



Internal Revenue Service

DEPARTMENT OF THE TREASURY

LB&I Concept Unit

Unit Name	Overview of IRC 987 and Branch Operations in a Foreign Currency	
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General Overview

Overview of IRC 987 and Branch Operations in a Foreign Currency

In a global economy, many U.S. Corporations (“USC”) are doing business through foreign branches, divisions or disregarded entities that operate in currencies other than the U.S. dollar. The U.S. federal income tax system for U.S. owned Multinational Enterprises (“US MNE”) is based on worldwide income in U.S. dollars, so it is necessary to translate amounts that are measured or denominated in different currencies into U.S. dollars.

A US MNE that conducts business in a foreign currency will realize currency gains and losses on certain transactions resulting from the fluctuations in value of the foreign currency compared to the US Dollar (“USD”). The US MNE will recognize transactional foreign currency gains and losses under IRC 988. Rather than directly participate in the foreign currency transactions, the US MNE can establish a separate branch, division or disregarded entity, whose activities rise to the level of a trade or business and for which it maintains separate books and records. This is referred to as a Qualified Business Unit (“QBU”) under IRC 989. The QBU has its own functional currency, and the US MNE can enter into foreign currency transactions through the QBU. This will allow US MNE to not recognize IRC 988 gain or loss since the transactions will now be in the functional currency of the QBU and no longer be IRC 988 transactions. Instead, if the functional currency of the QBU is different from the owner of such QBU, the QBU will generally be subject to IRC 987.

Under IRC 987, income or loss of the QBU is generally computed separately in the QBU's functional currency and is translated into the owner's functional currency at the appropriate exchange rate. If the QBU transfers money or other property back to its owner or another QBU of the owner, then those transfers could constitute a “remittance.” A remittance by the QBU may require that the owner recognize foreign currency gain or loss under IRC 987.

A remittance may also occur as the result of a 987 QBU terminating. A termination may occur if, for example, the 987 QBU ceases its trade or business activity, or if substantially all the assets of the QBU are transferred (to the owner) or sold.

A Controlled Foreign Corporation (CFC) with a branch that has a functional currency different from the CFC will also be subject to IRC 987.

General Overview (cont'd)

Overview of IRC 987 and Branch Operations in a Foreign Currency

IRC 987 generally provides:

- How a QBU should determine its annual taxable income and earnings and profits (E&P) and how to translate such income or E&P into the owner/taxpayer's functional currency, AND
- How to compute foreign currency gain or loss on a remittance

IRC 987 also provides the rules for determining the character (e.g., ordinary versus capital) and the source (e.g., U.S. or foreign) for any gain or loss under IRC 987. The character is generally ordinary. The source of the IRC 987 gains and losses under the IRC is determined by reference to the source of the income giving rise to remitted earnings (but see sourcing rules under IRC 987 Proposed Regulations where applicable).

Presently there are several methodologies used by taxpayers to comply with the requirements under IRC 987. Some of the most common methods are:

- the methodology set forth in the 1991 Proposed Regulations;
- the "earnings only" variation on the 1991 Proposed Regulations;
- the methodology set forth in the 2006 Proposed Regulations; and
- the methodology set forth in the 2016 Final Regulations.

Relevant Key Factors

Overview of IRC 987 and Branch Operations in a Foreign Currency

Key Factors

The key factors when examining taxpayers having a QBU subject to IRC 987 are the following:

1. May apply to a division, branch, disregarded entity that is a QBU (Can also be a partnership or trust depending upon which methodology the taxpayer is using);
2. QBU (see Practice Unit “Overview of Qualified Business Units QBUs”):
 - Separate books and records maintained,
 - Trade or business activity;
3. Functional Currency (see Practice Units “Functional Currency Determination” and “Functional Currency of a QBU”): Typically, the currency of the economic environment in which a significant part of the QBU’s activities are conducted;
4. QBU subject to IRC 987: QBU with a functional currency different from its owner/taxpayer;
5. IRC 987 Methodologies commonly used by taxpayers:
 - 1991 Proposed Regulations,
 - “Earnings only”
 - 2006 Proposed Regulations, and
 - 2016 Final Regulations;
6. Taxable income or E&P of QBU subject to IRC 987:
 - First determined in the functional currency of the QBU,
 - Translated to the owner/taxpayer’s functional currency at the appropriate exchange rate;
7. IRC 987 gain/loss: Remittance triggers recognition.

