

# A Fresh Start for a Troubled QBU

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## I. Introduction and General Comments

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Code Sec. 987<sup>1</sup> provides that if a taxpayer has one or more qualified business units (QBUs)<sup>2</sup> with a functional currency (sometimes abbreviated as “FC”) other than the dollar, the taxpayer must make proper adjustments to take into account foreign currency gain or loss on certain transfers of property between such qualified business units. When a taxpayer uses foreign currency, gain or loss (referred to as “exchange gain or loss” or “FX gain or loss”) may arise from fluctuations in the value of the foreign currency relative to the U.S. dollar. Gain or loss results because foreign currency, unlike the U.S. dollar, is treated as property for U.S. federal income tax purposes.<sup>3</sup>

On September 7, 2006, the Treasury and the IRS issued long-awaited revised proposed regulations for computing Code Sec. 987 gain or loss (the “Proposed Regulations”). Proposed regulations issued in 1991 were never finalized (the “1991 proposed regulations”) and were withdrawn by the Proposed Regulations.<sup>4</sup> Because the 1991 proposed regulations were never finalized and were issued prior to the check-the-box rules,<sup>5</sup> unanswered questions abounded<sup>6</sup> and compliance with the rules was lax and varied from one multinational corporation to another.<sup>7</sup> In addition, the IRS and the Treasury were concerned with the triggering of noneconomic losses and gains.<sup>8</sup>

The Proposed Regulations adopt the “foreign exchange exposure pool method.” In general, the foreign exchange exposure pool method provides that the income of a Code Sec. 987 QBU, defined below, is determined by reference to the items of income, gain, deduction and loss booked to the QBU in its functional currency, adjusted to reflect U.S. tax principles.<sup>9</sup> With certain exceptions, items of income, gain, deduction and loss of a Code Sec. 987 QBU are translated into the functional currency of the QBU’s owner at the average exchange rate for the year.<sup>10</sup> However, the basis of historic assets and deductions for depreciation, depletion and amortization of such assets are translated at the historic exchange rate.<sup>11</sup>

The foreign exchange exposure pool method uses a balance sheet approach to determine exchange gain or loss, which is then recognized upon a remittance. Use of a balance sheet approach allows taxpayers and the IRS to distinguish between those items whose value fluctuates with respect to changes in the functional currency of the owner and those which do not.<sup>12</sup> Under this method, exchange gain or

loss with respect to “marked items” (defined by reference to Code Sec. 988(c)) is identified annually but is pooled and deferred until a remittance is made.<sup>13</sup> When a Code Sec. 987 QBU makes a remittance, a portion of the pooled and deferred exchange gain or loss is recognized.<sup>14</sup> In general, an amount taken into account is an amount equal to the product of the owner’s portion of the Code Sec. 987 QBU’s net unrecognized exchange gain or loss, multiplied by the owner’s remittance proportion.<sup>15</sup>

The Proposed Regulations have settled many of the unanswered questions and set forth rules that more precisely distinguish between items that give rise to economic gain or loss and those that do not for purposes of Code Sec. 987. However, the Proposed Regulations unfortunately have increased the complexity associated with computing translation gain or loss for purposes of Code Sec. 987. For example, under the Proposed Regulations, the basis of historic assets and deductions for depreciation, depletion and amortization of such assets are translated at the historic exchange rate whereas the 1991 proposed regulations provided for the translation of such items at the average exchange rate. Hence, the amount of time and resources necessary to comply with the new rules, in particular, tracking various items by historic exchange rates, will significantly increase. The Treasury and the IRS should consider further the impact that such additional complexity will have on bringing taxpayers in compliance with the new rules. The additional complexity is no surprise to practitioners familiar with the calculation of Code Sec. 987 gain/loss translation, including the maintenance of equity and basis pools for each of a taxpayer’s QBU branches, and many of the limitations of the 1991 proposed regulations. Code Sec. 987 is a simplified method of applying Code Sec. 988 transaction-by-transaction accounting to branch operations.<sup>16</sup> In order to achieve a more precise economical answer for both the IRS and taxpayers, additional complexity is a certainty. However, if the Treasury and the IRS are hoping for increased compliance with Code Sec. 987, they should consider simplifying the Proposed Regulations even if such changes would compromise some of the theoretical exactness of the Proposed Regulations.<sup>17</sup>

### A. The Statute—Code Sec. 987

The statute generally provides that a taxpayer will compute income or loss separately for each QBU in the business unit’s functional currency, convert-

ing this amount to U.S. dollars<sup>18</sup> using the weighted average exchange rate for the taxable period over which the income or loss was derived.<sup>19</sup> A taxpayer will recognize exchange gain or loss on any remittance of property (not just currency) to the extent the value of the currency at the time of the remittance (spot rate) differs from the value when earned.<sup>20</sup> The construct of the statute is notably straightforward. The Proposed Regulations are notably very complex. As discussed below, this difference between the statute and the Proposed Regulations is no more apparent than in the rules in Proposed Reg. §1.987-3 that set forth a litany of varying exchange rates to be used depending on the item involved.<sup>21</sup>

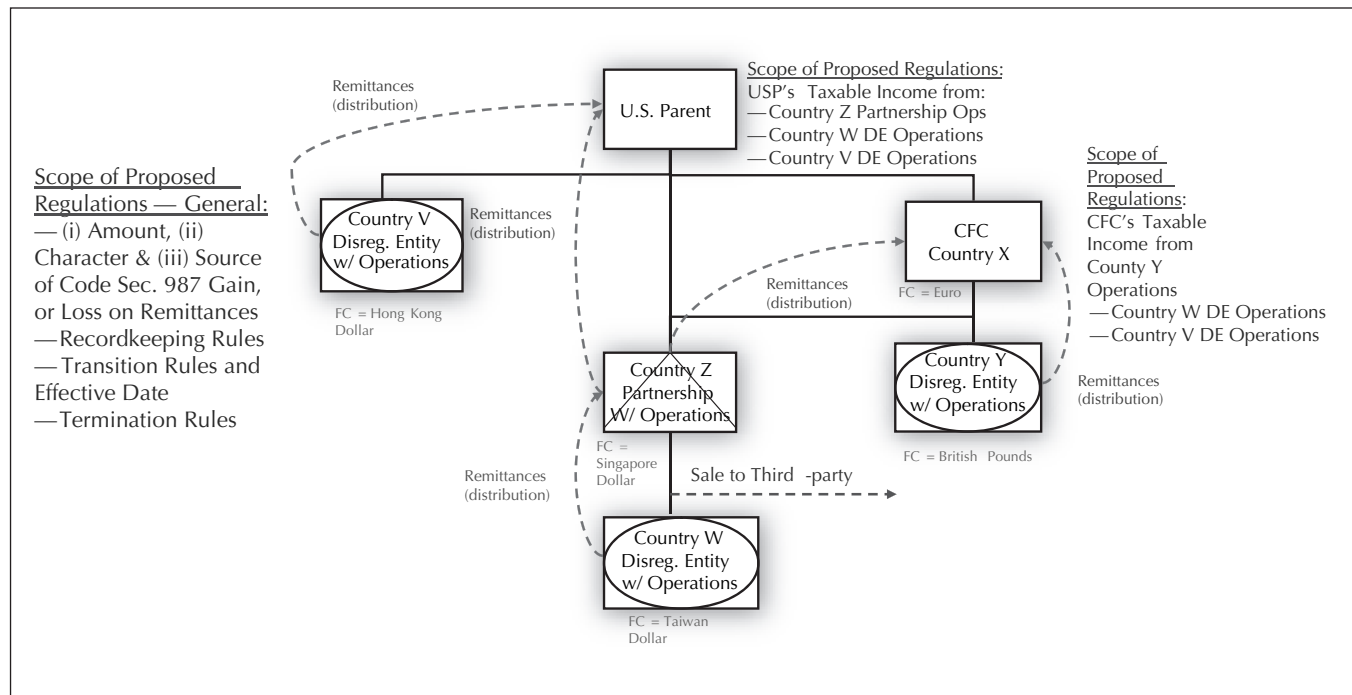
## B. Proposed Regulations

The scope of the Proposed Regulations is to provide (1) rules for determining the taxable income or loss of a taxpayer with respect to a Code Sec. 987 qualified business unit (“Code Sec. 987 QBU”), and (2) provide rules for determining the timing, amount, character and source of Code Sec. 987 gain or loss recognized with respect to a Code Sec. 987 QBU.<sup>22</sup> With the exception of a few corollary rules (e.g., the characterization of assets rule for expense apportionment purposes and the change of functional

currency rules under Code Sec. 985), the Proposed Regulations’ focus is accounting for Code Sec. 987 taxable income and Code Sec. 987 translation gain/loss. Diagram 1 generally depicts the scope of the Proposed Regulations.

This article’s objectives are to (1) explain the Proposed Regulations, and (2) suggest areas for simplification and/or clarification. This article is not an attempt to resolve the broader policy debate as to whether the Treasury’s and the IRS’s objective of recognizing Code Sec. 987 translation gain or loss on items that would similarly yield Code Sec. 988 gain or loss (outside of the Code Sec. 987 QBU context) warrants the substantial increased complexity of the new regulations.<sup>23</sup> The authors’ preliminary views are that the Proposed Regulations provide clarity to an area of tax law that was filled with noncompliance and confusion; however, the Proposed Regulations are overly complex and require simplification so that they can be applied by taxpayers and the IRS alike.<sup>24</sup> The regulations generally provide accurate results and tie together quite well. Nevertheless, because of the inordinate amount of complexity, one is left deliberating (1) whether a modified approach of the 1991 proposed regulations (on “earnings” only and without the daily-netting) would be a better approach,<sup>25</sup> or (2) whether the Pro-

**Diagram 1** Scope of Proposed Regulations



posed Regulations could be simplified by eliminating some of the historic exchange translations for certain assets and/or by recognizing net Code Sec. 987 gain or loss on an annual basis as opposed to at the time of a remittance (eliminate Proposed Reg. §1.987-5).<sup>26</sup> Because taxpayers will need to implement these rules, their comments should be given great weight prior to the resolution of the broader tax policy debate through the issuance of final regulations.

### **Effective Date**

The Proposed Regulations are set to be effective for tax years beginning one year after the first day of the first tax year following the date that the final regulations are issued.<sup>27</sup> Hence, the new rules would begin to apply in 2009 for calendar-year taxpayers, assuming the regulations are issued as final regulations in 2007. Pending finalization, the Treasury and the IRS would consider positions consistent with the Proposed Regulations to be reasonable constructions of the statute. As discussed below, Proposed Reg. §1.987-10 provides detailed transition rules.

## **II. Scope, Definitions and Special Rules of the Proposed Regulations**

### **A. Scope**

Subject to two exceptions,<sup>28</sup> an individual or corporation is subject to Code Sec. 987 under the proposed regulations if such person is an *owner* of an *eligible QBU* that is a *Code Sec. 987 QBU*.<sup>29</sup>

- **Owner**—Only an individual or corporation may be an owner of an eligible QBU.<sup>30</sup> The term “owner” for Code Sec. 987 purposes does not include an eligible QBU or a Code Sec. 987 QBU of an owner. Hence, the proposed regulations do not respect tiers of separate eligible QBUs. Rather, tiers of eligible and/or Code Sec. 987 QBUs will be treated as a “flat” structure, with each QBU in the tier considered as owned directly by the ultimate non-QBU owner.<sup>31</sup>
- **Eligible QBU**—The term eligible QBU means activities of an individual, corporation, partnership or an entity disregarded as an entity separate from its owner for U.S. federal income tax purposes (a “DE”), if:
  - the activities constitute a trade or business as defined in Reg. §1.989(a)-1(c)<sup>32</sup>;
  - a separate set of books and records is maintained as defined in Reg. §1.989(a)-1(d) with

respect to the activities, and assets and liabilities used in conducting such activities are reflected on such books and records under Reg. §1.987-2(b)<sup>33</sup>; and

- The activities are not subject to the Dollar Approximate Separate Transactions Method (DASTM) rules of Reg. §1.985-3.<sup>34</sup>

A corporation, partnership, or a DE itself is not an eligible QBU (even though it may have activities that qualify as an eligible QBU).<sup>35</sup>

- **Code Sec. 987 QBU**—A Code Sec. 987 QBU is an eligible QBU that has a functional currency different from its owner.<sup>36</sup>

Hence, in determining whether Code Sec. 987 applies to a particular structure, the first step is to determine whether an eligible QBU exists. The second step is to determine whether the eligible QBU’s functional currency is different than its owner.<sup>37</sup> These steps are familiar to taxpayers who made an effort to comply with the 1991 proposed regulations.

### **B. Code Sec. 987 Group Election**

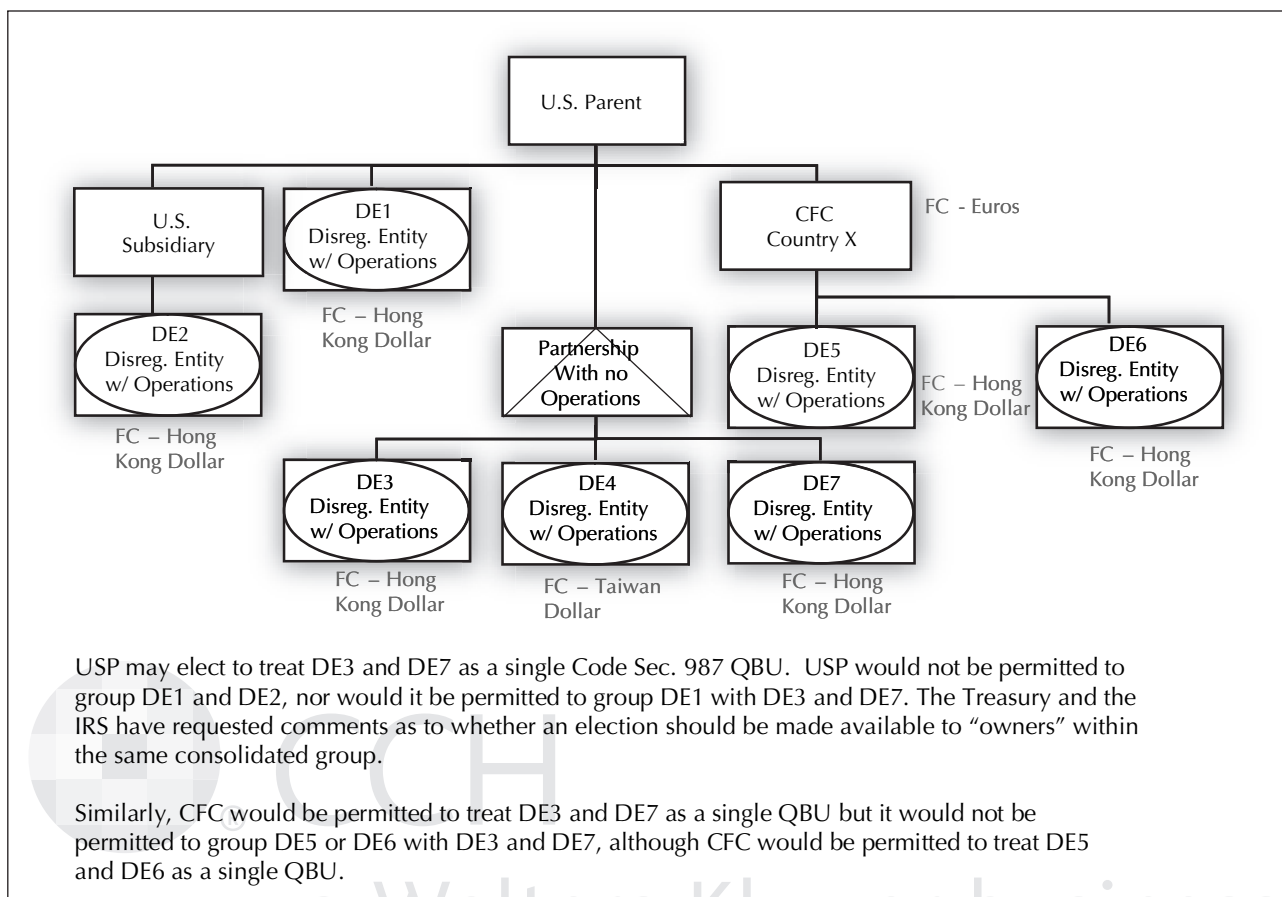
Subject to certain limitations, an owner may elect to treat all Code Sec. 987 QBUs with the same functional currency as a single Code Sec. 987 QBU.<sup>38</sup> An owner can group within the same partnership but not through different partnerships.<sup>39</sup> An owner can group a QBU owned directly with a QBU through a partnership.<sup>40</sup> Diagram 2 illustrates permissible and impermissible groupings.<sup>41</sup>

### **C. Other Definitions**

Finally, Proposed Reg. §1.987-1 contains a few additional definitions that are important to navigate the Proposed Regulations.

- **Code Sec. 987 branch**—A Code Sec. 987 branch is an eligible QBU of an individual, partnership, DE or corporation, all or a portion of which is a Code Sec. 987 QBU. Assets and liabilities of an eligible QBU of a partnership that are allocated to a partner under Proposed Reg. §1.987-7 are considered to be a Code Sec. 987 QBU of such partner, provided such partner has a functional currency different from that of such eligible QBU.<sup>42</sup>
- **Code Sec. 987 partnership**—A Code Sec. 987 partnership is a partnership that has one or more Code Sec. 987 branches.<sup>43</sup>
- **Code Sec. 987 DE**—A Code Sec. 987 DE is a DE that has one or more Code Sec. 987 branches.<sup>44</sup>

**Diagram 2 Code Sec. 987 Group Elections**



In Example 1 of Proposed Reg. §1.987-1(b)(7), the Treasury and the IRS make clear that the combined activities of holding stock and servicing a liability that was incurred to acquire such stock are not sufficient activities to constitute a trade or business within the meaning of Reg. §1.989(a)-1(c).<sup>45</sup> Hence, the activities of a typical financing DE will not be considered an eligible QBU for purposes of Code Sec. 987.<sup>46</sup> Payments of principal and interest by the DE on its note payable will be governed by Code Sec. 988 (assuming, as in the example, the note has a different functional currency from the owner). This guidance is helpful in the general determination of what constitutes a QBU because it goes beyond the examples provided in the Code Sec. 989 regulations.

