person is not related to the other partners within the meaning of section 267(b) or 707(b), first the section 987 regulations (such as §1.987-2(c)(5)) are applied to the transition as if the partnership continued to be a section 987 aggregate partnership; then this paragraph (b) applies to the partnership and its partners (including the acquiring partner) and the partnership ceases to be a section 987 aggregate partnership.

(c) *Partnership becomes a section 987 aggregate partnership—(1) In general.* Solely for purposes of section 987, when a partnership that was not a section 987 aggregate partnership becomes a section 987 aggregate partnership, each eligible QBU (*pre-termination QBU*) of the partnership is deemed to terminate and transfer all of its assets and liabilities to the partnership (the *deemed termination*) and the partnership is treated as forming each eligible QBU (*post-termination QBU*) that is indirectly owned by a partner (the *partner-owner*) and transferring to each post-termination QBU the partner-owner's share of the assets and liabilities of the partnership's eligible QBU.

(2) *Section 987 gain or loss with respect to pre-termination QBU.* Notwithstanding the deemed termination described in paragraph (c)(1) of this section, if a partner-owner had any net unrecognized section 987 gain or loss or suspended section 987 loss with respect to a pre-termination QBU that was a section 987 QBU, then either paragraph (c)(2)(i) or (ii) of this section applies.

(i) *Post-termination QBU is a section 987 QBU.* If, after the deemed termination, the partner-owner's indirectly owned post-termination QBU that relates to its share of the assets and liabilities of the pre-termination QBU is a section 987 QBU of the partner-owner, then—

(A) Section 1.987-12 does not apply to the deemed termination of the pre-termination QBU; and

(B) The partner-owner's net unrecognized section 987 gain or loss or suspended section 987 loss with respect to the pre-termination QBU is not recognized and instead becomes net unrecognized section 987 gain or loss or suspended section 987 loss with respect to the post-termination QBU.

(ii) *Post-termination QBU is not a section 987 QBU.* If paragraph (c)(2)(i) of this section does not apply, then paragraphs (c)(2)(ii)(A) and (B) of this section are applied sequentially.

(A) First, paragraph (c)(2)(i) of this section is applied as if the post-termination QBU was a section 987 QBU (the *deemed section 987 QBU*) after the deemed termination.

(B) Second, the section 987 regulations are applied as if the deemed section 987 QBU had transferred its assets and liabilities to the post-termination QBU. Thus, if the partner-owner had suspended section 987 loss with respect to the pre-termination QBU, §1.987-13(b) may apply to the deemed transfer and the post-termination QBU may be a successor suspended loss QBU. See §§1.987-5, 1.987-8, 1.987-11, and 1.987-13 for rules regarding when section 987 gain or loss is recognized on terminations.

(3) *Successor deferral QBUs and successor suspended loss QBUs.* If a partnership that was not a section 987 aggregate partnership becomes a section 987 aggregate partnership (the *transition*)—

(i) If the partnership owned any successor deferral QBUs before the transition, each successor deferral QBU is treated as transferring its assets and liabilities to the indirectly owned QBUs that hold the assets and liabilities after the transition for purposes of §§1.987-12 and 1.987-13. See §1.987-12(c)(2).

(ii) If the partnership owned any successor suspended loss QBUs before the transition, each successor suspended loss QBU is treated as transferring its assets and liabilities to the indirectly owned QBUs that hold the assets and liabilities after the transition for purposes of §1.987-13. See §1.987-13(c).

(iii) If the partnership was an original deferral QBU owner with respect to a

successor deferral QBU before the transition, each partner that has deferred section 987 gain or loss with respect to the successor deferral QBU becomes an original deferral QBU owner with respect to the successor deferral QBU for purposes of §1.987-12.

(iv) If the partnership was an original suspended loss QBU owner with respect to a successor suspended loss QBU before the transition, each partner that has suspended section 987 loss with respect to the successor suspended loss QBU becomes an original suspended loss QBU owner with respect to the successor suspended loss QBU.

(4) *Timing.* If a partnership that was not a section 987 aggregate partnership becomes a section 987 aggregate partnership within the meaning of §1.987-1(h), the partnership is not treated as a section 987 aggregate partnership until this paragraph (c) is applied. This paragraph (c) is applied immediately after the transaction (or series of transactions) or event (or series of events) that causes the partnership to become a section 987 aggregate partnership (the *transition*). Thus, for example, if a person acquires an interest in a partnership that is not a section 987 aggregate partnership from a partner, and as a result of the acquisition, all of the partners are related within the meaning of section 267(b) or 707(b), first the section 987 regulations (such as §1.987-7A(e)) are applied to the transition as if the partnership was not a section 987 aggregate partnership; then this paragraph (c) applies to the partnership and its partners (including the acquiring partner) and the partnership becomes a section 987 aggregate partnership.

16. Section 1.987-8 is amended by:

a. Adding a fourth sentence after the third sentence in paragraph (a);

b. Revising paragraph (b) introductory text;

c. In paragraph (b)(2) in the second sentence removing the language “shall be” and adding the language “is” in its place and revising the last sentence;

d. In paragraph (b)(3) in the first sentence removing the language “(as defined in section 957)”;

e. Adding paragraphs (b)(5) and (6);

f. Revising paragraph (c);

g. In paragraph (d) removing the text “For further guidance, see §1.987-8T(d)”;

h. Revising the second and third sentences in paragraph (e);

i. Designating *Examples 1* through 7 of paragraph (f) as paragraphs (f)(1) through (7).

j. In newly designated paragraph (f)(1):

i. Removing the language “2021” wherever it appears and adding the language “year 1” in its place; and

ii. Removing the language “2022” wherever it appears and adding the language “year 2” in its place;

k. Adding the language “the” before “Business A section 987 QBU” in the last sentence of newly designated paragraph (f)(1)(ii);

l. Revising newly designated paragraph (f)(3);

m. In newly designated paragraph (f)(4)(i), removing the language “transfers” and adding the language “distributes” in its place;

n. Removing and reserving newly designated paragraph (f)(5);

o. In newly designated paragraph (f)(6):

i. Removing the language “2021” wherever it appears and adding the language “year 1” in its place; and

ii. Removing the language “2026” wherever it appears and adding the language “year 6” in its place;

p. In newly designated paragraph (f)(6)(ii)(A), removing the language “§1.987-1(b)(4)(i)” and adding the language “§1.987-1(b)(5)” in its place.

The revisions and additions read as follows:

§1.987-8 Termination of a section 987 QBU.

(a) * * * Paragraph (d) of this section is reserved. * * *

(b) *In general.* Except as provided in paragraph (c) of this section, a section 987 QBU terminates if the conditions described in any one of paragraphs (b)(1) through (6) of this section are satisfied.

* * * * *

(2) * * * See paragraphs (f)(2), (5), and (6) of this section (*Examples 2, 5, and 6*).

* * * * *

(5) *Section 987 QBU ceases to be an eligible QBU with a functional currency different from its owner.* The section 987 QBU ceases to be an eligible QBU that

has a functional currency different from its owner. *See also* §1.985-5(d)(2) (section 987 QBU changes its functional currency to that of its owner) and (e)(4)(iii) (owner changes its functional currency to that of its section 987 QBU).

(6) *Change in form of ownership.* The owner of the section 987 QBU changes its form of ownership of the section 987 QBU from direct ownership to indirect ownership, or from indirect ownership to direct ownership.

(c) *Transactions described in section 381(a)—(1) Liquidations.* Notwithstanding paragraph (b) of this section, a termination does not occur when the owner (*distributor*) of a section 987 QBU ceases to exist in a liquidation described in section 332 pursuant to which it transfers the section 987 QBU to another corporation (*distributee*), except in the following cases:

(i) The distributor is a domestic corporation and the distributee is a foreign corporation.

(ii) The distributor is a foreign corporation and the distributee is a domestic corporation.

(iii) The distributor and the distributee are both foreign corporations and the functional currency of the distributee is the same as the functional currency of the distributor's section 987 QBU.

(2) *Reorganizations.* Notwithstanding paragraph (b) of this section, a termination does not occur when the owner (*transferor*) of the section 987 QBU ceases to exist in a reorganization described in section 381(a)(2) pursuant to which it transfers the section 987 QBU to another corporation (*acquiring corporation*), except in the following cases:

(i) The transferor is a domestic corporation and the acquiring corporation is a foreign corporation.

(ii) The transferor is a foreign corporation and the acquiring corporation is a domestic corporation.

(iii) The transferor is a controlled foreign corporation immediately before the transfer, the acquiring corporation is a foreign corporation that is not a controlled foreign corporation immediately after the transfer, and the acquiring corporation was related to the transferor within the meaning of section 267(b) immediately before the transfer.

(iv) The transferor and the acquiring corporation are foreign corporations and the functional currency of the acquiring corporation is the same as the functional currency of the transferor's section 987 QBU.

(e) * * * Thus, except as otherwise provided in the section 987 regulations, a termination generally results in the recognition of any net unrecognized section 987 gain or loss of the section 987 QBU (unless it is treated as deferred section 987 gain or loss or suspended section 987 loss). *See* §§1.987-5(c)(3) (generally recognizing section 987 gain or loss on a termination) and 1.987-11 through 1.987-13 (suspending section 987 gain or loss and deferring section 987 loss in certain instances).

(f) * * *

(3) *Example 3. Cessation of controlled foreign corporation status—(i) Facts.* Foreign parent (FP) is a foreign corporation that owns all the stock of U.S. Corp, a domestic corporation. U.S. Corp owns all of the stock of FC, a controlled foreign corporation as defined in section 957. FC is the owner of Business A. U.S. Corp liquidates into FP. FC no longer constitutes a controlled foreign corporation after the liquidation.

(ii) *Analysis.* Because FC ceases to qualify as a controlled foreign corporation as a result of a transaction after which persons that were related to FC within the meaning of section 267(b) immediately before the transaction collectively own sufficient interests in FC such that FC would continue to be considered a controlled foreign corporation if such persons were United States shareholders within the meaning of section 951(b), the Business A section 987 QBU terminates pursuant to paragraph (b)(3) of this section.

17. Section 1.987-9 is revised to read as follows:

§1.987-9 Recordkeeping requirements.

(a) *In general.* An owner (or the authorized person on behalf of an owner) must keep a copy of each section 987 election made by or on behalf of an owner (if not required to be made on a form published by the Commissioner) and reasonable records sufficient to establish a section 987 QBU's taxable income or loss and section 987 gain or loss.

(b) *Supplemental information.* A person's obligation to maintain records under section 6001 and paragraph (a) of this section is not satisfied unless the following

information is maintained in those records with respect to each section 987 QBU, successor deferral QBU, and successor suspended loss QBU for each taxable year:

(1) The amount of the items of income, gain, deduction, or loss attributed to the section 987 QBU in the functional currency of the section 987 QBU and its owner.

(2) The adjusted balance sheet of the section 987 QBU in the functional currency of the section 987 QBU and its owner.

(3) The exchange rates used to translate items of income, gain, deduction, or loss of the section 987 QBU into the owner's functional currency and, if a spot rate convention is used, the manner in which the convention is determined.

(4) The exchange rates used to translate the assets and liabilities of the section 987 QBU into the owner's functional currency and, if a spot rate convention is used, the manner in which the convention is determined.

(5) The amount of assets and liabilities transferred by the owner to the section 987 QBU determined in the functional currency of the owner.

(6) The amount of assets and liabilities transferred by the section 987 QBU to the owner determined in the functional currency of the owner.

(7) The amount of the unrecognized section 987 gain or loss for the taxable year.

(8) The amount of the net accumulated unrecognized section 987 gain or loss at the close of the taxable year.

(9) The amount of a remittance and the remittance proportion for the taxable year.

(10) The computations required under §§1.861-9(g) and 1.861-9T(g) for purposes of sourcing and characterizing section 987 gain or loss, deferred section 987 gain or loss, or suspended section 987 loss under §1.987-6.

(11) The cumulative suspended section 987 loss in each recognition grouping.

(12) The outstanding deferred section 987 gain or loss in each recognition grouping.

(13) The transition information required to be determined under §1.987-10(k).

(c) *Retention of records.* The records required by this section, or records that

support the information required on a form published by the Commissioner regarding section 987, must be maintained and kept available for inspection by the Internal Revenue Service for so long as the contents thereof may become relevant in the administration of the Internal Revenue Code.

(d) *Information on a dedicated section 987 form.* Information necessary to determine section 987 gain or loss and section 987 taxable income or loss must be reported on a form prescribed for that purpose in accordance with the instructions accompanying that form. A taxpayer satisfies its obligation described in paragraphs (a) and (b) of this section to the extent that the taxpayer provides the specific information required on Form 8858 (or its successor) or other form prescribed for this purpose (including the information required by the instructions accompanying those forms).

18. Section 1.987-10 is revised to read as follows:

§1.987-10 Transition rules.

(a) *Overview—(1) In general.* This section provides transition rules for the first taxable year in which the section 987 regulations apply. This paragraph (a) provides an overview of this section. Paragraph (b) of this section describes the scope of this section's application. Paragraph (c) of this section provides rules for determining the transition date. Paragraph (d) of this section provides rules relating to the application of the section 987 regulations after the transition date. Paragraph (e) of this section provides rules relating to the determination and recognition of pretransition gain or loss. Paragraph (f) of this section provides special rules for section 987 QBUs to which the fresh start transition method was applied. Paragraph (g) of this section provides transition rules relating to partnerships. Paragraph (h) of this section provides rules relating to the source and character of pretransition gain or loss. Paragraph (i) of this section is reserved. Paragraph (j) of this section provides adjustments to avoid double counting or omissions. Paragraph (k) of this section provides reporting requirements that apply in the taxable year beginning on the transition date. Paragraph (l) of this

section provides examples illustrating the rules of this section.

(2) *Terms defined under prior §1.987-12.* For purposes of this section, the terms *deferral QBU*, *deferral QBU owner*, *successor QBU*, *outbound loss QBU*, *outbound section 987 loss*, and *qualified successor* have the meaning provided in prior §1.987-12.

(b) *Scope—(1) Owner of a section 987 QBU.* Except as provided in paragraph (f) of this section, any person that is an owner of a section 987 QBU on the applicable transition date must apply the rules of this section with respect to the section 987 QBU.

(2) *Deferral QBU owner and owner of outbound loss QBU.* Except as provided in paragraph (f) of this section, a deferral QBU owner or the owner of an outbound loss QBU must apply the rules of this section with respect to the deferral QBU or outbound loss QBU if the deferral event or outbound loss event occurred before the applicable transition date.

(c) *Transition date—(1) In general.* Except as provided in paragraph (c)(2) of this section, the transition date for a section 987 QBU, deferral QBU, or outbound loss QBU is the first day of the first taxable year described in §1.987-14(a)(1), (b), or (c) to which this section applies.

(2) *Terminating QBU.* With respect to a terminating QBU, the transition date is the termination date, and this section is applied immediately before the termination. Until the transition date described in paragraph (c)(1) of this section, the owner of the terminating QBU must apply the section 987 regulations with respect to the terminating QBU, and any section 987 gain or loss attributable thereto, without regard to any section 987 elections.

(d) *Application of the section 987 regulations after the transition date—(1) Owner functional currency net value on the last day of the preceding taxable year.* Except as provided in paragraph (f) of this section, for purposes of applying §1.987-4 in the taxable year beginning on the transition date, the owner functional currency net value of a section 987 QBU on the last day of the preceding taxable year under §1.987-4(d)(1)(B) is determined by translating the assets and liabilities that are attributable to the section 987 QBU on the day before the transition date into the

owner's functional currency at the spot rate applicable to the day before the transition date.

(2) *Determination of historic rate and adjustments required under the simplified inventory method.* If a current rate election is not in effect for the taxable year beginning on the transition date, the historic rate for historic items that are attributable to a section 987 QBU on the day before the transition date (other than non-LIFO inventory subject to the simplified inventory method under §1.987-3(c)(2)(iv)(A)) is the spot rate applicable to the day before the transition date. The exchange rates used to apply §1.987-3(c)(3) (adjustments required under the simplified inventory method) are determined as though a current rate election was in effect for the previous taxable year and was revoked for the taxable year beginning on the transition date.

(e) *Pretransition gain or loss—(1) In general.* Except as provided in paragraph (f) of this section, pretransition gain or loss is determined and recognized under this paragraph (e).

(2) *Amount of pretransition gain or loss for an owner that applied an eligible pretransition method—(i) Owner of a section 987 QBU.* If an owner of a section 987 QBU applied an eligible pretransition method with respect to the section 987 QBU, the amount of pretransition gain or loss with respect to the section 987 QBU is equal to the sum of the deemed termination amount described in paragraph (e)(2)(i)(A) of this section and the owner functional currency net value adjustment described in paragraph (e)(2)(i)(B) of this section. See paragraphs (l)(1) through (3) of this section (*Examples 1 through 3*) for an illustration of this rule.

(A) *Deemed termination amount.* The deemed termination amount is the amount of section 987 gain or loss that would have been recognized by the owner under the eligible pretransition method if the section 987 QBU terminated and transferred all of its assets and liabilities to the owner on the day before the transition date and prior §1.987-12 did not apply.

