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Foreign Currency:
Final and Temporary Section 987 Regulations

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Agenda

Background
• What is section 987 and to whom does it apply?
• GAAP Treatment
• Companies affected by section 987
• Section 987 history

Final Regulations
• Scope of the final regulations
• Paradigm of the final regulations
• When section 987 gain or loss is recognized
• Character and source of section 987 gain or loss
• Example
• Transition rule
• Effective date and other considerations

Temporary Regulations
• Annual Deemed Termination Election and Hybrid Approach
• USD QBUs
• Interaction with Section 988
• Anti-Abuse Rules / Loss Deferral
Background

What is section 987?
- Applies foreign currency translation and transaction rules at the level of a qualified business unit (a section 987 QBU).

What does section 987 do when it applies?
- Income Translation. It requires the income of any section 987 QBU to be properly translated into the functional currency of the owner.
- Exchange Gain or Loss. It requires an amount of currency gain or loss to be recognized when a section 987 QBU remits property or cash to its owners or when it terminates.
  - Note: the temporary section 987 regulations can defer section 987 gains and losses when a section 987 QBU terminates in targeted transactions.

Background (Con’t)

To whom does section 987 apply?
- Most multinational corporations.
- Where a US corporation or controlled foreign corporation (CFC) owns a branch, disregarded entity ("DRE") or partnership interest (a qualified business unit, or QBU) when the functional currency of that entity is different from that of the corporation.

Example 1--QBU owned by US Corp. US Corp owns DREs in Mexico and China that have the peso and yuan, respectively, as their functional currencies. The DREs are operating companies that produce Product X.
  - Analysis. The activities of the DREs are section 987 QBUs of US Corp.

Example 2--QBU owned by CFC. Same facts as in Example 1, except US Corp owns CFC that owns operating DREs in Mexico and China.
  - Analysis. The activities of the DREs are section 987 QBUs of CFC. CFC is not a section 987 QBU of US Corp.
GAAP — ASC 830/FAS 52

Financial accounting has two components: P&L and balance sheet. Where a business unit has a non-USD functional currency, it must translate its financial statements into the dollar.

1. **P&L Component.** Profit and loss is determined in the entity's functional currency and translated into dollars at a current exchange rate.
   - The computation of all revenue and expense items in functional currency, consistent with 1991 proposed section 987 regulations.
   - GAAP has rules analogous to (but different from) the rules under section 988. Financial transactions in a non-functional currency give rise to exchange gain or loss in the entity's functional currency.

2. **Balance Sheet Component.** All assets and liabilities on the balance sheet are translated at the exchange rate on the balance sheet determination date (generally, the last day of each quarter).
   - As such, the net equity of the business unit generates translation gain or loss. Any translation exchange gain or loss is **not** included in profit and loss but is assigned to the cumulative translation adjustment (CTA) account, a component of equity. This gain or loss is taken into account upon a sale or other termination of the business entity.

Importantly, all of the assets are maintained in the entity's functional currency. There is no distinction between equipment depreciation and loan receivables. These rules were analogous to (but different from) the 1991 proposed section 987 regulations.

The Final Section 987 Regulations differ markedly from GAAP accounting treatment.

Companies Affected By Section 987

Companies **most** affected:

i. Companies with sizable amounts of first-tier DREs that may have chosen to elect disregarded status to flow through losses.

ii. Companies with partnership splitter arrangements with dozens or hundreds of DREs underneath them.

iii. High-tech and e-commerce companies that are in “all checked” structures for foreign base company sales income reasons.

   **Planning Point:** Companies described in (i) may revisit their choices. Companies in (ii) and (iii) may not easily "plan out of" the section 987 regulations.

Companies **least** affected:

i. Companies who have partnership joint ventures with third parties with checked entities underneath.

ii. Hedge funds.

iii. Private equity funds with unrelated partners.

**Note:** as described below, partnerships that are not otherwise subject to the final regulations are subject to the deferral rules of Temp. Treas. Reg. §1.987-12T and can make the annual deemed termination election of Temp. Treas. Reg. §1.987-8T(d).
Section 987 History

Section 987 enacted as part of the TRA of 1986, but no final regulations until 2016. So what have taxpayers done?