Diagram of Concept

Overview of IRC 987 and Branch Operations in a Foreign Currency

Diagram of Concept

Potential forms of US-owned Foreign QBUs subject to IRC 987 include:

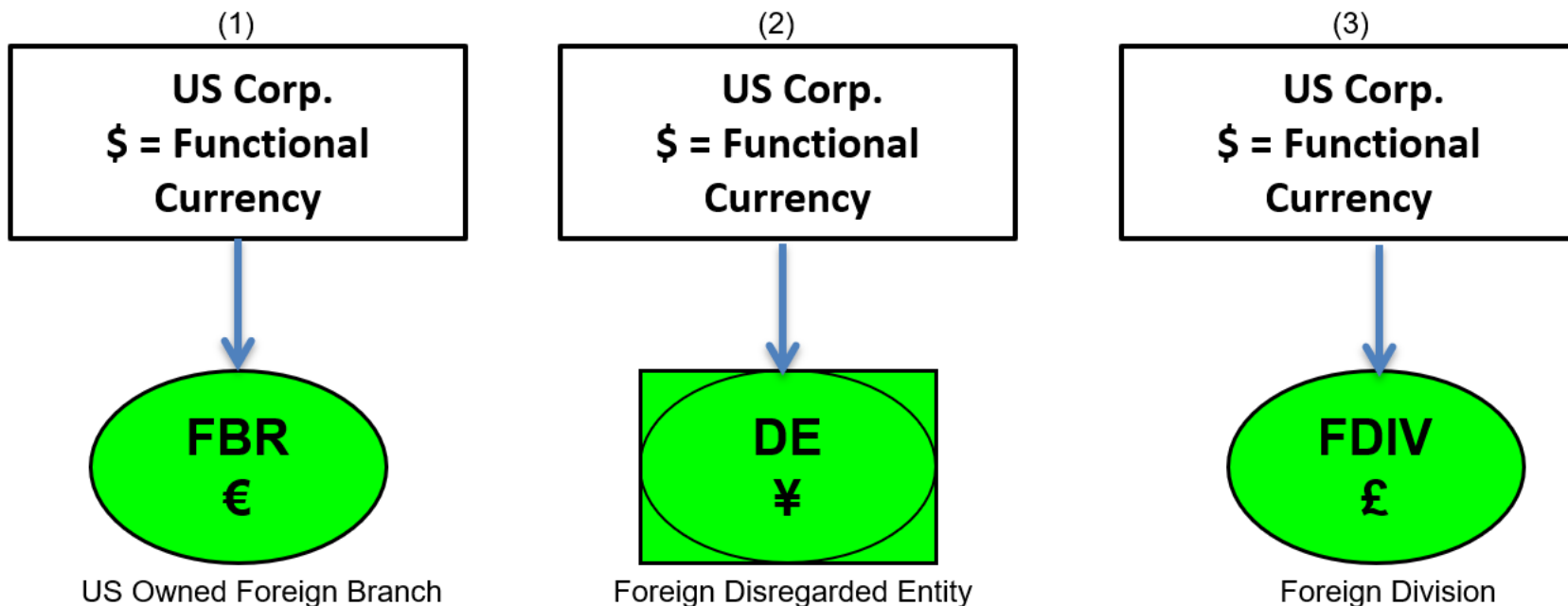
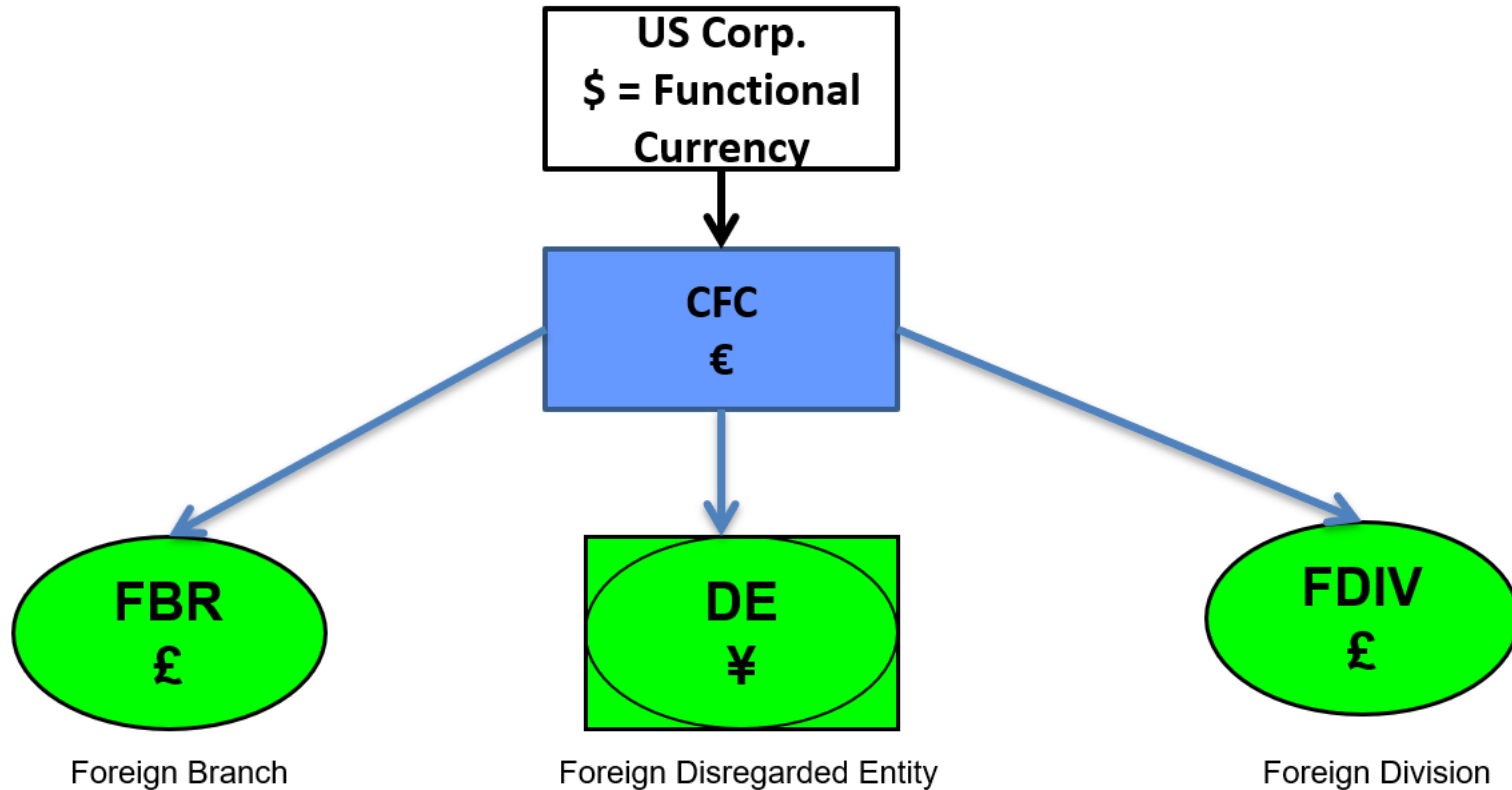