(B) *Owner functional currency net value adjustment.* The owner functional currency net value adjustment may be either positive or negative and is equal to the amount described in paragraph (e)

(2)(i)(B)(1) of this section reduced by the amount described in paragraph (e)(2)(i)(B)(2) of this section.

(1) The basis of the assets, reduced by the amount of liabilities, that are attributable to the section 987 QBU on the day before the transition date, translated into the owner's functional currency at the spot rate applicable to the day before the transition date.

(2) The basis of the assets, reduced by the amount of liabilities, that are attributable to the section 987 QBU on the day before the transition date, translated into the owner's functional currency at the pretransition translation rate on the day before the transition date.

(C) *Pretransition translation rate.* The pretransition translation rate is the rate that would be used under the eligible pretransition method to determine the basis of an asset or the amount of a liability in the hands of the owner of a section 987 QBU if the section 987 QBU transferred all of its assets and liabilities to the owner.

(ii) *Deferral QBU owner.* If a deferral QBU owner applied an eligible pretransition method with respect to the deferral QBU, the amount of pretransition gain or loss with respect to the deferral QBU is equal to the deferred section 987 gain or loss (determined under prior §1.987-12) that was not recognized before the transition date with respect to the deferral QBU.

(iii) *Owner of an outbound loss QBU.* If the owner of an outbound loss QBU applied an eligible pretransition method with respect to the outbound loss QBU, the pretransition loss with respect to the outbound loss QBU is equal to the outbound section 987 loss that was not added to the basis of stock or recognized under prior §1.987-12 before the transition date with respect to the outbound loss QBU.

(3) *Amount of pretransition gain or loss for an owner that did not apply an eligible pretransition method—(i) In general.* If the owner of a section 987 QBU did not apply an eligible pretransition method with respect to a section 987 QBU, the amount of pretransition gain or loss with respect to the section 987 QBU is determined under paragraph (e)(3)(ii) of this section. See paragraph (1)(4) of this section (*Example 4*) for an illustration of this rule.

(ii) *Computation of pretransition gain or loss.* With respect to a section 987 QBU described in paragraph (e)(3)(i) of this section, pretransition gain or loss is equal to the amount described in paragraph (e)(3)(ii)(A) of this section reduced by the amount described in paragraph (e)(3)(ii)(B) of this section.

(A) The sum of the owner's annual unrecognized section 987 gain or loss determined under paragraph (e)(3)(iii) of this section with respect to the section 987 QBU for all taxable years ending before the transition date in which it was the owner of the section 987 QBU.

(B) The total net amount of section 987 gain or loss recognized by the owner with respect to the section 987 QBU in all taxable years ending before the transition date.

(iii) *Annual unrecognized section 987 gain or loss.* An owner of a section 987 QBU described in paragraph (e)(3)(i) of this section determines annual unrecognized section 987 gain or loss with respect to a section 987 QBU under the rules of §1.987-4(d), applied as though a current rate election was in effect for all relevant taxable years, and subject to the following modifications—

(A) Only §1.987-4(d)(1) and (10) (steps 1 and 10) are applied;

(B) Section 1.987-4(d)(10) is applied by replacing “paragraphs (d)(1) through (9)” with “paragraph (d)(1).”

(iv) *Deferral QBU owner.* If a deferral QBU owner did not apply an eligible pretransition method with respect to the deferral QBU, the pretransition gain or loss with respect to the deferral QBU is equal to the amount that would be determined under paragraph (e)(3)(ii) of this section with respect to the deferral QBU if the transition date was the day of the deferral event, reduced by the amount of deferred section 987 gain or loss (determined under prior §1.987-12) recognized before the actual transition date.

(v) *Owner of an outbound loss QBU.* If the owner of an outbound loss QBU did not apply an eligible pretransition method with respect to the outbound loss QBU, the pretransition loss with respect to the outbound loss QBU is equal to the amount that would be determined under paragraph (e)(3)(ii) of this section with respect to the outbound loss QBU if the transition date

was the day of the outbound loss event, reduced by any outbound section 987 loss recognized or added to the basis of stock under prior §1.987-12 before the actual transition date.

(4) *Eligible pretransition method.* An eligible pretransition method means a method of applying section 987 before the transition date that is described in paragraphs (e)(4)(i) through (iii) of this section. An owner is treated as applying an eligible pretransition method with respect to a section 987 QBU only if it applied an eligible pretransition method with respect to each taxable year beginning before the transition date in which it was the owner of the section 987 QBU and any permissible change in pretransition method was applied in a reasonable manner that would not result in income, gain, deduction, or loss (including section 987 gain or loss) being taken into account more than once or not being taken into account.

(i) *Earnings and capital method.* An earnings and capital method is an eligible pretransition method if it is applied in a reasonable manner. For purposes of this paragraph (e)(4)(i), an earnings and capital method means a method of applying section 987 that requires section 987 gain or loss to be determined and recognized with respect to both the earnings of the section 987 QBU and capital contributed to the section 987 QBU (for example, the method prescribed in the 1991 proposed regulations under section 987). See paragraph (1)(1) of this section (*Example 1*) for an illustration of this rule.

(ii) *Other reasonable methods.* Any reasonable method of applying section 987 is an eligible pretransition method if it produces the same total amount of income over the life of the owner of a section 987 QBU as the method described in paragraph (e)(4)(i) of this section (taking into account the aggregate of section 987 gain or loss, section 987 taxable income or loss, and income or loss recognized by the owner of the section 987 QBU with respect to property transferred between the section 987 QBU and the owner or any QBU of the owner). See paragraph (1)(2) of this section (*Example 2*) for an illustration of this rule.

(iii) *Other earnings only methods.* An earnings only method (which determines section 987 gain or loss only with respect

to the earnings of a section 987 QBU) that does not meet the requirements of paragraph (e)(4)(ii) of this section is an eligible pretransition method, provided that—

(A) The earnings only method was first applied by the owner on a return filed before November 9, 2023;

(B) The earnings only method was applied consistently to all section 987 QBUs of the owner; and

(C) The owner of the section 987 QBU otherwise applies section 987 in a reasonable manner. See paragraph (l)(3) of this section (*Example 3*) for an illustration of this rule.

(iv) *Reasonable method must require recognition of section 987 gain or loss upon a transfer of property from the section 987 QBU.* For purposes of this paragraph (e)(4), a method of applying section 987 is not reasonable unless the owner of the section 987 QBU recognizes section 987 gain or loss upon a transfer of property from the section 987 QBU to the owner (or recognizes section 987 gain or loss on an annual basis). Therefore, a method under which the owner of a section 987 QBU defers the recognition of section 987 gain or loss until the section 987 QBU is terminated, sold, or liquidated is not a reasonable method.

(v) *Anti-abuse rule.* If an owner changes its pretransition method of applying section 987 with a principal purpose of reducing its pretransition gain or increasing its pretransition loss, the Commissioner may redetermine pretransition gain or loss based on the owner's original method of applying section 987 or by treating the owner as not applying an eligible pretransition method.

(5) *Recognition of pretransition gain or loss—(i) In general.* Except as provided in paragraph (e)(5)(ii) of this section—

(A) Pretransition gain with respect to a section 987 QBU is treated as net accumulated unrecognized section 987 gain (within the meaning of §1.987-4(c)). Pretransition gain with respect to a deferral QBU is treated as deferred section 987 gain and is attributed to one or more successor deferral QBUs under the principles of §1.987-12(b)(2) and (c)(2).

(B) Pretransition loss with respect to a section 987 QBU, a deferral QBU, or an outbound loss QBU is treated as

suspended section 987 loss with respect to the section 987 QBU, the deferral QBU, or the outbound loss QBU. In the case of a deferral QBU or outbound loss QBU, suspended section 987 loss is attributed to one or more successor suspended loss QBUs under the principles of §1.987-13(b)(1) and (c)(1).

(ii) *Election to recognize pretransition section 987 gain or loss ratably over the transition period—(A) In general.* A taxpayer may elect to recognize pretransition gain or loss ratably over the transition period. If an election is made to recognize pretransition gain or loss ratably over the transition period, then paragraph (e)(5)(i) of this section does not apply, and each owner to which the election applies recognizes one tenth of its pretransition gain or loss with respect to each section 987 QBU, original deferral QBU, and outbound loss QBU in each taxable year for ten taxable years beginning with the taxable year that begins on the transition date. See §1.987-1(g) for rules relating to section 987 elections (including consistency rules).

(B) *Special rules for inbound or outbound section 381(a) transactions—(1) Scope.* This paragraph (e)(5)(ii)(B) applies if a corporation (*acquiring corporation*) acquires the assets of an owner that is subject to an election under paragraph (e)(5)(ii)(A) of this section in a transaction described in section 381(a), and either the owner is a foreign corporation and the acquiring corporation is a domestic corporation or the owner is a domestic corporation and the acquiring corporation is a foreign corporation.

(2) *Recognition of pretransition gain or loss.* In the case of a transaction described in paragraph (e)(5)(ii)(B)(1) of this section, pretransition gain or loss that has not been recognized under paragraph (e)(5)(ii)(A) of this section ceases to be subject to the election to be recognized ratably over the transition period. Any unrecognized pretransition gain is recognized immediately before the transaction, and any unrecognized pretransition loss becomes suspended section 987 loss immediately before the transaction. As a result, the suspended section 987 loss may be recognized to the extent of section 987 gain recognized in the same recognition grouping pursuant to §1.987-11(e). See also §1.987-13(g) (providing

that any remaining suspended section 987 loss does not carry over to the acquiring corporation upon an inbound transaction to which section 381(a) applies).

(6) *Predecessor of an owner—(i) In general.* For purposes of this paragraph (e), references to an owner of a section 987 QBU, an original deferral QBU owner, and the owner of an outbound loss QBU include a predecessor described in paragraph (e)(6)(ii) of this section.

(ii) *Predecessor.* If a corporation (*acquiring corporation*) becomes the owner of a section 987 QBU in a transaction described in section 381(a) in which the section 987 QBU does not terminate, the corporation that was the owner of the section 987 QBU immediately before the transaction is a predecessor of the acquiring corporation. If a corporation (*acquiring corporation*) becomes a qualified successor of a deferral QBU owner or the owner of an outbound loss QBU (each, a *transferor corporation*), the transferor corporation is a predecessor of the acquiring corporation. A predecessor of a corporation includes the predecessor of a predecessor of the corporation.

(f) *QBUs to which the fresh start transition method was applied—(1) In general.* Paragraphs (d) and (e) of this section do not apply with respect to any section 987 QBU, deferral QBU, or outbound loss QBU with respect to which the taxpayer applied the rules of prior §1.987-10 (or applied §1.987-10 of the 2006 proposed regulations in a reasonable manner) on a return filed before November 9, 2023 or pursuant to paragraph (f)(3) of this section.

(2) *Application of the section 987 regulations after the transition date—(i) Owner functional currency net value on the last day of the preceding taxable year.* For purposes of applying §1.987-4 with respect to a section 987 QBU described in paragraph (f)(1) of this section for the taxable year beginning on the transition date, the owner functional currency net value of the section 987 QBU on the last day of the preceding taxable year under §1.987-4(d)(1)(B) is the amount that was determined for the preceding taxable year under §1.987-4(d)(1)(A) of the 2016 and 2019 section 987 regulations or the 2006 proposed section 987 regulations, as applicable.

(ii) *Determination of historic rate.* For purposes of applying the section 987 regulations with respect to historic items (other than inventory subject to the simplified inventory method under §1.987-3(c)(2)(iv)(A)) that are attributable to the section 987 QBU on the day before the transition date, a taxpayer must use the same historic rates as were used under the taxpayer's application of the 2016 and 2019 section 987 regulations or the 2006 proposed section 987 regulations, as applicable, in place of the historic rates that otherwise would be determined under §1.987-1(c)(3).

(iii) *Unrecognized section 987 gain or loss*—(A) *Net accumulated unrecognized section 987 gain or loss of a section 987 QBU.* In taxable years beginning on or after the transition date, for purposes of calculating the net accumulated unrecognized section 987 gain or loss of a section 987 QBU described in paragraph (f)(1) of this section under §1.987-4(c)—

(1) Amounts determined under prior §1.987-4(d) or under §1.987-4(d) or 1.987-10 of the 2006 proposed section 987 regulations, as applicable, are included in amounts determined under §1.987-4(d) for all prior taxable years; and

(2) Amounts taken into account under prior §1.987-5(a) or under §1.987-5(a) of the 2006 proposed section 987 regulations, as applicable, are included in amounts recognized under §1.987-5(a) for all prior taxable years. For this purpose, amounts taken into account under prior §1.987-5(a) or under §1.987-5(a) of the 2006 proposed section 987 regulations, as applicable, are determined without regard to prior §1.987-12 or prior §1.987-12T.

(B) *Deferred section 987 gain or loss attributable to a successor deferral QBU.* In the taxable year beginning on the transition date, the outstanding deferred section 987 gain or loss (as determined under prior §1.987-12) of a deferral QBU described in paragraph (f)(1) of this section becomes deferred section 987 gain or loss (within the meaning of §1.987-12). The deferred section 987 gain or loss is attributed to one or more successor deferral QBUs under the principles of §1.987-12(b)(2) and (c)(2).

(C) *Suspended section 987 loss attributable to a successor suspended loss QBU.* In the taxable year beginning on

the transition date, outbound section 987 loss of an outbound loss QBU described in paragraph (f)(1) of this section that has not been recognized or added to the basis of stock under prior §1.987-12 becomes suspended under section 987 loss. The suspended section 987 loss is attributed to one or more successor suspended loss QBUs under the principles of §1.987-13(b)(1) and (c)(1).

(3) *Taxpayers that are required to transition using the fresh start transition method.* If a taxpayer is subject to a consent agreement under which it is required to apply the fresh start transition method with respect to a section 987 QBU, then the taxpayer must apply the transition rules of prior §1.987-10 to that section 987 QBU for the taxable year beginning on the transition date and immediately before the taxpayer applies this section. In applying this section, the taxpayer is treated as having applied prior §1.987-10 to the section 987 QBU.

(g) *Partnerships*—(1) *Aggregate to entity.* If, for section 987 purposes, an aggregate approach to partnerships was applied to a partnership that owns an eligible QBU before the transition date and the partnership is not a section 987 aggregate partnership on the transition date, then the partnership is treated as a section 987 aggregate partnership at the beginning of the transition date for purposes of applying paragraphs (d) through (f) of this section and then as ceasing to be a section 987 aggregate partnership in a transition to which §1.987-7C(b) applies.

(2) *Entity to aggregate.* If, for section 987 purposes, an entity approach to partnerships was applied to a partnership that owns an eligible QBU before the transition date and the partnership is a section 987 aggregate partnership on the transition date, then the partnership is treated as not being a section 987 aggregate partnership at the beginning of the transition date for purposes of applying paragraphs (d) through (f) of this section and then as becoming a section 987 aggregate partnership in a transition to which §1.987-7C(c) applies.

(h) *Determination of source and character*—(1) *In general.* Except as provided in paragraph (h)(2) of this section, the source and character of pretransition gain or loss is determined under the rules of

§1.987-6. See §1.987-6(b)(1) (timing of source and character determination).

(2) *Deferral QBU or outbound loss QBU.* Notwithstanding paragraph (h)(1) of this section and §1.987-6, the source and character of pretransition gain or loss with respect to a deferral QBU or an outbound loss QBU is the same as the source and character of the outstanding deferred section 987 gain or loss (determined under prior §1.987-12) of the deferral QBU or the outbound section 987 loss of the outbound loss QBU (determined under §1.987-12(e) of the 2016 and 2019 section 987 regulations).

(i) [Reserved]

(j) *Adjustments to avoid double counting or omissions.* If a difference between the treatment of any item under the section 987 regulations and the treatment of the item under the taxpayer's prior section 987 method would result in income, gain, deduction, or loss being taken into account more than once or not being taken into account, then the pretransition gain or loss of the section 987 QBU, as determined under paragraphs (e)(2) and (3) of this section, is adjusted to account for the difference.

(k) *Reporting*—(1) *In general.* Except as otherwise provided in this paragraph (k), a statement titled "Section 987 Transition Information" must be attached to an owner's timely filed return for the taxable year beginning on the transition date providing the following information for each QBU described in paragraph (k) (2) of this section:

(i) A description of each QBU, the QBU's principal place of business, and a description of the prior method used by the taxpayer to determine its section 987 gain or loss, deferred section 987 gain or loss (under prior §1.987-12), or outbound section 987 loss with respect to the QBU, including an explanation as to whether such method was an eligible pretransition method.

(ii) The pretransition gain or loss with respect to each QBU and the computations used to determine pretransition gain or loss.

(iii) Whether the authorized person has elected to recognize pretransition gain or loss ratably over the transition period pursuant to paragraph (e)(5)(ii) of this section.

(iv) In the case of a statement filed by or on behalf of a partnership, a description of how section 987 was applied to the partnership, including whether an entity theory or aggregate theory of partnerships applied, and if an aggregate theory of partnerships applied, the owners of any QBUs consisting of assets and liabilities held by the partnership.

(v) With respect to each QBU for which any adjustment is made under paragraph (j) of this section, a description of each adjustment and the basis for computing the adjustment.