- Nothing / Follow GAAP.
- Earnings Only Method--imputes section 987 gain or loss only to the earnings of a section 987 QBU and not its capital.
- 1991 Proposed Regulations--imputes section 987 gain or loss to the earnings and capital of a section 987 QBU. Most closely analogous to FAS 52/ASC 830.
- 2006 Proposed Regulations--imputes section 987 gain or loss only to the cash, debt, payables/receivables and FX derivatives of a section 987 QBU. Most closely analogous to FAS 8 and the old (pre-1987) section 964 regulations.
- Variations on above
  - Example: Apply section 987 only to first-tier QBUs.

Final Section 987 Regulations
Scope of the Final Section 987 Regulations

- The final Section 987 regulations generally apply to section 987 QBUs of an individual or corporation.

- They do not apply to banks, insurance companies, leasing companies, certain finance coordination centers, regulated investment companies, real estate trusts, trusts, estates, S corporations and certain partnerships (see below).
  - The S Corporation exception is significant, but if S Corporation owns “C” corporation that has QBUs, the rules can still apply.

- The regulations apply only to partnerships where all partners are related under sections 267(b) or 707(b). These partnerships are referred to as “aggregate partnerships” because the regulations treat them as an aggregate, not an entity.

- The preamble to the final regulations provides that excluded entities must use a reasonable method to comply with Section 987 and cannot rely on the final regulations. Note that excluded entities may still be subject to anti-abuse and other rules set forth in the temporary section 987 regulations.

Paradigm of the Final Section 987 Regulations

- Adopts the general framework of the 2006 proposed section 987 regulations.

- Determination of the income of a section 987 QBU.
  - For purposes of translating a section 987 QBU’s income, each item of income, gain, deduction or loss is determined in the functional currency of the section 987 QBU and translated into the functional currency of the owner at exchange rates set forth in Treas. Reg. §1.987-3(c).
  - The default translation rate for an item of income, gain, deduction or loss is the average rate for the year or, if the owner elects, the spot rate for each day an item is properly taken into account for tax purposes under the owner’s method of tax accounting.
  - However, the basis of “Historic Items” (i.e., tangible property and depreciation deductions associated with them) are translated at an historic exchange rate (generally, the average rate for the year acquired).
    - Note: Certain section 988 transactions are considered “Historic Items.”
  - The regulations provide special rules for determining cost of goods sold.

Note: This is not what companies do for GAAP so there will need to be significant computations made outside of the company’s accounting software to compute taxable income under section 987.
Paradigm of the Final Regulations (Con’t)

Determination of Unrecognized Section 987 Gain or Loss Under a Balance Sheet Approach:

- Determined in the year when there is a remittance (net distribution of property from the QBU for the year) or termination of the QBU (but see Temp. Treas. Reg. §1.987-12T).

- Section 987 QBU’s Owner first determines the current year’s net value of the QBU in the Owner’s functional currency by translating “marked items” (cash, payables/receivables, debt and FX derivatives denominated in the QBU’s functional currency) on the QBU’s tax balance sheet at the year-end exchange rate and “Historic Items” (items that are not marked items) at the historic exchange rate (generally, the average rate when the QBU acquired them).

- The owner then subtracts from the amount determined in a. above, the net value of the QBU at the end of the prior year, giving rise to an amount which reflects the change in net value from the prior year.

- The change in net value in a taxable year is generally composed of three classes of items:
  1. a change in net value due to a change in exchange rates with respect to the marked items for the year;
  2. a change in net value due to contributions and distributions of assets and liabilities to or from the QBU during the year; and
  3. a change in net value due to profit or loss for the year.

- The eight-step process described in Treas. Reg. §1.987-4(d) essentially determines the section 987 gain or loss on the marked items for a taxable year by backing out from the total change in net value, the change in net value due to (c)(2) and (3) above. The amount so determined for a taxable year is added to the pool of unrecognized section 987 gain or loss and becomes a component of the “net unrecognized section 987 gain or loss.” Net unrecognized section 987 gain or loss is taken into the income of the QBU’s owner as described in below.