Diagram of Concept (cont'd)

Overview of IRC 987 and Branch Operations in a Foreign Currency

Diagram of Concept

Potential forms of CFC-Owned QBUs subject to IRC 987 include:



Facts of Concept

Overview of IRC 987 and Branch Operations in a Foreign Currency

Facts of Concept

Under the 1991 Proposed Regulations, income or loss is computed annually in the QBU's functional currency. The QBU's income is generally translated into the owner's functional currency at an average exchange rate for the year. Gains and losses from exchange rate fluctuation between the QBU's functional currency and the owner's functional currency on all the QBU's capital and earnings are not recognized as they accrue. Instead, exchange gain or loss under IRC 987 is recognized when the QBU makes or is deemed to make a transfer that qualifies as a remittance to the owner.

Under the 2006 Proposed Regulations and the 2016 Final Regulations, the translation of income and expenses of the 987 QBU into the owner's functional currency occurs on an item-by-item basis using either the average annual exchange rate or the historical exchange rate depending upon the nature of the income or expense item being translated. For purposes of determining IRC 987 currency gain or loss, the balance sheet of the 987 QBU is translated back into the owner's functional currency using the year end spot rate for financial assets and liabilities (i.e., accounts receivable and payable, etc.) and the historical rate for non-financial assets (i.e., land, building, equipment, etc.). The yearly change for financial assets and liabilities (after adjustments) is included in the Foreign Exchange Exposure Pool ("FEED"). IRC 987 gain or loss is recognized upon a remittance or termination of the QBU, but such gain or loss relates to currency changes on only the financial (or IRC 988 type) assets and liabilities.