(vi) A list of the QBUs described in paragraph (f)(1) of this section, or a statement that no QBUs are described in paragraph (f)(1) of this section.

(2) *QBUs for which reporting is required*—(i) *In general.* Except as provided in paragraph (k)(2)(ii) of this section, the information described in paragraph (k)(1) of this section must be provided with respect to—

(A) Each section 987 QBU described in paragraph (b)(1) of this section;

(B) Each deferral QBU described in paragraph (b)(2) of this section and each of its successor deferral QBUs; and

(C) Each outbound loss QBU and each of the successor suspended loss QBUs to which suspended section 987 loss with respect to the outbound loss QBU is attributed.

(ii) *QBUs to which the fresh start transition method was applied.* A taxpayer is not required to provide the information described in paragraphs (k)(1)(i) through (iv) of this section with respect to a QBU described in paragraph (f)(1) of this section.

(3) *Attachments not required where information is reported on a form.* This paragraph (k) does not apply to the extent provided on a form or instructions published by the Commissioner.

(4) *Form 3115 not required.* Taxpayers that properly comply with the reporting

requirements in this paragraph (k) are not required to file a Form 3115 in connection with the transition onto the section 987 regulations.

(l) *Examples.* The following examples illustrate the application of this section. For purposes of the examples, DC is a domestic corporation with the U.S. dollar as its functional currency and Branch is a section 987 QBU with the euro as its functional currency. DC has a taxable year ending December 31, and the transition date is January 1, year 4. For purposes of the examples, except as otherwise indicated, assume that no section 987 elections are in effect.

(1) *Example 1—(i) Facts—(A) Formation of Branch and Branch's operations.* DC formed Branch on November 30, year 1, with a contribution of €150. In year 1, Branch purchased a parcel of unimproved land for €100. In year 2, Branch earned €25. In year 3, Branch again earned €25. On June 30, year 3, Branch distributed €100 cash to DC, and DC immediately exchanged the €100 for \$135.

(B) *Exchange rates.* The relevant exchange rates are shown below.

Table 1 to paragraph (l)(1)(i)(B)

Exchange Rates

	Spot Rate	Yearly Average Exchange Rate
November 30, Year 1	€1 = \$1	
December 31, Year 1	€1 = \$1.10	
December 31, Year 2	€1 = \$1.20	
June 30, Year 3	€1 = \$1.35	
December 31, Year 3	€1 = \$1.40	
Year 1		€1 = \$1.05
Year 2		€1 = \$1.15
Year 3		€1 = \$1.25

(C) *Pretransition method.* DC used the method prescribed in the 1991 proposed regulations under section 987 with respect to Branch before the transition date. Under this method, DC maintains an equity pool in euros (Branch's functional currency) and a basis pool in U.S. dollars (DC's functional currency). When Branch makes a remittance (whether out of earnings or capital), DC recognizes section 987 gain or loss equal to

the difference between the amount of the remittance (translated into U.S. dollars at the spot rate on the date of the remittance) and the portion of the basis pool attributable to the remittance. DC's basis in assets distributed from Branch is equal to Branch's basis in the assets, translated into U.S. dollars at the spot rate on the date of the remittance. Branch's earnings are translated into U.S. dollars at the average exchange rate for the taxable

year. DC otherwise applies section 987 in a reasonable manner.

(D) *Application of the pretransition method before the transition date.* For purposes of determining section 987 gain or loss recognized as a result of the June 30, year 3, remittance, DC was required to determine the amount in Branch's equity and basis pools. Branch's equity pool was equal to €200, and its basis pool was equal to \$210, as shown below:

Table 2 to paragraph (l)(1)(i)(D)

Year 3 Equity and Basis Pools

	Equity Pool	Translation Rate	Basis Pool
Contribution (9/30/Year 1)	€150	€1 = \$1	\$150
Year 2 Earnings	€25	€1 = \$1.15	\$28.75
Year 3 Earnings	€25	€1 = \$1.25	\$31.25
Total	€200		\$210

Because the remittance was equal to 50% of the equity pool (€100), 50% of the basis pool, or \$105, was attributable to the remittance. The amount of the remittance was \$135 (€100 translated at the spot rate on June 30, year 3, of €1 = \$1.35). Therefore, in year 3, DC recognized section 987 gain of \$30, equal to the difference between the amount of the remittance (\$135) and the portion of the basis pool attributable to the remittance (\$105). As a result of the remittance, the equity pool was reduced by the amount distributed (€100), and the basis pool was reduced by the portion of the basis pool attributable to the remittance (\$105). Therefore, after the remittance, the equity pool was equal to €100, and the basis pool was equal to \$105. In the hands of DC, the euros distributed had a basis of \$135 (equal to the €100 distribution translated at the spot rate on June 30, year 3, of €1 = \$1.35). DC did not recognize section 988 gain or loss when it exchanged the euros for \$135.

(ii) *Analysis—(A) DC’s method is an eligible pretransition method.* Before the transition date, DC followed the method prescribed in the 1991 proposed regulations under section 987 with respect to Branch. This method is an eligible pretransition method under paragraph (e)(4)(i) of this section. Therefore, DC determines its pretransition gain or loss with respect to Branch under paragraph (e)(2) of this section.

(B) *Pretransition gain or loss.* Under paragraph (e)(2) of this section, DC’s pretransition gain or loss with respect to Branch is equal to the sum of the deemed termination amount described in paragraph (e)(2)(i)(A) of this section and the owner functional currency net value adjustment described in paragraph (e)(2)(i)(B) of this section. As explained in paragraphs (l)(1)(ii)(B)(1) and (2) of this section, DC’s deemed termination amount is \$35 and its owner functional currency net value adjustment is zero. Therefore, DC has \$35 of pretransition gain with respect to Branch. Under paragraph (e)(5)(i)(A) of this section, the pretransition gain is treated as Branch’s net accumulated unrecognized section 987 gain. However, if DC elects to recognize its pretransition gain ratably over the transition period under paragraph (e)(5)(ii) of this section, the pretransition

gain is not treated as net accumulated unrecognized section 987 gain. Instead, DC recognizes \$3.50 (one tenth of its pretransition gain) for each of the ten taxable years from year 4 through year 13.

(1) *Deemed termination amount.* Under paragraph (e)(2)(i)(A) of this section, the deemed termination amount is the amount of section 987 gain or loss that would have been recognized by DC under the eligible pretransition method if Branch terminated and transferred all its assets and liabilities to DC (the land with a basis of €100) on December 31, year 3, and prior §1.987-12 did not apply. Under DC’s eligible pretransition method, DC would have recognized section 987 gain of \$35, determined by subtracting the remaining basis pool of \$105 from the amount of the remittance of \$140 (€100 translated at the spot rate on December 31, year 3, of €1 = \$1.40). Therefore, the deemed termination amount is \$35.

(2) *Owner functional currency net value adjustment.* On December 31, year 3, Branch had no liabilities and only one asset: land with a basis of €100. Under paragraph (e)(2)(i)(B) of this section, the owner functional currency net value adjustment is equal to the basis of the land, translated into U.S. dollars at the spot rate on December 31, year 3, reduced by the basis of the land, translated into U.S. dollars at the pretransition translation rate on December 31, year 3. Under paragraph (e)(2)(i)(C) of this section, the pretransition translation rate is the rate that would be used under DC’s eligible pretransition method to determine the basis of the land in the hands of DC if Branch transferred the land to DC on December 31, year 3. Under DC’s eligible pretransition method, if Branch transferred the land to DC, DC’s basis in the land would be equal to Branch’s basis (€100) translated at the spot rate on the date of the remittance. Therefore, the pretransition translation rate on December 31, year 3, is equal to the spot rate on December 31, year 3. Consequently, the owner functional currency net value adjustment is zero.

(C) *Determination of unrecognized section 987 gain or loss in year 4.* For purposes of determining unrecognized section 987 gain or loss in year 4 under §1.987-4(d), the owner functional currency net value

of Branch on the last day of year 3 is determined by translating the €100 basis of the land at the spot rate on December 31, year 3 (€1 = \$1.40). Therefore, the owner functional currency net value of Branch on the last day of year 3 is \$140.

(2) *Example 2—(i) Facts—(A) In general.* The facts and exchange rates are the same as in paragraph (l)(1) of this section (*Example 1*), except that DC uses an earnings only method with respect to Branch before the transition date, as described in paragraph (l)(2)(i)(B) of this section.

(B) *Pretransition method.* Under the earnings only method, DC maintains an equity pool in euros (Branch’s functional currency) and a basis pool in U.S. dollars (DC’s functional currency) with respect to Branch’s earnings. DC also maintains separate equity and basis pools with respect to Branch’s capital. Distributions are treated as being made first out of earnings and then out of capital. When Branch makes a remittance out of earnings, DC recognizes section 987 gain or loss equal to the difference between the amount of the remittance (translated into U.S. dollars at the spot rate on the date of the remittance) and the portion of the earnings basis pool attributable to the remittance. No section 987 gain or loss is recognized on a distribution out of capital. DC’s basis in assets distributed out of Branch’s earnings is equal to Branch’s basis in the assets translated at the spot rate on the date of the remittance. DC’s basis in assets distributed out of Branch’s capital is equal to the portion of the capital basis pool attributable to the distribution. Branch’s earnings are translated into U.S. dollars at the average exchange rate for the taxable year. DC otherwise applies section 987 in a reasonable manner.

(C) *Application of the pretransition method before the transition date.* On June 30, year 3, Branch distributed €100 cash to DC. Of this amount, €50 represented a remittance out of earnings, and €50 represented a distribution out of capital.

(1) *Remittance out of earnings.* For purposes of determining section 987 gain or loss recognized on the remittance, Branch’s earnings equity pool was equal to €50, and its earnings basis pool was equal to \$60, as shown below:

Table 3 to paragraph (l)(2)(i)(C)(1)

Earnings Equity and Basis Pools

	Equity Pool	Translation Rate	Basis Pool
Year 2 Earnings	€25	€1 = \$1.15	\$28.75
Year 3 Earnings	€25	€1 = \$1.25	\$31.25
Total	€50		\$60

Because Branch remitted 100% of the earnings equity pool (€50), the entire earnings basis pool, or \$60, was attributable to the remittance. The value of the remittance was \$67.50 (€50 translated at the spot rate on June 30, year 3, of €1 = \$1.35). Therefore, in year 3, DC recognized section 987 gain of \$7.50, equal to the difference between the value of the

remittance (\$67.50) and the portion of the basis pool attributable to the remittance (\$60). As a result of the remittance, the earnings equity pool and the earnings basis pool were each reduced to zero. In the hands of DC, the €50 distributed out of earnings had a basis of \$67.50 (€50 translated at the spot rate on June 30, year 3, of €1 = \$1.35).

(2) *Distribution out of capital.* The basis of the €50 distributed out of capital was equal to the portion of the capital basis pool attributable to the distribution. For this purpose, the capital equity pool was equal to €150, and the capital basis pool was equal to \$150, as shown below:

Table 4 to paragraph (l)(2)(i)(C)(2)

Capital Equity and Basis Pools

	Equity Pool	Translation Rate	Basis Pool
Contribution (6/30/Year 1)	€150	€1 = \$1	\$150
Total	€150		\$150

Because Branch distributed 33% of the capital equity pool, or €50, 33% of the capital basis pool, or \$50, was attributable to the distribution. In the hands of DC, the €50 distributed out of capital had a basis of \$50. As a result of the capital distribution, the capital equity pool was reduced to €100 and the capital basis pool was reduced to \$100.

(3) *Section 988 gain recognized.* On June 30, year 3, DC exchanged €100 with an aggregate basis of \$117.50 (equal to the sum of the \$67.50 basis of the remittance out of earnings and the \$50 basis of the distribution out of capital) for \$135. Therefore, DC recognized \$17.50 of gain under section 988.

(ii) *Analysis—(A) DC's method is an eligible pretransition method.* Before the transition date, DC followed a reasonable method of applying section 987 that would result in the same total amount of income over the life of DC (\$125) as an earnings and capital method, as explained in paragraphs (l)(2)(ii)(A)(1) and (2) of this section. Therefore, this method is an eligible pretransition method under paragraph (e)(4)(ii) of this section. Consequently, DC determines its pretransition gain or loss with respect to Branch under paragraph (e)(2) of this section.

(1) *DC's total amount of income under its pretransition method.* Under DC's pretransition method, DC recognized \$7.50 of section 987 gain and \$17.50 of section 988 gain in year 3. In addition, on December 31, year 3, DC had \$40 of embedded gain in its capital equity and basis pools (equal to the difference between its capital equity pool of €100, translated at the spot rate on December 31, year 3, of €1 = \$1.40, and its capital basis pool of \$100) which will be taken into account in the future (when Branch distributes property out of capital and the property is sold). DC also recognized \$60 of earnings with respect to Branch (\$28.75 in year 2 and \$31.25 in year 3). Thus, DC's total income (recognized and unrecognized) with respect to Branch is \$125.

(2) *DC's total amount of income under an earnings and capital method.* If DC had instead applied an earnings and capital method, as described in paragraph (l)(1)(i)(C) of this section (*Example 1*), DC would have recognized section 987 gain of \$30 in year 3 and would not have recognized section 988 gain in year 3, as explained in paragraph (l)(1)(i)(D) of this section. On December 31, year 3, DC would have unrecognized section 987 gain in its equity and basis pools of \$35 (see paragraph (l)(1)(ii)(B)(1) of this section (*Example 1*)). DC would also have recognized \$60 of earnings with respect to Branch (\$28.75 in year 2 and \$31.25 in year 3). Thus, DC's total income (recognized and unrecognized) with respect to Branch is \$125.

(B) *Pretransition gain or loss.* Under paragraph (e)(2) of this section, DC's pretransition gain or loss with respect to Branch is equal to sum of the deemed termination amount described in paragraph (e)(2)(i)

(A) of this section and the owner functional currency net value adjustment described in paragraph (e)(2)(i)(B) of this section. As explained in paragraphs (l)(2)(ii)(B)(1) and (2) of this section, the deemed termination amount is zero and the owner functional currency net value adjustment is \$40. Therefore, DC has \$40 of pretransition gain with respect to Branch. Under paragraph (e)(5)(i)(A) of this section, the pretransition gain is treated as Branch's net accumulated unrecognized section 987 gain. However, if DC elects to recognize its pretransition gain ratably over the transition period under paragraph (e)(5)(ii) of this section, the pretransition gain is not treated as net accumulated unrecognized section 987 gain. Instead, DC recognizes \$4 (one tenth of its pretransition gain) for each of the ten taxable years from year 4 through year 13.

(1) *Deemed termination amount.* Under paragraph (e)(2)(i)(A) of this section, the deemed termination amount is the amount of section 987 gain or loss that would have been recognized by DC under the eligible pretransition method if Branch terminated and transferred all of its assets and liabilities to DC on December 31, year 3, and prior §1.987-12 did not apply. Under DC's eligible pretransition method, if Branch had transferred all of its assets and liabilities to DC, this would have been treated as a distribution out of capital. Under its eligible pretransition method, DC would not have recognized section 987 gain or loss on a distribution out of capital. Therefore, the deemed termination amount is zero.

(2) *Owner functional currency net value adjustment.* On December 31, year 3, Branch had no liabilities and only one asset: land with a basis of €100. Under paragraph (e)(2)(i)(B) of this section, the owner functional currency net value adjustment is equal to the basis of Branch's land, translated into U.S. dollars at the spot rate on December 31, year 3, reduced by the basis of Branch's land, translated into U.S. dollars at the pretransition translation rate on December 31, year 3. Under paragraph (e)(2)(i)(C) of this section, the pretransition translation rate is the rate that would be used under the eligible pretransition method to determine the basis of the land in the hands of DC if Branch transferred the land to DC. Under DC's eligible pretransition method, DC's basis in assets distributed from Branch is equal to the portion of the capital basis pool attributable to the distribution. If Branch transferred the land with a basis of €100 to DC on December 31, year 3, its remaining capital basis pool of \$100 would be attributable to the distribution, and the land would have a basis of \$100 in the hands of DC. Because the land had a basis of €100 in the hands of Branch, and would have a basis of \$100 in the hands of DC if it were distributed on December 31, year 3, the pretransition translation rate is €1 = \$1. The €100 basis of Branch's land, translated at the spot rate on

December 31, year 3 of €1 = \$1.40 is equal to \$140. The €100 basis of Branch's land, translated at the pretransition translation rate on December 31, year 3 of €1 = \$1 is equal to \$100. Therefore, the owner functional currency net value adjustment is equal to \$40 (\$140 - \$100).

(C) *Determination of unrecognized section 987 gain or loss in year 4.* For purposes of determining unrecognized section 987 gain or loss in year 4 under §1.987-4(d), the owner functional currency net value of Branch on the last day of year 3 is determined by translating the €100 basis of the land at the spot rate on December 31, year 3 (€1 = \$1.40). Therefore, the owner functional currency net value of Branch on the last day of year 3 is \$140.

(3) *Example 3—(i) Facts—(A) In general.* The facts and exchange rates are the same as in paragraph (l)(1) of this section (*Example 1*), except that DC used an earnings only method with respect to Branch before the transition date, as described in paragraph (l)(3)(i)(B) of this section.