When Section 987 Gain or Loss is Recognized

- Section 987 gain or loss is taken into income by the owner of a Section 987 QBU when the QBU makes a remittance of cash or property to the owner or the QBU terminates (subject to Temp. Treas. Reg. §1.987-12T).
  - Annual Netting: Unlike the 1991 Proposed Regulations, the Final Regulations look at whether there has been a net remittance during the year.

- A remittance is determined in the owner’s functional currency on the last day of the taxable year (or when the QBU terminates), with reference to the basis of property and is the excess of distributions from the QBU to the owner for the taxable year over the contributions from the owner to the QBU for the taxable year.

- The amount of accumulated section 987 gain or loss taken into account is determined by reference to the percentage of the QBU’s gross assets remitted (determined on a gross basis before the remittance).
  - In the case of a termination (that is not subject to the loss limitation rules set forth in Temp. Treas. Reg. §1.987-12T), all section 987 gain or loss is recognized.
Character and Source of Section 987 Gain or Loss

• Section 987 gain or loss is ordinary gain or loss.

• The character and source of section 987 gain or loss is determined in the year of a remittance or termination under Treas. Reg. §1.987-6 for all purposes of Code including sections 904(d), 907 and 954.

• The owner must use the asset method of Treas. Reg. §1.861-9T(g) to characterize and source section 987 gain or loss taking into account only the assets of the section 987 QBU.
  • Only asset method can be used. If a CFC owns a Section 987 QBU and uses the “gross income” method of apportionment, the CFC must nevertheless use the tax book value method for apportioning section 987 gain or loss.

• Solely for purposes of section 954(c)(1)(D), section 987 gain or loss that is characterized by reference to assets that give rise to subpart F income is treated as section 988 gain or loss that does not meet the business needs test of section 954(c)(1)(D)—i.e., as foreign personal holding company income. Some articles and comments have raised questions on the basis for characterizing section 987 gain or loss as subpart F income.

Example

US Corp provides engineering services. US Corp owns a corporation in the UK providing engineering services to businesses in London. The UK corporation is a DRE for Federal income tax purposes, has the pound as its functional currency and is a “section 987 QBU.”

At the beginning of Year 1 when the QBU is established, the section 987 QBU has no debt and owns:
  1. a building with a basis of £100,000 which was purchased when £1 = $1. Assume that depreciation is properly £3,000/year;
  2. a painting with a purchase price of £1,000 when £1 = $1; and
  3. £5,000 purchased when £1 = $1.

In year 1, QBU earns £5,000 from providing engineering services. It also sells the painting for £1,200.
  • The exchange rate at the beginning of the year is £1 = $1; at the end of the year is £1 = $2 and the average exchange rate is £1 = $1.50.

Assume that the QBU terminates at the end of year 1, triggering all section 987 gain or loss.
Calculation of Net Income

Determination of net income.

<table>
<thead>
<tr>
<th>Description</th>
<th>Pounds</th>
<th>Dollars</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income from services:</td>
<td>£5,000</td>
<td>$7,500  (Ave.)</td>
</tr>
<tr>
<td>Depreciation</td>
<td>(£3,000)</td>
<td>($3,000) (Hist.)</td>
</tr>
<tr>
<td>Income from sale of painting</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Sales price:</td>
<td>£1,200</td>
<td>$1,800</td>
</tr>
<tr>
<td>Basis:</td>
<td>(£1,000)</td>
<td>($1,000)</td>
</tr>
<tr>
<td>Gain:</td>
<td>£200</td>
<td>$800</td>
</tr>
</tbody>
</table>

Section 987 Taxable income $5,300

Note: This methodology differs from what a company does for GAAP purposes. For GAAP, the "income" would be £2,200. Historically, for tax, you would translate at an average rate of £1:$1.50 or $3,300. Consider the mechanics of getting this information as part of the tax package every year.