The 2019 Final Regulations finalized portions of the 2016 Temporary Regulations most notably pertaining to Deferral Rules of certain IRC 987 gains and losses (applicable to all methodologies).

The next slides provide general information concerning IRC 987 and Branch Operations regardless of methodology utilized.

Detailed Explanation of the Concept

Overview of IRC 987 and Branch Operations in a Foreign Currency

Important terms and concepts.

Analysis	Resources
<p>Generally, IRC 987 applies to operations being conducted by a foreign branch. The foreign branch, division or disregarded entity must have a functional currency that is different from its owner. A partnership can also be subject to IRC 987 depending upon which methodology the taxpayer is using.</p> <p>IRC 987 utilizes the terms and concepts shown below and on the next two slides.</p>	<ul style="list-style-type: none"> ▪ Prop. Treas. Reg. 1.987-1 through 1.987-3 (1991 Proposed Regulations) ▪ Prop. Treas. Reg. 1.987-1 through 1.987-10 (2006 Proposed Regulations) ▪ Final Treas. Reg. 1.987-1 through 1.987-12 (2016 Final Regulations)
<p><u>QBU</u></p> <p>For a division, branch or disregarded entity to constitute a QBU, separate books and records need to be maintained and there needs to be a trade or business activity conducted by the QBU.</p>	<ul style="list-style-type: none"> ▪ IRC 989(a) ▪ Treas. Regs. 1.989(a)-1
<p><u>Functional Currency</u></p> <p>The currency of the economic environment in which a significant part of the QBU's activities is conducted if the QBU keeps its books and records in that currency.</p>	<ul style="list-style-type: none"> ▪ IRC 985 ▪ Treas. Reg. 1.985-1(c)(1)

Detailed Explanation of the Concept (cont'd)

Overview of IRC 987 and Branch Operations in a Foreign Currency	
Analysis	Resources
<p><u>QBU Subject to IRC 987</u></p> <p>For IRC 987 to apply to a QBU, the QBU must have a different functional currency from its owner.</p>	<ul style="list-style-type: none"> ▪ IRC 987 ▪ Prop. Treas. Reg. 1.987-1(a) (1991) ▪ Prop. Treas. Reg. 1.987-1(b)(2) (2006) ▪ Final Treas. Reg. 1.987-1(b)(2) (2016)
<p><u>Taxable Income of QBU Subject to IRC 987</u></p> <p>Under IRC 987, a QBU must first determine its taxable income or E&P in its functional currency. The taxable income or E&P is then translated into and included in the owner's income at the appropriate exchange rate for the year.</p>	<ul style="list-style-type: none"> ▪ IRC 987(1) ▪ IRC 987(2) ▪ Prop. Treas. Reg. 1.987-1(b) (1991) ▪ Prop. Treas. Reg. 1.987-3 (2006) ▪ Final Treas. Reg. 1.987-3 (2016) ▪ IRC 989(b)(4)
<p><u>IRC 987 Exchange Gain/Loss</u></p> <p>Remittances from a QBU to its owner, or a termination of the QBU are required to trigger recognition of any IRC 987 gain or loss.</p>	<ul style="list-style-type: none"> ▪ IRC 987(3)(A) and (B) ▪ Prop. Treas. Reg. 1.987-2 (1991) ▪ Prop. Treas. Reg. 1.987-4 and 5 (2006) ▪ Final Treas. Reg. 1.987-4 and -5 (2016)

Detailed Explanation of the Concept (cont'd)

Overview of IRC 987 and Branch Operations in a Foreign Currency	
Analysis	Resources
<p><u>Remittance</u></p> <p>The net transfer of any money or property from the QBU to its owner or to another QBU of the owner (or the contribution of a liability to a QBU), which exceeds the transfers of money or other property from the owner to the QBU. When a remittance occurs depends upon the methodology the taxpayer is following to account for its IRC 987 transactions.</p> <ul style="list-style-type: none"> ▪ 1991 Proposed Regulations – daily netting ▪ 2006 Proposed Regulations / 2016 Final Regulations – annual netting 	<ul style="list-style-type: none"> ▪ Prop. Treas. Reg. 1.987-2(b)(4) (1991) ▪ Prop. Treas. Reg. 1.987-5(c) through (e) (2006) ▪ Final Treas. Reg. 1.987-5(c) through (e) (2016)
<p><u>Deferral of Certain IRC 987 Exchange Gains and Losses</u></p> <p>The Deferral Rules were first promulgated as temporary regulations and then finalized under Treas. Reg. 1.987-12 in 2019. The Explanation of Provisions states that these rules were established to defer IRC 987 losses when there was a continuity of ownership of the QBU within a single controlled group. This deferral was also applied to similar IRC 987 gains UNLESS the assets of the IRC 987 QBU was transferred by a U.S. person to a related foreign person. This regulation applies to all taxpayers regardless of 987 methodology utilized and pertains to two types of specified events:</p> <ul style="list-style-type: none"> ▪ Deferral Events; and ▪ Outbound Loss Events. 	<ul style="list-style-type: none"> ▪ Treas. Reg. 1.987-12 (2019)