(B) *Pretransition method.* Under the earnings only method, DC maintains an equity pool in euros (Branch's functional currency) and a basis pool in U.S. dollars (DC's functional currency) with respect to Branch's earnings. However, DC does not maintain separate equity and basis pools with respect to Branch's capital. Distributions are treated as being made first out of earnings and then out of capital. When Branch makes a remittance out of earnings, DC recognizes section 987 gain or loss equal to the difference between the amount of the remittance (translated into U.S. dollars at the spot rate on the date of the remittance) and the portion of the earnings basis pool attributable to the remittance. No section 987 gain or loss is recognized on a distribution out of capital. Under DC's pretransition method, DC's basis in assets distributed by Branch (whether out of earnings or capital) is equal to Branch's basis in the assets translated at the spot rate on the date of the distribution. Branch's earnings are translated into U.S. dollars at the average exchange rate for the taxable year. DC first applied its earnings only method on a return filed before November 9, 2023. In addition, DC applied its earnings only method consistently to all of its section 987 QBUs and otherwise applied section 987 in a reasonable manner.

(C) *Application of the pretransition method before the transition date.* On June 30, year 3, Branch distributed €100 cash to DC. Of this amount, €50 represented a remittance out of earnings, and €50 represented a distribution out of capital.

(1) *Remittance out of earnings.* For purposes of determining section 987 gain or loss recognized on the remittance, Branch's earnings equity pool was equal to €50, and its earnings basis pool was equal to \$60, as shown below:

Table 5 to paragraph (l)(3)(i)(C)(I)

Earnings Equity and Basis Pools

	Equity Pool	Translation Rate	Basis Pool
Year 2 Earnings	€25	€1 = \$1.15	\$28.75
Year 3 Earnings	€25	€1 = \$1.25	\$31.25
Total	€50		\$60

Because Branch remitted 100% of the earnings equity pool (€50), the entire earnings basis pool, or \$60, was attributable to the remittance. The value of the remittance was \$67.50 (€50 translated at the spot rate on June 30, year 3, of €1 = \$1.35). Therefore, in year 3, DC recognized section 987 gain of \$7.50, equal to the difference between the value of the remittance (\$67.50) and the portion of the basis pool attributable to the remittance (\$60). As a result of the remittance, the earnings equity pool and the earnings basis pool were each reduced to zero.

(2) *Basis of euros distributed.* In the hands of DC, the €100 distributed had a basis of \$135 (€100 translated at the spot rate on June 30, year 3, of €1 = \$1.35). DC did not recognize gain or loss under section 988 when it exchanged the €100 for \$135.

(ii) *Analysis—(A) DC's method is an eligible pretransition method.* Unlike in paragraph (l)(2) of this section (*Example 2*), DC's earnings only method would not result in the same total amount of income over the life of DC as an earnings and capital method described in paragraph (e)(4)(i) of this section because DC does not maintain capital basis and equity pools and DC translates the basis of all property distributed from Branch at the spot rate on the distribution date. However, this method is an eligible pretransition method under paragraph (e)(4)(iii) of this section because DC first applied its earnings only method on a return filed before November 9, 2023, DC applied its earnings only method consistently to all of its section 987 QBUs, and otherwise applied section 987 in a reasonable manner. Consequently, DC determines its pretransition gain or loss with respect to Branch under paragraph (e)(2) of this section.

(B) *Pretransition gain or loss.* Under paragraph (e)(2) of this section, DC's pretransition gain or loss with respect to Branch is equal to sum of the deemed termination amount described in paragraph (e)(2)(i)(A) of this section and the owner functional currency net value adjustment described in paragraph (e)(2)(i)(B) of this section. As explained in paragraphs (l)(2)(ii)(B)(I) and (2) of this section, the deemed termination amount is zero and the owner functional currency net value adjustment is zero. Therefore, DC has no pretransition gain or loss with respect to Branch.

(I) *Deemed termination amount.* Under paragraph (e)(2)(i)(A) of this section, the deemed termination amount is the amount of section 987 gain or loss that would have been recognized by DC under the eligible pretransition method if Branch terminated and transferred all of its assets and liabilities to DC on December 31, year 3, and prior §1.987-12 did not apply. Under DC's eligible pretransition method, if Branch had transferred all of its assets

and liabilities to DC, it would have been treated as a distribution out of capital. Under its eligible pretransition method, DC would not have recognized section 987 gain or loss on a distribution out of capital. Therefore, the deemed termination amount is zero.

(2) *Owner functional currency net value adjustment.* On December 31, year 3, Branch has no liabilities and only one asset: land with a basis of €100. Under paragraph (e)(2)(i)(B) of this section, the owner functional currency net value adjustment is equal to the basis of the land, translated into U.S. dollars at the spot rate on December 31, year 3, reduced by the basis of the land, translated into U.S. dollars at the pretransition translation rate on December 31, year 3. Under paragraph (e)(2)(i)(C) of this section, the pretransition translation rate is the rate that would be used under DC's eligible pretransition method to determine the basis of the land in the hands of DC if Branch transferred the land to DC on December 31, year 3. Under DC's eligible pretransition method, if Branch transferred the land to DC, DC's basis in the land would be equal to Branch's basis (€100) translated at the spot rate on the date of the distribution. Therefore, the pretransition translation rate on December 31, year 3, is equal to the spot rate on December 31, year 3. Consequently, the owner functional currency net value adjustment is zero.

(C) *Determination of unrecognized section 987 gain or loss in year 4.* For purposes of determining unrecognized section 987 gain or loss in year 4 under §1.987-4(d), the owner functional currency net value of Branch on the last day of year 3 is determined by translating the €100 basis of the land at the spot rate on December 31, year 3 (€1 = \$1.40). Therefore, the owner functional currency net value of Branch on the last day of year 3 is \$140.

(4) *Example 4—(i) Facts.* The facts and exchange rates are the same as in paragraph (l)(1) of this section (*Example 1*), except that DC did not apply section 987(3) with respect to Branch and did not recognize section 987 gain or loss with respect to Branch before the transition date.

(ii) *Analysis—(A) DC's method is not an eligible pretransition method.* Because DC did not apply section 987(3) with respect to Branch before the transition date, DC did not apply an eligible pretransition method under paragraph (e)(4) of this section. Therefore, DC determines pretransition gain or loss under paragraph (e)(3) of this section.

(B) *Pretransition gain or loss.* Under paragraph (e)(3) of this section, DC's pretransition gain or loss with respect to Branch is equal to the annual unrecognized section 987 gain or loss with respect to Branch for all taxable years ending before the transition date in which DC was the owner of Branch (that is, years 1 through 3), reduced by section 987 gain

or loss recognized by DC before the transition date. As explained in paragraphs (l)(4)(ii)(C) through (E) of this section, DC's annual unrecognized section 987 gain for year 1 is \$7.50, DC's annual unrecognized section 987 gain for year 2 is \$16.25, and DC's annual unrecognized section 987 gain for year 3 is \$23.75. DC did not recognize any section 987 gain or loss with respect to Branch before the transition date. Therefore, DC has \$47.50 of pretransition gain with respect to Branch. Under paragraph (e)(5)(i)(A) of this section, the pretransition gain is treated as Branch's net accumulated unrecognized section 987 gain. However, if DC elects to recognize its pretransition gain ratably over the transition period under paragraph (e)(5)(ii) of this section, the pretransition gain is not treated as net accumulated unrecognized section 987 gain. Instead, DC recognizes \$4.75 (one tenth of its pretransition gain) for each of the ten taxable years from year 4 through year 13.

(C) *Annual unrecognized section 987 gain or loss for year 1.* Under paragraph (e)(3)(iii) of this section, annual unrecognized section 987 gain or loss with respect to a section 987 QBU is determined under the rules of §1.987-4(d), applied as though a current rate election was in effect for all relevant taxable years (such that all items are treated as marked items), but modified so that only §§1.987-4(d)(1) (change in owner functional currency net value) and 1.987-4(d)(10) (adjustment for residual increase or decrease to the balance sheet) are applied. As explained in paragraphs (l)(4)(ii)(C)(I) and (2) of this section, in year 1, the change in owner functional currency net value under §1.987-4(d)(1) is an increase of \$165, and there is a negative adjustment of \$157.50 under §1.987-4(d)(10). Therefore, DC's annual unrecognized section 987 gain for year 1 is \$7.50.

(I) *Change in owner functional currency net value for year 1.* On December 31, year 1, Branch held land with a basis of €100 and €50 cash. Therefore, on the last day of year 1, Branch's owner functional currency net value is \$165 (150 euros translated at the spot rate on December 31, year 1, of €1 = \$1.10). Because Branch was formed in year 1, its owner functional currency net value on the last day of the preceding taxable year is zero. See §1.987-4(d)(1)(iii). Therefore, the change in owner functional currency net value is an increase of \$165.

(2) *Residual increase to the balance sheet for year 1.* Under §1.987-4(d)(10), unrecognized section 987 gain or loss for a taxable year is decreased by any residual increase to the balance sheet (and increased by any residual decrease to the balance sheet), translated into the owner's functional currency at the yearly average exchange rate for the taxable year. For this purpose, the residual increase (or decrease) to the balance sheet is equal to the

change in net value of the section 987 QBU, determined in the section 987 QBU's functional currency. On December 31, year 1, Branch held land with a basis of €100 euros and €50 cash. Therefore, on the last day of year 1, Branch has a net value (in its own functional currency) of €150. Because Branch was formed in year 1, its functional currency net value on the last day of the preceding taxable year is zero. See §1.987-4(d)(1)(iii). Therefore, the residual increase to the balance sheet is €150. This results in a negative adjustment to annual unrecognized section 987 gain or loss of \$157.50 for year 1 (equal to €150 translated at the yearly average exchange rate for year 1 of €1 = \$1.05).

(D) *Annual unrecognized section 987 gain or loss for year 2.* As explained in paragraphs (l)(4)(ii)(D)(1) and (2) of this section, in year 2, the change in owner functional currency net value under §1.987-4(d)(1) is an increase of \$45, and there is a negative adjustment of \$28.75 under §1.987-4(d)(10). Therefore, DC's annual unrecognized section 987 gain for year 2 is \$16.25.

(I) *Change in owner functional currency net value for year 2.* On December 31, year 2, Branch held land with a basis of €100 euros and €75 cash. Therefore, on the last day of year 2, Branch's owner functional currency net value is \$210 (175 euros translated at the spot rate on December 31, year 2, of €1 = \$1.20). As explained in paragraph (l)(4)(ii)(C)(1) of this section, Branch's owner functional currency net value on the last day of year 1 was \$165. Therefore, the change in owner functional currency net value is an increase of \$45.

(2) *Residual increase to the balance sheet for year 2.* On December 31, year 2, Branch held land with a basis of €100 euros and €75 cash. Therefore, on the last day of year 2, Branch has a net value (in its own functional currency) of €175. As explained in paragraph (l)(4)(ii)(C)(2) of this section, Branch had a net value of €150 on December 31, year 1. Therefore, the residual increase to the balance sheet is €25. This results in a negative adjustment to annual unrecognized section 987 gain or loss of \$28.75 for year 2 (equal to a reduction of €25, translated at the yearly average exchange rate for year 2 of €1 = \$1.15).

(E) *Annual unrecognized section 987 gain or loss for year 3.* As explained in paragraphs (l)(4)(ii)(E)(1) and (2) of this section, in year 3, the change in owner functional currency net value under §1.987-4(d)(1) is a decrease of \$70, and there is a positive adjustment of \$93.75 under §1.987-4(d)(10). Therefore, DC's annual unrecognized section 987 gain for year 3 is \$23.75.

(I) *Change in owner functional currency net value for year 3.* On December 31, year 3, Branch held land with a basis of €100. Therefore, on the last day of year 3, Branch's owner functional currency net value is \$140 (100 euros translated at the spot rate on December 31, year 3, of €1 = \$1.40). As explained in paragraph (l)(4)(ii)(D)(1) of this section, Branch's owner functional currency net value on the last day of year 2 was \$210. Therefore, the change in owner functional currency net value is a decrease of \$70.

(2) *Residual decrease to the balance sheet for year 3.* On December 31, year 3, Branch held land with a basis of €100. Therefore, on the last day of

year 3, Branch has a net value (in its own functional currency) of €100. As explained in paragraph (l)(4)(ii)(D)(2) of this section, Branch had a net value of €175 on December 31, year 2. Therefore, the residual decrease to the balance sheet is €75. This results in a positive adjustment to annual unrecognized section 987 gain or loss of \$93.75 for year 3 (equal to €75, translated at the yearly average exchange rate for year 3 of €1 = \$1.25).

(F) *Determination of unrecognized section 987 gain or loss in year 4.* For purposes of determining unrecognized section 987 gain or loss in year 4 under §1.987-4(d), the owner functional currency net value of Branch on the last day of year 3 is determined by translating the €100 basis of the land at the spot rate on December 31, year 3 (€1 = \$1.40). Therefore, the owner functional currency net value of Branch on the last day of year 3 is \$140.

19. Section 1.987-11 is revised to read as follows:

§1.987-11 Suspended section 987 loss relating to certain elections; loss-to-the-extent-of-gain rule.

(a) *In general.* This section provides rules relating to suspended section 987 loss. This paragraph (a) provides an overview of this section. Paragraph (b) of this section provides rules for computing the cumulative suspended section 987 loss with respect to a section 987 QBU or successor suspended loss QBU. Paragraph (c) of this section provides rules that suspend section 987 loss that would otherwise be recognized when a current rate election is in effect. Paragraph (d) of this section provides rules that treat net unrecognized section 987 loss and deferred section 987 loss as suspended section 987 loss when an annual recognition election is made or a current rate election is revoked. Paragraph (e) of this section describes the extent to which suspended section 987 loss is recognized under a loss-to-the-extent-of-gain rule. Paragraph (f) of this section provides rules for determining recognition groupings based on the source and character of section 987 gain or loss. Paragraph (g) of this section provides examples illustrating the rules of this section.

(b) *Cumulative suspended section 987 loss in a recognition grouping—(1) In general.* The cumulative suspended section 987 loss in a recognition grouping with respect to a section 987 QBU or a successor suspended loss QBU for the current taxable year is equal to the cumulative suspended section 987 loss in the recognition grouping for the prior

taxable year decreased by the amount of suspended section 987 loss in the recognition grouping that was recognized with respect to the QBU under paragraph (e) of this section or under §1.987-13(b) through (d) in the prior taxable year, and increased by the amount that becomes suspended section 987 loss in the recognition grouping with respect to the QBU in the current taxable year. If the taxable year is the first taxable year of the section 987 QBU (or the first taxable year in which the section 987 regulations apply), the cumulative suspended section 987 loss for the prior taxable year is zero. An owner or original suspended loss QBU owner's total cumulative suspended section 987 loss in a recognition grouping is equal to the sum of its cumulative suspended section 987 gain or loss with respect to each section 987 QBU and successor suspended loss QBU. See §1.987-13(g) for rules preventing the carryover of suspended section 987 loss in connection with certain inbound transactions.

(2) *Combined QBU.* For purposes of paragraph (b)(1) of this section, in the taxable year of a combination, the cumulative suspended section 987 loss in a recognition grouping with respect to a combined QBU for the prior taxable year is equal to the sum of the cumulative suspended section 987 loss in the recognition grouping with respect to each combining QBU for the prior taxable year; the suspended section 987 loss in a recognition grouping with respect to a combined QBU that was recognized in the prior taxable year is equal to sum of the suspended section 987 loss in the recognition grouping with respect to each combining QBU that was recognized in the prior taxable year.

(3) *Separated QBU.* For purposes of paragraph (b)(1) of this section, in the taxable year of a separation, the cumulative suspended section 987 loss in a recognition grouping with respect to a separated QBU for the prior taxable year is equal to the cumulative suspended section 987 loss in the recognition grouping with respect to the separating QBU for the prior taxable year multiplied by the separation fraction; the suspended section 987 loss in a recognition grouping with respect to a separated QBU that was recognized in the prior taxable year is equal to the suspended section 987 loss in the recognition grouping with

respect to the separating QBU that was recognized in the prior taxable year multiplied by the separation fraction.

(c) *Suspension of section 987 loss for taxable years in which a current rate election is in effect and an annual recognition election is not in effect.* In a taxable year in which a current rate election is in effect and an annual recognition election is not in effect, to the extent that an owner's net unrecognized section 987 loss with respect to a section 987 QBU would otherwise be recognized under §1.987-5 (including pursuant to §1.987-12(b)), or its deferred section 987 loss would otherwise be recognized under §1.987-12(c), the net unrecognized section 987 loss or deferred section 987 loss is not recognized by the owner and instead becomes suspended section 987 loss. See paragraph (g)(1) of this section (*Example 1*) for an illustration of this rule.

(d) *Suspension of net unrecognized section 987 loss upon making or revoking certain elections—(1) Making an annual recognition election.* At the beginning of the first taxable year for which an annual recognition election is in effect, net accumulated unrecognized section 987 loss and deferred section 987 loss are converted into suspended section 987 loss if either—

(i) A current rate election was in effect for the immediately preceding taxable year; or

(ii) A current rate election was not in effect for the immediately preceding taxable year and, as of the beginning of the taxable year, the sum of the owner's net accumulated unrecognized section 987 loss and deferred section 987 loss exceeds the sum of the owner's net accumulated unrecognized section 987 gain and deferred section 987 gain by more than \$5 million.