Calculation of Section 987 gain

<table>
<thead>
<tr>
<th>Description</th>
<th>Pounds</th>
<th>Dollars</th>
</tr>
</thead>
<tbody>
<tr>
<td>Opening Year 1 Balance Sheet</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td>£5,000</td>
<td>$5,000</td>
</tr>
<tr>
<td>Building</td>
<td>£100,000</td>
<td>$100,000</td>
</tr>
<tr>
<td>Painting</td>
<td>£1,000</td>
<td>$1,000</td>
</tr>
<tr>
<td>Net value</td>
<td>$106,000</td>
<td></td>
</tr>
<tr>
<td>Closing Year 1 Balance Sheet</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash (opening)</td>
<td>£5,000</td>
<td>$10,000</td>
</tr>
<tr>
<td>Cash (services)</td>
<td>£5,000</td>
<td>$10,000</td>
</tr>
<tr>
<td>Cash (painting)</td>
<td>£1,200</td>
<td>$2,400</td>
</tr>
<tr>
<td>Building</td>
<td>£97,000</td>
<td>$97,000</td>
</tr>
<tr>
<td>Net value</td>
<td>$119,400</td>
<td></td>
</tr>
</tbody>
</table>

The exchange rate at the beginning of the year is £1 = $1; at the end of the year is £1 = $2 and the average exchange rate is £1 = $1.50.

Calculation of §987 gain

a. Closing net value $119,400
b. Less: opening net value ($106,000)
c. Less: profit ($5,400)
d. Section 987 gain $8,100

Proof: the only marked items are the three pools of cash. The cash changed in value as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>£ amount</th>
<th>Change in value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash (opening)</td>
<td>£5,000</td>
<td>$5,000 ($10,000 - $5,000)</td>
</tr>
<tr>
<td>Cash (services)</td>
<td>£5,000</td>
<td>$2,500 ($10,000 - $7,500)</td>
</tr>
<tr>
<td>Cash (painting)</td>
<td>£1,200</td>
<td>$600 ($2,400 - $1,800)</td>
</tr>
</tbody>
</table>

Proof: the only marked items are the three pools of cash. The cash changed in value as follows:

Item | £ amount | Change in value |
---|----------|-----------------|
Cash (opening) | £5,000 | $5,000 ($10,000 - $5,000) |
Cash (services) | £5,000 | $2,500 ($10,000 - $7,500) |
Cash (painting) | £1,200 | $600 ($2,400 - $1,800)   |
Notes on Example

• The example contains some key simplifications:
  • There are no “Specified Owner Functional Currency Transactions” (which we will address in the next section on the Temporary Regulations).
  • There are no Section 988 Transactions in a currency other than the pound which would be considered historic assets.
  • There is no “inventory” requiring FIFO or LIFO layers.
  • There is no manufacturing costs which requires a determination of the historic exchange rate for “inventoriable” depreciation under section 263.

Transition Rule

**Fresh Start Method**

• All QBUs subject to section 987 are deemed to terminate (solely for purposes of section 987) and re-form into a new section 987 QBU; section 987 gain or loss is **not** taken into account under the taxpayer’s prior method on the deemed termination; rather, historic exchange rates are used in determining the amount of assets and liabilities deemed transferred to the new section 987 QBU.
  • **Note:** this means all assets and liabilities (not just Historic Items such as tangible assets and certain section 988 transactions).
  • The effect of this rule is twofold.
    1. Currency gain or loss on “historic assets” (**e.g.**, plant, property, equipment, inventory, intangibles) is never recognized.
    2. At the end of the first year to which the final regulations apply, the marked items, having a historic basis, will generate section 987 gain or loss for the period between the time the asset was acquired by the old QBU (not the new QBU) to the last day of the first year. Note this amount is not recognized unless there is a remittance.

**Note:** Taxpayers will not likely “have” this information readily available because there was no reason to maintain it. Treas. Reg. §1.987-10(b)(3) (last sentence) allows taxpayers to make reasonable assumptions.
Effective Dates and Other Considerations

1. **General Rule: One Year Delay.** Generally taxable years beginning on or after one year after the first day of the first taxable year following December 7, 2016. For calendar year taxpayers, January 1, 2018.
   
a. **Early Adoption.** Taxpayers can elect to apply the regulations to taxable years beginning after December 7, 2016. There is a conformity rule with respect to all QBU's owned by taxpayer (directly or indirectly), for QBU's owned by consolidated group members and CFCs.