Proposed Reg. §1.987-1(c) through -1(e) sets forth the relevant rules to determine the appropriate exchange rates for various type of assets and liabilities and create two broad categories of assets and liabilities of a Code Sec. 987 QBU. These provisions represent important foundational provisions of the new Code Sec. 987 rules, defining (1) a *Code Sec.*

*987 marked item* as in general, an item that would be a Code Sec. 988 transaction if held directly by the owner),<sup>47</sup> and (2) a *Code Sec. 987 historic item* as any asset or liability that is not a “Code Sec. 987 marked item.”<sup>48</sup> In short, Code Sec. 987 marked items give rise to Code Sec. 987 gain or loss, whereas Code Sec. 987 historic items do not. This approach was intended to, and should, limit the recognition of noneconomic Code Sec. 987 gain or loss. The new rules provide for a new exchange rate convention for Code Sec. 987 historic items—such items, when transferred, are subject to the historic exchange rate, as defined in Proposed Reg. §1.987-1(c)(3). Thus, these assets and liabilities, which should not give rise to foreign exchange gain or loss, are translated and maintained at the spot rate<sup>49</sup> on which the asset was transferred to<sup>50</sup> (or acquired by)<sup>51</sup> the Code Sec. 987 QBU, or on the date in which the liability was entered into by<sup>52</sup> (or transferred to)<sup>53</sup> the Code Sec. 987 QBU.<sup>54</sup>

### D. Elections

There are a number of elections to be made under the Proposed Regulations. Proposed Reg. §1.987-1(f)

provides that these elections are treated as methods of accounting; as a result, a change in such elections would require compliance with the advance consent accounting method change procedures. Generally, such elections are to be made by the owner of the Code Sec. 987 QBU.<sup>55</sup> Where a Code Sec. 987 QBU is held by a controlled foreign corporation (CFC),<sup>56</sup> elections shall be made in accordance with Reg. §§1.952-2(c)(2)(iv) and 1.964-1(c) by its controlling U.S. shareholders.<sup>57</sup> The election must be made for the first tax year that Code Sec. 987 is relevant.<sup>58</sup> Similar to errant filings in other areas (e.g., filings required by the proposed DCL regulations and gain recognition agreements required by the Code Sec. 367(a) regulations), the Treasury and the IRS pushed the remedy for late elections to the field. In general, the taxpayer must demonstrate to the district director that such failure to file was due to reasonable cause and not willful neglect.<sup>59</sup> Because there is a regulatory provision providing relief for late filing of elections, Code Sec. 9100 relief would not be appropriate. Finally, elections under the Proposed Regulations cannot be revoked without the consent of the Commissioner.<sup>60</sup> The Proposed Regulations reserved guidance on elections in the case of certain acquisitions but presumably normal rules would apply. That is, in taxable acquisitions, the new owner should be allowed to make new elections and in Code Sec. 381 transactions, such as foreign-to-foreign asset reorganizations, the historic elections should carry over.

### III. Attribution of Assets/Liabilities and Income/Loss to a Code Sec. 987 QBU

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Proposed Reg. §1.987-2(b) provides that items are attributable to an eligible QBU to the extent they are reflected on the separate set of books and records, as defined in Reg. §1.989(a)-1(d), of the eligible QBU. The term “item” refers to assets and liabilities, and items of income, gain, deduction and loss.<sup>61</sup> Consistent with the no-tiering rule described above, Proposed Reg. §1.987-2(b)(2)(i) provides that (1) stock of a corporation (whether domestic or foreign),<sup>62</sup> (2) an interest in a partnership (whether domestic or foreign), or (3) a liability that was incurred to acquire such stock or partnership, shall not be considered to be on the books and records of an eligible QBU.<sup>63</sup> Income, gain,

deduction or loss arising from such items, e.g., a Code Sec. 951(a) inclusion with respect to stock, shall not be considered to be on the books and records of the eligible QBU.<sup>64</sup>

The rules include the dawning of a new type of anti-abuse rule. Specifically, the Commissioner may allocate any item between or among the eligible QBU, the owner of such eligible QBU, and any other persons, entities (including disregarded entities), or other QBUs within the meaning of Reg. §1.989(a)-1(b) (including eligible QBUs) if a principal purpose of recording (or failing to record) an item on the books and records of an eligible QBU is the avoidance of U.S. tax under Code Sec. 987.<sup>65</sup> Factors indicating no tax avoidance include<sup>66</sup> (1) a significant and *bona fide* business purpose, (2) economics that support the underlying transaction, (3) consistency with generally accepted accounting principles or internal policies, and (4) consistency in treatment from year to year. Factors indicating tax avoidance<sup>67</sup> include (1) circular flows, (2) lack of economic substance, and (3) offsetting positions of the Code Sec. 987 QBU’s functional currency.

As discussed above, neither a partnership nor a DE is an eligible QBU and, thus, cannot be a Code Sec. 987 QBU.<sup>68</sup> As a result, a partnership or DE may own assets and liabilities that are not attributed to an eligible QBU (or a Code Sec. 987 QBU) and, therefore, are not subject to Code Sec. 987. FX gain or loss on these assets and liabilities will be accounted for by the owner under Code Sec. 988.<sup>69</sup>

### IV. Transfers to and from Code Sec. 987 QBUs

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Proposed Reg. §1.987-2(c) provides that an asset or liability shall be treated as transferred to (or transferred from) a Code Sec. 987 QBU if, as a result of a disregarded transaction,<sup>70</sup> such asset or liability is reflected (or not reflected) on the books and records of the Code Sec. 987 QBU within the meaning of Proposed Reg. §1.987-2(b). Disregarded transactions will not give rise to items of income, gain, deduction or loss that must be taken into account in determining Code Sec. 987 taxable income or loss under Proposed Reg. §1.987-3.<sup>71</sup>

Proposed Reg. §1.987-2(c)(3) provides a similar rule for assets of a Code Sec. 987 partnership. Solely for purposes of Code Sec. 987, an asset shall be treated as transferred to an indirectly owned Code Sec. 987 QBU if, and to the extent, the asset is contributed

to the Code Sec. 987 partnership that carries on the Code Sec. 987 QBU provided that immediately following such contribution, the asset is reflected on the books and records of the Code Sec. 987 QBU within the meaning of Proposed Reg. §1.987-2(b). Conversely, an asset shall be treated as transferred from an indirectly owned Code Sec. 987 QBU if, and to the extent, the Code Sec. 987 partnership that carries on the Code Sec. 987 QBU distributes the asset to a partner provided that, immediately prior to such distribution, the asset was reflected on the books and records of such Code Sec. 987 QBU. Deemed contributions and deemed distributions under Code Sec. 752 are disregarded.<sup>72</sup> Proposed Reg. §1.987-2(c)(4) through (6) provides certain additional rules that govern transfers. The main thrust of these rules is that a transfer is triggered when an asset or liability moves (e.g., is transferred, exchanged, etc.) for legal (e.g., local law) purposes.

- *Assumption of Partner Liabilities*—A liability shall be treated as transferred to an indirectly owned Code Sec. 987 QBU if, and to the extent, the Code Sec. 987 partnership assumes such liability, provided that immediately following such assumption, the liability is reflected on the books and records of the Code Sec. 987 QBU.<sup>73</sup>
- *Assumption of Partnership Liabilities*—A liability shall be treated as transferred from an indirectly owned Code Sec. 987 QBU if, and to the extent, the owner assumes such liability of the Code Sec. 987 partnership provided that immediately prior to such assumption, the liability is reflected on the books and records of the Code Sec. 987 QBU.<sup>74</sup>
- *Acquisitions and Dispositions of Interests in DEs and Partnerships*—An asset or liability shall be treated as transferred to a Code Sec. 987 QBU if, as a result of an acquisition (including by contribution) or disposition of an interest in a Code Sec. 987 partnership or Code Sec. 987 DE, such asset or liability is reflected on the books and records of the Code Sec. 987 QBU. Similarly, an asset or liability shall be treated as transferred from a Code Sec. 987 QBU if, as a result of an acquisition or disposition of an interest in a Code Sec. 987 partnership or Code Sec. 987 DE, the asset or liability is not reflected on the books and records of the Code Sec. 987 QBU.<sup>75</sup>

Importantly, a mere change in form of ownership of an eligible QBU shall not result in a transfer to or from a Code Sec. 987 QBU.<sup>76</sup> Instead, the determination

of whether a transfer has occurred in such case shall be made under Proposed Reg. §1.987-2(c)(5).<sup>77</sup>

Diagrams 3 through 7 illustrate some of the rules for purposes of determining whether there is a transfer of an asset or liability from the owner to a Code Sec. 987 QBU under Proposed Reg. §1.987-2(c).

## V. Determination of the Taxable Income/Loss of an Owner of a Code Sec. 987 QBU

Proposed Reg. §1.987-3 provides the framework for determining an owner's "Code Sec. 987 taxable income" with respect to a Code Sec. 987 QBU.<sup>78</sup>

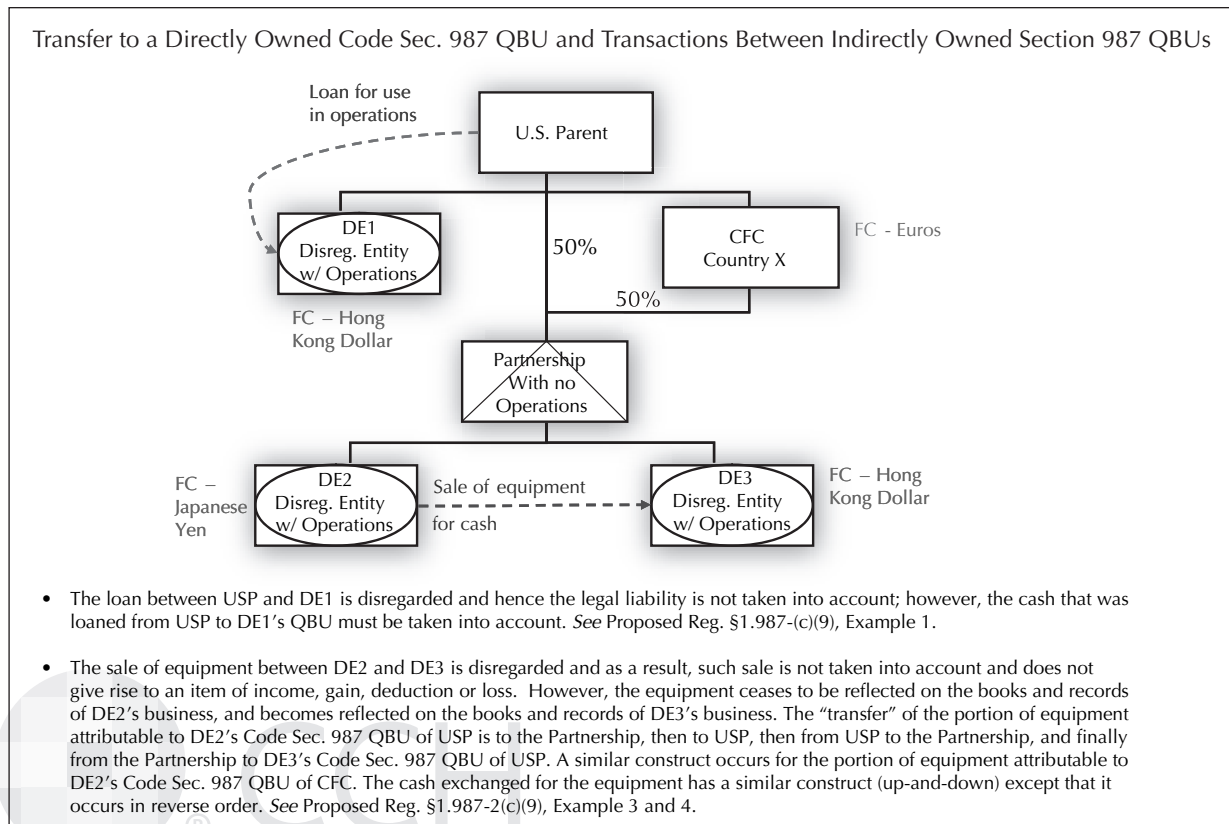
As discussed above, Proposed Reg. §1.987-2 provides rules for determining each item of income, gain, deduction or loss that is attributable to a Code Sec. 987 QBU. Generally, these items are determined in the functional currency of the Code Sec. 987 QBU and are translated into the functional currency of the owner at exchange rates determined under Proposed Reg. §1.987-3(b).<sup>79</sup>

### A. Translation of Items to Owner's Functional Currency—Generally

Generally, an owner translates a Code Sec. 987 QBU's items of income, gain, deduction or loss into its functional currency at the yearly average exchange rate for the tax year.<sup>80</sup> However, an election is available pursuant to which an owner may translate the Code Sec. 987 QBU's items at the spot rate for the day each item is properly taken into account.<sup>81</sup>

For example, US Corporation ("US Corp") is a domestic corporation with the dollar as its functional currency. US Corp owns French DE, a Code Sec. 987 DE that has a Code Sec. 987 branch with the euro as its functional currency. French DE's activities constitute an eligible QBU that is a Code Sec. 987 QBU because its functional currency of the euro is different from the functional currency of US Corp.<sup>82</sup> On September 15, 2009, French DE provides services to an unrelated customer, in exchange for €2,000. US Corp would generally translate this item of income into USD at the yearly average exchange rate of EUR1:USD 1.05, for income of USD 2,100.<sup>83</sup> US Corp may instead elect to apply the spot rate to translate French DE's items of income, gain, deduction and loss. In such case, US Corp would translate French DE's income at the spot rate of EUR 1:USD 1.06, for income of USD 2,120.<sup>84</sup>

**Diagram 3**



**B. Translation of Deductions Allowable with Respect to Code Sec. 987 Historic Assets and Gain/Loss Recognized on Sale or Other Dispositions of Code Sec. 987 Historic Assets**

Special rules apply to the translation of deductions allowable with respect to Code Sec. 987 historic assets and gain or loss recognized on the sale or other disposition of Code Sec. 987 historic assets.<sup>85</sup> An owner must use the historic exchange rate to translate depreciation, depletion and amortization deductions allowable with respect to Code Sec. 987 historic assets.<sup>86</sup> For example, French DE owns a truck and in 2009 has depreciation expense of €100 with respect to such truck. The truck was purchased on January 15, 2008. The historic exchange rate with respect to the truck was EUR1:USD1.02.<sup>87</sup> Consequently, US Corp translates French DE's 2009 depreciation expense into USD at a rate of EUR1:USD1.02 for depreciation expense of USD102.<sup>88</sup>

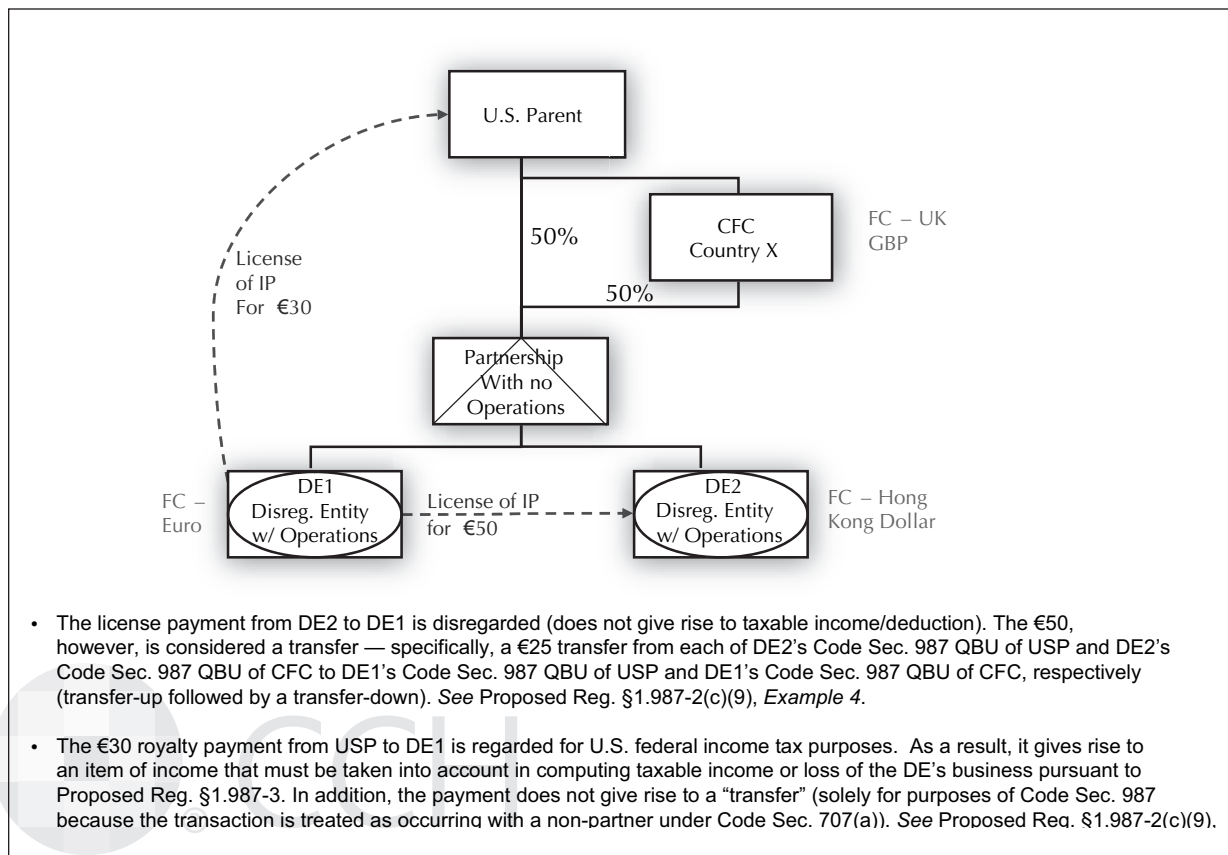
An owner must use different exchange rates with respect to the amount realized and adjusted basis for

purposes of determining the gain or loss recognized on a sale or other disposition of property that is reflected on the books and records of a Code Sec. 987 QBU for a tax year.<sup>89</sup>

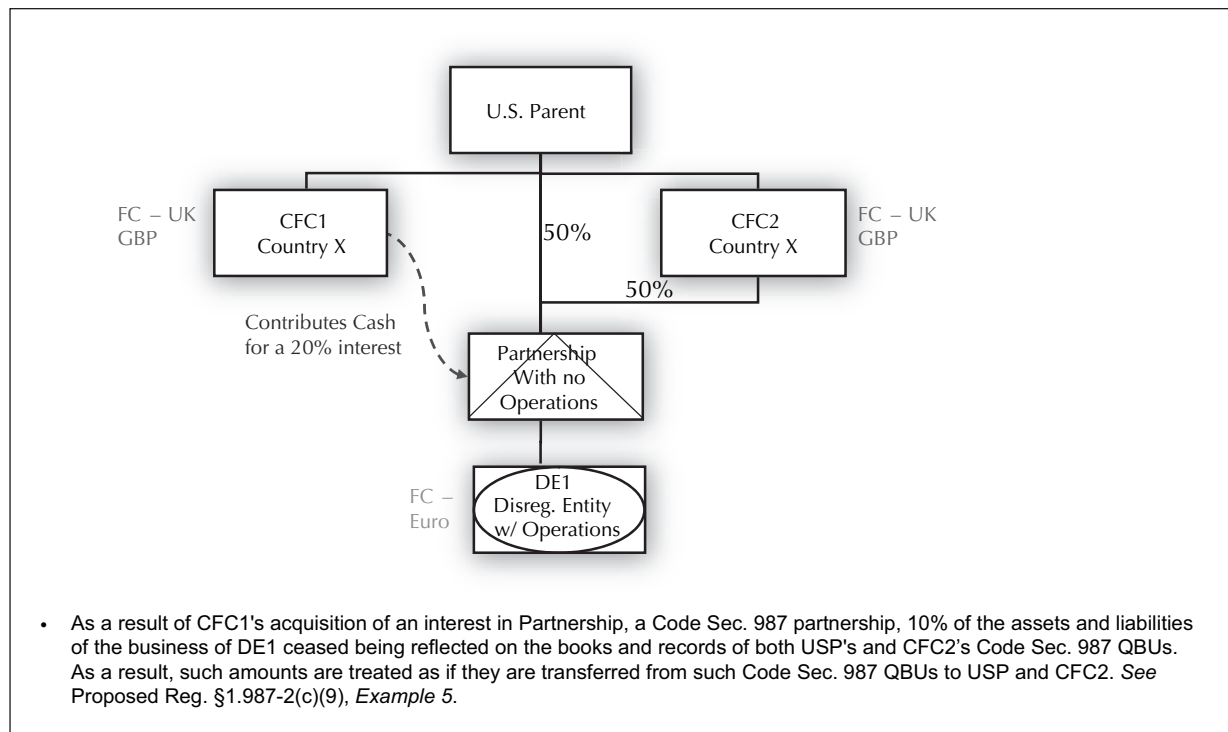
To translate the amount realized on such a sale or disposition, the owner shall generally apply the exchange rate used to translate the Code Sec. 987 QBU's items of income, gain, deduction or loss into the owner's functional currency for the tax year.<sup>90</sup> As discussed above, this is either the yearly average exchange rate or, if elected, the spot rate for the day the item is properly taken into account. To translate the adjusted basis of property sold or otherwise disposed of by the Code Sec. 987 QBU, the owner shall generally apply the historic exchange rate for such asset.<sup>91</sup>