(2) *Revoking a current rate election.* In the first taxable year in which a current rate election ceases to be in effect, net accumulated unrecognized section 987 loss and deferred section 987 loss are converted into suspended section 987 loss. See paragraph (g)(2) of this section (*Example 2*) for an illustration of this rule.

(e) *Recognition of suspended section 987 loss to the extent of recognition of section 987 gain—(1) In general.* Subject to paragraph (e)(2) of this section, in a

taxable year of an owner of a section 987 QBU or an original suspended loss QBU owner, the owner recognizes a portion of its total cumulative suspended section 987 loss in a single recognition grouping to the extent of the amount of section 987 gain in that recognition grouping that the owner recognizes in that taxable year (the *loss-to-the-extent-of-gain rule*). Because the recognition groupings are determined on the basis of the initial assignment of section 987 gain or loss under §1.987-6(b)(2) (i), the loss-to-the-extent-of-gain rule is applied on the basis of the initial assignment of section 987 gain or loss. The amount of cumulative suspended section 987 loss in a single recognition grouping that the owner or original suspended loss QBU owner recognizes in the taxable year is treated as attributable to each section 987 QBU or successor suspended loss QBU in proportion to its suspended section 987 loss in that recognition grouping. See paragraph (g)(1) of this section (*Example 1*) for an illustration of this rule.

(2) *Special rule for taxable years in which both an annual recognition election and a current rate election are in effect.* This paragraph (e)(2) only applies to suspended section 987 loss in taxable years in which both a current rate election and an annual recognition election are in effect.

(i) *Loss to the extent of gain rule limited to net gain, not gross gain.* For purposes of applying paragraph (e)(1) of this section, references to section 987 gain in a recognition grouping are treated as references to net section 987 gain in that recognition grouping.

(ii) *Net section 987 gain in a recognition grouping.* For purposes of this paragraph (e), net section 987 gain in a recognition grouping is equal to the total section 987 gain recognized and taken into account by the owner in that recognition grouping during the testing period, reduced by the total section 987 loss recognized and taken into account by the owner in that recognition grouping during the testing period (other than suspended section 987 loss recognized in the current taxable year).

(iii) *Testing period.* For purposes of this paragraph (e), the testing period with respect to any suspended section 987 loss means the current taxable year and all prior taxable years during which both—

(A) The section 987 loss was a suspended section 987 loss of the owner (including the taxable year in which it became a suspended section 987 loss of the owner); and

(B) A current rate election and annual recognition election were in effect.

(iv) *Ordering rule.* If an owner has any suspended section 987 loss that has a different testing period than other suspended section 987 loss (for example, because the owner succeeded to and took into account additional suspended section 987 loss in a section 381(a) transaction), all suspended section 987 loss that has the same testing period is aggregated in a single group and this paragraph (e) is applied separately to each suspended section 987 loss group, in chronological order based on the earliest date included in the testing period of the group.

(3) *Consolidated group members.* All members of a consolidated group are treated as a single owner for purposes of applying this paragraph (e).

(f) *Recognition groupings.* The term *recognition grouping* means the section 987 gain or loss (including section 987 gain or loss that is recognized, deferred section 987 gain or loss, or suspended section 987 loss) that is initially assigned to the statutory and residual groupings described in paragraph (f)(1) of this section and to the statutory and residual groupings described in paragraph (f)(2) of this section, if applicable, under §1.987-6(b)(2)(i).

(1) *Sourcing and section 904 category.* Section 987 gain or loss that is initially assigned to the following subcategories:

(i) U.S. source income; and

(ii) Foreign source income in a single section 904 category.

(2) *Statutory and residual groupings for CFC owners.* Solely with respect to owners that are controlled foreign corporations, section 987 gain or loss that is initially assigned to the following statutory and residual groupings:

(i) Tentative tested income;

(ii) Foreign currency gain or loss taken into account under section 954(c)(1)(D) pursuant to §1.987-6(b)(2)(i)(C);

(iii) Income described in section 952(b) (ECI that is excluded from subpart F income); and

(iv) Income not described in paragraphs (f)(2)(i) through (iii) of this section.

(g) *Examples.* The following examples illustrate the application of this section.

(1) *Example 1: Suspension of section 987 loss and recognition of suspended section 987 loss—(i) Facts.* CFC is a controlled foreign corporation that has the U.S. dollar as its functional currency. CFC owns three section 987 QBUs, QBU1, QBU2, and QBU3. QBU1 has the euro as its functional currency, QBU2 has the pound as its functional currency, and QBU3 has the yen as its functional currency. CFC is subject to a current rate election but not an annual recognition election. An election has not been made under §1.951A-2(c)(7) with respect to CFC. In year 1, CFC did not have cumulative suspended section 987 loss with respect to any of its QBUs and did not have outstanding deferred section 987 gain or loss. In year 2, CFC has net unrecognized section 987 loss of \$200 with respect to QBU1, net unrecognized section 987 loss of \$1,000 with respect to QBU2, and net unrecognized section 987 gain of \$1,000 with respect to QBU3. In year 2, each QBU makes a remittance, and CFC's remittance proportion (determined under §1.987-5(b)(1)) is 25% with respect to QBU1, 15% with respect to QBU2, and 10% with respect to QBU3. For purposes of §1.987-6(b)(2)(i), all of QBU1's assets generate foreign source passive category income that corresponds to one or more subpart F income groups described in §1.960-1(d)(2)(ii)(B)(2)(i) through (v) and all of QBU2's and QBU3's assets generate foreign source general category tested income.

(ii) *Analysis—(A) Application of §§1.987-5 and 1.987-6 and paragraph (c) of this section.* In year 2, CFC recognizes \$100 of section 987 gain with respect to QBU3 (10% of \$1,000) under §1.987-5(a). Under §1.987-6(b)(2)(i)(A), (B), and (D), the section 987 gain is initially characterized as foreign source general category tentative tested income. If a current rate election was not in effect, CFC would recognize \$50 of section 987 loss with respect to QBU1 (25% of \$200) and \$150 of section 987 loss with respect to QBU2 (15% of \$1,000). However, under paragraph (c) of this section, these amounts instead become suspended section 987 loss. Under §1.987-6(b)(2)(i)(A) and (B), the \$50 of suspended section 987 loss with respect to QBU1 is initially characterized as foreign source passive category income assigned to a subpart F income group described in §1.960-1(d)(2)(ii)(B)(2)(i) through (v), and under §1.987-6(b)(2)(i)(C) is treated as foreign currency loss taken into account under section 954(c)(1)(D). Under §1.987-6(b)(2)(i)(A), (B), and (D), the \$150 of suspended section 987 loss with respect to QBU2 is initially characterized as foreign source general category tentative tested income.

(B) *Cumulative suspended section 987 loss.* Under paragraph (b) of this section, in year 2, CFC's cumulative suspended section 987 loss in the recognition grouping of foreign source passive category foreign currency gain or loss taken into account under section 954(c)(1)(D) with respect to QBU1 is \$50, the amount that became suspended section 987 loss in the recognition grouping in year 2. In addition, CFC's total cumulative suspended section 987 loss in that recognition grouping is \$50. Similarly, CFC's cumulative suspended section 987 loss in the recognition grouping of foreign source general category tentative tested income with respect to QBU2 is

\$150, the amount that became suspended section 987 loss in the recognition grouping in year 2. In addition, CFC's total cumulative suspended section 987 loss in that recognition grouping is \$150.

(C) *Recognition of suspended section 987 loss.* Under paragraph (e)(1) of this section, in year 2, CFC recognizes a portion of its total cumulative suspended section 987 loss in a single recognition grouping to the extent that it recognizes section 987 gain in the same recognition grouping with respect to any section 987 QBU. In year 2, CFC has \$50 of total cumulative suspended section 987 loss in the recognition grouping of foreign source passive category foreign currency gain or loss taken into account under section 954(c)(1)(D) and \$150 of total cumulative suspended section 987 loss in the recognition grouping of foreign source general category tentative tested income. CFC recognized \$100 of section 987 gain in year 2 with respect to QBU3 in the recognition grouping of foreign source general category tentative tested income. Therefore, CFC also recognizes \$100 of its total cumulative suspended section 987 loss in the same recognition grouping. The cumulative suspended section 987 loss that is recognized by CFC is attributable to QBU2, because QBU2 is CFC's only QBU with cumulative suspended section 987 loss in the recognition grouping of foreign source general category tentative tested income. Because no election under §1.951A-2(c)(7) applies in year 2, both the \$100 of recognized section 987 gain and the \$100 of recognized section 987 loss are allocated to foreign source general category tentative tested income. See §1.987-6(b)(2)(ii) The amounts of suspended section 987 loss not recognized (that is, \$50 of suspended section 987 loss characterized as foreign source passive category foreign currency gain or loss taken into account under section 954(c)(1)(D) with respect to QBU1 and \$50 of suspended section 987 loss characterized as foreign source general category tentative tested income with respect to QBU2) remain suspended. Paragraph (e)(2) of this section does not apply because an annual recognition election is not in effect. The result would be the same if CFC had recognized section 987 gain in year 1, because section 987 gain from prior years is not taken into account under paragraph (e)(1) of this section.

(2) *Example 2: Suspension of section 987 loss when a current rate election is revoked—(i) Facts.* U.S. Corp is a domestic corporation that owns all of the interests in DE1. DE1 owns Business A, which is a section 987 QBU of U.S. Corp. In year 1, U.S. Corp made a current rate election but not an annual recognition election. In year 9, U.S. Corp has net unrecognized section 987 loss of \$2 million with respect to Business A, which is not recognized or suspended in year 9. U.S. Corp revokes its current rate election effective for year 10. In year 10, before the application of this section, U.S. Corp has net accumulated unrecognized section 987 loss of \$2 million.

(ii) *Analysis.* Under paragraph (d)(2) of this section, U.S. Corp's net accumulated unrecognized section 987 loss of \$2 million with respect to Business A is converted into suspended section 987 loss at the beginning of year 10, the first taxable year in which the current rate election ceases to be in effect.

20. Section 1.987-12 is revised to read as follows:

§1.987-12 Deferral of section 987 gain or loss.

(a) *Overview—(1) Scope.* This section provides rules that defer the recognition of section 987 gain or loss and rules for recognizing (or suspending) deferred section 987 gain or loss. This paragraph (a) provides an overview of this section and certain instances when this section does not apply. Paragraph (b) of this section describes the extent to which net unrecognized section 987 gain or loss is recognized under §1.987-5 (or in certain cases, suspended) or becomes deferred section 987 gain or loss in connection with a deferral event. Paragraph (c) of this section describes the extent to which deferred section 987 gain or loss is recognized (or in certain cases, suspended) upon the occurrence of subsequent events. Paragraph (d) of this section provides a rule relating to the treatment of a successor deferral QBU when deferred section 987 loss becomes suspended section 987 loss. Paragraph (e) of this section provides an anti-abuse rule. Paragraph (f) of this section provides rules for determining the deferred section 987 gain or loss of combined and separated QBUs. Paragraph (g) of this section provides definitions. Paragraph (h) of this section provides examples illustrating the rules described in this section.

(2) *Exceptions—(i) Annual recognition election.* This section does not apply to a termination of a section 987 QBU in a taxable year in which an annual recognition election is in effect.

(ii) *De minimis rule.* This section does not apply in a taxable year if the aggregate amount of net unrecognized section 987 gain or loss of the owner with respect to all of its section 987 QBUs that would become deferred section 987 gain or loss under this section does not exceed \$5 million.

(b) *Treatment of section 987 gain and loss in connection with a deferral event.* Notwithstanding §1.987-5 (general rule requiring recognition of section 987 gain or loss in the taxable year of a remittance), the owner of a section 987 QBU with respect to which a deferral event occurs (an *original deferral QBU*) includes in taxable income section 987 gain or loss in connection with the deferral event only to the extent provided in this paragraph (b).

(1) *Gain or loss recognized (or suspended) in the taxable year of a deferral event.* In the taxable year of a deferral event with respect to an original deferral QBU, the owner of the original deferral QBU recognizes section 987 gain or loss under §1.987-5, except that, solely for purposes of applying §1.987-5, all assets and liabilities of the original deferral QBU that, immediately after the deferral event, are reflected on the books and records of a successor deferral QBU are treated as not having been transferred and therefore as remaining on the books and records of the original deferral QBU notwithstanding the deferral event. Notwithstanding the prior sentence, any section 987 loss that would otherwise be recognized under this paragraph (b) (1) and §1.987-5 may instead become suspended loss under §1.987-11(c) if a current rate election is in effect, or under §1.987-13(h) if the deferral event also constitutes an outbound loss event.

(2) *Deferred section 987 gain or loss attributable to a successor deferral QBU.* In the taxable year of a deferral event with respect to an original deferral QBU, any net unrecognized section 987 gain or loss that is not recognized (under §1.987-5 including pursuant to paragraph (b)(1) of this section) or suspended (under §1.987-11(c) or (d) or 1.987-13(h)) in the taxable year of the deferral event becomes deferred section 987 gain or loss of the original deferral QBU owner. A portion of the deferred section 987 gain or loss becomes deferred section 987 gain or loss with respect to each successor deferral QBU. Such portion is equal to the deferred section 987 gain or loss multiplied by a fraction, the numerator of which is the aggregate adjusted basis of the gross assets transferred to the successor deferral QBU in connection with the deferral event and the denominator of which is the aggregate adjusted basis of the gross assets transferred to all successor deferral QBUs in connection with the deferral event.

(c) *Recognition (or suspension) of deferred section 987 gain or loss following a deferral event.* An original deferral QBU owner recognizes deferred section 987 gain or loss with respect to a successor deferral QBU in the taxable year of the deferral event and in subsequent taxable years as provided in this paragraph (c).

(1) *Recognition upon a subsequent remittance—(i) In general.* Except as provided in paragraph (c)(2) of this section, an original deferral QBU owner recognizes deferred section 987 gain or loss in the taxable year of the deferral event, and in subsequent taxable years, upon a remittance from a successor deferral QBU to the owner of the successor deferral QBU (*successor deferral QBU owner*) in the amount described in paragraph (c)(1)(ii) of this section. Notwithstanding the prior sentence, any deferred section 987 loss that would otherwise be recognized under this paragraph (c)(1) may instead become suspended section 987 loss under §1.987-11(c) if a current rate election is in effect with respect to the original deferral QBU owner.

(ii) *Amount.* The amount of deferred section 987 gain or loss that is recognized (or suspended) pursuant to this paragraph (c)(1) in a taxable year of the original deferral QBU owner is the original deferral QBU owner's outstanding deferred section 987 gain or loss (that is, the amount of deferred section 987 gain or loss not previously recognized or suspended) with respect to the successor deferral QBU multiplied by the remittance proportion of the successor deferral QBU owner with respect to the successor deferral QBU for the taxable year ending with or within the taxable year of the original deferral QBU owner, as determined under §1.987-5(b) without regard to any annual recognition election of the successor deferral QBU owner. See paragraph (h)(4) of this section (*Example 4*) for an illustration of this rule.

(iii) *Deemed remittance by a successor deferral QBU.* For purposes of this paragraph (c)(1), in a taxable year of the original deferral QBU owner in which a successor deferral QBU ceases to be owned by a member of the controlled group that includes the original deferral QBU owner, the successor deferral QBU is treated as having a remittance proportion of one. Accordingly, if a successor deferral QBU ceases to be owned by a member of the controlled group that includes the original deferral QBU owner, the original deferral QBU owner's outstanding deferred section 987 gain or loss with respect to that successor deferral QBU will be recognized (or suspended). For purposes of this paragraph (c)(1), if the original deferral

QBU owner goes out of existence and there is no qualified successor, in the last taxable year of the original deferral QBU owner, each successor deferral QBU is treated as having a remittance proportion of one. This paragraph (c)(1)(iii) does not affect the application of the section 987 regulations to the successor deferral QBU owner with respect to its ownership of the successor deferral QBU.

(2) *Deferral events and outbound loss events with respect to a successor deferral QBU.* Notwithstanding paragraph (c) (1) of this section, if assets of the successor deferral QBU (*transferred assets*) are transferred (or deemed transferred) in a transaction (the *deemed transaction*) that would constitute a deferral event or an outbound loss event if the original deferral QBU owner owned the successor deferral QBU directly and the original deferral QBU owner had net unrecognized section 987 gain or loss with respect to the successor deferral QBU equal to its outstanding deferred section 987 gain or loss with respect to the successor deferral QBU, then, in accordance with §1.987-13(h)—

(i) The original deferral QBU owner recognizes outstanding deferred section 987 gain or loss, or suspends outstanding deferred section 987 loss, to the extent it would have recognized or suspended net unrecognized section 987 gain or loss under the deemed transaction;

(ii) Each section 987 QBU is a successor deferral QBU to the extent it would have been under the deemed transaction and the original deferral QBU owner has deferred section 987 gain or loss with respect to the successor deferral QBU to the extent it would have under the deemed transaction;

(iii) Each eligible QBU is a successor suspended loss QBU to the extent it would have been under the deemed transaction and the original deferral QBU owner has suspended section 987 loss with respect to the suspended loss QBU to the extent it would have under the deemed transaction.