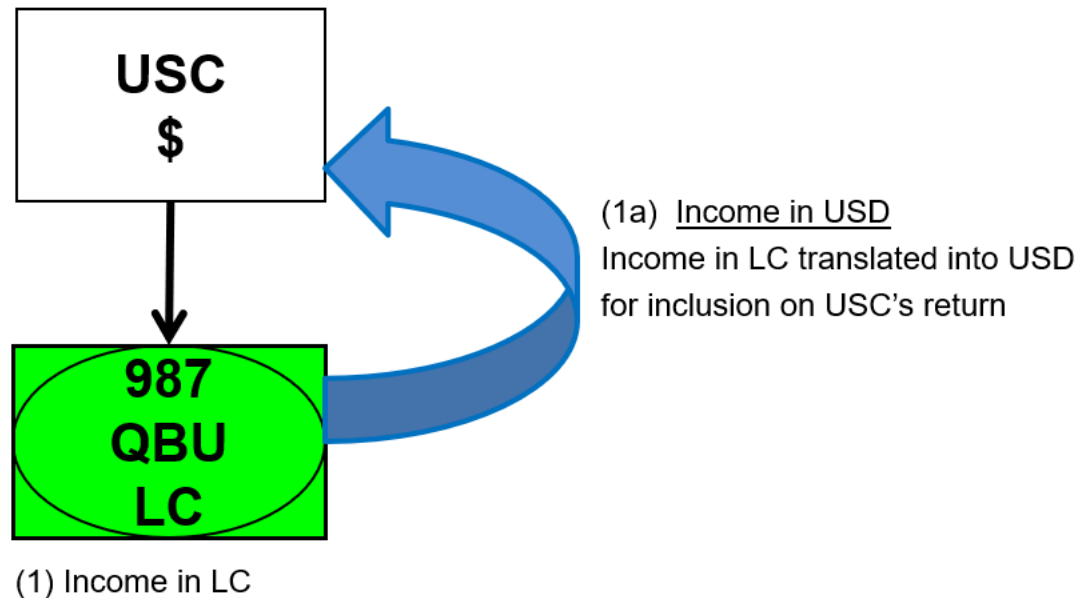
Examples of the Concept

Overview of IRC 987 and Branch Operations in a Foreign Currency

Example

Example:

If a disregarded entity that is a QBU with the LC as its functional currency ("987 QBU") is owned directly by a US taxpayer: (1) the income/loss of the 987 QBU for the tax year is first determined in the QBU's functional currency and then (1a) translated at the appropriate exchange rate for the year and included in the taxable income of US taxpayer.



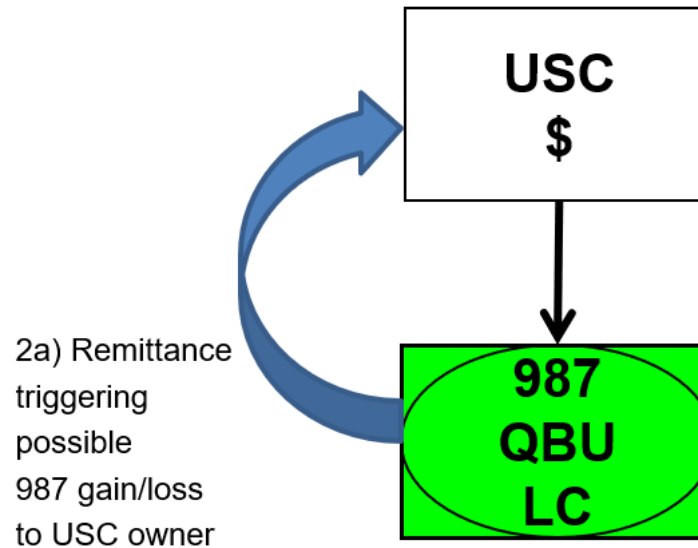
Examples of the Concept (cont'd)