2. Affected taxpayers will need to transition to the method required by final section 987 regulations on the transition date (first day of the first taxable year to which the regulations apply).

3. There may be financial accounting implications with respect to a corporation's deferred tax assets and liabilities that have to be taken into account this quarter (not when the regulations are effective).

4. Section 987 QBU's that today are mere holding companies will disappear.

5. Need to consider that section 987 gain could be subpart F income.

   **Note:** Some taxpayers may seek to challenge that conclusion, but in the interim period, there will likely be a financial statement reserve required.

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### Key Dates

**Assuming Calendar Year Taxpayer**

- **December 7, 2016**
  - Temp. Treas. Reg. §1.987-12T(j)(2)
    - Applies to any "Deferral Event" or "Outbound Loss Event" entered into with a Principal Purpose of Recognizing a Section 987 Loss.

- **January 1, 2017**
  - Temp. Treas. Reg. §1.987-12T
    - Gain and Loss Deferral Rules Apply to All Transactions Whether there is a Principal Purpose of Avoidance or Not.

- **January 6, 2017**
  - Temp. Treas. Reg. §1.987-12T(j)(2)
    - Taxpayer "may" apply the Final and Temporary Regulations from this date; Treas. Reg. §1.987-1T(c)(2)(i)(B).

- **December 31, 2017**
  - Temp. Treas. Reg. §1.987-1T
    - Taxpayer may make the "Annual Deemed Termination Election" from this date or else will be limited to making it in years when its losses do not exceed $5 million. See Temp. Treas. Reg. §1.987-1T(g)(2)(i)(B).

- **January 1, 2017**
  - Temp. Treas. Reg. §1.987-1T(g)(2)(i)(C)
    - If the taxpayer makes the Annual Deemed Termination Election, then the taxpayer has a once-in-a-lifetime opportunity to make the Yearly Average Exchange Rate election. See Temp. Treas. Reg. §1.987-1T(g)(2)(i)(C).

**Note:** Manner of Making Elections Prescribed by Treas. Reg. §1.987-1(g). Generally requires a statement filed with the Form 1120 for the year to which the election relates.
Key Dates
Assuming Calendar Year
Taxpayer

Regulations Apply to Everybody

Elections to be Considered and/or Filed
3. Election to have U.S. Dollar QBUs of CFCs apply the Section 987 Regulations rather than the Section 988 Regulations. Temp. Treas. Reg. §§1.987-17(b)(1)(ii)(A) and 1.987-17(g)(2)(ii)(E).

Elections Must be Filed for 2017 Year if Taxpayer Chose to Apply the Regulations from Jan. 1, 2017
1. Make Annual Deemed Termination Election (if applicable).
2. Make Yearly Average Exchange Rate Election (if applicable).

Temporary Section 987 Regulations
Annual Deemed Termination Election

1. **General rule.** Temp. Treas. Reg. section 1.987-8T(d) provides that a taxpayer (including a taxpayer that is excluded from the final regulations under Treas. Reg. section 1.987-1(b)(1)(ii)) may elect to deem all of the section 987 QBUs of which it is an owner as terminated on the last day of each taxable year for which the election is in effect.

2. **Fiction created.** The regulations create a fiction that the owner of a section 987 QBU that is deemed to terminate is considered to have transferred the assets and liabilities of the terminated section 987 QBU to a new section 987 QBU on the first day of the following taxable year.
   a. The basis of marked items are translated into the functional currency of the owner at the spot rate on the first day of the new taxable year.
   b. The basis of historic items are translated into the functional currency of the owner at the historic rate.