(d) *Successor deferral QBU becomes a successor suspended loss QBU.* A successor deferral QBU becomes a successor suspended loss QBU, and an original deferral QBU owner becomes an original suspended loss QBU owner, if any of the original deferral QBU owner's deferred section 987 loss with respect to

the successor deferral QBU becomes suspended section 987 loss. An eligible QBU may be both a successor deferral QBU and a successor suspended loss QBU and the original deferral QBU owner may also be an original suspended loss QBU owner.

(e) *Anti-abuse.* No section 987 loss is recognized under this section, §1.987-5, or §1.987-13 in connection with a transaction or series of transactions that are undertaken with a principal purpose of avoiding the purposes of this section.

(f) *Combinations and separations of successor deferral QBUs.* A combined QBU is a successor deferral QBU if either combining QBU was a successor deferral QBU. A separated QBU is a successor deferral QBU if the separating QBU was a successor deferral QBU.

(1) *Combined QBU.* The deferred section 987 gain or loss of a combined QBU in each recognition grouping for a taxable year is equal to the sum of the combining QBUs' deferred section 987 gain or loss in that recognition grouping.

(2) *Separated QBU.* The deferred section 987 gain or loss of a separated QBU in each recognition grouping for a taxable year is equal to the sum of the separating QBU's deferred section 987 gain or loss in each recognition grouping multiplied by the separation fraction.

(g) *Definitions.* The following definitions apply for purposes of this section.

(1) *Deferral event.* A deferral event with respect to a section 987 QBU means any transaction or series of transactions that satisfy the conditions described in both paragraphs (g)(1)(i) and (ii) of this section.

(i) *Events.* The transaction or series of transactions constitutes either:

(A) A termination of the section 987 QBU under §1.987-8(b)(2) (substantially all the assets transferred to the owner), §1.987-8(b)(5) (section 987 QBU ceases to be a section 987 QBU), or §1.987-8(b)(6) (ownership of section 987 QBU changes between direct and indirect ownership); or

(B) A disposition of part of an interest in a section 987 aggregate partnership or DE through which the section 987 QBU is owned, a disposition of part of a directly held section 987 QBU, or any contribution by another person to a section 987 aggregate partnership, DE, or section 987

QBU 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 contribution gives rise to a deemed transfer from the section 987 QBU to the owner.

(ii) *Assets on books of successor deferral QBU.* Immediately after the transaction or series of transactions, assets of the section 987 QBU are reflected on the books and records of a successor deferral QBU.

(2) *Successor deferral QBU.* A section 987 QBU (*potential successor deferral QBU*) is a successor deferral QBU with respect to a section 987 QBU referred to in paragraph (g)(1)(i) of this section if, immediately after the transaction or series of transactions described in that paragraph, the potential successor deferral QBU satisfies all of the conditions described in paragraphs (g)(2)(i) through (iii) of this section.

(i) The books and records of the potential successor deferral QBU reflect assets that, immediately before the transaction or series of transactions described in paragraph (g)(1)(i) of this section, were reflected on the books and records of the section 987 QBU referred to in that paragraph.

(ii) The owner of the potential successor deferral QBU and the owner of the section 987 QBU referred to in paragraph (g)(1)(i) of this section immediately before the transaction or series of transactions described in that paragraph are members of the same controlled group.

(iii) If the owner of the section 987 QBU referred to in paragraph (g)(1)(i) of this section immediately before the transaction or series of transactions described in that paragraph was a U.S. person, the potential successor deferral QBU is owned by a U.S. person.

(3) *Original deferral QBU owner.* An original deferral QBU owner means, with respect to an original deferral QBU, the owner of the original deferral QBU immediately before the deferral event, or the owner's qualified successor.

(4) *Qualified successor.* A qualified successor with respect to a corporation (*transferor corporation*) means another corporation that acquires the assets of the transferor corporation in a transaction described in section 381(a) (*acquiring*

corporation), provided that the acquiring corporation is a domestic corporation and the transferor corporation was a domestic corporation, or the acquiring corporation is a controlled foreign corporation and the transferor corporation was a controlled foreign corporation. A qualified successor with respect to a partnership (*transferor partnership*) means another partnership (*acquiring partnership*) that acquires the assets of the transferor partnership in a merger or consolidation described in section 708(b)(2)(A). A qualified successor with respect to an individual decedent means the estate of the decedent. A qualified successor of a person includes the qualified successor of a qualified successor.

(h) *Examples.* The following examples illustrate the application of this section. For purposes of the examples, DC1 is a domestic corporation that owns all of the stock of DC2, which is also a domestic corporation, and CFC1, a controlled foreign corporation. In addition, DC1, DC2, and CFC1 are members of a controlled group, and the de minimis rule of paragraph (a)(2)(ii) of this section is not applicable. Finally, except as otherwise provided, Business A is a section 987 QBU with the euro as its functional currency, there are no transfers between Business A and its owner, and Business A's assets are not depreciable or amortizable.

(1) *Example 1: Contribution of a section 987 QBU with net unrecognized section 987 gain to a member of the controlled group—(i) Facts.* DC1 owns Business A. The adjusted balance sheet of Business A reflects assets with an aggregate adjusted basis of €1,000x and no liabilities. DC1 contributes €900x of Business A's assets to DC2 in exchange for DC2 stock in a transaction to which section 351 applies. Immediately after the contribution, the remaining €100x of Business A's assets are no longer reflected on the books and records of a section 987 QBU (but are instead reflected on the books and records of DC1's home office). DC2, which has the U.S. dollar as its functional currency, uses the Business A assets in a business (*Business B*) that constitutes a section 987 QBU. At the time of the contribution, Business A has net unrecognized section 987 gain of \$100x.

(ii) *Analysis—(A)* Under §1.987-2(c)(2)(ii), DC1's contribution of €900x of Business A's assets to DC2 is treated as a transfer of all of the assets of Business A to DC1, immediately followed by DC1's contribution of €900x of Business A's assets to DC2. The contribution of Business A's assets is a deferral event within the meaning of paragraph (g)(1) of this section because:

(1) The transfer from Business A to DC1 is a transfer of substantially all of Business A's assets

to DC1, resulting in a termination of the Business A QBU under §1.987-8(b)(2); and

(2) Immediately after the transaction, assets of Business A are reflected on the books and records of Business B, a section 987 QBU owned by a member of DC1's controlled group and a successor deferral QBU within the meaning of paragraph (g)(2) of this section. Accordingly, Business A is an original deferral QBU within the meaning of paragraph (b) of this section, and DC1 is an original deferral QBU owner of Business A within the meaning of paragraph (g) (3) of this section.

(B) Under paragraph (b)(1) of this section, DC1's taxable income in the taxable year of the deferral event includes DC1's section 987 gain or loss determined with respect to Business A under §1.987-5, except that, for purposes of applying §1.987-5, all assets of Business A that are reflected on the books and records of Business B immediately after Business A's termination are treated as not having been transferred and therefore as though they remained on Business A's books and records (notwithstanding the deemed transfer of those assets under §1.987-8(e)). Accordingly, in the taxable year of the deferral event, Business A is treated as making a remittance of €100x, corresponding to the assets of Business A that are no longer reflected on the books and records of a section 987 QBU, and is treated as having a remittance proportion with respect to Business A of 0.1, determined by dividing the €100x remittance by the sum of the remittance and the €900x aggregate adjusted basis of the gross assets deemed to remain on Business A's books and records at the end of the taxable year. Thus, DC1 recognizes \$10x of section 987 gain in the taxable year of the deferral event. DC1's deferred section 987 gain equals \$90x, which is the amount of section 987 gain that, but for the application of paragraph (b) of this section, DC1 would have recognized under §1.987-5 (which is \$100x), less the amount of section 987 gain recognized by DC1 under §1.987-5 and this section (which is \$10x).

(2) *Example 2: Contribution of a section 987 QBU to a member of the controlled group when a current rate election is in effect—(i) Facts.* DC1 owns Business A, which is engaged in the business of manufacturing Product X. In a taxable year in which a current rate election is in effect (and an annual recognition election is not in effect), the adjusted balance sheet of Business A reflects assets with an aggregate adjusted basis of €1,000x and no liabilities. DC1 contributes €900x of Business A's assets to DC2 in exchange for DC2 stock in a transaction to which section 351 applies. Immediately after the contribution, the remaining €100x of Business A's assets are no longer reflected on the books and records of an eligible QBU that is engaged in the business of manufacturing Product X (but are instead reflected on the books and records of DC1's home office). DC2, which has the U.S. dollar as its functional currency, uses the Business A assets in a Product X manufacturing business (*Business B*) that constitutes a section 987 QBU. At the time of the contribution, Business A has net unrecognized section 987 loss of \$100x.

(ii) *Analysis—(A)* For the reasons described in paragraph (h)(1) of this section (*Example 1*), the contribution results in a termination of the Business A QBU and a deferral event with respect to the Business A QBU, an original deferral QBU; DC1 is

an original deferral QBU owner within the meaning of paragraph (g)(3) of this section; Business B is a successor deferral QBU with respect to Business A; and DC2 is a successor deferral QBU owner.

(B) Under paragraph (b)(1) of this section, for purposes of applying §1.987-5, all the assets of Business A that are reflected on the books and records of Business B immediately after Business A's termination are treated as not having been transferred and therefore as though they remained on Business A's books and records (notwithstanding the deemed transfer of those assets under §1.987-8(e)). Accordingly, in the taxable year of the deferral event, Business A is treated as making a remittance of €100x, corresponding to the assets of Business A that are no longer reflected on the books and records of a section 987 QBU, and DC1 is treated as having a remittance proportion with respect to Business A of 0.1, determined by dividing the €100x remittance by the sum of the remittance and the €900x aggregate adjusted basis of the gross assets deemed to remain on Business A's books and records at the end of the taxable year. Thus, but for the application of §1.987-11(c), DC1 would recognize \$10x of section 987 loss in the taxable year of the deferral event. Under §1.987-11(c), because a current rate election is in effect (and an annual recognition election is not in effect), the loss is instead treated as suspended section 987 loss. DC1's deferred section 987 loss equals \$90x, which is the amount of section 987 loss that, but for the application of paragraph (b) of this section, would have been suspended under §1.987-11(c) (which is \$100x), less the amount of section 987 loss suspended under §1.987-11(c) (which is \$10x).

(C) Under §1.987-13(b)(1)(i), Business B is a successor suspended loss QBU because, immediately after the termination of the Business A section 987 QBU, a significant portion of the assets of Business A was reflected on the books and records of Business B (an eligible QBU), Business B continued to carry on the trade or business of Business A, and Business B was owned by DC2, a member of the same controlled group as DC1 (which is the original suspended loss QBU owner under §1.987-13(l)(1)). Therefore, under §1.987-13(b)(1)(ii), all of Business A's suspended section 987 loss (including the suspended section 987 loss resulting from the termination of Business A) becomes suspended section 987 loss with respect to Business B.

(3) *Example 3: Election to be classified as a corporation—(i) Facts.* DC1 owns all of the interests in Entity A, a DE. Entity A conducts Business A, which has net unrecognized section 987 gain of \$500x. Entity A elects to be classified as a corporation under §301.7701-3(c). As a result of the election and pursuant to §301.7701-3(g)(1)(iv), DC1 is treated as contributing all of the assets and liabilities of Business A to newly-formed CFC1, which has the euro as its functional currency. Immediately after the contribution, the assets and liabilities of Business A are reflected on CFC1's books and records.

(ii) *Analysis.* Under §1.987-2(c)(2)(ii), DC1's deemed contribution of all of the assets and liabilities of Business A to CFC1 is treated as a transfer of all of the assets and liabilities of Business A to DC1, followed immediately by DC1's contribution of those assets and liabilities to CFC1. Because the deemed transfer from Business A to DC1 is a transfer

of substantially all of Business A's assets to DC1, the Business A QBU terminates under §1.987-8(b)(2). The contribution of Business A's assets is not a deferral event within the meaning of paragraph (b) of this section because, immediately after the transaction, no assets of Business A are reflected on the books and records of a successor deferral QBU within the meaning of paragraph (g)(2) of this section due to the fact that the assets of Business A are not reflected on the books and records of a section 987 QBU immediately after the termination. In addition, the requirement of paragraph (g)(2)(iii) of this section is not met because Business A was owned by a U.S. person and the potential successor deferral QBU, which is owned by CFC1, is not owned by a U.S. person. Accordingly, DC1 recognizes section 987 gain of \$500x with respect to Business A under §1.987-5 without regard to this section. Because the requirement of paragraph (g)(2)(iii) of this section is not met, the result would be the same even if the assets of Business A were transferred in a section 351 exchange to an existing foreign corporation that had a different functional currency than Business A.

(4) *Example 4: Partial recognition of deferred gain or loss—(i) Facts.* DC1 owns all of the interests in Entity A, a DE that conducts Business A in Country X. During year 1, DC1 contributes all of its interests in Entity A to DC2 in an exchange to which section 351 applies. At the time of the contribution, Business A has net unrecognized section 987 gain of \$100x. After the contribution, Entity A continues to conduct business in Country X (*Business B*). In year 3, as a result of a net transfer of property from Business B to DC2, DC2's remittance proportion with respect to Business B, as determined under §1.987-5, is 0.25.

(ii) *Analysis—(A)* For the reasons described in paragraph (h)(1) of this section (*Example 1*), the contribution of all the interests in Entity A by DC1 to DC2 results in a termination of the Business A QBU and a deferral event with respect to the Business A QBU, an original deferral QBU; DC1 is an original deferral QBU owner within the meaning of paragraph (g)(3) of this section; Business B is a successor deferral QBU with respect to Business A; DC2 is a successor deferral QBU owner; and the \$100x of net unrecognized section 987 gain with respect to Business A becomes deferred section 987 gain as a result of the deferral event.

(B) Under paragraph (c)(1)(i) of this section, DC1 recognizes deferred section 987 gain in year 3 as a result of the remittance from Business B to DC2. Under paragraph (c)(1)(ii) of this section, the amount of deferred section 987 gain that DC1 recognizes is \$25x, which is DC1's outstanding deferred section 987 gain of \$100x with respect to Business A multiplied by the remittance proportion of 0.25 of DC2 with respect to Business B for the taxable year as determined under §1.987-5(b).

21. Section 1.987-13 is added to read as follows:

§1.987-13 Suspended section 987 loss upon terminations.

(a) *Overview—(1) In general.* This section provides rules relating to suspended

section 987 loss of an owner with respect to a section 987 QBU or successor suspended loss QBU that terminates. Paragraph (b) of this section provides rules treating suspended section 987 loss as recognized or attributable to a successor when a section 987 QBU terminates. Paragraph (c) of this section provides rules treating suspended section 987 loss as recognized or attributable to a subsequent successor when a successor suspended loss QBU terminates. Paragraph (d) of this section provides rules regarding the recognition of suspended section 987 loss when interests in a successor suspended loss QBU owner are transferred. Paragraph (e) of this section provides rules that apply when interests in an original suspended loss QBU owner are transferred. Paragraph (f) of this section provides rules that apply when an original suspended loss QBU owner ceases to exist. Paragraph (g) of this section provides rules preventing the carryover of suspended section 987 loss in connection with certain inbound transactions. Paragraph (h) of this section provides rules that suspend section 987 loss in connection with certain outbound transactions. Paragraph (i) of this section is reserved. Paragraph (j) of this section provides rules relating to the termination of a successor suspended loss QBU. Paragraph (k) of this section provides an anti-abuse rule. Paragraph (l) of this section provides definitions that apply for purposes of this section. Paragraph (m) of this section provides examples illustrating the rules of this section.

(2) *Ordering rule.* Paragraphs (b) through (d) of this section are applied after the application of §1.987-11(e) (loss-to-the-extent-of-gain rule).

(b) *Termination of a section 987 QBU with suspended loss.* If a section 987 QBU terminates, and at the time of termination, the owner has suspended section 987 loss with respect to the section 987 QBU (including because the termination was an outbound loss event or because net unrecognized section 987 loss became suspended section 987 loss upon termination as a result of a current rate election), then either paragraph (b)(1) or (2) of this section applies.

(1) *Suspended section 987 loss becomes suspended section 987 loss with respect to a successor suspended loss QBU—(i)*

Successor suspended loss QBU. If, immediately after the termination, a significant portion of the assets of the terminating section 987 QBU are reflected on the books and records of an eligible QBU that carries on a trade or business of the section 987 QBU and is owned by the owner of the section 987 QBU or a member of its controlled group, then the eligible QBU is a successor suspended loss QBU and the rules described in paragraph (b)(1)(ii) of this section apply.

(ii) *Attribution of suspended section 987 loss to successor suspended loss QBU.* A portion of the cumulative suspended section 987 loss with respect to the terminating section 987 QBU that is not recognized in the taxable year of the termination under §1.987-11(e) becomes suspended section 987 loss with respect to each successor suspended loss QBU. Such portion is equal to the suspended section 987 loss described in the preceding sentence, multiplied by a fraction, the numerator of which is the aggregate adjusted basis of the gross assets transferred to the successor suspended loss QBU in connection with the termination, and the denominator of which is the aggregate adjusted basis of the gross assets transferred to all successor suspended loss QBUs in connection with the termination.