For example, French DE purchases raw land for €8,000 on October 16, 2007, when the spot rate was EUR1:USD1. French DE sold this land for €10,000 on November 1, 2009. The yearly average exchange rate for 2009 was EUR1:USD1.05. French DE determines the adjusted basis in the land and the amount realized on the sale of the land in euro.<sup>92</sup> US Corp, however, makes these determinations in USD. The adjusted basis of the land is translated at the historic exchange rate of EUR1:USD1, for an adjusted basis of USD 8,000.<sup>93</sup>

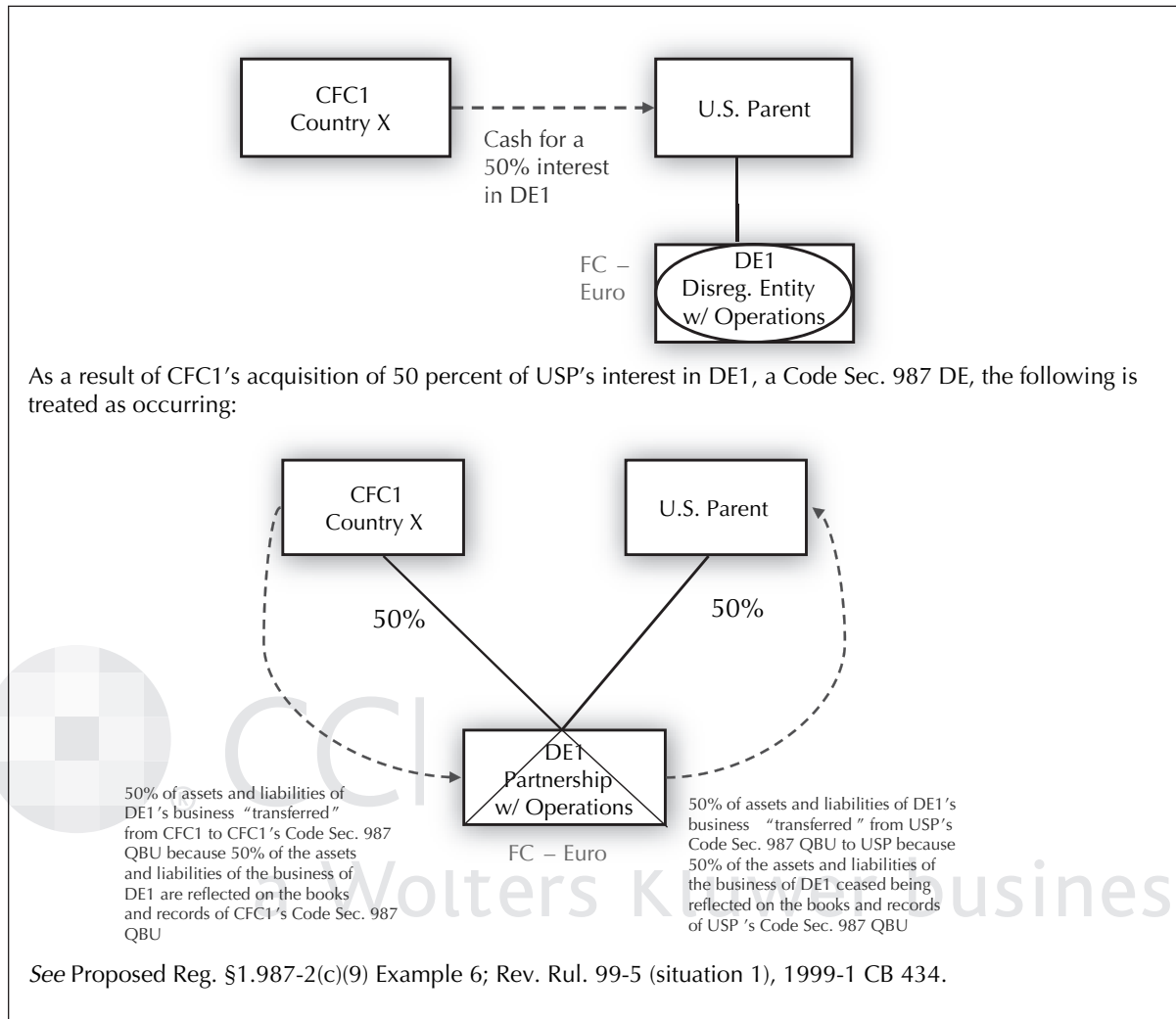
**Diagram 4 Transactions Between Indirectly Owned Code Sec. 987 QBUs**



**Diagram 5 Acquisition of an Interest in a Partnership**



**Diagram 6 Conversion of a DE to a Partnership Through a Sale of an Interest**

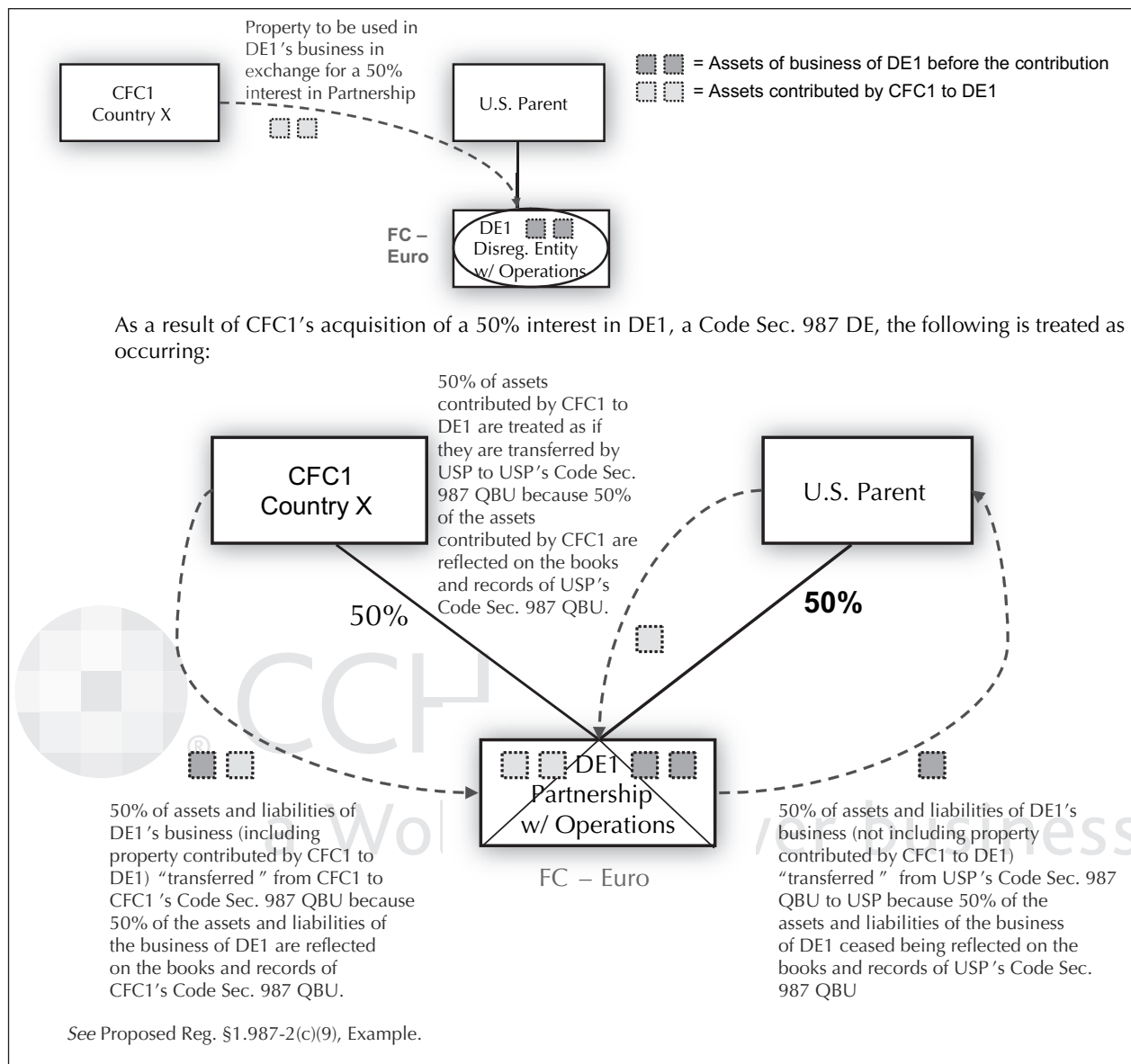


The amount realized is translated at the yearly average exchange rate of EUR1:USD1.05, for an amount realized of USD10,500.<sup>94</sup> Consequently, US Corp's gain recognized on French DE's sale of the land is the USD10,500 amount realized less the USD 8,000 adjusted basis in the land for a gain of USD 2,500.<sup>95</sup>

The use of the historic exchange rate to translate deductions allowable with respect to historic Code Sec. 987 assets and the use of the yearly average exchange rate to translate the amount realized on the sale or other disposition of such assets is a departure from the approach taken in the 1991 proposed regulations. As set forth in the Preamble to the Proposed Regulations, the use of the different exchange rates for the amount realized and adjusted basis "is designed to more closely reflect the economic gain or loss to the owner of the section 987 QBU than the 1991 proposed regulations."<sup>96</sup>

However, the same exchange rate is used to translate both the amount realized and adjusted basis of Code Sec. 987 marked assets (other than cash).<sup>97</sup> For Code Sec. 987 marked assets that were held on the first day of the tax year, the appropriate exchange rate is the rate used to determine the owner's functional currency net value of the Code Sec. 987 QBU in the preceding tax year.<sup>98</sup> If, on the other hand, the Code Sec. 987 marked asset was acquired by the Code Sec. 987 QBU during the tax year (by transfer or otherwise), the appropriate exchange rate is the spot rate for the date the asset was acquired.<sup>99</sup> The purpose of these rules is to ensure that foreign currency gain or loss on Code Sec. 987 marked assets is reflected through the balance sheet calculations of Proposed Reg. §1.987-4, rather than the profit and loss calculations of Proposed Reg. §1.987-3.<sup>100</sup>

**Diagram 7 Conversion of a DE to a Partnership Through a Contribution**



**C. Translation of Other Items**

A Code Sec. 987 QBU's items of income, gain, deduction or loss that are denominated in, or determined by reference to, the owner's functional currency are not translated.<sup>101</sup> Rather, such items are taken into account by the Code Sec. 987 QBU under U.S. tax principles in the owner's functional currency.

A Code Sec. 987 QBU's items of income, gain, deduction or loss that are denominated in, or determined by reference to, a nonfunctional currency other than the owner's functional currency are translated into the Code Sec. 987 QBU's functional currency at the spot rate on the day such item is properly taken into account.<sup>102</sup> For example, French

DE performed services for a UK person on January 12, 2009, in exchange for £10,000 of compensation. The spot rate on January 12, 2009, was £1:€1.25. Under Proposed Reg. §1.987-3(d), French DE translates the pounds into euro at this spot rate for compensation income of €12,500.<sup>103</sup>

**D. Code Sec. 988 Transactions**

Code Sec. 988 generally applies to Code Sec. 988 transactions attributable to a Code Sec. 987 QBU and such transactions are treated as Code Sec. 987 historic items.<sup>104</sup> For example, French DE disposes of the £10,000 that it acquired on January 12, 2009, in exchange for €10,000 on October 16, 2009. Under

Code Sec. 988(c)(1)(C), French DE's disposition of nonfunctional currency is a Code Sec. 988 transaction. Under Reg. §1.988-2(a)(2), French DE realizes a loss of €2,500 (€10,000 amount realized less €12,500 basis) and under Proposed Reg. §1.987-3(b), US Corp translates this into USD at the yearly average exchange rate of EUR1:USD1.05 for a loss of USD 2,625.<sup>105</sup>

Transactions that would otherwise be Code Sec. 988 transactions that are denominated in, or determined by reference to, the owner's functional currency are not treated as Code Sec. 988 transactions to the Code Sec. 987 QBU to which they are attributable. As a result, no currency gain or loss is recognized by a Code Sec. 987 QBU under Code Sec. 988 with respect to such transaction. In the above example, if French DE had disposed of USD, such disposal would not have been a Code Sec. 988 transaction because USD is the functional currency of US Corp. Therefore, French DE would not have realized Code Sec. 988 gain or loss on such disposition.

## VI. Determination of Code Sec. 987 Net Unrecognized Gain/Loss

Proposed Reg. §1.987-4 sets forth the rules to compute a Code Sec. 987 QBU's Code Sec. 987 net unrecognized gain or loss. This amount represents the inherent gain or loss with respect to *marked assets* resulting solely from movements in the relevant currency exchange rates.<sup>106</sup> As the Preamble states, the combination of the mechanics of Proposed Reg. §1.987-4 and Proposed Reg. §1.987-5 (*recognition of section 987 gain or loss*) form the mathematical core of the foreign exchange exposure pool method.<sup>107</sup> In summary, Proposed Reg. §1.987-4 uses a balance sheet to distinguish the items of a Code Sec. 987 QBU that give rise to a Code Sec. 987 gain or loss (Code Sec. 987 marked items) from those that do not (Code Sec. 987 historic items).<sup>108</sup>

Net unrecognized Code Sec. 987 gain or loss of a Code Sec. 987 QBU is determined on an annual basis by the owner in the owner's functional currency.<sup>109</sup> Net unrecognized Code Sec. 987 gain or loss of a Code Sec. 987 QBU for a tax year equals the sum of:

- the Code Sec. 987 QBU's net accumulated unrecognized Code Sec. 987 gain or loss for all prior tax years<sup>110</sup>; and
- the Code Sec. 987 QBU's unrecognized Code Sec. 987 gain or loss for the current tax year.<sup>111</sup>

A Code Sec. 987 QBU's *net accumulated* unrecognized Code Sec. 987 gain or loss for all prior tax years is the aggregate of the Code Sec. 987 QBU's unrecognized Code Sec. 987 gain or loss for all prior years (determined under Proposed Reg. §1.987-4(d)) to which the Proposed Regulations apply, reduced by the amounts taken into account under Proposed Reg. §1.987-5 upon a remittance for all such prior tax years.<sup>112</sup> Diagram 8 explains the seven steps required to compute the unrecognized Code Sec. 987 gain or loss of a Code Sec. 987 QBU for a tax year.

Under Proposed Reg. §1.987-4, US Corp must calculate the net unrecognized Code Sec. 987 gain or loss of the Japan Branch using the seven-step approach set forth in Diagram 8.

In Step 1, US Corp must determine the owner functional currency net value of the Japan Branch for the current year. This is the aggregate of the basis of each asset on the Japan Branch's balance sheet less the aggregate of each liability on the Japan Branch's balance sheet on the last day of the year, translated into U.S. dollars. Marked items are translated into U.S. dollars at the spot rate on the last day of the year, while historic items are translated into U.S. dollars at the historic exchange rate.

The Japan Branch's assets and liabilities on December 31, 2009, are:

- Cash = ¥100,000 + ¥10,000 borrowing + ¥12,000 earnings - ¥2,000 expenses = **¥120,000**
- Land = Basis of \$500 \* 100 = **¥50,000**
- Liability = **¥10,000**

The cash and the liability are marked items (*i.e.*, because they would be Code Sec. 988 items in the hands of US Corp), while the land is an historic item. These items are translated into U.S. dollars as follows:

- Cash = ¥120,000 translated at the December 31, 2009, spot rate = **\$999.60**
- Land = ¥50,000 translated at the July 1, 2009, historic rate = **\$500**
- Liability = ¥10,000 translated at the December 31, 2009, spot rate = **\$83.30**

The owner functional currency net value of the Japan Branch at December 31, 2009, is equal to \$1,000 cash + \$500 land - \$83 liability = **\$1,416.30**. In this case, the owner functional currency net value at December 31, 2009, equals the change in owner functional currency net value because the Japan Branch was formed in 2009.

In Step 2, the amount determined in Step 1 is increased by amounts transferred by the Japan Branch to US Corp during the year. Since no amounts were

transferred by the Japan Branch to US Corp, there is no change as a result of Step 2.

In Step 3, the amount determined in Step 1 is decreased by amounts transferred by US Corp to the Japan Branch during the year. US Corp transferred cash of \$1,000 and raw land with a basis of \$500 to the Japan Branch on July 1, 2009. Therefore, the \$1,416.30 determined in Step 1 is reduced by \$1,500 for a total of (\$83.70).

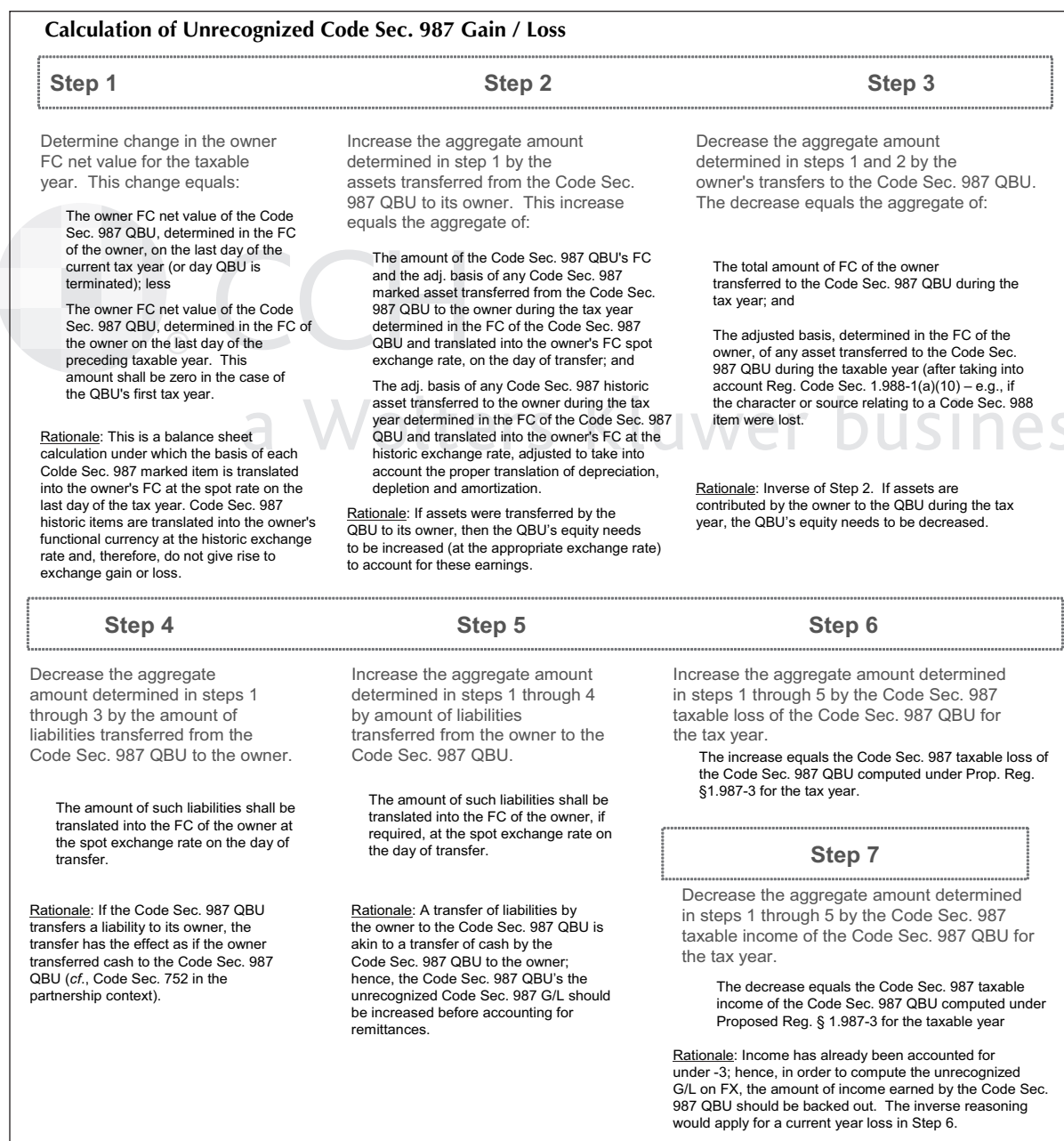
In Steps 4 and 5, the amount determined in Steps 1 – 3 is decreased/increased by the amount of li-

abilities transferred from the Japan Branch to US Corp/ from US Corp to the Japan Branch. Since no liabilities were transferred to or from the Japan Branch during the year, there is no change as a result of Steps 4 and 5.