4. **Election.** The annual deemed termination election generally must be made for all section 987 QBUs of the taxpayer including the those owned by any person that is related to the taxpayer under sections 267(b) and 707(b). **Such an election cannot be revoked.**
   a. **Fresh start taxpayers.** Taxpayers that transition to the final regulations under the fresh start method can make this election only with respect to: (i) the first taxable year beginning on or after the transition date, or (ii) after the transition date or in a year when the taxpayer’s controlled group aggregate section 987 loss, if any, does not exceed $5 million.
   b. **Other taxpayers (non-fresh start taxpayers).** Non-fresh start taxpayers with a related party that is a fresh start taxpayer must follow the rules in (a) above. Otherwise, taxpayers must make the election in the first taxable year in which it is relevant in determining income or section 987 gain or loss, or in a subsequent taxable year in which the aggregate section 987 loss of the controlled group does not exceed $5 million. Note that the effective date is taxable years beginning after December 7, 2016. **Non-fresh start taxpayers may need to analyze this quickly.**
   c. **QBU by QBU election.** Notwithstanding the conformity rules in (a) and (b) above, an election may be made for one or more QBUs (without conformity) if for the first taxable year for which the election would apply, the QBU has a section 987 a loss not exceeding $1 million. What about 10 QBUs each with $1 million of loss?

**Note:** This election is a condition precedent for electing the “hybrid approach” in Temp. Treas. Reg. section 1.987-3T(d). Also, the anti-abuse rules of Temp. Treas. Reg. section 1.987-12T do not apply to section 987 QBUs covered by the election.
The Hybrid Approach

1. **Rule.** Under Temp. Treas. Reg. section 1.987-3T(d), a section 987 QBU that is otherwise subject to the final regulations and that has made an annual deemed termination election may elect to translate **all** income, gain, deduction or loss with respect to a section 987 QBU (including income related to historic items) into the functional currency of the owner at the yearly average exchange rate for each taxable year.
   a. The effect of this election is that depreciation and the basis of property is translated currently for purposes of determining net income of a QBU. (Note that depreciation and the basis of property is translated at historic exchange rates for purposes of calculating section 987 gain or loss.)
   b. The election eliminates the need to keep track of historic exchange rates on the P&L side (but not on the balance sheet side).
   c. Why is an annual deemed termination election a condition precedent for making the hybrid approach election? The discontinuity derived from translating depreciation and the basis of property at different exchange rates on the section 987 P&L and balance sheet reconciles in a reasonable manner if the income and section 987 gain or loss are taken into account in the same year.

2. **Election.** The hybrid approach election can be made only in conjunction with the annual deemed termination election and only with respect to a section 987 QBU that is subject to the final regulations. That is, the hybrid approach election can be made only if the first taxable year for which it would apply is the first taxable year in which the annual deemed termination election applies for a section 987 QBU. The hybrid approach election is made on a QBU by QBU basis.

**Note:** KPMG and the New York Bar suggested the hybrid approach in comments to the 2006 proposed section 987 regulations.

Special Rules for U.S. Dollar QBUs

1. Generally, section 987 does not apply with respect to an eligible QBU that has the USD as its functional currency and would be subject to section 987 if it had a functional currency other than the dollar. **This rule applies to all taxpayers including excluded taxpayers under Temp Treas. Reg. section 1.987-1T(b)(1)(iii).**

2. A CFC that owns a dollar QBU applies section 988 as if the items properly reflected on the books of the QBU were entered into directly by the owner.
   a. A CFC with a U.S. trade or business determines its effectively connected income with respect to section 988 transactions with reference to the USD.
   b. A CFC that is the owner of a dollar QBU may elect to apply section 987 to the dollar QBU. There are special rules if the CFC is an excluded taxpayer and if the section 988 gain or loss is effectively connected income.

**Effective date:** The rules regarding dollar QBUs are effective with respect to taxable years beginning on or after one year after the first day of the first taxable year following December 7, 2016. However, if a taxpayer makes an election under section Treas. Reg. section 1.987-11(b), then these rules apply to taxable years to which Treas. Reg. sections 1.987-1 through 1.987-10 apply as a result of such election.
Section 988 Transactions of a Section 987 QBU

New rules are set forth in Temp Treas. Reg. section 1.987-3T(b)(4) regarding section 988 transactions entered into by a section 987 QBU.