(2) *Recognition of suspended loss.* If, immediately after the termination of the section 987 QBU, there is no successor suspended loss QBU under paragraph (b) (1) of this section, then the owner recognizes the cumulative suspended section 987 loss with respect to the section 987 QBU that is not recognized in the taxable year of the termination under §1.987-11(e).

(c) *Termination of a successor suspended loss QBU.* If a successor suspended loss QBU terminates (as described in paragraph (j) of this section), then either paragraph (c)(1) or (2) of this section applies.

(1) *Successor to the successor suspended loss QBU—(i) Successor suspended loss QBU.* If, immediately after the termination, a significant portion of the assets of the terminating successor suspended loss QBU (*initial successor*) are reflected on the books and records of an eligible QBU (*subsequent successor*) that carries on a trade or business of

the initial successor and is owned by the original suspended loss QBU owner or a member of its controlled group, then the subsequent successor is a successor suspended loss QBU and the rules described in paragraph (c)(1)(ii) of this section apply.

(ii) *Attribution of suspended section 987 loss to successor suspended loss QBU.* A portion of the cumulative suspended section 987 loss with respect to the initial successor that is not recognized in the taxable year of the termination under §1.987-11(e) becomes suspended section 987 loss with respect to each subsequent successor. Such portion is equal to the suspended section 987 loss described in the preceding sentence, multiplied by a fraction, the numerator of which is the aggregate adjusted basis of the gross assets transferred to the subsequent successor in connection with the termination, and the denominator of which is the aggregate adjusted basis of the gross assets transferred to all subsequent successors in connection with the termination.

(2) *Recognition of suspended loss.* If, immediately after the termination of the initial successor, there is no subsequent successor that is a successor suspended loss QBU under paragraph (c)(1) of this section, then the original suspended loss QBU owner recognizes the cumulative suspended section 987 loss with respect to the initial successor that is not recognized in the taxable year of the termination under §1.987-11(e).

(d) *Transfer of successor suspended loss QBU owner.* If a successor suspended loss QBU ceases to be owned by a member of the original suspended loss QBU owner's controlled group as a result of a direct or indirect transfer, or an issuance or redemption, of an ownership interest in the successor suspended loss QBU owner, then the original suspended loss QBU owner recognizes the cumulative suspended section 987 loss with respect to the successor suspended loss QBU that is not recognized in the taxable year under §1.987-11(e).

(e) *Transfer of original suspended loss QBU owner.* If an original suspended loss QBU owner ceases to be a member of the successor suspended loss QBU owner's controlled group as a result of a direct or indirect transfer, or an issuance or redemption, of an ownership interest in

the original suspended loss QBU owner, the original suspended loss QBU owner's suspended section 987 loss ceases to be suspended section 987 loss with respect to any section 987 QBU or successor suspended loss QBU. As a result, the suspended section 987 loss can be recognized under §1.987-11(e) but cannot be recognized under paragraph (b)(2), (c)(2), or (d) of this section.

(f) *Original suspended loss QBU owner ceases to exist.* If an original suspended loss QBU owner ceases to exist and there is no successor under paragraph (l)(1)(ii) of this section (for example, as a result of a section 331 liquidation), then any suspended section 987 loss that is not recognized after application of the loss-to-the-extent-of-gain rule in §1.987-11(e) cannot be recognized and is eliminated.

(g) *Inbound nonrecognition transactions – no carryover of suspended section 987 loss.* If an owner of a section 987 QBU with suspended section 987 loss, or an original suspended loss QBU owner, ceases to exist in a transaction described in §1.987-8(c)(1)(ii) (inbound section 332 liquidation) or (c)(2)(ii) (inbound reorganization), then any suspended section 987 loss of the owner or original suspended loss QBU owner that is not recognized after application of the loss-to-the-extent-of-gain rule in §1.987-11(e) is eliminated. As a result, the distributee or acquiring corporation does not succeed to or take into account any suspended section 987 loss of the owner or original suspended loss QBU owner under section 381.

(h) *Outbound transactions – recognition or suspension of net unrecognized section 987 loss.* This paragraph (h) applies to taxable years in which neither a current rate election nor an annual recognition election is in effect.

(1) *In general.* Notwithstanding §1.987-5, if an outbound loss event occurs with respect to a section 987 QBU (an *outbound loss QBU*), the original owner of the section 987 QBU includes in taxable income in the taxable year of the outbound loss event section 987 loss with respect to the outbound loss QBU only to the extent provided in paragraph (h)(3) of this section.

(2) *Outbound loss event.* An outbound loss event means, with respect to a section 987 QBU:

(i) Any termination of the section 987 QBU as a result of a transfer by a U.S. person of assets of the section 987 QBU to a foreign person that is a member of the same controlled group as the U.S. person immediately before the transaction or, if the transferee did not exist immediately before the transaction, immediately after the transaction (*related foreign person*), provided that the termination would result in the recognition of section 987 loss with respect to the section 987 QBU under §1.987-5 but for this paragraph (h); or

(ii) Any transfer by a U.S. person of part of an interest in a section 987 aggregate partnership, or part of an interest in a DE, 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 DE 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 but for this paragraph (h).

(3) *Loss recognition upon an outbound loss event.* In the taxable year of an outbound loss event with respect to an outbound loss QBU, the owner of the outbound loss QBU recognizes section 987 loss as determined under §§1.987-5 and 1.987-12(b), except that, solely for purposes of applying §1.987-5, assets and liabilities of the outbound loss QBU that, immediately after the outbound loss event, are reflected on the books and records of an eligible QBU owned by the related foreign person described in paragraph (h)(2) of this section are treated as not having been transferred and therefore as remaining on the books and records of the outbound loss QBU notwithstanding the outbound loss event.

(4) *Loss suspension upon outbound loss event.* Net unrecognized section 987 loss or deferred section 987 loss that, as a result of this paragraph (h), is not recognized in the taxable year of the outbound loss event (*outbound section 987 loss*) under §1.987-5 becomes suspended section 987 loss.

(i) [Reserved]

(j) *Termination of a successor suspended loss QBU.* For purposes of

applying paragraph (c) of this section, a successor suspended loss QBU terminates if it ceases to be an eligible QBU of its owner.

(k) *Anti-abuse.* No section 987 loss is recognized under this section, §1.987-5, or §1.987-12 in connection with a transaction or series of transactions that are undertaken with a principal purpose of avoiding the purposes of this section.

(l) *Definitions.* The following definitions apply for purposes of this section.

(1) *Original suspended loss QBU owner—(i) In general.* An *original suspended loss QBU owner* is the person that was the owner of a section 987 QBU before its termination in a transaction to which paragraph (b)(1) of this section applies.

(ii) *Successors.* If an original suspended loss QBU owner is a corporation (*transferor corporation*) and another corporation acquires the assets of the transferor corporation in a transaction described in section 381(a), then the acquiring corporation becomes the original suspended loss QBU owner.

(2) *Successor suspended loss QBU.* A *successor suspended loss QBU* is an eligible QBU (which may or may not be a section 987 QBU) with respect to which the original suspended loss QBU owner has suspended section 987 loss after the termination of its section 987 QBU. See paragraphs (b)(1) and (c)(1) of this section and §1.987-12(d) for rules regarding when an eligible QBU is a successor suspended loss QBU.

(3) *Successor suspended loss QBU owner.* A *successor suspended loss QBU owner* is the owner of the assets and liabilities of a successor suspended loss QBU.

(4) *Ownership interests.* The term *ownership interests* means stock in a corporation, partnership interests in a partnership, and beneficiary interests in a non-grantor trust or an estate.

(5) *Significant portion.* With respect to the assets of an eligible QBU, the term *significant portion* means a significant portion of the operating assets, determined based on all the facts and circumstances, provided that more than 30 percent of the operating assets will constitute a significant portion in all cases and less than 10 percent of the operating assets will not constitute a significant portion in all cases.

(m) *Examples.* The following examples illustrate the application of this section. For purposes of the examples, DC1 is a domestic corporation that owns all of the interests in Entity A, a DE. Entity A conducts Business A, a section 987 QBU that is engaged in the business of selling Product X. Business A has the euro as its functional currency and has cumulative suspended section 987 loss under §1.987-11(b) of \$500x.

(1) *Example 1: Trade or business of a section 987 QBU ceases—(i) Facts.* Entity A's trade or business of selling Product X ceases, resulting in a termination of the Business A section 987 QBU under §1.987-8(b)(1). After the trade or business is wound up, the remaining assets are transferred to DC1 and are not used in the trade or business of selling Product X immediately following the termination.

(ii) *Analysis.* Immediately after the termination of the Business A section 987 QBU, a significant portion of Business A's assets is not reflected on the books and records of an eligible QBU that carries on a trade or business of Business A and is owned by DC1 or a member of its controlled group. Therefore, Business A has no successor suspended loss QBU under paragraph (b)(1) of this section. Consequently, DC1 recognizes the cumulative suspended section 987 loss with respect to the Business A section 987 QBU under paragraph (b)(2) of this section.

(2) *Example 2: Trade or business of a section 987 QBU is sold to a third party—(i) Facts.* DC1 sells all the interests in Entity A to a third party for cash.

(ii) *Analysis.* Under §1.987-2(c)(2)(ii), the sale of the Business A assets and liabilities for cash that is reflected on the books of DC1 is treated as a transfer of all of the assets and liabilities of Business A to DC1, followed immediately by DC1's sale of those assets and liabilities. Because the deemed transfer from Business A to DC1 is a transfer of substantially all of Business A's assets to DC1, the Business A section 987 QBU terminates under §1.987-8(b)(2). Immediately after the termination of the Business A section 987 QBU, a significant portion of Business A's assets is not reflected on the books and records of an eligible QBU that carries on a trade or business of Business A and is owned by DC1 or a member of its controlled group. Therefore, Business A has no successor suspended loss QBU under paragraph (b)(1) of this section. Consequently, DC1 recognizes the cumulative suspended section 987 loss with respect to the Business A section 987 QBU under paragraph (b)(2) of this section.

(3) *Example 3: Outbound loss event—(i) Facts.* Entity A elects to be classified as a corporation under §301.7701-3(c) of this chapter. As a result of the election and pursuant to §301.7701-3(g)(1)(iv) of this chapter, DC1 is treated as contributing all of the assets and liabilities of Business A to newly-formed CFC1, which has the euro as its functional currency. Immediately after the contribution, the assets and liabilities of Business A are reflected on CFC1's books and records. After being classified as a corporation, CFC1 owns Business A, and Business A conducts the same trade or business it conducted when it was

owned by DC1. Neither a current rate election nor an annual recognition election is in effect.

(ii) *Analysis—(A)* Under §1.987-2(c)(2)(ii), DC1's contribution of all of the assets and liabilities of Business A to CFC1 is treated as a transfer of all of the assets and liabilities of Business A to DC1, followed immediately by DC1's contribution of those assets and liabilities to CFC1. Because the deemed transfer from Business A to DC1 is a transfer of substantially all of Business A's assets to DC1, the Business A section 987 QBU terminates under §1.987-8(b)(2). The contribution of Business A's assets to CFC1 is not a deferral event within the meaning of §1.987-12(g)(1) because, immediately after the transaction, no assets of Business A are reflected on the books and records of a successor deferral QBU within the meaning of §1.987-12(g)(2) due to the fact that the assets of Business A are not reflected on the books and records of a section 987 QBU immediately after the termination, as well as the fact that the requirement of §1.987-12(g)(2)(iii) is not met because Business A was owned by a U.S. person and the potential successor deferral QBU, which is owned by CFC1, is not owned by a U.S. person. The termination of the Business A section 987 QBU as a result of the transfer of the assets of Business A by a U.S. person (DC1) to a foreign person (CFC1) that is a member of DC1's controlled group is an outbound loss event described in paragraph (h)(2) of this section.

(B) Under paragraphs (h)(1) and (3) of this section, in the taxable year of the outbound loss event, DC1 includes in taxable income section 987 loss recognized with respect to Business A as determined under §1.987-5, except that, for purposes of applying §1.987-5, all assets and liabilities of Business A that are reflected on the books and records of CFC1, a related foreign person described in paragraph (h)(2) of this section, are treated as not having been transferred. Accordingly, DC1's remittance proportion with respect to Business A is 0, and DC1 recognizes no section 987 loss with respect to Business A. DC1's outbound section 987 loss is \$500x, which is the amount of section 987 loss that DC1 would have recognized under §1.987-5 without regard to paragraph (h) of this section (\$500x), less the amount of section 987 loss recognized by DC1 under paragraph (h)(3) of this section (\$0). Under paragraph (h)(4) of this section, the \$500x of outbound section 987 loss becomes suspended section 987 loss.

(C) Under paragraph (b)(1)(i) of this section, Business A (in the hands of CFC1) is a successor suspended loss QBU because, immediately after the termination of the Business A section 987 QBU, the Business A assets are reflected on the books and records of Business A (in the hands of CFC1), Business A was an eligible QBU that continued to carry on the same trade or business, and Business A was owned by CFC1, a member of the same controlled group as DC (which is the original suspended loss QBU owner under paragraph (l)(1) of this section). Therefore, under paragraph (b)(1)(ii) of this section, all of Business A's suspended section 987 loss (including the suspended section 987 loss resulting from the termination of Business A) is treated as suspended section 987 loss with respect to Business A (in the hands of CFC1).

22. Section 1.987-14 is added to read as follows:

§1.987-14 Applicability date.

(a) *Section 987 regulations applicability date—(1) In general.* Except as provided in this section, the section 987 regulations apply to taxable years beginning after December 31, 2024.

(2) *Applicability date for a terminating QBU.* The section 987 regulations apply to the owner of a terminating QBU beginning on the day the section 987 QBU terminates, but only with respect to the section 987 QBU, any successor deferral QBUs or successor suspended loss QBUs (in their capacity as such), and any net unrecognized section 987 gain or loss, deferred section 987 gain or loss, or suspended section 987 loss with respect thereto. See §1.987-1(h) for the definition of a terminating QBU.

(3) *Partnerships.* If the section 987 regulations apply to a taxable year of a partnership and would not otherwise apply to the taxable year of a partner in which or with which the partnership's taxable year ends, then the section 987 regulations apply to that taxable year of the partner solely with respect to the partner's interest in the partnership and its section 987 gain or loss attributable to an eligible QBU held by the partnership.

(b) *Application of the section 987 regulations to taxable years beginning on or before December 31, 2024, and ending after November 9, 2023.* A taxpayer (including a taxpayer that has applied the 2016 and 2019 section 987 regulations to a prior taxable year under paragraph (c) of this section) may choose to apply the section 987 regulations to a taxable year beginning on or before December 31, 2024, and ending after November 9, 2023, provided the taxpayer and each member of its consolidated group and section 987 electing group:

(1) Consistently apply the section 987 regulations in their entirety to the taxable year and all subsequent taxable years beginning on or before December 31, 2024; and

(2) Apply the section 987 regulations on their original timely filed (including extensions) returns in the first taxable year in which the section 987 regulations apply.

(c) *Application of the 2016 and 2019 section 987 regulations*—(1) *In general.* A taxpayer may choose to apply the 2016 and 2019 section 987 regulations to a taxable year beginning after December 7, 2016, and beginning on or before December 31, 2024, provided the taxpayer and each member of its consolidated group and section 987 electing group:

(i) First apply the 2016 and 2019 section 987 regulations to a taxable year ending before November 9, 2023;

(ii) Consistently apply the 2016 and 2019 section 987 regulations in their entirety to all section 987 QBUs (within the meaning of prior §1.987-1(b)(2)) directly or indirectly owned (within the meaning of prior §1.987-1(b)(4)) by the taxpayer and each member of its consolidated group and section 987 electing group on the transition date for that taxable year and all subsequent taxable years before the taxable year in which the taxpayer and each member of its consolidated group and section 987 electing group apply the section 987 regulations pursuant to paragraph (a) or (b) of this section; and

(iii) Either—

(A) First applied the 2016 and 2019 section 987 regulations on their returns filed before November 9, 2023; or

(B) First apply the 2016 and 2019 section 987 regulations on their returns filed on or after November 9, 2023 and apply §1.987-10 in lieu of prior §1.987-10.

(2) *Application to section 987 QBUs not owned on the transition date.* For any taxable year in which a taxpayer applies the 2016 and 2019 section 987 regulations pursuant to paragraph (c)(1) of this section, the taxpayer may choose to apply the 2016 and 2019 section 987 regulations to any section 987 QBU (within the meaning of prior §1.987-1(b)(2)) that the taxpayer did not directly or indirectly own (within the meaning of prior §1.987-1(b)(4)) on the transition date, provided the taxpayer applies the 2016 and 2019 section 987 regulations consistently to that QBU for that taxable year and all subsequent taxable years before the taxable year in which the taxpayer applies the section 987 regulations pursuant to paragraph (a) or (b)(1) of this section, provided that the taxpayer either—

(i) First applied the 2016 and 2019 section 987 regulations to the section 987

QBU on its return filed before November 9, 2023; or

(ii) First applies the 2016 and 2019 section 987 regulations to the section 987 QBU on its return filed on or after November 9, 2023 and applies §1.987-10 in lieu of prior §1.987-10.