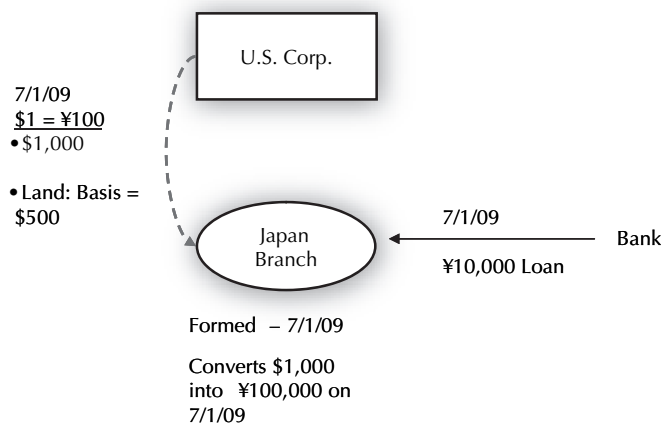
In Step 6, the amount determined in Steps 1 – 5 is increased by the amount of the Japan Branch’s taxable loss. Since the Japan Branch did not have a taxable loss, there is no change as a result of Step 6.

In Step 7, the amount determined in Steps 1 – 5 is decreased by the amount of the Japan Branch’s

### Diagram 8



The application of the seven steps described above is illustrated in the following example:



Facts

- Japan Branch earns ¥12,000 of income from 7/1/09 – 12/31/09 that translates into \$109.08 using the spot rate convention adopted by U.S. Corp.
- Japan Branch incurs ¥2000 of expenses from 7/1/09 – 12/31/09 that translates into \$18.18 using the spot rate convention adopted by U.S. Corp.
- Japan Branch’s net income from 7/1/09 – 12/31/09, translated into USD = \$90.90
- At 12/31/09, \$1 = ¥120

taxable income, which was \$90.90. Therefore, the unrecognized Code Sec. 987 loss of the Japan Branch for 2009 is (\$83.70) minus \$90.90 = (\$174.60).

## VII. Recognition of Code Sec. 987 Gain or Loss

Proposed Reg. §1.987-5 contains the operative provisions that set forth the mechanics for determining the amount of Code Sec. 987 gain or loss a taxpayer must recognize in a tax year.<sup>113</sup> An owner’s Code Sec. 987 gain or loss recognized with respect to a Code Sec. 987 QBU shall be equal to:

- the owner's net unrecognized Code Sec. 987 gain or loss of the Code Sec. 987 QBU determined under Proposed Reg. §1.987-4 on the last day of such tax year (or, if earlier, on the day the Code Sec. 987 QBU is terminated under Proposed Reg. §1.987-8); multiplied by
- the owner's remittance proportion for the tax year, as determined under Proposed Reg. §1.987-5(b) (discussed below).

In other words, the amount determined from Proposed Reg. §1.987-4 (discussed in Section VI above) is multiplied by the owner’s remittance proportion (set forth in Diagram 9)<sup>114</sup> to arrive at taxable Code Sec. 987 gain or loss for the current tax year.

A few observations are noteworthy:

- The quotient, in simple terms, aims to trigger Code Sec. 987 gain or loss on any net positive remittance that is drawn from the Code Sec. 987 QBU’s gross assets (grossed-up to include the net remittance) for a given tax year (both the remittance and the Code Sec. 987 QBU’s gross assets are determined in the owner’s FC).<sup>115</sup> Thus, if a portion of the Code Sec. 987 QBU’s assets are remitted to its owner in a given tax year, then a portion of any unrecognized Code Sec. 987 gain or loss with respect to the relevant Code Sec. 987 QBU will be *recognized* by the owner for that tax year.
- A taxpayer will have Code Sec. 987 gain or loss in a given year (with respect to a Code Sec. 987 QBU) only if the taxpayer (the owner) has received net positive remittances. As shown above, the numerator in the quotient, is the “excess, if any” of the transfers from the Code Sec. 987 QBU to the owner over the transfers from the owner to the Code Sec. 987 QBU.<sup>116</sup> Hence, if there is no positive net remittance amount for a given tax year, then none of the Code Sec. 987 QBU’s unrecognized Code Sec. 987 gain or loss will be *recognized by the owner* for such tax year.
- Because an owner's net positive remittance, if any, from a Code Sec. 987 QBU is determined

on the last day of the owner's tax year, the “daily netting” rule of the 1991 proposed regulations has been discarded. Although the Proposed Regulations are generally more complex than the 1991 proposed regulations, the change from a daily netting rule to an annual netting rule is a welcome simplification.<sup>117</sup>

- The full amount of a Code Sec. 987 QBU’s unrecognized Code Sec. 987 gain or loss (determined under Proposed Reg. §1.987-4) will be recognized upon a termination of the Code Sec. 987 QBU.

The owner’s adjusted basis in an asset received in a transfer from the Code Sec. 987 QBU (whether or not such transfer is made in connection with a remittance) is determined as follows:

- *Code Sec. 987 Marked Asset*—The tax basis of a Code Sec. 987 marked asset shall be determined in the owner’s functional currency and shall be the same amount of the Code Sec. 987 QBU’s tax basis translated at the spot exchange rate (as defined in Proposed Reg. §1.987-1(c)(1)) on the day of the transfer.<sup>118</sup>
- *Code Sec. 987 Historic Asset*—The tax basis of a Code Sec. 987 historic asset shall be its historic basis translated at the historic exchange rate for such asset (as defined in Proposed Reg.

§1.987-1(c)(3), less any proper translation of depreciation, amortization or depletion.<sup>119</sup>

The regulations contain two examples that are helpful in understanding the mechanics of the Code Sec. 987 quotient discussed above.<sup>120</sup> The first example is illustrated in Diagram 10: Assume (1) USP operates in the U.K. through U.K. DE; (2) the following transfers took place between USP and U.K. DE during Year 2; and (3) U.K. DE holds the assets and liabilities. Finally, assume that the net unrecognized Code Sec. 987 gain for U.K. DE under Proposed Reg. §1.987-4 is \$80 as of the last day of Year 2. Based on the foregoing facts, USP’s Code Sec. 987 gain from the remittances received from UK DE in Year 2 is \$6.80 as computed in Diagram 10.

## VIII. Character and Source of Code Sec. 987 Gain or Loss

Proposed Reg. §1.987-6(a) provides that Code Sec. 987 gain or loss is ordinary income or loss. Further, Proposed Reg. §1.987-6(b) provides that the source and character<sup>121</sup> of Code Sec. 987 gain or loss must be determined in the year of a remittance by applying the asset method set forth in Reg. §1.861-9T(g).<sup>122</sup> The Proposed Regulations contain an example that

Diagram 9

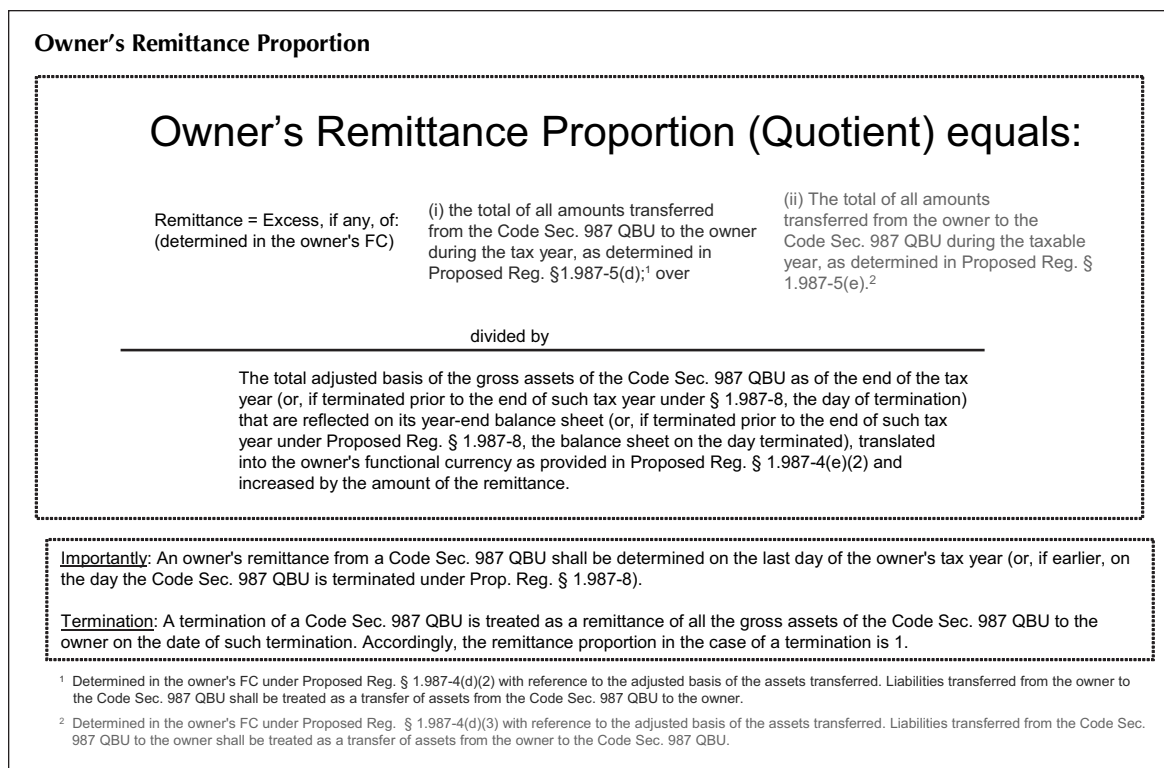
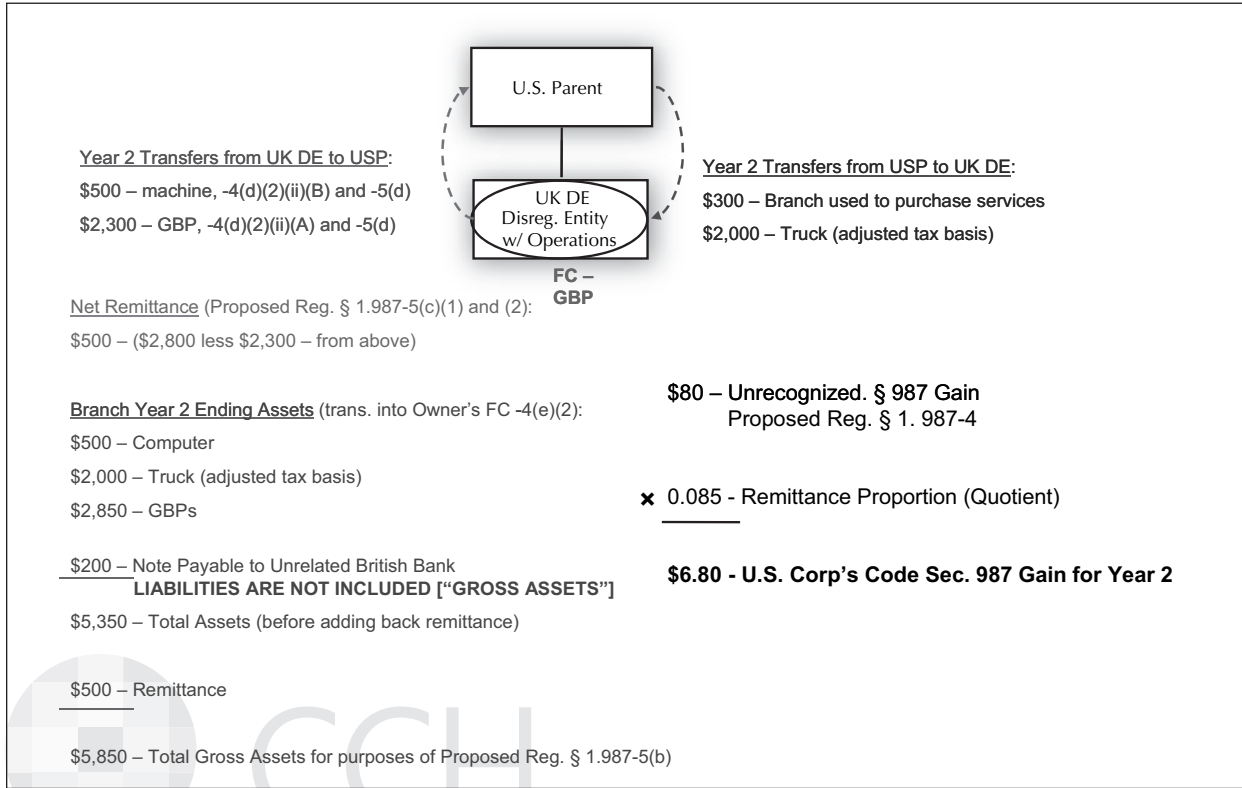


Diagram 10



illustrates that Code Sec. 987 gain or loss will be considered allocable to subpart F income in proportion to the Code Sec. 987 QBU's assets that generate subpart F income for the year. In the example, a CFC with the Swiss franc ("CHF") as its functional currency owns all of the shares of a German DE with significant operations that has the euro as its functional currency. The German DE has CHF750,000 of assets that generate foreign source general limitation income under Code Sec. 904(d)(1)(I), none of which is subpart F income under Code Sec. 952, and CHF250,000 of assets that generate foreign source passive income under Code Sec. 904(d)(1)(B), all of which is subpart F income. Hence, 25 percent of the realized Code Sec. 987 gain computed under Proposed Reg. §§1.987-4 and 1.987-5 will be considered subpart F income of the CFC.<sup>123</sup> All of the Code Sec. 987 gain is treated as ordinary income.

Prior to the issuance of the Proposed Regulations there was much debate as to whether Code Sec. 987 gain recognized by a CFC should be considered subpart F income. Given that the fundamental approach of the Proposed Regulations is to recognize Code Sec. 987 gain (or loss) with respect to marked assets only, the Treasury and the IRS's approach is reasonable and no further debate is warranted; however, the Treasury

and the IRS should consider whether an extension of the business needs exception rule is appropriate for Code Sec. 987 gains.<sup>124</sup>

## IX. Partnerships

### A. Allocation of Assets and Liabilities

Proposed Reg. §1.987-7 provides rules for determining an owner's share of assets and liabilities of a Code Sec. 987 QBU owned indirectly through a partnership in which such owner is a partner. This determination is necessary for purposes of applying the foreign exchange exposure pool method at the partner level.

The Proposed Regulations generally provide that a partner's share of the assets and liabilities reflected on the books and records of an eligible QBU or Code Sec. 987 QBU indirectly owned through a partnership will be determined in a way that is consistent with the way that the partners have agreed to share the economic benefits and burdens corresponding to the assets and liabilities.<sup>125</sup> Code Secs. 701 through 761, including Code Sec. 704(b) and Reg. §1.701-2, apply in making this determination.

The application of this rule and its relationship to the calculation of a partner's net unrecognized Code Sec.

987 gain or loss is illustrated in the following examples. In the first example, the partnership has functional currency of GBP 100 at the end of the year and does not have any liabilities (see Diagram 11).<sup>126</sup>

This next example is the same as the first, except that the Code Sec. 987 partnership in this example has GBP 150 of assets and has a GBP 50 recourse liability at the end of the year (see Diagram 12).<sup>127</sup>

The general rule set out above was selected because it will allocate assets and liabilities consistent with the economic arrangement agreed to by the partners.<sup>128</sup> A method consistent with the partners' economic arrangement should avoid a distortion of the partner's Code Sec. 987 gain or loss. The Treasury and the IRS are concerned that taxpayers may attempt to distort a partner's Code Sec. 987 gain or loss by inappropriately shifting such partner's share of the underlying assets and liabilities of a Code Sec. 987 QBU owned indirectly by a Code Sec. 987 partnership.<sup>129</sup> Therefore, the allocation of the assets and liabilities is subject to the review of the Commissioner to ensure that it is consistent with the economic arrangement of the partners and the rules of subchapter K.<sup>130</sup>

The Treasury and the IRS are considering the inclusion of a safe harbor in the final regulations that would provide that an allocation would be considered to be consistent with the economic arrangement of the partners if certain conditions are satisfied.<sup>131</sup> Comments have been requested as to whether a safe harbor should be included and, if so, what form it should take. The Preamble to the Proposed Regulations proposes a safe harbor that would apply if (1) assets, to the extent of a partner's share of partnership capital, are allocated in accordance with such capital, and (2) assets in excess of partnership capital are allocated consistent with the manner in which the partners have agreed to share the economic burden of the liabilities incurred to acquire such assets.

## B. Coordination with Subchapter K

Proposed Reg. §1.987-7 also provides rules for determining the impact of the Proposed Regulations on the partner's adjusted tax basis in its Code Sec. 987 partnership interest. A partner's adjusted basis in its Code Sec. 987 partnership interest is maintained in that partner's functional currency.<sup>132</sup> This adjusted basis is not adjusted for fluctuations in the value of the partner's functional currency and the functional currency of the section 987 QBU indirectly owned by the Code Sec. 987 partnership.<sup>133</sup> Rather, such

fluctuations are addressed by the application of the foreign exchange exposure pool method.