1. Generally, section 988 applies to section 988 transactions of a section 987 QBU.

2. In determining whether a section 987 QBU has entered into a section 988 transaction, the functional currency of the section 987 QBU is used as the reference currency, but section 988 gain or loss is determined in the functional currency of the owner, but see (3) and (4).

3. Generally, section 988 transactions relating to cash, debt and payables/receivables that are denominated in the functional currency of the owner are not section 988 transactions to the section 987 QBU (or to the owner).

4. Gain or loss with respect to "qualified short term section 988 transactions" that are accounted for under a mark-to-market method of accounting (e.g., sections 475 and 1256), or for which a foreign currency mark-to-market election under Temp Treas. Reg. section 1.987-3T(b)(4)(iii)(C) is in effect (and any related hedges) is determined in the functional currency of the QBU.
   a. A qualified short term section 988 transaction is a section 988 transaction entered into in the ordinary course of business and that has an original term of one year or less determined on the date the transaction is entered into by the QBU.

Section 988 Transactions of a Section 987 QBU (Con't)

5. **Election to use a foreign currency mark to market method of accounting.** A taxpayer may elect to use a foreign currency mark to market method of accounting for all qualified short term section 988 transactions and any related hedges that are properly attributable to a section 987 QBU on or after the effective date of the election and that are not otherwise accounted for under sections 475 and 1256.

6. A section 988 transaction subject to the election is not subject to the "netting rule" set forth in Treas. Reg. section 1.988-2(b)(8) in taxable years prior to the taxable year in which section 988 gain or loss would be recognized with respect to such section 988 transaction but for this election.

**Effective date:** The rules regarding section 988 transactions are effective with respect to taxable years beginning on or after one year after the first day of the first taxable year following December 7, 2016. However, if a taxpayer makes an election under Treas. Reg. section 1.987-11(b), then these rules apply to taxable years to which Treas. Reg. sections 1.987-1 through 1.987-10 apply as a result of such election.

**Note:** The interactions of section 987 and section 988 as set forth in the temporary regulations adds additional complexity to an already complex set of rules.
Temp. Treas. Reg. Section 1.987-12T.
Deferral of Certain Section 987 Gains and Losses

1. **Scope.** Temp. Treas. Reg. section 1.987-12T applies to any gain or loss realized under section 987(3) including the section 987 gain or loss of an excluded entity under Treas. Reg. section 1.987-1(b)(1)(ii).
   a. **Exceptions.** The following section 987 QBUs are exempt from the rules under Temp. Treas. Reg. section 1.987-12T: (i) a section 987 QBU with respect to which the annual deemed termination election described in Temp. Treas. Reg. section 1.987-8T(d) is in effect, and (ii) a section 987 QBU if the amount that would not be recognized under Temp. Treas. Reg. section 1.987-12T does not exceed $5 million in the taxable year.

2. Temp. Treas. Reg. section 1.987-12T applies to two categories of transactions:
   a. Deferral events, and
   b. Outbound loss events.

3. **Effective date.** Temp. Treas. Reg. section 1.987-12T applies to a deferral event or outbound loss event that occurs on or after January 6, 2017. However, the rules apply to a deferral event or outbound loss event that occurs on or after December 7, 2016 (i.e., immediately upon publication) if the deferral event or outbound loss event is undertaken with a principal purpose of avoiding the rules of Temp. Treas. Reg. section 1.987-12T.

**Note:** The general anti-abuse rule of Temp. Treas. Reg. section 1.987-12T(g) denies a section 987 loss with respect to a transaction or series of transactions undertaken with a principal purpose of avoiding the rules of Temp. Treas. Reg. section 1.987-12T.

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Deferral Events

Under Temp. Treas. Reg. section 1.987-12T(b)(2) a deferral event is a transaction (or series of transactions) described below if immediately after the transaction (or series of transactions) assets of the section 987 QBU are reflected on the books and records of a successor QBU.