(3) *Modifications of defined terms for purposes of this paragraph (c).* Solely for purposes of this paragraph (c)—

(i) *Application of §1.987-10 in lieu of prior §1.987-10.* For any taxpayer to which paragraph (c)(1)(iii)(B) or (c)(2)(ii) of this section applies, the term *2016 and 2019 section 987 regulations* includes §1.987-10 and not prior §1.987-10.

(ii) *Partnerships not included in section 987 electing group.* The term *section 987 electing group* does not include foreign partnerships, foreign non-grantor trusts, or foreign estates.

(iii) *Transition date.* The term *transition date* has the meaning provided in prior §1.987-10.

(d) *Prior §1.987-12.* For the applicability dates of prior §1.987-12, see prior §1.987-12(j). Prior §1.987-12 applies through the end of the taxable year immediately preceding the first taxable year in which a taxpayer applies §1.987-12 pursuant to paragraph (a) or (b) of this section.

23. Section 1.988-1, as proposed to be amended by 81 FR 88882 (December 8, 2016), is further amended by:

a. Removing the language “§1.987-1(b)(5)” in paragraph (a)(4)(i) and adding the language “§1.987-1(h)” in its place.

b. Removing the language “§1.987-1(b)(3)” wherever it appears in paragraphs (a)(4)(i) and (iv) and adding the language “§1.987-1(b)(4)” in its place.

c. Removing the language “§1.987-1(b)(4)” wherever it appears in paragraphs (a)(4)(ii) and (iii) and adding the language “§1.987-1(b)(5)” in its place.

d. Removing the language “§1.987-7(b)” in the second sentence of paragraph (a)(4)(ii) and adding the language “§1.987-7B(b)” in its place.

2. Revising paragraph (i).

The revisions read as follows:

§1.988-1 Certain definitions and special rules.

(i) *Applicability date*—(1) *In general.* Except as otherwise provided in this section, this section applies to taxable years beginning after December 31, 1986. Thus, except as otherwise provided in this section, any payments made or received with respect to a section 988 transaction in taxable years beginning after December 31, 1986, are subject to this section.

(2) *Paragraphs (a)(4) and (a)(10)* (ii). Generally, paragraphs (a)(4) and (a)(10)(ii) of this section apply to taxable years beginning after December 31, 2024. However, if pursuant to §1.987-14(b), a taxpayer chooses to apply §§1.987-1 through 1.987-14 to a taxable year before the first taxable year described in §1.987-14(a)(1), then paragraphs (a)(4) and (a)(10)(ii) of this section apply to that taxable year. See §1.988-1(i), as contained in 26 CFR in part 1 in effect on April 1, 2017, for a prior applicability date for paragraphs (a)(4) and (a)(10)(ii) of this section.

24. Section 1.988-4 is amended by revising paragraph (b)(2) to read as follows:

§1.988-4 Source of gain or loss realized on a section 988 transfer

(b) ***

(2) *Proper reflection on the books of the taxpayer or qualified business unit*—(i) *In general.* For purposes of paragraph (b)(1) of this section, the principles of §1.987-2(b) apply in determining whether an asset, liability, or item of income, gain, deduction, or loss is reflected on the books and records of a qualified business unit.

(ii) *Applicability date.* Generally, paragraph (b)(2)(i) of this section applies to taxable years beginning after December 31, 2024. However, if pursuant to §1.987-14(b), a taxpayer chooses to apply §§1.987-1 through 1.987-14 to a taxable year before the first taxable year described in §1.987-14(a)(1), then paragraph (b)(2)(i) of this section applies to that taxable year.

25. Section 1.989(a)-1 is amended by:

a. In paragraph (b) removing the language “§1.987-1(b)(5)” in paragraph (b)(2)(i)(C) and adding the language “§1.987-1(h)” in its place; and

b. Revising paragraphs (b)(2)(i)(D), (b)(4), and (d)(3) and (4).

The revisions read as follows:

§1.989(a)-1 Definition of a qualified business unit.

(b) ***

(2) ***

(i) ***

(D) *Trusts and estates.* A non-grantor trust (within the meaning of §1.987-1(h)) and an estate is a QBU.

(4) *Applicability date.* Generally, paragraph (b)(2)(i) of this section applies to taxable years beginning after December 31, 2024. However, if pursuant to §1.987-14(b), a taxpayer chooses to apply §§1.987-1 through 1.987-14 to a taxable year before the first taxable year described in §1.987-14(a)(1), then paragraph (b)(2)(i) of this section applies to that taxable

year. *See* §1.989(a)-1(b)(4), as contained in 26 CFR in part 1 in effect on April 1, 2017, for a prior applicability date for paragraph (b)(2)(i) of this section.

(d) ***

(3) *Proper reflection on the books of the taxpayer or qualified business unit.* The principles of §1.987-2(b) apply in determining whether an asset, liability, or item of income, gain, deduction, or loss is reflected on the books of a qualified business unit (and therefore is attributable to such unit).

(4) *Applicability date.* Generally, paragraph (d)(3) of this section applies to taxable years beginning after December 31, 2024. However, if pursuant to §1.987-14(b), a taxpayer applies §§1.987-1 through 1.987-14 to a taxable year before the first taxable year described in §1.987-14(a)(1), then paragraph (b)(2)(i) of this section applies to that taxable year. *See* §1.989(a)-1(d)(4), as contained in 26 CFR

in part 1 in effect on April 1, 2017, for a prior applicability date for paragraph (d)(3) of this section.

26. Section 1.1502-13, as proposed to be amended at 88 FR 52057 (August 7, 2023), is further amended by:

a. In paragraph (a)(6)(ii) in the table revising the entry “(G) Miscellaneous operating rules”

b. Redesignating paragraph (j)(9) as paragraph (j)(10).

c. Adding a new paragraph (j)(9).

d. Adding paragraphs (j)(10)(viii) and (ix).

e. Adding paragraph (l)(10).

The additions and revision read as follows:

§1.1502-13 Intercompany transactions.

(a) ***

(6) ***

(ii) ***

Rule	General location	Paragraph	Example

(G) Miscellaneous operating rules.	§1.1502-13(j)(10)	(i)	Example 1. Intercompany sale followed by section 351 transfer to member.
		(ii)	Example 2. Intercompany sale of member stock followed by recapitalization.
		(iii)	Example 3. Back-to-back intercompany transactions—matching.
		(iv)	Example 4. Back-to-back intercompany transactions—acceleration.
		(v)	Example 5. Successor group.
		(vi)	Example 6. Liquidation—80% distributee.
		(vii)	Example 7. Liquidation—no 80% distributee.
		(viii)	Example 8. Loan by section 987 QBU.
		(ix)	Example 9. Sale of property by section 987 QBU.

(j) ***

(9) *Section 987 QBUs.* No intercompany transaction is attributable to a section 987 QBU (within the meaning of §1.987-2(b)). That is, in order to produce single entity treatment, an intercompany transaction that otherwise would involve the section 987 QBU(s) of one or more members is treated instead as occurring directly between the members

(without the involvement of any section 987 QBUs), and transfers are deemed to take place between each section 987 QBU and its owner (*see* §1.987-2(c)(2)(ii)). For example, if a member (M1) lends money to the section 987 QBU of another member (M2), this intercompany transaction is treated as a loan from M1 to M2 and a contribution from M2 to its section 987 QBU.

(10) ***

(viii) *Example 8. Loan by section 987 QBU.* (A) *Facts.* S owns all the interests in DE1, a disregarded entity operating a business that is a section 987 QBU (S QBU) whose functional currency is the euro. S has net unrecognized section 987 gain with respect to S QBU. In year 1, S QBU lends €100 to B with interest due annually. B makes interest payments on the loan to S QBU in years 1 through 3. In year 3, B repays the loan and recognizes section 988 loss of \$12 on the loan repayment. B recognizes no section 988 gain or loss on the euros it uses to pay the interest and principal. Other than with respect to the loan, there are no transfers between S and S QBU during years 1 through 3.

(B) *Analysis—(1) Loan.* Under paragraph (j)(9) of this section, the loan is treated as a transfer from S QBU to S and a loan directly between S and B. Specifically, S is treated as receiving a transfer of €100 from S QBU in year 1; S is then treated as lending €100 directly to B. For purposes of §1.987-2, the loan is attributable to S, not to S QBU. As an intercompany loan, S's loan to B is subject to the rules of this section. Because there is a remittance from S QBU to S in year 1, S recognizes section 987 gain under §1.987-5.

(2) *Interest payments.* While the loan is outstanding, each of B's interest payments to S QBU is treated as an interest payment from B to S, followed by a transfer from S to S QBU. S's intercompany interest income offsets B's corresponding interest expense. See paragraph (g)(7)(ii)(A)(2) of this section (*Example 1*). Since the functional currency of both S and B is the dollar, if B recognizes any section 988 gain or loss on the interest payments, S will recognize an offsetting amount of section 988 loss or gain. Because the only transfer between S and S QBU in year 2 is from S to S QBU, there is no remittance from S QBU to S and S does not recognize section 987 gain under §1.987-5.

(3) *Repayment.* Upon the year 3 repayment of the loan, B is treated as repaying €100 to S, and S is treated as transferring €100 to S QBU. Since the functional currency of both S and B is the dollar, and B recognizes section 988 loss of \$12 on the loan repayment, S will recognize an offsetting section 988 gain of \$12. Because the only transfers between S and S QBU in year 3 are from S to S QBU, there is no remittance from S QBU to S and S does not recognize section 987 gain under §1.987-5.

(4) *Summary.* Overall, the group's taxable income includes S's section 987 gain in year 1 (the

section 988 inclusions offset). This result is consistent with the treatment of a single corporation that borrows from its section 987 QBU.

(ix) *Example 9. Sale of property by section 987 QBU—(A) Facts.* M1 owns all the interests in DE1, a disregarded entity operating a business that is a section 987 QBU (M1 QBU) whose functional currency is the euro. M1 has net unrecognized section 987 gain with respect to M1 QBU. M1 QBU sells property to M2 for €100 in year 1.

(B) *Analysis—(1) In general.* Under paragraph (j)(9) of this section, the sale of property is treated as a transfer of the property from M1 QBU to M1, followed by an exchange of the property for €100 directly between M1 and M2, and a transfer of the €100 from M1 to M1 QBU.

(2) *Distribution.* M1 QBU is treated as transferring the property to M1.

(3) *Exchange.* M1 is then treated as selling the property to M2 for €100. M1 will take into account its intercompany gain or loss on the property under the rules of this section. M2 recognizes intercompany section 988 gain or loss on its exchange of €100 for the property. See paragraph (b)(1)(iii) of this section for property exchanges between members.

(4) *Contribution.* Finally, M1 is treated as transferring the €100 to M1 QBU. Because M1's basis in the €100 equals its fair market value, M1 has a corresponding section 988 gain or loss of zero upon the contribution. See §1.988-1(a)(10). Both the transfer of the property from M1 QBU to M1 and the transfer of the €100 from M1 to M1 QBU are taken into account in determining whether there is a remittance from M1 QBU to M1 in year 1 and whether M1 recognizes section 987 gain under §1.987-5.

(5) *Summary.* Overall, in year 1, M1 may take into account section 987 gain if the transfers between M1 and M1 QBU result in a remittance, and M2 takes into account section 988 gain or loss on the €100. This result is consistent with the treatment of a single corporation that purchases property from its section 987 QBU.

(1) * * *

(10) *Applicability date.* Generally, paragraph (j)(9) of this section applies to taxable years beginning after December 31, 2024, for which the original Federal income tax return is due (without extensions) after [DATE OF PUBLICATION OF THE FINAL REGULATIONS IN THE FEDERAL REGISTER]. However, if pursuant to §1.987-14(b), a taxpayer chooses to apply §§1.987-1 through 1.987-14 to a taxable year before the first taxable year described in §1.987-14(a)(1), then paragraph (j)(9) of this section applies to that taxable year and subsequent years.

Douglas W. O'Donnell,
Deputy Commissioner for Services and Enforcement.

(Filed by the Office of the Federal Register November 9, 2023, 4:15 p.m., and published in the issue of the Federal Register for November 14, 2023, 88 FR 78134)

Definition of Terms

Revenue rulings and revenue procedures (hereinafter referred to as "rulings") that have an effect on previous rulings use the following defined terms to describe the effect:

Amplified describes a situation where no change is being made in a prior published position, but the prior position is being extended to apply to a variation of the fact situation set forth therein. Thus, if an earlier ruling held that a principle applied to A, and the new ruling holds that the same principle also applies to B, the earlier ruling is amplified. (Compare with *modified*, below).

Clarified is used in those instances where the language in a prior ruling is being made clear because the language has caused, or may cause, some confusion. It is not used where a position in a prior ruling is being changed.

Distinguished describes a situation where a ruling mentions a previously published ruling and points out an essential difference between them.

Modified is used where the substance of a previously published position is being changed. Thus, if a prior ruling held that a principle applied to A but not to B, and the

new ruling holds that it applies to both A and B, the prior ruling is modified because it corrects a published position. (Compare with *amplified* and *clarified*, above).

Obsoleted describes a previously published ruling that is not considered determinative with respect to future transactions. This term is most commonly used in a ruling that lists previously published rulings that are obsoleted because of changes in laws or regulations. A ruling may also be obsoleted because the substance has been included in regulations subsequently adopted.

Revoked describes situations where the position in the previously published ruling is not correct and the correct position is being stated in a new ruling.

Superseded describes a situation where the new ruling does nothing more than restate the substance and situation of a previously published ruling (or rulings). Thus, the term is used to republish under the 1986 Code and regulations the same position published under the 1939 Code and regulations. The term is also used when it is desired to republish in a single ruling a series of situations, names, etc., that were previously published over a period of time in separate rulings. If the

new ruling does more than restate the substance of a prior ruling, a combination of terms is used. For example, *modified* and *superseded* describes a situation where the substance of a previously published ruling is being changed in part and is continued without change in part and it is desired to restate the valid portion of the previously published ruling in a new ruling that is self contained. In this case, the previously published ruling is first modified and then, as modified, is superseded.

Supplemented is used in situations in which a list, such as a list of the names of countries, is published in a ruling and that list is expanded by adding further names in subsequent rulings. After the original ruling has been supplemented several times, a new ruling may be published that includes the list in the original ruling and the additions, and supersedes all prior rulings in the series.

Suspended is used in rare situations to show that the previous published rulings will not be applied pending some future action such as the issuance of new or amended regulations, the outcome of cases in litigation, or the outcome of a Service study.

Abbreviations

The following abbreviations in current use and formerly used will appear in material published in the Bulletin.

A—Individual.
Acq.—Acquiescence.
B—Individual.
BE—Beneficiary.
BK—Bank.
B.T.A.—Board of Tax Appeals.
C—Individual.
C.B.—Cumulative Bulletin.
CFR—Code of Federal Regulations.
CI—City.
COOP—Cooperative.
Ct.D.—Court Decision.
CY—County.
D—Decedent.
DC—Dummy Corporation.
DE—Donee.
Del. Order—Delegation Order.
DISC—Domestic International Sales Corporation.
DR—Donor.
E—Estate.
EE—Employee.
E.O.—Executive Order.
ER—Employer.

ERISA—Employee Retirement Income Security Act.
EX—Executor.
F—Fiduciary.
FC—Foreign Country.
FICA—Federal Insurance Contributions Act.
FISC—Foreign International Sales Company.
FPH—Foreign Personal Holding Company.
FR.—Federal Register.
FUTA—Federal Unemployment Tax Act.
FX—Foreign corporation.
G.C.M.—Chief Counsel's Memorandum.
GE—Grantee.
GP—General Partner.
GR—Grantor.
IC—Insurance Company.
I.R.B.—Internal Revenue Bulletin.
LE—Lessee.
LP—Limited Partner.
LR—Lessor.
M—Minor.
Nonacq.—Nonacquiescence.
O—Organization.
P—Parent Corporation.
PHC—Personal Holding Company.
PO—Possession of the U.S.
PR—Partner.
PRS—Partnership.

PTE—Prohibited Transaction Exemption.
Pub. L.—Public Law.
REIT—Real Estate Investment Trust.
Rev. Proc.—Revenue Procedure.
Rev. Rul.—Revenue Ruling.
S—Subsidiary.
S.P.R.—Statement of Procedural Rules.
Stat.—Statutes at Large.
T—Target Corporation.
T.C.—Tax Court.
T.D.—Treasury Decision.
TFE—Transferee.
TFR—Transferor.
T.I.R.—Technical Information Release.
TP—Taxpayer.
TR—Trust.
TT—Trustee.
U.S.C.—United States Code.
X—Corporation.
Y—Corporation.
Z—Corporation.

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¹ A cumulative list of all revenue rulings, revenue procedures, Treasury decisions, etc., published in Internal Revenue Bulletins 2023–27 through 2023–52 is in Internal Revenue Bulletin 2023–52, dated December 27, 2023.

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Internal Revenue Service

Washington, DC 20224

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INTERNAL REVENUE BULLETIN

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