A partner's adjusted tax basis in a Code Sec. 987 partnership must be adjusted to take into account (1) such partner's share of the items of income, gain, deduction or loss of a Code Sec. 987 QBU indirectly owned through a Code Sec. 987 partnership, which is translated into the partner's functional currency as provided in Proposed Reg. §1.987-3, and (2) such partner's share of the Code Sec. 987 gain or loss of the Code Sec. 987 QBU, which is determined in the partner's functional currency by applying the foreign exchange exposure pool method.<sup>134</sup> These adjustments are necessary to prevent the duplication of income or loss attributable to the Code Sec. 987 QBU.<sup>135</sup>

The Proposed Regulations provide that a partner's share of the items of income, gain, deduction or loss of a Code Sec. 987 QBU indirectly owned through a Code Sec. 987 partnership are treated as income or loss of the Code Sec. 987 partnership.<sup>136</sup> Consequently, the partner's share of such items is taken into account, after translation into the partner's functional currency, in determining the adjustments to the partner's adjusted tax basis in its partnership interest under Code Sec. 705.<sup>137</sup> Similarly, Code Sec. 987 gain or loss of a Code Sec. 987 QBU indirectly owned by an individual or corporation through a Code Sec. 987 partnership is treated as income or loss of the Code Sec. 987 partnership with the result that such income or loss is taken into account as an adjustment to the partner's adjusted tax basis in its partnership interest under Code Sec. 705.<sup>138</sup>

A partner's tax basis in its interest in a Code Sec. 987 partnership must also be adjusted to take into account both actual and deemed contributions and distributions between an owner of a Code Sec. 987 QBU that is owned indirectly through a Code Sec. 987 partnership and such Code Sec. 987 partnership.<sup>139</sup> For purposes of making such adjustments, the amounts are taken into account in the partner's functional currency.<sup>140</sup>

The Proposed Regulations provide rules for translating liabilities giving rise to deemed contributions and distributions to a Code Sec. 987 partnership under Code Sec. 752 (*i.e.*, those resulting from an increase/decrease in the partner's share of the liabilities of the partnership or an increase in the partner's individual liabilities by reason of the assumption by such partner of partnership liabilities, where such liabilities are reflected on the books and records of a Code Sec. 987 QBU indirectly owned by the Code Sec. 987 partner-

Diagram 11

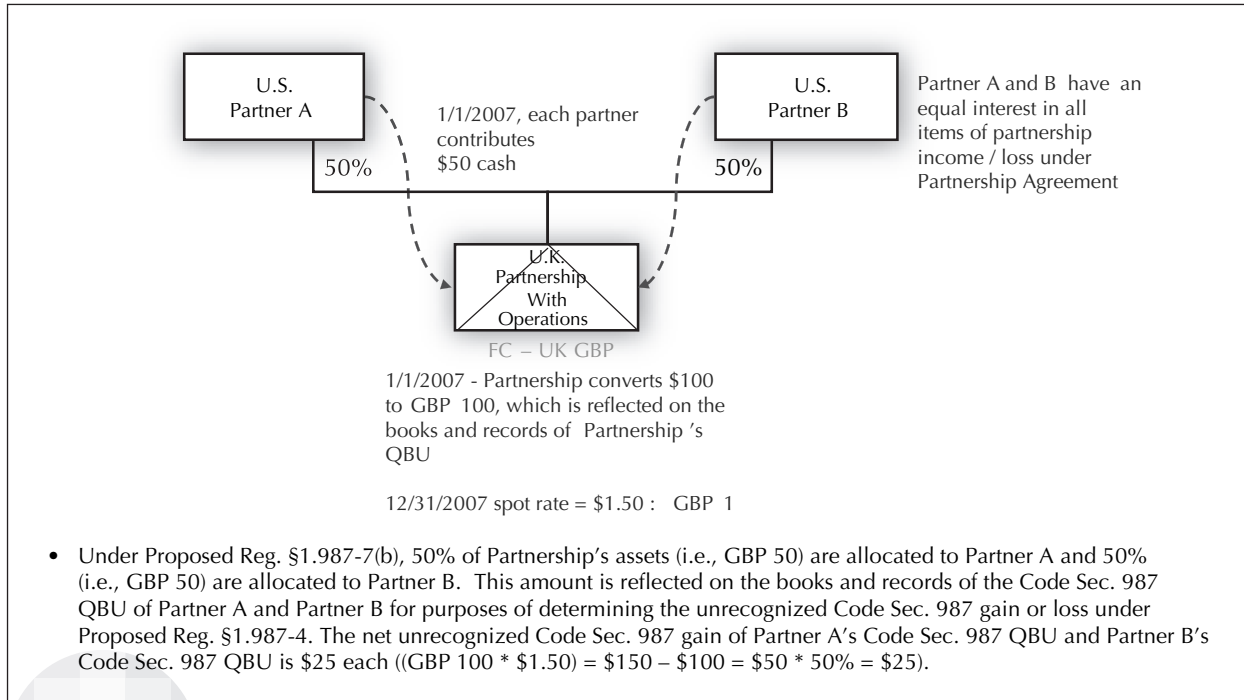
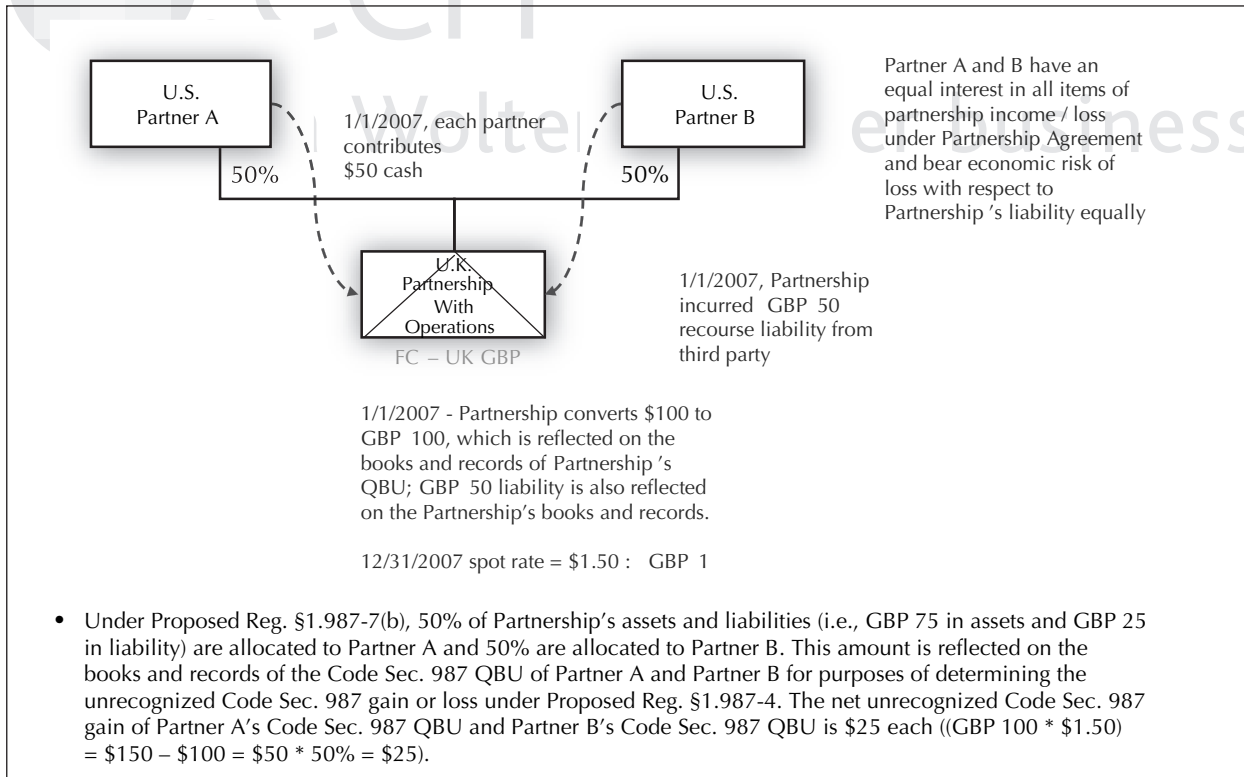


Diagram 12



ship).<sup>141</sup> For purposes of determining the amount of a deemed contribution (i.e., resulting from an increase in the partner's liabilities), such liabilities, if denominated

in a functional currency different from the partner's, are translated into the partner's functional currency using the spot rate on the date of the increase.<sup>142</sup>

On the other hand, for purposes of determining the amount of a deemed distribution (*i.e.*, resulting from a decrease in the partner's liabilities), such liabilities, if denominated in a functional currency different from the partner's, are translated into the partner's functional currency using the historic rate for the date on which the liabilities increased the partner's adjusted basis in its partnership interest.<sup>143</sup>

These rules are illustrated in Diagram 13, in which there is a deemed contribution from the partners to the Code Sec. 987 partnership resulting from an increase in the partnership's liabilities.

Finally, the Proposed Regulations include a special rule for the determination of gain or loss on a partner's sale, exchange, or other disposition of an interest in a Code Sec. 987 partnership.<sup>144</sup> Upon such a disposition, the partner's share of the liabilities of the Code Sec. 987 partnership would generally be treated as additional purchase price under Code Sec. 752(c) (*i.e.*, because the partner is relieved of such liabilities as a result of the disposition). The Proposed Regulations provide that liabilities of the Code Sec. 987 partnership that are reflected on the books and records of the Code Sec. 987 QBU are translated into the partner's functional currency at the historic rate for the date on which the liabilities increased the partner's adjusted basis in its partnership interest.<sup>145</sup>

## **X. Termination of a QBU**

Proposed Reg. §1.987-8 provides the rules that govern a termination of a Code Sec. 987 QBU. A termination of a Code Sec. 987 QBU will be treated as a remittance of all the gross assets of the Code Sec. 987 QBU to its owner, triggering the recognition of any net unrecognized Code Sec. 987 gain or loss of the Code Sec. 987 QBU.<sup>146</sup>

A Code Sec. 987 QBU terminates when:

- its activities cease<sup>147</sup>;
- substantially all (within the meaning of Code Sec. 368(a)(1)(C)) of the Code Sec. 987 QBU's assets are transferred from such Code Sec. 987 QBU to its owner, as provided under Proposed Reg. §1.987-2(c).<sup>148</sup> For purposes of this "substantially all" test, the amount of assets transferred from the Code Sec. 987 QBU to its owner as a result of a transaction (for example, a contribution of property to a DE or a partnership) as provided under Proposed Reg. §1.987-2(c) shall be reduced by assets that are transferred from the owner to such Code Sec. 987 QBU, pursuant to the same transaction;

- a CFC that is the owner of a Code Sec. 987 QBU ceases to be a CFC<sup>149</sup>; or
- the owner of a Code Sec. 987 QBU ceases to exist (including in connection with a transaction described in Code Sec. 381(a)).<sup>150</sup>

With respect to the termination of a Code Sec. 987 QBU by reason of the owner of such Code Sec. 987 QBU ceasing to exist, Proposed Reg. §1.987-8(c)(1) and -8(c)(2) provide exceptions for Code Sec. 332 liquidations and reorganizations described in section 381(a)(2), respectively. However, an exception will not be available if:

- the distributor (transferor) is a domestic corporation and the distributee (acquiring corporation) is a foreign corporation<sup>151</sup>;
- the distributor (transferor) is a foreign corporation and the distributee (acquiring corporation) is a domestic corporation<sup>152</sup>; or
- the distributor (transferor) and the distributee (acquiring corporation) are both foreign corporations and the functional currency of the distributee (acquiring corporation) is the same as the functional currency of the distributor's (transferor's) Code Sec. 987 QBU.<sup>153</sup>

Proposed Reg. §1.987-8(c)(2)(iii) includes an additional situation where an exception to a triggering event will not be available in a reorganization where the transferor is a CFC immediately before the transfer and the acquiring corporation is a foreign corporation that is not a CFC immediately after the transfer.

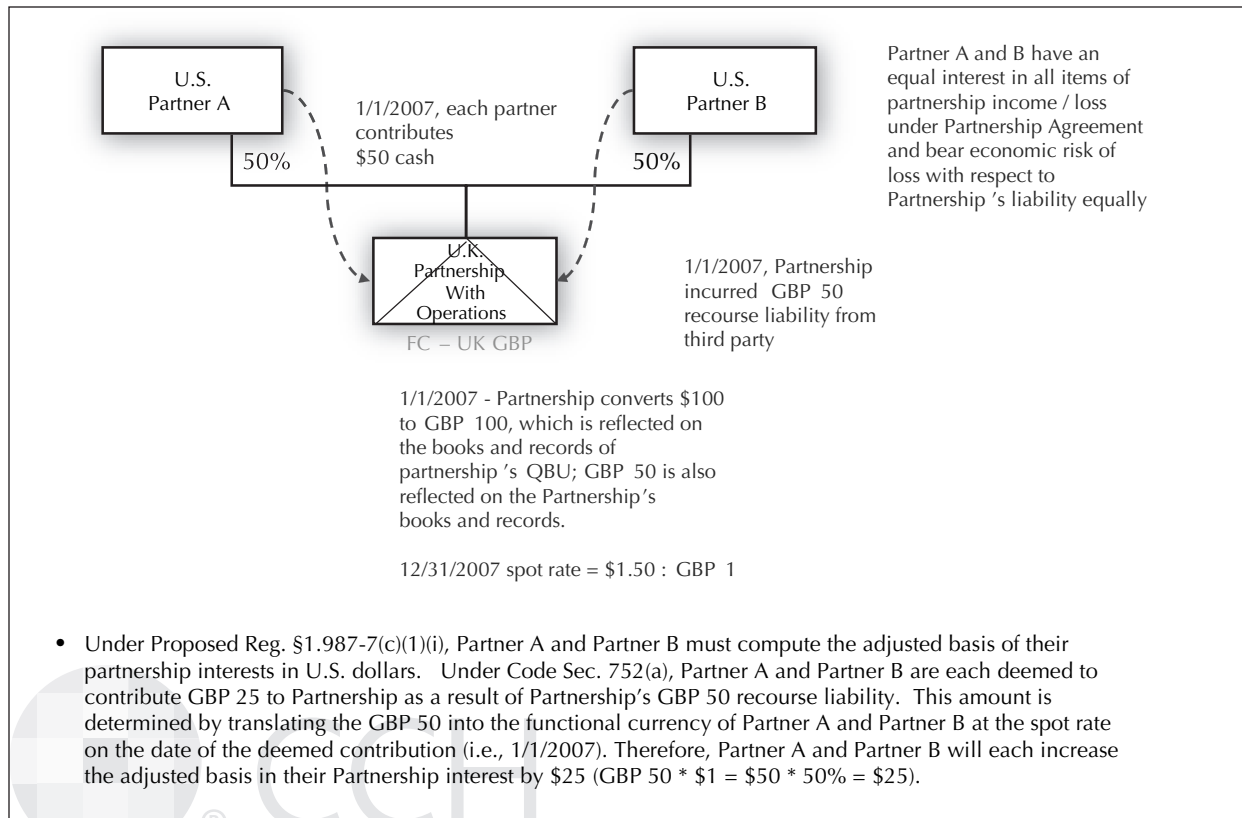
In addition to the above triggering events, the Preamble and Example 2 of Proposed Reg. §1.987-8(e) provide for a fifth triggering event involving a transfer of a Code Sec. 987 QBU to a corporation in exchange for stock in a Code Sec. 351 transfer; however, the operative rule appears to have been mistakenly omitted from the regulations.<sup>154</sup> When the proposed regulations are finalized, an exception for Code Sec. 351 transfers within a consolidated group should be included.<sup>155</sup>

Diagram 14 illustrates the rule in the "substantially all" test that requires netting of the assets transferred from the owner to such Code Sec. 987 QBU against the assets transferred from the Code Sec. 987 QBU to its owner.

## **XI. Recordkeeping Requirements**

Proposed Reg. §1.987-9 requires taxpayers to maintain sufficient records to allow the IRS to audit a taxpayer's Code Sec. 987 gain or loss computations.

**Diagram 13**



## XII. Transition Rules

A taxpayer that is the owner of a Code Sec. 987 QBU on the first day of the first tax year to which the final Code Sec. 987 regulations apply to such taxpayer (the “transition date” as defined in Proposed Reg. §1.987-10(b)) must transition from the method previously used by such taxpayer to comply with Code Sec. 987 (the “prior Code Sec. 987 method”) to the foreign exchange exposure pool method prescribed by the regulations.<sup>156</sup> This transition is required whether or not such taxpayer applied Code Sec. 987 in prior years.<sup>157</sup>

Proposed Reg. §1.987-10 provides rules for making this transition. However, Proposed Reg. §1.987-10 does not address how to apply these transition rules to partnerships that were treated as QBUs for Code Sec. 987 purposes under the 1991 proposed regulations. The IRS and the Treasury are requesting comments on the application of these transition rules to such partnerships and to QBUs of such partnerships.<sup>158</sup>

### A. Transition Methods

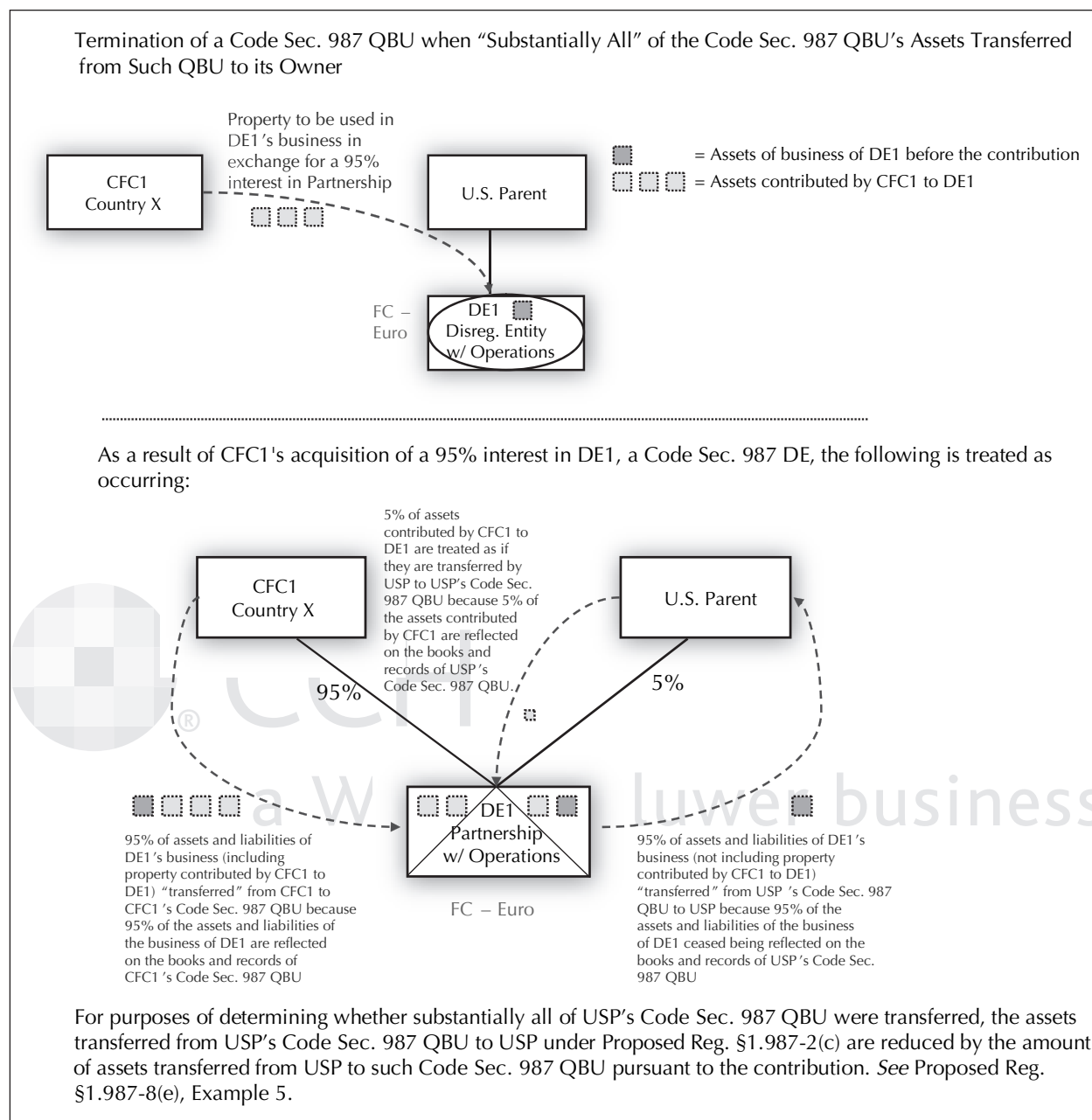
There are two transition methods provided by the proposed regulations—the “deferral transition method” and the “fresh start transition method.”<sup>159</sup> Subject to

a conformity rule described below, a taxpayer can generally elect to apply either transition method. However, a taxpayer must apply the fresh start if such taxpayer failed to make required determinations under Code Sec. 987 in prior years or if its prior Code Sec. 987 method was unreasonable.<sup>160</sup>

The Proposed Regulations themselves do not provide any guidance regarding what prior methods of calculating Code Sec. 987 gain or loss are considered to be reasonable. However, the Preamble provides that the use of the 1991 proposed regulations is considered to be reasonable.<sup>161</sup> In addition, the Preamble provides that the use of an “earnings only” method is also considered to be reasonable. The Preamble’s endorsement of the earnings only method as reasonable may present an opportunity to taxpayers who have been applying the method provided in the 1991 proposed regulations. It may be possible for taxpayers to change to the earnings only method for the period before the effective date of these proposed regulations.<sup>162</sup> However, such a change may be viewed by the IRS as a change in accounting method requiring the advance consent of the Commissioner.<sup>163</sup>

On the other hand, any method resulting in the recognition of Code Sec. 987 gain or loss with respect

Diagram 14



to stock, where such gain or loss does not reflect economic gain or loss derived from the movements in exchange rates, will be scrutinized and may be considered unreasonable based on the facts and circumstances of the particular case.<sup>164</sup>

A taxpayer is required by a conformity rule to consistently apply the same transition method with respect to all of its QBUs subject to Code Sec. 987 that are owned on the transition date.<sup>165</sup> In addition, the same transition method must be applied by all members of the consolidated group that includes the taxpayer and by any controlled foreign

corporation that is more than 50-percent owned, by vote or value, by the taxpayer, as determined under Code Sec. 957(a).<sup>166</sup> This conformity rule is provided to prevent taxpayers and related entities from taking inconsistent positions with respect to QBUs that have unrecognized Code Sec. 987 gains or losses.