1. **Category 1—** A termination of a section 987 QBU but not including:
   a. A termination described in Treas. Reg. section 1.987-8(b)(3);
   b. A termination described in Treas. Reg. section 1.987-8(c);

2. **Category 2—**
   a. A disposition of part of an interest in a section 987 aggregate partnership (including, for this purpose, an excluded partnership as provided in Temp. Treas. Reg. section 1.987-12T(a)(2)) or a DE through which the section 987 QBU is owned; and
   b. Any contribution by another person a section 987 aggregate partnership (including, for this purpose, an excluded partnership as provided in Temp. Treas. Reg. section 1.987-12T(a)(2)) or a DE, 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.

The Category 1 and Category 2 transactions described in the preceding paragraph are referred to in this presentation as “targeted transactions” and QBUs described above are referred to as “targeted QBUs.”
Deferral Events (Con’t)

A section 987 QBU is a successor QBU if immediately after the targeted transaction, the potential successor QBU satisfies all of the following conditions:

1. The books and records of the potential successor QBU reflect assets that immediately before the targeted transaction were reflected on the books and records of the targeted QBU.
2. The owner of the potential successor QBU and the targeted QBU are members of the same controlled group (persons with relationships to each other described in sections 267(b) and 707(b)).
3. In the case of a targeted QBU described in Temp. Treas. Reg. section 1.987-12T(b)(2)(ii)(A), if the owner of the targeted QBU was a U.S. person, the potential successor QBU is owned by a U.S. person.

Note: Condition 3 above does not require in every case that the successor QBU be owned by a U.S. person. Accordingly, targeted foreign-to-foreign transactions can be captured by the deferral rules.

What Happens When There Is A Deferral Event?

1. Basic idea—the original owner of the targeted QBU (referred to in Temp. Treas. Reg. section 1.987-12T(c)(1)(ii) as the “deferral QBU owner”) takes into account section 987 gain or loss of the targeted QBU with respect to (a) remittances made that are not part of the targeted transaction and (b) subsequently, when the successor QBU makes remittances to the new owner of the successor QBU.

2. How is the subsequent amount determined? The amount is determined by multiplying the deferred section 987 gain or loss by the remittance proportion of the successor QBU that ends with or within the taxable year of the original owner (or using the terminology of the regulations, the “deferral QBU owner.”) The determination of the remittance proportion of the successor QBU does not take into account the annual deemed termination election and multiple successor QBUs are treated as a single QBU. Further, if the successor QBU ceases to be owned by a member to the controlled group, the remittance proportion is considered to be 1 and all deferred section 987 gain or loss is recognized.

3. There are a number of special rules regarding successor QBUs but these are beyond the scope of this presentation.
Temp. Treas. Reg. Section 1.987-12T(d)
Outbound Loss Events

What is an outbound loss event? An outbound loss event is:

1. Any termination of a section 987 QBU in connection with a transfer by a U.S. person of the assets of a section 987 QBU to a foreign person that is a member of the controlled group or, if the transferee did not exist immediately before the transaction, is a member of the controlled group immediately after the transaction provided the termination would result in the recognition of loss with respect to the section 987 QBU under Treas. Reg. section 1.987-5 and Temp Treas. Reg. section 1.987-12T(b) but for Temp Treas. Reg. section 1.987-12T(d); or

2. Any transfer by a U.S. person of part of an interest in a section 987 aggregate partnership or 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 Treas. Reg. section 1.987-5 and paragraph (b) of this section but for this paragraph (d).

What Happens When There Is An Outbound Loss Event?

The rules for outbound loss events are summarized as follows:

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

2. If the outbound loss event results from the transfer of a section 987 QBU’s assets in a transaction described in section 351 or section 361, the basis of the stock that is received in the transaction is increased by the unrecognized section 987 loss in the year of the outbound loss event.

3. If the outbound loss event is not described in section 351 or section 361, the loss is recognized by the owner of the outbound loss QBU in the first taxable year in which the owner or any qualified successor of the owner ceases to be a member of a controlled group that includes the related foreign person to which the assets and liabilities were transferred, or any qualified successor of such person.
Source and Character of Deferred Section 987 Gain or Loss

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

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