Overview of IRC 987 and Branch Operations in a Foreign Currency

Example (cont'd)

Example (cont'd)

(2) When a remittance is made from the 987 QBU to the US taxpayer, (2a) IRC 987 gain or loss will generally be determined. The amount of gain or loss depends on the IRC 987 methodology used by the US taxpayer. Consider whether the deferral rules in Treas. Reg. 1.987-12 apply to such remittance.



(2) Remittance

Index of Referenced Resources

Overview of IRC 987 and Branch Operations in a Foreign Currency
IRC 985
IRC 987
IRC 988
IRC 989(a)
IRC 989(b)(4)
Treas. Regs. 1.989(a)-1
Prop. Treas. Reg. 1.987-1 through 1.987-3 (1991 Proposed Regulations)
Prop. Treas. Reg. 1.987-1 through 1.987-10 (2006 Proposed Regulations)
Final Treas. Reg. 1.987-1 through 1.987-12 (2016 / 2019 Final Regulations)

Training and Additional Resources

Overview of IRC 987 and Branch Operations in a Foreign Currency	
Type of Resource	Description(s)
Reference Materials	<ul style="list-style-type: none"> ▪ <i>BNA Tax Management Int'l Portfolio</i> 921-2nd ▪ <i>Bittker and Lokken - Fundamentals of International Taxation</i> Para 74.2 ▪ <i>Keyes - Federal Taxation of Financial Instruments and Transactions</i>, Chapter 15 ▪ <i>Mertens - Law of Federal Income Taxation</i>, Chapter 45C
Other Training Materials	<ul style="list-style-type: none"> ▪ IE Phase III: <i>IRC 985 and 989: Foreign Currency Terms and Definitions</i> ▪ IE Phase III: <i>Section 986 Translation Rules</i> ▪ IE Phase III: <i>Sec 987 - Branch Rules and CTB Rules</i> ▪ IE Phase III: <i>Foreign Currency Section 988 Transactions</i> ▪ IE Phase III: <i>Foreign Currency Hedging</i> ▪ IE Phase III: <i>Financial Products Basics - Four Major Categories</i> ▪ IE Phase I: <i>Module E - Lesson 1 Foreign Currency</i> ▪ IE Phase III, <i>Module D - Interaction of International and Financial Products Issues</i> ▪ FP Phase 1: <i>Lesson 9 - Foreign Currency</i> ▪ FP Phase III: <i>Lesson 4 - Foreign Currency</i>

Glossary of Terms and Acronyms

Term/Acronym	Definition
CFC	Controlled Foreign Corporation
E&P	Earnings and Profits
FBR	Foreign Branch
FEEP	Foreign Exchange Exposure Pool
FX	Foreign Currency Exchange
LC	Local Currency
MNE	Multi-National Enterprise
QBU	Qualified Business Unit
US	United States
USC	U.S. Corporation
USD	US Dollar

Index of Related Practice Units

Associated UIL(s)	Related Practice Unit
9470	<i>Change in Functional Currency Section 985 Procedural Matters and Calculation</i>
9470	<i>Character of Exchange Gain or Loss</i>
9470	<i>Definition of Appropriate Exchange Rate Overview</i>
9470	<i>Disposition of a Portion of an Integrated Hedge</i>
9470	<i>Exchange Gains or Losses on Payables and Receivables</i>
9470	<i>Functional Currency Determination</i>
9470	<i>How to Assess Penalties for Failure to File a Form 8886 Disclosing IRC 988 Losses</i>
9470	<i>Official vs Free Market Exchange Rate</i>
9470	<i>Overview of IRC Section 988 Nonfunctional Currency Transactions</i>
9470	<i>Overview of Qualified Business Units QBUs</i>
9470	<i>Sourcing of Exchange Gains or Losses in Currency Transactions</i>
9470	<i>Functional Currency of a QBU</i>
9470	<i>Disposition of Nonfunctional Currency</i>
9470	<i>Overview of IRC 986(c) Gain or Loss Prior to Tax Cuts and Jobs Act of 2017</i>
9470	<i>Computation and Review of IRC 986(c) Gain or Loss – Pre-TCJA</i>