It is important to properly apply the transition rules set forth in Proposed Reg. §1.987-10. If a taxpayer fails to properly transition to these regulations, the IRS has the authority to determine the appropriate transition method for such taxpayer.<sup>167</sup>

**1. Deferral Transition Method.** Under the deferral transition method, the taxpayer must determine the Code Sec. 987 gain or loss under its prior Code Sec. 987 method as if all of its QBUs subject to Code Sec. 987 terminated on the last day of the tax year preceding the transition date. The Code Sec. 987 gain or loss determined on the deemed termination of a Code Sec. 987 QBU is not immediately recognized; rather, such Code Sec. 987 gain or loss is treated as net unrecognized Code Sec. 987 gain or loss of such QBU for the first tax year for which the regulations are effective. The recognition of this net unrecognized Code Sec. 987 gain or loss is governed by the remittance rules of Proposed Reg. §1.987-5 for periods after the transition date.<sup>168</sup>

The owner of a QBU that is deemed to terminate under the deferral transition method is treated as having transferred all of the assets and liabilities attributable to such QBU to a new Code Sec. 987 QBU on the transition date.<sup>169</sup> In order to avoid double counting, the amount of assets and liabilities treated as transferred from the owner to the Code Sec. 987 QBU on the transition date is determined by reference to the historic exchange rates on the day the assets were acquired or the liabilities entered into by the QBU deemed terminated, adjusted to take into account gain or loss determined on the deemed termination. If the historic exchange rate for a particular asset or liability cannot be traced, the taxpayer must determine an exchange rate under a reasonable allocation method that takes into account an allocation of the aggregate basis and an allocation of the deferred Code Sec. 987 gain or loss.<sup>170</sup>

**2. Fresh Start Transition Method.** The fresh start method is similar to the deferral transition method in that all of a taxpayer's QBUs subject to Code Sec. 987 are deemed to terminate on the last day of the tax year preceding the transition date. However, unlike the deferral transition method, no Code Sec. 987 gain or loss is determined as a result of the deemed termination.<sup>171</sup> Therefore, under the fresh start method there is no amount treated as net unrecognized Code Sec. 987 gain or loss as a result of the deemed terminations.

As with the deferral transition method, the owner of a QBU that is deemed to terminate under the fresh start method is treated as having transferred all of the assets and liabilities attributable to such QBU to a new Code Sec. 987 QBU on the transition date.<sup>172</sup> Unlike the deferral transition method, the total amount of assets and liabilities deemed transferred by the owner to the Code Sec. 987 QBU is determined solely by reference to historic exchange rates.<sup>173</sup>

The fresh start method is meant to prevent the recognition of noneconomic currency gain or loss with respect to unremitted assets attributable to a QBU.<sup>174</sup>

## **B. Reporting Requirements**

A taxpayer is required to attach a statement to its U.S. federal income tax return for the first tax year beginning on the transition date. This statement should include a description of each QBU to which the transition rules apply, including the QBU's owner, its principal place of business, and the prior Code Sec. 987 method used by the taxpayer to determine the Code Sec. 987 gain or loss with respect to such QBU.<sup>175</sup> The statement should also state which transition method the taxpayer applied with respect to each QBU.<sup>176</sup> If the taxpayer applies the deferral transition method, the statement should also explain the method used to determine the Code Sec. 987 gain or loss upon the deemed termination of its QBUs and provide the amount of the net unrecognized Code Sec. 987 gain or loss for each QBU.<sup>177</sup> Finally, the statement should describe the method used by the taxpayer to determine the exchange rates used to translate the basis of assets and the amount of liabilities deemed to be transferred by the taxpayer to each Code Sec. 987 QBU into the functional currency of the owner of Code Sec. 987 QBU.<sup>178</sup>

## **XIII. Coordination with Provisions Outside of Code Sec. 987**

The regulations contain two additional provisions that coordinate the new rules with the expense apportionment and the method change rules.

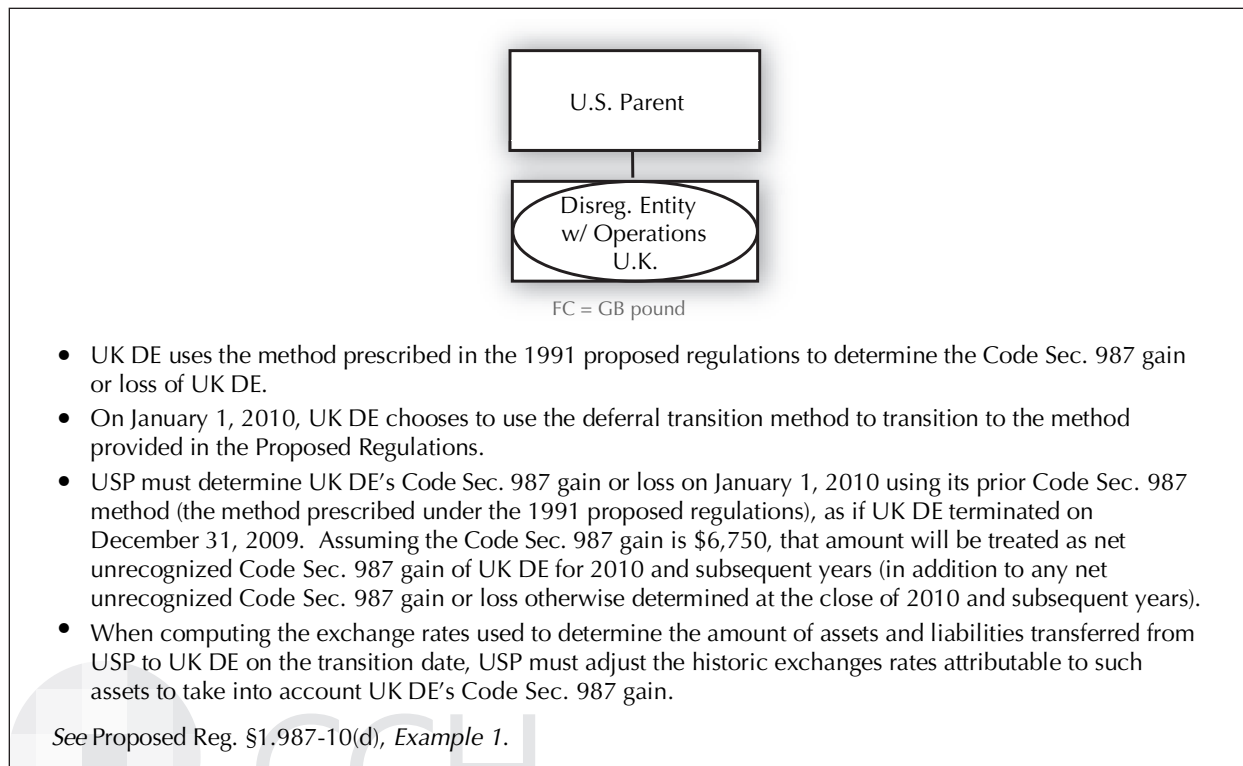
### **A. Coordination with the Expense Apportionment Rules**

The Proposed Regulations contain a specific rule for determining the amount of assets for purposes of apportioning interest expense to the various statutory groupings based on the average total value of assets within each such grouping for the tax year.<sup>179</sup> In short, the rule requires that the amount of assets be determined in accordance with the rules for determining "unrecognized Code Sec. 987 gain or loss of a Code Sec. 987 QBU."<sup>180</sup>

### **B. Change in Functional Currency—Required Adjustments**

The Proposed Regulations contain a set of rules in Proposed Reg. §1.985-5 that, in general, (1) require the affect of a change in functional currency to be

## Diagram 15 Deferral Transition Method



taken into account in one tax year<sup>181</sup>; (2) require Code Sec. 988 items that will lose their character to be taken into account<sup>182</sup>; and (3) provide that the basis of assets and liabilities are translated into the new currency at the spot rate.<sup>183</sup> The rules then split depending on whether the QBU<sup>184</sup> or the taxpayer/owner is changing its functional currency.<sup>185</sup>

When the QBU undergoes a change in its functional currency, where prior to the change the Code Sec. 987 QBU and owner had different functional currencies, *historic items* are translated from the old currency and into the new currency at the spot rate,<sup>186</sup> and *marked items* are translated from QBU's old functional currency into the QBU's new functional currency at the spot rate.<sup>187</sup>

If prior to a change in currency, the owner and the QBU had identical functional currency, and either the owner or the QBU changes to a different FC, the owner and the QBU begin to account for Code Sec. 987 gain/loss translation for the year of change and subsequent years.<sup>188</sup>

If a Code Sec. 987 QBU changes its functional currency to its owner's functional currency, the Code Sec. 987 QBU shall be treated as if it terminated on the last day of the tax year ending before the year of change.<sup>189</sup> A similar rule applies where the owner changes its FC to the FC of the QBU.<sup>190</sup>

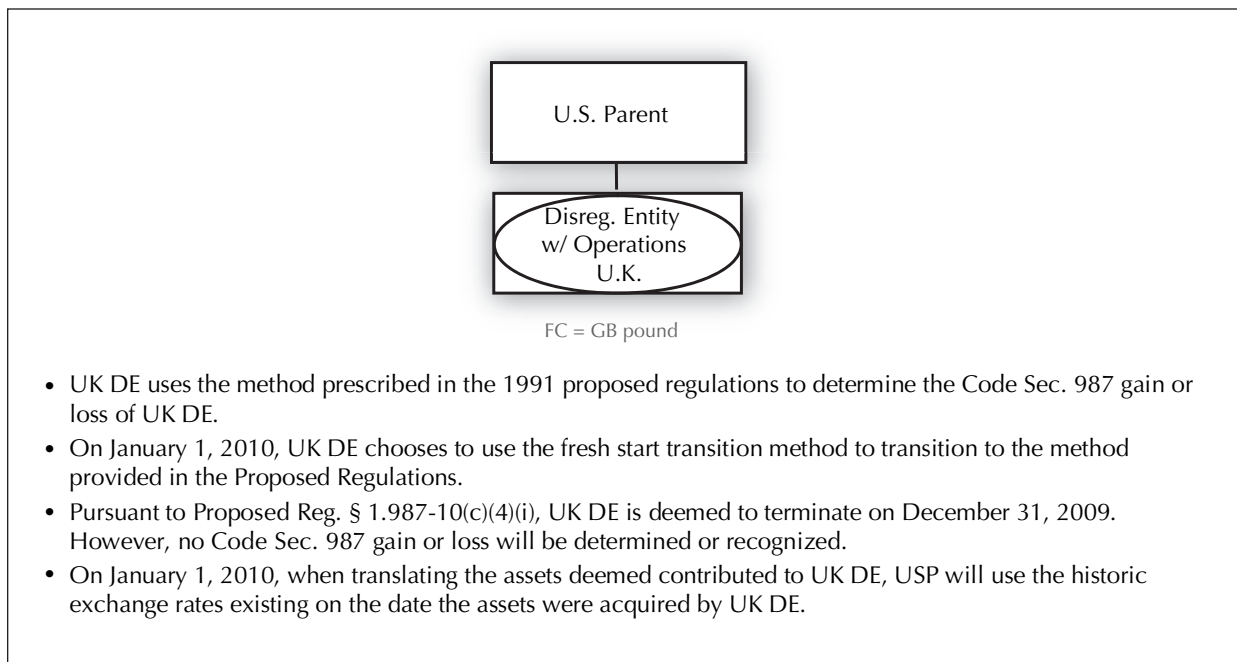
When the taxpayer/owner changes its functional currency, the amount of a corporation's new functional currency earnings and profits and the amount of its new functional currency paid-in capital (for Code Sec. 987 purposes) shall equal the product of the old functional currency amounts of such items multiplied by the spot rate.<sup>191</sup> No translation is necessary for a corporation's post-1986 pool of foreign taxes because such pool is kept in U.S. dollars.<sup>192</sup>

When the owner changes to a functional currency different than the QBU, historic items are translated first from the owner's old FC at the historic exchange rate as defined in Proposed Reg. §1.987-1(c)(3). The owner then translates the historic items into its new functional currency using the new functional currency/old functional currency spot rate on the last day of the tax year ending before the change. Marked items and "unrecognized Code Sec. 987 gain or loss" are translated at the spot rate on the last day of the tax year ending before the year of change.<sup>193</sup>

## XIV. Conclusion

The rules are welcome relief in terms of providing clarity to an area of tax law that has been unsettled for the past 15 years and for which the prior rules were willfully inadequate. This area of law was significantly

**Diagram 16 Fresh Start Transition Method**



exacerbated with the issuance of the check-the-box regime in 1997. While complexity is never welcome, alternative approaches to the complex Proposed Regulations are few. There are, however, options for the Treasury and the IRS to simplify the Proposed Regulations to decrease the tremendous burden on taxpayers to maintain two separate books and records that would otherwise result from these Proposed Regulations. Perhaps certain changes can be made without significantly compromising the more correct economic result embodied in the Proposed Regulations. For instance, consideration should be given to (1) whether a modified approach of the 1991 proposed regulations (on “earnings” only and without the daily-netting) would be a better approach, or (2) whether the Proposed Regulations could be simplified by eliminating some of the historic exchange translations for certain assets and/or by recognizing net Code Sec. 987 gain or loss

on an annual basis as opposed to at the time of a remittance (eliminate Proposed Reg. §1.987-5).

Congress could lighten the compliance burden of accounting for Code Sec. 987 gain/loss translation if it made Code Sec. 954(c)(6), the CFC Look-Through Rule, permanent. Making Code Sec. 954(c)(6) permanent would afford U.S.-based multinational corporations the ability, without the need to check-the-box, to re-deploy their offshore active earnings as dictated by their business needs—a concern that their non-U.S.-based counterparts do not need to consider when pricing the cost of various business opportunities.<sup>194</sup>

The somewhat lengthy transition period should provide multinational corporations the time necessary to recalibrate their accounting software to properly reflect the new rules and to send helpful practical comments to the government in the hope of simplifying the rules.

### ENDNOTES

<sup>1</sup> Unless otherwise specified, all “Code Sec.” references are to the Internal Revenue Code of 1986, as amended (the “Code”), all “Reg. §” references are to the Treasury Regulations promulgated thereunder, and all “Proposed Reg. §” references are to the Proposed Regulations, defined below.

<sup>2</sup> Generally, a QBU is a separate and clearly identified unit of a trade or business of a taxpayer which maintains separate books and records. Code Sec. 989(a) and Reg.

§1.989(a)-1(b)(1). The new proposed regulations do not change what constitutes a QBU but rather add two new QBU definitions—“Code Sec. 987 QBU” and “eligible QBU,” each a key operative term in the Proposed Regulations. Thus, the term “QBU” remains but it has been relegated to a less prominent role in the overall makeup of the Code Sec. 987 rules and regulations.

<sup>3</sup> See GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986, 99th Cong., 2d Sess., 1068

(1987). Subpart J of the Code, which includes Code Sec. 985 through Code Sec. 989, was added to the Code as part of the Tax Reform Act of 1986 (P.L. 99-514 (Oct. 22, 1986)) to provide a coherent set of rules to address gain or loss from foreign currency transactions. “Prior law did not prescribe criteria for use in determining when it is appropriate to record the results of a foreign operation in a foreign currency. Further, for the most part, the method used

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- to translate foreign currency results into U.S. dollars was left to the taxpayer's discretion. The available translation methods could produce substantially different U.S. tax consequences." GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986, 99th Cong., 2d Sess., 1081 (1987). In the Preamble, the Treasury and the IRS explain their reasoning for the paradigm changes in the Proposed Regulations by contrasting such changes to the 1991 proposed regulations and the "net worth" and "profit and loss" method used by taxpayers prior to the enactment of Code Sec. 987. See Rev. Rul. 75-107, 1975-1 CB 32; Rev. Rul. 75-106, 1975-1 CB 31; Rev. Rul. 75-134, 1975-1 CB 33. See Preamble to the Proposed Regulations, REG-208270-86, 71 FR at 52,876–52,880 (Sept. 7, 2006).
- <sup>4</sup> 56 FR 48,457 (Sept. 25, 1991).
- <sup>5</sup> Reg. §§301-7701-1 through -3. T.D. 8697 (Dec. 17, 1996).
- <sup>6</sup> For example, whether the legal ownership of tiered disregarded entities was respected, or whether such entities were viewed as brother-sister entities for purposes of computing Code Sec. 987 gain or loss. See note 31.
- <sup>7</sup> Another reason for pervasive lack of compliance with the 1991 proposed regulations was their inconsistency with the statutory language of Code Sec. 987. While the statutory language of Code Sec. 987 focuses on the recognition of Code Sec. 987 gain or loss on a QBU's earnings (see Code Sec. 987(3)(A) and (B) (referring to "post-1986 accumulated earnings")), the 1991 proposed regulations required the recognition of 987 gain or loss on the earnings and all of the equity of a QBU, regardless of whether such gain or loss was economic. The Treasury and the IRS even seemed uncertain as to whether it was appropriate to require Code Sec. 987 gain or loss to be recognized with respect to all of a QBU's equity. Notice 2000-20, 2000-1 CB 851, provides that "Treasury and the IRS are reevaluating the treatment under section 987 of contributions of capital to, and distributions of capital from, a QBU branch . . . An approach different from the proposed regulations might compute currency gain and loss only on remittance of earnings, rather than taking remittances of capital into account. In most cases, this approach would align section 987 principles more closely with the principles of section 986(c)."
- <sup>8</sup> See Preamble to the Proposed Regulations, REG-208270-86, 71 FR at 52,879 (Sept. 7, 2006).
- <sup>9</sup> *Id.* at 52,880.
- <sup>10</sup> *Id.*
- <sup>11</sup> *Id.*
- <sup>12</sup> *Id.*
- <sup>13</sup> *Id.*
- <sup>14</sup> *Id.*
- <sup>15</sup> *Id.*
- <sup>16</sup> See GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986, 99th Cong., 2d Sess., 1091–92 (1987) (describing the basic framework of subpart J).
- <sup>17</sup> In addition to taxpayers' compliance with the Proposed Regulations, consideration should be given to the capacity of the IRS's ability to audit taxpayers under the new Proposed Regulations. Additionally, publicly traded multinational corporations will be concerned with the review from their outside financial statement auditors.
- <sup>18</sup> Code Sec. 987(1).
- <sup>19</sup> See Code Sec. 987(2); Code Sec. 989(b)(4) (average exchange rate as the "appropriate exchange rate").
- <sup>20</sup> Code Sec. 987(3)(B). See GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986, 99th Cong., 2d Sess., 1107 (1987).
- <sup>21</sup> See also Letter from John Ryan, McDermott Will & Emery LLP, to IRS dated Dec. 7, 2006, at 2–3, reprinted by Tax Analysts, 2006 TNT 246-24. It appears that the Treasury and the IRS have a fair amount of authority on the exchange rate to be used. See Code Sec. 989(b) ("[e]xcept as provided in regulations . . ."); Code Sec. 985(a) ("[u]nless otherwise provided in regulations, all determinations under this subtitle. . .").
- <sup>22</sup> Proposed Reg. §1.987-1(a). Proposed Reg. §1.987-1 addresses the scope of the regulations and provides for certain definitions.
- <sup>23</sup> The Treasury and the IRS outlined their policy reasons for the more complicated approach of the Proposed Regulations in the Preamble. See Preamble to the Proposed Regulations, REG-208270-86, 71 FR at 52,876–52,880 (Sept. 7, 2006).
- <sup>24</sup> Part of understanding the balance between the competing objectives will involve assessing the capabilities of the anticipated computer software programs that taxpayers will undoubtedly use in complying with the new regulations. If taxpayers can rely on computer programming to do much of the work, then perhaps the additional complexity and workloads can be minimized. Obviously, taxpayers must still undertake a technical analysis of the output from such computer programming. From the authors' experience, tax software generally is a source of complaints for in-house tax professionals, and developing software that works well for the proposed regulations may prove challenging.
- <sup>25</sup> The Treasury and the IRS could include a broad anti-abuse rule to prevent taxpayers from claiming losses not tied to currency exchange movements.
- <sup>26</sup> This last thought may require a legislative change (see Code Sec. 987(3)(A)). Pursuit of a legislative change should not be off the table if such a change would result in better overall tax policy (*i.e.*, simplification).
- <sup>27</sup> Instead of allowing one full tax year to toll before applying (future) final regulations, a taxpayer may elect to apply final regulations to tax years beginning after the date such regulations are issued. Such election is binding on all members that file a consolidated return with the taxpayer and any controlled foreign corporation, as defined in Code Sec. 957, in which the taxpayer owns more than 50 percent of the voting power or stock (as determined in Code Sec. 957(a)).
- <sup>28</sup> First, Proposed Reg. §1.987-1(b)(ii) provides a *de minimis* exception for an individual or corporation that owns a Code Sec. 987 QBU indirectly through a Code Sec. 987 partnership if the individual or corporation owns, directly or indirectly, less than five percent of either the total capital or the total profits interest in the Code Sec. 987 partnership. Proposed Reg. §1.987-3 would apply instead. Second, the Proposed Regulations do not apply to banks, insurance companies and similar financial entities (including leasing companies, finance coordination centers, regulated investment companies and real estate investment trusts). The Treasury and the IRS should set forth additional guidelines as to what is meant by a "finance coordination center." Although not entirely clear, it would appear that a finance coordination center would include an offshore treasury center of a major U.S. multinational corporation. Further, the Proposed Regulations do not apply to trusts, estates and S corporations. Proposed Reg. §1.987-1(b)(iii).
- <sup>29</sup> Proposed Reg. §1.987-1(b)(i).
- <sup>30</sup> Proposed Reg. §1.987-1(b)(4) provides that an individual or corporation is an owner of an eligible QBU if—  
(1) the individual or corporation is the tax owner of the assets and liabilities of an eligible QBU as defined in paragraph Proposed Reg. §1.987-1(b)(3) (so called, "direct ownership"); or  
(2) in the case of an individual or corporation that is a partner in a partnership, the individual or corporation is allocated, under Proposed Reg. §1.987-7, all or a portion of the assets and liabilities of an eligible QBU of such partnership (so-called, "indirect ownership"). See Proposed

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- Reg. §1.987-1(b)(7), Example 4, (ii)(B) and (C) for an indirect ownership example.
- <sup>31</sup> See Proposed Reg. §1.987-1(b)(7), Example 5. This approach is similar to the approach in the dual consolidated loss regulations. Cf. Reg. §1.1503-2(b)(2); Proposed Reg. §1.1503(d)-3(b); Proposed Reg. §1.1503(d)-5(c), Example 29.
- <sup>32</sup> Proposed Reg. §1.987-1(b)(3)(i)(A). Whether the activities of an entity constitute a trade or business is dependent on the facts and circumstances. Reg. §1.989(a)-1(c) attempts to clarify the required level of activity with the following language:  
Generally, a trade or business for purposes of section 989(a) is a specific unified group of activities that constitutes (or could constitute) an independent economic enterprise carried on for profit, the expenses related to which are deductible under section 162 or 212. ... To constitute a trade or business, a group of activities must ordinarily include every operation which forms a part of, or a step in, a process by which an enterprise may earn income or profit. ... [A]ctivities that are merely ancillary to a trade or business will not constitute a trade or business under this paragraph (c). Activities of an individual as an employee are not considered by themselves to constitute a trade or business under this paragraph (c).
- <sup>33</sup> Proposed Reg. §1.987-1(b)(3)(i)(B).
- <sup>34</sup> Proposed Reg. §1.987-1(b)(3)(i)(C).
- <sup>35</sup> Proposed Reg. §1.987-1(b)(3)(ii). Thus, the rules to determine an eligible QBU are aimed at identifying *real* operations as contrasted to activities that are merely ancillary in nature.
- <sup>36</sup> Proposed Reg. §1.987-1(b)(2)(i).
- <sup>37</sup> The functional currency of an eligible QBU shall be determined under Reg. §1.985-1, taking into account all of the QBU's activities before the application of Proposed Reg. §1.987-7. Proposed Reg. §1.987-1(b)(2)(i).
- <sup>38</sup> Proposed Reg. §1.987-1(b)(2)(ii). An owner cannot pick and choose which 987 QBUs elect in and which ones do not. Moreover, the election is solely for purposes of Code Sec. 987 (e.g., the rule does not apply for purposes of the DCL rules). The Treasury and the IRS may have considered whether it may have been plausible to coordinate this 987 election with the "separate unit combination rule" of Proposed Reg. §1.1503(d)-1(b)(4)(ii). Unfortunately, the two rules and their varying objectives are unlikely to be sufficiently compatible to allow for such coordination. DEs in different countries but with the same FC may qualify for the single Code Sec. 987 QBU election but not for the separate unit combination rule. Conversely, separate units held through a partnership may qualify for the separate unit combination rule but would not qualify for the single Code Sec. 987 QBU election.
- On a somewhat similar point, in the May 2005 DCL proposed regulations, the Treasury and the IRS requested comments whether Code Sec. 987 gain or loss of a domestic owner is "attributable to" a separate unit for purposes of the DCL rules. This point was not included in these Code Sec. 987 Proposed Regulations; however, it is likely that the Treasury and the IRS will issue the appropriate rule when the DCL regulations are issued in final form (expected in the near-term). Another interesting question is, in the inbound context, whether Code Sec. 987 gain or loss is effectively connected income under Code Sec. 882(a)(1).
- <sup>39</sup> Proposed Reg. §1.987-1(b)(2)(ii)(B)(1), (2).
- <sup>40</sup> Proposed Reg. §1.987-1(b)(2)(ii)(B)(3).
- <sup>41</sup> It should be noted that this article, including the diagrams and examples, uses DEs with business operations to illustrate an "eligible 987 QBU." As we know from Proposed Reg. §1.987-1(b)(3), a DE itself would not be an "eligible 987 QBU" although the DE's activities may qualify as an eligible QBU.
- <sup>42</sup> Proposed Reg. §1.987-1(b)(6)(i).
- <sup>43</sup> Proposed Reg. §1.987-1(b)(6)(ii).
- <sup>44</sup> Proposed Reg. §1.987-1(b)(6)(iii).
- <sup>45</sup> Proposed Reg. §1.987-1(b)(7), Example 1 (ii)(B). The second example is helpful in terms of understanding the relevant definitions, but is otherwise not particularly notable. The example does, however, illustrate that activities that would otherwise constitute an eligible QBU is an eligible QBU even if its books and records are maintained at the DE level. This would not be the typical fact pattern but is plausible.
- <sup>46</sup> In certain situations, taxpayers had claimed exchange losses under Code Sec. 987 with respect to assets such as stock and/or equipment, neither of which, the value of fluctuates with movements in exchange rates. The Treasury and the IRS considered these instances abusive and have effectively eliminated taxpayers' ability to claim such losses in the future.
- <sup>47</sup> Specifically, a Code Sec. 987 marked item is an asset (a "Code Sec. 987 marked asset") or liability (a "Code Sec. 987 marked liability") that (1) is reflected on the books and records of a Code Sec. 987 QBU under Proposed Reg. §1.987-2(b); (2) would be a Code Sec. 988 transaction if such item were held or entered into directly by the owner of the Code Sec. 987 QBU; and (3) is not a Code Sec. 988 transaction with respect to the Code Sec. 987 QBU. See Proposed Reg. §1.987-1(d).
- <sup>48</sup> A Code Sec. 987 historic item is an asset (a "Code Sec. 987 historic asset") or liability (a "Code Sec. 987 historic liability") that (1) is reflected on the books and records of a Code Sec. 987 QBU under Proposed Reg. §1.987-2(b); and (2) is not a Code Sec. 987 marked item as defined in Proposed Reg. §1.987-1(d). See Proposed Reg. §1.987-1(e).
- <sup>49</sup> There are various spot rate conventions available to the taxpayer. See generally Proposed Reg. §1.987-1(c)(1). It is apparent that the Treasury and the IRS thought the flexibility would assist taxpayers in terms of conforming Code Sec. 987 reporting with the financial reporting for such units.
- <sup>50</sup> Proposed Reg. §1.987-1(c)(3)(A).
- <sup>51</sup> Proposed Reg. §1.987-1(c)(3)(B).
- <sup>52</sup> Proposed Reg. §1.987-1(c)(3)(C).
- <sup>53</sup> Proposed Reg. §1.987-1(c)(3)(D).
- <sup>54</sup> See also Proposed Reg. §1.987-1(e)(2), Example.
- <sup>55</sup> Proposed Reg. §1.987-1(f)(2)(i).
- <sup>56</sup> A CFC means any foreign corporation if more than 50 percent of (1) the total combined voting power of all classes of stock of such corporation entitled to vote, or (2) the total value of the stock of such corporation, is owned (within the meaning of Code Sec. 958(a)), or is considered as owned by applying the rules of ownership of Code Sec. 958(b), by U.S. shareholders on any day during the tax year of such foreign corporation. Code Sec. 957(a). For this purpose, U.S. shareholder is defined as a U.S. person who owns, or is considered to own, 10 percent or more of the total combined voting power of all classes of stock entitled to vote of such foreign corporation. Code Sec. 951(b).
- <sup>57</sup> If a foreign corporation with a Code Sec. 987 QBU is not a CFC, then its majority U.S. shareholder shall make any Code Sec. 987 elections.
- <sup>58</sup> Proposed Reg. §1.987-1(f)(3).
- <sup>59</sup> Proposed Reg. §1.987-1(f)(6). Once the owner becomes aware of the failure, the owner must attach the election, as well as a written statement setting forth the reasons for the failure to timely comply, to an amended income tax return that

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- amends the return to which the election should have been attached.
- <sup>60</sup> Proposed Reg. §1.987-1(f)(7).
- <sup>61</sup> Items that are attributed to an eligible QBU for this purpose must be adjusted to conform to U.S. tax principles as provided in Proposed Reg. §1.987-4(e). These attribution rules apply solely for purposes of Code Sec. 987. For example, the allocation and apportionment of interest expense under Code Sec. 864(e) is independent of the rules under Code Sec. 987.
- <sup>62</sup> However, certain “portfolio” stock (less than 10-percent owned) can be considered part of the books and records of the eligible QBU. Proposed Reg. §1.987-2(b)(2)(ii).
- <sup>63</sup> See also *supra* note 31 and accompanying text (discussing definition of “owner”); *supra* note 45 and accompanying text (providing that combined activities of holding stock and servicing a liability that was incurred to acquire such stock are insufficient activities to constitute a trade or business within the meaning of Reg. §1.989(a)-1(c)).
- <sup>64</sup> Proposed Reg. §1.987-2(b)(2)(i)(D).
- <sup>65</sup> Proposed Reg. §1.987-2(b)(3)(i).
- <sup>66</sup> Proposed Reg. §1.987-2(b)(3)(ii).
- <sup>67</sup> Proposed Reg. §1.987-2(b)(3)(iii).
- <sup>68</sup> Proposed Reg. §1.987-2(b)(4). See also Proposed Reg. §1.987-1(b)(2) and (3).
- <sup>69</sup> Proposed Reg. §1.988-1(a)(4). See Proposed Reg. §1.987-1(b)(7), Example 1, (ii)(B) and the discussion, *infra*, at note 45.
- <sup>70</sup> For purposes of this section, the term disregarded transaction means a transaction that is not regarded for U.S. federal income tax purposes. A disregarded transaction shall be treated as including the recording of an asset or liability on one set of books and records, if the recording is the result of such asset or liability being removed from another set of books and records of the same person or entity (including a DE or partnership). Proposed Reg. §1.987-2(c)(2)(ii). This appears to be the first instance in which a disregarded transaction has been defined in regulations. In the past, various references have been drawn upon to conclude that a certain transaction was disregarded. See e.g., Reg. §1.884-1(d)(5)(iii) and (e)(1) (inter-branch transactions do not result in the creation of a liability or asset for purposes of determining a branch’s U.S. net equity under the U.S. branch profits rules); Reg. §1.882-5(b)(1)(iv) and (c)(2)(vii) (inter-branch transactions are ignored for purposes of determining a foreign corporation’s assets and liabilities when allocating its interest expense to its U.S. trade or business income); Reg. §§1.446-3(c)(1)(i) and 1.863-7(a)(1) (an agreement between a taxpayer and its qualified business unit is not a notional principal contract “because a taxpayer cannot enter into a contract with itself.”).
- <sup>71</sup> Proposed Reg. §1.987-2(c)(2)(iii).
- <sup>72</sup> Proposed Reg. §1.987-2(c)(3).
- <sup>73</sup> Proposed Reg. §1.987-2(c)(4)(i).
- <sup>74</sup> Proposed Reg. §1.987-2(c)(4)(ii).
- <sup>75</sup> Proposed Reg. §1.987-2(c)(5).
- <sup>76</sup> Proposed Reg. §1.987-2(c)(6).
- <sup>77</sup> *Id.* For example, a transaction with respect to an eligible QBU that causes a direct owner of the eligible QBU to become an indirect owner of such eligible QBU, shall not, except to the extent provided in Proposed Reg. §1.987-2(c)(5), result in a transfer to or from a Code Sec. 987 QBU. The regulation specifically references Rev. Rul. 99-5, 1999-1 CB 434, and Rev. Rul. 99-6, 1999-1 CB 432. Hence, only *actual* changes to the legal ownership of a DE and of a partnership will give rise to a *transfer* for Code Sec. 987 purposes.
- <sup>78</sup> Note that the allocation of expenses under other provisions is not taken into account for purposes of computing Code Sec. 987 taxable income. See Preamble to the Proposed Regulations, REG-208270-86, 71 FR at 52,886 (Sept. 7, 2006).
- <sup>79</sup> Proposed Reg. §1.987-3(a)(1).
- <sup>80</sup> Proposed Reg. §1.987-3(b)(1). The yearly average exchange rate is a rate determined by the owner that represents an average exchange rate for the tax year. Proposed Reg. §1.987-1(c)(2). A daily, monthly or quarterly averaging convention may be applied to determine this exchange rate and it may be either weighted or unweighted. *Id.* It may also take into account forward rates for a period not to exceed three months. Whatever the methods used by the owner to determine the yearly average exchange rates, they must be consistently applied by the taxpayer. *Id.*
- <sup>81</sup> Proposed Reg. §1.987-3(b)(1). The spot rate is generally determined under the principles of Reg. §1.988-1(d)(1), (2) and (4) on the relevant date, although a number of spot rate conventions may be utilized if elected by the owner. Proposed Reg. §1.987-1(c)(1).
- <sup>82</sup> See Proposed Reg. §1.987-1(b)(2).
- <sup>83</sup> Proposed Reg. §1.987-3(f), Example 5. See Proposed Reg. §1.987-3(f), Example 7, for an example of this rule in the case of expenses by French DE.
- <sup>84</sup> Proposed Reg. §1.987-3(f), Example 6. See Proposed Reg. §1.987-3(f), Example 8, for an example of this rule in the case of expenses generated by French DE.
- <sup>85</sup> Proposed Reg. §1.987-3(b)(2).
- <sup>86</sup> Proposed Reg. §1.987-3(b)(2). The historic exchange rate with respect to an asset is the spot rate for the date the asset was acquired (through transfer or otherwise) by the Code Sec. 987 QBU. Proposed Reg. §1.987-1(c)(3)(i)(A) and (B).
- <sup>87</sup> The spot rate was determined by applying a spot rate convention that was property elected by US Corp. Under this convention, the historic exchange rate was determined by averaging the spot rate on the first and last day of the month preceding the month in which the truck was acquired.
- <sup>88</sup> Proposed Reg. §1.987-3(f), Example 9.
- <sup>89</sup> Proposed Reg. §1.987-3(b)(2)(ii).
- <sup>90</sup> Proposed Reg. §1.987-3(b)(2)(ii)(A)(1).
- <sup>91</sup> Proposed Reg. §1.987-3(b)(2)(ii)(B)(1).
- <sup>92</sup> See Proposed Reg. §1.987-3(a)(i), (ii).
- <sup>93</sup> See Proposed Reg. §1.987-3(b)(2)(ii)(B).
- <sup>94</sup> See Proposed Reg. §1.987-3(b)(2)(ii)(A).
- <sup>95</sup> Proposed Reg. §1.987-3(f), Example 3. See Proposed Reg. §1.987-3(f), Example 4, for US Corp’s calculation of gain recognized on French DE’s sale of the land where US Corp has elected to translate French DE’s items of income, gain, deduction or loss at the spot rate. In that example, the amount realized on the sale of the land is translated into USD at the applicable spot rate, rather than at the yearly average exchange rate for the tax year.
- <sup>96</sup> Preamble to the Proposed Regulations, REG-208270-86, 71 FR at 52,886 (Sept. 7, 2006).
- <sup>97</sup> As provided in the Preamble to the Proposed Regulations, “[c]ash is not included in these special rules because the disposition of cash cannot generate profit or loss to the section 987 QBU for purposes of Proposed Reg. §1.987-3.” Preamble to the Proposed Regulations, REG-208270-86, 71 FR at 52,886 (Sept. 7, 2006).
- <sup>98</sup> Proposed Reg. §1.987-3(b)(2)(ii)(A)(2) and Proposed Reg. §1.987-3(b)(2)(ii)(B)(2).
- <sup>99</sup> Proposed Reg. §1.987-3(b)(2)(ii)(A)(2) and Proposed Reg. §1.987-3(b)(2)(ii)(B)(2).
- <sup>100</sup> Preamble to the Proposed Regulations, REG-208270-86, 71 FR at 52,886 (Sept. 7, 2006).
- <sup>101</sup> Proposed Reg. §1.987-3(c).
- <sup>102</sup> Proposed Reg. §1.987-3(d).
- <sup>103</sup> Proposed Reg. §1.987-3(f), Example 10.
- <sup>104</sup> Proposed Reg. §1.987-3(e)(1).
- <sup>105</sup> Proposed Reg. §1.987-3(f), Example 10.

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- <sup>106</sup> Proposed Reg. §1.987-4 uses a balance sheet approach to distinguish items of a Code Sec. 987 QBU that give rise to Code Sec. 987 gain or loss (Code Sec. 987 marked items) from those that do not (Code Sec. 987 historic items). As noted in the Preamble, this approach avoids the distortions caused by the 1991 proposed regulations that compute Code Sec. 987 gain or loss on all assets of a Code Sec. 987 QBU, even those assets the value of which does not fluctuate with currency movements, e.g., machinery and equipment, stock of a CFC. See 71 FR 173 (2006) at 52,886.
- <sup>107</sup> See Preamble to the Proposed Regulations, REG-208270-86, 71 FR at 52,886 (Sept. 7, 2006).
- <sup>108</sup> See Preamble to the Proposed Regulations, REG-208270-86, 71 FR at 52,886 (Sept. 7, 2006). This approach avoids the distortion caused by the 1991 proposed regulations that impute Code Sec. 987 gain or loss to all assets of a Code Sec. 987 QBU, even those assets the value of which does not fluctuate with currency movements.
- <sup>109</sup> Proposed Reg. §1.987-4(a).
- <sup>110</sup> Proposed Reg. §1.987-4(b)(1). This amount shall include amounts appropriately considered as net unrecognized exchange gain or loss under the transition rules of Proposed Reg. §1.987-10.
- <sup>111</sup> Proposed Reg. §1.987-4(b)(1) and (2).
- <sup>112</sup> Proposed Reg. §1.987-4(c).
- <sup>113</sup> Proposed Reg. §1.987-5(a). The general notion that a remittance gives rise to taxable Code Sec. 987 gain or loss should be familiar to those practitioners familiar with the 1991 proposed regulations. Withdrawn Proposed Reg. §1.987-2(a)(1), 56 FR 48,457. Proposed Reg. §1.987-5, not surprisingly, is more difficult to navigate than its predecessor because of the Proposed Regulations' goal of recognizing Code Sec. 987 gain or loss with respect to Code Sec. 988 items only.
- <sup>114</sup> In writing this article, the authors deviated from normal explanatory styles for an article given the density of certain rules such as the owner's remittance proportion and, instead, opted to explain these rules with diagrams and wording.
- <sup>115</sup> The new Code Sec. 987 quotient is unique in terms of using a "transfer" (net remittance) amount for the numerator and the Code Sec. 987 QBU's gross assets (part of the balance sheet) as the denominator. Quotients are commonplace in the U.S. international tax bar, although it is interesting to compare this new Code Sec. 987 quotient to other commonly known quotients, such as the Code Sec. 864(e) quotient (percentage of assets) for purposes of apportioning interest expense, or the Code Sec. 902 foreign tax credit quotient (dividend/Code Sec. 902(c) earnings and profits) to derive the amount of indirect foreign tax credits. Obviously, each foregoing quotient is different because of the different code sections and policies each carries out.
- <sup>116</sup> The discussion of Proposed Reg. §1.987-2 covering "transfers" is important to correctly determine the numerator in the above quotient.
- <sup>117</sup> Although the change from a daily netting rule to an annual netting rule will ease taxpayers' administrative compliance burden, this may not have been the main reason for the adoption of an annual netting rule by the Treasury and the IRS. Notice 2000-20, 2000-1 CB 851 (Mar. 22, 2000), indicates that the Treasury and the IRS were concerned that the daily netting rule was "susceptible to manipulation by taxpayers." Nevertheless, this will doubtlessly be a change that is appreciated by taxpayers facing the daunting task of complying with the Proposed Regulations.
- <sup>118</sup> Proposed Reg. §1.987-5(f)(2). Note, the cross-reference to Proposed Reg. §1.987-4(d)(2)(ii)(A) for the operative rule, which in turn cross-references Proposed Reg. §1.987-4(d)(2)(iii)(A), which in turn cross-references Proposed Reg. §1.987-1(c)(1) to determine the proper exchange rate to be used. The numerous cross-references in the Proposed Regulations are challenging and certainly not for the faint of heart. The Treasury and the IRS should consider whether the numerous cross-references in the Proposed Regulations can be minimized—compliance with the future final regulations would benefit.
- <sup>119</sup> Proposed Reg. §1.987-5(f)(3). The same madness with respect to multiple cross-references exists with this rule.
- <sup>120</sup> Proposed Reg. §1.987-5(g), Examples 1 and 2.
- <sup>121</sup> For all purposes of the Code, including Code Secs. 904(d), 907 and 954.
- <sup>122</sup> The modified gross income method described in Temporary Reg. §1.861-9T(j) cannot be used because the Treasury and the IRS consider gross income earned in a single year as an inadequate measurement for purposes of applying the source and character rules. These rules may impact, *inter alia*, whether income is subpart F income under Code Sec. 954. Code Sec. 987(a)(3)(B) provides that Code Sec. 987 gain or loss should be sourced according to the income giving rise to the post-1986 accumulated earnings; however, the Treasury and the IRS were concerned with taxpayers' ability to track such earnings over an extended period of time and hence settled for sourcing such earnings according to the asset apportionment method used to allocate and apportion interest expense. This seems to be a reasonable approach. See Preamble to the Proposed Regulations, REG-208270-86, 71 FR at 52,888 (Sept. 7, 2006).
- <sup>123</sup> Proposed Reg. §1.987-6(c), Example. The Code Sec. 904 cites in the Example will need to be changed when the Proposed Regulations are made final. Section 404(a) of The American Jobs Creation Act of 2004 (P.L. 108-357) reduced the number of baskets in Code Sec. 904(d)(1) to two—"general" in Code Sec. 904(d)(1)(A) and "passive" in Code Sec. 904(d)(1)(B).
- <sup>124</sup> As explained above (see note 47), marked items (assets and liabilities) are items that would be Code Sec. 988 transactions if entered into directly by the owner. Code Sec. 954(c)(1)(D) includes net foreign currency gains under Code Sec. 988(b) as subpart F income of a CFC. Code Sec. 954(c)(1)(D) provides an exception from subpart F income treatment for currency gains from any transaction directly related to the "business needs" of the CFC. In general, FX gain on receivables or payables relating to a CFC's active business and normal operations will qualify for the business needs exception. See Reg. §1.954-2(g)(2)(ii)(B)(1)(i).
- <sup>125</sup> Proposed Reg. §1.987-7(b).
- <sup>126</sup> Proposed Reg. §1.987-7(d), Example 1.
- <sup>127</sup> Proposed Reg. §1.987-7(d), Example 2.
- <sup>128</sup> Preamble to the Proposed Regulations, REG-208270-86, 71 FR at 52,888 (Sept. 7, 2006).
- <sup>129</sup> *Id.*
- <sup>130</sup> *Id.*
- <sup>131</sup> *Id.*
- <sup>132</sup> Proposed Reg. §1.987-7(c)(1)(i).
- <sup>133</sup> *Id.*
- <sup>134</sup> Proposed Reg. §1.987-7(c)(1)(ii).
- <sup>135</sup> See Preamble to the Proposed Regulations, REG-208270-86, 71 FR at 52,889 (Sept. 7, 2006).
- <sup>136</sup> Proposed Reg. §1.987-7(c)(1)(ii)(A).
- <sup>137</sup> *Id.*
- <sup>138</sup> Proposed Reg. §1.987-7(c)(1)(ii)(B).
- <sup>139</sup> Proposed Reg. §1.987-7(c)(1)(iii).
- <sup>140</sup> *Id.*
- <sup>141</sup> Proposed Reg. §1.987-7(c)(1)(iv). Notably, the Proposed Regulations do not address the adjustments required upon a deemed distribution of money resulting under Code Sec. 752(b) when a Code Sec. 987 partnership assumes a

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- liability of a partner and such liability is denominated in a functional currency different from the partner's functional currency. According to the Preamble to the Proposed Regulations, it is "unclear whether the amount of the [deemed] distribution should be determined by reference to the spot rate (on the date of assumption) or the historic exchange rate (on the date the liability was originally incurred by the partner). In addition, this issue raises concerns as to how section 988 would operate upon such assumption." See Preamble to the Proposed Regulations, REG-208270-86, 71 FR at 52,889 (Sept. 7, 2006). The Treasury and the IRS request comments on this issue in general, on whether Code Sec. 988 should be amended to coordinate Code Secs. 987 and 988 in this context, and on whether Code Sec. 988 should be amended to coordinate the aggregate approach adopted by the Proposed Regulations with respect to assets and liabilities not reflected on the books and records of the eligible QBU of the partnership.
- <sup>142</sup> Proposed Reg. §1.987-7(c)(1)(iv)(A).
- <sup>143</sup> Proposed Reg. §1.987-7(c)(1)(iv)(B).
- <sup>144</sup> Proposed Reg. §1.987-7(c)(2).
- <sup>145</sup> *Id.*
- <sup>146</sup> Proposed Reg. §1.987-8(d). The amount of net unrecognized Code Sec. 987 gain or loss is determined as of the date of termination by closing the books and records of the Code Sec. 987 QBU on that date.
- <sup>147</sup> Proposed Reg. §1.987-8(b)(1) (such that the QBU no longer meets the definition of an eligible QBU as defined in Proposed Reg. §1.987-1(b)(3)).
- <sup>148</sup> Proposed Reg. §1.987-8(b)(2). Similar to the first trigger, the Treasury and the IRS have concluded that recognition of the unrecognized Code Sec. 987 gain or loss is warranted where most the Code Sec. 987 QBU's assets have been transferred.
- <sup>149</sup> Proposed Reg. §1.987-8(b)(3). This rule is consistent with Reg. §1.367(b)-4(b) which generally requires a Code Sec. 1248 pick-up in foreign-to-foreign reorganizations where the CFC loses its status as a CFC.
- <sup>150</sup> Proposed Reg. §1.987-8(b)(4).
- <sup>151</sup> Proposed Reg. §§1.987-8(c)(1)(i) and -2(c)(2)(i). Otherwise, unrecognized Code Sec. 987 gain may escape U.S. taxation. This rule is consistent with Code Sec. 367(e) and the regulations thereunder.
- <sup>152</sup> Proposed Reg. §1.987-8(c)(1)(ii) and -8(c)(2)(ii). One practitioner has commented to the IRS that they should consider application of this rule for net unrecognized Code Sec. 987 losses only (to preclude importation of a built-in loss) but otherwise permit deferral of net unrecognized Code Sec. 987 gains. See Letter from John Ryan to IRS, dated December 7, 2006, at 6, reprinted by Tax Analysts, 2006 TNT 246-24. The authors agree with Mr. Ryan's suggested comment to the IRS. See Proposed Reg. §1.987-8(c)(2)(ii) for an identical rule in the context of a reorganization described in Code Sec. 381(a)(2).
- <sup>153</sup> Proposed Reg. §1.987-8(c)(1)(iii) and -8(c)(2)(iv). This rule is consistent with the principles of Reg. §1.988-1(a)(10)(ii) that seeks to tax intra-taxpayer transfers of Code Sec. 988 items that would otherwise lose their character as such. See Proposed Reg. §1.987-8(c)(2)(iv) for an identical rule in the context of a reorganization described in Code Sec. 381(a)(2).
- <sup>154</sup> See Preamble to the Proposed Regulations, REG-208270-86, 71 FR at 52,890 (Sept. 7, 2006); Proposed Reg. §1.987-8(e), Example 2.
- <sup>155</sup> The Treasury and the IRS acknowledge that they are studying ways to permit deferral under the intercompany transaction rules of Reg. §1.1502-13. See Preamble to the Proposed Regulations, REG-208270-86, 71 FR at 52,890 (Sept. 7, 2006).
- <sup>156</sup> Proposed Reg. §1.987-10(a)(1).
- <sup>157</sup> *Id.* See also Preamble to the Proposed Regulations, REG-208270-86, 71 FR at 52,890 (Sept. 7, 2006).
- <sup>158</sup> See Preamble to the Proposed Regulations, REG-208270-86, 71 FR at 52,890 (Sept. 7, 2006).
- <sup>159</sup> Proposed Reg. §1.987-10(c)(1).
- <sup>160</sup> Proposed Reg. §1.987-10(a)(2). It would appear that this rule would prevent a taxpayer from using the *deferral transition method* if a reasonable method was used for Code Sec. 987 QBUs and an unreasonable method was used for one QBU. This harsh result has broader implications as discussed below.
- <sup>161</sup> See Preamble to the Proposed Regulations, REG-208270-86, 71 FR at 52,890 (Sept. 7, 2006).
- <sup>162</sup> Taxpayers may consider this, for example, if their QBUs (as defined under the 1991 proposed regulations and Code Sec. 989) have operated in currencies that have appreciated against the dollar (which generally has been the case for the currencies of a number of the United States' major trading partners, e.g., GBP, Yen, euro). As previously discussed, the mechanics of the 1991 proposed regulations computed Code Sec. 987 gain or loss on a broader class of assets. The larger the *equity* and *basis* pools under the 1991 proposed regulations, the greater the gain or loss recognized as the FX rates moved. Thus, a taxpayer computing Code Sec. 987 gain or loss on both capital and earnings would recognize (or have the potential to recognize) a larger amount of Code Sec. 987 gain with respect to QBUs that operate (and have operated) in currencies that have appreciated against the USD. Changing to an *earnings only* approach would (1) reduce the net unrealized Code Sec. 987 gain with respect to transitioning into the *deferral method* (discussed below), and (2) reduce the amount of Code Sec. 987 gain recognized for remittances in prior tax years that remain open, the current tax year, and future tax years prior to the effective date of these Proposed Regulations. The IRS should not have difficulty with taxpayers examining their Code Sec. 987 practices in this regard as it would result in an accounting for Code Sec. 987 gain or loss that is more closely aligned with the Proposed Regulations (*i.e.*, generally the earnings only approach should minimize the recognition of Code Sec. 987 gain or loss that does not reflect economic gain or loss derived from the movements in exchange rates).
- <sup>163</sup> See *American Pad & Textile Co.*, 16 TC 1304, Dec. 18,342 (1951), *acq.*, 1951-2 CB 1; Rev. Rul. 75-106, 1975-1 CB 31; and Rev. Rul. 75-107, 1975-1 CB 32 (net worth method versus the profit-loss method was viewed as a method of accounting prior to the enactment of subpart J, including Code Sec. 987, in the Tax Reform Act of 1986). See also, Form 8858, *Information Return of U.S. Persons With Respect to Foreign Disregarded Entities*, Schedule C-1, Question 4, which asks whether the tax owner of a foreign disregarded entity changed its "method of accounting" for Code Sec. 987 gain or loss with respect to remittances from such disregarded entity during the tax year.
- <sup>164</sup> See Preamble to the Proposed Regulations, REG-208270-86, 71 FR at 52,890 (Sept. 7, 2006).
- <sup>165</sup> Proposed Reg. §1.987-10(c)(2).
- <sup>166</sup> *Id.* The IRS and the Treasury are requesting comments on the inclusion of controlled foreign corporations within the scope of the conformity rules. See Preamble to the Proposed Regulations, REG-208270-86, 71 FR at 52,890 (Sept. 7, 2006).
- <sup>167</sup> Proposed Reg. §1.987-10(c)(1).
- <sup>168</sup> Proposed Reg. §1.987-10(c)(3)(i).
- <sup>169</sup> Proposed Reg. §1.987-10(c)(3)(i).
- <sup>170</sup> Proposed Reg. §1.987-10(c)(3)(ii).
- <sup>171</sup> Proposed Reg. §1.987-10(c)(4)(i).
- <sup>172</sup> *Id.*
- <sup>173</sup> Proposed Reg. §1.987-10(c)(4)(ii).

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- <sup>174</sup> See Preamble to the Proposed Regulations, REG-208270-86, 71 FR at 52,890 (Sept. 7, 2006).
- <sup>175</sup> Proposed Reg. §1.987-10(c)(6).
- <sup>176</sup> *Id.* Recall the conformity rule of Proposed Reg. §1.987-10(c)(2) that will require the same transition method to be used for all commonly controlled QBUs subject to Code Sec. 987. See *supra* note 166 and accompanying text.
- <sup>177</sup> *Id.*
- <sup>178</sup> Proposed Reg. §1.987-10(c)(6).
- <sup>179</sup> Temporary Reg. §1.861-9T(g)(1) and (g)(2) provide rules for determining asset valuation amounts, and Temporary Reg. §§1.861-9T(g)(3) and -12T provide rules for determining the asset characterization of assets.
- <sup>180</sup> See Proposed Reg. §1.987-4(d)(1)(i)(A) and (B) and 1.987-4(e). Beginning and end-of-year amounts are determined and then averaged for this purpose.
- <sup>181</sup> Proposed Reg. §1.985-5(a).
- <sup>182</sup> Proposed Reg. §1.985-5(b).
- <sup>183</sup> Proposed Reg. §1.985-5(c).
- <sup>184</sup> Proposed Reg. §1.985-5(d).
- <sup>185</sup> Proposed Reg. §1.985-5(e).
- <sup>186</sup> Proposed Reg. §1.985-5(d)(1)(ii)(A).
- <sup>187</sup> Proposed Reg. §1.985-5(d)(1)(ii)(A)(2).
- <sup>188</sup> Proposed Reg. §1.985-5(d)(1)(iii) for a change to the QBU's FC, and Proposed Reg. §1.985-5(e)(ii) for a change to the owner's FC.
- <sup>189</sup> Proposed Reg. §1.985-5(d)(2). The Proposed Regulations cross-reference Proposed Reg. §§1.987-5 and 1.987-8 for the effect of a termination.
- <sup>190</sup> Proposed Reg. §1.985-5(e)(iii).
- <sup>191</sup> Proposed Reg. §1.985-5(e)(1).
- <sup>192</sup> See *generally*, Code Sec. 986(a). The foreign income taxes and accumulated profits or deficits in accumulated profits of a foreign corporation that were maintained in foreign currency for purposes of Code Sec. 902 and that are attributable to tax years of the foreign corporation beginning before January 1, 1987, shall be translated into the new functional currency at the spot rate. See Proposed Reg. §1.985-5(e)(1). U.S. shareholders of CFCs that change to the U.S. dollar will recognize the unrealized Code Sec. 986(c) gain/loss attributable to undistributed previously taxed income. See Proposed Reg. §1.985-5(e)(2).
- <sup>193</sup> Proposed Reg. §1.985-5(e)(i)(A)(2), (e)(i)(B).
- <sup>194</sup> Many structures that are subject to Code Sec. 987 result from the lack of a permanent solution to the Code Sec. 954(c)(6) conundrum (*i.e.*, check-the-box structures that typically lead to Code Sec. 987 accounting are used by U.S.-based multinational corporations to minimize the U.S. tax cost (under the subpart F rules) in redeploying their active earnings offshore as dictated by their business needs). Thus, making Code Sec. 954(c)(6) permanent would allow U.S.-based multinational corporations to operate outside the United States with little to no need for the check-the-box regime. See J. Caliano and M. Collins, *The CFC Look-Through Rule: Congress Changes Landscape of Subpart F*, 112 TAX NOTES 155 (July 10, 2006); Lowell D. Yoder & Martin J. Collins, *Practical Analysis of Look-Through Treatment for Related Controlled Foreign Corporation Payments*, in TAX INCREASE PREVENTION AND RECONCILIATION ACT OF 2005: LAW & EXPLANATION ¶1540 (CCH Tax Research Network, 2006).

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